Portal on Central Eastern and Balkan Europe

AN ECONOMIC AGENDA FOR THE REPUBLIC OF MACEDONIA

POLICY GUIDELINES FOR FURTHER INTEGRATION
IN THE WORLD ECONOMY:
FOREIGN DIRECT INVESTMENT AND FOREIGN TRADE (2006-2010)

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XII CEI International Summer School of Cervia
"Economic transition, enlargement processes and globalization"
November 2006

Foreword

In August 2006 the right-wing political leader, Mr Nikola Gruevski, became the Prime Minister of the Republic of Macedonia[1]. Since May 2003, he is also the leader of VMRO-DPMNE (Internal Macedonian Revolutionary Organization-Democratic Party for Macedonian National Unity), a Christian Democratic party which supports the admission of Macedonia to NATO and the European Union-EU.

He was Minister of Finance in the VMRO-DPMNE Government led by Ljubco Georgievski until September 2002; among Gruevski's main achievements in this role there were the privatisation of Fenimak (mineral-processing enterprise) and the implementation of financial reforms, including the VAT (Value Added Tax) of 18% (requiring fiscal receipts for all Macedonian businesses) which was a program designed to fight tax evasion. Gruevski's most famous program was "*Kupuvajte makedonski proizvodi*" ("Buy Macedonian products"), which promoted buying Macedonian products.

Mr Gruevski, with his program "100 Steps for Progress", will rule Macedonia for the next 4 years and the aim of this paper is to provide for him and his Government some policy guidelines that can be used to better integrate Macedonia in the world economy, via attracting more Foreign Direct Investment (FDI) and further developing foreign trade, in order to have a bigger economic development which has to be environmentally and social sustainable.

Structure of the paper

Part 1 presents Macedonian economy and its links with world economy looking at FDI and foreign trade, with some key information and data provided by international sources (mainly the European Bank for Reconstruction and Development-EBRD) as well as by national sources (Ministry of Economy, Central Bank of Macedonia, Agency for Foreign Investments-MacInvest, Agency for Promotion of Entrepreneurship-APPRM, Economic Chamber of Macedonia).

Part 2 describes the incentives for foreign investors existing in Macedonia and tries to explain why, so far, they did not work enough to attract a proper stock of FDI.

Taking into consideration data showed in Part 1 and the evaluation on current measures to attract FDI made in Part 2, the third and last Part of the paper proposes some possible measures the new Government could take into account to attract bigger flows of FDI and better integrate Macedonian economy in the world trade and international division of labour.

Part 1. Macedonian: basic data

Despite heavy difficulties in the transition period, which achieved the top in the second half of 2001 with the inter-ethnical fights between the Macedonians (64% of population) and the Albanians (25%), the Country undertook serious political and economic reforms toward building a democratic society and open market economy.

Good results were also recognized by international credit rating agencies, such as Standard & Poor's (which, in August 2005, raised its long-term foreign and local currency sovereign credit ratings to 'BB+' from

[1] From now on simply called Macedonia.

'BB', and to 'BBB-' from 'BB+', respectively, on sustained political stabilization and macroeconomic stability) and Fitch Ratings (which has assigned Macedonia short-term rating of 'B').

The future of the Country is in the European Union and the European Council on 17 of December 2005 granted Macedonia candidate status for membership of EU, recognising the progress that the Country has made in meeting the Copenhagen criteria[2].

Macedonia achieved political and macro-economic stability and its goals for the future are: a) further economic growth and development; b) active participation in regional and global integration processes; c) maintenance of the macroeconomic stability; d) further implementation of structural reforms, including promotion of Small and Medium-sized Enterprises-SMEs; e) further attraction of FDI that will lead to economic growth, reduce unemployment[3] and alleviate poverty.

Objective e) is particularly important but also hard to achieve since the Country, so far, attracted the lowest cumulative FDI inflows (1.155 millions US$) among all the former Yugoslavia states. Moreover, around 700 millions US$ came from the privatization process (which is almost totally completed); it means that now the real challenge for Macedonia is to attract greenfield investments. Anyway, Macedonia attracted more cumulative FDI inflow *per capita* than Bosnia and Herzegovina and Serbia and Montenegro (table 1).

Table 1. FDI: net inflows recorded in the balance of payments

Country	Cumulative FDI inflows (1989-2004)[a]	Cumulative FDI inflows *per capita* (1989-2004)[b]	FDI inflows *per capita* (2003)[b]	FDI inflows *per capita* (2004)[b]	FDI inflows (2003)[c]	FDI inflows (2004)[c]
Slovenia	3.130	1.573	-70	139	0.0	1.0
Croatia	9.102	2.049	383	202	6.0	2.6
Bosnia and Herzegovina	1.661	437	101	129	5.0	6.0
Serbia and Montenegro	4.150	498	169	123	7.0	4.0
Macedonia	1.155	577	48	75	2.0	3.0

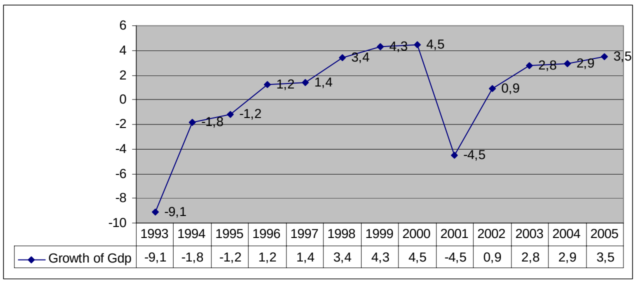
[a]In US$ mln; [b]US$; [c]In per cent of GDP. Source: EBRD (2005)

Following data show how the economic growth of Macedonia and the FDI inflows have been influenced not only by main economic phenomena which occurred since the independence in 1991, but also by political and military phenomena (charts 1 and 2).

[2] Expected EU joining date is 2012.

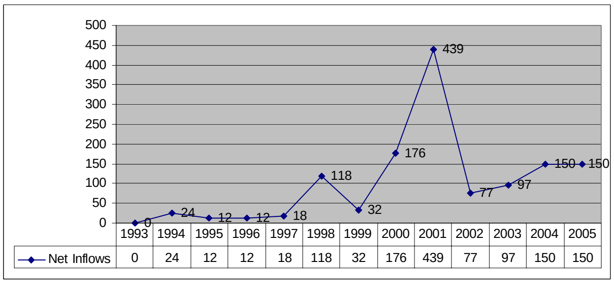
[3] *"The single biggest cause of poverty in Macedonia today is unemployment. Not only does it affect the daily lives of those who seek work but fail to get it. At the same time it means for the public that instead of tax revenues it has to pay out unemployment benefits. This reduces Government's ability to invest in growth and address other pressing social needs."*-United Nation Development Program representing in his speech at the Conference "Foreign Direct Investments in Macedonia" Tuesday 21st December, 2004, at Alexander Palace Hotel in Skopje.

Chart 1. Growth of GDP, 1993-2005



Source: EBRD (2005)

Chart 2. Net inflows of Foreign Direct Investment (US$ mln), 1993-2005



Source: EBRD (2005)

According to data showed in these charts, Macedonian economy can be divided into three periods:

1) 1991-1995: economic stagnation. When Macedonia gained independence, it was strongly integrated in the Yugoslavian economic system, with specialization in metal processing and semi-finished products. The end of the centralized economy, the end of the Comecon [4], the end of the unique market of the former Yugoslavia, the Greek embargo[5] and the international sanctions against Serbia and Montenegro (these two last facts *de facto* stopped trade relations with the two main economic partners of Macedonia) let economic transitional crisis and a dramatic fall of GDP with very low level of FDI.

2) 1996-2001: interrupted growth. From 1996 Macedonia had five years of constant economic growth and also foreign investors operated in the Country, due to good and stable macro-economic indicators and the image of stability the Country had abroad. FDI decreased in 1998-1999 due to the general crisis related to the Russian financial shock, but it recovered in 2000 and 2001.

This stable growth was suddenly interrupted at the end of 2001 due to the Albanian rebels who, for some months, fought a kind of inter-ethnical civil war[6]: this fact brought a decreased of internal and international trade (the borders were often closed), a growth of public deficit due to the growing expenses for defence and a general climate of uncertainness that scared national and international investors.

3) 2002-2006 a new period of stable growth. In the last 4 years Macedonian economy recovered and GDP and FDI inflows grew constantly. Main macroeconomic indicators (table 2) show an achieved stability and, even if

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[4] Council for Mutual Economic Assistance.
[5] Greece put an embargo because it did not want Macedonia to use this name to denominate itself and for other political reasons.
[6] Now the crisis is solved thanks to the “Ohrid agreement” that recognized more rights for the Albanian minority.

the official unemployment rate is still high (37%) and the official *per capita* GDP is still low (2.500 Euro/year)[7], the Country did the firsts right steps that will let it joining the EU.

Table 2. Macroeconomic indicators, 2002-2005

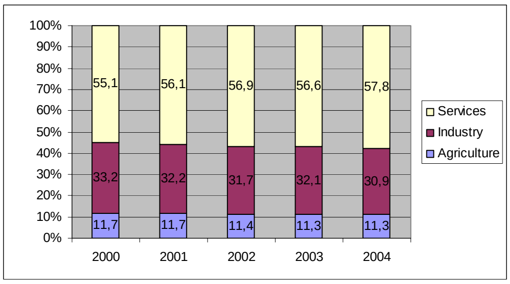
	2002	2003	2004	2005
Inflation rate	2,4	1,1	-0,3	0,0
Exchange rate MKD/Euro	61,0	61,3	61,3	61,3
Foreign reserves (US$ mln)	725,3	903,4	975,3	1324,7

Source: MacInvest (2006)

Data clearly show the tight link between the political risk perceived abroad by foreign investors and the actual amount of FDI flows. According to the theory indeed, the political risk is the first problem foreign investors take into consideration before making an investment abroad. Today the political risk seems not to exist anymore in Macedonia but problematic situations (such as minorities' rights or other social problems) should be carefully monitored.

Data in chart 3 show that Macedonian economy moves toward the pattern of production typical in the most developed Countries, with a predominant importance of services in the GDP creation, followed by industry and agriculture.

Chart 3. GDP production by sectors, 2000-2004



Source: MacInvest (2006)

Looking at the size of companies that constitute Macedonian economy, SMEs play a key role: in 2004 they were 99% of the total number of active enterprise (they were around 40.000 on the total number of 41.000 active enterprises) and they employed around 80% of the total employed persons. The contributed for about 66% of industrial production (table 3).

Table 3. Industrial production according to size of enterprises, 2004

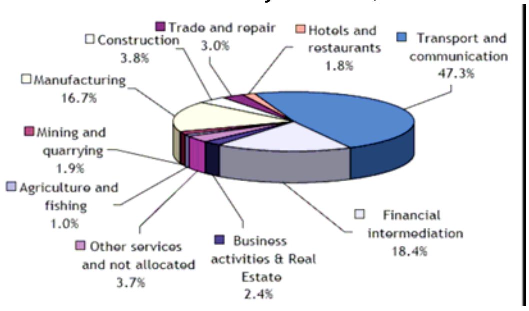
	Milions of Dinars	Percentage
Small	206.368	47,8
Medium	77.890	18,1
Big	146.809	34,1
Total	431.068	100

Source: MacInvest (2006)

[7] The black economy however is estimated to be around 20% of GDP, it means that the actual unemployment rate is around 29% and actual *per capita* GDP around 3.000 Euro/year.

Being services the sector that most contributes to GDP creation, it is also the most dynamic one and the one that, in the last years, received the biggest amount of FDI (chart 4). In particular FDI went into transport and communication (thanks to the biggest foreign investment in Macedonia: the Hungarian Matav[8] bought the Macedonia Telecom for 310 millions US$) and in financial intermediation (foreign banks bought local banks); the manufacturing sector follows.

Chart 4. FDI inflows by sectors, 2000-2004



Source: MacInvest (2006)

It is also interesting to see which Countries invested more in Macedonia, in order to adopt proper policies to incentive them (see part 3). Table 4 show that the main investors are Hungary and Greece, then the Netherlands and Cyprus (but investments from these two Countries probably came from other nationalities' investors) and then some Central European Countries (Germany, Switzerland, Austria and Slovenia) and UK.

Table 4. FDI inflows by Countries, 2000-2004 and total (US$ mln)

Country	2000	2001	2002	2003	2004	Total 1991-2004
Hungary	0.009	322.682	0.002		0.019	322.754
Greece	103.166	67.471	45.124	6.904	30.151	266.889
Netherlands	0.546	0.581	0.661	31.606	66.226	101.901
Cyprus	4.772	3.916	7.545	0.155	1.675	81.935
Germany	11.280	4.757	0.631	4.885	6.567	57.375
Switzerland	1.301	8.784	2.689	13.402	8.018	50.452
Great Britain	25.180	1.222	2.352	0.303	0.981	41.714
Austria	2.191	2.849	0.575	2.643	0.940	36.296
Slovenia	11.585	3.866	3.988	6.066	4.743	35.323
Italy	2.514	2.721	0.412	0.816	7.425	32.488
USA	3.472	15.147	4.279	3.507	1.056	30.756
Bulgaria	0.060	0.433	4.965	10.961	4.950	22.754
Turkey	0.160	0.079	0.236	0.700	2.428	21.524
Serbia & Montenegro	1.068	1.612	2.976	1.092	0.329	11.732
Others	11.220	9.014	5.241	16.305	27.611	94.975
Total FDI	**178.524**	**445.134**	**81.676**	**99.345**	**163.119**	**1 208.868**

Source: Ministry of Economy (2005)

[8] Hungarian Telekom Telecommunications.

Another key phenomenon, strictly connected with FDI, is foreign trade. Macedonia can be described as a Country that mainly exports cheap semi-finished goods (e.g. textile and metals) and agricultural goods (beverage, tobacco and food) and mainly imports expensive technology and raw materials (charts 5 and 6). This pattern of foreign trade produced a big deficit in the trade balance (table 5).

Chart 5. Export by commodities, 2004

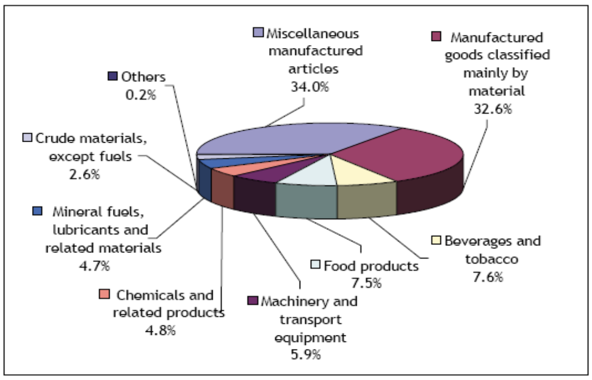
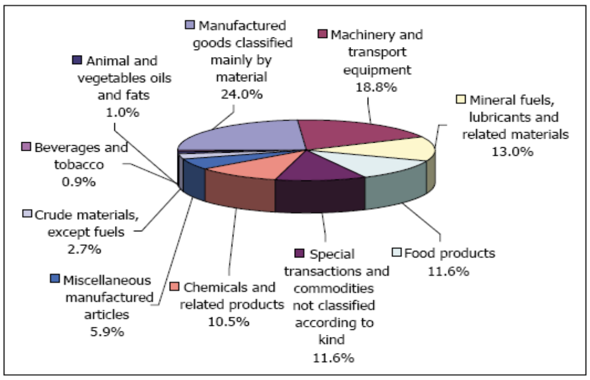


Chart 6. Import by commodities, 2004



Source: MacInvest (2006)

Table 5. Trade balance (% of GDP)

2000	2001	2002	2003	2004 (est.)	2005 (pr.)
-19.8	-15.3	-21.3	-18.3	-20.8	-18.5

Source: MacInvest (2006)

Beside the sectors that constitute Macedonian foreign trade, also looking at the main trade partners can help to think proper policies to attract more FDI.

Chart 7. Main export partners, 2004

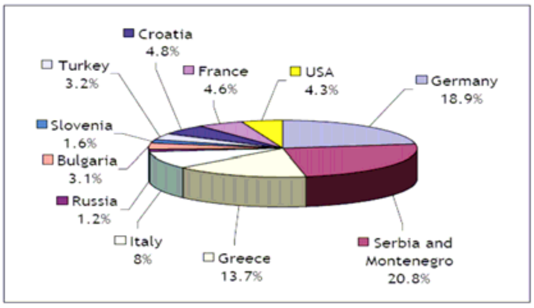
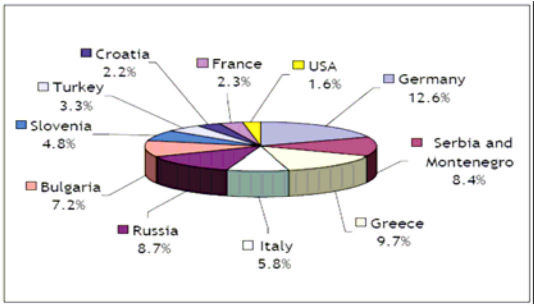


Chart 8. Main import partners, 2004



Source: MacInvest (2006)

Three Countries (Germany, Serbia and Montenegro e Greece) buy more than half (53.4%) of Macedonian export and the same three Countries provide almost one third (30.7%) of Macedonian import. Russia has an important role as provider of raw materials and infrastructure and is a major investor in the mineral sector (mine in Bucin for example).

Part 2. Incentives for FDI and foreign trade: what is working, what is not

In the last years, macroeconomic stability and structural reforms created a more favourable business climate in Macedonia. The Government developed a Public Investment Program (PIP) for 2005-2007 which consists of 99 investment projects. The total cost of these projects is estimated at 1.2 billion Euro. A part of the projects (174.26 millions) has been executed by the end of 2004 while the fulfilment of certain investment activities (estimated at 174.63 millions) will be shifted beyond 2007. It is foreseen to effectuate 751.97 million for the period 2005-2007, that is 283.57 millions in 2005 alone.

Besides this Program, there are some specific incentives aimed to attract foreign investors and develop foreign trade. The incentives for foreign investors include various exemption from customs duties as well as tax breaks. Main examples follow, with an evaluation of their effectiveness.

a) Free Trade Agreements (FTA): Macedonia respects the general rules of the World Trade Organisation (the Country has joined the WTO on 4 April, 2003). Besides this, Macedonia implemented eleven FTA: nine on a bilateral bases (with Serbia and Montenegro, Croatia, Bulgaria, Romania, Bosnia and Herzegovina, Albania, Turkey, Ukraine and Moldova) and two on a multilateral bases: the Central European Free Trade Agreement (in February 2006 Macedonia became the fourth member, joining Croatia, Bulgaria and Romania) and the Stabilization and Association Agreement with EU. At the end of 2005, the Macedonian Parliament ratified also a FTA with UNMIK (Kosovo). Over 85% of the trade exchange of Macedonia is realised under preferential conditions in accordance to the concluded bilateral and multilateral FTA.

These agreements –in theory- should be very attractive to foreign investors, but actually the distance from Central and Western European Countries and especially the lack of good transport infrastructure make commercial flows difficult. More, similar conditions offered by neighbouring Countries, which are closer to European Union borders and have better infrastructure, limit the effectiveness of FTA signed by Macedonia.

Probably there will be a growth in foreign trade in the following years, due to the new railways and streets that are going to be built in the framework of EU corridors VIII and X. Also Bulgaria’s accession to EU could boost Macedonia’s economic and trade relations with the EU.

b) Free Economic Zones (FEZ): they are part of the customs area of Macedonia, separately fenced and marked as a zone in which economic activities are performed under special conditions. The following activities could be performed in the FEZ: manufacture, services intended for export, foreign trade exchange, banking and other financial activities, property and individuals insurance and reinsurance, and other commercial activities except for those related to textile industry. Main offered advantages and incentives are **monetary advantages** (no tax duties regarding the VAT and Excise tax; no income tax and property tax for 10 years; no custom duties for goods, equipment and machinery in the free zone; no municipal fees for construction land, water connection, sewerage, heating, gas and electricity), **commercial advantages** (foreign companies can start their activities quickly; companies active in the FEZ can be 100% local companies, as well as foreign or joint venture companies; there is no prohibition against selling from the FEZ to the domestic market; companies can use the FEZ as a re-export centre; bureaucracy in the FEZ is minimized) and finally **employment advantages** (company can easily recruit highly qualified Macedonian employees).

In theory, FEZ should be a great magnet for FDI and the concerning law was aimed to develop many of them, but until today only one FEZ in actually working: the “Nickel Valley” in Kavadarci. This FEZ, founded in 2000 with already existing industrial capacities, has an area of 155 ha and eight users operate in it. The second FEZ is “Bunardzik” and it is projected on an area of about 160ha, 10 km East of Skopje (3 km away from the “Petrovec” airport).

The main problems that avoid these zones to be operative are the lack of infrastructures, a general lack of interest from both domestic and foreign firms and a competition from neighbouring Countries that propose to foreign investors similar zones, even on the coast line.

c) MacInvest: is the Agency for Foreign Investments of Macedonia. It started its activities in January 2005 to increase the inflow of FDI. The Agency is a state institution, mainly focusing on giving services to investors, securing and supplying them with all relevant information and assistance. The Agency was successful to attract some big investors, but the main lack this Agency has is that it is not taking in the right consideration foreign SMSs that want to invest in Macedonia.

d) Agreements for stimulating and mutual protection of investments: Macedonia signed this kind of agreement with 29 Countries[9] and its Constitution guarantees equal, national treatment to all investors. Since 1994, Macedonia has been a member of MIGA.

e) Agreements for avoidance of double taxation: Macedonia signed this kind of agreement with Albania, Bulgaria, Belarus, China-Taiwan, Croatia, Czech Republic, Denmark, Egypt, Finland, France, Hungary, Iran, Italy, the Netherlands, Poland, PR China, Romania, Russian Federation, Serbia and Montenegro, Slovenia, Spain, Sweden, Swiss, Turkey, Ukraine and Germany (not yet ratified).

Part 3. Some policy guidelines

According to data showed in Part 1, and taking into account the incentives already existing to attract FDI and develop foreign trade described in Part 2, here we suggest some measures that the new Government should take into consideration to achieve the goal of further economic development.

1) To avoid another “security crisis” –and the decline of FDI due to the “political risk”, as it happened in 2001- the Government should carefully monitor the political and social situation (for example concerning minorities’ rights, weak and poor part of population) in order to prevent any serious social and security/military problem.

This should be done creating a sort of “Observatory”[10]for critical situations that eventually can involve the Albanian minority and other groups. The Observatory could cooperate with local and foreign Non

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[9] Albania, Austria, Bosnia and Herzegovina, Bulgaria, Belarus, Belgium and Luxemburg, Germany, Egypt, Iran, Italy, Serbia and Montenegro, PR China, Republic of Korea, Malaysia, Poland, Romania, Russian Federation, China-Taiwan, Slovenia, Turkey, Ukraine, Hungary, Finland, France, The Netherlands, Croatia, Czech Republic, Switzerland, and Sweden.

[10] The Agency for Promotion of Entrepreneurship has a similar tool that actually works, the “Observatory on SMEs”.

Governmental Organizations, that can also have an economic role as stakeholders for foreign investors and donors (foreign Governments, international organizations).

The Government should work also to improve the image of the Country abroad and advertise FDI opportunities, for example with missions in foreign Chambers of commerce, sectoral fairs, business and industrial associations' meetings and so on (other Countries in the area are more active than Macedonia concerning this strategy).

2) Macedonia should continue its way towards the EU membership and to better integrate its economy with foreign Countries[11]. Priority should be given on one side to the main obstacles recognized by the EU (good relations with neighbouring countries and reforms to judicial and police system) and on the other side to infrastructures. Macedonia should implement projects in transport and infrastructure connected with Corridors VIII and X; these improvements can be useful tools to develop trade (for example with Bulgaria, EU member from January 2007) as well as to promote tourism, which can be a good source of investment and growth.

3) The production structure of Macedonia is mainly made by SMEs: the Government should create training centres and *ad hoc* assistance services (also financial services) for this kind of enterprises. New policies should be aimed to promote trade and industrial cooperation with foreign partners and to promote export of goods and services produced by SMEs: this can be also a strategy to decrease the size of the deficit in trade balance.

The above cited "Observatory on SMEs" is a good tool; its main task is to conduct an overview of the nature and performance of the SME Sector in the Country (for example collecting data and information, creating and updating data bases, analysing collected data and information) and it could also to provide services to local entrepreneurs (training and assistance).

Government could also work with associations, Chamber of commerce and other economic entities to promote cooperation among local SMEs, to create clusters and industrial districts.

4) Government should promote to foreign investors some specific sectors which are very dynamic or that constitute a big part of export. Besides to attract big multinational companies, special attention should be given to foreign SMEs willing to invest. Here we suggest to promote this sectors:

a) i**nformation and communication technology**: this sector is living a fast growth and it is easy to find local labour force which is cheap and well trained. Government should further support the project that USAID is implementing to make Macedonia the first Country completely wireless connected to internet[12];

b) agriculture: this sector has a long tradition in Macedonia and the output is good and can be sold abroad. In particular, the wine sector can be interesting for foreign investors and Macedonia wine should be promoted in wine fairs abroad or to the supply chain for catering, restaurants and so on. Local production could supply the Russian market due to the fact that Russia has recent banned Georgian and Moldovan wine;

c) textile: this sector could attract more FDI in the next years, especially by foreign companies that until now invested in Romania and Bulgaria, but that probably will leave these Countries due to rising costs after the EU accession.

[11] The motto of Macedonia in its path towards the EU is: The Sun, too, is a star!
[12] USAID's Program is called "Macedonia connects".

For big investors Government should promote:

d) chemical and pharmaceutical industry because of the large chemical industry present in the Country, which accounts for 10% of industrial output. There is a well-developed capacity for the production of basic chemicals, synthetic fibers, polyvinyl chloride, as well as detergents, fertilizers, polyurethane foams and fibres, etc.;

e) telecommunications and **electricity** industries.

5) A successful reform that took place at the beginning of 2006 is the creation of "one stop shop" for foreign investors in the Central Registry office. It is a very good example of proper policy to help foreign investors. Following this starting point, to avoid one of the most typical problem foreign investors have[13] and to meet their needs, Government should simplify the bureaucratic process and make more transparent the law concerning the property rights of land and houses. Another problem foreign investors meet is the not impartiality and slowness of the juridical system: Government should undertake some reforms in the field to make this sector more efficient and more transparent (this is also one of the problem EU recognized).

6) Due to the role that Russia has as investor in strategic sectors and the possibility this market offers, Government should promote a FTA with Russian Federation. In the area only Serbia has such a very interesting agreement and Macedonia could have it as well. A FTA with Russia should attract many European investors willing to achieve the Russian market. Now Russia counts for 8,7% of import and only 1,2% of export, but this market could be further developed.

7) Government could better promote FEZ, integrating them with the economical and social environment surrounding these special areas. It could promote the creation of clusters inside the FEZ, possibly also integrating Universities and technical schools active in the field in which the cluster-FEZ is specialized. Exemption from customs duties and tax breaks are welcomed by foreign investors, but so far they did not work very well because these incentives can not exist in a *vacuum*: they should be supported by physical infrastructure and various kind of services.

8) The Agency for Foreign Investments worked well so far, but it should provide more services also to foreign SMEs and not only try to attract big foreign investors (Multinational Companies for example). The Agency could create a division dedicated to foreign SMEs assistance, for example providing *ad hoc* guides for investors for this kind of enterprises. Here we suggest that the Agency could provide foreign SMEs with lists of local lawyers, accountants and other professionals who speak specific foreign languages and had already worked with SMEs coming from a specific Country; short *vademecum* written in foreign languages etc.

9) To offer to foreign investors a strong and valid counterpart in their investments, Government should encourage the development of enterprises' associations (according to the industry they work in). These associations on one side have positive effects on national economy (more awareness about problems and needs, more coordination and better information concerning specific sectors etc.), on the other side they can be good

[13] According to interviews I made in Macedonia in August 2006.

sources of information and for example they could do proper match-making between local firms and foreign firms (mainly SMEs) willing to find local partners for FDI and trade.

Conclusions

The next four years will be a turning point for Macedonia and this Government has the possibility to drive the Country very close to the EU accession (provisions say Macedonia could join the EU in 2012).

In the last years (after 2001) the Country started to grow and good macro-economic reforms have been undertaken; also the image of the Country abroad improved, but still more promotion should be done. Suggest measures could be used to achieve further economic development, wider integration in the international trade and also strength competitiveness of local SMEs.

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