# BUILDING NATIONAL COMPETITIVENESS IN SOUTHEAST EUROPE

# NATIONAL COMPETITIVENESS REPORT FOR MACEDONIA

*FINAL REPORT*


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# EXECUTIVE SUMMARY

**Introduction**
With the objective of supporting the competitiveness-building process in Southeastern Europe, the Europe and Eurasia Bureau of USAID asked J. E. Austin Associates, Inc. (JAA) to carry out a Competitiveness Assessment to instigate a National Competitiveness Building Process in Albania, Croatia, Macedonia, and Romania. This brief summary recapitulates the main findings of JAA's work in Macedonia under USAID Task Order No. GBT–008 of the Nathan-MSI SEGIR GBTI PCE–I–00–98–00016–00 contract.

**Economic Overview**
With a population of two million people, Macedonia is the only country in Central and Eastern Europe that achieved its independence without experiencing a civil war, but the current ethnic conflict is negatively impacting the image of the country in international business circles. However, over the past ten years of independence, Macedonia has faced unprecedented challenges in its economic transition due to a volatile business environment, collapsed export markets, an economic embargo, wars in the Balkan region, and its own limited market and isolated location.

To restore the country's macroeconomic stability, Macedonia has implemented an economic stabilization policy package consisting of restrictive monetary policy, stringent budgetary discipline, a fixed-exchange-rate system, and public sector wage controls. Through this massive reform program, Macedonia has been successful in establishing a relatively stable macroeconomic framework. In 2000, the country achieved a GDP growth of 5.1% compared to an average growth rate of 2% over the 1996 – 1999 period, and consistently negative growth prior to that. The impressive recovery in 2000 was mainly driven by substantial year-on-year increases of 8.1% in private consumption, 15.7% in gross fixed investment, and a remarkable 21.5% in export value[1].

A tight fiscal stance in support of restrained demand management has been a key element in Macedonia's economic strategy in recent years. Prior to 1999, the fiscal deficit had actually been relatively small, which, according to the IMF, was mainly due to externally financed capital expenditures. Nevertheless, a balanced budget was achieved in 1999[2], and by end-November 2000, a solid budget surplus was recorded of about 5% of GDP. This was mainly due to the introduction of a value added tax (VAT) in April, which increased tax revenue by 26.6% for the first eleven months of 2000[3].

The adoption of a fixed-exchange-rate policy since 1996, in which the denar is pegged against the Deutsch Mark, has proved successful in reducing and controlling inflation. Inflation was brought down from 2,000% at the end of 1992 to 2.3% in 1996[4]. Although inflation surged to 10.8%[5] in 2000, this was mainly due to such external factors as increased oil prices and the implementation of VAT early in the year.

[1] Source: EIU
[2] Source: EIU: 1999 budget surplus was Den 1,052 billion, accounting for about 0.5% of GDP
[3] Source: EIU
[4] Source: IMF Staff Country Report, Macedonia, June 2000
[5] Source: EIU

According to the IMF, a low level of intermediation, the high cost of capital, a severe lack of financial discipline, and poor allocation of credit characterize Macedonia's weak and fragile banking system. In order to strengthen banking supervision, reforms have been carried out which include the establishment of a unit within the Supervision Department in the National Bank of the Republic of Macedonia (NBRM) to closely monitor banks that are chronic violators of prudential standards, and to specify immediate action and performance criteria for insolvent or illiquid banks. To improve the legal framework for banking, intense efforts have been made to revise and upgrade existing legal documents. The following laws were passed during 2000: the Banking Law, the Deposit Insurance Fund Law, the Securities Law, the Law on Collaterals, the Law on Amendments, and Modifications to the Law on Executive Procedures.

Macedonia undertook the transformation of socially owned and state enterprises in mid-1993. By December 2000, there remained over 120 companies scheduled for privatization through public tender[6]. Stability in the overall economic environment in turn has had a positive impact on both public and private investment. According to the NBRM, foreign direct investment increased to US$125 million during the first nine months of 2000, compared to just US$30 million for all of 1999. Although this is encouraging, given Macedonia's limited domestic market and small population, it is worth noting that much of the foreign investment during 2000 was through privatization.

Macedonia has been working towards further trade liberalization, consistent with negotiations for accession to the WTO. The country has also significantly diversified its trade away from the other former Yugoslav republics towards the European Union, as well as to other states in the SEE region. Macedonia has concluded Free Trade Agreements (FTAs) with Croatia (1997), Slovenia (1996), and Bulgaria (2000). Macedonia is also the first country in the Western Balkans to sign a Stabilization and Association Agreement (SAA) with the EU, in April 2001. The SAA envisages the asymmetrical opening of the markets of the EU and Macedonia, in view of the establishment of a Free Trade Area within ten to twelve years. It also includes provisions on the approximation of Macedonia's legislation with the EC legislation.

In terms of taxation, the government lowered the corporate profit tax from 30% to 15% in early 1997, which compares favorably with rates in other Central and Eastern European countries, which range from 20% in Croatia to 35% in the Czech Republic. Similarly, the tax on profit transfers overseas by foreign investors is moderate, at 10%. To encourage investment, companies are allowed to offset reinvested earnings against taxable income. VAT was introduced in April 2000 at the rate of 19%, with various exemptions, including residential buildings and apartments, banking and financial services, health services, education, exports, and services related to exports and imports. A reduced rate of 5% is levied on certain products such as foodstuffs, basic agricultural products, books, newspapers, and public transportation.

The prevailing high unemployment rate, accounting for about one-third of the labor force[7], remains one of Macedonia's major political and economic issues. In addition, labor legislation makes it very difficult and costly to dismiss workers[8]. Companies are

[6] Source: Privatization Agency of the Republic of Macedonia

[7] Source: EIU, IMF

[8] According to the IMF Staff Country Report, No. 00/72, June 2000, payroll taxes constitute about 75% of an employee's net earnings. High non-wage benefits are mandatory for all enterprises that are less than

also dissuaded from hiring by the high labor costs imposed by wage legislation and the fiscal code[9].

The enforceability of laws and regulations is of concern from a competitiveness point of view. An inadequately empowered institutional framework and a lack of qualified staff are serious problems, hindering Macedonia's legislative enforceability. Macedonia's judicial system is a good example: the system faces problems similar to those of Croatia in that the judiciary has been unable to cope with its new functions and the rapidly increasing volume and complexity of cases, which result in bottlenecks in business registration and other approval procedures.

**Competitiveness Benchmarking**
JAA has carried out a competitiveness benchmarking exercise to reflect how Macedonia ranks relative to the other countries in Southeastern Europe[10], the EU accession countries, the EU countries themselves, and all countries of the world for which data were available in the areas that are generally understood to be closely correlated to competitiveness. Informed by competitiveness theory, by the methodologies used by the World Economic Forum, Harvard University, and the Institute for Management Development, along with its own work in 100 countries over fifteen years, JAA has selected forty indicators related to eight competitiveness-related categories: economic performance, exports, investment, the financial sector, human resources, science/technology, infrastructure, and government policy.

The competitiveness benchmarking indicated that Macedonia was highly trade dependent. Nevertheless, export growth had fallen well behind the world average. Although not engulfed directly by the disturbances in the region, the disruption of trade and investment linkages took its toll. The impacts of macroeconomic reform were felt towards the end of the transition decade. Although low inflation rates were maintained, the economy operated under high trade and current account deficits contributed by the low levels of foreign direct investment. A high unemployment level is certainly another problem of the Macedonian economy.

As displayed by the economic performance indicators, Macedonia has shown signs of healthy economic recovery despite several adverse conditions. Macedonia's limited economic growth over the last decade is due in part to the instability in the Balkans, including the Kosovo crisis that caused a flood of refugees and detached Macedonia from its largest trading partners.

Macedonian policies have created rather favorable macroeconomic conditions (as displayed by the policy indicators), such as inflation elimination and the budget deficit, but have failed to provide an effective regulatory framework for business activity.

The investment indicators show that the regulatory deficiencies in Macedonia include the lack of active investment promotion, and especially the failure to attract foreign investments for its privatization programs. Though moderately successful, domestic investment will not suffice to build competitive industries in the long term and only

70% private. The main non-wage benefits are food allowances (about 25% of the average monthly wage), transportation, and holiday allowances (equivalent to one month's salary on average).

[9] Source: IMF Staff Country Report, No. 00/72, June 2000.

[10] Croatia, Bulgaria, Macedonia, and Albania

foreign investment can balance the growing trade and current-account deficits. The financial sector indicators point out that Macedonia needs to create a reliable and credible financial sector and focus on improving the competitiveness of its industries with potential for growth.

However, underlying modest results are indicators of great potential for future competitiveness due to the strength of a highly educated workforce, and a focus on science and technology. As reform and restructuring continue, Macedonia's competitiveness, as measured by these indicators, has the potential to improve quickly. Actual results will depend on good public policy and institutional reform, the emergence of competitive clusters, dialogue, and coordination.

**Trade and Investment Competitiveness**

Macedonia finished the year 2000 with a trade deficit of US$766 million amounting to an increase of 31%. The factors that contributed to an increase in the trade deficit were the denar/D-mark peg, the depreciation of the D-mark against the dollar, increased gasoline imports, and iron and steel imports for re-processing. While the equipment and vehicles, food and beverages, and chemical products were the top three import groups for 2000, textiles and clothing, non-ferrous metals, and food and beverages were the top three export groups. The 31.0% increase in exports to Yugoslavia (Serbia-Montenegro) from 1999 to 2000 reflected Macedonia's return to the Yugoslav market after the disruption of the last ten years. Since the first half of 2000, Yugoslavia, which was a traditional major trading partner for Macedonia, has taken over Germany as Macedonia's largest trading partner. Trade with the EU has increased steadily, and this trend may be expected to continue as a result of the EU's trade preferences for the Western Balkans, which allows 95% of goods free of customs duties.

The assessments by the International Trade Center in 1998 indicate that flat rolled products and men's trousers and shorts made of synthetic fibers were the export product groups in which Macedonia has performed very well. These were dynamic products, which grew faster than world trade in general, and for which Macedonia has been able to outperform world market growth and has increased its share of world imports. Electric conductors, medicaments, lumber and beech were sectors that presented challenges for Macedonia. While the international demand has been growing at above-average rates, Macedonia's exports of these products have either been falling behind or grown less dynamically than the world trade, resulting in Macedonia losing its international market share. Macedonia's share in the world import markets in grape wines, tobacco, women's/girls' blouses and shirts, men's/boys' shirts of cotton, ferro-silico-manganese, and ferro-nickel grew between 1994 and 1998, even though these markets were declining or growing below world average in the same period. From a strategic perspective, Macedonia needs to identify niche-marketing strategies to isolate the positive trade performance from the overall decline in these markets.

FDI inflows and FDI per capita figures have been relatively low for Macedonia, however over the last few years the investment activities have intensified. Macedonia recorded its best year since independence for FDI in 1998, with an inflow of US$118 million. In the 1998 – 2000 period, privatization-related inflows accounted for a significant share of total FDI received. The security crisis in 2001 caused more cautious investor behavior in Macedonia. Prior to the breakout of violence, Macedonia enjoyed an increase in the presence of foreign companies. Any further drop in foreign investors would be a heavy blow to the country's economic recovery and overall stability.

Macedonia can increase its competitiveness through enhancement of productivity in its traditional industries such as apparel and textiles by seeking market niches, in its raw-material-based sectors such as ferro-silicon by focusing on more value-added production, and in its human-resource-intensive industries such as the electronics industry, food processing, telecommunications, and computer software services by focusing on strategic alliances that will benefit domestic industry by technology transfer, knowledge of markets, and increasing human skills.

**Competitiveness Constraints**

Although the economy of Macedonia showed signs of improvement in 2000, there is uncertainty related to the sustainability of the current economic recovery. Based on JAA's preliminary study of the Macedonian economy and industry sectors, major constraints to the country's ability to achieve higher competitiveness, and, therefore, better overall economic development, are summarized below. It is worth noting that many of these constraints are similar to those facing other Southeastern European countries, given their similarities in historical backgrounds and economic conditions.

General Constraints

- Although the government has indicated its commitment to furthering economic reform, and been successful in improving the country's overall economic performance for 2000, there is uncertainty due to the ethnic conflict in Macedonia.
- Macedonia has had some success in controlling the fiscal deficit and inflationary pressures, but the desired level of macroeconomic stability is yet to be achieved.
- Reform has been carried out in the banking sector, but the banking system is still weak, with a low level of intermediation, high cost of capital, severe lack of financial discipline, and poor allocation of credit.[11]
- Though significant improvements have been made to the legislation and institutional framework, the deficient policy framework that is in existence in Macedonia erodes the country's competitiveness by discouraging both domestic and foreign investors.
- The inadequacy of law enforcement is an area of serious concern that erodes Macedonia's competitiveness.
- Non-transparent procedures in Macedonia are diminishing the country's competitiveness as they reduce the country's attractiveness as an investment destination.
- The lack of strong private investment in the Macedonian economy diminishes the private sector's ability to compete in global markets.
- Macedonia's physical infrastructure is relatively good when compared to the rest of the region, but the current condition of the infrastructure needs to be improved, to accelerate Macedonia's economic development and increase its competitiveness.
- Delayed engagement in higher-technology and higher value-added economic activities is wearing away Macedonia's competitiveness.
- The private sector's lack of focus on international markets, combined with a small domestic market, is undermining Macedonia's competitiveness.

[11] Source: IMF Staff Country Report No. 00/72, June 2000

- The <u>lack of a market mentality and management systems</u> as well as the <u>inability to access information</u> about both domestic and foreign markets hinders the private sector in competing in global markets.
- The government's policy-making process <u>lacks an institutionalized private sector consultation</u>. As a result, policies fail to systematically reflect the most important constraints to the Macedonian private sector's competitiveness.

<u>Industry-Specific Constraints</u>
After consultation with key stakeholders and counterparts in Macedonia, three industry sectors of key importance to Macedonian economy were selected for in-depth analysis. These were the export-oriented apparel and textiles, information technology, and tourism sectors. A SWOT (Strengths, Weaknesses, Opportunities, and Threats) analysis and a Competitiveness Diamond analysis were carried out for each sector. The constraints that hamper the competitiveness of each of these sectors are summarized below:

<u>*a. Apparel and Textiles:*</u> Macedonia has so far relied on the exploitation of a low-cost and labor-intensive strategy to compete with other countries. Over the past decade, the industry has experienced an erosion of its competitiveness. The following are some of the main factors that have contributed to this decline:

- Declining labor cost advantage, due to competition from other low-cost countries
- Strong competition from illegal imports of finished products
- Inadequate access to financing
- A lack of transportation cost advantages, due to Macedonia's land-locked position and infrastructure damages during the war in Kosovo
- Inadequate re-capitalization and restructuring efforts to infuse new technology into the industry and to establish industrial linkages that could help Macedonia engage in high value-added activities
- A lack of strong individual companies that pioneer and lead technological change and upgrade the processes in the industry
- Inadequate information about both domestic and external markets
- Over-dependence on a few external markets such as Germany, Yugoslavia, and Greece
- A lack of market-oriented management and marketing skills that can improve efficiency in the industry, make Macedonian brand names better known in the world markets, and proactively find new markets for Macedonian products.

<u>*b. Information Technology (IT):*</u> Macedonia ranks high in the world in terms of the number of scientists and engineers in the population, and has excellent telecommunication services, but the IT sector is underdeveloped. Major impediments include the following:

- Inadequate legal and regulatory framework to support the sector
- Insufficient demand stimulation from domestic industries and individuals due to the difficult economic situation and relatively low living standards
- Limited participation of foreign investors who could introduce new managerial know-how and technology to the industry
- A lack of entrepreneurship, marketing and management skills that could bring more international exposure and experience to domestic firms
- Ineffective protection and enforcement of intellectual property rights

- Limited R&D base, and insufficient investment in R&D for new technologies and software
- A lack of private sector consultation in policy formulation to support the industry as well as in R&D activities
- A need for more proactive policy support from the government to stimulate the growth in the industry and make it internationally competitive.

*c. Tourism:* Tourism in Macedonia has so far been concentrated around certain historical towns and ski resorts in the country. The sector has been following a low-end, low-price competition strategy, and suffers from a lack of quality and strategy that could increase its competitiveness relative to other countries in the region. Major constraints on the tourism industry in Macedonia include the following:

- Perceived image of Macedonia as an unsafe destination
- The low-cost competition strategy that has proven to be ineffective due to price competition from other countries in the region
- Delayed engagement in high-end and more sophisticated tourism products
- Limited knowledge of outside markets and high-end product segments
- Degrading and inadequate infrastructure facilities, including roads, hotels, airports, and utilities
- A lack of quality market-oriented customer service
- A lack of management and marketing skills that can increase efficiency, attract more clients, and generate high-end demands for the sector
- A lack of strong private investment in the sector
- Absence of an adequate legal and regulatory framework to support the sector.

**Recommendations for Next Steps**

Building Macedonia's competitiveness requires a complex set of mutually reinforcing activities at the level of the firm and the industry cluster, reinforced by policy and institutional action at the national and local government levels. Learning from nations that have built prosperity quickly and aided by the foregoing analysis, one can formulate recommendations that deal with the private sector, with the public sector, and with the dialogue that connects them.

Private Sector: Firms in the private sector are in very different conditions and no one set of recommendations applies to all. In general, competitive firms will seek direct exposure to the most demanding customers, clients and markets and adapt their products, services and strategies to respond to the signals that these demanding customers are providing. This requires and openness to change and the desire to innovate with products, service and processes that respond to these needs.

Macedonian firms that have exportable products and services now have new opportunities to serve European markets, but will need to invest in learning how to take advantage of these opportunities. Firms that have non-tradable products and services and that serve the Macedonian market only can explore trends in neighboring countries that have longer experience with privatization, liberalization, and globalization and can selectively test the innovations in Macedonia. Firms that are not competitive will need to take stock of their human, capital, and organizational resources and then migrate to other market segments or even industries.

Competitiveness also requires the ability to cooperate as a cluster to be able to achieve this, as no one firm can do it all. Competitiveness depends on the ability to form good alliances and partnerships. At the industry level, business associations can participate in efforts representing the business sector before the government.

However, it is important to gather together as an industry cluster—that is the entire value chain plus the related and supporting industries. The industry cluster can then benchmark the industry, develop industry strategies, and implement specific action initiatives to boost competitiveness. These will vary by industry. For example, the tourism cluster should formulate specific strategies for creating international demand for attracting more tourists to Macedonia and for increasing the management skills and training of the Macedonians in the tourism sector. The IT sector should explore initiatives for increasing software development ability, boosting software exports, and retaining talented professionals. The apparel and textiles sector will need to move beyond its focus on providing assembly labor so as to survive after the expiration of quotas in 2005.

Business associations, working with the government of Macedonia, can develop international trade and investment linkages to get access to markets and technology. But this undertaking requires greater communication and cooperation between the private sector and the public sector.

Industry clusters can also implement workforce development, and human resource and training initiatives by working with education and training providers so that the latter adapt their programs to industry needs.

Another field of activity will be that of research, development, testing, and certification initiatives that can add value to the industry while adapting to ISO and similar standards.

Public Sector: With regard to policy and institutional reform, this can be analyzed by industry cluster. For example, in tourism the government must provide guidance, planning, and a development framework to the sector. The government can enhance the competitiveness of the tourism sector by introducing and requiring high standards that are in line with EU standards for hotels and tour operators. The government may also use some of the tax revenues to co-finance initiatives that the private sector itself could undertake to carry out competitiveness initiatives for its sector. The industry itself is in the best position to design and implement initiatives to migrate from natural-resources-based tourism to higher-end markets such as conference tourism, adventure tourism, and eco-tourism.

The government should play a key role in coming up with a comprehensive national strategy for the IT sector. The government should promote e-government, encourage FDI into the IT sector, promote the use of computers in schools, and work with universities and training providers to improve the relevance of education programs to changing needs. The introduction of e-governance systems contributes to transparency and reduces corruption by making information and services available on the Web.

Following the example of Ireland, the government of Macedonia, with the help of leading think-tanks in the country, should publish an annual Macedonia Competitiveness Benchmarking report that could provide sound data on Macedonia's competitiveness in areas related to investment, exports, technology, human resources, economic policy, economic performance, and infrastructure. This would help to inform government and industry leaders about the strengths and weaknesses of Macedonia relative to other EU accession countries, while helping to set priorities and monitor implementation.

Macedonian Competitiveness Council (MCC): It is recommended that the key private sector leaders establish the Macedonian Competitiveness Council to institutionalize dialogue between the private and public sectors[12]. This Council would establish priorities for reform and communicate these clearly to the government and then monitor implementation. It would also undertake its own initiatives and help coordinate the work of various industry clusters.

Examples of such initiatives might include:

- Encouraging the development of a world-class business school in Macedonia with high involvement of the private sector
- Conducting an annual survey of SMEs and systematically remove bureaucratic constraints to business formation and entrepreneurial activity
- Supporting the institutionalization of private-public dialogue by identifying the priority concerns
- Cooperating with the government in negotiating access to foreign markets on good terms.

In the early months, it would be useful to have encouragement from the government of Macedonia and it would be helpful to have technical and perhaps even financial support to jump-start such a council. The Council would meet monthly or more often if necessary and would commission specific initiatives designed to build Macedonia's competitiveness. It would review progress on these and provide leadership and vision.

The Council should work through existing business associations and research institutes and not attempt to duplicate them. It should also build on prior research done on Macedonia competitiveness, on policy reform, and on specific industry clusters, rather than doing new and repetitive research. The focus should be on action rather than study and on building a self-reinforcing virtuous cycle of private-public cooperation to implement change.

There are many things that must be done to build the competitive advantage of Macedonia. The recommendations above suggest some of the priorities that need to be undertaken. More importantly, this study recommends a mechanism in the Macedonian Competitiveness Council to move to action while building trust and a private-public partnership that is necessary to a strong economy and civil society.

It is impossible in a study of four countries with limited scope and resources to accurately address all of the constraints or to lay out a comprehensive set of well-sequenced recommendations. Nonetheless, it is hoped that this report will serve as a stimulus for discussion and analysis and thereby provide Macedonia's leaders with the relevant information needed for consensus and allow them to move forward with a preliminary action plan for strengthening Macedonia's position globally.

[12] In May 2001, Croatia's private sector bodies came together to form the Croatian Competitiveness Council

# CHAPTER 1 – INTRODUCTION

With the objective of supporting the competitiveness building process in Southeastern Europe to ensure that Stability Pact activities accelerate sustainable recovery from financial and political instabilities in the region, the E & E Bureau of USAID asked J. E. Austin Associates, Inc. (JAA) to carry out a "National Competitiveness Building" exercise in Macedonia, Croatia, Romania, and Albania. The objective of this report is to present the findings of the work carried by JAA in Macedonia under Task Order No. GBTI–008 of the Nathan-MSI SEGIR GBTI PCE–I–00–98–00016–00 contract.

The methodology followed in this exercise started with a benchmarking exercise that ranked the four countries against all countries in the world, the EU, EU accession countries, and Southeastern European countries. Visits were made to all countries and subcontractors in each country were identified to apply competitiveness tools to selected sectors and a central point to convene issues on competitiveness. A regional conference to expose the participants from public and private sectors of all countries to the concept of competitiveness and competitiveness benchmarking was organized in Macedonia. As a result of this initial exercise and the demand from Croatia, an in-depth competitiveness exercise has been activated by USAID Croatia.

This exercise had certain limitations such as a limited budget and level of effort to cover all four Southeastern European countries. Thus, this report, by no means should be treated as a substitute for a major study on competitiveness. Due to the limited budget available, JAA was unable to apply competitiveness tools on site together with the local counterparts that were identified in each country. Also, workshops, which usually are performed once the leadership in a country is informed about the competitiveness concept, were not utilized. Time delays were experienced in meeting the expected completion date for the study as a result of elections in Albania, ethnic conflicts and civil unrest in Macedonia, and the fact that the Macedonian subcontractor was called to serve in the Macedonian Army.

This report is composed of nine chapters.

Chapter 1 provides an introduction to the report.

Chapter 2, "Recent Economic Developments," summarizes the latest economic performance of Macedonia in order to provide the reader with an understanding of the country's development efforts and their results.

Chapter 3, "National Platform for Competitiveness," reviews Macedonia from the point of view of political stability, and analyzes the microeconomic and macroeconomic environment in the country. The chapter ends with an analysis of the legal and institutional environment in which Macedonian businesses operate.

Chapter 4, "Competitiveness Benchmarking: Macedonia," summarizes the findings of the competitiveness benchmarking exercise that ranks Macedonia relative to the EU, the EU accession countries, countries in Southeastern Europe, and all other countries of the world for which data are available in areas that are generally understood to be closely correlated to competitiveness.

Chapter 5, "Trade and Investment Competitiveness," examines the trade and investment flows in and out of Macedonia and lays out the trade and investment competitiveness of Macedonia.

Chapter 6, "Industry- and Firm-Level Competitiveness," presents the competitiveness of three important Macedonian industries and the firms that operate in these sectors, namely Tourism, Information Technology, and Apparel and Textiles.

Chapter 7, "Competitiveness Constraints," summarizes the competitiveness constraints in Macedonia from a general and industry-specific perspective.

Chapter 8, "Private-Public Dialogue in Macedonia," reviews the current status of the dialogue between the private sector and the public sector.

Chapter 9, "Recommendations," presents the recommendations to increase the competitiveness of Macedonia on three different levels: firm level, industry level, and government level. This chapter ends with the National Competitiveness Initiative, which presents the steps that should be taken in order to increase the capacity and active participation of stakeholder representatives in a dialogue about developing industries in the target clusters. This chapter also presents potential follow-on activities for USAID.

Annex 1, "Competitiveness Benchmarking," is a presentation of competitiveness benchmarking graphs and data for all indicators selected.

Annex 2 is the Scope of Work.

# CHAPTER 2 – RECENT ECONOMIC DEVELOPMENTS

With a population of two million people, Macedonia is the only country in Central and Eastern Europe that achieved its independence (in 1991) without experiencing a civil war. However, an ethnic conflict emerged in June 2001. Over the past ten years of independence, Macedonia has faced unprecedented challenges in its economic transition due to a volatile business environment, collapsed export markets, an economic embargo, wars in the Balkan region, its own limited market, and its isolated location. To restore its macroeconomic stability, Macedonia has implemented an economic stabilization policy package consisting of restrictive monetary policy, stringent budgetary discipline, a fixed-exchange-rate system, and public sector wage controls.

Through this massive reform program, Macedonia has been successful in establishing a relatively stable macroeconomic framework. In 2000, the country achieved a GDP growth of 5.1% compared to an average growth rate of 2% over the 1996 – 1999 period, and a consistently negative growth prior to that. The impressive recovery in 2000 was mainly driven by substantial year-on-year increases of 8.1% in private consumption, 15.7% in gross fixed investment, and the remarkable 21.5% in export value[13]. It is expected that the real GDP will contract by 0.5% in 2001.[14]

The current account deficit for 2000 was 5.8% of GDP and is expected to narrow to 4% of GDP in 2001[15]. Though the account deficit is still high, Macedonia was able to keep it within the government's target for the year. In addition, Macedonia succeeded in increasing its foreign exchange reserves by almost 74%, from US$428.7 billion in 1999 to US$750 billion in October 2001, mainly due to proceeds from privatization.

A tight fiscal policy has been a key element in Macedonia's economic strategy in recent years. By end-November 2000, Macedonia recorded a solid budget surplus of 5% of GDP. This was mainly due to the introduction of a value added tax (VAT) in April, which increased tax revenue by 26.6% for the first eleven months of 2000[16].

Low inflation has been maintained during the past few years in Macedonia, thanks to the government's implementation of tight fiscal and monetary policies since 1994, which brought inflation down from 2,000% at the end of 1992 to 2.3% in 1996[17]. Though inflation surged to 10.8% in 2000, this was due to rising oil prices, increased energy charges, and the introduction of the VAT. Inflation was reported to be 6% for the January-June 2001 period by the National Bank of Macedonia and is expected to be 6.3% for the whole year of 2001.[18]

Stability in the overall economic environment in turn had a positive impact on both public and private investment. According to the National Bank of the Republic of Macedonia

[13] Source: EIU
[14] EIU estimates
[15] The EIU's estimate of the current account deficit for 2000 was about US$210 million, compared to the government's forecast of US$230 million. In 1999, Macedonia's current account deficit accounted for 3.5% of GDP.
[16] Source: EIU
[17] Source: IMF Staff Country Report, Macedonia, June 2000
[18] EIU estimates

(NBRM), foreign direct investment increased to US$125 million during the first nine months of 2000, compared to just US$30 million for the entire 1999. Although this is encouraging, given Macedonia's limited domestic market and small population, it is worth noting that much of the foreign investment during 2000 was achieved through privatization.

The government is also focusing on completing the privatization process, including the sale or liquidation of the country's largest loss-making state-owned enterprises. While privatization so far has largely been restricted to insiders, strategic foreign investors are being encouraged to participate in the remainder of the process, as the government believes that they represent an important source of capital as well as skills in corporate restructuring. Recently, the telecommunications monopoly was privatized and a majority stake was sold to a foreign investor.

Alongside many achievements, Macedonia still faces a number of key transition challenges. The country needs to make further progress with its privatization of loss-making enterprises, and rationalize the financial sector through further privatization and consolidation. Unemployment in Macedonia remains high, estimated to be one-third of the labor force, and that creates reluctance to close loss-making enterprises.

Macedonia needs to enhance its investment climate, and reduce bureaucratic obstacles and inconsistencies in the legislation, in order to attract further foreign direct investment. Another area that needs improvement is enterprise development, which is suffering from a lack of capital, restrictive labor laws, and high labor taxes, all factors that discourage enterprises from expanding employment. The government of Macedonia has recently reduced personal income taxes and the VAT in an attempt to boost employment and the private sector.

# CHAPTER 3 – NATIONAL PLATFORM FOR COMPETITIVENESS

## 3.1 Political Stability

Macedonia is a presidential parliamentary democracy. The government is a coalition of three different parties: the Internal Macedonian Revolutionary Organization-Democratic Party of Macedonian National Unity, the Democratic Party of Albanians, and the Liberal Party.

As a coalition, the government faces considerable difficulties not only in reconciling different goals among the member parties, but also in overcoming ethnic tensions within the country. The government lacks a clear majority in the parliament, which may make the task of reconciliation harder. However, it is encouraging that, although party politics in Macedonia is divided along ethnic lines, neither of the two main ethnic communities, Slavs and Albanians, is tied to one party, therefore, possibly reducing the level of inter-ethnic tension in the country to a certain extent. Failure to address these inter-ethnic conflicts could destabilize Macedonia, deter foreign investment, and damage its economic links with Kosovo and the rest of Yugoslavia, as indicated by the recent outbreak of ethnic conflict in early 2001. Despite the approval of a new government on May 13, 2001, a quick end to the disturbance in Macedonia is becoming less likely, and the polarization of Slav Macedonians and ethnic Albanians is deepening.

The government has indicated its commitment to maintaining price stability and high growth rates, completing privatization, encouraging private sector development, and attracting foreign direct investment through various policy reforms. Several economic indicators for 2000 suggest improvement in Macedonia's economic performance and business environment. The government is also focusing on building closer ties with the EU and NATO, and on developing good relationships with its neighboring countries. These policies have been well supported by the EU and major multilateral organizations. If the recent trend of economic improvement continues, it will positively affect the Macedonian people's confidence in their government, and thus overall stability in the country.

## 3.2 Macro- and Microeconomic Environment

### Fiscal Policy

A tight fiscal stance in support of restrained demand management has been a key element in Macedonia's economic strategy in recent years. The government aims to balance the budget over the long term, with a deficit not exceeding 1% of GDP[19]. Prior to 1999, the fiscal deficit had been relatively small, which, according to the IMF[20], was mainly due to externally financed capital expenditures. Nevertheless, a balanced budget was achieved in 1999[21], and by end-November 2000, a solid budget surplus of about 5% of GDP (or Den11.7 billion) was recorded. This was mainly due to the introduction of a

[19] Source: EIU
[20] Source: IMF Staff Country Report No. 00/72, June 2000
[21] Source: EIU: 1999 budget surplus was Den 1,052 billion, accounting for about 0.5% of GDP.

value added tax (VAT) in April, which increased tax revenue by 26.6% for the first eleven months of 2000[22].

Other fiscal measures include downsizing the civil service through early retirement and retrenchment schemes. According to the IMF[23], non-discretionary spending—mainly wages, transfers and social sector outlays—accounted for about four-fifths of total government expenditure. The government acknowledges that there are substantial inefficiencies in the civil service, and the formulation of a public administration reform plan is under way[24].

**Monetary and Exchange Rate Policy**
The preservation of the price stability and exchange rate stability is considered as the primary objective of Macedonia's monetary policy[25]. The adoption of a fixed-exchange-rate policy since 1996, in which the denar is pegged against the D-mark, has proven successful in reducing and controlling inflation. Although inflation surged to 10.8%[26] in 2000, it was mainly due to such external factors as increased oil prices and the implementation of the VAT early in the year.

The National Bank of the Republic of Macedonia (NBRM) considers the current exchange rate adequate for Macedonia's export competitiveness, and, therefore, would not rely on local currency depreciation as a mechanism to strengthen export competitiveness. However, considering the need to make up for deviation from EU inflation rates over time, an exchange-rate band may be a more useful exit mechanism for Macedonia from its current fixed-rate regime.

**Banking Reform**
Macedonia's banking system is highly concentrated. As of end-September 1999, Stopanska Banka, the largest bank, accounted for 31% of the system's total assets and 41% of total deposits. Jointly with Komercijalna Banka, the two banks accounted for 55% of total assets and two-thirds of all deposits in the system. The rest of the banking system was dispersed among smaller and weak banks[27]. As of June 2000, there were twenty-one banks in Macedonia, which is a large number for a country of two million people and where financial intermediation is relatively low.

The IMF views Macedonia's banking system as weak and fragile.[28] A low level of intermediation, the high cost of capital, the severe lack of financial discipline, and poor allocation of credit characterize the system. As the quality of the loans is very poor, the system is highly vulnerable to credit risk.

Reform has been carried out in the banking sector in order to strengthen banking supervision and improve the legal environment for the sector's operation. The NBRM

[22] Source: EIU
[23] Source: IMF Staff Country Report No. 00/72, June 2000
[24] Source: Statement by J. de Beaufort Wijnholds, Executive Director for Former Yugoslavia Republic of Macedonia to the IMF, May 2000.
[25] Source: Address of the Governor Ljube Trpeski to the Parliament of the Republic of Macedonia on the goals and Objectives of the Monetary Policy for the Year 2001.
[26] Source: EIU
[27] Source: IMF Staff Country Report, No. 00/72, June 2000
[28] Source: IMF Staff Country Report, No. 00/72, June 2000

has created a unit within the Supervision Department charged with closely monitoring banks that are repeated violators of prudential standards, and specifying immediate actions and performance criteria for insolvent or illiquid banks. The unit is expected to strengthen the NBRM's supervision capacity through closer supervision and rigorous enforcement of rules and regulations. In dealing with unsound banks, the government has taken a bold step in encouraging foreign investor participation in the process. The recent example of the majority share sale of Stopanska Banka, the leading domestic bank, to foreign investors represents an important step toward independent profit-oriented banking in Macedonia.

To improve the legal framework for banking, intense efforts were made to revise and upgrade existing legal documents. The following laws were passed during 2000: the Banking Law, the Deposit Insurance Fund Law, the Securities Law, the Law on Collateral, the Law on Amendments, and Modifications to the Law on Executive Procedures. These laws were designed to enhance the quality of financial services and, particularly, overall banking supervision, with the aim of increasing public confidence in the system[29].

A low level of public confidence, the high level of bad debts, the high cost of capital, poor allocation of credit, and the lack of competition characterize the banking system[30].

**Privatization**

Macedonia undertook the transformation of state-owned enterprises in mid-1993. Under the Law on the Transformation of Enterprises with Social Capital, enacted during the same year (6/1993), all publicly owned enterprises except agricultural enterprises and cooperatives, a number of strategic enterprises, and state-owned enterprises including electric power, telecommunications and railway companies, were targeted for privatization. In April 1996, privatization was expanded to agricultural enterprises and cooperatives. Two government agencies have been instrumental in assisting the privatization process: the Privatization Agency and the Bank Rehabilitation Agency.

At the start of the reform process, the majority of workers were employed by state-owned enterprises[31]. As of June 2001, the privatization of 1,646 enterprises was completed[32]. While the Law on the Transformation of Enterprises with Social Capital allows for several privatization methods, the government, so far, has chosen to offer most enterprises to workers and managers through management and employee buy-out schemes[33]. The participation of outside private investors and foreign investors, therefore, has been limited. According to the IMF[34], there is little evidence that privatization in Macedonia has increased profits in the short run, which may reflect problems associated with insider privatization and the weak regulatory framework.

By June 2001, 113 companies were deemed to be in the process of privatization through public tender[35]. For these enterprises and, especially, for the more difficult cases among

29 Source: National Bank of Macedonia
30 Source: FYR Macedonia Investment Profile
31 Source: IMF Staff Country Report, No. 00/72, June 2000
32 Source: Privatization Agency of the Republic of Macedonia
33 Source: IMF Staff Country Report, No. 00/72, June 2000
34 Source: IMF Staff Country Report, No. 00/72, June 2000
35 Source: Privatization Agency of the Republic of Macedonia

them, the government has announced its intention to focus on foreign strategic investors, since they believe that foreign investors represent an important source of capital as well as skills in corporate restructuring.

**Import and Export Policy**

Under the Foreign Trade Laws, the government monopoly on exporting and importing has been replaced by a new system, whereby private enterprises are allowed to engage in foreign trade. Exporting and importing of goods can be done on the basis of company registration with the courts and the Customs Office.

Macedonia has been working towards further trade liberalization, consistent with negotiations for accession to the WTO. The country has also significantly diversified its trade away from the other former Yugoslav republics towards the European Union, as well as to the other states in the SEE region. Macedonia has concluded Free Trade Agreements (FTAs) with Croatia (1997), Slovenia (1996), and Bulgaria (2000). Macedonia was also the first country in the Western Balkans to sign a Stabilization and Association Agreement with the EU, in April 2001. The agreement aims at free trade in Macedonia within ten years. It also includes provisions on the harmonization of Macedonia's legislation with the regulatory framework of the EU.

Macedonia's trade policy is characterized by the following:

- No quantitative restrictions on imports and exports (over 98% of the goods are freely exchanged)
- Import-export tariff quotas applied to certain products depending on bilateral agreements (reciprocity basis)
- No customs duties on exports
- Import licenses required for the purpose of domestic business/environment protection
- Export licenses required for certain products
- Case-by-case customs valuation
- Lengthy registration process (about 4 weeks)[36]
- Gradual abolishment of customs duties within ten years on industrial products (but within five years on steel), within three years on agriculture and agricultural products, and immediate reductions of customs duties up to 50% and total elimination after six years in accordance with the Stabilization and Association Agreement with the EU.[37]

**Tax Policy**

The taxation system in Macedonia is going through a transformation process. With the intention of making the taxation system attractive for foreign investors, the parliament has enacted changes on the Profit Tax Law, the Property Tax Law, and the Value Added Tax Law. To stimulate private investment, the government lowered the corporate profit tax from 30% to 15% in early 1997, which compares favorably with the rates in Central and Eastern European countries, which range from 20% in Croatia to 35% in the Czech Republic. Similarly, the tax on profit transfers overseas by foreign investors is moderate

[36] Source: Special Coordinator of the Stability Pact for Southeastern Europe, December 2000

[37] Source: Memo/01/127: On the road to Europe: First Stabilization and Association Agreement to be signed on 9 April 2001 with former Yugoslavia Republic of Macedonia

at 10%. To encourage investment, companies are allowed to offset reinvested earnings against taxable income.

VAT was introduced in April 2000 at the rate of 19%, with various exemptions, including residential buildings and apartments, banking and financial services, health services, education, exports, and services related to exports or imports. A reduced rate of 5% is levied on certain products such as foodstuffs, basic agricultural products, books, newspapers, and public transportation.

**Foreign Investment Restrictions**
Foreign investments in Macedonia are governed by the Law of Trading Companies (Official Gazette no. 28/998, amended Official Gazette no. 7/97, 21/98 and 68/98), which ensures that investment conditions for foreigners in Macedonia are no less favorable than for domestic investors. Foreigners are granted national treatment and may invest in any kind of local enterprises: banks and other financial institutions; insurance companies; co-operatives or collectives; and may own 100% of a local company. Macedonia's investment environment has improved, as indicated by increased FDI flows in 2000[38]; but certain elements in the legal and regulatory framework are still in need of improvement to make Macedonia a more attractive destination for foreign investors: e.g. business approval procedures, and licensing and registration systems.

**Business Start-up Procedures**
Although the business start-up procedures overall were simplified by the new amendments to the Company Law, the problem seems to be a lack of sufficient training of the judges, who are given the right of administerial review, without going into the corporate documents, regarding the new laws. The new amendments specify strict durations of three, eight, and fifteen days for the judges' response.

**Unemployment and Labor Policy**
The prevailing high unemployment rate, accounting for about one-third of the labor force[39], remains one of Macedonia's major political and economic issues. According to the IMF[40], there are two main causes of unemployment in Macedonia: anemic economic growth and labor market rigidities. Real growth per capita (adjusted for purchasing power parity) averaged 0.47% per annum between 1990 – 98, compared to 3.5% in the EU and 1.1% among EU accession countries[41]. In addition, labor legislation makes it very difficult and costly to dismiss workers[42]. Companies are also dissuaded from hiring by the high labor costs imposed by wage legislation and the fiscal code[43].

The government has undertaken several measures over the past few years to mitigate the severe restrictions under labor legislation with a view to making the labor market

[38] According to the National Bank of Macedonia, FDI increased rapidly during 2000, to US$125 million for the first nine months, compared to a total of US$30 million for the whole of 1999.
[39] Source: EIU, IMF
[40] Source: IMF Staff Country Report, No. 00/72, June 2000
[41] Source: World Development Indicators, The World Bank, 2000
[42] According to the IMF Staff Country Report, No. 00/72, June 2000, payroll taxes constitute about 75% of an employee's net earnings. High non-wage benefits are mandatory for all enterprises that are less than 70% private. The main non-wage benefits are food allowances (about 25% of the average monthly wage), transportation, and holiday allowances (equivalent to one month's salary on average).
[43] Source: IMF Staff Country Report, No. 00/72, June 2000.

more flexible. These measures include amendments to the labor code to decentralize wage bargaining; lower dismissal costs; and reductions in the amount and duration of unemployment benefits, which are considered quite generous compared to other countries in the region. To encourage employment directly, the government, in 1997, decided to exempt firms from payroll taxes on new hires for a period of three years, and to provide wage subsidies to employers taking on unemployed people. This policy was abolished in 1999, since the government found it to be ineffective and a burden on the budget overall, although it helped increase the hiring rate. Without further reform and a pickup in economic growth, it will be difficult for the government to reduce unemployment substantially.

### 3.3 Legal and Institutional Environment

Over the past decade significant changes have been made in Macedonia's laws and legal institutions in the transformation towards a market economy. Macedonia has also made considerable efforts in developing a mechanism that can help it integrate with the European Union. However, while the overall policy environment still needs to be improved to make Macedonia a more favorable place for both foreign and domestic investors, a key element in this process is to strengthen the enforcement of the country's rules and regulations. Effective enforcement can have an extremely positive effect on the investment environment. A good example is the banking system, where prompt corrective actions and strict implementation of prudential rules can save the system from becoming illiquid or insolvent.

There are two major problems that hinder the enforceability of laws in Macedonia: the inadequately empowered institutional framework and the lack of qualified legislative staff. Macedonia's judicial system is a good example: the system faces problems similar to those of Croatia in that the judiciary has been unable to cope with its new functions, and that the rapidly increasing volume and complexity of cases result in bottlenecks in business registration and other approval procedures.

# CHAPTER 4 – COMPETITIVENESS BENCHMARKING

This chapter summarizes the findings of the competitiveness benchmarking that is presented as Annex 1 of this report.

## 4.1 Definition

Competitiveness can be defined as sustainable increases in productivity leading to improvements in the standard of living for the average person. Benchmarking is the ability to measure one's performance relative to a particular reference group and normally relative to those who are doing the best job in a particular industry or area of endeavor. The Competitiveness Benchmarking for Macedonia, compiled by JAA, ranks Macedonia relative to the EU, EU accession countries, Southeastern Europe, and the remaining countries of the world for which data are available in areas that are generally understood to be closely correlated to competitiveness.

## 4.2 Objectives of Benchmarking Report

Encourage private-public dialogue. Annual competitiveness benchmarking encourages reflection and discussion on issues related to the speed and effectiveness of Macedonia's transition to a competitive economy. Benchmarking focuses attention on strengths and weaknesses, improvement and deterioration, and helps private and public leaders set priorities.

Provide objective data. Effective dialogue and policy reform require the use of good data, rather than anecdotal evidence, and the ability to relate this data to a broader context. National dialogue is subjective, when proponents of current policies present selective data, which is then interpreted as excellent performance. Critics of current policy may also present selective data and assert conclusions alleging that the situation is more pessimistic than is really the case. By presenting many sets of data, benchmarking provides a mosaic of Macedonia in which the true picture comes into sharper focus. By comparing it to the EU, EU accession countries, and countries of Southeastern Europe, benchmarking provides a basis for drawing reasonable conclusions.

Serve as a powerful tool to measure progress and set priorities for policy and institutional reform for governments. Ireland uses an annual competitiveness report to benchmark its performance against the leading countries of the world. Not content to measure its own progress against itself, it has for a number of years compared its rate of improvement relative to the best country in the world in a given area.

Provide a rich source of data for analysis for economic faculties, business schools, technology institutes and think tanks. Those researching IT-readiness, export performance, investment, economic results, human capacity, infrastructure, and other areas will find in this data a rich source of information that can be used to inform their research and strengthen their ability to contribute to a national dialogue.

Encourage national debate on Macedonia's competitiveness by the publication of Competitiveness Benchmarking and its use by the economic press. It is important that the average citizen understand what is at stake for Macedonia's future.

## 4.3 Methodology

Informed by competitiveness theory and by the methodologies used by the World Economic Forum (WEF), Harvard University, the Institute for Management Development (IMD), and its own work in one hundred countries over fifteen years, JAA has selected forty indicators in eight competitiveness-related categories: economic performance, exports, investment, the financial sector, human resources, science/technology, infrastructure, and government policy. These categories are not dissimilar from those used by the WEF and IMD, neither of which is yet to provide rankings for Macedonia. The rankings are based entirely on secondary sources and efforts were made to select the most internationally qualified source for each data set. The data were then entered into JAA databases and ranked for all countries of the world for which data were available. Data for each indicator were provided for the country, along with its position relative to all other countries of the world.

For this exercise, analysis was done for Macedonia relative to the five countries included in the Southeast Europe Competitiveness Initiative (Romania, Bulgaria, Albania, Macedonia and Croatia), as well as the EU accession countries, and the EU itself. The following summary of the results is meant to be *descriptive* and is not meant to propose any particular ideology or set of policy prescriptions. The authors do not intend to make judgments regarding the effectiveness or ineffectiveness of previous or current policies. Rather, the report is intended to provide good descriptive data to stimulate and encourage debate on matters important to Macedonia's future.

## 4.4 Uses and Limitations of the Study

The study reflects the latest available comparative data for all countries of the world, which is usually 1998 data. Macedonia's situation is changing so quickly that this data may not accurately reflect the current situation. Unfortunately, while it is possible to get more recent data for Macedonia, this is the most recent data one can get for all countries of the world. Although there was a lack of data for Macedonia for some indicators, all competitiveness categories are presented for reference.

Nonetheless, the study allows Macedonia to identify its position and its achievements relative to the world's most competitive countries, and to set goals and targets that are realistically based on the achievements of other countries over a sustained period of time. It provides an objective source of data upon which to rest analysis and conclusions. This data can be verified by going to the sources cited. It is hoped that the provision of this study will encourage productive dialogue leading to action that supports the improvement of Macedonia's living standards in the immediate and long-term future.

### 4.5 Overview of Competitiveness Categories

**Economic Performance**

In relative wealth, Macedonia's GDP per-capita in 1998, adjusted for purchasing power parity (PPP) placed the country 82nd in the world at US$4,254 per-capita. This is the second lowest among the five countries of Southeastern Europe and is lower than the US$9,034 average GDP for EU accession countries and over US$21,000 for the EU itself. Economic growth in non-per-capita terms for the period 1990 – 1998 was only 1.00%. However, GDP growth for 1998 increased to a healthy 3.33%, placing Macedonia 92nd among 170 countries. Data on income distribution were not available for Macedonia.

**Export Competitiveness**

Macedonia is the most highly trade-dependent country in Southeastern Europe. Macedonia's trade as a percentage of GDP was 97%, indicating that export competitiveness is critical for Macedonia. While the world trade increased by 8% a year, and the average growth of merchandise exports was 15% for the top twenty countries, Macedonia's average growth of exports is a low 0.7%, indicating that the country was not competitive in exports in the 1990s. In 1998, Macedonia's exports totaled US$1.449 billion, placing it 98th among 140 countries of the world, and again, second-to-last among the five countries of Southeastern Europe. The growth of exports per-capita of 0.7 % for 1990 – 1998 shows that Macedonia is not progressing quickly towards developing competitive export sectors. However, exports as a percentage of GDP were 41%, ranking Macedonia 50th out of 129 countries, proving that Macedonia is highly dependent on international trade.

**Financial Sector**

No International Country Risk Guide (ICRG) country risk rating for Macedonia was available, but other indicators point to a problematic financial sector. Domestic credit to the private sector, expressed as a percentage of GDP, was 19%, ranking far below average for Southeastern Europe and other EU accession countries. Also, Macedonia's credit to the private sector in terms of GDP only reached 17.8% (101st out of 155 countries), and M-2 as a percentage of GDP (an indicator of financial depth) even placed Macedonia 131st among 146 countries.

**Investment**

Gross domestic investment in Macedonia for 1998 was 22.7% (61st out of 132 countries) and gross domestic investment growth from 1990 – 1998 was a decent 6.7%. Otherwise, total foreign investment of 1998 reached US$118 million, ranking Macedonia 86th among 162 countries. FDI per-capita was only US$59 for 1998, placing Macedonia 75th among 162 countries. In contrast, FDI as a percentage of GDP was an impressive 4.7%, ranking Macedonia 28th in the world, even above the average of EU accession countries for the year.

**Policy**

Macedonia's policy record is mixed. Macedonia has successfully eliminated inflation, ranking 30th out of 171 countries with an inflation rate of only 1.03%. Trade openness, too, provided relatively high scores (45th among 126 countries). However, Transparency International ranked Macedonia 63rd among 99 countries indicating a perception of corruption at the time of the ranking in 1999. Furthermore, proceeds from privatization placed Macedonia 44th in the world among emerging economies, lower than most other Southeastern European countries on a per-capita basis.

**Science and Technology**
Macedonia ranked 59th in the world for Internet hosts, at 4.4 per 10,000 people in July 1999, well behind other Southeastern European countries (except for Albania) which are moving quickly towards connectivity. In addition, high technology exports barely totaled US$11 million placing Macedonia 70th in the world in 1998, and measured as a percentage of exports, high technology exports only accounted for less than 1% of total exports. However, Macedonia ranked 35th out of 88 countries with 1,335 scientists and engineers in research and development per million people. Domestic telecom costs are quite low, but international telephone costs are average.

**Infrastructure**
With 64% of roads paved, Macedonia ranks 59th out of 159 countries. Macedonia also has a fairly high telephone density (47th in the world) at 199 lines per 1,000 people, yet only ranks 69th in the world for mobile phones per 1,000 people.

**Human Resources**
According to the UN Human Development Index, which ranks 174 countries, Macedonia ranked 69th in the world. However, low labor force participation places Macedonia 119th out of 177 countries, indicating that it is probably not utilizing most of its population toward building the country's future. Macedonia's life expectancy at birth, 72.6 years, is higher than both the Southeastern European average and the EU accession countries' average.

## 4.6 Summary

As displayed by the economic performance indicators, Macedonia has shown signs of economic recovery despite several adverse conditions. Macedonia's limited economic growth over the last decade is in large part due to the instability in the Balkans, including the Kosovo crisis, which caused a flood of refugees into the country, and ostracized Macedonia from its largest trading partners.

The remaining obstacles to Macedonian competitiveness are still associated with regional conflicts, the pursuit of economic independence, the loss of traditional markets and financial aid, and the difficulties in restructuring the economy from a centrally planned economy to one that is market driven. In particular, although Macedonian policies have created rather favorable macroeconomic conditions (as displayed by the policy indicators), like eliminating inflation and the budget deficit, they have failed to provide an effective regulatory framework for business activity.

The indicators show Macedonia to be highly trade dependent. Nevertheless, export growth has fallen well behind the world average. Although not engulfed directly by the disturbances in the region, the disruption of trade and investment linkages took its toll. The impacts of macroeconomic reform were felt towards the end of the transition decade. Although low inflation rates were maintained, the economy operates under high trade and current account deficits caused by low levels of foreign direct investment. A high unemployment level is certainly another problem for the Macedonian economy.

The investment indicators show that the regulatory deficiencies in Macedonia include the lack of active investment promotion, and especially the failure to attract foreign investments for the country's privatization programs. Though moderately successful, domestic investment will not suffice to build competitive industries in the long term and only foreign investment can balance the growing trade and current account deficits. The financial sector indicators point out that Macedonia needs to create a reliable and credible financial sector and focus on improving the competitiveness of its industries with potential for growth.

However, underlying modest results are indicators of great potential for future competitiveness such as the strength of a highly educated workforce, and a focus on science and technology. As reform and restructuring continue, Macedonia's competitiveness, as measured by these indicators, has the potential to improve quickly. Actual results will depend on good public policy, institutional reform, the emergence of competitive clusters, dialogue, and coordination.

# CHAPTER 5 – TRADE AND INVESTMENT COMPETITIVENESS

## 5.1 Background on Trade, Investment, and Growth

The relationships between exports and economic growth, investment and economic growth, as well as the linkages between trade and investment have been among the topics most debated by economists over the last twenty years.

The World Bank argues that export success had been the centerpiece of the East Asian countries' economic success, not only because exports generated income and savings and were a source of foreign exchange, but also because they contributed to technological developments in many sectors and to higher productivity[44].

The Inter-American Development Bank (IDB) states that since the dynamism and composition of exports may help conditions under which firms operate and the difficulties they confront, export performance of a country is a manifestation more than a measure of competitiveness[45]. The IDB's calculations indicate that while some countries with successful export performances had more high-technology-content goods in their portfolios, others with similar success had abundant natural resources and more low-technology-content goods. Thus, one can conclude that there are many routes to success and there is no single recipe for innovation or competitiveness.

The findings of the IDB indicate that exports with a medium and high technology content do help to speed up economic growth[46]. The IDB also states that development of exports with high and medium technology content and possibilities for economic growth depend not so much on the absolute conditions of competitiveness as on the environment in which firms operate relative to the country's income level. Although world trade is shifting gradually from more basic goods toward new high-technology goods, this trend is not a sufficient reason for countries to "choose winner products," especially for small economies forced to focus on a few products in order to penetrate world markets[47]. Indeed, many countries that achieved successful results did so not by "choosing winning products," but by spending efforts aimed at offering financial services, compensation for tax costs, and facilitating access to trade information. Small economies are at a disadvantage for fixed investments in research, development, and technological adaptation needed to produce highly elaborated manufactures. They also lack the variety of abilities and knowledge required by more complex production processes and the economies of scale involved in marketing and international transportation.

Foreign direct investment (FDI) affects the economic growth of a country through the transfer of technology, as well as through its role as a stimulus to competition, innovation, savings, and capital formation in host countries. Many export-oriented activities, particularly those integrated into international production systems, are new to developing countries and involve green-field FDI. The studies by the United Nations Conference on Trade and Development (UNCTAD) on FDI indicate that FDI brings in capital and financial resources, transforms and upgrades production technologies,

[44] "The East Asian Miracle," 1993, The World Bank
[45] "Competitiveness: The Business of Growth," 2001, John Hopkins University Press.
[46] "Competitiveness: Business of Growth," 2001, John Hopkins University Press
[47] Source: IDB statistical calculations

improves the capabilities of human resources, increases innovative activity, improves exports and foreign exchange earnings, increases gainful employment and shifts it towards higher-quality jobs, increases the host country's access to foreign markets, and helps countries exploit existing comparative advantages and build new ones[48].

While UNCTAD cites that statistical analyses show a positive link between FDI and manufactured export performance[49], the World Trade Organization (WTO) reports economic, institutional, and legal linkages between FDI and trade. It stated that the empirical evidence points to a modestly positive relationship between FDI and home country exports and imports. The WTO noted evidence that indicates that FDI and host country exports are complementary, but FDI and host country imports may be either substitutes or complements, depending on the details of the situation, including the policies pursued by the host country. (FDI attracted by low costs of production and liberal trade regimes is likely to be complementary with imports, and vice versa for tariff-jumping FDI.)

FDI and trade play a key role in firms' efforts to organize their production processes efficiently. By subdividing a production process into different phases, locating each phase in a country where it can be done efficiently, and then linking all the various phases through trade, firms can supply efficiently produced goods and services to buyers worldwide.

International trade can be a permanent source of economic growth if it functions as a channel for acquiring new knowledge and technologies and as a stimulus for continually improving productivity. It can also benefit firms that use imported capital goods, or firms that produce export goods according to international standards of technology, quality, or price. Through their relations with other firms, as customers, suppliers, and local competitors, firms that are not involved in international trade enjoy the continued growth generated by increasing demand of international markets, increasing global competition among firms, and improving telecommunications infrastructure (all stimulated by increasing international trade).

Competitiveness is the capability to generate prosperity by producing goods and services that stand the test of the marketplace under normal conditions. In order to avoid an erosion of their competitiveness and to achieve a sustainable share in the world markets, developing countries should seek strategies that will help reposition themselves over time, based on increased productivity levels, and try to increase the share of high- and medium-technology-content products in their export portfolios.

## 5.2 Approach

Based on the above information on trade, investment, and growth, the following approach is taken to assess Macedonia's trade and investment competitiveness. First, a review of Macedonia's trade performance, trade portfolio, and trade partners is presented in order to provide a basic understanding of whether the country has a trade surplus or not, what it trades, and with whom it trades. The trade performance review

[48] "World Investment Report 2000," UNCTAD
[49] Ibid.

provides a quantitative picture of a country's exports and imports. Trade performance is, in part, the result of strategic decisions of firms in a given country, which occur in the context of overall business environment incentives. Last, the trade portfolio and trade partners provide a qualitative snapshot and indicate how well diversified Macedonia's export products and markets are overall.

When a country has only a few export markets and a few products in its portfolio, its trade balance is more vulnerable to fluctuations in these markets or products. Also, the trade competitiveness of a country is correlated to the presence of high-value-added products in a country's trade portfolio. As the percentage of high-value-added products in a country's trade portfolio increases and productivity levels in a country rise, its exports become more competitive.

Next, an analysis of global competitiveness of Macedonia's exports by the International Trade Center (ITC) is presented, which highlights how well Macedonia's products are competing in world markets. This analysis indicates which of the country's products performed better than the world averages (increased their share), and whether the world markets for those products were an increase or a decline.

The FDI flows in and out of Macedonia are presented to provide an understanding of the country's success and ability in attracting FDI. Finally, potential opportunities for growth of Macedonia's exports, and what the country can do to reposition itself over time on the basis of increased productivity are discussed.

## 5.3 Current Trade

**Trade Performance.** While Macedonian exports recorded a high in 1998, the negative impacts of the Kosovo conflict reflected negatively on the performance of the country's exports with a decrease of 9.2% in 1999. Led by iron and steel products, and apparel and textiles, Macedonia's exports rose by 11% in 2000 when compared with 1999. The country's imports, because of the higher international oil prices, rose by 17% to US$2.1 billion. Imports were led by the raw materials for iron and steel products. Macedonia, thus, finished 2000 with a trade deficit of US$766 million (see Table 5.1), amounting to an increase in the deficit of 31%.

The factors that contributed to an increase in the trade deficit were the denar/D-mark peg, the depreciation of the D-mark against the dollar, increased gasoline imports, and iron and steel imports for re-processing.

**Table 5.1: Trade Figures of Macedonia (US$ billion)**

| | 1992 | 1993 | 1994 | 1995 | 1996 | 1997 | 1998 | 1999 | 2000 |
|---|---|---|---|---|---|---|---|---|---|
| Exports | 1199 | 1055 | 1086 | 1204 | 1147 | 1237 | 1311 | 1191 | 1319 |
| Imports | 1206 | 1199 | 1484 | 1718 | 1626 | 1778 | 1915 | 1776 | 2085 |
| Deficit | 7 | 144 | 398 | 514 | 479 | 541 | 604 | 585 | 766 |

Source: Statistical Bureau of the Republic of Macedonia

**Major Products.** The apparel and textiles industry dominated exports in the first quarter of 2001. The next largest export category was iron and steel products. Tobacco came in third. The structure of exports changed compared with 2000: the dominance of apparel and textiles exports brought finished goods to 49.9% of total exports, compared to 42.3% in 1999. Semi-finished goods dominated exports, forming 54.4% of the total during 2000[50]. The metallurgical industry provided a major contribution to the exports. This trade portfolio was disadvantageous, since higher-value finished goods formed a smaller proportion of the total (42.8%), and capital goods only 2.5%.

Table 5.2 below displays the major product categories and their export and import performance in 1999 in which Macedonia recorded a shrinking trade deficit. While the equipment and vehicles, food and beverages, and chemical products were the top three import groups, textiles and clothing, non-ferrous metals, and food and beverages were the top three export groups.

**Table 5.2: Imports and Exports of Macedonia (1999)**

| Imports of Macedonia | | Exports of Macedonia | |
|---|---|---|---|
| Equipment and vehicles | 19,1% | Textiles and clothing | 15,3% |
| Food and beverages | 16,1% | Non-ferrous metals and products thereof | 15,3% |
| Raw materials | 14,5% | Food and beverages (incl. tobacco) | 14,3% |
| Chemical products | 10,6% | Iron and steel | 8,6% |
| Fuels | 8,5% | Equipment and vehicles | 7,8% |
| Clothing and shoes | 4,9% | Chemical products | 5,9% |
| Others | 26,3% | Shoes | 4,5% |
| | | Others | 28,3% |

Source: Privatization Agency of the Republic of Macedonia

Table 5.3 displays the export and imports of Macedonia by SITC product categories and their US$ amount percentages in 1997 and 1998. Although most of the product categories maintained their existing levels, "Mineral fuels, lubricants and related materials," "Manufactured products classified mainly by materials," and "Miscellaneous articles" were the categories responsible for the increase in exports from 1997 to 1998. On the imports side, the noticeable increases were recorded in "Machinery and transport equipment" and "Special transaction & commodities not classified according to kind" categories.

**Table 5.3: Exports and Imports of Macedonia (in US$ thousands)**

| | EXPORTS | | | | IMPORTS | | | |
|---|---|---|---|---|---|---|---|---|
| | 1997 | % | 1998 | % | 1997 | % | 1998 | % |
| **Total** | **1,236,808** | **100** | **1,310,679** | **100** | **1,778,515** | **100** | **1,914,663** | **100** |
| Food products | 70,870 | 5.7 | 66,185 | 5.0 | 243,143 | 13.7 | 255,940 | 13.4 |
| Beverages & tobacco | 177,125 | 14.3 | 143,767 | 11.0 | 19,749 | 1.1 | 25,901 | 1.4 |
| Crude materials, expect fuels | 68,979 | 5.6 | 56,653 | 4.3 | 69,176 | 3.9 | 67,278 | 3.5 |

[50] EIU Country Report, February 2001

| | | | | | | | | |
|---|---|---|---|---|---|---|---|---|
| Mineral fuels, lubricants & related materials | 5,559 | 0.4 | 10,459 | 0.8 | 197,044 | 11.1 | 162,591 | 8.5 |
| Animal and vegetables oils & fats | 280 | 0.0 | 241 | 0.0 | 15,472 | 0.9 | 25,573 | 1.3 |
| Chemicals & related products | 72,691 | 5.9 | 65,449 | 5.0 | 192,151 | 10.8 | 203,374 | 10.6 |
| Manufactured products classified mainly by materials | 422,706 | 34.2 | 448,384 | 34.2 | 343,767 | 19.3 | 278,147 | 14.5 |
| Machinery & transport equipment | 95,910 | 7.8 | 98,183 | 7.5 | 302,044 | 17.0 | 366,119 | 19.1 |
| Miscellaneous manufactured articles | 321,313 | 26.0 | 419,238 | 32.0 | 213,773 | 12.0 | 93,724 | 4.9 |
| Special transaction & commodities not classified according to kind | 1,376 | 0.1 | 2,121 | 0.2 | 182,195 | 10.2 | 436,017 | 22.8 |

Source: UN

**Direction of Trade.** As Table 5.4 presents, most of Macedonia's recent exports are directed to the EU or to the countries of former Yugoslavia. Its imports are mainly from EU, Eastern Europe, and former Yugoslavia.

**Table 5.4: Foreign Trade of Macedonia (US$ million)**

| | 1999 | 2000 | % CHANGE | % SHARE 2000 |
|---|---|---|---|---|
| **EXPORTS** | | | | |
| EU | 539.5 | 561.5 | 4.1 | 42.6 |
| EFTA | 24.2 | 40.1 | 65.6 | 3.0 |
| Other developed countries | 153.0 | 188.7 | 23.4 | 14.3 |
| Eastern Europe | 75.5 | 60.2 | -20.2 | 4.6 |
| Former Yugoslavia | 356.9 | 430.4 | 20.6 | 32.6 |
| TOTAL including others | 1191.3 | 1319.0 | 10.7 | 100.0 |
| **IMPORTS** | | | | |
| EU | 722.6 | 795.0 | 10.0 | 38.1 |
| EFTA | 24.3 | 29.6 | 21.6 | 1.4 |
| Other developed countries | 149.0 | 179.3 | 20.4 | 8.6 |
| Eastern Europe | 371.0 | 582.3 | 56.9 | 27.9 |
| Former Yugoslavia | 411.6 | 396.5 | -3.7 | 19.0 |
| TOTAL including others | 1776.2 | 2084.7 | 17.4 | 100.0 |

Source: Economist Intelligence Unit, 2001 Macedonia Country Report

Table 5.5 presents the top five countries that Macedonia traded with over the 1997 – 2000 period. Germany and Yugoslavia have been the largest trading partners for Macedonia during the last four years.

**Table 5.5: Top 5 Countries Trading with Macedonia (in US$ millions)**

| | 1997 | |
|---|---|---|
| | **Exports** | **Imports** |
| Yugoslavia | 273.5 | 206.0 |
| Germany | 199.0 | 239.0 |
| Greece | 98.9 | 130.0 |
| USA | 117.0 | 83.4 |
| Slovenia | 58.9 | 137.6 |

| | 1998 | |
|---|---|---|
| | **Exports** | **Imports** |
| Germany | 280.6 | 255.2 |
| Yugoslavia | 240.0 | 245.6 |
| USA | 174.0 | 101.6 |
| Italy | 92.0 | 109.1 |
| Greece | 83.2 | 112.9 |

| | 1999 | |
|---|---|---|
| | **Exports** | **Imports** |
| Germany | 254.3 | 245.8 |
| Yugoslavia | 254.5 | 183.9 |
| Greece | 85.9 | 164.6 |
| USA | 136.1 | 54.7 |
| Slovenia | 34.0 | 156.7 |

| | 2000 * | |
|---|---|---|
| | **Exports** | **Imports** |
| Yugoslavia | 333.1 | 189.8 |
| Germany | 256.1 | 252.2 |
| Greece | 83.8 | 200.1 |
| USA | 165.6 | 82.9 |
| Ukraine | 0.5 | 205.7 |

Source: State Statistical Office, Macedonia
* estimated data

The 31.0% increase in exports to Yugoslavia from 1999 to 2000 reflects Macedonia's return to the Yugoslav market after the disruption of the last ten years. Since the first half of 2000 Yugoslavia (Serbia-Montenegro), which was a traditional major trading partner for Macedonia, has taken over Germany as Macedonia's largest trading partner. Trade with EU has increased steadily, and this trend may be expected to continue as a result of the EU's trade preferences for the Western Balkans, which make 95% of most goods free of customs duty. The temporary agreement with the EU covering steel and textiles from Macedonia will definitely support this trend.

The free trade agreement Macedonia signed with Ukraine in January 2001 may make Macedonia's exports cheaper[51] and help reduce its trade deficit. Macedonia's existing free trade agreements with Yugoslavia, Bulgaria, Turkey, and EFTA are also expected to play a key role in improving exports in the years to come.

Table 5.6 presents the trade flow of each of the Southeastern European Countries with EU countries and within the Southeastern Europe region. Macedonia's imports from and exports to the EU countries are only above that of Bosnia and Herzegovina and Albania. The country has relatively small trade with the Southeastern European countries.

**Table 5.6: Direction of SEE trade flows, by partner, 1998 (US$ million)**

[51] Macedonia imports raw materials for the iron and steel industry from Ukraine.

| | Albania | BiH | Bulgaria | Croatia | FRY | Macedonia | Romania | SEEC-7 |
|---|---|---|---|---|---|---|---|---|
| **Imports** | | | | | | | | |
| Industrial Countries | 707 | 1133 | 2418 | 5616 | 2042 | 1192 | 7637 | 20630 |
| EU. Com. | 683 | 1048 | 2019 | 4586 | 1878 | 1089 | 6535 | 17765 |
| Partner 1 | 334 **Ita** | 372 **Ger** | 631 **Ger** | 1616 **Ger** | 652 **Ger** | **297 Ger** | 2039 **Ita** | |
| Partner 2 | 211 **Gre** | 297 **Ita** | 356 **Ita** | 1500 **Ita** | 588 **Ita** | **285 Ita** | 2033 **Ger** | |
| Partner 3 | 68 **Ger** | 124 **Aus** | 289 **Gre** | 401 **Fra** | 228 **Aus** | **184 Aus** | 810 **Fra** | |
| Other Countries | 25 | -7 | 398 | 1030 | 165 | 102 | 1101 | 2774 |
| SEEC`s & Slovenia | 60 | 1096 | 155 | 959 | 450 | 597 | 174 | 3647 |
| Albania | - | - | 0 | 1 | 0 | 5 | 0 | 31 |
| BiH | - | - | 0 | 156 | - | 1 | 11 | 178 |
| Bulgaria | 27 | 11 | - | 9 | 94 | 107 | 47 | 295 |
| Croatia | 7 | 719 | 5 | - | 0 | 65 | 4 | 801 |
| FRY | 1 | - | 37 | 0 | - | 236 | 5 | 336 |
| Macedonia | 15 | 1 | 38 | 56 | 126 | - | 61 | 354 |
| Romania | 5 | 15 | 57 | 15 | 117 | 7 | - | 210 |
| Slovenia | 6 | 350 | 18 | 722 | 113 | 177 | 46 | 1442 |
| Other Countries | 97 | 303 | 1956 | 1324 | 95 | 275 | 3866 | 7410 |
| *Total* | **864** | **2525** | **4528** | **7899** | **2587** | **2064** | **11677** | **31680** |

| | Albania | BiH | Bulgaria | Croatia | FRY | Macedonia | Romania | SEEC-7 |
|---|---|---|---|---|---|---|---|---|
| *Exports* | | | | | | | | |
| Industrial Countries | 239 | 268 | 2304 | 2360 | 972 | 786 | 5745 | 10369 |
| EU. Com. | 226 | 253 | 1946 | 2024 | 941 | 617 | 5101 | 9161 |
| Partner 1 | 150 **Ita** | 111 **Ita** | 531 **Ita** | 816 **Ita** | 367 **Ita** | 266 **Ger** | 1809 **Ita** | |
| Partner 2 | 33 **Gre** | 93 **Ger** | 443 **Ger** | 767 **Ger** | 335 **Ger** | 135 **Ita** | 1587 **Ger** | |
| Partner 3 | 21 **Ger** | 22 **Aus** | 373 **Gre** | 102 **Fra** | 70 **Fra** | 44 **Bel** | 476 **Fra** | |
| Other Countries | 14 | 15 | 358 | 336 | 31 | 169 | 644 | 1209 |
| SEEC`s & Slovenia | 8 | 195 | 312 | 1121 | 340 | 271 | 267 | 2201 |
| Albania | - | - | 25 | 6 | 1 | 13 | 4 | 25 |
| BiH | - | - | 10 | 654 | - | 1 | 14 | 706 |
| Bulgaria | 0 | 0 | - | 5 | 37 | 34 | 78 | 155 |
| Croatia | 1 | 142 | 7 | - | 0 | 51 | 15 | 208 |
| FRY | 0 | - | 94 | 0 | - | 125 | 117 | 242 |
| Macedonia | 4 | 1 | 97 | 59 | 236 | - | 7 | 307 |
| Romania | 0 | 10 | 51 | 7 | 5 | 4 | - | 26 |
| Slovenia | 2 | 42 | 29 | 390 | 61 | 43 | 33 | 570 |
| Other Countries | 7 | 34 | 1448 | 941 | 279 | 135 | 2116 | 3099 |
| *Total* | **254** | **497** | **4064** | **4421** | **1312** | **1192** | **8128** | **15803** |

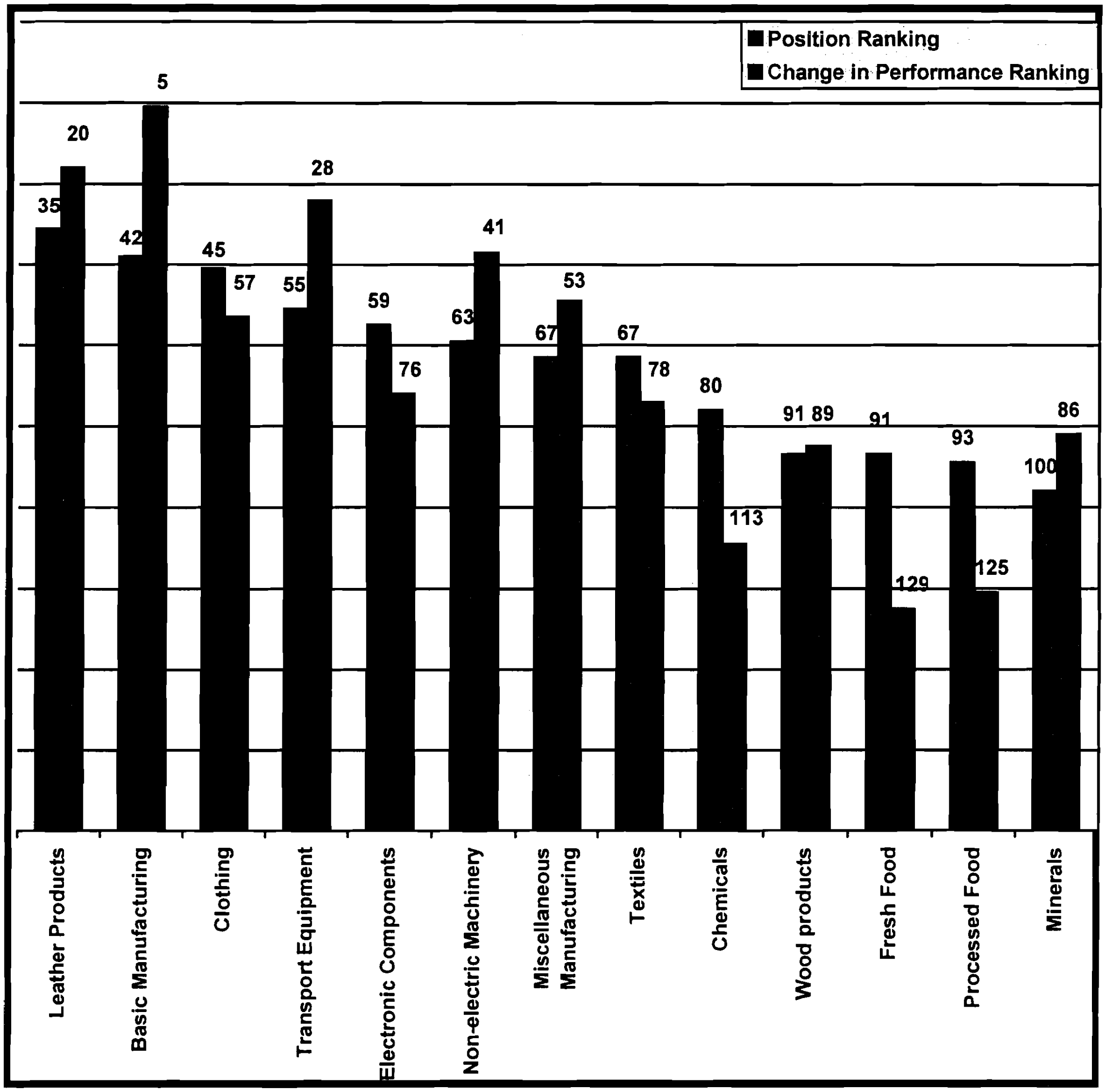
**Table 5.6 continued:**

Source: IMF Direction of trade
Figures for regional trade of FRY are estimated using non-adjusted partner data.
The total for exports from FRY does not include exports for developing countries.

### 5.4 Global Competitiveness of Macedonian Exports

In order to understand the competitiveness of Macedonian exports, it is important to benchmark export performance, to identify new markets, and to monitor the role of competitors. The Trade Performance Index (TPI) developed by the International Trade Center (ITC) assesses the multifaceted dimensions of export performance and competitiveness of countries and their principal export sectors. Using the COMTRADE database of the UN Statistics Division and covering 184 countries, TPI calculates two composite rankings, one for the *overall position* of the country and the sector under review and another one for the *change in performance*. Thus, TPI allows comparison of the performance of a country's export sector with that of other countries as well as with the performance of other sectors of the same country, shedding light both on the competitive and the comparative advantage. As seen in Chart 5.1 below, Macedonia ranked between thirty-five and one hundred for the export sectors under review. While leather products, basic manufacturing, and clothing exports of Macedonia ranked within the top fifty in the world, in terms of change in performance, basic manufacturing, leather products, and transport equipment ranked in the top five, twenty, and twenty-eight respectively.

**Chart 5.1: Trade Performance Index for Macedonia**




The International Trade Center (ITC) has developed a number of tools to provide a country's export portfolio in terms of the dynamics of national supply and international demand. Chart 5.2 presents the performance of Macedonia's top twenty leading export product groups as stated by ITC. It displays the export value of the products, and compares national export growth with the growth of the international demand. Chart 5.2 also indicates the average nominal growth of total exports of Macedonia (about 1.0% per annum indicated by the vertical line) for the period 1994 to 1998 and the average nominal growth of world imports over the same period (5.8% per annum indicated by the horizontal line). The diagonal line (the line of world constant market share) divides the

REPLACE PAGE WITH CHART 5.2

chart into two parts: exports of products to the right of this line have increased their share in the world market, while the ones to the left have experienced an erosion of their world market share. The large bubbles such as flat rolled products, zinc, tobacco and men's/boys' shirts (of cotton, not knitted) indicate that Macedonia's exports are relatively concentrated. The chart has four quadrants as explained below:

Champions – winners in growth markets. Flat rolled products, not alloyed zinc, and men's trousers and shorts made of synthetic fibers are the export product groups in which Macedonia has performed very well. These are dynamic products, which grew faster than the world trade in general, and for which Macedonia has been able to outperform world market growth and to increase its share of world imports. Exporters of these products have proven their international competitiveness over the 1994 – 1998 period.

Underachievers – losers in growth markets. Electric conductors, medicaments, lumber and beech are sectors that present challenges for Macedonia. While the international demand has been growing at above-average rates, Macedonia's exports of these products have either been falling behind or grown less dynamically than the world trade, causing Macedonia to lose its international market share. With these products, the bottleneck is on the supply side rather than the demand side. It is essential for Macedonia to remove the barriers that impede a more dynamic expansion of these exports.

Losers in declining markets – bleak export prospects. There are no products that fall into this category.

Achievers in adversity – winners in declining markets. Macedonia's share in the world import markets in grape wines, tobacco, women's/girls' blouses and shirts, men's/boys' shirts of cotton, ferro-silico-manganese, and ferro-nickel has grown between 1994 and 1998, even though these markets were declining or growing below world average in the same period. From a strategic perspective, Macedonia needs to identify niche-marketing strategies to isolate the positive trade performance from the overall decline in these markets.

Table 5.7 presents the exports of Macedonia's thirty product categories at the HS 6-digit level in 1998. While the "Trend 94 – 98" column shows the annual percentage growth of the export value, the "Volume Trend" column shows the annual percentage growth of quantity of the product. The "World Trend" column indicates annual percentage growth of world imports of the product under review in the period of 1994 – 98. Looking at the values under this column (with only eight product categories with a growth of more than 10%), one can argue that Macedonian exports were not among the products in the world that experienced higher growth. The table also indicates that Macedonia's market shares in these products are between 0.1% and 3.5%. Products with a "Unit Value" above one suggest that the products are positioned in a market segment characterized by above-average quality and prices. The "No." column indicates the number of countries importing the product under review from Macedonia.

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As a small country, Macedonia's growth depends heavily on export-oriented industries. The export competitiveness of Macedonian goods was substantially increased following the 15% currency devaluation in mid-1997. However, the weakness of the domestic supply to meet the demand so far reflects the need to deepen reform in areas such as the financial sector, and corporate governance to increase the export competitiveness of Macedonia. The country's economic growth depends on continued strong growth of agriculture, trade, and services, coupled with accelerated growth in industry and mining.

### 5.5 Current FDI flows to/from Macedonia

FDI inflows to Macedonia have been relatively low, however over the last few years the investment activities have intensified. Macedonia recorded its best year since independence for FDI in 1998, with an inflow of US$118 million. In 1998, privatization-related inflows accounted for a significant share of total FDI received, and eighteen privatization transactions totaling up to US$27 million were reported by the Privatization Agency of Macedonia. In 1999, the FDI inflows were low, due to the timing of payments, but as of November 2000, the FDI due to privatization totaled US$80.58 million[52].

As Table 5.8 presents, FDI has increased rapidly during 2000, to a cumulative US$71.6 million[53]. Macedonia attracted significantly more foreign direct investment in 2000 than in 1999, as the end of the Kosovo crisis fueled interest in the region. Foreign-exchange reserves increased in January 2001, mostly because of the US$322.5 million acquisition of a 51% stake in the state telecommunications company, Makedonski Telekomunikacii (MT) by the Hungarian Matav. Most of FDI flows, however, were focused on privatization of state-owned enterprises rather than into green-field investments.

**Table 5.8: FDI Flows to/from Macedonia (in US$ millions)**

| | 1994 | 1995 | 1996 | 1997 | 1998 | 1999 | 2000 |
|---|---|---|---|---|---|---|---|
| **INFLOWS** | 19.1 | 8.4 | 7.2 | 30.9 | 112.3 | 38.1 | 71.6 |
| **OUTFLOWS** | 0 | 0 | 0 | 1 | 1 | 1* | 1* |

Source: World Investment Report 2000 and Privatization Agency of Macedonia
*: Estimate

The security crisis in 2001 has caused more cautious investor behavior in Macedonia. Prior to the breakout of violence, Macedonia enjoyed an increase in the presence of foreign companies. Any further drop in foreign investors would be a heavy blow to the country's economic recovery and overall stability. Already Macedonian officials were at pains to assure potential foreign investors that the situation in Tetovo was under control, as a Greek company halted construction of a shopping complex in Skopje.

The FDI per-capita figures for 1998 (Table 5.9) indicate that Macedonia ranked third among the Southeastern European countries. However, with US$59 per capita, the country attracts only slightly above one-third of the average, US$149.25 per capita, for EU accession countries.

[52] DM184.3 million, converted into US$ by using an exchange rate of US$1 = DM2.2870 for November 2000 reported by Federal Reserve Bank of St. Louis
[53] Source: Privatization Agency of the Republic of Macedonia

**Table 5.9: FDI inflows of Selected Countries, 1998**

| | FDI per Capita (US$) | Total FDI (US$ million) |
|---|---|---|
| Estonia | 401 | 581 |
| Lithuania | 250 | 926 |
| Czech Republic | 248 | 2,554 |
| Hungary | 191 | 1,936 |
| Poland | 165 | 6,365 |
| Latvia | 146 | 357 |
| Slovak Republic | 104 | 562 |
| Slovenia | 83 | 165 |
| Cyprus | 49 | 37 |
| Turkey | 15 | 940 |
| **EU Accession Average** [54] | **149.25** | **1404.58** |
| Croatia | 194 | 873 |
| Romania | 90 | 2,031 |
| Macedonia, FYR | 59 | 118 |
| Bulgaria | 49 | 401 |
| Albania | 13 | 45 |
| **SE Europe Average** | **81.00** | **693.60** |

Source: World Bank data

## 5.6 Opportunities

It is a fact that Macedonia does not have the inherent attractions of the large markets of China and Brazil, or the industrial experience of Hungary and the Czech Republic, which have succeeded in attracting large amounts of FDI over the last decade. However, Macedonia has the potential to be one of those countries that have managed to create competitive advantages for themselves by creating a better business climate, such as Estonia and some provinces of the Russian Federation. Although the Macedonian market is thought to cover no more than two million consumers, through its well-developed and growing system of symmetrical and asymmetrical free trade agreements, it provides access to well over sixty million consumers in the region—extending from Turkey to Slovenia.

Macedonia can increase its competitiveness through enhancement of productivity in its traditional industries such as apparel and textiles by seeking market niches, in its raw-material-based sectors such as ferro-silicon by focusing on more value-added production, and in its human-resource-intensive industries such as electronics, food processing, telecommunications, computer software, and services by focusing on strategic alliances that will benefit the domestic industry by technology transfer, knowledge of markets, and increasing human skills.

[54] The average includes all of the countries above plus Romania and Bulgaria.

# CHAPTER 6 – INDUSTRY- AND FIRM-LEVEL COMPETITIVENESS

## 6.1 Introduction

This chapter presents three industry analyses—Apparel and Textiles for Exports, Information Technology (IT), and Tourism—from a competitiveness point of view. The three tools used in the analyses are briefly described below:

**Diamond Analysis**
The industry analyses below utilize the competitiveness diamond, developed by Michael Porter, which helps understand the decision-making process for firms in a particular industry in a given country. The four sections of the diamond are: factor conditions; demand conditions; related and supporting businesses; and firm strategy, structure, and rivalry. Factor conditions refer to the presence of basic and advanced factors such as labor, technical infrastructure, and other factors related to productivity. Factor conditions are analyzed on how well the country has upgraded its natural conditions. Demand conditions reflect the level of sophistication of the local customer base, which would ideally be anticipating global trends and preparing local producers for future upgrades. Related and supporting businesses are the local suppliers and distributors who can serve as catalysts for innovation, reinforce skills in product manufacture, process technologies and market channels. Finally, strategy, structure, and rivalry describe firms' choices, positioning, and the presence of local competition. Some innovation-driven economies present a very high degree of rivalry. Generally, strong local competition is a positive preparation for firms in the global marketplace.

**SWOT Analysis**
SWOT analysis refers to *strengths, weaknesses, opportunities, and threats* and helps firms assess the business environment they operate in from a strategic perspective. *Strengths* look into the advantages faced by an industry. *Weaknesses* cover the points that should be avoided, disadvantages, and poor characteristics of a particular sector. *Opportunities* represent changes in market trends, potential technical innovations, government policies, and demand trends that may positively affect the industry in question. Finally, *threats* cover the rival's strategy, threatening trends in technology, potential cash-flow problems, and changes in the products and job specification that may negatively impact the firm.

**Fairbanks 7 Opportunities Analysis**
In his book *Plowing the Sea*, Michael Fairbanks identifies seven patterns of uncompetitive behavior commonly present in developing countries. The first pattern is an over-reliance on basic factors of advantage, which causes the export of natural resources at devalued exchange rates, the depletion of the exported products, and the pressures to keep costs low. The remedy for this pattern is to develop more complex sources of advantage. The second damaging pattern is a poor understanding of customers. Private sectors in most developing countries do not make explicit choices about customer segments, do not understand different customer needs, and do not seek out the most attractive customers. Industries must invest in customer research to become competitive and gain better customer understanding. The third pattern is ignorance of relative competitive position. This pattern reflects a tendency to make uninformed choices resulting in a high degree of vulnerability to competition. In order to

correct this pattern, businesses in developing countries must research their relative competitive position. A fourth pattern is that of a failure to forward integrate. Studying these opportunities and interacting with buyers is crucial for enhancing a firm's relative competitive position. Poor inter-firm cooperation is the fifth damaging pattern. Cooperation within the value chain and with related and supporting industries can substantially raise firm productivity levels. Finally, the seventh pattern is excessive paternalism. Heavy control of key sectors of the economy prevents innovation and needs to be eliminated.

## 6.2 Apparel and Textiles for Export

### A. Industry Definition and Background

The apparel and textiles for export sector is defined as manufacturing of textile fibers and fabrics[55] and assembly of ready-to-wear textile products, including men's and boys' trousers of synthetic fiber origin, non-knitted men's and boys' shirts, non-knitted women's and girls' blouses.

For many years, the apparel and textiles industry was one of the dominant sectors that absorbed a significant portion (mostly female) of the working population in Macedonia. In the early 1990s, at the peak of its performance, the sector employed some 65,000 – 70,000 workers. However, since then, the sector has experienced a decline and many companies have gone through liquidation. Although some 425 apparel companies were established between 1996 and 2000, the number of employees in the apparel sector was only around 27,000 in 2000.

While in the early 1990s, apparel and textiles had an average share of 25% of the total industrial production, that share fell to around 10% in the late 1990s. The utilization of installed capacities was around 80% for apparel and textiles in 1991, and dropped to an average of only 49% in 1999. This underutilization is partly due to the cumbersome and still ongoing restructuring and privatization process of the Macedonian economy, as well as the complex political conditions in the entire region.

The Macedonian apparel and textiles sector's original focus was to service both the domestic market (i.e. ex-Yugoslav market) as well as to provide exports to the former socialist countries in Eastern Europe. Currently, the apparel and textiles sector services clients in Western Europe and the United States mostly through "lohn"[56] contracts.

Most of the Macedonian firms in apparel and textiles are export-oriented. Following the reunification of East and West Germany, the beginning of the transition process in Central and Eastern European countries gaining momentum, and the disintegration of the former Yugoslavian Federation, most of the traditional export markets for Macedonian apparel and textiles products were lost. A decade of political turmoil in the region (the wars in Slovenia, Croatia, Bosnia and Herzegovina, Kosovo, the economic

[55] Cotton thread and fabric, wool yarn, fabric and knitted fabric are the main products manufactured in Macedonia.
[56] A German-origin word ubiquitously used in apparel sector for a contract arrangement where the contracted firm processes goods supplied by the contractor and ships the final product back to the contracting firm.

sanctions against Yugoslavia and the Greek embargo on Macedonia) had a very negative impact on the apparel and textiles industry in particular.

**B. Diamond Analysis**

Factor Conditions

The apparel and textiles industry takes advantage of abundant human resources with good basic technical skills. Macedonia offers quality education at the elementary, secondary, and university levels. However, managerial and other specialized skills are still in short supply. Salaries in the apparel and textiles sector are far below the salary average for the manufacturing sector.

The physical infrastructure in Macedonia is relatively developed compared to other countries of Southeastern Europe, however the transportation costs are comparatively high. The road network and connections have been partly damaged due to the recent disruptions in the region.

Information technology and scientific research infrastructure need to be upgraded in order to promote technological innovation, which the Macedonian apparel and textiles sector lacks. Likewise, university curricula in particular will have to be improved, while research facilities at the institutions of higher learning need to interact and cooperate more closely with the industry.

Capital for investment purposes is still in short supply and the biggest apparel and textiles plants, "Bitolateks," "Jugoteks," "Prima," "Goblenka," "Sniteks," "Prepateks," are having cash flow problems, as local banks have limited assets and are reluctant to lower interest rates, due to unstable political and economic conditions. The latter is partly why apparel and textiles manufacturers prefer to work on a contract basis rather than engaging in more complex production activities.

Demand Conditions

The home market for apparel and textiles in Macedonia is too small to reap significant economies-of-scale benefits and there is little incentive to invest aggressively. Therefore, it is unlikely that a large percentage of Macedonian firms would develop products with only the Macedonian market in mind.

Macedonian buyers are not yet sophisticated, as the purchasing power of the majority of the Macedonian population is low and the average consumer demands low-price products, which are in turn of low quality. Only about 5 to 10 percent of the population demands somewhat sophisticated products and seeks products at EU-quality standards. In Macedonia, there is almost no pressure on producers to continuously upgrade or improve their products or production because buyers, for the most part, accept what they are given.

Strategy, Structure and Rivalry

There are only about ten businesses in the apparel and textiles sector with significant business activity to be considered medium-to-large-size firms. Other companies operating in this sector are small-size enterprises and little cooperation takes place among them.

The competition on the domestic wholesale and retail market of apparel and textiles products is very intense. The retail market for apparel is becoming very competitive partly due to illegal trading activities (irregular imports, tax evasion, cash transactions etc.) in apparel and textiles consumer goods. However, the competition is mostly price-based and does not push the companies to increase quality and innovate.

The Macedonian companies currently place too much focus on assembly operations and do no yet have a focus and strategy to capture better shares of the large markets open to them through Free Trade Agreements. Moreover, they are too weak to compete with larger companies in these markets and lack an understanding of these markets. Thus, the Macedonian apparel and textiles firms have no drive to innovate and upgrade their productivity levels.

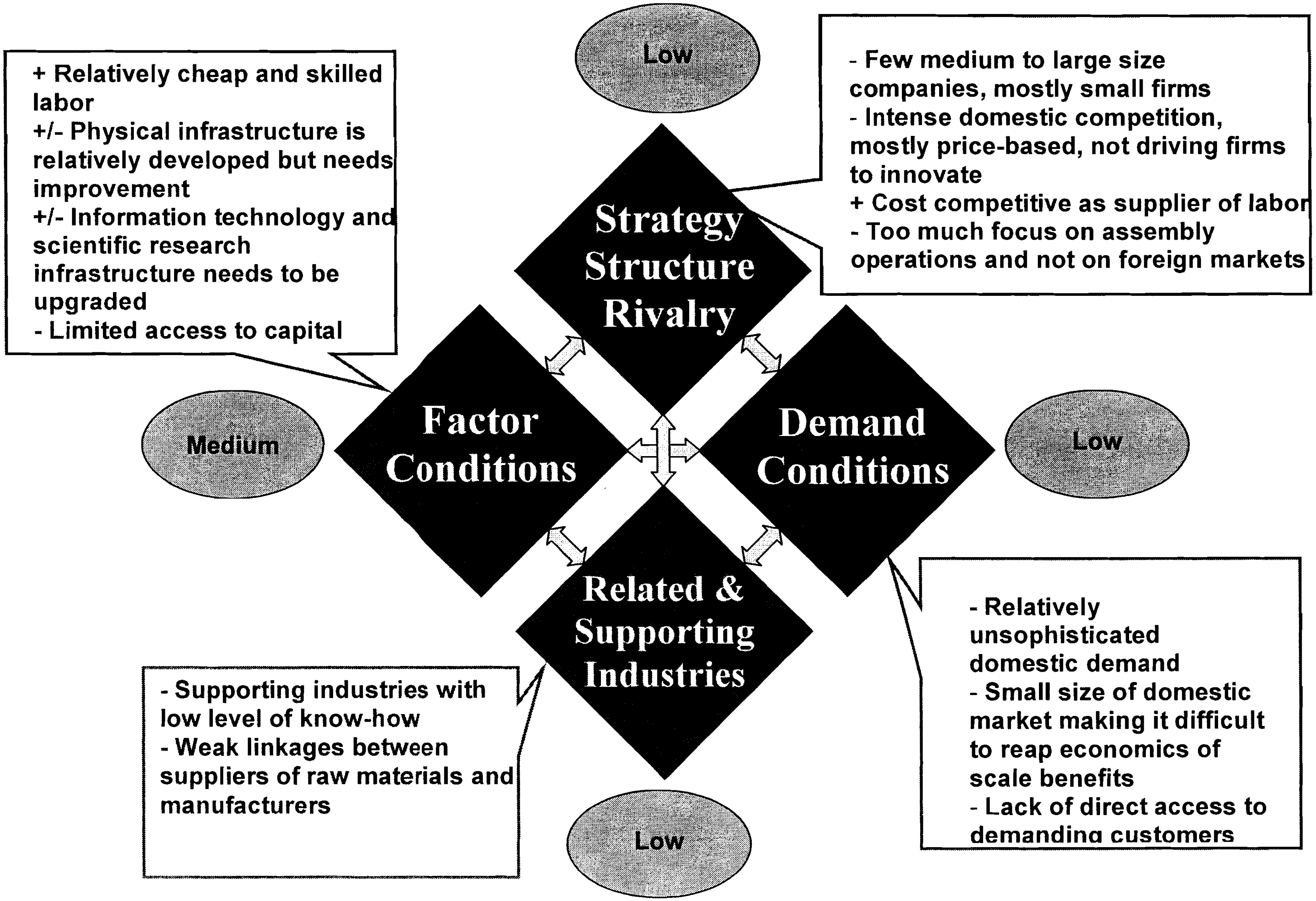
Related and Supporting Industries

In Macedonia, the working relationship among companies within the apparel and textiles industry is a weak one, with little incentive for facilitating and coordinating innovation. Related industries, such as accessories, and printing and packaging, lack competitive advantages and have low levels of know-how. The existing linkages between raw material suppliers and manufacturers are not strong. These factors do not contribute to an environment where opportunities for positive exchanges for new ideas, insights, and innovation may flourish.

However, the entire retail network of apparel and textiles has improved significantly over the last ten years. Modern and fashionable retail facilities have replaced the former uniformly furnished and modestly supplied department stores and sales outlets.

So far, the presence of foreign direct investment in the sector is small. Therefore, there are no significant opportunities for the domestic firms to establish strategic alliances with foreign companies, which would enable technology and knowledge transfer to take place.

## MACEDONIAN APPAREL AND TEXTILES INDUSTRY DIAMOND



## C. Role of Government

The legal framework that is in effect in Macedonia is relatively suitable to support the growth and development of the Macedonian apparel and textiles industry, especially the fiscal and custom regulations for "lohn contract" transactions, which are dominant in Macedonian apparel and textiles sector.

The government of Macedonia has played an important role by enabling Macedonian firms to have access to the EU markets in accordance with the Stabilization and Association Treaty and through several bilateral agreements for free trade, which may have a very important influence on exportation of finished products (reducing the percentage of "lohn contact" products in the total firm turnover), as a basis for development of the apparel and textiles sector.

Bearing in mind the high labor-intensive nature of the sector, the government should give serious consideration to the issue of the high percentage of tax levied on salaries.

Some other constraints that should be addressed by government are:

- Losses from financial transactions and differences in exchange rates
- Inefficient export support institutions
- Lack of funding and high interest rates imposed by domestic financial institutions.

## D. SWOT Analysis Table

| Strengths | Weaknesses |
|---|---|
| • Existence of qualified labor<br>• Relatively low labor costs<br>• Low capital dependence<br>• Low energy dependence<br>• Relatively developed assembly market<br>• Good regulation of assembly transactions (customs and fiscal aspects) | • Outdated technology and equipment<br>• Weak corporate governance, strategy and management<br>• Low awareness of fashion trends and design<br>• Low profitability<br>• Limited domestic market<br>• Strong competition from imports<br>• High dependency on contract ("lohn") work<br>• Limited access to capital<br>• High reliance on apparel and textiles imports (raw materials, machinery)<br>• Lack of competitive supporting institutions<br>• Lack of internationally recognizable trade marks, know-how, and franchises |

| Opportunities | Threats |
|---|---|
| • Underutilized production capacities<br>• Bilateral free trade agreements with most East European countries<br>• Open EU markets in accordance with the Stabilization and Association Treaty<br>• Export-oriented potential of manufacturing capacities for finished products<br>• Increasing interest in FDI and joint-ventures<br>• Underutilized raw material production capacities<br>• Existence of specialized educational institutions (in textiles) | • Informal imports of finished apparel and textiles products<br>• Insufficient and expensive investment<br>• High fiscal costs on labor<br>• Unstable domestic and neighboring political environment<br>• Unreal price (exchange rate) of local currency |

## E. Looking Ahead

Although it currently has low profitability levels, the apparel and textiles goods for exports sector, due to its high labor-intensive nature and potential for exports, emerges as a short-term priority for the Macedonian economy. Most economic development experts envisage this sector as one of the driving forces of Macedonian exports. Therefore, impediments to this sector's competitiveness need to be properly addressed.

The revitalization of the apparel and textiles industry will enrich the variety of products in Macedonia and yield increased product standards and quality in accordance with international market standards. In order to be competitive in the international market, the Macedonian apparel and textiles sector needs to increase its knowledge of foreign markets, modernize its existing technologies, identify market niches, and focus on raising its standards to the levels that are sought by international consumers.

Although the apparel and textiles sector recently has reported a low rate of profitability, it has the following advantages at the current stage of development of the Macedonian economy:

- Labor intensity
- Export orientation
- Access to EU market
- Low energy dependence.

Among other things, the revitalization of the apparel and textiles industry will lead to product diversification and improve standardization levels and product quality in accordance with international market criteria.

Further prospects for development of this sector depend on three basic factors:

- Low direct labor costs
- Large supply of skilled labor
- High production capacities.

The ongoing privatization of the remaining large (loss-making) textile companies offers opportunities to entrepreneurs for cheap rental or purchase of parts of plants or even entire production facilities.

Macedonia's apparel and textiles sector has an untapped and mostly underutilized production capacity, which may serve as a good base for future development. At the same time, emerging apparel and textiles manufacturers may also take advantage of the large supply of unemployed qualified labor and thus ensure low direct costs—a major pre-condition for achieving rational and profitable production.

### F. Fairbanks 7-Opportunities Table

| Opportunity Category | Potential Opportunity | Suggested Action |
|---|---|---|
| 1. Improve Customer Learning | By increasing information about customers and clients, Macedonian firms can increase their exports primarily to the EU and countries with which Macedonia has signed free trade agreements | Marketing research, Standardization of products, Education of staff on export sales management, Participate in exhibitions, and trade fairs |
| 2. Explore Forward Integration | By learning about the value-chain in their industries and integrating value-added activities to their businesses, Macedonian firms explore opportunities for better profits | Explore "full package" production with existing clients |
| 3. Innovate | By innovating and/or learning about the recent technology & equipment, Macedonian firms can increase their productivity levels or produce for different market niches | Develop a suitable system of fiscal and custom duties for equipment changes<br>Organize visits of specialized fairs & exhibitions |
| 4. Cooperate with Cluster | By promoting the cluster concept, Macedonian firms enjoy the synergies that result from acting as a cluster | Educate entrepreneurs on cluster concept and cluster management |
| 5. Understand Competitive Position | By researching the competitiveness of Macedonian apparel and textiles sector, firms can assess their needs and better strategize | Analyze the advantages and disadvantages of the apparel and textiles sector |

| | | |
|---|---|---|
| 6. Avoid Over-Reliance on Basic Factors | By not focusing solely on the cheap labor, but focusing efforts on market niches Macedonian firms can improve competitive position | Development of fashion know-how & franchises<br>Creation of facilities for higher degrees of finalization and production<br>Spend efforts to learn about establishing internationally recognizable trade marks |
| 7. Avoid Government Paternalism | Practically no governmental paternalism exists (the imports are on a free regime) | Government should focus its efforts to stop illegal imports of cheap finished apparel and textiles goods |

## 6.3 Information Technology

### A. Industry Definition and Background

For the purposes of this report, the definition of Information Technology (IT) sector will be limited to the production of computer hardware and software, and the sale and maintenance of these items.

The domestic IT market presently relies exclusively on imports of IT hardware and software. Most major international manufacturers of IT technology products are represented through a network of some one hundred local wholesalers and retailers.

Some one hundred companies are active in the market providing IT products and services ranging from the assembly, sale, and maintenance of computer hardware (both PC configurations and high-end computer systems), the sale and development of software, computer education, to ISP. However, there are only about twenty companies that are serious players in the field. The annual sales volume of computer hardware has not exceeded 7000 units (on the average) over the last two years. Almost 60% of the total sales of PC configurations are intended for replacement of outdated or irreparable hardware[57].

Prices of IT products and services have been rather stable over the past few years but are somewhat higher than corresponding products and services in most developed countries. Despite the presence of quality hardware (Intel, Compaq, Apple), the market is dominated by imports of mostly hybrid hardware, often inferior in quality. The Macedonian IT industry suffers from relatively low competition among importers of Western IT goods.

[57] There are no official statistical figures for the sector, and the figures quoted in this section of the report have been acquired through field survey and research.

## B. Diamond Analysis

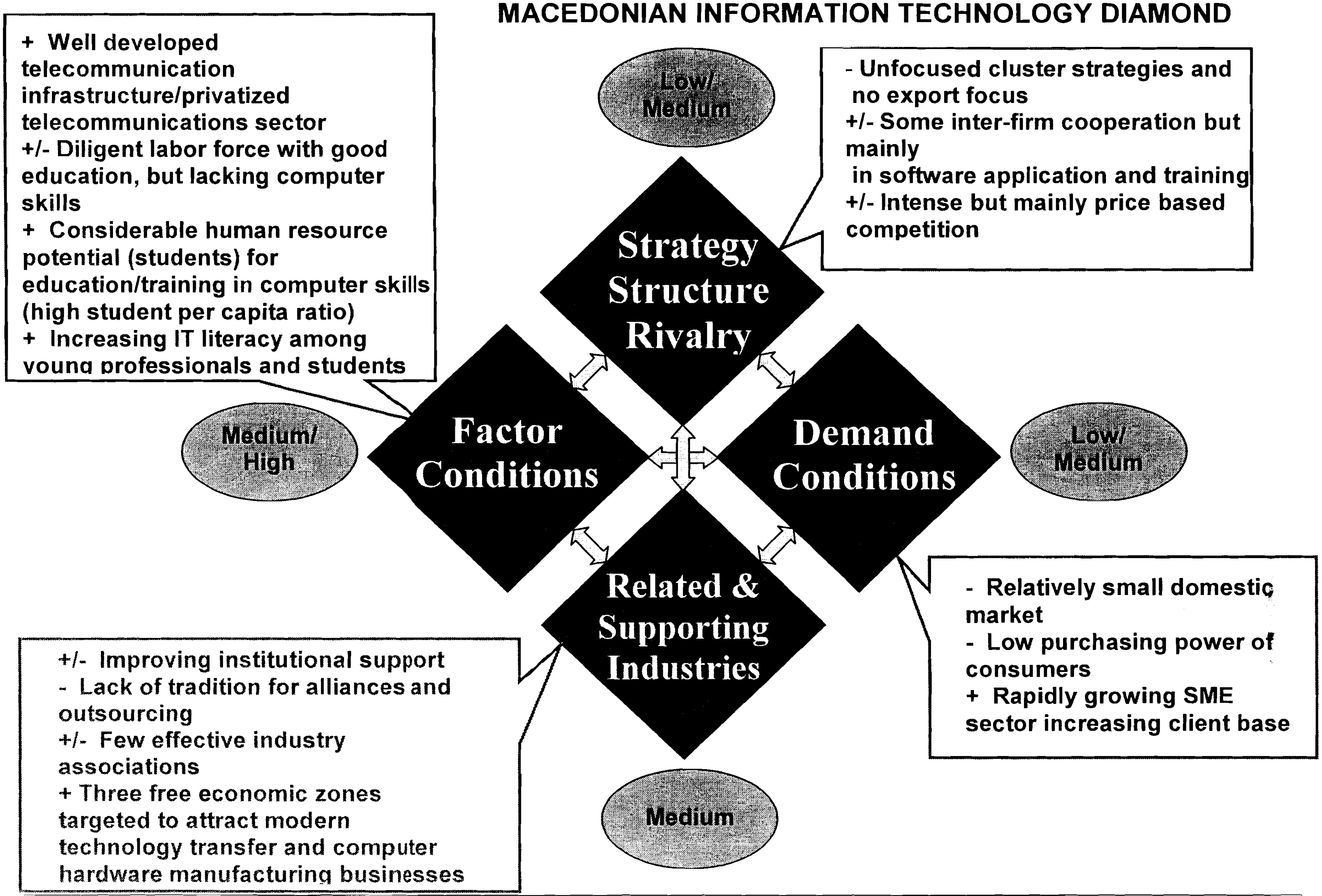
Factor Conditions
Macedonia has a well-developed telecommunications infrastructure (known to be the best in the Southeastern European region), and the telecommunications sector has undergone privatization. However, there remain issues with accessibility, cost, and capacity of bandwidth. The basic factor for IT is human resources and there is a strong potential to improve the current IT skills of the Macedonian workforce. IT literacy among young professionals and students is increasing. There are about 40,000 students at the university level, 90,000 students in secondary schools, and 255,000 students in primary schools in Macedonia who are being exposed to the Internet and are potential users of IT.

Demand Conditions
One of the challenges for the Macedonian IT sector is the small size of the domestic market, and the limited demand generated by the local market. Low purchasing power of the Macedonian residents is another disadvantage the IT firms are faced with. These two factors create an environment that is not enticing IT firms to be innovative. On the other hand, growing small and medium enterprises are demanding IT solutions for their businesses, which is positive.

Strategy, Structure, and Rivalry
Currently, the Macedonian IT sector has unfocused strategies and no export focus. There is some inter-firm cooperation, but mainly in software application and training. The domestic market exhibits intense but mainly price-based competition. Previously limited credit availability is increasing, which enhances the ability of small and medium enterprises to deal with their competition.

Related and Supportive Industries
The Macedonian IT sector does not have many other sectors supporting it except for those that create opportunities for IT firms such as banking. Traditionally, there are no alliances among the firms in the industry and almost no outsourcing. However, institutional support to the IT industry has been increasing over the last few years. Although not very active and strong, there are a few industry associations, which have been established recently to voice the problems and needs of the IT sector.

## MACEDONIAN INFORMATION TECHNOLOGY DIAMOND



### C. Role of Government

There is no comprehensive (national) strategy and focus on IT sector development. However, the recently established National Committee for Information Technology Promotion (NCITP) is expected to improve sector visibility and draw wider support from government, the business community, and foreign donors alike. The sector is currently completely deregulated, with low focus from the government on sector promotion, development, and support. In addition, the country lacks efficient legal instruments for the protection of computer technology, know-how, and software.

### D. SWOT Analysis Table

| **Strengths** | **Weaknesses** |
|---|---|
| • Awareness of IT and its usage by the entire population is increasing: particularly among professionals and student population<br>• Expanding SME sector is perceived as one of the major beneficiaries, but also a partner and an important vehicle for IT promotion and development<br>• Growing number of Internet users<br>• Growing awareness and interest for qualified computer training by professional staff, secondary school and university students<br>• National Council "e-Macedonia for Everyone" (an initiative sponsored by the President of the Republic) and a National Committee for Informatics (a lobby group) established<br>• Excellent telecommunication services (best in SEE region) and a growing body of competitive Internet providers | • Lack of a (comprehensive) national strategy for sector development<br>• Lack of corresponding legislature and legal instruments for protection of computer technology (both hardware and software)<br>• Volatile political and business environments (in the region)<br>• No tradition of distance learning (via Internet)<br>• Curricula in education (all levels) needs upgrading in conformity with development of information society<br>• Low purchasing power of the population (in general) is a constraint for higher sales of computer products<br>• Inability to pool resources (public, private, foreign donors) for enhanced sector promotion and development<br>• Lack of incentives to encourage substantial foreign participation in sector development and attract FDI |

| **Opportunities** | **Threats** |
|---|---|
| • Establishment of an (regional) Education and Research Center for Informatics and Information Technologies in Skopje<br>• Possibility for computer technology manufacturers to locate in a free economic zone<br>• Growth potential (only 3% of the population has a PC) | • Continued volatile political, social and business environment (in the region)<br>• Prevailing weak interest by foreign investors<br>• Lack of better government support and long-term strategy for sector development<br>• Slow development of SME sector |

## E. Looking Ahead

A current initiative by the Institute of Informatics of the Faculty of Natural Sciences and Mathematics in Skopje for the establishment of a Regional Education and Research Center for Informatics and Information Technologies is expected to trigger wider support for further sector promotion and development. The initiative is gaining visibility, partly due to efficient lobbying by NTCIP, and it is expected that funding, estimated at some US$10 million, will be provided jointly by the Macedonian government and a body of domestic (Macedonian Telecom) and foreign donors (the government of Japan).

One major challenge for the industry is the lack of appropriate legislation. The government must give its full attention to developing appropriate laws for the IT sector. The sector, which is very liberalized, suffers from an absence of proper copyright protection. Existing weak legislation prevents significant levels of foreign investment from flowing into the industry. Also, computer-based education and the Internet have yet to receive wide recognition in the education system. Legislation introducing computer-based education systems in schools will correct this problem. In addition, the Ministry of Education should get more involved in the IT sector implementation.

Given the constraints it faces, Macedonia needs to identify those market niches, such as e-banking, which can offer opportunities for its IT sector development. At the same time, the country needs to work on removing telecommunications infrastructure constraints so Macedonia can better connect with the rest of the world.

## F. Fairbanks 7-Opportunities Table

| Opportunity Category | Potential Opportunity | Suggested Action |
|---|---|---|
| 1. Improve Customer Learning | By improving knowledge and demand needs of the customers, IT firms can better serve the market | Increase information on local and international market trends and needs |
| 2. Explore Forward Integration | By integrating themselves with other members of the IT chain, Macedonian firms could leverage their competitive position | Improve relations with firms that are in distribution and marketing of IT products and explore possible alliances |
| 3. Innovate | By focusing on innovation through research and education, Macedonia can establish itself as a leader in a particular niche | Keep up with technological developments through the Internet, literature, relevant exhibitions etc. |

| | | |
|---|---|---|
| 4. Cooperate with Cluster | By acting as a cluster of firms, Macedonian companies can enjoy the benefits that will result from joint marketing, R&D, and projects | Explore possible advantages that will be borne as a result of acting as a cluster of firms, and strengthen sector association(s) |
| 5. Understand Competitive Position | By learning more about their competitive position and how they rank in the global market, IT firms will find out ways to improve their deficiencies | Assess Macedonian IT sector's global competitive position to target realistic and achievable goals |
| 6. Avoid Over-Reliance on Basic Factors | By investing not only in development of its workforce, but in research and development, IT sector will be able to increase its competitiveness | Do not rely only on the experienced engineers and other IT labor force, but link IT sector's needs with educational programs in Macedonia |
| 7. Avoid Government Paternalism | No significant government paternalism | Pass legislation enforcing intellectual property rights |

## 6.3 Tourism Sector

### A. Industry Definition and Background

For the purposes of this report, the definition of tourism sector will be limited to accommodation facilities, catering and food outlets, as well as other tourism-related services and products. Accommodation facilities describe all commercial establishments such as hotels, bed and breakfasts, and motels, which serve visitors to Macedonia.

Tourism has a significant place in the overall economic and social development of Macedonia. This is due in part to the number of natural attractions within Macedonia. Each year, these places are visited by approximately 550,000 people, with a total of 2,500,000 overnight stays. Of the 80,000 available beds, 15,000 are in primary lodging facilities, while the rest are found in camps, tourist projects, and other accompanying areas.

The Macedonian tourism industry is currently estimated at a low 2% of GDP, but has the potential to help spur economic development, especially in rural areas. The sector has a relatively short history and its development should be viewed in conjunction with the general economic growth of the country.

In general, most of the tourist attractions in Macedonia (archeological, historic, or other attractions) are not sufficiently developed to attract more demanding consumers. In addition, most of the tourist sights and attractions lack supplementary amenities such as food and drink outlets, souvenir shops, and resting facilities. With regard to the movement of the labor force in the industry, direct employment in the tourism and catering sector dropped from 12,000 employees in 1990 to less than 6,000 in 1998.

## B. Diamond Analysis

Factor Conditions

A variety of scenic natural resources, especially around the lake areas of Ohrid, Prespa, Mavrovo, and Dojran, combined with a rich cultural and historical background, including the presence of a variety of monasteries, numerous old churches, archeological sites, winter sport centers, many thermal springs and spas, as well as national parks create opportunities for further development of tourism in Macedonia.

Macedonia has ninety hotels, ten campsites, two tourist settlements, and roughly an additional 27,000 private beds. The total number of beds in all facilities exceeds 80,000. Most of the hotels in the country do not meet international standards as many are in need of renovation and refurbishment. Yet, when compared with hotels of similar standards in neighboring destinations, hotel accommodation in Macedonia is more expensive.

Skilled labor is in good supply and the labor force possesses foreign language skills. In terms of tourism-related education in Macedonia, there is one full-time university program as well as several college-level training programs that offer specialized training in tourism and catering. However, the level of customer service needs further improvement beyond the training programs mentioned above.

Physical infrastructure, the road network in particular, is fairly well developed in Macedonia. Most tourist attractions are well connected to one another. Institutional infrastructure, as a result of the massive ongoing legislative and administrative reforms, is constantly improving. Tourism-related information services and sector-related market research activities are also improving. In contrast, the domestic financial market lacks sophistication, and access to capital is still limited.

Demand Conditions

Domestic tourist consumption is currently showing a downward trend. During the 1987 – 1998 period, domestic visitors dropped from 494,000 to some 418,000 people, representing a drop of almost 18%. Domestic visitors recorded an average of 1.3 overnight stays in Skopje versus an average of 6.1 overnight stays in the lake districts. Statistical records show a relatively high number of overnight stays in the lake districts (predominantly over the summer season), which is attributed to the presence of domestic vacationers.

Most of the hotels have experienced extremely low levels of occupancy rates over the last decade (an average of 10% occupancy has been achieved). Hotels in the prestigious Ohrid Lake area remain generally closed over the winter period.

Domestic demand is not sophisticated, partly because domestic consumers are looking primarily for cheap services. In addition, international demand is mainly generated by less demanding visitors from the neighboring Southeastern European countries, which partly explains why service providers lack motivation for innovation and product development.

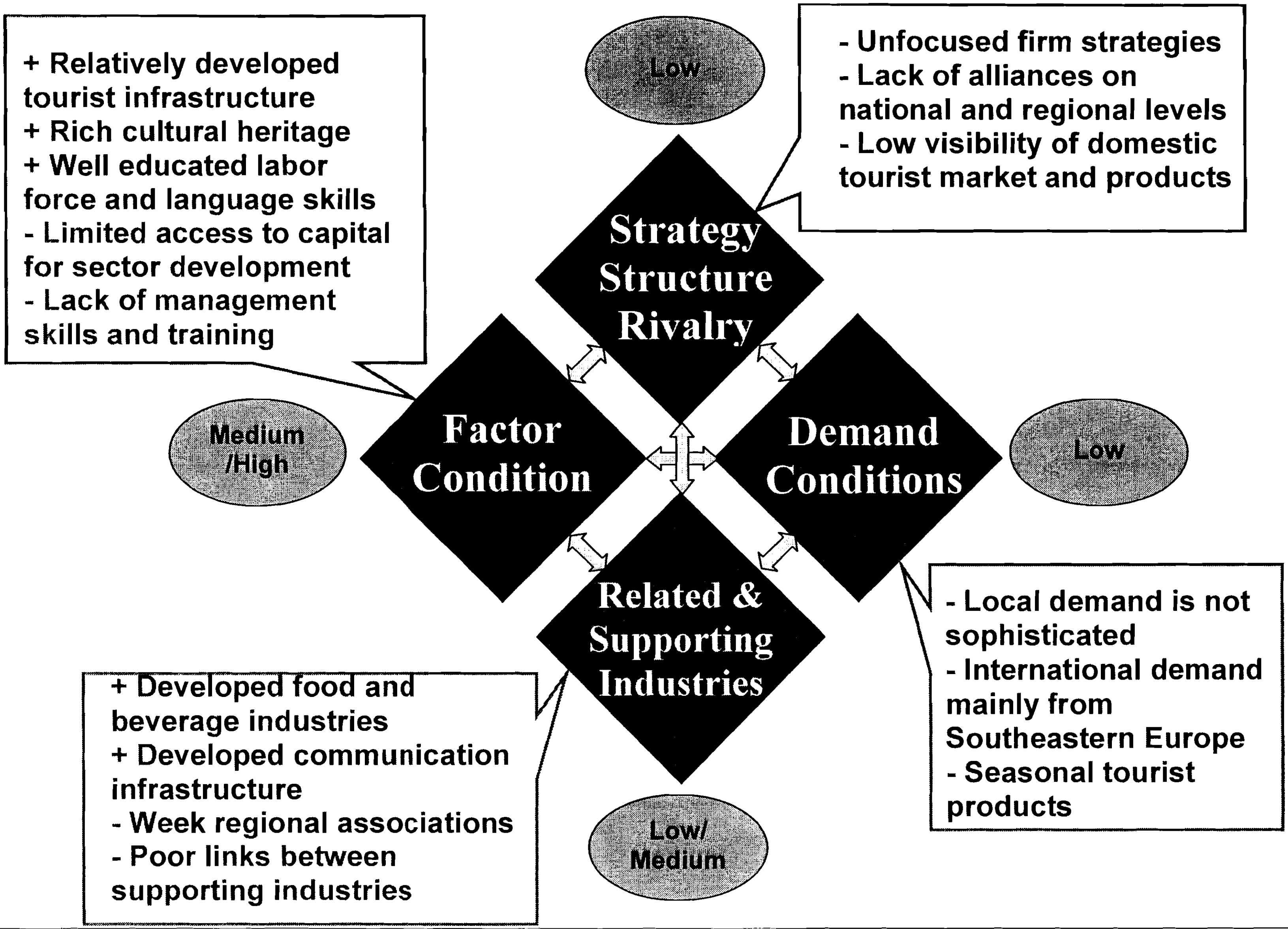
Strategy, Structure, and Rivalry
There is a lack of focus and strategy among the majority of the companies across the tourism sector. There are many small enterprises operating on an ad hoc basis, trying to meet the demand as it emerges. Managerial skills are also in short supply and there is poor inter-firm cooperation. The privatization of the state-owned enterprises in the tourism sector is not completed yet. There are about 80,000 beds of which 15,000 are being used primarily in lodging facilities. In principle, each municipality in Macedonia has its own tourism association, which is responsible for destination marketing and for the provision of general visitor information. However, in practice, the Tourist Association of Skopje is the only active industry association.

Related and Supporting Industries
In addition to what may be regarded as the core of tourism-related business, hotels and restaurants, a universe of tour operators, tour guiding and car rental companies, as well as other specialized service providers also play an important role in the Macedonian tourism industry. Among such operators are passenger transportation companies providing coach services for domestic and international travel. However, the quality of services (particularly transportation services) may not be at a standard acceptable to a more demanding, particularly international, clientele.

Another important category of tourism-related businesses—the souvenir and handicraft sector—is considered limited in capacity. In addition, it is reported that traditional skills, particularly in woodcarving and silver filigree work, are in rapid decline.

The domestic food and beverage industry is well developed and provides quality products for the tourism sector. Small-scale farmers play an important role as specialized suppliers to the hotel and catering sector. In addition, there is a growing supply of locally produced non-alcoholic and alcoholic beverages, while the wine industry is quite well developed and has some competitive advantages.

## MACEDONIA TOURISM INDUSTRY DIAMOND



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### C. Role of Government

The recent disturbances in the region and in Macedonia have severely undermined the country's ability to revive this sector and to attract significant numbers of foreign visitors to the country. Thus, due to the negative impact of such disruptions on the tourism sector, the government should focus its efforts on political and economical stability as the primary driver of tourism recovery.

Macedonia lacks a comprehensive Tourism Development Strategy and a sustainable Action Plan. The tourism sector has been developing on an ad hoc basis as it lacks a development framework, which would provide clear guidance and planning. Another role the government should play is that of a promoter of image building for Macedonia until a stronger private-sector tourism promotion board can emerge to take over that function.

A Hotel Classification Law was passed in 1995, in order to make the hotel classification system comparable to international standards and procedures. The Ministry of Economy is currently working on a new Tourism Law that will define and set new criteria for regulating the operations of travel companies.

### D. SWOT Analysis Table

| Strengths | Weaknesses |
|---|---|
| • Varied scenery and landscapes<br>• Presence of natural parks and protected areas covering a variety of eco-systems<br>• Rich in endemic flora and fauna<br>• Limited air pollution<br>• Rich cultural heritage, rich history and presence of important archeological and historic sites<br>• Friendly and hospitable people<br>• Relatively good accessibility and reasonable well-developed road infrastructure<br>• Two major international airports<br>• Excellent telecommunications service sector (recently privatized and operated by strategic foreign investor)<br>• Constantly improving administrative infrastructure<br>• Well-developed general education system but specialized training is in short supply<br>• Financial market and services are improving | • Lack of national tourism strategy and action plan to promote tourism<br>• Adequate accommodation classification and rating system not yet implemented<br>• Lack of adequate tourism statistics<br>• Limited awareness of up to date international market trends, market targeting techniques and visitor profile segmentation<br>• Perceived image of Macedonia as an unsafe destination (the continued political turmoil in neighboring region has a negative impact on the perception of Macedonia)<br>• Weak regional tourism associations (limited or no budget allocation to finance production of marketing and promotional materials)<br>• Absence of the Macedonia Tourism Product<br>• Geographically and seasonally concentrated tourism products<br>• Lack of product development and innovation<br>• Unfashionable design of accommodation establishments<br>• Inadequate-service standards |

| | |
|---|---|
| | • Undeveloped souvenir and handicrafts sector<br>• Lack of cooperative effort by individual private enterprises<br>• Lack of knowledge of changing market trends |
| **Opportunities** | **Threats** |
| • Potential for development of cultural, historical and nature tourism products<br>• Potential for development of alternative tourism products such as rest, culture, adventure, eco-tourism<br>• Potential for further development of winter sports activities | • Continued unstable social and political conditions<br>• Continued limited investment interest by foreign investors<br>• Development of competing destinations in neighboring countries |

## E. Looking Ahead

Macedonia's geographical location, seasonable climate, and historic and religious sites provide favorable conditions for the development of the tourism industry. The country is ecologically clean. Its well-preserved countryside offers excellent possibilities for rest and recreation and contains possibilities for fishing and hunting, mountain climbing, mountain biking, and other alternative tourism activities.

However, the tourism sector in Macedonia cannot expect holiday tourism to be restored until the internal political disruptions and the Balkan crisis cease. Even then, it will take effort for both the private and public sectors to build up a sustainable tourism environment. In particular, efforts will be needed in product diversification, awareness, marketing and promotion activities. Taking into account the existing poorly maintained and outdated tourism facilities; the new (private) owners of the tourism facilities will have to invest significant resources to upgrade the facilities, services, and quality standards. The currently limited financial means for SME sector development, in addition to the lack of public sector development initiatives, result in a poor operating environment for the sector's development.

The future development of tourism in the Republic of Macedonia depends on image building in foreign markets for the country as a whole. A single thought and image should come to the minds of cash-spending foreign tourists when they think of Macedonia, and that requires political stability in the region and a well-designed and well-implemented image-building campaign. The restructuring and revitalization of the tourism sector depends on: properly targeting the specific priority segments of the tourist market and their swift modernization and activation; insisting on the authenticity of the package of the tourist services; raising the environmental and cultural standards of these services; and devising better marketing and promotional activities.

## F. Fairbanks 7-Opportunities Table

| Opportunity Category | Potential Opportunity | Suggested Action |
|---|---|---|
| 1. Improve Customer Learning | The more tourism service providers know about the demands of customers the better they can address these needs | Improve tourism service providers learning about their customers needs and demands through collecting data about recent tourism trends and exposing them to international fairs, etc. |
| 2. Explore Forward Integration | Through integration, all groups that support the tourism sector will enjoy synergies | Hotel operators, tour operators and travel agents should join efforts and share information in order to coordinate activities among themselves and to prepare for the season |
| 3. Innovate | Product innovation and marketing and management activities will yield enhanced performance of the sector | Through research and expert advice, identify niche markets and attractive tourism products that appeal to higher income customer group |
| 4. Cooperate with Cluster | Better cooperation among the parties that form the tourism cluster will benefit all involved as joining forces they can achieve more than they can alone | Organize structured dialogue between the parties that form the tourism sector in the country and have them collaborate in marketing, education, training and promotional efforts |
| 5. Understand Competitive Position | Understanding how Macedonia ranks competitively and what it can offer that competitors can't or don't will pose new opportunities for development of the sector | Compare Macedonia with countries with similar offerings and study how the tourism sector could improve |
| 6. Avoid Over-Reliance on Basic Factors | Macedonian tourism sector should not depend solely on its natural resources while developing its strategy | Creation of a more complex and niche range of products (including congresses, village tourism, heath tourism, hunting etc.) that will extend the season and promote tourist development |

| | | |
|---|---|---|
| 7. Avoid Government Paternalism | Government ownership in the hotel sector should be reduced and effective management is necessary to operate the existing infrastructure | Implement efficient privatization of the hotel chains<br>Promote to attract FDI |

# CHAPTER 7 – COMPETITIVENESS CONSTRAINTS IN MACEDONIA

Over the past ten years of independence, Macedonia has faced unprecedented challenges in its economic transition, which stem not only from unfavorable external factors but also from constraints in its own domestic environment, tension in domestic politics, and unresolved conflicts in its inter-ethnic relations. In 2000, the economy of Macedonia showed signs of improvement, only to suffer the setback of ethnic conflict in 2001. Major constraints to the country's ability to achieve higher competitiveness are summarized below into two sub-sections: (1) general competitiveness constraints, and (2) industry-specific constraints.

## 7.1 General Competitiveness Constraints

The government faces considerable difficulties in reconciling different goals among the member parties, and in overcoming ethnic tensions within the country. Although the government has indicated its commitment to furthering economic reform and has been successful in improving the country's overall economic performance for 2000, uncertainty remains about sustained political stability in Macedonia. Failure to carefully handle these inter-ethnic conflicts could destabilize Macedonia, deter foreign investment, and damage the country's economic links with Kosovo and the rest of Yugoslavia.

Macedonia has had some success in controlling the fiscal deficit and inflationary pressures, but the desired level of <u>macroeconomic stability is yet to be achieved</u>. Macedonia's fiscal deficit remains a serious concern of the government of Macedonia, since their continued over-spending on non-discretionary items, mainly wages, transfers, and social sector outlays[58], could in turn trigger inflationary pressures if not resolved properly and in a timely manner.

Although reform has been carried out, <u>the banking sector is still weak</u>, with a low level of intermediation, a high cost of capital, a severe lack of financial discipline, and poor allocation of credit[59]. This situation clearly hampers the private sector's ability to access credit, and thus restricts investment in the economy.

Though significant improvements have been made to the legislation and institutional framework, <u>a deficient policy framework</u> discourages both domestic and foreign investors. For example, registration procedures for import-export activities and for business start-ups remain time-consuming. Macedonia needs to simplify the process to make it easier for investors.

<u>The business environment is somewhat burdened with bureaucratic procedures</u>. This is partly a result of complex legislation and a traditional lack of efficiency on the public administration's side. Although a gradual improvement is taking place through ongoing massive public sector reforms, the judicial system has been unable to cope with the

[58] Source: IMF Staff Country Report No. 00/72, June 2000
[59] Source: IMF Staff Country Report No. 00/72, June 2000

growing workload and complexity of cases. However, the judicial system is fairly independent and already harmonized, to a great extent, with European judicial practices.

Non-transparent procedures in Macedonia deter private investment. According to Transparency International, Macedonia ranked 63rd out of 99 countries in terms of the Corruption Perception Index in 1999. The perception of potential foreign investors and businessmen of Macedonia must be changed.

There has been a lack of strong private investment in the Macedonian economy. Macedonia's economic development over the past decade has not benefited from strong private investment, a driving factor for sustained growth and employment generation to occur.

As for foreign investment, like Croatia, much of Macedonia's FDI flows over the past decade materialized through privatization of state-owned enterprises. The failure to attract green-field foreign investment is the result of various factors, which include high political risk, macroeconomic instability, and a limited domestic market.

Macedonia's physical infrastructure is in relatively good condition when compared to the rest of the region, but the current condition of infrastructure needs to be improved for accelerating Macedonia's economic development and increasing its competitiveness.

Delayed engagement in higher-technology and higher value-added economic activities has caused an erosion of Macedonia's competitiveness. Macedonia has over-relied on its low-cost, labor-intensive competitive advantages, which have been declining over time, largely as a result of competition from other low-cost countries. In 1998, Macedonia's high-tech exports were only 1%[60] of total manufactured exports, which was among the lowest in SEE, as well as in the world.

Lack of focus on international markets combined with a small domestic market undermines Macedonia's competitiveness. Macedonia is not endowed with a natural advantage of a huge domestic market and large population. For this reason, Macedonia needs to focus more on the demand from outside markets in order to generate more domestic production and exports.

Macedonia lacks a market mentality and management system as well as access to information about both domestic and foreign markets it needs to compete better in the new global market context. There is a lack of entrepreneurial mentality and strong marketing and management skills, that are essential not only for new business development, but also for renewal in existing companies in every sector, from tourism to apparel and IT. (This will be illustrated in the following subsection.) In addition, industries suffer from a shortage of information about foreign and domestic markets.

There is a lack of institutionalized private sector consultation in the government's policy-making. The government has made certain efforts to involve the private sector in the policy formulation process. Nonetheless, there is still no mechanism for the private sector to collectively present its feedback on the government's policies, or a mechanism to ensure proper and timely follow-ups on their policy recommendations.

[60] Source: The World Development Indicators, The World Bank, 2000

## 7.2 Industry-Specific Constraints

The following paragraphs offer a brief analysis of the constraints that Macedonia would face in the development of three illustrative industry clusters—Apparel and Textiles, IT, and Tourism—that JAA investigated.

**Apparel and Textiles:** Macedonia has so far relied on the exploitation of a low-cost and labor-intensive strategy to compete with other countries. Over the past decade, the industry has experienced erosion of its competitiveness. The following are some of the main factors that have contributed to this decline:

- Declining labor cost advantage, due to competition from other low-cost countries
- Strong competition from illegal imports of finished products
- Inadequate access to financing
- A lack of transportation cost advantages, due to Macedonia's land-locked position and infrastructure damages during the war in Kosovo
- Inadequate re-capitalization and restructuring efforts to infuse new technology into the industry, and to establish industrial linkages that help Macedonia engage in high-value-added activities
- A lack of strong individual companies that pioneer and lead the technological change and upgrade the processes in the industry
- Inadequate information about both domestic and external markets
- Over-dependence on demand from existing external markets such as Germany, Yugoslavia, and Greece
- A lack of market-oriented management and marketing skills that can improve efficiency in the industry, make Macedonian brand names better known in the world markets, and proactively find new markets for Macedonian products.

**Information Technology (IT):** Macedonia ranks high in the world in terms of the percentage of scientists and engineers in the population, and has excellent telecommunication services, but the IT sector is underdeveloped. Major impediments include the following:

- Inadequate legal and regulatory framework to support the sector
- Insufficient demand stimulation from domestic industries and individuals due to difficult economic situation and relatively low living standards
- Instability in the political and business environments
- Limited participation of foreign investors who could introduce new managerial know-how and technology to the industry
- A lack of entrepreneurship, marketing, and management skills that could bring more international exposure and experience to domestic firms
- Ineffective protection and enforcement of intellectual property rights
- Insufficient investment in R&D for new technologies and software
- A lack of private sector consultation in policy formulation to support the industry as well as in R&D activities
- A need for more proactive policy support from the government to stimulate the growth in the industry and make it internationally competitive.

**Tourism:** Tourism in Macedonia has so far been concentrated around certain historical towns and lake and ski resorts in the country. The sector has been following a low-end, low-price competition strategy, and suffers from a lack of quality and strategy that could increase its competitiveness relative to other countries in the region. Major constraints on the tourism industry in Macedonia include the following:

- Perceived image of Macedonia as an unsafe destination
- Erosion of competitiveness in the low-cost competition strategy due to price competition from other countries in the region
- Delayed engagement in high-end and more sophisticated tourism products
- Limited knowledge of outside markets and high-end product segments
- Deteriorating and/or inadequate infrastructure facilities, including roads, hotels, airports, and utilities
- A lack of quality market-oriented customer service
- A lack of management and marketing skills that can increase efficiency, attract more clients, and generate high-end demands for the sector
- A lack of strong private sector investment in the sector
- An inadequate legal and regulatory framework to support the sector.

# CHAPTER 8 – ANALYSIS OF PRIVATE-PUBLIC DIALOGUE

There is hardly any tradition of formal private-public dialogue in the Republic of Macedonia. As a result, institutional mechanisms for the promotion of such a dialogue are either nonexistent or in their early stages of development.

## 8.1 Institutional Landscape

Public Sector

The Economic Chamber of Macedonia, formerly an umbrella organization intended to represent the entire socialist self-management business community, is unable to cope with the challenges of a constantly changing environment and is perceived as an institution reminiscent of the old socialist era. The Chamber is perhaps the only institution which remains practically unaffected by the process of restructuring and still operates within an inherited legal framework dating from the pre-transitional period, including its funding through mandatory memberships. As a consequence, and due to a lack of a corresponding legal framework, private businesses currently use other channels and express their concerns through industry associations registered as NGOs.

Private Sector

A legislative reform pertaining to association of businesses is recently being worked on. The latest amendment to the Law on Handicrafts, passed in November 2000, resulted in the establishment of the first independent industry association—the Association of Macedonian Handicrafts—which operates outside the system of the Economic Chamber of Macedonia. In addition, the Macedonian Ministry of Economy is currently drafting a new law intended to "redefine" the role of the Economic Chamber, in order to bridge the existing gap between the private sector and the government. The Ministry of Economy and the Ministry of Finance would like to promote a form of private-public dialogue by encouraging all relevant interest groups (industry associations, for example) to voice their concerns in direct dialogue with the government rather than using the existing intermediary channel of communication (via the Economic Chamber network). This, however, may not be sufficient for a wider promotion of policy dialogue. Therefore, both formal and informal vehicles will have to be employed in order to foster dialogue between the key stakeholders.

Apparel and Textiles

The only official representation of the apparel and textiles industry is exercised via the Economic Chamber of Macedonia. Small- and medium-sized apparel and textiles manufacturers in particular voice disenchantment with the Chamber's lack of capacity and dedication to represent the sector. In contrast, the government's concern for the sector is on a gradual but steady increase. The government, with the aim of improving the operating environment, as well as for sector promotion and development, recently introduced a series of reform ideas in fiscal, regulatory, and tariff policies.

Tourism

At the national level, the tourism portfolio is the responsibility of the Department of Tourism within the Ministry of Economy. The Department of Tourism is responsible for liaison with the relevant departments of the Economic Chamber of Macedonia as well as with the municipalities. Macedonia does not have an independent National Tourism Board with joint public- and private-sector representation.

The Department of Trade, Catering, and Tourism encompasses all tourism-related legal entities as (mandatory) members of the Economic Chamber of Macedonia. An association of travel agents and tour operators (ATAM) and the Hotel Association of Macedonia (HOTAM) are also represented at the Chamber. However, the organizational structures of the latter associations are rather loose, with unclear functions and are short of strategy and/or focus.

Tourist associations exist on the municipal level as well, though mostly on paper. In practice, only the Tourist Association of the City of Skopje is an active service provider.

There is neither a tradition of associations within the sector nor a visible corporate effort to upgrade the visibility of the sector. As a result, no forum has been established yet to advocate tourism-related issues and to promote dialogue.

Information Technology (IT)

Despite the important role IT plays in fostering social and economic development and improving the country's competitiveness, the Macedonian IT sector, so far, is not really high on the agenda of national priorities. From the legal point of view, the sector is fully liberalized, with a host of some one hundred computer hardware/software distributors and computer-training providers competing in a relatively limited market.

In contrast to the lack of a comprehensive long-term national strategy for sector promotion and development, a group of influential scholars (professors in the Faculty of Mathematics and Natural Sciences headed by Dr. Maryan Gushev of the Informatics Department), business persons, and politicians has recently embarked on an initiative intended to both raise public awareness and lay the groundwork for the establishment of a national IT training and research facility: Education and Research Center for Informatics and Information Technology (ERCIIT). This initiative was brought to the attention of the head of state and the foreign minister and is gaining increasing support from major stakeholders in the country, including some leading institutions of higher learning, the business community, and the government.

There is at least one active industry association (department) under the auspices of the City of Skopje Regional Economic Chamber. The association represents most local private firms specializing in IT-related activity. In addition, a recently founded association of independent management consultants (MCA 2000) comprising, among other experts, some of the leading local IT specialists, is envisaged as one of the first institutional vehicles for the fostering of private-public dialogue. Outside the promotion of its respective trade, the Association is becoming increasingly involved in the promotion, through fostering private-public dialogue on various national issues such as: Corporate Governance and Business Ethics, Country Competitiveness, and IT Development. Apart from achieving better visibility on the part of domestic stakeholders, the above-mentioned issues are being eagerly supported by several reputable multilateral organizations and foreign donor entities operating in the country.

Media

Private-public discourse is maintained mostly through open communication via the electronic and print media. A growing universe of independent media carry issues of national importance in their daily services thus encouraging public debate and/or reaction by concerned parties representing the general public, the business community, or the government. The leading promotional vehicles of debate and dialogue are currently represented by a body of leading electronic (MRTV, A-1, Sitel and Telma TV channels), and printed media with highest circulation in the country (Utrinski Vesnik, Dnevnik and Nova Makedojnija). In contrast, various influential lobby groups or individuals (mostly comprised of political elite, but also influential business persons) are active in parliament and government circles, thus partly substituting the deficiency of institutional mechanisms for the promotion of private-public dialogue.

## 8.2 Overview of Legislation Change Process in Macedonia

In Macedonia, the parliament establishes parliamentary commissions with specific competencies, including the drafting of laws on particular subjects. In addition to members of parliament, these commissions include outside experts, and they may include experts from NGOs. There are no laws in Macedonia requiring participation of the general public in deliberations of parliament or of the government. The government does most of the actual drafting of laws. The applicable governmental authority charged with drafting a law develops a working text, which is submitted to various experts for their comments. After the comments are received, a revised text is prepared and submitted for additional comments from other ministries and the Chamber of Commerce. After incorporation of these comments, the draft is finally submitted to the Council of Ministers. During the consultation and commenting process, the responsible ministry may, but is not required to, include members of the public (in most cases this does not take place). Organizations whose comments are solicited may include government-related institutes, NGOs, representatives of the business community, and others.

## 8.3 Summary

Macedonia currently lacks an institutionalized mechanism for the private sector to assess the leading constraints to its growth and to dialogue with the government to help identify priorities that could lead to rapid expansion of investment, employment, GDP, exports, and resulting tax revenues. For example, there is no mandatory comment period for new laws and regulations, while many Western market economies do have such a period that includes open hearings. Finally, business people do not regard the Economic Chamber as being highly responsive to their needs; yet alternative business associations have been slow to develop.

# CHAPTER 9 – RECOMMENDATIONS

Building Macedonia's competitiveness requires a complex set of mutually reinforcing activities at the level of the firm and the industry cluster, reinforced by policy and institutional action at the national and local government levels. A key barrier to competitiveness is the mindset of the people and their resistance to change combined with their inability to comprehend the open-market economy.

Learning from nations that have built prosperity quickly and aided by the foregoing analysis, one can formulate recommendations that deal with the private sector, with the public sector, and with the dialogue that connects them. In this process there is also an important role for civil society institutions such as business associations, think tanks, and social enterprises.

<u>Private Sector Recommendations</u>
Firms in the private sector are in very different conditions and no one set of recommendations applies to all. In general, competitive firms will seek direct exposure to the most demanding customers, clients, and markets and adapt their products, services, and strategies to respond to the signals that these demanding customers are providing. This requires openness to change and the desire to innovate with products, service and processes that respond to these needs.

Macedonian firms that have exportable products and services now have new opportunities to serve European markets but will need to invest in learning how to take advantage of these opportunities. Firms that have non-tradable products and services and serve the Macedonian market can explore trends in neighboring countries that have longer experience with privatization, liberalization, and globalization and selectively test the introduction of innovations in Macedonia. Firms that are not competitive will need to take stock of their human, capital, and organizational resources and then migrate to other market segments or even to other industries.

Competitiveness also requires the ability to cooperate as a cluster to be able to achieve this as no one firm can do it all. Competitiveness depends on the ability to form good alliances and partnerships. At the industry level, business associations can participate in efforts representing the business sector before the government. Industry-specific associations can play an important role in this regard and can support reforms that improve the environment for businesses.

However, it is important to gather together as an industry cluster—that is the entire value chain plus the related and supporting industries. The industry cluster can then benchmark the industry, develop industry strategies, and implement specific action initiatives to boost competitiveness. These will vary by industry. For example, the tourism cluster should formulate specific strategies for attracting higher-spending tourists to Macedonia and for extending the limited summer season. The IT sector should explore initiatives for e-government, introducing price-competitive imports of computer equipment, boosting software exports, and retaining talented professionals. The apparel and textiles sector should focus on finished-goods exports to the European Union and the countries of former Yugoslavia in order to capture a bigger share of the market.

Business associations, working with the government of Macedonia, can develop international trade and investment linkages to get access to markets and technology. But this undertaking requires greater communication and cooperation between the private sector and the public sector.

Industry clusters can also implement workforce development and human resource and training initiatives by working with education and training providers so that the latter adapt their programs to industry needs. In addition, concentrating on research, development, testing, and certification initiatives can add value to the industry while adapting to ISO and similar standards.

Government Level Recommendations

Policy and institutional reform can be analyzed by industry cluster. For example, in tourism, there is a need to complete the privatization agenda and to reduce taxes on the sector, while using some of these tax revenues to co-finance initiatives that the private sector could undertake to carry out competitiveness initiatives for its sector. The industry itself is in the best position to design and implement initiatives to migrate from mass tourism to higher-end markets such as conference tourism, adventure tourism, eco-tourism, and yachting tourism.

In the information technology sector, the government should foster competition among importers of high-tech computer equipment. Furthermore, the government should promote the education of IT specialists in Macedonia in order to improve the software-manufacturing environment.

Macedonia badly needs a coherent investment promotion strategy and a new agency with a structure informed by best practices and taking into account Macedonia's specific strengths and weaknesses and the opportunities presented by access to EU markets. Macedonia can learn from best practices relevant to Europe such as in Ireland, Scotland, the Netherlands, Hungary, and the Czech Republic.

Following the example of Ireland, the government of Macedonia, with the help of the leading think-tanks in the country, should publish an annual Macedonia Competitiveness Benchmarking report that could provide sound data on Macedonia's competitiveness in areas related to investment, exports, finance, technology, human resources, economic policy, economic performance, and infrastructure. This would help to inform government leaders and also industry leaders with regard to the strengths and weaknesses of Macedonia relative to other EU accession countries, while helping to inform the efforts to set priorities and monitor implementation.

Macedonian Competitiveness Council (MCC)

This report recommends that the key private sector leaders establish the Macedonian Competitiveness Council to institutionalize dialogue between the private and public sectors. This Council would establish priorities for reform and communicate these clearly to government and then monitor implementation. It would also undertake its own initiatives and help coordinate the work of various industry clusters.

The Council would set the initiatives such as:

- Encourage the development of a world-class business school in Macedonia with high involvement of the private sector
- Conduct an annual survey of SMEs and systematically remove bureaucratic constraints to business formation and entrepreneurial activity
- Support the institutionalization of private-public dialogue by identifying the priority concerns
- Cooperate with the government in negotiating access to foreign markets on good terms.

In the early months, it would be useful to have encouragement from the government of Macedonia and it would be helpful to have technical and perhaps even financial support to jump-start such a council. The Council would meet monthly, or more often if necessary, and would commission specific initiatives designed to build Macedonia's competitiveness. It would review progress on these and provide leadership and vision.

The Council should work through existing business associations and research institutes and not attempt to duplicate them. It should also build on prior research done on Macedonian competitiveness, on policy reform, and on specific industry clusters, rather than doing new and repetitive research. The focus should be on *action* rather than study and on building a self-reinforcing virtuous cycle of private-public cooperation to implement change.

There are many things that must be done to build the competitive advantage of Macedonia. The recommendations above suggest some of the priorities that need to be undertaken. More importantly, this study recommends a mechanism in the Macedonian Competitiveness Council to move to action while building trust and a private-public partnership that is necessary to a strong economy and civil society.

It is impossible in a study of four countries with limited scope and resources to accurately address all of the constraints or to lay out a comprehensive set of well-sequenced recommendations. Nonetheless, it is hoped that this report will serve as a stimulus for discussion and analysis and thereby provide Macedonia's leaders with the relevant information needed for consensus and allow them to move forward with a preliminary action plan for strengthening Macedonia's position globally.

# ANNEX 1

# COMPETITIVENESS BENCHMARKS

# ANNEX 2

# COMPETITIVENESS BIBLIOGRAPHY

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## Current Webography of Competitiveness Resources

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   EU White Paper on competitiveness policy.

2. http://www.compete.org/
   US Council on Competitiveness: Includes a benchmarking of US competitiveness and descriptions of an ongoing cluster analysis project led by Michael Porter.

3. http://www.cid.harvard.edu/andes/
   Harvard's Andean Competitiveness Project: With leadership from Jeffrey Sachs and Michael Porter. See especially the project description and outline.

4 http://wbln0018.worldbank.org/psd/compete.nsf/d3fe1ba1940f13908525650d005355 4f/c2b07f0ad3cc44d68525650d00536564?OpenDocument
   World Bank Competitiveness Indicators: Data available for nearly all countries.

5. http://www.competitiveness.org
   The Competitiveness Institute, a professional group for cluster development advisors, which held its first international conference on cluster development in Barcelona in 1998. Most resources available only to members.

6. http://www.competitiveness.com
   Competitiveness.com is an international group with headquarters in Barcelona, specialized in the implementation of business to business vertical portals with a cluster approach.

7. http://www.cofi.org/blueprint.html
   Blueprint for competitiveness in forestry products for British Columbia, Canada.

8. http://www.dist.gov.au/itt/tskforce/allen/index.html
   Extensive report from 1997 on competitiveness of information industries in Australia.

9. http://www.changingnations.com/new/wldbnk.zip
   Changingnations.com (Monitor Group) World Bank training manual on discussing and fostering competitiveness.

10. http://www.cipe.org/mdf1997/advantge.htm
    Michael Porter comments on ten of the most important preconditions to improving competitiveness in a country (or geographic area). They are most applicable in cases where a country is conducting a formal project to enhance competitiveness.

11. http://www.worldbank.org/wbi/mdf/mdf1/product.htm
    The World Bank Group internet site presenting the selections from the Mediterranean Development Forum: Knowledge and Skills for Development in the Information Age held at Morocco between May 12-17, 1999.

## Selected Organizations Undertaking Studies and Assessments of Competitiveness

1. The Organization for Economic Co-operation and Development, 2 rue Andre Pascal, 75775 Paris, CEDEX 16, France.

2. The International Labor Office, 4 route des Morillons, CH-1211, Geneva 22, Switzerland.

3. The World Bank, 1818 H Street, N.W., Washington DC 20433, USA.

4. IMD International, P.O.Box 915, Chemin de Bellervive 23, CH-1001, Lausanne, Switzerland.

5. International Trade Center, 54-56 rue de Montbrillant, 1202 Geneva, Switzerland.

6. The Commonwealth Secretariat, Marlborough House, Pall Mall, London SW1 9SY, England.