Policy Study No. 19

BRIDGING GAPS AND SEIZING POTENTIAL

DOMESTIC SMEs IN THE SUPPLY CHAIN OF MULTINATIONAL COMPANIES IN THE COUNTRY

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DOMESTIC SMEs IN THE SUPPLY CHAIN OF MULTINATIONAL COMPANIES IN THE COUNTRY

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Abstract

In the past ten years FDI inflow in The Former Yugoslav Republic (FYR) of Macedonia averaged 3.4% of GDP, providing direct benefits to the economy by contributing to sector and export diversification, import coverage and job creation. Apart from this, indirect benefits such as building linkages between multinational companies and domestic SMEs; technology and skills transfers; and improvements in productivity and competitiveness have been limited. The main objective of the study is to understand the gaps and potentials for inclusion of dSMEs into the supply chain of the MNCs operating in FYR Macedonia. To that end, we base the research on primary-collected data through surveys with domestic and multinational companies that operate in the country, accompanied by a context analysis through interviews and focus groups. The linkages between dSMEs and MNCs that operate in the country are analyzed from three points of view: (i) stakeholders', (ii) MNCs' and (iii) dSMEs', taking into consideration the type and the sector of investments. We find that there is an evident established cooperation between dSMEs and MNCs in the country, though largely determined by (i) the likelihood of MNCs to find the required products and a suppliers locally and (ii) the procurement policy of MNCs. We also find that technological development, standardization and certification, price and production gaps, soft skills and human capital, are the key gaps identified by the three sources of the analysis (stakeholders, dSMEs and MNCs). Accordingly recommendations for bridging these gaps have been provided, specifically addressed to policy makers, domestic companies and multinational companies in the country.

JEL: F21, M11, L25

Keywords: FDI, domestic SMEs, multinational companies, supply chain, FYR Macedonia

Acknowledgements

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Abbreviations

dSME	Domestic small and medium-sized enterprise
MNC	Multinational Company
FDI	Foreign direct investment
TIDZ	Technological-industrial development zone
FEZ	Free economic zone
DTIDZ	Directorate for technological industrial development zones
EU	European Union
M&A	Merger and Acquisitions
SME	Small and medium-sized enterprise
ERP	Economic Reform Program

1. Introduction

Macedonian governments have been putting **efforts to attract** Foreign Direct Investment (FDI) of multinational companies (MNC) since 2000, though they significantly intensified in 2007. Until 2007, most of FDI inflows were related to privatization of the, so called, monopoly companies and banks. In 2007, the then new right-wing government led by the then perceived reformist and technocrat Nikola Gruevski, launched fast-pace regulatory reforms and new tax policy with reducing and flattening tax rates, under an ambitious agenda called “Invest in Macedonia”. The cornerstone of the program was an affluent package of tax incentives, state land and direct financial grants to foreign investors to settle in the newly-established technological-industrial development zones (TIDZ). While the Global Financial Crisis hit the economy soon after, “Invest in Macedonia” started bearing the first gains, as FDI started flowing into the economy. The determination to elevate, modernize and diversify the economy remained the cornerstone of Gruevski’s government until its demise in late 2016. The domestic political crisis which emerged in early-2015 plagued this objective and potentially slowed-down the pace of new companies entering the economy. The full non-transparency of how much public money has been spent for this policy, though justified with the need for tailor-made approach to each incoming company, populated the public debate over the crisis, frequently unjustly politicized with the issues of the level of wages and workers’ rights in the MNCs.

The new left-wing government led by Zoran Zaev, which took office in June 2017, did not dismantle the FDI attraction policy as vehicle and model of growth and job creation, despite with much more heterogeneous voices inside and less ambition manifested. Soon, however, after the costs of “Invest in Macedonia” were made public and the spending on marketing to attract FDIs in all forms was abolished, FDIs were again put a key contributor to growth and job creation in the “Plan for Economic Growth 2018-2020”. The novelty was that the Plan put at least equal weight on domestic companies and all costs born for the program were made transparent. An important and distinct feature of the Plan was that it recognized the importance of how MNCs root into the domestic economy and the need to support this process.

FDIs are considered a driving force of transition economies: many countries – the Vishegrad and Baltic groups, as well Ireland – followed the “FDI path” of development and achieved significant results. Similarly, FDIs are considered to have positive impact on exports growth and diversification, strengthen industrial base and economic growth, and foster employment. Box 1 provides the FDI experience of the Vishegrad countries in more detail. In general, FYR Macedonia is not an exception in terms of FDIs' effects. Between 2007 and 2017, the average FDI inflow in FYR Macedonia has been about 3.4% of GDP, although lower than the other countries in the region. Compared to the period before, the structure of FDIs, impacting economy's structure also changed: presently, 50% of total FDIs are concentrated in the manufacturing and mining sectors, according to NBRM data. Half of the total export originates from MNCs operating in FYR Macedonia (Ramadani et al. 2017). According to own calculations based on NBRM data, the export diversification almost doubled: the Herfindahl index reduced from 14.3% in 2005 to 9.6% in 2015, indicating increased competition on the market. A recent IMF study (2016) found that one percent increase of FDI inflows will increase the real per capita GDP of the country by about 0.5 percentage points per year. Similarly, own study (FISCAST, 2016) finds a positive net benefit of FDIs for the economy. According to the data supplied by the Directorate for Technological Industrial Development Zones (DTIDZ), FDIs in the country created over 12.000 direct jobs.

Apart from the direct impact, FDIs could provide indirect benefits through building linkages between Multinational companies (MNCs) and domestic small and medium enterprises (dSMEs); technology and skills transfer; and improvements in productivity and competitiveness in the overall economy. In FYR Macedonia, these linkages have been quite limited. According to the latest Global Competitiveness Report 2016-17, FYR Macedonia ranks 89/135 on FDI and technology transfer; 67/135 on firm-level technology absorption; 62/135 on value chain breath; all against the significant business-climate improvement (10th of 190 places on Doing Business of the World Bank). Moreover, no progress is noted in the "FDI and technology transfer" between 2011 and 2017, while the categories "firm-level technology absorption" and "value chain breathe" note an improvement of 18% each, over the same period. The potential for improvement could be even higher if particular efforts are put and

[1] Herfindahl index (HHI-score) is an indicator for the amount of competition existing within an industry. Increase of the Herfindhal index indicates lower competition and higher market power, whereas decrease of the index indicates the opposite.

specific program is organised to intermediate between MNCs and dSMEs in order to influence the inclusion into supply and value chain.

MNCs in FYR Macedonia are lightly sourced in the domestic economy. Less than 10% of their total liabilities have been generated toward domestic companies (FISCAST, 2016), which amounts to negligible 46 million EUR in 2015, which compared to the overall exports of MNCs (cca. 2 billion EUR in 2015) is substantially negligible. IMF (2015, p.11) identified the main reason for such situation to be the inability of dSMEs to meet the technical and safety EU standards and requirements. Similarly, the EU Progress Report for FYR Macedonia, 2015, identifies the large differences in the technological levels of the domestic and foreign firms as reason for lack of any measures undertaken so far for MNCs' sourcing in the domestic economy. The value chain supply for the SMEs is even in a worse condition. In general, SMEs participate with only 36% in national export against over 90% contribution to GDP; they mostly export to neighbouring countries, suggesting that their export capacities for countries requiring higher standards are limited. DSMEs also face low investment in innovation and Research and Development (R&D), and consider the need for new technologies and knowledge capital as minimal or even non-existent. The capacity of the domestic sector to innovate has been ranked 91/135 and 62/135 on the SMEs' spending on R&D. Hence, there is a large gap between domestic capital stock and MNCs focused on higher productivity, technology and standards.

Apart of the gaps in the value chain, soft infrastructure and skill development, there is lack of transfer-knowledge mechanism from MNCs to dSMEs, as well information asymmetries. Technical and managerial skills are considered key factors of a country's integration into global supply chains by the IMF study (2016). Moreover, the occasions to bridge information deficit and build network capital between dSMEs and MNCs are rare. Several associations have been established in the automotive industry and metal & electricity industry with an objective to organize joint events between domestic companies and MNCs. Still, the partnerships between both sides are built very slowly. Around 500 domestic companies already collaborate with the MNCs, with a total turnover of 50 million Euros per year . Partially, the reason is the

[2] Statement by the Minister of Finance (2017). Available on: http://vlada.mk/?q=taxonomy/term/4&page=8&ln=en-gb

insufficient information about demand and supply of services, as well "who is who" on the market and the incapability of dSMEs to present themselves to MNCs .

This policy study aims to understand the gaps and potentials for inclusion of dSMEs into the supply chain of the MNCs operating in FYR Macedonia. It is based on primary-collected data through surveys with domestic and multinational companies that operate in the country, accompanied by a context analysis through interviews and focus groups.

The paper is organized in the following manner. Section 2 presents stylized facts about the foreign direct investment in FYR Macedonia. Section 3 presents the methodology of the conducted research and analysis. Sections 4 and 5 present the results of the current cooperation, potentials and gaps for cooperation between dSMEs and MNCs. Section 6 provides conclusion and summary of the main recommendations.

[3] Statement by the Director of the TIDZ (2016)

Box 1: Visegrad countries and the FDI inflow

Foreign direct investments (FDIs) have been considered very influential for transitional economies, including Visegrad countries, (Poland, Czech Republic, Hungary and Slovakia) in the past 20 years (Hintosova, Kubikova, Rucinsky, 2016; Czerniak and Blauth, 2016; Fifekova and Nemcova, 2015, Szent-Ivanyi, 2017; Szent-Ivanyi, 2017a). FDIs in these countries endorsed better transition to the global economy. The positive experience of the FDIs in Visegrad countries could not have been achieved if it was not due to the promptness of implementation of economic reforms in each country - privatization of state assets and scale of investment incentives offered (Fifekova and Nemcova, 2015). FDIs helped the integration of these countries into global supply chains and helped in transitioning within these supply chains to higher value-added activities. FDIs helped in developing new sectors and replaced declining traditional sectors which on the other hand strengthened their competitiveness and improved the resilience to shocks. This was achieved with a better distribution among sectors (Fifekova and Nemcova, 2015; Czerniak and Blauth, 2016, Roaf et al. 2014).

In terms of productivity, FDIs in the Visegrad countries have improved the areas of total factor productivity growth and performance. Roaf et al. (2014) argue that Greenfield foreign direct investment played a key role in inciting a self-enforcing cycle of fast productivity convergence. The increased capital and adoption of new technologies from the foreign investments, improved the Polish economic growth, on an average of 3% of GDP per year, especially in the increase of annual productivity per employer (Czerniak and Blauth, 2016).

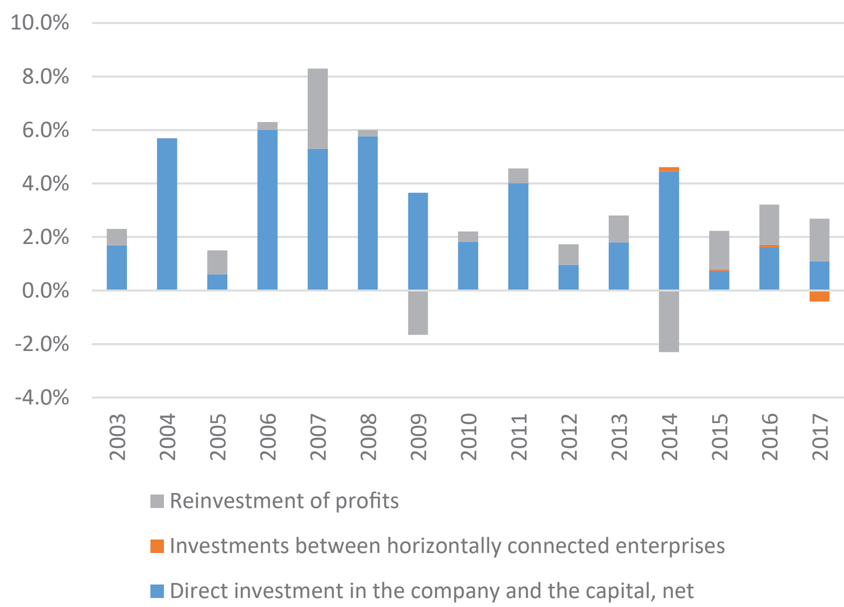
Additionally, foreign direct investments in the Visegrad countries had a significant impact in accelerating higher levels of technological performance (Fifekova and Nemcova, 2015). Namely, Greenfield investment offered transfers of technology which contributed to rapid economic growth of the countries (Rauf et al. 2014). Czerniak and Blauth (2016) note that Polish companies could not have moved so rapidly in the global value-added chains if it was not due to FDIs that motivated domestic businesses to allocate a significant part of their revenues in technological innovation. Polish companies that were passed into foreign ownership increased their value added at a rate of 2.2 percentage points a year faster than the rest (Czerniak and Blauth, 2016). Furthermore, foreign direct investments in the Visegrad countries offered essential know-how transfer, managerial and marketing skills, and transfer of knowledge (Fifekova and Nemcova, 2015; Czerniak and Blauth, 2016; Rauf et al. 2016). This motivated a cycle of fast economic growth driven by job creation and expansion of operations. Czerniak and Baluth (2016) argue that one of the most beneficial aspects of the Polish economy has been the labor market where FDIs contributed with an 8.9% increase in wages, 8.5% to employment and reduced income inequality by around 5%.

However, Visegrad countries do face challenges regarding their FDI. In the past, they relied on export-oriented assembly lines and cheap yet skilled labour force. Currently, this competitive advantage is decreasing, mainly because these countries experienced high wage increase, severe rise of cheaper manufacturing in other locations and mass emigration (Czent-Ivany, 2017). As a result, the Visegrad countries have focused more in upgrading FDI activities in areas which produce higher value-added products and services, which in turn require more skilled labor (Gereffi et al. 2005; Szent-Ivany, 2017a). In resolving these challenges, the Visegrad countries have promoted schemes for MNCs already present in the region in order to grant their subsidiaries new mandate, regardless of the tasks of simple assembly such as procurement, logistics or R&D (Szent-Ivaniy, 2017). There are two main focuses that Visegrad countries take into account towards the FDIs. First is incentivizing new FDIs with a higher value added than what is already present, and second is promoting upgrades among the investors already present (Szent-Ivaniy, 2017).

2. Stylized facts on FDIs in FYR Macedonia

Over 10 years, on average, FYR Macedonia has benefited 264 millions of euros or 3.5% of GDP annually from foreign direct investment inflows (Figure 1). One of the reasons for this has been the new policy and strategy for attracting foreign direct investments introduced by the government in 2007, accompanied by a new Law enforced on technological-industrial development zones, so called Free Economic Zones (FEZ). The peak has been recorded in 2007 when FDIs were 8.3% of GDP. Then, the size of FDI inflows varied, mainly due to interacting with the effects of the Global Financial Crisis 2007-2011 and the European Sovereign Crisis 2012-2013.

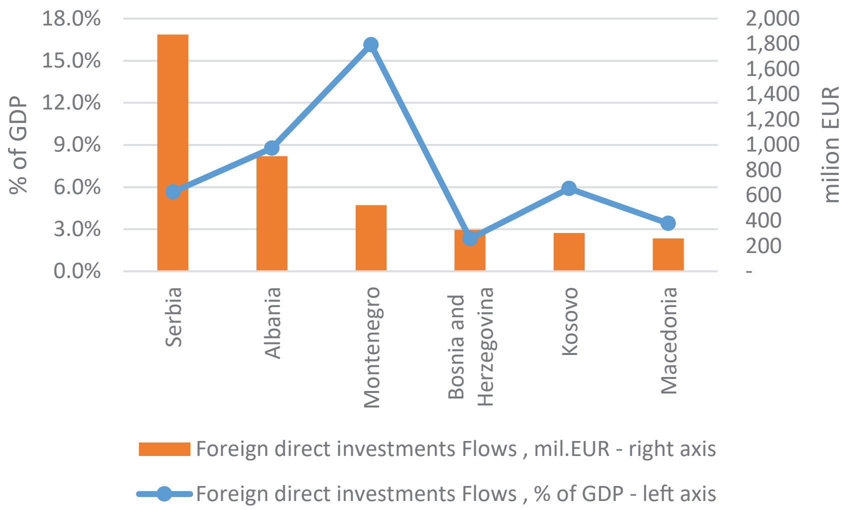
***Figure 1*: Direct Investments by type, % of GDP**



Source: National Bank of Republic of FYR Macedonia

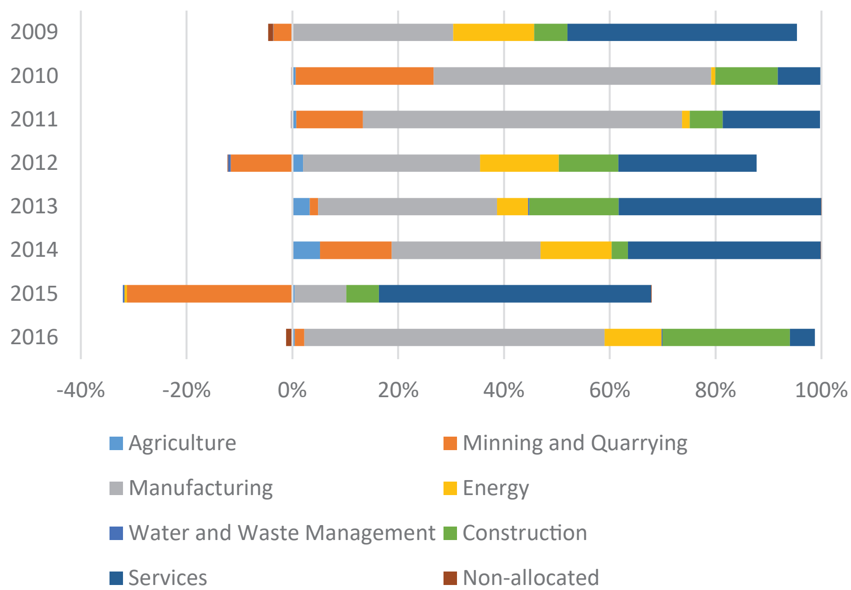
FYR Macedonia recorded the lowest inflow of FDI (260 million of euros) compared to the other Western Balkan countries (Figure 2). In relative terms – which are more suitable for such comparisons, FYR Macedonia again stands among the countries with lowest share of FDI in GDP (3.4%), with only Bosnia and Herzegovina being behind (2.3%). On the other hand, Montenegro tops the list, with 16.1% FDIs of GDP, annually, mainly being dominated by Russian real estate investments in tourism, followed by Albania (8.8%), Kosovo (5.9%) and Serbia (5.6%).

***Figure* 2: Average foreign direct investments Flows in Western Balkan countries (in millions of euros) and (as % of GDP), 2007-2017**



Source: Author's calculation, Data on FDI flows from National Banks of the respective countries, Data on GDP at market prices from Eurostat

***Figure 3:* Share of FDI according to industry sector**

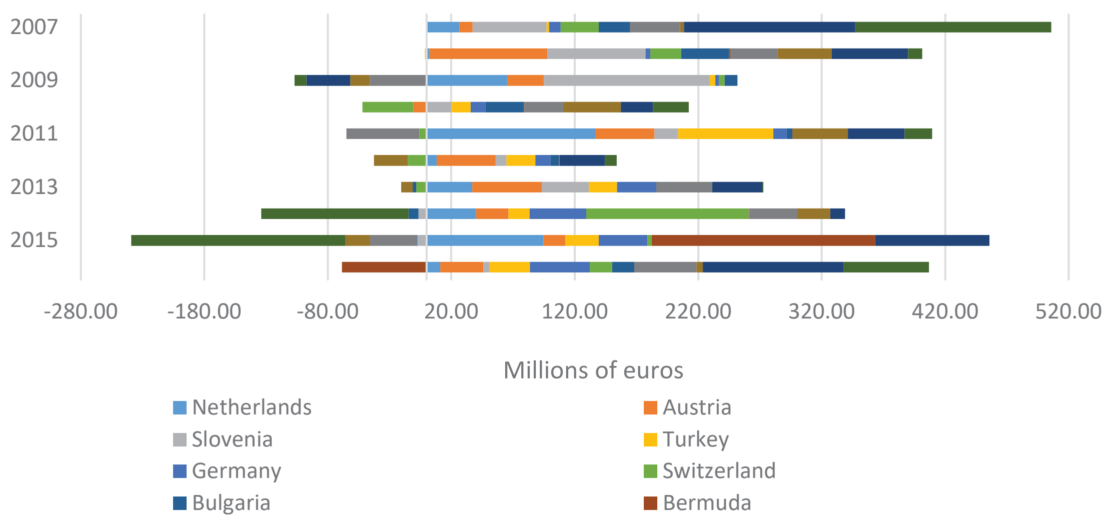


Source: Author's calculation, data from National Bank of FYR Macedonia

Figure 3 presents FDIs distribution by sector in FYR Macedonia. The manufacturing sector appeared to be the most attractive sector for foreign investors in the past 8 years (42.3% of the total FDI inflows on average). The main driver of these investments has been the vehicles & other transport equipment industry, with an average share of 74.5% of all total foreign investments in the manufacturing sector. Other significant drivers of FDIs have been the service sector (41.5%) and the construction sector (12.7%). The service sector is mainly led by the wholesale and retail trade on repair of motor vehicles and motorcycles, along with the financial and insurance services. There has also been a tendency of disinvestment or reverse investment in the mining and quarrying sector that on average has amounted to a loss of 11 million of euros. Inflows from foreign investors in the other sectors fluctuated over the years.

Figure 4 presents the FDI flows by investor country. Six countries out of the top 10 are investor countries from the European Union (including United Kingdom), where Netherlands (42.2 million of euros), Austria (35.7 million of euros) and Slovenia (34.9 million of euros) recorded the highest investments in FYR Macedonia, on average, in the past 10 years. An important note is that Bermuda and St. Vincent and Grenadines fall in the top 10 investment countries, with an average of 11.4 and 9.8 million of euros respectively, in the analyzed period. Additionally, the largest decline in investments or disinvestment in the past few years has been recorded to be from the Bermuda, and from the rest of the World (countries not in top 20). In 2014 and 2015, FDIs from the rest of the world have recorded a 119.2 and 173.3 million of euros' decrease, respectively. Moreover, while Bermuda has recorded one of the highest FDI flows in FYR Macedonia for 2015 (181.1 million of euros), it also recorded the only disinvestment in FDI for 2016 (68.6 million of euros). Given that Bermuda and St. Vincent and Grenadines are globally known as offshore tax havens for international investors, this means that foreign investors and international investment funds funnel money to FYR Macedonia through these two havens in order to avoid international tax burdens.

Figure 4: **FDI flows by investor country per year**



Source: Author's calculation, data from National Bank of FYR Macedonia

In absence of data for the exports and imports of foreign direct investors and their influence, we use the conclusions from a research conducted by the National Bank of FYR Macedonia for the foreign direct investors in the technological-industrial development zones (TIDZ). Ramadani et al. (2017) state that the value added by the companies in TIDZ is constantly growing, reaching 240 million of euros in 2016. Moreover, the value added by these companies in the total value added in the economy in 2016 is about 3%. The authors argue that these companies registered a positive trade balance, where this tendency has intensified in the last three years (2014, 2015 and 2016). In the period between 2008 and 2016, companies in TIDZ averaged 21.8% of the total exports in the country. Hence, the total export of goods from these companies has been constantly increasing until 2016, reaching 47.1% of the total exports, whereas in 2017 a slight decrease is recorded to 40.7% of total exports . On the other hand, the net export of the companies in TIDZ between 2011 and 2013 averaged 0.6%, and significantly increased in 2016, reaching 3.8% of GDP. The study argues that as a result, the growth of exports of the companies in TIDZ is the main driving factor for the growth of the overall export activity of the country.

[4] Data from DTIDZ

Contrary, the share of imported goods and equipment by the companies in TIDZ has been also continuously growing, although with a lower rate compared to the growth of exports. Imports by these companies averaged 13% of total imports in the economy, reaching 27.3% and 25.7% of total imports in 2016 and 2017, respectively[5]. Though true, Ramadani et al. (2017) argue that the lower rate of growth in the imports also implies a continuous decrease in the import component of the export, i.e., constant growth in the value added of the export of goods. This tendency improves country's overall trade balance, which although still negative, decreased during the years. Additionally, it is important to mention that the structure of the exports of the companies in TIDZ significantly differs from the country's traditional export structure. The export of these companies is dominated by products of the chemical industry and equipment and machinery as well as export of vehicles. This structure indicates favorability of products with higher degree of processing which tend to be resistant to stock exchange shocks. This also helps in diversifying the exports and reducing the vulnerability of price shocks. On the other hand, imports of the TIDZ' companies tend to be driven by the demand or the need for raw materials, such as metals and equipment and machinery. One explanation for this can be found in the inadequate (as well frequently inexistent) supply of the required raw materials for their economic activities in FYR Macedonia.

[5] Ibid

Box 2: Projects to improve FDI impact in FYR Macedonia

Several projects have been implemented in FYR Macedonia to tackle the issues of competitiveness, FDIs and linkages of FDIs with domestic companies. The first project, USAID FYR Macedonia Competitiveness Project (MCP), was implemented and conducted by CARANA Corporation[6]. The project helped Macedonian companies and sectors respond to the opportunities and challenges of the global market with targeted interventions in market development, access to finance, workforce development, and innovation. The project's key outcomes were: (1) creation of market linkages with international companies that resulted in new export deals and strategic partnerships involving joint business ventures, (2) investment and knowledge/technology transfer, new foreign investments (greenfield, brownfield and joint ventures) which led to export oriented job creation and improvement of supply chains and industries, (3) Macedonian companies improved profitability, competitiveness and market share through investments in capacity expansion, productivity and product development, (4) domestic companies became certified and adopted modern technologies and practices in order to increase their credibility to foreign partners (Macedonia Competitiveness Project, 2012; Snelbecker et al. 2010).

World Bank implemented two Programmatic Competitiveness Development Policy Loan (DPL 1 and DPL 2) projects. The two projects supported four pillars: (1) Developing high value-added manufacturing, (2) Facilitating the restructuring of the agribusiness sector, (3) Improving the efficiency of trade logistic services, and (4) Establishing enabling conditions for labor market flexibility and skills development. These two projects helped to maximize the impact of government interventions to stimulate Greenfield investment in advanced manufacturing plants and enhancing the support to exporters so that local firms can become more closely connected to global firms and markets. Additionally, the projects improved the efficiency of trade logistic services through upgrading the trade logistic sector (Implementation Completion Report Review, 2016; Implementation Status and Results Report, 2014).

With the joint effort of the International Bank for Reconstruction and Development (IBRD) and the International Finance Corporation (IFC), World Bank designed a pilot Supplier Development Program (pilot SDP) at the request from the Macedonian government, with the objective to facilitate linkages between local SMEs and large foreign companies operating in country. The program used targeted and

[6] Macedonia Competitiveness Project: http://www.carana.com/index.php/projects/79-europe-and-eur-asia/319-macedonia-competitiveness-project [Accessed date: 12.04.2018]

coordinated interventions to increase the sophistication of local SMEs, in order to help them compete more effectively, and integrate into the global and regional supply chains of the large foreign companies located in and outside the TIDZs. The key lessons for furthering such a program have been the following: (1) it is important to define the scope and budget for the expected activities, (2) large SDP is required to be implemented at least for two years in order to see tangible results and improvements in participating companies, (3) one institution must be responsible for implementing the program in order to have better collaboration with key stakeholders, (4) well targeted selection of MNCs and local potential suppliers and (5) the institution must ensure provision of appropriate government consultancy support in customized and straightforward way for participating SMEs (Supplier Development Pilot Program, 2017).

3. Methodology and data

This study is based on mixed method approach, including: i) semi-structured interviews, ii) focus group and iii) online surveys. Sayer (1992) generalizes the reason for conducting qualitative research by mentioning that although quantitative data deals with numbers, qualitative data deals with meanings, which are expressed through language and action that create perceptions. Patton (1980) examines another difference between quantitative and qualitative data, where the latter is freely defined by the subject instead of being pre-designed by the researcher. The benefit of such a research is that the data, their length, detail, content and relevance is not determined by the researcher, but it is recorded as spoken or as it happens, usually in the form of notes or tape recordings (Dey, 2005). It is important to mention that both methods allow to generate context analysis for the research and ground basis for creating online surveys distributed to MNCs and dSMEs in the latter stage of the research. The online surveys, however, have had the task to gather quantitative data by using larger sample of companies (domestic and multinational), in order to produce accurate and detailed analysis on the linkages between dSMEs and MNCs in the country. Worth to note, none of the three methods aims at exhaustiveness or representativeness; contrary, it aimed to have sufficient variety, so as to enable quality insight into contexts in which the MNC-dSME relation happens (or the lack of).

In turn, we explain the specifics of each method used.

Two rounds of interviews are conducted. The first round is conducted with stakeholder organizations, followed by a round of interviews with representatives of MNCs operating in the country. In the analysis, as stakeholder organizations are referred organizations with high expertise in the topic, such as Economic Chambers, International organizations, Business confederation, policymakers, Direction of the technological industrial development zones and relevant policymakers. Whereas, as multinational companies are referred majority-owned foreign investment enterprises. For the first round, individual interviews are conducted with representatives from nine stakeholder organizations from diverse backgrounds. Along with the open-ended questions, interviewees have been asked to share their general opinion for the business sector in Macedonia and recommendations for improvement. Interviews with MNCs are conducted in the same manner as the ones with the stakeholder organizations. Thus, the second round of interviews have been held with eleven MNCs, randomly selected – with regards to keep diversity in the industry (automotive, agriculture, textile etc.), location (in or out of TIDZ) and type of investment (greenfield, brownfield or other). From the interviewed MNCs, six are greenfield investments located in TIDZ Skopje, TIDZ Ohrid and TIDZ Stip, one is a greenfield investment located outside TIDZ in the area of Skopje, two companies are acquisitions from an already existing domestic companies in Skopje and Ohrid, one is a brownfield investment in the area of Prilep, and one company is other type of foreign investment located in Skopje.

The research methodology includes conducting a focus group with domestic SMEs. As domestic SMEs are referred domestic small and medium enterprises that are non-subsidiary and independent companies with less than 250 employees and not exceeding EUR 50 million annually (OECD definition, EU standards). The aim of the focus group is to discuss in-depth the gaps and potentials in the cooperation with MNCs from the perspective of the domestic companies. The discussion has been conducted according to a previously designed questions and agenda. Focus group participants are selected mainly from the manufacturing dSMEs based on the type of their manufacturing process (chemical, metallurgy, food production etc.) and established cooperation with MNCs (already cooperating with MNCs, in a process to cooperate and dSMEs that are not cooperating). Therefore, five dSMEs have been present on the focus group, out which two have successfully established cooperation with MNCs, one has been starting a negotiation process for cooperation, and two companies that were export-oriented and have had some experience with MNCs in the country but were not fully cooperating with them. Additionally, banking-sector and government representatives have been also attending the focus group.

Finally, two surveys are conducted, one for MNCs in the country and another for dSMEs. The survey for MNCs covers 26 questions, divided in two parts: a general part with basic company information questions (location, sector, number of employees, type of investment, etc.) and part with specific questions about the gaps and the potentials for cooperation with domestic companies. The second part is composed of questions relating to: type of purchases products/services/machines and sector in which suppliers operate; procurement policy of the company, cooperation with domestic companies and procurement by type of product of dSMEs; advantages and disadvantages of cooperation, main gaps and potentials in the cooperation; reasons for not having an established cooperation; and type of policy measures needed for cooperation improvement. The questionnaire is electronically and physically distributed to more than 100 identified MNCs in the country, from different sectors, location and type of investment. The survey sample is composed of 23 individual answers from MNCs that operate in manufacturing, finance, services and agriculture sector. The survey for domestic companies is composed of general questions similar to those for MNCS; and 22 specific questions related to their capacities for production, technological development and standardization, and experiences in cooperation with MNCs, as well their perspectives on gaps and potentials for cooperation. The online questionnaire is distributed to over 200 SMEs in the country and has been answered by 37 companies that operate in manufacturing, construction, services and financial sector. We consider the response rates of 23% and 19%, respectively, to have provided sufficient ground for generalization of the responses.

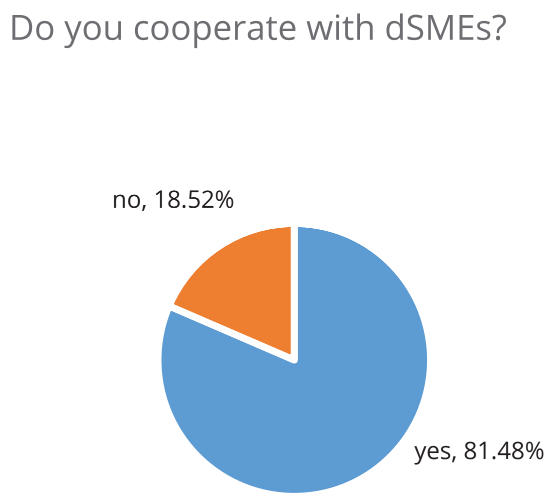
4. Cooperation and potentials for cooperation between dSMEs and MNCs

In this part of the study, we analyze the current cooperation and potentials for cooperation between dSMEs and MNCs that operate in the country from three points of view: (i) the stakeholders', (ii) the MNCs' and (iii) the dSMEs' ones, taking into consideration the type (greenfield or brownfield) and the sector of investments.

4.1. Existing and potential cooperation: brief overview

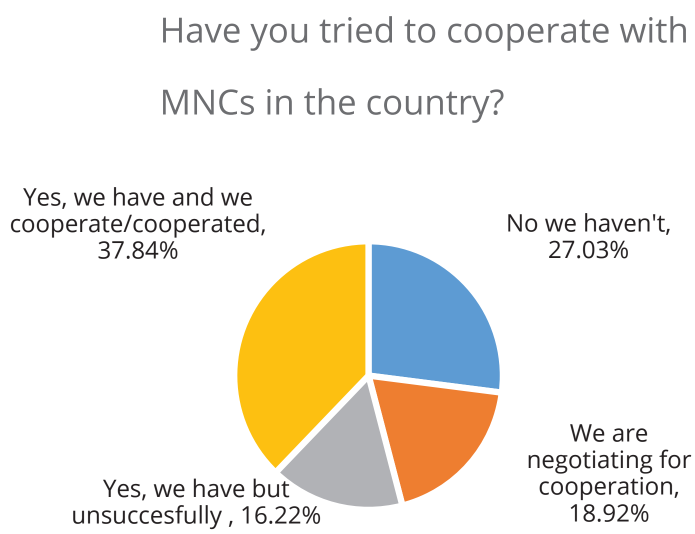
There is an evident established cooperation between dSMEs and MNCs in the country. **81.5% of MNCs** in the country answered they **cooperate or have cooperated with dSMEs**, compared to **18.5%** that **have not established any kind of cooperation** (*Figure 5*). Even though significantly lower, 37.8% of dSMEs have approached at least one MNC and successfully established cooperation with, compared to 27.0% that have not done so *(Figure 6)*. Moreover, 18.9% of dSMEs are in the process of negotiation for cooperation, whereas only 16.2% of them have reported an unsuccessful cooperation with MNC, such as failed negotiations, interrupted cooperation due to failure to comply with the agreed terms etc.

Figure 5: **MNCs' perspective on cooperation with dSMEs**



Source: Results from the questionnaire conducted with MNCs in the country, April-May 2018

Figure 6: **Domestic SMEs' perspective on cooperation with MNCs**



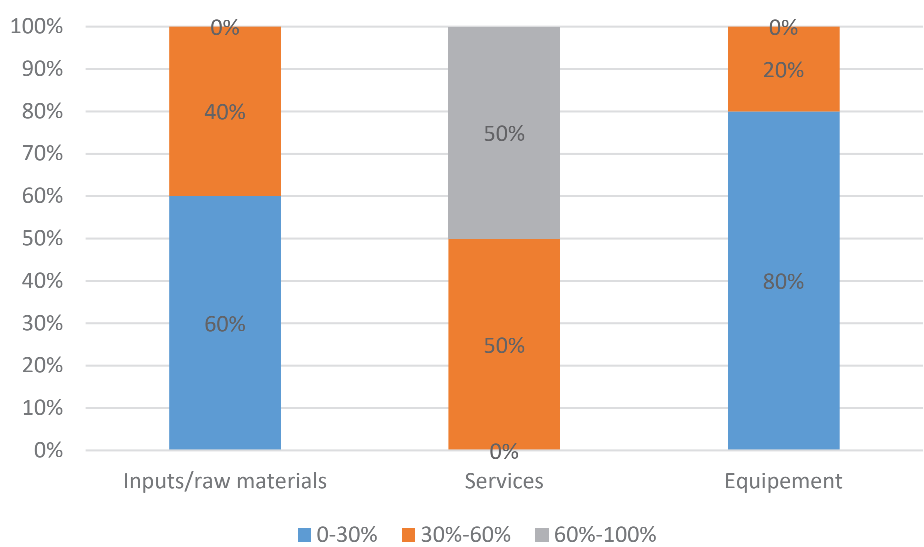
Source: Results from the questionnaire conducted with dSMEs', May -June 2018

The **benefits of cooperation with domestic suppliers** identified by MNCs include: fast delivery due to proximity with suppliers, lower transportation and logistics costs, better communication due to the direct contact with the suppliers, easy and fast procedures etc. On the other hand, dSMEs benefit from the cooperation by expanding their production and business operations, and by becoming technologically advanced and certified producers. The analysis identified some factors for successful cooperation. According to MNCs, the main factors that affect cooperation are good product quality, competitive price and on-time delivery. Additionally, business confidence and good communication among the parties is essential. On the other hand, dSMEs require greater openness of the MNCs, less strict requirements and on-time payment with shorter payment period.

MNCs identified a number of industries as their main suppliers (domestic and foreign), such as ferrous and non-ferrous metallurgy, machinery, automotive and electrical equipment industry, packaging industry, textile industry, agriculture etc.

Noticeably, almost 70% of MNCs have their main suppliers from the machinery, automotive and electrical industry. Significant role is also assigned to the suppliers from the agriculture and chemical industry, by 20% and 15% of MNCs, respectively. These suppliers are mainly suppliers of raw materials and direct inputs for the production. It is important to mention that these purchases are of high volume and on average represent almost half of the total purchases of MNCs. It is hard to evaluate the quantity of cooperation in terms of share of purchases from domestic companies in total purchases due to heterogeneous and missing answers. Still, some indicative results could be identified *(Figure 7)*. The volume of cooperation with dSMEs in purchasing services is the largest, ranging 30%-100% in total purchased services. On the other hand, 80% of MNCs answered that the share of purchased machinery and equipment from domestic suppliers is between 0% and 30% in total purchases, and none with more than 60%. Similarly, 60% of the surveyed MNCs responded their domestic purchases of raw materials in total purchases ranges between 0% and 30%, and none above 60%.

***Figure 7*: Volume of cooperation with dSMEs**



The above mentioned purchases are consisted of packaging and labeling materials, mostly purchased from local producers, with 75% of the purchases. Significantly lower, but still important are domestic purchases of metal connectors and fertilizers. However, it is evident that the share of purchased services from domestic suppliers in total purchased services is significantly higher than purchased raw materials or main inputs. Thus, service providers are companies from the construction and real estate industry, oil and energy providers, ICT services, maintenance, catering, consulting, transport and logistics. Expectedly, services such as construction and real estate (71% of total service purchases), catering services (63%) and legal and administrative services (56%) are the categories that are almost fully purchased locally. The machinery and equipment purchases represent lower percentage of the total purchases of MNCs. Most of them use massive production lines, including assembly lines and SMT (surface-mount technology) lines. Additionally, for their production, MNCs use injection molding machines, packaging machines and automatic crimping machines. The equipment used by MNCs is technologically advanced and it cannot be found nor purchased locally. However, what MNCs purchase locally are spare and other steel parts, various IT equipment such as computers, software and other machinery and equipment.

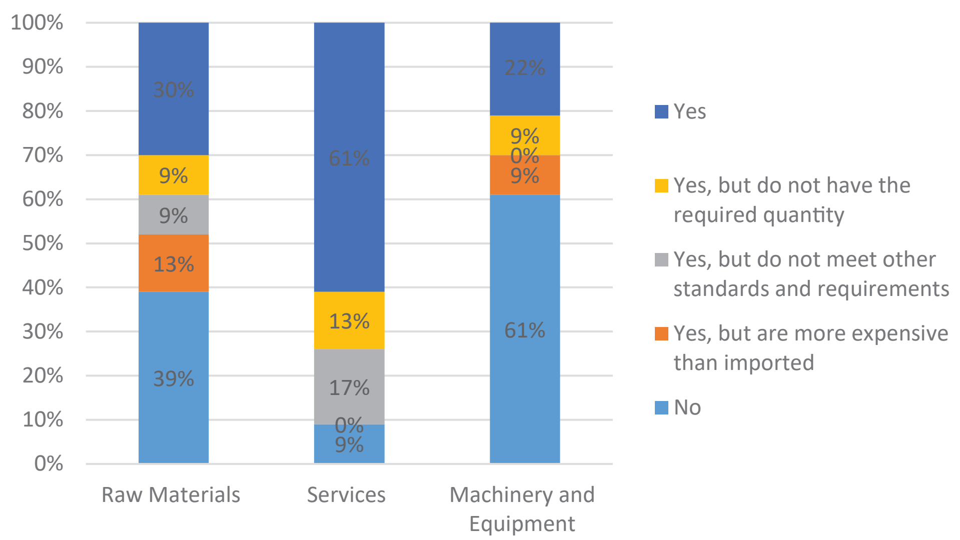
4.2. Obstacles to cooperation

The possibility for cooperation and satisfying the need for procurements in certain sectors/products is largely determined by the **likelihood for the foreign companies to find the products and a supplier for the requested products locally**. Therefore, there are differences in the type of procured products: raw materials, machines or services. When asked, *"If the products / raw materials, machines, equipment and services you procure can be found in the country?"* 61% of MNCs responded they could find the services they purchased in the country (*Figure 8*). Additional 13% could find the services, but the quantity was limited, while 17% considered that offered services did not satisfy required standards. Only 9% responded the services they were looking for could not be found in the country, while the price of the offered services is not considered as limitation (or it is adequate). Overall, the potential to find required services locally amounts to 91%, out of which a third mainly requires interventions in the standardization of the service provides and increasing the quantity of the services offered.

In the same line, with lower percentages though, 30% of MNCs reported they could find the required raw materials, while additional 31% reported they could, but with various limitations. The higher domestic than imported prices stands as a key obstacle (13%), followed by insufficient quantity and standardization (9%, each). Overall, a 61% potential to find a raw material locally undoubtedly suggests that the potential for local procurement of inputs for production – specifically, raw materials and services – is prevalently large, or large enough to provide for linking dSMEs with MNCs.

On the other hand, and expectedly, the potential for local purchase of machinery and equipment is considerably limited, as 61% of MNCs clearly reported they could not find the required input on the local market.

***Figure 8*: Responses from MNCs if they could purchase the required raw materials/services/machinery and equipment in the country**



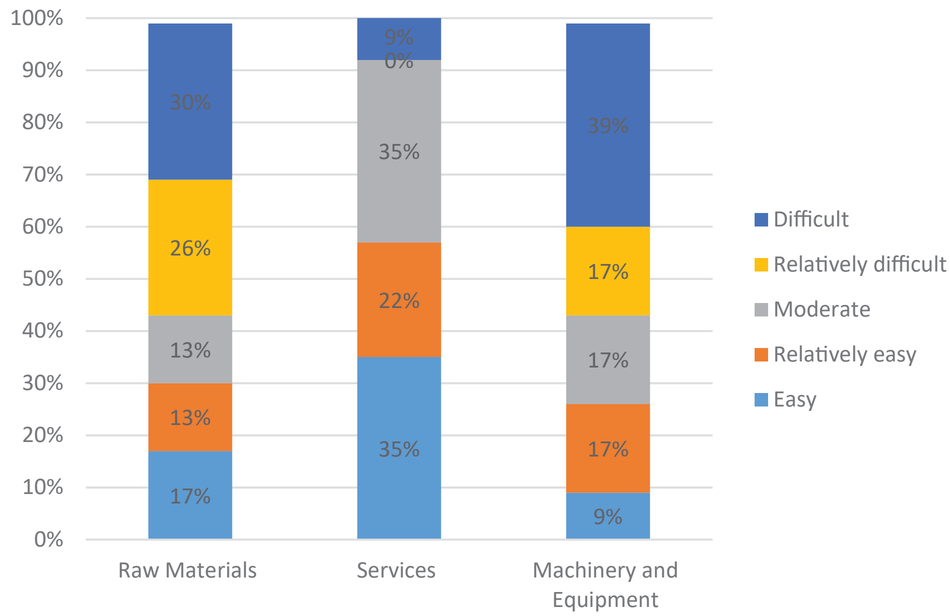
Source: Results from the questionnaire conducted with MNCs in the country, April – May 2018

Figure 9 evaluates the easiness with which MNCs could find suppliers locally. We assume that it is not only important to have certain supplier on the market, but to have reasonable transaction cost for accessing the supplier in the broadest sense of the word. 92% of MNCs reported they could easily, relatively easily or moderately easily find a supplier in the country for the procurement of services. The figure corroborates the 91% availability of the required services observed on *Figure 9*. It validates the **large potential for increasing cooperation and providing full supply of services from domestic suppliers in the short run**.

On the other hand, 43% reported they could easily, relatively easily or moderately easily find a raw material on the domestic market. There is a **gap between the easiness** (43%, *Figure 9*) and **the availability** (61%, *Figure 8*) of raw materials domestically, potentially suggesting that despite availability there are other obstacles and inhibitors which deter MNCs to purchase raw materials domestically.

In the same lines of *Figure 8*, MNCs have considerable difficulties to find local supplier for machinery and equipment. Only 26% can find them easily or relatively easily, compared to more than half (56%) which found it difficult or relatively difficult to find a supplier of machinery and equipment in the country. This indicates that, in contrast to the services, the cooperation for supply of machines and equipment would require larger and potentially **costly interventions and investments**.

***Figure 9*: How easy MNCs can find the required raw materials/services/machinery and equipment in the country**



Source: Results from the questionnaire conducted with MNCs in the country, April – May 2018

According to a banking sector representatives, the potential exists for the SMEs [to link with MNCs, n.b.] only if they are price competitive and increase their production efficiency. Additionally, MNCs suggest devising and setting high standards in the business sector will create the so called 'domino effect', meaning, companies that have already implemented technical standards will become more successful and will motivate the smaller companies to do so. This will create a clear distinction between companies which should stay and which should not stay in business.

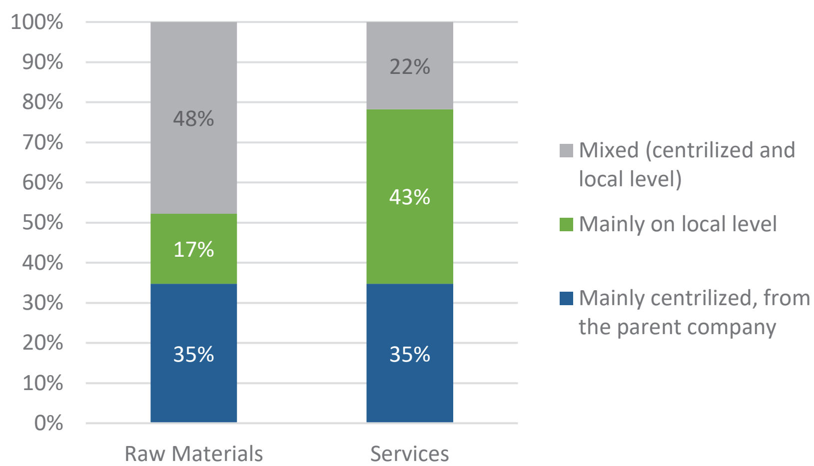
Hence, the main conclusion is that there is a **fairly large potential for cooperation, especially if few key obstacles are overcome: improved standardization and certification of the domestic service providers and increased quantity of services; and price competitiveness and increase of production efficiency of raw materials.** In the medium term, **larger investments** are needed in the production of raw materials, equipment and machinery, despite the latter may be costly until it reaches **import competitiveness.**

At this space, it is also important to mention that the **access to information** for existing domestic suppliers is very difficult. There is **missing unique repository database about the potential domestic suppliers** classified by sector, type of products, production potential, etc. The chambers of commerce do have certain databases of domestic companies, but they are neither easily accessible nor their comprehensiveness and exhaustiveness could be easily assessed. On the other hand, various initiatives attempted to collect such information, along with attempts to create a domestic supplier base, but the systematic, consistent and continuous approach was lacking. Hence, it is important that the government commences creating "institutional memory", with designated government institution will be responsible for publishing and updating this information with the help of the chambers of commerce and other involved stakeholders in this process. Similarly, there is a lack of a single database of information for all foreign investors in the country. Such **inaccessibility to information considerably complicates the potential cooperation and reduces the space for the existing cooperation.** Hence, it is necessary to build an institutional memory on the side of foreign investors too.

4.3. The need for redefined procurement policies

Procurement policy of MNCs in the country has been found an important determinant of the cooperation with dSMEs. On average, 35% of procurements have been made through a centralized decision making procurement policy, regardless of the type of procurement (raw materials or services) *(Figure10.)*However, there are differences in the procurement decision making policy at the local and mixed levels, depending of the type of purchases (raw materials or services). 43% of services procurement decisions are made at the local level, compared with only 17% of product and raw materials ones.

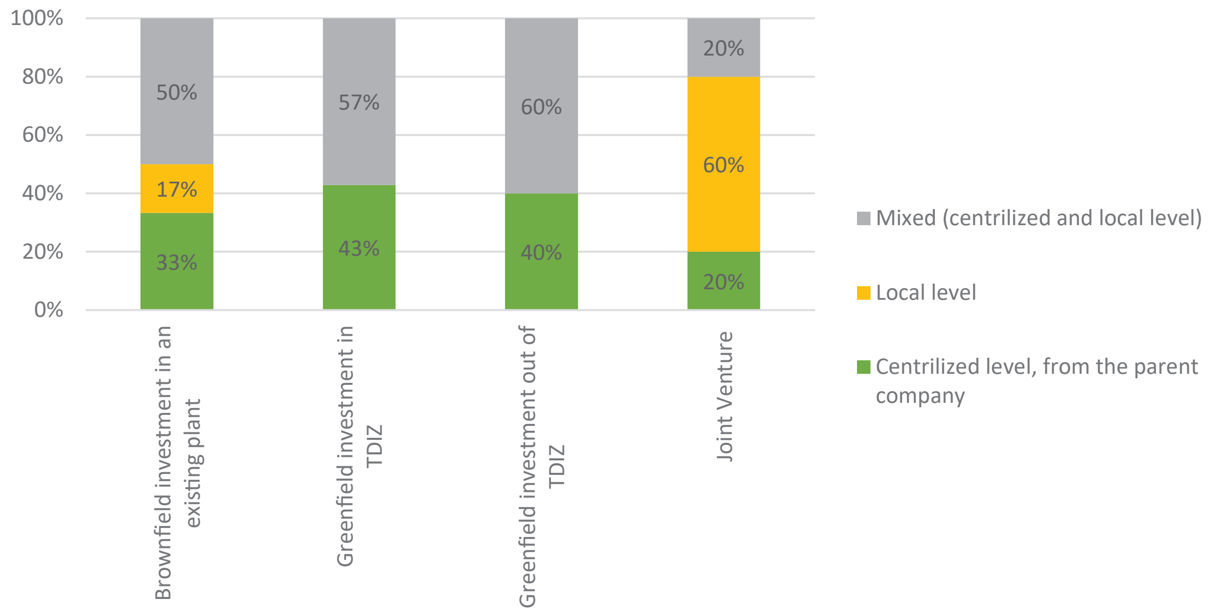
***Figure 10*: Type of procurement decision making policies of MNCs regarding purchases**



Source: Results from the questionnaire conducted with MNCs in the country, April – May 2018

Figure 11 presents the decision for raw materials procurement depending on the type of investment. **Greater potentials for cooperation exist between dSMEs and MNCs operating outside the technological industrial zones,** rather than between dSMEs and MNCs in the zones. According to the survey, 43% of the greenfield investments in TIDZs and 40% of those outside the zones have centralized decision making policy for products/raw materials, compared to only 20% of joint venture investments and 33% of brownfield investments. Thus, **the potential for cooperation in raw materials procurements is larger with MNCs of the brownfield type or joint ventures**, since for these most of the purchase decisions for raw materials are made at local level.

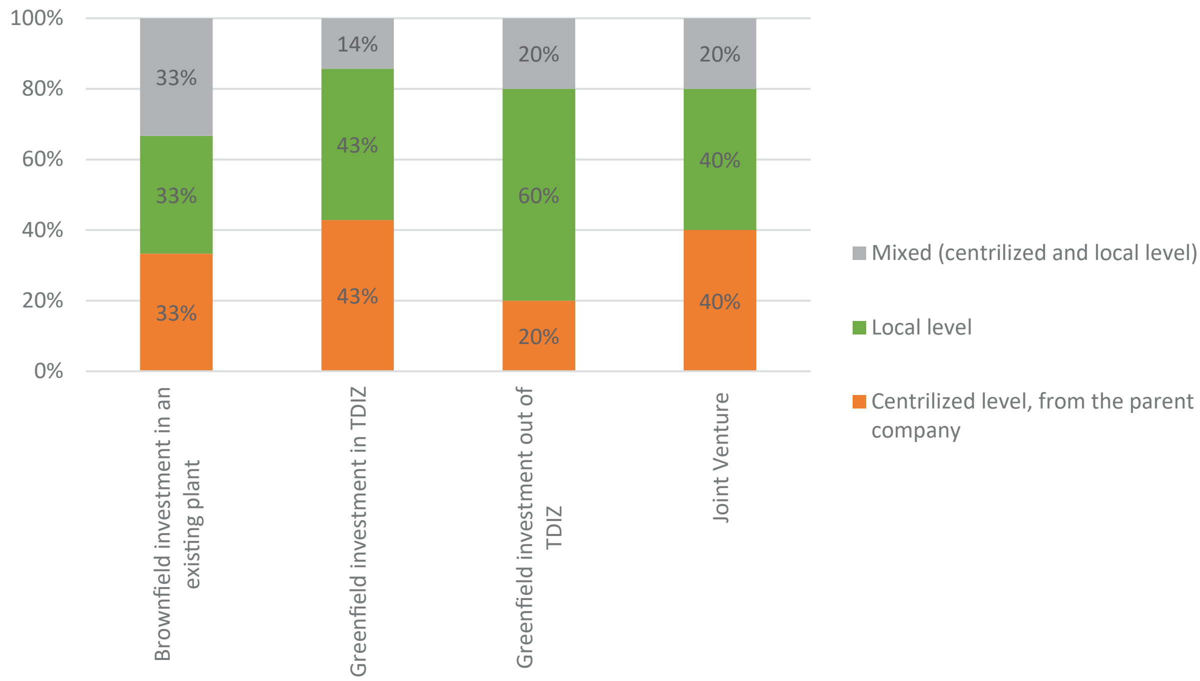
***Figure 11*: Type of procurement decision making policies of MNCs for raw materials according to the type of investment**



Source: Results from the questionnaire conducted with MNCs in the country, April – May 2018

Unlike the case with raw materials, **greenfield investments outside TIDZ have the largest potential for cooperation with domestic service providers,** since only 20% of the decision making process is centralized and 60% is local *(Figure 12)*. This suggests that these companies can easily make choices and change suppliers, as well swiftly add new suppliers in their value chains. The brownfield investments have equally distributed decision making, with 33% centralized and 33% local.

***Figure 12*: Type of procurement decision making policies of MNCs for services according to the type of investment**



Source: Results from the questionnaire conducted with MNCs in the country, April – May 2018

We did not identify significant differences in the procurement decision making process across different sectors. Hence, the potential for cooperation between dSMEs and MNCs in the country could be improved if **procurement decision making policy is shifted from centralized to local level** to the utmost extent possible. In addition, the cooperation with brownfield and greenfield investments outside the zones should be enforced, while attempts to the **greenfield MNCs inside the zones** should be supported by the government, as these are currently the most **closed-for-cooperation** part of the foreign companies in FYR Macedonia.

Box 3: Domestic SME upgrades with the support of a brownfield investor to become their supplier

A brownfield investment in the country has been purchasing packaging materials from several suppliers from abroad for a long period of time. However, these purchases were causing financial burden and additional stock problems due to the large quantities of the order. At the same time, the material was quite sensitive on temperature variation and required special conditions in order to keep its quality. All these factors were affecting the efficiency and effectiveness of the operations of the company.

After a careful review of their existing domestic suppliers, the management of the company approached an existing local supplier with a suggestion/requirement for investment in new technology and capacity. The idea of the foreign investor was to motivate the domestic producer to invest in new production and to start a production of the new packaging materials, with guaranteed further supply to the foreign company, as well potential for supply to other companies in the country.

With the support of the foreign company, the domestic producer visited many international fairs in order to choose the best-fitting machinery and equipment. At the beginning, the investment was small and the capacity was limited, but over time, the company developed at the level to offer and supply the new packaging materials not only domestically but also internationally.

Source: Interview with the management of a brownfield Investment, May 2018.

5. Gaps in the cooperation between dSMEs and MNCs

In this part of the study, we thoroughly analyze the gaps in the cooperation between dSMEs and MNCs that operate in the country. Technological development, standardization and certification, price and production gaps, soft skills and human capital, are the key gaps identified by the three sources of the analysis (stakeholders, dSMEs and MNCs). *Figure 13,* presents the ranking of the main gaps and weaknesses of dSMEs from the MNCs' perspective. The weaknesses are ranked from most important (point 1) to the least important (point 11) one.

***Figure 13*: MNCs' evaluation: Weaknesses of domestic suppliers (1 = most important; 11 = least important)**

Source: Results from the questionnaire conducted with MNCs in the country, April – May 2018

We analyse these gaps as follows.

5.1. Technological development gap

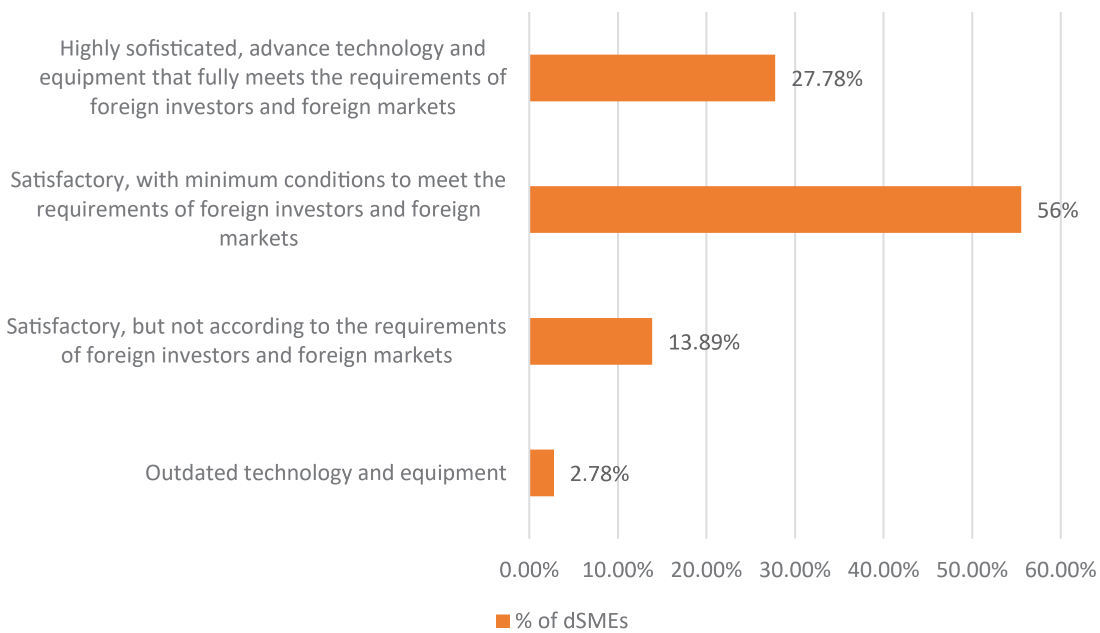
Insufficient technological development and readiness of dSMEs has been ranked as the main weakness by MNCs, having the highest rate of importance on cooperation, 4.2 out of 11. By technological development, in business terms, is meant systematic approach through which a business applies innovation, invention and improved production processes by using digital technologies in its operational activities. Domestic SMEs can undertake significant benefits by using digital technologies, such as better access to new markets, human capital and better communication among the business environment. Moreover, digitalization appear to be powerful tool, for SMEs to scale-up and to introduce new models for growth. [6]

[6] OECD, 2018, Enabling SMEs to scale up. Discussion Paper. SME Ministerial Conference, Mexico City. OECD Publication. Available at: https://www.oecd.org/cfe/smes/ministerial/documents/2018-SME-Ministerial-Conference-Plenary-Session-1.pdf

Many of the MNCs consider that technological development is essential for increasing the competitiveness of dSMEs. However, to keep up with the latest technologies in the business, willingness and readiness for investment is needed and this is something that SMEs in the country do not characterize with. Stakeholder organizations have the same view towards the technological development of dSMEs, saying that there is a lack of advanced and sophisticated equipment. The technological development gap is closely related with the production capacity of the companies, thus by improving their technological support, the production process will become more efficient and the capacity will be increased.

Unlike MNCs and stakeholders, **84% of the surveyed dSMEs consider that their technological equipment is satisfactory or more, and it is in accordance with the minimum requirements of the foreign investors** *(Figure 14)*. Only 2.8% agreed that their technological equipment needs to be fully upgraded.

***Figure 14*: Assessment of dSMEs for their technological equipment and capacity**



Source: Results from the survey conducted with dSMEs, May – June 2018

However, the **lack od attentivness and readiness for investment is evident.** Domestic companies are not ready to invest in new technologies, since they face with high financial risks in terms of illiquidity and cannot achieve sustainability in their sales. As the General Manager of a domestic company from the checmical industry pointed out: *"I personally don't allow investments in new technology for certain productions in my company… in order to afford investments in new technology, we need to achieve satisfactory level of profit, since we have 6000 shareholders and we need to show them gowth and profitability every year and, therefore, we cannot allow ourselves to invest at the same time… we can invest in production that is profitable and therefore bring new and modern technology… but it takes time, it needs to be done step by step."*

Overcoming the technological development gap can be a long process, as MNCs need domestic suppliers that are technologially advanced. However, dSMEs are neither aware of this need nor ready to invest in such development.

5.2. Standardization and certificates implementation gap

The **standardization and certificates implementation has been ranked second most important gap** in the cooperation between dSMEs and MNCs in the country, graded with 4.72 out of 11. "Standard" is generally known as a commonly recognized way of doing something, such as performing a business activity, producing a product, delivering service, managing a process etc. Thus, various certificates are provided to businesses in order to ensure their activities are in accordance with the industry standards. In our case, a gap between dSMEs and MNCs exists due to **not implemented or not fully implemented** standards and/or internationally accepted certificates. There is a mutual agreement among stakeholders, dSMEs and MNCs, that implementing quality standards and certificates in the process of production will significantly increase dSMEs' competitiveness and potential to become part of the MNCs supply chains.

- *"MNCs have quite high requirements for their suppliers and we are aware that for dSMEs to implement them will be a huge investment, but it will pay off."* – Representatives from the Direction of TIDZ.

The type of foreign investment, whether greenfield or brownfield, is not found to make differences in the requirements for standardization and certification. While, the industry sector makes differences in the required standards, as well the rigorousness in the requirements. The perception among interviewed stakeholders is that the automotive industry has the most rigorous requirements for cooperation with domestic companies. Therefore, according to one of the stakeholder organizations, a major cause for the existence of this gap, specifically in that industry, is **not having the IATF 16949 and TS 16949 standards implemented**. IATF 16949 and TS 16949 are International Standards for Automotive Quality Management Systems that contribute to the efficiency & effectiveness of operations, improve customer satisfaction, provide continual improvement of the operations and reduce variation and waste in the supply chain[7]. 23.8% of the surveyed MNCs consider that having implemented IATF and TS standards is essential criteria for a company to become their supplier.

Besides the automotive industry, the tight and strict requirements can be identified in the construction and engineering industry as well. A multinational construction and engineering company, operating in FYR Macedonia, is considering that standards such as: Quality Management Standard - ISO:9001, Environmental Quality Standard – ISO:14001, Health and Safety Management Standard – ISO:18001, General requirements for competence of testing and calibration laboratories – ISO:17025 and Conformity assessment standards – ISO:17065 are required ones. The representatives of the company pointed out that: - "*it is quite rare for a domestic company to have all the certificates and procedures implemented and that is why we require from their suppliers to have at least the minimum standards that are regulated by law*".

Another stakeholder organization pointed out that as per their previous analysis on dSMEs competitiveness, many of them, especially in the food industry, are operating under poor conditions, lacking vital standards such as International Quality Management Standard - ISO:9001. **The importance of the ISO:9001 has been confirmed by more than half of the surveyed MNCs.** In particular, 57.1% of the MNCs in the country responded that having an ISO certificate is compulsory criteria for a company to enter their supply chain. Moreover, ISO:14001 and ISO:9001 are the

[7] International Automotive Task Force
http://www.iatfglobaloversight.org/

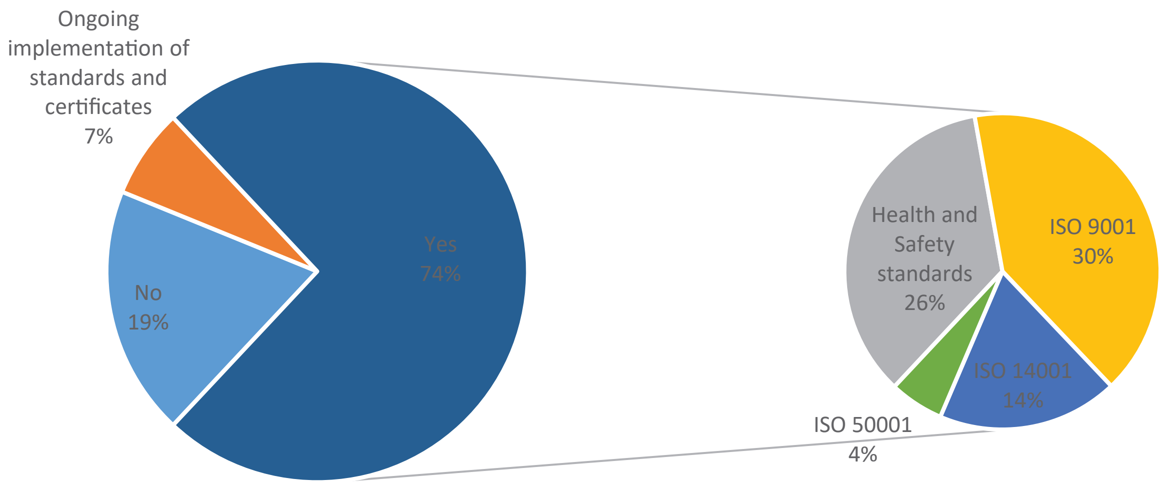
most frequently required technical standards. MNCs consider implemented ISO certificate as a starting point for a cooperation with a domestic supplier.

- *"One of, let's say, 'must' for us, is a company to be ISO:9001 certified … and not all companies are ready to be ISO certified, but this is really the starting point… if you have more, you are more than welcome, but the minimum to cooperate with us is to be ISO certified company. "* – Manager of FDI in TIDZ Skopje.

There are sectors, like agriculture, where MNCs are very dependent on the domestic suppliers since importing agricultural products involves tariffs, indicating a large potential for cooperation. However, the general manager of a foreign company from the agricultural sector has pointed out that the company is struggling to find domestic suppliers that are certified and work according to the requirements. *"Our suppliers are mostly farmers, they don't have certified seeds, nor they have modern and sophisticated methods of working, the use of fertilizers is not in accordance with the EU regulations and all these factors influence our operations and still we are dependent on them"* – general manager of a foreign agricultural company.

Even though MNCs argue that domestic producers are lacking technological standards, **75% of the domestic companies have responded they have implemented technological standards in their operations** *(Figure 15)*. From those that have done so, most are holding ISO:9001 (30%), safety and health security standards (26%) and ISO:14001 (14%). However, only 4% have implemented ISO:50001, and none has implemented the standards required for the automotive industry, such as IATF 19696 and TS16949.

Figure 15: Implementation of technical standards by dSMEs



Source: Results from the survey conducted with dSMEs, May – June 2018

Moreover, domestic companies do not agree entirely with the opinion of MNCs regarding the implementation of standards and certificates. Domestic SMEs point out that many of them already export in the EU and the Balkan region, and for this purpose they have implemented internationally recognized standards and certificates, which are expected to be accepted by MNCs in the country. However, this has not been the case. *"If we work outside of FYR Macedonia and if we meet the required standards abroad, aren't they the same standards? The standards we have are internationally recognized standards, we don't invent them… and if we meet and fulfill the standards abroad, how come that we don't fulfill them for the foreign companies in the country?"* – Deputy Manager of a domestic manufacturing medium enterprise form the metal industry.

Half of those without implemented technological standards and certificates listed that there is no need for them, 30% that they are costly, while minority reported that the procedure is complex (6%) and there are not enough authorized standardization institutions in the country (6%). Therefore, the awareness about the standards among those who do not possess such is apparently low or missing.

Additionally, the standardization and certification process is considered an expensive process among dSMEs and therefore not many of them can afford to implement more than one standard or certificate. Thus, the analysis shows that 58% of dSMEs invested in implementing at most one certificate, followed by 35% of them with two or three certificates and only 4% who have implemented more than three certificates. Furthermore, 79% of the companies with implemented standards employed trained staff to monitor a proper implementation, whereas the rest considered that having a staff for this purposes is additional burden, or they used external experts.

Hence, the **existence of the gap in the standardization and certification is clear**. In order to close the standardization and certification gap, a further effort by domestic companies should be done in the implementation of missing standards required by the MNCs in the country. On the other side, financial support and measures should be provided to dSMEs to improve standardization and certification process.

5.3. Production capacity gap

The **production capacity is considered an additional gap in the cooperation between dSMEs and MNCs.** The production capacity, i.e. the volume of products and services that dSMEs can produce with their available resources, is considered as limited by MNCs and therefore not sufficient to satisfy their demand. Thus, 35% of the surveyed MNCs responded that the limited capacity of production of dSMEs is one of the main issues when a cooperation needs to be established.

- *"As a consequence of the small competition, certain manufacturing companies are full with their capacity and they are not interested in taking new customers and grow, as they are anyhow producing and have their business."*- says the manager from a FDI located in TIDZ Skopje.

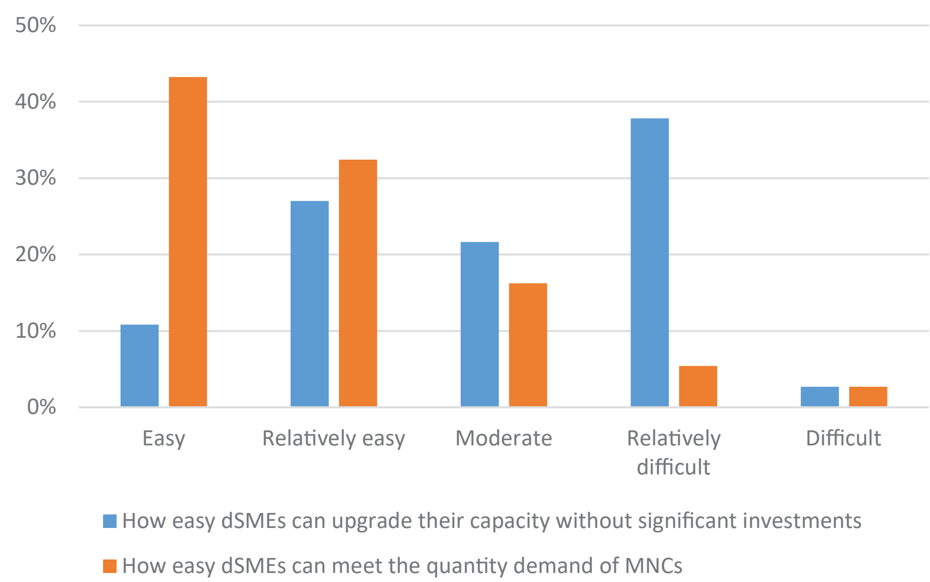
The manager also provided an example of the capacity problems they are facing with the domestic companies*:*

- *"Now we are dealing with two local companies that are producing metal parts for our machines; they are overloaded. They have orders from 6 months ago and they are not capable to deliver them simply because they are full! ... Would be great to have an additional supplier, but for the time being, we don't have anyone."*

From the stakeholders' point of view, the gap in the production capacity exists due to the **lack of attentiveness** of the domestic companies to invest in growth and development of their production plants. Whereas, from MNCs' point of view, this gap exists because there is **no competition on the market** or it is significantly reduced and therefore dSMEs have no intentions for capital investments.

On the other side, dSMEs have quite a contradictory opinion on the production capacity and their ability to satisfy the demand of the MNCs in the country. 75% of the surveyed dSMEs actually consider they could easily or relatively easily meet the demand of MNCs in terms of quantity *(Figure 16)*. Furthermore, when it comes to investments for altering the capacity of the production plants, only 37% of dSMEs stated that they could easily or relatively easily upgrade their capacity without significant investments. These results again suggest that there is a lack of awareness among dSMEs regarding the needs of MNCs, and the barriers that exist in the cooperation with them.

***Figure 16*: Ability of dSMEs to satisfy the demand of MNCs**



Source: Results from the survey conducted with dSMEs, May – June 2018

Furthermore, dSMEs explain that the problem of limited production capacity and decreased level of investments is because they do not have **sustainable and**

affordable sources of financing. Domestic companies tend to avoid significant investments, in order to maintain profitability and liquidity. One of the most common source of financing for the SMEs in FYR Macedonia is the use of traditional bank loans,which appear to have high and uncompetitive interest rates.

As the general manager of a domestic manufacturing company pointed out: *"... the current interest rates on the investment loans and the loans for support of the export ... are actually making us uncompetitive out there [on the global market, n.b.]. These loans offer extremely high interest rates ... and now the government is providing alternative funding for future investments, but what about the existing ones? We already have invested..."* . Thus, the sources of funds for dSMEs appear to be critical and crucial factor for their growth.

Box 4: Altering source of inputs increased the price of dSMEs product

A Macedonian company from the packaging industry producing cardboards and packing products has been collaborating with a MNC located in one of the TIDZs. The collaboration was negatively affected due to the production capacity problems that the domestic company faced with. Namely, it was not able to acquire the required amount of inputs in order to produce the products, and for that reasons it altered importing inputs from a neighboring country. This increased the price, which negatively impinged on the sale to the MNC.

Source: Interview with the management of a stakeholder organization, April 2018.

There is demand by MNCs for some specific products (such as seven-layer cardboard boxes), and not many of the domestic companies are ready to satisfy the demand and invest in production.

- *"An investment in seven-layer paper for a small and medium-sized printing company is a huge investment (the estimate is about 500,000 euros). It is necessary to purchase a large volume of raw materials and to accumulate huge stocks, as well to invest in special equipment and additional space, because machines are large. In FYR Macedonia,only large-capacity companies can afford to invest, because they have the space and resources. However, investing in such production technology bears the risk of large inventories and potentially unsold products, which negatively influences investment decisions. While for us, SMEs, it is a financial burden that we cannot afford."* – says the owner of a small printing house.

However, there are several real-case scenarios where, with greater support of the foreign investor, the local companies would undertake an initiative to invest and therefore establish cooperation. Such examples are seen with some of the brownfield investments in the country (Box 1), which again proves their greater openness and attentiveness for cooperation with domestic producers.

The problem of limited capacity, additionally raises the question if dSMEs are sufficiently ready for producing goods intended for the automotive and electronics industry. However, regardless of the industry, dSMEs responded that in order to make certain advancements in their production capacity, they would need large financial and administrative support, qualified human capital, and sustainable source of revenues as well as stable sales of their products.

5.4. Price gap

Highly priced products significantly affect the cooperation between the dSMEs and MNCs, stakeholder organizations and MNCs pointed out. Many of the surveyed MNCs acknowledged that dSMEs offer uncompetitive price of their products, which seriously affects the decision for local purchases.

- *"Domestic companies consider MNCs as cash-cows and they think they can offer higher prices for their products, but every foreign company has a local staff in the country. In this case, it is myself and I see and understand the prices"- says a local manager of a MNC. Another foreign investor has similar conclusion: "For us, people knocking on our door and trying to sell their products would be welcomed, [but] … they see a foreign company and the price is 3-4 times more than what we are actually paying. Therefore, I want to be in FYR Macedonia and I like spending in FYR Macedonia, but I cannot spend more than what I pay. At least the same price, the same quality or better. I think this is an "ABC" for the business"* – says the manager of a MNC located in TIDZ.

MNCs argue that the existence of this gap is due to the **low number of local suppliers** leading to low competition and abuse of the **quasi-monopoly advantage** that exists in certain industries. On the other side, stakeholders indicated that the reason for this gap is because domestic SMEs are **struggling to achieve economies of scale and efficiency in the production process**. "*Domestic producers are finding* *difficulties to sustain a consistent product quality and to achieve economies of scale and, therefore, they are not able to offer competitive prices on the global market"* - says a representative of an independent agency for international development. From the dSMEs perspective, the uncompetitive price is due to the **high cost of financing** they have access to. *"... It's the price of our raw materials. We really encounter issues in the procurement of our raw materials and that is because we have custom barriers, we have additional transportation costs and we also have problems with the quality and quantity of the raw materials of our suppliers. That poses a big problem for us to making an offer with low price ... and low price is everything the companies from the TIDZ are asking for."*- says a representative of dSME from the manufacturing sector. Furthermore, dSMEs argue that MNCs, especially the ones inside the TIDZ, are asking for unreasonably low prices for the products and they often cannot understand the external factors that actually influence the price. Hence, domestic companies are losing their competitive advantage due to the prices of the imported products, which in many cases, compared to the price of the domestically produced products, are significantly lower.

Box 5: Higher price will be paid if delivery is timely

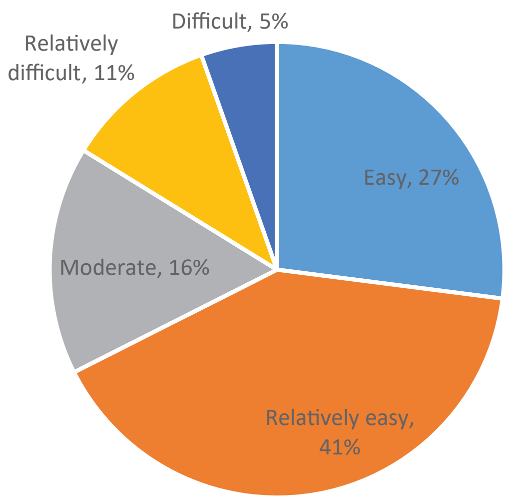
When a MNC operating in one of the TIDZs needed to order a compressor for one of its machines, it contacted a local supplier. The price of the compressor was really advantageous, but the delivery deadline has not been precisely presented upfront and it was said to be 'about' 40 days. Unlike the local supplier, an Italian supplier for the same part offered a delivery that was said to be in to be exactly 30 days, at a slightly higher price. The company decided for the second option because their production is serial production and it was of utmost importance to have accurate delivery date.

Source: Interview with the management of a MNC, May 2018.

Clearly, this interrupts the entire supply chain, whether it is between dSMEs and MNCs or between domestic companies.

Moreover, dSMEs are not utterly aware that the high prices of their products and services seriously affect cooperation with MNCs and the opportunity to enter their supply chain. Such opinion is supported by the results of the survey in *Figure 17*, whereby more than 60% of the surveyed dSMEs responded they easily or relatively easily met the demand of MNCs in terms of price competitiveness. This suggest that **dSMEs consider their prices as competitive** with regards to MNCs demands. Still, such opinion is not supported by MNCs; and in order to overcome this gap, price adjustments of the offered products and services had to be considered.

***Figure 17*: Ability of dSMEs to satisfy the demand of the MNCs in the country regarding the prices**



Source: Results from the survey conducted with dSMEs, May – June 2018

5.5. Organizational gap

5.5.1. Corporate Structure

Lack of corporate structure of dSMEs has been identified as a cause for the organizational gap in the cooperation between domestic SMEs and MNCs. The organizational structure can be defined as formal arrangement among individuals and groups according to their allocated tasks, responsibilities and authority in the organization (Galbraith, 1987; Greenberg, 2011). Most of the Macedonian SMEs have been identified as organizations with quite simple structure consisting of top management and operative workers, lacking techno-structure and support stuff (Mintzberg's framework). According to the representatives of the banking sector, having a decentralized organizational structure, where work processes are standardized with high degree of formalization and work specialization, along with an aim to achieve internal efficiency, is a crucial aspect to be taken into consideration when developing a potential cooperation with MNCs. **The organizational gap, i.e. the poor organizational structure of the dSMEs has been valued with an average grade of importance of 5.67 by the MNCs** (*Figure 12*). According to them, having a corporate structure is important because in this way the domestic company shows reliability and stability. "*The SMEs in FYR Macedonia are mostly family owned businesses and it is important for them to understand that ownership needs to be separated from the management responsibilities*" – says representative from the banking sector.

Another reason for the existence of the organizational gap in the dSME-MNC cooperation, identified by the stakeholders and the MNCs, is the **corporate culture** of dSMEs in FYR Macedonia. By corporate culture is meant values and beliefs that give meaning for the members of the organization and provide them with behavior rules for effective functioning of the organization (Stanley M. Davis, 1984). Thus, incorporating a culture in the organization that includes sophisticated values and norms, will lead to expanding and implementing those values and norms in the everyday life as well. This is something that one of the managers of a MNC, located in TIDZ Ohrid, believes in and integrates in his company. Lack of corporate culture has been pointed out as a matter for the dSMEs. "*The domestic SMEs need to learn about the global market and they need to learn the way how it works"* – manager of MNC located in TIDZ outside of Skopje.

On the other side, dSMEs appear to be companies with relatively **long tradition on the market**. As per the survey, the most of dSMEs are between 15 and 30 years old. This suggests that domestic companies have been going through many transitional periods, while incorporating strong but traditional corporate culture, values and believes. Therefore, the difference in the corporate culture appears to be crucial for establishing healthy cooperation, as most of MNCs come from technologically highly advanced and economically well-developed western countries.

Additionally, managerial skills applied in dSMEs were assessed as poor, by both stakeholders and MNCs. As per the survey, it is believed that adapting to the new business environment is crucial for effective leading of an SME along with a constant development through learning.

- *"The system of internal processes is something that not many businesses have established here in FYR Macedonia. This is mainly because there is lack of knowledge of how to actually do that... SMEs have to learn how to manage their operations properly in order to become part of the MNCs' supply chains. "*– says a representative of an economic chamber in FYR Macedonia.

According to the MNCs in the country, besides the **poor management skills**, the cooperation gap is reinforced due to the **mindset and mentality** of the management teams in dSMEs. Such mindset and mentality are characterized with the tendency of not providing precise delivery deadlines or not respecting certain terms of the agreement and similar activities. As a director of a German FDI pointed out, the cooperation between the MNCs and dSMEs is misbalanced because both sides are rather dissimilar and the conflict among them will always exists.

5.5.2. Terms of contracts

As part of the organizational gap, **poor responsibility** that dSMEs have towards **meeting the terms of their contracts and pursuing on-time delivery** have been identified as bottlenecks. Many of dSMEs not only have difficulties to meet delivery deadlines, but also have difficulties to assess the time for the delivery. This is a major problem for manufacturing companies, especially for the ones in TIDZ, since all of them have implemented just-in-time production lines.

Box 6: Lost cooperation due to changing agreed terms

A foreign company located in FYR Macedonia is producing capacitors. For every capacitor it uses small plastic box. The company produces five million pieces per month and thus needs five million small plastic boxes. Hence, a domestic plastic producer was identified and approached in order to source the input domestically. The foreign company provided their mold and shared the specifics of the product. Both sides agreed on the terms, the target price and all the details of the cooperation. The local producer started to produce samples in a couple of rounds until the product received its final approval. Once the product was approved, the foreign company confirmed and requested to start a mass production. However, at that point, the local manufacturer provided another, higher price of the product, without any significant explanation. The new price has not been competitive anymore. Hence, the cooperation has been cancelled.

Source: Interview with the management of a MNC, May 2018.

Domestic SMEs also agree that the terms of the contracts are negatively affecting the (potential) cooperation with MNCs. However, they rather position the responsibility on the side of MNCs. As one of the deputy directors of an export-oriented dSME argued: *"We cooperate more with the foreign companies that are outside the technological zones, rather than the ones that are in. The cooperation with the companies that are in the zones is minimal, having in mind the capacity they have, and there are several reasons for that. One of the reasons is the requirements they set. They impose such rigorous terms of agreement and such strict demands in the terms for cooperation".* Compared to MNCs, which claim the terms of deliveries as a major issue, dSMEs point out the terms of payments as a major issue (delayed payment or long payment terms). Therefore, rigorous and strict contract terms set by MNCs are something that dSMEs are not typically ready to accept.

Box 5: Rigorous terms of agreement set by a MNC led to lost cooperation

A domestic producer for specific automotive elements, mainly export-oriented, had the high potential to cooperate with a MNC located in TIDZ Skopje. The foreign company requested a certain amount of parts to be produced and not to be delivered at the same time, but to be stocked and kept available whenever it will need it to use. The domestic supplier did not agree on this, as it was going to impose high risk for him in case parts were left unpurchased, hence also representing financial burden. Thus, the local supplier did not agree on the terms and the cooperation was not established.

Source: Working meeting with representatives from dSMEs, May 2018.

5.6. Soft skills and human capital gap

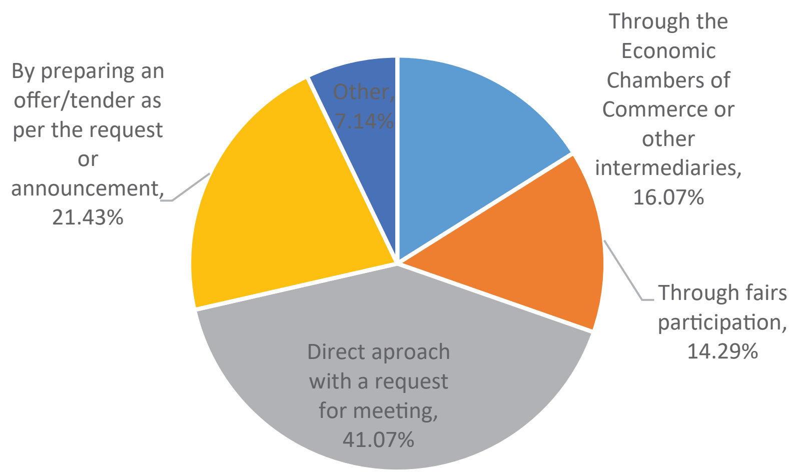
MNCs and stakeholder organizations consider the **lack of soft skills** by dSMEs as another important aspect that needs to be considered for potential cooperation. Soft skills are attained by personal development trainings and utilized throughout the entire working and personal life (Klaus, 2008). People with developed soft skills are better in solving problems and in performing their everyday jobs (Gladwell, 2011). According to representatives of a domestic producers' association and independent agencies, domestic companies are required to improve their soft skills in order to represent their business on higher professional level at global and international fairs. This is very important, especially for domestic light manufacturing companies that seek international cooperation. MNCs identify the lack of soft skills mostly when it comes to **networking**.

- *"We had organized networking event for establishing cooperation with domestic companies. About 15 companies came to the event, 12 of the participants did not speak English, while their presentation skills and prepared presentation materials were not sufficient for effective promotion of their products"*- says representative of a MNC located in TIDZ outside of Skopje Ohrid.

Most of the MNCs have never been approached by a local manufacturer with a request for cooperation. As one of the managers from a foreign company explains: *"There was a meeting of foreign and local companies, and definitely we didn't feel and* *didn't see interest from local companies to approach and say … 'this is my business card, my catalogue… can I visit you? We didn't see that."* – says MNC located in TIDZ Skopje.

This is in line with the ways in which dSMEs reported to have approached (or have not done so) MNCs. 41% of dSMEs responded they approached MNCs directly by requesting a meeting; additional 21% responded they prepared an offer upon request. Only 14% participated on a fair, while 16% utilized economic chambers as a channel to connect *(Figure 17)*.

***Figure 18*: How dSMEs approached MNCs**



Source: Results from the survey conducted with dSMEs, May – June 2018

As some of the economic chamber representatives pointed out, *the lack of soft skills within businesses is a result of the non-competitive educational system in the country*. The latter also reflects the identified human capital gap (**lack of qualified workforce and lack of workforce development)** being in close relation with the soft skills gap. Both MNCs and dSMEs are aware of the existence of the human capital gap and the fact that competent workforce is insufficient in the country. The cause of this issue could be likely explained by the **high emigration** and the so called **"brain-drain"** that neither the foreign investments nor the EU integration have been able to prevent it. Representatives of MNCs are aware of the investment needed in people to arrive at qualified workforce, hence they are practicing and implementing this approach. "*Well, qualified workforce is limited; we have vacancies for process engineer after three months of searching. What we are doing is trying to retain good workers …*

Therefore, whenever we identify them we invest in them, we send them in Germany, in Italy, in Bulgaria, train them and make them grow internally. So, basically, what we are doing is really a success story for us" – says a MNC representative located in TIDZ Skopje. Additionally, another MNC representative from the agricultural sector pointed out: - "*It is difficult for us when searching for qualified people in the country with certain knowledge, but qualified workforce is also something we don't find in the domestic companies, our suppliers, either".*

The concern regarding this issue is rather addressed towards dSMEs, since they are mostly affected by it, thus creating a gap for cooperation between the two parties.

- *"We constantly invest in the staff ... in FYR Macedonia we ... have a lot of unemployment, but the quality and capacity of the staff is the biggest problem, which means that we are working on creating and training qualified staff ... because to find quality people in mechanical engineering, with specific knowledge, is the biggest problem ... I think the other companies will agree on this, as we have the main problem in the education in FYR Macedonia."* – says a deputy manager of an export-oriented domestic company.

Soft skills and human capital gap are a serious concern not only for the business environment but for the entire economy of the country. The potentially non-competitive educational system and the lack of workforce development have a considerably negative influence on the creation of qualified human capital, and rather increased stimulus for emigration. Therefore, companies are strongly recommending institutional changes and improvements in the system as a long-run solution of the problem.

6. Conclusion and recommendations

The objective of this policy study is to understand the gaps and potentials for inclusion of dSMEs into the supply chain of the MNCs operating in FYR Macedonia. Between 2007 and 2017, the average FDI inflow in FYR Macedonia has been about 3.4% of GDP, although lower than the other countries in the region. The main benefits of the FDIs inflow are: the sectors and export diversification (50% of the total FDIs are concentrated in the manufacturing and mining sectors, while the Herfindahl index dropped from 14.3% in 2005 to 9.6% in 2015), import coverage and more than 15,000 jobs created. Apart from the direct impact, FDIs could provide indirect benefits through building linkages between Multinational companies and domestic small and medium enterprises; technology and skills transfer; and improvements in productivity and competitiveness in the overall economy. In FYR Macedonia, these linkages have been quite limited.

The analysis is based on a mixed method approach, including: semi-structured interviews, a focus group and online surveys. The aim of both the semi-structured interviews and the focus group was to gain a rather general perspective on the factors affecting the cooperation between dSMEs and MNCs, as well as motives, intentions and barriers for their cooperation. The individual interviews were conducted with representatives from nine stakeholder organizations from diverse background and with eleven MNCs, randomly selected – with regards to keeping diversity in the industry (automotive, agriculture, textile etc.), location (in TIDZ or out of TIDZ) and type of investment (greenfield, brownfield or other). The focus group was conducted with five dSMEs, out which two companies have successfully established cooperation with MNCs, one company that is starting a negotiation process for cooperation, two companies that are export-oriented and have some experience with MNCs in the country but are not fully cooperating with them. The survey sample is composed of 23 individual answers from MNCs and 37 answers from dSMEs.

The results show that **there is an established cooperation between dSMEs and MNCs** in the country. 81.5% of MNCs in the country answered that they cooperate or have cooperated with dSMEs and 37.8% of dSMEs have approached at least one MNC and successfully established cooperation with it. The possibility for cooperation and satisfying the need for procurements in certain sectors/products is largely determined by **the likelihood for the foreign companies to find the products and a supplier** for the requested products locally. Overall, the potential to find required services locally amounts to 91%, out of which a third mainly requires interventions in the standardization of the service provided and increasing the quantity of the services offered. In the same line, with lower percentages though, 30% of MNCs reported they could find the required raw materials, while additional 31% reported they could, but with various limitations. On the other hand, and expectedly, the potential for local purchase of machinery and equipment is considerably limited, as 61% of MNCs clearly reported they could not find the required input on the local market. At the same time, **the access to information for domestic suppliers is very difficult**. A unique repository database is missing about the potential domestic suppliers, and there is a lack of a single database of information for all foreign investors in the country. **Procurement policy of MNCs in the country has been found an important determinant of the cooperation with dSMEs**. There are differences in the procurement decision making policy at the local and mixed levels, depending of the type of purchases (raw materials or services). In general, services procurement decisions are made mainly at the local level, compared to raw materials procurement decisions that are made at the centralized or mixed level. Taking into consideration the type of investment and the location of investments, greater potentials for cooperation exist between dSMEs and MNCs operating outside the technological industrial zones, rather than between dSMEs and MNCs in the zones. While, the potential for cooperation in raw materials procurements is larger with MNCs of the brownfield type or joint ventures, since for those most of the purchase decisions for raw materials are made at the local level.

The analysis identified several gaps in the cooperation between MNCs and dSMEs in the country. Insufficient technological development and readiness of dSMEs, the standardization and certificates implementation and the production capacity have been considered as the main three (out of eleven) weaknesses by MNCs, having the highest rate of importance on cooperation. **Insufficient technological development and readiness of dSMEs** has been ranked as the main weakness by MNCs, having the highest rate of importance on cooperation. According to the domestic companies, they are not ready to invest in new technologies, since they face high financial risks in terms of illiquidity and cannot achieve sustainability in their sales. **The standardization and certificate implementation gap** exists due to not implemented or not fully implemented quality and safety standards and internationally accepted certificates, especially in the automotive industry. There is misperception in the viewpoint of MNCs and dSMEs regarding the level and adequacy of standardization, relevant for the cooperation. Even though MNCs argue that domestic producers are lacking technological standards, 75% of the domestic companies have responded they have implemented technological standards in their operations. However, the majority of dSMEs are holding some of the ISO, safety and health security standards, but only a limited number of dSMEs have implemented specific standards required by the MNCs. Additionally, the standardization and certification processes are considered as expensive processes among dSMEs and therefore not many of them can afford to implement more than one standard or certificate. According to the MNCs, **the limited capacity of production of dSMEs** is one of the main issues when cooperation needs to be established. From the stakeholders' point of view, the gap in the production capacity exists due to the lack of attentiveness of the domestic companies to invest in growth and development of their production plants. The unsustainable and affordable sources of financing is considered as the main reason for poor investments in production capacity according to the dSMEs. **The uncompetitive price of dSMEs products**, **the organizational gap and the human capital and soft skills are additional gaps** identified in the cooperation. As part of the organizational gap, poor responsibility on the part of dSMEs towards meeting the terms of their contracts and pursuing on-time delivery have been identified as bottlenecks. While, the lack of soft skills is mostly concerning the networking and the ways in which dSMEs have approached MNCs.

This policy study gives the following recommendations:

<u>To policymakers</u>

- **Measures for standardization process improvement**. The pillar for increased co-operation between domestic and foreign investors from the plan for economic growth is to be upgraded with additional measures for standardization process improvement. The following measures can contribute to the improvement of *Measure 10: Support of investments* in the *Economic*

Reform Programme (ERP) 2018-2020[9]. We propose two types of support for domestic companies (applicable in activity 3 within the planned measure, meant to incentivize SMEs to obtain quality certificates) :

- The government to provide subsidies for improvement in standardization and certification of the domestic service providers (fully paid upon implementation), for the most specific standards required by the MNCs, such as: ISO:50001, IATF 19696, TS16949, etc.
- The government to provide subsidies to domestic businesses, by covering 50% of the cost for implementing standards and certificates and by covering 100% of the costs associated with trainings of the staff that implement the standards and certificates within the companies.
- Grants for any implemented standard that will increase cooperation with MNCs. Repayment based on success of obtaining new customers in a period of three years after certification; i.e. if receiving 5 new international customers, no need to pay the money back; If 3 customers – 50% repayment; 1 customer – 75% repayment; 0 customers – full repayment.

- **Measures to stimulate raw material and inputs production.** Package of measures for domestic companies, composed of: tax incentives, state land and re-payment grants without interest rate for new investment and increased production of raw materials and inputs.
- **Incentivizing new FDIs with a higher value added** and promoting upgrades among the investors already present. The process can complement and improve *Measure 9: Supporting activities for attracting FDIs and investments by domestic companies* included in the ERP. The method can enhance the efficiency and effectiveness of the activity within the measure that plans support of major impactful economic projects in the country by supporting involvement of domestic companies in international value chains.
- The strategy for attracting foreign investments **to avoid targeting large scale companies**, in need of a large number of employees and low paid jobs due to the lack of adequate work force. Instead, the strategy should be targeting:

[8] Economic Reform Programme 2018 – 2020: https://www.finance.gov.mk/en/node/4832

    - Companies with higher value-added products and services, which in turn require more skilled labor and consequently higher paid jobs;
    - Brownfield investments;
    - Medium sized companies with up to 150 employers;
- **Strategy for incentivizing M&A activities among domestic companies,** in order to strengthen the domestic enterprises. Such strategy will contribute in the creation of companies with higher capacity and expertise that are able to satisfy the demand of MNCs. M&A activities will additionally lead to decreased number of small-sized enterprises and rather increased number of medium-sized enterprises that are better positioned and more competitive on the market. This devised strategy can complement the activities listed in *Measure 9: Supporting activities for attracting FDIs and investments by domestic companies* in the ERP by motivating and supporting domestic companies to undertake M&A activities. This would help and enhance their ability of involvement in international value chains and in higher value added sectors.
- **Easy, fast and quality access to information for foreign investors and potential domestic suppliers in the country,** to facilitate the establishment of cooperation. The government to build unique repository database about the potential domestic suppliers classified by sector, type of products, production potential, etc. and foreign investors in the country, classified by type of investments, sector, products and location. The government begins creating "institutional memory", with a designated government institution that will be responsible for publishing and updating this information with the help of the chambers of commerce and other stakeholders involved in this process.
    - The government and the state agency for foreign investments and export promotion to establish system of SME support and to promote domestic suppliers by organizing supplier's days and reverse exhibitions.
- **Further reduction of customs tariffs and facilitation of the customs procedure for import of raw materials and inputs.**

<u>To domestic companies</u>

The following proposed measures can improve the efficiency and effectiveness of the support instruments planned in *Measure 14: Improving infrastructure and access to finance for research, development and innovation* listed in the ERP. These measures can incentives domestic companies to focus in research, access to finance and improvement in skills that will enhance growth and build capacity of domestic companies.

- Service providers **to invest in standardization process**, with a focus on standards and certificates required by the foreign investors in the country.
- Producers of raw materials and inputs **to invest in quantity of production, price competitiveness, quality and production efficiency.**
- **To increase corporate culture, mindset and mentality in cooperation with foreign investors** in terms of:
    - providing precise delivery deadlines and pursuing on-time delivery;
    - improving responsibility towards meeting the terms of their contracts;
    - Being more aware and informed about global market and corporate culture of foreign companies in the country.
- **To improve the soft skills** in terms of:
    - representing their business on higher professional level at global and international fairs;
    - increasing the networking with MNCs
    - Improving the approaching strategy by preparing adequate presentation of their company and products/services and representative materials (brochures, business cards, catalogues of products, etc.).

<u>To Multinational companies in the country</u>

- **To redefine procurement policies**, especially companies that operate in the technological industrial zones. The procurement decision making policy to be shifted from the centralized to local level to the extent possible.
- MNCs **to invest in mentoring programs**, and capacity building of domestic suppliers. The investment could be in joint activities for smooth transition and

adaptation of domestic suppliers to the standards required by the MNCs, leading in the standardization and implementation process.

- **To motivate domestic producers to invest in new production** with guaranteed further supply to the foreign companies or long-term contracts.

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Policy Study No. 19

BRIDGING GAPS AND SEIZING POTENTIAL

DOMESTIC SMEs IN THE SUPPLY CHAIN OF MULTINATIONAL COMPANIES IN THE COUNTRY

FINANCE THINK
OUT OF THE BOX

This project is funded by the European Union

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