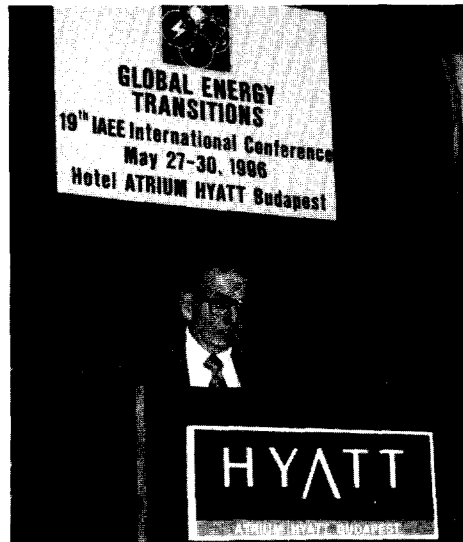
## Globalization of the World Economy

*By Morris A. Adelman**

"Globalization of the world economy" rolls trippingly off the tongue. The thing itself is 450 years old. By 1600 A.D. there was large scale trade from the Americas and Asia into Europe. A poor country – Spain – used its great new mineral wealth from the Americas to support all its old unproductive habits and to buy glory. The sun never set on the Spanish domains, the first global empire in history. It did not shine there for long.

Global trade expanded greatly from 1600 to 1800, despite wars and the controls of which Adam Smith wrote with such graceful scorn. But after 1800, trade and now investment flows increased much faster. John Maynard Keynes summed up:

> "What an extraordinary episode in the economic progress of man that age was which came to an end in August 1914! ... The inhabitant of London could order by telephone...the various products of the whole earth ... and by the same means adventure his wealth in the natural resources and new enterprises of any quarter of the world ...or... any substantial municipality in any continent. He could secure ...cheap and comfortable means of transit to any country or climate ... (without) ... the least interference. But, most important of all, he regarded this state of affairs as normal, certain, and permanent, except in the direction of further improvement, and any deviation from it as aberrant, scandalous, and avoidable...(M)ilitarism and imperialism, racial and cultural rivalries, monopolies, restrictions, and exclusion ... were little more than the amusements of his daily newspaper." (Keynes 1920, pp. 11-12)




Morris Adelman addresses the conference.

Thus the freedom to move people, goods and capital allowed massive investment for expansion and improvement. But then as now, one set of political forces lets the process work, and another set can stifle or break it. Global expansion is no gift of nature, there is nothing certain about it.

In fact, recovery after World War I was slow and incomplete. Trade and investment were stifled. The global economy became ever more fractured. To my generation, which came of age in the great depression and World War II, further breakdown looked all too likely.

But the quarter-century after 1945 saw a great expansion, and restoration of world trade. Progress was much less in the Communist blocks into which Central Europe was long submerged. Today they are back in the global economy after a miserable detour in Russia "seventy-five years on the road to nowhere."

But expansion slowed greatly after 1973. Every large developed economy suffered a sharp down-deflection in the growth of output and productivity. The fastest-growing, Japan, slowed the most.

Some of the deflection must have been due to the oil price shock. What a disproportion between cause and effect! We are told that in the right conditions the beating of a butterfly's wings can set off a hurricane. Perhaps this was such a case. The oil production cutback in late 1973 was very small. It was less than the net inventory additions in the previous nine months. But fear of the unknown caused panic: a surge in precautionary and speculative demand for ever-more inventories, which multiplied the price several times over.

After price volatility up, and with overflowing oil stocks and excess productive capacity, one would expect volatility down. But the producing nations curtailed supply enough to drive the price much higher still. In 1978-79 came the same sequence: threats, panic, a price surge; then a further cooperative ratcheting-up of price.

Each oil price shock was amplified by the disrupted world payments system, the anticipated kick to inflation, the direct price controls and monetary contraction, and much more. Energy demand contracted in response to the higher price, but only by diverting investment away from where it would have gone to raise productivity.

More price shocks were expected because it was known – *known!* – that the wells were drying up, and the world was running out of oil. The ghost is still at large. We still read that "growing demand" and "tight markets" may bring another "oil crunch." But each price spike came when supply was ample or in excess. Only deliberate action made oil scarce.

Comparing now, 1996 with 1914: freight transport is much faster, personal travel is many times faster, communication sometimes infinitely faster. In fact, radio and television may have destroyed the Communist blocks. These economies did not collapse. There was no famine. The standard of living rose, very slowly. But the inhabitants came to know something of the outside. Chernobyl in 1986 might have been kept a leaky secret, but not when the news of fallout came quickly across the border from Sweden and Germany.

The second change from 1914 is one aspect of communications. Financial assets can now move so fast that the difference of degree has become one in kind. I will refer again to this. The third change has been the climb of some of Asia toward or into the ranks of the developed countries.

The fourth big change from pre-1914 is the end of colonialism. It was inevitable, and welcome. But many newly independent nations tightly controlled and distorted their

*Morris A. Adelman is Professor Emeritus at the Center for Energy & Environmental Policy Research, MIT. This is an edited version of his remarks at the 19th IAEE International Conference, May 27-30, 1996 in Budapest, Hungary.

economies. Some expropriated mineral and other assets, or set terms which claimed so much of the prospective rent as to abort investment. The high barriers to investment are now decreasing, very slowly. Half of the world's oil and gas is still produced by State companies. Outside investment is barred. Similarly with most of the world's electric power, and other industries.

Nations, new and old, have been slow to see the results of a poor reputation in financial markets. There is a 150-year-old lesson from my own country. In the 1840s, many States of the young American Republic borrowed heavily from European lenders, then defaulted. Eventually, they all paid up, having decided that reputation was too valuable to lose, or even to impair.

Perhaps the revised contract with Enron will benefit the Maharashtra state in India. But there is an offsetting cost - a contract voided after signing is a classic political risk. Indian borrowers and perhaps others will pay more in interest charges, or do without.

Russia has just rescheduled interest payments to foreign creditors. It would have gained many times as much in revenues as in loans had it been willing to make contracts with foreign oil companies. But inability to see risk and return, holding back promising areas but not developing them, demanding the impossible in order to split the difference, piling on taxes or local demands, etc., have kept the potential from becoming actual. The losses from not producing oil far exceed any possible gains from better terms.

Russian pipeline charges may well extract most of the rent on Central Asia production. But it will be a high proportion of a low rent. As the French say: you pay for your pleasures. The payment will be: all the rents aborted by preventing investment.

Prime Minister Chernomyrdin fears that "the West is undermining the security of the [Former Soviet Union] by seeking to exploit their oil and natural gas reserves." (*Wall Street Journal*, May 14, 1996, p. A17.) It would certainly undermine his declared aim: "a cartel to coordinate production, exports, tariffs and taxes," to enrich his friends at the expense of everyone else. But with no outside competition for investment, the total will be much less.

Globalization means the injection of competition: widening markets to inflict rivalry on business firms once shielded by barriers of distance, tariffs, regulation, language, etc. As more governments permit access to foreign investment, a particular government's excessive demands will drive the investors elsewhere. Conversely, as the circle of investors widens - as in international oil - it becomes hard or impossible to exploit even a small unsophisticated country, lest some other company jump in to make a better offer.

These examples show that to understand the global economy today, we need both politics and economics. But the more the two are mingled in practice, the greater the need to separate them in analysis. Neglect of the need sows confusion.

The supposed competition among nations, "the younger rises when the old doth fall," is poetry. Competition is among business firms. If the firms succeed and grow, the increasing income can benefit the nation. Conversely, the politics and society of any nation may make the business firms' success more likely, and economic progress: attitudes to work and to postponing consumption; health and education; the rule of law; contract enforcement; freedom of information and movement.

Relations among States are governed by power, which is purely relative, a zero-sum game. In competition among firms, within or across national boundaries, there are winners and losers, but the total is always a net gain.

Of course, we hear today, as ever, that the low-wage countries will conquer the earth. In my country, it is "unfair" competition from Mexicans or Asians; elsewhere they many demand protection from cheap foreign goods produced, I suppose, where capital is "unfairly" cheap.

Wages are only one cost, sometimes important, sometimes not. But never mind that. If some lucky nation could produce everything more cheaply, had an advantage over everybody, it would still benefit by doing only the things where its advantage over others was greatest, and importing everything else. And if one were least efficient in everything, it would do those things which it was in the others' interest to let go. The competitive result holds even under these wildly unrealistic assumptions.

Some years ago we heard anew about "strategic trade theory." Imagine an industry with economies of scale, or great gains on the learning curve. Subsidize or protect a firm to get the perpetual momentum of an early start, and the benefits of a great new industry. On paper, it is smooth sailing compared with private markets which at best are full of inertia and error, blind alleys, wasted effort.

The trouble with this strategy of picking winners is that they are probably losers. Worse yet: those in authority can not admit the mistake, but keep pouring, out of the public purse, good money after bad. Vested interests quickly build up, who persuade themselves and others that a running sore is a national asset.

This confusion affects international trade politics. Years ago, Japanese automobile makers began to export, especially to the United States. This was opposed by the Ministry of International Trade and Industry (MITI), the mythical general staff of mythical Japan, Inc. One reason the Japanese auto-makers succeeded was that the U.S. firms had become inefficient as producers and blind to consumers' wants, for a time.

But another coincidence was far greater and more stubborn. My country has in recent decades had a very low savings rate. Add a budget deficit, and we have aggregate national dis-saving. To maintain spending, we borrow from others. These dollar flows represent real goods and services. To consume and invest more than we produce, we import more than we export.

So the U.S. balance-of-payments deficit is due entirely to low saving and the budget deficit. It has nothing whatever to do with any nation's trade restrictions. In fact, a nation's bilateral deficit with any one country is no more significant than my permanent deficit with the barber shop where I always buy and never sell. (There is now some heavy breathing over the U.S. trade deficit with China. If we include Hong Kong, the deficit is only half as large, but just as meaningless.)

But for over a decade, my government has engaged in a senseless brawl with Japan, subverting our own free trade

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Significant changes have occurred or are under way in the energy sectors throughout Latin America. Privatization, deregulation, regional integration are important trends in Central and South America; and Mexico, to a limited extent, is no exception. The concern for the environment is already influencing energy policies and the physical and financial structure of the energy suppliers, as well as their development plans. The Congress will provide an analysis of the current situation and of the expected evolution of the Latin American energy systems in both the external and internal contexts.

The main themes of the Congress - Latin America in the world energy market; regional energy markets; deregulation in the energy sector; externalities of energy chains - will be addressed in the following panels, assembled jointly by executives of the Mexican energy sector and the IAEE:

- Global overview of energy markets
- The upstream oil sector in Latin America: present and future
- The downstream oil sector in Latin America: regional and global markets
- Deregulation in the power sector: Latin American experiences and prospects
- Environmental externalities of energy systems
    - Part I: mitigation through technology and energy efficiency
    - Part II: impact on energy costs and prices

Concurrent paper sessions can cover other topics in addition to the above.

This Second National Congress is being sponsored by the Mexican public energy sector, with the participation of its top level executives and policy makers in the plenary discussion panels and invited lectures. As these will address matters of continental concern, a similar participation from the foreign public and private energy sectors and related industries is assured.

| Registration Fee: | Members AMEE/IAEE | US$ 70.00 |
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The Congress will be held at the Technological Museum of the Comision Federal de Electricidad (Federal Electricity Commission), in Chapultepec Park. Information about convenient hotels will be provided.

Inquiries should be submitted to:

Dr. Mariano Bauer, President AMEE
c/o Programa Universitario de Energia-UNAM
Mail: A.P. 70-172
04510 Mexico, D.F., MEXICO
Tel: (52 5) 622-8236 / 622-8533 / 550-0931
Fax: (52 5) 622-8532
e-mail: bauer@servidor.unam.mx

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goals by demanding quotas for computer chips and for automobiles which nobody wanted to buy. Yet many believe that the balance-of-payments deficit has some relation to Japanese restrictions on U.S. exports. (To make a bad joke worse, we prohibited the export of Alaskan oil.)

The brawl is good theater: trade war, conflict of giants, Asian versus Western economics, etc. The fact is more dreary and ordinary: each side pays off some domestic supporters, penalizes its own consumers, avoids responsibility for difficult actions, and blames the foreigner.

The brawl has been pushed aside – permanently, one hopes – by concern for security, the need for American-Japanese unity to maintain peace in East Asia. That region is today as vulnerable as 1914 Europe to the "militarism and imperialism, racial and cultural rivalries" which so damaged the older global economy.

A final area of mixed economic-political forces: it is possible that the near-instant financial markets have helped restrain inflation in the past decade. It is another case of lower barriers to investment wiping out barriers to market action. Governments perceived as favoring inflation – or not sufficiently opposing it – may be penalized immediately by capital movements and higher interest rates. But the preceding 20 years saw an inflationary surge. I think the financiers' increased use of computer networks was only part of the process. More important in keeping prices stable was the gradual buildup of a worldwide revulsion against continued accelerating price increases.

In many countries, not long ago, there was a kind of social compact or understanding. Since everyone expected prices and wages to keep rising, it made good sense to contract now for higher wages, to keep from losing labor. With higher wages and other factor payments, it was a good bet that prices next year would indeed be higher. The inflationary circle was complete.

I think there is some nostalgia for that old "social compact", the system of channels for permanent inflation. Trade which is out of the loop of any agreement is always disruptive. But "the need to compete in the global economy" means the need to do what competition forces us to do, wherever the source of the competition.

To see changing economic forces at work in a political setting, let me conclude by looking at some of the energy industries in my own country. The lessons apply elsewhere.

The natural gas industry in the United States (and Canada) has been turned upside down. A decade ago, field prices were still under ceilings, and the rest of the industry was a set of hermetically sealed channels running from producers to pipelines to local distributors, with prices set under long-term contracts at each toll gate.

But while producers, pipelines and consumers fought over regulation, the battle appeared ever less relevant. They all had assumed growing scarcity of gas, and had signed "take or pay" contracts for future delivery at extravagant prices. Partial deregulation and more competition forced them to see a fact: increasing volumes of gas at constant or declining costs, hence lower prices.

Complete North American deregulation was less a political choice than an intelligent political reaction to surplus gas and technological advances which made marketing far easier. We are now close to a huge network in which thousands of producing centers, many pipelines and junctions, and hundreds of local distributors are in instant communication, any one with any other. Gas flow is governed by a price system, everything from spot deals to long-term contracts, which is far more sensitive and accurate in registering supply and demand, and doing the job of allocating much more economically.

It did not just happen, and government had to do more than simply get out of the way. Buyers and sellers needed instant access to pipeline systems, who were compelled to pay their way by transporting not owning gas.

In the electric power industry, a similar evolution is under way. Generation is in large plants, of course, but if they can be tied together in a transmission network, it becomes a national market so large that there is room for many competing producers. Transmission will be governed by a pool allowing firms to buy and sell as in a commodity exchange, matching bids and offers. It is harder to accomplish, of course, than a gas network, because unlike gas, electricity cannot be stored. And as with gas, there is a very large amount of "stranded assets", facilities which were built at huge expense to cope with shortages which never arrived. It is a sensitive issue: who is to bear that cost.

Coal, the principal fuel for electricity, has become much cheaper. Mine-mouth ("pithead") prices declined, although coal is like oil a "limited non-renewable resource". More important, deregulation of railroad rates allowed low costs to be translated into a drastic fall in coal freight charges. Low-sulfur coal from the Rocky Mountains became much cheaper in the big coal-burning States.

North America has shrunk. As markets have merged in gas, coal, and electricity, costs and prices are down. This is globalization, seen close up.

There is no better place than Budapest to point out that the technology and basic economics are no different in what General de Gaulle called "Europe from the Atlantic to the Urals." (One difference: in 1966 I wrote that coal in Europe was "no longer an industry, only a means of social insurance.")

As Michael Lynch and I pointed out in 1986, the underlying physical and economic fact is the enormous amount of cheap gas which could be made available to the European market if producers would compete. Small clubby groups find this hard to do. They are, very slowly, shedding the belief that holding back gas is a good investment. It has proved a very bad one. They will begin to compete – slowly, unwillingly, but irretrievably. The Interconnector gas line from the U.K. to the Continent may some day be seen as the thin end of the wedge of a transformation that would greatly benefit the European economy.

"Globalization of the world economy" consists of expanding markets and lower prices and costs. But its political environment in the next decades is not clear.

I mentioned earlier the 25-year period of slow growth in the industrial countries. It certainly is not due to any destructive imports from Asian newcomers, too small even now to have much impact. Much of the high unemployment

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