

## Abstract

### EXCHANGE RATE OF THE DENAR IN AN EXPORT ORIENTED DEVELOPMENT STRATEGY

Macedonia, as a small country has a generally accepted determination to develop as an open economy. This is a prerequisite for rational inclusion of the national economy in the international division of labor, and such an orientation is also a prerequisite for achieving permanent and sustainable development. The results of this development, however, suggest that the economy has seen low growth rates and high unemployment, though ever increasing trade deficit and external debt. The reasons for the unsatisfactory results are in inappropriate export oriented development strategy.

The adverse effects of the current level of exchange rate and possibly indulging it to fluctuate in the direction of depreciation imposed to stop the fruitless debate about any devaluation of the currency of any further consistent defense of the fixed exchange rate. It is high time the exchange rate of national currency to be addressed as a price that is crucial in the determination of the economic entities for directing the current production and build new capacity for export. It means to find a "balanced exchange rate" within the export-oriented development strategy. Moreover, the burden of price competition does not fall only on the level of the exchange rate but also on a number of measures to encourage the development of certain activities and branches in order to achieve greater export effects.

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### EXCHANGE RATE OF THE DENAR IN AN EXPORT ORIENTED DEVELOPMENT STRATEGY

#### I

The increasing trend of the foreign trade deficit and the foreign debt of the Republic of Macedonia preoccupy the scientific community and the public at large for a long time now. In addition, in spite of the growth of the debt, the country still faces low growth rates, high unemployment and high level of poverty. These deficits are typical for underdeveloped countries and developing countries such as the Republic of Macedonia. One problem, however is that the foreign debt increase does not lead to intensified growth which in turn could lead to better servicing of the debt. The acquisition of debts to foreign entities in order to fulfill the consumption requirements in the country is a trap that temporarily provides social peace, but cannot avert tensions that will arise the moment the possibilities for taking on new debt have been reduced and the old debt has to be repaid.

The awareness of the unsustainability of the foreign disbalance is present in the country. On multiple occasions it was pointed out that the problem of the foreign trade deficit should not be resolved by “shortening the long leg” (restrictions in imports) but by “extending the short leg” (increase exports). This means that, as a small country aspiring to enter the European Union Macedonia should continue to fulfill the obligations for liberalization of the relations with abroad achieving price stability as a basis for rational inclusion of the economy in the international division of labor. These are the core guidelines in both the Development Strategy of the Republic of Macedonia and the Export Strategy of the Republic of Macedonia<sup>1</sup>.

However there is a problem that in spite of the mentioned strategies and the achievement of the general commitment to the development of an open economy (sanctioned by declaring foreign convertibility of the denar) the Macedonian economy cumulates foreign disbalance that threatens, at a certain point in time, to jeopardize the price stability and the foreign exchange rate of the denar, because internal stability cannot be sustained without balancing the foreign economic relations, synthesized in a harmonious payment balance.

**Table**  
**Selected economic indicators of economic movements in the period 1999-2009**

	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009
Real GDP growth rate (%)	4.3	4.5	-4.5	0.9	2.8	4.6	4.4	5.0	6.1	5.0	-0.9
Inflation (end of period)	2.3	6.1	3.7	1.1	2.6	-1.9	1.2	2.9	6.1	4.1	-1.6
Budget balance (% of GDP)	0.0	1.8	-7.2	-5.7	-1.1	0.0	0.2	-0.5	0.6	-0.9	-2.7
Current account balance (% of GDP)	-1.8	-2.9	-6.8	-10.1	-4.0	-8.4	-2.7	-0.4	-7.4	-12.6	-6.5
Coverage of imports with foreign currency reserves (monthly)	2.8	3.8	4.8	4.0	4.2	3.5	4.4	5.3	4.6	3.3	4.9
Trade balance (million DENAR)	-496	-691	-527	-806	-851	-1139	-1063	-1260	-1638	-2589	-2157
Unemployment rate	32.4	32.2	30.5	31.9	36.7	37.2	37.3	36.0	34.9	33.8	32.2
Foreign debt (million USD)	1502	1548	1494	1641	1841	2079	2275	2411	-	-	-
Debt servicing (million USD)	157	187	206	235	250	247	234	510	-	-	-
Gross foreign debt (million USD)*						2830	2983	3297	4174	4658	5420

Source: Core economic indicators for the Republic of Macedonia, NBRM, updated as of 31.01.2011

\*The data have been calculated according to a new methodology. These types of data for previous years are not available.

<sup>1</sup> The strategies have been developed and discussed in the Macedonian Academy of Arts and Sciences (MAAS).

The above mentioned threat imposes the need to reconsider the reasons for the unsatisfactory growth dynamics and for the generation of foreign disbalance.

There are no researches or comments that question the commitment to develop an open and export oriented economy. For a small and underdeveloped market economy, opening to foreign influences is a prerequisite for rational inclusion of the national economy in the international division of labor, and that is a precondition for achieving a lasting and sustainable development. This knowledge also does not affect the lack of satisfactory results from the development so far, because it is more and more obvious that the problem is not in the choice of the strategy, but in the model used to operationalize the strategy. In that context, the problem is located in the building and functioning of an active export policy (including an efficient import substitution).

The results from the development thus far indicate that the Republic of Macedonia does not have an efficient export oriented development policy. To corroborate this one may consider the data that show a decline in the coverage of imports with exports, and growth of the trade deficit in the GDP. In a successfully implemented policy of export driven growth, that would not happen. There are very few new products in the lists of exported products. Why is there no interest in increasing the export production?

There is no doubt that the reasons for the inefficiencies in the achievement of the undisputed export oriented development strategy are in the model of its operationalization.

The key assumptions for achieving the goals of the macroeconomic policy of the country (including a satisfactory growth of GDP, increase of employment and reduction of unemployment, harmonizing the relations with foreign entities), after the signing of the Stabilization and Association Agreement with the EU are: sustain the price stability in the country and stability of the foreign currency exchange rate of the denar and gradual liberalization of the economic relations with foreign countries. In such an environment, the economic entities can achieve their interest to improve the material and financial situation of the companies only by increasing labor productivity and cost-effectiveness of their operations, including measures and activities for restructuring of production in accordance with the prices in the country and abroad, through the foreign currency exchange of the denar.

The stabilization policy declaration nipped in the bud the inflationary expectations as an option to continue existing on the market without having to undertake the mentioned activities to improve the qualitative commercial factors. This commitment was sealed by declaring the foreign convertibility of the denar in June 1998 and with the strict enforcement of the monetary and credit policies of stabilizing the foreign currency exchange rate between the denar and EUR (monetary policy of targeting the foreign currency exchange rate) as a nominal anchor of internal stability.

This monetary policy concept, based on sustaining the foreign currency exchange rate between MKD and EUR, together with the obligation to sustain the convertibility status of the denar (including possibility to convert denars in current as well as capital transactions), aimed at stimulating the inflow of foreign capital in the country. This mechanism provided guarantees for foreigners to convert their MKD profits into EUR or other convertible currencies without any risk of possible devaluation of the denar. It is no accident that the first significant foreign investments in Macedonia are in banking, telephony (fixed and mobile), electricity distribution and other services (earning profit in

denar) and there are very few foreign investments in new, export oriented capacities. It is about the interest of investors. The implementation of the monetary policy of targeting the foreign currency exchange rate of the denar (policy that boils down to defending a fixed exchange rate) generates greater interest rates in the countries than abroad, which, without any doubt attracts “hot” capital. In addition, the guarantee for conversion of profits at a fixed rate only reduces the risk of investing if the earnings are in MKD. However, one has to have in mind that this mechanism, if the foreign currency exchange rate becomes overestimated due to shifts in the ratios between prices in the country and abroad, will have an adverse effect on the domestic and foreign investors and their investments in production targeting foreign markets and imports become more lucrative.

## II

The application of this concept of stabilization was expected and, unfortunately without providing any rational argumentation<sup>2</sup>, is still expected to lead to the achievement of the goals of the macroeconomic policy. The long term stagnation of the growth, the high unemployment and poverty, the growth of the foreign trade deficit and the foreign debts suggest that one should reconsider the present development model and build a different model that will yield the expected results. In particular because the country is still far from acceding to NATO and this is an important if insufficient precondition for a more noticeable inflow of foreign investments. Therefore it is very important to see the reasons for the failure to achieve the development goals in spite of the consistent effectuation of price stability in the country and sustaining the stability of the foreign currency exchange rate of the denar.

If we exclude the lack of expected inflow of foreign capital, the reasons for foreign balance, an in turn for the unsatisfactory growth and development can be located in the unrealistic determination of the foreign currency exchange rate of the denar. This conclusion is corroborated by the fact that foreign trade deficit is continuously growing. At the same time the foreign debt of the country also grows, although there is an increase of the net current transfers. That there is something wrong with the inter-currency value of the denar was shown by the devaluation of the national currency in 1997, before undertaking the obligation to sustain the convertible status of the denar. It was rightfully pointed out that the objective of the devaluation was to provide for greater price competitiveness of the national economy on the foreign markets, which should have provided for harmonizing the economic relations with foreign countries and entities, as a prerequisite to sustaining the fixed foreign currency exchange rate of the denar. However, in spite of the devaluation, the creation of the deficit and the “building” of the debt continued in the subsequent years.

Theoretically speaking, there is no doubt that the establishment of a higher price for EUR in MKD would lead to a shift in the economy to greater sales on foreign markets, and this would also provide for disincentives for importers whose number grows continuously. This could lead to more balanced foreign economic relations. However, it is difficult, at this point, to determine the level of the foreign currency exchange rate that

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<sup>2</sup> The National Bank of the Republic of Macedonia still stands by its opinion to strictly implement the monetary policy of targeting the foreign currency exchange rate of the denar, irrespective of the consequences arising from this, and the Government of the Republic of Macedonia continues to hope for an inflow of foreign investments which would capsize the development dynamics.

will generate more balanced relations. Certain international experiences suggest that “a balancing foreign currency exchange rate” can be determined if, for a period of time, the value of the national currency is left to be determined on the foreign currency market, and once it stabilizes on a certain level where the relations with foreign entities are balanced (of course, for an underdeveloped country such as Macedonia, such a balance also includes the deficit that could be financed from foreign entities, and which the country has no problem servicing) to shift to a policy of sustaining a fixed exchange rate towards the currency used in most of the international transactions and therefore increase the qualitative factors of doing business in the country. From this point of view, today we can say that the application of a fixed exchange rate of the denar had been premature. Moreover, the effects of this on the commercial entities had not been practically tested (it was shown that imports are promoted and exports are discouraged).

Truth be told, in this context we need to mention that the “ballpark” estimation of the level of exchange rate of the denar was influenced in part by the knowledge that an increase in the underestimation of the value of the national currency leads to a reduction of the value of the national production expressed in foreign currencies. Political elites, not only here, but also in most countries, are not prepared to face such a valorization of the national production. Even more significant is that devaluation is done through a redistribution of national income in favor of export oriented (foreign currency earning) entities at the expense of those that have MKD revenues. The import “lobby”, as a rule, in the less developed democracies (countries) has more power to fight for its interest, especially due to the fact that country itself is a debtor of foreign countries and entities. This can easily be seen from the argumentation in favor of the stability of a fixed foreign currency exchange rate of the denar, in the past few years, in spite of the deterioration of the foreign balance in the country. Almost always there was greater understanding of the interests of importers and entities that had foreign currency debts, followed by “caring” for the population in the sense that the depreciation of the value of the denar would increase the prices in the country and reduce the standard of living, the debtors would have to set aside more denar funds in order to pay for their foreign currency debts.

There is no doubt that the consequences from reducing the value of the national currency are adverse. However, from the point of view of achieving the long term development objectives, these consequences are smaller than the lack of the inevitably export oriented growth of the country. The policy of ensuring social peace only delays the real solution of the problems with the economic development and foreign relations.

In this context one must not have illusions that a constant shift of the foreign exchange rate towards depreciation will overcome the problems facing the country. This approach is also one sided. Probably it will lead to a certain balance of the foreign relations, but will aggravate the relations in the social protection sphere. The macroeconomic policy in Macedonia, for several years now faces the challenge of modifying the development strategy with a view of creating export oriented economy, as well as modifying the economic policy that relies on the fixed exchange of the denar as a nominal anchor of the internal stability. In the past period, it could be seen that this policy generates low growth rates, unemployment and foreign disbalance, and the exit valve – the long expected foreign investments, did not function (due to numerous reasons, as well as the overestimated exchange rate of the denar when we talk about new investments in export oriented production). After the significant de-industrialization

(closing of numerous industrial capacities) and the insufficient interest for foreign direct investments, the only thing that remains, failing the above mentioned changes, is to “export” labor. However, here we have even bigger problems due to the uncertainties regarding the integration of the country in NATO and the EU.

### III

The adverse effects from an established fixed exchange rate of the denar on one hand and a fluctuating exchange rate with a depressing trend impose a need to stop with the vain discussions either for devaluation of the denar or to continue with defending the fixed exchange rate of the denar. It is high time to approach the exchange rate of the national currency as to a price that is of crucial importance for the economic entities when they determine the direction of their production and building of new capacities. Its level will determine the extent to which the economic entities will orientate themselves to foreign markets or domestic markets. It goes without explaining that the capsizing of the development of the country depends on whether proper economic conditions will be provided to stimulate a more emphasized export orientation. Other things which are unacceptable are the continuous depreciation of the value of the denar in order to provide price competitiveness of the domestic economy on the foreign markets, but also the long term defense of the fixed exchange rate of the MKD with respect to the EURO in spite of the increase of the foreign trade deficit and the growth of the foreign debt of the country. During the debates “for” or “against” one of the mentioned alternatives Macedonia lost at least one decade of its development, and, what is even worse, the restructuring of the economy in the direction of an export driven growth was suppressed. The possibility to achieve a permanent and sustainable development is in the achievement of an export driven growth.

These arguments suggest that it is high time to instigate coordinated activities to seek out the “balancing foreign currency exchange rate” of the denar. According to the definition of Professor Majhsner “the balancing foreign currency exchange rate must fulfill the following conditions: 1) the payment balance must remain balanced during a period of five to ten years and at the end of that period it should not show any significant modifications in the monetary reserves, 2) this balance in the international payments should be achieved without applying any import restrictions, 3) the balance must not be achieved at the cost of unemployment in the country.”<sup>3</sup>

The definition suggests that it is essential to first determine the foreign currency exchange rate of the denar as “a balancing exchange rate” within an export oriented development strategy, because only such a strategy can generate equilibrium of the payment balance, maintenance of a satisfactory level of foreign currency reserves and growth of the employment. According to the provisions of the Statute of the International Monetary Fund, the determination of the level of the balancing exchange rate одредбите must not make use of multiple foreign currency exchange rates (different exchange rates for different products or activities) or direct stimulations of the achieved exports. However, the rules of the World Trade Organization allows numerous measures for stimulating the development of specific activities or branches with a view of achieving greater export orientation. This has to do with applying measures with limited scope:

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<sup>3</sup> Vjekoslav Majhsner: Foreign monetary stability and instability, script for the third degree on the Faculty of Economy, Skopje, 1966, p.56.

profit tax exemptions for a certain period of time; full exemption from payment of customs duties on raw materials, equipment and spare parts; provision of more favorable loans to finance the export cycle and modernization of the capacities etc.

It is very important to use this in the future policy to support exports from Macedonia, because this will help avoid the unnecessary devaluation of the national currency with the intent to achieve price competitiveness on the market. The application of the above mentioned measures presupposes building of a clear export oriented development strategy of the country. This means, not a list of all products produced in the country, but only of those products which have possibilities to increase their scope and quality and which are in demand on the foreign markets. In this context, it is necessary to develop a methodology to support the export in order, with fewer subsidies, to provide for export feasibility and to ultimately increase the exports. It is high time to take the increasing amount of funds for subsidies (increase these amounts if there is a need) and put them to work in support of export oriented production, rather than using them to directly mitigate the aggravated social tensions. This does not mean that the latter segment should be completely eliminated. However, it is essential to make it smaller and through supporting export, increase production for export and thereby the employment and standard of living of people working in export oriented activities (this will contribute to reducing the need for social subsidies). Objectively, not everything which was produced in the country can be or should be exported. Support, in addition to the export related production, should also be given to the type of production which requires the least amount of support from society to increase and substitute imports and thus contribute to balancing the foreign trade.

There is no doubt that by applying measures of support of export oriented production, the level of the balancing foreign currency exchange rate of the denar will be lower than if we only depreciated the denar in order to provide for competitiveness of export to an extent that will have an effect of reducing the foreign trade deficit. This will help mitigate the dangers related to “pure or naked” devaluation of the Macedonian denar which directly affect the import dependent economy and debtors that owe foreign currencies (as well as the consumers of imported goods, of course), and opens up a process of restructuring of the economy based on export support.

Looking at the above mentioned export support measures we can see that these are one time or temporary measures which ensure (by reducing the costs for starting up or increasing export production) that a potential export oriented economy is feasible and competitive on foreign markets from the very beginning, with an obligation to sustain and improve its operations by improving the qualitative factors of doing business.

Possible bed estimates of the level of the “balancing exchange rate of the denar” (in combination with the devaluation rate of the denar and the measures for export support and appropriate protection policies) can be tested by abandoning the fixed exchange rate approach and applying one of the forms of fluctuating exchange rates. After some time of having this fluctuating exchange rate of the denar on the foreign currency market, based on the supply and demand of foreign currencies, it will be shown whether the estimated foreign currency exchange rate was actually the balancing exchange rate. Then, if such an exchange rate, after a period of 3 to 5 years generates balance of the foreign relations, the fixed exchange rate of the national currency can be reinstated, with a clear alternative for bankruptcy of the entities that are not able to

provide satisfactory material and financial performance on domestic or foreign markets. In this case, we can say that the country is not only prepared to integrate in the EU, but also to be included in the Eurozone.

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