



Sector Specific Sources of Competitiveness in the Western Balkans

KEY CONCLUSIONS AND NEXT STEPS



SCOPE OF THE STUDY

The *Sector Competitiveness Project* is designed to assist the Western Balkans to attract more investment and increase trade through the implementation of sector specific policy actions. It covers seven economies – **Albania, Bosnia and Herzegovina, the former Yugoslav Republic of Macedonia, Montenegro, Serbia and Kosovo under UNSCR 1244/99** – and has been based on a collaborative process involving OECD experts, Western Balkan governments and the private sector.

The competitiveness of the economies of the Western Balkans represents a strategic European interest. Well-functioning market economies, resistant to global competitive pressures, contribute to the political stabilisation of the Western Balkan region as well as to growth and jobs for Europe, which is the EU's main policy objective for the years to come.

Foreign direct investment (FDI) inflows help sustain economic growth and generate employment in the formal sector, promote exports, rebalance growing trade deficits and maintain the process of economic reconstruction. With intensifying global competition to attract investment -- especially in the wake of the economic crisis -- dedicated investment and private sector development policies are needed. For policies to be successful in the long term, governments of the region need to identify which sectors can offer this competitive advantage and find ways to remove barriers to their development.

This brochure contains the main conclusions from the 2009 report “Sector Specific Sources of Competitiveness in the Western Balkans: Recommendation for a Regional Investment Strategy”. It highlights key recommendations to policymakers on ways to overcome sector-specific policy barriers in three key sectors: apparel manufacturing, automotive components and business process and information technology outsourcing. It also outlines the first achievements since the publication of the projects' implementation phase, as well as the challenges which lie ahead.

Apparel Manufacturing

SECTOR STRENGTHS:

The Western Balkans has demonstrated that it can be competitive in the traditional apparel manufacturing sector. Apparel products are one of the largest manufacturing export categories in the region, representing over 7% of total exports in 2006. The region combines cost competitiveness with relatively high productivity and is increasingly seen as a key supplier of Western European markets and an effective location for European and other investors to diversify risk by spreading suppliers across geographic areas. The region has also responded well to the opportunities presented by changes in the apparel sector. It has gone a long way towards implementing more efficient systems to ensure apparel products can be shipped in the shortest time. Many regional manufacturers have facilitated data communication with their buyers, especially in Croatia and Serbia, and some have implemented advanced automated technology, particularly in the former Yugoslav Republic of Macedonia.

FAST FACTS:

7% of total exports from the Western Balkans in 2006 were apparel products.

42% of firms surveyed* by OECD in the Western Balkan region still provide only basic assembly services.

71% of Western Balkan firms consider access to finance to be an obstacle to the growth of their businesses.

63% of firms in the Former Yugoslav Republic of Macedonia identified skills as a barrier limiting the operation and growth of their businesses. In Croatia, management capability was identified as the most serious shortage. In Albania and Kosovo¹, the biggest problem is the electricity infrastructure which causes daily power outages.

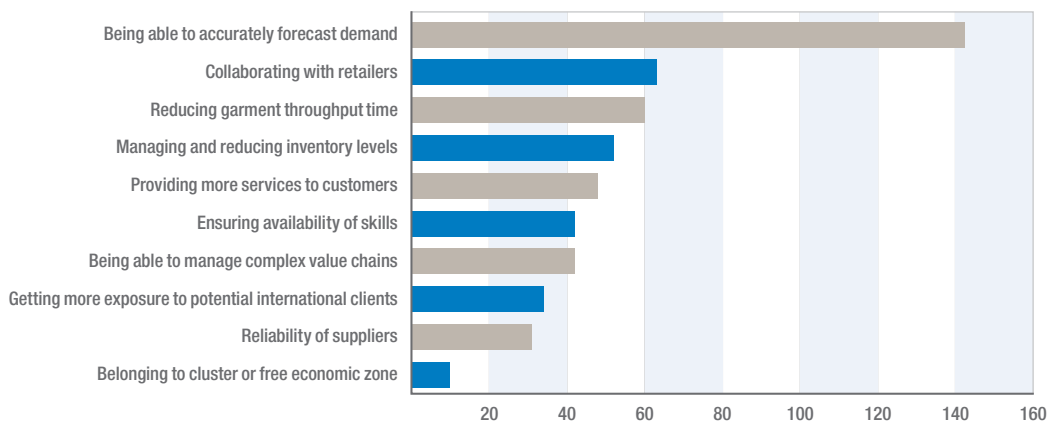
¹ Throughout the report, "Kosovo" refers to Kosovo under UNSCR 1244/99"

* results based on 2007 survey

SECTOR CHALLENGES:

- **Time to market:** Reducing the time it takes to complete an order by improving plant throughput time was identified as a key success factor by Western Balkan apparel firms, even though many firms have not yet made necessary investments to achieve this goal.
- **Value:** Apparel manufacturers are situated at the less profitable, lower end of the value chain.
- **Access to finance:** Firms have difficulty obtaining affordable financing for investments in their businesses.
- **Other policy barriers:** Slow and bureaucratic systems of value-added tax (VAT) reimbursement, which reduce companies' cash flow, are particularly important in a sector with narrow profit margins. Infrastructure and skills gaps also create drag on sector growth.

MOST IMPORTANT KEY SUCCESS FACTORS FOR COMPANIES



Note: Firms were asked to select their three most important success factors. The figure reflects aggregated responses.

Source: OECD RCS (2008).

SECTOR REFORM:

With the Western Balkan region's low wages, knowledgeable local workforce, close proximity to EU markets and relatively high levels of productivity, it is clear why retailers and apparel buyers are increasingly sourcing apparel products from the region's manufacturers. Until now the region has depended on low wages to distinguish it as an attractive location to source clothing. As this advantage will gradually dissipate due to economic growth, which will inevitably lead to wage appreciation, the sector needs to capitalise on its geographic proximity to Western markets. This means that major improvements must be made in decreasing time to market and offering full-package sourcing services to buyers. To achieve this, both operational improvements and policy barriers need to be addressed.

OPERATIONAL IMPROVEMENTS FIRMS CAN MAKE:

- **Reduce time to market through internal process changes:** improve plant throughput times, streamline payment and contractual processing times through electronic data interchange, improve inventory control systems, reduce transport times and guarantee the protection of goods.
- **Increase profitability by introducing more value-added services:** move from Cut-Make-Trim (CMT) work (the main activity of 42% of Western Balkan apparel manufacturing firms) to higher value services such as Original Equipment Manufacturing (OEM) and Original Brand Manufacturing (OBM).
- **Promote their businesses to international clients to increase exposure and reduce excess capacity:** leverage the potential of the internet and participate actively in international fashion and trade fairs.

TYPES OF APPAREL MANUFACTURERS: CMT, OEM, OBM



Source: Gereffi and Memedovic (2003).

ACTIONS GOVERNMENTS CAN TAKE:

- **Improve companies' access to and cost of finance:** introduce policies that will reduce required collateral for firms to obtain a loan.
- **Reduce delays in VAT reimbursement:** enforce existing legislation to ensure that companies receive their VAT reimbursements, which represent a large portion of firms' working capital, in less than 60 days.
- **Reduce import duties:** reduce duties on imported textile products, upon which the region's apparel manufacturing industry relies heavily and which can represent over 60% of total costs incurred by an average textile firm.
- **Improve logistical channels:** improve transport infrastructure and reduce delays caused by customs and trade bottlenecks.

SOURCES OF FINANCING NEW INVESTMENT: THE WESTERN BALKANS AND OECD

	New investment	
	Western Balkans (%)	OECD (%)
Internal funds or retained earnings	64.97	56.98
Local commercial banks (loan, overdraft)	16.92	20.21
Foreign owned commercial banks	8.79	0.89
Leasing arrangement	1.07	9.50
Investment funds, special development financing or other state services	0.61	0.54
Trade credit (supplier or customer credit)	1.99	3.40
Credit cards	0.00	0.52
Equity, sale of stock	2.70	5.78
Family, friends	1.04	1.04
Informal sources (e.g. money lender)	0.37	0.10
Other	1.55	1.06

Source: BEEPS 2005; OECD: Germany, Greece, Ireland, Korea, Portugal, Spain.

NEXT STEPS:

Since the 2009 SSSC report was released, Western Balkan governments and the private sector have consulted extensively to determine the most effective focus for an action-oriented reform strategy for the apparel sector. As a result of these discussions, both firms and government representatives have agreed that among the obstacles highlighted in the report, access to finance remains the key impediment to sector growth. Facilitating firms' access to finance is of key importance to the future development not only of the apparel manufacturing industry but also to a broad range of sectors in the region, and has become even more pressing with the current economic crisis.

To support governments in implementing report recommendations and increasing firms' access to finance, the OECD is working to:

- **Distil OECD good practices governments can follow to improve access to finance:** review schemes, institutions and legislation in place to help countries of the region find ways to reduce credit rationing. Specific OECD expertise includes: credit guarantee schemes, credit information sharing, creditor rights, collateral definitions, etc.
- **Assess Western Balkan implementation:** evaluate how institutions in Western Balkan countries compare against these good practices.
- **Recommend reform priorities:** provide country specific recommendations and next steps to support governments in implementing policies to improve access to finance. Promote these reforms among key ministries.
- **Inform firms about ways to overcome operational and policy barriers:** provide firms with information about areas where operational improvements are needed to increase competitiveness and how they can tap into potential sources of financing.
- **Provide a venue for regional learning:** hold a regional workshop on access to finance to encourage cross-country dialogue on key issues affecting the financing environment.

Automotive Components

SECTOR STRENGTHS:

Despite the impact of the global crisis and a global automotive market that has undergone dramatic changes in response to increasingly stringent customer demand, the Western Balkans has clear opportunities to attract investment and remain competitive. The continued strength of the sector in the region has relied upon cost competitiveness, geographical proximity to markets and a historical legacy of manufacturing automotive components.

FAST FACTS:

60%
LOWER

Operational costs in the Western Balkans as compared to Hungary and Poland.

2
DAYS

The time it takes for Western Balkan suppliers to send products to key markets in Europe like Germany and Italy.

51%

of companies surveyed in the region feel that they are experiencing some degree of skills gap in engineering.

ONLY
34%

of companies surveyed had developed a new product, design or service since 2004.

ONLY
12%

of companies surveyed had received industry-specific quality certification.

58%

of companies reported encountering barriers associated with customs and trade regulations.

SECTOR CHALLENGES:

- **Cost and quality:** The region's cost competitiveness may be eroded due to wage increases following EU integration (which has occurred in Central and Eastern Europe). The region must also strive to meet stringent quality standards and new requirements for design and component development.
- **Lack of exposure:** There are few sector specific investment promotion tools to raise awareness of local suppliers' strengths and capabilities among international customers and investors.
- **Skills gaps:** A majority of Western Balkan component companies suffer from skills gaps in areas where it is necessary to build and maintain long-term collaborations with customers, especially with regard to design, supply chain management and quality assurance.
- **Innovation:** There is a lack of existing collaborative mechanisms to enable innovation to flow between research centres, academia and foreign and local companies.

THE REGIONAL AUTOMOTIVE COMPONENTS INDUSTRY, KEY DATA

Value-added	EUR 169.9 million
Market growth	13%
Cumulative FDI inflows	EUR 116 million
FDI inward stock ⁴	EUR 63.5 million
Exports	EUR 209 million
Employment	33 785 persons employed
Number of firms	230

Note: Data above covers the time period 2003-2007.

Source: Roland Berger, Vienna Institute for International Economic Studies, national offices of statistics, National Central Banks, UN Comtrade.

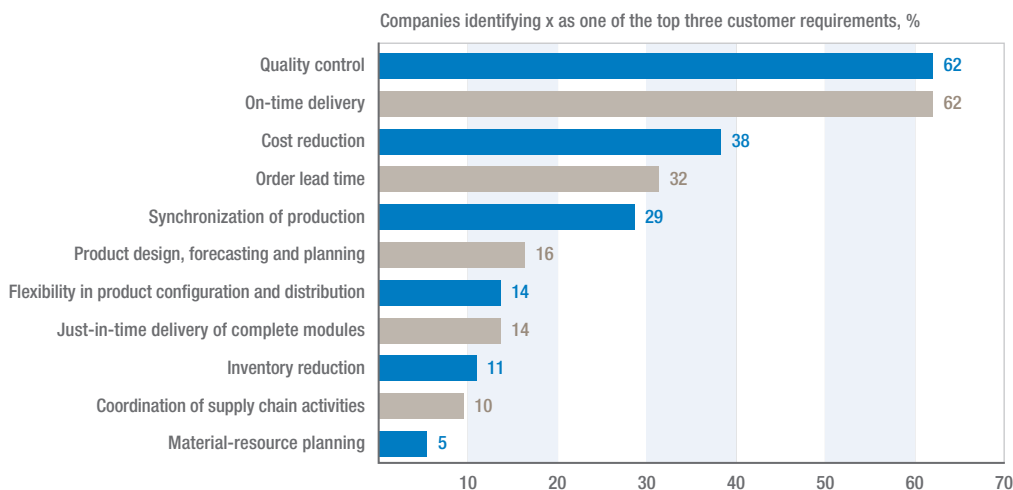
SECTOR REFORM:

To maintain their competitive edge in this changing environment, automotive component suppliers in the Western Balkans will need to modify their business practices to meet new requirements in terms of quality standards, design and development capabilities and supply chain management. Governments must also change the focus of their reform efforts, as the experience in other CEE countries has shown that once the initial wave of privatization-related investment subsidies, factors such as institutional development, infrastructure and the quality of the business environment become increasingly critical to ensuring the sustainable competitiveness of the sector.

OPERATIONAL IMPROVEMENTS FIRMS CAN MAKE:

- **Improve quality standards and quality management:** to be considered as partners by international companies, regional suppliers must meet basic requirements for the sector such as ISO 9001 and ISO/TS16949.
- **Step up innovation:** increase focus on innovation in product development, design and service.
- **Implement on-line procurement initiatives:** respond to demand from first-tier suppliers and international companies for business-to-business web portals to facilitate business dealings.

KEY CUSTOMER REQUIREMENTS FOR AUTOMOTIVE COMPONENT SUPPLIERS IN THE WESTERN BALKANS



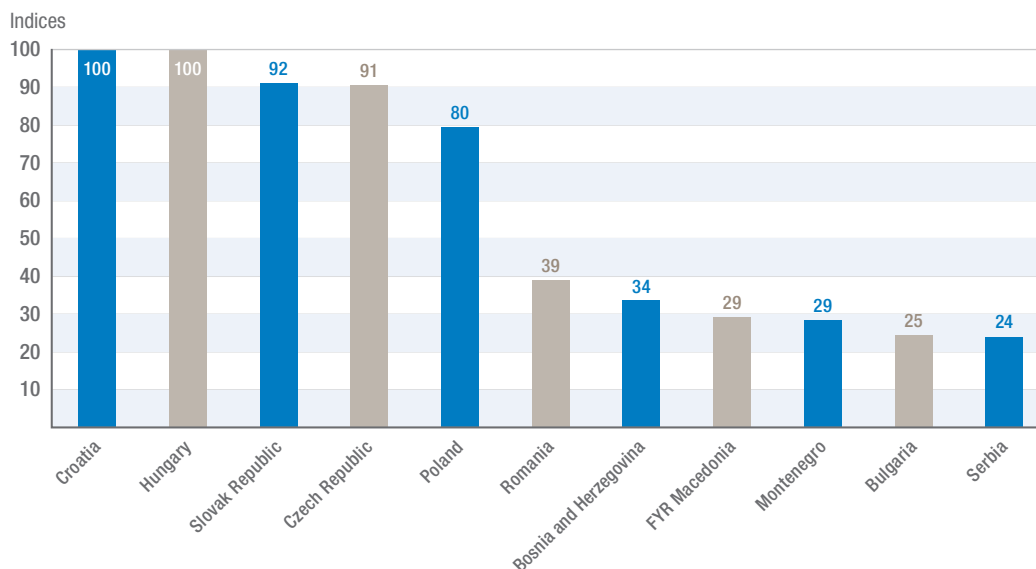
Note: Results based on 2007 survey.

Source: OECD RCS (2008).

ACTIONS GOVERNMENTS CAN TAKE:

- **Focus first on investment promotion and human capital:** ensure that efforts being made by companies to increase quality, design and development capabilities are promoted to potential investors through investment promotion tools and sector linkage programmes and supported by government initiatives to improve skills.
- **Enhance collaborative innovation efforts:** channel innovation by developing stronger collaboration between foreign and local companies as well as research centres and academia.
- **Improve customs and trade regulations:** improve time to market and ensure just-in-time delivery capability by removing customs and trade barriers and reducing import duties on capital goods.
- **Enhance transport infrastructure:** increase investment in road and rail infrastructure to provide potential investors with guaranteed delivery capability.
- **Address labour regulations:** labour market rigidities need to be improved across the region, as employers need to be able to count on a stable and reliable presence of both skilled and non-skilled workers.

LABOUR PRODUCTIVITY IN THE MANUFACTURING INDUSTRY, 2004
(indexed on Hungary's productivity level)



Source: OECD analysis based on Eurostat, national offices of statistics.

NEXT STEPS:

In consultations to define the best strategy for implementing reform measures, regional governments and firms agreed that an approach which focused first and foremost on investment promotion would allow the sector to reap the most rapid competitiveness benefits. An influx of investments would also allow countries to meet other sector objectives, as the presence of international companies would drive up quality, innovation, and human capital standards in response to investor demand.

To help Western Balkan firms better promote their capacities abroad with potential investors and support governments in creating an enabling framework to attract foreign investment, the OECD is working to:

- **Map capabilities of Western Balkans suppliers:** produce a regional investment promotion tool to highlight specific sector activities (design, R&D, automotive components manufacture, capital intensive production or labour intensive production) that could be integrated into existing automotive promotional materials (such as websites) and be used widely by investment promotion agencies.
- **Provide recommendations on how to improve regional co-operation in promoting the automotive industry:** work together with beneficiaries and partners to implement recommended improvements at the regional level.
- **Support the organization of a Western Balkans Automotive Industry Conference:** provide a forum for discussion on how to improve existing investment promotion activities, and promote the region as a supply base for automotive components and as a destination for FDI in the automotive sector.

Business Process and Information Technology Outsourcing

SECTOR STRENGTHS:

With a yearly growth rate of 25%, the flourishing global business process and technology outsourcing (BPTO) market offers the Western Balkans many opportunities for economic development. Although India captures close to 60% of this market share, the Western Balkans has emerged as a strong contender in three segments: software development, back office development and call centers. Its cost competitiveness, proximity to the EU market, as well as the strong language skills of its workers positions the region strongly in the competition to attract BPTO providers.

FAST FACTS:

**USD
250
BILLION**

The value the global BPTO market is expected to reach by 2010.

25%

The annual rate at which the IT/software development sector grew between 2006 and 2008.

**FIVE
TIMES LOWER**

The cost of labour in services in the Western Balkans as compared to Hungary and Poland.

13

The average number of employees in BPTO firms in the Western Balkans.

18%

Average non-wage labour costs in the region, as compared to 11% average for East Asia and the Pacific.

50%

of employers in the BPTO sector consider that limited human capital is a significant barrier in the Western Balkans.

SECTOR CHALLENGES:

- **Declining cost competitiveness:** EU integration will continue to erode regional cost competitiveness, meaning that the region will need to identify other sources of market differentiation over the long term.
- **Increasing level of required worker skill:** International companies are demanding higher levels of skill, for both managers and line employees.
- **Fragmentation:** BPTO firms in the Western Balkans are currently too small to compete successfully.
- **Social charges:** Firms cite high social charges as a key obstacle for the competitiveness of this labour-intensive sector.

KEY FIGURES FOR THE IT/SOFTWARE DEVELOPMENT SEGMENT IN THE WESTERN BALKANS

Market size (€ million)	1 300
Market growth (2006-08)	25%
FDI (inward flow, € million)	40
Exports (€ million)	75
Employment	55 000
Number of firms (estimates)	8 000

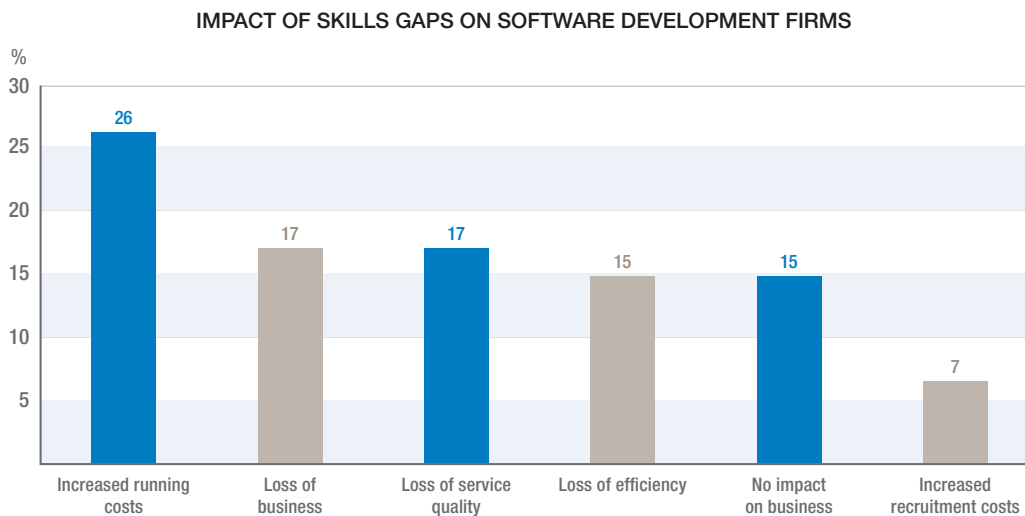
Note: Data covers 2002-2003.

SECTOR REFORM:

To ensure the continued growth and competitiveness of the BPTO sector in the Western Balkans, both operational and policy changes need to be made. Firms need to re-evaluate their business models to become more specialized in high-growth segments of their sectors, and they need to focus more on EU markets. At the same time, governments should address gaps in human capital, upgrade ICT infrastructure, reduce social charges and target investment promotion activities at global BPTO providers.

OPERATIONAL IMPROVEMENTS FIRMS CAN MAKE:

- **Focus on EU markets:** leverage firms' proximity and linguistic advantage through nearshoring, including by targeting the regional market and Central and Eastern Europe.
- **Specialise:** increase productivity and enable firms to set higher prices and build an international network of clients by carving out specialized niches and implementing strategies to promote firm specialization.

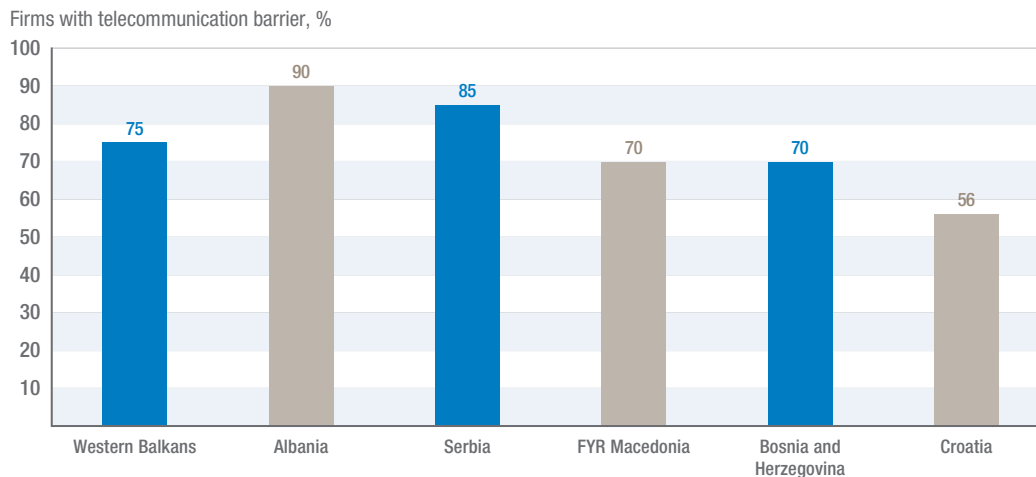


Source: OECD RCS (2008).

ACTIONS GOVERNMENTS CAN TAKE:

- **Ensure that workforce skills continue to grow:** to meet rising employer demand for skills, governments must invest both in the quality and quantity of human capital, increase private sector involvement and create more tailored educational programmes.
- **Upgrade ICT infrastructure:** despite increased government investment in recent years, BPTO firms consider that there is room for the region to improve to meet heightened industry standards.
- **Reduce social charges:** to maintain regional competitiveness in BPTO, governments need to reduce the substantial burden that social charges levy on companies and diminish their competitiveness compared to East Asia and Pacific firms.
- **Target investment promotion at global BPTO providers:** focus investment promotion activities on global BPTO providers, especially European-grown or based sector leaders already present in the region (for example: IBM, EDS, Capgemini, Accenture, SAP, Tata, Convergys, Genpact, Wipro, etc.)

TELECOMMUNICATIONS AS A BARRIER TO THE OPERATIONS AND GROWTH OF BPTO AND ICT COMPANIES



Source: OECD RCS (2008).

NEXT STEPS:

Following the publication of the 2009 SSSC report, it was decided that governments would focus reform efforts on policies to further develop links between the private sector and universities. To determine concrete measures to foster stronger linkages, extensive consultations were organised throughout the first semester of 2010 between representatives from government, public and private universities and the private sector. Among a number of identified initiatives, the development of policies to support the creation of internship programmes in the Western Balkans was flagged as being of particular interest. Although several individual institutions have taken measures to develop internships, very limited policy support currently exists in the region for such programmes. However, as internships are commonplace in OECD countries, the Organisation is well placed to share best practices with Western Balkan governments in this area. Furthermore, such programmes are attractive as they produce positive outcomes while placing relatively small burden on governments in terms of expenditure and other resource requirements.

To support governments in identifying policy measures to further develop internship programmes, the OECD is working to:

- **Define international good practices governments can follow to develop internship programmes:** review legislation, support schemes, and institutions that have been set up in OECD countries to develop internship programmes. In particular, potential schemes to increase the internship capacity of the private sector will be assessed.
- **Assess initiatives being undertaken in the Western Balkans:** identify existing programs in each Western Balkan country. Basic information on the existing programs, such as number of participating institutions, number of students and companies, is being collected.
- **Review legal framework for internships in the Western Balkans:** in certain cases, internships are not covered by labour laws. This can represent a major barrier for their development. Institutional settings and university-level procedures and norms may also need to be changed. The current situation will be assessed and reforms that need to be made will be highlighted.
- **Develop a guide for policy makers:** identify gaps in the legislation and potential for policy actions in each Western Balkan country. The guide will give an overview of the situation on internships and provide guidance on the policy steps that need to be made.
- **Provide a venue for regional learning:** hold a regional workshop on human capital development that will focus specifically on the issue of internships. During this workshop, initiatives led in Western Balkan countries will be presented and cross-country dialogue will be encouraged.



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