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Professional paper

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FOREIGN DIRECT INVESTMENTS IN REPUBLIC OF MACEDONIA: AN OPPORTUNITY FOR DOMESTIC ENTERPRISES TO PARTICIPATE IN GLOBAL SUPPLY CHAINS

Abstract

The attraction of foreign direct investments and international cooperation are considered to be important priorities for small economies. They are desirable because of the positive effects in terms of increased employment and inflow of capital, technology, skills and knowledge in host countries. Especially important are the opportunities for building deeper, long-term relationships of cooperation and partnerships between domestic enterprises and foreign investors. Through this cooperation domestic enterprises can participate in global supply chains and ensure stabile sale and market share for their products in form of materials and semi-finished products for foreign investors.

The purpose of the research is to identify the opportunity for involvement of domestic enterprises in global supply chains, through cooperation with foreign direct investors. The subject is to explain theoretically the category of foreign direct investments and their implications on domestic economy, to explain the current situation with foreign direct investments in Macedonia and to provide recommendations about their attraction and intensified involvement of domestic enterprises in global supply chains. The research is based on qualitative approach, using the methods of analysis and synthesis, induction, deduction and comparison.

The research shows that foreign direct investments are important for the development of Macedonian economy, but it is necessary to take

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several measures to increase them and intensify the cooperation with domestic enterprises in order to exploit the full potential they offer. In this regard, the Government, the Macedonian Bank for Development Promotion, as well as the domestic enterprises play a critical role.

Key words: diffusion, knowledge, technology, capital, cooperation

JEL classification: F21, L26.

1. Foreign direct investments: concept, positive and negative implications for domestic enterprises

Foreign direct investments play a key role in the process of international economic integration. They are creators of direct, stabile and long-term relationships between the economies of the affected countries, encourage transfer of technology and knowledge between them and can be a significant generator of economic growth.

Foreign direct investments are cross-border investments by residents in foreign economy with the objective of obtaining a lasting interest in enterprises residents in another economy. The lasting interest implies the existence of a long-term relationship between the direct investor and the enterprise and a significant degree of influence by the direct investor on the management of the enterprise.[1] According to the National Bank of the Republic of Macedonia direct investments are cross-border investments made to obtain a lasting interest in an enterprise resident in an economy other than of the investor, and to gain influence on the business strategy of that enterprise.[2] They allow transfer of management and technical skills and diffusion of knowledge or entrepreneurship in form of research and development, production technology, marketing knowledge and managerial skills.[3]

The effects they generate are subject to fierce and often contradictory debate between researches and politicians. Politicians and

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[1] OECD Factbook 2013: Economic, Environmental and Social Statistics, [http://www.oecd-ilibrary.org/sites/factbook-2013-en/04/02/01/index.html?itemId=/content/chapter/factbook-2013-34-en]

[2] National Bank of the Republic of Macedonia [http://www.nbrm.mk/?ItemID=79D1B7E53FF9B74FA7DA40C529AAB550]

[3] Dunning J., (1992), “*Multinational Enterprise and Global Economy*”, Addison Wesley Publishing, 55-56;

economists in countries that export capital are concerned about the capital leaving their country, unlike those in countries in which the capital is invested, which are concerned about the impact this capital has on domestic enterprises. However, in transition countries, as well as in developing countries, foreign direct investments are desired and welcomed because of the positive effects associated with multinational investments in capital, technology and expertise. They are an important factor for national economy development and have long-term implications over its competitiveness.

Positive externalities in the literature usually arise from the assumption that foreign investors possess more advanced technology compared with domestic enterprises resulting in processes of diffusion of knowledge and technology between foreign investors and domestic enterprises.[4] The foreign investors have advantages arising from the possession of specific resources; advantages that are commonly achieved through high levels of investments made in innovative activities.[5]

The advantage arising from the possession of specific resources combined with the advantages provided by the host country, in terms of access to cheaper and plentiful resources and raw materials, is the most frequent and important stimulus behind the decision to displace the production capacity to another country.[6] Once foreign enterprises enter the domestic market, diffusion of ideas and technologies takes place in the respective and related industries.[7]

Knowledge diffusion is usually generated through demonstration effects that can be identified horizontally in enterprises from the same industry. For example, demonstration effects are generated when local enterprises modernize their technology, develop new products and processes or implement similar organizational practices with those presented by foreign investors. The cooperation with foreign investors and the possible imitation of their innovation by local enterprises can help local enterprises to increase their productivity.

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[4] Caves, R. (1996), "*Multinational enterprise and economic analysis*", Cambridge, England: Cambridge University Press.

[5] Guadalupe, M., Kuzmina, O. and Thomas, C. (2012), "Innovation and foreign ownership". *American Economic Review*, 102(7), 3594-3627.

[6] Rugman, A. (1981), "Inside the multi-national: The economics of internal markets". New York; Columbia University Press.

[7] Javorcik, B.S. (2004), "Does foreign investment increase the productivity of domestic firms? In search of spillovers through backward linkages", *American Economic Review*, 94(3), 605-627.

Another way by which diffusion of technology, skills and knowledge can be generated is through labor mobility.[8] Normally, when foreign enterprises hire local workers they organize trainings through which the workers acquire new skills in correlation with the strategies, operations and processes implemented by the enterprise. Trained local workers can terminate the employment contract with the foreign enterprise and start working in domestic enterprise or start their own business. Also, the knowledge accumulated as a result of the international experience of foreign enterprises can have influence on domestic enterprises' export decisions.[9] In some circumstances, this knowledge can become a stimulus for establishment of new enterprises and exploitation of export opportunities identified by domestic enterprises.

Although, this kind of knowledge diffusion usually takes place within one industry, still there is an opportunity for diffusion of knowledge between different industries, a process that is associated with the national economy development. This kind of knowledge transfer is generated when foreign enterprises develop cooperation relationships with local enterprises. If foreign enterprises set quality standards on higher level, the local suppliers usually would have to ask for technical support in order to improve their production, organizational and managerial skills.[10] Ultimately, this would result with increased productivity of those domestic enterprises that cooperate with the foreign ones. Additionally, being part of a global supply chain can mean creation of advantage from economies of scale, as well as stimulation of new domestic enterprises entry in the industry. Labor mobility between vertically related industries can foster improved performances of local enterprises. However, the degree of diffusion will depend on the degree of cooperation between foreign and domestic enterprises and whether and how much foreign enterprises use locally produced inputs. If foreign enterprises work solely with foreign associates and use only foreign sources, in that case cooperation opportunities with domestic enterprises are limited and modest.

[8] Fosfuri, A., Motta, M. and Ronde, T. (2001), "Foreign direct investment and spillovers through labor mobility", *Journal of International Economics*, 53(1), 205-222.
[9] Kneller, R. and Pisu, M. (2007), "Industrial linkages and export spillovers from FDI", *The World Economy*, 30(1), 105-134.
[10] Burstein, A.T. and Monge-Naranjo, A. (2009), "Foreign know-how, firm control, and the income of developing countries", *Quarterly Journal of Economics*, 124(1), 149-195.

On the other hand, foreign direct investments are perceived as creators of negative externalities for the domestic economy. The entry of foreign enterprises increases the competitive pressure on domestic enterprises, which may drive less efficient local firms out of the market.[11] Increased competitive pressure often leads to prices reduction, which ultimately results in displacement of local companies form the market, which although inefficient in the international boundaries, still can contribute to increased employment and income on a local level. The effect of stealing the market share from foreign enterprises occurs because their entry decreases the productivity of domestic enterprises as a result of the pressure to lower the production quantities.[12] This effect can easily be identified in the context of a single industry, when foreign and domestic enterprises compete directly as suppliers of other upstream foreign enterprises. The efforts for cost reduction by foreign enterprises can be a reason for international instead of local procurement of intermediate goods. Ultimately, in order to meet the global standards local sourcing can be replaced with international one.

Also, negative externality can be seen on the factor market. The foreign enterprises have the necessary resources and perspective opportunities to attract the most productive domestic resources and this is particularly true for labor. They have the power to provide better working conditions and higher wages as opposed to domestic enterprises, and that's why they'll attract the most talented and capable domestic workers. In regards with potential impacts on entrepreneurship, foreign direct investments may lower the rate of establishment of new domestic enterprises by altering the payoffs to potential entrepreneurs with those from wage employment.[13] In this context, a research concludes that under particular circumstances the monetary return for entrepreneurs is valued less compared with the risk-free salary earned from employment in foreign enterprise.[14] However, the crowding out of domestic enterprises in terms of products, labor or suppliers doesn't always mean deterioration

[11] Djankov, S. and Hoekman, B. (2000), "Foreign investment and productivity growth in Czech enterprises", *World Bank Economic Review*, 14(1), 49-64.
[12] Aitken, B. J. and Harrison, A.E. (1999), "Do domestic firms benefit from direct foreign investment? Evidence from Venezuela", *American Economic Review*, 89(3), 605-618.
[13] De Backer, K. and Sleuwaegen, L. (2003), "Does foreign direct investment crowd out domestic entrepreneurship?", *Review of Industrial Organization*, 22(1), 67-84.
[14] Hall, R.E. and Woodward S.E. (2010), "The burden of the non-diversifiable risk of entrepreneurship", *American Economic Review*, 100(3), 1163-1194.

of economic welfare. Indeed, the increased competition imposed by the foreign direct investments can induce more efficient use of local resources and subsequent increase of welfare.

2. Foreign direct investments in Republic of Macedonia, 2007-2012

The promotion of international cooperation and the attraction of foreign direct investments are considered to be one of the five strategic areas of action for achieving the vision of the Macedonian industrial policy.[15] In this direction the country makes efforts to attract a larger share of foreign capital through foreign direct investments. In regards with the investment climate particularly important are the economic and legal activities taken in the last years. In the recent years we have witnessed the reforms in the tax system (proportional corporate and personal income tax rate of 10% and 0% tax on reinvested profit, investors operating in the technological industrial zones use tax relives for ten years), reforms to improve the credibility and the services provided by the public institutions and cut the bureaucratic procedures (easy firms' registration, easier processes for obtaining planning permissions), better protection of property rights and contracts execution (legal protection), etc. Also, marketing campaigns and activities are continuously launched in order to promote Macedonia as a desired investment destination, with more sectors promoted in front of foreign investors. Regional forums are organized, councilors and local promoters are hired, potential investors are contacted and so on.

Meanwhile, the macroeconomic stability was maintained through stabile fiscal and monetary policy, low inflation, balanced public finances with low budget deficits and low public debt. Besides the national macroeconomic stability, the Government's actions and policies are considered to be an important factor that influences the level of foreign direct investments. In this regard, the attraction of foreign direct investments is an important priority for the Government and represents

[15] Industriska politika na Republika Makedonija 2009-2020 [Industrial Policy of Republic of Macedonia 2009-2020], Ministerstvo za ekonomija na Republika Makedonija, 2009, 29-30.

an important category in the Government program 2011-2015.[16] Related with this is the Program of the Ministry of Economy for investment incentives, 2011-2014[17] aimed at developing policies and implementing reforms that will lead to more dynamic economic growth and development, in correlation with the strategic objectives of the Government program. The following table presents the levels of foreign direct investments in Republic of Macedonia from 2007 to 2012. The highest level is recorded in 2007, when the country attracted foreign direct investments worth 505,97 millions of euros, as a result of which it reached GDP growth of 5%. In 2008 the level dropped to 399.89 million of euros and GDP growth remained around 5 per cent. In 2009 as a result of the global crisis, the level of foreign direct investments was 144,97 millions of euros. In 2010, 160,02 millions of euros were attracted. The lowest level was recorded in 2012, when the level dropped to 104,77 millions of euros.

Table 1: Foreign direct investments in Republic of Macedonia, 2007-2012

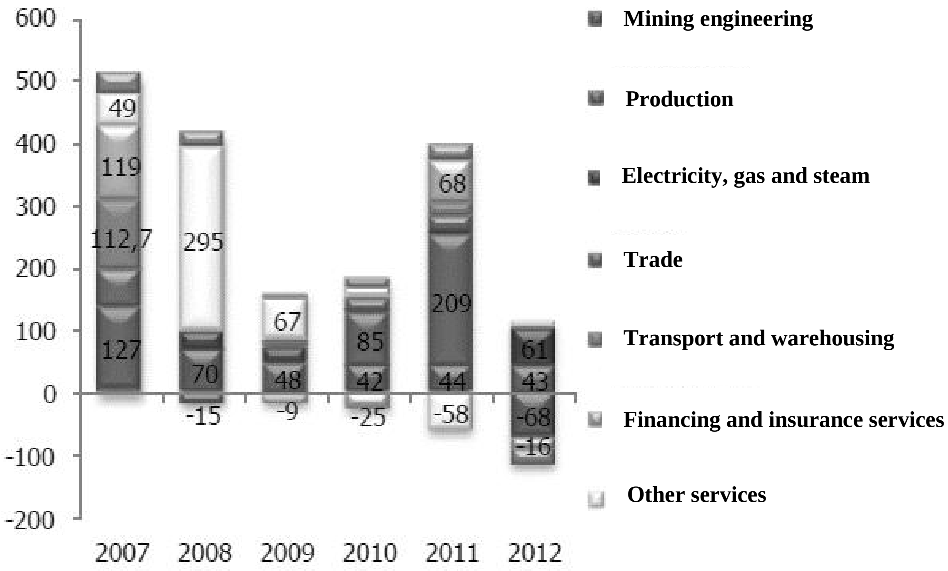
Year	Foreign direct investments (in millions of euros)
2007	505,97
2008	399,89
2009	144,97
2010	160,02
2011	336,79
2012	104.77

Source: Adapted from data of the Narodna Banka na Republika Makedonia

[16] Programa na Vladata, 2011-2015 [Government Program 2011-2015], Government of the Republic of Macedonia, [http://vlada.mk/node/262?language=en-gb]
[17] Programa za pottiknuvanje na investicii, 2011-2014 [Program for Investment Support 2011-2014], Ministry of Economy of Republic of Macedonia, [http://economy.gov.mk/ministerstvo/sektori_vo_ministerstvo/sektor_za_pottiknuvawe_investicii/3388.html]

The next figure provides a graphical representation of foreign direct investments by sector in millions of euros in the period of 2007 to 2012. In terms of sector distribution, foreign direct investments are mainly concentrated in manufacturing and services, with the largest share invested in manufacturing in 2011 and the least in 2008. Most of the production refers to the production of automotive parts and electronics.

Picture 1: Foreign direct investments by sector (in millions of euros)



Source: Godisen izvestaj na rabotenjeto na NBRM vo 2012 godina, (2013), Narodna banka na Republika Makedonija;

Compared with other transition economies, in 2012 Macedonia had the lowest inflow of foreign direct investments from all transition countries. Lower level compared with the politically and safety unstable Bosnia and Herzegovina, also Albania and Montenegro have far higher levels. The next table shows the inflow of foreign direct investments in transition countries in South-East Europe in millions of dollars.

Table 2: Inflow of foreign direct investments in transition countries in South-East Europe (millions of dollars)

Inflow of foreign direct investments						
Region / economy	2007	2008	2009	2010	2011	2012
Transition economies	93 371	121 429	72 750	75 056	96 290	87 382
SE Europe	13 187	13 257	8 577	4 592	7 202	4 235
Albania	659	974	996	1 051	1 036	957
BiH	1 818	1 025	149	324	380	633
Croatia	5 041	6 220	3 339	432	1 502	1 251
Serbia	3 439	2 955	1 959	1 329	2 709	352
Montenegro	934	960	1 527	760	558	610
Macedonia	693	586	201	212	468	135

Source: UNCTAD, FDI – TNC – GVC Information system, FDI database, (2013) [http://unctad.org/en/PublicationChapters/wir2013References-Annexes_en.pdf]

The inflows of foreign direct investments in other European counties are much higher than these levels. That’s why comparison with them isn’t even worth making.

3. Opportunities and recommendations for attracting foreign direct investments and domestic companies’ participation in global supply chains

Macedonian economy is one of the smallest in Europe therefore internationalization is a necessity for the functioning of the economy. The development of market economy and economic reforms, along with the stable macroeconomic policy, are important factors for development of the investment climate in Macedonia and for the perception that foreign investors have about the investment opportunities offered by the country. The favorable geo-strategic position is an important comparative advantage that creates the potential for the country to become a regional center for facilitating trade and developing competences in supply chain management. Unfortunately, the underdeveloped, old and expensive infrastructure prevents the complete utilization of this potential. Low labor costs are particularly important for labor-intensive industries (such as textile and automotive industry), but they are not sufficient by themselves to attract foreign investors. Regarding the workforce qualification, although the statistical figures are favorable, yet the actual market situation is different and less desirable. The country is still highly rated in terms of corruption[18] and this continues to be a serious problem and destructive obstacle to economy development. According to this characteristics of the national economy, actions that would increase the inflow of foreign direct investment in the country are:

- Better protection of property rights and ensured effective execution of contracts through effective and independent judiciary;
- Consistency and stability in terms of the tax system and the established legal framework;
- Serious investments in building and modernizing of infrastructure;
- Increased quality of services provided by the public administration;
- Research the actual needs of the labor market and make adjustments into the education strategy (secondary and higher education) according to the market's real needs;
- The eventual EU and NATO entry would mean reduced risk and increased national safety and security, as well as increased confidence of investors to invest their capital in the country.

We have noted earlier that foreign direct investments create opportunities for huge development implications over the domestic economy, especially in cases when it comes to industries that weren't included in the business structure of the country previously and in which there are no domestic manufacturers that operate. In this way direct competition between domestic and foreign enterprises for taking bigger market share is avoided as well as the subsequent displacement of the less efficient enterprises from the market (usually the domestic ones). In terms of the negative impact on the labor market, i.e. the attraction of the few talented and skilled workers and the reduction of the formation rate of new local enterprises, the propensity of the prospective entrepreneurs to take risk and start their own business plays an important role.

[18] Corruption Perceptions Index 2013, Transparency international, [http://cpi.transparency.org/cpi2013/results/#myAnchor1]

Thus, foreign direct investments in Macedonian case can be creators of significant positive externalities, especially through the opportunities for participation of domestic enterprises in global supply chains and absorption of knowledge, technology and skills. However, in order to be part of global supply chains, Macedonian enterprises would have to make their contribution in increasing the overall value of supply chains and thus to participate in the creation of the competitive advantage of the chain. Also, the Government can have a great influence in deepening the cooperation by obliging foreign direct investors to use a certain minimum percentage of locally produced raw materials and semi-finished materials, providing export to third markets or joint participation on some other projects, in exchange of the benefits provided by the host country.

Of course, in this case from domestic manufacturers it is expected to redesign their operations and to increase the technology, management, research and development levels at the required level, i.e. to provide internationally competitive prices and way of working.

The following activities are recommendations for successful development of domestic enterprises by achieving and maintaining long-term cooperation with foreign enterprises:

- Increase of quality and productivity levels through implementation of reliable methods for productivity improvement, quality standards, increased research and development and introduction of new, more efficient technologies;
- Make production orientation modifications and focus on prospective industries and strategic markets where foreign investors operate or potentially will;
- Take more aggressive and proactive approach in terms of searching information about the needs and production programs of foreign investors, the cooperation rules and the global market trends;
- Attend trainings and seminars to keep up with technological changes and +participate in trade shows in order to present the capacities of the enterprise. Also, business meetings should be organized more frequently, where foreign investors as well as domestic enterprises could present their capacities and needs. These business meetings should be organized and managed by the Government.

Additionally, the Macedonian Bank for Development Promotion, as the only development bank in the country, whose main objective is to support and encourage the development of the Macedonian economy by providing investment credits to small and medium enterprises and export companies, should facilitate the access to cheaper credit lines for domestic enterprises that have or seek to build a deeper cooperation with foreign investors. In regards of providing the necessary institutional support, it is important to establish a public institution whose main purpose will be promotion and facilitation of cooperation between domestic enterprises and foreign investors, which will distribute timely and relevant informations to local enterprises and will provide the necessary services for international operation and cooperation.

Of course, further entrance of high-quality foreign direct investments, which will bring new technologies, knowledge, investments and new employments and will be willing to cooperate with domestic enterprises and utilize local materials and semi-finished products, will open up new opportunities for collaboration and vertical integration across supply chains.

Conclusion

In the process of international economic integration, foreign direct investments play a key role. They are creators of direct, stable, long-term relationships between the economies of the countries, encourage transfer of technology and knowledge and can be an important generator of economic growth. Positive externalities are usually referred to the assumption that foreign investors possess more advanced technology than domestic enterprises resulting with processes of knowledge and technology diffusion. Negative externalities, however, are associated with the claim that the entry of foreign enterprises increases the competitive pressure on domestic enterprises, which can displace the less efficient domestic enterprises from the market.

Foreign direct investments in the case of Macedonia can be creators of significant positive externalities, especially through the opportunities for participation of domestic enterprises in global supply chains and absorption of knowledge, technology and skills. In recent years the country has increased inflow of foreign direct investments (except in 2012), but yet they are the lowest in the region and under the desired level. Activities such as making changes in the judicial system, maintaining consistency and stability in the tax system, building new and modernizing the existing infrastructure, increasing the quality of public administration’s services, as well as adjustment of the education system according to the needs of the labor market can have positive influence on foreign direct investments inflow. On the other hand, in order to deepen the cooperation between domestic and foreign enterprises it is necessary that domestic enterprises redesign their operations and increase the technology, management, research and development levels at the required level, i.e. provide internationally competitive prices and way of working. Also, the Government and the Macedonian Bank for Development Promotion must actively provide the needed support to domestic enterprises in this process.

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