NATIONAL BANK OF THE REPUBLIC OF NORTH MACEDONIA

Resilience to global headwinds? CESEE responses to changing trade and financial landscape – focus on the Macedonian economy[1]

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Abstract

This analysis is aimed at investigating the response of the CESEE economies, and especially of the Macedonian economy, to the changing global environment in the latest period, predominantly to the recent challenges coming from the global trade and financial landscape. It offers a historical overview of the trade and financial linkages between these countries and the EU, as well as the EU largest economy - Germany, with a further focus on the growing importance of the Global Value Chains for the trade integration between the CESEE region and Germany. More detailed perspective is given for the Macedonian economy, through the recent change in the trade and production structure, driven by the deeper integration into the GVCs in the last decade. Additionally, a short overview of the recent trade disputes between the US and China is given, focused on the potential adverse effect on the global and EU economy, as an increasing external risk for the prospects of the domestic economy and the region as a whole.

[1] The views expressed in this paper are those of the author and do not necessarily represent the views of the National Bank of the Republic of North Macedonia.

Resilience to global headwinds? CESEE responses to changing trade and financial landscape – focus on the Macedonian economy

As of the beginning of the early 90s of the last century, rapid expansion in global and regional trade occurred. Trade liberalization and removal of tariff and non-tariff barriers was a process in particular pertinent to the Eastern European Bloc, as an important cornerstone of the overall transformation towards fully functional market economies. The EU accession supported and enhanced greatly the overall trade and financial integration of these economies. CESEE[2] countries followed a process of significant structural and political reforms and one of the stepping-stones of the transformation was the opening of their economies to free trade and capital movement, as one of the founding principles of the EU.

At the same time, the world trade was going through increased fragmentation of production, also known as "vertical specialization". It resulted in much higher trade volumes of intermediate inputs[3], resulting in dramatic shift more than 20 years later, when half of world-manufactured imports are intermediate goods and more than 70 percent of world services imports are intermediate services (OECD, 2012). The new opportunities from the changing trade environment in Europe, and broadly in the world, had led to increased vertical specialization and buildup of the regional and global value chains. Firms were given the option to easily shift part of their production, or outsource it, harvesting the gains of wage differences, productivity, more conducive business laws and taxation systems[4].

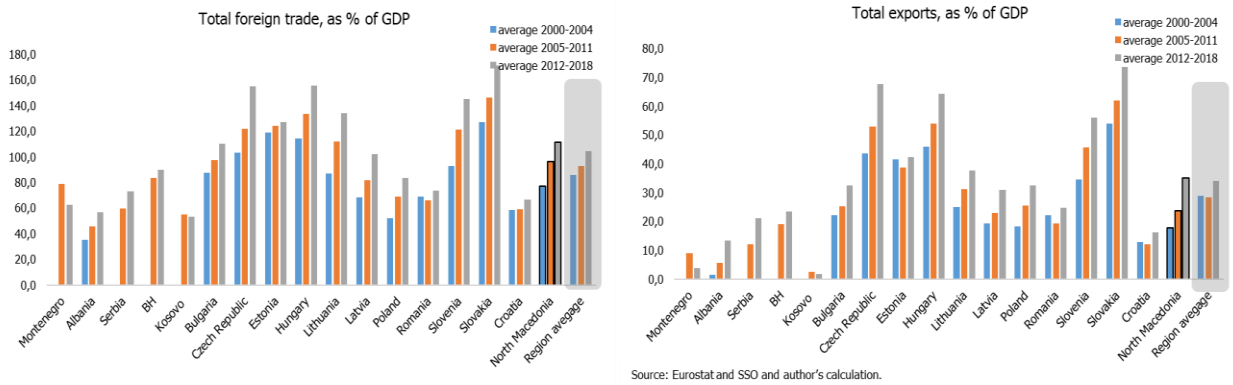
For the economies in the CESEE group, the changing global landscape opened possibilities for faster growth and convergence towards western economies. The Central European countries, including the Visegrad Four[5], pioneered in both trade and financial integration with the EU economy, due to the faster reform process, as well as cultural and sectoral similarities and the geographical proximity, especially with Germany. Since the early 90s, they have built strong supply chains with Germany, and the EU in general. The strongest link in this supply chain has been the automotive industry, mostly the outsourcing of the strong German

[2] This analyses focuses on the following CESEE countries: Bulgaria, Czech Republic, Estonia, Hungary, Lithuania, Latvia, Poland, Romania, Slovenia, Slovakia, Croatia, North Macedonia, Montenegro, Albania, Serbia, Bosnia and Herzegovina and Kosovo.
[3] German-Central European Supply Chain—Cluster Report—First Background Note—Trade Linkages, Augustyniak et al., IMF (2013).
[4] German-Central European Supply Chain—Cluster Report—First Background Note—Trade Linkages, Augustyniak et al., IMF (2013).
[5] Czech Republic, Hungary, Poland and Slovakia.

automotive industry, a process that was largely supported by greenfield FDIs in the manufacturing sector.

The income and wage convergence of these Central European countries, in parallel with bolder reforms in the Western Balkan countries, have shifted the interest from foreign investors to the group of SEE countries. The last decade has been particularly vibrant for the Macedonian economy as well, as it also entered the global supply chains, in a similar manner as some of the CEE countries. Many of the benefits gained by the more advanced CESEE EU member states are coming to the fore in the Macedonian economy, as well. The greater integration into the global value chains was predominantly driven by the new facilities in the free economic zones, most of them in the automotive industry with direct or indirect linkages with the German industry. These changes in the last few years have further opened the economy, increasing the trade openness from 108.7% of GDP in 2008 (before the structural changes) to 126.1% of GDP in 2018. Additionally, the deeper involvement in the global value chains increased the share of export of goods in GDP by 14.8 percentage points in the last ten years, from 39.8% of GDP to 54.6% of GDP in 2018. Currently, these two indicators bring the country on the average level of the region as a whole. In terms of the export share, it is closer to the average of the CEE countries of 74.1% in 2018, than to the Western Balkan group average (excluding North Macedonia an average of 21.2% of GDP).

Figure 1

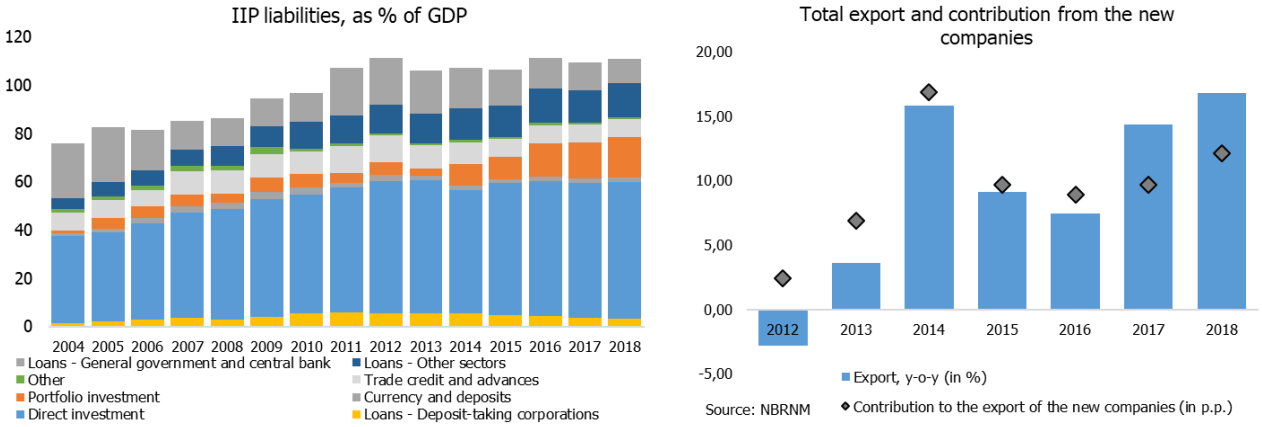


Source: Eurostat and SSO and author's calculation.

Similar to the CEE experience, inflows of foreign direct investments in the tradable sector supported greater trade integration with the EU. This process reduced the exposure of the economy to external shocks, through the diversification of the export structure, and lesser reliance on export dependent on commodities prices. The decomposition of the IIP liabilities

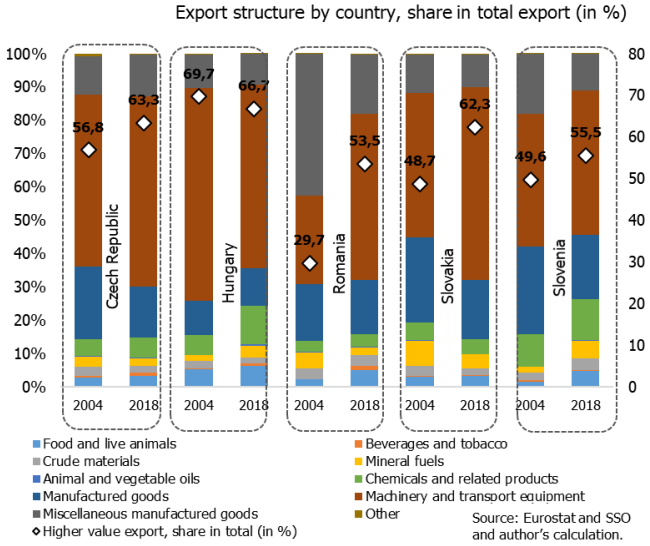
reveals dominance of FDI liabilities, with nearly 40% of the FDI stock in 2017 being in the manufacturing sector, and visible increase of the FDI share in motor vehicle production.

Figure 2



The stronger integration, into the global supply chains, has enhanced the resilience of the Macedonian export, making it less vulnerable to commodity price fluctuation. The export of the new companies, most of them integrated into the supply chain of the German automotive industry, has been the main driving force behind the strong export performances in the last five years. The exports of these companies have increased by nearly six times since 2011[6], and their net-exports reduced the trade deficit markedly.

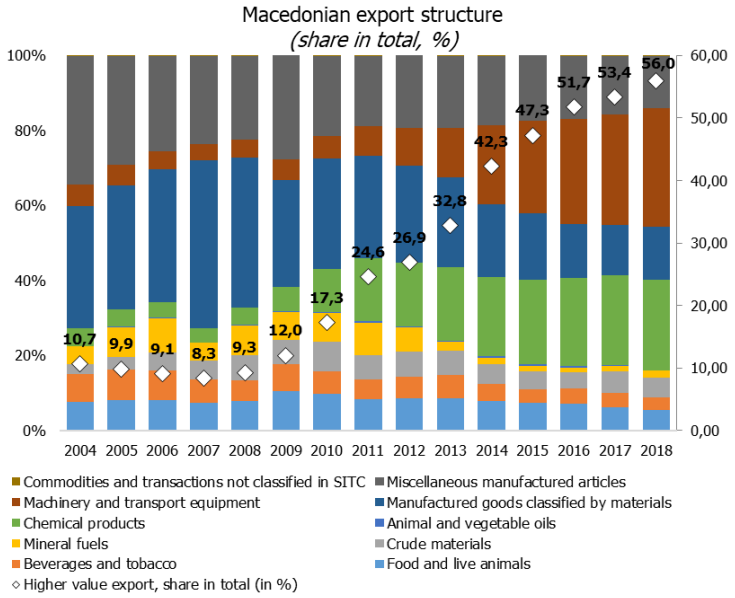
Figure 3



[6] 2011 is considered as a starting point for analyzing the export performance of the new FDI based capacities in the domestic economy.

The structural shift in the export, analyzed by the Standard International Trade Classification (SITC) categories, shows a significant increase in the share of higher-value products, specifically machinery and transport equipment and chemical products, while significantly reducing the relative importance of traditional export sectors like iron and steel, food and tobacco and textile exports. Similar to the experience of the CESEE EU member states, the deeper integration into the global value chain has shifted greater export share towards knowledge intensive sectors, which include transport and electrical equipment, machinery and chemical products – the driving force behind the export growth in the period 2013-2018. The structural change in the export of the domestic economy is more than obvious. Current share, as in 2018, of higher-value export is 56%[7], compared to 9.6% in 2008, a rise of 46.7 percentage points.

Figure 4

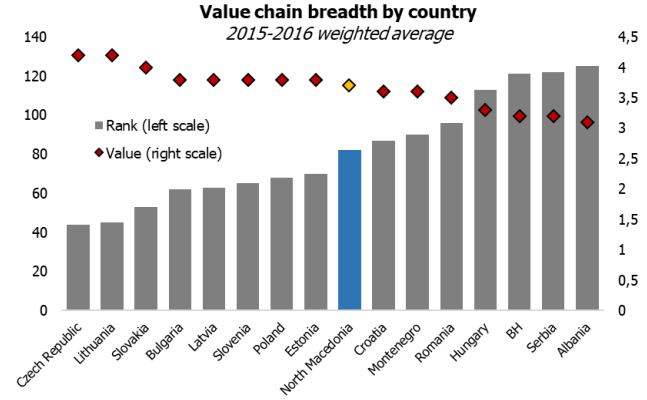


The export diversification process resembles few high performing CESEE countries, such as Czech Republic, Hungary, Slovakia, Slovenia, and in the last couple of years, Romania. Significant portion of these economies export is classified as machinery and transport equipment and chemical products, as most of them are integrated into the global value chains through the Germany's automotive industry. The share of higher-value exports of 56% in the total Macedonian export is getting closer to the more advanced CESEE economies, like Czech Republic with 63.3% share in 2018, Hungary – 66.7%, Slovakia - share of 62.3%, Slovenia and Romania

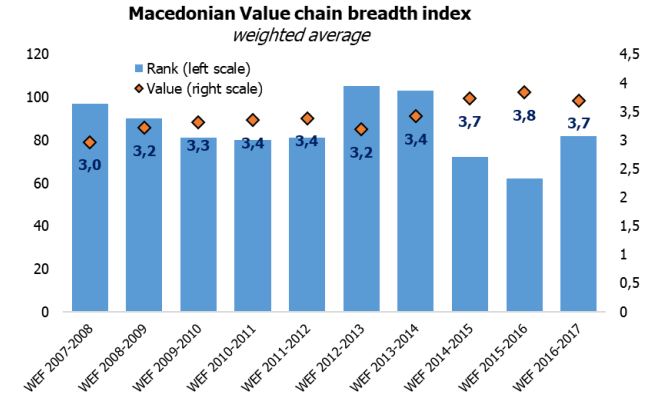
[7] Including machinery and transport equipment and chemical products exports.

with 55.5% and 53.5% respectively[8]. Comparably, the Western Balkan average share (excluding North Macedonia) is below 30%.

Figure 5



Value meaning 1 = narrow, primarily involved in individual steps of the value chain; 7 = broad, present across the entire value chain; 2015–16 weighted average. Source: World Economic Forum, Executive Opinion Survey.



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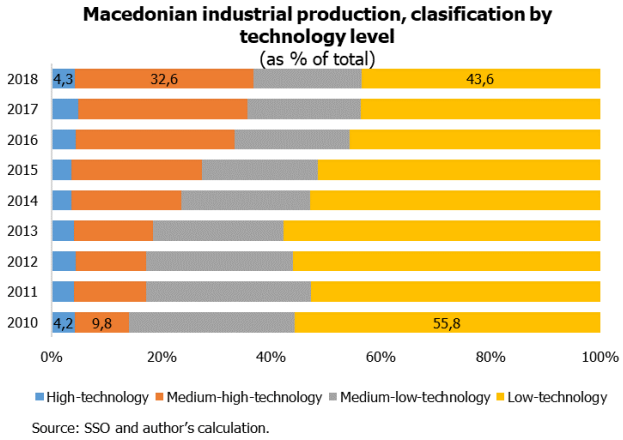


Source: SSO and author's calculation.

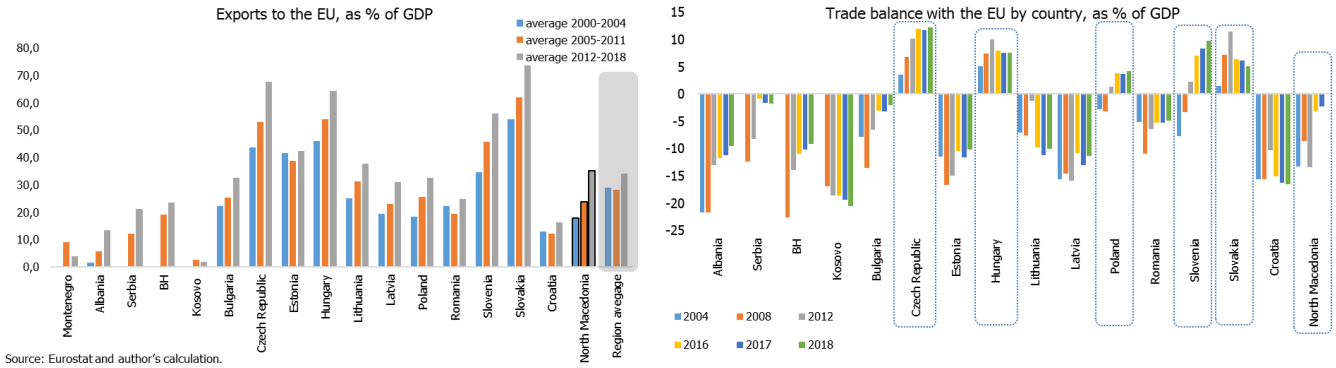
The proximity to the CEE region is visible by two additional indicators. Namely, the World Economic Forum *value chain breadth* indicator[9] shows broader presence across the entire value chain of our economy (amounting to 3.7) compared to the Western Balkans region. The latest 2015-2016 weighted average data rank North Macedonia almost equally to countries like Bulgaria, Latvia, Slovenia, Poland and Estonia (index of 3.8). Additionally, a significant positive gain from the deeper integration into the GVC is the redistribution of the industrial production towards sectors with higher technology levels, especially in the middle-high-

[8] Calculations are based on the same product categories.

[9] Value meaning for a specific country refers to companies' presence in the value change, ranging from narrow to broad presence. Value of 1 means narrow presence, companies are primarily involved in individual steps of the value chain (e.g. resource extraction or production); while value of 7 means broad presence, across the entire value chain (e.g. companies do not only produce but are included in marketing, distribution, design, etc.). Countries are ranked by the value chain breadth and lower ranking shows that the country is broadly present in the value chain, e.g. Czech Republic with rank of 40 is better ranked than Estonia (70).

technology sectors were the share has increased from 9.8% in 2010 to 32.6% in 2018, reflecting the decline of the relative importance of low and medium-low-technology sectors.

Figure 6

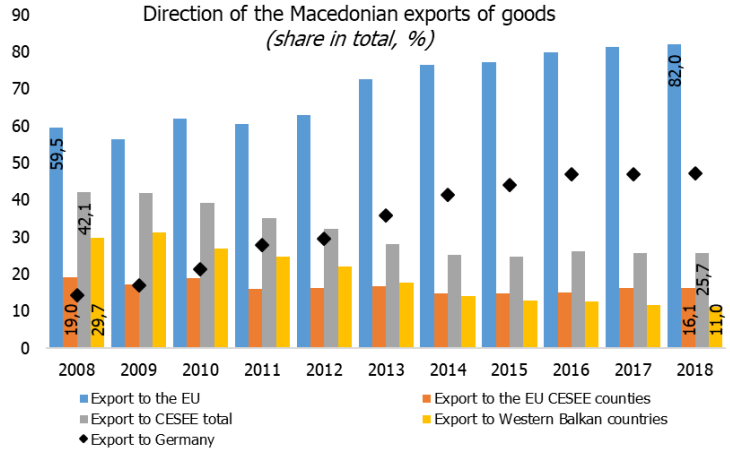


Source: Eurostat and author's calculation.

The experience of the EU member states in the CESEE group has confirmed that the best route to prosperity for small countries is to integrate with the global economy. It is not only a question of selling into overseas markets, but tapping into overseas investment, expertise, and economies of scale. Rebalancing away from domestic consumption towards investment and exports creates a more sustainable growth model for a small landlocked economy. Hence, finding a place in the global or regional production chains is fundamental for future growth and prosperity[10]. Given the geographical location, the EU is a dominant trade partner that is one of the main preconditions for having the pegged exchange rate of the denar against the euro. The latest available trade data for 2018 show that 62.4% of the imports comes from EU countries and as much as 82% of the domestic exports is directed to the EU. The gains are more pronounced on the export side, where the share of the EU directed export in the total exports has increased by 34% since 2002, from 61% to 82% in 2018. Or, as a share of GDP, the relative importance of the export to the EU increased from 17% of GDP in 2002 to 45% in 2018.

[10] The Western Balkans: Revving Up the Engines of Growth and Prosperity, World Bank, 2017.

Figure 7



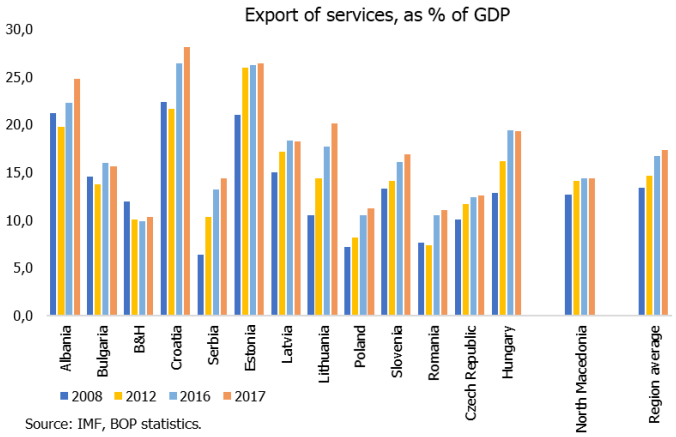
In parallel with the closer trade linkages with the EU, and Germany on the export side in particular, the importance of the neighboring region as a trade partner was reduced. In the last ten years, the share of exports to the Western Balkans region have almost halved. Downward trend is evident in the relative importance of the total CESEE region directed exports. The lack of CESEE regional integration can be explained by the high concentration of the export towards Germany, evident in all major countries in the region (with the exception of Albania and Montenegro). Considering that most of the region's economies are moderately to highly integrated into the German supply chain, the problem of lack of regional trade integration can be scrutinized through supply chain linkages among all these economies, that is a more complex research question for the future.

The Macedonian trade model brought substantial benefits, but certain challenges are also present. The concentration of the export in a specific industry and trading partner can cause greater vulnerability in times of stress of the specific industry and export destination. **Hence, the main challenge is the need for diversification towards higher-value, technology driven export that will further reduce the economy's vulnerability and will also increase the transfer of technology and know-how in the domestic economy**. Still, it should be pointed out that conventional trade statistics tend to overestimate exposures within a supply chain due to the high prevalence of trade in intermediate goods. According to Augustyniak et al. (2013), Germany's exposure to the EU analyses by using the value added (VA) embodied in total exports percent is significantly below the implied exposure under directions of trade statistics, while its exposure to the rest of the world is much higher. The same applies to the exposure of CEE'4 exposure to Germany, that is overestimated by the standard trade statistics,

while the exposure to the rest of the world is suppressed in its importance. It is due to the fact that substantial fraction of CEE exports passes through Germany, before being exported outside the EU. Given some of the similarities of the Macedonian economy with these countries, the same might apply to the domestic economy as well.

In order to maximize the benefits of the increased integration into the GVC, stronger backward linkages with the local economy should be exploited. Due to the short time span and lack of data and detailed research in the area, it is hard to present comprehensive overview for this matter in the case of North of Macedonia. The IMF 2015 Country Report[11] showed that the main reason for limited backward linkages is the inability of domestic small and medium companies to meet the EU technical and safety standards and requirements. Similarly, the EU Progress Report, 2015, shows large differences in the technological levels of the domestic and foreign firms as a reason for lack of any measures undertaken so far for multinational companies sourcing in the domestic economy. Further export diversification can also be achieved through a **stronger focus on the services sector, telecommunication, computer and information services, in particular.** Positive shifts are visible in this domain in the last couple of years, but still the share of the exports in services compared to the region average lags behind.

Figure 8



On a more general note, strengthening current and building potential comparative advantages of the economy is needed in order to respond to challenges. While geographical location of the country and the strong and stable trade linkages with the EU are

[11] IMF Country Report No. 15/243, The FYR Macedonia, Selected Issues, September 2015.

considered an important comparative advantage, it is mostly relevant in comparison with countries outside the CESEE region. Favorable business climate, simple and favorable tax system, as well as supportive government towards foreign investments have been considered as an advantage of the country. Yet, considerable reforms are needed for strengthening the comparative advantages of the economy. Apart from the above-mentioned need for diversification of the economy and the exports in particular, reforms are needed to improve the overall environment, by increasing the quality of institutions, infrastructure, human resources and overall governance. We provide comparative ranking of several structural indicators according to the latest Global Competiveness Report, to illustrate the room for improvement.

Figure 9

		Institutions	Infrastructure	ICT adoption	Health	Skills	Business dynamism	Innovation capability
CEE	Czech Republic	60	84	66	88	74	70	57
	Hungary	54	78	61	81	68	57	48
	Poland	57	79	54	86	73	61	49
	Slovakia	56	78	68	84	69	65	47
	Slovenia	63	77	66	92	73	70	58
SEE	Bulgaria	54	70	70	80	65	60	44
	Croatia	52	77	60	86	63	56	38
	Romania	58	71	67	80	62	60	40
	Serbia	52	73	57	81	68	61	40
	Albania	54	57	52	87	69	64	32
	Bosnia and Herzegovina	46	61	46	85	58	53	28
	Montenegro	55	62	57	85	68	63	35
	North Macedonia	51	64	54	80	59	61	31
Baltic	Estonia	70	75	77	85	78	69	53
	Latvia	58	73	80	79	74	64	42
	Lithuania	61	75	76	79	73	65	47
CESEE		**56,3**	**72,1**	**63,2**	**83,6**	**68,4**	**62,4**	**43,1**
EU15		**69,9**	**85,1**	**69,9**	**95,5**	**78,5**	**72,3**	**70,5**

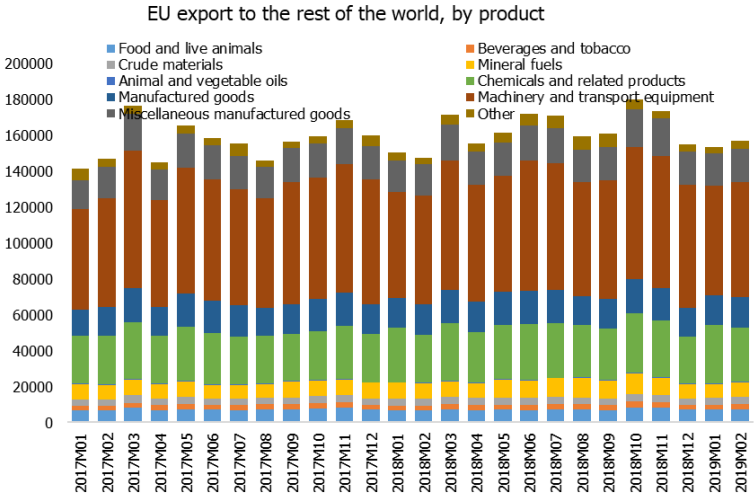
Source: Global Competitiveness Report 2018.

Aside from the challenges pertinent to the Macedonian economy, related to the local business environment and intrinsic to the current stage of development, a potential threat to the overall export-oriented growth model are the latest global trade disruptions. The protectionism friendly environment, with the increase of non-tariff as well tariff barriers can seriously disrupt the global trade and acts as an important setback of the global growth prospects[12]. Considering the uncertainty of how protectionism will evolve, and to what extent it will curb overall globalization, it is very hard to evaluate its potential impact. Rising

[12] The current US-China trade dispute that started by the introduction of tariffs on solar panels and washing machines in January 2018, followed by tariffs of 25% on imports of steel and 10% on imports of aluminum for a wide range of countries in March 2018 (including the EU since June 2018). While there has been some smoothening between the US and EU tensions, the dispute between the US and China has since escalated, with further introduction of tariffs on both sides.

protectionism can affect the economy through several channels[13], first and foremost through the **direct trade channel**, where higher import duties increase trade costs, altering quantity and price of international goods. Additionally, higher trade costs can affect **financial flows and credit conditions**, by increasing uncertainty and causing financial stress, followed by scarce financing, tighter credit conditions and postponement of investment. The impact is conditioned on the specifics of the economy, such as the trade openness, inclusion in the Global Value Chains (GVCs), export structure, the ability to substitute foreign for domestically produced goods, the level of financial integration.

Figure 10



Source: Eurostat.

Assessing the impact of the growing protectionism on the Macedonian economy is not straightforward. The potential adverse effects are expected to be indirect, through the EU growth, as the dominant export destination of the Macedonian export. The latest estimates, including the ECB[14] and the BdF[15], predict that the US will suffer the most through lower GDP, greater financial volatility and higher prices. While the impact on China and the EU GDP is not expected to be large in the short run, general reduction of global trade as well as rising cost of capital and increased uncertainty will incur losses to all the economies. Additionally, higher

[13] Gunnella, V. and Quaglietti, L. (2019), The economic implications of rising protectionism: a euro area and global perspective, ECB Economic Bulletin, Issue 3/2019, April 2019.

[14] Gunnella, V. and Quaglietti, L. (2019), The economic implications of rising protectionism: a euro area and global perspective, ECB Economic Bulletin, Issue 3/2019, April 2019.

[15] Berthou, A. et al. (2018), Costs and consequences of a trade war: a structural analysis, Banque de France, Rue de la Banque No. 72, December 2018.

import duties will incur loss of productivity and competitiveness for all countries integrated into the global trade.

Table Model-based simulations for themacroeconomic effects of trade wars - overview

Type of analysis	Estimated effects
Paul Krugman: a generalised tariff increase of between 30-60 percentage points	Global real GDP loss of 2% to 3% over the long term
French Council of Economic Analysis: a 60 percentage points increase in import tariffs	3% to 4% decline in real GDP in large economies in the long run
Banque de France analysis: a 10 percentage points increase in import tariffs from all trading partners	Permanent loss of GDP of more than 4% for the EU, and around 3% for China and the United States i.e. an annual average loss of Euro 1,250 per capita in the EU
ECB analysis: a 10% increase in US' tariff and non-tariff barriers against imports from all trading partners (and assuming that the other countries retaliate symmetrically)	1% decline in global GDP; 2.5% of US GDP; and neutral effect of EA

For a small open economy, such as the Macedonian economy, highly integrated into the global value chain and reliant on external financing, the adverse effects might be amplified. The broken link of international trade would almost certainly cause **disruptions in the export**, but additionally put **pressure on prices** by increasing the import costs. Due to the complexity of the global value chains the goods cross borders several times, causing tariff costs to accumulate, as a result of tariffs on intermediate goods. The final effect is significantly higher price of the final goods when they reach the consumer. Additionally, the financial distress and the high volatility can create **external financing difficulties** for the economy, causing **credit shortages and investment delays**. *Tighter financing conditions associated with growing uncertainty can increase the cost of capital, with a negative impact on investment that could* ***hinder productivity growth*** *in the countries affected by the tariffs. Trade barriers can also lead to the misallocation of production factors across firms and countries.* Empirical studies have found strong connection between trade openness and higher income per capita, increasing the trade openness helps in reducing poverty globally[16], hence by reducing the world trade and the individual country's trade openness, **growth in inequality and loss of welfare** is expected.

[16] The Role of Trade in Ending Poverty, The World Bank and World Trade Organization, 2015.

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Structural changes in the export sector brought the Macedonian economy closer to the global value chains, increasing the country's trade openness, shifting the production towards higher-value sectors and increasing the export share of higher-value products. Yet, numerous challenges are ahead, some arising from the inevitable broad structural reforms and some coming from the global surrounding and the rising protectionism. Recent escalation of the US-China trade war and the potential further escalation leading to interferences in the global value chains is a big challenge for small open economies. Decades of promoting free trade, leading to greater trade and financial integration in the world and even more pronounced in the EU, has benefited the CESEE region in numerous ways, increasing the wellbeing of their citizens and reducing the poverty in the region. **Potential serious disturbance in the world and regional trade can lead to reversal of the positive gains the region has witnessed so the need for further reforms to increase the resilience of the economy is even more pronounced.** Trade and financial integration among the numerous benefits, also pose certain risks mainly by increasing the vulnerability of the economy to external shocks and disturbances. So in order to shield the Macedonian economy from the vulnerabilities coming from the external environment **additional reforms are needed, predominantly focused on increasing productivity, achieving further production and also export diversification, on higher value added products; greater focus on the service sector and its export potential.**

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