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A CN TRADE RELATIONS FORUM THE OBAMA ADMINISTRATION AND CANADA: YEAR ONE AND BEYOND

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The Obama Administration and Canada: Year One and Beyond by Grant Aldonas

Building on a foundation of shared values and friendship arising from confronting common challenges together, relations between U.S. and Canadian relations have remained close over many years. At the same time, there have been serious disagreements and points at which goodwill ebbed.

In the mid 1960s, differences over both economic policy and foreign affairs led to a serious breach between Washington and Ottawa. In the economic arena, conflicts arose over Canada's pursuit of economic policies that openly discriminated against American trade and investment. In the international arena, we differed over expanding the conflict in Vietnam.

Similarly, in the early 1980s, we found ourselves at odds over the direction of our respective foreign policies, this time over the response to the Soviet Union's introduction of intermediate nuclear forces in Eastern Europe and the declaration of martial law in Poland. Our disputes over economic policy focused, most pointedly, on the extraterritorial reach of U.S. law and trade issues, including the first softwood lumber conflict.

In each instance, the tide of goodwill that should exist between neighbors began to flow again, but not without considerable effort on the part of both Canadians and Americans.

Despite the areas of conflict in the mid 1960s, for example, we moved closer on the economic front with the signing of signal agreements like the 1965 U.S.-Canada agreement on automotive trade. In the case of the 1980s, tensions gave way to the signing of the U.S.-Canada Free Trade Agreement and an era of strong cooperation along a broad front from energy to the environment to competition policy.

Throughout both eras, there remained a thick network of cooperation at a practical level on everything from defense, including NORAD, to shared waterways like the St. Lawrence and the Great Lakes.

The early years of this decade witnessed another ebb tide in our relations. Again, there were compound conflicts over foreign and economic policy. The most significant lay in differences between the Bush and Chretien Administrations over the perceived threat of Iraq's putative weapons of mass destruction and the subsequent U.S. invasion of Iraq. But, the continuing friction over U.S. security controls implemented after the events of September 11 and another flare up over softwood lumber led many to question whether we were on the cusp of a more definitive breach in U.S.-Canadian affairs.

As has often been the cases, changes in domestic political currents in both countries brought new leadership and a fresh opportunity to focus on what unites our interests and to overcome the issues that divided us. The two questions I would like to address are, first, whether either country has taken full advantage of that opportunity and, second, how we can significantly strengthen U.S.-Canadian relations once more.

The fact that we are now almost a year on from President Obama's election gives us something of a track record to examine.

What that record reflects, unfortunately, is that we have largely failed to seize the opportunity that Prime Minister Harper's election in Canada and President Obama's election in the United States presents. That is not for want of trying on Prime Minister Harper's part.

It instead reflects a dynamic that always shapes (and often afflicts) U.S. – Canadian affairs. The United States is, once again, preoccupied with its own domestic economic and political agenda.

Given the sharp downturn in the U.S. economy, the weaknesses in our financial markets, and the fallout in any number of U.S. industries, President Obama's preoccupation with the economy should come as no surprise. Domestic policy, rather than foreign policy, is, moreover, where President Obama's instinct and experience, such as it is, would otherwise lead him.

The early months of his administration focused the passage of a massive economic stimulus package. More recently, he has laid down the gauntlet on health care reform and taken up the issue of strengthening regulation over the financial services industry. He has also signaled his interest in and support for climate change legislation with major implications for virtually every corner of the American economy.

Although President Obama's foreign policy forays have been limited up to this point, they too have focused elsewhere, principally the Middle East. While the President has now met with the Prime Minister multiple times, those meetings have not led to any fundamental reorientation of U.S.-Canadian relations or a broad agenda worthy of the close and continuing partnership we share.

President Obama and Prime Minister Harper have launched a new effort on energy and the environment, at Prime Minister Harper's urging. But, even there, the Obama Administration has yet to signal what it intends to do in concrete terms that might offer a basis for the progress Prime Minister Harper seeks.

In short, we have not embraced the opportunity that new political leadership has offered us on both sides of the border. The natural question is why?

Seen from the perspective of the challenges President Obama faced entering office, the failure to grasp fully the opportunity that this moment in of political change presents is certainly understandable. To the extent President Obama ran against the ghost of President Bush, rather than Senator John McCain, his instinct to signal an early end to America's commitment in Iraq, outline a new approach to the Arab world in Cairo, and refocus our military efforts on Afghanistan was entirely predictable. The scant attention paid to relations closer to home is, at least, understandable in light of the political arguments that brought President Obama to office.

The same holds true in the context of economic policy. To the extent that President Obama ran on a platform that demonized the Bush Administration tax cuts as taking money out of the hands of the poor and giving it to the rich, the fact that he has turned his attention to policy approaches that would, as he has said, "redistribute the wealth" should not come as a shock.

Yet, for a self-professed agent of change, that explanation doesn't fully satisfy. While the instinct for change is laudable, the approach that the Obama Administration has adopted is conventional.

The stimulus package – which has yet to kick in even while the U.S. economy is starting to rebound – was standard Keynesian demand management. Indeed, much of its intended strength was sapped by the fact that a Democratically-controlled Congress steered it toward projects that satisfied long-standing demands by parochial political constituencies.

On health care, identifying the basic problem as one of insufficient health insurance coverage, rather than rising health care costs, the President's solution draws deeply on the conventional Democratic approach to health care – which is to compel individuals to buy health insurance in order to broaden the pool of insured as a way of reducing the cost of covering the uninsured. This is, ironically, the same generational redistribution involved in both Social Security and Medicare, which are currently going bankrupt.

In the trade arena, President Obama has made positive noises about the need to conclude an ambitious WTO round, but his administration has yet to put a concrete proposal on the table that would back up that rhetoric. Indeed, where the Administration has acted, it has been conventional in the worst sense, responding to pressure from organized labor to slap 30 percent tariffs on imported tires from China, despite the President's pledge at previous G20 meetings to refrain from taking protectionist actions.

Canada has not, thus far, found itself the target of these sorts of policies, but the President's decision ought to chill every Canadian pork producer's or lumberman's blood.

What I suspect is at work is something more serious than simply a case of diverted attention. It is, instead, that President Obama – and the rest of U.S. society – is trying to address today's challenges with yesterday's tools.

A Failure of Imagination

In fact, I fear Washington is stuck in a mindset that is roughly 40 years out of date and that it will be difficult to make progress with Canada on the problems we both face in a more globalized world until we recognize that fact and reorient our thinking.

It is this failure of imagination that is the ultimate constraint. To understand why, it helps to provide some context on the common currents we face in both the global economy and in international affairs. Let me start with the global economy.

First, and in my view, most importantly, globalization has fundamentally altered the conduct of international trade and the basis for economic competition. Since 2003, a majority of world trade involves intermediate goods – inputs into some later stage of processing or manufacture. What that reflects is the extent to which globalization both permits and, arguably, requires the reorganization of production on a globally efficient basis.

The forces driving globalization have all contributed to that result. The end of Cold War erased political divisions that had also divided the world economy for the

better part of the 20th Century. It also marked the end of socialism as an alternative economic model, leading much of the developing world to join the global economy.

Those geopolitical events created a broader geographic plane across which the revolution in computing, communications, transportation and logistics has played out. That revolution made it possible to operate a global supply chain and, as in all things, it quickly became a competitive necessity.

The globalization of world capital markets facilitated the ensuing reorganization of production on a global basis. Private capital flows outstripped any public flows, posing new challenges to economic policymakers, particularly central bankers, while at the same time contributing to a process that has redrawn economic geography.

The progressive lowering of traditional barriers to trade, principally through the General Agreement on Tariffs and Trade and its successor, the World Trade Organization, has amplified the effects of these other currents. As the multilateral process has stalled, bilateral and regional arrangements have proliferated. As much as economists frequently (and rightly) balk at the instinct to move ahead on a bilateral or regional basis, there is no denying the momentum that this shift has acquired.

Second, globalization has altered the basis of competition in world markets. As that affects the organization of firms, the need to operate on a globally efficient basis has fragmented what were previously vertically integrated enterprises. Their boundaries have softened to the point where it is more realistic to think of the enterprise not as a single corporate entity, but the some of the various networks to which it belongs.

In this context, global firms have been forced to change the way they manage. Indeed, the core of what globally engaged firms do is now akin to systems integration. They mobilize the capital, talent and ideas that drive innovation and organize the value chain that provides the product of that innovation to a customer's doorstep all over the world.

The role of companies further upstream or downstream in a given value chain has also changed. Increasingly, to qualify as suppliers, these firms need to be capable of contributing to every phase of the value chain's success, including the sharing of research and development (and its costs) all the way through to responding to shifts in consumer demand.

The challenges facing workers have changed as well. They face an accelerating pace of economic change, imposing new demands on their ability to adapt and acquire new sets of skills that will allow them to contribute to innovation and rising productivity from the shop floor to the executive suite.

Trade theory offers a useful lens through which to examine what is driving these changes. What globalization has done in trade terms is increase the opportunities for specialization, as trade liberalization always does. The key to specialization is innovation.

Competition, in this context, is less about market share and scale. Rather, the new economic competition focuses on access to those factors of production that drive innovation – capital, talent and ideas.

Third, globalization has also altered what defines both comparative and competitive advantage in a more globalized, knowledge-driven world economy. Traditionally, trade economists thought of comparative advantage in terms of

resource endowments – such as labor and natural resources. But, in a world where talent and ideas increasingly rule, institutions may matter more.

That is true at a local level in terms of physical infrastructure, private property, and public education. It is certainly true at a national level in terms of the rule of law, the depth and liquidity of capital markets, and effective labor laws that allow a person to bargain freely for the full value of their labor. And, not surprisingly, it is also true at an international level in terms of trade agreements, cooperation on issues like energy security and the environment, and practical things like the efficiency of customs processing and border crossings.

What that means is that our approach to economic policy must increasingly be geared toward reinforcing and improving those institutions that enable entrepreneurialism and innovation. Measured against that standard, it is not clear to me that either the Harper or Obama government meet the test. But, it is abundantly clear that we are not using our bilateral relationship in any way that would reinforce their ability to do so.

A similar logic plays out in the foreign policy and defense arena. Globalization has made its impact felt there as well. The same forces that have been driving what was until recently the strongest global economic growth in over 30 years have atomized the assumptions that underpinned a Westphalian system of nation states.

What defense experts view as “asymmetric threats” are in fact the end product of a process that makes it just as cheap to export terror, as it is to export textiles and non-rubber footwear. The boundaries of “states” have softened much like the boundaries of enterprises.

Perhaps even more important is that, in the process of creating a global economy, the process has also expanded what we might think of as the global commons with all that implies for the problems of collective action. The most telling example is that of climate change.

Even for the climate change skeptics, I would suggest that there is every reason to take out an insurance policy against the possibility that the best environmental scientists in the world may be right. That means thinking hard in terms of mitigation, while at the same time ensuring that the approach we adopt lowers the human cost of adjustment to a low carbon global economy.

Framing the question that way helps illuminate the real underlying problem. We, in fact, now live in a global system that demands global governance even while the pillars of global governance, such as they are, fail to inspire much faith. What that calls for in the foreign policy arena is that our efforts must simultaneously be directed at improving the system of global governance, even while we try to democratize it to ensure that individuals in our society have some reason to trust those institutions.

Needless to say, that will require greater imagination than we have mustered thus far.

Given what I have outlined thus far, it is pretty clear that there is no map that will easily point us in the right direction. How then should President Obama and Prime Minister Harper think about our relationship and what practical steps could they take to ensure that our bilateral relationship contributes to the achieving the broader goals both administrations think are essential in the global system? I would suggest four steps that I think are essential if the President and the Prime Minister are going to close the gap between the economic and political reality that confronts us and the dated paradigms we are currently applying to find solutions.

The first and most important thing is to acknowledge that we are in this together. We have largely integrated our economies in ways that have served both Canadians and Americans well. We have not, however, gone on to suggest ways in which we should approach both the domestic and global problems we face that would honor that fact.

Confronting the challenge of climate change offers a telling example. The legislation currently taking shape in the U.S. Congress adopts a national solution to what is a global problem. It fails to consider [the impacts of] that solution [which] has proposed cuts directly across the supply chains that have grown up in response to the U.S.-Canada Free Trade Agreement and the North American Free Trade Agreement. By failing to understand how closely intertwined our economic fortunes have become, we are putting our prosperity at risk.

In my view, even health care also presents an opportunity. If you stop thinking of solving the United States health care problem and think about the U.S. market as part of a larger economic enterprise, we might find that there are solutions that would both encourage efficiency and drive costs down through expanded competition. Opening the borders fully to trade in prescription medicines and primary care could go a long way toward that end.

Second, it is absolutely essential that we get things done on a practical basis that benefit people on both sides of the border in tangible ways. There has been, for a variety of reasons, a progressive loss of faith in institutions in the United States – whether it was the federal government in the course of the response to Hurricane Katrina, the prosecution of the war in Iraq, the failure of financial markets, or any number of other headline events that have driven home that point over the past 10 years.

I suspect that many Canadians would feel the same way. Indeed, some of that sentiment must have played a role in Prime Minister Harper's election.

In some respects, both President Obama and Prime Minister Harper are suffering from that loss of faith. The only tonic is to start the slow process of rebuilding trust. That requires doing concrete things that are visible to people – tangible things that serve as a reminder of what we can do when we cooperate.

Here, the obvious target is the border. We are long past the time when we should have improved the physical infrastructure to match the possibilities we created when we entered into the NAFTA. I would suggest in U.S. political parlance that expanding border crossings and easing congestion is a “shovel ready” project.

Equally, it is time we merged our efforts on customs and immigration. By that I mean adopting a common approach that we implement at a common external border in order to ensure that we remain secure within it.

Third, I think it is absolutely essential to embed our efforts in a broader economic and foreign policy agenda. Our economic policies should increasingly be designed to build on the strengths that we undoubtedly have in a knowledge-driven global economy. That includes our institutions, the dynamism of our entrepreneurs, the flexibility of our workforce and our openness to economic change.

On the foreign policy front, we have any number of challenges that would be better faced together. From climate change to trade to energy security, aligning our efforts will strengthen our hand.

Finally, we must think creatively about what we can do within the U.S.-Canadian relationship to develop solutions that suggest alternatives to the rest of the world. We have lost the notion of North America as a laboratory for policy innovations. The sooner we reclaim that idea the quicker we can put it to good use in the effort to match our policies to the challenges that we confront together in a more globalized, knowledge-driven world economy and a more fragmented and uncertain system of international politics.

The reason I think that is particularly important is because of the values we share. The stake we both have in a global economy that encourages openness and transparency, that ensures that producers fully internalize the environmental costs of their production, and that vindicates the idea of free markets the more likely both the United States and Canada are to prosper in the world economy going forward.

In closing, let me underscore that there is not challenge we face that will not prove more tractable if we face it together and offer a North American perspective on the great issues of the day. For that reason, I hope that Prime Minister Harper will continue his efforts to engage in the Obama Administration on multiple fronts and I hope that President Obama will understand that it is manifestly in both his own political interest and America's broader interest to grasp that hand of friendship.

Thank you.

Helmut Mach

Welcome to the start of the 2009-2010 CN Trade Relations Forums. My name is Helmut Mach. I am the director the Western Centre for Economic Research at the Alberta School of Business. I am also the CN Executive Director of Canada/US Trade Relations. We are much appreciative for the CN sponsorship for our initiatives and the expansion of knowledge and understanding of international trade issues. We will be having a series of these events, two more this fall and more in the winter and spring terms. I hope you will continue to watch for them as we have quite a number of prominent and formative speakers attending.

Today we have with us Mr. Grant Aldonas who has held a variety of in the US administration. He also served as a legal advisor to the Senate Finance Committee and Trade subcommittee. He has extensive experience in the political arena in the United States and his last position was under the Secretary of Commerce for International Trade. He has been a senior trade negotiator for the United States in bilateral negotiations, bilateral disputes as well as world trade negotiations, also led the United States through negotiating softwood lumber issues with Canada. Mr. Aldonas has a wide background, as we will hear from his remarks on economic and trade aspects and the relationship between Canada and the United States. He is currently the Senior Economic Advisor for the Centre for Strategic and International Studies in Washington, D.C. He brings a wealth of background and experience to international relations. Mr. Aldonas will be commenting on the present situation between Canada and the United States with President Obama in office for approximately a year, how Canada/ US relations have fared, and what might be there in terms of future initiatives. A question and answer session will follow his presentation.

Speaker: Grant Aldonas

I have spent actually much of my career over 30 years involved in US and Canadian affairs. As it turned out, some of the first negotiating experience I had was with Canada, working on something that doesn't exist any longer. There were multilateral export controls during the days of the Soviet Union, and we worked together negotiating in Paris in an organization called COCOM. Later on when I was at US Trade, I was responsible for western hemisphere affairs which involved me at the outset of our preparations for a US/Canada Free Trade Agreement. Later in private practice I represented the Canadian government in those negotiations. I represented British Columbia in the softwood lumber dispute, which is where I first met Helmut some years ago. Then, after many years in private practice, I went into the government with the finance committee as the Chief Trade Council and then into the administration. Since that time I opened a business and what we do is trade and development essentially. It has moved slightly away from where I spent the first 25 years of my career, and thankfully so, in part because many of the things that I see in

the firmament, not just for US/Canadian relations, but I find, generally, that the American approach to the world around us unsettling. There are things that make me uncomfortable about our willingness to engage in the world and our ability to address many of challenges we have in front of us. In some respects that will shape what I am about to say about US/Canadian relations.

So let me launch in. I always like to say I will leave plenty of time for questions at the end, and ripe fruit or tomatoes if you must. But the more important point is I really want to engage you in thinking this through with me, because this is obviously a work in progress. The relationship between the Prime Minister and the President has been launched, I think, on a positive basis. The real question is how can we make use of the opportunity that these two new figure present? So that will really provide the framework for what I am about to say.

Building on a foundation of shared values and friendship, the United States and Canada have confronted an awful lot of challenges together, over many, many years. We've been close as neighbors and close as, really collaborators, in outlining a liberal world order, one that, in many respects, reflects the underlying values of both our societies and what we bring to the globe. At the same time there is no doubt there have been serious disagreements and times when good will has ebbed between the United States and Canada. You can look back to an era like the mid sixties, when we had sharp disagreements over economic policy, for example, the approach that Pierre Trudeau took with respect to economic nationalism in Canada, and similar disagreements about the prosecution of the war in Vietnam.

At the same time that gave way to collaboration on things like the 1965 Auto Pact and gradually reuniting our interests in the succeeding years. I would say a similar thing happened in the early 1980s, when there were very significant differences over the extraterritorial reach of US law, on issues like export controls, energy policy, competition policy, and the original softwood lumber dispute. There were also serious disagreements, foreign policy wise, about the Reagan administration's initial approach to the Soviet Union, and the introduction of intermediate nuclear forces in Western Europe, what that meant for a NATO alliance, and things of that nature. And of course this was followed by a new era of collaboration in the context of the US/ Canada Free Trade Agreement, later on the North American Free Trade Agreement, our collaboration in the completion of the Uruguay round of trade negotiations, and the creation of the World Trade Organization out of the firm foundation of the General Agreement on Trade and Tariffs.

Obviously in the early years of this decade, when I was at the Commerce department in the Bush administration, there was another ebb in the tide in our relations. Again there were compound conflicts I think over foreign and economic policy, certainly the most significantly in the differences between President Bush and Prime Minister Chrétien over the invasion of Iraq, and more broadly in the response to what Bush viewed as the war on terror--a conflict over how we would come to grips with that. That spawned smaller disjunctures over how we grappled with a common border and how we address the challenges that terrorism might present in the context of two economies that have become heavily integrated. So there are continuing conflicts over that, and certainly there continue to be economic conflicts, [such as] the latest flare-up on softwood lumber, and a variety of other points of contention between the United States and Canada.

As is often the case, the political currents in both Canada and the United States brought us new leadership, and in one sense a new opportunity to recalibrate US and Canadian relationships. Almost a year from President Obama's election, we do have something of a track record to examine and suggest what that implies for the direction forward. I think the best way to capture where we are now in my view, is really the failure to embrace this opportunity that has been created by the election of these two new leaders. What the record reflects, unfortunately, is that while we created something of an opportunity, a new opening has yet to come to fruition and it's not for one of trying on Prime Minister Harper's part. It reflects the dynamic that always shapes US/Canadian relationships and often afflicts US/Canadian relations.

The United States is once again preoccupied with its own domestic affairs, its own domestic economic and political agenda. And given a sharp downturn in the US economy, the weaknesses in our financial markets that have been on display, and the fallout in any number of US industries (most significantly the auto industry, which affects both sides of the border), President Obama's preoccupation with the economy should not come as any surprise. Domestic policy rather than foreign policy just as importantly reflects his instincts as well as his experience, such as it is. Most of that was focused on domestic issues, particularly on how you encourage the people at the bottom of the economic pyramid in America to share in a prosperity that trade and economic activity has created. In the early months of his administration he was necessarily focused on a massive economic stimulus package. More recently he has laid down the gauntlet on health care, on regulating the financial services industry, and trying to move a piece of climate change legislation that has major implications, competitively, for every industry in the United States. So, a pretty big agenda. And you wonder where Canada fits. I'd also say it's a similar sort of thing on the foreign policy side, although President Obama's foreign policy forays have been more limited. His focus has been more limited on foreign policy; his focus has been elsewhere. It really has been on the Middle East and America's relationship with much of the Muslim world.

So while the President has met with the Prime Minister multiple times, those meetings have not led to a fundamental reorientation of US/Canadian relations, or equally important I think, a broad common agenda that would help open the political space on either side of the border to lead us to new economic solutions that would vindicate the continuing partnership. They have launched a new effort on energy and the environment. But, in all honesty, there have yet to be any concrete steps, certainly by the US administration, to fill in behind that and that would give a sense of how productive it might be or actually an indication of what the US administration's stance is with respect to the environment and energy. Much of that has been tied up in the climate change legislation. So in short, we have not really embraced the opportunity that the new political leadership has created. The natural question is why?

Well one answer certainly flowed from the preoccupation with the current circumstance, but ironically for a self-professed agent of change that explanation does not fully satisfy. I think the instinct for change is laudable, but the approach the Obama administration has adopted is utterly conventional, despite the fact we are in extraordinarily unconventional times. So the stimulus package which is really yet to kick in, even as the US economy is starting to rebound, was a standard Keynesian

demand management approach to an economic downturn. Indeed much of its intended strength was sapped by the fact that the bill itself was a payoff to a variety of parochial political interests that had gone unsatisfied while Republicans were in office. Very little went to “shovel ready projects”, that were supposed to provide some economic stimulus. On health care, frankly, having identified the question for all those years that Democrats were out of office as a problem of insufficient health insurance coverage, it is no great surprise that the solutions that Democrats have hit on, that the Obama administration has hit on, is what should we do about extending insurance coverage? This is one of those classic examples of when you ask the wrong question you’re bound to get the wrong answer. In fact, the real problem is that we have had stagnating wages in the States for roughly 30 years. Much of what has come in an income pack has gone into things like health insurance rather than wages, and at the same time we have had rising costs.

The problem is a cost problem for people at the bottom of the pyramid, much more than it is a question of insurance coverage. So the question is what kind of drivers would you introduce into the system to bring those costs down? The one thing anyone in business will tell you is that introducing the middleman in between the producer and the consumer is not likely to contain costs. This is one reason why the Congressional Budget Office comes back with its predictions about every one of the bills that has been produced thus far saying it will not only increase the deficit, but raise health care costs rather than lower them.

So in one sense we have this process unfolding where there are positive noises about what we are trying to accomplish, but that the series of questions being asked don’t really confront the real challenges we are facing. And there is no natural point of, ingress for Canada to participate in helping solving those problems or collaborating on addressing those issues. Even with trade policy, what we have seen with the Obama administration is a vacuum--no real trade policy. This is in part bound by the commitments he made last year when he was running against Secretary Clinton. He trailed around Ohio with Jared Brown, the most protectionist Senator in the US Congress, and borrowed a part of his brand name to reassure workers in Ohio that he was every bit their friend as Hilary Clinton was. Obama is now constrained by the commitments he made at that point in his campaign, which explains the lack of a trade policy.

Now unfortunately, what that means is that his trade policy is being set by episodic decisions like the recent decision on imports of tires from China. While I can tell you honestly that I certainly understand the politics of it, much of it is designed to be helpful to unions that he needs in the health care debate much more than it was a trade policy decision. Honestly, it should chill the hearts of any pork producer, or lumber producer in Alberta. You know, this is the sort of thing where you can see the trend line is not a positive one if it is going to continue on in this direction. But what I suspect is at work is something more than a case of diverted attention or asking the wrong question. I think Obama and the rest of US society is trying to address today’s challenges with yesterday’s tools. In many respects in Washington, and this afflicts both parties, the mindset is roughly 40 years out of date relative to where the market has gone. Politicians have a tendency to think about the world economy, and the US role in it, as if we are still in the 1960s. They think about the transaction that go on in the market as if the United States economy was still made up of vertically integrated

enterprises that produced everything in the United States, as if the Rouge Plant still existed for the Ford company and iron and coke were coming in one end and finished automobiles out the other. The truth is that model died with the Rouge Plant when Ford itself started to outsource in the mid 1950s. Now we are seeing the effect of that. I am going to explore this in a little greater depth, but we are yet to have politics that have [caught] up and embraces that reality.

So really, what I am suggesting is that in many respects there is a failure of imagination on the US part that would embrace how integrated the US and Canadian economies have become and vindicate the extent to which we derive a lot, both Canada and the United States, our prosperity from that collaboration. Just some examples of how this has taken place. First, and most importantly, globalization has fundamentally altered the conduct of international trade and the basis of international competition. In 2003, we really crossed the Rubicon; that was the point where more than 50% of trade was in intermediate goods, essentially inputs, not an arms-length sale between independent buyers and sellers in different countries, but all a part of a single manufacturing enterprise that was producing a final output. So I always like to pull [a Blackberry] out of my pocket at this point. When I buy this, it is an American consumer buying something from an American service provider and a Canadian service provider, with some hardware that has been designed in the United States and Canada; all the guts of that hardware, the components, [were] produced, in Japan, Singapore, Korea, and Taiwan; and it was assembled in China and shipped back to the United States. So despite the fact that the domestic transaction is me buying this, it involved an entire framework of international trade and a set of transactions that aren't apparent to me. But that's the world we are living in today. Yet our trade policy, such as it is in the United States, is trade policy that is left behind in that world of 40 years ago.

Now, what's driving all that? Well, the first and most important thing we have to understand in the United States is that, while much of the political debate about our response to globalization has focused on trade, , trade is a very small eddy in the changes that are affecting American workers and affecting American enterprise. If we focus on trade much like I was suggesting about health care, we are bound to think of trade tools, like trade barriers, as the solution, with the idea that somehow we can build a wall around our prosperity. Of course you can't. You've never been able to do that; we can't do that now. But just to give you a little background, when you think about it, the real driving force of much of what we think about globalization comes from a series of geo-political changes in the late eighties/early nineties. We are still trying to find a new equilibrium relative to those changes. The second thing has been a revolution in technology. What I mean by that was the end of the Cold War. People don't have a sense of that in economic terms. We think about it in geo-political terms, but just to remind everybody, and I'm probably the oldest person in the room, but the reality is the economies were so sharply divided then that trade between the Western Bloc, Canada, United States, Europe and Japan, and the Eastern Bloc was reduced to barter.

Now, not surprisingly, that meant you built up a lot of industrial production on either side of that divide that you wouldn't need if we were, in fact, reunited as a single global economy. [Furthermore] nobody should be surprised by the deflationary impact of that, what that means for a shakeout of manufacturing, and

what that means particularly if the end of the Cold War was the end of an alternative model. Now the developing world buys into the idea of a global market based economy. The thing I want to identify for US audiences is that was a unilateral choice; it's not something where the US held veto power over China's instinct to join the global economy. The proof of course is that Deng Xiaoping started the process in 1979, and it was 2001 when we finally voted on China's membership in the WTO. So you already had 20 years of that process, of an extra billion workers, as it were, joining the global economy, unilaterally. Our question is how we come to grips with that; not that we could have deterred it; not that we somehow could have slowed it down; not that 30% tariffs on tires is going to make a difference relative to the choice they made to join the global economy.

Well, what does this do? What it does is give a broader plain over which a revolution in computing, communications, transportation, and logistics has played out. So again, I always like to use this device [Blackberry]. Of course when I was born the first commercial computer, the ENIAC, was created. This is about 1955, and that computer was the size of this room and it had less computing power than is contained in my Blackberry. We now have the ability to redraw economic geography; we now have the ability to reduce the cost of communicating, finding new sales opportunities, and uniting/reorganizing production on a global basis, almost without reference to the underlying resource endowments. It is important to understand the value of this content. What you have done is reduced the weight to value ratio of transportation, so I can now put this stuff because it is so valuable, per ounce, on a plane instead of a ship, and have just in time delivery. So that's the world we're operating in, even though we're still thinking about it as the world that we saw 40 years ago when shipping costs were 12% of the cost of US exports. Today it's a footnote in terms of a company's costs.

This has changed the nature of both trade and the challenges that firms face. I think trade theory offers a useful lens to think about this. Globalization has increased, in trade terms, the opportunities for specialization. That's what happened with any degree of economic liberalization. Competition in this context becomes less about market share and scale--the traditional things that you look at when you go off shore, enter a new market, and outcompeting the other guys (think about Toyota relative to GM here)--and instead it has become a global competition for those factors that matter most for innovation — access to capital, access to talent, and access to ideas. So the basis of economic competition and how you define even comparative advantage, even on a national basis, is now governed by a different set of factors than it once was.

The implication for economic policy is that you have to start thinking about a series of economic policies that embrace this economic reality and grapple with what drives these underlying factors of competition. The irony in this context is what really matters most are institutions. When economists talk about institutions they don't necessarily mean the building next door; they mean things like private property rights, the rule of law, the extent to which information flows freely in a market--all those incentive structures that are designed for a very transparent, open market based economy that tends to reduce a lot of information to price, lowers the risk and uncertainty of transactions so trade can flow, and, by the way does a very, very, very credible job of creating the human capital it takes to run this enterprise, because

that's what becomes the distinguishing feature of success in the context of a more globalized, knowledge driven economy.

Ironically, there is a similar logic that has been playing out on the foreign policy side as well. Globalization has made its impact felt there too. The same forces that had been driving what had been the strongest economic growth in 30 years, until recently, have atomized the assumptions that underpinned the Westphalian system of nation states. So what defense experts talk about in terms of asymmetric threats, or asymmetric warfare, are in fact the end-product of a process that makes it just as cheap to export terror as it does to export textiles. In one sense you have to come to grips with that reality as well when you think about your alliance systems, when you think about how you respond in foreign policy or national security terms.

Perhaps even more important, in the process of creating the global economy, we have actually created a broader global commons. Our ability to do damage to the planet environmentally has gone up with our ability to trade globally, and what that also means is there is a whole set of global issues that we used to grapple with on a national basis. What I mean by that is not environmental problems per say, but collective action problems in economic terms. A collective action problem is, of course, when one group of people have a very strong interest to pursue their economic demands through the political process, and the other folks who might be affected, which may be a very much larger group, have no incentive to organize themselves and try and combat what that individual small interest wants to retain.

Now in the trade world you think about the interests that want to continue to pursue protection and we have to go negotiate an agreement that provides export market access to some other folks to bring that new political constituency into play to offset the folks who want to continue the protection. While I would suggest that paradigm now applies to the environment, it applies to grappling with the fact that America provides a public good, the seventh fleet, which lowers the cost of transactions coming out of China and to which China does not contribute. There are a whole host of things that give you a very powerful insight into how it shapes our foreign relations or should shape our view of it, and framing the question in that light helps illuminate the real underlying problem. We now live in a global system that demands global governance even as the pillars of global governance such as they are fail to inspire much faith. When you think about the standards we apply, whether it's the World Health Organization or the World Trade Organization, nobody could point to any of those organizations as leading the way; and they wouldn't point to the membership of those organizations as demanding changes in the institutions that would measure up to the global economy in which we now exist. So, needless to say, that's going to require greater imagination than we have mustered thus far.

How do we make progress without a map? Well, given what I have outlined thus far it is pretty clear that there is no map that is easily going to point us in the right direction. You have to ask what are the guidelines that ought to shape how Prime Minister Harper and President Obama think about our relationship and the practical steps they could take to ensure that our bilateral relationship is not only strong and contributing to solving problems in our own domestic arenas, but also contributing to our ability to secure the sort of liberal world trading environment and the associated values we would like to see propagated in the global economic order. [In light of this] I would suggest four steps that I think are essential if we are going to

close this gap that I perceive between economic reality and the existing political paradigm t.

The first and most important thing to acknowledge is that we are in this together. I often times like to say probably the first thing the United States has to realize is that we are in a hole and we should quit digging, but we may in fact be in that hole together. We should at least recognize that we are in the hole together, and we ought to acknowledge that we have largely integrated our economies. We haven't yet found ways to embrace that, whether it was negotiating a free trade agreement, later the North American Free Trade Agreement, and never making the investments in physical infrastructure at the border that would actually allow companies to seize the opportunities that this integration created. Whether it was fully fleshing out what it meant to coordinate a series of policies that really would allow us to all but erase the border. None of those things were followed through and then the events of 911 happened. So now you have this thing where you really didn't have the foundation set in a way that would embrace the opportunity we created. You had some events and a predictable reaction by the United States, I think, where we reacted reflexively rather than reflectively about the border. Now we are sort of down one, that's the hole I was describing, and we have to find a way to climb out.

I want to do is use the example of climate change as a way of explaining what I mean here. If you think about the bill that is moving through US Congress right now, it is a national solution to a global problem. It is wrong in its particulars because it wants to create an emissions trading regime, but then it has a series of exceptions built into the bill itself which undermines the price discipline which is supposed to force producers to internalize the environmental cost of production. And, by the way, money being fungible, we should also recognize that when you pay \$100B to General Motors and its various parts suppliers, for them you are also undermining the price discipline which would encourage them to fully internalize the environmental cost of production. This is not a system that is capable of moving us meaningfully in the direction we would need to go to contribute to a solution on climate change. Equally, it contains a provision which would impose tariffs, or a tax, on any imports that come in from any country that did not adapt similar rules, undefined. Again, this should chill the hearts of any pork producer and lumberman in Alberta.

But my point is that it cuts right across these supply chains which have been built up as a result of integrating the US and Canadian economies. We are, in fact, cutting across that which provides our prosperity in pursuit of this environmental goal. Until we recalibrate this exercise, recognize we are in this together, and come up with a solution that vindicates how the economies have reorganized themselves, we are going to be raising the cost, the friction, associated with trying to make this transition to a low carbon economic environment. You know who suffers from that. It's always the people at the bottom. So, if in fact, for President Obama's purposes, you purport to represent the folks at the bottom, one of the things you ought to be thinking about this bill that is moving through Congress, is what is the fallout when I start to damage relations with Canada, damage relations with Mexico? Unfortunately that is not the paradigm we are thinking about, because we are still thinking about national solutions. In my view, even health care presents that opportunity, although most people don't want to take me up on that.

The second factor that I think would contribute is actually getting things done on a practical basis, and for me that means tackling the problems at the border. I start from a point of thinking about the US political psyche, and right now much of what President Obama is facing, though he may not realize it, is not antipathy, necessarily, to his health care suggestions per se, but a progressive loss of faith on the part of Americans in all institutions, but particularly the institutions of government. It's because the institutions of government have failed Americans at many levels.

An example is Hurricane Katrina, and the reason I say that is because most people think about this guy who ran the Arabian Horse Association and went on to run FEMA as if he was the problem. Well, I was on the ground in Long Beach, Mississippi a couple of days after the hurricane hit and I will tell you it was a failure up, down, sideways, and any way you look at it. FEMA utterly failed, and that wasn't the leadership at the top, they just didn't deliver. Now what we had done was persuaded a client, Mittal Steel to adopt a town. Mittal's ability to call UPS, its major supplier, and deliver things that were needed in Long Beach, *that day*, relative to what FEMA could produce, was a pretty stark example of how FEMA had utterly failed in this crisis. Yes, you could argue it is oversight at the top (that was a part of it) but this was really something that would lead the good people of Mississippi to say "that's not a government I can trust."

So now think about what has happened with financial markets. Well, you know how Americans feel, we don't trust markets either. And I hate to say it, but when you look at the debate it reminds me of the old joke about the person who calls the pizza delivery shop and they say "I want a pizza." The guy on the other end says "well, what would you like on it, pepperoni?" "No, no pepperoni, but I want a pizza." "Well, how about cheese, would you like cheese?" "No, no cheese, but I want a pizza." "Crust, thin or thick?" "No, I don't want any crust, but I want a pizza."

You can see where I am going with this. Americans want health care reform, we just don't want anything that has been suggested so far and we don't have any ideas of our own. Much of this stems from the feeling of antipathy towards the institutions that really have failed to deliver. I would suspect that many Canadians often times feel the same way if not only about their government, but about markets. It may not be quite with the depth that Americans feel that. [Nonetheless] that is something that both the President and the Prime Minister would have to grapple with.

Now, my own sense about the border [concerns] building the infrastructure and merging our customs services so that there is a single, external way of keeping track of things that are coming in to what has become, in effect, a common market. [This] would be much wiser than the approach we have now, and essentially would probably make it safer if we were doing that level of coordination and information sharing. This is obviously not something that our friends in this Orwellian named Homeland Security Department are likely to greet with equanimity, but nonetheless, it is the direction we should be going if we are going to embrace the opportunity we have created in our trade agreements.

Third, I think we have to embed our efforts in a broader economic and foreign policy agenda. Our economic policies should increasingly be designed to build on the strengths we undoubtedly have in both the United States and Canada in a knowledge driven global economy. But, ironically, what that means is thinking hard in both Canada and the United States about that which makes us competitive in this

global economy. Much of that comes down to building human capital. In the United States, we have a declining high school graduation rate, and a declining rate of kids who actually do graduate going to college.

Now think about that in the context of a global economy which is demanding more, even of people who go to technical schools, not just to get into the market and compete, but the habit of acquiring skills over a lifetime that allows them to continue to compete. I would suggest that a much stronger relationship on a North American basis, because Mexico plays a role in this as well, that addressed the challenge of human capital would be essential. As you know, that is nowhere in the agenda, in terms of the conversation, but it is critically important as to how we succeed because we have to keep exiting spaces that allow the rest of the world to come in.

So let me conclude, just to underscore, there is no challenge we face that isn't more tractable of Canada and the United States if we approach it together. There is no global problem, where moving on multiple fronts we couldn't make a better contribution. But I will underscore one point, which is Canada is always a better friend and a better collaborator when it articulates a very independent stance on world affairs. This will sound anomalous. You know everybody likes their friend to always be supportive of them, and it's true even when you're an alcoholic. But what you really need in a friend is someone who has their strength, their own independent demands, their own independent qualities that they bring to the partnership. Increasingly, I think what we have to see from Canada and the United States is that independence of mind, because when it has its own agenda about how the world should look, how it should be shaped, and brings to bear, Canada's unique comparative advantage in that context, it's a better friendship and there is a lot more that we can build together. By the way, [it also] gives the Prime Minister more currency when he goes down to talk to President Obama. So let me close there and open it up for questions. Thank you very much for listening.

Questions

Helmut Mach

We have quite a bit of time for questions. We are recording this session.

Question, Joe Rosario, WCER

I was very surprised that you did not comment on this whole business about “Buy American” and the problems that are faced in terms of trade relationships between Canada and the US in terms of inputs for the stimulus program expenditures in the United States. I wonder if you have any thoughts in terms of where we are going on that issue?

Answer

Well, I would have thought, at least with this audience, that we have such a common perspective on the utility of those provisions that I didn't need to talk about them. But where we are going on that issue is nowhere. The demands are important, but the President is currently spending his political capital on the health care debate, a health care debate that has escaped his control and he is currently losing, and which I want to stress is a debate within his own party, much more than it is a debate among Republicans. I want to remind everybody that the Democrats have a 60 vote or so majority in the House of Representatives and a filibuster proof margin in the Senate. This is principally an argument among Democrats as to how the shape of this legislation will look, and they can't produce a bill. So, many of the reasons why the President won't take on the issue of the “Buy American” act, particularly that pernicious effect in terms of local and state contracting, is because he does not have the political capital to invest there. He has to spend it all on the health care debate right now. I will say that, in addition, the Senate thinks that it has solved the problem, and until someone makes a convincing case that they didn't solve the problem by allowing the United States to satisfy its international obligations with the waiver authority that the Senate gave the President, they won't act. So right now we are nowhere in terms of trying to solve that particular problem.

Question

Do you think the fact that President Obama has relatives/in-laws living in Canada is contributing to an understanding of this issue that no previous president has had?

Answer

No. No, I don't think so at all. It's interesting, the fact that he does have relatives certainly provides a degree of friendship and it may offset any other concerns he might have with talking freely with a Prime Minister with a different economic or political philosophy. So it might help on the margins there, but our interests are still our interests, and his interests are still his interests, and right now those are focused on the health care debate, not across the border. Even in addressing the sorts of issues we should about the border, particularly with immigration and customs, I'm not sure

that particular, peculiar aspect of his relationship with Canada is a net positive, to be honest. But yeah, part of it is trying to make sure there is enough on the table on both sides that we would benefit and that probably won't factor into that equation.

Question

We are a pretty energy focused province here and there is a sector in the US that thinks we have dirty oil, and there is a sector that feels the US needs our oil. I was wondering if you could shed some insight on where the Obama administration is going?

Answer

The glib response would be environment trumps energy security, with this administration, but jobs trump everything else. So the answer is not to continue to articulate the contribution that Alberta makes to the North American economy the way we had in a Republican administration, for example, which was very interested in energy security and thought of it as the solution to the war on terror and a variety of other things. The way to think about it is you have this supply chain that helps produce that contribution Alberta makes. And guess what, just like everything else in this economy that supply chain extends down into the United States. You don't have to go very far in Alberta until you see Caterpillar equipment all over the place. Well, guess where they make that stuff--Illinois. To the extent that an environmental argument would diminish the contribution Alberta can make to our economy, it's going to cost jobs in Illinois.

So the answer in some respects is a political equation, always tying things back to the forces you know are driving the administration more than any other. In this instance I think there is a pretty strong argument to say (remember the model I have in mind about these supply chains that are going back and forth across the border), ironically, there are a lot of Americans that have a stake other than oil in the success of the venture in Alberta, even if that stuff is being sold in China. It's trying to make that economic interest clear to members of Congress and to the President that is essential in terms of driving this debate. You can see what I'm doing. What I'm saying is the old game in Washington is always if you have a circle this big and you got the right people inside it to make the decision, move the circle. If you got too many people in there, you close the circle. If you don't have enough you need to widen the circle. Well, this is one where we have to widen the circle. You have to bring in some other interests to air this debate out so it's not tied up in these things I know people say, because of their theology, rather than some analysis of the oil sands in Alberta. So part of it is you really have to extend that analysis. I'd also say that to the extent that Alberta, as I know it does, makes significant investments in a variety of other areas with respect to conservation, the environment, and a variety of other things. Making sure people know that side of the story is an important part of communicating with the United States, and particularly the noise that you have to find a way through in a Washington political market.

Question

I was wondering if you could comment on your sense of where protectionism is going in Congress as the economy gets stronger, which it hopefully is. Will we see

these protectionist instincts decline? And my second thought is will we see the free trade wing of the Democratic Party aligning with the free trade wing of the Republican Party, who lie in the center, as we saw when Bill Clinton got NAFTA through against Ross Perot?

Answer

Sorry, so remind me what the first question was...direction of protectionism, yes. I think the answer is no, because in fact what we have seen is a semi-permanent shift in populist direction of the entire US political spectrum, and it metastasizes in different ways in either party. Among Democrats it's a debate of protection, driven largely by old line industrial unions who keep the issue current, not because we can do anything in a free trade agreement that would benefit them, but because it keeps them relevant in a union movement that is now public employees and teachers. So there is nothing about leaving the trade issue aside or solving the trade issue, or economic growth that alters *that* political equation which is driving the political debate among Democrats. It is the unions that finance their campaigns. Among Republicans, it metastasizes in the debate about immigration and about border control. That, since 911, has sort of become their mantra. It's the same instinct on either side, in one sense, that populist instinct that you can build a wall around your prosperity. I don't see that going away any time soon on either side, even though it comes out in different ways on either side of the party. Now I have forgotten the second question, I apologize.

Question

Are centrist Republicans and Democrats putting a coalition together?

Answer

Let's see, the way I would describe it is not centrist, and I certainly wouldn't describe it as the free trade wing of the Democratic Party, which doesn't exist. What I would say is that there are internationalists in the Democratic Party, and the debate among Democrats. Or the way I always pose the debate to my Democratic friends, is it is a question of whether they will pursue Roosevelt's legacy, or the legacy of William Jennings Bryan. If they pursue the legacy of William Jennings Bryan, who was all about the farmer and don't crucify a man of a cross of gold (you remember the old silver/gold dispute in the like 1890s). If they pursue that instinct then woe betide the United States in a global economy. If you appeal to the Roosevelt instinct, which is a much stronger part of the Democratic Party in many respects, and embarrass them into saying you have to stand up and pick a stand, then you can make some progress. [Also] I would say among Republicans, there are free trade Republicans, but, as you point out, there are also internationalist Republicans, and that is really the group that you are searching for, and with whom you can make that coalition. The reason I say this is, the only reason we really actually moved since Clinton was disabled by impeachment, on trade, again because he owed his success in the impeachment trial on their support in many respects. He couldn't bring any trade legislation to the Senate or the House in the latter part of the 1990s; anything post NAFTA basically he couldn't get done; he couldn't get negotiating authority from his own Congress, in effect.

Well, what we did in the end of the day was pose this question exactly that way to normalize trade relations with China, to rewrite the tax code in ways that it would make it easier to trade and invest globally, [and] to adopt a new set of preferences with respect to Africa, called the African Growth and Opportunity Act. All of that was done very intentionally, with calling out the internationalists in the Democratic Party and asking whether they would join in this effort. Now it's a much more dicey thing for Obama to do, but I think you have your finger on exactly the right point. That's the only place where you can get it.

So then you think about the mechanics. Well, what can take me there? And I think it is trying to say ways that trade liberalization or trade policy could contribute to solving other problems that we confront together. Climate change is a good example. The truth is climate change, even though we think of it as an environmental negotiation, and it has been negotiated by environmental negotiators, is fundamentally a trade negotiation. We're really talking about negotiating the economic consequences of the mitigation steps that we have to undertake. In that context, approaching it like trade negotiators makes some sense; smaller, smaller, wider, right. I'm thinking wider, I think we need more things on the table to be able to sweeten the deal that would allow us to join with China and come up with a solution to this. What would drive efficiency in China, or in India? What would make sure that the guy with the three-wheeled scooter and the two-stroke engine has a low cost alternative that allows him to contribute to a solution? What would allow him, if he imposes the carbon accounting measures Wal-Mart wants so he can continue to play in their market? How can he generate savings that he can now trade in a climate change regime?

Well, we haven't thought those things through, but it is certainly the right set of questions to be asking, because we know, unless we are effecting the behavior of the guy who is living off the three-wheeled scooter, we have not fundamentally altered the emissions efficiency of India going forward. So what this suggests to me is that there might be some kind of bargain available that involves some difference in what we accept in the way of caps between developed and developing [countries], particularly in the United States in return for market access for environmental goods/services technology. Whatever that solution is, we certainly need more things on the table to trade right now, because right now we are bargaining over the price of a rug and a suit, and it's a zero sum game. So we need to make this less zero sum, and if we can, I think it really does imply approaching this like trade negotiators rather than environmental negotiators.

Question

During the election there was some discussion as to whether Obama would be willing to reopen discussion of NAFTA, specifically the proportionality clause that constrains legislative decision making that would impact oil output. Do you foresee, as Alberta reaches peak oil output that the United States would be willing to reopen discussing concerning the proportionality clause?

Answer

I guess I would answer that by saying I would put the question just the opposite way. If the United States came to Canada and said we have to renegotiate this,

wouldn't you put that on the agenda? I think so, yeah right, exactly. Because the truth is, given where we are with the price of oil, the circumstances we negotiated way back when, first in 1987 and later on in the context of the NAFTA, don't make a hell of a lot of sense from Alberta's perspective. So if what I was doing now was saying, look a deal is a deal. You know you want to make changes in these relationships fundamentally where we have reorganized ourselves economically and that would impose huge adjustment costs on our side. Not so fast, we have an agenda too. Now, independent of that circumstance, do I think there would be any instinct on the part of the Obama administration to address that concern on the part of Alberta? No, because if you think about it, what they are really saying is: I'm going to upset a bargain that I have locked in place. That's sensitive for a whole host of political reasons that I really don't want to touch right now. What I am going to be doing is saying I actually want to import higher energy costs at a time when I'm trying to stimulate the US economy, so the politics of that would be deadly.

Question Helmut Mach

Just as an editorial comment, from my own experience, there is no use, value, benefit, interest, or purpose to renegotiating the proportionality clause, either for Alberta or Canada. It's irrelevant in terms of the integrated energy structure we have in the North American market, and Alberta would not benefit from any attempt to renegotiate that. There would probably be costs for Canada in terms of trying to change something in the NAFTA that somebody else values. There is no benefit for Alberta to be derived out of it.

Question

You mentioned that a carbon tariff could somehow interfere with global trade, in the sense that we have established this network and this would slow it down. But it would also seem to give a competitive advantage to places like the United States, over China, because it then places a value not just on labor but also on how you produce. It would seem to benefit the United States in accomplishing protectionist measures in a meaningful way, but you're saying it would negatively impact the consumer in the United States through added costs in the products they consume. Somehow these must balance out. I haven't really seen Obama leverage that kind of advantage on the carbon tariff to promote a protectionist viewpoint, I guess, in his own party. How do you think these will balance out?

Answer

Those are two separate questions. Obama's approach thus far to legislating has been to outsource everything to Nancy Pelosi. That has not proved effective because what you end up with is a result that is biased to the far left within the Democratic Party and which is reflected among the class of 1974 Democrats elected in the context of Watergate. That was true of health care, and it certainly is true of the climate change bill that has made its way through. What I would suggest to you is that the tariff provision, the carbon tax provision in that bill, actually very much favors abuse by those who are interested in protection, in the market. So in that sense, I think the assumption you are making with respect to how Obama has addressed that is ... how

to put it... I want to say he hasn't engaged fully, but by setting up the process the way he has, he embraces a model that favors those protectionist interests.

I will tell you honestly, and I know this based on my own experience, is that the guys from steel, the steel workers union, the UAW are all in there lobbying for that tariff and they want the definition of it to be as loose as possible so that it allows them to achieve their economic demands through the political process, completely unrelated to what the environmental effect would be. Does that answer the question?

Question

How does that balance out with effect on the consumer?

Answer

The consumer is getting screwed. There is no instinct among Democrats... now think about this. This is a party that says it represents the people at the bottom of the pyramid. We collect \$20 billion from tariff revenues and \$10 billion of that comes from shoes and clothing alone, at the behest of the Needle Workers Union and the folks who make non-rubber footwear in America. What that means is the shoes we are all wearing basically carry no tariff in the United States, but if you wanted to buy tennis shoes and jeans for your kid and you're a single mom going to the Wal-Mart in Winchester, Virginia, roughly 40% of what you are going to be paying is tariffs. You are penalizing the people at the bottom with that set of tariffs. But somehow in the Democratic Party, they have got themselves wrapped around the axle to the point where they think that trade policy is damaging to the people they purport to represent. They can't get themselves to the position where they understand why Roosevelt believed in a liberal international trade order, which is because it served the people at the bottom at the end of the day.

So, I think part of the answer to your question of why they aren't balancing these issues out, is in effect, through their own theology. They have read the consumer part of the equation on trade right out of this. I think until, in some respects, (I'm getting a little heated about this) until you can reintroduce that moral quotient into our trade policy, I'm not actually sure we will succeed in bridging these differences, because at some point you know you have to rebut these arguments. Take the trade agreement with Colombia. The United States isn't willing to stand up to its own drug addiction that has ruined a country, and at the same time wants to say, because of rules we want to impose, we won't give you another opportunity to enter our market. There is something fundamentally morally wrong with this position, and yet that is the position of Democrats on the US-Colombia Free Trade Agreement. So at some point we are going to have to get down to some rally harsh arguments about where the morality really lies in exposing the hypocrisy of these positions.

Now there is plenty of hypocrisy among Republicans on immigration and things where they feel this populist momentum coming out, the border stuff and all the rest. But on this particular issue it is a Democratic problem. And I will say Obama, by embracing Sherrod Brown in Ohio did a lot to contribute to that, including his economic advisor Larry Summers suggesting that the law of comparative advantage no longer applies in the global economy, that entirely vindicates the principle of comparative advantage, and he should know better.

Question, Jason Brisbois, WCER

You have talked at fairly great length about the Democratic Party, but haven't said a lot about the Republican Party, giving us the sense that you might be a Republican. Could you comment on the future of the Republican Party, both going into the next presidential election, whether it's possible for them to upset President Obama, and the leadership of the Republican Party and where that might be going?

Answer

The future is irrelevancy and the leadership doesn't exist. Really, if you think about it, what you have is a party that in reaction to two rather bitter losses, just like Democrats did in 1994, is tacking right in response. It is saying that you know the real problem was that John McCain was too liberal, rather than understanding what had happened from 1994 to 2006. Wholly apart from the issue of Iraq, the Republican Party made a contract with America and probably broke it. A Republican Congress became exactly what they had vilified for a very long time--taking the people's money and spending it on things that were going to their cronies. That is a large reason why they got thrown out. It was not because they weren't conservative enough.

So now when you see Dick Cheney making his arguments, he becomes, since there is no one to compete, the voice of the Republican Party. Or I think one thing David Axelrod and Rom Emanuel have done well is label Rush Limbaugh as a spokesperson on behalf of the Republican Party. Well look, I'm Republican but the truth is that's a pretty thin veneer over my principle, and if those two guys represent Republicanism, than guess what, I'm not a Republican anymore. You know what I believe in is hard money and human freedom. I'm a libertarian basically when it comes to social issues, and that is where most Minnesotans are whether if they call themselves Democrats or Republicans. I don't care what's going on behind your bedroom door, that's not my business. So when you get a party that is weighing in on that set of issues and ignoring the challenges we are facing in our public education system and, importantly, ignoring that the government does have a facilitating role to play in how we make these investments in human capital, in how we embrace the global economy, and is unable to pay for it, it is very difficult for them to gain some traction even if Obama is putting obstacles in his way politically.

On the leadership question, you know the truth is that people got along in the Republican Party for a long time on what set of ideas that largely embraced the Reagan revolution, and those ideas had their time. Where we had gotten to the in the 1970s was intolerable – high inflation, high unemployment. We had to break the log jam. Some ideas came along that, in their time, were good and valuable ideas. The purchase those ideas have on the world economy around us ebbed absolutely because the world economy has changed. You have a new set of ideas that vindicate the notion of hard money and human freedom that somehow correspond to the world we are living in, and that's not what Republicans have right now. Until you embrace that, you are unlikely to capture the soccer mom, unlikely to capture the person that is worried about putting a roof over their head. You are unlikely to capture the middle class that has seen their wages compressed and prices rise. You must to find a way to respond to that problem, and if you are out talking about homosexual marriage and you're saying Obama is a Nazi and all the rest of that kind

of stuff, well you know most people are looking at this and saying, I'm more interested in my paycheck which looks smaller, and now it's a more risky environment in terms of my job, and what are you doing to help me? Oh, and by the way, when you are taking my tax dollar am I seeing a school? Am I seeing a road? Am I seeing a bridge? Am I seeing something that would actually benefit me and my community? Am I seeing anything that would reinforce a sense of community?

So you can see why I think, from a Republican perspective, you really have a lot to do. Here it is. They sort of build themselves into a coalition, and the temptation is seeing the obstacles that Obama has put in front of himself in terms of health care, and by adopting, really, the wrong approach to the question. I think they are tempted to think that more of the same will work and that would be a real problem. You understand what I am really saying: in any democracy you need the pressure from the other side; you need the dialectic. You need the pressure from both sides to refine good ideas and obtain a sustainable result that a democracy can exist with, feel comfortable with, and it has to be sufficiently transparent that people feel comfortable with the bargain. Well if the Republican Party can't play that alternative, then the system doesn't work. You end up with a lot of bad ideas, like I was alluding to, the problem of a Democratic party that can ignore the interests of the poor in favor of a set of union interests, where the average member's salary is \$90,000 a year, putting them in the top 5% of American income earners. Well that's not an equation that is right, but there is not an effective opposition that will call them out, so you can continue to exist with that sort of hypocrisy.

Question

Given what you have just spoken about, at the truly fundamental grassroots level, what do you do to draw out, to engage people to come to the new kinds of answers, or solutions that we need to move forward?

Answer

As it turns out, you hold a lot of town hall meetings after you introduce a bad health care bill, because you know a lot of people are now interested in what's going on in Washington. I think you have to do is use this as a teachable moment. But to use that as a teachable moment to draw people into an enterprise, you better have an explanation of how the world really works that matches the reality they face. Much of the gap I describe between the political paradigm and reality is really a gap between how we talk about politics and how individual workers experience the global economy on a daily basis. Most workers you talk to know that throwing up a lot of tariffs is not going to help them with their job. It's not going to help them with acquiring new skills. They look at a trade adjustment assistance program, and you know everybody thinks you add a billion dollars and you get another trade agreement. But it doesn't work that way. If you want broad public support for embracing globalization, you fundamentally need a different social contract, one that actually says that we are going to invest in the workforce, and honor the fact that that is the asset that is our future in this globalized, knowledge driven society.

So I think it really requires you to think back. What's the fundamental problem? How do I make sure that what I am offering bears some relationship to the competitive pressure that both firms and workers face, so they can say, "that makes a

lot of sense, at a very practical level"? Above all, my reaction is 'do the right thing.' You know it's amazing, I have found in politics that if you do the right thing you can find a way to explain it to your constituents. But if you are doing a stupid thing, it's pretty hard to explain and people get mad because they just feel that someone is trying to pull the wool over their eyes. A lot of what I was describing about that dissatisfaction or the loss of faith Americans have in their institutions goes right to that part. Think about the Bush administration, of which I was a part. There were an awful lot of people that wanted to talk about accountability but didn't want to be held accountable. Brownie is a good guy, even though Katrina was a mess, sorry. I always like to say the only native borne philosophy in America is pragmatism, you know William James, and there is a reason. That's who we are. I don't think Canadians are any different. That's where I think you have to go to solve this problem.

Question

Just as an extension to that, maybe this is a loaded question. From your point of view, given the way the world has changed, is part of the answer, part of the solution, getting Americans and Canadians, perhaps, to realize that the old expectations of standard of living have changed and there are new players?

Answer

No, actually I think that what we should be doing instead is saying you have every right to expect a rising standard of living, and our job is to line up the incentives in our own economy and work together to line up the incentives in the global economy that allows that to happen. Properly understood, that means dealing with the inefficiencies in our own market, to the degree to which we humble ourselves and stymie the ability of individuals to rise.

Let me just give you a couple of examples in a US context. We have a tax code that favors debt over equity, yet we are surprised that we have a highly leveraged economy, and yet the incentive in the system is debt. Now I say the market is treating you like you are your own corporation; you have to invest in your own capital because a lot of other people are not going to do that for you; and I'm making it very hard for you with this vice that I was describing between higher costs and lower wages for you to do that. So what does the tax code do? It allows you to deduct the expenses for any training related to your current job, but if you were smart enough to say I better be thinking about a new job, you can't deduct that. You can't even treat it as a capital expense even though it is an investment. That's insane. That is a non-adjustment policy.

You see where I am going with this – there are whole set of things you can unite into a political program that would actually embrace the idea of a rising standard of living by equipping people to succeed in this global economy. This means addressing very fundamental things like our public education system. It means addressing how you ensure that the liquidity trap that middle class families find themselves in doesn't prevent people from getting into college and aspiring to something more. That's where we have to go. But I would say, if that's the way you frame the issue that I don't think you have to buy into Paul Krugman's idea of an age of diminished expectations. What it really is, is embracing a world of creativity that should allow

us, as well as the Chinese, to prosper, and by the way, if we do it properly, will fully internalize the cost of emissions.