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God's Diplomacy - International Trade and the Macedonian Economy

By Sam Vaknin, Ph.D.

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by: **Sam Vaknin, Ph.D.**

A British politician, Richard Cobden once (1857) wrote:

"Free Trade is God's diplomacy and there is no other certain way of uniting people in the bonds of peace"

International, free trade is particularly important to developing, poor, countries (among them the "economies in transition").

Without international trade, the local economy is limited. It does not manufacture and produce more than it can consume. If it produces excess products, commodities, or services - no one buys them, they accumulate as inventory, and they bring about losses to the producers and, often, a recession. So, in the best of cases - even assuming optimal management and unlimited availability of capital - a firm in a closed economy can expect to grow by no more than the rate of growth of the local population.

This is where exports mitigate population growth as a constraint.

An export market is equivalent to a sudden growth in the local population. Suddenly, the firm has more people to sell to, additional places to market its products in, an increasing demand which really is unlimited. No firm in the world is big enough not to be negligible in the global marketplace. With 6.2 billion people and 170 million new ones added every year - it is much cleverer to export than to limit oneself to a market with 2, 20, or even 200 million inhabitants. In sum: local firms - and, as a result, the economy as a whole, can increase their production above the level of local consumption and export the surplus.

This, obviously, has the beneficial effect of increased employment. Export oriented industries in economies in transition are labour intensive. The more the country exports - the more its industries employ. This equation led some economists to say that a country exports its unemployment when it exports products. Every product contains a component of labour. When someone buys an imported product - he really buys the labour invested in this product, among other inputs. See the Technical Appendix for more.

But free trade cuts both ways. Some products are so expensive to manufacture locally, that it is more cost effective to import them cheaply. In aggregate, the local economy

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benefits from this more efficient use of its (ever limited) resources.

It has been proved in numerous studies that countries benefit from certain kinds of imports no less than they benefit from exports or the resulting enhancement of local manufacturing. This is called the theory of "comparative relative advantage".

Cheap imports (only as a replacement for expensive locally produced goods) have two additional effects: they reduce the costs of operating enterprises (and thus encourage the formation of businesses) - and, naturally, they reduce inflation. Where cheap products are available - inflation, by its very definition, is subdued.

So, instead of wasting money on purchasing expensive products, which are manufactured locally - instead of paying high interest payments on liabilities due to high inflation - the economy can optimally allocate its resources where they are at their productive best.

Free trade assists the economies of all players. It allows them to optimize the allocation of their (scarce) economic resources and, thus, maximize national incomes.

Optimal allocation frees up sizeable resources which were previously engaged in inefficient production, or dedicated to defraying financing expenses, or locked into the consumption of expensive local products. A consumer allowed to buy a cheap, imported car instead of an expensive locally manufactured one, saves the difference and invests it in a savings account in a bank. The bank, in turn, lends the money to firms - and this is the relation between free trade and high savings and, hence, high investment rates. Free trade reduces the overall price level in the economy, more money can be saved, and the savings can be lent to more businesses on better terms. Plants can, thus, be modernized, technological skills can be acquired, more comprehensive education provided, infrastructure can be improved.

Above all, those who trade do not fight. Free trade pacifies countries. It leads to the peaceful and prosperous coexistence of neighbouring nations. It yields mutual collaboration on trade, investments and infrastructure.

But free trade cannot exist in a legal and infrastructural vacuum. To achieve all these good outcomes a country must rationalize its trading activities.

First and, above all, it must gradually dismantle regulatory and tariff barriers to allow the unobstructed flows of goods, services, products, commodities, and information.

I used the word "gradually" judiciously. A poor country must make the transition from a protectionist environment, heavily isolated by regulations, customs, duties, quotas, tariffs and discriminating standards - to completely free trade in minute, well measured steps. The influence on local industries, the level of employment, the national foreign exchange reserves, interest rates, and many other parameters - economic as well as social - should be gauged regularly to prevent unnecessary shocks. But these monitoring and fine tuning should not serve as fig leaf, they should not be an excuse to prevent or delay the freeing of trade. The country must, unequivocally, announce its plans and intentions, replete with timetables and steps to be adopted. And the country

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must stick by its plans - and not succumb to the inevitable and forceful demands of special interest groups.

On the other hand, the country must encourage foreign investment. (Foreign Direct Investment (FDI) and even portfolio investments are a critical part of free trade. Investors build manufacturing plants, which export their products, or sell them locally, substituting for imports. Direct investors are usually connected - directly or indirectly - to trading networks. Financial (portfolio) investors usually come only much later, when the local capital markets have matured and have become much safer. A country can encourage the inflow of foreign investment by providing investors with tax incentives (tax holidays, tax breaks, even outright grants and subsidized loans). It can provide other incentives - there are too many to enumerate here. Above all, though, it must protect the property rights of investors of all kinds - domestic, as well as foreign. Investors flock to secure places and no incentive in the world can convince them to put their money, where they do not feel certain that they can always - and unconditionally - recover it. Property rights is the countries in transition's weak point in this respect: the appropriate legislation is lacking, courts are slow, ignorant, and indecisive, law enforcement agencies are immature and uncertain of their authorities and how to exercise them. Some countries are outright xenophobic. This is not conducive to foreign investment.

But all this is not enough. A skilled, well educated workforce is a prerequisite for the development of export industries. Even low-tech industries (textiles, shoes) require the workers to be literate and to know basic arithmetic. As industries mature, the workers are required to train, retrain and re-qualify ceaselessly.

The nation must make education as a top priority. education is as much an infrastructure as roads and electricity. To think differently is to be left behind and to be left behind in today's competitive world is to die a slow economic death.

All this will be to no avail if a country does not make an intentional, conscientious effort to identify those things that it is good at, its "relative, competitive advantages".

But should a nation leave the forces of the marketplace to take their course, unhindered? Alternatively, should a government determine the priorities of the nation within a very long term plan?

Personally, I do not support fanatic views. The market has its flaws. It is never perfect. Governments should intervene (marginally) to fix market imperfections and failures. Otherwise, who will supply public goods like defence or education?

The same is true for trading. Japan and Israel are two prime examples of extremely successful government involvement in determining national priorities and in pursuing them (the current slump in Japan notwithstanding). The all powerful Ministry of Industry and Trade (MITI) in Japan virtually dictated what should be done, where, with whom and how for decades. Israel actively encourages the formation of hi-tech, labour-poor, high value added industries. But both governments recognized the limits of their intervention, and the difference between advice, incentives and coercion.

The government of a country should identify its relative competitive advantages and

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re-orient itself to materialize them.

This realization phase can be successful only if the country is an active and complying member of and participant in the international community of nations. It must peacefully and willingly adhere to international agreements on trade and investments and it must agree to resolve its conflicts within the international judicial and arbitration frameworks.

Macedonia is in a difficult economic spot - but it is by no means unique. Almost all the newly-formed countries lost almost all their previous export markets simultaneously. COMECON and the USSR disintegrated almost at the same time as Yugoslavia did. Some countries have not adapted to the new situation:

Their GDP was halved, their industrial infrastructure was demolished and they ran ever-widening trade deficits. They preferred to mourn their situation and blame the whole world for it. Others have oriented themselves to become a (geographical and mental) bridge between East (Europe) and West (Europe). They adopted the Western mentality, Western institutions and Western legislation regarding investments, banking and finance. They emphasized their roles as transit countries in the best sense of the word: having a lot to contribute within the process of transit.

What is common to all the more successful countries is that they encouraged joint ventures with foreign investors, suppressed xenophobia and ethnic discrimination, shared economic benefits with their neighbours by collaborating with them, imported mainly capital goods (instead of consumption goods), adopted sound fiscal policies and really privatized. In most of them, lively capital and money markets have developed.

This is the future that Macedonia should aspire to. It can become the Switzerland of the Balkans. It has all that it takes. Ask the financial markets: they are paying for Macedonian government securities (almost) the same price they pay for Slovenian national debt. That means that they think that Macedonia is the Slovenia of tomorrow.

And that, in my view- is not such a bad future, at all.

TECHNICAL APPENDIX

International Trade, Inflation and Stagflation

Situation I

The exporting country has: An overvalued currency Low inflation or deflation as prices and wages decrease to restore competitiveness

The exporting country thus exports its deflation (through the low and competitive prices of its goods and services) and its unemployment (through the labour component in its exports).

The importing country's inflation rate is affected by the deflation embedded in imported goods and services. Cheap imports thus exert downward pressure on prices and wages

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in the importing country.

This, in turn, tends to increase the purchasing power of the local currency and to cause its appreciation.

In other words:

The macro-economic parameters of the importing country tend to REFLECT the macro-economic parameters of the exporting country.

If the exporting country's currency is overvalued - the importing country's currency will tend to appreciate as a result of the export/import transaction.

If the exporting country's inflation is low - it will exert a downward pressure on wages and prices (on inflation) in the importing country.

Unemployment will tend to decrease in the exporting country and increase in the importing country.

Following the export transaction, the importing country will have: An appreciating currency Deflation or low inflation Higher unemployment

Why would anyone import from a country with an OVERvalued currency?

Because it has a monopoly or a duopoly on knowledge, intellectual property, technology, or other endowments.

Situation II

The exporting country has: An undervalued currency High inflation as prices and wages increase (to restore equitable distribution of income)

The exporting country thus exports its inflation (through the higher though competitive prices of its goods and services) and its unemployment (through the labour component in its exports).

The importing country's inflation rate is affected by the inflation embedded in imported goods and services. Expensive imports thus exert upward pressure on prices and wages in the importing country.

This, in turn, tends to decrease the purchasing power of the local currency and to cause its devaluation.

In other words:

The macro-economic parameters of the importing country tend to REFLECT the macro-economic parameters of the exporting country.

If the exporting country's currency is undervalued - the importing country's currency will

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tend to depreciate as a result of the export/import transaction.

If the exporting country's inflation is high - it will exert an upward pressure on wages and prices (on inflation) in the importing country.

Unemployment will tend to decrease in the exporting country and increase in the importing country.

Following the export transaction, the importing country will have: A depreciating currency (devaluation) Higher inflation Higher unemployment

The state of higher inflation with higher unemployment is called "stagflation". So, in this scenario, the importing country imports stagflation as part of the goods and services it imports.

Sam Vaknin is the author of "Malignant Self Love - Narcissism Revisited" and "After the Rain - How the West Lost the East". He is a columnist in "Central Europe Review", United Press International (UPI) and ebookweb.org and the editor of mental health and Central East Europe categories in The Open Directory, Suite101 and searcheurope.com. Until recently, he served as the Economic Advisor to the Government of Macedonia.
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Monitoring Macedonia

by: **Sam Vaknin, Ph.D.**

Close to 500,000 people - one in four - live under the poverty line in a country where the average monthly salary is less than 150 US dollars. More than one in three members of the workforce are chronically unemployed. With inflation up 5.5% in the last 12 months and taxes - borne disproportionately by the poor and the working class - at 37% of GDP, life is tough in this small, landlocked country. When faced with the choice between raising VAT from 5% to 19% on bare necessities (such as bread and milk), or extending the "temporary" "war" tax (0.5% on all financial transactions) - the finance minister of Macedonia, after an emotional all-night consultation involving the Prime Minister, chose the latter. The "war" tax brought in the equivalent of 2% of GDP (on an annualized basis) since it was introduced in July this year and helped to contain a dangerously soaring budget deficit, now at 9% (and rising) of a shrinking GDP. Yet, the controversial decision to extend it brought on sharp rebukes by local tax experts. The finance ministry also plans to cut expenditures by a further 50 million US dollars.

This gaping hole in public finances is not the result of profligacy. Most of the government's budget is "locked" into paying pensions, state obligations, wages, and other mandatory items. Only 2% are discretionary. The vertiginous 15% of GDP tilt from surplus to deficit is the direct result of the six months of civil war that gripped Macedonia between February and August this year. The damages were direct - in new military spending, increased security expenditures, and about 500,000 US dollars a day used to accommodate and feed c. 80,000 internally displaced citizens, most of them non-Albanian Macedonians. But the war also had indirect consequences. The tax base shrank as GDP collapsed by at least 4-5% and industrial production contracted by 9-10%. The direct damages to the agricultural sector alone are estimated to be c. 100 million US dollars. The textiles sector has suffered even more. At least 17% of the country became physically inaccessible and the panic that gripped the population well into July interrupted tax collection. Tax, customs, and excise revenues, VAT excepted, decreased by 20-40% (!). The government was forced to use some of the proceeds of the sale of the telecom company, Makedonski Telekom, to MATAV.

In an effort to stem the monetary flood and to fend off potential currency speculation (which consumed more than 100 million US dollars of the National Bank's reserves by mid-June) - the central bank was forced to raise interest rates and to absorb excess liquidity. On October 15, one week and two weeks treasury bills (zero coupons) yielded 11% to maturity - and the same bills for 28 days yield 17%, a yield curve which signals distrust in the macroeconomic stability of the country. Eerily, after a brief, speculation driven, spurt, the currency settled to its 4 years old average exchange rate of 31 to the DM and 67 to the US dollar.

In its ten years of independence - mostly due to external shocks such as trade sanctions and wars - Macedonia has developed a chronic case of acute trade deficit, equal to c.

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15% of GDP (c. half a billion US dollars annually). Luckily for it, unilateral transfers - remittances by expatriates, international aid and grants, international credits, and growing, though small, foreign direct investment - served to ameliorate the problem. The World Bank alone has invested more than 550 million US dollars in Macedonia since 1991. But a sharp collapse in exports (by c. 20%), coupled with increased foreign exchange expenditures on weaponry, and the drying up of Albanian remittances (at least through official channels) - have exacerbated the financing gap that Macedonia faces from a projected zero to more than 100 million US dollars in 2001.

The Macedonian side has a vested interest in exaggerating both the damages of the civil war and its financing needs. Macedonia, to its great detriment, has long been addicted to foreign aid. Nor does it seem to have any coherent plan to cope with the crisis - ad hoc, stopgap, measures notwithstanding. The IMF was forced to place Macedonia under "Staff Monitoring" - the equivalent of freezing of all credit arrangements with the fund for a period of 6 months. This, though, does not prevent Macedonia from reverting to a standby arrangement down the road, or from participating in a donor conference.

Actually, Macedonia has received more financing and pledges for financing during the first 9 months of 2001 than during the comparable period last year. Spain has promised to finance the "Lera" hydroelectric power station. Italy has granted Macedonia 4 million US dollars in "urgent financial aid". The EU has earmarked 198 million euro to remedy war damages. The EU CARDS program (project financing) was signed (43 million euro). The World Bank added 37 million US dollars to 3 new projects since March 2001and has disbursed 15 million to projects already approved. And this is a partial list.

Yet, the majority of these funds - whether approved or pledged - are conditioned upon the fulfillment of the August 13th Ohrid Framework Agreement between the Macedonian and the Albanian political parties. The EU has made it abundantly clear that its financial assistance will be withheld if what it calls "Macedonian intransigence" continues. A donor conference, already postponed three times, had to be put off yet again indefinitely (though the World Bank expresses unfounded optimism regarding a date sometime in December). Such a conference is supposed to tackle Macedonia's balance of payments needs and the costs of reconstruction and implementation of the Framework Agreement. With each postponement, Macedonian disappointment and xenophobia grow. The West is seen widely as interested mainly to assist the Albanians at the expense of all other segments of the population. The euphoria that gripped Macedonia after the September 11 attacks on the USA ("now they will understand what it means to confront terrorism") - has evaporated. It was replaced by grim realism. The USA and the EU are bent on securing a pacified Macedonia. The IMF and the World Bank are subject to political considerations, constraints, and arm twisting. The economy is fast deteriorating. Macedonia has very few choices.

Sam Vaknin is the author of "Malignant Self Love - Narcissism Revisited" and "After the Rain - How the West Lost the East". He is a columnist in "Central Europe Review",

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