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Dear reader,

"Economic Development", published by the Institute of Economics - Skopje, is an academic journal in the field of economic development and has been an important medium for 12 years. The main goal of "Economic Development" is to provide intellectual platform to the wider academic and professional publics, and promote the development of economic thought in the country and the world. The interest and need for publishing of the journal were continuously increased all these years

On the path of development of the economic thought and building a wide network of research and professional cooperation with other countries in the world, we set new goals, criteria and challenges in order to improve the journal's quality. In this regard, during 2010 and 2011, significant changes have been made in editorial policy, design and its availability to broader academic and professional public in the region and worldwide. As result of all this changes, starting from no. 3/2010 "Economic Development" will shift into international journal, will be published in English language and will be distributed in all countries of the region and worldwide.

This academic journal covers theoretical and empirical researches in the field of economic and social development, demography, education, corporate governance, international economics, international management, administrative management, corporate and public finance, economics and tourism management, agricultural policy and agricultural management, marketing and marketing management, entrepreneurial management and other areas in the field of social sciences.

The journal "Economic development" has an open approach in accepting and publishing the papers reviewed by an international editorial board consisting of three domestic and five foreign experts. The journal is available in print and online form, through the database of academic papers published by the Institute.

Skopje, May 2012

prof. Biljana Angelova, PhD
Editor-in-chief

Biljana ANGELOVA^{*)}

CREDIT RATING – INDICATOR OF NEW ECONOMIC PROSPECTIVE AND CHALLENGES

Abstract

Credit rating is a credit rating of the state. The process of awarding rating is based on a detailed qualitative and quantitative analysis of the creditworthiness of countries, including: political risk, income and economic structure, the prospects for future economic growth, fiscal and monetary flexibility, general government debt, external liquidity, and by the public and private sector .

Generally, a high credit rating certainly has a positive impact on its position in the international capital market, the movement of interest rates and the inflow of foreign investment.

Last economic crisis from 2008 causes huge problems in many advanced and developing economies. Rating agencies were faced with a problem of being blamed for not early warning of difficulties in banks and investor's funds. The economic crisis in US and Euro zone, decline economic growth and credit rating in the most of them

Key words: credit ratings, credit rating agencies, economic crisis, rating crisis, creditworthiness.

JEL classification: G21

Introduction

New economy order after the world crisis announced in 2008 open a wide field of different attitudes about reasons and consequences of the economic crash and measures for overcoming. The ratings of many countries, cities, companies and governments were decreased. Whatever, publicity blames credit rating agencies for over-due reaction and absence of early warning reacting.

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The world's largest rating agencies employ top experts in finance who determine credit rating for the countries (sovereigns and sub-sovereigns) and financial institutions. Credit rating is a primary criterion for approving loans, as well as the conditions under which these loans are approved. Criteria for obtaining loans are an important indicator for investors, but also for the country's reputation or financial institutions in international financial surroundings. The credit rating includes evaluation of economic and financial characteristics of individual countries such as level of debts, assets and other macroeconomic indicators.

The last "rating crisis" caused by the decision of the agency "Standard and Poor's," which lowered the credit rating of France, Austria, Slovenia, Slovakia, Malta, Italy, Spain, Portugal and Cyprus. This decision provoked a negative reaction from officials of the EU and the Euro-zone, particularly Germany and France, because this decision is very unfavorable for the Euro-zone countries, faced with a serious debt crisis. Again emphasizes the fact that the world's strongest rating agencies are private companies from the United States, and that such decisions are not only economic but also a serious political dimension.

SOVEREIGN CREDIT RATING – EXPLANATION OF RATINGS

Credit rating is the rating of general creditworthiness of a borrower or debit instruments - securities or other financial obligations, based on appropriate risk factors. In that sense, credit ratings provide an international framework for comparing the credit quality of individual borrowers and debt instruments (securities). It should be noted that the rating in any case does not give an opinion on how a lender (i.e. bank) or investment "good" or "bad", a profitable, successful, and the like, but only and exclusively the probability of return credited funds within the agreed period .

Credit rating provides an assessment of the ability and willingness of government to a country in full and on time services its debt. This is a descriptive rating of creditworthiness. In evaluating the credit rating takes into account : the economic (estimated ability to repay the debt) and political factors (willingness to return the debt). In relation to the country risk, as well as from the standpoint of narrow political risk, credit rating is an important indicator of the level of confidence in the functioning of the government of a state. Based on the credit ratings of the investors are able to directly compare the credit risk countries and thus decide whether and under what conditions to redeem government bonds or state grant loans.¹⁾

Any country that wants to independently borrow in international capital markets and issue bonds or borrow as a state commercial banks in the world, should have a

¹⁾ Ljubic, Marijana (2008): Analysis, evaluation and rating of commercial entities, Proceedings - May Conference on Strategic Management, 7-8. June 2008., University of Belgrade, Technical Faculty at Bor, p. 224.

credit rating. What is more favorable rating, the country has a better borrower. This means you will be able to borrow at favorable market and at a lower interest rate, higher loan amount or a longer repayment period.

The process of awarding credit rating is a complex, lengthy and continuous. In allocating the first sovereign rating, the rating agencies in the first phase of the country requires a series of economic and political indicators and information. Usually it required series of economic data for a period of five years, as well as the short and medium term projections. An integral part of the rating process and rating agency analysts coming into the country where the ground, in detailed discussions with representatives of all relevant institutions and authorities collected additional information about the political and economic situation and trends in the country. After awarding the first rating, the rating agencies once a year coming into the country and to review rating, with publication of regular annual reports on the rating of the country. In addition to the annual report, the rating agency publishes quarterly information on the rating of the country (Credit Opinion). The process of credit rating is a continuous process that requires continuous delivery of updated data and good cooperation and coordination among all levels of government and institutions in the country.

Rating agencies, in addition to data submitted to them by the state, in the process of monitoring and updating of the situation in the country, using a variety of other

Table 1

EXPLANATION OF RATING CATEGORIES

	Moody's	Explanation of rating categories
AAA	Aaa	Financial position of the country is very strong
AA	Aa	The financial position of the country is very strong, but in the long term risks are higher than the highest ranked category
A	A	Country's financial position is strong with some clues to this position in the future could be impaired
BBB	Bbb	The country has adequate capacity to meet its obligations, but the negative economic or political events may impair the ability of future debt service
BB	Bb	In the short-term financial ability is good, but in the future may lead to a sharp drop capabilities ispunavanja obligations
B	B	Currently the state is unable to meet obligations to its creditors, but the medium is extremely sensitive and the compliance in the long term is questionable
CCC	Ccc	The state is very sensitive to the negative economic, political and financial developments, and the fulfillment of obligations in foreign currency depends on a favorable external environment
CC	Cc	The state is very sensitive to the negative economic, political and financial development
C	C	The state is not fulfilling its obligations and the possibility of recovery is extremely low

Source: Baric, Renata (2006): The credit history of BiH, the BiH Central Bank, age 9, No. 5, p. 3

data sources that are available to them, for example. world media reports. Therefore, in the case of new countries and developing countries that often accompanies a negative image, very important that representatives of the country's continuous rating agency informed of the positive trends in the country.

Countries that are unable to meet their debt obligations and debt service which is interrupted marked with SD (Selective Default) or simply D (Default). Fitch and Standard & Poor's rating categories A, B and C can add a plus sign (+) or minus (-) to show the status of the country within a given category. Moody's modifies A, B and C category added by adding a numeric sub-categories²⁾: 1 indicates a strong position in the country within a given category 2 means that the status of the average and 3 shows that the weakest country in a given category. In addition to letter grades, the agency gives its predictions for the future in the form of descriptive marks: stable prediction, positive and negative predictions.

Table 2

COMPARATIVE OVERVIEW OF MOODY'S AND S&P/FITCH RATINGS		
Moody's	S&P / Fitch	Explanation of rating categories
Investment scale		
Aaa	AAA	Outstanding credit rating
Aa1	AA+	
Aa2	AA	A high credit rating
Aa3	AA-	
A1	A+	
A2	A	Strong possibility of servicing its obligations
A3	A-	
Baa1	BBB+	
Baa2	BBB	Adequate serviceability of its obligations
Baa3	BBB-	
Uninvestment level		
Speculative level		
Ba1	BB+	
Ba2	BB	Service obligations is likely to
Ba3	BB-	Conditioned
B1	B+	
B2	B	High risk for fulfilling obligations
B3	B-	
The level of potential failure - Default		
Caa	CCC+	
	CCC	The high probability of failure or the debt service for vulnerable
	CCC-	
Ca	C	
D	DDD-D	Bankruptcy or debt service is interrupted

Source: Baric, Renata (2006): The credit history of BiH, the BiH Central Bank, age 9, No. 5, p. 4.

²⁾ Baric, Renata (2006): The credit history of BiH, the BiH Central Bank, age 9, No. 5, p. 2.

Agency's credit rating companies carefully measure, and six-month intervals, usually in published evaluations of the risk exposure of individual countries, so called -credit rating.

Large international financial institutions and non-profit character development, as well as large institutional investors have to follow strict rules not to invest in countries with low credit ratings. These institutions have established periodic monitoring of country risk and reporting on identified risks, which provides risk monitoring of each country based on the rating determined by external agencies. The weakening credit position has a profound effect on the loans are made in the financial markets, as investors use ratings of specialized agencies when making investment decisions.

One of the parameters that are considered when determining the country's credit rating are the interest rates on Treasury bills. The relationship between interest rates on these bills and credit rating is the reverse direction - lower interest rates mean a higher credit rating. The growth of the credibility of the country influences to a significant reduction in interest rates and other international financial institutions, foreign government bodies in charge of borrowing abroad. Thus, greater government transparency, and improving the country's credit rating further influence its future costs by new taken loans. Also, credit rating affects the interest rates charged by foreign lenders to the commercial and financial loans to domestic companies and financial institutions that are state owned.

Use of the credit rating of the country is numerous. Credit rating greatly influences the amount of risk premium in the interest rate, at which banks can borrow domestic markets abroad. Any improvement of credit rating reduces the premium and allows cheaper sources of banking resources.

If we observe the economic aspect of country risk rating of the country's credit rating is important because it affects: the flow of foreign direct and portfolio investment, increase interest rates on foreign loans, as well as increasing interest rates in the country. Macroeconomic risk of these trends was to significantly reduce the inflow of foreign investment, and therefore the possibility of occurrence of high and growing balance of payments deficit, which is covered by this investment. The end result would be a violation of macroeconomic stability and reducing the level of economic activity.

THE THREE BIGGEST CREDIT RATING AGENCIES

Not, so long ago, the three most influential rating companies: "Standard and Poor's", "Fitch" and "Moody's", were called witches who settled in the world of finance, when in August 2010, decided to reduce the credit rating of the United States. This decision caused concerns at official Washington on one side and the public attacks on the rating agencies on another. Some reviewers and experts have stressed that the rating agencies were just one of the causes of the global financial crisis which

started in America 2008th year. Especially was emphasized, “Moody’s”, because of the assigned high rating of the company, “Freddie Mac”, which had the support of US government, and then fell into difficulties due to problems with secondary loans. Reviews have been addressed and to the account of the agency “Standard and Poor’s,” because, as critics have argued, their ratings helped to “inflate” a balloon.

The three most influential global rating agencies at the beginning of 2012 were the subject of criticism and anger in the EU’s due to the decision to reduce the rating for the nine member states, including France and Austria.

“Standard and Poor’s” (S&P) is a privately held financial services company with 150 years of tradition, which annually publishes 870 000 ratings and covers 2,000 stock markets. It was founded by Henry Pur Varnam who published “The history of railways and canals in the United States,” which was a document whose purpose was an ode to gather information on financial and technical status of American railroad companies. In 1906. Luther Lee Blake founded the “Standard Statistics Bureau”, and in 1941st year the two companies were merged and established the “Standard & Poor’s Corp.”..

“Moody’s” was founded 1900th by John Moody, but the company did not survive the credit crunch in 1907th year. The company was re-established in 1909. According to official data in 2010 this credit rating agency had revenue of about two billion dollars, with about 4,500 employees in 26 countries worldwide.

“Fitch Ratings” was founded in New York 1913 by John Knowles Fitch. The company has headquarters in Paris, New York and London and has 51 offices worldwide.

The “rating crisis”, which started by the decision of Standard & Poor’s to lower the credit rating of France and Austria, has seen the culmination with the same agency decision to lower the credit rating of the European Fund for financial support from the highest triple A rating to AA +. The decision by Standard & Poor’s to downgrade of the European Fund is expected, because the score of this mechanism depends on the financial rating of euro-zone countries to guarantee it, especially those with the highest rating.

Again, hear the argument that the credit agencies could be triggers of new, more severe financial crisis that Europe would be plunged into decline. It is therefore all the more advocates of the idea of forming an independent European rating agency. This idea was particularly sported by the German which clearly confirms the thesis that the EU does not want to tolerate decisions of “independent” rating agencies from the United States, how much they are based on economic indicators. Solving the debt crisis in the euro - zone is becoming a first-rate political objective, on which depend the survival of the EU. It is therefore more and more advocates for the idea of forming an independent European agency, although the situation was somewhat mitigated by the agency “Moody’s”, which confirmed the superior grade rating of AAA France, although he still is considering whether to keep “stable” outlook for the country.

CREDIT RATING IN EURO-ZONE AND OUTLOOK

France and Austria's credit rating lowered from the maximum AAA to AA + with a negative outlook, meaning that the two countries in the medium term could face another reduction.

In the case of Austria, such a decision was made because of "the Austrian banking sector vulnerability", which is extensively involved in the countries of Eastern Europe and Hungary, countries hard hit by the financial crisis.

France has given a negative outlook because of "deteriorating political, financial and monetary indicators" in the euro area with which the country is closely connected.

France's credit rating lowered for the first time since 1975 This is not good news, but not a disaster, as well.

Maximum credit rating maintained by Germany, the Netherlands, Finland and Luxembourg.

However, Germany has only received such a grade with a stable perspective, while the other three countries it is negative.

One level lowered the ratings of Slovenia (on A +), Slovakia (in A) and Malta (the A-). Slovenia and Malta have given it a negative outlook, while Slovakia has remained stable.

Spain's credit rating downgraded two levels from AA to A, and with a negative outlook or with 33 percent in the midterm to be reduced again if the government fails into implementation of reforms in the labor market.

Italy has also lowered the rating two levels, from A to BBB + with a negative perspective, and 33 percent in the midterm to be lowered again.

Cyprus's credit rating lowered to BB +, or the speculative level, with a negative outlook. Portugal was lowered to BB, also the speculative level, and with a negative outlook.

Belgium (AA), Estonia (AA-) and Ireland (BBB +) are retained in this revision of the existing ratings, but with a negative a perspective

Credit implications of recent worldwide news events

At the beginning of 2012, euro area heads of state or government announce the finalization of Treaties on Stability, Coordination and Governance in the Economic and Monetary Union and on the European Stability Mechanism (ESM). The ESM treaty was subsequently signed on 2 February.

Agreement on these treaties is credit positive for European sovereigns. However, the treaties leave unresolved a number of important areas of concern that will

obstruct a sustained improvement in investor sentiment or in sovereign credit risk. Specifically, they provide no new information on the resources that will be made available to deal with the crisis, or on the prospects for fundamental change to the euro area economic and fiscal framework.

The Treaty on Stability, Coordination and Governance sets out the terms of the 'Fiscal Compact', which will promote sound fiscal governance by requiring euro area governments to preserve strict budgetary controls in national law using provisions 'of binding force and permanent character, preferably constitutional. These will limit structural deficits to 0.5% of GDP and government debt to 60% of GDP other than in 'exceptional circumstances'.

The agreement, which requires ratification by 12 member states to come into force, will allow the European Court of Justice to impose fines on transgressors, unless a qualified majority of euro area states oppose such fines. It also contains measures to improve economic policy coordination and mechanisms to promote economic convergence by strengthening the governance of the euro area, and embraces the European Commission's recent proposal for heightened economic and budgetary surveillance.

The ESM Treaty provides for the ESM's introduction in July 2012 rather than in 2013 as originally planned, with governance changes intended to accelerate decision-making.

The finalization of these Treaties, have an important achievement. The policy initiatives they contain are politically significant, and by reaffirming policy makers' collective commitment to resolve the crisis, their agreement will bolster investor confidence. The Fiscal Compact is a necessary step towards reforming the fiscal architecture of the euro area, which may be bolster by parliamentary support in the stronger states, like Germany, for further financial support to the weaker states.

However, the two treaties provide investors with no new information on the resources that will be deployed to manage the crisis, or on the prospects for more fundamental change to the economic and fiscal framework in the euro area, which are two key areas of concern for investors. While the Fiscal Compact will strengthen collective oversight, the fiscal policy remains substantially the prerogative of national governments. Measures to discourage and penalize rule-breakers have been bolstered, but fall short of automatic correction mechanisms. They are, in effect, a strengthened version of the Stability and Growth Pact, which failed to prevent excessive borrowing by governments during the first decade of the euro's existence. While the authorities have reaffirmed their commitment to move towards closer fiscal and economic integration, no concrete steps have been set to achieve that objective, or to provide clarity over the role that common debt issuance might play in that framework.

Similarly, substantial uncertainty remains over the funds that will be available to the European Financial Stability Fund (EFSF) and the ESM. Net of the €44 billion committed to the Irish and Portuguese programmes and €10 billion intended for Greece, the EFSF has around €286 billion remaining of its €440 billion capacity, while the ESM will have €500 billion. It remains uncertain whether the funds available to the two entities while they coexist will be the sum of the two or a lower amount. Nor is it yet clear how far it will be possible to leverage those funds as policy makers proposed in October. The amount of IMF funding likely to be available remains similarly uncertain.

As a result, there remains considerable uncertainty about the firepower available to the authorities to deal with the crisis. This will continue to weigh on investor sentiment, despite the restatement that private sector involvement in Greece is ‘unique’. We believe that private sector involvement remains an option for improving the debt sustainability of any member state that suffers prolonged loss of access to private debt markets.

In short, whatever the summit’s achievements, its outcome illustrates the challenges the authorities continue to face in developing the crisis management framework and instituting long-term institutional reforms, given the union’s decentralized governance and the tensions inherent in its policy objectives. The need to make collective financial support available for weaker states while maintaining pressure on those states to consolidate their finances, to demand austerity while seeking to promote growth and most fundamentally to achieve more effective collective control over nations’ finances while preserving national sovereignty all continue to pose a significant challenge to policy makers. So long as that remains the case, the credit quality of many sovereigns and banks in the region will remain pressured. In the meantime, a high risk of further shocks persists, including 1) economic shocks emanating from a further deterioration in global growth, 2) political shocks arising from electoral opposition to austerity programs, and 3) financial shocks given fragile confidence in the European banking sector. In this environment, negative pressure on sovereign and bank creditworthiness, and ratings, will remain.

As 92% of Greece’s marketable debt is governed by Greek law, the government has wide latitude in dealing with its outstanding debt. The exhibit below shows that many other euro area sovereigns have a higher proportion of their respective debt governed by domestic law. Although the deterioration in Greece’s credit profile is markedly worse than that of other stressed euro area countries, were another euro area sovereign to require a debt write-down in the future, the substantial proportions of domestic law debt suggest a similar path could be taken to coerce 100% participation from private creditors. Governing Law of Outstanding Sovereign Debt

Table 3

GOVERNING LAW OF OUTSTANDING SOVEREIGN DEBT

Issuer	Proportion of Outstanding Debt Governed by Domestic Law	Proportion of Outstanding Debt Governed by Foreign Law
Germany	100%	
France	100%	
Netherlands		
Belgium	99.8%	0.1% English law
Spain	98.9%	1.1% English law
Italy	97.5%	1.8% US law 0.2% English law 0.5% Other/Not known
Portugal	97.4%	2.6% English law
Greece	92.0%	6.4% English law 0.1% Italian law 1.4% Other/Not known
Ireland	90.8%	0.1% English law 9.1% Other/Not known
Finland	89.4%	9.9% English law 0.4% US law
Austria	88.1%	9.5% English law 1.6% German law 0.1% Italian law

*Note: As of 16 January. Short-term debt is not included .
Source: Moody's Report.*

Remaining countries with AAA credit ratings

As a result of the weakening economy, and following the ratings agency actions, 24/7 Wall St. has decided to re-examine the entire global triple-A landscape. This was taking due to the fact that some nations already seemed to be far less deserving of the triple-A rating category than others. The key assumption here is that the U.S. is no longer a true triple-A-rated nation. This implies that other nations with similar conditions are also at risk of losing their triple-A rating, and that there are really far fewer than 16 true nations in the triple-A club now. The review below includes updated figures from Standard & Poor's and Moody's along with revised statistics from the CIA World Fact-book. Some of the data are sourced from the Economist Intelligence Unit, Fitch, Egan Jones, and elsewhere.

S&P still has a triple-A rating on Australia, Austria, Canada, Denmark, Finland, France, Germany, Netherlands, Norway, Singapore, Sweden, Switzerland, and the United Kingdom. "Other triple-A nations like Liechtenstein and Luxembourg are left out due to their small size and dependence upon other nations. Moody's ratings were also used to make sure that the discrepancies are not overlooked".³⁾

³⁾ [www: world business on msncc,.com](http://www.worldbusinessonmsncc.com)

1. Australia

GDP per capita: \$39,699.358

Australia was a solid AAA earlier this year and nothing has changed. The country faces pressure from floods earlier this year, but the country is rich in natural resources that have to be used to build the world whenever the economy rises again. The low population of 21.5 million, an \$882.4 billion GDP in 2010 projections, vast resource reserves, lower labor costs, and a low unemployment rate all act as a shield of global woes. Its public debt for 2010 was only projected to be 22.4 percent of GDP. The AAA rating given by S&P is stable, and at Moody's it's AAA with a stable outlook.

2. Canada

GDP per capita: \$39,057.444

Canada has a solid triple-A rating, and its deep trading ties to the U.S. doesn't jeopardize it, even if the U.S. has a troubled triple-A with a negative outlook. Canada has huge natural resources and its citizens mostly avoided the real estate and debt bubble that hurt the U.S. The population is under 34 million, its GDP is about \$1.33 trillion, and public debt at the end of 2010 was a mere 34 percent of projected GDP. Neither Moody's nor S&P have any issues with the triple-A ratings and stable outlook, and the expert's take is that Canada is perhaps the safest triple-A rating of all nations in the Western Hemisphere.

3. Denmark

GDP per capita: \$36,449.554

Denmark has a relatively strong economy and claims a well-educated population. The nation has a large dependence on foreign trade for goods and services and a small population of just over 5.5 million. Revised GDP data was put at \$201.7 billion. What helped Denmark so much is that it had a surplus in its balance of payments before the government started spending to drive the economy. Its high property prices are a concern, as is a slowing trade environment. S&P has given a solid AAA with a stable outlook and Moody's has a AAA with a stable outlook. The country has kept the Danish Kroner rather than officially joining the euro. Low birth rates, an aging population, taxation, immigration trends, and climate change are all risks for the small country longer-term by the count of rating companies. However, Denmark has a sub-5 percent unemployment rate and a 2010 debt to GDP of only 46.6 percent. Denmark's triple-A status remains firm here unless its services sector gets hit too hard with land prices all over again.

4. Germany

GDP per capita: \$36,033.284

Germany is still what it call “King of the Euro” with what is now just an under-valued Deutsche mark. With a population of 81.4 million and having the No.5 global economy, it cannot avoid leading the euro zone bailouts. GDP was \$2.94 trillion in 2010 and its unemployment rate is healthy for a European nation. It also has a highly skilled labor force. The growing pains of absorbing East Germany are behind it and the ratings agencies bring no quarrel with its triple-A rating. Budget deficits, subsidies, tax cuts, aging population trends, immigration and the obvious leadership in euro-zone bailouts do pose a risk. Still, public debt is tolerable at 78.8 percent of 2010 GDP. While any continued spending would pose longer-term risks, rating companies take is that Germany will keep a triple-A rating longer than most nations.

5. Holland

GDP per capita: \$40,764.548

Holland, or The Netherlands, is in better shape than many euro-zone countries. Its population is nearly 16.8 million and GDP is roughly \$676.9 billion. A solid labor force, a surplus to its current account, and strong global industry all make it appear better than many euro-zone sister nations. High-tech exports, financial firm’s dominance, and its trade are all lags if and when the next recession takes hold. Budget deficits were high at 4.6 percent of 2009 targets and 5.6 percent of GDP in 2010 per earlier CIA data this year. Public debt is now projected at 64.6 percent of GDP and the ratings agencies have no current issues with the Dutch. They take that the triple-A rating has no severe risk as long as those dikes holding back the sea continue to work just fine.

6. Norway

GDP per capita: \$52,012.506

Norway has one of the best ratings going for it and the Economist Intelligence Unit gave it the only true AAA in earlier reports. The nation is rich in resources with a low population of almost 4.7 million people. GDP is highly dependent on the price of oil and was about \$255.3 billion, and unemployment remains very low. Public debt was 47.7 percent of GDP. Norway is just about self-sufficient even if the climate of ‘welfare capitalism’ exists with close to 50 percent of exports being in oil. It also has the world’s second largest sovereign wealth fund valued at more than \$500 billion. S&P and Moody’s have no issue with the triple-A ratings.

7. Singapore

GDP per capita: \$56,521.731

Singapore is the sole Southeast Asian nation with a solid triple-A rating. Despite a reliance on foreign trade exports, investors consider Singapore the safest place today for Asia. Its population is tiny at 4.74 million and its revised GDP is \$291.9 billion. Singapore did not avoid the recession, but it also proved to bounce back the most. Public debt is artificially high at 102.4 percent of GDP but that is a government tie of the Central Provident Fund. Imagine this for austerity measures: Singapore has actually not borrowed to finance any government deficits since the 1980s. S&P and Moody's give AAA rating and positive outlook. The only obvious risks are military action, climate change, or an unknown geological event. Barring those, Singapore has as solid of a triple-A status as they come.

8. Sweden

GDP per capita: \$38,031.484

Sweden is the largest of Scandinavian nations with nearly 9.1 million people. GDP was \$354.7 billion per revised 2010 CIA data. Public debt in 2010 was 40.8 percent of GDP, shockingly low for Europe and Scandinavia. The nation was also not wrecked by World War II due to its neutral-nation status. Still, the country does rely heavily on exports; it was not immune from the recession; and it has reformed some financial policies while recovering. Immigration and population trends have been an issue, but the ratings agencies actually have no issue with its triple-A status.

9. Switzerland

GDP per capita: \$41,663.047

Switzerland has only grown in standing since the woes of Europe and the world have grown in 2011. The solid triple-A status appears to be immune to the happenings around its border nations. The world's banking center has actually had to warn that it might intervene if its currency strengthens too much more because it cannot export if other currencies keep falling. The mountain nation has a population of just over 7.6 million and 2010 revised GDP of about \$324.5 billion. Unemployment is shockingly low; public debt is still at 38.2 percent per revised 2010 data; its taxation is rather low; its healthcare system is a blended mechanism; there are barriers to getting citizenship; and a sensible retirement model all combine to offer no real threats at all to the triple-A rating here.

CONCLUSION

Country risk is the possibility that the borrower can not reconcile its commitment to the foreign creditor for political, social, legal and economic upheaval that is happening in his country. He basically has three components: political risk, transfer risk and sovereign risk, risk assessment methodology of one country includes qualitative and quantitative analysis of political, economic, social and natural environment in the country where the loan is approved. The analysis of country risk typically results in a kind of index that includes a variety of weighted variables derived for each country. As an indicator of the country risk, most commonly is used the ratio of differences between the export earnings (Ee) and import costs (Ic), on the one hand and the amount of mandatory debt service, on the other.

Credit rating is a credit rating of the state. The process of awarding rating is based on a detailed qualitative and quantitative analysis of the creditworthiness of countries, including: political risk, income and economic structure, the prospects for future economic growth, fiscal and monetary flexibility, general government debt, external liquidity, and by the public and private sector. Most financial institutions use the country risk rating numerical scale (usually from 1 to 10) or letters of rating agencies (ie, AAA to D) used for the ranking of credit risk. Some of the biggest agencies involved in the ranking of countries according risks are Moody's Investor Service, Standard and Poor's and Euromoney. These countries assigned ratings ranging AAA/Aaaa/A3 to C / D, which indicates the willingness of the state to repay its commercial debt in full, and on time. Credit rating has an impact on its position in the international capital market, the movement of interest rates and the inflow of foreign investment. Should be distinguished rating of the subject and I rating of the country in which the same is, where it should be noted that the impact of the two ratings made on one another.

Generally, a high credit rating certainly has a positive impact on its position in the international capital market, the movement of interest rates and the inflow of foreign investment.

Credit rating is very important for potential foreign investors on the basis of getting a kind of assessment of the economy of the country you intend to invest, which is important information for the government to be able to properly assess the situation and take necessary steps to his promotion.

A bad credit rating is a central obstacle to future economic growth, which is why all the reform measures is largely dependent on success in improving the quality of these dimensions of the macroeconomic environment.

Reviews and assessments by rating agencies are particularly important for countries that are potential new markets, as investors respect the assessment by rating agencies. On the basis of credit assessments investors have access to credit risk and the ability of states, which directs and assists them in investment strategies. Rating contributes to better transparency and better information about the country.

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IMPORTANCE OF INNOVATION AND DYNAMICS OF CHANGES IN COMPETITIVENESS ENHANCEMENT PRODUCTION PROGRAMS OF MACEDONIAN COMPANIES

Abstract

Innovation and successful internationalization of companies on the global market are closely related to competitiveness. Any form of innovation, technology innovation (process and product innovation), organization innovation, service or process innovation has influence on the competitive capacity of modern companies to offer competitive products or services.

Regarding competitiveness, the Republic of Macedonia belongs to the group of countries whose economies are efficiency-driven, and from the perspective of business sophistication, companies/exporters mainly rely on traditional industries and uncompetitive products with low value added. There is a lack of innovation and new product development, as well as of quality, design, branding, promotion, etc.

One of the main reasons for such situation is in that the Republic of Macedonia entered the independence period with negative tendencies in technology development, with inappropriate structure and obsolete technology and technical equipment in production processes, especially in leading industries, mainly labor intensive and on low technology development level. Country's technology development weaknesses came mostly to the fore in the product policy area. In a large number of companies, rapid production program changes have not been a permanent component of their business strategies, which added considerably to low competitiveness on the global market.

Keywords: competitiveness, new products, innovation, technology development

JEL classification: M31, O31

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Introduction

Survival and growth of an economy in a globalizing environment is not possible without market orientation of companies, more exactly orientation toward consumer needs and desires. Real market orientation by winning and retaining certain market segment can be accomplished merely by achieving appropriate competitiveness, which will be based on innovation, development, and improvement of the products or services offered.

The unfavorable foreign trade exchange standing of the Republic of Macedonia is a result of the low competitiveness of Macedonian companies on foreign markets. Low competitiveness also constitutes a kind of deterrent to a more serious market relations development, whereas adding value to Macedonian products is the only way of export competitiveness improvement.

Competitiveness is largely determined by development specificities and stages of individual national economies, product nature, and market conditions. In an era of economy of knowledge, economic growth depends mainly on the capability to implement new technologies and on innovation in developing new products and services, which has an effect on competitiveness maintaining and improvement in global realms.

Technology development constitutes one of the fundamental drivers of overall economic development, and is an outstandingly important factor of the global economy and international economic cooperation. Technology development by its effects causes a number of structural changes in the material production as a whole, and allows social productivity increase and higher efficiency in using all available resources. The effects of technology development are also recognizable in company activity and development, especially with the view to equipment modernization and introduction of new production processes, as well as in the area of product policy.

1. OVERVIEW OF COMPETITIVENESS OF THE MACEDONIAN ECONOMY

Competitiveness is a concept which must be inevitably adopted and one must insist on its incorporation in any deliberation on creating policies and strategies of both companies and national economies. Thereby, its complexity needs to be considered as being multilayered, interdisciplinary, multidimensional, and intersectoral a category.

Competitiveness can be observed on multiple levels: macro, meso-, and micro. Micro aspects of competitiveness are related to factors and mechanisms of competitive adjustment on company level, meso-aspects on sectorial level, whereas macro aspects refer to the national economy. However, it has to be emphasized that this is a conditional division, because competitiveness is mostly a combination of company, industry, sectoral, and national performance, and constitutes an aggregate indicator

on national economy's rating on the global market. Competitiveness enhancement on company level inevitably leads both to higher competitiveness of the respective sector and the country's economy as a whole, and vice versa.

Competitiveness is also multidimensional a concept. Its multidimensionality results from the vast number of factors which determine it, and the even larger number of tools which are used in competitive adjustment.

In different time periods and under different conditions prevailing both in individual national economies and globally, the impact and relative importance of competitiveness factors undergo changes. However, not all national economies and all producers are able to follow such trends.

Technology progress and technology process improvements have allowed companies to reduce production-, organization-, and distribution- costs to the minimum, and to increase the price-based competitive advantage. However, under current conditions non-price factors get higher importance for competitiveness enhancement, mostly of which quality, technology advantages, industry specialization, business environment, marketing practices, etc.¹⁾ Thereby, quality is considered to be integrative of all other non-price competitiveness factors and it can sublimate their subsequent effects.

Developed countries consider competitiveness as an issue of aggregate expression of specific global features of a national economy. As a foreign trade phenomenon, it is a structural characteristic of an economy, and good criteria basis for identifying problems on company, sectorial, and national economy level.

According to the Global Competitiveness Index (World Economic Forum – WEF), since 2007 the Republic of Macedonia has been in the group of countries that are in the second development stage regarding their national economy's competitiveness, i.e. countries driven by factors which increase production efficiency (**Table 1**).

In the area of innovation and business sophistication, in 2011 Macedonia was ranked 105th. Business sophistication takes into account the quality of country's overall business networking, as well as the quality of companies' activities and strategies (branding, marketing practices, presence of value chains, production of unique and sophisticated products), which lead to sophisticated and modern business processes. An analysis of the structure of this index allows one to conclude that regarding business sophistication, Macedonian companies/exporters are mainly active in resource extraction or production industries (metals and textile), unlike developed countries, where companies are focused in product design, marketing and sales, logistics, and after-sales services.

¹⁾ J. Monteagudo and F. Montaruli, European Commission, Directorate General for Economic and Financial Affairs, Analysing non-price competitiveness in euro area countries, www.tesoro.it/export/sites/sitodt/modules/documenti_it.., (15.11.2011)

Table 1

WEF'S RANKING OF REPUBLIC OF MACEDONIA BY THE GCI

WEF	2007 (131)	2008 (134)	2009 (133)	2010 (139)	2011 (142)
The Global Competitiveness Index	94	89	84	79	79
Subindex: Basic requirements	72	68	73	70	69
Institutions	102	90	83	80	81
Infrastructure	85	89	90	91	86
Macroeconomic environment	53	31	49	47	37
Health and primary education	47	55	60	69	80
Subindex: Efficiency enhancers	98	92	85	83	87
Higher education and training	75	73	70	72	80
Goods' market efficiency	98	98	76	57	63
Labor market efficiency	112	113	86	71	72
Financial market development	83	83	75	87	82
Technological readiness	90	83	52	64	67
Market size	106	104	103	106	107
Subindex: Innovation and sophistication	101	105	93	97	104
Business sophistication	108	107	96	96	105
Innovation	92	99	92	97	105

WEF's ranking of Republic of Macedonia by the GCI

In the stage of efficiency-driven economies, where the Republic of Macedonia has to transit, competitiveness does not rely on low prices, but rather on product quality, enhanced productivity, and innovation. Since productivity has already increased the labor price, in this stage one has to also increase technology processes efficiency, and products and services quality. This is a preparation for proceeding to the third stage of innovation-driven economies, where competitive advantages are a result of production processes sophistication and production of new, sophisticated products and services with maximum value added.²⁾

2. FOREIGN TRADE EXCHANGE DYNAMICS AND STRUCTURE AND FOREIGN MARKETS COMPETITIVENESS

Trade competitiveness is often a verification of competitiveness on foreign markets. It is a priority for Macedonia as a small, open economy, which must constantly enhance its export potentials.

Total trade exchange figures (**Table 2 and Graph 1**) show the growth dynamics of export and import, as well as of the trade deficit, which is an important indicator for measuring economy's competitiveness. In the past two-year period, it is observable that export and import have constant growth, which is particularly accentuated in the last 5-6 years, notwithstanding the 2009 data, when economic crisis had negative

²⁾ Национален извештај за конкурентност 2010, p. 10-11

Table 2

FOREIGN TRADE EXCHANGE OF THE REPUBLIC OF MACEDONIA

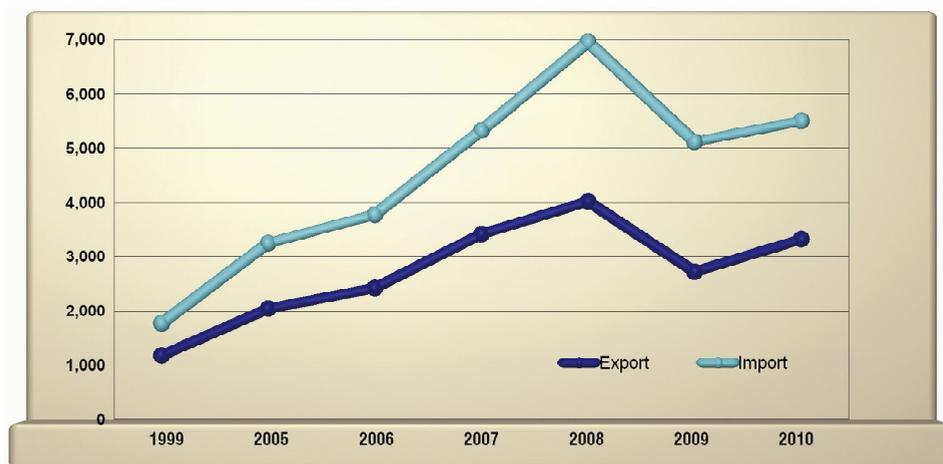
In USD mil.

	1999	2005	2006	2007	2008	2009	2010
Export	1,191.3	2,042.3	2,415.2	3,398.3	3,990.6	2,708.5	3,301.8
Import	1,776.1	3,232.8	3,752.3	5,280.6	6,882.7	5,072.8	5,450.7
Total trade exch.	2,967.4	5,275.1	6,167.4	8,678.9	10,873.3	7,781.3	8,752.5
Trade deficit	-584.9	-1,190.5	-1,337.1	-1,882.3	-2,892.0	-2,364.3	-2,148.8

Source: State Statistical Office of RM

Graph 1

FOREIGN TRADE EXCHANGE OF THE REPUBLIC OF MACEDONIA



Source: State Statistical Office of RM

effects on the overall foreign trade exchange. As the growth of import is higher than the growth of export, a constant and ever increasing trade deficit has been created.

Graph 1 indicates that both export and import grow constantly. Export and import trends are almost parallel, and the rate of export growth is equal to the rate of import growth, which points to import dependency of the export.

In order to analyze trade competitiveness, it is necessary to analyze the production structure of Macedonian export and import. This is indicative of the sustainability of export growth, which is directly dependent on global trends and on the existence of export products with higher value added, which in fact constitutes economy's export competitiveness.³⁾

³⁾ Мајсторска Јасмина, Извозната промоција како еден од инструментите на индустриската политика (докторска дисертација), Скопје 2011, p.179

Foreign trade exchange structure is usually analyzed from multiple aspects. For labor purposes it is analyzed according to economic function of products, by industries and products.

Table 3 shows the export structure according to economic function of products, i.e. the level of finalization, which allows for identification of the value added in products of this category as well.

Table 3

**MACEDONIAN EXPORT ACCORDING TO ECONOMIC
FUNCTION OF PRODUCTS**

	<i>In USD mil.</i>						
	1999	2005	2006	2007	2008	2009	2010
Total	1,191.27	2,042.3	2,415.2	3,398.3	3,990.6	2,708.5	3,301.8
1. Reproduction goods	565.11	1,110.4	1,398.9	2,086.1	2,444.1	1,369.3	1,949.3
Crude materials and semi-products	432.01	787.7	1,003.8	1,694.9	1,868.3	971.5	1,504.0
Power generation fuels	20.16	161.9	223.7	164.2	310.6	201.6	256.2
Final reproduction goods	112.94	160.8	171.4	227.0	265.1	196.2	189.1
2. Instruments of labor	37.16	39.9	51.5	76.6	133.9	125.8	105.5
Plant machinery	2.6	1.0	0.7	1.6	2.0	4.7	0.6
Agriculture machinery	0.23	0.6	0.3	0.8	0.8	0.7	0.8
Metal processing machinery	0.59	0.7	0.7	0.8	0.8	0.4	1.1
Other machines and devices	5.29	7.7	10.9	18.9	23.4	24.8	49.3
Electric machines and devices	8.2	10.1	13.3	17.4	28.4	36.0	11.7
Transportation means	6.57	7.4	2.1	2.6	2.3	3.1	4.8
Other investment related goods	13.68	12.3	23.6	34.6	76.2	56.1	37.3
3. Consumer goods	563.7	891.2	964.7	1,235.6	1,412.6	1,213.3	1,247.0
Food products	63.16	163.5	188.5	245.6	309.3	276.8	326.6
Beverages and tobacco	81.98	74.3	100.0	121.8	121.3	109.0	107.1
Garments and footwear	351.88	535.7	552.3	707.0	775.8	641.9	615.8
Furniture	6.32	8.1	10.8	18.3	24.1	21.9	23.3
Textile (except garments)	17.91	28.7	21.2	22.8	24.4	16.8	27.1
Medical and pharmaceutical cosmetics	25.24	44.7	46.6	58.2	77.9	74.6	78.1
Other consumer goods	17.2	36.3	45.3	61.8	79.8	72.3	69.0
4. Unknown	25.3	0.8	0.0	0.0	0.0	0.0	0.0

Source: State Statistical Office of RM

Data of the foregoing table lead to the conclusion that Macedonian export grows mainly as a result of the export of reproduction goods and instruments of labor. Consumer goods, which are characterized by higher value added, brands, and recognizability, contribute less to export growth.

Further to **Table 4**, export structure by industries confirms the foregoing conclusions on export growth dynamics. It can be noticed that the share of crude materials and mineral fuels is increasing, whereas the share of final products is dropping.

Table 4

EXPORT STRUCTURE

SITC sectors	<i>In %</i>						
	1999	2005	2006	2007	2008	2009	2010
Food products	5.6	8.2	8.0	7.4	7.8	10.5	10.0
Beverages and tobacco	13.4	8.0	8.0	6.2	5.5	7.3	6.1
Crude materials except fuels	4.3	3.3	4.7	5.1	6.8	6.4	7.9
Mineral fuels, lubricants	1.9	8.0	9.4	4.9	7.9	7.5	7.8
Animal and vegetable oils and fats	0.0	0.1	0.1	0.1	0.3	0.3	0.3
Chemical products	4.6	4.4	4.2	3.9	4.6	6.4	11.6
Manufactured goods classified by material	29.7	33.4	35.5	44.8	40.2	28.6	30.0
Machinery and transport devices	7.0	5.4	4.9	4.5	4.6	5.3	4.6
Miscellaneous manufactured goods	31.3	28.9	25.2	23.1	22.3	27.5	21.7
Transactions and commodities n.e.s.	0.0	0.2	0.1	0.1	0.1	0.0	0.1
TOTAL	100.0						

Source: State Statistical Office of RM and estimates by authors

With a view to the nature of Macedonian export over a longer period of time, it is observable that its growth is actually a result of the export of larger quantities of ever the same (traditional) Macedonian export products. Namely, over a period of nearly 20 years, and even in the past 30 years or so, Macedonian export has mainly relied on more or less 10 products, which account for about 2/3 of the total: iron and steel, garments (i.e. ready-to-make production and finalization), and to a lesser extent fruits and vegetables (fresh, not processed), beverages (this includes wine), tobacco (unprocessed), metal scrap, medical and pharmaceutical products, processed metal goods, parts for electric machines, and footwear, and in the last few years export of petroleum is present (to Kosovo).

This suggests that Macedonian export growth is not in fact a result of embarking on production of goods with higher value added, which have higher prices on foreign markets, but rather of the production and export of larger quantities of the traditional textile products (made by finalization and processing), as well as metals (iron, steel, and alloys), which in the last few years experience price growth on the world market (i.e. on commodity exchanges). In addition, the structure of Macedonian export is characterized by weak innovation and production programs' changes, which is one of the main reasons for the low trade competitiveness. The export structure based on production of goods with low degrees of processing and low value added (eg. ready-to-make production of textiles, metals etc.), cannot make a foundation for rapid and sustainable economic growth.

The structure of Macedonian export in the period after declaration of country's independence points to the following two conclusions, which are affirmative of the low level of export competitiveness:⁴⁾

- *The structure of Macedonian export products has experienced very few changes during the 20-year period of transition, and*
- *Macedonian export products have a very small component of value added.*

According to this analysis, in a period of about 20 years there has been no significant change in the production structure of the Macedonian economy, mostly as a result of the absence of an active and efficient industrial policy. Furthermore, Macedonian economy's export competitiveness is based on three product groups (clusters): crude materials/metals, textile/clothing, and food products/beverages. Thereby, the majority of crude materials/metals cluster products are either primary or semi-products, intended for further processing and finalization. The majority of companies that manufacture textile and clothing have contracts with foreign partners for providing sewing services by using law-skilled female labor. In the case of food products/beverages, Macedonian export products include mostly primary agriculture goods, which are distributed on regional (neighboring) markets. The export of petroleum/chemical products is growing in volume in the last few years due to the sales of oil derivatives of the OKTA Refinery to Kosovo.⁵⁾

It may be concluded that the Republic of Macedonia is still a traditional economy that is not restructured, and with no diversified and competitive production base. With a purpose of raising the Republic of Macedonia to a higher stage of economic development compared to other countries in the world, it is necessary to provide support for development, as well as to enhance the competitiveness of Macedonian products and services through knowledge, implementation of new technologies, innovation, and production programs modification.

3. INNOVATION AND MODIFICATION OF PRODUCTION PROGRAMS OF MACEDONIAN COMPANIES – TRENDS AND RECENT DEVELOPMENTS

Production range improvements, by introducing new and modification of the existing products, are of great importance for operation efficiency, and particularly

⁴⁾ Узунов Ванчо: Конкурентноста на македонската економија во текот на транзициониот период (1991-2011), труд презентирани на меѓународната конференција на тема: Регионалната трговска интеграција на земјите од Југоисточна Европа: придобивки и предизвици, одржана на 12.12.2011, Скопје (во фаза на објавување)

⁵⁾ Ibid

for company's competitiveness on the global market. Companies are trying various innovation strategies to enhance and ensure their competitive ability.⁶⁾

Specialization may bring high competence and highly achieved competitiveness level of the leading products. However, this is not a characteristic of the leading export products of the Republic of Macedonia, and the stated situation is more a result of the weak performance of the economy, and its inability to diversify its supply. Furthermore, a highly simplified export program is very sensitive to market fluctuations. In that regard, in the case of Macedonian economy it is about structural problems of a longer-term character, and the present export focus in several leading products may be defined as negative.

Should one also consider the even greater concentration of exports by countries, it becomes even more clear that the problems are more complex and that solutions need to be searched in profound and thoughtful long-term strategic interventions. Identifying the reasons for, and finding the ways out of the unfavorable situation need thorough analyses by the "country by country" and "product by product" approach.

The goal of ensuring good product or service in absolute terms, and being better than the competition, assumes making a competitive advantage and keeping it in place. Strategic competitive advantage understands achieving certain supremacy compared to the competition, which must meet the following three criteria:⁷⁾

1. Such advantage or supremacy must refer to product's (or service's) properties that are important to consumers;
2. The advantage must be noticed by consumers; and
3. The advantage is not to be achieved quickly by competitors, i.e. it has to be of permanent character, to be "sustainable" or "defendable" on a long term.

Macedonian economy was increasingly less able to offer complete production programs on foreign markets, particularly products of higher degrees of processing. Negative consequences of the absence of marketing oriented product policies have their manifestation primarily in the relatively narrow, insufficiently thorough and consistent production programs, as well as in the slow dynamics of changes regarding introduction of new, modification of existing, and abandonment of outdated products. Majority of products have carried the attribute "new" only from the perspective of particular companies. The innovation process has got local character, since products

⁶⁾ Eg. preferences in the US are placed in product innovation, in Japan in process innovation; in Germany, on the other hand, a focus in the technological side of innovation is evident, whereas it is supposed that Italians strongly focus their innovation toward the market and consumers.

⁷⁾ H. Simon: Management strateischer Wettbewerbsvorteile, Zeitschrift für Betriebswirtschaft, April, 1988, p. 465, (Cited according to: Prof. R. Senik PhD: Inovativnost kao izvor konkurentske prednosti savremenog preduzeka, "Poslovna politika", januari / 1992, Beograd, p. 53)

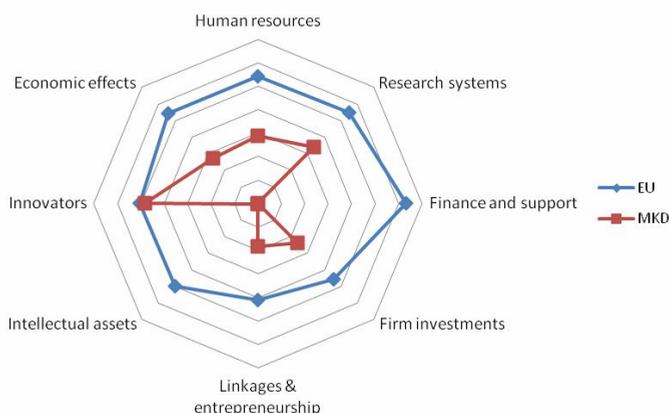
have not been achieving the quality that would promote them as new, highly competitive products.

Analyses made in the European Union regarding the interrelation of internationalization and innovation show that internationally active enterprises introduce more process and product innovation than enterprises that are not internationally active. Almost half of internationally active enterprises introduce certain kind of innovation in the recent three years (the average for all active enterprises is about 20%), and 60% of internationally active enterprises develop their innovation internally. Here is strongly emphasized the effect of “learning from internationalization/export”, which opens possibilities for access to new knowledge and technologies that are not available on the national market, but this is also a result of exposure to strong competition and constant pressure to keep the position on the market. The role of foreign companies as catalysts on the national market that encourage national companies’ innovation should not be disregarded as well. It is also interesting that enterprises which have developed internationalization plans are more innovative in their activities compared to enterprises with no such ambitions.⁸⁾

According to the Innovation Union Scoreboard’s (IUS) [previously known as European Innovation Scoreboard (EIS)] analysis of the 25 indicators (based on eight groups of factors), compared to EU-27 the Republic of Macedonia is on the bottom regarding company investments for introducing new products or production processes. The same analysis states that one of the greatest weaknesses is low spending on companies’ R&D (**Graph 2**).

Graph 2

2010 INNOVATION INDEX FOR EU-27 AND MACEDONIA



Source: *Innovation Union Scoreboard 2010 Database*

⁸⁾ EU Commission, DG Enterprise and Industry (2010), Internationalisation of European SMEs, Final Report

Table 5 presents the results of the research of Macedonian companies which have introduced various types of innovation in the period between 2008 and 2010. GfK's research finds that 56% of the companies are innovative, 19% are very innovative, 2% are extremely innovative, and only 23% are insufficiently innovative.⁹⁾

Table 5

INNOVATION TYPES OF MACEDONIAN COMPANIES

Country	EU-27		Macedonia	
	CIS	CIS (1980 companies)	CIS (1980 companies)	GfK (492 companies)
Innovation type introduced by companies in the recent three years				
New product or service	34%	39.2%	17%	34.6%
Process innovation			19%	23.2%
Marketing innovation	39%	30.8%	32%	33.3%
Organization innovation			29%	23.8%

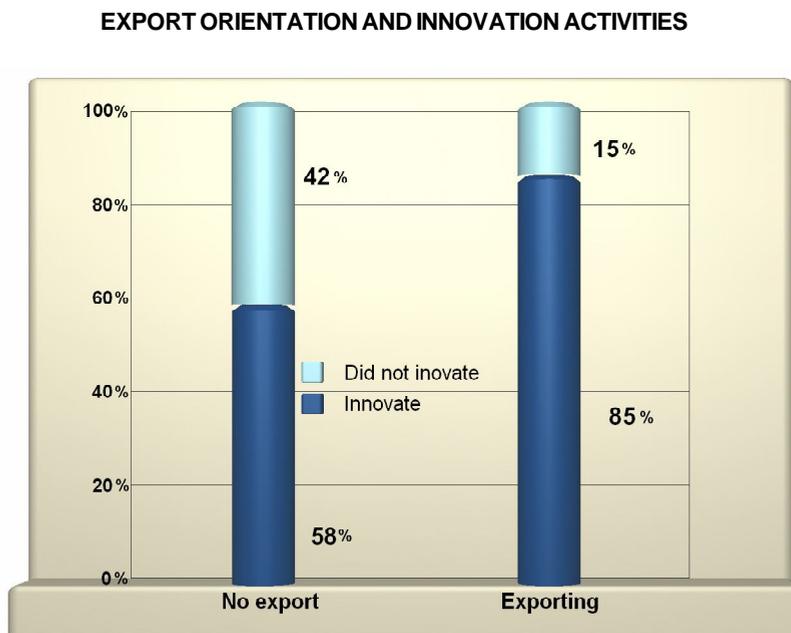
Source: OECD: review of the National Innovation system of RM, 2010, p.45

During recent three years, more than half of the companies have introduced certain innovation, which improved their competitiveness performance on the market. Analyses show that micro companies have limited access to innovation activities, and almost half of them do not introduce any form of innovation. It is significantly characteristic that export companies innovate more often than those oriented merely toward the national market. About 85% have at least one innovation in the period 2008-2010, whereas only 58% of those that do not export have made innovation in the same period (**Graph 3**). Innovation is crucial for enhancing company efficiency and productivity, and creates possibilities for higher differentiation and competitiveness on export markets.

To increase their interest in, and need for, introducing innovation and new items in production programs, companies also need government support, through implementation of measures and policies for advancement and improvement.

⁹⁾ "OECD Questionnaire on innovation activities of private companies" – internal document for the purposes of the Regional Competitiveness Initiative, a three year project funded by the European Union with focus on Development of Macedonian Innovation Policy 2012-2020

Graph 3



Source: OECD: *Review of the National Innovation system of RM, 2010* p.47.

CONCLUSION

An analysis of the export structure of Macedonian companies leads to the conclusion that this structure is not sufficiently competitive. Namely, export mainly relies on traditional industries and products, with low value added, of which majority are not competitive. Innovation and development of new products is absent, as well as quality, design, branding, promotion, and there is high dependability on imported raw-materials, which make Macedonian exports more expensive and uncompetitive.

In the production structure dominate products of low degrees of processing, and there is also weak company orientation toward innovation or new product development, which would differentiate them on the market. Products of low degrees of processing (primary and homogeneous) and standardized commodity exchange products (which are mainly goods for reproductive consumption), do not allow the possibility of making differential advantages against competition. Such structure is a consequence of numerous legacies from the past, which linger for decades. These are: low volume of investments and R&D activities, obsolete production equipment, outdated technology processes, low production capacity usage, low productivity, etc. With a purpose of creating a possibility for inclusion of the Macedonian economy in the global competitiveness arena on an equitable level, it is necessary to first resolve the problems that result from the aforementioned developments.

the problems that result from the aforementioned developments.

Economy's orientation toward knowledge and innovation provides long-term competitiveness, diversified production, and active participation on the international market. Further to the Lisbon Strategy, and the new EU 2020 strategy, commitments to increasing investments in innovation and R&D up to 3% of GDP remain unchanged. This implies increase of public and private support to R&D and innovation, whereby two thirds of R&D investments have to come from the business sector, i.e. from the companies themselves.

Certainly, innovation development needs regulation which is predictable, supportive of new products and services development, and which provides protection of intellectual property and operation standards. The industrial policy of the Republic of Macedonia, beside its other measures, supports innovativeness, applied research, and innovation development. Basically, from innovation perspective, as an integrated policy it is focused in awareness raising for promoting innovation development and applied R&D of innovation-driven industries.

An important role in innovation support belongs to clusters, as a form of linking companies, which helps in promoting cooperation between business, research, and financial sources. Clusters stimulate productivity, attract investments, promote research, strengthen industrial foundations, develop particular products and services, and become a front for developing special skills.

An important prerequisite for technology innovation success is social innovation. It means that not any technology innovation focused in production process improvement will have an ultimate success, unless company's organization structure undergoes innovation. It means that it is necessary to make significant changes in the overall production organization.

Innovation contributes to brand development and to attracting new consumers, as well as to keeping the existing ones. Because of this, one needs to stimulate creativity at any level, which will result in new ideas and new projects for innovative products and services with higher value added, which, on the other hand, also opens the possibility for extending the markets and the competitive opportunities of Macedonian companies on the global market.

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Verica JANESKA *)

HIGHER EDUCATION REFORMS AND GRADUATE UNEMPLOYMENT IN THE REPUBLIC OF MACEDONIA

Abstract

The paper addresses the graduate unemployment changes in the Republic of Macedonia in the context of the profound reform activities in the higher education. The reforms in the tertiary education and the inflow of the graduate students, the scope and main characteristics of the graduate unemployment in the country, as well as its consequences and implications of the manifested changes are elaborated. Since 2006, the enrolment rates noted significant rise and resulted in almost doubled inflow of graduated students. These trends were accompanied by increase in the graduate unemployment rates, amounting about 22.7% in 2010. Consequences and implications of such changes are numerous and are manifested in many domains, including the brain drain increase. The importance of the policy initiatives in the higher education, in terms of employability skills development, career management learning, entrepreneurship and innovation as well as macro policy options for promoting economic growth with jobs are identified as an essential precondition for decrease of the graduate unemployment in the country.

Keywords: Higher education, enrolment rate, unemployment, graduate unemployment, brain drain

JEL classification: J210

Introduction

The established framework for socio-economic and political changes during 1990s, determined by the collapse of communist regimes and rising political hegemo-

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ny of neo-liberal market ideologies, asserts considerable reform pressure on all sectors of society, including higher education. At the same time, the process of globalization was intensified. Thereat, there is a general agreement that most nation states are going through a transformation process that is strongly affected by global trends and pressures, which form an important basis for national public sector reforms with respect to higher education¹⁾.

Globalization, a key reality in the 21st century, has already profoundly influenced higher education. The process of globalization is the reality shaped by an increasingly integrated world economy, new information and communications technology (ICT), the emergence of an international knowledge network, the role of the English language, and other forces beyond the control of academic institutions²⁾. At the same time, the higher education has faced the challenge of massification, which includes greater social mobility for a growing segment of the population, new patterns of higher education funding, increasingly diversified higher education systems in most countries, an overall lowering of academic standards and other tendencies.

Profound reforms in the educational system in the Republic of Macedonia started at the beginning of the previous decade. They were particularly emphasized in higher education and accompanied by the phenomena of massification, due to the significant changes in the enrolment rates. These reforms resulted in continuous increase of the number of graduate students and notable changes in the educational structure of the labor force in the last few years. The aim of this paper is to identify the impact of the higher education reforms on the increase of the graduate unemployment in the country. The analysis would be focused on relevant aspects of the global trends in higher education and graduate unemployment, reforms in the tertiary education and the inflow of the graduate students on the labour market in the Republic of Macedonia, the scope and main characteristics of the graduate unemployment in the country, as well as its consequences and implications of the manifested changes.

The analysis is referring to the inflow dynamics of the graduate students in the Republic of Macedonia in the period 1990-2010 and on the graduate unemployment features since 1996, on national level. The observation of the trends of the above mentioned aspects was done by use of the available data from State Statistical Office, in particular data published in the Statistical Reviews and Labor Force Survey (LFS).

1) Transformation in Higher Education - Global Pressure and Local Realities, (group of authors) Higher Education Dynamics, 2006, Volume 10, <http://www.springerlink.com/content/j4g5m6216646112q/>

2) Trends in Global Higher Education: Tracking an Academic Revolution, Executive Summary (Philip G. Altbach, Liz Reisberg, Laura E. Rumbley), A Report Prepared for the UNESCO 2009 World Conference on Higher Education UNESCO, Paris, 2009, p. 8.

1. GLOBAL TRENDS IN HIGHER EDUCATION AND GRADUATE UNEMPLOYMENT

Since the beginning of 1990s, the economic growth and the spread of democracy have raised the value of education and increased the importance of ensuring that all segments of the population have access to high quality education. At the same time, the education reforms were increasingly driven by growing meaning of the human resources, i.e. human capital as one of the most important determinants of the economic and social development.

In this respect, the tertiary education serves as a major determinant of economic competitiveness in the knowledge based economy. The imperative for all countries is to raise higher-level employment skills, to sustain a globally competitive research base and to improve knowledge dissemination to the benefit of society. Tertiary education contributes to social and economic development through four major missions³⁾:

- The formation of human capital (primarily through teaching);
- The building of knowledge bases (primarily through research and knowledge development);
- The dissemination and use of knowledge (primarily through interactions with knowledge users);
- The maintenance of knowledge (inter-generational storage and transmission of knowledge).

In last two decades, the scope, importance and qualitative features of the tertiary education have changed significantly i.e. its expansion has been remarkable. According to OECD, around 132 millions students in the world have enrolled the tertiary education in 2004, against 68 millions in 1991. Average annual growth in tertiary enrolment over the period 1991-2004 stood at 5.1% worldwide⁴⁾.

Since 2000, this trend was intensified. The available data shows that, globally, the share of the age cohort enrolled in tertiary education has grown from 19% (2000) to 26% (2007), with the most dramatic gains in upper middle and upper income countries (Figure 1). In 2007, there were some 150.6 million tertiary students globally or around 53% more than in 2000. The available data shows that in the low-income countries, the tertiary-level participation has improved only marginally, from 5% to 7% respectively. Sub-Saharan Africa has the lowest participation rate in the world (5%). In Latin America, the enrolment is still less than half of that of the high-income

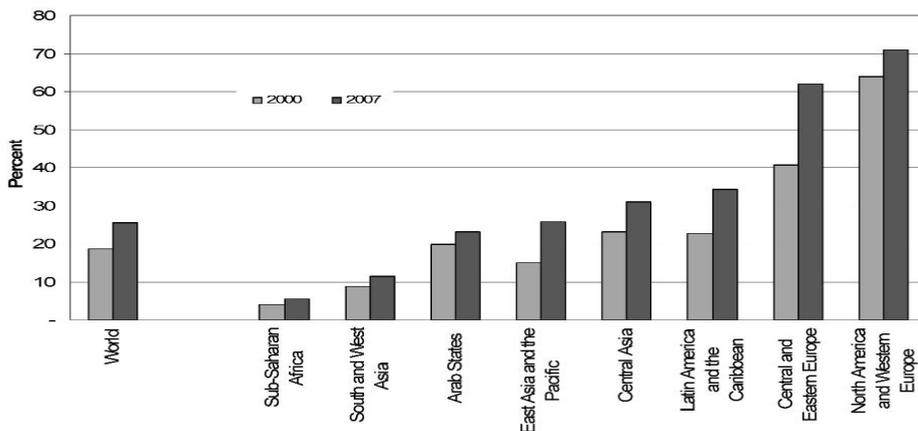
³⁾ Tertiary Education for the Knowledge Society, Thematic Review of Tertiary Education: Synthesis Report, Overview, OECD, 2008, p. 4. <http://www.oecd.org/dataoecd/20/4/40345176>.

⁴⁾ *Ibid.*, p. 5

countries. The attendance entails significant private costs, which, in average, amount up to 60% of GDP per capita⁵).

Figure 1

TERTIARY GROSS ENROLMENT RATIO BY GEOGRAPHICAL REGION, 2000 AND 2007



Source: Trends in Global Higher Education: Tracking an Academic Revolution, Executive Summary (Philip G. Altbach, Liz Reisberg, Laura E. Rumbley), A Report Prepared for the UNESCO 2009 World Conference on Higher Education, UNESCO, Paris, 2009, p. 8.

The growth of private higher education worldwide has been one of the most remarkable developments of the past several decades. Today, about 30% of the global higher education enrolment is private⁶). The private higher education exists in many countries, but it has traditionally been the dominant force in East Asian countries. In Indonesia, Japan, the Philippines and the Republic of Korea, the private higher education enrolment has share of over 70% in the total enrollment.

The information presented on the UNESCO World Conference on Higher Education in 2009, shows that: the private sector currently educates more than half of the student population in such countries as Mexico, Brazil, and Chile; private universities are rapidly expanding in Central and Eastern Europe, in the countries of the former Soviet Union and in Africa; China and India have significant private sectors as well. In general, the private sector is “demand absorbing”, offering access to students who

⁵) Trends in Global Higher Education: Tracking an Academic Revolution, Executive Summary (Philip G. Altbach, Liz Reisberg, Laura E. Rumbley), A Report Prepared for the UNESCO 2009 World Conferenceop.cit., p. 8.

⁶) Ibid, p. 14.

might not be qualified for the public institutions or who cannot be accommodated in other universities because of overcrowding⁷⁾. While some selective private universities exist, in general the private sector serves a mass clientele and is not seen as prestigious. The sector is run mostly on a business model, with power and authority concentrated in boards and chief executives, faculty hold little authority or influence and students are seen as consumers⁸⁾.

Nowadays, the tertiary education is much more diversified and encompasses new types of institutions. The changes have been created for a number of reasons: to develop a closer relationship between tertiary education and the external world, including greater responsiveness to labor market needs; to enhance social and geographical access to tertiary education; to provide high-level occupational preparation in a more applied and less theoretical way; to accommodate the growing diversity of qualifications and expectations of school graduates⁹⁾. In this context, the main challenges in tertiary education are seen in the following domains: steering tertiary education; funding tertiary education; quality of tertiary education; equity in tertiary education; the role of tertiary education in research and innovation and the academic career links with the labor market; Internationalization of tertiary education¹⁰⁾.

With respect to the topic of this paper of particular interest are the challenges concerning links with the labor market related to: Including labor market perspectives and actors in tertiary education policy; Ensuring the responsiveness of institutions to graduate labor market outcomes; Providing study opportunities for flexible, work-oriented study.

Unemployment rates indicate the match, or lack of it, between what the education system produces and what skills the labor market demands. Those with lower educational qualifications are at particular risk of economic marginalization since they are both less likely to participate in the labor force and more likely to be without a job, even if they actively seek one. The indicators of World Bank, OECD, Eurostat and other data sources shows that unemployment rates for those with tertiary education are two times or more lower than those with secondary education. According to the latest data for the OECD countries, the unemployment rate for the unemployed with a tertiary-type A education are still below 4% in many OECD countries (4.1% and 4.4%, on average, for men and women, respectively), and for those with a lower secondary education are above 10% in most countries (on average about 12.0% for

7) Ibid, p. 15.

8) Ibidem.

9) Tertiary Education for the Knowledge Society, Thematic Review of Tertiary Education....., p. 4. <http://www.oecd.org/dataoecd/20/4/40345176>.

10) Ibid, p. 7.

men and women)¹¹⁾. With few exceptions, unemployment rates increased across the board, but less for those with higher education (2.8 percentage points for those without an upper secondary education, by 2 percentage points for those with an upper secondary education and by 1.1 percentage points for those with a tertiary education).

In 2011, 74.8 million youth aged 15–24 were unemployed, which mean an increase of more than 4 million since 2007. The global youth unemployment rate, at 12.7 per cent, remains a full percentage point above the pre-crisis level¹²⁾. Globally, young people are nearly three times as likely as adults to be unemployed. Great part of the youth unemployment is with university education as a result of the increasing tertiary employment rate in last decade. High youth unemployment is likely to cause long-term damage to labor market prospects and potential growth. As noted in a recent ILO report on the topic, “the bad luck of the generation entering the labor market in the years of the Great Recession brings not only current discomfort (from unemployment, underemployment, and the stress and social hazards associated with joblessness and prolonged inactivity), but also possible longer term consequences in terms of lower future wages and distrust of the political and economic system”¹³⁾.

2. TERTIARY EDUCATION REFORMS AND GRADUATE UNEMPLOYMENT IN THE REPUBLIC OF MACEDONIA

2.1. Reforms in tertiary education and the graduate students trends

In the period of transition, along with the political changes, Republic of Macedonia faced a task of abandoning old and creating a new economic and social system that corresponds to the needs of a market economy. The process of transition took longer than expected and was accompanied by deep reforms in all sectors, with various intensity and in different time intervals.

In the sector of education, more significant reforms started in the first half of the previous decade with adoption of the strategic documents and their implementation through sets of programs, measures and activities. They were conducted in all levels of education with particular emphasize in the tertiary education as a result of the identified importance of the human resources i.e. human capital for the socio-economic development of the country.

¹¹⁾ Education at a Glance 2009, How Does Educational Attainment Affect Participation in the Labor Market? – Indicator A7 chapter A, OECD 2011, p. 119. <http://www.oecd.org/dataoecd/41/25/43636332>.

¹²⁾ Global Employment Trends 2012, Preventing a deeper jobs crisis, ILO, Geneva, 2012, p.14 http://www.ilo.org/wcmsp5/groups/public/@dgreports/@dcomm/@publ/documents/publication/wcms_171571.pdf

¹³⁾ Ibidem.

Tertiary education reform activities in the Republic of Macedonia included: Opening of private universities (2003); Increase of the number of faculties (from 29 in the academic year 2003/2004 to 101 in the 2009/2010¹⁴⁾); Implementation of dispersed studies and larger geographical access to tertiary education; Adoption of the Law on Adult Education (2008); Compulsory implementation of the Bologna Declaration since the academic year 2009/2010; Increase of the enrollment quotas and continuous campaign for admission to higher education institutions since 2006. All these changes of the system in higher education were accompanied by the phenomena of massification, due to the significant increase in the enrolment rates, as well as the growth of the private higher education.

The State Statistical data shows that the share of the Macedonian age cohort enrolled in tertiary education in the academic years 2004/2005 and 2005/2006 was 24.9% and 24.3%, respectively. Rapid growth of the gross enrolment rates followed afterwards, and they amounted up to 28.7% (2006/2007), 32.6% (2007/2008), 32.5% (2008/2009) and 29.8% (2009/2010)¹⁵⁾. The increase of the gross enrolment rates in Macedonia since 2006 can be evaluated as a big change in a short period of time. It is the same or even higher than in the above mentioned regions worldwide.

Over 1991-2010, significant changes happened in the annual increase of the persons with higher vocational education, graduated students, masters and specialists, doctor of science. They are particularly evident in the scope and the profile of the graduated students. In the period 1990-1995, the number of graduated students experienced decreasing trend year on year, followed by almost continuous increase afterwards, which is especially pronounced starting from 2008 onwards (Table 1). In last three years, the number of graduated students stood at over 9000 persons per year, which is almost double than the average increase in the period 2000-2007.

Besides the emphasized absolute increase of the number of graduated students, important changes happened in their structure, from the perspective of the scientific area of the earned degree. The share of graduated students in social and humanitarian sciences (out of the total number of graduated) rose from 58.3% (2000) to 73.0% (2010), on the account of the lowered share of all other scientific areas. More specifically, over the period, the share of Natural sciences and mathematics dropped from 7.4% to 3.8%; Technical and technological sciences from 20.3% to 14.9%; Medical sciences from 9.7% to 5.0% and Biotechnical sciences from 4.3% to 3.4%, respectively. Having in mind the current situation on the labor market in Republic of Macedonia, as well as the requirements of the contemporary knowledge economy these changes may be deemed as unfavorable.

¹⁴⁾ Source: State Statistical Office of the republic of Macedonia, Enrolled Students in the 2009/2010 School Year, Statistical Review No. 2.4.11.11/694, Skopje, 2011.

¹⁵⁾ Ibidem.

Table 1

GRADUATED STUDENTS, MASTERS, SPECIALISTS AND DOCTORS OF SCIENCE OF THE REPUBLIC OF MACEDONIA									
Year	Higher vocational education*	University education						Master of science and specialist	Doctors of science
		Total	Natural sciences and mathematics	Technical and technological Sciences	Medical sciences	Biotechnical sciences	Social sciences and humanities		
1990	980	2884	197	635	274	241	1537	95	46
1991	884	2500	181	558	282	221	1258	104	91
1992	890	2464	182	613	287	228	1154	92	80
1993	547	2325	195	637	255	200	1038	67	38
1994	534	2179	164	559	264	210	982	67	49
1995	680	2150	167	647	297	163	876	66	28
1996	671	2527	153	723	279	167	1205	44	51
1997	528	2597	168	765	292	202	1170	78	56
1998	436	2564	246	722	315	139	1142	76	51
1999	447	3288	205	688	292	168	1935	106	34
2000	402	3338	248	678	323	142	1947	84	46
2001	300	3180	236	573	295	132	1944	156	68
2002	324	3294	246	530	287	147	2084	96	51
2003	226	4178	280	612	306	213	2767	61	59
2004	285	4725	304	651	385	250	3135	110	67
2005	265	5132	370	659	353	301	3449	198	92
2006	442	5771	356	763	382	347	3923	203	85
2007**	525	7835	407	915	406	374	5733	277	82
2008**	811	10027	594	1209	564	297	7363	272	87
2009**	662	9570	525	1556	558	378	6553	425	119
2010	914	9030	340	1346	447	303	6594	691	157

* Higher vocational education also includes students at first qualification and professional studies

** Corrected data

Source: State Statistical Office of the Republic of Macedonia, *Graduated Students, 2010, Statistical Review, No. 2.4.II.12/695, Skopje, 2011.*

In addition, the second half of the previous decade was marked with continuous increase of the master's degrees and specializations. That was particularly emphasized in 2009 and 2010, when also highest number of newly acquired PhD degrees (doctors of science) was registered.

Tertiary education reforms in the Republic of Macedonia were mainly focused on the quantitative changes and resulted in rapid growth of the enrollment rates and the number of new highly educated persons. At the same time, quality of the higher education in terms of provision of high-level occupational preparation in a more applied and less theoretical way and responsiveness to the labor market needs, were neglected. Such changes, as well as relatively low and jobless economic growth resulted in a great increase of the graduate unemployment.

2.2. Changes in the scope and main features of the graduate unemployment

The compulsory secondary education introduced in 2007, along with the increased number of graduated students caused significant changes in the educational structure of the labor force and inactive working-age population in the Republic of Macedonia. These were particularly manifested in the category of unemployed. Labor Force Survey (LFS) data shows that in the period 1996-2010, the share of unemployed with low level of education decreased, while the share of those with secondary and higher level of education increased, although with different intensity (Table 2). Since 2003, there is a continuous and very high increase year on year of the unemployed persons with higher level of education.

Table 2

SHARE (IN %) OF THE UNEMPLOYED PERSONS IN THE REPUBLIC OF MACEDONIA, BY LEVEL OF EDUCATION

	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010
Total number of unemployed persons	251489	288213	284064	261451	261711	263196	263483	315900	309286	323934	321274	316905	310409	298873	300439
Low level of education	46,3	44,8	45,6	41,7	41,7	40,0	42,9	42,1	38,1	35,7	36,9	35,9	37,5	34,5	33,5
Secondary level of education	43,4	44,4	47,7	51,0	50,4	52,1	49,7	49,9	54,2	55,7	54,1	54,6	52,7	54,0	53,8
Higher level of education	6,7	7,5	6,7	7,3	7,8	7,8	7,4	8,0	7,8	8,6	9,0	9,5	9,8	11,5	12,7
Unknown	3,5	3,3		0,0											

Source: State Statistical Office of the Republic of Macedonia, Labour Force Survey, Statistical Reviews: No. 2.4.06 (1999); No. 2.4.1.03 (2000); No. 2.4.2.08/410 (2001); No. 2.4.2.21/429 (2002); No. 2.4.3.13/453 (2003); No. 2.4.5.02/494 (2004); No. 2.4.6.07/531 (2005); 2.4.8.06/593 (2007); No. 2.4.9.12/ 632 (2008);

Also, the structure of the unemployed with higher level of education had changed. In the observed period, the number of unemployed with higher vocational education noticed tendency of decrease, while the unemployed with university level education increased from 9768 (1996) to 32973 persons (2010) or for more than three times (Table 3). This resulted in enormous growth of the share of the unemployed with university education in the total number of unemployed with high education from 57.6% to 86.5%. In parallel, the unemployment rates of both categories of unemployed person's had certain oscillations, but with different trends. While for unemployed with higher vocational education they remain almost the same, the unemployment rates of those with university education have risen significantly since 2003, amounting up to 22.1% in 2009 and 22.7% in 2010.

Table 3

THE STRUCTURE AND UNEMPLOYMENT RATES OF THE UNEMPLOYED WITH HIGH LEVEL OF EDUCATION IN THE REPUBLIC OF MACEDONIA															
	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010
Total	16964	21519	19052	19036	20514	20651	19537	25400	24046	27772	28849	30185	30310	34340	38136
Higher vocational education	7196	8298	7702	8449	8097	8067	6022	7700	6126	7880	6939	6635	6233	4964	5163
University level education*	9768	13221	11350	10587	12417	12584	13515	17700	17920	19892	21910	23550	24077	29376	32973
Structure in % (total=100.0%)															
Higher vocational education	42,4	38,6	40,4	44,4	39,5	39,1	30,8	30,3	25,5	28,4	24,1	22,0	20,6	14,5	13,5
University level education*	57,6	61,4	59,6	55,6	60,5	60,9	69,2	69,7	74,5	71,6	75,9	78,0	79,4	85,5	86,5
Unemployment rates (in %)															
Higher vocational education	16,2	20,2	17,8	18,5	17,2	19,6	16,3	20,2	17,4	20,5	20,7	20,4	20,2	17,3	17,3
University level education*	14,5	18,9	16,2	15,0	18,2	16,6	15,9	19,1	18,6	20,5	21,3	20,5	21,7	22,1	22,7

* University level education includes persons with university education, Master's degree and Doctorate (PhD)

Source: State Statistical Office of the Republic of Macedonia, Labour Force Survey, Statistical Reviews: No. 2.4.06 (1999); No. 2.4.1.03 (2000); No. 2.4.2.08/410 (2001); No. 2.4.2.21/429 (2002); No. 2.4.3.13/453 (2003); No. 2.4.5.02/494 (2004); No. 2.4.6.07/531 (2005); 2.4.8.06/593 (2007); No. 2.4.9.12/ 632 (2008); No. 2.4.10.04/ 651 (2009); No.2.4.11.09/692 (2010).

Having in mind these changes, as well as the aim of the paper, our attention is focused on the features of the graduate unemployment, i.e. the unemployed persons with university level education. Based on the available LFS data, the demographic characteristics and duration of graduate unemployment are observed.

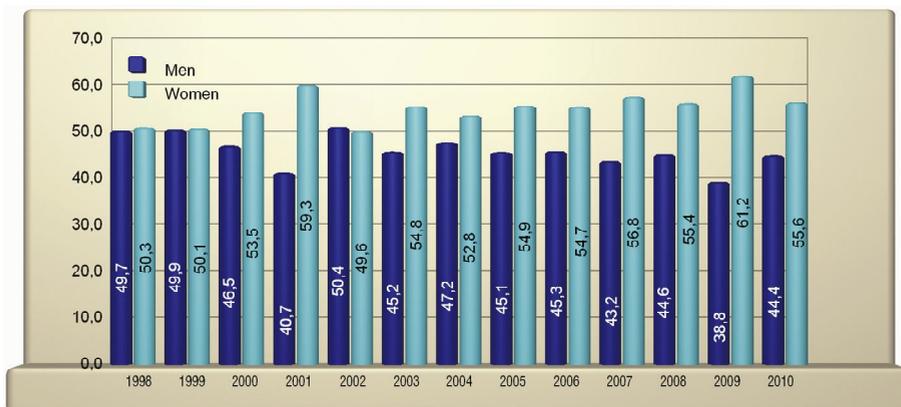
Gender structure of graduate unemployment in the Republic of Macedonia is characterized by relatively high increase of the share of unemployed women. After manifested oscillations in the period 1998-2002, since 2003 up until now the share of unemployed women prevails, and in last few years it is higher than 55%¹⁶⁾ (Figure 2). It means that unemployed women with university diplomas are in a less favorable situation nowadays than at the beginning of the observed period.

Even more emphasized changes are evident at the *age structure of the unemployed with university education in the Republic of Macedonia*, determined by the great differences in absolute growth of the particular age groups (Table 4). Graduate unemployment increase is highest among young persons aged 20-29 years. Over the period 1999-2010, the number of unemployed persons in the age group 20-24 had increased for more than five times, and those aged 25-29 for about four times.

¹⁶⁾ Changes in 2001 were caused by the War conflict in the country.

Figure 2

GENDER STRUCTURE (IN%) OF THE UNEMPLOYED WITH UNIVERSITY LEVEL EDUCATION IN THE REPUBLIC OF MACEDONIA



Source: Same as in Table 2

Table 4

AGE STRUCTURE OF THE UNEMPLOYED PERSONS WITH UNIVERSITY LEVEL EDUCATION IN THE REPUBLIC OF MACEDONIA

	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010
Unemployed persons with university education	10587	12417	12584	13515	17700	17920	19892	21910	23550	24077	29376	32973
20-24	1187	1332	1099	709	1100	2147	2429	3769	3632	5154	7335	6713
25-29	3491	4364	5043	5549	6100	5921	6883	7389	8775	8507	12192	14004
30-34	2566	3468	2558	1900	3300	3239	3379	4784	3152	3099	3689	5226
35-39	948	1396	1335	2192	2300	1791	1996	3023	1521	1381	1468	2473
40-49	1660	1372	1316	1920	2700	2735	2620	2546	3337	2670	1941	1512
50-59	735	414	1005	1172	2100	1868	2227	371	2461	2448	2063	2227
60 +		72	228	73	100	220	359	27	672	819	689	820
	Structure in % (total=100.0%)											
20-24	11,2	10,7	8,7	5,2	6,2	12,0	12,2	17,2	15,4	21,4	25,0	20,4
25-29	33,0	35,1	40,1	41,1	34,5	33,0	34,6	33,7	37,3	35,3	41,5	42,5
30-34	24,2	27,9	20,3	14,1	18,6	18,1	17,0	21,8	13,4	12,9	12,6	15,8
35-39	9,0	11,2	10,6	16,2	13,0	10,0	10,0	13,8	6,5	5,7	5,0	7,5
40-49	15,7	11,0	10,5	14,2	15,3	15,3	13,2	11,6	14,2	11,1	6,6	4,6
50-59	6,9	3,3	8,0	8,7	11,9	10,4	11,2	1,7	10,5	10,2	7,0	6,8
60 +	0,0	0,6	1,8	0,5	0,6	1,2	1,8	0,1	2,9	3,4	2,3	2,5

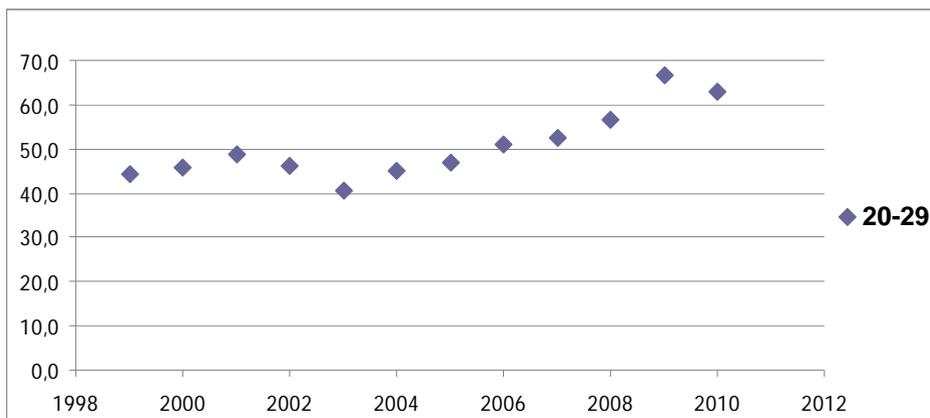
Source: State Statistical Office of the Republic of Macedonia, Labour Force Survey, Statistical Reviews: No. 2.4.06 (1999); No. 2.4.1.03 (2000); No. 2.4.2.08/410 (2001); No. 2.4.2.21/429 (2002); No. 2.4.3.13/453 (2003); No. 2.4.5.02/494 (2004); No. 2.4.6.07/531 (2005); 2.4.8.06/593 (2007); No. 2.4.9.12/ 632 (2008); No. 2.4.10.04/ 651 (2009); No.2.4.11.09/692 (2010).

As a result of such growth, the share of both age groups in the total number of unemployed persons with university education increased significantly, i.e. from 11.2% (1999) to 20.4% (2010) for aged 20-24 and from 33.0% to 42.5%, respectively for

aged 25-29 years. In last two years, the common share of these age groups reached about two thirds of the total graduate unemployment in the country or 66.5% (2009) and 62.9% (2010) (Figure 3).

Figure 3

SHARE (IN%) OF THE AGE GROUP 20-29 IN THE TOTAL NUMBER OF UNEMPLOYED WITH UNIVERSITY LEVEL EDUCATION IN THE REPUBLIC OF MACEDONIA



Source: Same as in Table 2

Concerning the participation of the other age groups in the total number of unemployed persons with university education, decreasing tendency was registered at those aged 30-39 and 40-49 years, the share of age group 50-59 remained almost the same, while the unemployed persons aged 60 and over recorded continuous increase.

Furthermore, the long-term unemployment is one of the main features of the unemployment in the Republic of Macedonia. In the period 1999-2010, big changes also happened in the structure of unemployed with university education in terms of *duration of the unemployment*. They are mainly caused by the intensified inflow of the graduated students since 2003 (Table 5). In the observed period, the number of unemployed up to 11 months and 12-23 month increased for more than four times, of those unemployed 2 years by eight times, while for the unemployed 3 and 4 years it was doubled i.e. more than doubled respectively.

The unemployment duration rose with different intensity, observed from the perspective of the mentioned groups. The short term graduate unemployment (up to 11 months) has most intense increase and reached about 30% or more of the total number of unemployed with university education. Lower intensity of the growth was noted for the unemployed 12-23 months, which share in 2010 amounted about 20%. Therefore, the common share of these two groups of unemployed increased from 36.8% (1999) to 50.8% (2010) (Figure 4). It implied decrease of the participation of unemployed two years and longer (from 63.1% to 49.3%, respectively). As these

Table 5

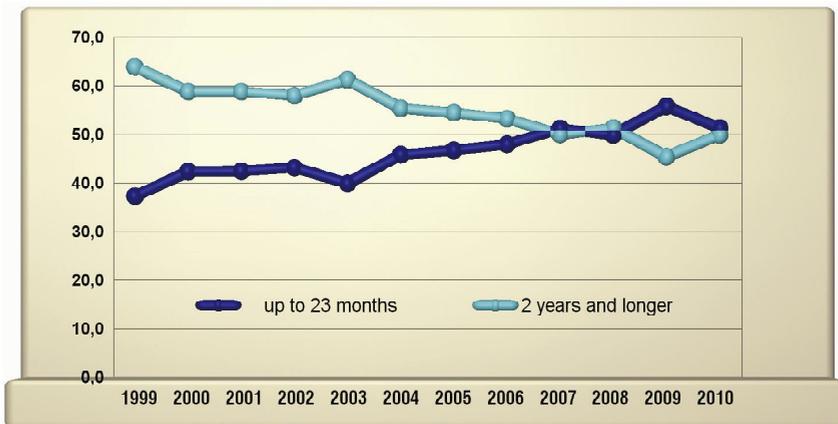
**UNEMPLOYED PERSONS WITH UNIVERSITY LEVEL EDUCATION
IN THE REPUBLIC OF MACEDONIA, BY DURATION OF UNEMPLOYMENT**

	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010
Unemployed persons with university education	10587	12417	12584	13515	17700	17920	19892	21910	23550	24077	29376	32973
up to 11 months	2301	3148	3442	3146	4300	5014	5421	6935	7771	7790	11341	9846
12-23 months	1601	2052	1838	2623	2700	3105	3776	3441	4142	4083	4848	6880
2 years	73	303	174	317	100	127	288	358	297	444	429	648
3 years	1839	908	1259	1560	2700	2232	2091	2585	2803	2290	3131	3646
4 years and longer	4773	6006	5873	5870	7900	7444	8316	8590	8537	9470	9627	11953
Structure in % (total=100.0%)												
up to 11 months	21,7	25,4	27,4	23,3	24,3	28,0	27,3	31,7	33,0	32,4	38,6	29,9
2 years	15,1	16,5	14,6	19,4	15,3	17,3	19,0	15,7	17,6	17,0	16,5	20,9
12-23 months	0,7	2,4	1,4	2,3	0,6	0,7	1,4	1,6	1,3	1,8	1,5	2,0
3 years	17,4	7,3	10,0	11,5	15,3	12,5	10,5	11,8	11,9	9,5	10,7	11,1
4 years and longer	45,1	48,4	46,7	43,4	44,6	41,5	41,8	39,2	36,3	39,3	32,8	36,3

Source: State Statistical Office of the Republic of Macedonia, Labour Force Survey, Statistical Reviews: No. 2.4.06 (1999); No. 2.4.1.03 (2000); No. 2.4.2.08/410 (2001); No. 2.4.2.21/429 (2002); No. 2.4.3.13/453 (2003); No. 2.4.5.02/494 (2004); No. 2.4.6.07/531 (2005); 2.4.8.06/593 (2007); No. 2.4.9.12/ 632 (2008); No. 2.4.10.04/ 651 (2009); No.2.4.11.09/692 (2010).

Figure 4

**SHARE (IN %) OF UNEMPLOYED WITH UNIVERSITY LEVEL EDUCATION IN THE
REPUBLIC OF MACEDONIA, BY DURATION**



Source: Same as in Table 2

changes were determined by the great inflow of new generations of graduated students in the recent years, there are no prospects for improvement of the situation in terms of shortening the unemployment duration.

The analyses of the scope and the main features of the graduate unemployment in the Republic of Macedonia, particularly in terms of the participation of the youth unemployment (aged 20–29), undoubtedly shows that the manifested changes mainly are caused by the highly education reforms. Graduate unemployment has a great impact on the labor market in the country and implicates short-term and long-term consequences in many domains.

2.3. Consequences and implications of the graduate unemployment

In the second half of XX century, the Republic of Macedonia faced a tendency of continued growth of the long-term unemployment. In the last decade, this trend was accompanied by large and rapid changes in the educational structure of the unemployed persons. It is evident through significant increase of the graduate unemployment, mainly caused by the reforms in the higher education. Persistent high unemployment creates huge costs for individuals and for the economy. They are manifested in many domains and some of these costs are difficult to value and measure, particularly in the circumstances of long-term unemployment of the labor force with university level education such is the case of Republic of Macedonia.

The practice show that the unemployment basically results in: loss of income, negative multiplier effects, loss of national output, fiscal costs and social costs. On *national level*, the unemployment involves a loss of potential national output (i.e. GDP operating well below potential) and is a waste of scarce resources. In this context, the costs of graduate unemployment are even more emphasized, especially nowadays, when the human capital is one of the most important development factors and a key determinant of the knowledge based economy. Having in mind the current development level of the country, as well as the limitations of other development factors (financial capital, natural resources) for the Republic of Macedonia, this loss is even more emphasized. At the same time, certain part of the unemployed with university education chooses to leave the labor market permanently because they have lost the motivation to seek work. According the 2010 LFS data, the share of the inactive graduated working-age population (15-64) in the total working-age population with university education amounted 7.6% (12023 persons out of which 5675 persons or 47.2% aged 20-29 years)¹⁷⁾. In a long run, this could have a negative effect on aggregate labor force supply and thereby, damage the economy's growth potential, particularly in circumstances of intensified population and labor force aging process that takes place in the Republic of Macedonia. Some economists call this the "hysteresis effect". When unemployment is high there will be an increase in spare capacity - in

¹⁷⁾ State Statistical Office of the Republic of Macedonia, Labor Force Survey 2010, Statistical Review No.2.4.11.09/692, Skopje.

other words the output gap will become negative and this can have deflationary forces on prices, profits and output¹⁸⁾.

On a national level, the fiscal costs, expressed in a fall in tax revenues and higher spending on welfare payments for families with people out of work, are equally important. This implicates an increase in the budget deficit, which then increases the risk that the government will have to raise taxation or scale back plans for public spending. The great scope and long-term graduate unemployment in the Republic of Macedonia assumes significant and long-term loss of tax revenues, as well as rise of the welfare payments. The problems that the Macedonian government faces in the area of fiscal policy today are closely linked to the surge in unemployment, including growing unemployment of the highly educated labor force.

The Macedonian labor market is characterized by emphasized regional differences of the employment and unemployment rates caused by the closure of the local factories in the period of transition and uneven inflow of the labor force. Large-scale unemployment has multiplier effect on the local and regional economy in the country (one person's spending is another's income so the lack of well-paid jobs leads to a drop in demand for local services, downward pressure on house prices, etc). In the regions with very high unemployment rates, including those with university education, this effect is partially absorbed by the inflow of the remittances of the Macedonian citizens abroad.

As for the costs on *individual level*, the graduate unemployment results in a loss of income and living standard decline. This leads to a decline in spending power and the rise of falling into debt problems. Persistently high long-term unemployment is linked to social deprivation. It implicates worsening health and lower life expectancy, falling of real incomes and a widening of inequality of income and wealth. The recent figures on poverty in the Republic of Macedonia are testimony to the social damage that high unemployment can have. According to the State Statistical Office data, the poverty rate (Head Count Index) for the unemployed was 41.8% in 2010, i.e. 44.8% of all poor people were unemployed¹⁹⁾. Part of them is with university education. In addition, the rising graduate unemployment (in which the share of young person's prevails) is accompanied by the delayed marriage and increased divorce rates causing serious long-term demographic consequences.

Without diminishing the importance of the above mentioned costs of the graduate unemployment in the Republic of Macedonia on national and individual level, one of the most serious consequences is the intellectual emigration i.e. the rising brain

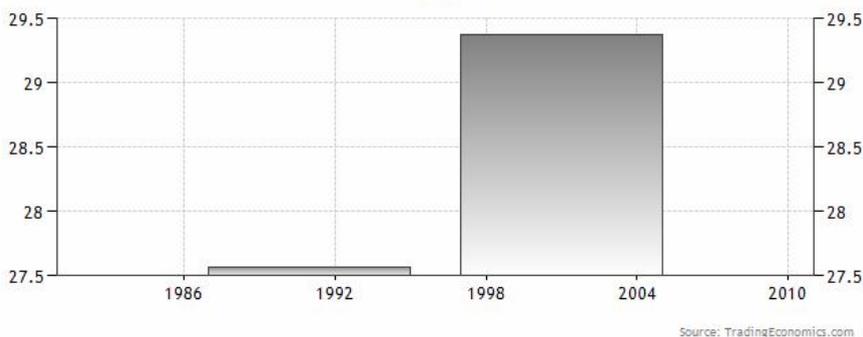
¹⁸⁾ <http://tutor2u.net/blog/index.php/economics/comments/revision-consequences-of-unemployment>

¹⁹⁾ State Statistical Office of the Republic of Macedonia, News Release No.4.1.11.48 / 11.07.2011

drain. Since 1990, Macedonia faced a great increase of emigration of highly educated persons (with tertiary level of education), which by all attributes could be treated as “brain drain”. According to some estimation referring to the beginning of this century, about 20% of the total number of Macedonian citizens aged over 15 with university education is residing abroad²⁰⁾. Another data source shows that in the period 1997-2005, the Macedonian emigration rate of the tertiary educated persons was about 29.4%²¹⁾ (Figure 5). Having in mind the great changes of the graduate unemployment after 2005, particularly since 2008, there is a realistic assumption that the current emigration rate of the tertiary educated persons is even higher.

Figure 5

**MACEDONIA - EMIGRATION RATE OF TERTIARY EDUCATED
(% OF TOTAL TERTIARY EDUCATED POPULATION)**



At the same time, there is evident rise of the brain drain. The global competitiveness indicators of the World Economic Forum for 2011-2012 shows that according to the brain drain indicator, the Republic of Macedonia was ranked on 133 position out of 142 countries in the world (Table 6). Such high position according to this indicator means that nowadays Republic of Macedonia is in a group of countries with the highest brain drain intensity worldwide. One of the findings of the OECD Investment Reform Index 2010 is that emigration of skilled workers, often referred to as brain drain, is significant in many SEE countries, including Macedonia²²⁾. Brain drain indicators for the Western Balkan countries, shows that in the last observed year only Serbia was ranked behind (139) Macedonia.

²⁰⁾ Janeska, V. (2003): Potential Intellectual Emigration from the Republic of Macedonia, in: *Economic Development*, Journal of the Institute of Economics, 5, No. 1-2-3, Skopje, p. 67.

²¹⁾ Source: TradingEconomics.com: <http://www.tradingeconomics.com/macedonia/emigration-rate-of-tertiary-educated-percent-of-total-tertiary-educated-population-wb-data.html>.

²²⁾ OECD (2010): *Investment Reform Index 2010. Monitoring Policies and Institutions for Direct Investment in South-East Europe*, Paris, France, p. 70.

Table 6

**BRAIN DRAIN INDICATORS FOR THE COUNTRIES
OF WESTERN BALKANS**

	Brain drain			
	2008-2009 rank 134	2009-2010 rank 133	2010-2011 rank 139	2011-2012 rank 142
Republic of Macedonia	126	125	126	133
Albania	104	101	107	83
Bosnia and Hercegovina	119	131	138	126
Croatia	75	98	122	128
Monte Negro	65	67	55	46
Serbia	131	132	136	139

Source: World Economic Forum, *The Global Competitiveness Reports: 2008-2009; 2009-2010; 2010-2011; 2011-2012*.

As main consequences and implications of the “brain drain” in Republic of Macedonia could be distinguished: Decrease of the average level of human capital in the country with all negative effects on the socio-economic development; Long-term unfavorable implications on the development of scientific activities, particularly on the faculties of technical and natural sciences; Acceleration of the population and labor force ageing process and significant reduction of population reproductive base in the country. Summarized, this would imply permanent loss of the human capital in the Republic of Macedonia, which could cause very serious damage to the country’s development in the future.

CONCLUSION

Profound reforms in the tertiary education worldwide since 1990 were determined by deep changes in the socio-economic development and intensive process of globalization. They were manifested in significant increase of the enrolment rates in the last decade, accompanied by graduate unemployment growth, particularly since the beginning of the financial crises in 2008. Nowadays, the graduate unemployment, especially of the youth, is a problem of the governments of many countries, including USA, EU countries, Western Balkan countries, China, etc.²³⁾.

Under the influence of such global labor market trends on the last G20 Cannes summit (September 2011) a declaration committed to combating unemployment and promoting decent jobs, especially for youth and others most affected by the crisis was adopted. It set up a G20 Task Force on Employment, calling on the IMF, OECD,

²³⁾ As the world enters 2012, 1.1 billion people – one out of every three people in the labor force – are either unemployed or living in poverty. After three years of continuous crisis global unemployment has increased by 27 million, and more than 400 million new jobs will be needed over the next decade merely to avoid a further increase in unemployment. Source: *Global Employment Trends 2012*, ILO...op. cit., p. 84.

ILO and World Bank to report to the Finance Ministers on a global employment outlook, and how an economic reform agenda under the G20 framework would contribute to job creation²⁴⁾.

Republic of Macedonia is a country that faces the unemployment problem for more than five decades. Today, it is a more complex and harder problem than ever before, because of the growing and very large graduate unemployment. In 2010, the number of unemployed with university education reaches 32973 persons (which mean an increase of 11063 or about one third since 2006) and unemployment rate amounts 22.7%. Along with the graduate unemployment growth significant changes in the features of the unemployed persons occurred in terms of the participation of the unemployed women, youth unemployment (aged 20–29) and short-term unemployment (up to 11 months), which in 2010 amounts: 55%; 62.9% and 29.9% respectively. They corresponds with the implementation of the higher education reforms which resulted in the increase of share of the Macedonian age cohort enrolled in tertiary education and of the graduated students. Having in mind the enrolment rates in the last few years, it could be expected that the number of graduate students will grow implying even higher graduate unemployment.

The identified negative consequences and implications of the graduate unemployment on national and individual level are numerous and very complex. The human capital loss through the permanent emigration abroad of the tertiary educated persons i.e. brain drain is the most expensive cost of the increasing and persistent high unemployment. In these circumstances, Republic of Macedonia needs urgent policy initiatives in a macro policy options for promoting economic growth with jobs and in the higher education.

In the case of the Republic of Macedonia the identifying macro policy options for promoting economic growth, which delivers new jobs is of crucial importance. So far implemented active labor market measures and activities of the annual operational employment plans did not result in graduate unemployment decrease.

Higher education policy should be addressed to the graduate unemployment dedicating greater attention to the qualitative aspects of the education and to the labor market needs. In this context, the higher education policy should be focused on several aspects. The *employability skills development* is particularly important in terms of the evident reduction in the quality of the education. In this respect, the provision of high-level occupational preparation in a more applied way and accommodation of the growing diversity of qualifications are particularly important. *Career management learning* is an important determinant of the development of the country as a knowl-

²⁴⁾ *Global Employment Trends 2012*, ILOop. cit., p. 85.

http://www.ilo.org/wcmsp5/groups/public/@dgreports/@dcomm/@publ/documents/publication/wcms_171571.pdf

edge economy and society. Nowadays, the career management is recognized as a skill deficit for many students which impede their individual career. In the circumstances of low growth of the Macedonian economy, with very limited job creation, the *entrepreneurship and innovation* are identified as significant factors of the economic recovery and graduate unemployment decrease.

Having in mind the current situation on the labor market in the Republic of Macedonia, in terms of the upsurge in graduate unemployment, there is indisputable need for profound research of the relationship between the development of higher education and economic growth. It will show whether the Macedonian's higher education should continue to expand on such a large scale.

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TALENT MANAGEMENT - STRATEGIC CORPORATE APPROACH TO SUPERIOR PERFORMANCE

Abstract

Talent management, as a modern approach in the field of human resources management, proposes a solution to all contemporary business trends. Thus, any company whose goal is to have a competitive advantage based on its human resource must have a talent management strategy. Talent management is the process by which an organisation identifies, manages and develops its people currently and for the future. This essay demonstrates how talent management theory was developed, and advances the argument how to balance between corporate strategy, human resource strategy and talent management strategy. The implications of the theory are profound. For effective use of talent management, the role of managers is essential in terms of comprehending this approach as investment in intangible assets which will position the organization as a leader in the market. The basic idea behind talent management is the assumption that there is potential in each and every one. In addition, there are certain key competences an organisation requires for sustainable competitive advantage, and the aim is to identify, retain and nurture them.

Key words: talent management, human resources management, corporate strategy, competitive advance.

JEL Classification: M0, M1, M12, M19, O, O15

Introduction

Talent management is a strategic activity of the company which gains great importance in recent years. Today, amid great competition, the success of companies

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is based on human resources, especially their talent and of course the corporate strategic talent based on management approach. It refers to the processes, systems and strategies, and their strategic implementations to boost productivity in the workplace through the development of improved processes for attracting, utilizing and retaining talented employees in accordance with current and future business needs.

Human resources are those which give substantial value to the organization. Most appropriate way to achieve competitive advantage of the organization is to understand human resources as a strategic business partner that contributes to improvement of business performance. Talent management arises from the need to devote more attention to human resources in the company context in order to address the talent, then to properly train and of course to keep the company sustainable.

That is what talent management advocates. Today, people search companies, not companies people. Today talented people are scarce, unlike previously when jobs were scarce, and the requirements of the workers today are much higher than previously when they accepted the conditions that were offered.

Talent management, as a modern approach in the field of human resources management, proposes a solution to all contemporary trends- dating from the beginning of the war for talents. Thus, any company whose goal is to have a competitive advantage based on its human resources must have talent management strategy through which the company can achieve its goal.

Talent management is trying to achieve balance in terms of human resources in a company, so that each employee is on the right job, in real time, on track to building a career according to one's needs and business directions of the company.

Talent management is committed to analyzing each employee individually in terms of desires for career, job satisfaction, training according to specific goals and needs, motivation to stay in the company rather than go to another company.

Talent management placed special emphasis on retention of workers as the most important of all its functions, and thus fights the trend of increased global mobility which now governs the world with the war for talent and all the other reasons that are mutually dependent.

CONCEPT OF TALENT MANAGEMENT

According to Davis,¹⁾ talent is a special skill or possession of high mental abilities. Highly skilled people are valuable resources of the organization said Drucker²⁾.

¹⁾ *Davis et al. (2007), Talent assessment: a new strategy for talent management*, Gower, United States of America, pg.1

²⁾ *Drucker P.F. & Maciariello J. A., The Daily Drucker (2005): 366 Days of Insight and Motivation for Getting the Right Things Done*, 13th edition, pg.26

The definition of talented people will be clearer if we point out the differences between talented and specialized people, because the boundaries between these two concepts are not clearly defined. Specialists are those who have vast knowledge of the precise activity or subject, they are professionals in their field, while talented people have other personal characteristics.

Talented people who show superior performances that inspire others, and which reflect the basic competencies and values of the company.

Talented people are a group of individuals who manifest superior performances that inspire others and who reflect the values of the organization, possess personal characteristics that enable social and emotional competence³⁾.

Talent management is a relatively new concept, but its components arise from the concept of “war for talent” which was first used by a group of consultants from McKinsey in 1997. The concept reflects the changes that were in accordance with the needs and practices of human resources to meet the competitive and dynamic environment. “The war for talent” is a real war that started between organizations to attract, develop, motivate and to retain talented employees. The war for talent began in the 1980s with the emergence of information technologies. Thus, the importance of machinery, factories and capital becomes relative to the importance of intangible assets such as brands, intellectual capital and talent.

The dedication of companies toward talented people has dramatically increased in the last century. In 1900, only 17% of jobs needed workers who possess knowledge, and today the figure exceeds 60%. It is important to choose a good talent. The best software developers can be ten times more useful than average and their products can earn ten times more income. Manager John Chambers at “Cisco” said: “One of the world’s best talented engineers can be more productive than the average 200 engineers.”

The war for talent appears quietly as a consequence of industrialization in the eighties, it intensified in the nineties and will continue to reform business conditions in the decades ahead.

Despite widespread demand for talent, the demand for high-level managers is growing. Companies today need managers who can respond to dynamic changes in business environment. Companies need managers willing to take risks, global entrepreneurs and skilled IT managers. They need people who understand business and motivate employees. Research conducted in 2000 showed that companies are “hungry” for solid managerial talent. 99% of the managers of companies that participated

³⁾ *Berger, L. A. & Berger D. R. (2004), The talent management handbook: creating organizational excellence by identifying, developing, and promoting your best people, McGraw-Hill, New York, pg.3-4*

in the survey said that the management potential in three years should be stronger than the present. Only 20% said they have enough talented leaders who can take advantage of all opportunities that are offered to the company.⁴⁾

The concept of talent management has been developed gradually. First it was understood as a concept associated with the practices of human resources such as planning and recruiting or concept that includes the provision of future need for employees. Further treatment was associated with employees, their needs and development in the organization and more attention to the personal needs of employees for achieving their welfare.

The true meaning of the concept introduced the idea of key positions in the organization which need to be identified, and subsequently filled with talented people, i.e. the idea is to find the right people for the right position and achieve high performance through motivation of these employees.⁵⁾

The essence of the concept is the definition that talent management is a strategy that treats employees of the organization in a way that motivates them to take the full potential of their talents to achieve superior performance for the company.

According to Davis, talent management is a set of activities of employing, developing and retaining talented people who are able to achieve superior performance in a particular company. Talent management activities have to be implemented through a strategy; it means “a deliberate and structured corporate approach to realize talent management.”⁶⁾

The key element in talent management strategy is to create a talent in the organization that will create sustainable competitive advantage based on their employees. Top managers believe that there is a lack of alignment between strategy management talent and corporate strategy. Therefore, talent management is not just a matter of the department of human resources, but the management team is also included. The task of the management team in talent management strategy is to define what kind of talent or ability of the organization needs now and in the future. The most important challenge for organizations is to maximize the organizational human potential.

The role of HRM in talent management

For successful development of talent management in an organization, professionally trained staff has the main role in the department of human resources. The

⁴⁾ <http://www.worldwideerc.org/resources/mobilityarticles/pages>

⁵⁾ *Mellahi, K. &Collings, D. G. (2009), “Strategic talent management: A review and research agenda”, Elsevier, Vol.19, n.4, pg.304-313*

⁶⁾ *Davis et al. (2007), Talent assessment: a new strategy for talent management, Gower, United States of America, pg.14*

team from the Human Resources Department must design, plan, apply and develop successful talent management programs. Then, the organizational progress comes to the fore. The role of top and line management is not negligible, they must have in mind the process of talent management in organizational behavior in today's global environment of intense change, demographic trends and high labor mobility, with constant growth of technology. Any organization without proper talent management process will face insolvency and will become meaningless in a business environment.

Human Resources Department should first develop all operational activities for talent management. HRM should develop a review according to the requirements of management, develop a plan of action to anticipate costs and finally approaches to implementing that plan. To hire a specialist for talent management, could be very useful, to guide HR professionals to perform schedule. The activities that the human resource department needs to develop are related primarily to recruitment of talent, which involves identification and evaluation of talented people with great potential for the organization and the recruitment of the necessary talent from the external labor market, their employment and promotion.

Second, HR professionals need to develop a pool of talent, that is to train employees to acquire skills that the company needs for the future, to exploit their full potential, and focus entirely on improving the organization. The development of talented people is through the cultivation and nurturing their talents and can be achieved through training or training through formal or informal way of learning. And third, the most important task of HR professionals is the retention of talented people, retention can only be achieved for a solid salary, this is achieved also with motivation and commitment, as provided by creating good working environment and model of organizational culture shared by all.

According to Berger and Berger, the function of talent management professionals can be divided into four different tasks: The first is a forecast that is predicting the possible **promotion** of employees according to their income, their past experience and talent shown, thus Talent Management professionals can see which employees are talented people and include them in the pool of talent. The second task is to create **measurement scales** for potential performance. The third is to identify **key competencies** that the organization and the need to empower the employees. The important competencies are: orientation towards results, communication skills, creativity, innovation, customer orientation, leadership, teamwork. Finally the last task of talent management professionals is to choose a **mentor** guide that will help talents to develop the necessary skills to maintain their motivation.⁷⁾

⁷⁾ *Berger, L. A. & Berger D. R. (2004), The talent management handbook: creating organizational excellence by identifying, developing, and promoting your best people, McGraw-Hill, New York, pg. 3-4*

We can connect these four tasks with each of the activities of talent management as defined above, the first two are more related to recruiting talent, the third is part of the development of talent, while the fourth refers to developing and retaining talent.

According to Davis, there are three elements that shape the strategy of talent management, which are recruitment, development of talents that include cultivation and breeding, and retention through motivation and commitment. Talent management is a strategy that involves all levels of the organization and the employment, development and retention of most talented people within the organization. The aim of the strategy is to create a pool of talent with talent potential and skills that the company needs or will need in the future. These talents are expected to achieve superior performance for the firm and thus ensure company's sustainable competitive advantage.⁸⁾

The company with good talent management strategy will become a learning company where employees are "employees with knowledge", which means they have the knowledge necessary to do a good job, but also it means they learn faster and can apply this knowledge in a practical and efficient way, and finally they have the ability to transfer that knowledge to others in a useful and structured way.

An organization will give its employees tools to make it through talent management activities, because it is aware that the outcome largely depends on the competence of its employees, so the company will take appropriate steps to ensure their training and their potential exploitation.

An important aspect that should be taken into consideration is that talent management is investment in intangible assets; hence its possible results should be analyzed before starting the application. The expected outcomes are superior performance of the workers and sustained competitive advantage based on talent.

There are ways that the human resources team can contribute to talent management beyond the traditional functions:

- Retention strategy: Departments of Human Resources may assist the organization in identifying key performers of strategic processes. They can achieve academic and operational leadership through retention interviews that include face to face meetings with key players in the organization to ensure that individuals realize that their investment is highly valued and the organization can support the employee's continued success and allegiance to the company.
- Planning for continuity: The necessity to make organizational planning staff charts which express the current and future position of each employee and

⁸⁾ *Davis et al. (2007), Talent assessment: a new strategy for talent management, Gower, United States of America, pg. 33-34*

his qualifications, taking into account future retirements, training needs assessment, additional training, etc.. This is necessary to maintain long-term competitive advantage.

- Transfer of knowledge: Human Resource Managers can assist in the planning process of knowledge transfer.

TALENT MANAGEMENT BENEFITS

The talent management benefits are

- Placement on each employee on a job that really suits: Every employee is on a suitable workplace and employee productivity increases. There is a balance in the interests of individuals and their job profiles and their job satisfaction is higher.
- Retention of top talents: Despite the opportunities in the global economy, the outflow of personnel is a major concern for companies. Retention of top talents is important for leadership and market development. Companies which are unsuccessful in retaining top employees, risk being outdone by competitors. The focus should be on programs and strategies for selection of personnel, developing, retaining and encouraging loyalty to the company.
- Proper selection: Superior organizations are recognized by the labor force they have. The best way to keep talents on the top of organization is to have talents to its lowest level. Therefore it's no wonder that talent management programs and investment in "hunting" the right human resources have become an important part of the processes in human resources departments.
- Better understanding of employees: Analyzing the employees is helpful and indicates how to address them. Their development needs, career aspirations, strengths and weaknesses, capabilities, and what they want and do not want. Then, it's easier to determine what motivates each employee, and it provides precious effects for both sides.
- Decisions for better professional development: When the organization determines its highest goal, it becomes easier to invest in the employees professional development that includes learning, training and development at the individual level, planning staff, etc.. If the organization knows where to direct its investments, talent management solves this problem.⁹⁾

⁹⁾ Cheese, P., Thomas, R. J. & Craig, E. (2008), *"The talent powered organization: Strategies for globalization, talent management and high performance"*. London and Philadelphia: Kogan Page, pg.223-225

The result is a workforce that is trustworthy and loyal to the organization, determined to overcome the competition and ensure leadership in the market for its organization.

CONCLUSION

Talent management is part of the corporate strategy and is consistent with achieving the mission of the organization. Talent management is not just a matter of the department of human resources and it must be integrated within the overall strategy of the organization. Every company should develop its own talent management strategy that will fit their corporate strategy and culture.

What talent management requires from the human resources department is to collaborate with managers at all levels, in order to gain feedback on all organizational levels. Managers have direct contact with employees, they know their abilities, skills, ambitions and certainly know what motivates them, and know the plans, needs, desires and capabilities of the company. They are liaison with the human resource department.

However, managers need to be professional, competent, ambitious and certainly good leaders. These are people that in the world today and in future will be lacking. The fact that every leader can be a manager, but not every manager can be a leader, suggests that leaders are a special category of people who require additional investments of resources by the company primarily for their recognition, and then for their normal development during their career and certainly their retention in the company.

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KNOWLEDGE SOCIETY IN MACEDONIA – POLICY PERSPECTIVES AND CHALLENGES

Abstract

This paper addresses the main policy perspectives and challenges towards building a knowledge society in Macedonia. Knowledge society encompasses variety of aspects determining the wealth generation and sustainable development, but it is primarily shaped by three core policy areas – education and training, ICT and research and development. Those three policies are elaborated from the perspective of the undertaken reforms, mutual coherence and crucial challenges with respect to the knowledge society. The need for developing better key policies and create a comprehensive policy framework encompassing all relevant policy aspects is stressed out as necessary to achieve progress towards the knowledge society. In that respect, proactive policy approach is distinguished as vital to ensure an optimal balance between the knowledge and utilization of the available resources in a sustainable way.

Keywords: Knowledge society, Information and Communication Technologies (ICT), Education and Training, Research and Development (R&D).

JEL classification: 0380

Introduction

In the 21st century, a new society is emerging where knowledge has become the most important factor determining the wealth generation and sustainable development (SD). The core element of the knowledge society is information economy, based

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on advanced information and communication technologies (ICT). Technological change imposes reconfiguration of the economic, social, cultural, political and organizational structures, as well as adaptation of supporting legal and regulatory frameworks. Maximisation of the possibilities to benefit from the technological changes highly depends from the pro-activity towards the changes. Only proactive policy approach could ensure an optimal balance between the knowledge and utilization of the available resources in a sustainable way, resulting in a comprehensive wealth for the country, combined with social cohesion and a healthy environment.

The strategic goal for 2010 set for the European Union at the Lisbon European Council (March 2000) was “to become the most competitive and dynamic knowledge-based economy in the world, capable of sustainable economic growth with more and better jobs and greater social cohesion”.¹⁾ However, the EU realised that it has been intrinsically difficult to come close to the Lisbon objectives. At the European Commission’s request, in November 2004, a group of independent experts assessed the results of the first cycle of the Lisbon Strategy and the causes of the muted progress, and proposed a way forward in order to achieve the Lisbon objectives. The Lisbon Agenda was narrowed to ten priority areas focusing on three primary objectives: Europe as a more attractive place to invest and work; knowledge and innovation for growth; and more and better jobs.²⁾ Significant efforts were put in these areas, but the outcomes were not as expected. The financial crises from 2008 which put the EU into recession contributed to the underperformance of the Lisbon goals. Therefore, building of a knowledge based economy proved to be a difficult task, even for developed countries. At the same time, the EU reaffirmed that despite difficulties, the knowledge based economy should remain the primary navigation course in the 21st century.

Macedonia, as a candidate country for the EU membership needs to start its transformation towards the knowledge society without delay. Building of a knowledge society in Macedonia is not just relevant for faster integration into the EU, but it is primarily essential for better utilisation of the available resources of the country. The paper strives to provide profound discussion about the importance of perceiving knowledge society as target for the future by the national policy-makers, and the necessary steps that need to be undertaken in that direction. The paper analyses were largely based on the extensive theoretical and empirical analysis related to the subject.

1) http://www.europarl.europa.eu/ftu/pdf/en/FTU_4.1.pdf

2) <http://eu2009.cz/en/eu-policies/competitiveness/competitiveness/competitiveness-684/index.html>

1. KNOWLEDGE ECONOMY INDICATORS

Given the importance of the knowledge economy, the World Bank has developed methodology for its measurement. Four key variables serve as proxies for Knowledge Economy Index (KEI):³⁾

- 1) Economic Incentive and Institutional Regime
- 2) Education
- 3) Innovation and
- 4) Information & Communications Technology (ICT),

In addition to this, there is Knowledge Index (KI) – a simple average of the country scores on the key variables in the three mentioned pillars – education, innovation and ICT. Table 1 provides an insight into both indexes for top 20 countries and Macedonia in 2012. The performance has been measured on a scale from 0 (lowest) to 10 (highest) score. Also, the rank from previous available measurement in 2000 and 1995 has been included in the Table.

Table 1

KNOWLEDGE ECONOMY INDEX AND KNOWLEDGE INDEX IN TOP 20 COUNTRIES AND MACEDONIA IN 2012

Rank 2012	Rank 2000	Rank 1995	Country	KEI	KI	Economic Incentive Regime	Innovation	Education	ICT
1	1	4	Sweden	9.43	9.38	9.58	9.74	8.92	9.49
2	8	7	Finland	9.33	9.22	9.65	9.66	8.77	9.22
3	3	2	Denmark	9.16	9.00	9.63	9.49	8.63	8.88
4	2	5	Netherlands	9.11	9.22	8.79	9.46	8.75	9.45
5	7	3	Norway	9.11	8.99	9.47	9.01	9.43	8.53
6	9	6	New Zealand	8.97	8.93	9.09	8.66	9.81	8.30
7	10	10	Canada	8.92	8.72	9.52	9.32	8.61	8.23
8	15	14	Germany	8.9	8.83	9.10	9.11	8.20	9.17
9	6	9	Australia	8.88	8.98	8.56	8.92	9.71	8.32
10	5	8	Switzerland	8.87	8.65	9.54	9.86	6.90	9.20
11	11	12	Ireland	8.86	8.73	9.26	9.11	8.87	8.21
12	4	1	United States	8.77	8.89	8.41	9.46	8.70	8.51
13	16	22	Taiwan, China	8.77	9.10	7.77	9.38	8.87	9.06
14	12	11	United Kingdom	8.76	8.61	9.20	9.12	7.27	9.45
15	14	13	Belgium	8.71	8.68	8.79	9.06	8.57	8.42
16	19	24	Iceland	8.62	8.54	8.86	8.00	8.91	8.72
17	13	15	Austria	8.61	8.39	9.26	8.87	7.33	8.97
18	25	19	Hong Kong, China	8.52	8.17	9.57	9.10	6.38	9.04
19	26	27	Estonia	8.4	8.26	8.81	7.75	8.60	8.44
20	22	20	Luxembourg	8.37	8.01	9.45	8.94	5.61	9.47
57	73	68	Macedonia	5.65	5.63	5.73	4.99	5.15	6.74

Source: World Bank database (http://info.worldbank.org/etools/kam2/KAM_page5.asp)

As evident from the Table 1, the Scandinavian countries –Sweden, Finland and Denmark were leaders in the knowledge economy in 2012, with KEI scores of 9.43; 9.33 and 9.16, respectively. Sweden and Denmark had the same ranking in 2000 (Table 1/Column 2), while the ranking in 1995 included both countries in the top four (Table 1/Column 3). That indicates the continuity of the investment into Education, Innovation and ICT in these countries in a longer period of time. Furthermore, the KEI indicators positioned 11 EU countries (out of 27) in the top 20 in 2012, indicating the EU commitment to achieve good performances in the measured areas.

The biggest drop in the rankings was registered by USA, which dropped from the 1st position in 1995 to the 4th position in 2000 and down to the 12th position in 2012. This was largely attributable to the deterioration of the education score from 9.44 in 1995 down to 8.70 in 2012, while innovation score also decreased - from 9.84 (1995) to 8.51 (2012).⁴⁾ Only ICT score remained relatively stable.

Macedonia has been ranked on the 57th position (out of 146 countries) in 2012 or 16 positions up compared to the 73rd ranking in 2000. Macedonian KEI score was 5.65 in 2012 (out of 10) against 4.76 in 2000 (Table 2). In terms of specific variables, the best performance in 2012 was registered in the ICT with score of 6.74, while education score was 5.15. All indicators, apart of education, experienced positive change compared to 2000, while education score dropped to 5.15 in 2012 against 5.54 in 2000. In the group of lower middle income class countries, Macedonia took the 2nd position in 2012 (out of 42 countries), which could hardly be assessed as success, as previously the country has been included in the group of upper middle class country, where most of the neighbouring countries still belong, apart of Bosnia and Herzegovina (included also in the group of the lower middle income class countries).

Table 2

**KNOWLEDGE ECONOMY INDEX AND KNOWLEDGE INDEX IN
MACEDONIA IN SELECTED YEARS**

Year/ indicator	KEI	KI	Economic Incentive Regime	Innovation	Education	ICT
2012	5.65	5.63	5.73	4.99	5.15	6.74
2000	4.76	5.15	3.62	4.35	5.54	5.55
1995	5.14	5.41	4.32	4.43	4.81	7.00

Source: World Bank database (http://info.worldbank.org/etools/kam2/KAM_page5.asp)

The KEI ranking for Macedonia in the period 2000-2012 (Table 2) provide some ground for optimism related to building of a knowledge development platform in Macedonia, although the current economic situation in the country is not really en-

³⁾ http://info.worldbank.org/etools/kam2/kam_page5.asp

⁴⁾ Ibidem

couraging. In the course of 2011, the unemployment rate was over 31%, the trade deficit reached over US\$2.3bn and the FDI were rather low – around US\$400m.⁵⁾ Those indicators, along with the changing economic environment on the global level, should be taken as a warning that holding the status quo is not an option. Macedonia needs to move forward and embrace the conditions necessary to underpin higher value added economic activities, better and more productive jobs, new social prosperity and sustainable use of the resources within the environmental limits. In that respect, governance's vision and quality of the policies determine the country's success in transition towards knowledge society.

2. POLICIES CONTRIBUTING TO KNOWLEDGE SOCIETY IN MACEDONIA

The knowledge society encompasses variety of aspects of the modern society – primarily education, technology, research and development (R&D), employment, infrastructure, industry, services and agriculture. The governance focused on building knowledge society needs to provide an optimal balance among the relevant policies. Policies related to science and technology, industry and education will need to emphasize the role and importance of the innovation systems, as well as necessary infrastructure and incentives to boost investments in research and development. Therefore, knowledge as an essential asset of the new society should be managed through governance system based on an integral policy-making to ensure interrelation of all policies regulating or contributing to some aspects of the knowledge society.

The main challenges to build knowledge society in Macedonia will be addressed from the perspective of the three core policy areas – education and training, ICT, research and development. Those policies tackle the KI variables mentioned previously.

2.1. Education and training policy

In the context of the knowledge society, the policy on education and training in Macedonia should aim towards creating values and knowledge that correspond to the demands of the domestic economy, as well as changing global society in all sectors. Moreover, educational policy should have a broader role of developing ethics, moral and social behaviour aiming at reducing inequalities and exclusion. Accomplishment of these tasks imposes the responsibility of the policy-makers to:

- Develop a comprehensive policy and regulatory framework for education and training to support the information economy and knowledge society;

⁵⁾ National Bank of the Republic of Macedonia/ main economic indicators/ <http://www.nbrm.mk/?ItemID=750FC531FC3D1B49B16440313562D400>

- Establish a system for professional development of teachers, trainers, researchers and all workers in the education and training sector and
- Enhance cooperation between industry and education.

Regarding the development of a comprehensive policy and regulatory framework for education, Macedonia experienced intense reforms in the education system in the past decade. The reforms were mostly tailored to strengthen the management, administration and teachers' competences in primary and secondary schools. The 2003-2010, the Education Modernization Project, financed with an IBRD loan, has helped Macedonia to respond to the challenges of creating a decentralized education system by:⁶⁾

- Establishing a school self-evaluation process; an evaluation performed by the State Education Inspectorate; and a nationally administrated assessment of student achievement, which provides data about the quality of the education system;
- Introducing medium and long-term planning at both central administration and school levels;
- Providing School Improvement Grants – of up to \$30,000 each – to all 427 primary and secondary schools to improve infrastructure, strengthen student security and hygiene, and provide teacher training and teaching aids.

According to the project assessment, the results have shown that between 2004 and 2008, the enrolment into secondary schools increased to 95 percent from 85 percent, and dropout rates decreased to 1.9 percent from 2.1 percent. A market for teachers' training has been established, along with criteria for accreditation and monitoring of teacher training services. In addition, from 2004 to 2007, 48.8 percent of school managers and teachers reported improvements in students' achievements, 60.7 percent saw improvement in planning and assessment processes, and 28.5 percent confirmed that attendance and participation of students improved.⁷⁾

In addition, there were reform activities in the higher education that included "liberalisation" of the education by enabling opening of private universities (2003), as well as compulsory implementation of the Bologna Declaration as of academic year 2009/2010.⁸⁾ That resulted into serious increase of the number of graduated from the higher education institutions (Table 3), in particular from post-graduated studies, while the absorption capacity of the economy has not increased, which caused changes on the labour market with regards to the structure of the unemployed.

⁶⁾ <http://web.worldbank.org/WBSITE/EXTERNAL/NEWS/0,,contentMDK:22489080~pagePK:64257043~piPK:437376~theSitePK:4607,00.html>

⁷⁾ Ibidem

⁸⁾ Law on Higher Education (Official Gazette of the Republic of Macedonia 35/08)

Table 3

UNIVERSITY AND POST-GRADUATE DEGREES IN MACEDONIA (2005-2011)

	Category/Year	2005	2006	2007	2008	2009	2010
1.	Graduated university students (total)	5132	5771	7835	10027	9570	9030
2.	Master of science	198	203	277	272	425	691
3.	Ph.D	92	85	82	87	119	157

State Statistical Office of the Republic of Macedonia/Statistical Review No. 2.4.11.12/695

Furthermore, the need for life-long learning was recognized and put into legal framework with the Law on Adult Education enacted in 2008.⁹⁾ These reforms aim to produce educated persons in accordance with the labour market needs and towards improvement of the competitiveness of the country’s economy, but the outcome is determined by many factors. Unfortunately, no detailed and comprehensive assessment of the introduced reforms in the tertiary and long-life education has been conducted so far.

Vital part of the efforts for promotion of the education’s outcomes is the professional development of the educational and training personnel. The education and training sector’s ability to adjust quickly to the demands of the information economy significantly determines the pace of adjustment of the workforce and community as a whole. So far, the professional development in the educational system in Macedonia has been supported with different projects funded by donors such as World Bank, USAID and EU that have provided part of the personnel in this sector with modern methodological and didactical skills. Furthermore, the Government project on modernisation of education¹⁰⁾ started in 2006 and the component “Computer for every child” has already provided sufficient IT equipment in the education system, enabling introduction of interactive and interesting teaching methods. These activities imply extensive changes in the education, but the process is a gradual one, given the complexity and size of the system.

Despite reforms, the KEI score indicated downward movements in the field of education in Macedonia, given the decrease of the score to 5.15 in 2012 against 5.54 in 2000. Furthermore, the education had lower performances compared to other variables, apart of innovation (Table 1). In addition, the current labour market situation in Macedonia indicates serious problems with regards to the engagement of the available human resources. Although decreasing in the past few years, the rate of unemployment is still rather high – over 31% in the period 2005-2011 (Table 4). The labour

⁹⁾ European Commission Progress report on the Republic of Macedonia 2008, Chapter 26/ <http://www.sep.gov.mk/Default.aspx?ContentID=36&ControlID=IzvestaiEU.aspx>

¹⁰⁾ Project on modernisation of education, *Ministry for information society* www.mon.gov.mk/PMO/files/mk/vazni-dokumenti/Progress-Report-MK-5.pdf

market is facing a situation of a continuous increase of the unemployment of the youth and highly educated persons, which raises a question about the matchmaking between the education reforms and labour market demands.

Table 4

PARTICIPATION OF THE UNEMPLOYED PERSONS WITH HIGHER EDUCATION* ON THE LABOUR MARKET IN MACEDONIA(2005-2011)

Category	2005	2006	2007	2008	2009	2010
1. Rate of unemployment	37.3	36.0	34.9	33.8	32.2	32.0
2. Unemployed persons (in absolute number)	323934	321274	316905	310409	298873	300439
3. Unemployed persons with higher education (in absolute number)	19892	21910	23550	24077	29376	32973
4. Share of the unemployed with higher education in total unemployed persons (in %)	6.1	6.8	7.4	7.8	9.8	11.0

* Data refer to the persons with graduate education, masters and Ph.D

Source: State Statistical Office of the Republic of Macedonia/Labour Force Survey, Statistical Review No 2.4.11.09/692; No 2.4.10.04/651; No 2.4.9.12/632; No 2.4.8.06/593 and No 2.4.6.07/531.

The current situation of large share of the unemployed persons with university degree in the total unemployed, imposes a great challenge to these persons to increase their flexibility to the economy's demands. In this context, there were/are some programmes and projects related to increase of the skills of the labour force, in particular the EU funded V.E.T (Vocational Education and Training) project providing technical and financial assistance to the reforms in the Macedonian education since 1999.¹¹⁾ There were four V.E.T. projects so far, while the latest one (since 2006) aims to enhance secondary education and to modernise VET schools in order to meet the needs of the labour market. The previous projects aimed to introduce new equipment and to implement new curricula related to modern IT equipment and specific branch equipment in workshops and laboratories.¹²⁾ Another project focusing on the link between the labour market and education is the USAID project "YOUTH EMPLOYABILITY SKILLS (YES) NETWORK ACTIVITY" (2010-2015) that should provide the youth will relevant skills that will enable them to participate in the modern economy. The programme targets students in their final year in the Macedonia's Vocational Education and Training (VET) Schools, unemployed registrants with the Employment Service Agency (ESA) and other out-of-school youth, aged 15-24.¹³⁾ There are two components of the project: 1) Build public-private dialogue to better match the skills

11) EFT country plan 2009 for Macedonia/European Training Foundation [http://www.etf.europa.eu/pubmgmt.nsf/\(getAttachment\)/D11CDB3695FA111CC12575390036E66D/\\$File/NOTE7N5DQR.pdf](http://www.etf.europa.eu/pubmgmt.nsf/(getAttachment)/D11CDB3695FA111CC12575390036E66D/$File/NOTE7N5DQR.pdf)

12) <http://www.bfi-wien.at/eu-projekte/vet-macedonia/>

13) <http://macedonia.usaid.gov/en/sectors/education/YES.html>

required in the labour market with those developed in schools and 2) Improve the “supply” of future workers by creating Youth Employability Skills networks.¹⁴⁾ Given the start of the project in September 2010, no assessment of the results is yet available.

The mentioned projects mostly refer to acquiring skills in the secondary schools or vocational training, while the cooperation between industry and higher education in Macedonia appear mostly ad hoc, i.e. there is no systematic integration between those two sectors. The higher education policy has not been really related to the industrial policy, as evident from the growing number of the unemployed highly educated persons (Table 4), who, implicitly, have specialization in non-propulsive industrial branches. In addition, there is a strong trend of increase of the number of the persons with higher and postgraduate education in the period 2009-2011 (Table 3), while the industrial policy has not designated specific areas of development which should serve as a guide in curricula formulation by the Universities. Further lack of systematic link between both fields (university education and industrial policy) would likely to continue producing educated workforce that would face problems to find adequate jobs. This situation, along with the decreasing score of the education component in the KEI index (Table 2) indicates huge challenges in the area of the education policy towards building of a knowledge society in the country.

The education policy should be further developed to contribute genuinely to a knowledge society platform. The university education must be closely linked to the labour market demands and the lifelong learning must really become a key policy focus, highlighting the mutually reinforcing importance of the economic and social strands to the knowledge society development. Moreover, the policy framework should ensure sufficient public investment in education, but also needs to encourage effective partnerships with the private sector that can provide access to a wider pool of expertise and technology, open up new market opportunities and create more favourable climate for innovation of efficient and effective methods of education and training.

2.2. ICT policy

Creation of a knowledge society is not possible without advanced ICT infrastructure in the country, available to all citizens under favourable terms. The ICT policy in Macedonia should aim to enable access to advanced information technology and telecommunication infrastructure at an affordable price for all citizens and especially to education, training and research institutions. Better access to the current ICT

¹⁴⁾ Ibidem

infrastructure has been foreseen in the National Strategy for Development of Information Society in Macedonia elaborated in 2005.¹⁵⁾ So far, a noticeable progress has been registered in this area, as the number of the companies (with 10 or more employees) using internet increased from 70.3% in 2006¹⁶⁾ to 88.6% in 2011.¹⁷⁾ In addition, internet access was significantly improved in the households from 14% in 2006¹⁸⁾ to 55% in 2011.¹⁹⁾

The KEI index confirmed that the country stands well in the area of ICT (Table 2). The score ranged from 7.00 in 1995, down to 5.55 in 2000 and up to 6.74 in 2012. Given that the ICT index refer to the “information and communication technology to facilitate the effective creation, dissemination, and processing of information”,²⁰⁾ the increasing use of the internet in the country is encouraging, along with the rising availability of the e-services. Within the framework of the USAID project e-government (2004-2011), the following e-services were developed:²¹⁾

- Electronic public procurement;
- Single portal for export/import licences (EXIM);
- Online registration of employment;
- Automated system for management of international cargo transport licences;
- E-tax services;
- Online application for civil servant positions and
- E-budgeting.

However, the electronic trade is still barely used in the country, while use of e-learning systems in Macedonia is rather limited, due to the insufficient infrastructure in the education and training institutions, as well as limited equipment that end-users possess for access and use of the online services. The project on modernisation of the

¹⁵⁾ National Strategy for Development of Information Society in the Republic of Macedonia, *Ministry for information society* http://www.mio.gov.mk/files/pdf/dokumenti/Strategija_i_Akcionen_Plan.pdf

¹⁶⁾ Information society news release 8.1.7.05, *State Statistical Office of the Republic of Macedonia*

¹⁷⁾ Information society news release 8.1.11.22, *State Statistical Office of the Republic of Macedonia*

¹⁸⁾ Information society news release 8.1.6.14, *State Statistical Office of the Republic of Macedonia*

¹⁹⁾ Information society news release 8.1.11.25, *State Statistical Office of the Republic of Macedonia*

²⁰⁾ <http://web.worldbank.org/WBSITE/EXTERNAL/WBI/WBIPROGRAMS/KFDLP/EXTUNIKAM/0,,contentMDK:20584268~menuPK:1433162~pagePK:64168445~piPK:64168309~theSitePK:1414721,00.html>

²¹⁾ <http://macedonia.usaid.gov/en/sectors/economic/egov.html>

education, in particular, the component “Computer for every child” has provided some infrastructure in the primary and secondary schools, but the foreseen outcomes of the projects should be expected in a longer period of time.

As the modern trends in the education and training encourage wider use of e-learning as key mode of education, the ICT policy should promote establishment of reliable, sustainable, affordable and mutually compatible infrastructure support systems and high capacity networking within and among education, training and research institutions. Furthermore, rapid technological changes in the world impose a need for prompt adaptation of the national economy that should be based on carefully selected industries for development, with highest potential for technological advancement and innovation. Therefore, although performing better compared to the other KEI components, ICT policy should continue to follow developments in this area, in purpose of providing platform for other knowledge economy components.

2.3. Research and development policy

Another core policy area contributing to the knowledge society is research and development (R&D). The importance of R&D has been recognized as a priority in the EU Lisbon Strategy aiming at boosting employment and growth in Europe. The rapid pace of technological change on the global level imposes need for immediate actions for research and development on the local level, especially in the countries that are economically and technologically lagging, such as Macedonia. The KEI indexes confirm that the country needs to undertake serious reforms in the area of R&D, given the lowest score in the area of innovation, compared to other KEI components (Table 2). The score ranged from 4.43 in 1995, down to 4.35 in 2000 and up to 4.99 in 2012.

The current situation in the country reflects lack of genuine support to this sector, represented through low technological level in the industry, very low funds for research and innovations, negligible investment in talents and narrow embedding of research in practice. Central budget allocation for research and development stands on a low level, although it registered an increase from €12.9m in 2007 up to €20.4m in 2008, but decreased again to €15.4m in 2009 (Table 5). Most of these finances were allocated for the salaries of the personnel employed in these institutions, leaving very scarce budget for the equipment and other necessities for the research activities.

As evident from the Table 5, the number of employed in the research institutions decreased by 17% year on year in 2009, or down to 5085 persons against 6114 in 2008. Given that only around 60% of the total employees in these institutions are researchers, this fact additionally stresses out the unfavourable situation with regards to research and development sector in Macedonia. The number of employed in R&D in the business sector is not sufficient, as well, confirmed by the low number of domestic patents in the analysed period, in particular 2008-2009.

Table 5

EMPLOYEES AND SUPPORT IN THE R&D INSTITUTIONS (2007-2009)

Category	2007	2008	2009
1. Number of research institutions	53	53	51
2. Total number of full-time employees in the R&D institutions	6245	6114	5085
2a) Business sector	1865	1407	1465
2b) Government sector*	710	712	647
2c) Higher education sector	3670	3995	2973
3. Employees on contract in the R&D institutions	515	495	316
4. Share of the researchers in the total number of employees in R&D (in %)	62.1	61.8	61.2
5. Ministry of education and science allocation on R&D (in millions \square), including salaries in the sector	12.9	20.4	15.4
6. Number of domestic patents	150	34	39

* The government sector includes the institutions financed by the Government, which primarily deal with R&D, such as research institutes.

Source: State Statistical Office of the Republic of Macedonia/Statistical Review on Research and Development No.2.4.0.01/611; No.2.4.11.08/691; No.2.4.11.18/703; Annual Report of the State Office of Industrial Property 2010.

The insufficient R&D activity in the country has been affecting the country's competitiveness. According to the World Economic Forum Global Competitiveness Index (GCI) 2011-2012, Macedonia was ranked 79 (out of 142) with score of 4.05 (out of 7), according to the overall index of competitiveness. In terms of sub-indices, Macedonia had lowest score in "innovation and sophistication factors" - only 3.14 (rank 104).²²⁾

The low competitiveness index reflects the lack of the industrial policy in a longer period of time. Macedonia has formulated the industrial policy relatively late, in 2009. Nevertheless, the recently formulated policy framework does not clearly stress out the industrial areas that should be prioritized. Certain prioritization was done within USAID project on "Macedonian competitiveness activity" in 2003,²³⁾ which selected five clusters with highest potential for competitiveness increase – lamb meat and cheese, tourism, information technology, wine and textile apparel. In addition, Macedonian government has distinguished the sectors with highest investment and export potential in 2007. These are: automotive components industry, information communications technology, healthcare products (pharmaceuticals and medical devices) and agro-business and food processing industry.²⁴⁾ However, no specific development measures are undertaken following the mentioned prioritization.

²²⁾ http://www3.weforum.org/docs/WEF_GCR_Report_2011-12.pdf

²³⁾ USAID Macedonia Competitiveness Project, http://macedonia.usaid.gov/English/EG/MCA_eng.htm

²⁴⁾ Invest in Macedonia, <http://www.investinmacedonia.com/page.aspx?language=EN&page=UM729bN5xqDvjEyW5Mhx0Q>

Those priorities should serve as guidelines for the reforms in the R&D policy, as well as education system, but need to be supported by both - the private and public sector. The focus of the research policy should not be only on the individual research institutions and researchers, but on the interaction between research and various business and social actors crucial for applying knowledge and delivery of better jobs and higher standard of living. According to the Global Competitiveness Index 2011-2012, the third ranked factor as problematic for doing business in Macedonia was “inadequately educated workforce”.²⁵⁾ The intense reforms in the education and increased number of unemployed highly educated persons (Table 3) raises question about the quality of the undertaken reforms in education in line with the demands of the global economy. In this respect, establishment of the educational clusters of excellence in the selected areas for development could be a good approach towards enhancement of the cooperation between industry and education.

R&D determine competitiveness in the knowledge society at great extent, as information economy is based on knowledge-based industries. Therefore, further efforts should be focused on formulation and implementation of coherent R&D and industrial policy, focused on technological advancement, higher growth and prosperity for a country. Both these policies needs to ensure higher technological base that will underpin higher value added economic activities, optimal utilisation of human and other resources, increased employment, growth in productivity and higher international competitiveness. Accomplishment of these tasks requires not only a strong R&D and technology base, but also strong capacities in industry to convert fundamental and applied research into new products, services or processes, as well as to bring these innovations quickly to the market. That is certainly a serious challenge for the policy-makers, but the pace of the technological development is not leaving an alternative.

* * *

Considering the variety of specific challenges for development of a knowledge-based society in Macedonia, ***the policy-makers need to develop proactive approach aiming at better key policies and to build coherent framework that will encompass all policy aspects relevant for the knowledge society.*** Sustainable future of the country could be ensured if citizens are embodied with the key competencies and functional literacy for the knowledge economy. As Charles Darwin said: “It is not the strongest of the species that survive, nor the most intelligent, but the ones most responsive to change”.²⁶⁾ In the knowledge society’s terminology, only nations acquiring and effectively using knowledge could be winners in the modern world.

²⁵⁾ http://www3.weforum.org/docs/WEF_GCR_Report_2011-12.pdf, p.242

²⁶⁾ Charles Darwin Quotes, *Brainy Quote*, http://www.brainyquote.com/quotes/authors/c/charles_darwin.html

CONCLUSION

Knowledge society has become a target of many societies at the start of 21st century, as it provides preconditions for comprehensive wealth, social cohesion and a healthy environment. Knowledge society encompasses variety of aspects determining the wealth generation and sustainable development, but it is primarily shaped by three core policy areas – education and training, ICT, research and development. In each of these policies, the knowledge is an essential asset that should be managed through effective and efficient policy approach on both levels – individual and integral policy making. The latter one is distinguished as vital to ensure an optimal balance between the knowledge and utilization of the available resources in a sustainable way. The current situation in Macedonia indicates determination towards building of a knowledge society in the country, but substantial efforts needs to be focused on development of integral policy approach.

In terms of specific policies, Macedonia has experienced significant reforms in the area of education and training in the past decade. Management, administration and teachers' competences in education were strengthened and life-long learning was brought into the policy-makers' focus. The main challenges with regards to further reforms in the area of education and training are related to introduction and application of new technologies and methods in the education and training that should enable delivery of proper skills for knowledge society, maintaining the lifelong learning as key policy focus, ensuring sufficient public investment in education and promotion of partnerships with the private sector. Also, the policy on education and training should ensure continuous professional development of the personnel in this sector, as well to provide advanced ICT infrastructure in the country that will have a strong role in performing and boosting economic activities. Additional challenge for the policy-makers is to enhance cooperation between industry and education through establishment of educational clusters of excellence in the selected areas for development, according to the country's resources. This also requires for improved link between education and labour market in Macedonia.

Another core policy area contributing to the knowledge society is research and development. The current situation in the country reflects lack of real support in this sector, especially visible through decreasing number of personnel in this area, as well as insufficient funds for research and innovations. Therefore, a better R&D policy in Macedonia should ensure strong support to research institutions and boost cooperation between industry and R&D, essential to accelerate the achievement of the knowledge society goals. In this respect, lack of specific industrial policy in the country represents a serious obstacle that should be promptly addressed by formulation and implementation on coherent industrial policy focused on technological advancement, higher growth and prosperity for a country. The R&D policy needs to ensure higher technological base that will underpin higher value added economic activities leading

toward better economic performances of Macedonia, but it should also contain a dimension that will ensure sustainable use of the available resources. Implicitly, this requires a development of a proactive and coherent integral policy framework for knowledge society that would encompass the policy aspects relevant for maximisation of the benefits from the technological changes in a sustainable way.

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FINANCIAL CONVERGENCE OF THE REPUBLIC OF MACEDONIA WITH THE EUROPEAN UNION

Abstract

In this paper we explore the issue of financial convergence of the Republic of Macedonia with the EU. The purposes of our analysis is to determine the degree to which the domestic financial markets have become more similar to european financial markets. Is it interesting for several reasons. First, the country, the Republic of Macedonia, considered were centrally planned economy with undeveloped financial services. The transition path to a market economy was very uneven in the beginning due to delayed structural reforms and bad macroeconomic policies. As a result is achieved some markedly better outcomes, but there is greater room for the improvement in terms of increase of per capita income and price stability. These differences might have influenced also the process of integration of the domestic financial sector with those of the EU states. Secondly, the removal of barriers to factor mobility (a prerequisite for an economic union) implies convergence of the factor returns. Since capital tends to be relatively more mobile than labour, for example, the price equalization should take place more rapidly. The state of financial integration is also important from a policy making point of view. Well integrated markets are characterized by faster and more complete transmission of changes in the monetary policy.

The analysis in this paper will be based on two approaches to measuring convergence which have been originally developed in the growth literature-cross-sectional measures and compared with to the European standards- cointegration analysis.

Key words: financial convergence, financial markets, interest rate, bond yield, structural changes.

JEL Classification: E44

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1. Introduction

Measuring financial integration between the "new" EU member states and Eurozone is of great interest for policymakers and researchers. To begin, both theory and empirical findings suggest that financial integration contributes to a more efficient capital allocation, which, in turn, fosters economic growth. Several studies find that financial integration in the "old" EU member countries resulting from the introduction of the euro is beneficial for economic development and growth. In addition, the extent to which financial markets in the "new" EU member states are integrated with the Eurozone countries is an important factor in the recent debate on the appropriate time to adopt euro in these countries. Although the benefits from giving up monetary autonomy and adopting a single currency are considered to be proportional to the degree of financial integration already achieved, the financial integration itself can be promoted by the elimination of currency risks following the expansion of the Eurozone. Finally, financial integration has important implication for international investors and portfolio managers.

More integrated financial markets offer greater opportunities for agents to diversify portfolios and share idiosyncratic risks across countries. However, the more integrated financial markets can also lead to spill-overs of negative systematic shocks originating in the "old" EU countries to the "new" EU member states.

Despite the importance of financial integration for monetary convergence and economic development in the "new" EU member states, only few studies provide a quantitative account of the degree and development of financial integration in these countries. Most of the existing studies focus on various aspects of financial integration in the most developed "new" EU member states, including the Czech Republic, Hungary and Poland, for which the information on various financial indicators is more readily available, although some recent studies cover more countries and financial markets. A popular approach for studying financial integration is based on the so-called-convergence and convergence measures borrowed from the economic growth literature. The convergence detects catching-up tendencies across countries, while convergence identifies the state of the convergence for a particular period in time. Both measures are based on the law of one price, which disregards the presence of market frictions and transaction costs.

Another widely used technique employed in the financial integration literature is based on the co-movement of interest rates across countries. The workhorse methodology in this type of empirical works is cointegration analysis. However, similarly to the previous measures, a simple linear cointegration methodology is too restrictive since it does not take into account the impact of transaction costs and market frictions, that restrict the adjustment of interest rates towards long run equilibrium. In addition, a direct application of cointegration methods in the context of "new" EU member countries, most of which evolved through the transformation process from

planned to market economy during the 1990s, is problematic as during the transformation period relationships are changing.

Given the wide variety of empirical strategies employed for studying financial integration in the "new" EU member states, it is not surprising that the evidence coming from these studies is controversial.

In this paper we address the issue of financial market integration in the Republic of Macedonia. Our estimation results suggest that financial markets in the Republic of Macedonia gradually became more financially integrated with EU members. However, the degree of integration differs across financial segments: money markets appear to be the most integrated ones due to lower transaction costs, while loan markets display the lowest degree of integration.

2. THEORETICAL BASE AND ANALYTICAL FRAMEWORK

The interest in economic convergence emerged from the work on growth theory. One important implication of the neoclassical growth model is that the rate of increase of per capita output is inversely related to the absolute or conditional (if differences in the parameters of the economies are allowed) convergence. In this case the relevant concept of convergence is conditional convergence. Within the framework of conditional convergence, based on the Barro and Sala-i-Martin¹⁾ equation (which is a loglinearized approximation of the Solow growth model with Cobb-Douglas production function), an economy tends to grow faster when the value of the parameter β is positive (that means the speed of adjustment to equilibrium).

The concept of β -convergence has been criticized on a number of grounds. One of the best known critiques comes from Milton Friedman. In his article²⁾ Friedman is assumed that the true test of convergence is a decline in the variance among individual observations. This description of convergence has become popular as σ -convergence³⁾. For an extensive review of the literature on the various tests of convergence can see Rassekh⁴⁾.

The idea of convergence, that originated in relation with economic growth, was later applied to a wide range of problems, including the integration of financial markets. There is a well developed strand in the literature that tries to test and find evi-

1) Barro, R., Sala-i-Martin, X.: Convergence, *Journal of Political Economy* 100, No.2, 1992.

2) Friedman, M.: Do Old Fallacies Ever Die?, *Journal of Economic Literature* 30, No. 4, 1992.

3) Barro, R., Sala-i-Martin, X.: *Economic Growth*, McGraw-Hill, 1995.

4) Rassekh, F.: The Convergence Hypothesis: History, Theory and Evidence, *Open Economies Review* 9, 1998.

dence for the financial convergence among countries and especially, within a monetary union. Since the adoption of the Maastricht Treaty, which set the principles for further integration in the EU and the establishment of common currency, there has been substantial interest in testing the financial convergence hypothesis within the EU and the euro area. The expectations to find convergence are based on the effects of the removal of national barriers to flow of capital, explicit and market driven harmonization of regulations and supervisory standards and the mechanisms for coordination and convergence of macroeconomic policies of the national authorities within the union. Although the economic union should allow all factors of production to move freely across the borders, capital flows cross the borders much more easily than people or goods. Hence, one would expect to see a faster convergence in the financial markets as compared to the labour and goods markets.

A comprehensive methodology for analyzing the process of financial market integration in the European Union is provided by Adam et al.⁵⁾ The authors suggest to use a variety of indicators, based on price and returns data as well as indicators based on quantities (besides the β and σ convergence measures) to infer about the degree of integration of capital markets in the EU. The paper by Baele et al.⁶⁾ steps on the methodology developed in Report to the European Commission and complements it with some additional indicators for integration, like the response of interest rates to common news vs. local news. Also, analysis of the corporate bond market is included. They find that in the period 1993-2003 the degree of integration has increased in all markets except for the credit market. The money market is found to be the most integrated among the markets notwithstanding the differences that still remain between the various segments of the money market. As far as the new EU member states are concerned, a recent study by Baltzer et al.⁷⁾ provides valuable insights about the developments of the financial markets in these countries.

Following Baele et al. the authors estimate price-based, news-based and quantity-based measures of integration. They find that the financial markets in the NMS are considerably less integrated than the countries in the euro area. Yet, the process of integration is under way and the EU accession has given a significant impetus to it. Integration is more visible in the money and banking markets, both among NMS and vis-a-vis euro area, whereas in the bond markets it seems to be more relevant for the large economies.

5) Adam, K., Japelli, T., Menichini, A., Padula, M., Pagano, M. : Analyse, Compare, and Apply Alternative Indicators and Monitoring Methodologies to Measure the Evolution of Capital Market Integration in the European Union, Report to the European Commission.

6) Baele, L., Ferrando, A., Hordahl, P., Krylova, E., Monnet, C.: Measuring Financial Integration in the Euro Area, ECB Occasional Paper No. 14, April 2004.

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The backbone of the financial convergence analysis in the above cited papers is the following panel regression:

$$(1) \quad \Delta r_{i,t} = \alpha_i + \beta r_{i,t-1} + \sum_{l=1}^L \gamma_l \Delta r_{i,t-l} + \epsilon_{i,t}$$

where $r_{i,t}$ denotes the spread between the return on some asset in country i and the return of the benchmark asset, Δ is the difference operator, $\epsilon_{i,t}$ is the error term and α_i is a country-specific constant. The main parameter of interest in this equation is β . Negative and statistically significant estimate of this parameter implies that returns in countries with high returns tend to decrease more rapidly. This specification was considered by Evans and Karras¹ in their study of economic growth.

Along with the β and σ measures, which are based on cross-sectional data, there are a number of studies which employ time-series tests of convergence. The time-series notion of convergence requires that the forecasts of the variable of interest y in countries i and j , given the available information I_t at time t , should be equal, i.e.

$$\lim T \rightarrow \infty E(y_{j,t+T} - y_{i,t+T} | I_t) = 0$$

This approach to convergence is associated with a number of assumptions, e.g. zero mean stationarity of the difference of the variables. Datta⁹⁾ noted that co-integration based tests, which assume structural stability, would fail to detect convergence if the countries are still in the process of converging. She proposed an alternative approach to capture the idea that the cross-country differences reflect the fact that the steady-state has not been reached yet. Furthermore, the process may not be “smooth”, i.e. there could be structural changes which could lead to a rejection of the hypothesis of convergence. To overcome this shortcoming Datta suggests estimating a time-varying parameter model where the parameter $\hat{\alpha}_t$ changes over time following a first-order autoregressive process. In doing so she uses a definition of convergence as catching up: if $y_{i,t} > y_{j,t}$ then $E(y_{i,t+k} - y_{j,t+k} | I_t) < y_{i,t} - y_{j,t}$. The model used to infer about convergence is written in a state-space form:

$$(2) \quad y_t = X_t \beta_t + \epsilon_t$$

$$(3) \quad \beta_t = M \beta_{t-1} + v_t.$$

Here X_t is a matrix of exogenous variables and M is a diagonal matrix.

The time-varying parameters β_t are estimated with the Kalman filter. The “convergence as catching up” concept has been applied for a sample of OECD countries by estimating the following equation:

⁸⁾ Evans, P., Karras, G: Convergence Revisited, *Journal of Monetary Economics* 37, 1996.

⁹⁾ Datta, A.: Time-series Tests of Convergence and Transitional Dynamics, *Economics Letters* 81, 2003, pp. 233-240.

$$\ln Y_i(t) = \beta_0(t) + \beta_1(t) \ln Y_{us} + \varepsilon_i(t),$$

where Y_i and Y_{us} denote the per-capita GDP of country i and us, respectively. Convergence in this setup is measured by the difference ($Y_{us} - \hat{Y}_i$), i.e. the difference between the actual value for the reference economy and the fitted value from the time-varying parameter (TVP) model for country i . The declining trend of this difference signals convergence.

It is obviously that there is no single measure which would capture all aspects of financial integration. Many of the relevant authors consider financial markets to be integrated if all potential market participants with the same relevant characteristics face similar rules in dealing with financial instruments, have equal access to the mentioned financial instruments and are treated equally when active in the market. The authors divide existing measures of financial integration into three broad categories: (a) price-based, (b) news-based, and (c) quantity-based measures.

The first set of measures is based on the interest parity relationship, which is presentation of the no-arbitrage condition (law of one price) in financial markets. The second set of measures makes use of the asset pricing theory and distinguishes between common (systematic) and local (idiosyncratic) risks. The markets are considered to be fully integrated when only the common risk factors (often proxied by yields in the benchmark country) determine the equilibrium returns. Finally, the third group of measures accounts for quantitative characteristics of cross-border investment activities in the form of capital flows, listings, M&A and other relevant indicators.

3. STUDIES ON EU FINANCIAL INTEGRATION

Most of the existing studies on EU financial integration have focused exclusively on financial integration in the “old” EU member states¹⁰⁾. This literature documents that European countries have become more financially integrated over time and that

¹⁰⁾ Fratzscher, Marcel, “Financial Market Integration in Europe: on the Effects of EMU on Stock Markets,” European Central Bank Working Paper Series n. 48. 2001; Adam, K., Japelli, T., Menichini, A., Padula, M., Pagano, M.: Analyse, Compare, and Apply Alternative Indicators and Monitoring Methodologies to Measure the Evolution of Capital Market Integration in the European Union, Report to the European Commission; Adjaoute, Kpate, and Jean-Pierre Danthine (2000), “EMU and Portfolio Diversification Opportunities,” FAME Research Paper no. 31, April. Adjaoute and Danthine, 2003; Baele, L., Ferrando, A., Hordahl, P., Krylova, E., Monnet, C.: Measuring Financial Integration in the Euro Area, ECB Occasional Paper No. 14, April 2004; Hardouvelis, Gikas A., Dimitrios Malliaropoulos and Richard Priestley (1999), “EMU and European Stock Market Integration,” CEPR Discussion Paper no. 2124., 2006; Kalin Hristov and Rosen Rozenov: Financial Convergence in the New EU Member States, W.P. D.1.2., European Commission, 2009.

the degree of integration has accelerated following the launch of the single currency in 1999. However, the current level of financial integration differs across different financial segments. In particular, some financial markets still exhibit various frictions preventing full integration.

The evidence on financial integration in the “new” EU member states is far less exhaustive. The existing studies on financial integration in the “new” EU members can be subdivided into descriptive studies and quantitative empirical applications. The descriptive studies focus on various aspects of legal and institutional adjustments, which took place in the “new” EU member countries to adjust their financial markets to the European standards.

A common finding in this literature is that increasing harmonization of the regulatory framework and integration of underlying financial infrastructures has bolstered the general convergence tendencies in the “new” member states.

The quantitative studies make a use of standard measures of financial integration and apply them to different financial market segments in the “new” EU member states, usually using Germany as a benchmark country. Among those studies, analyze integration of money markets, examine the validity of the monetary independence hypothesis using money market interest rate data for a group of advanced “new” EU member states with different degrees of flexibility in exchange rate regimes: the Czech Republic, Hungary and Poland. They find that neither of the countries could enjoy full monetary independence. The correlation between Czech and foreign interest rates tended to decrease with the increase of the exchange rate flexibility, but for Poland the degree of sensitivity of domestic interest rates to the foreign benchmark has increased with the introduction of more flexible exchange rate regime.

Others study the covered interest parity in “new” members with respect to the Euro area countries and provide a quantitative assessment of the factors driving systematic deviations from parity. They find that money markets in the “new” member countries show an increasing degree of integration with the Euro area. However, discrepancies are not completely eliminated yet due to transaction costs caused by the low level of liquidity and underdeveloped financial markets, which diminish the possibilities of arbitrage. They analyze the dynamics of interest rate spreads between eight CEE “new” EU member countries and the Euro area and report continuing decrease of the margins over time.

In addition, they show that integration between the “new” EU members and the Euro area has evolved through different phases: the bull period 2000-2003 characterized by a sharp spread contraction, the bear period 2003-2004 of spread widening, and the second bull period 2004-2005. Among the factors contributing to the segmentation of the national financial markets they also mention restrictions on short-term capital movements, which were abolished in 2001.

A number of recent papers studies integration of equity markets in the “new” member states using different methodologies. Some of them apply linear cointe-

gration methods, then employ a GARCH methodology, make a use of the -and - convergence indicators, and use a "comovement box" methodology based on the conditional correlations of different time-varying quantiles of the returns.

The common conclusion coming from these studies is that equity markets are becoming more integrated over time, which is reflected in statistically significant long-run relationships between stock indices (cointegration) and decreasing time varying volatility of stock returns in more recent periods. However, the speed and degree of integration greatly varies across countries and the studies provide contradictory conclusions in this regard. The conflicting results coming from differencies in apply this methodology also for studying integration in bond markets.

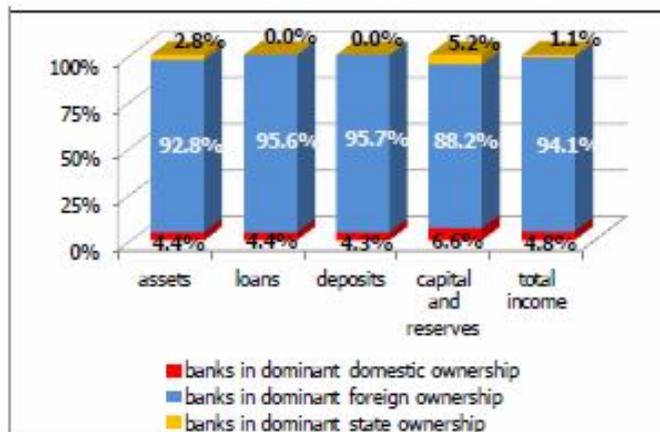
4. ASSESING THE FINANCIAL MARKETS IN THE REPUBLIC OF MACEDONIA

4.1. Financial sector development

The banking system in the Republic of Macedonia consisted of seventeen banks and eight savings hoses. Most numerous are the banks in dominant ownership of foreign shareholders, who have the biggest share in the structure of all major balance sheet categories(see Figure1).The share of state ownership in the sector remains low, at 7% of the sector’s assets.

Figure 1

FIGURE 1 STRUCTURE OF THE MAJOT BALANCE SHEET ITEMS, ACCORDING TO THE DOMINANT OWNERSHIP OF BANKS



Source: NBRM,

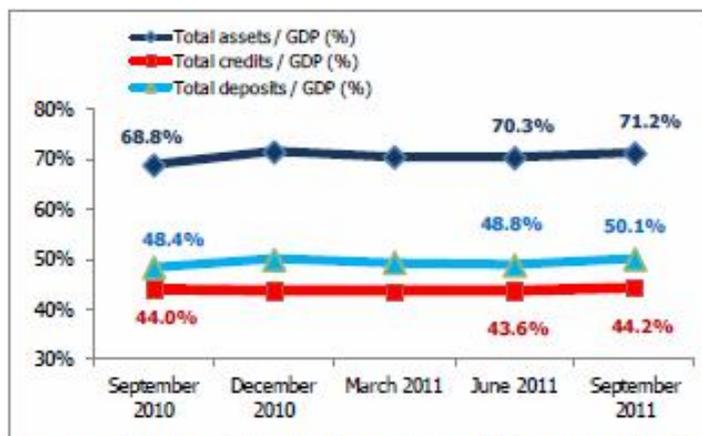
The share of savings houses in the total activities of deposit institutions (banks and savings houses) remained insignificant (0.9% share in total assets, 1.4% in total loans and 0.3% in total deposits of non-financial entities¹¹).

Concentration in the banking system is high, but generally it shows a tendency of decreasing¹². The five largest banks account for over 75% of all segments of the banks' operations. The high concentration is confirmed by the participation of the assets of an individual bank in total assets, with ten banks having individual participation of up to 3% or 15.3% all together¹³.

At the end of the third quarter of 2011 compared to June 2011 (as presented on figure 2), financial intermediation measured through the ratio of total assets, loans and deposits to GDP went up by 0.9 percentage points, 0.6 percentage points and 1.3 percentage points, respectively.

Figure 2

LEVEL OF FINANCIAL INTERMEDIATION IN THE BANKING SYSTEM



Source: National Bank, based on data submitted by banks.

The financial sector's significance and its intermediation function has increased, reflecting additional capital from foreign investors but also increased deposits and lending. In the banking sector, total assets as a share of GDP were up from 67% mid of 2010 to 69% of the estimated GDP by mid 2011.

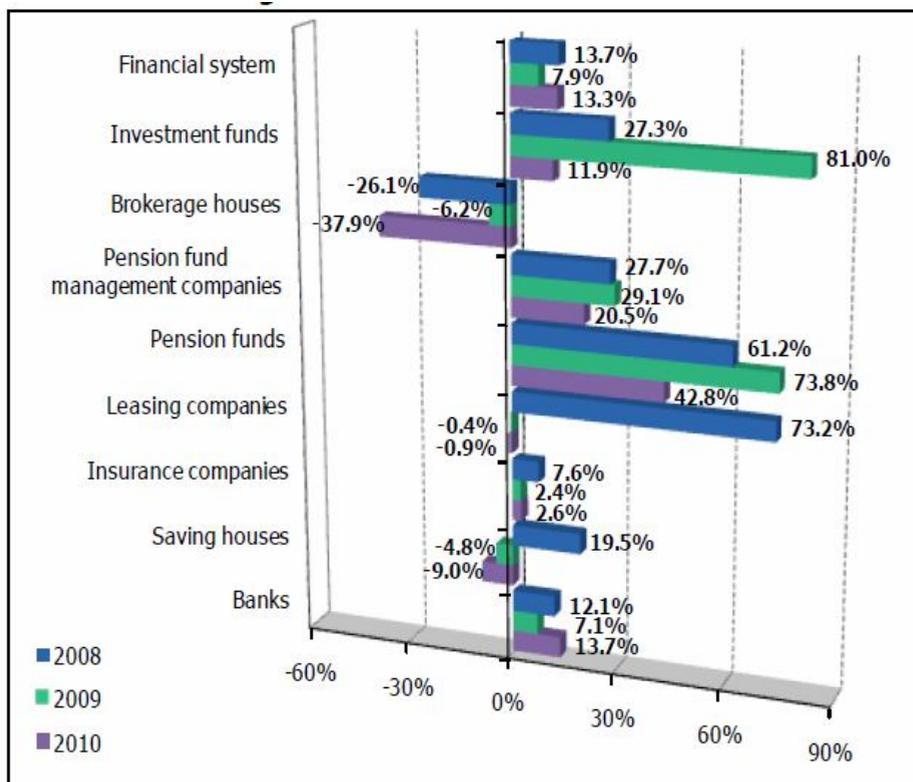
¹¹) Report on Banking System of the Republic of Macedonia in the third quarter of 2011, NBRM, 2011, p. 8.

¹²) Measured by the Herfindahl-index and CR5 index.

¹³) Report on Banking System of the Republic of Macedonia in the third quarter of 2011, NBRM, 2011, p. 10.

Figure 3

ANNUAL GROWTH RATES OF THE ASSETS OF EACH INSTITUTIONAL SEGMENT OF THE FINANCIAL SECTOR



Source: NBRM, SEC, MAPAS, ISA and the Ministry of Finance

Credits as a share of GDP increased from to 43.5% in October 2010 to some 45% of the estimated GDP end of August 2011, while the level of deposits rose from 48% end of October 2010 to around 50% of the projected GDP in August 2011¹⁴⁾.

Deposits continue to be the sector's main source of liquidity. The coverage of loans by deposits is still above 100%. The main state asset is the majority share in the country's only development bank and a limited number of remaining minority shares. Market concentration remains high, but has decreased slightly during the past year. The assets of the five biggest banks as a share of total assets declined only marginally, from 77.4% end of 2009 to 77.2% end of 2010. However, the three biggest banks lost some market shares to medium-sized banks. The efficiency of the banking sector has

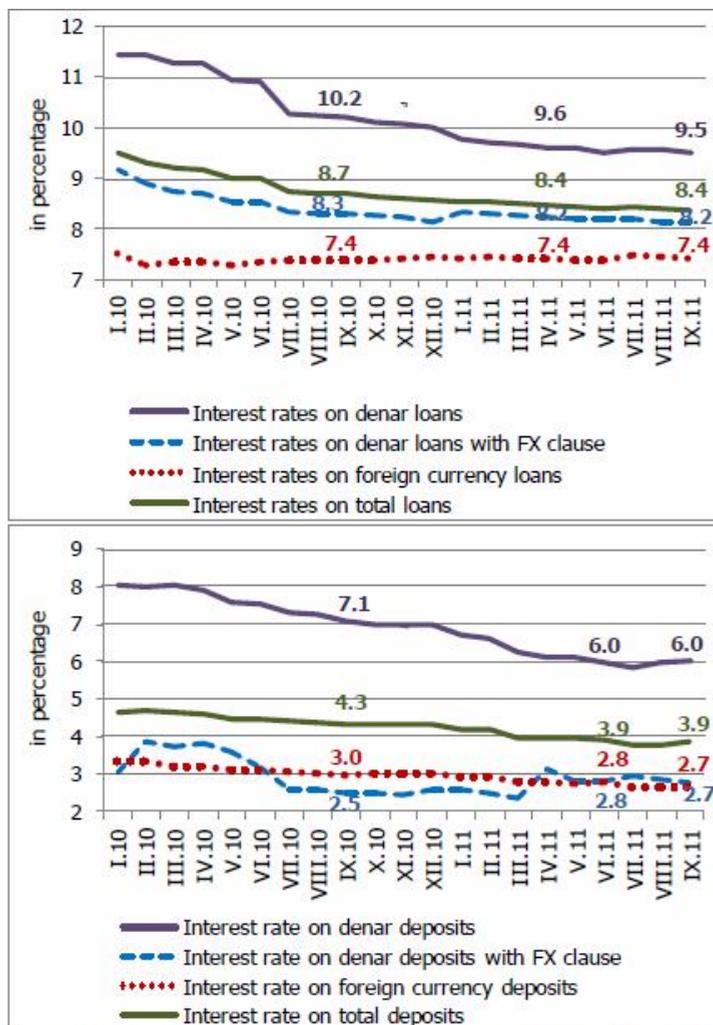
¹⁴⁾ European Commission Progress report on the Republic of Macedonia 2011, p 27.

remained largely unchanged. Profitability of the sector as a whole remains low, with slightly negative returns-on-assets and equity at the end of September 2011, relative to the same period of the previous year. However, larger banks performed better than smaller ones. Credit growth slowed down on annual basis.

Private-sector weighted interest rates declined following their peak in the last quarter of 2009. Rates for denar loans declined from 9.2% in September 2010 to 8.9% in July 2011, while the rates for denar deposits declined from 6.8% to 5.8%.

Figure 4

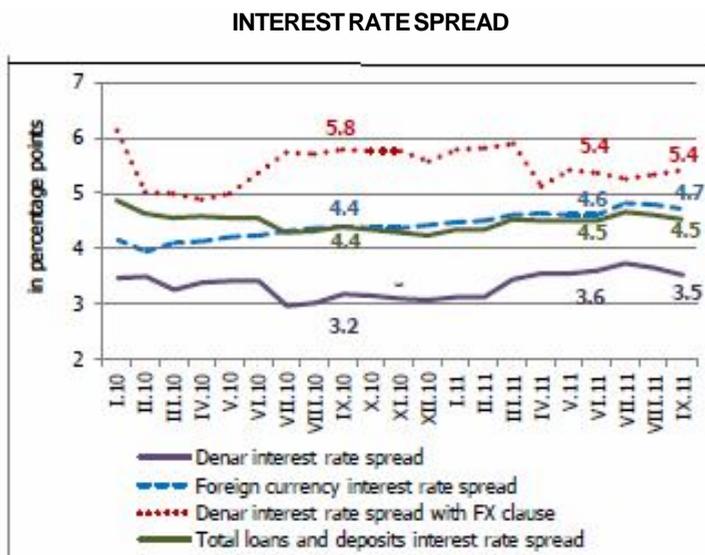
MOVEMENTS OF LENDING (UP) AND DEPOSIT (DOWN) INTEREST RATES



Source: National Bank, on the basis of data submitted by banks.

a result of the faster decline of deposit rates, spreads widened from 2.4 percentage points in September 2010 to 3.1 percentage points in July 2011. In the third quarter of 2011, the average interest rates on newly extended credits rose insignificantly (by 0.1 percentage point), and confirms the perceptions for higher risks and explains the slower trend of lending in this quarter.

Figure 5



Source: National Bank

Financial stability has been maintained, with sound liquidity, solvency and capital adequacy ratios. The share of non-performing-loans has started to decline, from a peak of 10.6% in September 2010 to 9.3% by end-June 2011, also increased their share in total loans to 9.8% (0.5 percentage points more compared to June 2011). The actualization of problems in the Euro area and the increasing global uncertainty is one of the main reasons behind the contraction of lending activity.

Banking regulation and supervision is largely in line with international standards. However, the proper functioning of regulatory and supervisory agencies, such as the Agency for the supervision of fully funded pension insurance (MAPAS) or the security exchange commission (SEC), is still hampered either by still insufficient financial independence and/or by insufficient human and IT resources. Furthermore, sometimes institutional competences are not sufficiently defined. As a result, the leverage of those institutions has not yet reached an adequate level. Transparency of the credit market has improved through the establishment of a private credit bureau, providing credit history reports.

The relevance of other financial market intermediaries is limited, with assets accounting for some 10% of the financial sector's assets or some 8% of GDP. Insur-

ance institutions account for some 4% of the sector's assets, while leasing companies and pension funds account for about 3% each.

4.2. Money market

In 2010, the significance of the money market in the Republic of Macedonia to the financial system was still modest. The limited range of instruments, shallow secondary market and low level of integration to the international financial flows remained major traits of this market. The interbank market of unsecured deposits still remained main money market segment making up 99% of the total turnover. Other market segments (short-term securities and repo markets) played insignificant role, with no derivative market, whatsoever.

Basic primary money market instruments include CB bills and government securities. The trading on the secondary market is insignificant. In spite of the cut of interest rate on CB bills for seven times in 2010, the banks showed considerably larger interest in this instrument compared to 2009.

The permanent relaxation of monetary policy by cutting the NBRM key interest rate in the period when the ECB preserved its key interest rate, in 2010, tended to narrow the interest rate spread between the interest rates of the NBRM and the ECB.

The decrease of key interest rate (as presented on the next figure) had a transmission effect on SKIBOR¹⁵⁾ and MKDONIA¹⁶⁾. Conversely, the ECB remained consistent, and did not change its key interest rate in 2010. Thus, the gap between the one-month SKIBOR and the one-month EURIBOR rate¹⁷⁾ decreased by 4.7 percentage points, p.a. and equaled 3.7 percentage points. Thus the gap between EONIA¹⁸⁾ and MKDONIA also reduced by 3.5 percentage points, and equaled 2.2 percentage points.

¹⁵⁾ Skopje Interbank Offer Rate – interbank indicative interest rate introduced in July 2007, for selling unsecured Denar deposits, calculated as arithmetical mean of quotations of reference banks, for four standard maturities (over night, one week, one month and three months).

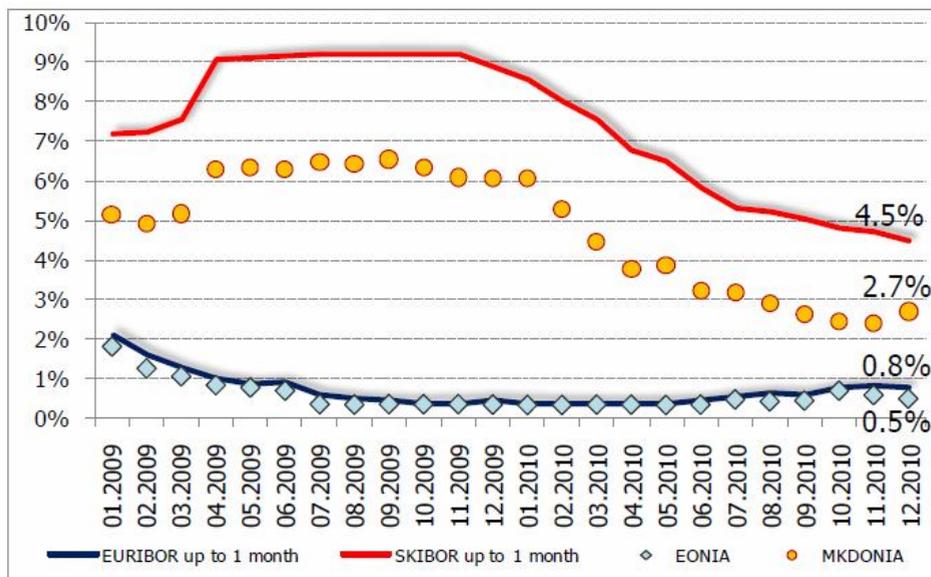
¹⁶⁾ MKDONIA started being calculated on October 15, 2008, as weighted average interest rate of already concluded over night transactions, with reference banks playing the role of sellers of unsecured Denar deposits.

¹⁷⁾ Euro Interbank Offered Rate – specific interest rate, at which a reference bank on the EU money market is willing to sell deposits to another reference bank, calculated on the basis of indicative interest rates.

¹⁸⁾ Euro OverNight Index Average – effective interest rate on the EU money market, calculated as weighted value of all overnight transactions where the reference bank acts as deposit seller.

Figure 6

**INTEREST RATES ON THE MONEY MARKET IN THE REPUBLIC
OF MACEDONIA AND IN THE EURO AREA**



Source: NBRM and website of the European Central bank

4.3. Free movement of capital and capital market

The country already met the requirements of the first stage of the Stabilisation and Association Agreement (SAA) in the field of capital movements and payments in 2008. Further liberalisation is conditional on the transition to the second stage of the SAA, pending a decision by the Council. Progress was limited to relaxing some of the restrictions on residents regarding portfolio investments in foreign markets; however, all restrictions remained. The restrictions for the amounts of cash that may be carried across borders and on the amounts of transfers that non-residents can perform through their local and foreign currency accounts are not aligned with the acquis. Foreign investment has not kept pace with neighbouring economies. Modernisation of infrastructure has to be reinforced. The legal provisions preventing nationals from buying foreign securities, opening accounts in foreign banks, or purchasing real estate abroad remain. Preparations in the area of capital movements and payments are moderately advanced.

In 2010, the private sector was less interested in issuing new shares, and therefore the total value of new issues of long-term securities decreased compared to the previous year. The lower interest in new issues of long-term securities was mostly

caused by the downward price trend on the secondary capital market, the lower volume of trade on the stock exchange market and decrease in the total stock exchange turnover.

Notwithstanding the gradual improvement of the domestic economic environment, the downward correction of the turnover on the Macedonian Stock Exchange continued in 2010. Compared to the same period of the last year, the stock exchange turnover was decreasing slowly, almost solely reflecting the lower turnover of shares. The poor shareholder activity on the Macedonian Stock Exchange indicates that they are risk averse. In 2010, in spite of the slightly higher number of foreign investors, their demand for securities on the Macedonian Stock Exchange kept on decreasing. The potential increase of their demand is contingent upon the speed of revival of the global economy and markets necessary to create positive effects on the near surrounding, the permanent and sustainable growth of the domestic economy, the positive performances of domestic corporations and the higher returns on investments in domestic securities. In 2010, the price growth on the capital market tended to decrease the market capitalization of the companies listed on the Macedonian Stock Exchange.

Progress is achieved in the area of securities markets and investment services. Most of the present directives on market abuse, markets in financial instruments, investors' compensations schemes, transparency and prospectuses, are already transposed; alignment remains to be confirmed. Further steps need to be taken to achieve alignment with Directive 2007/16 and other developments in the EU acquis relating to undertakings for collective investment in tradable securities (UCTIS IV package).

CONCLUSIONS

From the theoretical point of view the analysis of financial convergence in the new EU member states reveals a mixed picture. The application of the β -convergence concept suggests that the spreads of the interbank interest rates and the interest rates on bonds tend to move towards a long run equilibrium. For government bonds yields the convergence hypothesis is not supported by the data which may reflect the heterogeneity of fiscal policies in the EU. The σ -convergence measure in general indicates convergence until 2007. After that, most likely due to the effects of the global financial crisis and the associated uncertainty, the coefficient of variation of spreads increases. The effects of the financial crisis are also evident in the time-series measure of convergence based on estimation of a time-varying parameter model. In some countries a tendency of decline in spreads was observed initially which was later reversed. One possible extension to the work presented in this paper is to estimate the panel data model (1) with country-specific coefficients β_i . This would allow for differences in the speed of convergence among countries and would possibly yield more reliable results when computing the equilibrium levels of the spreads.

Also, conditional on data availability the analysis can be extended to include other asset prices or a more detailed breakdown of interest rates by instrument. The use of aggregated deposit and lending rates may disguise specific features of the credit and deposit markets.

The financial sector of Republic of Macedonia continued its gradual process of deepening and widening. However, the level of financial intermediation and competition in the market are still low, impeding more dynamic growth in the private sector, particularly for SMEs. Furthermore, some regulatory and supervisory agencies have not yet reached a sufficient level of independence, resource endowment and leverage.

Progress in the area of free movement of capital was uneven and focused on enforcement in the area of combating money laundering and financing of terrorism. There are still restrictions on short-term portfolio investments and on cross-border payment transfers. There are plans for the further liberalisation of the capital movements and payments after the transition to the second stage of the SAA. Preparations in the area of free movement of capital are on track.

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Klimentina POPOSKA *)

SHIFT TOWARD NON-INTEREST INCOME AND ITS IMPACT ON BANKING PROFITABILITY

Abstract

Growing competition in the banking industry, innovation trends, shrinking in the interest margin, growing regulations and costs have realigning the role of the Non-interest interest to bank's long –term goals. The paper addresses the shift of banking industry toward Non-interest income. The focus is put on the trend of Non-interest income in the last few decades as well as the trend in Republic of Macedonia. Furthermore, the paper address the outstanding dilemma for the influence of Non-interest income on the bank income, since most of the recent studies shows mix results for the impact of this shift on the bank performances. The empirical findings indicate that banking sector in RM shows steady upward trend toward increase of Non-interest income, unlike the general trend of rapid shift toward Non-interest income by the developed banking industries. Yet, regression analysis pointed Non-interest income as significant variable in Net income of the banking sector of Republic of Macedonia which generate solid base for further development of Net interest income in Total Bank Income. Other significant variables influencing Net Income of the banks are Interest costs and Total assets, indicating that bank should pay more efficiency on interest costs as well as pointing out that higher performance can be align by bigger banks.

Key words: Noninterest income; Interest income, Net income; Fee Income; Banking.

JEL classification: G21

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1. Introduction

The increased awareness by the bank for revenue origination has been always the main challenges for bank managers. This question is of particular importance at the moment when banks compete in previously inaccessible domestic and foreign markets, with products offered by other nonfinancial companies, and particularly after the experience with the latest financial crises which put additional pace for discussing the justification of each Non-interest income. Such stance adds additional pressure for the banking industry to search for the real measurement of the Non-interest income at the total Net income of the bank and for attaining better performances.

Enlarged pressure forces banks to seek for the new sources for profit origination. Consequently in the practice of many countries, particularly developed ones, decreasing trend of interest income activities was offset by severely growth in the Non-interest income bank activities and searching for the new banking innovative banking products which would offset the decreasing role of the traditional banking activities as key element in bank profit. In the USA, banking industry decrease the reliance on the interest income activities and increase its Non-interest income, whilst the greater reliance on Noninterest income, particularly the trading revenue resulted in lower risk-adjusted profits (Stiroh, Kevin J., 2002).

Non-interest income has been treated in the last two decades, mainly in the connection with the bank profits, whereas recently, after the financial crises the raised question is whether the Non-interest income urges for volatility of the banking profit or the secure steady bank income and risk diversification. These questions have been discussed by many researchers, hence there are no common understanding for the role of Non-interest income in profit origination.

According to our knowledge, Non-interest income and its influence on the bank income in the Republic of Macedonia as well as on the stability of the income has not been treated in a single study. The focus of the research is confirming or rejecting the widely accepted recent trend of rapid shift¹⁾ toward Non-interest income by the banking sector of Republic of Macedonia by identifying the participation of the Non-interest income into Net Operating Revenue. Furthermore, the regression analyze should identify if Noninterest income has significant influence in net bank income. The impact of Non-interest income on the diversification of the risk in banking and providing stable income as well as quantifying its influence would be a topic of further research.

The paper will contribute in enriching the existing literature with the newest data with focus on the Non-interest income. Obtained results confirm some of the previ-

¹⁾ The rapid trend has been converted into steady trend after the latest financial crises since year 2007.

ous findings in other countries or regions, whereas several findings are different than the literature before and supported only by few papers. The study itself seeks to enlighten the role of Non-interest income in banking industry in scope of new technological and innovation trends from one side, as well as the financial crises and its negative implication on the Non-interest income from another side.

The paper is organized in the following manner: Section two represent literature review, section three analyses the trend of Non-interest income in the contemporary banking industry, section four illuminates the the role and recent trends of Non-interest income in banking sector of Republic of Macedonia and demonstrates the empirical results of the regression analysis and section five provides the main conclusions, policy recommendations and suggestions for further research.

2. LITERATURE REVIEW

The literature on banking has provided mixed evidence about whether Non-interest income influence on increasing or decreasing the Net income of the bank, or have impact on the its volatility via diversification the bank income. Interest income/ Non-interest income is not very often tested variable as determinate for bank profitability.

Non-interest income is becoming increasingly important because of pricing pressure of the Net interest income and its decreasing trend in the last years (MacDonald and Koch, 2006:64). There are not any expectation that the banks with higher Interest income/lower Non-interest income (traditional oriented) are more profitable than the banks with less interest income/higher non-interest income (complex banks).²⁾

Demirguc-Kunt and Huizinga (1999) indicate that banks with a relatively high share of Non-interest earning assets are less profitable. Opposite of this findings, the common view of banks managers and analysts is that bank will rely more on Non-interest income to improve profitability; hence the highest earning banks will be those that generate the increased share of Non-interest income in the Operating Revenue (MacDonald and Koch, 2006:120). Furthermore, the banks that are more reliant on activities that generate Non-interest income do not earn higher average equity returns, but are much more risky as measured by return volatility and market betas, which imposes the conclusion that shift toward Non-interest income has not improved the risk/return outcomes of US banks in recent years (Stiroh. J. Kevn, 2006: 1351).

In the literature, even in the case of the same type of the banks (such as Islamic banks) the findings differ. For some countries, in which the bulk of the earnings of Islamic banks come from Non-interest activities, it is expected that non-interest in-

²⁾ For possible classification of the traditional/complex banks consider Poposka K. et al. (2004: 10-11).

come will impact banks profitability positively. However, in the case of Islamic banks in Malaysia, the Non-interest activities did not play an important role to generate the bank return. Therefore, it is expected to affect the profitability negatively (Nur Azura Sanusi and Abd. Ghafar b. Ismail 2005). Thus there are mix results if Non-interest activities influence positive or negative on the bank profitability and it can not be generalized if Non-interest activities contribute for a higher profitability to the bank compared to others basic activities. Such mixture of finding imposes essential need of further research of this significant bank activity which increase its relevance in the last two decades.

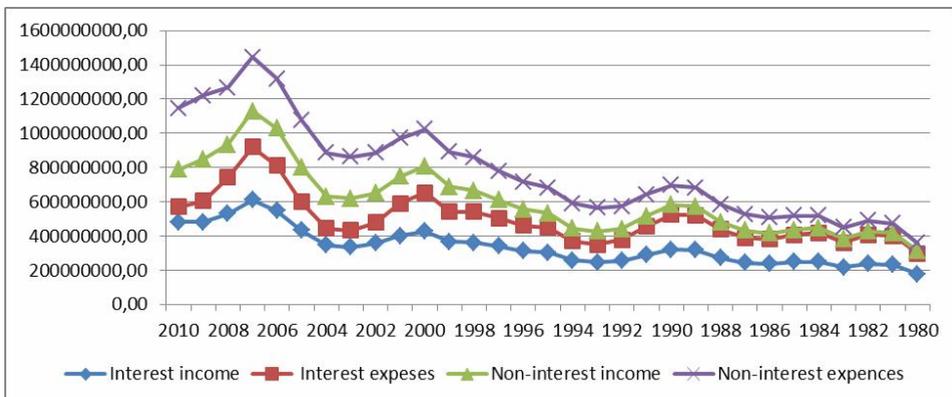
3. TREND OF NON-INTEREST INCOME IN THE CONTEMPORARY BANKING INDUSTRY

Highly regulated banking industry and increased competition in banking sector forced the banks to shift steadily toward Noninterest income. Moreover the technological and financial innovations created the opportunity for banks to utilize the synergies between complementary financial activities which might provide the diversified benefits for the banks. Albeit empirical research do not always support the positive effect of the increased Noninterest income, most articles indicate that further increase of the Noninterest income would increase the exposure to the volatile activity without offsetting diversification gains (Stiroh K. Kevin, P:136).

The trends of the Interest and Fee income and cost in USA Commercial Banking in the last three decades is presented on the Graph 1.

Graph 1

TRENDS ON INTEREST INCOME AND EXPENSES AND NON-INTEREST INCOME AND EXPENSES IN USA COMMERCIAL BANKS IN THE PERIOD 1980-2010



Source: Calculated upon data from <http://www2.fdic.gov/hsob/HSOBRpt.asp> Accessed on 24.02.2012

As shown in the Graph 1, Non-interest income and expenses have steadily upward trend in the period 1980-2007, whereas Interest income and expenses shows more stable trend. However, financial crises in 2007 clearly shift the Non-interest income and expenses downward rapidly, indicating that those variables are more under the pressure of the crises.

The question which is quite important for understanding the such trend of Non-interest income is why banks moved significantly into those activities, whilst the financial crises turn them in declining trend. One explanation for rapid shift toward Non-interest income is the fact that managers overestimated their role in diversification. However, "cross selling" multiple products to the same core customer do not diminish the risk such as industry slowdown or changing customer preference. Second explanation is that the bank managers put focus on the effect on the profitability and place little weight on the volatility of the income. Third explanation would be that the managers are driven by non-profit maximization motives (Stiroh K. Kevin, P:137). Nonetheless, no matter what kind of motivation had manager when shifting toward Non-interest income, the Graph 1 clearly indicates that the banks are pulling back from Non-interest income activities.

4. TREND IN NON-INTEREST INCOME IN BANKING SECTOR IN REPUBLIC OF MACEDONIA AND ITS IMPACT ON NET INCOME

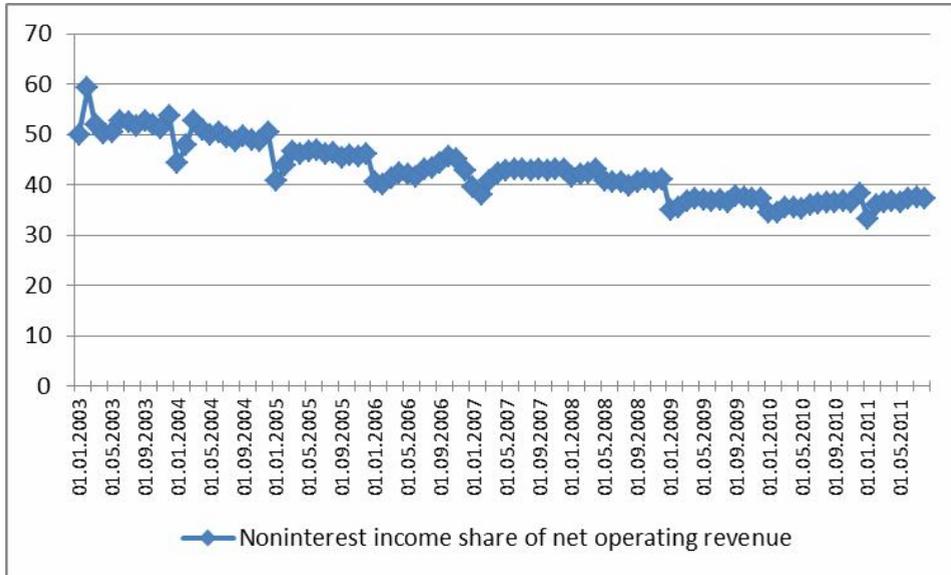
Banking sector in Republic of Macedonia holds the attribute of traditional banking industry with dominance of the credit activities, hence the major input in the Net income of the banks is represented by Interest income. Having in mind the recent trend of increasing role of the Non-interest income in the Operating Revenue of the banks in USA,³⁾ we would like to test if this ratio influences on the bank profitability in the Commercial banks in Republic of Macedonia. Graph 2 indicate the Non-interest income as share of Net Operating Revenue in Banking industry in the Republic of Macedonia.

Graph 2 point to the steady line of Non-interest income with minor downgrade trend of Non-interest income in Net operating revenue in Banking sector. Having in mind major trend of banking sector of Republic of Macedonia toward increasing the total income, this trend has been offset by the fact that in absolute amount, the Non-interest income increase. Unlike this trend, in the developed economies, for instance,

³⁾ The ratio of noninterest income as fraction of operating revenue (sum of net interest income and noninterest income) is increased dramatically in USA in the last 3 decades. Namely, this ration equalled 24% in 1980 for all insured banks and it sharply increased to 42.5% in 2004. (MacDonald and Koch, 2006:122).

Graph 2

NON-INTEREST INCOME SHARE OF NET OPERATING REVENUE IN THE BANKING SECTOR OF RM IN THE PERIOD 2003-2011



Source: Database created upon data from NBRM <http://www.nbrm.mk/?ItemID=A55FFC32FC478E4A89444507A6C02C45>

USA, the banking industry represent trend of steady shift toward activities that generate fee services charges, trading revenue and other type of non-interest income. In the period of 1952-1977, noninterest income was stable source of revenue and accounted for about 20% of Net operating revenue. Since late 1970s, Non-interest income accounted for more than 40% of Net operating revenue (Stiroh, 2004:133-134).

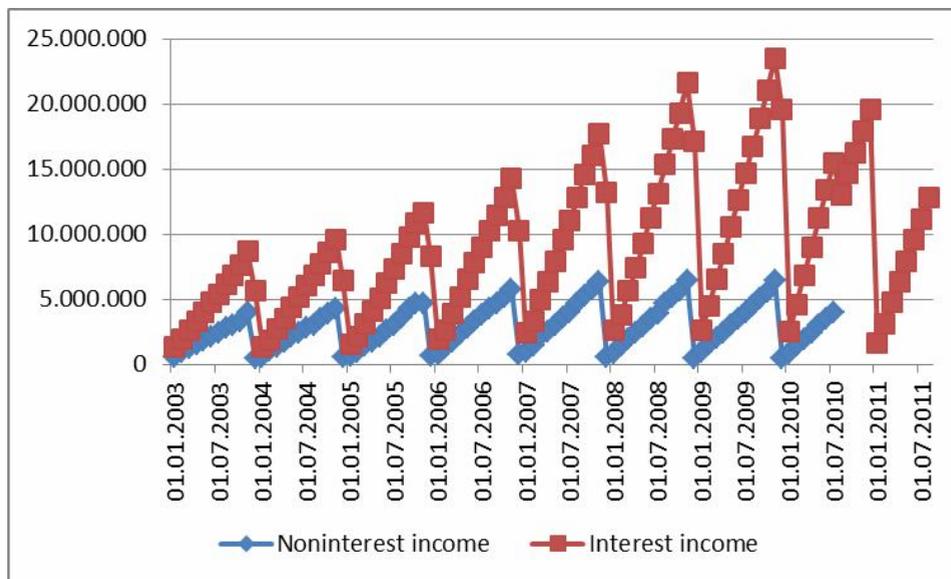
Traditional characteristics of Banking sector in the Republic of Macedonia, can be perceived by observed trend of Interest and Non-interest income. Graph 3 indicate the dominance of the Interest income relative to Non-interest income in the banking sector in the period of 2003-2011.

Graph 3 point out the prevailing role of the interest income relative to Noninterest income in the Banking sector of RM in the last decade, ascertaining the traditional orientation of the banking sector of Republic of Macedonia.

Only few systematic studies for the influence of the Non-Interest Income on the financial performance have been completed, yet those studies tend to contradict the conventional belief of the Non interest income (Young de Robert and Rice Tara, 2004: 34). The mixture of empirical results indicating positive and negative influence of the Non-interest income on the total income of the banks, forces further research in observing the purpose of Fee generating income position on the total bank income in the banks of Republic of Macedonia.

Graph 3

INTEREST AND NON-INTEREST INCOME OF BANKING SECTOR OF REPUBLIC OF MACEDONIA IN THE PERIOD 2003-2011*



* Calculations for Interest and Non-interest income from beginning of each year starts from zero.

Source: Database created upon data from NBRM <http://www.nbrm.mk/?ItemID=A55FFC32FC478E4A89444507A6C02C45>

In order to understand the role of Non-interest income in Net Interest income of the banks of RM, the study further continues with regression analysis in order to identify if Non-interest income has significant variable in the bank performance. Dependent variable is Net interest income whereas independent variables are: Interest income, Interest Costs, Non-interest income, Non-interest costs, Employee costs and Total assets. The period range from January 2003 until September 2011. Exploited method is least Squares, whereas included observation are 75 (after adjustment).

The results of the regression analysis indicates that in the period of 2003-2011, three variables are identified as significant for the Net income of the banks: Income costs, Non-interest income and Total assets. Such findings indicate that Non-interest income has significance in financial performances of the banks, namely higher Non-interest income increase Net income. Furthermore, Income costs are also significant which points out that bank managers should make efficient utilization of the Income costs. Finally, the empirical research prove that “size of the bank matters”, by result that variable Total Assets influence on higher Net interest income. The quality of the results can be justified by figure R^2 which clearly indicate that indicated variables explain nearly 81% of the variables influencing Net income of the banks. The results

Table 1**REGRESSION ANALYSIS OF NET INCOME FOR BANKING SECTOR IN
REPUBLIC OF MACEDONIA IN THE PERIOD 2003-2011**

Variable	Coefficient	Std. Error	t-Statistic	Prob.
D(INTEREST INCOME)	-0.000143	0.000218	-0.654776	0.5148
D(INTEREST COSTS_1)	0.000567	0.000429	1.321599	0.1907
D(NONINTEREST INCOME_1)	0.001501	0.000268	5.601931	0.0000
D(NONINTEREST COSTS_1)	-0.000513	0.000515	-0.996903	0.3223
D(EMPLOYEE COSTS_1)	-0.001408	0.000571	-2.465304	0.0162
D(TOTAL ASSETS)	0.022587	0.008257	2.735502	0.0079
C	-94.64837	42.67522	-2.217876	0.0299
R-squared	0.812223	Mean dependent var		-2.629120
Adjusted R-squared	0.795655	S.D. dependent var		606.8839
S.E. of regression	274.3392	Akaike info criterion		14.15529
Sum squared resid	5117815.	Schwarz criterion		14.37159
Log likelihood	-523.8235	F-statistic		49.02206
Durbin-Watson stat	2.104508	Prob(F-statistic)		0.000000

of the empirical research support the hypotheses that banks in the Republic of Macedonia have steadily shift toward Non-interest income and it has positive impact on the total income of the bank, which might be beginning of the trend from traditional toward complex banking.

5. CONCLUSIONS

Main conclusion and Policy recommendations

The banking industry is moving further away from stylized version of intermediation between depositors and borrowing. The most indicative symptom of this process is shifting toward Non-interest income. The study indicate that developed countries have rapidly shifted toward Non-interest income, albeit such trend has been diminished with the last financial crises from 2007. The evidence in many research papers do not support the hypotheses that such shift means higher bank performances as empirical findings show mix effects regarding the influence of the Non-interest income on the bank performances.

In the banking sector of Republic of Macedonia, Non-interest income show downgrade trend relative to Interest income, even though in absolute amount the trend is increasing. The empirical analysis pointed that Non-interest income is significant for Net income of the bank which support the notion that steady shift toward Fee income activities has positive impact on bank performances.

Results of the empirical findings imply policy recommendations for major player in the banking sectors. Namely stockholders are interested if the bank is subject to

overexposure to Non-interest income, which is of considerable importance for the risk profile of the bank. The shift toward Non-interest income appear to be of high concern for the borrowers, bondholders and equity holders, particularly if shifting toward Non-interest income appear not to increase bank profitability. Finally, the bank regulation and supervision have profound interest in risk level, since providing a sound and healthy banking sector represent the major concern of each national financial authority.

Further research

The finding of empirical analyses of the banking sector of Macedonia indicated that Non-interest income has significant influence on the net Income, yet the further research should focus of separating the Non-interest income on traditional and non-traditional and searching which part has positive influence on the bank performances. Namely, traditional non-interest income comprise Deposit account services (safe-keeping, checking, on-line bill pay, ATMs, etc.), Lending (letter of credits, securitizations, servicing, etc.), Cash Management (payroll processing, traditional lock box, etc.), Trust Accounts Services (wealth management, etc.), whereas non-traditional Non-interest generating activities comprise investment banking, security brokerage, insurance activities, etc. Such diversification and estimation of influence of each Non-interest activity on Net interest income would be guide for the bank managers for change in their policy and focus on operation.

Further research in enlightening this topic should encompasses the influence of Non-interest income on diversification of bank income, and reducing the risk. The dilemma is whether the Non-interest income is stable and imposes less volatility on the total income of the bank, as well as increase diversification and reducing the risk in bank operation.

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Diana BOSKOVSKA*)

THE ROLE AND SIGNIFICANCE OF THE PROCESS OF INTERNATIONALIZATION OF THE SMALL AND MEDIUM ENTERPRISES

Abstract

The speed with which changes occur in the international business environment requires participants to think globally and act quickly. In such an ambient, the companies can't to be successful on the long run if they are focused on building a business model to only operate on the domestic market, because in that case would be faced with the risk of disappearing or being undertaken by entrepreneur-oriented firms. Indeed, the internationalization of business is a necessary process and how this process starts early, it will be more possible firms to grow faster and achieve long-term development. The major role in the global economy has multinational companies (MNC). But, in the contemporary terms under the influence of rapid technological development (development of information and communication technology, the biotechnology and etc.) is facilitates the accessing and opportunity for the internalization of the business of the small and medium enterprises.

Benefits from the internationalization of business are multiple, but at the same time this process is followed by the a series of barriers, particularly highlighted for small and medium enterprises such as: lack of knowledge and skills for entering in new foreign markets, lack of sufficient financial resources to support internationalization of the business and etc., that along greater engagement of the internal factors of influence, in the same time imposes the need for greater government support of SME in order to encourage the decision for internationalization of the business.

Key words: Globalization; internalization; small and medium enterprises; benefits; treats.

JEL classification: F23, L25, L26.

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1. THE NEED AND NECESSITY FOR INTERNATIONALIZATION OF THE SME

Subject of research in the paper present the small and medium enterprises in order to determine the benefits that they realize from internationalization, and the impact of the factors that affect this process.

Modern economics has the character of the global economy, which means possibility for global production and global market. Major role in the global economy has the multinational companies. But in modern conditions, rapid technological development (development of information and communication technology, biotechnology etc.) facilitates the access and opportunity for internationalization of the small and medium enterprises. Benefits of the internationalization of business are multiple, but at the same time this process is faced by a series of barriers, particularly highlighted for small and medium enterprises, such as lack of knowledge and skills for entering in new foreign markets, lack of sufficient financial resources to support internationalization of business and the like.

Sector of small and medium enterprises is one of the key factors for the development of any economy, developed or less developed large or small economy. Hence, the need to support and development this sector in the national economy is very important, that in same time understands the support for their internationalization too, in order to overcome the factors that limit such process.

SME development is imposed as one of the imperatives of development of the Macedonian economy, because the development of this sector in the same time provides faster development of the overall economy. Macedonian economy is a small economy with little market for operating of the domestic enterprises. Hence, internationalization of the business of the enterprises presents a very important factor for their performance and development, including the SME's.

The theory of the growth models of the firms indicates the factors that affecting the growth of firms, and the degree of influence of these factors on the growth. One of these factors presents size of the firm. In analysis of the conditionality between the size of the firm and the rate of growth, it is realized that small firms grow faster than large firms, as the new firms than companies that exists longer period.

Generally, there are two ways to realize the growth of the firm, internal and external growth. External growth is accomplished through the internationalization of the operations of companies or through the export or investment activities beyond own national economy. It should be noted that although internationalization is primarily a feature of large companies, in terms of globalization, when the local market is open for foreign firms it creates direct competition on the domestic market, which exercised influence over the operations of domestic firms, including the domestic small and medium firms. In this way even small businesses primarily located locally, again faced with foreign competition, that forces them to take appropriate action in

order to be in possible to compete with foreign firms and to survive in the market. Also, although small firms operate primarily on the domestic local market under the impact of globalization they do not remain outside of the global market, but contrary they are included as part of global supply chains.¹⁾

Global expansion of firms regardless of their size, it allows of the firms to increase their profitability, if the opportunities for growth and development of the domestic market are already used. Companies that operate across national boundaries are able to:²⁾

1. To expand the market for its products by selling those products in international markets;
2. To realize economies of location, through the dispersion of the activities to locations worldwide, where they can be performed most efficiently and most effectively;
3. To reduce costs through the effect of learning (through repetition of activities) and economy of scale (increased volume of production);
4. To make more profit with dissemination of knowledge and skills acquired in foreign affiliates through other parts of the firm.

Companies that act on the world market usually are faced by two types of factors that make pressure on the process of the formulation of the strategy for entering in the foreign market:

- Pressure to reduce costs;
- Pressure to response to the requirements at the local level.

Such competitive pressures according to their nature, to the firms set to face with contradictory requirements. Namely, the firm to respond to pressures to reduce costs; it should try to minimize their unit costs. But on the other hand, pressure for local reaction may require the firm to differentiate its production according to specifics on the local level, so as would be possible to meet various demands of consumers, business practices, distribution channels, government policies, etc., among different market. The need for differentiation of product offer does not allow production standardization that would be cause to increase costs, and consequently to increase the prices of products and services.

¹⁾ Dickens D., Phils M.(2010): Entrepreneurship and small firms, fourth edition, TRI, Skopje, p.206.

²⁾ Hill V. L., Charles (2010): International business: competing on the global marketplace, MAGOR, Skopje, p.414.

2. ADVANTAGES AND DISADVANTAGES OF THE INTERNATIONALIZATION OF SME

Contemporary processes of globalization have a great impact on the business of small and medium enterprises. Some companies through internationalization see new opportunities for expansion and growth, and if these enterprises don't have serious problems and obstacles in their adaptation to new circumstances arising from the entering into new business environment, they soon become internationally competitive. But in most cases, increasing economic dependence arising from involvement in international trends and competition leads to new, very serious challenges and threats.

2.1. Benefits of the internationalization

Internationalization of business can be defined as a series of business activities that performance across national borders. It should be noted also, that the internationalization of business is a process that occurs in stages, and that can arise large changes in the enterprise. Internationalization making decision is influenced by multiple factors (conditions) as follows: size of the domestic market, market position and flexibility of the firm, the openness of the domestic economy, the degree of development of the sector in which the company belongs, management skills, etc. However, it is important to emphasize that the process of internationalization of enterprises is closely related to the application of appropriate marketing strategies, or a firm can internationalize their business without to have an adequate marketing concept to perform on the global market. Accepting the global orientation of the firm does not necessarily mean that the company will participate in all world markets, but they can focus their efforts on most promising markets. The global orientation of the company as previously stated is not necessarily related to its size. Much of the enterprises, regardless of their size and location, may become global. The main feature of the global enterprise is locating production factors where growth potential is optimal (using the economics of location).

In the contemporary world, small businesses are dominant in the business activities (more than 95% of the business activities of all countries come from this sector). Such a high share of SMEs in the national economy is the result of several factors that allow SMEs to realize an advantage over the large firms, such as openness, dynamism and innovation, lack of barriers in terms of a hierarchy of decision making, greater flexibility in the decision making, shorter time to respond to consumer needs and market, easier concluding partnerships with companies that are suitable to achieve synergistic business results and etc.

Managers of small and medium enterprises are mainly interested for the direct benefits that the enterprise can realize by the process of internationalization, which simultaneously represent factors that affecting the company's decision to act outside

national borders. As important motives for the internationalization of small and medium enterprises are points out the following:

- having a unique product;
 - achieving technological advantage over the competition;
 - achieving economies of scale and
 - the desire to use potential business opportunities in foreign markets.
- Besides these four basic motives it could be possible to indicate also and other additional motives for internationalization of business such as:

The reduction of domestic demand, that may arise the fear the firms to lose own share of the domestic market;

- saturation of the domestic market and
- enhance the sales of the company beyond national borders.

The revenue that the firms earn additionally from foreign markets undoubtedly provides opportunities for further enterprise growth and development. With the expansion, companies gain access to new technologies and experience in international business, and adopt new skills. Also, through involvement in the international market they set up cooperation with other companies and provide access to new sources of funding.

All the previously mentioned elements can be characterized as the advantages of internationalization of the business of small and medium enterprises, which in turn as it were previously stated enable faster development and growth of SMEs. This is particular importance because the SME sector has a key role in the development of national economies, because its participation in economy is very important according to their participation: in the total number of firms in the economy, in the total employment, in the export activity of the economy and so in the creation of GDP (gross domestic product).³⁾

2.2. Weaknesses (barriers) for internationalization

Despite numerous advantages that internationalization are provided to the companies, in the same time it is accompanied by numerous barriers. The barriers of the internationalization can be seen through the factors that in the same time act as barriers to growth of firms. From this point of view, the theory points out three segments where a possible to occurrence is the limitations of the internationalization:⁴⁾

³⁾ In 2010 in Republic of Macedonia, the share of the SME's in the total number of the enterprises was 99.7%, or 75.294 SME. It's share in the total employment was over 80 %, while in the export and GDP it's participated with around 50 %.

⁴⁾ Dickens D., Phils M, cited book, p.198.

- management and motivation;
- financial assets and
- market opportunities and structure.

The first type of limitation specifically refers to the lack of managerial skills, possession relatively low qualifications, inability to delegate tasks and obligations, and the need to adopt new managerial skills and techniques in accordance with the needs for growth and development of the firms.

In the literature many authors emphasize the importance of this factor for the success of the internationalization process, emphasizing that knowledge, attitudes and motivation of the entrepreneurs or managers in small and medium enterprises play a crucial role in making decision to internationalize the business. From this aspect, mainly stands out two factors that are necessary for the progress of the company towards internationalization: expectations of management for the benefits of the company's internationalization and their commitment to the process of internationalization.

In the initial stage of internationalization, one of the biggest barriers is a lack of knowledge for the foreign markets. Knowledge that managers possess is determined by their level of education, experience acquired by the operation in the foreign markets, knowledge of foreign languages, and the like. Managers who already work in internationalized small businesses have access to new knowledge, whose knowledge can then be used by other small and medium enterprises in the process of internationalization of their business. Also in the process of internationalization it is necessary the enterprises to develop structures and procedures complementary to their internal resources and capabilities, that is crucial for success of the internationalization of their business. Hence, it is necessary to identify knowledge and skills that are essential for the success of a particular company, and setting an adequate system of transfer of knowledge to the rest of the organization, that means accumulation of knowledge, which plays an essential role in international growth of the companies.

The second type of obstacle concerns to the opportunities for access and use of appropriate sources of funding, access to technology and trained staff. SMEs more than large firms are facing with significant financial problems in the process of internationalization. Initially they have less financial ability to finance their international business operations. In the same time also, because of its lower creditworthiness, financing of the small and medium companies was seen by financial intermediaries as a highly risky investment. Therefore, before to approve each loan, they require additional guarantees, whose value can often, be greater than the amount of the loan, by one side, and by the other side the loans are approved with higher interest rates compared to loans that are approved to the large firms. This is especially pronounced in the first few years of operation of the enterprise.

The third type of restriction concerns to the opportunities for the market growth, the size and dynamic of the sales, the degree of market segmentation and opportunities for cooperation and association.

Additionally, barriers in the process of the internationalization of SMEs and hence their non-participation in international business can be divided into two groups:

- 1) those who over stress internal and external obstacles, or barriers for internationalization
- 2) those who on the internationalization don't look like a way and opportunity to develop own business in future.

The second group of firms believes that the demand on the domestic market will lasting longer period simply have no ambition for growth.

Based on the earlier said that SMEs are perceived exercise benefits range from internationalization, but face several problems in implementing this process because often management or Contractors are not defined for such a qualitative change in its business.

3. INTERNATIONALIZATION OF SME IN EUROPEAN COUNTRIES

In this article to considerate the extent of internationalization of SMEs are used the data of the research conducted by the European Commission in 2009, on the 9,480 SMEs in 33 European countries of which 27 countries are in European Union and 6 countries outside the EU (Croatia, Ireland, Liechtenstein, Macedonia, Norway and Turkey).

Because, the issue of internationalization of firms is very complex issue, in this section is stressed only some aspects of this process based on the data obtained from the previously mentioned research.

When analyzing the different models of internationalization of the business of SMEs between 2006 and 2008, which includes exports, imports, FDI, technological cooperation, to be subcontractor of a foreign company and to be foreign subcontractor, on the basis of the data is found that 44% of SMEs are internationalized, whereas most of the internationalization of SMEs is based on imports (29%) and least in respect of FDI (2%), see Table 1.

According to the data from the Table 1 it is possible to perceive also the degree of dependence between internationalization firms and the size of the firm. Namely, according to data is seen that 73% of medium enterprises are the least internationalized based on one of the six activities for internationalization of business (export,

Table 1

**PERCENTAGE OF SMES WITH INTERNATIONAL BUSINESS ACTIVITIES
IN 2006-2008, BY ENTERPRISE SIZE**

Mode of internationalization	Micro	Small	Mediumsized	Total
Percentage of all SMEs				
SME with direct exports	24%	38%	53%	26%
SME with direct imports	28%	39%	55%	28%
SME has invested abroad	2%	6%	16%	2%
SME with technological cooperation with enterprises abroad	7%	12%	22%	7%
SME has been a subcontractor to a foreign main contractor	7%	11%	17%	8%
SME had foreign subcontractors	7%	12%	16%	7%
SMEs with at least one of these 6 international activities	43%	58%	73%	44%
Total N, unweighted	3253	3260	2967	9480

Source: *Internalization of European SME's, Final report, European Commission, 2010, p.17*

import, FDI or long-term production cooperation), as opposed to small and micro enterprises where this percentage is 58% or 43%, respectively.

To compare the extent of internationalization of the SMEs among member states and six non-EU countries are used the data shown in Table 2.

Table 2

**PERCENTAGE OF SMES WITH INTERNATIONAL BUSINESS ACTIVITIES
IN 2006-2008, BY COUNTRY GROUP**

Mode of internationalization	EU	Non-EU	Total
Percentage of all SMEs			
SME with direct exports	25%	28%	26%
SME with direct imports	29%	33%	29%
SME invested abroad	2%	3%	2%
SME with technological cooperation with enterprises abroad	7%	9%	7%
SME has been a subcontractor to a foreign main contractor	7%	13%	8%
SME had foreign subcontractors	7%	7%	7%
SMEs with at least one of these 6 international activities	44%	49%	44%
Total N, unweighted	8332	1148	9480

Source: *Internalization of European SME's, Final report, European Commission, 2010, p.20.*

Based on the information provided is perceived that in the member states of EU, 44% of SMEs are internationalized based on at least one activity, while the percentage among non-EU countries is higher and is 49%.

Also an important aspect in the research presents sectorial analysis in order to see the extent of internationalization of the SMEs by sector. Based on this analysis recognizes that:

- imports highest percentage of internationalization in of the wholesale,
- the export is internationalization in the domain of wholesale and manufacturing,

- in FDI and technical cooperation, internationalization is the highest in business services and
- for SME has been a subcontractor to a foreign main contractor and SME had foreign subcontractors, internationalization is the highest in transport and communications.⁵⁾

The results of this survey are in favor of the previously given conclusions the advantage and the need for internationalization of business. The SMEs that are much more internationalized realize higher income from sales, higher employment rates, and greater transfer of technology and introduction of products and processes innovated in relation to SMEs who are not internationalized.

CONCLUSION

In the contemporary term the internationalization presents the need and necessary, for all types of companies in the modern era of economy. Companies, as well as the countries may gain numerous benefits of this process, but at the same time, they can face with many barriers that difficult and slow down this process.

Overall, the internationalization is very expensive, requires time, knowledge and skills that is particularly constraining for small and medium enterprises, because these companies have very limited funds. Therefore is very important, in the process of making decision, managers have to make the right decisions about timing and how to enter to foreign markets. There is no universal model that can be applied to each individual case. This is especially emphasized in modern conditions, due to large uncertainty and unpredictability of future trends in the development of economy and market. In respect to future business operations for the internationalization of the operations of businesses requires finding an appropriate combination of existing models for the input.

Key motives of the enterprise where, why and how to expand their business in foreign markets lies in adequate selection and identification of opportunities and capabilities of the manager or entrepreneur and their propensity to risk. Experience of entrepreneurs or managers and their network of contacts play a key role in the development of relevant knowledge of the internationalization of the business. Managers simply must understand the motives, the importance and need to be involved in this challenging and sophisticated process. To be successful in the global economy means to possess the ability to dealing with constant change; to identification key business factors; to make decisions whose outcomes are unpredictable; to have a vision and to

⁵⁾ For more information see Final report: Internalization of European SME's, European Commission, 2010, p.19.

transmit it to other employees; to choose the optimal strategy and to motivate employees to implement the goals.

On the other hand, when we consider the role and importance of the SME sector for the development of a national economy, the government support to SMEs is needed in order to encourage them in making a decision of the internationalization of business. Such support includes several activities such as: providing opportunities to acquire knowledge for the management for the companies that haven't international experience; to assist in identifying compatible foreign partners for joint ventures and/or cooperation; stimulate exports through strong institutional support (Strategy for export, formation of investment promotion agencies, providing funds under the favorable terms) and etc.⁶⁾

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⁶⁾ Final report: Internalization of European SME's, European Commission, 2010, p.8.

Zoran JANEVSKI*)

BLUE OCEAN STRATEGY IN E-COMMERCE BUSINESSES

Abstract

Blue Ocean Strategy is the systematic pursuit of new market and new demand creation through the simultaneous pursuit of differentiation and lower cost (value innovation). In this paper the blue ocean strategy is deployed on the online industry, especially on e-commerce. The six paths framework and four action models are used in creation of many successful e-commerce businesses such as Yahoo!, Amazon.com, etc. Those blue oceans make their competitors irrelevant, but to keep them with sustainable competitive advantage the companies must constantly look across their environment and trying innovate the value of its products and services.

Key words: E-Commerce, Blue ocean strategy, value innovation, six paths framework, four action model, entrepreneurship, competitive advantage.

JEL Classification: D23, L26, L81

Introduction

The basic competitive strategies imposed by Michael Porter mainly focus on the traditional way of competitiveness and they imply: 1) a particular industry and 2) clearly defined competitors within that industry. Then, the key company's performances are measured relative to those of other competitors (to be different from the other competitors, to produce and offer products with lower costs than the competition, etc.). Thus, competitive advantage, according to this concept, comes down to incremental improvements, that are a small increase in the product/service value propo-

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sition or reducing of its manufacturing cost.¹⁾ This approach causes relentless fight between the existing and potential competitors, a struggle that causes creation of a whole “Red Ocean of blood from the defeated” by which sail all that are implementing one of the generic strategies.

There is a completely different approach to establishing and implementing a business strategy that is not targeted where is the focus of existing industry as such, but its priority is finding or creating new market spaces through a wider range of other industries. This strategy is called *Blue Ocean Strategy*.

The purpose of this paper is to examine the role and impact of Blue Ocean Strategy implementation in businesses that are part of the e-commerce industry, and enterprises in which e-commerce plays important role in realizing their business goals and activities.

1 THE NEW MARKET SPACE AND E-COMMERCE: VALUE INNOVATION

In “Red Oceans” boundaries between industries are clearly defined and the rules of the competitive struggle are accepted from all participants. There are companies trying to beat its rivals to seize for themselves most of the existing demand. But because the market space, in the end, always becomes too narrow for all interested companies, the chances for profit and growth are reduced for everyone. Products slowly becoming commodities and “bloody” struggle become more and more ruthless. In contrast, the “Blue Ocean” is characterized with an unmarked space market, with creating products/services demand and opening opportunities for high, profitable growth. For an enterprise that implements this strategy competition becomes irrelevant, it moves away from it in a new noncompetitive market space.²⁾

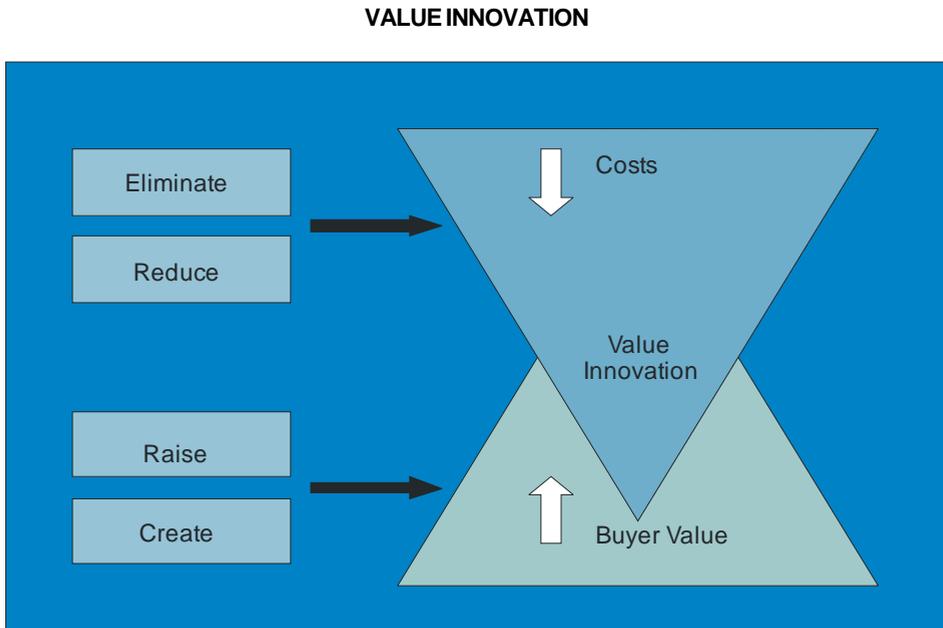
In essence of Blue Ocean creation or creation of new market space is systematic approach to value innovation. Companies that are trapped in the “Red Ocean” stick to the conventional battle with the competitors in their particular industries. Here the industry boundaries are defined and accepted and the competitive rules of the game are known.³⁾ On the other hand, the Blue Ocean creators, do not measure their success in comparison to its competitors, but they follow a different strategic logic

¹⁾ Porter, Michael E., “Competitive Advantage”, the Free Press, New York, 1985.

²⁾ Kim, V. Cen and Rene Moborni, “Blue Ocean Strategy: How to Create Uncontested Market Space and Make the Competition Irrelevant”, Harvard Business Scholl Publishing, Boston, USA, 2005, pp. 16-17.

³⁾ Porac, Joseph F. and Jose Antonio Rosa, “Rivalry, Industry Models and Cognitive Embeddedness of the Comparable Firm”, in *Advances in Strategic Management*, 13, 363-388, 1996.

Figure 1-1



Adapted from: Kim, V. Cen and Rene Moborni, “Blue Ocean Strategy: How to Create Uncontested Market Space and Make the Competition Irrelevant”, Harvard Business Scholl Publishing, Boston, USA, 2005, p. 16.

called *value innovation* (Figure 1-1). Instead of trying to beat their competition, with a breakthrough of value for the customers and themselves they make it not important themselves they make it not important for their future.

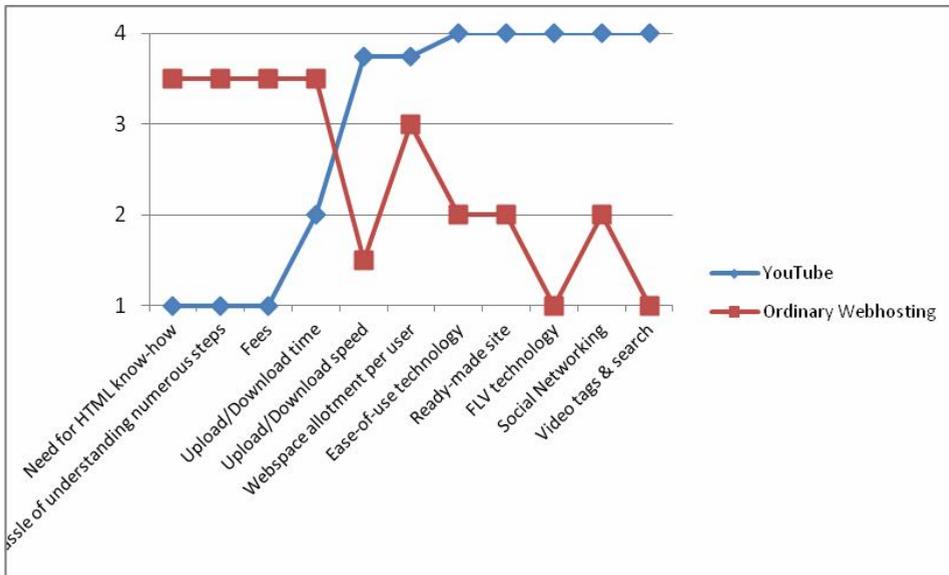
The creation of blue oceans is done by cost reduction, while the buyer value increases. Value innovation is created in areas where the company’s activities have positive influence on its cost structure, and on the value it offers to its customers. The cost savings are made through *elimination* or *reduction* of certain factors which the company use to competes in the market, while the value for customers increases by *raising* or *creating* elements that the industry had not offered before. Thus a value leap is achieved for both enterprise and for its customers.

The concept of value innovation of YouTube can be seen on Figure 1-2. It shows how YouTube redefines its competition through different dimensions of value that it offers to its users.

Various aspects of the value in the webhosting industry for storage and video playback over the Internet are: the need for HTML know-how, the problems due to complex procedures (many steps), expenses, time for upload/download, upload and download speed, web space size available per user, the easy to use technology, ready-

Figure 1-2

VALUE INNOVATION FOR YOUTUBE – STRATEGY CANVAS



Adapted from: Castillo, Anne, "YouTube's Blue Ocean Strategy", *Hub Pages*, 2006. Available online on: <http://hubpages.com/hub/On-YouTubes-Blue-Ocean-Strategy>. Accessed on 25.07.2010.

made site to use, FLV technology (Flash Video), social networking and video tags and search. It is obvious that in these value aspects provided to the consumers, YouTube offer different levels of benefit compared to the other companies offering ordinary webhosting. The vertical axis value "4" means the "highest value", while the value "1" means the "lowest".

Drawing the value curves of different companies on the same graph allows understanding what encourages value creation and how companies relates to key elements (factors) that determine the value provided to the customers. When the value curve of a company is compared with the value curves of other companies or with the industry average, than this graph is also called *strategic canvas*.⁴⁾

Strategic canvas is a diagnostic tool of the blue ocean strategy that provides a basis for thinking about some new forms of value curves in the future that can help to make a step forward in the company's existing offer provided through their current strategies and business models.

⁴⁾ Kim, V. Cen and Rene Moborni, op. cit., pp. 36-40.

2 SIX PATHS FRAMEWORK MODEL IN E-COMMERCE

To innovate value for its customers the company that wants to introduce electronic commerce in their business or entrepreneur who wants to start a new, fully online business venture, they should start with a broader view of things outside of standard business practices in their existing industries. For example, an entrepreneur who wants to start online book sales should reject the business practice of physical bookstores and seek inspiration elsewhere. This way they can discover new, uncovered market space that is somewhere between the existing industries. For this kind of rearrangement of the boundaries of the industries and the markets six basic approaches exist also called a *six paths framework model*. According to this model, the company that wants to build its own blue ocean strategy should follow the following principles:⁵⁾

1. *Looking across alternative industries instead of focusing on competing within an industry.* This helps to understand how the consumer makes trade-offs between different products or services that are substitutes. The goal is to understand how the consumer is determined to buy and use one product, not the other, and all criteria under which he is wearing his decision to purchase. In traditional industries choices made by consumers are between products that does not comes from within the industry. For example, they chose to use cash or credit card, to drive a car or traveling by public transportation, going to the cinema or to the restaurant. On the other hand, in the world of online business, the buyer makes a trade-off between buying online or going to physical stores, using online banking or waiting right in front of bank counters. Products and services may have a different shape and perform a different function and still serve the same purpose. Thus, buyers making a decision to purchase something, and often unconsciously, consider different options and make compromises between alternative industries. The company needs to find alternative industries to that in which it operates or intends to start a business venture. That way it could identify the key factors that drive customers to change across alternative industries and by eliminating and reducing all other elements it can create a blue ocean under the new market space.
2. *Looking across strategic groups within industries instead of a company confining itself to established strategic groups.* Strategic groups consist of companies that offer the same type of products to a certain target markets,

⁵⁾ Jelassi, Tawfik and Albrecht Enders, "Strategies for e-Business: creating value through electronic and mobile commerce: concepts and cases", Second Edition, Pearson Education Limited, 2008, pp. 135-139.

such as clothing, sports equipment, soft drinks. So, companies usually compare with competitors that are positioned in the same strategic group that includes themselves. But thus they cannot gain the opportunity for a radical value innovation, because companies that are in the same strategic groups tend to offer similar products and services. Looking across other strategic groups gives insight into what companies that offers the same product but for different market segments are doing, and thus they have the opportunity to find potential new innovative way to create value. For example, after www.kupibrend.mk analyzed the market for branded clothing, they developed their own online business for selling branded clothes at prices that are competitive with non-branded clothing offered in traditional physical stores.

3. *Looking across the chain of buyers instead of focusing on the same buyer group as the rest of the industry.* The key for this principles is the fact that the one who is responsible for buying (purchasing) is not always the one who will use (consume) the product or service. The buyer (if is not also a user) will be primarily interested for the price and ease buying process.

On the other hand, the user has a different idea of the value of what is purchased and more will be focused, for example, on ease of use of the purchased product. If an online business previously treated only one of these two different interested parties (buyer or user), then taking into account the perspective of another group can come to creating new value. For example, in the early '80s of the 20th century, the dominant position in the industry of providing online financial information had the Reuters and Telerate which provided real-time news and prices for brokers and investors. But, their systems were standard IT systems and they were appreciated by IT managers only, because the standard systems were easy to maintain. However, the brokers and financial analysts require customized systems that will enable immediate decision making. Then Bloomberg appeared and offered a special system with easy terminal access, keyboards marked with well-known financial terms and with two monitors that offer users the opportunity to seeing all the information they need without opening and closing too many windows on the computer screen. Bloomberg quickly became the largest and most profitable provider of business information in the world.

4. *Looking across complementary products and services instead of a company limiting itself to the scope of an industry's products and services.* Very often the products are not used as such, but in combination with other complementary products. Thus, in order to operate, computer hardware needs some software. Understanding the effect of complementary products Amazon.com has launched a service to its customers which allows personalized book recommendations to readers based on their previous purchase history. To use the power of complementary products, the company

engaged in e-commerce should try to find a context in which its products and services are used, as well as what happens before, during and after the use. This would provide opportunity to identify possible obstacles, as well as ways how to overcome them offering some complementary products or services.

5. *Looking across functional or emotional appeal to buyers instead of accepting an industry's functional or emotional orientation.* Some companies compete in price and functionality of their products and services. They communicate to their customers pointing out the rational elements in decision-making process of buying. Others, mainly compete on the basis of feelings (customer care, brand, etc.), and their address to consumers is more emotional. If a company is ready to bring into question the functional-emotional orientation of the industry where it belongs, then it can find a new market space. Then, industries that had previously functional orientation, with the blue ocean get emotional aspect and vice versa, those who had previously purely emotional orientation in the new market space receive purely functional orientation.
6. *Looking across time instead of focusing on the same point in time as the rest of the industry.* With the skill to assess the impact of future changes in their environment on their business operations, the companies make favorable opportunities for creating blue oceans, i.e. they can adapt their strategies to create value in terms of expected changes. These changes can come with developing new technology, changes of the regulations or because of many other reasons. In all cases, entrepreneurs need to focus on these changes, including on the questions which will be the future trends, how these trends will change the benefit for customers and how they affect the company business model. Apple, for example, has felt the trend brought by new technology for online music download. Buyers often do not want to pay for the entire album or CD, only because they like one song from the disc. This trend in digital music had forced Apple to make agreements with the five major record labels in the world and open online music store called iTunes. Now the customers can buy a particular song from an album for 99 cents, instead of buy the entire album with that song for \$20.

The comparison indicates that the creation of blue oceans is not a simple prediction of future industry trends, nor introduction of the bravest business ideas that are the result of the creative process of entrepreneurs. Instead of relying on their intuition, entrepreneurs in the creation of blue oceans are oriented towards structured process of remodeling market reality on a totally new way. Thus, by restructuring the existing market elements they can manage to get rid of merciless competition that reigns in red oceans.

Table 2-1 summarizes the six paths framework in direct competition (red ocean) and in creation of blue ocean strategy.

Table 2-1

**COMPARISON BETWEEN DIRECT COMPETITION (RED OCEAN)
AND CREATING A BLUE OCEAN**

Six paths framework	Direct Competition	Blue Ocean Creation
Industry	Focuses on rivals within its industry	Looks across alternative industries
Strategic group	Focuses on competitive position within strategic group	Looks across strategic groups within industry
Buyer group	Focuses on better serving the buyer group	Redefine the industry buyer group
Scope of product or service offering	Focuses on maximizing the value of product and service offerings within the bounds of its industry	Looks across to complementary product and service offerings
Functional-emotional orientation	Focuses on improving price performance within the functional-emotional orientation	Rethinks the functional-emotional orientation of its industry
Time	Focuses on adapting to external trends as they occur	Participates in shaping external trends over time

Source: Kim, V. Cen and Rene Moborni, "Blue Ocean Strategy: How to Create Uncontested Market Space and Make the Competition Irrelevant", Harvard Business Scholl Publishing, Boston, USA, 2005, str. 79.

3 FOUR ACTIONS FRAMEWORK AND ITS ELEMENTS

After a six paths framework analysis will be done, through which the company can create new market space, it needs to reconstruct the value elements to customers combining them into a new value curve. For this purpose, the company uses the *method of four actions*, which puts focus on four different issues (Figure 3-1):⁶⁾

- *Eliminate*. Does the company really offer value to its customers? If not, then the question is which factors (elements of the product or service) it can eliminate that the industry has long competed on?
- *Reduce*. Which factors should be reduced well below the industry's standard? What cost the company too much money, yet does not create at all, or create just small benefit?
- *Raise*. Which factors should be increased well above the industry's standard? What is it that the companies can emphasis more, and will cause an increase of the customer's benefit?
- *Create*. Which factors should be created that the industry has never offer? What should be done but has been never done before?

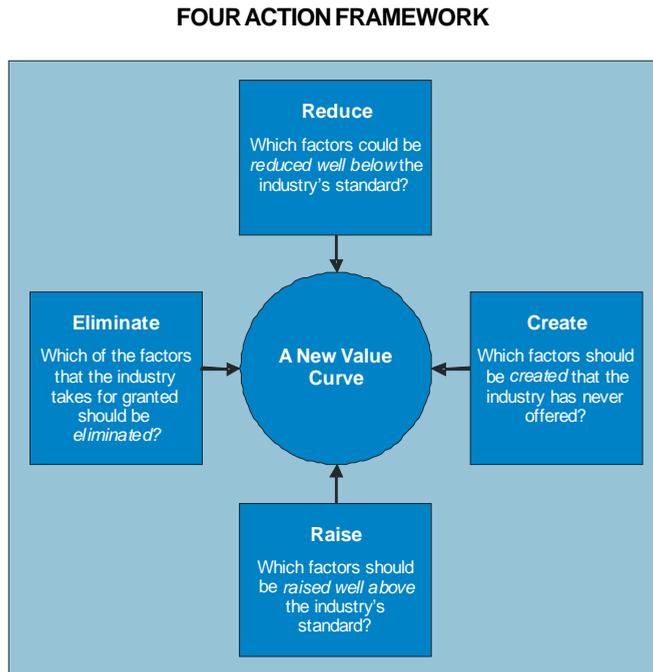
Utilizing the previously undiscovered market space, company creates an opportunity not only to win a bigger market share by taking some market share from its competitors, but also to extend the total market size. Amazon.com, for example, has developed its own strategy with focus on taking over the customers from the physical book stores, but in addition, focusing on a wide range of specific services offered by

⁶⁾ Osterwalder, Alexander & Yves Pigneur, "Business Model Generation: A Handbook for Visionaries, Game Changers, and Challengers", John Wiley & Sons, Inc., Hoboken, Ney Jersey, p. 231.

physical bookstores, as well as books reviews and personalization possible only in online digital environment. The result of this was even those who previously had not bought a single book turned them into passionate book lovers and buyers.

In case of YouTube, based on a six paths framework it remake a market boundary of the webhosting industry. Its four action framework consists of:

Figure 3-2



Adapted from: *Ferrel, O. C. and Michael D. Hartline, "Marketing Strategy", fifth edition, South-Western Cengage Learning, USA, 2011, p. 142.*

- Eliminate:
 - o Need for HTML Know-how
 - o Hassle of undergoing numerous steps just to upload/display a video in a website
 - o Fees for having a huge web space
- Raise:
 - o Upload and Download speed
 - o Amount of web space allotted for each user
- Reduce:
 - o Time spent by users uploading or downloading videos

- Create:
 - o Ease of use technology for uploading and sharing/displaying video files
 - o The use of FLV technology to stream videos
 - o A ready-made website for each user
 - o Venue for social networking through various features (i.e. comments, subscribe, mail, etc.)
 - o Video tags and Search function

However, creating new market space and overcome the importance of competition does not last forever, only until other competitors enter this new market. As with the basic strategies of Porter, competitors will begin to apply the same patterns and practices that they believe are promising attractive return on their investments, thus gradually reducing the profitability of all players in that market space. And here, the long term sustainability depends on how value innovation is a unique, distinctive, exclusive and difficult to imitate.

CONCLUDING DISCUSSION

Online businesses, whether they apply some basic strategies for competitive advantage (differentiation or cost leader) or business creates new market space through value innovation, it is very difficult to make competitive position viable on long term. For e-commerce it is particularly difficult because there are very few sources of competitive advantage that can remain stable over time. Moreover, transparency and easy access to information that brings Internet technology and e-commerce further hinder online businesses to protect their success from imitators and other followers. There is a far known case of Netscape Navigator, the most successful web browser in the 90s of the twentieth century that was defeated by his imitator Internet Explorer developed by Microsoft Corporation.

However, to imitate a successful online business is not an easy task at all. First, potentially successful imitator must be able to identify its competitive superiority. Those who are already successful in the market are protecting themselves from this threat keeping the information about the profit, return on investment, and other long term success indicators confidential. Second, those who want to enter into a market at least must be prepared to imitate the successful business model (if not able to innovate new, a superior one). But those who defend themselves from imitators may apply measures of intimidation that should deter potential new companies from entering the industry. For example, if a company wants to enter a market with a cost leader strategy, existing competitors may reduce their prices that will void its advantage and its entry into the market will become questionable. Third, the potential new market entrants must be able to understand well the sources of competitive advantage. One of the best protections from potential imitators is to build competitive advantage based on knowledge and practices that are develop in-house, and not provided from out-

sourcing. Fourth, the potential imitator must also be able to create or provide the necessary resources and skills necessary to be able to replicate the business model that has a dominant market position. Best defense of existing market players from these imitators is to build their own competitive advantage on the resources that are scarce, specialized or who are protected by a contract.

But, protection from potential imitators is only one way of keeping company's competitive advantage. The second way is to constantly upgrade own skills and knowledge through continuous innovation, thus making imitation irrelevant. However, the most successful way of preserving a sustainable competitive advantage over competition is to make that same competition irrelevant, and to overcome the struggle with it by creating new market space implementing blue ocean strategy.

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Natasha DANILOSKA*)

DECENTRALIZED ENVIRONMENTAL DECISION MAKING

Abstract

This paper discusses the importance and means of incorporating environmental issues into decentralized decision making processes. Accepting the concept of sustainable development as an underlying framework, it is logical to debate and care for the environment, including the economic role of the environment in life support on local level. Main objective of this paper is to discuss key issues concerning the environment and its relevance to policy decisions on decentralized decision making processes. It argues upon the economic, ecological, and social dimensions of environmental and natural resources, and the need to balance development objectives of different uses and claimants. In the focus of this discussion are two sets of environmental issues: those relating to natural resource use and management; and problems arising from environmental pollution, depletion and degradation. This paper argues that there is need to integrate economic, social and ecological dimensions in development strategies and plans.

The paper reviews various types of linkages and relationships within the environment-economy system. These include the interactions between natural resources and their use for production and consumption, and as waste assimilator; cause and effect relationships linking environmental pressures and societal responses; stakeholder interests and linkages over the micro-macro continuum; and potential conflicts and trade-offs. Implications for decentralized decision making are also discussed.

A key message conveyed is that there is need to integrate economic, social and ecological dimensions in development strategies and plans and to mainstream environment in decentralized decision making within the overall context of local development, rather than treating it merely as an activity of specialized environmental protection agencies.

Key words: environment, natural resources, decentralization, sustainable development

JEL Classification: Q01, Q2, Q20, Q3

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Introduction

Problems of environment and natural resource degradation are not new, but nowadays they are viewed with increasing concern by policy makers in many parts of the world. By the 1970s main environmental problems were pollution and depletion of natural resources caused with human activities. Afterwards, intense national and international concerns revolved around their integration with the aims of rapid economic growth and development. That resulted in treating environmental issues as a part of the development equation, together with achievements of social and economic goals. Thus, the struggle to resolve environment degradation questions as we know it today, fits perfectly in the concept of sustainable development. This equation is valid for development at any level: international, national, sub-national, but especially so for planning at the local level. An important conclusion of this is that development must be conservation based, and must protect the structure, functions and diversity of the world's natural systems upon which the human species depends. Since the sustainable development motives are particularly relevant to the decentralization context, it is logical to expect that ecological problems will be best solved at local level, with decentralized decision making. In order to clearly point out why and how one should care for the environment, two sets of issues that require policy attention at different administrative and geographic level, needs to be discussed and distinguished. First issue is related to natural resource use and management, and second to the problems arising from environmental pollution, depletion and degradation. Both issues are of great interest to many stakeholders, so it is important to understand their relationships and linkages, and the need for right institutional choice for management and policy response.

TAXONOMY AND SOCIO-ECONOMIC DIMENSION OF ENVIRONMENTAL ISSUES

When we discuss the role and contribution of environment in sustainable development, it is necessary to first understand the nature of environmental issues. As stated previously, there are two categories of issues¹⁾: those relating to natural and environmental resources, and environmental problems associated with pollution, depletion and degradation of these resources, each one with its own specific characteristics as well as management and policy implications. Namely, critical issue relating to the natural and environmental resources is how to manage them in ecologically sound manner, which in a same time meets the criteria of economic efficiency and social acceptability.

¹⁾ FAO: EASYPol: Economic Rationale in Caring for the Environment, on-line resource materials for policy making, FAO, Rome, Italy, 2008, p. 7.

Natural and environmental resources are all physical (soil, water, animals, minerals), gaseous (oxygen, helium, hydrogen) and abstract (solar and wind energy, landscape) elements available in the nature that are or can be used in the economic system. There are renewable and non-renewable natural and environmental resources. Renewable resources are reproducible and with management practice for their optimal rate of extraction, they could be maintained perpetually. An important aspect of renewable resources is their conditional or non-conditional renewability. The former could be renewed only subject to certain biological (plants animals, entire ecosystems) or non-biological (e.g. water, oxygen, soil nutrients) processes taking place, and could be depleted through poor management. Non-conditional renewable resources are generally non-living flow resources like solar, wave or wind energy that in principle are inexhaustible. Non-renewable resources cannot be regenerated, or their regeneration is very slow and without a significant increase of the resources stock in foreseeable time. Non-renewable resources can further be split into recyclable and non-recyclable. Recyclable ones do not lose their properties when they are used in economic processes and can be reused, while non-recyclable resources once used, are no more available for future use. Management challenge to be met in exploiting non-renewable natural resources is their substitution with renewable resources and determination of the efficient amount of recycling.

Environmental problems are in fact the negative impacts of human activities on environmental resources. In order to adopt most appropriate policy measures and management practices, as well as the most suitable institutional arrangements, it is very important to clearly identify and classify them. Most frequent forms of environmental problems are pollution, depletion and/or degradation of water, air and soil, demonstrated in global, as well as national and local dimensions. When source of the negative impact can be identified, and accordingly the area of damages is limited, we have point pollution. Non-point pollution happens when the sources of emission cannot be identified and affected area is extended. Emitted pollutants can be absorbed (stock pollution) or accumulated (fund pollution) by the environment.

Environmental and natural resources interacts with socio-economic system through tree main functions²⁾: supply of raw materials; sink for waste and provide direct utility to people, and thus create a base for life support and welfare. As already seen, both renewable and non-renewable natural resources are limited and they cannot perform their functions, unless managed properly. This relationship perhaps is best illustrated by the following “The bank (environment) is filled with limited amounts of renewable and non-renewable natural assets or capital. Through bank operations, the capital generates interest. An environmentally sustainable society protects the renew-

²⁾ Daly, H. E.: Sustainable Development: From Conceptual Theory Towards Operational Principles, Population and Development Review, 1991, p 25.

able capital, lives-off the interest, and uses the non-renewable capital wisely. In this way massive debt is avoided and the ecosystems are kept running³⁾.

There are various conceptual standpoints used to better understand these cause-effect linkages between human socio-economic activities and environment. First institution to address these issues is OECD that promoted the **pressure-state-response (P-S-R)** framework⁴⁾. In this framework human activities are the **pressure** on the environment, which induce changes to the **state** of the environment, accompanied with certain bio-physical or socio-economic impacts. The **response** in form of policies, programmes or other actions comes from the society (government or communities themselves) and the main objective is to mitigate pressures and/or environmental damage. Being that in response stage many different stakeholders are taking part, it is very important to determine the actual response, the appropriate level of decision making and acting, as well as individual roles and responsibilities.

The P-S-R framework actually reveals the multiplicity of socio-economic interactions with environment and need to address them at various levels of the system. Namely, pressure part of this framework is not a unitary process, and it can take place amongst many individuals and groups, in different locations, and at various time frames. Respectively, the state part can happen on-site of a particular pressure or in areas further away. The appropriate response to it, in form of decisions of local, regional and central governments and authorities will affect how individuals use natural resources in relation to production and consumption requirements. The P-S-R pattern demonstrates that micro level decision and actions have significance in wider society (meso and macro level), and vice-versa. Thus, the P-S-R framework will demonstrate its full capacity only if perceived as an integral part of the micro-macro continuum.

Multiplicity and inter-linkages between human socio-economic activities and environment involve many stakeholders, with various interests, and thus can produce many conflicts. Real or perceived opportunity to win or lose, pose potential disputes between different stakeholders over the use of a resource. At the same time, decisions on the use of a resource, whilst giving benefits of one kind, may result in a sacrifice or trade-off in other objectives. In the already mentioned micro-macro continuum both gains and losses have to be addressed at various levels of the economic and administrative system. Only win-win solutions for all parties involved will contribute to sustainable development⁵⁾.

³⁾ Markandya, A., Harou, P., Bellu, L.G., Cistulli, V.: *Environmental Economics for Sustainable Growth: A Handbook for Practitioners*. The World Bank, Edward Elgar, Cheltenham, UK, 2002.

⁴⁾ OECD: *Project and Policy Appraisal: Integrating Economics and Environment*, Paris, France, 1994, p. 41.

⁵⁾ IUCN/UNEP/WWF: *Caring for the Earth: A Strategy for Sustainable Living*, Gland, Switzerland, 1991 p.25-31.

DECENTRALIZATION AND ENVIRONMENTAL ISSUES

As for many other questions of public interest, first official responses to environmental issues were formulated at central level, mostly in form of controls and regulations. The experiences of limited success, followed by increased environmental problems, impose the need to broaden up the front, to mobilize participatory and locally based methods of environmental protection. This approach proved to be more effective basically for two major reasons: in a national context, it is supportive and complementary to the decentralization process, and at local levels it encourages participation and thus enhances democratization of the society. Additionally, there are many positive aspects from decentralized environmental decision making, among which the most obvious include⁶⁾:

- Local institutions and people have a better knowledge of environmental and socio-economic problems and potentials of the area, and are best placed to protect and enhance the environment if they are given clear rights (and obligations) with regard to natural resources.
- Assigning greater degree of responsibility in decision making will be accompanied by better motivation for a more efficient use of natural resources.
- It is more likely to involve less favored groups and populations in decision-making.
- It facilitates local participation due to greater homogeneity of common needs with lower sizes of population, and more transparency in decision-making processes.
- It allows building of local capacities for the provision of services that are more consistent with local requirements.

However, we must underline that not all environmental related decisions can be decentralized. As already elaborated, natural resources and environmental issues are complex and above all context specific, so careful analysis of all physical and institutional factors is required before deciding where and by whom they are best addressed.

ENVIRONMENT IN DECENTRALIZED DECISION MAKING

Efforts made to mainstream environment into decentralized decision making can be supported by taking into consideration several important aspects. First of all, current institutional and administrative setting for environmental questions needs to be revised and actual weaknesses must be recognised. It is true that many countries have

⁶⁾ FAO: EASYPol: Environment in Decentralized Decision Making, on-line resource materials for policy making, FAO, Rome, Italy, 2009, p. 10.

national strategies, action plans, administrative procedures and legislations, governmental ministers or departments for environment protection and managements, but it is also true that many times they failed to deal with environmental problems. Major reason is because they are generally focused on point-source pollution and large investments, while non-point source pollution, caused by large numbers of small-scale enterprises and/or individuals, are less well articulated. For developing countries, additional burden is lack of financial and technical resources.

For a successful decentralized environmental decision making, substantive participation of key stakeholders needs to be ensured. The idea is to enhance partnership between political entities and community organizations and businesses and to give them power to influence things. This is actually a practical expression of decentralization and will help to organize many environmental issues with respect to a range of policy formulation, fiscal, planning, administrative control and regulatory functions.

As indicated before, not all environmental issues can be addressed at the community or local levels, especially where problems of externalities, conflicts and trade-offs are involved. Thus, choosing the appropriate level and institutional form to deal with various kinds of issues is of crucial importance. Considering the nature of ecological factors, differences and specifics of geographical areas are guiding principle for institutional arrangements and policy measures and/or instruments. Although there isn't a single type of institutional arrangement that will suit all situations, yet some general rules that may be used as a guide for deciding which type of stakeholders i.e. private and civil society organizations or institutions at central government or sub-national/local government levels are most suitable for environmental decisions⁷⁾:

Private or civil society organizations such as farmers associations, private entrepreneurs and NGOs are better suited when:

- Only a few parties are involved;
- Negotiation costs are low;
- The “producer” of the externality is aware of and informed about the effects;
- The cause and the effects of the externality take place in the same geographical area (local government, community) or very near the source; and
- Property rights are defined or can be easily defined.

Government institutions at central or sub-national levels can be considered if:

- Number of parties involved and conflicting interests are high;
- Geographical distance between the parties is large;
- Transaction costs are high;

⁷⁾ FAO: EASYPol: Environment in Decentralized Decision Making, on-line resource materials for policy making, FAO, Rome, Italy, 2009, p. 16.

- Negotiations between the parties cannot achieve important social, political, and moral goals;
- Property rights are not defined clearly;
- The scale and timeline of environmental problems cannot be addressed by individuals or private organizations;

Already mentioned micro-macro continuum opens many possibilities to incorporate environmental issues into decentralized decision making, at various points. When, by whom and how it will be done primarily depends on the level to which planning and management functions have been decentralized and the type of adopted participatory processes.

Last, but not least, in decentralized environmental decision making, much needs to be done in capacities building, especially in developing world. This refers not only to institutional capacities for designing and implementing environmental plans and procedures, but also to learning and adopting appropriate technical skills and knowledge in environmental economics and natural resources management, and above all, attitudes on environmental issues overall.

CONCLUSIONS

An important challenge for policy makers, managers and individuals in general is to first understand economic, social and ecological implications of environmental issue, and to find practical ways of balancing these. Given the nature of natural and environmental resources i.e. location specific, with multiple stakeholders at various levels, it is obvious that environmental initiatives are consistent with, and complementary to decentralization processes and both areal as well as functional delegation of power and responsibility may be implicate. But whilst local initiatives could make useful contributions to environmental management or protection, they do not on their own signify a wider process of decentralization. For greater success, a more substantive institutionalized process of decentralization in various political, administrative and fiscal aspects is required.

Ideal decision making framework for environmental issues should be dynamic, inclusive of major stakeholders at various stages of the process, integrative of other social and economic criteria, and characterized by effective communication and capacity building elements. If such a framework is absent, even its development and adoption is itself an important goal of environmental decision making, and of the decentralization process itself.

There is generally limited capacity to support and foster decentralized development processes across much of the developing world, although notable progress has been made in recent years. Additionally, there is evident lack of awareness and appreciation of the economic and social significance of caring for the environment, and the potential contribution of decentralized approaches to sustainable natural environment

management. Also, greater effort is needed in the areas of skill training, institutional strengthening, and mutual learning. This includes the assembling of scientific information, building upon local knowledge systems on the environment, and communication of such information to development professionals, agricultural technicians and the public at large.

Another crucial factor for fostering decentralized environmental decision making and sustainable development in general is awareness and positive attitude on environmental issues. To adopt the ethic for living environmentally friendly and sustainably, people must re-examine their values and alter their mindset of “it’s alright as long as it is not in my own backyard”. In a same time, society and local communities must promote care for the environment and encourage sustainable way of life.

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ISLAMIC BANKING - BASIC PRINCIPLES AND CHALLENGES

Abstract

The current situation in the European economy release on a surface a signal about the need of new types of operating of the financial institutions, especially banks on sound and stable manner. This was a trigger for the focus in this article and attempt to closely review Islamic banks as the part of Islamic finance institutions.

For this purpose, it is briefly analyzed, the role of Islamic Law and the basic principles of Islam in comprehensive functioning on Islamic banks and their influence in financial and commercial transactions according to the Shari'ah. This was a good way to understand specifics of Islamic banking and review of several challenges they are facing within the conventional banks environment in non-Muslim countries.

Many efforts have been put, but many things remain to be researched and completed by both sides, the regulatory agencies and the Islamic banks, to exceed the open questions.

Key words: Islamic finance, Islamic bank, Conventional banking, Shari'ah, basic principles.

JEL classification: G21

Introduction

The Islamic banking describes the sector of banking, which follows the rules of Shari'ah, the Islamic law. The Islamic banks, in particular, are geared primarily towards local consumers and small businesses and includes, among other products,

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interest-free current accounts, Shari'ah-compliant savings products, Islamic mortgages and other interest-free financial services. Regarding the above mentioned, the Islamic banking always arise the attention, especially within the countries with conventional banking systems which are currently in financial crises. The raised interest is guided from the data which represent continuous arising of the Islamic economies and in the Islamic banking as a whole. Since the beginning, almost three decades ago¹⁾, the world financial circles had doubts about its sustainability, particularly because of the highlighting of the relation between the ethics and the finances. Nowadays, the Islamic banking succeeded to show that it has potential for greater global influence and it became a growing force in global financial circles.

The Islamic Banks found in over 70 countries worldwide and in the 10 years preceding 2005, the growth rate of Islamic Banking assets had been ~15% p.a. In 1999 Dow Jones created 'Islamic Indexes' to offer Shari'ah-compliant investment portfolios to cash-flush pious Muslims. Several major Western banks, e.g. Citibank, ABN Amro, Bank of America, HSBC, Standard Chartered and the Union Bank of Switzerland, either have Islamic Banking subsidiaries or offer Islamic financial products to their customers. Clearly Islamic Banking and Finance has transformed itself from an obscure financial experiment to a major factor in global finance.²⁾ According to the data of the Federal Reserve Bank of San Francisco, the total assets in the Islamic finance market totaled between USD750bn and USD800bn as of July 2009. The figure may exceed USD1 trillion in 2010. Iranian Islamic banks still dominate the market with a share of 40% of the top 100 bank's total assets. Together with Saudi Arabia and Malaysia, the three countries make up the key players in Islamic finance.³⁾

It is important to highlight that Islamic banks generally operate within three different types of environment. The first one includes countries which have completely adopted the Islamic Shari'ah principles (e.g. Iran, Pakistan). The second one includes predominantly Muslim countries where along conventional banks, function

1) The first tentative steps toward the creation of nointerest "Islamic" banks were taken in the 1960s. The initiative gained further momentum a decade later, in the aftermath of the spectacular increase in oil prices and state revenues during the early 1970s. Governments and private foundations in Saudi Arabia and the Gulf committed some of their new wealth to religious programs, including think-tanks and institutions dedicated to the cause of Islamic banking. The founding of the Saudi-finance Islamic Development Bank in 1975 lent additional support to the cause, since the bank was supposed to sponsor interest-free financial institutions., Hefner R. W., *Islamic Economics and Global Capitalism*, SOCIETY, (Volume 44, Number 1), November/December, The State University of New Jersey, USA, 2006, p.18.

2) Khan F., *How 'Islamic' is Islamic Banking?*, Journal of Economic Behavior & Organization 76 (2010), doi:10.1016/j.jebo.2010.09.015, 2010 Elsevier, p.805.

3) Federal Reserve Bank of San Francisco, *Islamic Finance: Malaysia's Growing Role*, Asia Focus, Country Analysis Unit, July 2009. www.frbsf.org/publications/banking/asiafocus/2009/asia_focus_july_09.pdf

also the Islamic banks (Arab countries). The third one, which is the most specific one, includes non-Muslim countries with dominant conventional banking system, where the Islamic banks attempt to enter into the financial market with Islamic financial instruments.

To understand the Islamic banking, first of all, it is necessary to make brief review on its basic principles. These are the principles upon which the Islamic financial and the whole legal system is based on. This is the way to clarify some challenges and obstacles which arise while introducing the Islamic banking in western, conventional financial systems along conventional banks.

1. ECONOMIC ENVIRONMENT AND LEGAL FRAMEWORK

Within the Islamic Economy, the Islam is not only a religion but also a codification of the general standards of behavior that reach far beyond the contents of belief. It declares close connectivity between the economy, politics, social aspects and religion. In particular, in financial matters, the trade and commerce are encouraged by the Qur'an as long as they are honest and legitimate. Islamic financing is based upon several root transactions which lead to the most important concepts of partnership or profit and loss sharing. These basic elements create a solid basis for the understanding of the products and compliance structures in Islamic banking institutions. The four root transactions according to Shari'ah are the following: sales (Bay), hire (Ijâra), gift (Hiba) and loan (Ariyah), describing respectively the transfer of ownership, the transfer of the right to use, the gratuitous transfer of ownership and the gratuitous transfer of the right to use. These basic forms are applied to specific transactions such as pledge, deposit and guarantee and create the basis of all transaction structures within the Islamic finance. Although, the Muslims that live in countries where the Islamic banking or the Islamic banking windows in conventional banks, does not exist, they are allowed to use conventional banking products.

The Islamic legal system is based on the Islamic law which promotes a certain code of behaviour according to the Qur'an. Shari'ah is much wider in scope than the concept of law as understood in the West. Shari'ah law encompasses aspects of belief and religious practice, including rules relating to prayer, fasting, the making of the Haj and giving Zakat. It also covers aspects of everyday life such as behaviour towards other people, dietary rules, dress, manners and morals. Lastly, it includes laws relating to crime and evidence, international relations, marriage, divorce and inheritance, commercial transactions and many other subjects that would be included under the Western definition of law.⁴⁾

4) Venardos Angelo M., *Islamic banking and finance in South-east Asia : Its development and future*, World Scientific Publishing Co. Pte. Ltd., Singapore, 2005, p.27.

In practice there is no universality of Islamic law, as it is applied adhering to the principles of analogical reasoning and independent human reasoning of those specialized in law. The Shari'ah scholars are experts in Islamic law, who can interpret the Shari'ah themselves and this results in a great flexibility in law making.

2. BASIC PRINCIPLES OF ISLAMIC BANKING

As it was previously mentioned, Shari'ah has great influence on the Islamic economy and its legal systems, and therefore the Islamic banks are obligated to follow the basic principles of Islamic financing, such as: the prohibition of interest – Riba; the prohibition of gambling and transactions involving speculation - Maysir and Gharar; the code of ethical investment - Halal and Haram; and the social duty to benefit society – Zakat.

2.1. Prohibition of interest

In an Islamic literature, interest and *riba* are treated synonymously, and the prohibition of interest is the main characteristic that distinguishes the Islamic economy and the Western countries economy. The prohibition of interest is not an exclusivity of the Islam, it is also prohibited in all monotheist religions (See Exodus 22:25, Leviticus 25:35-36, Deuteronomy 23:20, Psalms 15:5, Proverbs 28:8, Nehemiah 5:7 and Ezakhiel 18:8,13,17 & 22:12).⁵⁾

According to the historical data, the prohibition of *riba* has not ever been in force within the Islamic economy. In Islamic societies, financiers (and not just village moneylenders) operated on an explicitly interest-based basis and financial transactions were never characterized by the predominance of direct-equity participation. After analyzing 17th century Ottoman Shari'ah court records from the town of Kayseri, concludes that interest rates below 20% “were accepted by the entire religious community as in accordance with the Shari'ah” and offering collateral or third-party guarantees for loans was also common practice. Similarly, in their study of 18th century Egypt find that trade between it and the Barbary States was normally financed at rates varying from 7% to 12% per annum and “that to take interest over 10% was regarded as usurious.”⁶⁾

In the Muslim world there is a substantial difference between profits resulting from entrepreneurial activities and profits generated by granting loans. In order to

⁵⁾ Shaikh S. .A, “A Brief Review & Introduction to Practiced Islamic Banking & Finance”, January 14, 2010, p.2. <http://ssrn.com/abstract=1536943>

⁶⁾ Khan F., *How 'Islamic' is Islamic Banking?*, Journal of Economic Behavior & Organization 76 (2010), doi:10.1016/j.jebo.2010.09.015, 2010 Elsevier, p.810.

understand the principles of financing in Islam, the distinction between *riba* (interest) and *bai'* (sale) is of crucial importance looked into the difference between *bai'* and interest in the context of the equitable distribution and efficient management of risk. In interest-based transactions, risk is transferred to the borrower so that all interest-bearing assets become risk free. This is socially inequitable and economically inefficient. On the other hand, trade by conforming to natural uncertainty is not only equitable but also efficient. This is generally used as a criterion to differentiate *riba*-based transactions from sale/trade.⁷⁾

In terms of *riba* prohibition, in case of insufficient resources, there are two ways to finance any commercial venture in Islamic economy: to enter into a partnership or to borrow interest-free money. The first one is profit and loss sharing (PLS), and it simply means that, instead of lending his money and becoming a creditor, the provider of financial capital joins the borrowing entrepreneur in the enterprise and, in return for the funds supplied, he shares the profits as well as the risks of the business; hence becoming a partner of the enterprise.

The second one is non-profit and loss sharing (non-PLS), where the financier may choose to be non-participatory and not to take an equity stake which is more closely to trade-based financing modes, than to partnership.

2.2. The prohibition of gambling and transactions involving speculation - Maysir and Gharar

Islamic banking and finance rest on certain principles and ethos that govern not only the interest-free mechanism but also several other prohibitions and unethical practices discouraged by the Shari'ah. These include such practices as uncertainty (*gharar*), cheating (*ghish*) and gambling (*qimar*).⁸⁾

In any case of having enrichment through games of pure chance, without effort it is forbidden according to the Qur'an. *Maysir* is involved in contracts where the ownership of a good depends on the occurrence of a predetermined, uncertain event in the future. In other words, there will be a gain for one party and a loss for the other party, but when the contract is signed, it is not sure who will be the winner or the loser. The transactions which contain excessive risk are supposed to foster uncertainty and fraudulent behavior. Consequently every contract that is created on speculative assumptions should be avoided. However minor uncertainties and a certain degree of risk are permitted as it is involved in every economic activity. In an economic context

⁷⁾ Kahf M., Khan T., *Principles of Islamic Financing – A Survey*, Research Paper No. 16, Islamic Research and Training Institute, Islamic Development Bank, 1413H (1992), p.19-20.

⁸⁾ Ahmad K., Rustam, G.A. Dent M.M., *Brand preference in Islamic banking*, Journal of Islamic Marketing Vol. 2 No. 1, Emerald Group Publishing Limited, 2011, p.75.

the ban of Maysir and Gharar has particular relevance for financial markets notably the derivatives market and the insurance business. As a derivative financial instrument speculates, in general, on the development of its underlying value (for example in future contracts or short-selling transactions) the concept of Gharar applies.

Therefore the trade of all conventional derivative instruments is impossible in Islamic finance, and also for the Islamic banks within the conventional systems.

2.3. Code of ethical investment - Halal and Haram

In Islamic economy exist several ethical and social criteria for exclusion regarding the investment targets and financial products. The forbidden and not admissible actions and businesses are called Haram whereas legal and permitted activities are referred to as Halal. Neither private investors nor companies or banks are allowed to invest in Haram businesses dealing with, for instance, alcohol, tobacco, pork-related products, gambling, cinema, pornography and such like.

As it was already described before, in the Islamic financial service industry, *riba* is forbidden. Thus, the securities issued by banks that operate in the conventional, interest-based financial system are not admissible for Muslim investors. Furthermore, it is forbidden to invest in companies that are debt-ridden. These Shariah requirements are of special importance in stock investment and Islamic mutual funds. In order to separate Halal investments from Haram stocks, a sophisticated screen process has to be executed.

2.4. The social duty to benefit society – Zakat

In Islam, wealth is regarded as a trust from God and should therefore take over a social duty in order to benefit society. It is an obligation for the Islamic state to guarantee a fair standard of living to its people and to balance social imbalances. The most important mechanism is establishing a Zakat-fund within the Islamic financial institutions, and then to redistribute the collected fund to the deserving poor, either directly or via religious institutions. The concerned assets include initial capital, reserves and profits. The calculation and payment of the Zakat is overseen by the Shariah Supervisory Board.

3. SOME CHALLENGES ON INTRODUCTION ISLAMIC BANKING IN CONVENTIONAL BANKING SYSTEMS

The current changes in the world economy, the revolution in information technology and globalization is resulting in dramatic changes in the world trade, place pressure on businesses in general and banks in particular. The most interesting for us,

are those that function in predominantly non-Muslim countries along with conventional banks.

What is interesting about the European case is that countries such as the United Kingdom (UK), France, the Netherlands, Spain and Germany progressed at very different speeds towards developing Shari'ah compliant financial retail products and services. In fact, the UK has emerged as the spearhead of Islamic Retail Bank in Europe and the entire Western World whereas, for example, the German Islamic Retail Bank market must still be regarded as being in its infancy. Expansion of IRB in Europe is not only a matter of technical implementation, but also an economic, legal, political and ultimately a fundamental societal issue.⁹⁾

Some of the challenges that should be reached in direction of fully integration of the Islamic banking institutions in European and other conventional banking system, are the following:

Lack of Standardization – It appears because the interpretations of Islamic Shari'ah principles are left to Muslim scholars, that are from different schools, cultures and Islamic societies. Due to this, there is a disagreement on some basic issues¹⁰⁾, and therefore each Islamic bank appoints a Shariah Supervisory Board whose remit is to assess whether its bank transactions and activities are in accordance to the Islamic Shariah.¹¹⁾ The lack of standardization is time-consuming and costly for the Islamic banks, and it is an obstacle to its widespread acceptance, especially in understanding the idea of Islamic banking by the regulatory agencies. Thus, standardization is expected to clarify the functions of Islamic banking and to better the understanding and the acceptance of Islamic banking as a serious competitor to the conventional banking system.

Regulation and Legislation weaknesses of the Islamic banking are the result of its not sufficient developed regulatory and supervisory techniques, which differs it from the conventional banking system, which has an effective regulatory and supervisory bodies. One of the major problems facing the development of Islamic banks is the current legal structure. In particular, such provisions should determine which

⁹⁾ Volk S., Pudenko M. , *Challenges and opportunities for Islamic retail banking in the European context: Lessons to be learnt from a British – German comparison*, Journal of Financial Services Marketing Vol. 15, 3., Macmillan Publishers Ltd. 2010, p. 192.

¹⁰⁾ For example, the prohibition of *riba* (interest) *vis-à-vis* the prohibition of *'inah* sales (double sale by which the borrower and the lender sell and then resell an object between them, once for cash and once for a higher price on credit, the net result being a loan with interest). Venardos, Angelo M. *Islamic banking and finance in South-east Asia: Its development and future*, World Scientific Publishing Co. Pte. Ltd., Singapore, 2005, p.99.

¹¹⁾ Nienhaus V., *Governance of Islamic banks*, Handbook of Islamic banking, Edward Elgar Publishing Limited, U.K. 2007, p136-140.

enterprises may call themselves Islamic banks, collect deposits and carry out banking practices on the basis of Islamic principles. Moreover, it should be clearly established that the central bank (or a separate supervisory authority) has the authority and all necessary powers to supervise Islamic banks as well as conventional banks, if applicable.¹²⁾ This causes tension between Islamic banks and regulatory agencies, which need to hold very strict policies about banking and to stand firm their definition of a bank as an institution that can guarantee deposits and provide a declared return on them.

Capital and Liquidity Requirements is another issue related to regulation and supervision of Islamic banks, which arises from the Basle Committee's minimum capital requirement.

The Basle Committee overestimates the risk to Islamic banks' assets and finds them more risky than the conventional banks. This is because conventional banks maintain a large portion of their assets in fixed interest-bearing deposits that are relatively easy to value. In return, the value of an Islamic bank's assets, invested in long-term projects and ventures, is difficult to assess. Moreover, the Islamic bank cannot use the central bank as a safety net and take advantage of its services as a lender of last resort because of the interest that must be paid on the loan during repayment.

Financial Instruments of the Islamic banks are related to the profit and loss sharing (PLS) techniques. One of the weaknesses of the PLS technique is that it is long-term and has a higher degree of uncertainty, which requires the banks to be continuously involved in rigorous analyses, evaluations, and assessment procedures in order to determine the risk and returns. Another problem related to the financial instruments of Islamic banks is the lack of short-term instruments to meet short-term capital needs and immediate liquidity concerns. Providing this service under an interest-free regime, possesses certain problems, which can be attributed to the application of PLS on short-term loans, which effectively means that risks and returns must be calculated for short periods of time. The classification of a short-term loan is typically from one day to a year. This cannot be considered as an acceptable solution, since the Islamic bank is set out to be a business rather than a charity.

Accounting Practices and policies adopted by Islamic banks present another technical problem. Islamic banks are based on different set of objectives, beliefs, and assumptions from conventional banking institutions. There are three main areas of difference between Financial Accounting Standards (FAS) developed for Islamic banks and conventional accounting frameworks. They relate to the treatment of investment accounts, the concept of substance over form and the time value of money.¹³⁾ These

¹²⁾ Venardos Angelo M., *Islamic banking and finance in South-east Asia : Its development and future*, World Scientific Publishing Co. Pte. Ltd., Singapore, 2005, p. 111.

¹³⁾ Venardos Angelo M., *Islamic banking and finance in South-east Asia : Its development and future*, World Scientific Publishing Co. Pte. Ltd., Singapore, 2005, p. 102.

assumptions lead to different types of transactions such as Zakat funds, PLS sharing accounts, and so forth, all of which must be accounted for in the books. Empirical evidence on Islamic banks' financial reporting practices is plausible that IASs are unable to sufficiently reflect all transactions of Islamic banking in an acceptable manner.

Risk management is one of the most important activities of any bank and both conventional and Islamic banks are subject to similar risks. Islamic banks are more vulnerable to investment risk, due to the longer-term nature of their transactions. In another hand, the interest-rate risk plays an important part in a conventional bank but is non-existent for Islamic banks. As it was explained for the other questions before, risk management is more developed area in the conventional banking system than in the Islamic banking system, which is a challenging task.

In terms of well established conventional banking system, there are limited possibilities for training the employees in Islamic banks.¹⁴⁾ The lack of professional courses and trainings resulted in lack of qualified staff. This may cause slow innovation of the Islamic banks products and instruments and affect relations with central banks due to the inability to clarify and explain various issues to them.

4. CONCLUSION

The current situation within the economy, in particular, in EU countries, the new movement in financial integration processes between Russia and other former soviet states and the investments in Europe and USA from Arabian world, might result in serious changes in global busines relationships, and the position of the Islamic banks in particular. Although, the conventional banks will remain as key players on markets, the further developments and innovations which occur in the Islamic finances, will increase Islamic bank's potential and secure them better market position.

In the long run, the sustainability of Islamic banking rests on two pillars. The first one is satisfying the demand for quality of products and services that Islamic finance can offer. This means having ability to provide a comprehensive range of Islamic financial products and services which are not only Shari'ah compliant, but also enough innovative and competitive with conventional financial instruments. The second one is related to the comprehensive regulatory framework for Islamic banks in conventional banking environment which includes an effective prudential supervision on Islamic banks.

¹⁴⁾ Abdul-Rahman Y., *The art of Islamic finance and banking: tools and techniques for community-based banking*, Published by John Wiley&Sons, Inc., Hoboken, New Jersey, USA, 2010, P.331.a

Despite this, Islamic banking institutions must be a subject on clarifying several points with introduction of:

- an appropriate risk management, taking into account the modes of the Profit and Loss Sharing,
- an instrument and mechanisms in Islamic financing systems according to Shari'ah which will guarantee sound and stable condition to the Islamic banking institution,
- high level of standardization and create confidence in its depositors as well as all the other operators in the market through foundation of Centralized Shari'ah Board, introducing Shari'ah clearance, internal audit and external audit,
- a training of both, the staff and the clients of the banks, and inform the general public about the principles of Islamic banking,
- a development an Islamic financial market, in particular, the secondary market for Islamic financial instruments as better manner for Islamic banks to manage their liquidity,
- a facility which will function as the lender-of-last resort, which is available to conventional banks in the face of the Central Banks, to overcome the liquidity crises when they suddenly occur.

Resolving these points is not a simple task under the Shari'ah requirements. But, reaching these challenges brings the Islamic banks on a better position, especially in EU countries, where the Central banks will allow them to continue their operating under banking acts.

The place and significance of these principles and readiness to accept the primary rules of operation in Europe countries at first side, will determine the future presence of Islamic banking in western banking systems.

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Professional paper

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THE INTEREST RATE POLICY IN THE REPUBLIC OF MACEDONIA AND ITS INFLUENCE ON FINANCIAL STABILITY AND ECONOMIC GROWTH

Abstract

The interest rate policy is an instrument of the monetary credit policy in achieving of determined goals. Its task is to ensure efficient allocation of financial resources and achieving an internal and external stability of the economy, and thus to directly contribute to stimulating the development and improvement of living standard.

The National bank of the Republic of Macedonia, through regulating of the spectrum of interest rates, influenced on keeping the nominal exchange rate of MKD (Denar) to a target level, and realization of price stability in the economy. This way, the bank sent signals to all commercial banks to adjust the interest rates level. The commercial banks in the Republic of Macedonia conceive and run their own interest rate policy, in accordance to the effectuated level of economic activity, the level of liquidity, the inflation rate, the course of monetary policy, competition, risks and the high level of indirect and operation costs.

In recent years, the rigid bank interest rate policy gradually relaxed. However, yet the limited level of domestic saving from one side, and high demand for investment funds and inadequate quality of the banks' credit portfolio, on the other side, in the following period, will determine the establishment of relatively higher bank interest rates in the Republic of Macedonia, that adversely reflects on acceleration of the economic growth.

Key word: monetary-credit policy; NBRM interest rate policy; interest rate of treasury notes; positive bank interest rate; passive bank interest rate.

JEL Classification: E43, E52, E58, G21

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Introduction

The policy of interest rate is one of the most important instruments of the monetary and macroeconomic policy in general, in every modern economy. The emphasis on the interest rate policy as a mechanism for managing money offer and demand of, suggests the need for providing efficient allocation of financial resources, as well as to enable achievement of internal and external stability of the economy. Establishment of the optimal interest rate policy, through the influence of the capital mobility, maintaining of low inflation level and stable exchange rate, should present a basic prerequisite for enhancing acceleration of economic growth, increasing employment, and improving the living standard.

Establishment of adequate interest rates in countries with a developed, diversified financial structure is realized through market principles implementation. However, the establishment of optimal interest rates in countries with underdeveloped financial markets, unsatisfactory performances in the real economy, with a structural imbalance in the financial supply and demand, and with incomplete performing of the monetary transmission mechanism, imposes a special need of attention when conducting interest rate policy.

The interest rate, as a specific price for use of resources for a particular time period, should ensure reward to the saver, for his restrained current consumption, while it presents a part of expected profit for the investor, from which he should cancel and pay as a fee for utilization of financial resources. At this, the interest rate has a decisive role in mobilizing free money assets and formation of the financial potential, as well as absorbing an optimal allocation of the formed saving. Anyway, only the real interest rates can influence the saving and investing level. Hence, this rate presents an important determinant for balancing the supply and demand of financial resources in every economy.

The impact of the interest rate on the behavior of economic subjects is realized through three mechanism: a) the substitution effect- at low interest rates there is a greater inclination to invest and smaller inclination to save, and vice versa, at higher interest rates there is a greater inclination to save and smaller inclination to invest; b) the effect of wealth - at low interest rates the price of financial assets-the assets of entities is raising , and thus influences on the decisions about spending - investing, while at higher interest rates the value of the properties reduces and imposes a restrained spending, and c) the effect of income (interest)- at low interest rates the savers get smaller amount of interest and have less opportunity for spending and vice versa, in case of higher interest rates the savers have higher income, get greater interest, and so they can spend more, while at higher interest the borrowers reduce their spending.

The Republic of Macedonia economy is a small and open economy, which still carried out transition structural reforms. It is an economy that depends greatly on

foreign markets trends. In recent years, it has great budgetary deficit in the trade and payment balance. Besides the built financial structure, the financial market of the country is small and underdeveloped. On the other side, our economy has great necessity for financial resources, as well as for additional credit support inside the reproduction processes. In recent years, the economy conditions became more serious with further occurrence of the financial mortgage crisis, which quickly spread in the world economy. In such a complex situation, it is necessary to view how effective the interest rate policy of the Republic of Macedonia is, and to face the challenges for maintaining the financial stability and encouraging the economic development.

1. THE INTEREST RATE POLICY OF THE NATIONAL BANK OF THE REPUBLIC OF MACEDONIA

The main objective of the monetary credit policy in Macedonia, as in most developed countries in the recent period, is maintaining the financial-price stability, as most favorable environment for stimulating economic activity and achieving long term sustainable economic development. The monetary growth, only for a short term, may contribute stimulating of the economic dynamics, while for a long term, its impact is reflected only on raising of prices. The inflation increases the uncertainty of economic results, de-stimulates the investment procedures, and reduces the efficiency of price signals and markets. The monetary credit policy can best contribute to achieve economic growth only through maintaining a low, stable and anticipated rate of inflation.

In Macedonia, a small and open economy that is highly exposed to the impact of the world market movements and with underdeveloped financial markets, the defined objective of achieving price stability is accomplished through a target strategy of the MKD exchange rates versus the Euro. Conditions of the domestic economy disabled achievement of the objectives of low inflation rate and positive economic growth, through targeting of the interest rates. In terms of permanently high structural liquidity of the banking system, the interest rate policy implemented by the central monetary authority, may not implement the basic function of regulating the required amount of liquid assets in the economy. Hence, this policy becomes primarily an instrument for maintaining stability of the MKD exchange rate and generating a foreign capital inflow. In this way, it indirectly regulates the money offer and demand, and thus the price stability. Through everyday interventions in the foreign exchange markets, by targeting the exchange rates it ensures stability, which is resulting in repressing the inflation results and maintaining the financial -price stability.

In recent years, the central monetary authority, in order to achieve financial-price stability, defended the target level of the MKD exchange rate by neutralization of effects caused by the impact of autonomous factors on the banking sector liquidity. In this regard the National Bank of Macedonia mainly did withdraw the surplus liquid assets. In addition, it governed a cautious interest rate policy, using a spectrum of interest rates. The interest rates were set on a flexible market basis, that enables a

constant changing and adopting in order to increase their efficiency and successful realization of the determined goals. The amount of these rates was determined by accomplished economic results in the country, particularly the level of economic activity, the export and balance of payment, movements of the exchange market, the level of liquidity in the banking sector, governing a prudent fiscal policy, risks and uncertainties in the economy and banking, and expected inflation.

Considering the positive achievement in the real and external sector of the economy and high structural liquidity of deposit banks, the rigid restrains of the monetary-credit policy, gradually and overtime the interest rate of the National Bank of the Republic of Macedonia relaxed, and gained a positive downward trend. However, this situation was disrupted with emerging and spreading of the financial mortgage crisis in 2007. Due to high uncertainties in the world market, high inflationary pressures and deepening of external imbalance, the interest rate policy governed by the central monetary authority has strained again.

In Macedonia, the discount rate of the central monetary authority does not present a basic instrument for regulating of the liquidity assets offer and demand, as it is in the developed market economies. Despite, this rate is the basis for calculating of the penalty interest rate in the banking system, as well as for giving signals for the exchange of the monetary policy course. In the analyzed period, the discount rate was stable-intact and was kept at the same level at 6,5%.

The Lombard loans interest rate is the highest rate of the central bank interest rates spectrum. It applies in circumstances where the bank can not overcome their liquidity problems and cannot use other resources, so, they use short time collateral short-time loans from NBRM, as from last resort lender. Due to a high liquidity of the banking sector, in 2007, this rate noted reduction from 13,0% in 2004 to 7,5% in 2007. But, in terms of increased uncertainties and reduced liquidity resulted from the financial crisis, the Lombard loans interest rate increased to 10,0% in 2009, while showing certain stabilization in 2010, the interest rate level showed a decrease up to 5,5% . However, in the studied period, the Lombard loans were barely used by the commercial banks.

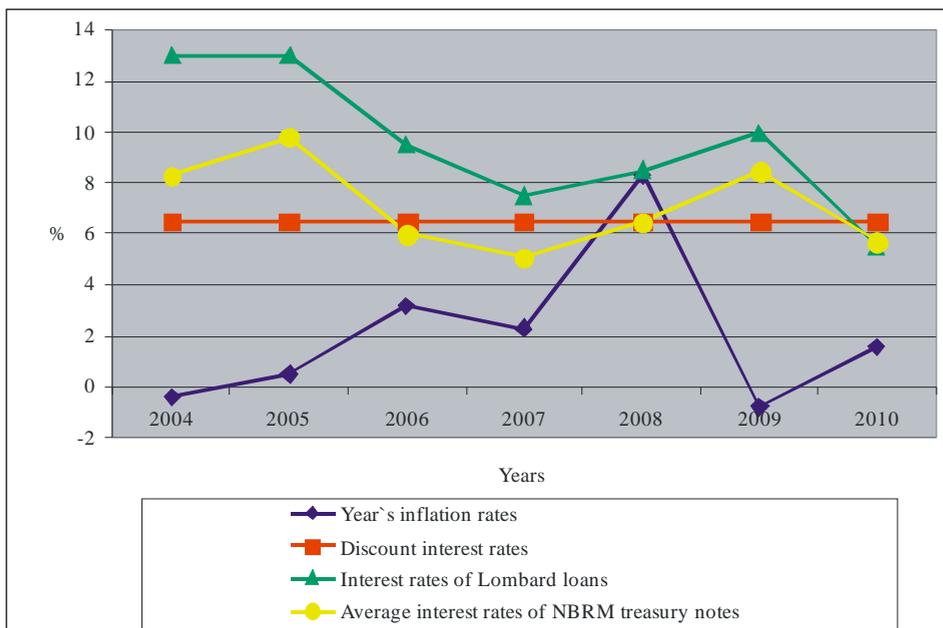
The basic referential interest rate, for realization of the established monetary-credit policy in Macedonia, is the interest rate of treasury notes. In terms of structural surplus of MKD liquidity in the banking system, the underdeveloped and shallow financial market, and insufficiently diversified portfolio of securities, the interest rate of NBRM treasury notes represent a basic instrument for regulation and withdrawal of liquidity. This interest rate has the greatest influence on formation of interest rates on the money market and short term securities, and partly on the interest rates of the banking sector. In the recent years, due to the increased foreign currency reserves, the prudent fiscal policy and the stable economic environment, the average pondering interest rate of NBRM treasury notes has gradually declined. Namely, the higher average demand of the average offer of treasury notes, has contributed to the reduction of the interest rate from 8,3% in 2004 to 5,1% in 2007. However, the unfavorable

global environment caused by the global crisis, has the effect to increase the uncertainties and risks, was expressed through the growing external imbalance and pressure on the foreign exchange market, which produced increase of the average interest rate of the NBRM treasury notes. Thus, this rate reached to 8,46% in 2009, while in 2010 it decreased, adjusted and stabilized to 5,7%. (Figure1.).

The established interest rate of the central monetary authority in the recent years, was focused on a permanent sterilization of the surplus liquidity in the banking sector, which resulted from the NBRM high foreign currency net purchase from the foreign exchange markets. In addition, the monetary authority, despite the frequent pressure has successfully maintained the exchange rate of the MKD versus the EURO, on a stable level. This type of monetary strategy of targeting the exchange rate has allowed generating of a relatively low and stable inflation. Thus, the rate of inflation (measured by the cost of living index rate) was kept controlled. In some years, the rate was negative. In the period before the financial crisis, the rate amount ranged from -0,4% in 2004 to 2,3% in 2007. Then, as a result of the uncertainties and inflationary pressures on the global financial market, the rate reached to 8,3% in 2008, while later, in 2009 , in terms of positive shifting, the rate fell within the scope of negative value at the level of -0,8% , and in 2010 it stabilizes at 1,6%.

Figure 1

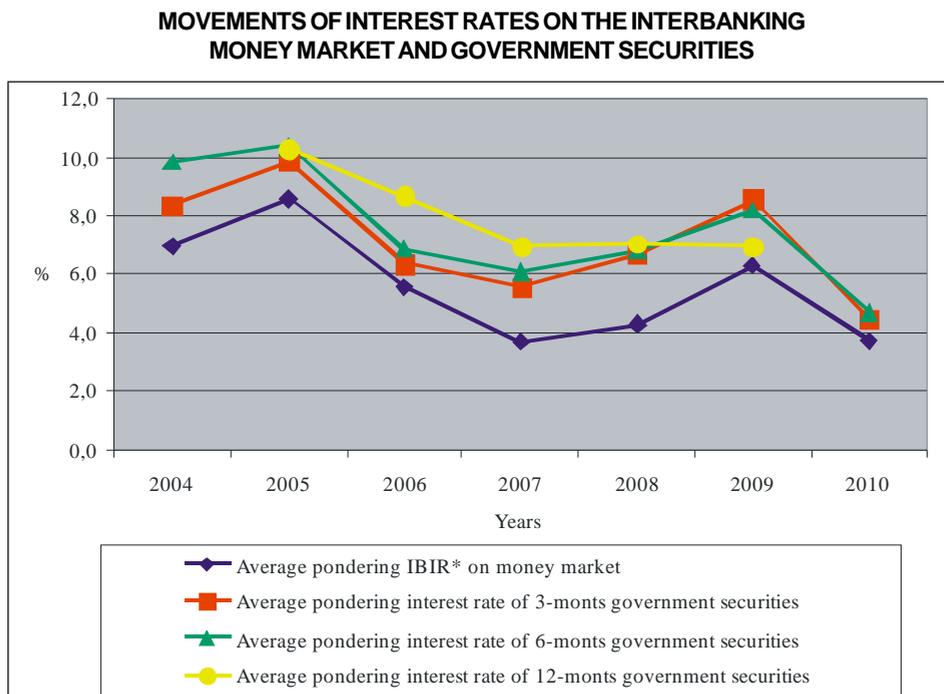
MOVEMENT OF SHORT-TERM INTEREST RATES OF NBRM AND YEAR'S INFLATION RATE



Source: NBRM quarterly report-Statistical annex , 4/2010, Skopje, 2010

Also, in the analyzed period, the interest rates on financial markets in the Republic of Macedonia (the inter-banking money market and government securities market) were in close correlation with the established rate of relaxation of the monetary-credit policy. The interest rate on the inter-banking money market did harmonize the surplus and the shortage of short-term MKD liquidity assets within the banking sector. In recent years, this interest rate showed response to the most apparent changes in the referential interest rates. Particularly, the gradual reduction of the interest rate of treasury notes was followed by an appropriate response in decline of the average pondering interest rate on the inter-banking money market. Thus, the pondering interest rate showed a continuous decline of 7,0% in 2004 up to 3,7% in 2007. In subsequent years, during the crisis, the downward trend of the interest rate was disturbed in 2008 and 2009, when higher rates of 4,3% and 6,31 % were registered, respectively. However, in 2010, the inter-banking interest rate reduced again, and thus reduced at the level of 2007, when the rate was 3,75%. (Figure 2.).

Figure 2



Source: NBRM quarterly report-Statistical annex , 4/2010, Skopje, 2010

*IBIR = Inter-banking interest rates

In Macedonia, issuing short-term government securities is made primarily in order to realize the monetary objectives. The interest rate of government securities

with validity of 3; 6; and 12 months, has the function of regulation, i.e. withdrawal of the present structural surplus liquidity from the banking sector. In the analyzed period, changes at this interest rates was a reaction to the movement of the NBRM basic interest rate. Precisely, the average pondering interest rate of government securities from 2004 to 2007 produced a downward movement. Thus, the interest rate for 3 months validity of treasury bills has reduced from 8,4% to 5,6% ; the interest rate for 6 months validity of treasury bills has reduced from 9,9% to 6,1%; and the interest rate for 12 months validity of treasury bills reduced from 10,3% (in 2005) to 7,0%. During the most intensive shocking period of the financial crisis (2008-2009), in conditions of reduced liquidity, the interest rate has increased and stabilized in 2010, at the level of 4,48% at 3- months, and 4,73% at 6 -months treasury bills.

The interest rate policy which the NBRM conducted last year, in correlation with the financial markets interest rates, has a relaxing characteristic. Although this policy represents an instrument of an indirect regulating of the amount of liquidity assets in the economy, yet, it successfully maintained the financial-price stability. It was sending positive signals to the banking system to ease the interest rate policy, to intensify credit loans, and create possibilities for acceleration of the economic activity.

2. THE INTEREST RATE POLICY OF THE COMMERCIAL BANKS OF THE REPUBLIC OF MACEDONIA

The banks of the Republic of Macedonia, whose main business is collecting deposits and its placement in loans and other investments, presents legal entities with the main goal of profiting. This kind of establishment of the banking system enables them independence in frames of creating business and pricing policy. Considering the fact that the interest rates, as a price for placement of financial resources for a given time, simultaneously represents the cost and revenue component in the banking operations, that implies careful conduct of the pricing policy.

Usually, the banks behavior in designing the interest rate policy is determined by the influence of several factors. Thus, the growth of the deposit basis, the intensity of credit demand, the position of liquidity of banks, quality of the credit portfolio, the amount of operating expenses and expenses for mediation, the degree of competition, the access to market finances, the degree of overall economic activity in the country, the inflation rate, risks and uncertainties, as well as the courses of the monetary-credit policy, are factors that decisively effect on the banks reaction in adjusting the interest rates. The banks, at forming individual interest rates on their own products, can take into consideration the NBRM referential interest rate as a basic interest rate, as well as the interest rate of inter-banking money market LIBOR or EURIBOR- interest rate.

In recent years, commercial banks in Macedonia reduced the rigidity of their own interest rate policy. With its relaxation, the policy was put in a position to be used

for intensification of the economic development. The gradual relaxation of this policy was induced primarily by: expansion of the deposit basis for a good banking liquidity position; relaxation of the NBRM monetary credit policy; improved economic conditions and reduced risks and uncertainties; low inflation level; stronger competition pressure among banks; banks' increased access to market financing; as well as the positive expectations of the overall economic activity. However, in recent years, the banking interest rate policy was negatively influenced by the emerging of the financial crisis.

Active interest rates, by which the banks approved loans, realize a tendency of continuous decline. Relief of the interest rate was more expressed at MKD interest rate. The average positive pondering Denar interest rate continually decreased from 12,5% in 2004, to 9,5% in 2010. (Figure 3.). In addition, dynamics of reduction of the interest rate was not identical among different sectors. Greater downward correction was performed on the interest rate in the household sector, as a less risky segment. Banking interest rate policy that was implemented in the enterprises sector was more conservative. Unlike the Denar interest rate, the average positive pondering foreign currency interest rate was positioned at a significantly lower level of 7,7% in 2005, slightly increased to 8,4% in 2007, and then dropped to 7,4% in 2010. Greater variability in the amount of the Denar versus the foreign currency interest rate derived from the fact that the foreign exchange interest rate followed the movement of the international financial markets.

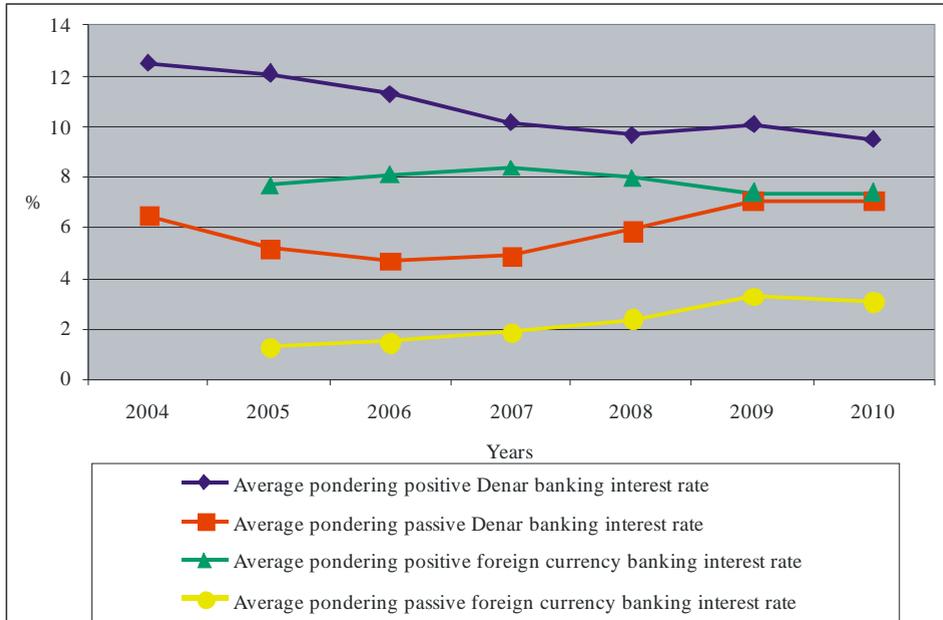
The passive (adverse) interest rate, with which banks stimulated saving in the past, had realized altering movements. The average passive pondering Denar interest rate realized downward trend, till the appearance of the financial crisis. Thus, this rate of 6,5% in 2004 dropped to 4,7% in 2006, and later in conditions of the crisis and limited financial resources, it gradually increased to 7,1% in 2010. The upward adjustment of the passive Denar interest rate was fairly expressed in the household sector. While, the average passive pondering foreign currency interest rate was set at a very low level. In recent years, according to the movement of international financial market, it registered growing and moving from 1,3% in 2005 to 3,1% in 2010. The existence of fairly broad range of income between deposits in domestic currency and foreign currency, has contributed a lot to encourage clients to save in the MKD.

Taking into consideration the movement of positive and passive interest rate of MKD, in the analyzed period Macedonian banks had gradually realized narrowing of the interest rate margins. The margin of 6,0% points in 2004 decreased to 2,4% points in 2010. However, the narrowing of the interest margins has primarily resulted from the increase of passive interest rates, while a small part resulted from the increased efficiency of the bank working.

Despite the achieved positive movements, the interest rate policy of commercial banks in Macedonia is characterized by a relatively high set positive interest rates, that actually do not function in favor of greater intensification of the economic activity in

Figure 3

POSITIVE AND PASSIVE INTEREST RATES OF COMMERCIAL BANKS
IN REPUBLIC OF MACEDONIA



Source: NBRM quarterly report-Statistical annex , 4/2010, Skopje, 2010

the country. There are various circumstances of objective and subjective characteristics that contribute the interest rate bank policy to be at low level. The most distinguished limiting factors are: instability, limited and poor domestic savings opposite to the high and rigid demand for bank loans, in conditions of underdeveloped financial market and non-banking financial mediators; poor quality of the banking portfolio with high degree of risking and unpaid debts, precautious and conservative course in conducting the bank credit policy, especially for financial indiscipline and problems in the case of charging claims in court, as well as high direct and operating costs due to the bad, inefficient and irrational banking operations. On the other hand, the high positioned passive interest rate should allow expansion of the financial basis, actually to contribute to attracting larger scope of saving. Such interest rates are striving to keep the existing savers and encourage new savers.

The established banking interest rate policy in recent years, was not in the line compared with the trend of the achieved level of price stability. Moreover, banks' responding to the NBRM monetary signals was unsatisfactory, and was implemented with delay and small intensity. This type of banking reaction of transferring the positive impulses from the central bank to the real economic sector, resulted from the reduced propensity of banks' exposure to risks, especially due to their own inefficient operating. The banking interest rate policy was quite rigid, especially in the downward correction of positive interest rates, i.e. the upward correction of passive interest

rates. On the other hand, banking positive interest rates in Macedonia, compared with other countries in transition, were positioned at a relatively higher level. Such designed interest rate policy, in terms of high and rigid credit demands, contributed to incomplete utilization of financial potentials for crediting the population and the economy, on one hand, and to placement of the obtained credit income in riskier projects, with which the realization of payment was endangered, on the other hand. "Non-performing loans" or bad credits that are difficult to be charged, are highly implemented in the banking credit portfolio. Its participation, in the previous period, was decreasing from 9,1% in 2004 to 4% in 2007, and in conditions of financial crisis it increased from 6,8% in 2008 to 9,3% in 2010. Despite the improved conditions, the share of non-functional loans is relatively high in the total credit investment of Macedonian banks, and it is above the average of non-performing loans in the EU, where it ranges between 2-3%.

In the following period, regarding the limited and low quality of domestic savings, as well as the need of increased investments in order to provide more intensive development, further we expect Macedonian banking interest rates to be set at a relatively higher level. On the other side, the improved macroeconomic performances—low inflation, a stable foreign exchange course, and favorable liquidity level will effect positively on positioning the interest rates on the economic rational level. However, the fact remains that Macedonian banking interest rates will continue negatively reflecting on acceleration of the economic growth.

CONCLUSION

The interest rate policy, that regulates the money offer and demand, is an important instrument of the monetary and macroeconomic policies of every country in achieving the fast economic development. In Macedonia, the interest rate policy conducted by the NBRM in recent years had a relaxing characteristic. Although this policy represented an instrument for indirect regulating of liquidity assets in the economy, yet, it successfully maintained the financial—price stability. In implementation of this course, the central bank was sending positive signals to the banking system to ease the interest rates policy and create possibility for accelerated economic activity.

The commercial banks in Macedonia are independent in conceptualization of their own interest rate policy. In recent years, as a result of expansion of the deposit basis and good liquidity position, eased monetary-credit policy, improved economic conditions, low inflation and the increased competition, the banks gradually carried out relaxation of the interest rate policy. However, despite the effectuated positive movements, the banking interest rate policy is still characterized by setting a relatively high positive interest rate, which aimed to intensification of economic activities in the country.

In the following period, considering the limited and low quality domestic savings, as well as the need for greater investment, we can further expect the Macedonian banking interest rates to be set at a higher level, thereby adversely effecting the acceleration of the economic growth.

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SOME POSSIBILITIES FOR FINANCING RURAL TOURISM DEVELOPMENT IN THE REPUBLIC OF MACEDONIA

Abstract

Given the availability of the EU funds enabling opportunities in supporting the countries toward EU accession, this paper focuses on EU funds available for developing the rural tourism in Macedonia.

The paper elaborates two out of five IPA (instrument for pre-accession) components, while a special focus is paid to EU community funds from rural tourism perspective. The paper treats the effectiveness and efficiency in absorbing the EU funds.

The authors have used the desk research as well as the inputs of different stakeholders dealing with the field of rural tourism.

The paper concludes that the EU funds offer a great opportunity for rural tourism development, but its absorption is very low.

Key words: Rural tourism; IPA; Community Funds; development; Macedonia.

JEL Classification: F35

Introduction

Rural tourism in the Republic of Macedonia is less explored field and its further development expects to boost in the coming years. A critical issue is providing neces-

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sary financial resources toward its development. Republic of Macedonia as a candidate country has access to EU funds which may be used as a financial support for implementation of concrete project initiatives aiming rural tourism development.

Having that in mind we will explore potential of two out of five IPA (instrument for pre-accession) components: Cross-Border Cooperation (CBC) and Instrument for Pre-Accession in Rural Development (IPARD), as well as possibilities of some EU community funds regarding the rural tourism perspective.

However accessibility of EU funds is not guarantee for their engagement in rural tourism development process. They are prerequisite, but their real mobilization seen through efficiency of their absorption is fundamental for further rural tourism development in the Republic of Macedonia.

1. IPA COMPONENTS AS A POSSIBILITY FOR FINANCING RURAL TOURISM DEVELOPMENT IN THE REPUBLIC OF MACEDONIA

As we already mentioned we will elaborate two out of five IPA (instrument for pre-accession) components: Cross-Border Cooperation (CBC) and Instrument for Pre-Accession in Rural Development (IPARD), as components with high potential for financing rural tourism development.

1.1. Cross-Border Cooperation and rural tourism development in Republic of Macedonia

The objective of this component is to promote good neighborhood between the countries, and strengthen stability and security of countries as part of a wider region. Under the second component of the IPA, the Republic of Macedonia continues the cross-border cooperation with EU member states - Bulgaria and Greece (started earlier with the so-called Phare instrument), as well as with the Republic of Albania, Serbia and Kosovo. Macedonia takes part also in transnational program for South Eastern Europe, which is continuation of the CADSES program.

IPA cross-border cooperation between Macedonia and Greece started with the first call released on August 17, 2010¹⁾. Under this call, the size of projects ranged between 150.000 and 750.000 Euros, and its implementation guaranteed EU financing up to 75% for Greece's applicants, and up to 85% for applications from Macedonia. Projects should've been implemented for a maximum of 15 months. The total budget

¹⁾ Call for Project Proposals "Greece – Republic of Macedonia IPA Cross – Border Programme" 2007 – 2013, Date 16/07/2010, Ref. No: 301291/MA2794.

for this call is about 6 million. The areas eligible for cross-border cooperation are at the level of NUTS III²⁾ (or equivalent), and they are³⁾:

- Florina, Pella, Kilkis and Serres and Thessaloniki in Greece and
- Pelagonia, Vardar, Southeast and Southwest regions in Macedonia.

The program forecasts the strengthening of the cooperation between economic actors through collaborative approaches to support local economic activities, development of local human resources and protection of human health as pillars for sustainable local economic development. The program also cared protection and promotion of environmental and cultural potentials as means for sustainable local development. The main priorities of the program are⁴⁾:

- Strengthening cross-border economic development in order to promote sustainable economic development through common interventions and facilitating cross-border relations. This priority will be implemented through four measures that focus on promoting entrepreneurship, improving human resources, development of sustainable tourism and protection of public health through cross-border activities.
- Strengthening of environmental resources and cultural heritage of the program area in order to promote joint activities to protect natural and cultural environment, and mobilization of natural and cultural resources. Both measures under this priority dealt with the promotion and protection of environmental resources and natural and cultural heritage of the region.
- Technical assistance was also part, aiming smooth implementation of the program for improving cross-border cooperation, and contributing primarily to the global aim.

Cross-border cooperation with Bulgaria started in 2009. Namely, first Call for the IPA CBC between Macedonia and Bulgaria was announced on September 2009⁵⁾. The first call for proposals from the two partner countries was the amount of 4.1 million Euros. The ultimate goal of the program is improving the ability of local and regional authorities to develop and implement joint projects in the border region at NUTS III level:

2) Regulation (EC) No 1059/2003 of the European Parliament and of the Council of 26 May 2003 on the establishment of a common classification of territorial units for statistics (NUTS).

Класификацијата NUTS ја дели територијата на економски и статистички зони, како што е дефинирано во Одлуката на Европска Комисија (EC) No 1059/2003. Во NUTS 3 спаѓаат регионите со жители помеѓу 150,000 и 800,000 жители. Република Македонија има 8 такви региони, познати како Статистички региони.

3) IPA Cross – Border Programme, 2007 – 2013, Greece – Republic of Macedonia, p. 7.

4) IPA Cross – Border Programme, 2007 – 2013, Greece – Republic of Macedonia, str. 42

5) Call for Proposals No: 2007CB16IPO007 – 2009 – 1, Bulgaria –Macedonia IPA Cross – border Programme.

- Blagoevgrad and Kystendil in Bulgaria
- Northeast, East and Southeast in Macedonia

Project proposals were related to one of the following priority areas.

- Economic development and social cohesion;
- Improve the quality of life.

Specific objectives of the program priorities with Bulgaria are the acceleration of sustainable economic development in the border region, promoting social cohesion and cross-border cooperation and developing the attractiveness and quality of life in the border area.

Cross-border cooperation program with Albania, commenced by the first call for proposals released on June 3, 2009⁶⁾. The budget for the first call for both sides was 340 000 EUR. Although the first call projects were still under evaluation process, on April 15, 2010 the second call for proposals was announced, which lasted until August 19 the same year⁷⁾. The budget for the second call was 3.5 million Euros. Individual projects if successfully selected, were granted with 50,000 to 200,000 Euros. Regions to benefit from cross-border cooperation are⁸⁾:

- Polog, Pelagonija and Southwestern region of Macedonia;
- Korca and Elbasan Debar region in Albania.

The main priorities of cross border cooperation between the two countries are:

- Promoting sustainable development in the border area. There are three measures: Economic development with an emphasis on tourism, Sustainable development environment with emphasis on protection, promotion and management of natural resources and ecosystems, and social cohesion and cultural exchange through people to people and from institutions to institutions. Under these priority axes, specific measures will support the development and implementation of common strategies, action plans, studies and analyzes. Special emphasis will be the creation of business contacts, networking, partnerships, tourism infrastructure, promotion and branding of regional products, socially disadvantaged groups, unemployed, rural youth, women in the workforce and the like.
- Promoting cross-border economic, environmental and social development. This priority is in response to different circumstances and needs identified in the cross order area. Special focus was given to the protection and management of natural resources (especially around the Lake of Ohrid and Pre-

⁶⁾ Call for Proposals reference: 2007/019361IPA Cross – border Programme between Macedonia and Albania.

⁷⁾ Second Call for Proposals reference: 2007/019361IPA Cross – border Programme between Macedonia and Albania.

⁸⁾ See: IPA Cross – Border Programme, 2007 – 2013, Macedonia – Albanija, str. 30,31.

spa), social issues associated with poverty and unemployment are considered of high priority.

Cross-border cooperation with Kosovo and Serbia as a north neighborhoods was delaying. The reason was the definition of the border with northern neighbors, which finally was marked. Means of cross-border cooperation with the northern border in 2007 were transferred to the program with Albania. Funds for 2008 were added to the first component - Fiche for integrated border management. Currently, there was a call for application with Kosovo, and the evaluation is ongoing.

1.2. Instrument for Pre-Accession in Rural Development and rural tourism development in Republic of Macedonia

The objective of the rural development component is to improve the market efficiency and application of the standards of the European Union in agriculture and rural economy. This component supports preparatory activities for implementation of rural environmental measures, local rural development strategies and encourages development of rural economies. Macedonia's government initially determined the following sectors as priorities to be supported by IPARD⁹⁾:

- Meat and milk;
- Fruit and vegetables;
- Grapes and wine;

The advantages that Macedonia possesses in this field, is the fact that these farming practices are among the most developed in our country and there are already numerous trials followed by domestic and foreign experts¹⁰⁾. IPARD program was developed including the assessment of the overall condition of the rural economy through agricultural development. There were defined the main problems and possible solutions addressed based on priorities identified in the content of the IPARD program. According to the above program there are three measures of financial support, associated with a proper codification as following¹¹⁾:

- Measure 101: investments in agricultural holdings to restructure and upgrade its utilities with the standards of the European Union;

⁹⁾ Operational Programme under the EU instrument for Pre – Accession for Rural Development (IPARD), National Plan for Agriculture and Rural Development 2007 – 2013.

¹⁰⁾ МЦМС (2007): Успешно Искористување на Фондовите ИПАРД, МЦМС – Скопје, стр. 48.

¹¹⁾ Програма за користење на средствата од инструментот за претпристапна помош за рурален развој од ЕУ (ИПАРД) за периодот 2007 – 2013 година (СВ на РМ број 83, од 03.07.2009 година).

- Measure 103: supports the processing and marketing of agricultural and fishery products, assuring its restructuring and upgrading to the standards of the European Union; and
- Measure 302, provides diversification and development of rural economic activities. Under this, the rural tourism occupies a central position.

Under the measure 302, rural tourism is eligible for further support.

2. OTHER EU FUNDS AIMED AT RURAL TOURISM IN MACEDONIA

In addition to the above IPA instrument; there are other opportunities for utilization of EU funds enabling thus the development of rural tourism across Europe, including Macedonia. These funds are known as Community Funds and are administered directly by the European Commission, more precisely by DGs (Directorate Generals).

According to a publication of the European Union, called Euro-funding¹²⁾, there are about 330 European development funds (where tourism expected to benefit as well). These funds are opened for the member states or candidate countries, and are accessible for the public institutions, local authorities, chambers, associations, private companies, NGOs etc. We certainly will not elaborate all these funds in this paper, but will focus to those funds where Macedonia is eligible and will focus on initiatives supporting the rural tourism. The opportunity to use the Community Programs, originates from the Thessaloniki agenda, adopted on 16 July 2003, which enabled the European Commission to propose a basic framework for participation of Macedonia and Western Balkan countries in programs of community (December 3, 2003)¹³⁾.

The community programs where Macedonia is eligible are the following: Progress, Europe for Citizens, FP7 (Seventh Framework Programme), Culture, CIP - Entrepreneurship and Innovation). Further these programmes are elaborated more in details.

Progress 2007 - 2013, is a program for employment and social issues. Progress has a global budget of 743 million Euros for seven years (2007-2013). There are five measures such as employment, working conditions, gender equality, social protection, inclusion and anti-discrimination and diversity. Usually (but not necessarily) an application should include more countries, thus increasing the chances to be successfully selected. Progress targets member states and EU candidate countries, with special focus on the local and regional authorities, public employment services and national statistical agencies, other specialized bodies, universities and research insti-

¹²⁾ EU (2009): Summary Eurofunding Guide, European Union funds, EU, Brussels.

¹³⁾ СЕП (2009): Програми на Заедницата, Секретаријат за европски прашања, Скопје, стр.5.

tutes, social partners and NGOs. European Commission selects projects for funding through tenders or calls for proposals. The program provides up to 80% grant of total project's budget. Macedonia joined the program in December 2007. Responsible body is the Ministry of Labor and Social Policy.

Europe for Citizens Programme (2007 – 2013) promotes active European citizenship, with particular focus on the citizens of new member-states. The financial framework 2007 - 2013 of the programme stands for 215 million Euros. The purpose of this program is to bring Europe closer to citizens and enable them to fully participate in building the Europe. Through this program, citizens have the opportunity to be involved in transnational exchanges and cooperation, which contributes to encouraging the process of European integration. One of the four targets of the program is to support civil society, whether through institutional support or support to the specific projects. Macedonia joined the program in April 2009 after aligning its legislation.

The programme ***Culture (2007 - 2013)*** aims to support creation of a common European cultural space. Under this Programme, cultural activities are supported throughout the countries of Europe. The idea behind this programme stands for cooperation in the field of culture between different countries. This program provides support to small and medium enterprises (SMEs), government institutions, agencies, universities, chambers, associations, federations, etc. The global budget of this program is 400 million Euros. The program operates by providing grant financing costs, which aims to promote transnational culture, craft products, intercultural dialogue and similar initiatives. Macedonia, together with the other Balkan countries, is eligible for this program. The application process is in two phases. The first phase requires provision of the concept note and if successfully selected, the second phase requires the development of the whole project application.

CIP-Entrepreneurship and Innovation¹⁴⁾ 2007 - 2013, is a big Community Programme, where Macedonia is also eligible. The program focuses on the establishment of the networks, knowledge sharing between companies, education, technical assistance and transnational cooperation. Global CIP programme stands for a budget of 2.16 billion Euros, supporting thus the EU Member States, candidate countries and the Balkans. The purpose of the program among others is encouraging women and young entrepreneurs. Macedonia has signed a Memorandum of Understanding for participation in the Program since 2007.

The Seventh Framework Programme¹⁵⁾ ***for Research and Technological Development (FP7) 2007 to 2013*** is a huge program with 521 million Euros, aiming the implementation of projects for a period of seven years. The primary objective of the

¹⁴⁾ EC (2010): Entrepreneurship and Innovation Programme (EIP), Working Programme 2010, Brussels.

¹⁵⁾ EC, 2006 Official Journal of the European Union, DECISION No 1982/2006/EC OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL of 18 December 2006.

Seventh Framework Programme for Research and Technological Development is to contribute to the strategic goals of the Lisbon strategy and help Europe to become the most competitive and dynamic knowledge-based economy. The Lisbon Strategy of the European Union has recognized the role of the research, in achieving greater competitiveness aiming more dynamic knowledge-based economy, capable of sustainable economic development in order to increase the employment and greater social cohesion. All Balkan countries are qualified to this programme. The program mainly addresses cooperation between universities, industries, research centers and public institutions, operating in several sectors including the tourism sector as well. Macedonia has signed a Memorandum of Understanding and is included in the program since 2007.

The above programs are programs that offer opportunities for development of rural tourism in Macedonia. Below we will analyze the main obstacles that do not allow the community programs to be used in an optimal way.

3. EFFECTIVENESS AND EFFICIENCY IN THE USE OF IPA AND OTHER EU FUNDS FOR RURAL TOURISM IN MACEDONIA

The EU funds, whether IPA or the other community funds, have strict procedures that must be met in order certain projects are successfully selected. Almost all European funds require financial participation known as co-financing, whether fifty-fifty or any other ratio.

The competition for EU funds is very high, and they can optimally be used only if applicants apply a proactive approach. Macedonia has a shortage of professional staff, whether within public institutions, private sector or civil society organizations. Public institutions are characterized by political interferences and politicization. On the other hand, the private sector has symptoms of family employment, without a merit-based philosophy. This condition certainly affects the use of European programs for rural tourism. The following will analyze absorptions efficiencies of the IPA and the community programs.

3.1. Absorption of IPA CBC for rural tourism development

Given all previous calls on the IPA CBC, the rural tourism was included in all these calls. However, generally this component is very little used. For 2007 and 2008, around 9.5 million Euros were planned, while only 4 million Euros were contracted out (by the time this paper is written). This is based on the contracted projects with Albania around 500,000 euros, additional 3.5 million euro with Bulgaria and Greece. According to these calculations, the absorption rate is around 42 % of available funds is on cross-border component. The low absorption level is due to several reasons.

The second call for proposals on CBC with Albania (2010) failed, due to insufficient capacities of relevant public institutions (Ministry of Local Government) to undertake all necessary steps in evaluating projects according to the timetable of the European Commission (eg, IPA funds for 2008 can be contracted until 2010). It is worth mentioning that the 12 awarded projects for cross-border program with Albania are entirely or to some extent linked to the rural tourism: such as raising awareness about the national park Jablanica, cross-border forum for civil society organizations, integrated alternative tourism, and so on. Similar situation is found with Bulgaria, where the majority of the applications are in favor of the development of rural tourism.

3.2 Absorption of IPARD for rural tourism development

Additionally, the IPARD funds offer very good opportunities for the development of rural tourism in Macedonia. According to the last measure (302) of this program, diversification of rural economic activities provides, inter alia, investment in establishing workshops for traditional craft activities, investments for reconstruction of farms intended the rural tourism development, complemented by recreational facilities, investments building, catering facilities, accommodation outdoors (camping), facilities for recreation, etc.. As seen, the intentions of the rural development program, which envisages the development of rural tourism is very large, starting from the above measures and sub-measures, which describe the activities to be supported by IPARD program. The IPARD funding opportunities are based on co-financing between Macedonia and EU. The current ration stands for 25% co-financing from Macedonia, and 75% from the EU, for each respective financial year¹⁶⁾.

Approximately 18% of the budget of IPARD program, (which is over 60 mil. Euros by the time this paper is written), is left for the measure diversification and development of rural economic activities. It should be noted that the funding is provided by the principle of co-financing, accounted to 50% grant of total project value (except for some special cases where this limit can be greater, such as for young farmers under 40 years, the grant is up to 55%). Within the measure 302, the smallest value for financing is EUR 5000 and the largest value of eligible costs for co-financing is EUR 200,000. In majority of cases the users provide agricultural holdings whose holders are individuals or legal entities, cooperatives or other entities that are registered in the register of agricultural holdings, in accordance with the Law on Agriculture and Rural Development, artisans registered pursuant to perform craft, micro enterprises, owners / concessionaires, forest owners and sole proprietors. IPARD program is implemented by the Ministry of Agriculture, Forestry and Water Economy

¹⁶⁾ Програма за користење на средствата од инструментот за претпристапна помош за рурален развој од ЕУ (ИПАРД) за периодот 2007 – 2013 година (СВ на РМ брј 83, од 03.07.2009 година) стр. 22.

of Republic of Macedonia, through its Payment Agency. The first public call for submission of application was announced on December 23, 2009¹⁷⁾. The total amount of funds to implement the first public call was 24,320,000 Euros. The first public call enabled 27 agreements on co-financing amounting to only 2.1 million euros. Unfortunately, only one out of 27 projects, falls in measure 302, which amounts 26.500 euros.

On September 30, 2010 the second call was announced¹⁸⁾, and the projected indicative budget for this call was EUR 40,028,365.00. On February 28, 2011 was published the third call¹⁹⁾. The available amount of the third call was 20,720,000.00 Euros. Preliminary analysis of the third call²⁰⁾ (though when the paper is prepared this call was under the evaluation), shows a higher number of rural projects compared to the first and the second call (in total 23 projects were expected to be contracted belonging to the measure 302).

3.3. Absorption of Community funds for rural tourism development

The community programs require a specific agreement for each of its programs, in order enabling certain countries to apply. If a country is not enough successful when applying, this means expenses are higher than benefits. Recently, Progress announced few calls for proposals. Calls are advertised in the official website of the Ministry of Labour and Social Policy of Macedonia, which is responsible for assisting in the utilization of this program. Currently, there aren't available data on absorption of the Progress programme. Additional calls of community programmes were on Entrepreneurship and Innovation Programme CIP. Recent calls of this programme aimed promoting international clustering activities in the EU, and the budget for the recent call (2011) was around 4 million Euros. Individual projects amounted to 400,000 euros. Our analysis show that unfortunately none of the applications from Macedonia belong to the rural tourism.

The program Europe for Citizens, granted the municipality Novaci in 2010, with a project for developing a strategy for rural tourism in three municipalities of different

17) Јавен повик бр. 01/2009 за доставување на барања за користење на средства од ИПАРД програмата 2007 – 2013, Агенцијата за финансиска поддршка во земјоделството и руралниот развој, Влада на РМ – Скопје.

18) Јавен повик бр. 01/2010 за доставување на барања за користење на средства од ИПАРД програмата 2007 – 2013, Агенцијата за финансиска поддршка во земјоделството и руралниот развој, Влада на РМ – Скопје.

19) Јавен повик бр. 01/2011 за доставување на барања за користење на средства од ИПАРД програмата 2007 – 2013, Агенцијата за финансиска поддршка во земјоделството и руралниот развој, Влада на РМ – Скопје.

20) Извори од ИПАРД Платежната агенција, Влада на РМ.

countries (Municipality Kufaliya from Greece, Pustec from Albania and Novaci from Macedonia). This is a good example to show of how a small community, like Novaci, submitted an application and was successfully selected. Another project called “Development through twining”, granted the municipality of Negotino with a project in wine tourism. Although funds from these projects are very large (the current practices from Macedonia showed these funds to be around 50,000 euros per project).

CONCLUSIONS

The European funds through IPA or other community funds offer good opportunities for developing the rural tourism in Macedonia. Unfortunately, these funds are not satisfactory used and the reasons for the low absorption level are manifold. One of the reasons is the lack of coordination across national and local institutions and with those of the European delegation, particularly in raising awareness of citizens and organizations for the opportunity the community programs are offering.

Competition for EU community resources is very high compared to the other instruments because these funds are open to a broader range of the countries (members, candidate countries, etc). Absorption of the community funds for rural tourism currently is very limited, with the hope this situation positively to change in the near future.

Rural tourism is an unexplored field and its further development expects to boost in the coming years. A critical role lies in EU support, whether applying good practices and successful stories from different countries, or mobilizing EU financial resources to implement concrete project initiatives aiming rural tourism development in Macedonia.

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- 4) IPA Cross – Border Programme, 2007 – 2013, Greece – Republic of Macedonia, p. 7

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CONDITIONS AND PERSPECTIVE OF ORGANIC PRODUCTION IN THE REPUBLIC OF MACEDONIA

Abstract

Main hypothesis in this paper is that organic agriculture is a great potential for Republic of Macedonia because the attendance of traditional agriculture. The attention is on the actual condition of the organic agriculture and there is analyze the perspectives for future organic agriculture development.

Key words: organic agriculture, Republic of Macedonia, market of organic products, farmers association.

JEL Classification : Q56

Introduction

The agriculture crisis, depopulation of rural areas, demographic draining of certain regions brought an initiative of alternative unconventional production of food. The raised standard of living, revival of village life inducted the younger generation of farmers to accept the organic agriculture. Organic agriculture is known in the world as the one taking care of environmental protection and preservation of biological balance, a coordinated relationship between production of crops and cattle raising, sustainable systems of land cultivation, usage of organic materials, limited usage of synthetic products, higher standard and better employment, as well as production of food with special quality.

Organic agriculture is of particular interest to developing countries because it is in consonance with long-term sustainable development strategies. Furthermore, the

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spectacular growth in demand for organic agriculture that took place in recent years has opened up export possibilities for developing countries.

The main purpose of this article is to establish the state of organic agriculture in Republic of Macedonia and to give some perspective trends for further development. The organic production in Republic of Macedonia has a great potential because the attendance of traditional agriculture mostly in mountainous regions. Products of these regions are known between Macedonians consumers as “ecological products” because of the familiar method of production.

1. CONCEPT OF ORGANIC PRODUCTION

Organic agriculture is best known as a farming method where no synthetic fertilizers and pesticides are used. However, this description does not mention the essence of this form of agriculture, which is the holistic management of the farming system. According to the definition of the Codex Alimentarius, “organic agriculture is a holistic production management system which promotes and enhances agro-ecosystem health, including biodiversity, biological cycles and soil biological activity. It emphasizes the use of management practices in preference to the use of off-farm inputs, taking into account that regional conditions require locally adapted systems. This is accomplished by using, where possible, agronomic, biological and mechanical methods, as opposed to using synthetic materials, to fulfill any specific function within the system.”¹⁾

Best way to understand organic production is to make effort to reject all former perception for agriculture, because:

- main purpose of organic production is not high profit, but quality of the product
- main point to start organic production is not the financial effect, but production of health food
- production of any crop must be in complete harmony with environment
- the soil cultivation must be when is advantageous, not when it's become
- the point of irrigate is to make optimal condition for development of micro-organisms who lives in the soil
- in organic agriculture are acceptable crop loss made of vermin
- in organic production leading registrar must be regular for all process on the farm

¹⁾ European Action Plan for Organic Food and Farming, Commission Staff Working Document, 2004, p. 3.

- for achievement of optimal outcome it's necessary cooperation with specialist.

According to FIBL (Research Institute of Organic Agriculture - Switzerland, Germany and Austria) contribution of organic production can group as:

1. **Ecological** – in organic agriculture is excluded or strictly limited the use of synthetic fertilizers and synthetic pesticides, plant growth regulators, live-stock feed additives, and genetically modified organisms (GMO). In this way improve biological diversity, soil fertility and energy save.
2. **Social** – organic agriculture offer save and healthy food for families, and on the other hand organic agriculture is traditional, it preserve local knowledge. In this way families participate in business with organic production, and it's make conditions for rural development and agro-tourism.
3. **Economical** - organic agriculture characterize with low cost inputs and because is traditional, has need of employment.

Actually, this group is inseparable and they are conditional and recompense side by side. Because organic agriculture constantly research, this group can increase.

2. THE ROLE OF ORGANIC PRODUCTION IN AGRICULTURE POLICY OF REPUBLIC OF MACEDONIA

Republic of Macedonia is predominantly mountainous country with numbers of basins. There are heterogeneous natural conditions and land structure in the Republic of Macedonia. It is situated between 40⁰51' and 42⁰22' northern geographic latitude and eastern geographic longitude of 20⁰27' and 23⁰02'. As to these geographic parameters, the Republic of Macedonia is situated in the southern part of the moderate zone and is bordered by the subtropical zone where almost all the crops can be successfully produced according to their requirements.

The Republic of Macedonia is mainly under the influence of 3 (three) climate types: continental, mountain and the Mediterranean climate. The climate indicators, especially the drought, the early autumn and late spring ice, are also limitation factors in regards to the intensiveness and the range of crops.

Out of the total area of the Republic of Macedonia, the agricultural area takes up 12.225 km² or 47.64%. Out of the total agricultural area, 35.84% are arable area (tab. 2). There have been great changes, mostly decreasing, of the arable area in the last ten years in the Republic of Macedonia. Thus, the size of arable land in the period 2000-2006 decreased from nearly 500 thousand ha, to 439 thousand ha in 2006 (tab. 2), while the meadows and pastures have increased from 692 up to 747 thousand ha. Nearly half of the arable land is under cereal crops, where wheat is the dominant crop with nearly 108 thousand ha. Vine-growing is present on about 25 thousand ha, or-

chards on about 15 thousand ha, vegetable production of 50 thousand ha and tobacco on about 24 thousand ha. ²⁾

The agriculture has been very significant for the national economy of the Republic of Macedonia. Besides the many policies and economic problems, that were previously stated, this sector has indicated an important flexibility, and for this period it has contributed significantly to the social and economic stability. The agriculture has a share of about 12% in the GDP, two thirds of which are covered by crop production and the remainder by livestock production. The total share of the agri-food sector, coupled with the food industry, accounts for approximately 16% of the GDP.

The share of the labour force in agriculture, in relation to the total labour force is noteworthy, representing about 20%. This significant share of the labour force in agriculture indicates the agricultural character of the Republic of Macedonia. It should be noted that in many rural areas there is a hidden labour force, such as the agricultural overpopulation, which largely worsens the situation in the sector. On the other side, in some rural areas there is a lack of labour force, especially qualified one, while a large part of the agricultural areas and the other production resources and potentials remain unused i.e. abandoned. The closing down of many industrial facilities contributed to the high number of labour force in agriculture since a large part of the workers returned to agriculture in order for them to provide for existence. ³⁾

Biological diversity in agriculture is especial important for persistence of people, primarily because of gratification of basic needs for food. With civilization development has create new type with better quality. But, in time, many of types and breed were destroy as genetic resource. Types, sorts and races who are domestic for Macedonia should be save above all for economic, science, cultural, socio-economic and ecological arouse. Republic of Macedonia characterize with traditional agriculture especial in mountain areas. Organic agriculture is close to traditional agriculture, so it has a potential for development. Main distinguishes between organic and traditional agriculture is the certification of organic products. There is two certifications body in Republic of Macedonia, "Balcan biosert" and "Procert".

Number of certificated producers of organic food in Republic of Macedonia notes continual intensive increase (Table 1). In total cultivated land, organic production is 0.1%, and 0.01% in organic wild collections area.

²⁾ <http://www.stat.gov.mk/>

³⁾ Dimitrievski D., Kotevska A., "Challenges faced by the agro-food sector in the Republic of Macedonia regarding its integration in the EU markets", http://www.daes.si/Konf07/MACEDONIA_Dimitrievski_Kotevska.pdf, 5.07.2010

Table 1

NUMBER OF CERTIFICATED ORGANIC PRODUCERS AND NUMBER OF CERTIFICATED AREA ⁴⁾

Year	Total certified production areas	Number of farmers	Areas under pastures and wild plants and fruits	Number of bee hives	Firms for processing and trade
2005	266	50	1.300	110	0
2006	509,42	102	1.593	505	2
2007	714,47	150	11.162	1.832	3
2008	1.029	226	50.000	11.709	8
2009	1.373,83	327	204.956	15.455	8

In 2006, 105 clients are apply for certification, 102 were certificated for primary production – farmers and 2 were companies for processing of organic food. and 1 were certificated for trade of organic food. In 2008 number of farmers is increase for 100%, respectively in 2006. Number of companies for processing and trade of organic food substantially is increase, from 3 to 8. Interest for organic production partly is increase because the increase of subvention from the government. (Table 2)

Table 2

STATE SUPPORT FOR ORGANIC AGRICULTURE IN REPUBLIC OF MACEDONIA ⁵⁾

Year	Amount/MKD denars
2005	6.000.000,00
2006	/
2007	11.000.000,00
2008	36.500.000,00
2009	50.100.000,00

Leading crop in organic production in Republic of Macedonia are the cereal with 166,35 ha certificated area, second are forage crop with 82.05 ha and orchards with 73,55 ha are third. (Table 3). In animal breeding organic production predominantly are goats – 248, and 21844 sheep are certificated as organic in conversion.

In Republic of Macedonia purchase is practice by 3 certificated points for organic products. Mostly, they purchase wild collection crops and they are organized by the companies for processing and trade of organic food.

The market of organic products in Republic of Macedonia is on low level, offer by quantity and assortment doesn't enable some significant export, and on the other

⁴⁾ MZSV, 2009, <http://www.mzsv.gov.mk/Tabela%20organsko.pdf>

⁵⁾ ibid

Table 3**ORGANIC PRODUCTION IN 2009 ⁴⁾**

Crop/animal	Organic in conversion /ha/number	Organic production /ha/number	Total /ha/number
Cereal	501,52	166,35	667,87
Forage	101,04	82,05	183,09
Industrial	12,31	31,32	43,63
Orchards	137,48	73,55	211,03
Vineyard	46,25	13,92	60,17
Gardening	84,22	58,64	142,86
Beef breeding	180	197	377
Sheep	21844	208	22052
Goats	791	248	1039
Pigs	5	0	5

side low domestic demand is limiting organic production. Deficiency of domestic organic processing products additional is limiting organic market development. Also, the logo of organic products from Republic of Macedonia is unknown for significant number of Macedonian consumers (45,9% didn't know at all, and 35,9% were not shore about the look of the logo). For Macedonian consumers organic food represents healthy and expensive food, they are ready to pay 10-30% more, and they trust more to foreign products than domestic.⁷⁾

3. PERSPECTIVE TRENDS FOR FURTHER DEVELOPMENT OF ORGANIC PRODUCTION IN REPUBLIC OF MACEDONIA

Main characteristic of Macedonian agriculture is traditional extensive agriculture, witch is main precondition for development of organic production. Traditional agriculture is proceed in mountain areas with utilize of old family methods. Also, traditional and organic agriculture can contribute for agro ecotourism development. State support for organic agriculture is high, except subventions main role has legislation which establish the rules for organic production in Republic of Macedonia.

Main problem for organic farmers is impossibility to produce enough quantity for export or processing of the products. Purchase of organic products is practice by 3 certificated points and they are organized by the companies for processing and trade of organic food. Mainly, purchase is high on wild collection crops or fresh organic products. For processing of organic products there's low interest because of the low

⁶⁾ Ibid

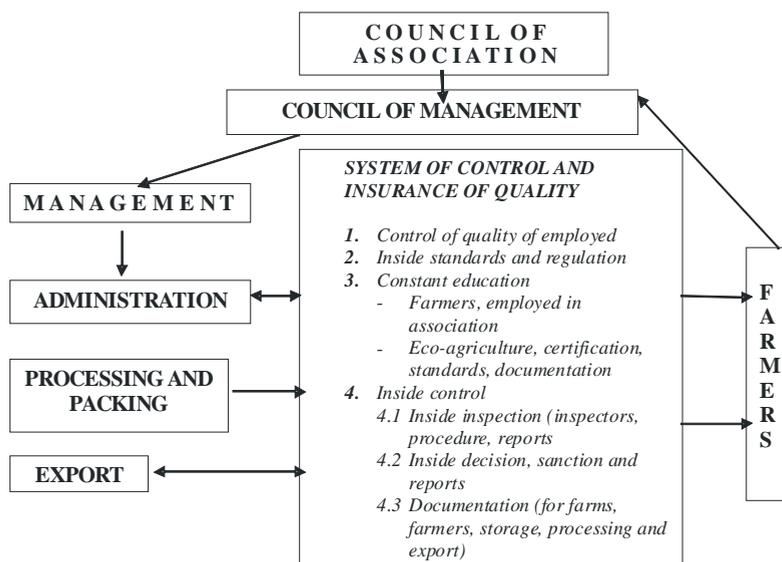
⁷⁾ Research of Blagica Sekovska, "Organic market development in the Republic of Macedonia with emphasis of domestic demand", Economic development, year 11, num. 1-2, 2009

quantity. Food processing companies don't have interest for processing organic food because certificate is expensive, there's a need of additional processing cost, and on the other side, quantity is low. Farmers are force to sell theirs organic products as conventional, in other words low price. Thus, it cannot get true number of quantity of organic production. So, great deficiency is nonattendance of register for export and import of organic products. Because of that, it cannot to provide some serious researches for possibilities of organic products market in Republic of Macedonia.

Also, problem is expensive certification for small farmers as farmers of organic production. There for it is necessary existing of association with Inside system of control of quality⁸ who will enable permanent support through initiation and implementation of organic production and reduction of certification cost. Image1 present an example of association of farmers with inside system of control of quality and system of control of small farms.

Image 3

QUALITY CONTROL MANUAL ORGANIC PRODUCTION IN SMALLHOLDERS FARMERS



Source: Frantz Augstburger; "Quality Control Manual Organic production in Smallholders Farmers" taken from the project "Развој кластера органске пољопривредне производње", <http://docs.google.com/viewer?a=v&q=cache:Qdg9xbK7a5cJ:80.71.144.22/download.php%3FID%3D12403+razvoj+klastera+organske+poljoprivredne+proizvodnje&hl=en&pid=bl&srcid=ADGEESieHv23Y62Evn3VkcqrpvEiohj1hkrsZq7PdDKDMLLS1ymZMRnJZnd6WVfjyriDHD ux5BlAaLki3fP 4Gj 1mk8dfBKb 1pshh6gMTsx7lv1ICGJn7Tj9WEfKfYWnYJ01mDyvO&sig=AHIEtbRMUvvXkrmXOMdG8z4E1ZmmkivuHA>

Market of organic products in Republic of Macedonia is on an early stage. For Macedonian consumers main deficiency of domestic organic products is indistinguishable and distrust of the logo. Ministry of agriculture should perform campaign for promotion of the logo, were it will be known under what condition this logo is published and used. The logo should be found on the packing of the organic products, market stall, but most of all should be used freely in medium for public informing as TV, radio, newspapers who because of their own purpose need to publish news, interviews and reportages of this domain.

For movement toward we need a correct research plan, establishing organic research programs, organic research centers, farms and greenhouses are also necessary. In those research centers are required several sections for research on different aspect of agriculture such as plant production, irrigation science, soil and nutrition science, plant protection, agricultural economics, food processing and other relative sciences. However, training of specialists in organic sector is the key point. In Republic of Macedonia there is not any course on organic agriculture and farming at the universities. Such universities and collages should work on establishing organic courses and researches focusing on organic issues for MSc and PhD students' thesis. In addition, governments, organic association, organic research centers and universities must arrange on-farm workshops and internship or apprenticeship programs to improve expert's experience and knowledge.

CONCLUSION

Organic agriculture is regarded as one important to agriculture and food production that is environmentally sustainable and can generate several positive impacts to rural society in Republic of Macedonia. Defining the main feature of organic agriculture and its importance is the starting point for conceptual establishment of organic agriculture.

The consumption of the organic food in Republic of Macedonia is, in spite of its permanent growth, still on a very low level. The reason is both on the side of supply and demand of organic food. Organic food products are new products on the Macedonia's market, so they are still not well-known to the costumers. The important role in informing potential customers quicker and easier plays the promotion of organic food at agricultural fairs, symposia and trough the activities of organic food production association. To produce enough quantity for export or processing of the products, farmers should be organized in associations that will establish advisory services and technical supports to help them and solve problems.

In this respect, it's necessary to evolve further research that would objectify the differences and support and information by the scientific studies.

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