

# **ECONOMIC PERFORMANCE OF NORTH MACEDONIAN ECONOMY AND THE EU INTEGRATION CHALLENGES**

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## ***Abstract***

*We investigate the performance of North Macedonian economy in terms of its capacity for acceleration of the real convergence process toward the EU living standards. The holistic growth diagnostic approach is used in order to analyze the country's growth performance by investigating the current growth model and to identify the main source and the most binding constraint. The results show that the average growth rate of North Macedonian economy in the last two decades is relatively lower than the other countries in the region, which delayed the process of convergence of the country to the level of living standards of the EU Member States. One of the reasons is the lower economic integration of a country with the advanced EU countries in terms of trade integration (the export demand from EU and other countries) and financial integration (FDI inflows and the foreign capital share in the domestic banking sector). There have been expectations that the accession of the country into NATO and its integration in the EU processes will automatically increase the FDI inflows and the trade integration of the country. However, this claim has not been supported by any objective evidence. It is true that the EU and NATO accession may contribute to the acceleration of the country's development process, but how that process will impact the national economy to a large extent depends on its government capacity to implement structural reforms, its ability to strengthen its institutional capacity, and its ability to design economic and industrial policies most conducive to improve its export competitiveness as a fundamental factor for sustainable economic growth for a small open economy.*

### **Keywords**

*Economic growth, North Macedonian economy, EU integration process, export competitiveness.*

## **Introduction**

During the last two decades, North Macedonian economy has achieved relatively slow development dynamics with an *average growth rate of 2.7% in the period 2001-2017*, which, compared to the countries in the region, lists the country in the group of countries with meager economic results. For example, the average economic growth rate for Albania in the same period was 4%, for Bulgaria – 3,7%, Serbia – 3%, Montenegro – 3%, Romania – 4%, Slovakia – 4%, Estonia – 4%, and Poland – 3.6%.

Such economic performances have slowed down and delayed the process of convergence of the country to the level of living standards of the EU Member States. For illustration, in 1998 Macedonia and Bulgaria had fairly the same level of per capita income, about 28% of the level of income in the EU. In 2017, the per capita income in Bulgaria came close to 60% of the EU income, while the per capita income in Macedonia remained at 35% of that of the EU. If we compare this convergence speed with which the Republic of North Macedonia has been closing the gap with the EU average with the fact that Slovenia and Slovakia, two successful countries from the CEE region, have reached more than 85% of the EU per capita income, we can conclude that the previous model of growth of the North Macedonian economy has not delivered the expected results and hence there is a need for serious changes in the course of economic policies.

Actually, the growth model of the North Macedonian economy in the last two decades has been based on the quantitative instead of qualitative changes in the production factors (labour and capital); it has been based on the demand-side factors (final household consumption and government spending) instead of supply-side factors and finally the economic growth has been driven by services instead of industry.

On the other side, the standard growth theory states that the only source of sustainable economic growth for a small open economy, such as that of the Republic of North Macedonia, with all its specificities and ideosyndic

conditions, is acceleration of the *process of modern re-industrialization and export diversification*.

Such processes should enable increasing the total productivity of the economy by diverting resources from sectors and industrial branches with lower added value to those with higher productivity, and will, at the same time, contribute to increasing the country's export competitiveness as a fundamental development process toward the EU accession path.

The paper is composed of three parts. In the introductory part we present the main goal of the research, the methodology to be used and the expected results of the research. The second part presents the results of the research itself and the conclusions based on the obtained results. At the end, the conclusion remarks are presented together with some policy suggestions.

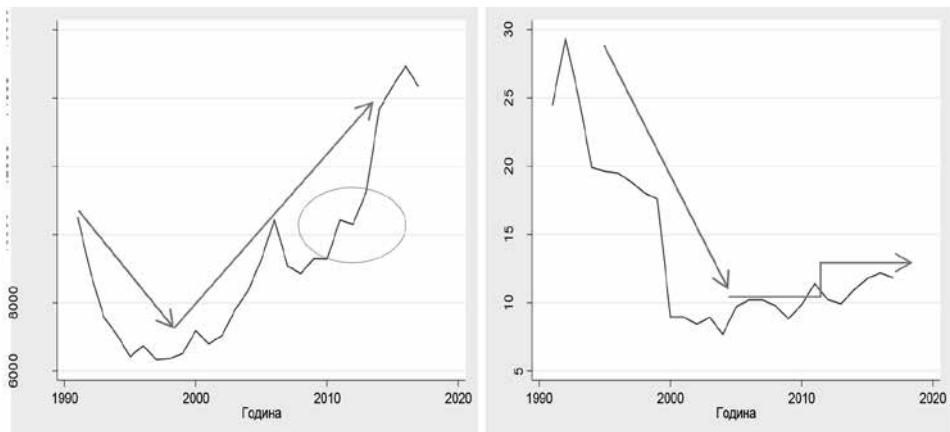
## **Empirical analysis of industrial and export performance of the North Macedonian economy**

In the second part of the paper, our main goal is the detailed study of the performance of the processing industry at the level of an individual industrial branch and the analysis of the export structure at the level of an individual product in order to address the challenges and identify the development opportunities and potentials for restructuring the North Macedonian economy.

### **Analysis of the manufacturing sector performance**

We begin the analysis with a detailed study of the trend of movement of the processing industry share in the GDP of the country from the Independence Day until today, as a synthetic indicator and an indicator for measuring the performance of the processing industry. Namely, as can be seen from the chart below, there is a serious decline in the relative share of the processing industry in GDP (trend of deindustrialization) with a slight improvement in the period after 2001 (with the exception of the period of the Global Economic Crisis), which is not enough to achieve the desired goals for faster economic growth of the country.

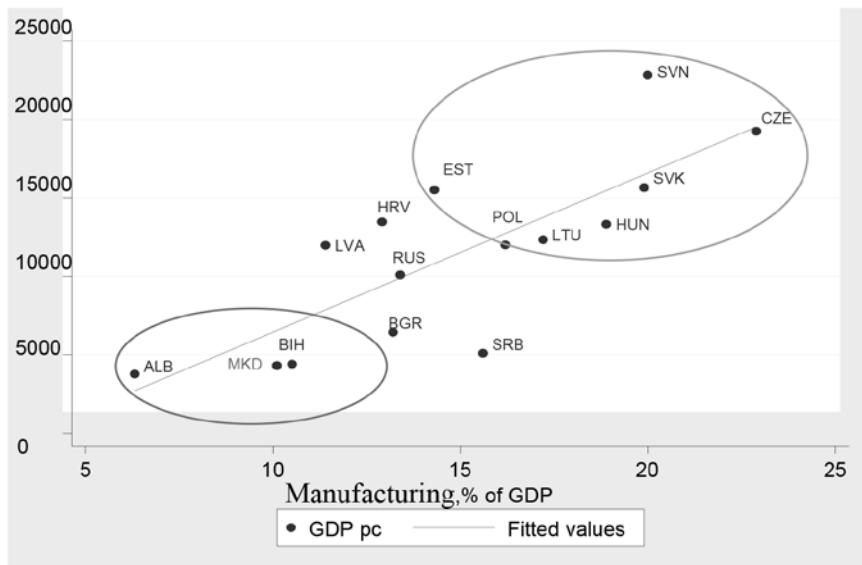
**Figure 1. Panel A – Gross added value of manufacturing, basic prices (000 US\$) and Panel B – Manufacturing (% of GDP) in the Republic of North Macedonia**



**Source:** Calculation of authors based on the World Bank database

In 2017, the relative share of the processing industry in GDP was 11.8%, which is below the EU average of 14%. This level is significantly higher in most of the more developed countries in the CEE region, such as Slovenia (20%), Slovakia (20%), Czech Republic (24%), Hungary (19%), Poland (18%), Romania (20%) and others. Practically, these are the countries which the Republic of North Macedonia should try to follow if we want to aim for faster growth in the future period.

**Figure 2. Manufacturing (% of GDP) in the CEE countries**



**Source:** Authors' calculation based on the World Bank database

The analysis of the performances of the processing industry, seen through the prism of the number of employees and the productivity per worker, shows positive trends that are still insufficient to change the unfavorable situation in the structure of employment in this sector. Namely, despite the fact that the number of employees in the **processing industry** has increased by **20 187 new jobs** (from 123 066 in 2006 to 143 253 in 2017), this increase is significantly lower in relation to **140 000 newly created jobs in the services sector** (especially in non-market services and services that are not subject of trading) for the same period.

Such slow dynamics of creating new jobs in the processing industry does not contribute to more significant structural changes in the economy, especially given the fact that a large part of the labor force is still stuck in the **agricultural sector** (120 311 employees, or 16% of the total) and **construction** (53 391 employees or 7% of the total), and that the **service sector** has increasing importance (relative increase from 47% in 2006 to more than 54% in 2017).

On the other hand, the **level of productivity of the processing industry** (measured as the ratio between the gross added value at basic prices in terms of the number of employees) in the analyzed period has **slightly improved**

(from 8 485 US \$ in 2006 to 10 000 US \$ in 2017) with cyclical oscillations, especially during the Global Economic Crisis 2007/2008 and the 2011/2012 recession.

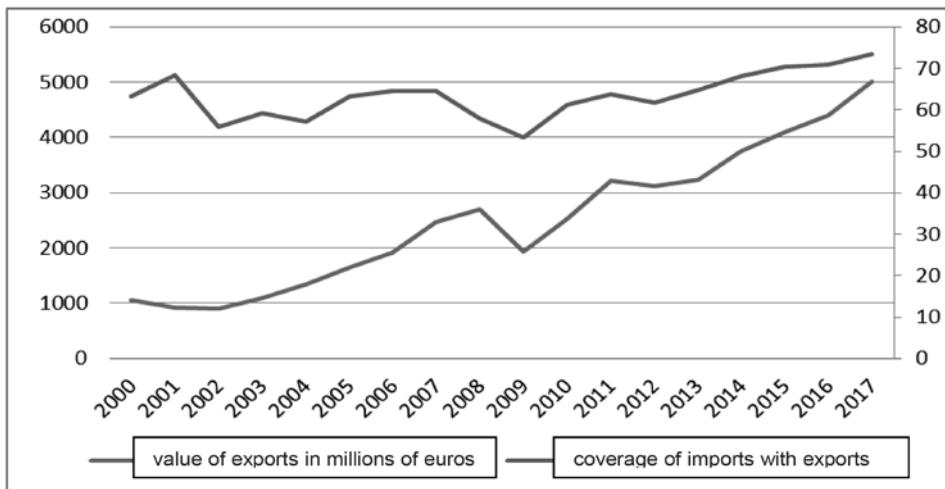
One of the **main reasons** for the **poor performance of the processing industry** seen through the prism of gross added value, exports, the number of employees, and productivity levels should be sought in the **unfavorable structure and slow intra- and intersectoral structural changes**. Namely, if we look at the structure of the processing industry, we will see that in 2010 the largest share according to the number of employees and gross added value had the industries with relatively low productivity, such as the textile industry (clothing and textiles), fabricated metals, leather industry, furniture and so on. On the other hand, industrial branches with high productivity, such as the chemical, pharmaceutical and machine industries, had significantly lower relative share.

### **Analysis of the export performance of the North Macedonian economy**

In the past period, the Republic of North Macedonia recorded a significant increase in the export from **1 billion euros in 2000** to **5 billion euros in 2017**, which means that exports in the analyzed period grew with an *average rate of 10.7%*. The largest part of this increase, especially in the period after 2007, is due to FDI and exports from Technological Development Industrial Zones (TIDZs).

However, such an increase of export has not significantly contributed to the dynamics of the economic growth due to the fact that it has been characterized by a significant "import" component, which indicates that the domestic added value in the export of foreign companies in the TIDZs has been extremely low and has lacked significant multiplicative effects on the North Macedonian economy.

Figure 3. Export volume and coverage of import with export in Macedonia



Source: State Statistical Office of the Republic of North Macedonia

The indicator which shows the percentage of imports coverage with exports in the analyzed period is still at the level of around 70%, and confirms the above-stated conclusion that the country's exports do not contribute to reducing the trade deficit and practically the reason why there has been a low magnitude in the correlation between exports and economic growth should be sought here.

### Policy proposals for growth acceleration

The estimated results of the analysis of industrial and export performance indicate that there are several fundamental binding constraints of the North Macedonian growth performance: 1) the low level of industrialization (manufacturing sector is less than 12% of GDP), 2) unsatisfactory export competitiveness (the relative share of exports is 55% of GDP), and 3) unfavourable industrial and export structure (predominant industrial and exporting sectors are textile, basic metals and agricultural products with exception of the structure in TIDZs).

However, an increase of the level of industrialization and export competitiveness, and improvement of the industrial and export structure are not *ad hoc* processes that can be achieved in several years, especially not without an effective and efficient development strategy. Hence, a clear devel-

opment vision of the policy makers with a modern industrial and economic strategy should be indispensable. However, the main thesis of the current government is that the accession of the country in NATO and its integration in the EU processes will automatically solve the economic problems which constrain the country's growth dynamics and will contribute to the increase in the living standards of the North Macedonian citizens, which has absolutely not been supported by any objective evidence.

The Republic of North Macedonia would accelerate its economic growth and the real convergence to the living standards of the EU developed countries only if the government puts all its efforts on real structural reforms and implements economic policies that would increase the country's competitiveness. In that context, we propose *several policies* which we believe can contribute to a significant acceleration of the growth dynamics.

*The first measure* should be directed towards providing **financial support for investments** of export-oriented domestic companies within the previously addressed strategic sectors where the country has a latent comparative advantage. *The second measure* refers to **improving the personnel and managerial capabilities** of export-oriented domestic companies. In this regard, our proposals refer to the creation of modern programs for improving managerial skills through trainings for specialization of managers in domestic export-oriented companies. *The third measure* refers to the **redefinition of the program for attracting foreign direct investments (FDI)** in which the focus will be put on attracting only those foreign companies within the previously addressed strategic sectors and subsectors in order to put them in function of the domestic economy by integrating domestic companies into their supply chains. *The fourth measure* is directed towards the **building an infrastructure for Industry 4.0** because of the fact that global trends are ruthless and the need for facing these global challenges as soon as possible is necessary if we don't want to deepen the gap in the country's technological development vis-à-vis the developed countries. Finally, *the fifth, not less important measure* refers to **strengthening of the institutional capacities of the state** and **improving the business regulation**. We are all aware that the basic precondition for successful business practices are strong institutional capacities, professional public administration and business regulation that will be friendly to the private sector and without bureaucratic barriers and selective treatment.

## Conclusion

The results of the economic performance analysis indicate that Macedonia has experienced the lowest growth rate in the last two decades compared with other countries in the region. For illustration, the average economic growth rate in Macedonia in the period 2001-2017 was 2.7%, while the growth rate in Albania was 4%, Bulgaria – 3.7%, Serbia – 3%, Montenegro – 3%, Romania – 4%, Slovakia – 4%, Estonia – 4%, and Poland – 3.6%.

There are many reasons which could explain the very low growth performance and slow convergence towards the EU living standards of the North Macedonian economy, such as weak institutional capacity, undeveloped financial system, lack of skilled human capital, low technological progress, etc. In addition to these factors, there are several fundamental binding constraints to the North Macedonian growth performance: 1) the low level of industrialization (manufacturing sector is less than 12% of GDP), 2) unsatisfied export competitiveness (the relative share of export is 55% of GDP), and 3) unfavourable industrial and export structure (the predominant industrial and exporting sectors are textile, basic metals and agricultural products with the exception of the structure in TIDZ).

However, the increasing the level of industrialization and export competitiveness, and improving the industrial and export structure are not *ad hoc* processes that can be reached in several years, especially not without an effective and efficient development strategy. Hence, a clear development vision of the policy makers with a modern industrial and economic strategy is necessary.

The Republic of North Macedonia would accelerate its economic growth and the real convergence to the living standards of the EU developed countries only if the government puts all its efforts on real structural reforms and implements economic policies that would increase the country's competitiveness. In that context, we propose *several policies* which we believe can contribute to a significant acceleration of the growth dynamics.

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