An Evaluation of the Devaluation

By Sam Vaknin, Ph.D.

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A Minister of Finance is morally right to lie about a forthcoming devaluation and a woman has the right to lie about her age. This is the common wisdom.

Rumours about a devaluation of the Macedonian Denar versus the major currencies were in the air during the last few weeks. Still, no government official had to lie. The market just did not believe it. The unofficial exchange rate stayed put at 27 MKD to the Deutschmark even as the devaluation was taking place.

This is strange. Devaluation rumours are usually reflected in the street exchange rates. The MKD has held its turf against other currencies in the last three years. A devaluation seemed like a reasonable proposition - or was it?

Why do governments devalue?

They do it mainly to improve the balance of trade. A devaluation means that more local currency is needed to purchase imports and exporters get more local currency when they convert the export proceeds (the foreign exchange that they get for their exports). In other words: imports become more expensive - and exporters earn more money. This is supposed to discourage imports - and to encourage exports and, in turn, to reduce trade deficits.

At least, this is the older, conventional thinking. A devaluation is supposed to improve the competitiveness of exporters in their foreign markets. They can even afford to reduce their prices in their export markets and to finance this reduction from the windfall profits that they get from the devaluation. In professional jargon we say that a devaluation "improves the terms of trade".

But before we examine the question whether all this is true in the case of Macedonia - let us study a numerical example.

Let us assume that we have a national economy with for types of products:

Imported, Exported, Locally Produced Import Substitutes, Locally consumed Exportable Products. In an economy in equilibrium all four will be identically priced, let us say at 2700 Denars (= 100 DEM) each.

When the exchange rate is 27 MKD/DM, the total consumption of these products will not be influenced by their price. Rather, considerations of quality, availability, customer service, market positioning, status symbols and so on will influence the consumption decision.

But this will all change when the exchange rate is 31 MKD/DM following a devaluation.

The Imported product will now be sold locally at 3100. The Importer will have to pay more MKD to get the same amount of DM that he needs to pay the foreign manufacturer of the product that he is importing.

The Exported products will now fetch the exporter the same amount of income in foreign exchange. Yet, when converted to MKD - he will receive 400 MKD more than before the devaluation. He could use this money to increase his profits - or to reduce the price of his product in the foreign markets and sell more (which will also increase his profits).

The Locally Produced Import Substitutes will benefit: they will still be priced at 2700 - while the competition (Imports) will have to increase the price to 3100 not to lose money!

The local consumption of products which can, in principle, be exported - will go down. The exporter will prefer to export them and get more MKD for his foreign exchange earnings.

These are the subtle mechanisms by which exports go up and imports go down following a devaluation.

In Macedonia, the situation is less clear. There is a great component of imported raw materials in the exported industrial products. The price of this component will increase. The price of capital assets (machinery, technology, intellectual property, software) will also increase and make it more difficult for local businesses to invest in their future. Still, it is safe to say that the overall effect of the devaluation will favour exporters and exports and reduce imports marginally.

Unfortunately, most of the imports are indispensable at any price (inelastic demand curve): raw materials, capital assets, credits, even cars. People buy cars not only to drive them - but also in order to preserve the value of their money. Cars in Macedonia are a commodity and a store of value and these functions are difficult to substitute.

But this is all in an idealized country which really exists nowhere. In reality, devaluation tends to increase inflation (=the general price level) and thus have an adverse macro-economic effect. Six mechanisms operate immediately following a devaluation:

The price of imported products goes up.

The price of goods and services, denominated in foreign exchange goes up. An example: prices of apartments and residential and commercial rentals is fixed in DEM. These prices increase (in terms of MKD) by the percentage of devaluation - immediately! The same goes for consumer goods, big (cars) and small (electronics).

Exporters get more MKD for their foreign exchange (and this has an inflationary effect).

People can convert money that they saved in foreign exchange - and get more MKD for it. A DEVALUATION IS A PRIZE GIVEN TO SPECULATORS AND TO BLACK MARKET OPERATORS.

Thus, the cost of living increases. People put pressure on their employees to increase their salaries. Unfortunately, there is yet no example in history in which governments and employers were completely successful in fending off such pressures. Usually, they give in, wholly or partially.

Certain countries tried to contain such wage pressures and the wage driven inflation which is a result of wage increases.

The government, employee trade unions and representatives of employers' unions - sign "economic pacts or package deals".

The government undertakes not to raise fees for public services, the employers agree not to fire people or not to reduce wages and employee trade unions agree not to demand wage hikes and not to strike.

Such economic pacts have been very successful in stabilizing inflation in many countries, from Israel to Argentina.

Still, some of the devaluation inevitably seeps into the wages. The government can effectively control only such employees as are in its direct employment. It cannot dictate to the private sector.

Inflation gradually erodes the competitive advantage awarded to the exporters by the devaluation which preceded it. So devaluations have a tendency to create a cancerous chain reaction: devaluation-inflation followed by more devaluation and yet by more inflation.

Arguably, the worst effect of a devaluation is the psychological one.

Macedonia has succeeded where many other countries failed: it created an atmosphere of macro-economic stability. It is a fact that the differential between the official and non-official exchange rates was very small (about 3.5%). This was a sign of trust in the macro-economic management. This devaluation had the effects of drugs: it could prove stimulating to the economic body in the short term - but it might be harmful to it in the longer term.

These risks are worth taking under two conditions:

That the devaluation is part of a comprehensive economic program intended to stimulate the economy and mainly the export sector.

That the devaluation is part of a long term macro-monetary plan with clear, OPENLY

DECLARED, goals. In other words: the government and the Central Bank should have designed a multi-year plan, stating clearly their inflation objectives and by how much they are going to devalue the currency (MKD) over and above the inflation target. This is much preferable to "shock therapy": keeping the devaluation secret until the last minute and then declaring it overnight, taking everyone by surprise. The instinctive reaction is: "But if the government announces its intentions in advance - people and speculators will rush to take advantage of these plans. For instance, they will buy foreign exchange and put pressure on the government to devalue by dilapidating its foreign currency reserves".

If so, why didn’t it happen in Israel, Argentina, Chile and tens of other countries? In all these countries, the government announced inflation and devaluation targets well in advance. Surprisingly, it had the following effects:

The business sector was able to plan its operations years in advance, to price its products properly, to protect itself by buying financial hedge contracts. Suddenly, the business environment became safe and predictable. This had an extremely favourable micro-economic effect.

The currency stabilized and displayed qualities normally associated with "hard currencies". For instance, the New Israeli Shekel, which no one wanted to touch and which was immediately converted to US dollars (to protect the value) - became a national hit. It appreciated by 50% (!) against the dollar, people sold their dollars and bought Shekels - and all this with an inflation of 18% per year! It became a truly convertible currency - because people could predict its value over time.

The consistency, endurance and resilience of the governments in implementing their macro-economomic agendas - made the populace regain their trust. Citizens began to believe their governments again. The openness of the government, the transparency of its operations and the fact that it kept its word - meant a lot in restoring the right, trusting relationship which should prevail between subjects and their administration.

That strict measures are taken to prevent the metamorphosis of the devaluation into inflation. The usual measures include a freeze on all wages, a reduction of the budget deficit, even temporary anti-import protective barriers to defend the local industries and to reduce inflationary pressures.

Granted, the government of Macedonia and its Central Bank are not entirely autonomous in setting the economic priorities and in deciding which measures to adopt and to what extent. They have to attune themselves to "advice" (not to say dictates or conditions) given by the likes of the IMF. If they fail to do so, the IMF and the World Bank will cut Macedonia off the bloodlines of international credits. The situation is, at times, very close to coercion.

Still, Macedonia could use successful examples in other countries to argue its case. It could have made this devaluation a turning point for the economy. It could have reached a nationwide consensus to work towards a better economic future within a national "Economic Agenda". It is still not to late to do so. A devaluation should be an essential part of any economic program. It could still be the cornerstone in an export driven, employment oriented, economy stimulating edifice.

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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Finding Your True North
by: **John Assaraf**

Okay Friends,

It's time for a 'check up from the neck up'! It's time for an evaluation in each area of your life.

Some of you may be saying 'I don't need one!'

Well, you may be right. And you may not be.

But you know what they say? The best time to go see the doctor is to have a preventative plan, not a recovery plan.

So, with that said, fill in all of the TRUE NORTH Evaluation Forms provided below and in the book, “The Street Kid’s Guide to Having it All” and you'll get a REAL snapshot of the mental diet you've been on.

You can get them right here (they are in Adobe PDF format):
http://www.thestreetkid.com/downloads/OPR_True_North.pdf

or if you prefer zipped files:
http://www.thestreetkid.com/downloads/OPR_True_North.zip

Here are the various areas you'll be able to assess in "Finding Your True North:" Accomplishments Strengths Perceived Weaknesses Mental Health Evaluation Physical Health Evaluation Spirituality Evaluation Relationships Evaluation Financial Evaluation Career/Business Evaluation

The results in every area of your life are in direct proportion to your past thinking and conditioned mind.

If you love the current results then great. If you don't...you may want to consider some changes!

Remember to Create a Great Life!

John Assaraf, aka The Street Kid, a New York Times & Wall Street Journal Best-Selling Author, Trainer & Entrepreneur. Go to: http://www.thestreetkid.com to discover his "Secrets To Building A Multi-Million Dollar Business – Guaranteed!" Go to: http://www.TheStreetKid.com/seminars to register for your No-Cost eCourse, "The Science Of Making Tons Of Dough."
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