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Macedonian Exports

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Executive summary

The Macedonian economy has weathered the post-2008 crisis better than most countries in the Balkans. Investments and exports have sustained growth and the performance of the labour market has somewhat improved. With exports to GDP at around 50%, the small, landlocked economy remains relatively closed, though not necessarily by Balkan standards. Also, with an unemployment rate above 20%, which has tended to be even higher for decades now, there is clearly untapped potential for growth and development.

Export-led growth is what the long-term macroeconomic framework has been designed for. There is a fixed exchange rate regime since 1994. Fiscal policy aimed at a balanced general budget for most of the pre 2008 period. Overall, the real exchange rate was not misaligned, so that a more active income and fiscal policy was available post-2008. Finally, an open foreign trade regime, with free trade with the EU and within the regional market of CEFTA, was supportive of growing exports in the last ten or so years.

The tradable sector remains small for the size of the economy, not sufficiently diversified and internationalised, with a dominance of larger firms, and not appropriately innovative. A small open economy in the context of internationalisation of production and trade grows through exports by expanding its tradable sector along both the extensive and the intensive margins. That also means that there is a lot of space for innovative activities that can access the large, primarily European market, even if those are small and medium-size companies.

With export-led growth remaining the main policy end, the economy is adapted to the stability that the long-term policy framework provides. There are possible improvements to the fiscal system and there is the need of better targeting of public investments.

The main policy interventions should be in support of innovation, easier access to the product market in support of entrepreneurship, support for internationalisation of economic activities, and as much support for innovation as possible. Both public policies and the financial system should be supportive of these improvements in the product market.

Finally, sustain growth and catching up with the more developed economies require sustained and efficient active labour market policies to bring the unemployment rate down to low single digits. With productivity improvements, the level of the Macedonian economy is about 20% below potential. With a potential growth rate of around 4%, within a generation Macedonian GDP per capita can be close to the EU average.

Keywords: Macedonia, trade, innovation, internationalisation, growth

JEL classification: F14, F41

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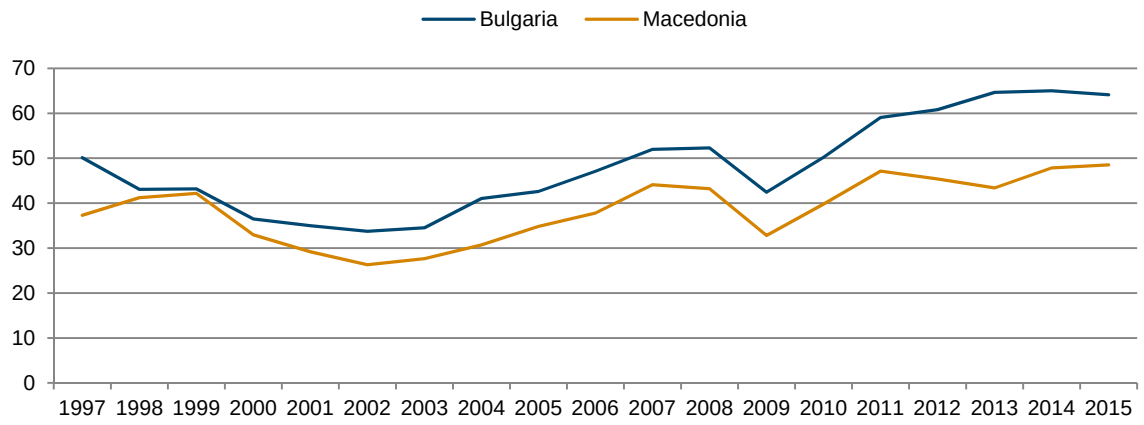
Introduction

The Macedonian policy mix has been geared towards export-led growth since the stabilisation in 1994 and the one-time devaluation in 1997. That strategy has led to the economy being more open, in terms of export share in production, than most others in the region. This is similar to the case of Bulgaria. Figure 1 shows the similar development of the two countries since 2007, the year of Bulgarian stabilisation and Macedonia's one-time devaluation. However, the export base has remained small and not all that much diversified, though there has been some improvement in the last few years. And the economy has remained relatively closed for its size – with exports being close to 50% of GDP.

Figure 1 / Exports of goods and services, % of GDP, 1997-2015



Source: Eurostat.

Macro and financial balances have proved sustainable, which allowed the economy to weather various internal and external shocks without undue costs of adjustment. However, growth and structural changes have still been slow. The latter have speeded up lately however.

After the 2008-2009 crisis exports have proved to be important to sustaining growth and their growth has supported the cut into the otherwise very high rate of unemployment. In part on account of preserved competitiveness in the period before the financial crisis, exports of goods and services advanced strongly, and certainly faster than the economy as a whole. For the most part, this was due to expenditure switching, which is to say that exports substituted for the lack of increase in domestic absorption. However, there was also some expansion of the tradable sector relative to the economy as a whole.

For development to go forward, further improvement in the tradable sector is required to support growing exports. The economy is still not altogether an open one in the sense that its overall growth is predominantly dependent on the external rather than domestic demand. A rather small economy as the Macedonian one will exhibit sustainable growth and development if indeed its consumption and

investment are expanding alongside the growth of the tradable sector and thus exports. This requires further changes in macro balances that may yet have to happen.

That will require certain policy adjustments, both in terms of macro policies and when it comes to structural reforms too. The trade regime is an open one, at least in the sense that tariffs are low. Macedonia is a member of the World Trade Organisation (WTO), has a free trade regime with the EU, regulated by the Stabilisation and Association Agreement (SAA), and participates in the regional free trade area, CEFTA. EU and CEFTA account for the bulk of Macedonian exports and overall trade, which is thus tariff free. Those agreements also govern cross-border investments, especially from the EU, which are considered to be quite important for the economic development of the country. There are non-tariff and non-trade barriers to be considered, some of which are structural rather than political in nature; e.g. there are rigidities in the product and labour markets which stand in the way of entrepreneurship and internationalisation.

Given the imbalances in the labour market, the low rate of employment and the high rate of unemployment with significant outward migration, and the relatively low level of GDP per capita, there is scope for policies to contribute to employment and growth. Clearly, development policies, including public investments, are needed to increase the productive and exporting capacities. In addition, remaining obstacles to openness to the outside market forces on the product, financial, and labour markets need to be removed.

Overall, going forward, and given the policy framework which is not going to be changed significantly, export growth and a further increase in the openness of the economy are important prerequisites for sustained growth and development. In the medium to long run, the ratio of exports to GDP needs to increase by about one half, to about 75%. This would lead to the convergence in openness with more developed small European economies (e.g. those in the Baltics).

This strategy of development is dependent on political stability. In the case of Macedonia, the monetary and fiscal policy mix has also been conditioned on the contribution to political stability. That has, more often than not, led to a more risk-averse approach than was required by the economic fundamentals. There was the threat of financial outflows, which was countered with monetary policy which was more restrictive than necessary. Also, fiscal policy was often either too restrictive or was targeting politically popular rather than projects which were justified in economic terms. That policy mix has had some negative consequences in the sense that public spending has increased foreign debt without at the same time increasing the share of the tradable sector, which has to be relied on to sustainably service that foreign debt.

Finally, the prolonged political crisis has contributed to the decline of the growth rate in 2016 and even more in 2017. The first quarter of this year saw stagnation over the same period of last year. For the most part, that was due to low investments and a widening trade deficit. Such developments risk the reversal of positive trends in the external sector and in the restructuring of the demand side of the GDP. A small open economy needs to ensure stable investment conditions and growing access to foreign markets. Political stability, which means a functioning and stable democracy, is needed for that.

A bit of informal theory

A small open economy does not need to depend on favourable external demand to expand its exports. The reason is that it is a price taker in foreign trade. The amount of goods for exports that it can supply is not significant enough to move prices in the relevant markets and so demand is not a constraint. That applies to the intensive margin (increased existing export offer) as well as to the extensive margin (i.e. exports of new products), which means that exports should support innovation. Exports depend on supply and on competitiveness. Table 1 reports the increase of exports, valued in euro, from the members of CEFTA (except Moldova) since the peak year of 2008 (except for Albania). This is the period when neither growth in the EU, where the bulk of the increased exports went, nor in the region was remarkable. However, domestic consumption recovered only slowly if at all, which is also evident in the much slower recovery of imports. It is also important to note that not only exports of goods grew, but also of services.

Table 1 / Exports of goods, services and GDP, % increase, 2016/2008

	Goods	Services	GDP
Albania	-15	26	21.3
Bosnia and Herzegovina	79	-2.5	6.9
Croatia	39	15	-8.8
Kosovo	56	134	29.0
Macedonia	59	69	19.1
Montenegro	-30	60	9.2
Serbia	83	64	2.1

Source: wiiw.

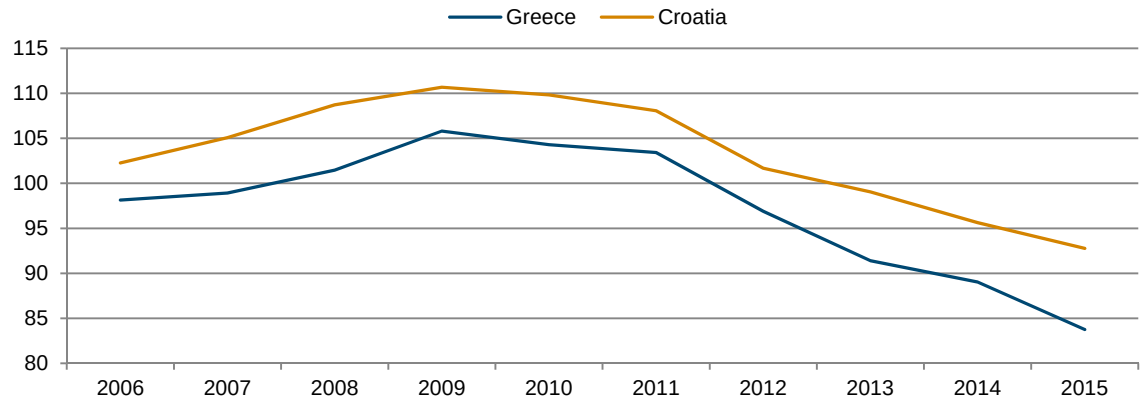
There are two issues to address here. One is that investing to export may not be all that attractive for foreigners – primarily because foreign investments may be more of interest if the scale of production is such that it does affect the demand in the intended markets. In other words, large-scale investments in a small open economy are not to be expected from abroad. That may not extend to production chains, e.g. regional ones, where some parts are produced in Macedonia, to make use of one or the other advantage. So, the important question is, how internationalised is the economy?

The other question is, how are relative prices behaving? In a number of small or less developed economies in the EU and in the Balkans, the period prior to the 2008 crisis was characterised by an appreciation of the real exchange rate. That often led to growth of non-tradable services and less pronounced growth of the tradable sectors. After 2008-2009, that required an adjustment in the real exchange rate and in wages and labour markets in order to regain competitiveness. The key question then is competitiveness of the economy in good times and bad, which is basically the question of the adequacy of the policy mix that is being pursued.

Figure 2 gives the development of the real effective exchange rate (REER) deflated by nominal unit labour costs for Greece and Croatia. These two countries have also had the least success with export

growth, and indeed some acceleration in Croatia happened only in the last couple of years. From the peak in 2009-2010, REER declined by almost 20 percentage points in Croatia, and by few points more in Greece. In Serbia the nominal exchange rate was devalued by more than 50%, though some of that was annulled by faster inflation.

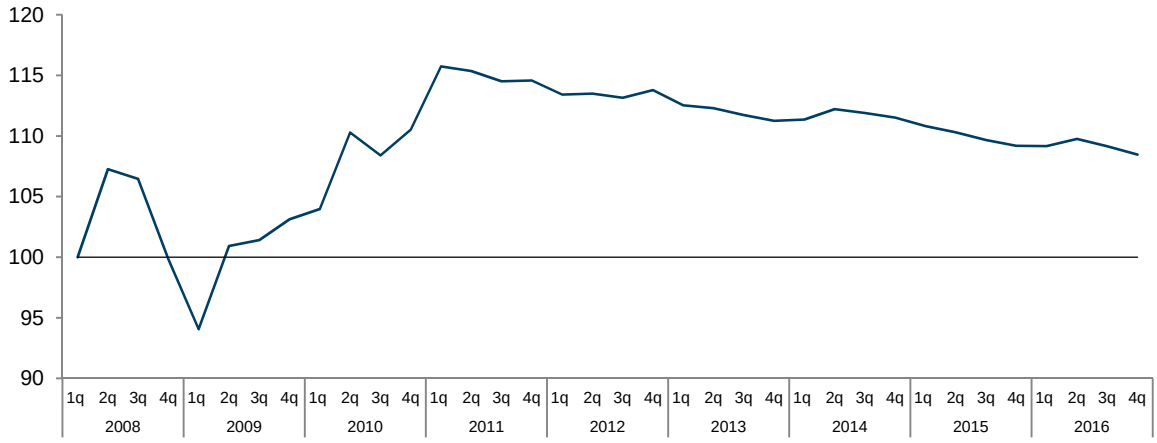
Figure 2 / Real effective exchange rates*, unit labour costs deflated, 2005 = 100



Source: Eurostat; * relative to a currency basket of 37 countries.

By comparison, the real exchange rate of the denar relative to the euro did not depreciate over the whole period, though it did so gradually starting from the first quarter of 2011 (Figure 3). That suggests that Macedonia's real exchange rate was not overvalued before the 2008 crisis. Put differently, in terms of competitiveness, there were no obstacles to increased exports. That supports the claim that in the case of a small open economy like the Macedonian one, it is the supply of tradable goods that drives exports.

Figure 3 / Real exchange rate of denar relative to euro, PPI-deflated, quarterly over previous year's quarter, 2008 = 100



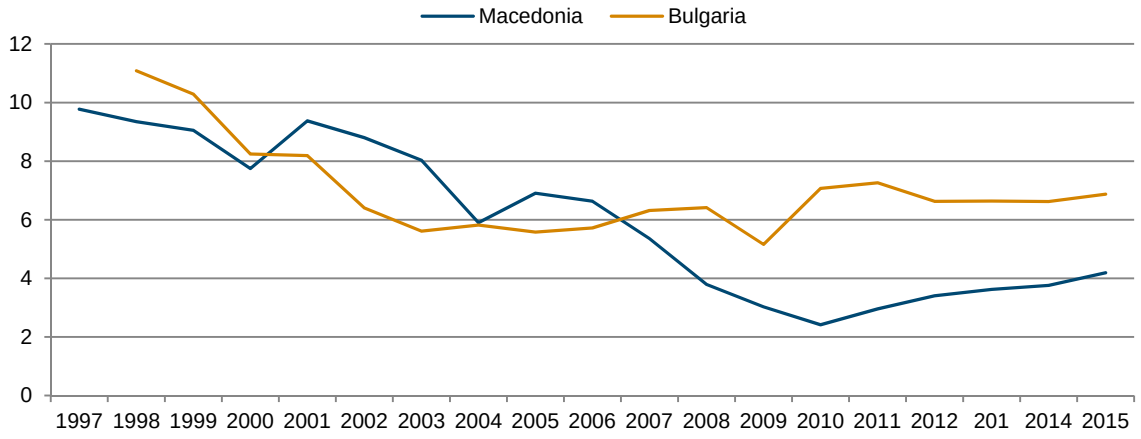
Source: wiiw.

That basically means that (i) supply-side policies, (ii) the savings-investment balance, and (iii) a competitive real exchange rate are the most important drivers of exports and thus of overall economic

activity in a small open economy like the Macedonian one. There is, however, a limited role for active trade policy especially because there are no obvious drivers of specialisation, e.g. natural resources or traditional industries or other country-specific factors of production. Export growth will mostly have to come from growing manufacturing and connected services.

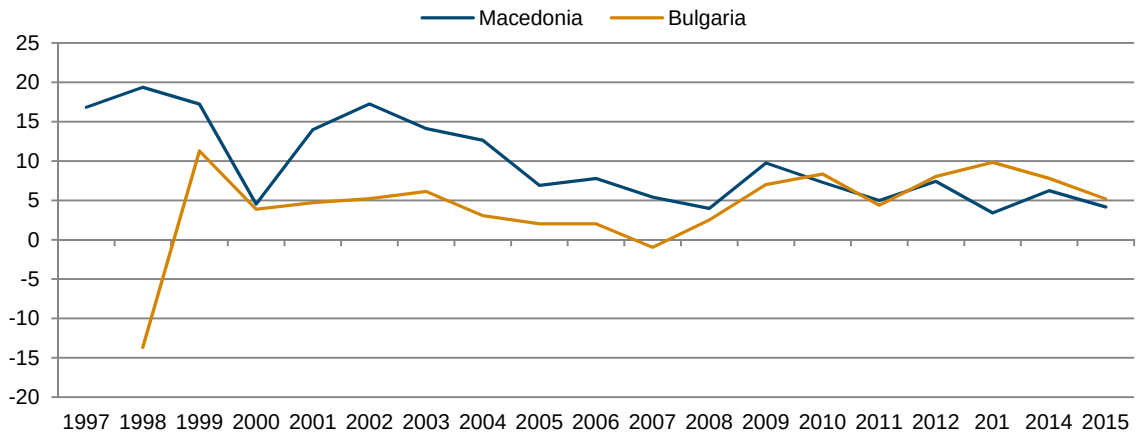
As already mentioned, the macroeconomic policy mix has been geared towards export-led growth since at least 1997. The relatively subdued performance, however, has been to an extent due to tight monetary and fiscal policies that were pursued especially after 2001-2002. Those were pursued because of high internal and external risks to stability. In particular, monetary policy was often too tight with a view to supporting the fixed exchange rate. The aim was to discourage financial outflows.

Figure 4 / Lending minus deposit interest rate, 1997-2015



Source: The World Bank.

Figure 5 / Real interest rate, 1997-2015

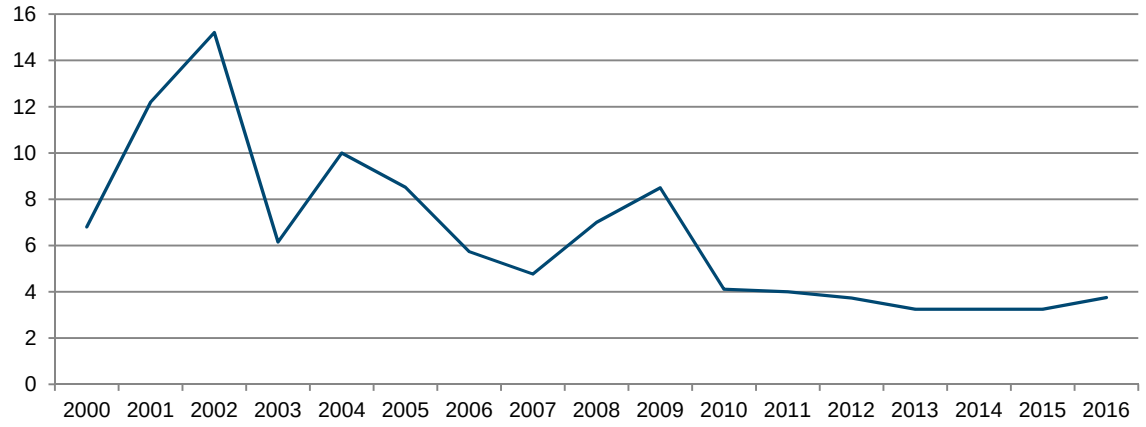


Source: The World Bank.

Figures 4 and 5 illustrate the tightness of financial market with both high spread between deposit and lending rates and high real interest rate. With the policy rate mainly driven by the foreign exchange

market, high policy rate, Figure 6, reflects the cross-border flows in view of risks to political and economic stability.

Figure 6 / Central bank policy rate, %, p.a., end of period, 2000-2016



Source: wiiw.

Towards the end of the period covered by Figure 6 there was clearly pressure to adjust the policy rate in order to stabilise the foreign exchange market because of risks from financial outflows. This is an indication of how sensitive monetary and by extension all the other policies are to political instability. The level of the policy rate is high given the world interest rates and has been tending upwards though the economic developments do not warrant tighter monetary policy. That of course also has consequences for foreign debts and then for the activity of the financial institutions.

In general, an open economy with financial stability and sustainable macroeconomic balances is the condition for growth which also presumes the proper working of the democratic process. There are in addition structural or supply-side issues to be addressed, which again require political legitimacy which cannot be sustained without reliance on the rule of law. A small open economy can advance if it couples price taking in foreign markets with policy-making which follows best practices in those markets. The direct way to ensure that is membership in the EU or in approximating membership as long as it remains unavailable.

Some history

Macedonia's economic history is certainly dominated by high unemployment and concerns with stability – the latter particularly after independence, from 1991 on, while the unemployment rate has been high or very high since the 1960s, and from the early 1980s more specifically. Long-term imbalances in the labour market cannot be explained by short-term shocks, so this is not a cyclical but rather a structural characteristic.

Table 2 / Historical trade shares, % GDP[1)]

	Internal trade, % GDP			
	1970	1976	1983	1987
Slovenia	53.6	60.9	42.4	57.5
Croatia	62.6	66.1	59.7	67.0
Vojvodina	49.0	58.8	54.8	58.1
Serbia (central)	58.9	64.0	52.1	62.3
Serbia (with Vojvodina and Kosovo)	67.0	71.3	60.9	69.0
Montenegro	50.8	59.9	54.4	57.5
Bosnia and Herzegovina	50.5	61.4	49.1	56.1
Macedonia	63.2	61.9	55.3	60.8
Kosovo	57.6	56.8	58.2	64.6
Yugoslavia total	*58.6*	*63.0*	*53.4*	*62.2*

	Inter-regional trade, % GDP			
	1970	1976	1983	1987
Slovenia	28.7	22.0	15.7	20.3
Croatia	21.8	19.0	14.8	18.7
Vojvodina	40.1	30.1	22.5	28.8
Serbia (central)	23.7	21.1	16.5	17.4
Serbia (with Vojvodina and Kosovo)	18.0	14.8	10.9	13.4
Montenegro	40.6	22.6	21.0	25.0
Bosnia and Herzegovina	36.6	22.7	18.6	24.2
Macedonia	23.1	23.1	18.1	21.4
Kosovo	34.7	25.7	19.2	24.0
Yugoslavia total	*26.3*	*21.9*	*16.6*	*19.9*

	Export, % GDP			
	1970	1976	1983	1987
Slovenia	17.7	17.1	41.9	22.2
Croatia	15.6	14.9	25.5	14.3
Vojvodina	10.9	11.1	22.7	13.1
Serbia (central)	17.4	14.9	31.4	20.3
Serbia (with Vojvodina and Kosovo)	15.0	13.9	28.2	17.6
Montenegro	8.6	17.5	24.6	17.5
Bosnia and Herzegovina	12.9	15.9	32.3	19.8
Macedonia	13.7	15.0	26.6	17.8
Kosovo	7.7	17.5	22.6	11.4
Yugoslavia total	*15.1*	*15.1*	*30.0*	*17.9*

Note: 1) Final and intermediate goods.
Source: OECD.

Table 2 details trade shares since 1970 and until 1987. Macedonia was for the most part more closed than other regions in Yugoslavia and also exported less to other countries. Overall, its trade is synchronised with cyclical changes in other Yugoslav regions. In any case, openness, exports to other Yugoslav regions plus to foreign markets as a percentage of GDP did not exceed 40%, while foreign trade proper was for the most part below 20% of GDP.

Table 3 gives unemployment rates since 1952 and until 1989. The Macedonian unemployment rate was consistently the highest or among the highest in Yugoslavia. Explanations for this long-term characteristic of the labour market are hard to come by because of the changing political and economic environment. The development of comparative advantages played a role undoubtedly. In the post-World War II period, the Yugoslav market was the most important one. There were, however, geographical and technological disadvantages to investing in Macedonia rather than in other regions of Yugoslavia. There was also the demographic factor, with the population growing faster than in other parts of the common country. But, it is probable that the real exchange rate tended to appreciate, as internal trade and current account balances were mostly negative.

Table 3 / Unemployment, %

	1952	1965	1974	1980	1989
Slovenia	1.8	1.7	1.4	1.4	3.2
Croatia	2.9	5.6	4.8	5.2	8.0
Serbia (central)	2.5	7.4	11.3	15.8	15.6
Serbia (with Vojvodina and Kosovo)	2.6	7.1	11.5	16.1	17.6
Vojvodina	2.9	4.5	8.9	12.4	13.6
Kosovo	2.6	15.2	21.0	27.6	36.4
Montenegro	3.2	5.1	12.7	14.7	21.5
Macedonia	6.3	13.5	19.7	21.5	21.9
Bosnia and Herzegovina	1.5	4.8	9.7	14.1	20.3

Source: OECD.

After independence, the regime of sanctions on Serbia, a major trading partner, and partly overlapping sanctions by Greece, which provides the connection to the sea, affected the economy importantly. Following the launch of the stabilisation programme in 1994, a fixed exchange rate regime, with the possibility for periodic devaluations, if needed, was introduced. So, this is a de facto, but not de jure, currency board exchange rate regime. Since then, there has been only one case of devaluation, in 1997 (in part caused by the collapse of Ponzi schemes in Albania, which had some spill-over into Macedonia). Thereafter, the banking sector was privatised with the National Bank of Greece taking over the largest bank, Stopanska banka.

In part because of the experience of the 1990s, and also because of the political instability and a close call with an internal civil conflict in 2001, economic stability was and has continued to be the main political and policy concern. Therefore, the central bank has maintained tight control of the money supply, targeting the stability of the exchange rate, while the fiscal authority targeted a balanced budget with tight control over the growth of wages. Growth and employment suffered as a consequence.

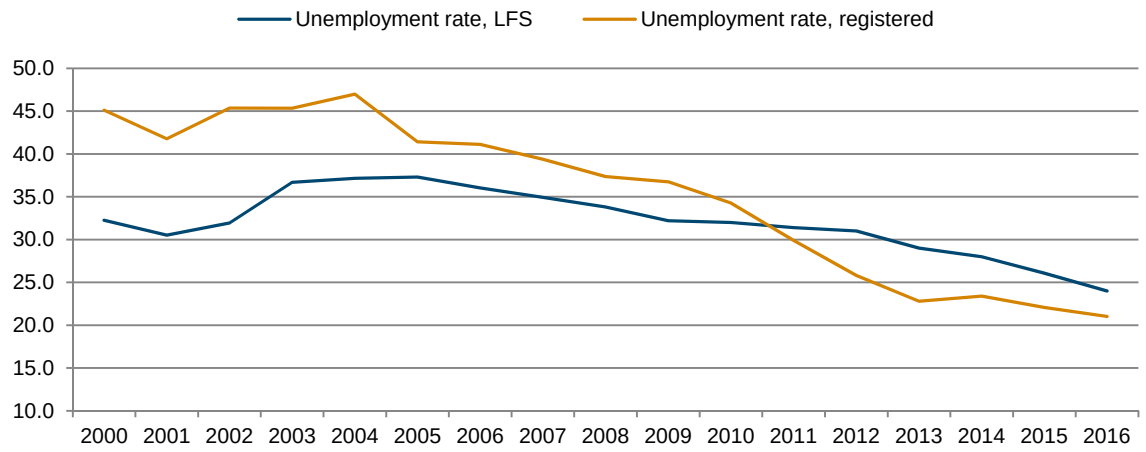
After 2008, however, sound macro balances made it possible to relax somewhat economic policy with the aim to increase employment in part by spurring public investment and hiking wages and compensations in the public sector. In addition, external balances improved, with exports growing faster than imports, even though the trade deficit remained relatively large, as opposed to the current account deficit, which narrowed much more significantly. The trade imbalance is in part due to high inflows of remittances, which in turn are sustained by continuing outward migration. In view of this persistent external imbalance, the concern with exchange rate stability dominates the choice of polices that are being pursued.

Overall, Macedonia faces the challenge of a historic transformation in terms of macro balances and when it comes to economic policies. In particular, that refers to openness, the efficiency of the labour market, and the savings and consumption behaviour. When it comes to the latter, which in some sense is the key issue, the discount rate of future consumption needs to be decreased significantly. That of course depends on institutional and political stability, which needs significant improvement.

Macro balances

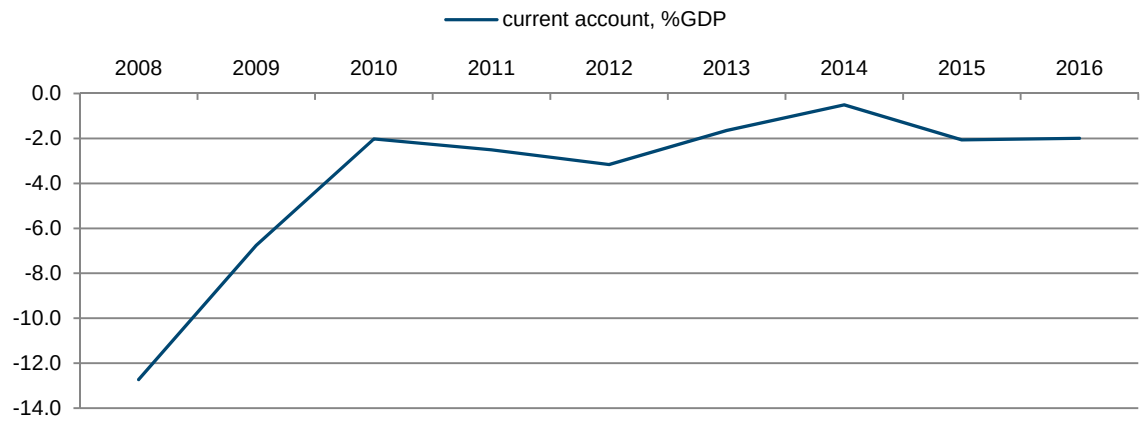
The key macro imbalance is in the labour market. The unemployment rate is down from the peak of 35% a decade or so ago to 23% currently (Figure 7). As is clear from the historical data, this is a long-term and thus structural problem. The reasons for the inefficiency of the labour market are certainly changing. One possible ground for optimism is that the development in the labour market has mirrored those in other transition countries, though from higher inherited unemployment level, in any case after 2002 or thereabout. That is to say that change in the product market has initially led to labour shedding, with increased employment thereafter – the latter seems to be happening in the last few years.

Figure 7 / Unemployment rate, 2000-2016



Source: wiiw.

Figure 8 / Current account, 2008-2016



Source: wiiw.

External imbalances have improved however (Figure 8). The trade deficit is still high, but the current account deficit has narrowed significantly. Due to subdued growth, though it has overall been better than in most neighbouring and even European countries, public debt has increased, but not necessarily in an unsustainable manner. Similarly, foreign debt is increasing, even though the level is still not all that worrisome. Private debt, those of households and the corporations, has also increased, but again the level is lower than in most comparator countries.

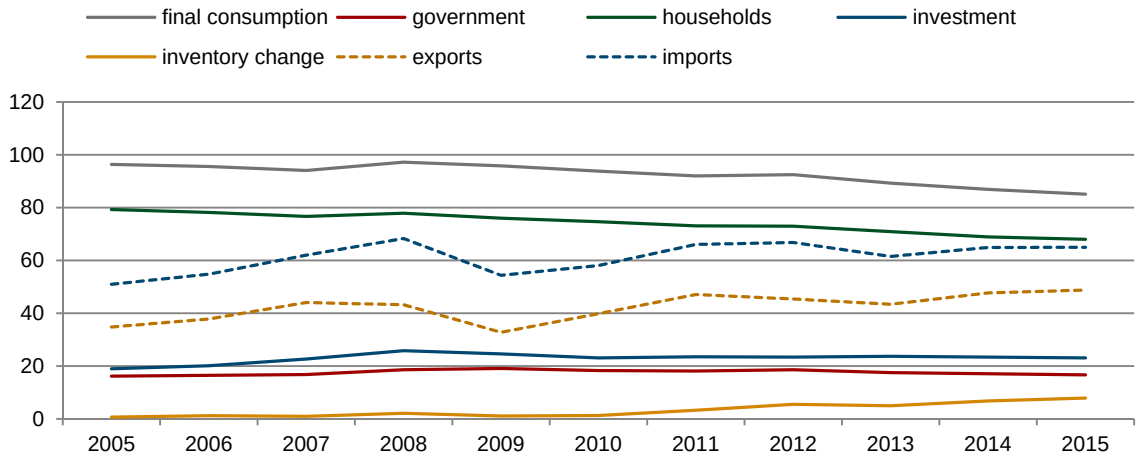
Overall, macro balances will continue to be sustainable as long as growth does not disappoint.[1] Importantly, macro balances do not stand in the way of faster growth.

Table 4 / Structure of demand side, 2007-2015

	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015
Consumption	96.4	95.6	94.1	97.2	95.8	93.8	92	92.5	89.3	86.9	85.1
- government	16.2	16.5	16.8	18.6	19.1	18.3	18.1	18.6	17.5	17.1	16.7
- households	79.3	78.2	76.7	77.9	76	74.7	73.1	73	70.9	68.9	68
Investment	19	20.1	22.7	25.8	24.6	23.1	23.5	23.4	23.7	23.4	23.1
Inventory	0.7	1.2	1	2.1	1.1	1.3	3.3	5.5	5	6.8	7.9
Exports	34.8	37.8	44.1	43.2	32.8	39.8	47.1	45.4	43.4	47.7	48.8
Imports	51	54.8	62	68.3	54.4	58.1	66.1	66.8	61.5	64.9	65

Source: Eurostat.

Figure 9 / Structure of demand side, 2005-2015



Source: Eurostat.

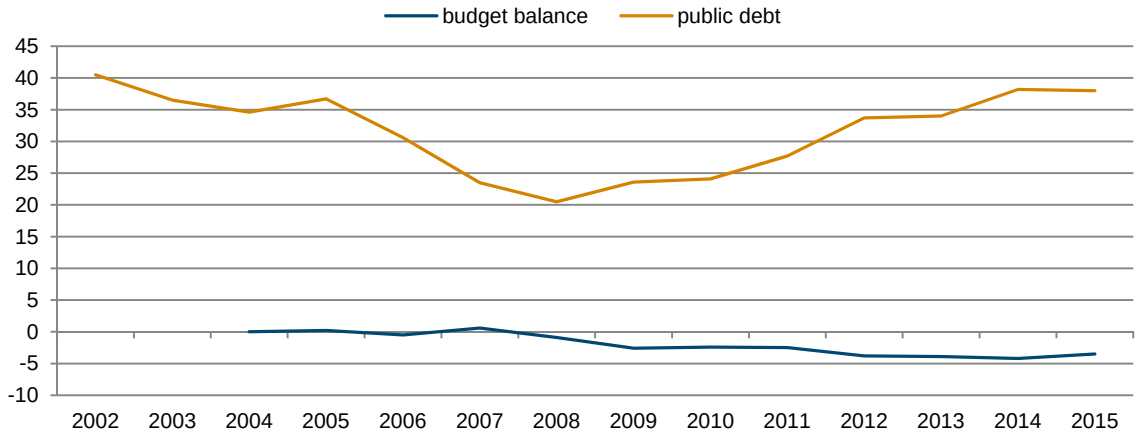
The key macroeconomic change, since 2008 or thereabout, is that growth is primarily driven by investments and exports, with consumption growing more slowly than the aggregate economic activity (GDP). Table 4, and more visibly Figure 9, show that the share of consumption in GDP, and almost exclusively of the households, has declined by about 10 percentage points while the share of

[1] In general, sustainability depends on whether the interest rate on debt is higher than the growth rate of income with the level of debt mattering to the extent that it influences the rate of interest.

investments in GDP has remained relatively high (though it looks as if it did decline possibly temporarily in 2016) while exports have grown as a per cent of GDP (there is a notable increase of inventories, which is a separate though important issue). The key question is whether this presents a structural shift towards growth and development, which would also mean that the economy is moving in the direction of better accordance with the long term policy framework.

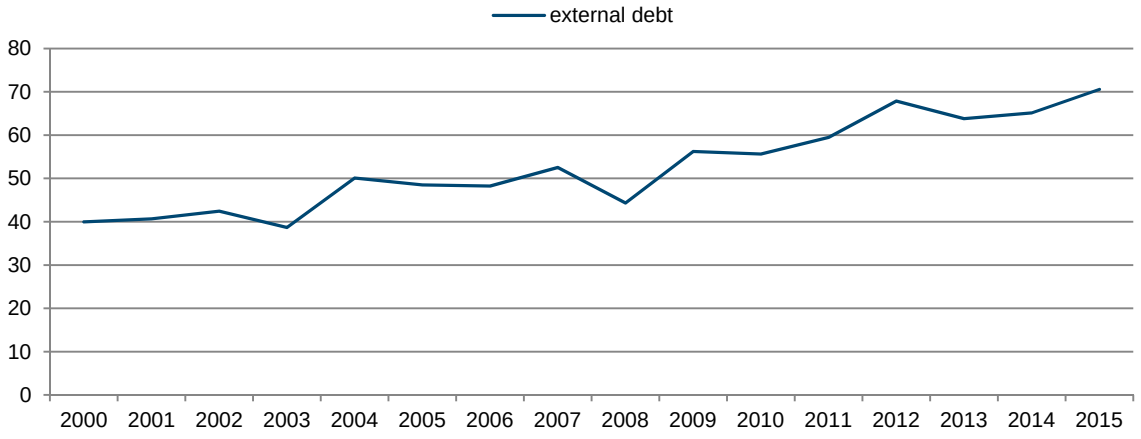
This also implies that investments are depending increasingly on domestic savings, which is clearly one of the more important structural developments. The issue is whether it is sustainable (Figures 10 and 11). In the past, growth tended to speed up with trade and current account deficits being high. Since 2008, external balances have been improving, which is at least in part due to the rebalancing between consumption and savings (Figures A2-A4). In part, this development is the consequence of the decline of oil and gas prices, as all of these commodities are imported. Similarly, the moderation of the prices of food has been supporting the trade balance, as Macedonia is a net importer of food too. However, export growth has clearly played an important role in improved macro balances.

Figure 10 / Public debt and general government balance, % of GDP



Source: Eurostat.

Figure 11 / External debt, % of GDP

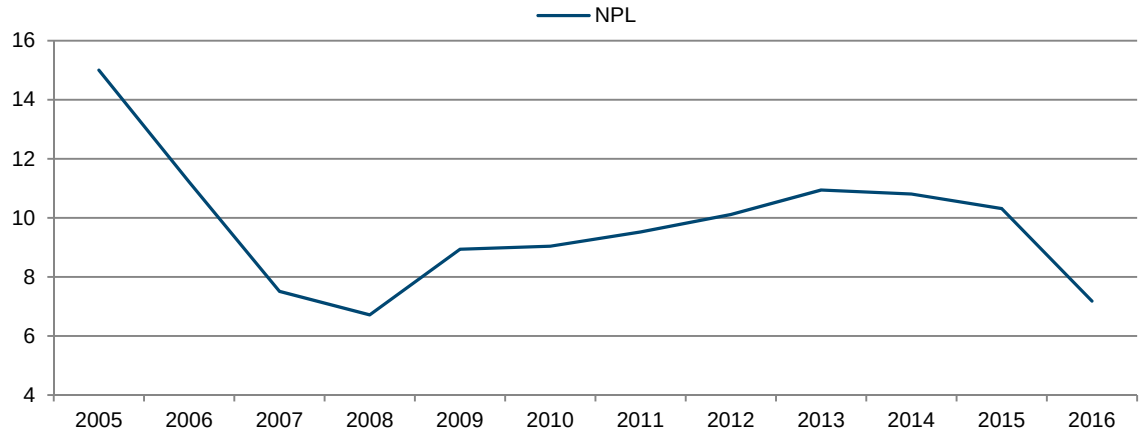


Source: Eurostat.

Public debt and foreign debt are sustainable in the sense that their increases have moderated or ceased with the improvement in the growth performance. In general, faster growth with relatively low interest rates, both on the public and the foreign debts, will provide for a sustainable path of their development even if the debt to GDP ratio is increasing if the growth rate is above the interest rate. (For interest rates see Figures A5 and A6.) With real interest rates around 4%, still a very high level, the real growth rate needs to be around 4% for debts to be sustainable. Given the high rate of unemployment, the potential growth rate is probably above 4% if the export-oriented growth strategy is maintained.

The financial sector is also in better shape (Figure 12) than in a number of comparator countries (in the region in particular, where non-performing loans are in double digits and often above 20% of total assets of the banks). This is in part due to the relatively low levels of indebtedness of the household and corporate sectors. Concern with the stability of the exchange rate has led to a relatively tight monetary policy for a long time, which is why access to credit has been limited by relatively high real interest rates. While that has led to undue reliance on reinvested profits rather than on loans and other forms of debt financing, real estate prices had not ballooned prior to the 2008 crisis, and consequently recession and slower growth have not led to an explosion of non-performing loans. Financial stability has been sustained irrespective of the fact that a significant share of the banking sector is in control of the Greek National Bank, and other foreign banks, some of which have faced restructuring problems at home.

Figure 12 / Non-performing loans, 2005-2016



Source: The World Bank.

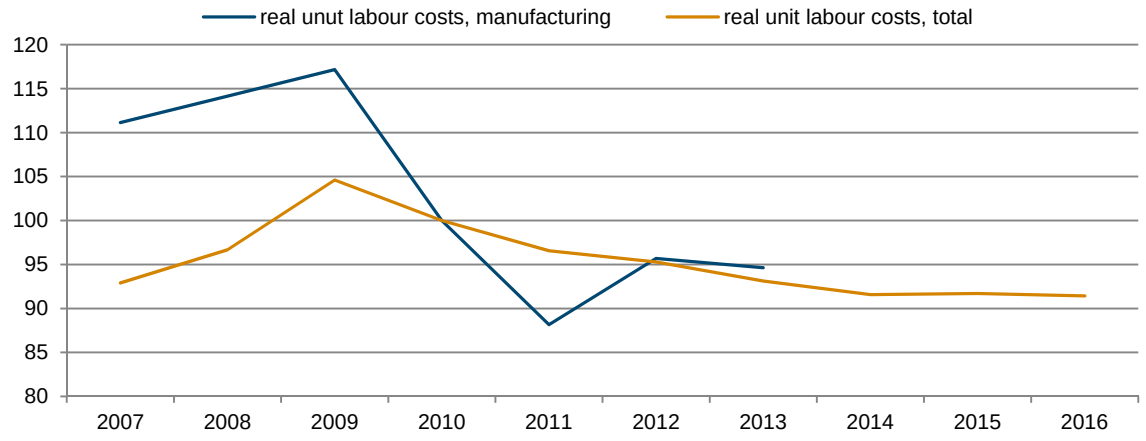
In general, macro balances are not standing in the way of further expansion of activity, public and foreign debt growth notwithstanding; domestic savings are increasingly financing investments; and financial stability, though supported by tight monetary policy, seems assured.

The adjustment

The 2008-2009 crisis led to transfer (deleveraging) and adjustment problems in many Balkan and European economies. In countries with high current account deficits and growing foreign debts, the reversal of financial flows was necessary, which is the transfer problem. Countries that were recipients of significant foreign investments have had to reverse the capital and financial flows in order to stabilise their foreign debts. That meant a decline in imports and an increase of exports which were driven mostly by cuts in investments and in some cases in consumption, which also meant higher unemployment and a stop to growth of wages. The latter is the adjustment problem – in this case depreciation of the real exchange rate in order to support exports and discourage imports. That in some cases required fiscal and structural adjustments too.

The leading example of the transfer and adjustment problem in action is provided by Greece. But a similar trajectory was taken by the Serbian and Croatian economies as well. In the case of Serbia, there was both nominal devaluation and a nominal wage cut. In the case of Croatia, the real exchange rate declined due to lower employment, stagnating wages, and deflation. Other Balkan countries did not adjust in the same way. This was in part due to the fact that they did not have a misaligned real exchange rate, so in some cases, such as in Macedonia, wages increased along with the growth of exports. Price moderation helped too, with deflationary pressures being the consequence of weak domestic demand and declining import prices. So, while in some countries foreign debt stopped going up, and even declined as a ratio of GDP, e.g. in Bulgaria, it continued to increase in Macedonia and some other countries in the region. The same is the case with the net international financial position.

Figure 13 / Real unit labour costs, total and industry, Macedonia, 2010 = 100



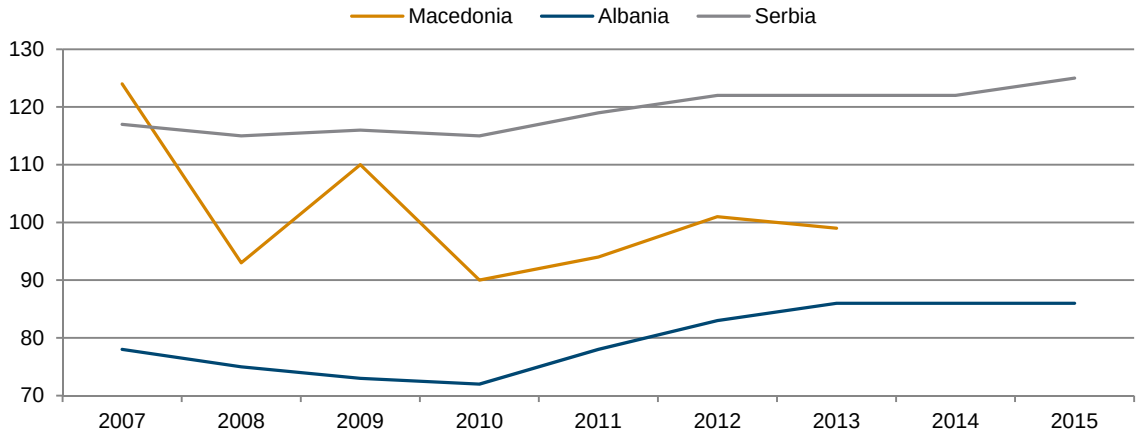
Source: Eurostat.

Figure 13 shows the adjustment in real unit labour costs, which jumped just during the initial phase of the crisis, due mainly to increases of wages in the public sector, while they went down thereafter. More

recent data on unit labour costs in industry are lacking, but they are certainly below their peak levels before the 2008-2009 crisis.

The terms of trade (Figure 14) improved too, after the initial correction, though Eurostat lacks more recent data for Macedonia. One expects that it would not be much different from that of Serbia due to the effect of falling oil prices. In any case, the adjustment in the terms of trade as well as in unit labour costs seems to have been appropriate for them to support increased exports.

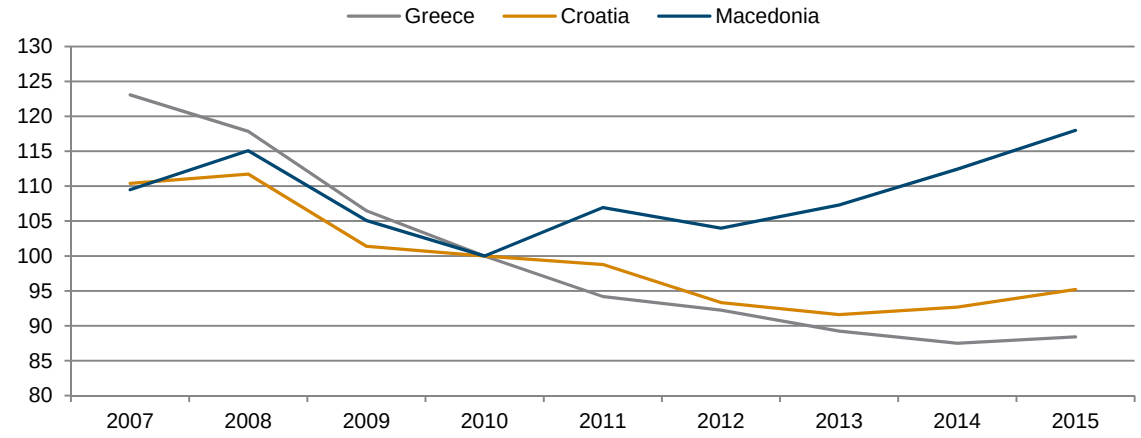
Figure 14 / Terms of trade



Source: Eurostat.

The important adjustment in countries without misaligned real exchange rates is the one on the supply side. As exports increase, there should be a change in the tradable versus non-tradable shares in the GDP. In particular, the share of production of manufacturing goods should increase in aggregate production (Figure 15).

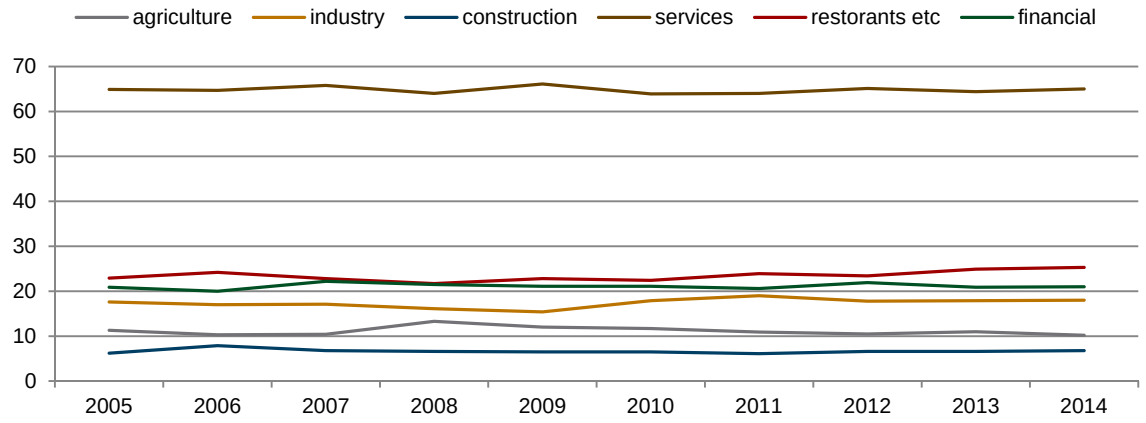
Figure 15 / Industrial production, 2010 = 100



Source: Eurostat.

This should be seen in the share of manufacturing value added, as indeed is the case (Figure 16; Greece and Croatia are given as comparator countries with a quite weak export performance after the crisis). As long as that is not the case, growing exports are mostly due to expenditure switching.

Figure 16 / Sectors of production, % of gross value added



Source: Eurostat.

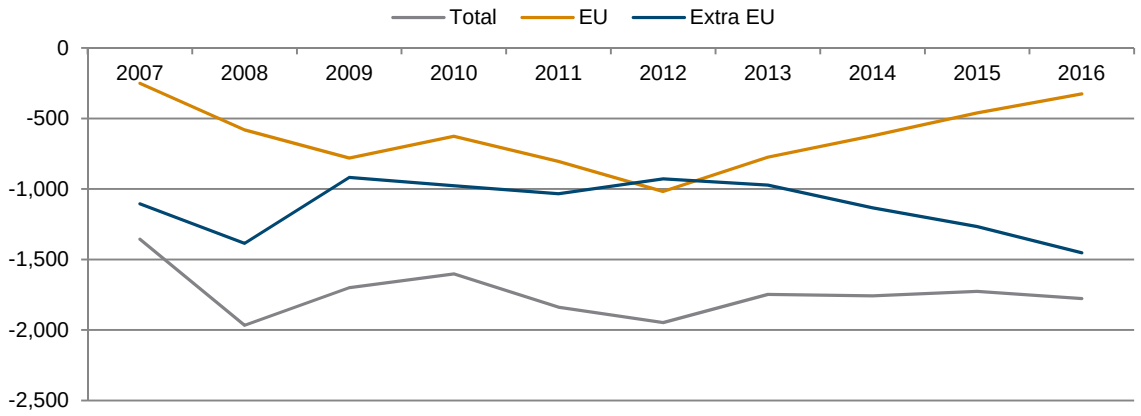
In the Macedonian economy, manufacturing has been growing faster than the GDP only in recent years (Figure 16, see also Figure 26 for a different structure of the same data). Compared to the pre-crisis, e.g. 2008 level, increases are modest but the recovery is notable. Tradable services are also growing as a share of GDP (Figure 16). So, the needed adjustment seems to have been taking place in the last few years. It is not clear, however, how enduring that development is. In terms of the real exchange rate, the existing policy mix should be able to avoid misalignment. Also, as long as employment is growing, pressure to increase wages may be postponed, at least until the labour market tightens sufficiently. Some adjustment in wages and compensations to reflect the differences in skills and productivity would be indeed welcome. Over time, the trade balance should improve and with that the risk of a potential financial crisis should decline. All that, however, depends on continued growth in exportable goods and services.

The tradable sector

Traditionally, agriculture accounts for the bulk of the production of tradable goods. Those also provide for exports. In addition, extraction has been a source of exports. Exports of services, primarily those connected with travel, have also been relied on. Macedonia is a destination for cultural as well as vacationing tourism. It is also a transit country, so transportation is also a source of exports.

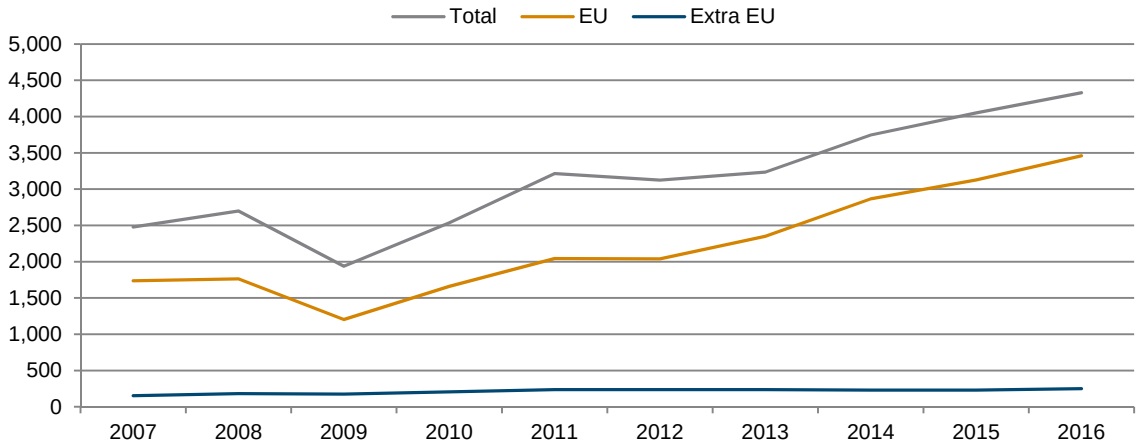
All of these are traditional sources of exports. Those are rather concentrated, in terms of goods and suppliers, and have limited growth potential. Also, they are sensitive to shocks, both those connected with the climate and also from world prices. So, significant fiscal intervention may be needed, especially in cases in which other ways to insure against shocks are not readily available.

Figure 17 / Trade balance, EUR million



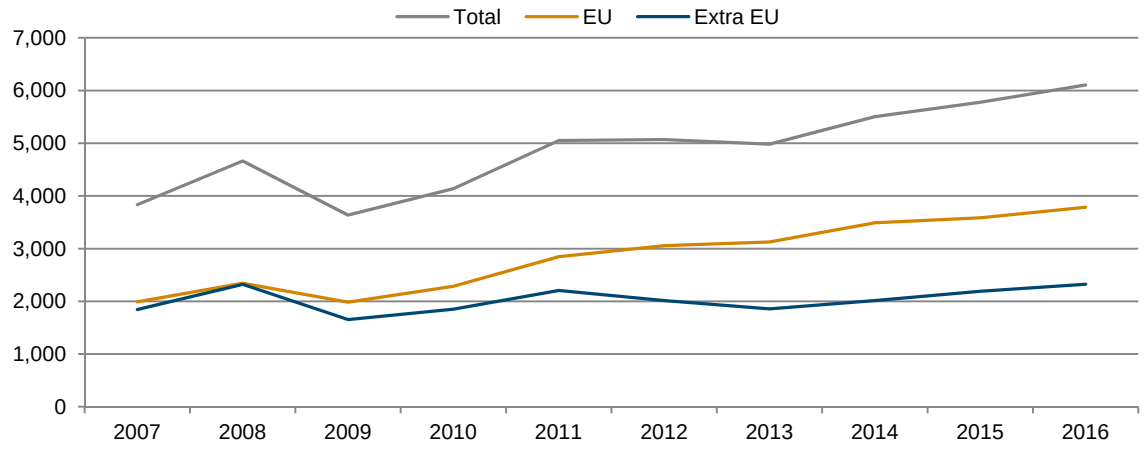
Source: Eurostat.

Figure 18 / Exports, EUR million



Source: Eurostat.

Figure 19 / Imports, EUR million



Source: Eurostat.

Much of this export specialisation has been inherited from the time of both managed trade and the adjustment to comparative advantages within the Yugoslav economy. Things have changed in the meantime with the Macedonian economy being much more open to trade with the EU and the Balkan region. That has opened up some new comparative advantages, which have not been utilised all that well primarily on account of the passive type of adjustment to changing external circumstances – mainly due to overriding concerns with stability (Figures 17-19).

However, some of the causes are to be found in the way privatisation was implemented. It favoured managers of existing firms and disregarded the potential that a more market-oriented privatisation would have possibly provided. As a consequence, some production was basically run down while the remaining product market exhibited significant concentration and increased monopoly power. Also, the financial results of privatisation were meagre, to say the least. That has cast a long shadow on the production activities and on the actual specialisation.

Figure 20 / Firms with over 250 employees, number and volume of foreign trade (in EUR)

Source: National statistics.

Table 5 / Trade balances, exports, imports by groups of products, EUR million, 2005-2016

Trade balance	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016
EU	-483	-366	-251	-581	-781	-626	-804	-1,018	-775	-623	-460	-325
RoW	-512	-696	-1,105	-1,386	-918	-977	-1,034	-928	-973	-1,134	-1,266	-1,453
Total	-995	-1,062	-1,356	-1,967	-1,700	-1,602	-1,838	-1,947	-1,748	-1,758	-1,726	-1,777
Balance: Food												
	2005	**2006**	**2007**	**2008**	**2009**	**2010**	**2011**	**2012**	**2013**	**2014**	**2015**	**2016**
EU	-13	16	9	-32	-29	-14	-62	-90	-48	-51	-73	-69
RoW	-30	-22	-78	-68	-65	-49	-33	-48	-45	-60	-88	-66
Total	-43	-6	-70	-100	-94	-63	-96	-138	-93	-110	-161	-135
Balance: Raw material												
	2005	**2006**	**2007**	**2008**	**2009**	**2010**	**2011**	**2012**	**2013**	**2014**	**2015**	**2016**
EU	-7	17	39	2	37	76	55	88	116	96	92	98
RoW	-34	-57	-163	-73	-85	-129	-153	-163	-111	-130	-120	-73
Total	-41	-39	-124	-71	-48	-53	-98	-75	4	-34	-28	25
Balance: Chemicals												
	2005	**2006**	**2007**	**2008**	**2009**	**2010**	**2011**	**2012**	**2013**	**2014**	**2015**	**2016**
EU	-182	-197	-223	-262	-256	-175	0	14	58	287	363	420
RoW	-15	-13	-35	-69	-28	-38	-58	-59	-85	-115	-128	-107
Total	-197	-210	-258	-331	-285	-213	-59	-45	-27	172	235	313
Balance: Manufacturing												
	2005	**2006**	**2007**	**2008**	**2009**	**2010**	**2011**	**2012**	**2013**	**2014**	**2015**	**2016**
EU	74	193	473	-24	72	75	-130	-263	-260	-555	-626	-722
RoW	-25	-123	-169	-259	-136	-135	-106	-52	-199	-264	-397	-660
Total	48	70	304	-283	-64	-60	-237	-315	-460	-819	-1,023	-1,382
Exports												
EU			1,737	1,763	1,203	1,659	2,043	2,039	2,350	2,867	3,126	3,459
RoW			740	935	734	875	1,172	1,085	885	880	925	870
Total			2,477	2,698	1,937	2,535	3,215	3,124	3,235	3,747	4,051	4,329
Exports: Food												
EU			183	178	170	197	201	212	241	231	219	244
RoW			152	181	174	205	237	237	237	231	231	249
Total			335	359	344	402	437	450	479	462	451	492
Exports: Raw materials												
EU			105	59	111	170	177	176	179	174	173	164
RoW			21	25	18	35	42	42	38	37	40	42
Total			126	84	129	205	219	219	217	211	214	206
Exports: Chemicals												
EU			29	28	35	196	436	424	532	701	824	926
RoW			68	58	88	92	102	105	98	95	99	111
Total			97	86	123	288	538	528	630	796	923	1,037
Exports: Manufacturing												
EU			1,352	771	821	965	1,009	929	1,011	1,018	967	987
RoW			313	208	265	328	476	486	386	402	449	349
Total			1,665	979	1,086	1,292	1,485	1,414	1,397	1,419	1,416	1,336
Imports												
EU			1,989	2,344	1,984	2,285	2,847	3,057	3,125	3,490	3,586	3,784
RoW			1,845	2,321	1,653	1,852	2,206	2,014	1,858	2,014	2,191	2,323
Total			3,834	4,664	3,637	4,137	5,053	5,071	4,983	5,505	5,777	6,107
Imports: Food												
EU			175	211	199	211	263	302	289	282	292	312
RoW			230	248	239	254	270	285	283	290	319	315
Total			404	459	438	465	533	587	572	572	611	627
Imports: Raw material												
EU			66	57	74	94	122	89	63	78	81	66
RoW			184	98	104	165	195	205	150	167	160	114
Total			250	155	178	258	317	294	213	245	241	181
Imports: Chemicals												
EU			252	290	291	372	436	409	474	414	461	506
RoW			103	127	116	130	160	164	183	210	227	217
Total			355	417	408	501	596	574	657	624	688	724
Imports: Manufacturing												
EU			879	795	749	890	1,139	1,192	1,272	1,573	1,593	1,710
RoW			483	467	400	463	582	538	585	665	846	1,008
Total			1,361	1,262	1,150	1,352	1,722	1,729	1,857	2,238	2,439	2,718

Source: Eurostat.

Figure 20 shows the importance of larger firms for exports. This is not unexpected, though it does seem that the share of large firms in exports is not rising as fast as in the past. This is important because of the need for small and medium-sized firms to also increase their exporting activities.

Table 5 gives the structure of exports and imports by sectors and also sectoral trade balances. Clearly, agriculture, chemicals, but also manufacturing have significant roles in exports and also in imports. Tables 6 and 7 give additional information on the growth of manufacturing exports and production respectively and their structure.

The Macedonian economy is a small one and also needs to be open for that same reason. There are scant opportunities for non-financial corporations to grow, outside of extraction and agriculture. So, growth of production of tradable goods depends significantly on the opportunities for entrepreneurship. In that, entry and exit flexibility of the product market is crucial. In addition, internationalisation and innovation are also more important than other factors of production. Given the unemployment rate and the availability of financing, the issues are more market access, fair competition, and support for innovation.

In particular: manufacturing

Like most of the post-Yugoslav countries, the Macedonian economy went through a process of deindustrialisation. Some of that happened because of the disintegration of the Yugoslav market. Some of the industrial production had been integrated in the Yugoslav production chains. Some of that was also part of production for the military. During the 1990s, much of that collapsed.

In addition, textiles and apparel were important, particularly in the *Lohnarbeit* type of production and trade. Those industries declined throughout Europe. Finally, foreign investment was slow in recognising Macedonia as a location because of the prolonged regional uncertainty and economic decline. Macedonia is a landlocked country and its access to local markets is more important than to most other Balkan economies. That was so also because of the slow trade liberalisation with the rest of the world, as membership in WTO had to wait until the early 2000s, as had the Stabilisation and Association Agreement with the EU, and bilateral free trade agreements with the neighbouring countries, which eventually were superseded by the regional free trade agreement – CEFTA.

Table 6 / Manufacturing exports, shares in total exports

	2011	2012	2013	2014	2015	2016
Total	73.55	75.39	75.78	75.52	81.38	80.73
Food	11.67	11.48	13.64	13.02	11.75	12.75
drinks	6.18	4.98	5.6	5.82	4.69	4.81
tobacco	4.48	5.07	4.44	4.68	4.15	2.53
textile	1.16	1.03	1	1.74	1.85	2.18
apparel	10.19	10.63	10.14	11.16	12.73	11.65
skin products	1.35	1.32	1.11	1.12	1.37	1.24
wood products	0.61	0.49	0.51	0.37	1.04	0.95
paper	1.41	1.11	1.85	1.49	1.13	1.35
printing	1.9	1.55	2.09	1.84	1.94	1.33
coal and refined oil	1.21	0.91	0.33	0.1	0	0
chemical products	1.89	1.87	1.54	1.48	1.72	2.03
pharmaceuticals	3.1	3.03	3.31	3.12	2.91	2.36
rubber	2.23	2.26	2.78	2.97	3	2.35
nonmetals	5.9	6.06	5.02	5.14	6.52	5.14
metals	9.34	10.06	9.16	7.94	5.49	5.76
metal products	2.97	2.98	2.65	1.5	3.52	3.5
computer, etc.	0	0	0	0	0	0.51
electric products	2.41	2.99	2.34	2.5	5.31	3.82
machinery	2.19	4.18	4.97	6.01	6.12	8.25
vehicles	0.38	0.33	0.21	0.17	2.94	4.81
transport equipment	0.34	0.58	0.71	0.71	0.19	0.34
furniture	1.4	1.52	1.58	1.85	1.72	2.21
other	0.67	0.58	0.53	0.47	0.69	0.54
repair	0.57	0.36	0.28	0.33	0.59	0.3

Source: National statistics.

As a consequence, manufacturing, which was less developed to begin with, declined not so much because of technological or changes in productivity, but mostly because markets were lost and domestic entrepreneurship was not enough to substitute for participation in regional and international production chains. This has started to change slowly in the last few years in part due to foreign investments, but also because of the push to access foreign markets with trade being mostly free and with transportation costs declining. Tables 7 and 8 illustrate the shifts in the structure of manufacturing production.

Table 7 / Manufacturing production, growth, chain index, previous year = 100

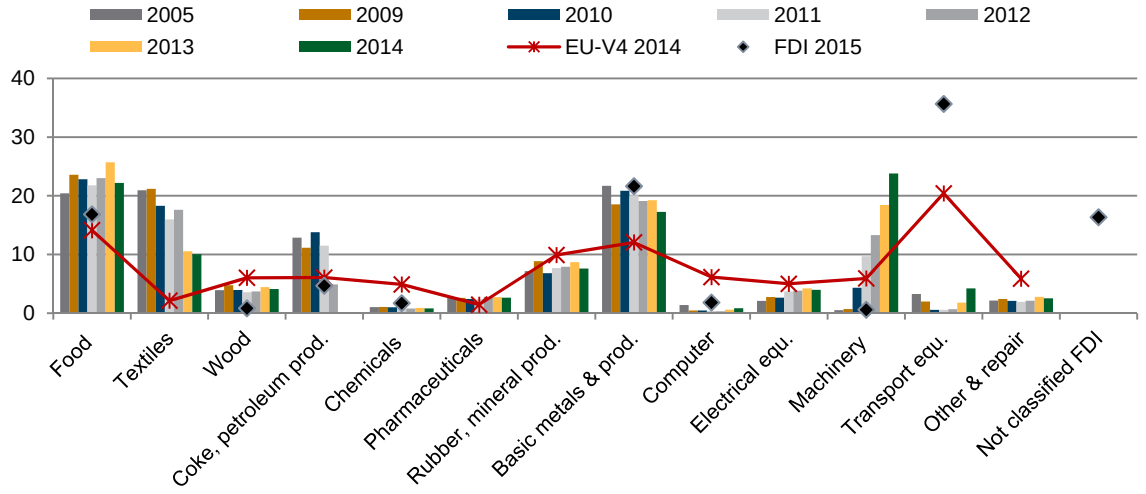
	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016
total	106.4	105.5	105.9	89.6	92.5	109.61	97.76	102.83	109.02	105.96	105.32
food	102.2	105.9	107.6	97.7	102.8	105.26	115.55	98.58	102.53	110.36	97.53
drinks	100.3	113.1	109.9	99.7	90.8	86.05	109	107.42	90.84	113.01	100.33
tobacco	102	99.2	101.9	96.8	119.6	120.96	85.12	108.96	105.6	77.51	102.56
textile	97.1	88.6	102.5	66.9	115.4	95.07	93.99	179.83	106.49	114.83	111.47
apparel	108.7	86	80	88.2	95.3	111.63	92.84	113.65	104.58	106.72	92.74
skin products	85.9	99.9	90.1	95.8	119.1	104.8	82.07	104.13	92.1	81.61	84.23
wood products	93.2	100.1	76.5	58.5	147.8	85.13	101.58	74.45	120.44	121.67	130.67
paper	102.6	102.6	103.8	118.1	87.9	84.4	162.04	83.11	109.6	112.75	98.79
printing	146.4	87.2	157.3	126.8	65.8	87.23	131.15	90.69	98.58	94.31	96.86
coal, refined oil	112.2	97.6	101.6	91.1	93.8	80.33	35.16	30.64	0.99	0	0
chemical	96.4	95.2	112.3	94.1	84.9	105.86	79.93	98.99	111.24	95.35	72.19
pharmaceuticals	104.9	104.3	125.2	86.8	97.2	104.43	106.16	97.38	105.17	104.56	109.75
rubber	80.9	102.2	125.9	98.3	88.8	108.41	119.21	110.46	120.12	95.65	118.22
non-metals	111.3	103.7	97	87.9	85.8	109.67	80.65	105.78	105.8	100.47	119.34
metals	117.8	132.2	94.7	57	131.8	115.26	88.87	89.49	101.39	106.3	88.88
metal products	116.3	144.9	152	138.8	46.5	107.31	86.38	58.38	105.12	111.81	88.85
electric products	120.5	81	127.8	75.2	56.8	132.98	75.81	110.1	130.11	93.99	113.23
machinery	89	161.9	110.7	77.1	116.2	204.52	115.37	125.01	122.8	121.3	122.02
vehicles	69.6	73	92.7	61.9	163.7	94.92	61.03	47.3	1494.07	137.03	152.17
transport	106.8	133.4	81.6	53.6	144.5	179.57	119.04	103.22	116.25	89.09	98.69
furniture	76.7	109.3	266.5	71.6	80.5	115.93	100.55	121.15	99.01	112.9	96.4
other	62.4	62.2	60.6	100	187.1	93.5	89.25	91.44	128.81	99.07	97.93

Source: National statistics.

Looking ahead, the expectation is that foreign investments will be regional in scope, so that Macedonian firms could be integrated within larger regional firms, which in turn are connected with multinational firms. Also, chances are that there will be increasing place for small and medium-sized firms as suppliers for the growing regional and primarily EU market. Traditionally, Macedonian manufacturing tended to be integrated with the regional and European production. With the changed nature of production and trade, where transport and other costs due to geographical distance lose importance, that opens the door for smaller firms and for domestic entrepreneurship more than was the case before.

The same goes for services which are supportive of manufacturing. It appears that the region as a whole, and Macedonian entrepreneurs in particular, have comparative advantages in those activities. That of course depends on the education system and on the incentives to invest in skill acquisition and in innovation. There is some indication that the young are investing in skills as the probability to be employed is higher for skilled than for unskilled, especially among the first-time job seekers.

Figure 21 / Macedonia: Output structure, in % of manufacturing



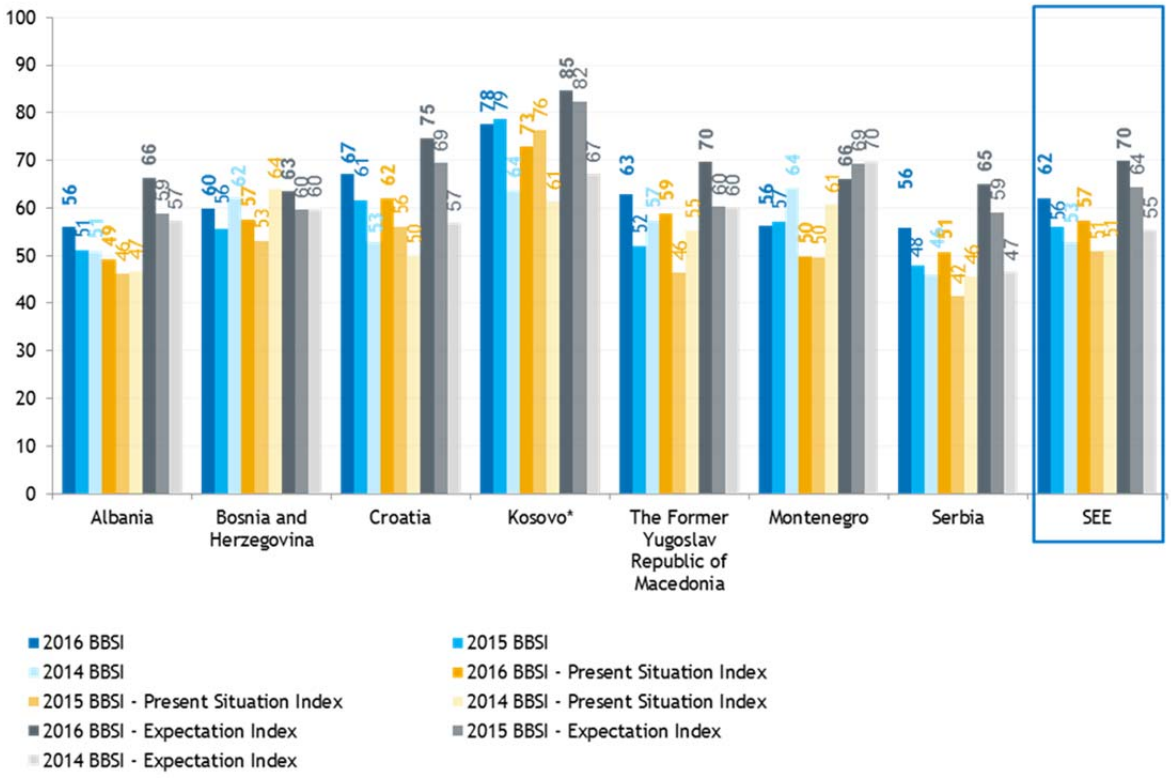
Note: ESA 10, N2. No FDI data for textiles, pharmaceuticals, rubber & mineral products, electrical equipment, other & repair.
Source: National Accounts based on National Statistical Institute, Eurostat, CEFTA FDI Database.

Between 2005 and 2014, some remarkable shifts took place in the output structure (Figure 21) which, however, is partly due to the sharp decline in the coke and petroleum industry. While the output share of the textile industry dropped significantly, that of machinery increased swiftly. FDI inflow patterns have followed the manufacturing specialisation pattern in the food industry as well as the basic metals & fabricated metal products sectors. The strong FDI stock in the transport equipment sector is not visible in the output structure while the machinery sector output expanded rapidly, thus there may be a problem of classification.

Business opinions

A positive factor is the improvement in business opinion. For the last three years, the Balkan Business Barometer[2] has been surveying opinions of the public and the business people in the region. Both the Macedonian public and the business people have been more optimistic than those of the region on average. In addition, business people have been more optimistic than the public. In that, they have expressed the belief that industrialisation and export promotion should be important within the overall policy stance.

Figure 22 / Optimism and expectations (Balkan Business Barometer 2017)



Business people believe that they can compete and support regional and European trade agreements. Overall, there is confidence in the ability of the businesses to sustain economic development and there is a high degree of self-confidence.

In the latest survey, there was less of an improvement in both the public and the business opinions practically across the board. Prolonged political tensions and the inability to resolve the conflict over the

[2] Balkan Business Barometer 2017 (forthcoming), Regional Cooperation Council.

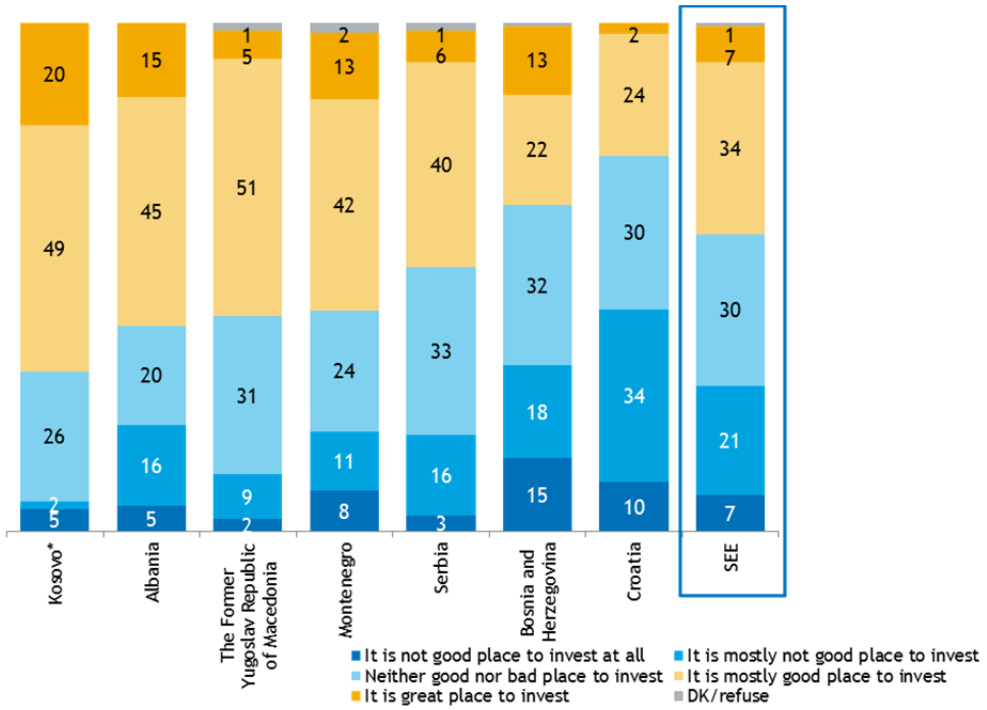
legitimacy of the elections and the actions of the governing parties and institutions have taken a toll on the economy. Support for policies that maintain the openness and competitiveness of the economy continues to be strong. There are complaints about lack of good governance and rule of law, but not more than in the rest of the region and in the EU in general. So, basically, business people tend to take a positive attitude towards their prospects and towards the prospects of the economy as a whole. Indeed, there is less of a support for various protectionist measures than in most other countries in the Balkans.

The last public and business Balkan Barometers, 2017 (interviews were conducted at the end of 2016), register growing concern with the political and business prospects. Though the political crisis has been developing for a longer time, it has started to have negative consequences for investment and growth more recently. Business confidence has started to suffer and that is visible in a number of responses to the Balkan Barometer. In general, businesses and the public are more confident in their own abilities and prospects than in political and social ones. Indeed, increasingly the political and the government's actions are seen as a burden on investment and employment. So, stabilisation is needed in order for the economy to rebound towards its potential growth rate.

Still, Macedonian business people tend to see the country as reasonably good placement for investment compared to other countries in the region (Figure 23; from Balkan Business Barometer 2017). Similarly, Macedonia comes out as a better place for doing business in terms of regulation, responsiveness of the administration, and corruption (in the Balkan Business Barometer).

Figure 23 / Do you believe that your economy is a good place to invest?

(All respondents – N = 1430, share in total, %)



In general, though business opinion is as a rule just around the average between good and bad on most criteria, business people seem more comfortable with the overall policy setup than is the case in most other countries in the region. Table 8 details the major obstacles to doing and growing business in the region of CEFTA. The main obstacles are the tax system, stability, financing, and enforcement of contracts. Those are clearly areas in which major policy interventions could be undertaken with relatively quick results.

Table 8 / Obstacles for business operation and growth (for each economy)

(All respondents – N = 1430, share in total, mean; 1 is the worst, 5 is the best)

	Albania	Bosnia and Herzegovina	Croatia	Kosovo*	The Former Yugoslav Republic of Macedonia	Montenegro	Serbia
Tax administration and tax rates	2,5	2,7	2,1	1,9	2,6	2,5	2,5
Macroeconomic instability	2,3	2,9	2,5	2,5	2,9	2,7	2,2
Contract violations by customers and suppliers and functioning of the judiciary	2,8	2,8	2,4	2,1	2,6	2,7	2,5
Risk of social instability, breakup of law and order and uncertainty about regulatory	2,6	2,8	2,3	2,2	2,7	2,6	2,6
Corruption	2,2	2,9	2,5	1,8	2,8	2,8	2,7
Customs and trade regulations and anti-competitive practices of other competitors	2,7	2,7	2,5	2,1	2,8	2,5	2,6
Access to financing and cost of financing	2,7	2,9	2,6	2,2	2,7	2,7	2,6
Labour regulations	2,7	2,9	2,4	2,4	2,8	2,6	2,8
Skills and education of available workers	3,1	2,9	2,3	2,4	2,9	2,7	2,9
Business licensing and permits	2,8	3,0	2,8	2,5	2,8	2,7	2,6
Telecommunications, transportation and electricity	2,7	3,3	3,1	2,1	3,1	2,7	2,9
Access to land and title or leasing of land	2,9	3,2	3,2	2,5	2,9	2,8	2,7
Organised crime/mafia	2,6	3,2	3,3	2,1	2,9	3,1	3,1
Social infrastructure which should enable women to accept and develop leading	3,1	3,4	3,3	2,5	3,0	3,0	3,0
Street crime, theft and violent crime	2,7	3,4	3,4	2,0	3,0	3,0	3,2
Risk of terrorism and violent conflicts	2,8	3,6	3,6	2,2	3,3	3,4	3,4
Migration crisis	2,8	3,8	3,8	2,9	3,4	3,5	3,5

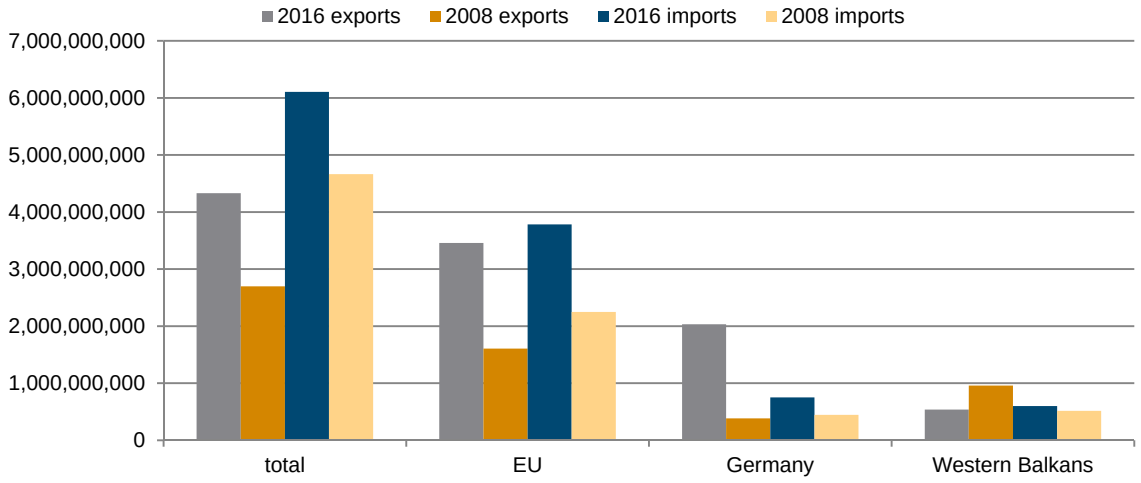
Major obstacles

Relatively positive business attitudes also suggest that there is confidence in their entrepreneurial abilities. This is important because development cannot advance sustainably without risk taking and innovative behaviour by the people, in particular by the young. In that respect, the recent increased concerns with political stability have clearly sapped the risk taking and investment incentives even though the access to markets has improved.

Trade policy

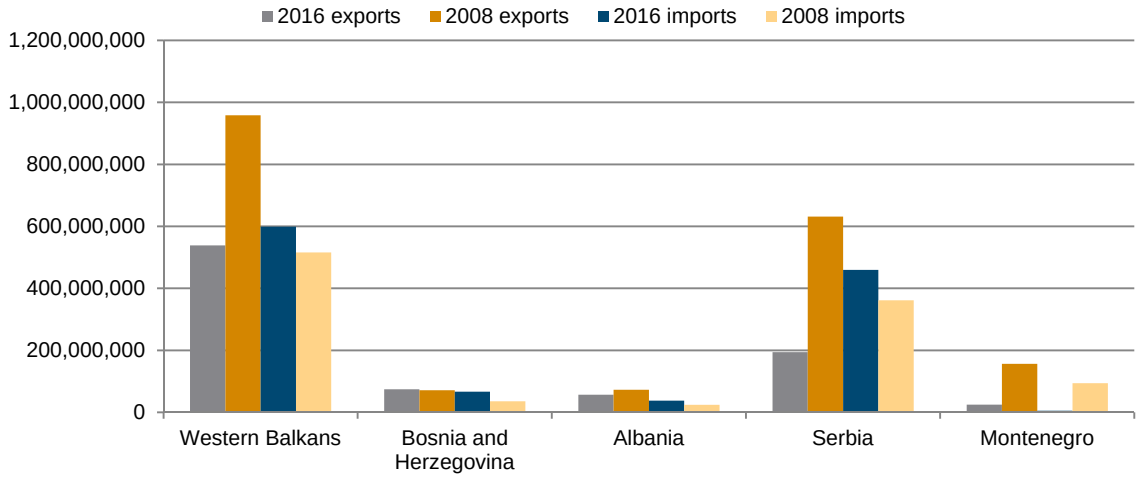
Macedonian trade policy is determined by the Stabilisation and Association Agreement (SAA) with the EU and with its membership in CEFTA. In terms of tariff barriers, those are low. Non-tariff barriers are higher, but more the *de facto* than the *de jure* type. Non-trade barriers are low by regional standards because of the monetary and fiscal policies being little if at all concerned with their effects on trade or external transactions altogether. That also means that in many ways Macedonia is a policy-taker, or that it has to absorb policy shocks from outside.

Figure 24 / Export to CEFTA and EU, in EUR



Source: National statistics.

Figure 25 / Exports to CEFTA countries, in EUR



Source: National statistics.

The part which is mostly in the focus is subsidies that are intended to support foreign investments. Though these instruments have had some impact, the overall effects on production and exports are not all that large. Still, those have advertised Macedonia as a business-friendly country, which is reflected in its relatively high position in most business and competitiveness rankings.

Also, business people do not seem to think that foreign investors are favoured unduly over the domestic ones. Access to loans and generally to financial services is better than in comparator countries. Also, institutional indicators and the opinion on the efficiency of the institutions are better than those of the general public and in most other countries in the region. In general, opinion surveys support the assessment that policies are business friendly in this country.

Finally, integration in the EU is still the preferred exit strategy and more so than in some countries which are already members (e.g. Croatia) or others that have higher chances of becoming members (Serbia). Macedonia's reliance on the EU perspective, all the disappointments notwithstanding, is relatively high and persistent, even though chances for a breakthrough in the negotiations with Greece are slim to say the least.

So, in general, the existing trade regime is seen as adequate, with improvement being expected with the further integration into the EU.

Figures 24 and 25 show the significance of the EU market and that of Germany in particular. Within CEFTA, exports are demand constrained because these are small markets and home bias tends to be strong (this is clear from the Balkan Barometer and the CEFTA Barometer). By contrast, the EU market is large enough for Macedonian exports not to be sensitive to the EU business cycle. Quite notably, exports to Germany have increased the most and those are mostly manufactured goods. Once growth strengthens in CEFTA, exports to that region should increase too.

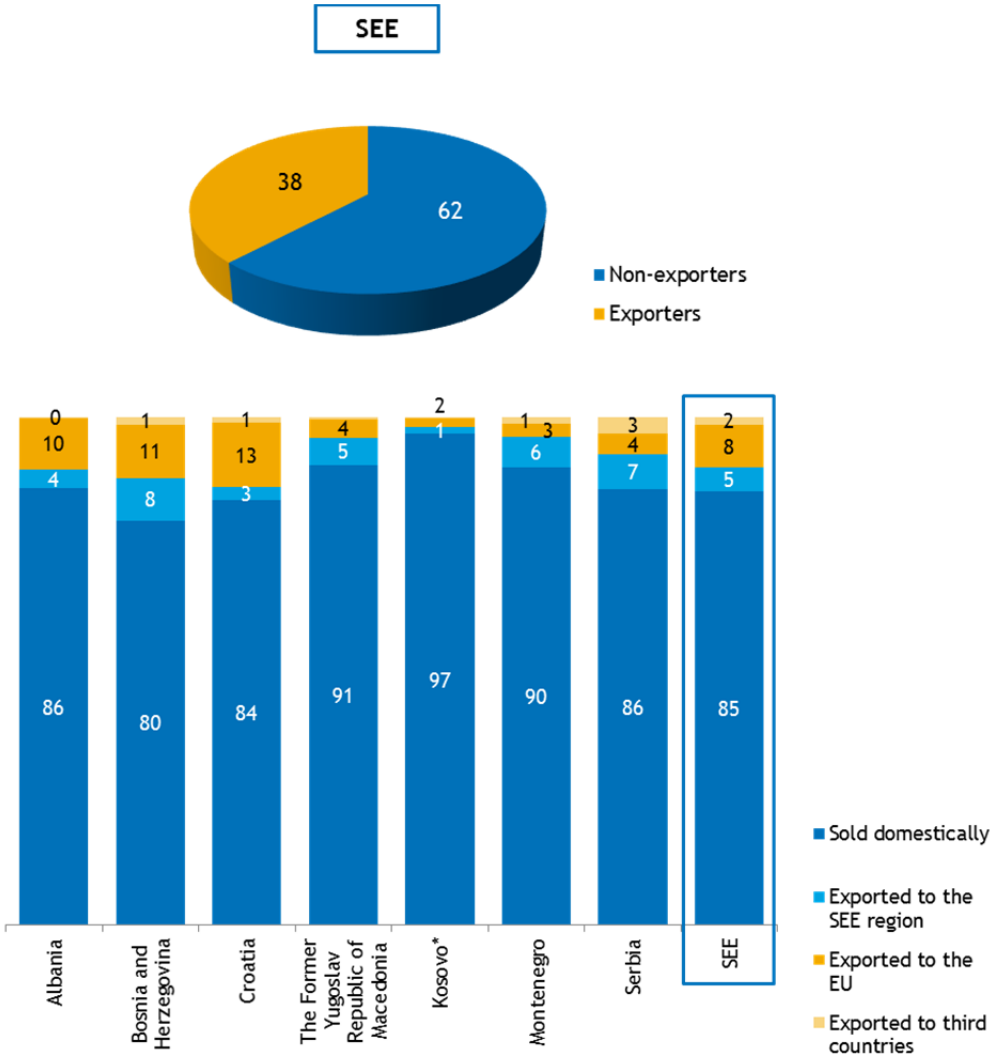
Clearly, openness, which is to say low protective barriers, is supportive of investments and of exports because of the small size of the economy. Support for openness is rather strong e.g. compared to the countries in the Balkan region, which is evident from the findings of the Balkan and CEFTA Barometers. That does not mean that there are no obstacles to entrepreneurship in the product market in particular. There are also barriers to a more active role to be played by the financial sector.

The Balkan and CEFTA Barometers do suggest, however, that most of the exporting is done by a relatively small number of larger firms. Figure 26 gives the responses of a sample of exporting and non-exporting firms and the distribution shows the overwhelming dependence on the domestic market. Macedonia does not do better or worse than other countries in the region. The implication is that either additional large firms are needed or small and medium-sized firms need to get internationalised. One reason that relying on large firms is not necessarily the best exporting strategy is the limited size of the Macedonian market. Often large firms rely on the domestic market also even if they export much of their activity. Or, alternatively, the regional market is important in addition to the rest of the world. In the latter case, it is really small and medium-sized firms that should carry a lot of exporting in connection with firms with a regional strategy.

This is part of the so-called Berlin Process of regional investments and connectivity, which should provide a significant boost to small but open economies in the Balkans, like the Macedonian one.

Figure 26 / What percentage of your company's sales are made domestically, exported to the SEE region, to the EU or to third countries?

(All respondents – N = 1430, share in total, %)

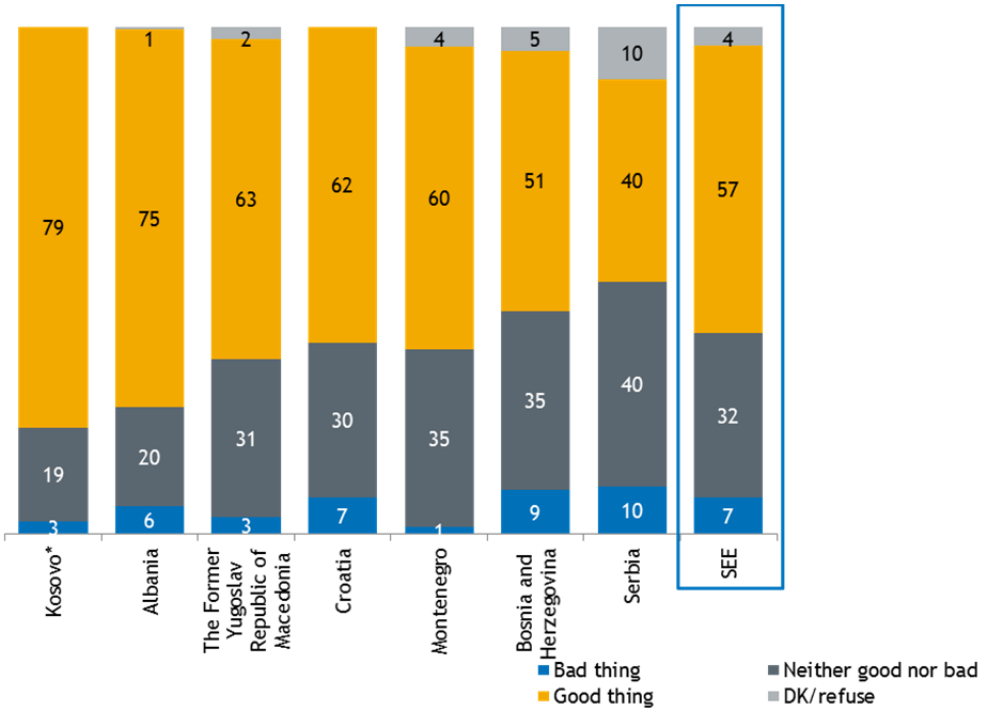


When it comes to the Berlin Process, it is not unimportant that Macedonian businesses are more enthusiastic about EU membership than most other candidate or potential candidate countries, even though the prospects are not terribly encouraging due to Greece's objections. This positive attitude is maintained though Macedonian businesses express somewhat higher worry than most other businesses in the region about foreign competition. That might indicate the need for measures that improve competitiveness rather than a push for a less open trade regime.

Overall, then, an open trade regime is clearly advantageous for Macedonia and mostly supported by the business community. However, actual openness of the economy still is limited by the structure of the supply side and in particular it appears that small and medium-sized enterprises need to be more present on the foreign markets.

Figure 27 / Do you think EU membership would be/is a good thing, a bad thing, or neither good nor bad for your company?

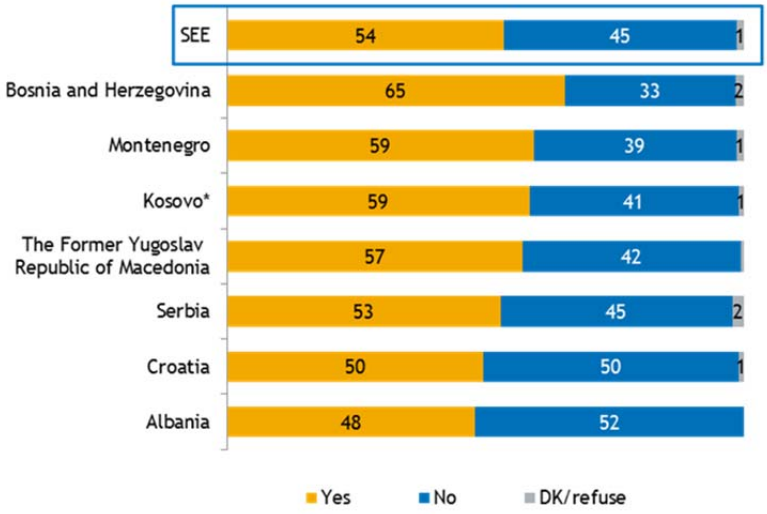
(All respondents – N = 1430, share in total, %)



Innovation

The key indicator of the health of the corporate sector is its innovativeness. While surveys of business opinions reveal the interest and intention to innovate (Figure 28), data do not provide support. What is produced is mostly what has always been produced.

Figure 28 / Measures of innovation, % of innovating firms



Source: Balkan Business Barometer 2017 (forthcoming).

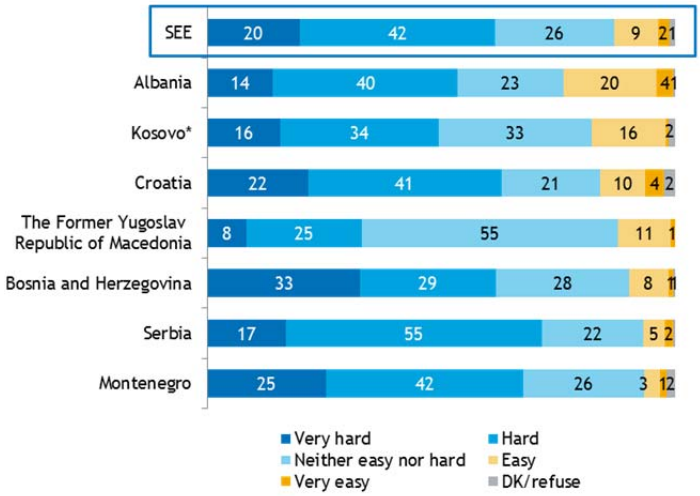
Data on small and medium-sized enterprises compiled by the EU suggest a relatively low level of innovativeness too. In general, new technology tends to be introduced, but the number and quality of the products does not tend to increase significantly. So, when it comes to the increase of exports that is mostly on the intensive, rather than the extensive margin. Notable exceptions are the growing production and exports of machinery and vehicles, which are mostly connected with foreign investments.

In the last few years, this has started to change with increased exports in manufacturing and in services. This is a trend that can be observed throughout the region. The growth of exports of services, outside of tourism, is a very encouraging sign because it is certainly due to entrepreneurship and innovation. Also, in most cases, investments are domestic rather than foreign. Still with all that, the overall level of innovativeness in the economy is not high and is clearly an obstacle to growth and exports.

Data on innovation that have been gathered by the Balkan Barometer in the last three years do not indicate that it has been a priority of the businesses. There is, to begin with, clearly a problem with the entry into the product markets. Figure 29 suggests that Macedonia is not the hardest place to start a business in the region, but still one third of business people say that it indeed is hard. Also, only about 12% say that it is easy. Clearly, new businesses face obstacles of various kinds to start and develop.

Figure 29 / How easy or hard is it to start a private business in your place of living?

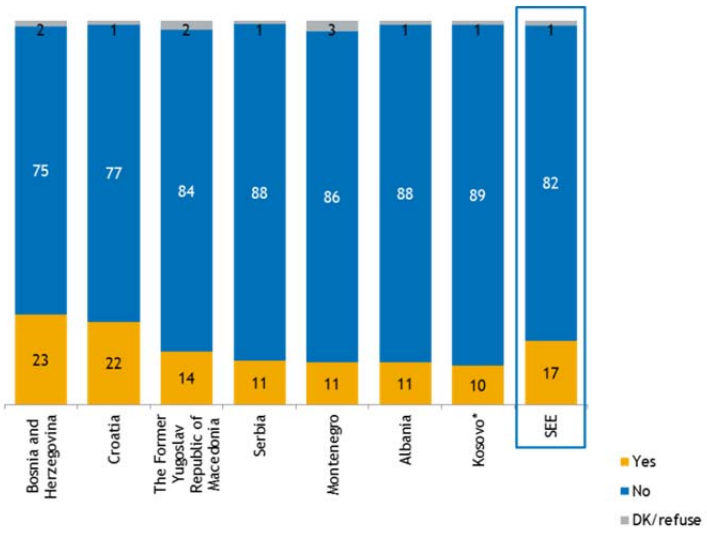
(All respondents – N = 1430, share of total, %)



There is also quite limited reliance on research and development with a view to developing new products (Figure 30).

Figure 30 / In the past 3 years, did you cooperate with any of the universities on research and development (R&D) or technology development projects to help develop new products or services?

(All respondents – N = 1430, share of total, %)



The last point is not unusual if new products and technologies can be just taken over from more developed economies. Still, it often proves useful for policies to be put in place which support investment in research and development which then can be used by local entrepreneurs to innovate and increase market share at home and even more so abroad. Again, those policies for technological development could be regional and need not be just national in character and scope.

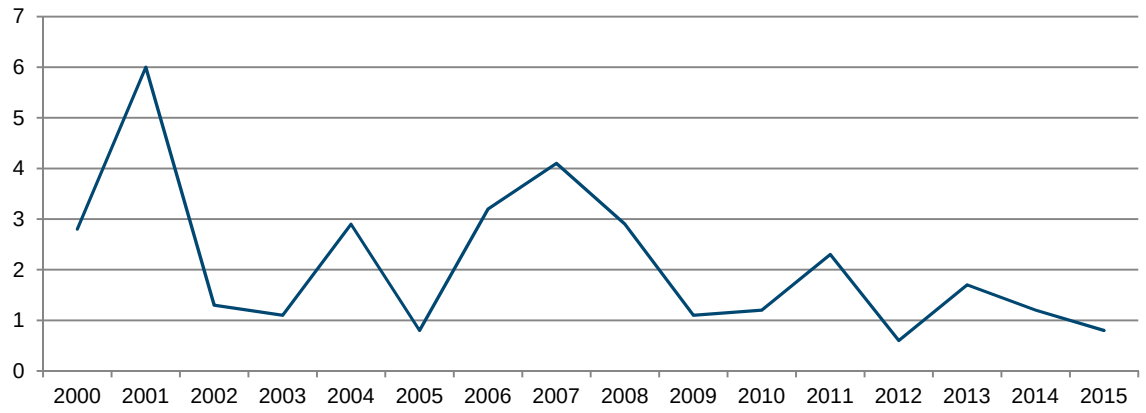
Usually, larger firms tend to be more innovative as they also tend to export more. That more often than not happens on the intensive margin, especially in economies that rely on available resources. However, a small open economy in the vicinity of a large freely accessible market can provide innovative opportunities to small and medium-sized firms in particular if appropriate infrastructure is developed. Most business people, responding to the question in the Balkan Barometer, seem happy enough with the existing infrastructure. It certainly can and should be improved. In such circumstances, basically the European market is similar to the domestic one, and thus new products and new technologies can be produced or respectively offered even by small firms which are well placed to work for larger ones or for the final consumer.

For that, perhaps the more important policy that the government can develop is that of support for research and development or for technological parks as it were.

Internationalisation

In Yugoslav times, there were production chains to which Macedonian firms contributed. This was in the automotive industry, in electronics, and also in food processing. In addition, the textile industry was to a very large extent internationally connected, and not only through *Lohnarbeit*, though that played a significant role. These connections collapsed and are the main route through which deindustrialisation happened. These connections have not been re-established, while integration with the European production chains is relatively small and accidental.

Figure 31 / FDI, % of GDP

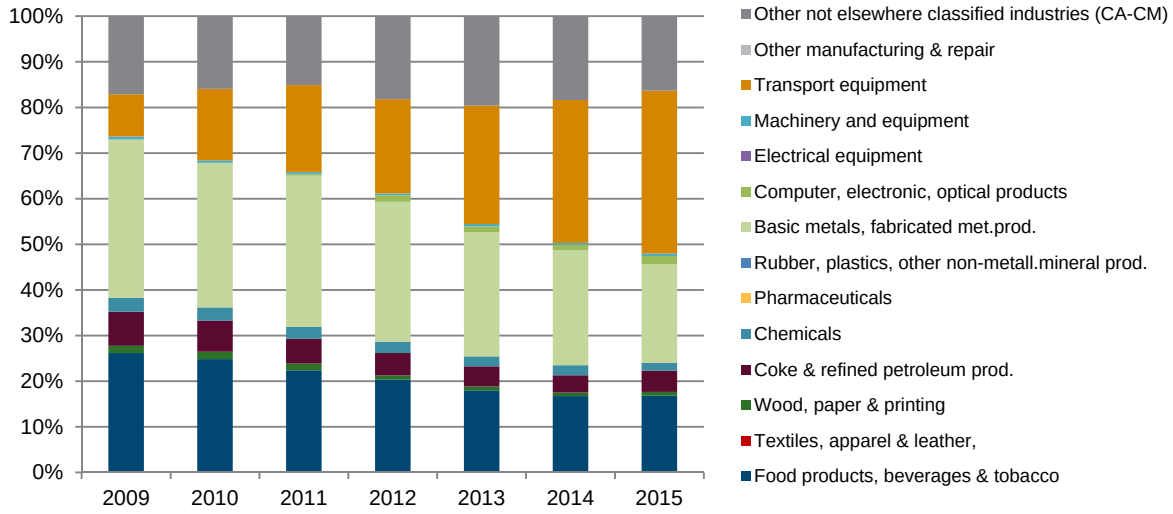


Source: Eurostat.

Also, foreign investment, though the primary policy target of long standing, has not been as excited with the Macedonian market as it has been hoped. Obstacles to economies of scale and scope as well as slow growth of regional markets have deterred a more pronounced presence of foreign investors. Policy-makers have aimed to compensate for these disadvantages with tax breaks and direct and indirect subsidies, but the resulting increase in foreign participation, though not negligible, has not been of a scale enough to make a difference to the structure of the economy. Figure 31 shows that foreign investments as a share of GDP have declined after 2007-2008.

In that respect, regional integration is important and is welcomed by the public and by the business people. The process is at the very beginning, however, so it is more of a promise than the reality. But there is no doubt that exports in particular will have to come from small and medium-sized firms which are internationalised financially and in terms of their production. This is not to say that large companies in traditionally exporting sectors will not continue to play a significant role. Exports are very much driven by larger firms as it is. However, for exports to reach e.g. 60% to 70% of GDP, which would be in line with the size of the Macedonian economy, small and medium-sized enterprises need to be much more internationalised and included in regional and EU production chains.

Figure 32 / Macedonia: Inward FDI stock manufacturing by industry, in % of total manufacturing, 2010 and 2015



Note: No data for textiles, pharmaceuticals, rubber & other non-metallic mineral products, electrical equipment and other manufacturing & repair.
Source: CEFTA FDI Database.

Figure 32 breaks down the FDI by sector of manufacturing and confirms the significant role that machinery, transport equipment, and chemicals play in overall exports. This is also evident from Table 6. In general, clearly it is manufacturing which needs to support exports. This is not surprising given that Macedonia is a landlocked country and industry is to be expected to be where it has comparative advantages.

The data suggest that there is scope for increased exports along the extensive margin. Given that manufacturing needs to be one of the basic factors for increased exports, it is important that new products enter the supply of tradable goods. The same goes for services, in particular those that are connected with or rely on manufacturing. In the new trading world, specialisation does not have to mean that only few products are offered by a country, especially a small one, to the world market. With the increase in exports of intermediaries, a much more diverse export offer is possible.

In the experience of European transition countries, especially in Central Europe and the Baltics, foreign investments and internationalisation in general support precisely that type of development of the tradable sector.

Economic policies

The policy mix has been unchanged more or less since 1994. A more active fiscal policy with wage hikes and public investments has contributed to the ability to weather the crisis and support growth in the post-crisis period. Monetary policy was more accommodative in the last few years, though it had to be tightened when faced with financial outflows due to the prolonged political crisis. However, stability should return after the resolution of the political conflicts and with the democratic process being revitalised. The most important test will be the strengthening of the rule of law.

The trade policy is basically set and can change mostly in multilateral agreements that Macedonia is party to. Closer regional integration is a positive development as it should increase regional investments. Also, liberalisation of the market for services and for labour would be helpful. Finally, improvement in the financial sectors in the region would have a positive contribution. All of that is now part of so-called Berlin Process in which Macedonia should be a very active participant.

The main policy innovations are those on the supply side. Of those, two are the most important ones. First, efficiency of the administration and of the various authorities needs to be improved. Second, good governance is a problem. Central and local governments lack the necessary impartiality, which distorts the product markets. Key to growth and development is going to be both domestic entrepreneurship and internationalisation. Those are sapped by biased policy-making. So, rule of law, and rule by law to put it in a nutshell.

As argued throughout, a whole bunch of industrial policies should be strengthened or introduced. A short summary includes:

› reform of the product market with support for start-ups, innovation, and access to foreign markets, e.g. by risk sharing arrangements between the government, the financial institutions and the entrepreneurs;

› support for technological and research and development projects and firms which should develop products and support their production, e.g. by an agreement between the Chamber of Commerce, the government and the universities and research institution to set up technological parks;

› support for increased regional cooperation e.g. via the Berlin Process so that access to markets is improved (in infrastructure and border-crossing) and also investments by multinationals increase;

› support for human capital development both at work and in educational institutions, e.g. by comprehensive active labour market policies both within firms and outside of them;

› overhaul of the tax system but also of the system of administration which should prove attractive for investment and also for the informal economy to come out of the shadows;

› greater reliance on public and private partnership in both public investments and in the management of the public sector.

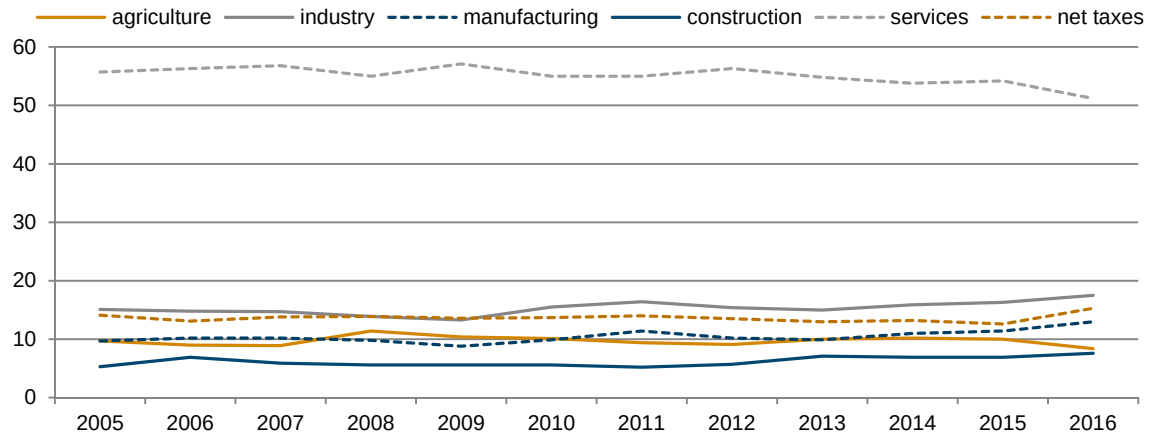
There are quite a number of other structural reforms that might turn out supportive of further strengthening the tradable sector, which should prove to be the main source of growth of production and improvement of welfare. In general, the aim should be to increase the export to GDP ratio to a similar level which is to be found in small open economies in the EU (which is roughly about 75%).

Forecasts

With the restructuring on the demand and the supply sides, the potential growth rate is moving upwards to around 4%. Along with the changing structure of demand and supply, exports should be growing by about 6%, household and public consumption by about 2% and investments by about 5%. That implies growth of imports of about 4%. In the long term[3] the trade deficit should decline slowly to about 10% of GDP, while the current account deficit should not be above 2% to 3% of GDP.

On the supply side, the development since 2005 and in particular since 2009 indicates increases in the share of manufacturing and decline of the share of services, with other sectors holding their own. With the growth of exports of services, that is not a development that is to be expected to persist. Generally, in the medium to long run (5 to 10 years), the share of manufacturing in GDP should increase by another 5 percentage points or so, the share of services should also increase to around 60% of GDP, which implies a significant increase in productivity in agriculture, so that its share should decline to less than 5% of GDP.

Figure 33 / Structure of the supply side, 2005-2016, in % of GDP



Source: National statistics.

When it comes to the structure of exports, Table 9 shows average growth by manufacturing products, current year over the year before. Clearly, the machinery and automobile industry together with traditional exporting sectors like textiles, rubber, and apparel play an increasing role. That growth is correlated with foreign investments and with strong growth of exports to Germany. If exports are to lead growth in the Macedonian economy and if those are going to be increasingly dominated by manufacturing products and given that the EU market will remain the most important one, especially for higher-quality exports of goods and services, then it is those sectors that should take an ever increasing share of production for exports.

[3] Meaning up to 10 years.

Table 9 / Manufacturing, growth rate, 2006-2016, export share, 2016-2011

	growth	share
Total	2.8	7.2
food	4.2	1.1
drinks	1.8	-1.3
tobacco	1.8	-1.9
textile	6.6	1
apparel	-1.8	1.5
skin products	-5.5	-1.1
wood products	0.9	0.3
paper	6	-0.5
printing	7.5	-0.6
coal, refined oil	-41.5	-1.2
chemical	-4.9	0.2
pharmaceuticals	4.2	-0.6
rubber	6.2	0.2
non-metals	0.7	-0.8
metals	2.1	-3.6
metal products	5.1	0.5
electric products	1.6	1.4
machinery	24.2	6.5
vehicles	122.5	4.5
transport	11.4	0
furniture	13.7	0.8
other	-2.5	-0.1

Source: Eurostat.

Figure 34 / Manufacturing, growth rate, 2006-2016, export share, 2016-2011

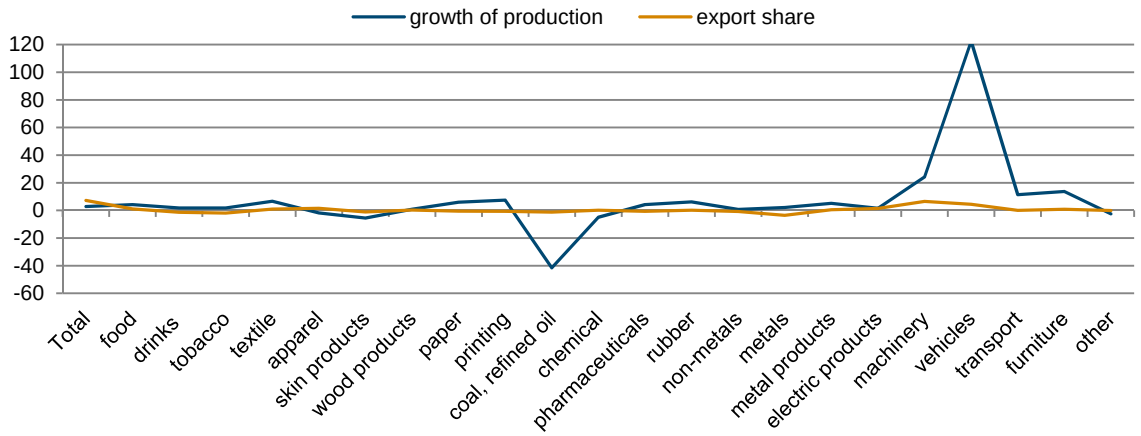


Table 9 gives the growth of manufacturing in the last 10 years and the change in the export share of specific manufacturing products in total exports. The first is an indicator of changing comparative advantages while the latter suggests that those are revealed in the growth of exports. While specific changes in product groups do not have to mean all that much, the increased share of manufacturing in exports and in particular the growing share of exports of vehicles and machinery suggest that there is an ongoing change in the structure of production and of exports. With growing export of services, that bodes well for the needed structural change on the supply side of the Macedonian economy. In general, the changing supply of manufacturing products is connected with the growing reliance on exports in the period after the 2008-2009 crisis in particular. Figure 34 gives a more transparent graphical

representation, with extreme positive and negative values cut off so that the change is made more visible.

Overall, exports and investments on the demand side and manufacturing and services need to characterise the demand and supply structures of the economy. Openness of the economy, i.e. export as a share of GDP, should move to around 60% in the medium run and continue to increase to levels characteristic of small open economies, somewhere around 75% of GDP. With the macro supply and demand data, and given the growth and developments in the last 6 to 10 years, the current structure should be transformed in the following way:

Table 10 / Change in aggregate demand and supply

Value added	Average, 2000-2016	2016		GP	Average, 2005-2015	2015
Agriculture	11.5	9.9		consumption	92.6	85.1
Industry	17.7	20.6		household	74.2	68
Manufacturing	11.5	15.3		Investment	22.9	23.1
Construction	7.1	9		Inventory	3.3	7.9
Services	63.7	60.5		net exports	-18.9	-16.2

Source: Eurostat and national statistics.

Table 10 shows the direction of changes in the structure of demand and supply. In addition, if one takes out short-lasting recessions induced by external shocks primarily, the real growth rate has been close to 4% since 2000. With the high rate of unemployment and with improving external developments, the potential growth rate is in all probability around 4%. With a long-term policy mix based on a fixed exchange rate and with a primary fiscal balance over the business cycle, and with investments remaining close to 25% of GDP, as well as a decline of the deficit in net exports to 10% or so of GDP (which would imply a balance on the current account), the share of consumption in GDP should decline to around 80% (about 60% households and some 18% government) with inventories making up for the difference.

On the supply side, manufacturing should increase to close to 20% of value added, somewhat more than 15% of GDP. Services should bounce back, while agriculture and construction should settle to their long-term shares, which in the case of the former would suggest a significant increase of productivity.

These developments can be stimulated in a number of ways, which depend on the growth rate of exports and investments primarily. In that, foreign investments should play a significant role, but given the gradual decline of the current account deficit and the declining share of consumption, savings should increase, which should also support a decline in the real interest rate.

Finally, growth of exports of manufacturing should probably follow the recent trends and that should also lead to continuous growth of manufacturing exports. In the past few years, the extensive margin of exports has been more important than the intensive one. In other words, new products have played more of a role than growth of exports of already existing revealed comparative advantages. That should continue to be the case at least until the new structure of specialisation is established. That will depend on the regional specialisation to an increasing extent, given that a similar adjustment to that in Macedonia is under way in the Balkans as a whole.

Conclusions

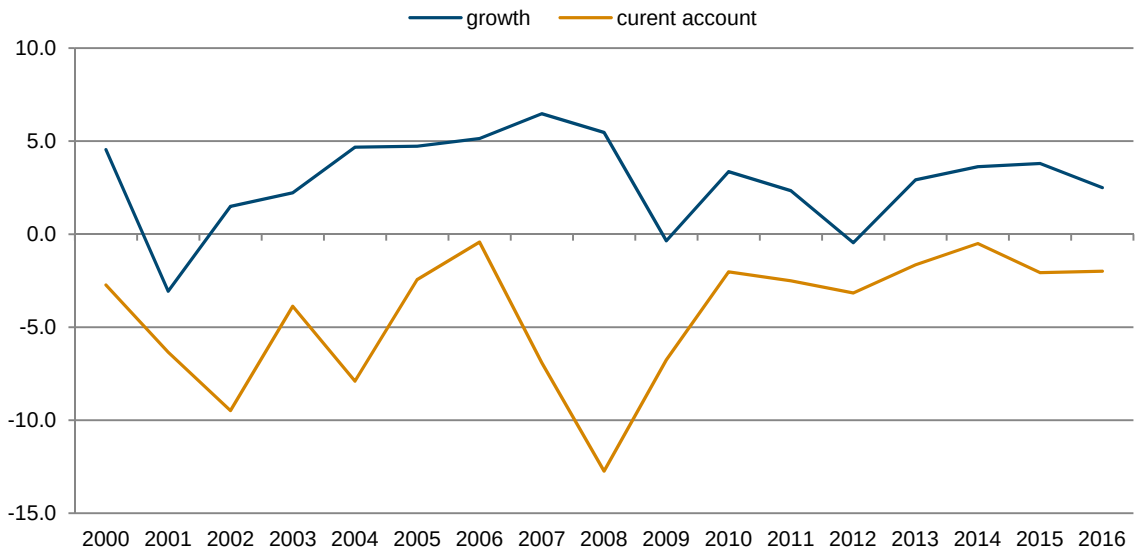
The economy is at the beginning of a process of restructuring which will see an increased role of exports and the tradable sector in general, both in goods and services. Macro balances are supportive of such development. Regional development is also taking off. And access to markets is better than it has ever been. Policies can be improved, especially when it comes to regulation and good governance, which should support entrepreneurship, innovation, and internationalisation. If sustained, this transition should move the potential growth rate to around 4% and increase openness of the economy by about 50%.

In terms of policies, macroeconomic stability is being maintained and the overall policy framework does not need to be changed. Monetary policy may perhaps become more active once risks to the exchange rate due to political and social instability are removed. The key to a more enduring stability is continuing improvement in the labour market. That also is the main instrument to keep the potential growth rate at around 4%. There is also huge potential for productivity catching-up, which should make innovation a rather promising activity.

The period going forward in the region and in the EU should prove favourable. With increased interest in EU support for the development of the region, through the Berlin Process, but also through the EU funds and investment banks, growth based on exports and on domestic entrepreneurship in addition to foreign investment should support both improvements in already developed tradable goods and in new ones. The financial behaviour of the population traditionally supports prudence and investments, which needs to be supported by progressive and responsive economic and other policies.

Appendix

Figure A1 / Growth and current account, 2000-2016



Source: wiiw.

Figure A2 / Growth dependence on the current account, 2000-2016

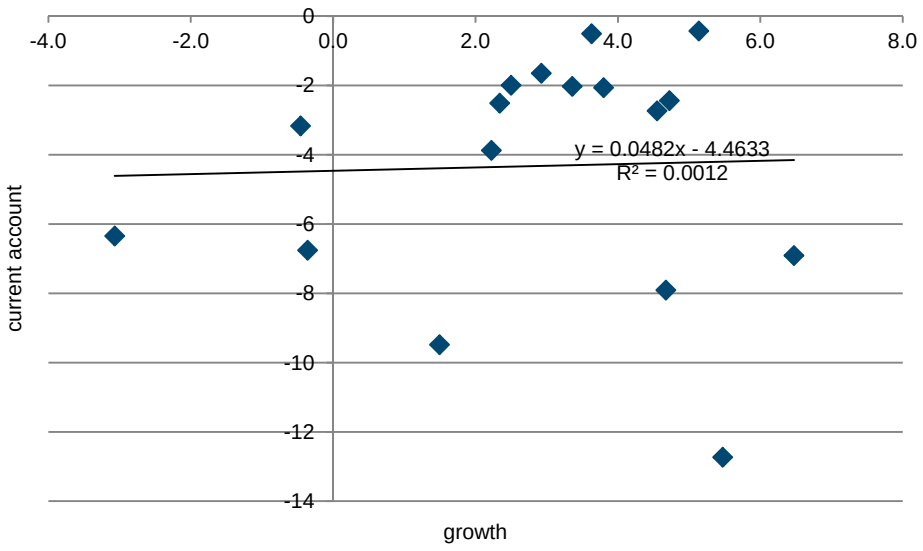


Figure A3 / Growth and current account, 2000-2008

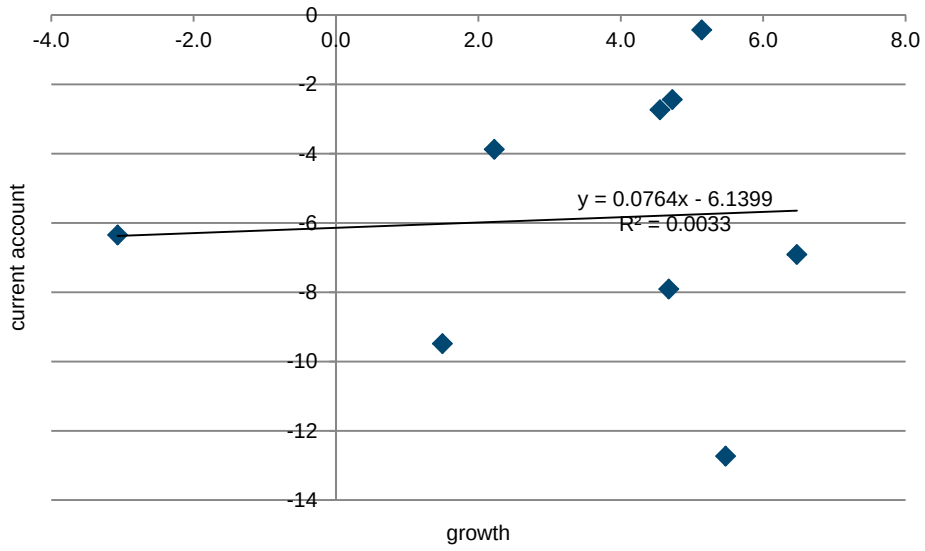


Figure A4 / Growth and current account, 2009-2016

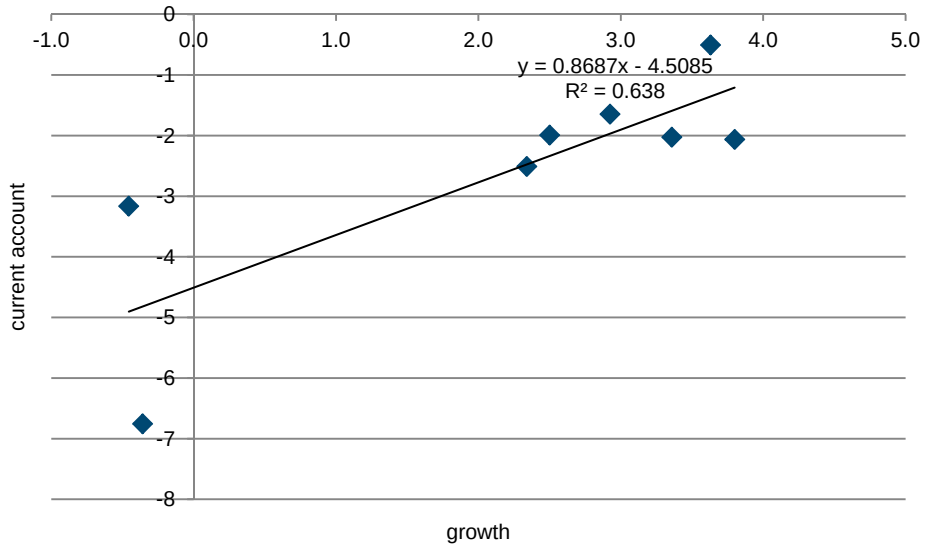
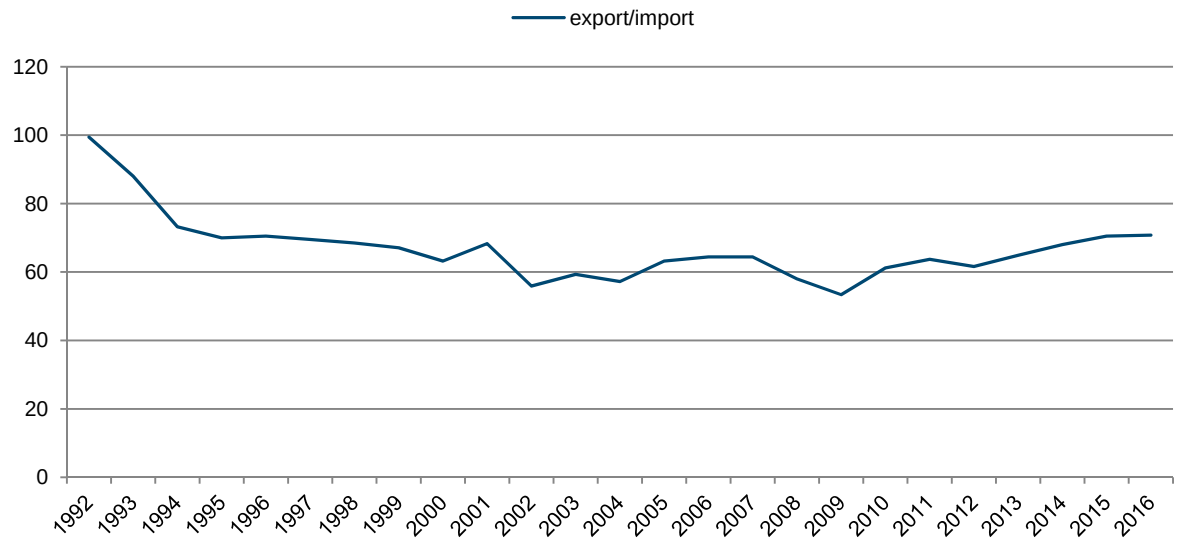
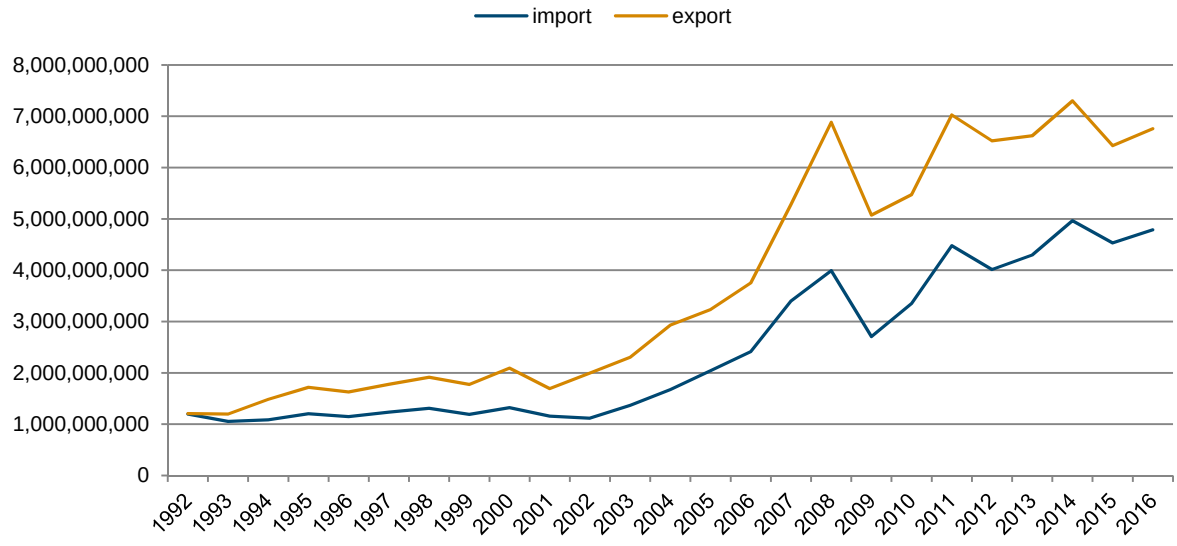


Figure A5 / Export coverage of imports



Source: National statistics.

Figure A6 / Exports and imports, in EUR



Source: National statistics.

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