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FACULTY OF ECONOMICS

MASTER'S THESIS

**THE IMPORTANCE OF FDI IN THE MACEDONIAN ECONOMY**

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## TABLE OF CONTENTS

<b>INTRODUCTION .....</b>	<b>1</b>
<b>1 DEFINION OF FDI.....</b>	<b>3</b>
1.1 Methodological contents of FDI .....	4
<b>2 THEORIES OF INTERNATIONAL PRODUCTION .....</b>	<b>5</b>
2.1 The theory of product lifecycle.....	5
2.2 The theory of internalization.....	6
2.3 The eclectic (OLI) paradigm.....	7
2.4 The investment development path .....	7
2.5 The Scandinavian School.....	9
<b>3 TYPES OF FDI.....</b>	<b>9</b>
3.1 The control rate of foreign ownership .....	9
3.2 FDI Motives .....	10
3.3 Methods of entry .....	12
3.3.1 Greenfield investments.....	12
3.3.2 Mergers and acquisitions.....	12
3.3.3 Joint ventures.....	13
3.3.4 Brownfield investments.....	13
<b>4 FDI EFFECTS IN THE HOST COUNTRY ECONOMY.....</b>	<b>14</b>
4.1 Host country employment, wages and human capital enhancement .....	14
4.2 Productivity, technology, and spillovers.....	16
4.3 Development and reorganization of the domestic companies .....	18
4.4 FDI and host country competition on the local market .....	19
4.5 FDI and trade integration (global economy).....	20
4.6 FDI and difficulties of implementation economic policies in the host country.....	21
4.7 FDI and the balance of payments, exchange rates and interest rates.....	22
<b>5 FDI POLICIES .....</b>	<b>24</b>

5.1 The Macedonian environment .....	29
<b>6 FDI IN MACEDONIA .....</b>	<b>38</b>
6.1 The Macedonian economy.....	45
6.2 The impact of FDI on the Macedonian economy .....	53
6.2.1 Model .....	54
6.2.2 Data .....	55
6.2.3 Methodology .....	55
6.2.4 Results.....	56
6.2.5 Conclusion from the analysis.....	60
<b>CONCLUSIONS AND RECOMMENDATIONS.....</b>	<b>61</b>
<b>REFERENCES .....</b>	<b>65</b>

## LIST OF FIGURES

Figure 1. FDI Inflows to Republic of Macedonia, 1994–2012 .....	39
Figure 2. FDI in Macedonia as a % of GDP .....	39
Figure 3. Inward FDI Flow in R. Macedonia by Country of Origin 1997-2011.....	44
Figure 4. Average Monthly Gross Salary.....	45
Figure 5. GDP (Real Growth Rates) .....	47
Figure 6. Movement of GDP and GDP per capita .....	48
Figure 7. Industrial Production Growth Rate .....	48
Figure 8. Real GDP Growth and Inflation in R. Macedonia, 1995–2012.....	49
Figure 9. Unemployment Rate from 1997-2012 .....	50
Figure 10. Current Account Balance in R. Macedonia (percentage of GDP).....	50
Figure 11. Trade Balance .....	51
Figure 12. Most Important Export Countries in R. Macedonia for 2011 and 2012 .....	52
Figure 13. Most Important Import Countries in R. Macedonia for 2011 and 2012 .....	52
Figure 14. Graphical Presentation of Logarithm of Levels.....	56
Figure 15. Graphical Representation of Log Difference (Growth Rate).....	57
Figure 16. OLS Results .....	58
Figure 17. Model Diagnostics .....	58
Figure 18. Jarque-Bera Normality Test.....	59
Figure 19. Autocorrelation of Residuals .....	59

## LIST OF TABLES

Table 1. Corporate Income Tax in European Countries .....	31
Table 2. Distribution of FDI by Activity .....	40
Table 3. Major Foreign Investors .....	43
Table 4. Structure of FDI, M&A vs. Greenfield .....	44
Table 5. Commodity Exchange by Economic Groups of Countries .....	53





## INTRODUCTION

Foreign direct investments (FDI) are a vital part of an open economy and a major facilitator for development. They can assist nations around the world to access to international markets, technology; can act as a source of economic growth and modernization, income growth and employment.

The perception towards inward FDI has changed coming noticeable from the fact that most nations around the world have liberalized their policies for the purpose draw more investments from foreign multinational companies. This is all done with the expectation that the foreign direct investors will facilitate to raise employment, exports, knowledge spill over to the host country. Bearing in mind these expectations, governments around the world have worked on lowering entry barriers, as well as on opening up new sectors for foreign direct investments.

The link between the FDI and the effects they have on a host economy creates debates throughout the years. In the literature, authors presented different views regarding the effects FDI pose on the economic growth of a host country, but there seems to be some kind of a consensus. One group of authors, such as Abor and Harvey (2008), Gohosh and Wange (2009), Hetes et al. (2009) and so on, emphasizes that FDI accelerates economic growth in the host country while another group of authors believes the opposite. In this context, FDI accelerates economic growth through creating new jobs (Nanak, 2000, 78), increases productivity and competition (Blomstrom and Kokko (1998), Rojec et al. (2012), industrial specialization, transfer of sophisticated technology (Damijan et al (2003), faster access to global markets and so on. On the other side of the coin, the negative effects are seen through cutting jobs because of the sophisticated technology multinationals use (OECD (2002), reduced support of the domestic companies (Vissak and Roolhat (2005), worsening the balance of payments Mencinger (2003) and so on.

Various countries have worked on promoting different forms of investment incentives (OECD, 2003) that will facilitate in the process of encouraging multinational corporations who seek to invest, to do so in their countries. Such incentives include fiscal and various financial incentives.

Most developing countries consider opening up their borders to FDI as a mean to support their development. In this thesis, R. Macedonia is to be examined; a transition country that has its own special characteristics. As a transition country, R. Macedonia was motivated to open up to import foreign private capital in form of foreign direct investments for several reasons,

including the possibility to accumulate additional capital as the balance between the investments and the savings was disturbed as a result of the economic depression.

The country was unable to accumulate enough capital through borrowing abroad, due to the continuous deficit in the balance of payments. In addition to this, the foreign direct investments would be an assurance that the import of the foreign capital will be efficiently distributed throughout the national economy as the foreign partner itself is interested in effective and efficient allocation of the capital (Kikerkova, 1998). The country believed that FDI can help to establish and grow new economic activities that previously did not exist, which in turn will encourage economic growth and development as well as generation of capital. In addition to this, the country anticipated the benefits that FDI can bring in a country in a form of new technologies, know-how, managerial skills and knowledge, development of new industries that previously did not exist and so on. The main problem that is to be analyzed is the impact FDI have on the Macedonian economy.

Generation of positive impacts of foreign direct investments is especially important for a small economy such as R. Macedonia. The environment in which the FDI occur is of high importance for the outcomes they generate. Therefore, it is essential to create an environment that will allow the country to fully utilize the benefits of FDI.

The broad research field of the master thesis is the foreign direct investments. Within this broad field of research, foreign direct investments will be explained in their meaning, their types, effects they have on the host country and policies for attracting foreign direct investments.

The theoretical overview will focus on the theory of international production, types of foreign direct investments; general host country effects of the foreign direct investments, policies for attracting FDI and a reference to the effects in the case of Macedonia.

Main research questions will:

- Provide background on what foreign direct investments are, their types, the effects they have on the host country, host country policies towards FDI;
- Qualitatively present the impacts of the foreign direct investments;
- Give a descriptive analysis of the movements of the foreign direct investments in R. Macedonia;
- Develop an empirical model on factors that influence GDP growth.

## **1 DEFINION OF FDI**

Defining foreign direct investment (FDI) is a challenging task. There are several definitions that define the concept of FDI. The OECD's fourth edition of the Detailed Benchmark Definition of Foreign Direct Investments from 2008 and the fifth edition of IMF's Balance of Payments Manual from 2008 offer generally accepted definitions of foreign direct investments. They define the FDI as an investment which involves lasting relationship and represents a long-term interest and control by a resident entity in one economy, which can be a foreign direct investor or a parent enterprise, in an enterprise resident in an economy other than that of the foreign direct investor (FDI enterprise or affiliate enterprise or foreign affiliate).

In accordance with the fifth edition of the IMF's Balance of Payments Manual, the foreign direct investments are defined as investments with which the investor has an intention to establish a lasting economic relationship and or to establish controlling interest in the enterprise in which it is investing.

Until the end of 1993 countries used different criteria to define the direct investments and data comparability among countries was difficult to be done. To ensure international data comparability the IMF's definition of what a foreign investor is widely accepted.

OECD (2008, 49) describes a foreign direct investor could be:

- An individual
- A group of related individuals
- An incorporated or unincorporated enterprise
- Public or private enterprise
- Group of related enterprises
- A government body
- An estate, trust or other societal organization
- Any combination of the above

According to the OECD (2008, 49) the direct investment enterprise is a resident in another economy and has to own 10% or more of the ordinary shares or voting power or equivalent. These 10% ownership of the voting power defines the existence of the direct relationship between the direct investor and the direct investment enterprise.

Macedonia accepts the IMF definition and guidance on the foreign direct investments. The country classifies its international investment position according to four types of investments (National Bank 2010, 6):

- Direct investments
  - In terms of the direction - inward and outward investments;
  - In terms of the instruments – equity capital and reinvested earnings; other capital.
- Portfolio investments
  - Equity securities;
  - Debt securities.
- Other investments
  - Trade credits;
  - Loans;
  - Currencies and deposits;
  - Other assets and liabilities.
- Reserves classified according to the types of instruments

FDI promotes steady and long-term economic relations among countries through allowing direct investors in home economies to production units of the host economies. If there is a proper policy framework in the host economy FDI are to assist host countries to develop their local companies, to contribute to transfer of technology and know-how, to promote international trade, develop the labor and financial markets and so on.

## **1.1 Methodological contents of FDI**

FDI as an item of the financial account of the balance of payments and is broken down on investments in: equity, reinvested earnings and other capital (long term loans from the parent company). The FDI composition can therefore be expressed follows (WTO, 1996):

Direct investment = Equity Capital + Reinvested Earnings + Other Capital

- Equity capital includes the direct investor's shares of an enterprise in a foreign country. This category includes mergers and acquisitions as well as greenfield investments;

- Reinvested earnings are the direct investor's share of affiliate earnings that are not allocated as dividends or forwarded to the direct investor;
- Other capital includes short-term borrowing and lending transactions between the direct investors and the companies in which they have ownership participation such as affiliates and associates. These loan relationships are captured in the intercompany receivables and payables.

A distinction is made between FDI outflows and FDI inflows into countries. The balance between the FDI outflows and FDI inflows in a country equals the country's net FDI position. According to the IMF, FDI is recorded as an entry on the financial account in the balance of payments. The inflow of FDI is connected with the replenishment of domestic savings taking the form of non-debt financing of the balance of payment's current account deficit. In the case when the national investments go above the national savings, the current account deficit that is created can be financed from foreign savings or by fall of foreign exchange reserves (Domesova, 2011, 52). Furthermore, the national foreign savings can come as an inflow of debt or non-debt foreign capital. Foreign savings in form of debt foreign capital are credits that come from foreign company – FDI and debt securities as inflow in the form of portfolio investments. Financing the current account deficit in this way creates foreign indebtedness of the country, which leads to a conclusion that when thinking long term the only viable source of financing of the current account deficit is financing it by using FDI inflows (Domesova 2011, 52).

## **2 THEORIES OF INTERNATIONAL PRODUCTION**

### **2.1 The theory of product lifecycle**

Vernon's production life cycle theory from 1966 was the first theory that dealt with FDI. Vernon theorized that each product passed through successive stages of production and trade and therefore there is a close relationship between the life cycle of the product, the characteristics of countries and the international expansion of companies (more in Vernon 1996, 190-297). Vernon's unit of analysis is the company, and particularly the location of its production (Dunning and Lundan 2008, 85). Vernon believes four stages compose the production cycle: innovation followed by growth, maturity and last is the decline stage (Denisia, 55). In the first stage manufacturers are in advantage that derives from the possession of new technologies used to develop new pioneering products meant for local use (Denisia, 55). At a later stage, due to favorable combination of innovation and production

advantages manufacturers start to export their surpluses and therefore start serving foreign markets. Products were exported mainly to countries with similar demand patterns and supply capabilities (Dunning and Lundan, 2008, 85). Gradually the product becomes standardized or mature, and there will be companies that will be able to imitate the product (European companies started to copy the U.S. products that were exported to their countries). Now, the consumer demand becomes price elastic, so pressure to minimize the costs appear, therefore the attraction of value added activities in foreign rather than domestic locations increase. When the product is fully standardized, cost advantages and production costs are of high importance and so production migrates to countries with lower labor costs (mainly in developing countries). Vernon argues that if the conditions in the host country are favorable, the subsidiary company might replace exports from the parent company or even export back to it (Dunning and Lundan, 2008, 86).

The model attempted to demonstrate the market seeking production. The theory does not talk about the institutional and organizational business problems. Vernon offered a partial theory in terms that it only addressed some of the issues of multinationals activity. Nonetheless, it was the first theory to translate the determinants of and the relationship between the international trade and foreign production and sets the stage for further research into the FDI field (Dunning and Lundan, 2008, 86).

## **2.2 The theory of internalization**

The internalization theory was set in the mid-1970 by a group of Swedish, Canadian, British and US economists who worked independently from one another (Dunning and Lundan, 2008, 94). The theory evolves from the concept of market failure. In 1976, Buckley and Casson built a model which is focused on the link between knowledge, market imperfections and the internalization of markets for intermediate goods. Internalization will happen only as long as the benefits are not outweighed by the costs of communication, co-ordination, control and the unfamiliarity associated with vertical and horizontal integrated firms. Internalization means spreading the direct operations of an organization and assuming control over the ownership and the control of the undertakings performed by intermediate markets. The overall idea is creating own internal market where transactions can be performed at a lower cost within a company. Therefore, companies seek to grow their own internal markets every time transactions can be made cheaper inside the company. At first the internalization theory focused only on the interpretation of the existence of multinational companies, but it was later expanded to include an analysis of alternative models of entering in foreign markets, analysis of the role of joint ventures, the role of culture in international business. However, the basis of

the theory stays the same over time so it retains its validity today (Buckley and Casson 2009, 1564).

### **2.3 The eclectic (OLI) paradigm**

Dunning's eclectic ownership-location-internalization (OLI) theory of multinational activity has been the most significant and prevailing description for international production in the 1970s and 1980s. The OLI framework (Dunning 1981, 1988) states FDI is a result of companies having ownership-specific advantages (O) they want to utilize in foreign locations (L); advantages companies are not able to profitably utilize except through internalization (I). The paradigm holds the following must hold true for FDI to happen: a company has to have company-specific advantages to be able to go abroad; the selected location abroad has to be superior to the domestic location, and internalization is the best approach for exploiting company-specific advantages (Svetlicic, 2004, 2). Ownership advantages have to be strong enough and are necessary, however are not a sufficient condition to invest abroad. Foreign location and internalization has to complement such firm specific advantages (Svetlicic 2003, 4).

Ownership specific advantages (O) are unique to firms of a particular company. They can be tangible resources, such as manpower, capital and natural endowments, as well as intangible resources such as technology and information, managerial skills, incentive structure, entrepreneurial skills and so on. Location specific advantages (L) are available to be used for all companies. These include legal, cultural, political, financial and institutional environment where they are organized. Location advantages are crucial to determining where the investment will take place. Internalisation (I) refer to advantages when the company believes that its ownership advantages are best utilized within the organization as opposed to being offered to other companies using contractual agreements such as licensing or establishing joint ventures.

### **2.4 The investment development path**

The Investment Development Path (IDP) theory was initially developed by Dunning in 1981 and was later refined but its basic philosophy remained the same. In accordance with this theory, the foreign direct investment goes through and develops through a path that represents the correlation between an economy's level of development (GDP or GDP per capita), and the country's net outward investment position. The IDP advises that countries undergo five main phases of development (Dunning, 2002, 138; Dunning and Narula 1998, 2-12). Each of these

phases can be categorized in relation to countries' propensity to the outward and/or inward direct investors.

The first stage of the IDP comprises the least developed countries which are net FDI receivers. At this stage the location-specific (L) advantages of a country are insufficient to attract inward FDI, except for its natural resources on which the inward FDI are likely to be based. The insufficient location advantages refer to a narrow domestic market (characterized with low income per capita), low level of education of the available workforce, political and/or economic instability, inappropriate economic system or government policies and inappropriate infrastructure. In such circumstances the multinationals are more willing to enter in such countries through trade or founding non-equity relations with companies in those markets. In the second stage, the net outward investment decreases because of an increased FDI inflow while the outward investment continues to be low or insignificant. As the country develops, so does the locational advantages that lead to an increase in FDI. At this stage the FDI are mainly focused on the primary commodity industries, natural resources as well as in industries in need of low qualified workforce. The opening of the domestic markets to foreign investors translates into possibilities to improve the existing infrastructure, possibilities for integration of the local companies into the multinationals' chains of production, transfer of know-how to the domestic companies, know-how that local companies can later take advantage to increase their O-specific advantages and possibly engage in outward FDI. The IDP model holds that at the lowest levels of development (the first two stages) the inward FDI is directed towards attaining natural resources or benefiting from low wages and there is very little or no outward FDI (Sauvant, 2008, 57). The third stage of the IDP embraces the emerging countries demonstrating growing net outward investment position. This stage is characterized with acceleration of industrialization, rise in the income per capita, domestic companies developing their own advantages, increased competition, increase in the created assets through investing in the working population; governments' focus in removing market failures as well as encouraging integration between domestic and foreign companies and through providing incentives aimed to stimulate investments in areas where local companies have no competitive advantages. In the fourth stage there is a positive net outward investment position seen through an increase in the outward investments over the inward investments. In addition, local companies compete in the domestic market with the foreign companies and expand their activities abroad searching for new markets and cheap workforce in countries at a lower level of development. The location advantages are in the countries' created assets such as competent labor, sophisticated markets and technological capacity. This stage is also characterized with more capital intensive processes accompanied with lower cost of capital compared to the cost of labor. In addition, there are little inward investments from countries of lower stages of development. The fifth stage is comprised with the most advanced countries such as Japan,



UK or USA whose net investment position oscillates round zero showing high levels of inward and outward FDI. The FDI at this stage depends much less on the individualities of the home and host countries, but more on the localization tactics of the multinationals.

## **2.5 The Scandinavian School**

The Scandinavian school was developed in the 1970s from an empirical observation of the internationalization process of individual, mostly Swedish companies (Bento, 2009, 25). The Uppsala model referred to the internationalization of any business entity as a process of learning and mastering supported with incremental commitments leading to a good evolutionary growth inside an international industry. The model's basic assumption is that the absence of understanding about the foreign markets represents a significant hindrance to starting international operations. Starting from this assumption the model deals with knowledge acquisition and learning. Johanson and Vahlne (2009) studied the Swedish companies to conclude the lack of market specific knowledge led them to grow their international operations little by little, carrying out gradual commitment decisions starting from locations in physically nearby countries in order to decrease market uncertainties. The main goal of the Uppsala model was to explain how the organizations learn and gain knowledge through international operations. The model predicted that resource commitment to foreign markets increases over time as a result of organizational learning and experience accumulation (Dunning and Lundan, 2008, 91) and the diversification of investments into more distant foreign markets is carried out progressively. The initial approach explained early stages of internationalization, but ignored competitive factors such as international competition which changes over time.

## **3 TYPES OF FDI**

The FDI types can be differentiated in accordance with three aspects of FDI are: degree of control, FDI motives and method of entry. FDI types are explained in detail below.

### **3.1 The control rate of foreign ownership**

The first criterion to divide foreign direct investments is the control rate of foreign ownership. This criterion establishes the autonomy of decision making of a company that has foreign investment. According to the above stated definition of FDI, as FDI is considered the investment where the share of foreign ownership exceeds 10% of the capital in a domestic company. This position however, does not mean the foreign investor has control over that

company (UNCTAD, 2009a). From here we can distinguish two types of businesses. We can differentiate between companies with minority share and companies with majority foreign control. Companies with minority foreign share own from 10-50% of the capital. The foreign investor in this case shares the control of the company with the domestic owner/owners. Companies under foreign control, as the name suggests, are completely under control of the foreign investor who holds the controlling ownership.

### **3.2 FDI Motives**

Another criterion for breakdown of the FDI is the motive of entry. Dunning and Lundan (2008, 67) summarized the motives for FDI as:

- Access to new markets -Market seeking FDI;
- Improving operational efficiency - Efficiency seeking FDI;
- Access to resources - Resource seeking FDI;
- Strategic advantage – Strategic asset seeking FDI.

Market seeking FDI are mainly interested in increasing their market share in the host country (also known as horizontal FDI) as they involve replicating of production facilities in the host country. These foreign investors are interested in reducing the costs associated with the supply in forms of tariffs or transportation costs. Companies follow their suppliers or customers and adapt their products to fit local customer tastes, local customer preferences and requirements. Multinationals decide for this type of foreign direct investments in markets where they previously served their customers by exports (Dunning and Narula, 2008, 69) and therefore these kinds of investments substitute imports in the host country.

The essence of efficiency seeking FDI is looking for such factors that will enable the foreign investors to optimize their manufacturing costs. These investments are mainly carried out in manufacturing facilities where there is cheap and qualified labor and suitable natural sources (also known as vertical FDI) and involves migrating parts of a production chain to a host country (Demirhan and Masca, 2008). These companies directly invest for the purpose to export.

The intention of resource seeking FDI is access to specific natural resources that cannot be obtained in their own countries or to acquire a higher quality of natural resources at a lower real cost than the cost at home. In addition to natural resources, these foreign direct investors seek to obtain information technology capacity, management or marketing and organizational skills.

Strategic asset seeking multinationals seek to obtain control of specific assets whether tangible or intangible that is not available at home. Multinationals that search for strategic assets usually do so to support their long-term corporate strategy. Such a long term strategy can be for example increasing global competitiveness. Strategic asset seeking multinationals do not seek to utilize an existing O- advantage, but seek to attain and complement new technological base and build new ownership advantages that will support the multinationals' long-term strategy.

For the foreign company to be sufficiently interested to locate its production capacities abroad, according to Dunning (1993) the company should have three necessary advantages. These three advantages are as follows:

- Ownership advantage;
- Localization advantage;
- Internalization advantage.

The ownership advantage - advantage of ownership of specific assets i.e. assets based on the cumulative knowledge of the company. Firm specific assets include patents, trademarks, trade secrets, management, human capital, distribution and marketing network and reputation. The specific tangible and intangible assets are important factors in determining whether a multinational should move abroad. The more O- specific advantages a company enjoys, the larger the likelihood that the company will internalize them and opt for a foreign production given the incentives the company has. For a company to be able to produce in a foreign market it must possess O- advantages which will be appropriate enough to cover the costs of servicing a distant and unfamiliar market (Dunning, 1980). In addition, the benefits associated with locating capacities abroad should be sufficient enough to cover the costs associated the location of its capacities abroad.

Localization advantage – the company must combine some of its firm specific advantages in connection with foreign factors to be able to yield the benefits of its advantages. Having this in mind, the location specific advantages are determining when it comes to making a decision where to locate. Potential foreign investors are interested in localization advantages such as economic situation – infrastructure, costs, scope and size of market and so on; political advantages, intercompany trade and international production; socio-cultural factors- language and cultural diversities, approach towards foreigners and so on. All of these are taken into consideration when foreign companies decide where to allocate their capacities (Dunning, 2005).

Internalization advantage – arises when there is a market failure which is a cause for uncertainty about a price and quality of a transaction between a company and foreign partners. The ownership advantages appear as a result of issues concerning putting together reliable and manageable contracts with possible foreign partners from which the company is to earn income. A company trusts that its ownership advantages are best if used within the organization rather than offered to other companies using contractual agreements such as licensing or joint ventures. In Dunning's paradigm, the ownership advantages are endogenous, coming from within the company. A company will certainly much more likely to want to participate in foreign production itself, taking advantage of their own expertise the greater the net benefit of internalizing cross-border markets is.

The first and the third advantages are endogenous and therefore dependent on the company. The localization factor is the deciding factor, whether the company will decide for foreign direct investments or it will stay in the domestic market. The localization advantages are dependent on the host country's economy. The company will decide for FDI if the proceeds of the transfer of the capacities to the host country exceed the cost of the move (Dunning, 1988).

### **3.3 Methods of entry**

#### **3.3.1 Greenfield investments**

UNCTAD (2009b) defines the greenfield investments as investments that entail creating new subsidiaries in a host economy. This type of investment translates to investments in establishing new entities and creating new offices, buildings and factories. When compared to the mergers and acquisitions the economic impact from the greenfield investments may be different, for example when it comes to job creations. Less competitive markets and developing or transition economies are more attractive for greenfield investments (UNCTAD, 2009b). In a host country a greenfield investment contributes to capital formation; creates new employment opportunities and increases the productive capacity.

#### **3.3.2 Mergers and acquisitions**

As per UNCTAD (2000a), M&A involves assuring control or merging of capital, assets and liabilities of existing companies. M&A represents at the largest portion of FDI in the developed countries. Companies decide for mergers and acquisitions to gain access to the most competitive and efficient markets fast (UNCTAD, 2000a). Besides these two factors the IMF states that the interest for M&A comes with opportunities to recover costs generated by certain

departments (such as R&D), convergence of consumer needs and preferences, availability of new capital, new opportunities that come with privatization of state-owned enterprises. The UNCTAD (2000a) states the most common strategic motivations for mergers and acquisitions as being increased access to raw materials, innovations, technology; growth by opening up to new markets; benefits from intangible assets such as brand, reputation, management; risk diversification and so on. The economic gains generated by mergers and acquisitions are achieved by business expansion and allow slipovers of know how or technical skills. On a longer term, the difference between greenfields and M&As with regards to the impact have on an economy is very small (UNCTAD, 2000a). The difference between greenfield investments and M&A is the implementation where in the case of M&A, the investment represents an expansion of the internal organization of firms and transfer of existing assets (Wang, 2009, 240). On the other side, in the case of greenfield investment, the establishment involves newly formed capital assets being controlled by the foreign investing company. A greenfield investment involves monetary exchanges from a multinational's headquarters to its subsidiary (and back). When it comes to M&A a distinction is drawn between cross border mergers, a case when resources and operations from various locations are put together to create a new legal organization, and cross border acquisitions, a case when the control of all resources and processes is taken from the local company and put into the hands of a foreign company (World Bank, 2004, 5).

### **3.3.3 Joint ventures**

UNCTAD web site defines joint ventures as a share-holding in a business entity which was established by a contractual agreement by two or more parties that have jointly put together resources for the functioning of the business of an entity they have created. This is a single business transaction where individuals or companies have created a contractual business undertaking to share their strengths, increase their competitive advantages in the marketplace and minimize risks. All the parties have mutual control over one or more activities as the parties have specified in their arrangement and at the same time none of the participants is to control the created venture by itself.

### **3.3.4 Brownfield investments**

Brownfields represent a special form of acquisition. Meyer et al. (2001, 577) propose the following definition to explain this type of investment: a brownfield investment is a type of investment which involves acquiring of an established business with the purpose of entry in the local market and replacement of the existing resources and capabilities of the purchased company with the investor's own resources and capabilities. The newly created subsidiary

goes through reorganization of the acquired entity, disposing or unbundling assets and creation of new management. This type of investment combines the resources of the acquired business and the investor's resources in a way that the investor dominates after the acquisition period. This investment allows quick entrance and instant access to host country's resources. Investors are motivated to invest in the brownfield if high transaction costs impede the more traditional ways of entry. Estrin and Meyer (2011, 485) state in the case of brownfield investments the acquiring company use only a fraction of the resources owned by the acquired company, a situation common in transition economies when mass privatization started. Estrin et al. (2009, 1183) argue, in transition economies, the mass privatization process is responsible for underpricing of assets which makes the brownfield investments cheaper and therefore more attractive than any other entry mode. Estrin and Meyer (2011, 487) further state, brownfields are attractive to investors who seek specific complementary resources that cannot be separated from the acquired company (such as possession of rare resources, but weak managerial or technological competences).

## **4 FDI EFFECTS IN THE HOST COUNTRY ECONOMY**

FDI attracts lots of attention in all countries. Every host country works on promotion and attracting foreign direct investments because of their expected impact on the host economy. The theory on the effects of FDI is not unified. Numerous studies on country level as well as cross country studies have delivered diverse conclusions concerning the impacts of FDI on host countries and therefore the effects they pose cannot be generalized. The effects FDI have on host countries are not straightforward; it is a function of many factors including macroeconomic environment, political stability, host country's FDI policy and the type of the investment.

### **4.1 Host country employment, wages and human capital enhancement**

Foreign investors may impact the employment in host countries by affecting the levels and standards of employment and by affecting the conditions of employment. The greatest employment impact on host countries is felt where the level of inward FDI is high in relation to the size of the economy. In a host country, FDI can have direct and indirect effects. The direct effects largely depend on the type of FDI in which the multinational company is engaged. When investor is engaged in FDI through greenfield investment, new jobs are almost immediately created. In the case of FDI through acquisitions jobs previously created are kept; (the employees of the troubled company would have been left without their jobs have the acquisition had not happened) leaving a trace of positive employment effects. The indirect effects arise when a foreign investor starts purchasing intermediate goods from local suppliers,

and thus causing an increase in demand of goods in other sectors of the host economy where in time new employment will be needed to be able to serve the needs of the foreign investor. Such effects are small in cases where foreign investors rely only on importing intermediate goods. The extend of the employment effects in a host country may vary from positive to negative and are dependent on the policies in the host country, the local innovating and production capacity and the type of FDI (Dunning and Narula, 2008, 437). Nanak (2000, 78) argues that the indirect impact on employment in a host country are of a large and maybe even larger than the direct employment opportunities. On the negative side, OECD (2002) argues that the use of the advanced technologies introduced by the foreign companies can lead to a need of a fewer workers therefore leading to an increase in unemployment. Connected with the employment effects FDI pose, is the issue of wages. The question is whether wages paid by foreign direct investors are above or below the wages paid by local companies in a host economy. The evidence advocates that on the whole, foreign investors do pay higher wages than domestic companies. Lipsey (2002) analyzed numerous studies that compared wages paid by foreign investors and domestic companies concluding that it is difficult to come across a study in which the wages of the foreign investors are lower than those of the domestic companies. Hill (1990) and Manning (1998) conducted studies of wages in Indonesia and agreed with Lipsey's findings that the foreign owned companies paid better wages for their employees than domestically owned ones. The same holds for Lipsey and Sjöholm (2001) that discovered the same i.e. foreign owned companies pay better wages for their employees than the domestically owned companies. In their case the former paid about 50 % higher wages. Grima, Greenway and Wakelin (2001) studied UK companies on wage differences and came out to conclude that there is 14 % higher wages in foreign companies then in domestic ones. The wages paid in foreign companies were studied by Rojec and Svetlicic (1998a); when studying Tobacna Ljubljana the company policy was set wages roughly 10 % more than the Slovenian average. The authors in the case of the company Bitem (1998b) which produces thermostats found out that wages paid are somewhat greater as opposed to other companies in the municipality. Grabbe (2001) states FDI can generally improve the skills and wages in a host country in a sense that foreign companies provide more trainings and better employment opportunities, arguing foreign investors' presence can motivate domestic companies to further develop the working conditions and the wages they pay for their workforce. When evaluating the effects of inward FDI the type and range of products supplied by the investing company, the motive for their investment as well as the country and industry specific characteristics have to be taken into account (Dunning and Narula, 2008, 438). The authors argue foreign investors pay wage premiums because the kind of skills the foreign investors demand are more advanced than those needed by domestic companies which further suggests that in order to attract suitable and qualified local workforce, foreign investors need to pay more attractive wages to be able to recruit the workforce they require. Foreign investors offer formal and

informal training programs and is often focused on the specific needs of the foreign investor. As opposed to domestic companies, foreign investors are able to draw upon and utilize a wide range of training systems relevant to the human capital enhancement, having the experience of operating in different cultural and institutional environments (Dunning and Narula, 2008, 445). Hetes et al. (2009), Abor and Harvery (2008) Ghosh and Wang (2009) indicate of the positive effect of FDI on human capital enhancement happening through formal and informal education, movement of the working capital from the foreign companies to the local companies leading to an increase in productivity of the domestic companies and improved managerial skills and methods. The acquired knowledge within the foreign companies is afterwards often used by employees to create their own companies in which the acquired knowledge will be transferred, argues Lim (2001). In some cases, host country governments are willing subsidize the costs of training foreign investors require. Knowledge (whether technical or managerial) gained at a foreign direct investor can be spilled over to the domestic economy, when the foreign investor provides technical assistance and training to their local suppliers for intermediate goods as well as in cases when former foreign investor's employees start working for a domestic company where they transfer the know-how gained while being employed at a foreign investor (Hanson, 2001). Meyer (1998) supports the notion that FDI lead to transfer of knowledge and managerial skills to local companies having in mind that foreign investors possess greater managerial expertise than the domestic companies. The knowledge spillovers increase the knowledge of domestic companies, but are hard to measure because there is no paper trail that can be used to track and measure them (Rojec and Knell, 2011). Management skills are less firm specific and therefore can be spilled over with higher ease than the firm specific skills and later be used in other company in a different context (Blomstrom and Kokko, 2001). Because FDI are a source of know-how in production, highly skilled workers and know-how in management, through formal and informal trainings, FDI can raise the productive capacity of a host country (Zhang, 2001, 690). Spillovers do not automatically happen; in order for the host economy to benefit from what the foreign investors have to offer - unique technologies, skills and expertise, the host economy must have absorptive capacity.

## **4.2 Productivity, technology, and spillovers**

Theory advises that in a host country FDI can produce positive spillovers. Since foreign investors are known to be a vital source of advanced technology, their entry can result with a transfer of the superior technical knowledge in the host economy which in turn can be a reason for other companies within the industry to increase their performance and competitiveness. The spillovers happen with interactions between the foreign and domestic companies in cases when they become either suppliers or customers to one another, or made possible through



moving of experienced workers previously employed in foreign companies to local companies (Aldaba, 2012, 1). However, a country's absorptive capacity plays a crucial role for the spillover to take place and for the country to benefit from it; the higher the absorptive capacity, the higher the benefit from the spillovers. The technological spillovers to the domestic companies can be either horizontal (occurring within an industry) or vertical (occurring inter industry). Vertical spillovers refer to spillovers that occur as a result of a direct business contract with the foreign investor on one side and companies from other industries on the other side. The spillovers may take place through backward (when foreign investors obtain their inputs from domestic companies) or forward trade linkages (formed through contacts) amongst foreign and local companies. The literature regarding the productivity externalities as a result of foreign investors' presence is not unified. While some authors argue positively for the presence of spillover effects, others claim the opposite. The different results can be explained by the inequalities among countries' capacity to gain from the presence of FDI which is largely depended on the level of their capacity to absorb them. Hence, companies with higher capacity to absorb are more likely to experience positive spillovers. It is hard to take advantage of spillovers when foreign investors operate in places where their products or technologies have nothing similar with the products and technologies of the domestic companies (Kokko, 1994). The author further writes that if the opposite holds true, and foreign investors are in competition with the domestic companies, spillovers are likely to happen. Examining the Mexican manufacturing industry Kokko (1994) concluded there is connection amongst the spillovers and the host country's ability to captivate them; in order for domestic companies to have a higher benefit from technological spillovers, the technology gap between them and the foreign companies has to be moderate (Bevan and Estrin, 2000). Analyzing the manufacturing sector in Uruguay Kokko, Tansini and Zejan (1996) concluded that when the technological capability at a company level is weak there is an obstacle for spillovers to happen. The same findings had Damijan et al. (2003), where the authors claim the technology spillovers will be positive as long as the host country's social capabilities and companies' absorptive capacities are high. The gains of the spillovers from FDI do not automatically happen; they depend on the local companies' effort to devote to educating themselves and taking actions to absorb the knowledge spilled from the foreign investors (Kathuria, 2008). Smarzynska (2002) tested the possibility of FDI spillovers through vertical and horizontal channels in Lithuania and delivered confirmation of positive spillovers through backward linkages only in cases where modest technological gap among domestic and foreign companies existed. Fortanier (2007) argue through vertical linkages among foreign companies and the local suppliers they use, the FDI's new technologies are spilled in a host country's domestic environment. The proceeds of Damijan et al. (2003a) research showed the direct effects of FDI were more significant in half of the transition countries they examined and discovered that the effect of the vertical spillovers is greater than the effect of the

horizontal spillovers. Blomstrom and Kokko (1998) investigated spillovers in the industries that supply the foreign companies and concluded these linkages occur partly because the foreign companies are willing to develop the quality of the intermediate goods they purchase locally. Damijan et al. (2003) examined eight countries in transition to discover the significance of the means of technology transfer in Eastern Europe and their effect on the productivity and growth. The authors concluded FDI was the most important drive for technology transfers in most transition economies and there is none or perhaps negative intra-industry spillovers moving from the foreign investors to the domestic companies. The technology transfer and the knowledge transfer of the foreign companies lead to improving the productivity of the domestic companies which leads to increase of the GDP which is why FDI is seen by many authors such as Hermes and Lensink (2003) and Saggi (2002) as a mean that induces economic growth. After becoming part of WTO, EU and signing bilateral and multilateral FTAs i.e. after becoming internationally more open, some SEE countries showed increased performance of their local companies and witnessed an increase of FDI and export. Putting their focus on six SEE countries and analyzing data for the period between 1994 and 2002, Damijan et al. (2009) were examining the perceived link between the openness of a country and the performance of domestic companies. The authors saw different effects in different countries. Namely, authors concluded that countries whose exports were focused on the more developed countries had incurred greater learning effects than the others. In addition to this, the results showed that those who benefit the most are the companies possessing higher absorptive capacities. Rojec et al. (2012) tested the impacts acquisitions had on performance in the period of 1997 to 2009, concluding that productivity of the acquired companies was improved after they were acquired. Rojec and Knell (2011) state that FDI can also produce negative externalities for example in cases when foreign investors owning superior technology make domestic companies to leave the market as they take away the demand from them. Using firm level data for over 4000 Venezuelan companies, authors Aitken and Harrison (1999, 616) reported evidence of negative spillover effects to domestic companies that is, productivity in domestic companies declined as foreign investment increased. Mateev (2009) states there is no spillover effect of the technologies of the foreign investor to the domestic companies because the foreign investor wants to keep its comparative advantage over the domestic companies. Vissak and Roolaht (2005) argue the host countries can become more and more reliant on technologies presented by foreign investors causing domestic companies to decline their interest about their own production and use of new technologies.

### **4.3 Development and reorganization of the domestic companies**

FDI can encourage companies' development in host countries. The direct impacts can be seen through efforts to increase efficiency and reduction of costs, synergies between the targeted

company and the acquiring foreign investor (OECD, 2012, 17). Efficiency gains are evident in industries with economies of scale where the sublimation of a separate company with a larger corporate unit induces efficiency gains. In addition, mergers and acquisitions lead to changes in corporate structures, management and governance. Foreign direct investments are of high importance for creating improved economic surrounding (Moura and Forte, 2010, 10). Foreign investors change the economic structure in the host economy; by possessing superior capabilities than local companies, they can manage to enter in sectors known to have high barriers to entry, resulting in reducing or eliminating current monopolies therefore modifying the structure of the economy (Blomstom and Kokko, 1998, 253). Generally, in cases of takeovers or privatization, foreign investors carry over their own company policies, working practices and a number of management positions to the acquired company (OECD, 2002, 18). Local companies' structure also changes because they copy the structures used by the foreign investors as they are considered more efficient (Hansen and Rand, 2006, 27). In cases of privatization of government owned companies; the participation of foreign investors has improved the efficiency of the acquired companies.

#### **4.4 FDI and host country competition on the local market**

The appearance of foreign companies may lead to economic development by promoting competition in the host country, which in time will lead to increased efficiency, decreased prices and effective resource allocation (Pessoa, 2005). A positive result of FDI in an economy is the investment of the domestic companies in new equipment, investments in knowhow of their employees and continuous work on improving their current technologies and methods of work so they will be able to cope with the competition which may not be the case having no foreign investors to compete with (Varamini and Vu, 2007). Increased competition results in an increase in R&D spending within the domestic companies which later use the improvements they have achieved to seize higher market share and become suppliers of the foreign companies (Blomström and Kokko, 1998). In this sense Kornecki (2010) adds that FDI increases innovation which in turn leads to an increase in competition. On the other side of the coin, FDI can increase the levels of concentration in the domestic markets leading to disrupting the competition; a scenario possible where the host country is a distinct geographic market characterized with high barriers to entry where the entrant holds a substantial international market position or simply where the legal framework regulating competition is not very strong or is poorly applied (OECD, 2002, 15). As per OECD (2002, 15) this effect is more evident in the less developed countries and leads to a concern that the foreign company's entry can be anti-competitive. Although economically speaking foreign competition replaces host country's companies that are less productive, there must be policies to maintain a healthy degree of competition. Ram and Zhang (2002, 207) argue that the introduction of competition

results with closing of some of the domestic companies that cannot compete with the foreign investors. This leads to increased concentration in the sector and with the shutting down of the domestic companies leads to a decrease in competition. In addition to this, Vissak and Roolhat (2005) and Zilinske (2010) argue FDI lead to distortion, sale, reduced competitiveness and support of domestic companies. Their logic behind this argument is that with all the efforts and money governments spend to attract more FDI, they are left with fewer funds available to support the domestic companies which in reality are in a higher need for financing than are the foreign companies. The position of the domestic companies is worsening because the banks prefer to lend to the subsidiaries of the foreign investors rather than the domestic companies because of the lower risk associated with them. Because of the better conditions and better career possibilities foreign companies are able to offer compared to the local companies, foreign companies are better able attract the more skilled labor workforce and can pull such workers from domestic companies or can impede local companies to hire them (Sylwester, 2005).

#### **4.5 FDI and trade integration (global economy)**

Globalization has been largely driven by economic forces characterized by the rise associated with international corporations leading the process of global transactions. To find superior competitiveness, multinationals have gone to extend their operations globally, positioning themselves in regions characterized with low wages and focused on intensive export from such locations (Mittelman, 2008, 38). In this particular sense, multinationals have heavily invested in decentralized production in developing countries in attempt to maximize profits. Countries' borders no longer represent boundaries for locating production facilities and production processes have become very compound involving encompassing global movements and cross border production processes (Dicken, 2011, 4). This has resulted in an increase of FDI on the relation developed - developing countries and is accompanied with transfer of technology. Bearing in mind the opportunities and benefits associated with technology and capital transfers, developing countries have gone through series of economic reforms that would increase their attractiveness to foreign investors. Such reforms include working on improving the macroeconomic indicators, deregulation, measures referring to export and took actions of privatization. In the new economic environment companies are more flexible in how they may produce and deliver their goods and services to foreign destinations making the world economy more integrated through international trade. Foreign companies are far more knowledgeable about internationalization than domestic companies because they already have gone through the process. By copying and attaining their knowledge, local companies can achieve integration in the global market (Blomström and Kokko, 1998). Having competitive advantages, wide areas of expertise and developed

networks, multinationals' operations are an important source for learning for domestic companies (Zang, 2001, 690). When local companies become suppliers or subcontractors to multinationals, domestic companies benefit from using the multinationals' established international channels and host countries' exports increase as local companies start to export (Zhang, 2001, 681). Moran (1999, 3) goes a step further explaining that the experience of supplying multinationals can be a starting point for local companies to start exporting their own products under their own brand to independent customers. If domestic companies are included in the multinationals' strategy, they can follow the foreign companies in their operation in other markets and replace multinational's suppliers in those markets too (OECD, 2002, 10). Barry (2000) points out to the positive effect on the economic growth resulting from the opening of the host country to the global economy and as a result of the use of the knowledge, brand and the connections of the multinational company. In addition, local companies can use the trade associations in which multinationals are members (as an important source for knowledge sharing) to learn about different markets from experience sharing (OECD, 2002, 11). The type of FDI plays an important role in integration in the global market. When the investment is in production facilities, imports of intermediate goods will increase followed with an increase in exports of final produces (Zhang, 2001b, 179). The impact FDI have on the import rather can have a damaging effect on host country the balance of payments (Mencinger, 2003 and Vissak & Roolhalt, 2005) because the foreign investors consume high amounts of intermediate goods and raw materials usually not available in the host economy in the quantity or quality needed. The above also holds true if the main objective of the investment is not exporting but rather supplying the local market (Ram and Zhang, 2002, 212). Furthermore, as host countries become a lot more open economies they become more sensitive to global shifts and thus increasing the chances of host countries to feel global negative impacts in their economies (Vissak and Roolah, 2005). If government's aim was to improve the balance of payments by initial financial flows from foreign investors, Hansen and Rand (2006) and Ozturk (2007) argue that in long run the profit repatriated may exceed the initial positive impact of the investment.

#### **4.6 FDI and difficulties of implementation economic policies in the host country**

Foreign direct investors can have a high influence in the host country economic policy. This is true especially in small host countries where some foreign direct investors have a very high impact on the macroeconomic indicators. The foreign direct investors can intervene in the domestic economic policy in a sense that they can lobby for lower import barriers for some products that are of high importance for their production processes (Vissak and Roolah, 2005). Foreign companies are able to do this because the host country economy is very much

dependent on their operations. Furthermore, FDI can lead to a decline in the autonomy of the local government in a sense that multinationals can be able to control the employment and some assets which gives them the power to interfere on political and economic decisions in a host country (Moura and Forte, 2010, 10). In addition, foreign investors can pressure host country's authorities on policies which they see beneficiary for their operations. However, authorities should carefully analyze any proposed policy and be aware that any policy should not be of benefit of the foreign investors only, but rather for the overall economy (Moura and Forte, 2010, 10).

#### **4.7 FDI and the balance of payments, exchange rates and interest rates**

A country's balance of payments represents a summary of outlays to and earnings from other states. The current account keeps track of a country's export and import of goods and services, investment income from foreign investments and payments to be made to foreigners investing in a country. A distinction is made between current account deficit (when imports overweigh exports) and current account surplus (when exports overweigh imports). The capital account keeps track of transactions which involve purchasing or selling of assets. FDI affect the capital account as they are reported there, but they also affect the current account through the volume of export and import in a county. FDI have a few effects on the balance of payments. First, when a foreign subsidiary is established in a host country, the immediate impact of the foreign investment is an increase in the capital account by the amount of the investment. Second, in the case where FDI act as substitute for goods or services a host country previously imported, FDI may improve the current account. The establishment of new facilities will result in a rise in trade balance because the outputs of the new establishment will now decrease host countries' imports of the same good. However, this increase in the trade balance will be offset by increased import of intermediate goods and services that the foreign investors use and as such accessible in the host country. If the new establishment is to export its outputs, additional increases in the current account will be noticed. Furthermore, dividend repatriation to the home country will lead to a decrease in the current account. If the investor's goal is to increase the wealth of its shareholders at home, the present value of the future dividends to be repatriated can be higher than the value of the initial investment. In order for the impact of FDI to be positive, the FDI needs to decrease its imports. The impact FDI have on the capital account of the country where the investment took place will largely depend how the investment is financed i.e. whether the finances are borrowed in the host country or from the repatriated profit. If the former is the case, the host country's capital account will raise. The host country's capital account will rise if profits are non-repatriated as they are counted as FDI from the home to the host country. On medium-term the impact of FDI may be negative because as the foreign company starts to fully operate they are in need for more intermediate

goods and services and therefore start to import more and at the same time it may start to repatriate profits (WTO, 1996). When there is an inflow of FDI, that inflow is associated with a demand of foreign exchange. In a situation when the demand for foreign exchange exceeds the foreign exchange generated by that FDI, both the benefits and costs of the FDI need to be weighted in order to make a decision whether or not to reject the FDI. The exchange rate regime also plays a crucial role of the impact FDI can have on the balance of payments. If there is imbalance between the supply and demand for foreign exchange under a flexible exchange rate regime this disturbance will be fixed by depreciation of the currency. If there is a net increase in the demand for foreign exchange caused by a foreign investment project, under a fixed exchange rate will cause to reduce a surplus or increase a deficit in the balance of payments. When the supply and demand for foreign exchange varies, governments using fiscal, monetary and exchange rate policies work on sustaining the level of the current account balance. Brada and Tomsik (2009, 7) dealt with dividends paid and reinvested earnings on one side and the deficit on the current account on the other side stating in cases profits are reinvested and when the profit is consumed in the host country, this is to be treated as a current account deficit because the domestic currency is replaced by a foreign currency. The authors point to three factors with which the reinvested earnings influence the size of the deficit on the current account: the volume of FDI and their profitability, the host country specifics as well as the specifics of the foreign partner and the financial life cycle of the FDI. The authors present the paradoxality of this relationship (the reinvested earning and the deficit of the current account) which indicates that the countries which have large FDI inflow and whose high profits are reinvested in the host countries will have higher deficits on the current account despite the fact that the reinvested earnings can be used to purchase local inputs for the foreign investor and there is no need of external financing. The short and long term effects of FDI on the current account balance change and can vary between countries depending on the impacts FDI have on the economic growth and the domestic savings (Mencinger, 2003). A large portion of the financial proceeds received with the sale of capital stock to foreigners are not used towards creation of capital but to stimulate consumption, which is why the relationship between FDI and the current account balance and between FDI and growth is negative (Mencinger, 2003). Mencinger (2008) is positive that if FDI does not add to capital creation and if the spillover effects of FDI are negligent or even negative in the host country, in long run FDI will deteriorate the current account balance. Dunning and Lundan (2008, 471) argue FDI has an indirect effect on the real exchange rate of the host country through changing the balances of the imports and exports as well as profit repatriation. If the impacts of the imports and exports are seen in isolation, the impact of the FDI will be depending on the foreign investor's motivation for investing in the host country as well as on the type of the investment. Typically the export oriented investment is expected to contribute towards a positive trade balance as the host country's exports will increase. However, the effects of

exports cannot be seen and calculated in isolation as they need to be seen as a net increase generated after deducting the inputs of intermediate goods. By manufacturing goods that were previously imported, the FDI saves foreign exchange and by manufacturing products which are later exported it earns foreign exchange. In the case of profit repatriation, all the foreign exchange build up though the FDI flow may be wiped out and the end result of the profit repatriation will be a demand for foreign exchange (Dunning and Lundan, 2008, 471). Khan, Malik and Hasan (1995, 1001) argue an increased demand of the host country's currency yields different results under different foreign exchange regimes. Namely, flexible exchange rate suggests that the market influence especially the increase in demand of the currency will firm up the host country currency through market forces. This is not the case with fixed exchange rate regime, a case where there will only be an increase in foreign exchange. In addition, under managed exchange regime the outcome of the exchange rate will be mostly dependent on the host country's policy decisions.

## **5 FDI POLICIES**

Dunning and Narula (2003) identify four basic types of FDI policies that countries have adopted. The first policy is a policy of non-intervention where the government encourages both inward and outward investment imposing a few constitutional controls or performance requirements (a practice in the OECD countries). The other policy refers to structural adjustment and upgrading, "where inward and outward FDI are either encouraged or inhibited as an integral part of the micro-organizational strategy of the government" (Dunning and Narula, 2003). The third policy towards is a selective investment policy, a case in which investment is limited to certain sectors and there are also performance standards being imposed to enhance the economic and social benefits of the investment itself. Last is a controlled investment policy, a policy that includes strict controls of inward and outward investment.

FDI policies play a significant part in the economic growth of developing countries and their main goal is to correct market imperfections and develop a positive business environment that makes foreign investors comfortable to conduct their businesses. With the FDI policy and its instruments governments strive to create an economic environment inviting enough new value adding FDI as well as environment that will keep existing FDI (UNIDO, 2009). FDI policies are to be aligned with the host country industrial policy and general development goals (UNIDO, 2005). Government's primary concern is increasing the welfare functions in the national economy for the advantage of its citizens, whereas foreign companies' primary concern is to maximize the long term value of the company for shareholder's benefit (Oman et al. 2002, UNIDO, 2009). For this reason the FDI policy is to be well developed and crucial.



Dunning and Narula (2003) divide the policies towards inward direct investment into four groups:

- Group relating to the conditions of entry
- Group relating to the operating requirements
- Group directed at the conditions of exit of foreign investors
- Group relating to the cost effective way of attracting inward FDI

The first group of policies deals with the conditions of entry or setting up of foreign investors. The authors specify there are several concerns to be minded, one being the degree of foreign ownership of local resources that is allowed i.e. whether a 100 % or majority foreign ownership is allowed or foreign companies are allowed only minority participation. Another concern is the kinds of value added activities in which the foreign investors can participate, referring here to the open sectors to foreign investors as well as the proportion of a sector's output allowed to be supplied by a foreign investor. In regards to the financing inward investment, various countries may require various ways of financing the initial capital investment; countries which do not have enough foreign currency are more likely to insist the initial capital investment to be financed by the foreign investor from the international capital markets. Other concerns may be the location as well as the pre-entry conditions for FDI. In this sense, countries with strong regional policies may insist foreign investors to position themselves in areas that lag with growth or have an unemployment rate above the average. In addition, when it comes to the pre entry conditions for FDI, governments deal with a broad set of investment incentives. FDI incentives are economic incentives that are approved to certain companies or categories of companies with the purpose to encourage their behavior in a certain way. They consist of actions specifically created to increase the rate of return of a certain investment in a form of FDI or to lowering and redistribution of its costs or risks (UNCTAD, 2000a). They are used to attract FDI to a specific host country and most of them do not favor domestic nor foreign investors (UNCTAD, 2003b). UNCTAD (2004b) differentiates between three main categories of investment incentives- financial, fiscal and other incentives. The financial and the fiscal incentives are most often used; in fact developing countries favor to use fiscal incentives and on the other side developed countries usually use financial incentives to attract FDI (UNCTAD, 2004b).

Governments are motivated to provide financial incentives to correct market imperfections and overcome transaction costs; to overcome the perception of the host country seen in disadvantageous position when compared to other sites because of the level of development and to minimize the costs the foreign company encounters when relocating as a possibility to

stop the foreign company from investing in the host country (OECD, 2003b). When financial incentives are provided to correct some market imperfections, they include: infrastructure grants (to suit the needs of the foreign investors to increase the attractiveness of a site) and job training subsidies (when there is a shortfall of qualified labor force). Most common financial incentives provided to increase the advantages of the host country are credits to investors (the governments provides loans or interest subsidies to lower the investors financing costs); real estate (authorities sell land or buildings below market value) and cost participation (contributing towards marketing/operating costs). Finally, most common financial incentives for the purpose of relocation are: administrative assistance (for example investment promotion agencies perform tasks that would have otherwise been done by the investing company); relocation and expatriation support (authorities provide grants to the foreign investors to help them with additional capital spending and relocation costs) and temporary wage subsidies (authorities provide temporary wage coverage for part of the total wages). The financial incentives are the measures that directly lower the costs of FDI. Oman et al (2002) describes the investment incentives such as tax reductions, cash grants and loans, start-up assistance and so on as a way of attracting foreign investors but points out the riskiness of such strategy in a way that governments need to decide how much to subsidize and what instruments to use. Foreign investors did not pay as much attention to the incentives before, but are now more and more interested in them since their importance for making investment decision has risen (Easson 2001, Clark 2000).

The second group of policies refers to the operating requirements. Performance requirements are conditions forced on investors that oblige them to fulfill certain goals with regards to entering or expanding in a host country, or for the receipt of some advantages (UNCTAD, 2004a). Such operating practices include guidelines or requirements that concern local purchases, proportion of output that is exported, recruitment and employment practices, type of value added undertaken and so on (Dunning and Narula, 2004). Such practices used to be very important and reappeared recently, but are mostly forbidden and made illegal by the Trade Related Investment Measures Agreement (TRIMs). WTO and several regional agreements have added to the formation of FDI incentives and have changed the balance between incentives and performance requirements (Kokko, 2003). Export controls have been forbidden; there are also some other requests are under debates which have contributed to develop policy packages that would enhance the welfares of the incoming FDI (Kokko, 2003). UNCTAD (2003a) conducted a study on some developed and developing countries on their involvement with performance requirements. The study concludes that generally in both developed and developing countries the use of performance requirements is declining and this is an outcome of an increased competition to increase the level of FDI and the need to obey

with international commitments. Countries need to weigh the potential benefits against the costs of using performance requirements.

The third group of policies refers to the conditions of exit of foreign investors. While it was a trend among the developing countries during the 1960s and 1970s, nowadays few governments provide divestment requirements at the time of entry of a new foreign investing company (Dunning and Narula, 2004). Developing countries at the time were keen to provide such divestment requirements due to the belief that the foreign investors in their countries were perceived as providers of education for the local companies and strongly believed that once all is done, the foreign investors should gracefully leave.

The last group of policy measures contains the other three, but strives towards creating and implementing the most cost-effective institutions and policies for attracting inward FDI. Governments do limit the participation of foreign-owned companies in one sector and give tax incentives to support foreign investments in another. They provide fiscal incentives; most common being tax holidays, employment premiums, regional grants, rents and so on. All forms of incentives directly influence the revenue costs of foreign companies and of course sometimes the profits they earn. Incentives do have their own impact on the location of the investment itself when the foreign investing company has to make a choice of a number of possible locations; however incentives have less of an impact on location decision where the unique assets and competences of a host country are important for making a location decision (UNCTAD, 2000a). Governments, however need to make sure that the benefits derived from all the incentives they provide to foreign investors outweigh the costs they incur to provide them (UNCTAD 2000a, OECD 2003a). Oman (1999) argues that if the fundamentals of the economy in the potential investment sites do not meet investors' basic requirements, governments will be less productive in attracting FDI. Governments justify the use of investment incentives with the purpose to attract foreign investors to poorer areas in their countries, but in practice this has limited effectiveness. On the part of the labor market standards, OECD (2000) reports there is no evidence that countries with low labor market standards provide better conditions for foreign investors. In addition, investors in export processing zones mainly seek for cheap labor and when conditions in the host economy change are able to relocate themselves with ease. Therefore, attracting FDI for the purpose of the host country's long term development of the host country is not effective as it does not go in line with such strategy. Blomstrom (2001) doubts FDI is more beneficial over any other form of investment and the importance of the host countries' enabling environment being as important to foreign investors as it is to the domestic investors. Blomstrom argues rather than governments' creating narrowly defined FDI policies, they should provide as attractive terms to domestic investors. Blomstrom and Kokko (2003) argue that subsidizing foreign investment

without at the same time encouraging the absorptive capacity of a host country's local companies will most likely not yield the preferred results of the expected spillovers.

Dunning and Naurla (2003) suggest that solely one host country government's efforts to attract foreign direct investors may not be sufficient enough in terms of obtaining the most out of the investors. The authors argue that this unilateral approach is better to be substituted by collaborative actions with other countries because that can strengthen the weak bargaining and negotiating position of a sole national government seen through the governments' inability to extract the desired share of any value added the foreign investors create. In addition, the need for a multinational action exists where because of cross-border market failure; the L advantages of host countries are not satisfactory enough to attract the investments that they opt for, a situation requiring intergovernmental efforts to reduce the disincentives to multinationals activity. Host countries most of the time compete with each other in the arena of attracting foreign companies and are doing it in imperfect market conditions and are adding to the problem. A collaborative effort to reduce the cross border market distortions or setting rules or guidelines of behavior to avoid inefficient inter country rivalry may be a better strategy (Dunning and Narula, 2003). Within the EU, the European Commission has passed restrictions on the amount and the kind of incentives which may be offered by its member states to foreign investors (Ghauri and Oxelheim, 2003). Introduction of internationally acceptable codes of conduct or guidelines of behavior drawn up by governments of individual countries or regional (EU, NAFTA) or international agencies can be another way a multilateral action can help. Acceptance of such conducts or guidelines implies willingness of both the companies and the governments to obey. Regional agreements are only beneficial if its signatories can receive benefits that are not available to those outside of the agreement. Büthe and Milner (2004) conducted an analysis whether annual FDI depends on the number of signed agreements and concluded that investment agreements should escalate the total inward FDI into a country, coming not only from the parties who signed the bilateral investment agreement. Despite this conclusion, the authors did not recommend that developing countries should use bilateral investment agreements to increase the FDI inflow because of the costs they pose in cases of violations of treaty commitments as well as the constraining policy choices. Authors Egger and Merlo (2007) were estimating the long-term effect of investment agreements on FDI and concluded the results from the signed investment agreements have long term impact on FDI rather than immediate. UNCTAD (2009c) states the IIAs have three key provisions: general standards of treatment (referring to fair and equal treatment following prescribed laws); protection of foreign investors (in terms of guarantees of compensation according to global criteria in case of expropriation of foreign property and also a guarantee of free transfer and repatriation of capital and profits) and dispute settlement. UNCTAD (2004a) states there is one special category of international investment agreements and those are

agreements that refer to avoidance of double taxation. Where the quality of the domestic institutions is poor, the bilateral and regional investment agreements can be useful to insure property rights and to resolve disputes (Hallward-Driemeier, 2003). In cases where host countries are associated with high political risk, both bilateral investment treaties as well as regional investment agreements promote foreign investment in a sense that they act as a neutralizer and protect foreign investors through guaranteeing them a certain standard of treatment and mechanisms for international settlement of disputes (UNCTAD, 2009). In 2003, Hallward-Driemeier was interested on the effect of the BITs on FDI and found out that such agreements are more of complements rather than substitutes for strong domestic institutions. In a case where there is political risk in a host country the IIAs act in favor of the host country attractiveness because they work towards reducing the political risk due to the fact that they state clear and enforceable rules that host countries oblige to follow (Salacuse and Sullivan, 2005 and Vandecelde, 2005). Tobin and Rose-Ackerman (2003) investigated the effects of IIAs on total FDI inflows and concluded that the number of investment agreements concluded has a very small effect on increasing the country's capability to draw FDI. Risky countries were able to generate more FDI from signing such investment agreements, whereas such agreements posed a small effect in countries that are relatively safe for investors.

On the way to its transition to market economy, Macedonia has opened itself to foreign investments and started a programme of reforms to ease the doing of business, improve the legal structure and the economic setting for investors.

## **5.1 The Macedonian environment**

The Macedonian Constitution stipulates national treatment i.e. equal rights between foreign and local companies and individuals when conducting economic activities except where it is otherwise provided by the law (KPMG, 2012). With Article 59, the Macedonian Constitution guarantees the right of the foreign investors to free transfer and profit and capital repatriation (UNCTAD, 2012a) only to those which have met their legal obligations. Technically, all companies founded in the country have equal treatment; however, in reality the quality of the treatment depends on who the investor is. In particular, prominent investors do not report many problems with the execution of the laws, whereas minor investors report substantial obstacles to national law implementation and execution (UNCTAD, 2012a, 31). In addition, when it comes to incentives and law enforcement, smaller companies have expressed their concern that foreign investors have a preferential treatment.

As a small country and therefore a small market, foreign trade relations play a crucial role for the development. From its independence the country was working on developing a policy of

external openness and liberalization. The country has signed multiple bilateral, multilateral and regional agreements for free trade that are of high importance. Macedonia has signed three multilateral Free Trade Agreements (Invest in Macedonia):

- Stabilization and Association Agreement (SAA) with EU member states, signed in 2001, entered into force in 2004;
- European Free Trade Association (EFTA) with Switzerland, Norway, Iceland and Liechtenstein, signed in 2000, entered into force in 2002;
- Central European Free Trade Agreement (CEFTA) between Macedonia, Albania, Kosovo, Serbia, Moldova, Montenegro and Bosnia and Herzegovina, signed in 2006, entered into force in 2007.

In addition to these multilateral agreements, Macedonia is a signatory of Bilateral Free Trade Agreements (Invest in Macedonia):

- Bilateral Free Trade Agreement with Turkey;
- Bilateral Free Trade Agreement with Ukraine.

With signing the SAA in 2001 the country moved closer to the EU trade regime and under the SAA terms most of Macedonian goods are free of duties and quotas to access to the EU market. Also, the country works on removing its trade barriers on EU products. In 2005 the country acquired its EU candidate status which improved its attractiveness.

Republic of Macedonia offers a certain levels of protection of investments. The protection can be seen through the signing of 36 Bilateral Investment Treaties for Mutual Protection and Encouragement of Foreign Investments, 29 already in force (UNCTAD, 2012). In addition to this, Macedonia is a partner to the Convention of the Settlement of Investment Disputes between States and Nationals of Other States (KPMG, 2012). Furthermore, the CEFTA, SAA and EFTA agreements contain investment related provisions (UNCTAD, 2012a). The SAA and CEFTA multilateral free trade agreements contain provisions on national treatment of foreign investors, whereas the EFTA multilateral free trade agreement contain provisions for the protection of payments and transfers which relate to investment and provisions on the promotions of investment in services (UNCTAD, 2012a).

The current Macedonia's Company Law is enforceable from 2004. The law defines the following forms of companies (Invest Macedonia c, PWC 2010, UNCTAD, 2012a):

- General partnership;

- Limited partnership;
- Limited Liability Company (DOO or DOOEL);
- Joint Stock Company (AD);
- Limited partnership by stock;
- Sole Proprietors.

The Central Register works as “One Stop Shop” meaning that the investors are served visiting one place for information and procedures obligatory to register its business to Macedonia. The “One Stop Shop” system is to enable investors to register their companies within 4 hours after the submission of the necessary documents. In practice this happens within 1-2 business days (Invest Macedonia, b).

Taxation is an important feature in Macedonia when it comes to attracting FDI. Companies are subject to corporate income tax of 10%; a very advantageous incentive especially since 2009 when an amendment was made stipulating that profit tax is payable only on distributed profits (PWC, 2011). The 10% is among the lowest rates among European countries as shown on the table below:

Table 1: Corporate Income Tax in European Countries

Location	2006	2007	2008	2009	2010	2011	2012	2013
Albania	20.0	20.0	10.0	10.0	10.0	10.0	10.0	10.0
Belarus	24.0	24.0	24.0	24.0	24.0	24.0	18.0	18.0
Bosnia and Herzegovina	10.0	10.0	10.0	10.0	10.0	10.0	10.0	10.0
Bulgaria	15.0	10.0	10.0	10.0	10.0	10.0	10.0	10.0
Croatia	20.0	20.0	20.0	20.0	20.0	20.0	20.0	20.0
Czech Republic	24.0	24.0	21.0	20.0	19.0	19.0	19.0	19.0
Estonia	23.0	22.0	21.0	21.0	21.0	21.0	21.0	21.0
Greece	29.0	25.0	25.0	25.0	24.0	20.0	20.0	26.0
Ireland	12.5	12.5	12.5	12.5	12.5	12.5	12.5	12.5
Macedonia	15.0	12.0	10.0	10.0	10.0	10.0	10.0	10.0
Montenegro	9.0	9.0	9.0	9.0	9.0	9.0	9.0	9.0
Poland	19.0	19.0	19.0	19.0	19.0	19.0	19.0	19.0
Romania	16.0	16.0	16.0	16.0	16.0	16.0	16.0	16.0
Serbia	10.0	10.0	10.0	10.0	10.0	10.0	10.0	15.0
Slovak Republic	19.0	19.0	19.0	19.0	19.0	19.0	19.0	23.0
Slovenia	25.0	23.0	22.0	21.0	20.0	20.0	18.0	17.0

Turkey	20.0	20.0	20.0	20.0	20.0	20.0	20.0	20.0
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Source: KPMG database, *Corporate Tax Rates*, 2006 – 2013.

Macedonia applies a withholding tax of 10%, unless it is otherwise stated in a DTT. The value added tax (VAT) of 18% is applied to transactions regarding the supply of import of goods and services. A preferential tax rate of 5% applies on a broad spectrum of goods and services. Exporters can ask for a return on the VAT they have paid on their input which is to be returned to the within 30 days (UNCTAD, 2012a).

Investors located in the Technological - Industrial Development Zones (TIDZ) can enjoy additional benefits. The Government's purpose of the establishment of such zones is to support the growth of new high technologies. The Law on TIDZ stipulates that the zones are to be employed to accomplish economic activities carried out under special conditions which among the other include also tax and other incentives (Law on Technological Industrial Zones).

As per the Invest in Macedonia on TIDZ and the site of the Directorate for technological industrial development zone, the advantages of operating in a TIDZ in Macedonia include:

- personal tax exemption for the first 10 years from the day of starting activities in TIDZ i.e. as of the month the first salary is paid to its employees (10% afterwards);
- Corporate income tax exemption for the first 10 years from the day of starting activities in TIDZ (10% afterwards);
- No VAT and customs duties for export production;
- Grant of up to €500,000 for construction costs;
- Land lease for up to 99 years at attractive concessionary rates;
- Free connection to utilities;
- Green Customs Channel expediting exports to the EU.

No doubt that the country provides a generous and competitive fiscal regime. However, the government should probably revise it as with such regime the government may not be able to generate enough public revenues as to make sure the public administration functions properly. UNCTAD (2012a, 44) made a comparison between UK, Bulgaria, France, Croatia, Slovenia Poland and Macedonia and reported Macedonia generates the lowest fiscal revenue to GDP deriving from direct taxes as well as the lowest fiscal revenue to GDP from both direct taxes and taxes on goods and services. This confirms that the tax incentives are very generous and it



might be of benefit to think about the effectiveness of such regime as well as to look into the tax regime to make sure the Government generates sufficient public revenues.

The labor market in Macedonia is not open employment-wise. The employment of foreign workers is very limiting and does not permit attracting and transmissions of new or non-existing skills (UNCTAD, 2012a, 50). For a stay of up to 90 days for purpose of employment and residence of foreigners, a short stay visa is required. Foreigners who are to work in country more than 90 days are obliged to have long stay visa and temporary residence permit (application is done at the diplomatic outposts of Macedonia abroad). There are three categories of work permit:

- Personal work permit – for investors and self-employed persons with one year validity. For the application for the permit a business plan with detailed explanation of the economic benefit for the country as well as the number of jobs that will be created.
- Employment permit – subject to a number of restrictive criteria. Local authorities verify that the foreign employment quota (5% of legally employ population) is not exceeded. Secondly a labor market search is done to ensure that there are no national candidates interested in the open positions. The permit is issued only after these conditions are met and is valid for a period of one year after which the foreign worker needs to go to the same procedure.
- Work permit – temporary permit with pre-determined duration.

This regime does not make a distinction between managerial positions, professionals with technical skills and low-skilled workers, which can negatively result for the attraction of skilled work force needed for specific FDI projects. In addition, the issuance and renewal of permits is too restrictive. Such a regime can damage the county's attractiveness to foreign investors and may discourage employers to look for foreign skills. The procedures are unnecessarily long and require applicants to personally submit their applications to a diplomatic or consular mission of Macedonia in their home country. Skills attraction has to become a clear objective in Macedonia's FDI policy. It may be better to replace the quota system and to search labor market at least for workers with specific skills and knowledge for a particular position. In addition, the country should extend the validity of the permits and consider the possibility for foreign applicants to be able to apply for such permits in their current country of residence instead sending foreigners to the diplomatic or consular mission of Macedonia in their home country.

On the part of obtaining construction permits, the current regime is too long and involves too many institutions which have limited exchange of information between them as well as have

insufficient information to provide help for applicants when needed. To ease the whole process and make it more efficient, the government may look into shortening the administrative procedure.

The Law for Protection of Competition is well developed and is lined up with the EU regulatory framework contributing towards effective functioning of the Commission for Protection of Competition which is the main regulatory and implementation body. The Commission for Protection of Competition exercises a restricted power to implement and impose the law. To be able to resolve all cases in an efficient manner the Commission should be given full political and financial independence. A lack of independence is also notable in the judiciary system due to political pressures. Despite this the system lacks efficiency due to slow and long procedures as well as poor performing courts. A significant problem for the country remains to be corruption even though laws were adopted to fight it.

The infrastructure in Macedonia went through some modernizations in the past period, however additional improvements are necessary. Foreign investors feel that the insufficient infrastructure poses higher costs and constraints to their operations (Kapital, 2013). Macedonia is connected through Corridor VIII to Eastern Europe and through Corridor X to North Europe. Investors point out that effective access to sea is a problem. On one side the fees charged by the Thessaloniki port are too high and on the other side the access to the Albanian port Durres which is around 20% cheaper is non-efficient (Kapital, 2013). The business people state that the air transport needs further development for example, direct connection to European major cities is of high importance (Kapital, 2013). The telecommunication infrastructure is generally acceptable to investors however the energy infrastructure is a challenge. The country needs to increase and expand the supply of electricity to be able to meet the growing domestic demand.

In March 2013, the Macedonian business magazine “Kapital” issued a special edition on all foreign investments in Macedonia. In this edition, the magazine discussed issues regarding the investment climate in the country as well as interviewed foreign investor on their views post investing. Below is a summary of the conducted interviews:

Paul D. Wohlers the US Ambassador in Macedonia spoke on behalf of the American companies and pointed out that for conducting a business companies are interested in several things such as quality of the workforce, high education, quality infrastructure, transport, locations to start up a business as well as stable business climate. As an important point the ambassador pointed the law enforcement as well as the administrative procedures.

Jatin Thakrar, a managing director of Johnson Matthey states the company is satisfied with the conditions in Macedonia, but thinks there are areas that need improvement. He points out the regulatory framework and some procedural questions that need to be focused in a different direction which can ease the administrative problems for the companies. One of the basic reasons why this British company invested in Macedonia, Thakrar states was the country's central position in the Balkans, the help and the speed in the negotiations that the company received regarding all critical questions from the government agencies including the National Bank, the Ministry of Finance, in relation to the customs and the taxes, Invest in Macedonia, The Technological Industrial Development Zone and so on as well as the closeness of the Skopje 1 zone where the company is situated to the airport and the city of Skopje. The company produces auto catalysts and recently built a second factory and is already considering new investment projects in the country. Of a great importance is that Johnson Matthey cooperates with around 45 local companies, totaling of around 20 million euros of business (Kapital, 2013).

Makren Gribi, the general manager of Johnson Controls assesses the business climate in Macedonia as very favorable to foreign investors. In his view, the biggest advantages that the country offers are the tax breaks. As a disadvantage, the general manager points out the infrastructure. Gribi suggests working on improvement in the transport infrastructure as well as the international air connections with Europe. Johnson Control's first investment was in the technological Industrial Development Zone "Bunardzik" in Skopje producing component for instrument panels for the automotive industry and last year the company opened a new plant in the city of Stip producing car seats.

Filip Van Hool, the CEO of Van Hool, a factory that produces busses, has a very good impression of the technical schools in the country. The company this summer started the production of busses and for now will only supply the American market. The company's further plans are that within one year to start introducing a European version of the busses and in two to three year period of time the company wants to start producing city busses. Van Hool, further states that they want to place the city busses in the domestic busses as well. Because they are at the beginning phase in Macedonia, they are importing all goods they are using in their production but have already started to look for domestic suppliers. They so far have made good connections with one company in the city of Ohrid and another one in the city of Stip. When the company started to look for locations in which they will start their operations, they looked at Poland, however because the high labor cost in Poland would not allow them to compete with the Chinese, Mexican and the Turkish producers, the company abandoned the idea of location in Poland. Their next option was Turkey, but they also gave up this idea because of the complex bureaucratic procedures. They were contacted six years

before they came in Macedonia by the country's Ministry of Finance and it was the persistence of the ministry that made them consider Macedonia as an option. The company considered Serbia as a possible location, however the CEO points out they picked Macedonia at the end because they felt more welcomed. Another thing that attracted them to Macedonia was that the country had experience in producing busses as well as the balanced program for foreign investment. The CEO's suggestion on improvement in the hunt for new investments is shortening the frustrating bureaucratic procedures.

Fatmir Begiri, a financial director at American Construction talks about their establishment in Macedonia. They are a construction company which started operating in the Macedonian market in 2008 with 100 % foreign capital. Their core business is the construction of residential buildings, commercial and industrial buildings. As Van Hool, he also points out the long bureaucratic procedures as an area for improvement.

Guido Gelleni, Managing Director of Kemet Electronics for the Balkans, is a US company that in Macedonia produces capacitors. The company opened in 2012 in the Technological Industrial Development Zone "Bunardzik" in Skopje. As a new company Kemet Electronics imports all their components they use in their production process. In long term, Gelleni states they would like to purchase as much as possible from local suppliers, but he has been made aware that it is not as easy as in other European countries to find certified suppliers locally. The Managing Director points out this as a drawback for the country, but is convinced that with cooperation with multinationals such certification can be worked on to be obtained. For now, all they use in the production process is imported, only supporting materials such as cardboards are bought locally. In the search for their staff, the company did not encounter any problems regarding finding qualified employees, however due to the specifics of their business; all engineering stuff is sent to be further trained in Italy or Germany. When choosing a location, the company reviewed Eastern Europe i.e. Turkey, Romania and the whole CEE. One positive thing, Galleni states for being located in Macedonia is the quality of the workforce, second is the labor cost and the third thing is the fact that they are located in an industrial zone gives them certain benefits. Gelleni strongly suggests that improvements should be made in the infrastructure as soon as possible.

Boban Todorovski co-owner of Stil kon and General Manager of Stil kon d.o.o. explains what it means to be export oriented company and which are the benefits to have a foreign partner. The total investment from Gerilko Group in Stil kon equals 3.5 million euro. The Gerilko Group is present in the Macedonia since 2010 when they bought 50% of Stil kon. The company's core business is the production of steel structures and after the entry of its foreign partner they began producing reinforcement details according to project documentation and

started with installation of reinforcement in buildings. A main characteristic of the company is that it is export oriented on which Todorovski says it provides better price, higher profit and efficient operation. However, Todorovski says to be present in a foreign market the basic parameter for success is the quality. He suggests that domestic companies start investing in the quality of their products and work on obtaining certifications which are internationally accepted to ensure operation in foreign market as well as business with domestic investors. Todorovski further complains on the transport infrastructure as an issue to be worked on. In their case the connection with the Thessaloniki port is of vital importance, however they are missing out on the connection with the Durres port. The further states that it is the transportation costs that make them uncompetitive when offered businesses in distant markets. In addition to this Todorovski points out the high cost of the capital, that the banks are still offering very high interest rates that enable companies to borrow and expand and improve their business processes.

Konstantinos Daskalakis is a CEO of Feni Industry based in the city of Kavadarci, a plant for nickel production which was acquired in 2005 and is now a part of the international group Cunico Resources. The company uses the “Rzanovo” mine as their input, however because the percentage of the nickel in the ore from this mine is very low to be economical having the current nickel price on the market, the company started to import ore richer with nickel from Indonesia, the Philippines, Albania, Turkey and so on. Feni Industry, as stated in previous paragraphs is one of the biggest exporters in Macedonia. Daskalakis, also points out the transport infrastructure as an issue for raising costs and points out that the state needs to make serious capital investments so the domestic production can be competitive in the global market. Daskalakis points out the high transport costs as well as the time for transport for the ore that comes from Albania and Bulgaria and that only the Thessaloniki port is a more economical way for transportation. The CEO suggests investments in railways, new wagons, new locomotives and faster roads.

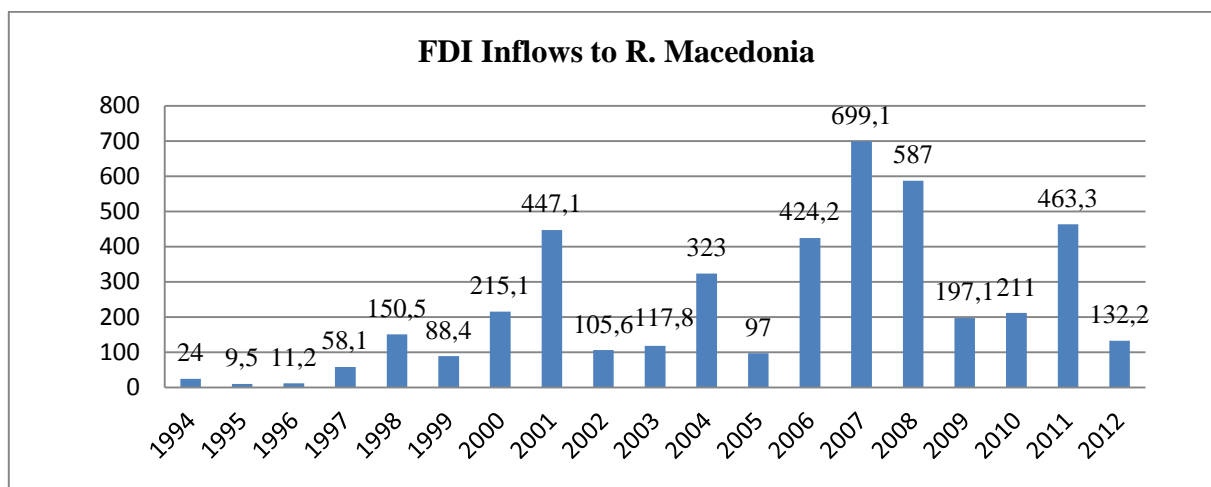
Halk Bank recently merged with ex Ziraat Banka in Macedonia. According to Halk Bank CEO Necdet Palakci, the bank is market oriented where the majority shareholder is Republic of Turkey. The main mission of the bank is supporting small and medium size companies and corporate clients. The CEO is satisfied with the conditions of doing business in the country and states that there is fair competition. Palakci sees the lowering of the interest rates by the National Bank as a signal in which way the credit activity of the bank needs to move. This means lowering the interest rates and increasing the credit support for the companies.

## **6 FDI IN MACEDONIA**

Macedonia has become a new destination for foreign investors. Macedonia has attracted a very small portion of foreign investors since its independence in 1991 with the fall of the Yugoslav Republic. During the 1990s until 2001 the FDI inflows in Macedonia remained very small as a result of unfavorable external situations as was the civil war in ex-Yugoslavia, the domestic political issues i.e. the civil unrest in Macedonia as well as the trade embargo Greece imposed because of the dispute between the two countries for using Macedonia as a name for the territory. The situation slightly changed from 2001 onwards when the political situation had stabilized resulting in economic growth and higher FDI inflows. The FDI inflows were mostly a result from the privatizations. The last years the business environment has significantly improved and the government has very actively worked on investment promotions to draw the attention of potential investors. The Macedonian Government is aware of the importance that FDI play for the country's economic development and therefore works on increasing the ease of doing business; increasing the country's welfare, EU integration and stabilizing the economy.

The FDI inflows were very small until 1998, almost negligent. From 1998 until 2007 there is a positive trend in FDI inflow which is mainly due to privatization and acquisitions of major companies and banks. In the analyzed period, as shown in the graph below, the highest level of foreign capital is seen in 2007 – 699.09mil US dollars and in 2008 – 586.95mil US dollars. The FDI saw their first peek in 2001 which was a result of the sale of AD Makedonski Telekom to the Hungarian branch of Deutsche Telekom – Magyar Telekom. The total investment was worth 346.5mil US dollars. In 2000 the investment flow was a result of the sale of AD Stopanska Banka and the sale of the cement factory AD Usje. In the crisis year of 2009 there were only 197.09mil US dollars in the country followed by 211mil US dollars of FDI in 2010 which is not as satisfactory compared to the levels FDI has reached in 2007 and 2008.

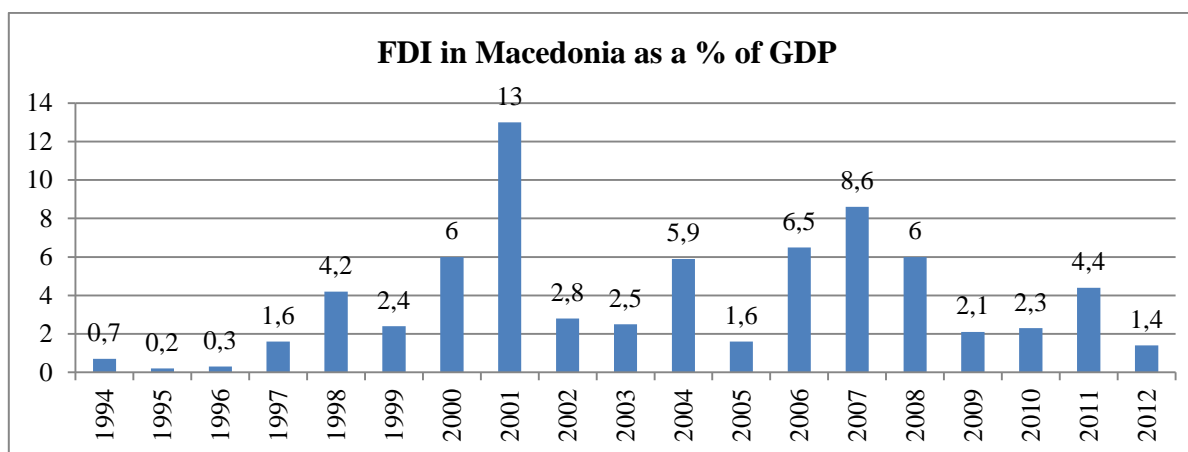
Figure 1: FDI Inflows to Republic of Macedonia, 1994–2012



Source: National Bank of the R. Macedonia database, *Basic Economic Indicators*, 1994 - 2012.

The largest share of FDI with 13 % of GDP is seen in 2001 followed by the second largest share of FDI with 8.6 % of GDP in 2007.

Figure 2: FDI in Macedonia as a % of GDP



Source: Kapital, *FDI in Macedonia as a % of GDP*, 2013, p. 12, Table 1.

The distribution of FDI by activity is only available from 1997 and is collected by the National Bank. The data collected shows that from the total investments from 1997 until 2011 the most FDI entered in the services sector.

The services sector (particularly the financial and the telecommunication sector) gained the highest interests of the foreign investors. Only in the last two years the manufacturing sector receives more foreign investments than the service sector. In 2011 according to the National Bank data, 62% of the total FDI was invested in the manufacturing sector, particularly in the vehicles and other transport equipment.

The agriculture sector (Kapital, 2013) is an important sector to the Macedonian economy due to favorable climatic conditions, skills and tradition. The FDI in the agricultural sector is narrow not only in Macedonia, but also elsewhere. FDI are possible in the value chain of the food industry i.e. in warehousing, retailing, food manufacturing and so on. The UNCTAD (2012) report devoted on FDI in Macedonia summarizes the foreign investments in the agriculture sector as follows: the Greek Hellecic Bottling together with Athenian Brewery S.A. bought 51 % of the stake in Pivara Skopje. In 1997 the Dairy Ideal Sipka was a joint venture with a Bulgarian dairy company and later was bought by the Croatian Dukat. The Slovenian supermarket chain Tus is also active in the market in the wholesale and distribution of food and beverages. In the tobacco industry, the UK Imperial Tobacco bought 99 % of the Macedonian's largest tobacco producer A.D Tutunski Kombinat. Imperial Tobacco now manufactures, sales and distributes tobacco products.

Table 2: Distribution of FDI by Activity

Year \ Activity	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011
Agriculture, forestry and fishing	1,05	0,60	0,90	0,78	2,67	3,73	9,81	23,09	22,98	23,11	27,00	30,86	16,35	29,16	30,93
% of total FDI	0,75	0,22	0,25	0,13	0,26	0,32	0,76	1,43	1,30	1,10	1,06	1,04	0,52	0,89	0,85
Mining and quarrying	0,27	0,472	0,68	9,89	13,6	16,94	15,53	22,37	39,27	45,3	50,74	168,52	89,32	133,02	179,41



Total FDI	% of total FDI	Service	% of total FDI	Construction	% of total FDI	Electricity Gas and Water	% of total FDI	Manufacturing	% of total FDI
141	48,4	68,31	0,41	0,58	0	0	47,76	67,45	0,2
270	36,3	98,12	0,31	0,83	0	0	61,15	165,33	0,2
360	34,7	124,9	1,56	5,63	0	0	61,7	222,08	0,2
580	40,8	236,9	5,68	32,94	0	0	50,83	294,83	1,7
1039	55,3	574,4	0,53	47,04	0	0	38,13	396,21	1,3
1161	53,4	619,6	4,83	56,06	0	0	39,43	457,7	1,5
1292	54,4	702,5	5,1	65,91	0,06	0,74	37,95	490,36	1,2
1610	51,1	822	4,01	64,49	0,32	5,17	41,29	664,92	1,4
1769	48,3	854,2	3,45	61,08	0,35	6,21	43,83	775,32	2,2
2099	46,9	984,6	3,36	70,48	7,49	157,08	38,21	801,86	2,2
2545	51,2	1303	3,42	87,05	6,35	161,70	35,65	907,35	2,0
2969	54	1602	3,95	117,25	5,54	164,33	29,85	886,28	5,7
3141	54,8	1722	4,11	128,99	7,31	229,65	30,35	953,40	2,8
3270	53,3	1743	2,5	81,68	7,00	228,82	32,23	1053,77	4,1
3649	49,4	1804	2,33	84,9	6,37	232,53	36,09	1317,08	4,9

Source: National Bank of the Republic of Macedonia database, *FDI Distribution by Activity*, 1997 - 2011.

The first investor that came to Macedonia is the Swiss Duferco in 1997 as a result of the privatization of the Macedonian Mines and Iron and Steelworks Skopje. In 1998 Knauf, a German company gypsum plaster board company entered the market in western Macedonia. Later in 2004 the Dutch based company Mittal Steel bought the Macedonian steel producer Zelezara Skopje. Mittal Steel is now Arcelor Mittal, a Luxemburgish affiliate of Mittal Steel. In 2006 the mines for lead and zinc Sasa, Zletovo and Toranica were bought by the UK affiliate of the Mumbai listed Binani Industries Ltd and restarted the mining processes. On the part of the automotive components there are 6 established and already operating companies and a few others that are now building their capacities. All of these are established in the free economic zones. The UNCTAD (2012) report further captures the energy sector in which Hellenic Petroleum which is a Greek State-owned oil company is present in the Macedonian market since 1999 when the company bought the Macedonian refinery OKTA. Later, in 2005 the state owned Elektrostopanstvo Makedonia (ESM) was divided in: AD ESM which took over the distribution of electrical energy; AD MEPSO which is now the transmission system operator; AD ELEM which takes care for energy generation and AD TEC Negotino which also takes care of energy generation (now AD ELEM is responsible for AD TEC Negotino). Having split the company like this, it was ready to be sold. However, only AD ESM was sold in 2006 to the Austrian EVN. Several other companies are interested in operating in the energy sector but are not yet present in the market. In 2005, Russian LUKOIL entered the market in the oil derivatives business. In the services sector (Kapital, 2013), there are 18 banks and 8 savings houses. In 13 financial institutions, foreign shareholders hold a majority stock. In the banking sector Stopanska Banka is owned by the National Bank of Greece and NLB Tutunska Banka AD Skopje is owned by Nova Ljubljanska Banka from Slovenia. Other foreign investors in the banking sectors are: Societe Generale from France, Halk Bank from Netherlands, Alfa Bank from Greece, ProCredit Holding from Germany, Ziraat Banksi from Turkey, Alfa Finance Holding from Bulgaria. The insurance sector is very small and also characterized by foreign investors. QBE, an Australian insurance company, entered the Macedonian market in 2000. Several other foreign investors in the insurance sector are present in the Macedonian market and are coming from Slovenia, Austria and Croatia. The ICT industry is starting to be heavily promoted by the Government. Several companies are already present such as Netcetera from Switzerland and Seavus from Sweden. It is also worth mentioning the real estate and tourism. Foreign investors are focused on shopping and business centers. Balfin, an Albanian company recently finished their project in building a retail space in Skopje. An Israeli company started construction of a commercial center in Skopje as well. Also Turkish Koc constructed Ramstore which is a shopping Mall in Skopje. Slovenian Merkur Group owns business and retail center in Skopje. In the municipality of Aerodrom, Cevahir Holding from Turkey bought land and started the construction of three skyscrapers.

Austria, Germany, Greece and Hungary are the major and biggest foreign investors in the country for the period of 2001-2010. Smaller but active participation in investment have done Holland, Cyprus and Slovenia.

One of the biggest investors is Magyar Telecom (Deutsche Telecom) followed by “EVN - Austria” which bought the electro distribution in 2006. From the table above we can also see that Greece also appears as an investor in several occasions. However because of the internal economic crisis they have currently in the country, new investments have slowed down.

Table 3: Major Foreign Investors

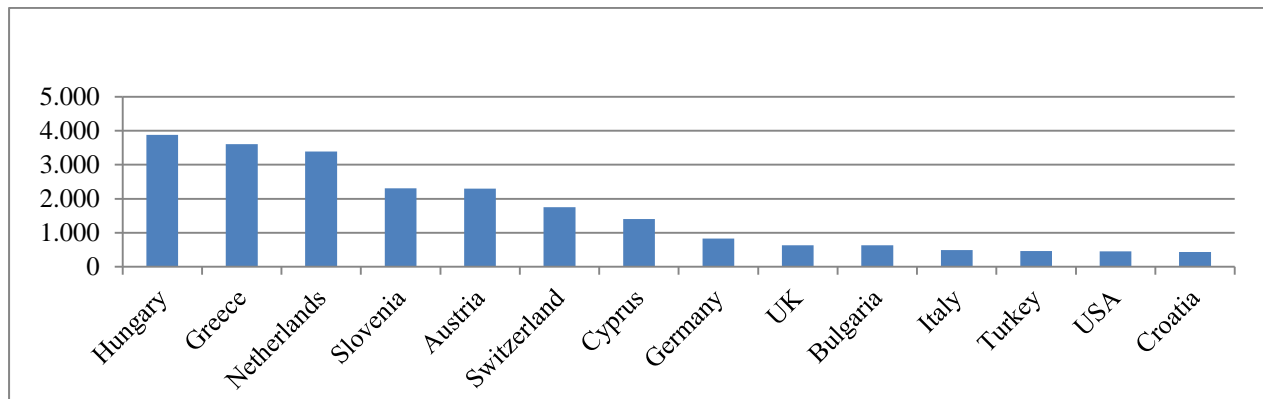
Investor	Country of Origin	Target company	Investment (mil USD)
Magyar Telekom (Deutsche Telekom)	Hungary (Germany)	Makedonski Telekom	346.5
EVN	Austria	ESM Distribution	270.2
National Bank	Greece	Stopanska Banka	46.4
Balkanbrew Holding	Greece	Skopje Brewery	34.0
Hellenic Petroleum	Greece	OKTA refinery	32.0
Société Générale	France	Ohridska Banka	30.4
Titan, Holderbank	Greece/ Switzerland	Usje Cement Factory	30.0
Balkan Steel	Liechtenstein	Ladna Valalnica	21.0
QBE Insurance	United Kingdom	ADOR Makedonija	14.8
Duferco	Switzerland	Makstil	11.5
East West Trade	Austria	Centro	11.0

Source: UNCTAD, *Top Foreign Investment Projects in Macedonia 2001-2008*, 2012a, p.12, Table 1.3.

Detailed data on FDI inflows by country of origin are available from the National Bank databases from 1997 onwards. Since 1997, the largest foreign investors in Macedonia have been Hungary, Greece, the Netherlands and Slovenia (as shown on the figure below). As mentioned before when the FDI by sector were discussed, the Greek investors' target industries are the banking industry, evident in the case of Alpha Bank, Stopanska Banka, the food and beverages industry represented by the ownership of the Skopje Brewery and the oil and refining industry represented with the ownership of the OKTA Refinery. The Netherlands appeared on this figure with the Mittal Steel investment. One of Austria's largest investments in the country is the investment that comes from the purchase of the power distribution AD ESM. The Slovenian investors are seen in the banking industry with Nova Ljubljanska Banka

(Tutunska Banka in Macedonia), in the telecommunication sector (ONE) and in real estate sector with ERA Group as well as Merkur. Greek investments were constantly increasing through the years and an upward trend of their investments is evident. However, in 2009 according to the National's Bank data the Greek investments dropped because of the economic crisis.

Figure 3: Inward FDI Flow in R. Macedonia by Country of Origin 1997-2011



Source: National Bank of R. Macedonia database, *Inward FDI Flows by Country of Origin*, 1997 - 2011.

Regarding the structure of the foreign investments in Macedonia in terms of greenfields and mergers and acquisitions; throughout the years Macedonia has received more investments in the form of mergers and acquisitions than in Greenfields. The National Bank reports the following data in millions of US Dollars:

Table 4: Structure of FDI, M&A vs. Greenfield

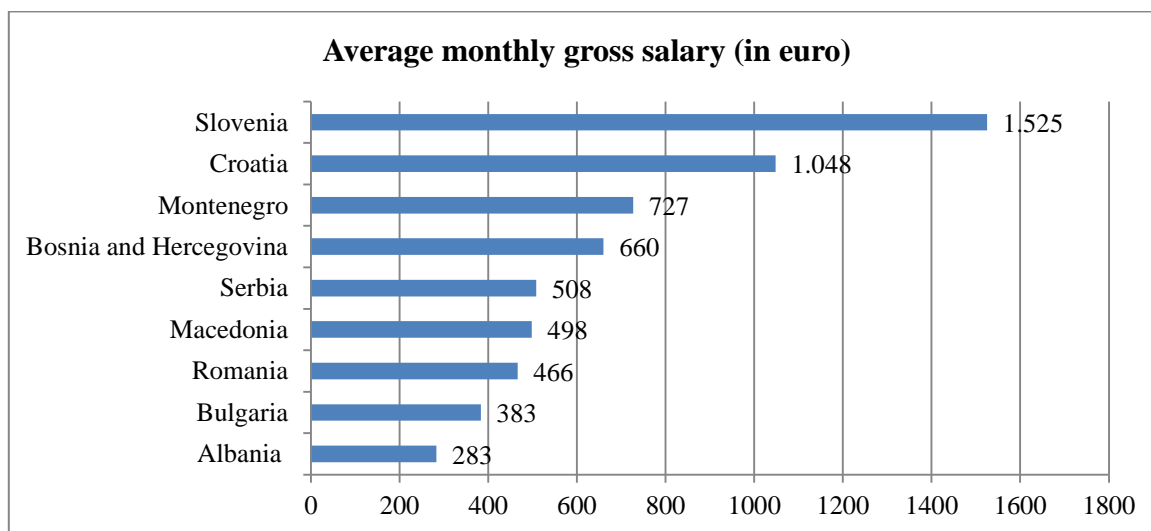
Year	M&A	Greenfield
1997	71,164,371	36,624,976
1998	181,462,084	44,648,801
1999	227,695,600	66,660,673
2000	405,722,067	111,682,087
2001	479,454,006	547,716,209
2002	596,997,980	541,567,690
2003	656,757,623	589,610,848
2004	753,494,097	642,001,483

Year	M&A	Greenfield
2005	904,696,421.00	719,645,569
2006	1,158,747,766.00	791,090,467
2007	1,446,550,764.00	912,655,694
2008	1,583,453,845.00	957,290,821
2009	1,562,772,817.00	1,047,556,265
2010	1,715,372,356.00	1,014,160,438
2011	1,951,334,271.00	1,233,958,034

Source: Kapital, *Structure of FDI, M&A vs. Greenfield* 2013, p. 12, Table3

In terms of average monthly gross salary, Macedonia ranks amongst the lowest in the region. Below is a graphical representation of the data:

Figure 4: Average Monthly Gross Salary



Source: Kapital, *Average Monthly Gross Salary*, 2013, p. 22

## 6.1 The Macedonian economy

The countries from CEE which until the end of the 80s and the beginning of the 90s belonged to the socialist block today are called transition countries. After the fall of the socialist system, the CEE countries had to implement a system of reforms to restructure their economic and political system, form adequate institutions and infrastructure for the transit to market economy and to open up the process of ownership transformation. The transition process was not the same in every country. It had different intensity, took different forms and ended with different results in each economy, because those were economies with their own (different) traditions, population size, economic performances, economic structure and level of economic development. Even though the transition was not the same in each country its aim was the same. The transition meant privatization of companies that were in state ownership, price and trade liberalization, liberalization of the financial markets, abandoning import quota, export permissions and so on. What marked this period were a fall in GDP and an increase in unemployment levels. There was a macroeconomic instability accompanied with grey economy causing further problems. The inflation rates were going up to enormous levels and the macroeconomic measures and instruments in place were not good enough to deal with the increase.

From what is presented in the above paragraph it is clear that the economies in transition were motivated to open up to foreign direct investments. There was a gap between the levels of domestic savings and the investments the countries needed in order to initiate development. The needed capital in these economies was hard to be obtained through new borrowings from abroad because they were already in debt and were showing deficit in the balance of payments. Countries also did not have enough reserves of convertible currency to finance that deficit. In this sense FDI appear as a very important source for gathering capital to finance the gap. In several ways FDI is better than borrowing abroad. Borrowing abroad does not mean that the money borrowed will be efficiently and effectively used in the host country to induce economic development. In addition, as discussed in previous chapters foreign investors can initiate the appearance and the development of new economic activities which previously did not exist in the economy. With this the economic growth is further stimulated, public revenues are increased and the state budget is improving. As previously stated, with FDI, modern technologies can be transferred to the host country, something that cannot be achieved when money are borrowed abroad. The transfer of modern technologies leads to increasing the technical and technological level of the host country. Of a higher importance are the managerial techniques and the investors' know-how. The presence of foreign companies in the domestic market introduces competition between the domestic companies which in turn leads to developing entrepreneurial skills. So, part of the transition process was associated with opening up the domestic borders to the international investment flows. FDI simultaneously affected many important aspects of transforming the ex-socialist economies in market economies, in transformation of ownership, sectorial restructuring of the economy, introduction in new modern management and marketing technologies, research and development activities and so on (Kikerkova, 1998).

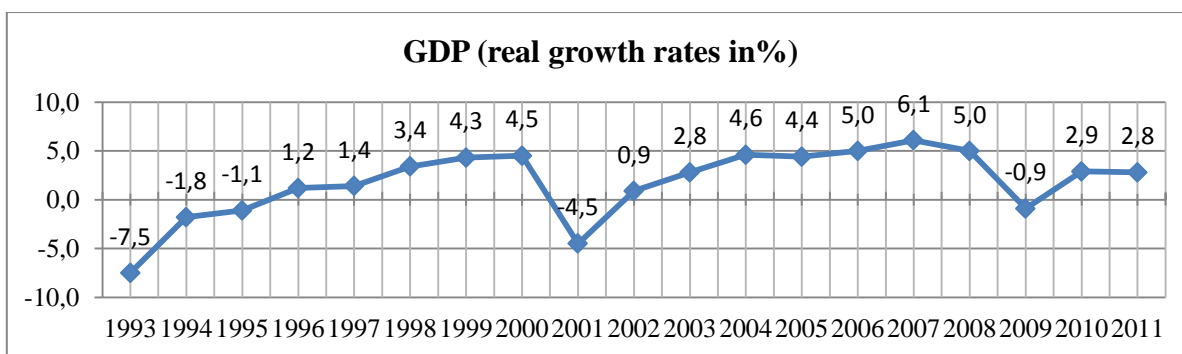
Macedonia gained its independence from the Socialist Federal Republic of Yugoslavia in 1991. From a socialist country from 1992 the country started to form its privatization frame and building its market economy. The process took ten years due to economic difficulties, but the country managed to privatize a large number of publicly owned companies. Out of about 2,000 State owned enterprises, less than 50 remain not privatized today (PWC). After the privatization of the telecommunication sector and partially privatizing the energy sector, the Macedonian government works on the restructuring and privatizing the remaining of the publicly-held energy sector, the health sector as well as the transportation sector.

In the first years of its independence the Macedonian economy witnessed declines in GDP accompanied with high inflation, substantial monetary deficits and nearly no foreign investment. From the recession which started in 1991 the Macedonian economy started to

grow again in 1996. This is the year when the GDP for the first time was in the positive values. In between 1996 and 2003 the growth rate was very small as a result of external shocks. The outcomes of these shocks left evident results on the economy.

The first shock was the war that followed in some of the successor states after Yugoslavia's break up. After that followed the break-up of the CMEA (Council of Mutual Economic Assistance) which in 1992 was followed by the UN Security Council sanctions imposed on Yugoslavia which impact was felt in Macedonia (Roceska and Kostoska, 2006). Later in 1995 the Greek unilateral embargo against on Macedonia happened. The embargo was followed by the Kosovo crisis in 1999 when the country made a decision to temporary host refugees from Kosovo (Roceska and Kostoska, 2006). At this time the country lost the Yugoslav market. Despite this the country managed to have a positive growth. Year 2001 was marked with a military conflict between national government forces and ethnic Albanian extremists which resulted in a deep fall of the GDP of -4.5 %.

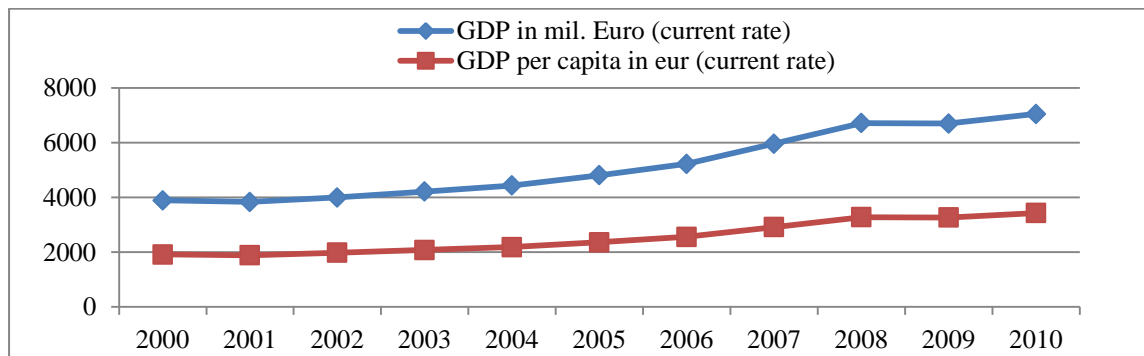
Figure 5: GDP (Real Growth Rates)



Source: National Bank of R. Macedonia database, *Basic Economic Indicators*, 1993 - 2011.

The increase/decrease of the GDP is reflecting in the improving/worsening the standard of living measured by GDP per capita. Below is a graph showing the movement of the GDP and the movement of the GDP per capita. We can see that they are as expected, moving in the same direction.

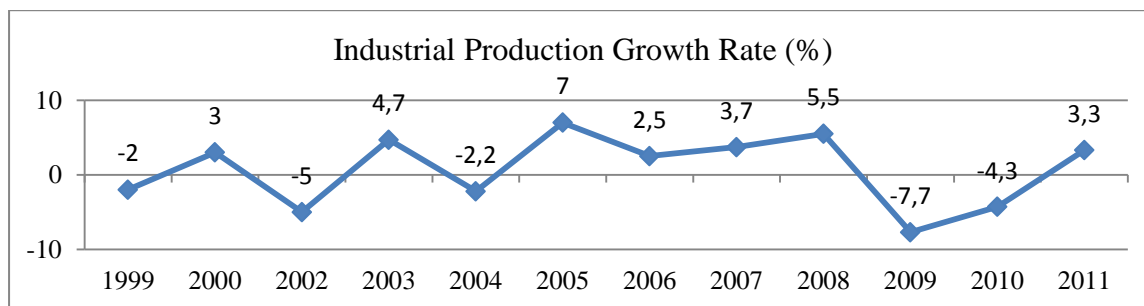
Figure 6: Movement of GDP and GDP per capita



Source: National Bank of R. Macedonia database, *Basic Economic Indicators*, 2000 - 2010.

In the development of the Macedonian economy, the industry has one of the most important roles. The fast development of the industry is one of the fundamental drivers of the whole economic development, socio-economic conditions, way of living and so on.

Figure 7: Industrial Production Growth Rate



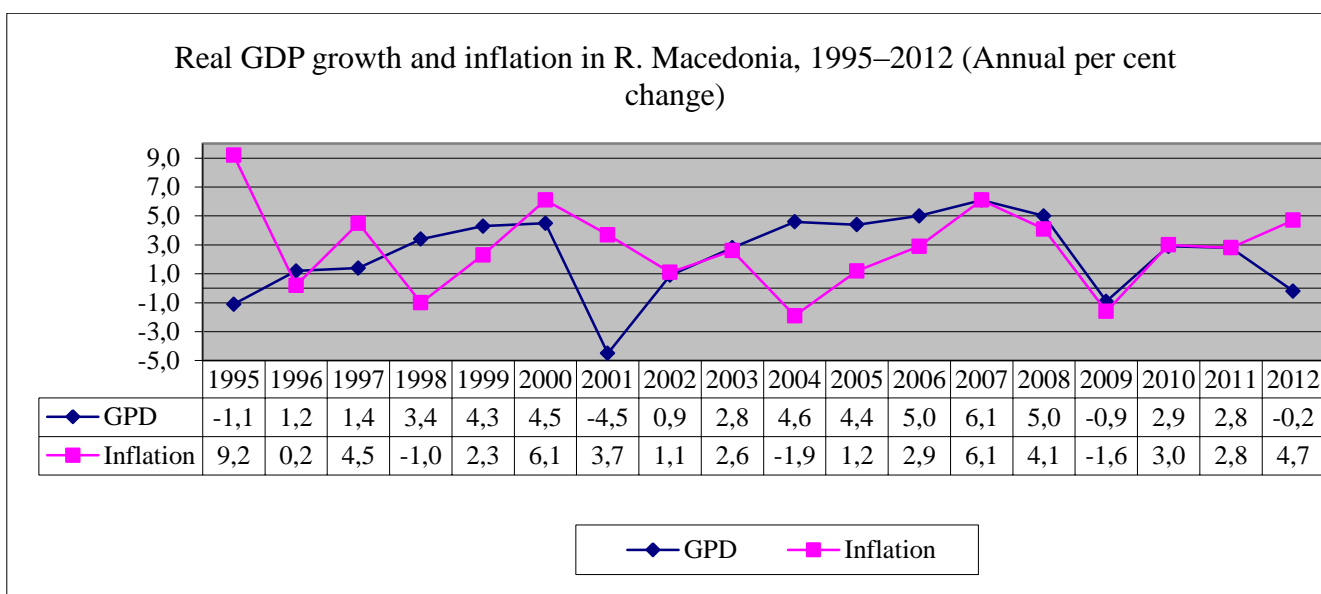
Source: State Statistical Office database, *Industrial Production Growth Rate*, 1999 - 2011.

The industrial sectors have an important participation in the structure of the gross domestic product. According to the State Statistic Office and according to previous data for GDP in 2010 the Mining and Quarrying sector participated with 1.5%, the Manufacturing sector participated with 12.6% and the Electricity, Gas, Steam and Air conditioning supply with 3.7% of the GDP. The industrial production is largely affected by the world economic crises. The numbers confirm this and show downward trend in 2009 and 2010. The lowest industrial production growth rate is seen in 2009 when it was -7.7%.



After the transition started and after the implementation of the stabilization policy, Macedonia managed to keep its inflation level stable and within a single digit. As a result of the economic climate in Europe during 2011 the inflation rate was 2.8 %. The Denar was pegged against the Deutsche Mark until the 2002 and to the Euro since 2002 and it has remained at a stable level. The financial system in Macedonia was resistant to the economic crisis as a result of a strict liquidity management standards and conducting standard i.e. traditional banking activities.

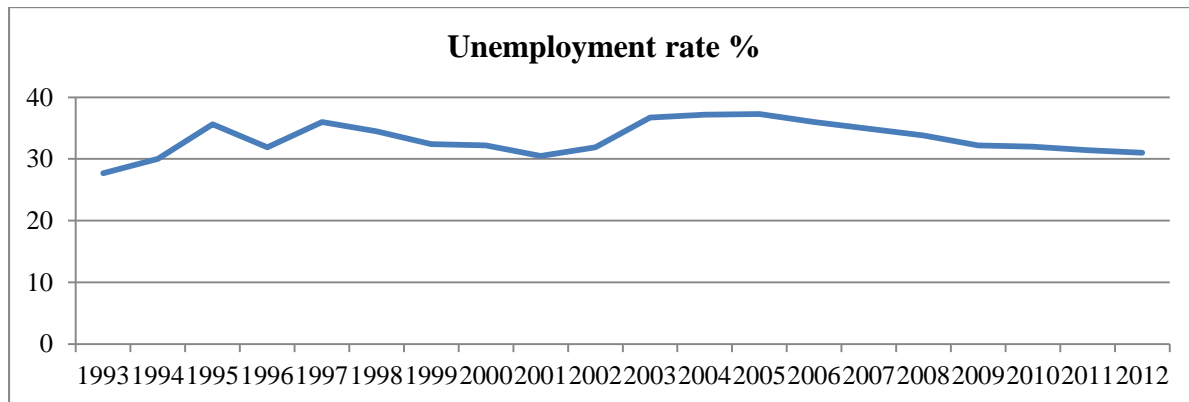
Figure 8: Real GDP Growth and Inflation in R. Macedonia, 1995–2012



Source: National Bank of R. Macedonia database, *Basic Economic Indicators*, 1995 – 2012.

Characteristic of the Macedonian economy is the high rate of unemployment which did not change despite the efforts of the different political parties, different measures and activities taken. The unemployment rate was constantly increasing year by year until 2004 when the unemployment rate reached its maximum level 37.7%. From 2005 onward we see a small decline in the unemployment rate, but despite this fact the unemployment rate remains at an unacceptable high level of above 30%. Below is the graphical representation of the unemployment rate from 1997-2011.

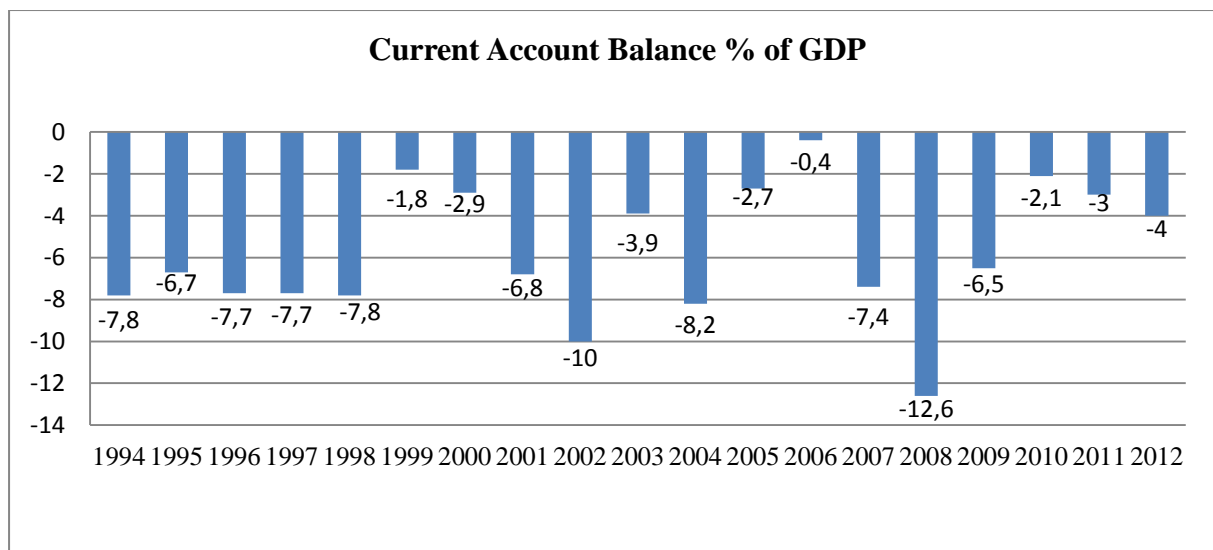
Figure 9: Unemployment Rate from 1997-2012



Source: National Bank of R. Macedonia database, *Basic Economic Indicators*, 1997 - 2012.

Trade liberalization is reflected in the current account and therefore is worth seeing it in more detail. External imbalance remains to be a weakness of the Macedonian economy. The current account balance in Macedonia is in constant deficit. The highest current account balance has been in seen in 2008 when it equaled -12.6% from GDP. Private transfers (remittances) have been constantly in surplus and they have been constantly financing the negative trade balance.

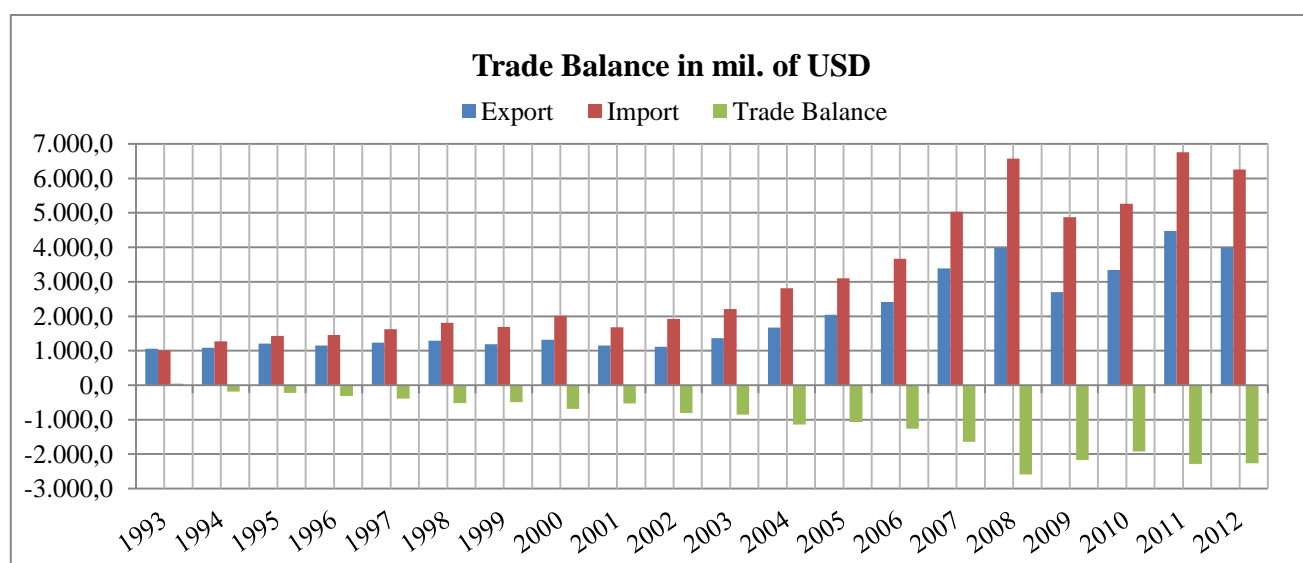
Figure 10: Current Account Balance in R. Macedonia (percentage of GDP)



Source: National Bank of R. Macedonia database, *Basic Economic Indicators*, 1993 - 2012.

What happens on the current account is highly dependent on its trade component. The trade balance has been in constant deficit in the country's transition period. The highest foreign trade in Macedonia is characterized with continuous increase in the trade volume with parallel increase of the import and export.

Figure 11: Trade Balance



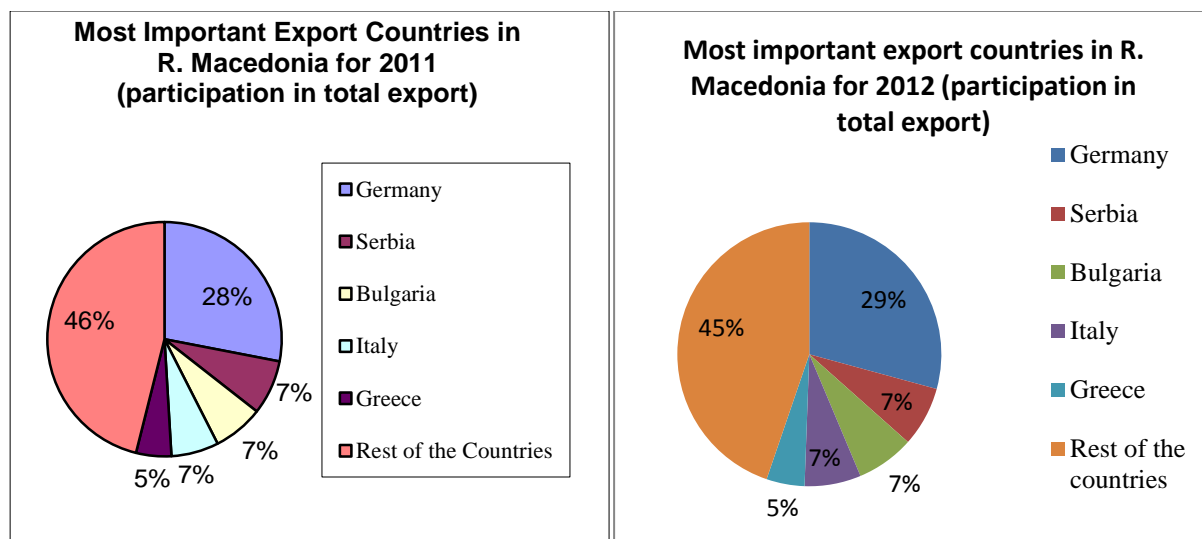
Source: National Bank of R. Macedonia database, *Basic Economic Indicators*, 1993 - 2012.

On the side of the exports, a special edition on the top 100 Macedonian export companies in 2011 published by a local business magazine “Kapital”, states that the top 100 export companies made total export of 2.85 million dollars which is 64% of the total Macedonian export. Out of those, the business magazine says, 59 are Macedonian companies whose export summarized together is less than the total export made by Johnson Matthey, a foreign direct investor from the UK established in one of the free economic zones. The biggest exporters in Macedonia are Feni Industry, a steel company and Johnson Matthey which produces auto catalysts. Over 100 million dollars of exports have only four companies: Johnson Matthey, Feni Industry, Okta, Arcelormittal all with foreign capital. None of the companies with Macedonian capital had made export higher than 100 million dollars (Kapital, 2012).

Macedonia's traditional trade partners are Germany, Russia and the neighboring countries (NBRM, n.d). According to the National Bank data, in 2010 this structure went through a change i.e. Great Brittan appeared in the picture. This also caused change in the structure of

the trade according to the types of products traded and led to appearance of new products in the foreign trade such as auto catalysts containing precious metals or their nitrates, platinum alloys and so on.

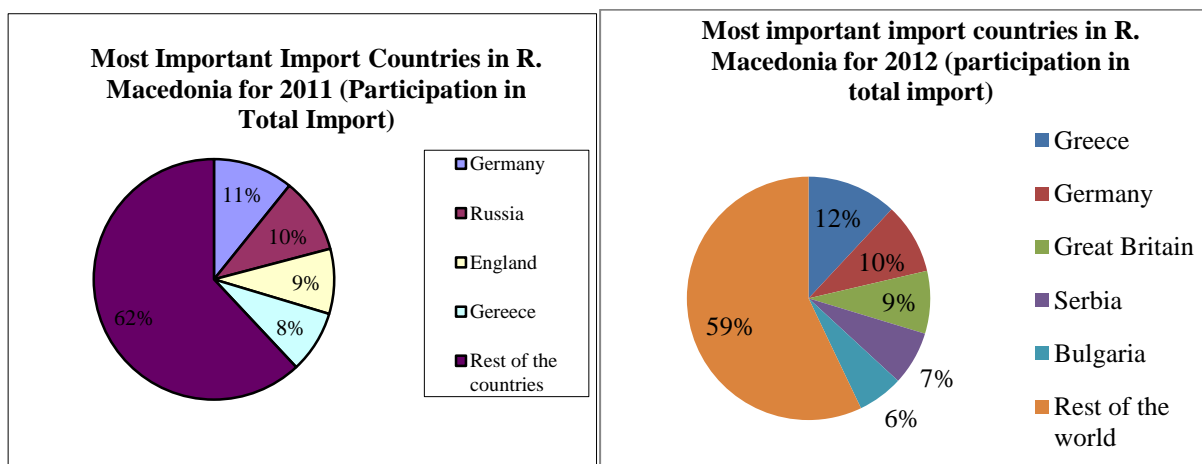
Figure 12: Most Important Export Countries in R. Macedonia for 2011 and 2012



Source: National Bank of the R. Macedonia, *Most Important Export Countries*, 2011 and 2012.

A great part of the export is import dependent, since it deals mostly with products, the creation of which is adding value to semi-finished products and imported raw materials.

Figure 13: Most Important Import Countries in R. Macedonia for 2011 and 2012



Source: National Bank of the R. Macedonia database, *Most Important Import Countries*

According to the State Statistics Office, the dominant trading partners in Macedonia are the developed countries (EU27, EFTA and other developed countries) which account for 63.8 % of the total export in 2011 and 61.0 % of the total import in 2011.

Table 5: Commodity Exchange by Economic Groups of Countries

	Export		Import		Structure	
	000 US \$		000 US \$		export	Import
	2010	2011	2010	2011	2011	2011
<b>Total</b>	<b>3 005 207</b>	<b>4 073 620</b>	<b>4 870 218</b>	<b>6 390 062</b>	<b>100</b>	<b>100</b>
<b>Developed countries</b>	<b>1 889 824</b>	<b>2 597 360</b>	<b>2 917 554</b>	<b>3 897 684</b>	<b>63.8</b>	<b>61</b>
EU 27	1 846 201	2 472 927	2 593 468	3 485 000	60.7	54.5
EFTA	18 380	30 062	86 339	159 225	0.7	2.5
Other developed countries	25 243	94 371	237 747	253 458	2.3	4
Undeveloped countries	3 498	16 648	51 246	66 991	0.4	1
Developing countries	179 582	328 324	1 335 111	1 701 523	8.1	26.6
West Balkan	932 304	1 131 287	566 307	723 864	27.8	11.3

Source: State Statistics Office database, *Commodity exchange of the R. Macedonia by economic group of countries*, 2010 and 2011.

We can conclude that the Macedonian economy is with structural problems, without new technologies, without capital and was isolated from the main movements of the world economy. The opening of the country and the institutional and legal adjustment to the generally accepted standards in Europe and the rest of the world and the international organizations starts to slowly give results in the economy. We can say the Macedonian isolation from the developed world as well as the close neighboring countries was one of the main reasons that the transition in Macedonia gave modest results. We can also say that all problems of the Macedonian economy are highlighted under the destructive effects of the modern global economic crisis which effects are already reflecting in the country's economy. The lack of capital in the financial market leads to difficulties and improper borrowing of the companies.

## 6.2 The impact of FDI on the Macedonian economy

Besides the theoretical research developed in the previous chapters, it is of high importance to evaluate the impacts of the FDI on economic growth. An economic model will be established first with all necessary data to define the relationship between the FDI and the economic growth, and at last the results of the models will be elaborated.

### 6.2.1 Model

Coefficients of equation are estimated using OLS (Ordinary Least Squares Method)

$RGDP = f(RFDI, RGDPEU, RCAPITAL\_EXP, RLOANS, RPRIV\_TRANSFERS)$

RGDP – Real Gross Domestic Product

RFDI – Foreign Direct Investments

RGDPEU – Real GDP of European Union

RCAPITAL\_EXP – Real Government Capital Expenditures

RLOANS – Real Loans to households and corporate sector

RPRIV\_TRANSFERS - Real Private Transfers

FDI, CAPITAL\_EXP, LOANS and PRIV\_TRANSFERS are deflated with CPI and are used in model in real terms.

Reasons why these variables are included in the model:

FDI has lately had a vital role of internationalizing economic activity and is a key source of technology transfer and economic growth. FDI contributes the economy to become more competitive, especially developing countries, leads to more exports and more gross investments and reduces the unemployment.

European Union GDP is proxy variable for foreign demand and represents the external sector channel. Having in mind that the economy of Macedonia is highly open to the rest of the world, and the main part of the trade of goods and services is related with EU economies. Higher EU economic growth means more demand for Macedonian goods and services and contributes to higher growth of exports, and thus to higher GDP growth.

Using government capital expenditures in the model we reflect the fiscal policy stance. Running expansionary fiscal policy and continuous fiscal deficits in the last few years had strong impact by preventing large fall of GDP in the edge of global financial and economic crisis. Moreover, during the global economic recovery it helped achieving solid growth rates.

Through total loans we capture the impact of monetary sector over the economy. Their higher increase signalizes loose monetary policy stance, which positively influences investments of corporate sector and private consumption, and thus to higher domestic demand growth.

Private transfers are very important for the economy of Macedonia. Their share to GDP is very high and on average is around 20% of GDP. A large part of private consumption is financed

through private transfers, and their increase contributes to higher domestic demand and higher growth of the total economy.

### 6.2.2 Data

Data sample starts from Quarter 1 1997 and ends in Quarter 2 2013. To remove the seasonal component of the time series, variables with seasonal pattern are seasonally adjusted using X12-ARIMA program. Each variable is expressed in logarithm and then in log difference (quarterly growth rate).

All calculations to analyze the equations will done using Eviews.

### 6.2.3 Methodology

The calculations can be done in many ways. There is no one single answer in the literature to answer the question which methodological approach to use. In this thesis Coefficients of equation will be estimated using OLS (Ordinary Least Squares Method).

$$y_i = \beta_0 + \beta_1 X_{1i} + \beta_2 X_{2i} \dots \beta_n X_{ni} + \epsilon_i$$

where:

$y_i$  is the dependent variable

$X_{1i}, X_{2i}, X_{ni}$  are the independent variable

$\beta_0, \beta_1, \beta_2 \dots \beta_n$  are the parameters that are to be calculated

$\epsilon_i$  is an error that contains all other factors that impact the dependent variable but are not included in the independent variables

The simplest way to solve the equation above is by using the method of least square roots. The calculated equation can be written in the following form:

$$y_i^{\wedge} = \beta_0^{\wedge} + \beta_1^{\wedge} X_{1i} + \beta_2^{\wedge} X_{2i} \dots \beta_n^{\wedge} X_{ni}$$

where:

$\beta_0^{\wedge}$  is a parameter to  $\beta_0$ ,  $\beta_1^{\wedge}$  is a parameter to  $\beta_1$ ,  $\beta_2^{\wedge}$  is a parameter to  $\beta_2$  and so on. The values of the parameters, the least squares method is calculating with minimizing the sum of the square roots of the deviations between the calculated and the real value. In other words, the least squares method minimizes the following equation:

$$\sum_{i=1}^m (y_i^{\wedge} - \beta_0 - \beta_1^{\wedge} X_{1i} - \beta_2^{\wedge} X_{2i} \dots \beta_n^{\wedge} X_{ni})^2$$

In accordance with this model, the coefficients defined in the previous section will be calculated.

#### 6.2.4 Results

Figure 14: Graphical Presentation of Logarithm of Levels

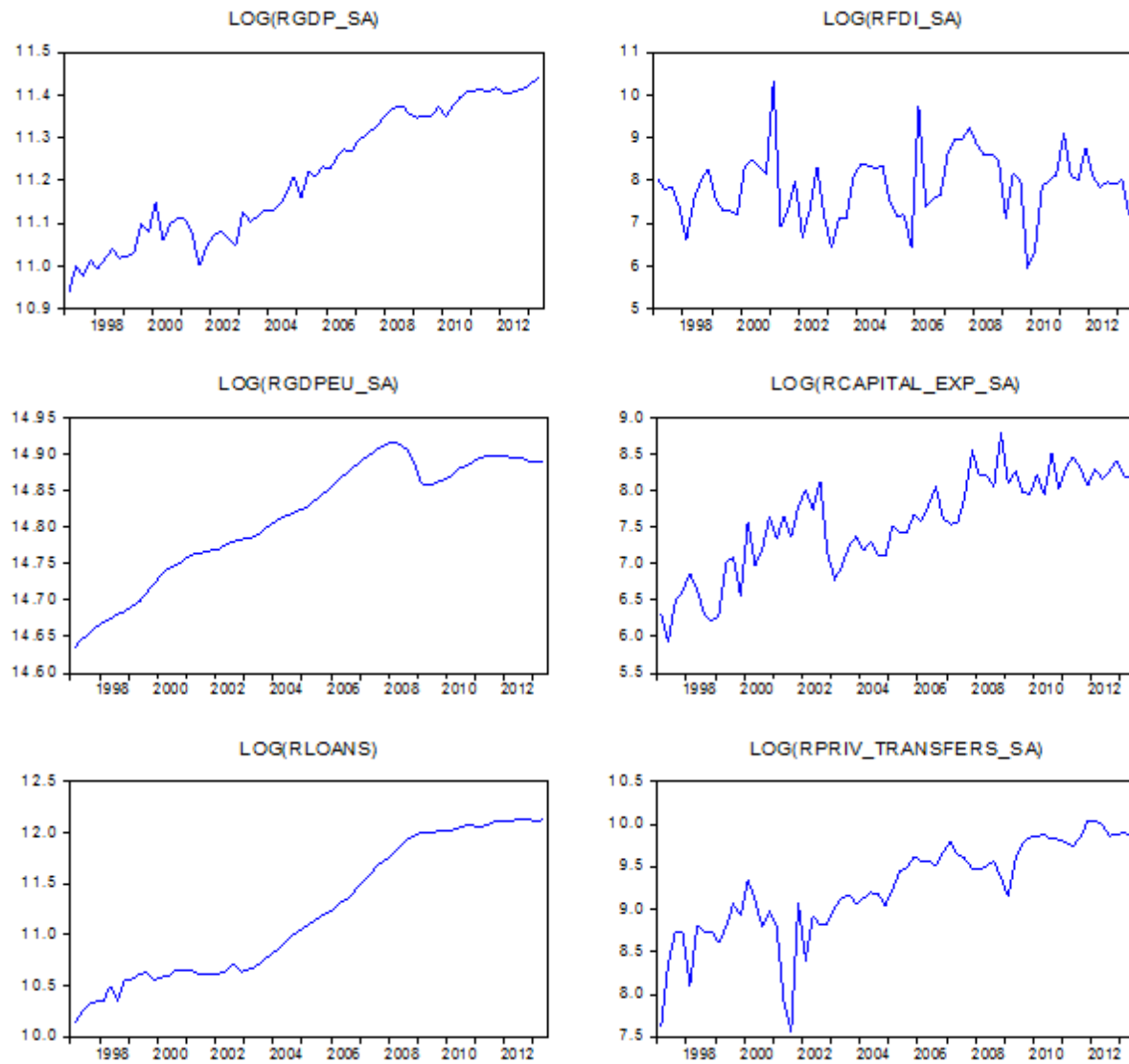
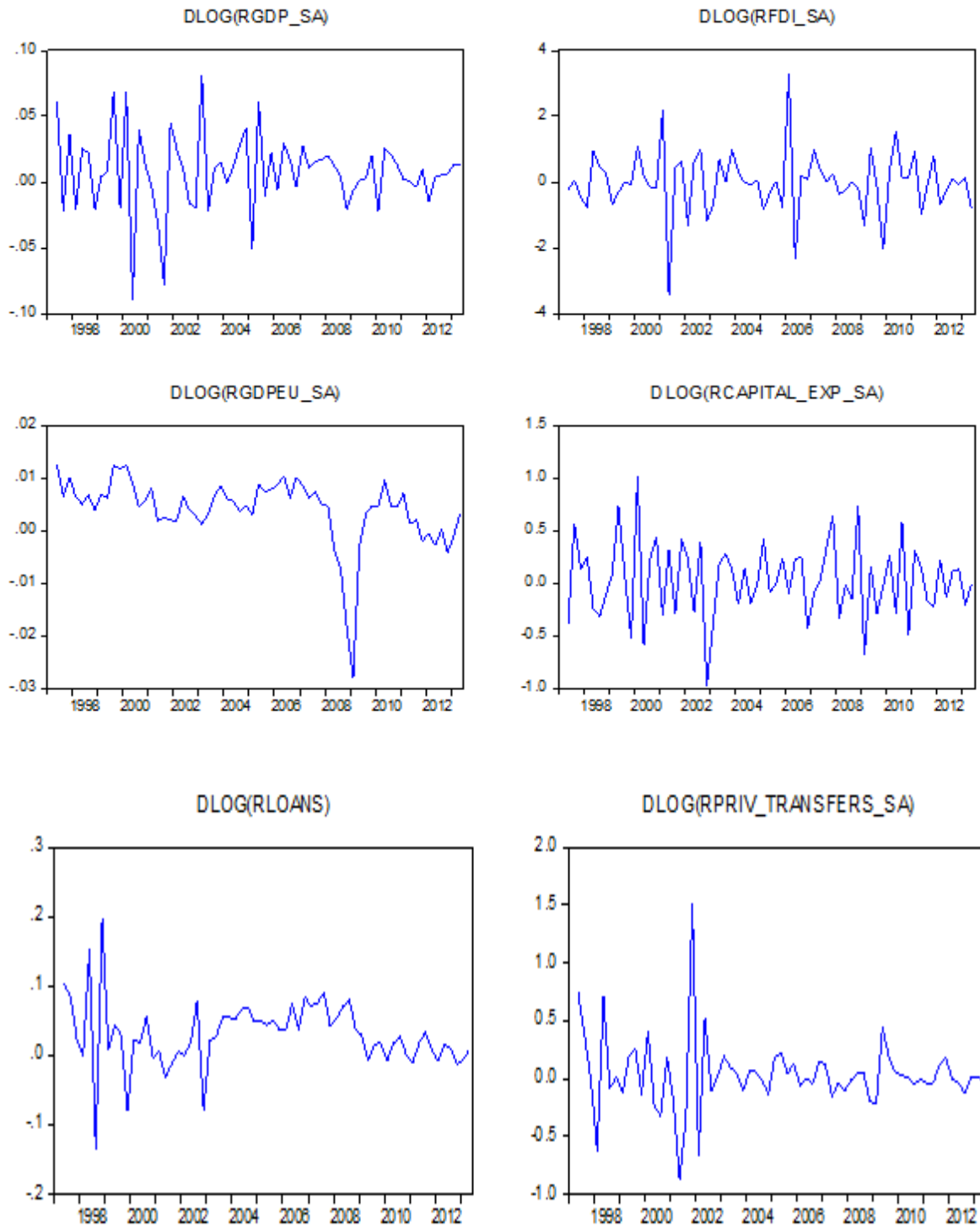


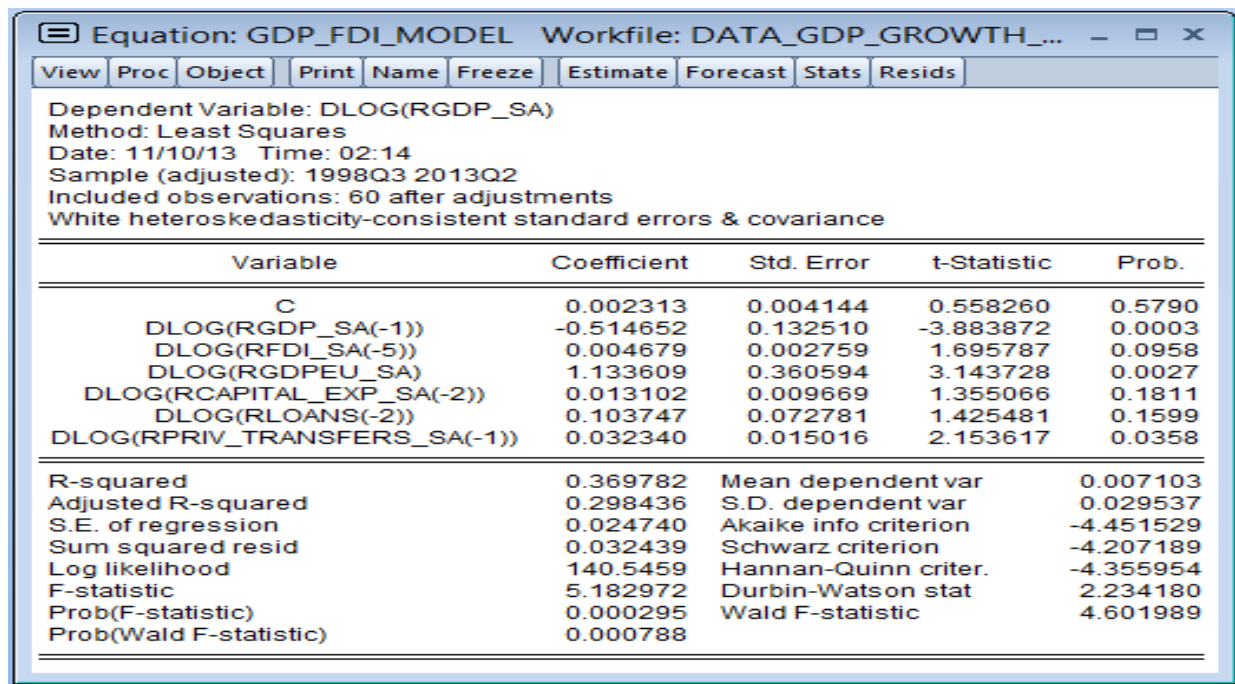


Figure 15: Graphical Representation of Log Difference (Growth Rate)



The results from the OLS yield the following results:

Figure 16: OLS Results

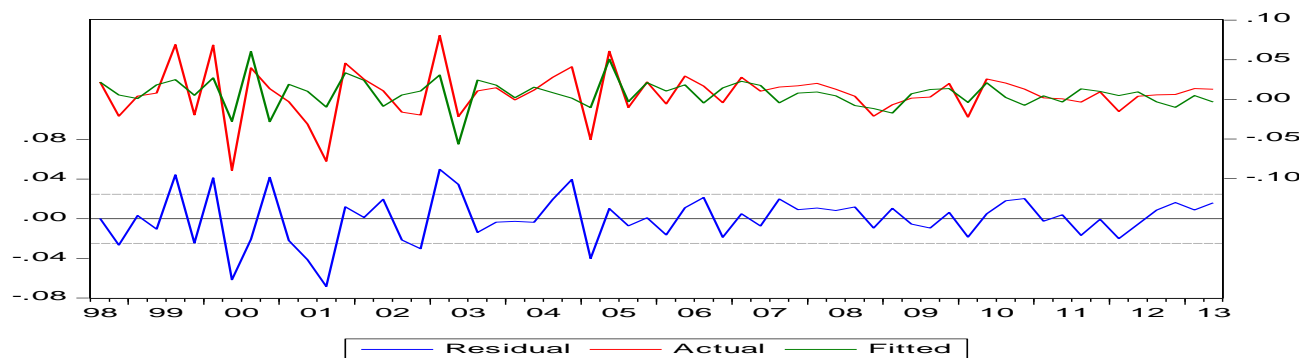


From the above, the equation can be re-written as:

$$\begin{aligned} \text{DLOG(RGDP\_SA)} = & 0.002 - 0.515 \cdot \text{DLOG(RGDP\_SA}(-1)) + 0.005 \cdot \text{DLOG(RFDI\_SA}(-5)) + \\ & 1.134 \cdot \text{DLOG(RGDPEU\_SA)} + 0.013 \cdot \text{DLOG(RCAPITAL\_EXP\_SA}(-2)) + \\ & 0.104 \cdot \text{DLOG(RLOANS}(-2)) + 0.032 \cdot \text{DLOG(RPRIV\_TRANSFERS\_SA}(-1)) \end{aligned}$$

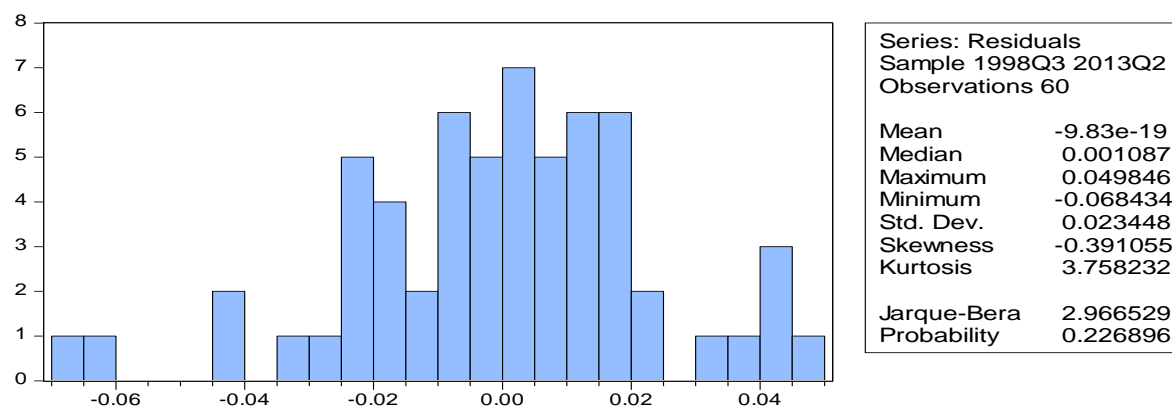
The model diagnostics is presented below

Figure 17: Model Diagnostics



The normality test of the residuals (Jarque-Bera normality test) is presented below and shows the residuals are normally distributed

Figure 18: Jarque-Bera Normality Test



The autocorrelation test of the residuals, Breusch-Godfrey Serial Correlations LM Test is presented below and shows the residuals are not autocorrelated

Figure 19: Autocorrelation of Residuals

Equation: GDP\_FDI\_MODEL    Workfile: DATA\_GDP\_GROWTH\_...

ViewProcObjectPrintNameFreezeEstimateForecastStatsResids

Breusch-Godfrey Serial Correlation LM Test:

F-statistic	1.140881	Prob. F(2,51)	0.3276
Obs*R-squared	2.569467	Prob. Chi-Square(2)	0.2767

Test Equation:

Dependent Variable: RESID

Method: Least Squares

Date: 11/10/13    Time: 03:19

Sample: 1998Q3 2013Q2

Included observations: 60

Presample missing value lagged residuals set to zero.

Variable	Coefficient	Std. Error	t-Statistic	Prob.
C	-0.001678	0.004434	-0.378368	0.7067
DLOG(RGDP_SA(-1))	0.213880	0.222445	0.961496	0.3408
DLOG(RFDI_SA(-5))	-0.000596	0.003370	-0.176908	0.8603
DLOG(RGDPEU_SA)	-0.126127	0.520421	-0.242355	0.8095
DLOG(RCAPITAL_EXP_SA(-2))	0.000789	0.009277	0.085048	0.9326
DLOG(RLOANS(-2))	0.013661	0.068175	0.200384	0.8420
DLOG(RPRIV_TRANSFERS_SA(-1))	0.001588	0.011711	0.135574	0.8927
RESID(-1)	-0.346370	0.255470	-1.355816	0.1811
RESID(-2)	-0.010958	0.168840	-0.064904	0.9485
R-squared	0.042824	Mean dependent var	-9.83E-19	
Adjusted R-squared	-0.107321	S.D. dependent var	0.023448	
S.E. of regression	0.024674	Akaike info criterion	-4.428631	
Sum squared resid	0.031050	Schwarz criterion	-4.114479	
Log likelihood	141.8589	Hannan-Quinn criter.	-4.305749	
F-statistic	0.285220	Durbin-Watson stat	2.024223	
Prob(F-statistic)	0.967898			

In accordance to the results of the residuals the model is good. With this we are able to interpret the results and with a lot of confidence can rely on them.

### 6.2.5 Conclusion from the analysis

All coefficients of explanatory variables have the expected sign and economically are significant. Also, they are statistically significant at 10% level of significance (except capital expenditures and loans). Moreover, the coefficients of explanatory variables are jointly statistically significant at 0% level of significance.

37% of variability of quarterly GDP growth is explained by independent variables. We can easily say that this is satisfactory, having in mind that the model includes the variables in first difference. An increase of FDI by 1% positively affects the GDP growth by 0.04% after 5 quarters (*ceteris paribus*). This lagged reaction of FDI to GDP was expected, because of the time required of investments to fully establish the production process. An increase of foreign demand by 1% with lead 1.13% increase of domestic economy, which shows that how crucial is the external economic environment for the development of domestic economy. Expansionary fiscal policy and loose monetary policy, which is highly present in this last period, have positive impact on GDP growth (although with a little lag) through increase of

capital expenditures and loans to private and corporate sector. The positive coefficient of private transfers shows their importance for the growth of domestic economy, and the developments of remittances again is correlated with the outlook of the international economic environment.

## **CONCLUSIONS AND RECOMMENDATIONS**

The rise of the globalization and liberalization gave rise to the need of production of goods and services that will manage to compete and survive the market conditions. For the most countries, the foreign direct investments are a key element to activate their own resources and access to a cutting-edge technology. The carriers of FDI are the multinational corporations which possess the latest achievements of science and technology, possess modern production methods, managerial, marketing and financing skills possess enormous capital. Because of the large effects multinational corporations have, for the countries seeking investments the question is no longer whether to open the doors of their national economy for foreign investors, but what measures, strategies and actions should be considered to attract multinational corporations. The net benefits of FDI in host countries depend on the type of investment, conditions in which they operate the existing comparative advantages of the host country and its economic policy. Numerous authors have delivered diverse conclusions regarding the impacts of FDI on host countries; the impacts cannot be generalized, rather they depend on individual countries and regions. The effect of the FDI on a host country is not straightforward; it is a function of many factors including macroeconomic environment, political stability, FDI policy in the host country as well as the motive and the type of the investment. When talking about the effects of FDI the forms and motives of the investors must be considered together with the host country's social, economic and political environment. FDI countries receive advanced technology, access to international markets for exporting of their own goods, increased competition among domestic companies, increases productivity, develop advanced managerial skills that through mobility of workers can transfer the knowledge obtained to a domestic company, access to necessary capital. The use of foreign direct investment allows compensation of domestic savings, without increasing the level of indebtedness. FDI can initiate the appearance of new economic activities and to induce economic development. The multinationals' motives for foreign production may be different. They may be looking to acquire natural resources or enter to new markets, or they may use their foreign production activities as means to improve their global positioning on the market made possible with achieving higher efficiency or with having their hands on to new sources of competitive advantages. When assessing the profit and the risk of an investment, foreign direct investors analyze a range of factors reflecting the complete stability of the country. When analyzing the environment of the potential host country, foreign investors look into the

basis economic indicators, existing infrastructure, monetary and fiscal policy and look to invest in a stable economy with a stable national currency, monetary and fiscal policy and low inflation. Foreign investors also look into the availability of information structure, availability and quality of labor, legal protection, constructed market institutions, protection of intellectual and industrial property and so on. In an effort to decrease the risks associated with their own economy, host countries often provide incentives to foreign investors including tax incentives, financial subsidies and regulatory incentives. Such incentives cannot be a substitute to creating a favorable general business climate, but can complement the good investment climate or can be a compensation for some imperfections on the domestic market. The country has taken measures to improve the economic and legal aspects of creating a favorable international investment position such as series of macroeconomic policies and reforms, reform of the tax system, protection of property rights, improving of the performance and functioning of the legislative and more efficient administration. FDI affected the transition process through transfer of technology, managerial skills, production and organizational know-how, restructuring of the national economy as well as aid to the transformation to a market economy. The effect of the foreign investments was reflected in the construction of institutional systems, encouraging the process of privatization and the creation of conditions for competition. For Macedonia of high importance is the impact of FDI accomplished by the transfer of technology to local partners. The introduction of competition to state monopolies contributed towards a more efficient resource allocation and free pricing. The early FDI in Macedonia came in form of M&A enabling better use of available resources and increased productivity. The most attractive industries were the food and beverage industry, the cement industry and the automotive industry. The limiting factors for foreign investors were uncertain political and business environment, inadequate legal framework, and numerous administrative and bureaucratic obstacles and so on, but the country went through a process of reforms to correct those flaws. Factors such as proximity to EU markets, relatively cheap and skilled labor, natural resources, favorable infrastructure, supported with various incentives provided by the country to foreign investors positively acted for an increase in greenfield investments in recent years. The FDI inflows were very small until 1998, almost negligent. From 1998 until 2007 there is a positive trend in FDI inflow which is mainly due to privatization and acquisitions of major companies and banks. The distribution of the foreign investments by activity shows that the most FDI entered in the services sector. Only in the last two years the manufacturing sector receives more foreign investments than the service sector. The major and biggest foreign investors in the country are of EU origin. In the first years of its independence the Macedonian economy witnessed declines in GDP accompanied with high inflation, substantial monetary deficits and nearly no foreign investment. The Macedonian economy started to grow again in 1997. After the transition started and after the implementation of the stabilization policy, Macedonia managed to keep its inflation level stable and within a single

digit. One of the main issues in the Macedonian economy is the constant high level of unemployment above 30%. The current account balance in Macedonia is in constant deficit. The highest current account balance has been seen in 2002 when it equaled -10% from GDP. The trade balance has been in constant deficit in the country's transition period. The highest foreign trade in Macedonia is characterized with continuous increase in the trade volume with parallel increase of the import and export. In the last part of the thesis using the OLS method the impact on GDP was tested having FDI, GDP of the EU, government capital expenditures (reflecting the fiscal policy), loans to households (reflecting the monetary sector) and corporate sector and private transfers as dependent variables. The analysis concludes that all variables are statistically significant and an increase of FDI by 1% positively affects the GDP growth by 0.04% after 5 quarters (*ceteris paribus*), an expected lag because of the time required of investments to fully establish their production process. An increase of foreign demand by 1% will lead to 1.13% increase of domestic economy, which shows how crucial external economic environment for the development of domestic economy.

This thesis offers essential evidence for policy makers. Below is a list of given proposals:

- No doubt that the country provides a competitive fiscal regime and uses it to compete against other countries. However, the government should probably revise its generous fiscal regime may be insufficient enough to generate enough public revenues as to make sure the public administration functions properly. The tax incentives are very generous and it might be of benefit to think about its effectiveness and possible rebalance the tax regime to make sure the Government generates sufficient public revenues.
- The country should loosen its procedures and shorten the time needed to obtain all documents for a foreigner to legally work in the country as well as shorten the time to renewal of documents. The country may look into making a distinction between hierarchies of positions, bearing in mind that the process as lengthy as it is now may reject high profile workers whose skills are much needed for specific FDI projects. Also to be considered is the possibility for foreign applicants to be able to apply for work permits in their present residing country instead of going to the diplomatic or consular mission of Macedonia in their home country.
- Investors are faced with a current regime for obtaining construction permits that is too long and involves too many institutions which have limited exchange of information between them-selves as well as have insufficient information to help the applicants. To ease the whole process, the government may look into shortening the administrative procedure and possibly developing an online system.

- Seen through economic performance, officials should put emphasis on attracting FDI in the tradable sector and work towards attracting export oriented industries. The attention should be put on attracting greenfield investments in capital intensive industries that will enable all possible spillovers on the domestic economy.
- The government should encourage links between the foreign investors and the local companies in a sense that the foreign investors can work with the local companies to help them reach the level of quality needed to qualify as a supplier for a foreign investor. Quality certification will be beneficial for both parties, as foreign investors will reduce their costs for importing and the domestic companies will obtain new businesses. The regulatory bottlenecks should be addressed and the existing laws and regulations that burden foreign investors improved.
- Of high importance is improving the country's infrastructure, in particular the transport infrastructure as a main source for slowing down a business and as a source that increases foreign investors' costs. This mainly refers to adding more international air connections, improved connection to the Durres port as well as investments in the railroad.

The empirical analysis showed the growth in the Macedonian economy is much dependent on the FDI the country has attracted. As a possible future research should be whether the country wants to be as dependent to FDI for its growth or whether it wants to develop its own industries and competences and stimulate economic growth coming from the domestic companies.



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