

The effects of the global economic crisis on Macedonian economy:

Some macroeconomic indicators and future policy recommendations

Elizabeta Tosheva, PhD

University St. Clement of Ohrid, Bitola

Faculty of Law – Kichevo, Republic of Macedonia (FYROM)

Abstract

The recent economic and financial crisis caused a severe blow to the fragile Macedonian economy, halting the positive development trends in the last decade. This, has in turn, intensified the future challenges.

The paper intends to analyze the impact of global economic crisis on the Macedonian economy focuses mainly on the macroeconomic level, identifying and analyzing fluctuations of major macroeconomic indicators that reflect the development and macroeconomic balances of the economy, such as GDP, the level of employment, inflation, budget deficit, public debt, etc. Secondary analysis of previous quantitative data and published studies, combined with an own qualitative study in the field, has provided a reliable and convincing basis for analysis.

The experiences and lessons taken from the global economic crisis should serve as a basis for changing the current economic model with a new one in order the economy of the country to catch a connection with the intense changes that are expected to occur in the coming period. It is expected that creating new economic model in Republic of Macedonia will result in multiple positive effects that primarily manifested in the increasing number of newly small and medium enterprises, domestic investments, industrial production, GDP, number of new employees and total exports as well as in reduction of the trade deficit in maintaining macroeconomic stability of the country.

Keywords: Republic of Macedonia; economic crisis; unemployment; inflation; budgetary deficit; policy recommendations

Introduction

Republic of Macedonia is a small, land-locked country of about 2 million people with a multi - ethnic population¹ in the middle of the Western Balkans. R. Macedonia was the third poorest among the South East European countries in 2012.² It is also the most

¹ According to the 2002 census, the population consists of ethnic Macedonians (64 percent), ethnic Albanians (25 percent), ethnic Turks, (4 percent), ethnic Serbs (1.7 percent), Roma (2.7 percent), and some other small minority communities.

² National Bank of Republic of Macedonia

open economy among its regional peers³, with an Openness index⁴ of 112 percent over the past decade. Since 2002, the country's exchange rate has been pegged to the euro, which has successfully supported price stability, and inflation has averaged 2.5 percent over the past 20 years. It was among the first Western Balkan countries to gain EU candidate country status in 2005, but it has yet to start EU accession negotiations.

The recent economic crisis caused a severe blow to the fragile economy and labour markets of the Macedonian economy halting the positive development trends in the last decade. The decline of economic activity in most neighboring states, the post-recession situation in Europe, the crisis in the euro zone, the debt crisis, the decrease in foreign investment and the increase in energy prices seriously affected the Macedonian economy. The Western Balkan countries are especially vulnerable to the effects of the euro zone crisis because of the high degree of „euroization“ (Bartlett & Uvalic, 2013). Almost 60% of the region's exports go to the EU, while the banking sector relies heavily on euro zone finance. The economic slowdown in EU countries - the main recipients of Macedonian exports weakened demand for exports and led to a drop in investment and remittances (Panagiotou, 2012). As a result, GDP growth was marginally negative.

Due to the extremely high interdependence of the economy with those of the euro-area, the euro-crisis (and particularly the meltdown of the Greek economy) have had extremely detrimental repercussions on the economy in terms of macroeconomic performance, growth, FDI, trade flows, remittances etc.

There are several points that define the weak condition in of Macedonia economy:

- The Eurozone crisis which resulted in declining exports and foreign investment;
- The blocked process of EU accession;
- Failed privatization processes of four large state-owned enterprises, due to weak company fundamentals and difficult economic environment;
- Reduction of the credit growth as a result of the conservative credit policy of the banks;
- High unemployment rate, of around 30%, especially among youth, of above 54% (EBRD, 2013).

However, the country has made strong efforts in recent years to improve the business environment and defy global trends by attracting much-needed FDI. These efforts should help growth to pick up this year and beyond. Strong investment growth, fuelled by public infrastructure projects and FDI boosted domestic demand in 2014, which is expected to remain the only growth driver in 2015 and 2016. The government relaxed its fiscal consolidation path, with targeted budget deficits declining less rapidly than

³ South East Europe refers here to Albania, Bosnia and Herzegovina, Kosovo, Macedonia, Montenegro, and Serbia.

⁴ The Openness index is calculated as exports plus imports as a share of GDP.

originally planned. While the rise in government debt is moderate, financing needs of state-owned enterprises weigh heavily on the public debt level (European Commission, 2015). Macedonia has managed to improve many dimensions of its business environment, showing that it can be done in other countries in the region, too (*World Bank and International Finance Corporation, 2013*). The country maintained its high ranking (30th) in the latest 2015 *Doing Business* report (World Bank Group, 2015).

This is the case of R. Macedonia in the context of the current economic and financial crises, identifying and analyzing fluctuations of major macroeconomic indicators that reflect the development and macroeconomic balances of the economy, such as GDP, the level of employment, inflation, budget deficit, public debt, etc. Secondary analysis of previous quantitative data and published studies, combined with an own qualitative study in the field, has provided a reliable and convincing basis for analysis. The paper highlights the need for the country to use opportunity to improve its investment climates and reduce public debt, while simultaneously eliminating payment arrears in the public sector - which will help improve financial discipline in the overall economy.

Economic Overview of Recent Macroeconomic Trends

As was discussed above, the economic situation in R. Macedonia in 2014 was characterised by post-recession trends and deterioration in exports to Macedonia's traditional trading partners. Obtaining economic growth and protecting the population, through reduction of inflation and measures for limitation of the unemployment phenomenon, are considered priorities. Budgetary deficit and public debt are the instruments the state can use to achieve these major objectives. The Maastricht criteria of nominal convergence for public finance are no longer considered in the short run, only in the medium and long run. In the context of the decline of the private consumption, decreasing the current account deficit is another issue of these crises.

The general policy mix in Macedonia is sound, as it remained stability oriented while trying to support the recovery. The prospects for growth are still higher than in most of the other countries of the region. Fiscal policy was oriented towards achieving the fiscal target, despite lower than expected revenue performance. The quality of public finances has not improved significantly and the issue of high unemployment, in particular among the young, remains a major policy challenge.

In the following section, we present fluctuations of the major macroeconomic variables during the period 2007-2015.

GDP. Gradual recovery of global economy had positive transferable effects on the activity in the Macedonian economy as well. Following the moderate drop in 2009 and 2012, real GDP increased by 2.2% in 2013 and continues increasing in the following year. The economy has recovered gradually, so GDP growth reached 3.8% in 2014.

The renewed growth of the economy remains narrowly based on investment, with only gradual strengthening of the external sector and marginal support from private consumption (European Commission, 2014).

2007	2008	2009	2010	2011	2012	2013	2014	Kv.1	Kv.2	Kv.3	Kv.4	Kv.1
								2014	2014	2014	2014	2015
6,5	5,5	-0,4	3,4	2,3	-0,5	2,7	3,8	3,3	4,7	4,3	2,7	3,2

Table 2.1. GDP (real growth rates in %) RM (2007-2015)
Source: National Bank of Republic of Macedonia, April 2015

According to the European Commission, Macedonia's government remains supportive, with plans for further infrastructure projects, and increases in entitlement spending, relaxing its mid-term fiscal consolidation strategy. Investment activity, driven by public expenditure on transport and energy projects, as well as the construction of new foreign investment facilities, is projected to post further solid gains, even though growth rates are slowing down to their long-term average. Household spending, benefitting from sound fundamentals, is likely to firm up further, and set to become the main source of output growth in 2015 and 2016. Domestic investment consumption and increased production of new industrial capacities, in conditions of gradual recovery of export demand and favorable trends in prices of metals on the global markets, contributed for continuation of the trend of economic recovery. Macedonia's GDP is expected to grow by 3.8% in 2015 and by 3.9% in 2016. Further gains in domestic demand are likely to set GDP growth at an even higher pace in 2015 and 2016, while the negative contribution from net exports is expected to diminish (World Bank Group, 2015).

Inflation. The values of inflation rate in 2014 and estimated for 2015 and 2016 indicates a stability of purchasing power of population in this difficult and very insecure period. In 2013 and the inflation was relatively low and stable, ranging around 2,8% to -0,3% in 2014. In a medium run, inflation will be under the influence of the changes in global primary commodity prices, and the pace of economic activity in the domestic economy. Global inflation factors in the medium term suggest moderate acceleration of domestic inflation after its low level in 2014. In 2015, foreign inflation is expected to reach 1.3% and in 2016, it is expected to increase moderately to 1.8% (NERP, 2015).

2007	2008	2009	2010	2011	2012	2013	2014	Kv1	Kv2
								2015	2015
2,3	8,3	-0,8	1,6	3,9	3,3	2,8	-0,3	-0,9	-0,3

Table 2.2. Inflation rate (%) R. Macedonia 2007-2015
Source: National Bank of Republic of Macedonia, August 2015

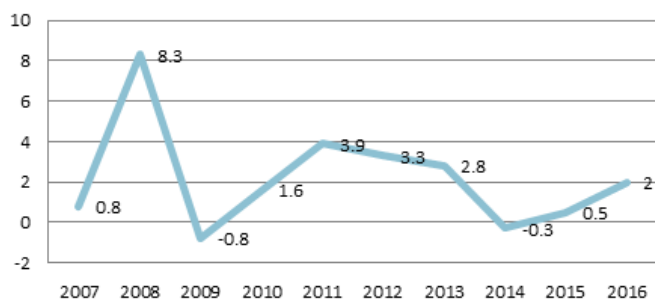


Figure 2.1. Inflation rate in Macedonia

Labour market. As for the labour market, certain positive dynamics was noticed, which can be considered as a reflection of the recovery of the economy from the global economic crisis. A prolonged economic downturn would add to the already chronic problem of long-term unemployment (Bogetić, et al. 2012). Unemployment rate in Macedonia, particularly youth and long-term unemployment, remained persistently high, pointing to deep-rooted structural impediments in the labour market. There was some gradual improvement in the official employment and unemployment rates. Macedonia has made impressive progress in reducing unemployment (declining from 34 percent in 2008 to 28 percent in the third quarter of 2014), yet most jobs were created in low-productivity sectors or in the public sector (World Bank Group, 2015). The recorded employment creation derives, to a large part, from an increase in part-time and self-employed occupations and from a rise in public sector employment. Overall, in spite of some incremental improvement in the official labour market figures, labour market policy has had limited success in addressing the persistently high unemployment. Structural challenges in the labour market remain to be tackled.

2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	Kv1 2014	Kv2 2014	Kv3 2014	Kv4 2014
37,3	36	34,9	33,8	32,2	32,1	31,4	31	29	28	28,4	28,2	27,9	27,6

Table 2.3. Unemployment rate (%) R. Macedonia (2005-2014)

Source: National Bank of Republic of Macedonia, April 2015

The sold of current account. The current account balance measuring the ratio between imports and exports is very important for the future perspectives of the country, as it indicates decreased confidence of foreign investors. Macedonia recorded a Current Account deficit of 64.60 USD Million in April of 2015. Current Account in Macedonia averaged -30.21 USD Million from 1998 until 2015, reaching an all time high of 107.80 USD Million in September of 2009 and a record low of -243.60 USD Million in November of 2008.⁵ For Macedonia, the estimated value is 3.6 % over GDP, with 0.2 percentage points higher than the average of the EU 27 (WIBF, 2013). The structural budget balance

⁵ State Statistical Office

refers to the general government balance, cyclically adjusted for nonstructural elements beyond the economic cycle. These include temporary financial sector and asset price movements as well as one-off, or temporary, revenue or expenditure items.

2007	2008	2009	2010	2011	2012	2013	2014
-7,3	-12,5	-6,5	-2,1	-2,5	-3,1	-1,8	-1,4

*Table 2.4. The sold of current account (% of BDP) (2007-2014)
Source: National Bank of Republic of Macedonia, April 2015*

The main current account components register divergent movements. Trade deficit is shrinks gradually, while the share of net inflows from private transfers in GDP slowdown insignificantly. Trade deficit reduction is based on the expected faster growth of exports compared to the growth of imports. Export performances of domestic companies are largely conditioned upon the developments of external demand and global prices, whose dynamics usually, and under current environment of disruption of regular streams of global economy, is additionally clouded by uncertainty. Hence, the developments of global economy are relevant risk factor to the developments of the balance of payments of the Macedonian economy in a medium run. The stress tests show that the expected external debt stabilization of the medium run, however, is particularly sensitive to the shocks in the primary deficit of the current account and in the economic growth (NERP, 2015).

Strong investment-related, and, gradually, also consumption-related import growth is likely to lead to a slight deterioration in the current account, even though private transfers are expected to remain stable (EC, 2015). On the other hand, it is a fact that the number of exporting companies in the economy grows steadily, which should result in export diversification and improvement of export performances in a medium run. This would simultaneously contribute to higher resilience of the economy to external shocks.

The public debt. Levels of public debt in R. Macedonia combined with the pressures on public finance due to increased demand for social assistance and sluggish revenue growth, further limit the fiscal space on the budget for further expanding infrastructure investments. At the same time, country is still lagging behind in terms of its capital stock, both private and public, so further investment is needed. The share of external debt in total general government debt increased by some 6pp to 69,8% of GDP in 2014. Other indicators of indebtedness, such as debt servicing to exports, and interest repayment to exports, continued to suggest low external indebtedness of the country. However, projections point towards a further increase in external debt levels over the next years, given the elevated financing needs of state-owned enterprises managing public infrastructure projects, which are likely to be met by foreign commercial loans (EC, 2015a).

2007	2008	2009	2010	2011	2012	2013	2014	Kv1 2014	Kv2 2014	Kv3 2014	Kv4 2014
46,6	48,8	55,9	57,8	64,2	68,2	64,3	69,8	66	67,3	74,3	69,8

Table 2.5. External debt RM in % (2007-2014)

Source: National Bank of Republic of Macedonia, April 2015

Central government debt. Even though government debt in R. Macedonia is still at a moderate level, but the increases over the last years give rise to concern. Central government debt stood at 33.6% of GDP by the end of July 2013, compared to 27.8% at end of 2011 (WIBF, 2013). Moreover, as the budget of the newly created public enterprise for state roads was excluded from the central budget as of 2013, its debt is no longer included in central government debt. Overall, fiscal governance and fiscal discipline deteriorated and would benefit from the implementation of a medium-term strategy. Between 2008 and 2014, R Macedonia's public debt almost doubled, increasing from 23 % of GDP in 2008 to an estimated 45.8 % of GDP in gross terms by 2014 (or 40.8 % in net terms). By comparison, public debt in the SEE region averaged 52.7% in 2014. This increase in public debt was driven by sustained fiscal deficits at the central government level and state-owned enterprise (SOE)-led investments (WBG, 2015).

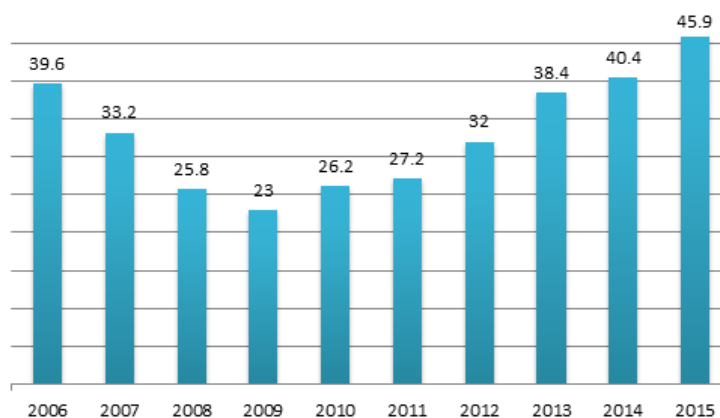


Figure 2.2. Central government debt Republic of Macedonia as % of GDP

Source: <http://www.tradingeconomics.com/macedonia/government-debt-to-gdp>

FDI. The recent economic crisis has underscored the importance of a competitiveness-supporting economic environment for better enabling national economies to absorb shocks and ensure solid economic performance (Penev, 2012).

So, the new set of measures was designed to facilitate the procedures for doing business in the country, improve access to credit of micro enterprises and SMEs, increase their liquidity, stimulate construction, increase privatisation of land, promote employment in agriculture, improve tourism, promote export and reduce unfair

competition. Inflows of foreign direct investment (FDI) averaged 2.8 percent of GDP per year between 2009 and 2014 but are still low by regional standards (World Bank Group, 2015). Between 2006 and 2013, net FDI on average amounted to 4.3 percent of GDP, which is significantly below the regional average of 8.1 percent of GDP over the same period. Backward linkages with local companies are limited, thus restraining employment gains, net export growth, know-how sharing, and other spillovers from the FDI. However, new FDI projects (especially in the automotive industry, mining, and textiles and apparel) offer good opportunities for increasing linkages with local companies (World Bank Group, 2015).

Poor institutional and physical infrastructure, relatively low market and labour efficiency, as well as limited innovation and sophistication potential of the region are serious limitations to the competitiveness (WEF, 2013). Skills, technology absorption, capacity, institution building and the overall business environment will become more important (Snoy, 2011). A closer look at the key aspects affecting the investment climate, in particular the frail institutional and administrative framework, clearly indicates that there is substantial room for improving the overall business climate to boost investments and other economic activities, notably for involving the private sector in infrastructure developments.

In the Table 2.6., we present SWOT analysis of the current economic situation on R. Macedonia and its future threats and opportunities.

STRENGTHS	WEAKNESSES
Moderate decline of GDP during the period of crisis Contracting current account deficit General government debt the lowest in the region Low and contracting fiscal deficit Level of competitiveness Quality of regulations Macroeconomic stability Significant progress in the elimination of barriers to market entry and exit	High exposure to the Eurozone crisis Growing external debt Capability for innovation High unemployment rate Rule of law Market size
THREATS	OPPORTUNITIES
Political crisis in the country EU accession negotiations not yet opened Underdeveloped non-banking sector Legal system weaknesses: Judicial independence Brain drain	EU candidate status Level of trade liberalization Level of price liberalization Private sector share in GDP Competition policy

Table 2.6. SWOT analyses - R. Macedonia
 Source: Author calculations

Challenges to Economic Growth

Despite the fact the Republic of Macedonia has accomplished a lot in terms of attaining economic growth, there are still number of challenges remaining in future. The Government of the Republic of Macedonia has identified all challenges to the economic policy in the coming medium-term period:

- reducing unemployment rate, as the most burning issue to the Macedonian economy, and
- realizing economic growth rates by increasing production with higher added value and diversifying and expanding the export to the end of strengthening competitive position of the country and the Macedonian companies globally (Ministry of Finance of the Republic of Macedonia, 2015).

Current macroeconomic climate and external macroeconomic risks for the Republic of Macedonia as a result of the turmoil on the global markets and the debt crisis in Euro zone impose the need to accelerate the process of implementation of accession criteria (Copenhagen Criteria), so as to increase economic growth and both domestic and FDIs, as a condition for job creation. That is why increase of economic growth and unemployment reduction, as precondition for increased living standard and better and quality life of the citizens in the Republic of Macedonia, is considered as a top strategic priority of the Government of the Republic of Macedonia.⁶

In order to respond to the challenges to realise the top strategic priorities, the country remains committed, in the coming medium-term as well, to implement the structural reform agenda in all aspects of the economic life. Realisation of these reforms will mean success in implementing the model of economic development based on competitive and integrated economy, providing equal opportunities for all by realizing the following economic objectives: macroeconomic stability, higher economic growth and job creation.

Such model, taking into account the particularities and the priorities of the Republic of Macedonia for full integration and real convergence with the EU, is based on the EU Strategy for fast, sustainable and inclusive economic development, known as "Europe 2020" Strategy.

Key reform areas: Taking into account the identified priorities and challenges to the economic policy, following are key areas in the structural reform agenda: continuous improvement of the business environment, support to entrepreneurship and SMEs, as main promoters of dynamic economic growth and unemployment reduction, promoting human capital and ensuring stronger link between supply and demand on the labour market and increased export support and promotion. In addition,

⁶ The Parliament of the Republic of Macedonia adopted the Operating Programme of the Government of the Republic of Macedonia (2011-2015) on 29th July 2011.

economic policy focuses on implementing reforms to create efficient, effective and professional public administration, strengthen legal safety and supervisory capacities of the regulatory bodies, as well as increase productivity in agriculture.

Future Policy Recommendations

Tackling structural problems in the economy will require a significant improvement in institutional capacity in the field of economic policy formulation and implementation. The transparency and quality of public financial management remain a concern.

Unemployment is still high despite a marginal decrease in the second quarter of 2014. Some specific measures have been adopted to tackle youth unemployment as part of the country's Unemployment policy, but their effect is yet to be seen. The public sector remains the main employer. Labour market participation remains very low, especially among women and young people. The national budget for active employment programmes and measures has somewhat decreased in 2014 however, and is not sufficient to meet the needs of the labour market. Little progress was made on the long-term process of modernising the Employment Service Agency. Some steps were made by the Ministry of Labour and Social Policy responsible for fighting informal economy in order to reduce the level of undeclared work. Recent educational reforms in Macedonia were mainly based on the premise that the country has a comparatively low level of human capital, and that improving the educational attainment of the population would bring greater productivity and growth (Arandarenko & Bartlet 2012).

Small and medium-size enterprises (SMEs) participate with 99% in the total number of enterprises and absorb the largest part of the working force (79% of the total number of employees are in SMEs) implying that SMEs are significant participants in the economy. Taking into account their significance in the increase of the economic growth and the reduction of the unemployment as a structural problem of the Macedonian economy, one of the basic priorities in the following period presents the increased support to the entrepreneurship and to SMEs through improvement of the business climate, facilitation of the access to capital and other activities. Financial sector vulnerabilities are a particular concern, given that the vast majority of the banking system is foreign-owned and that most countries rely on funding from abroad (Penev, 2012).

The new economic model of the R. Macedonia should be based on: recovering the labour market and reducing the number of unemployed, in particular by better matching skills with demand (EC, 2015a); improving the management of public finances; developing public spending schemes and further enhancing structural reforms; further attracting exports and foreign investment, further reducing the public debt and decelerating levels of FDI. Fiscal policy needs to be aligned with the country's structural reform priorities. A medium-term fiscal framework, multi-annual budgeting and strategic planning, as well as effective public financial management are required.

In the coming medium-term period, macroeconomic policy should be focused on:

- Further business climate improvement and creation of equal opportunities for economic growth and development of all participants in the economic processes, tax and customs policy aimed at supporting development of economic entities, encouraging investment activity and attracting FDIs, developing human capital and economic infrastructure of the country.
- Encouraging the as-yet-fragile economic recovery and supporting economic growth; consolidating fiscal policy; balancing national budgets, solving liquidity problems and problems connected with national currency fluctuations. Special attention must be paid to reducing unemployment and increasing the number of new jobs (Jeleva, 2012);
- Supporting the modernisation efforts of the country, including structural reforms in all the respective areas, but also strengthening the main domains of democratic development such as the rule of law, good governance, political consolidation and ethnic tolerance;
- Removing obstacles to regional cooperation and stability and supporting the multilateral dialogue on pressing issues;
- Improving communication with the business community in the country in order to improve the business environment, entrepreneurial climate and competitiveness;

Conclusions

Objectives of the macroeconomic policy of the R. Macedonia in the coming period should remain focused on maintaining macroeconomic stability and supporting Macedonian economy by conducting prudent fiscal policy with reasonable and non-distortive rates of budget deficit and government debt under the Maastricht criterion, improving the quality of public finance, mainly by intensifying capital investments aimed at improving infrastructure and physical capital, hereby supporting the policy of stable Denar exchange rate and maintaining low government debt.

Economic recovery continued in 2015 and financial stability was preserved, but unemployment, especially among youth, remained very high. Fiscal discipline as well as transparency and quality of government spending deteriorated. The Macedonian economy remains well advanced and made some further progress towards the establishment of a functioning market economy. To cope with competitive pressures and market forces within the EU, in the medium-term, the country needs to implement structural reforms. These include public finance management, multi-annual budgeting and strategic planning. Prospects for growth and employment depend largely on the development of the domestic private sector. To support this, there is a need for further improvement of the business environment, including access to finance.

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