The Role of Economic Diplomacy in Enhancing National Competitiveness

INTRODUCTION

Economic diplomacy is the term that has gained some importance among both academics and practitioners quite recently. In most publications on diplomacy it is underlined that economy, practically until 90s XX century, was regarded only as an “accessory” to the core work of professional diplomats. They used to focus mainly on politics-related issues, classifying other activities within the broad range from culture promotion and consular aid to domestic trade promotion into a second category. However, in contemporary, globalized world, economy has become a key issue influencing the international state of affairs and relations between the countries. In such circumstances there is an urgent need for the recognition of economic diplomacy as a vital instrument of states’ foreign policy. Beside international trade, spectrum of its interests includes: investments, capital flows, financial aid, bilateral and multilateral economic negotiations, technological exchange, state’s brand management and other factors which shape the country’s international image and its position on a global economic scene. What is more, as the economies of certain countries have become more open to the outside world and the international division of labor have intensified, the role of economic diplomacy will inevitable grow, replacing the traditional, primarily forceful, ways of settling interstate conflicts [Carron de la Carrière, 1998].

This article aims at pointing the relevance of economic diplomacy applied at micro and macro levels of economic activity, emphasizing its role in enhancing national competitiveness. It is underlined that economic diplomacy has been underused and limited only to macroeconomic factors of national competitiveness. In contrast, the article presents the arguments for economic diplomacy to operate in close relations to microeconomic factors of competitiveness. The thesis suggests that more attention should be given to the potential role of economic diplomacy not in state-to-state relations but state-enterprise relations and enterprise-enterprise relations (business facilitation between cross-countries private enterprises). The author’s conceptualization is based on a desk research and a literature review.
The reminder of the article is organized as follows. Firstly the definition of economic diplomacy is discussed. The next part provides the theory of competitiveness of nations. Then, the author combines the two theoretical frameworks, presenting a model of economic diplomacy in the light of competitiveness. Summary and concluding remarks are in the final part.

**Definition of the terms discussed**

In the paper several issues will be discussed which need a clear definition in order to avoid potential misunderstandings or too broad possibility of interpretation.

First of all, for the purpose of the research the author will refer to Melissen’s concept of diplomacy, which has been defined by him “as the mechanism of representation, communication and negotiation through which states and other international actors conduct their business” [Melissen; 1999, pp. 16–17] and which presents a broader perspective on diplomacy, characteristic in post-modern times. What is worth mentioning, such a definition of diplomacy does not limit it only to a state mechanism but allow incorporating under the term’s spectrum of interests non-governmental actors such as i.e. business organizations, lobbying agents, NGOs and TNC (Trans-national corporations).

Secondly, the term “economic diplomacy” shall be defined. In the paper the author will refer to economic diplomacy in the broader sense, where it is defined as diplomacy “concerned with economic policy issues i.e. work of delegations at standard setting organizations such as WTO and BIS” and employing economic resources like sanctions or rewards in order to achieve certain foreign policy objectives (“economic statecraft”); [Berridge, James, 2001, p. 81], and as the “work of diplomatic missions in support of the home country’s business and finance sectors in their pursuit of economic success and the country’s general objective of national development, which includes the promotion of inward and outward investments as well as trade” (which is sometimes referred to as commercial diplomacy).

In the literature the concept of “new economic diplomacy” can be often encountered in order to emphasize how economic diplomacy has changed recently and to contrast the diplomacy which is practiced nowadays with the mode it was perceived until the processes connected with the collapse of bipolar system in world geo-politics. In the article, however, the author propose to use the term “economic diplomacy” which makes use of all its tools and prerogatives within the certain paradigm. Economic diplomacy, with contrast to pure political one, is very market-sensitive. As the market conditions change, the need to modify economic diplomacy arises. The instruments need to respond the most current need and innovation in economic diplomacy is crucial in order to stay up to date with actual global and domestic situation. Having in mind above
mentioned element imported to economic diplomacy definition, it seems obvious that it is a subject of a continuous change to adjust to its operational conditions.

In the research the author would also continue the line of academics who analyze economic diplomacy as the integrated form of diplomacy- the one “where the lines of division between functional areas are blurred, each sector influences the other” [Rashid, 2010].

**NATIONAL COMPETITIVENESS THEORY**

The theory of states competitiveness has been at the center of economic research from the beginning of its existence as an academic discipline, having its roots in A. Smith's “The Wealth of Nations” (1776) and D. Ricardo’s “On the Principles of Political Economy and Taxation” (1817).

The majority of the studies on the competitiveness of nations concentrate on aggregate, economy-wide measures such as a balance of trade. One of the exceptions to the mainstream theory has been presented by M. Porter in his books and other publications connected with the theory of competitive advantage of nations, within which he embarks from the micro level analyzing individual industry’s and competitors’ contribution to the economy as a whole. He states that these are not nations that compete in the marketplace but firms and that the performance of individual companies in particular industries determines whether a competitive advantage is gained. Porter recognizes several sources of competitive advantages and although he reverses the distribution of power in growth generating factors from macro to micro level he does not withdraw from the concept that the government and home citizens influence the ability of domestic firms to succeed in particular industries. In a longitude study, Porter has analyzed major industrial powers (the United States, Japan, and Germany), plus other European and Asian countries different in size, government policy toward industry, social philosophy, geography, and region. Each case was studied separately (taking special interest in internationally competitive companies) and resulted in identification of a set of conditions in the home country which appeared favorable to the development of its industry. On the basis of Porter's research four determinants were chosen as the most vital. Their interaction was presented in a form of a “diamond”: firm strategy, structure and rivalry; factor conditions (e.g. natural resources); demand conditions; and related and supporting industries. Porter's “diamond” is further influenced by chance events and government action. The study has shown that there is no standard set of national conditions favorable to all industries and has been enhanced with possible implications for company strategy, government policy, and the national agendas. Various studies of national competitiveness contributed to institutionalization of
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The problem and a wide usage of measurements, while analyzing countries’ global standing. The popularity of the competitiveness benchmarking at the country level such as Global Competitiveness Reports, World Competitiveness Yearbooks, and National Competitiveness Reports is an indicator of growing interest in comprehensive frameworks and data for competitiveness-related decision-making.

Competitiveness approach to national growth and development shed a new light on the potential real role of economic diplomacy. Existing research usually relates diplomacy to macroeconomic factors and analyzes it from international relations and geo-politics perspectives. However, according to an alternative concept on national wealth understood as “created at micro-economic level of economy, rooted in the sophistication of actual companies as well as in quality of microeconomic business environment in which a nation's firms compete” [Porter, 2000], it may be much more useful and of practical value to relate economic diplomacy to micro-economic factors of growth and concentrate on its role in enhancing states’ business environment and availability of business information.

The competitiveness-related model of economic diplomacy

In a contemporary world, economic diplomacy may serve as one of the most effective ways to realize national economic interests. Analyzing it from different perspectives and using different definitions, still the common conclusion could state that “economic diplomacy” implies diplomatic efforts concentrated on confirming the country’s economic interests at the international level. In this respect, it is very important to use national competitive advantages, as well as specialization and cooperation in production to achieve the country’s overall short-term and long-term strategic goals.

In order to make use of competitive advantages and contribute to growth in national competitiveness, economic diplomacy must also require a realistic and profound economic research to evaluate state's opportunities and elaborate the methods for handling the competitive advantages that are available.

According to the literature review presented in previous sections of the article, the basis of competitiveness is to possess a specific advantage over competitors. Particularly precious one is when it is an exclusive possession, not available for anyone else. Such advantages may include:

- technological advantages, which enable to produce new products, products characterized by novel/better features or produced using lower costs
- financial advantages, resulting from access and ability to use own or international sources of capital
- managerial and marketing advantages
- resources-abundance-related advantages (access and use of cheaper factors of
productions; access to cheaper/high-educated, etc. labor force; access to cheap natural resources)
• other advantages: better information/communication networks; better infrastructure

Another competitive advantages classification presented by Prahalad and Hammel in “The Core Competence and the Corporation” [Prahalad, Hammel, 1990] distinguish between three main types of competitive advantages resulting from: a) core competences, such as technological advantages b) value-creating activities such as managerial and organizational innovations and c) bidding law regulations, such as privileged access to natural resources. Current studies emphasize the transformation from hard to soft competitive advantages, concentrating on knowledge and information-based ones, including: technological advantages, ability to creating own know-how, innovations management, innovation clusters development, brand management and generally marketing advantages [Porter, 1999; Dunning, 1993; Drucker, 1999].

Bearing in mind above mentioned, there is a logical connotation between general aims of economic diplomacy policies announced by governmental bodies and the sources of competitive advantages. To combine these two a model of an efficient economic diplomacy, grounded in competitiveness theoretical framework is to be presented. Knowing various sources of competitiveness may be particularly useful for economic diplomacy policy-makers, who may take advantage of its different levels to tailor an individual country-specific course of action in order to optimize the outcomes and the use of tools in economic diplomacy.

**Graph 1. Determinants of competitiveness**

Traditionally, economic diplomacy is associated with state's activity on macroeconomic level and natural resources management. Several case studies show the vast impact of economic diplomacy on first getting access to and later management of natural resources [Bahgat, 2003; Magerramov, Rustambekov, 2010]. State intervention and policy in this area can be described as resources diplomacy and is connected with the concept that in an economic diplomacy the crucial thing is to identify factors which bring the highest payoff in the short and long term. Without any doubt natural resources and especially raw energy resources, like oil and gas are the most obvious and relatively easy factors states wish to obtain on international markets in order to increase their production capacity [Magerramov, Rustambekov, 2010]. Case study on Azerbaijan reveals that oil is a raw material, the production of which is generated in combination with the technology used. Due to the fact that raw resources are mainly concentrated in economically underdeveloped areas of the world, while technical-technological capabilities are found in the industrially developed countries, the flow of raw material to the centers of its intensive use is an objective process. Accompanied by the reverse movement of goods often manufactured using this raw material, energy and industrial cycles appear to complement each other in today’s international economic system. Countries that are able to carry out both of these cycles, thus developing the national economy, will naturally ensure the most favorable opportunities in economic and social development and in self-assertion in the widest geo-economic sense of this word. In order to optimize the use or access to raw materials and obtaining necessary technology if not domestically available, economic diplomacy should be used [Magerramov, Rustambekov, 2010]. That is the basic reason why economic diplomacy is widely applied in the context of natural resources. Moreover, using diplomatic tools in resources management deliver the most spectacular examples (USA’s oil diplomacy in Persian Gulf, Russia’s gas diplomacy, etc). Undoubtedly, resources diplomacy, using mixture of tools, also from political spectrum contribute to the first sort of national competitive advantages – natural endowments. The role is higher the more resources-in-need the country is.

The second level of national competitive advantages – the macroeconomic one has been as well traditionally addressed by economic diplomacy policy makers. Macroeconomic activity involving states operation within multilateral organizations, global economic forums, regional platforms, bilateral agreements, etc constitutes the core of economic diplomacy and the key area of its interest. Main instruments – export promotion agencies, special units in embassies, consulates and states visits have been launched in both developed and developing countries to enable and ease their cross-national economic activities – exports, imports, FDI, financial flows, tourism or foreign aid. Several studies [Rose, 2007, Lederman et al., 2006] conclude that economic diplomacy instruments used for export facilitation and promotion do have an impact on state's overall trade.
The least obvious spectrum of interest of economic diplomacy are microeconomic competitive advantages, divided by M. Porter to quality of national business environment, state of cluster development and sophistication of company operation and strategy. However, these are the ones which according to recent studies contribute to stable and sustainable development [Porter, 2006]. The main fear of economists concerning state involvement in economy is the fear of inefficient allocations, the export promotion policies pursued by economic diplomacy may lead to over/under consumption and over/under production. However, they do allow public intervention in case of market failures, in situations when free market for some reasons do not produce efficient outcomes, when it cannot generate an efficient allocation of goods and services. Market failures are usually connected with informational imperfections (asymmetry between sellers and buyers, too costly information, incomplete, false information), transaction costs or agency problems (moral hazard, adverse selection), imperfect competition (market power) and various types of externalities, characteristics of certain goods (public goods), inertia and uncertainty [van Veenstra, Yakop, Bergeijk, 2010]. In international relations context market imperfections are also connected with barriers to trade. According to Ramaswami and Yang analyzing obstacles encountered by exporters four main categories of barriers can be identified: informational (lack of export knowledge), internal resources constraints (human resources, financial), procedural (language, cultural differences, red tape), exogenous (fluctuations in the exchange rate, taxation, corruption, etc). Many features of developing countries - lack of institutions, poor quality standards, poor infrastructure, lack of transparency, etc as well existing strong protective regulations make it sometimes impossible or very difficult to obtain by foreign companies to enter the market. Restrictive policy in giving permissions, posing additional restrictions and controls do not enable the cooperation either. All these market malfunction examples prove the rationale behind economic diplomacy. In this context economic diplomacy can ease the entrance and operation on the foreign market, which requires a good knowledge of foreign legislation, cultural differences, local peculiarities and business contacts in order to increase the chance of a success. According to some studies in order to export the investment in information has to be made, the investment that cannot be recovered unless the export initiative is successful. On the other hand if the initiative brings positive outcomes it motivates the competitors to follow the line (copycat behavior). Hausmann and Rodrik suggest that an enterprise will invest only if it has certainty its project will provide a competitive edge. Otherwise, especially if it is observed by competitors who want to benefit from information and operation pattern that has been already applied, in other words – free-riders, the firm is far less motivated to invest [Hausmann, Rodrik, 2003]. In consequence the market uses to under-provide 'trade knowledge capital' that can be identified as a public good. In fact, private enterprises invest too little in
trade-relevant information, what may give a rationale for public intervention, which in case of foreign trade analysis can include economic diplomacy activity.

In microeconomic environment economic diplomacy operates on different than traditionally perceived level. It is not state-to-state but state-private enterprise relationship. This type of relationship is much more market dependent because private firms are run in order to achieve private and not national interests. Moreover, companies in market economy cannot be forced to operate in preferable for a state way, they can only be encouraged. In case of realization state’s cross-national interests, firms may be given the right and efficient incentives to for example start exporting. When the state is interested in its firms to export or launch business enterprise, the role of embassies and consulates are recognized not only as state representation but also as “the eyes and ears” in the host country. Their informational role eases the process of overcoming market failures- they are located in or in proximity of export markets (embassies, consulates) and in exporting country (trade promotion agencies) serving as a source of information for domestic firms willing to internalize or foreign firm willing to enter the market. The trend of increase in number of promotion agencies has been observed over the years. They activities may be divided into four categories: country image building, export support services, marketing, market research and publications [Lederman et al., 2006]. Above mentioned services prove the swift in modern economic diplomacy, which operates closer to the market and which through its instruments supports internationalization of private enterprises, improves performance of internationalized firms, participates in country's positive image building and generally increases the country's competitiveness. Trade promotion agencies can also alleviate information problems, distinguishing between information problems for companies that try to enter new markets abroad or sell there the new products (extensive margin) and companies that are already exporting and attempt to increase the volume of their exports (intensive margin) [van Veenstra, Yakop, Bergeijk, 2010 after Volpe Martincus and Carballo, 2008]. This fact can show the usefulness of economic diplomacy's provided information, which according to Rose lost its importance with the drop of communication costs and easier access to information from other countries [Rose, 2007]. It seems that by adjusting “information picking and analyzing” ways and rationale behind, economic diplomacy's entities can in a positive and efficient way respond to the need of private investors.

On the other hand, in order to fight with other market imperfections, not related with problems with information, state should remove existing barriers in order to allow foreign firms to enter its market. In line with currently biding paradigm of accelerating national growth by attracting foreign direct investments, state’s actions are focused on a country promotion and sending a clear message to potential investors that it is worth investing within this particular state's borders. Thanks to actions accompanying country promotion, certain
basic investments are made to facilitate business (road infrastructure, access to electricity, broadband Internet, etc.) and in consequence the capital of micro-economic factors of national competitiveness is built. Such positive results often are brought by certain economic diplomacy instruments like state visits, international fairs, international conferences and forums, etc. organized in a country.

CONCLUSION

The proposed analysis of economic diplomacy focuses on economic, not political grounds of justification for its application. The analysis is made on the grounds of competitiveness theoretical framework, with particular focus on M. Porter’s national competitiveness concept, which is the novelty as far as academic research on economic diplomacy is concerned. The author shows different operational levels of economic diplomacy and tries to draw the attention
to the need of its close relations to micro-economic factors of competitiveness. Microeconomic competitiveness based on: quality of national business environment, state of cluster development and sophistication of company operation and strategy needs particularly tailored tools and must involve the cooperation of various actors on various levels from both private and public sectors. Economic diplomacy with its informational function can contribute to fight against market failures such as imperfect (asymmetric, incomplete, and false) information, imperfect competition (by e.g. giving incentives to and enabling firms’ internationalization), uncertainty, etc. Various instruments and institutions used by economic diplomacy’s policy-makers – embassies’ units, trade chambers, consulates, trade and investments promotional agencies are constant witness of informational flow between the countries, and the knowledge they are able to acquire should be processed and used for realization of national aims.

Findings of the research within economic diplomacy and its contribution to national competitiveness may be applied by policy-makers in order to increase the effectiveness of state’s economic diplomacy strategy and its instruments.

REFERENCES

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Summary

The paper aims at presenting the issues of economic diplomacy from economic perspective within competitiveness framework. The author combines two separately existing in the literature theoretical frameworks in order to obtain a new model of economic diplomacy. In the paper the thesis stating that economic diplomacy has been underused and limited only to macroeconomic factors of national competitiveness is discussed. The postulate of economic diplomacy to operate in close relations to micro factors of national competitiveness in order to contribute to country’s higher competitive position is proposed. Theoretical concept presented may serve both academics and policy makers as the reference point in their analysis, further empirical research and diplomatic strategy building. The novelty of the approach presented is competitiveness related model of economic diplomacy applied on both macro and micro-economic levels.

Rola dyplomacji ekonomicznej w podnoszeniu narodowej konkurencyjności

Streszczenie

Celem artykułu jest ukazanie roli dyplomacji ekonomicznej we wzroście konkurencyjności danego państwa. Autor prezentuje model dyplomacji ekonomicznej w oparciu o teorię konkurencyjności, sankcjonując jej stosowanie w świetle argumentów ekonomicznych. Wysunięta teza twierdzi, że do tej pory termin „dyplomacja ekonomiczna” był odnoszony jedynie do makroekonomicznych czynników konkurencyjności. Tymczasem korzystanie z instrumentów dyplomacji ekonomicznej na poziomie mikroekonomicznym pozwoli na podniesienie konkurencyjnej pozycji kraju w sposób efektywny i zgodny ze współczesnym paradygmatem wzrostu gospodarczego.