

BRIEFING PAPER

ECONOMIC CHALLENGES 2011 PLUS

MARCH 2011

FORUM ON ECONOMIC POLICIES

In this issue

- 1 Where are we today?**
- 2 Budget Sustainability**
- 3 Private Sector Development**
- 4 Corruption**
- 5 Inflation**
- 6 Privatization of POE's**
- 7 Energy**
- 8 International Trade and FDI**
- 9 Financing**

Introduction

Starting from March 2011 Friedrich-Ebert-Stiftung and Riinvest Institute will organize roundtables covering the economy, social and political fields of Kosovo. The final product of the organized roundtables will be this Briefing Paper, the aim of which is to encourage economy related debates for policymakers, media, civil society, and the international community.

In the first issue of the Paper, the research team has presented an overall summary of Kosovo's economic challenges for 2011 and onwards. The analysis of this issue are summarized in the topic "Economic Challenges 2011 Plus".

We decided for the first issue to summarize a range of country economic facts with the purpose of reflecting on Kosovo development needs, generating capacity and barriers in this journey. Later on, this reflection will serve as a basis for following bulletins and roundtables.

The research team is thankful to everyone who contributed to this issue.

Published by:

**FRIEDRICH
EBERT
STIFTUNG**



1. Where are we today?

According to UNDP reports, Kosovo has over **43% unemployed inhabitants; 34% living in poverty** with less than €1.42 per day, and around **18% in extreme poverty** with less than 94 cents per day. These economic parameters encourage migration and informal economy in the country, which is considered to be around €1 billion and an uncollected fiscal evasion by collecting mechanisms in the amount of €300-400 million, annually (Riinvest 2010)

With this kind of economic environment, our country continues to have a GDP of **€4.2 billion** (IMF 2010). This amount is twice lower than that of Macedonia and Albania, three times lower than Bosnia and Herzegovina and four times lower than Serbia. A country with an indifferent national product to regional developments has low chances of impressing with other parameters. This figure ranks Kosovo on the 158th spot (FMN 2010).

Kosovo continues to have a GDP of €4.2 billion

Furthermore, **economic growth** (GDP growth) of **4.6%** has not been able to fulfill country's growth requirements and needs (Progress Report 2010). This number, confirmed by the Progress Report 2010 as well, continues to figure as a statistic that does not translate into the standard of life, since neither unemployment nor poverty have moved from their bottom standing positions. According to World Bank, in order for Kosovo to reach the next last place in Europe, being Albania, by 2020 our country needs an annual economic growth of 8-10%.

Despite low transitory progress, Kosovo's economy continues to mainly depend on unsustainable sources of growth. **Government expenditures, remittances** from the Diaspora and international **financial assistance** continue to play the role of main economic drivers. International financial assistance constitutes around 20% of Gross Domestic Product.

Kosovo citizens continue to be the poorest in Europe with per capita income of only €1800 (IMF 2010). In a regional comparison, Bosnia and Herzegovina residents have per capita income of around €5000 annually, Albanian residents around 6000, Macedonians around 7000, and Serbian residents around 8000. According to the International Monetary Fund 2010, with this kind of per capita income, Kosovo ranks in 141st place from a total of 183 places.

Observed under the trade loop, our country continues to have an enormous imbalance in export to import relation. According to the Republic of Kosovo Customs, the total figure marked for **exports** in 2010 was around **€293 million**; this trade was recorded with 90% of EU trade markets. On the other side, Kosovo **imports** around **€2.14 billion** mostly from Macedonian, Serbian and German trade markets. Serbia and Bosnia alone, import over €400 million in Kosovo every year, in regular forms and over €200 million through the informal economy in the North side of the country (Kosovo Customs 2010).

2. Budget Sustainability

Having moved from abundant surplus to deep deficit has shown that Kosovo is spending more than it actually has earned. In 2010, pushed by budgetary conservatism, we have signed an international agreement with IMF. It is important to mention 3 key elements, which derived from this agreement:

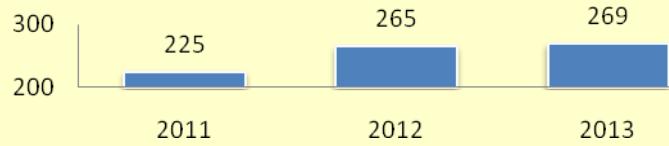
- Wages in public sector should not exceed 7.4% of GDP, or 290 million €;
- PTK should be sold for €300 million in order to cover potential deficit; and
- budget deficit should be held within the EU controllable limits, or 3.5% of GDP

Although the budget deficit was held within the limits, beginning of 2011 has marked marginal expenditures unbearable by the capacities. **Wage** increase to **€383 million** (Budget 2011) has increased wage percentage participation to GDP from 7.4% to 9.10%, or an increase of 23%.

In 2011 the budget oversees the collection of €1.264 billion and expenditures of €1.434 billion. KTA and Customs should collect over 18% more income than last year. Wages make up 26% of expenditures, goods and services 12.8%, subsidies and transfers 18.9%, meanwhile capital expenditures 39.8%.

2011 marks a record for capital investment. A big portion of the basket is allocated to highway "Ibrahim Rugova". In three coming years, the highway costs are planned to be allocated by 225 million for 2011, 265 million for 2012 and 269 million for 2013.

Highway cost for the next three years is estimated to be around €759 million



Source: Budget 2011: Highway cost for the coming years

At the same time, "Ibrahim Rugova" highway represents the essential portion for capital investments, which for year 2011 is **€572 million**, where €448 million will be invested from central level and €124 million from local level. Infrastructure Ministry heads the capital investment basket with a total of €263 million; **€225 million** are planned for the first **highway** installment and 30 million for investment in roads left over from 2010. Hence, new investments in road infrastructure will be only €8 million, a drastic decrease compared to the previous years.

Total budget **deficit** for 2011 is expected to be €226 million or around 5% of Gross Domestic Product. It is important to note that acceptable budget deficit norms in the European Union do not exceed 3.5%.

Our country plans to collect around **€300 million** from the **sale of national assets** and a **financial assistance** of **€167 million** from the International Monetary Fund, World Bank and the European Commission. The actual obtaining of these assistance funds has been put to risk, meanwhile the generation of funds from PTK sale can suffer serious postpones, thus increasing country deficit.

A cross-country comparison

Kosovo

Total expenditures for Kosovo in 2011 will be 1 billion and €434 million which is 232 million more than in 2010. For wages and salaries the government allocated €383 million or 26.7% of total expenditures. Goods and services represent a figure of €184 million or 12.83 % of total expenditures for 2011. Subsidies and transfers for 2011 have a value of 272 million or 18.96% of total expenditures. Meanwhile capital expenditures for 2011 reach €572 million or 39.88%.

In order to finance deficit, Kosovo plans the sale of PTK

| | RKS | ALB | SRB | MK |
|--------------------------------|--------|---------|--------|--------|
| Wages and salaries | 26.7% | 16.95% | 23.22% | 14.55% |
| Goods and services | 12.83% | - | 5.56% | 10.74% |
| Subsidies and Transfers | 18.96% | 0.41% * | 46.78% | 6.85% |
| Capital Expenditures | 39.88% | 20.15% | 3.75% | 14.59% |

* Only subsidies

Source: 2011 Budgets for Kosovo, Albania, Serbia and Macedonia

Albania

In Albania, total expenditures for 2011 will reach €2 billion and €901 million. Expenditures on wages will be €498 million or 16.95% of total expenditures. Subsidies will reach 12 million or 0.41% of total expenditures, meanwhile capital expenditures €591 million or 20.15% of total expenditures.

Serbia

Total expenditures for Serbia in 2011 are slightly above €8 billion. Total expenditures for wages and salaries will be €1.9 billion or 23.22% of total expenditures. Goods and services are €456 million or 5.56%. Subsidies and transfers in total have the value of €3 billion or 46.78% and total capital expenditures are €307 million or 3.75%.

Macedonia

Total expenditures of Macedonia for the year 2011 are €2 billion. Wages and salaries are €380 million or 14.55% of total expenditures. Goods and Services are €281 million or 10.74% of total expenditures. Subsidies and Transfers are €180 million or 6.85% of total expenditures and capital expenditures are €381 million or 14.59% of total expenditures.

3. Private Sector Development

One of the main economical problems of Kosovo is economic development based mainly on public expenditures. The country's economy has to heavily support and depend on development of the private sector, which should play a key role in national economic development. However, the private sector faces numerous obstacles. According to the Progress Report (2010) firms in Kosovo continue to face:

- weak rule of law
- lack of energy electricity
- poor infrastructure
- limited access to finance

High trade deficit in Kosovo derives as a result of low domestic supply. Country production is in an unsatisfactory level, and as a result is not able to cover internal demand. Therefore, one of the main challenges remains import substitution and export growth. However, weak rule of law, informal economy, high interest rates, and uncertainty related to private property are examples of barriers that hinder business environment development in Kosovo and consequently domestic product supply growth. According to industry strategy study, business representatives in Kosovo rank energy electricity as the main barriers to their business activities, followed by unfair competition and corruption. Improving energy electricity supply is a priority in order to ease doing business and increase domestic production. Furthermore, more work is required towards proper law implementation and improvement of legislation related to healthy and fair competition (Riinvest 2010, Industry Strategy)

Doing Business 2011

In 2011 Kosovo was ranked in the 119th place out of 183 economies, which are compared in the World Bank annual analysis "Doing Business". This year Kosovo falls for six places, compared to the 2010 annual report. According to the report the reforms in the business sector in 2011 have reflected negatively because with the replacement of the tax number with the fiscal number, the process of opening a business in Kosovo has become more difficult and has been extended. This is a result of the fact that the fiscal number takes more time to be issued and requires the tax administration of Kosovo to inspect the business facility.

Energy, Unfair
Competition and
Corruption
represent the
main barriers for
businesses

- To **start up a business** Kosovo is ranked in the 163rd place, 5 places down compared to the previous year. Albania has been ranked in the 45th position, Bosnia and Herzegovina in the 160th position, Serbia in the 83rd position, Macedonia in the 38th position, and Montenegro in the 51st position.
- To obtain a **construction permit** in Kosovo, one must wait 320 days and the price that has to be paid is 8.5 times the average per capita income. For this reason we are ranked in the 174th position, Serbia is ranked two positions after Kosovo while the other countries in the region stand at a better position. Albania is ranked in the 170th position, Bosnia and Herzegovina in the 139th position, Serbia in the 176th position, Macedonia in the 136th position, and Montenegro in the 161st position.

- For **investor protection**, the World Bank report ranks Kosovo in the 173rd position, which presents a fall for one position from the previous year. We share this position with Palau, Micronesia, Gambia, and Guinea. Only five places in the world protect investors worse than we do amongst which are Afghanistan and Venezuela. In relation with the region, Bosnia and Herzegovina ranks in the 93rd position, Serbia in the 74th position, Macedonia in the 20th position, and Montenegro in the 28th position.
- In **enforcing contracts** Kosovo has not changed from the previous year, remaining in the 155th position. The anomalies in the judicial system and the inefficient law enforcement are causing problems in contractual enforcement. In the report, Kosovo with 53 procedures is compared with less desirable countries. This report ranks Albania in the 89th position, Bosnia and Herzegovina is ranked in the 124th, Serbia is ranked in the 94th position, Macedonia in the 65th position, and Montenegro in the 35th position.
- Regarding **trade across borders**, the report ranks us in the 130th position, which increased for one position compared to last year. Again based on this report Kosovo stands last compared to the countries in the region, where Albania is ranked in the 75th position, Bosnia and Herzegovina in the 71st position, Serbia in the 74th position, Macedonia in the 66th position, Montenegro in the 34th position.
- In **closing a business** Kosovo falls for three places this year and is ranked in the 31st position. In this indicator, Bosnia and Herzegovina is ranked in the 73rd position, Serbia in the 86th position, Macedonia in the 116th position, Montenegro in the 47th position.

Kosovo in 2011
ranks 119th out of
183 economies

Referring to the quarterly bulletin published by the Statistical Office of Kosovo in January 2011, during 2010 in Kosovo there were a total of 7729 new businesses registered and 1363 were closed, which portrays the highest number of closed businesses within a year. In the first quarter of 2010, 603 businesses were closed while in the last quarter another 2,010 businesses were closed and only 210 new businesses registered. The last quarter of 2010 was the lowest for new business registration compared to the last quarter of 2009 for 8%.

4. Corruption

According to the Global Corruption Barometer in 2010 from Transparency International, 73% of surveyed Kosovars believe that from 2007 the level of corruption in the country has increased, while only 8% think that corruption has decreased. The same report adds that political parties in the country are viewed as corrupted, followed by the judiciary and legislative body. Kosovo is ranked as last in the region for high level of corruption, with a coefficient of 2.8 (0-3 are ranked countries where the level of corruption is widespread), and in the 110th place in the overall ranking. Three countries that are before Kosovo in this ranking are: **Bolivia**, **Gabon**, and **Indonesia**, while three countries that are ranked after Kosovo are: **the Solomon Islands**, **Ethiopia**, and **Guyana**.

*Kosovo in 2010
was ranked in
110th place for
the corruption
level*

The perception of the surveyed based on this report is that the sectors that are least corrupt in Kosovo are NGO's, religious institutions, and the police. Around 15% of the surveyed declared that they, or someone related to them, have given bribes in different forms and institutions. According to the Global Corruption Barometer, 61% of surveyed people think that anticorruption measures from the side of the government did not have any effect, while 32% think that the measures have been effective.

When asked if respondents were willing to participate in the war against corruption, 70% have declared themselves ready to report any corruption case. In addition, around 70% of them have declared that people have an impact in the war against corruption, while half of them have said that they can imagine themselves in a war against corruption.

Single source tenders

According to the Freedom House report published in 2010, procurement and tender procedures in Kosovo are not transparent. The EU Progress Report states that in 2009 only 77% of general signed contracts have been made with an open procurement procedure. This number increased in 2010 to 85%. The value of the contracts won through single source tenders has increased significantly from €60 million in 2008, to €200 million in 2009, and only slightly decreased in 2010 (€170 million). In addition, the general value of contracts won through public procurement has increased. The value of these contracts is 22% of Kosovo's GDP (Freedom House 2010).

5. Inflation

Based on the data obtained from the Statistical Office of Kosovo, the consumer price index (CPI), in Kosovo is higher for 1,4% in January 2011 compared to December 2010. In addition, the inflation rate in January 2011 compared to January 2010 was 7, 4%. For February the CPI in Kosovo is higher for 2, 2% in 2011 compared to January 2011. While the inflation rate measured in February 2011 compared to February 2010 is 9, 5%. Referring to the Progress Report, inflation continues to remain unstable, taking into account the contribution from the food prices and fuels. Inflation for 2011 is expected to be above 5, 3% (ESK 2011).

January 2011

The price increase in January 2011 compared to December 2010 occurred in these products: bread and cereals for 3, 6% with an impact of 0, 4%, vegetables 6, 9% with an impact of 0, 3%, usage of equipment for personal transport 3, 4% with impact of 0, 2%. Other products like meat 0,8%, oils and fats 2,6%, fruit 2,5%, sugar, jam, honey, and sweets 2,8%, clothing 1,0%, where each had an impact of 0,1% in the CPI (Consumer Price Index, January 2011).

February 2011

Increases in February 2011 compared to January 2011 occurred in these products: bread and cereals for 7,2%, vegetables 14,2% where each had an impact of 0,7%. Sugar, jam, honey, chocolate, and sweets had an increase of 7,9% with an impact of 0,2%. Meat 1,4%, oils and fats 4,3%, fruits 4,4%, the usage of personal transportation equipment 1,3%, purchase of vehicles 5,2%, transportation services 2,0%, where each had an impact of 0,1% on the CPI (Consumer Price Index, February 2011).

If we compare the prices of consumption in Kosovo for February 2011 with February 2010 and increase of 9,5% occurred. The price increases were evident in these products: bread and cereals 42,2% with an impact of 4,3%, oils and fats 46,9% with an impact of 1,2%, usage of personal transpiration equipment 18,8% with an impact of 1,1%. Sugar, jam, honey, and sweets increased by 24,7% with an impact of 0,6%, cigarettes 7,8% with an impact of 0,5%. Fruits 10,9% and clothing 3,6%, with an impact of 0,3% respectively. Meat 2,6%, milk, cheese, and eggs 2,9%, vegetables 5,0%, coffee, tea, and cacao 11,7% where each had an impact of 0,2%. Food products 2,4%, alcoholic drinks 10,2%, water supply and other services related to households 9,5%, newspapers, books, and office supplies 6,0%. Hospitality services 2,7%, personal care 2,7% each with an impact of 0,1% on the CPI.

*The increase of price
continuously
deepens the poverty
in the country*

6. Privatization of Publicly Owned Enterprises (POEs)

In the last two decades, many countries around the world (developed, developing and transition economies) initiated the reform of utility industries aiming at improving the efficiency of these companies through competition and private ownership. A common feature of these economic policies was that utility and other infrastructure projects should promote private sector participation in order to improve efficiency, quality of services and consumer welfare. As a result, the restructuring and privatisation of utility or the involvement of the private sector in the provision of these services, is now broadly accepted as a preferred option to their public ownership and provision. Over time, it has become clear that the state owned enterprises providing infrastructure services are unable to make efficient use of resources or produce high quality services. They are sometimes a major drain on public resources (despite their monopoly position) and usually in need of a large amount of resources to improve their conditions.

However, since these companies provide public services to citizens and have natural monopoly features, the way in which they are privatized should be subject of greater public debate and consent. Privatization of POEs in Kosovo has been embraced full-heartedly by the Government without creating a basic consensus among relevant stakeholders. What is more, government created the feeling that was rushing the process while it failed to establish a debate with the public at large. This rush accompanied by large discretion of the government in this process (no active oversight by the parliament) raised the doubts of the public towards the government and its benevolence in this process. In this short note, we will briefly comment on the privatization process in the case of airport, telecom and energy sector.

Privatization of POEs in Kosovo has been embraced full-heartedly by the Government without creating a basic consensus

The involvement of private sector in case of the airport was largely greeted in Kosovo. Although granting the exclusive right to operate an airport facility is not compatible with competition, it is possible to generate a competitive outcome if the concessionaire is selected through competitive bidding. Taking for granted that the process was transparent and competitive, one would expect the process to progress properly. However, recent developments related to unexplained delays in taking over the airport by the concessionaire and informal stories that there will be a possible renegotiation of the already signed contract raised worries. Riinvest in 2009 has drawn particular attention to the issue of renegotiating concession contract and discussed ways to minimize likelihood of that happening. We warned that the experience of other countries shows that many concessions are renegotiated, usually in favour of the concessionaire and at a cost to the consumers or government. Renegotiations were more likely if the concession contract was not embedded in a decree or a law. In case of Kosovo, the concession of infrastructural projects (even of strategic projects like airport) is in discretion of the government without any proper oversight by the parliament.

Moreover we warned that in cases where bidders offer terms which are 'too good to be true' than the offer should be vetted more carefully. We advocate for a more active role of the parliament in holding the government responsible in this matter, to ensure that the concessionaire is not taking an advantage from the government and that public's interest is preserved. Kosovo Government was very active in proceeding with the privatization of telecom company (PTK). The kick-off of this process was preceded by heavy over-employment in PTK without following basic recruiting procedures and the assignment of politically influenced board members which in turn deteriorated the state of this enterprise (note that the decreased market share of PTK is also due to the introduction of competing mobile operator). Since PTK is a profit making company, the arguments of the government for privatization failed to convince the parliament and the public at large that benefits from privatizing PTK were greater than keeping it in public domain.

Contracted infrastructural projects urge the need for privatizing PTK to meet the costs of these projects and to preserve fiscal sustainability. Privatization of PTK is part of the agreement between Kosovo and the International Monetary Fund. Proceeds from the privatization, as non-debt financing, should ensure that Kosovo can avoid commercial borrowing to meet costs incurred by contracted capital investments. Strategy for privatization of PTK, which faced strong opposition in the Parliament, foresaw the sale of 75% of shares of the company. Riinvest continues to oppose this option and suggests that Kosovo should sell the controlling stakes of the company, from 51% (simple majority) up to maximum 67% (qualifying majority) which carry respective controlling premiums. The remaining shares could be sold in later stages as is the experience of other transition economies. Privatization of energy sector was followed with great delays. While the unbundling of the energy sector was completed, the steps towards inclusion of private sector in distribution and generation were slow (if not backwards). KEK performed very poorly and was a major drain of public sources. The World Bank estimates that KEK received about € 1.1 billion in transfers (27 percent of 2010 GDP) over the past decade from the budget (€ 0.5 billion) and donors (€ 0.6 billion). Only during the last year KEK received from the state budget a transfer amounting at 3.8 percent of GDP. It still cannot meet the domestic demand and as a result about 10 percent of Kosovo's energy demand was imported last year at a cost to the budget of over 1 percent of GDP.

A strategy to reform and ensure participation of the private ownership in energy promoted by the government aims at (i) bundling a concession for lignite mining with the construction of a new generation plant and (ii) privatizing the electricity distribution network. While Riinvest consents with the latter, we fear that the former bears a great risk in creating a private monopoly in lignite mining which in turn would discourage new entries in power generation.

To sum up, the privatization of POEs has created the need for an active and effective involvement of the parliament that will ensure: (i) protection of consumers from the misuse of discretion by the government along with the exercise of monopoly power by private operators and (ii) protection of the private operators from future opportunistic behaviour by the government.

The World Bank estimates that KEK received about € 1.1 billion in transfers

7. Energy

The production of electricity in Kosovo is monopolised by the "Kosovo Energy Corporation" (KEK). The main electric energy sources in Kosovo are the coal fired power stations Kosovo A (5 units) and Kosovo B (2 units) and 2 small hydroelectric stations in the Zubin Potok municipality and the Decan Municipality. Power plant Kosovo A was built in the early 1960s while Kosovo B was built in the early 1980s, which are situated a few kilometres from Prishtina.

Based on an estimated population count of 2 million, the per capita consumption is 1,660 MWh per person annually. It should be noted that the lack of reliable electrical supply has prompted many to rely on generators as an alternative source of electricity. The production and consumption by generators is not accounted here. Other significant sources of energy in Kosovo come from district heating in some of the major towns such as: Prishtina and Gjakova. It is also important to note that a significant amount of the population relies on wood and coal stoves for heating and cooking purposes (Ministry of Energy and Mines 2010).

The major pollutants from the power stations are CO₂, SO₂, NO_X, O₃, air particles, and sediments.

The data produced by INKOS shows concentration of SO₂, fly ash (smut) and air particles twice WHO norms, whereas the suspended particles are more than 30 times beyond the WHO norms.

The production of electricity has been hampered by chronic technical problems

The main challenges of the Kosovo energy sector are:

- New power plant in accordance with Energy Strategy, approved by the Parliament, in capacities of maximum 1000 MW;
- Regional cooperation for production, consumption and energy transfer; with special focus to Albania and exploration of energy comparative advantages between two countries;
- Identification and usage of alternative sources of energy. MEM has identified over 80 Hydro-plants with total amount of 130 MW ;
- Commercial problems in collecting debt and payments from Kosovars;
- Support in the privatization process of energy resources and investment attraction in the sector;
- Energy efficiency;
- Care to environment.

8. International Trade and FDI

In the last decade, the Kosovar economy has been very liberal towards imports, but it has largely failed to export its goods and services and attract inward foreign direct investment.

Foreign trade statistics (see Table below) show a persistently high trade account deficit, with exports of goods and services accounting for merely 8.2% of imports over the last ten years.

| Year | Exports | Imports | Trade balance | Exports/Imports |
|------|---------|-----------|---------------|-----------------|
| 2001 | 10,559 | 684,500 | -673,941 | 1.5% |
| 2002 | 27,599 | 854,758 | -827,159 | 3.2% |
| 2003 | 35,621 | 973,265 | -937,644 | 3.7% |
| 2004 | 56,567 | 1,063,347 | -1,006,780 | 5.3% |
| 2005 | 56,283 | 1,157,492 | -1,101,209 | 4.9% |
| 2006 | 110,774 | 1,305,879 | -1,195,105 | 8.5% |
| 2007 | 165,112 | 1,576,186 | -1,411,074 | 10.5% |
| 2008 | 198,463 | 1,928,236 | -1,729,773 | 10.3% |
| 2009 | 165,328 | 1,935,541 | -1,770,213 | 8.5% |
| 2010 | 294,031 | 2,139,534 | -1,845,503 | 13.7% |

Source: Statistical Office of Kosovo (2010)

Although there has been a relatively high growth of exports and ratio of exports to imports, these have grown from a very low base and seem to be far from rectifying the economy's foreign trade imbalances. However, the outlook seems even grimmer if we consider that this increase in exports appears to be mainly driven by exports of basic metals, which during 2010 accounted for approximately 63% of total Kosovar exports (SOK, 2010).

Economic integration in terms of trade and investment integration is essential. Relying on the export of natural resources and/or processed goods as raw material to close the foreign trade deficit is neither a sustainable, nor conducive to productivity growth or job-creation in the economy. The (low) level and structure of the foreign trade appears to point to a low competitiveness of Kosovar products both in the domestic market and in foreign markets. The causes that are likely to be (at least partially) explain this underlying problem in the Kosovar economy are discussed in section 2 of this report.

Considering that Kosovar firms – like that of other transition economies, but even more so due to the political problems over the last decades – tend to lag behind in terms of technology, while at the same time being faced with very high costs of financing investment, inward foreign direct investment (FDI) appears to be particularly beneficial for its economy. In addition to providing a means of financing investment and inducing employment, FDI could potentially contribute to productivity growth through transfer of technology, development of workforce skills and spillovers to domestic firms. To date Kosovo has not been successful at attracting FDI, with the exception of the financial services sector and telecommunications sector. Moreover, due (partially) to the global economic crisis, FDI inflows in Kosovo have been continuously decreasing since 2007 when they peaked at around €440 million.

Kosovo faces a trade deficit of around € 2 billion



Source: Central Bank of Kosovo (2010)

One of the factors which has been argued to be contributing to the high trade deficit and insufficient attractiveness to foreign investors is the failure to implement the CEFTA agreement (e.g. CBK, 2011; GAP, 2011). The most notable of the problems related to CEFTA is the decision of two CEFTA members, Serbia and Bosnia and Herzegovina, to prohibit the import and transit of Kosovar products has been estimated to have caused a 9.8% decrease in Kosovar exports and increased the transportation costs for the remaining exports by 5-10% (GAP, 2011).

The failure to the implement the free trade agreement with- or through- these countries significantly decreases Kosovo's potential market (i.e. its own market plus access to other markets) and as such is likely to have a detrimental effect on FDI inflows of the country.

9. Financing

Sources of finance present an important factor for the development of Kosovo enterprises which would consequently affect economic growth of the country. But, financing opportunities are not facilitating the establishment of new businesses or the increase of actual capacities of Kosovo enterprises. This assertion is derived from the fact that interest rates of commercial banks which are main external financial source of enterprises are qualified as high and as an overload for the enterprise liquidity.

From the Riinvest research done on the industry level of Kosovo, it appears that most of the enterprises which have invested in Kosovo (75.8%) have used their own equity, whereas 20.7% of them have used bank credits from the banks operating in Kosovo. Other financing sources are proportionally smaller; credits from the banks operating outside of Kosovo participate by 0.5%, donator or NGO-s non-returning funds by 0.9% and loans from friends and family by 0.7%. Moreover, from the same research, results indicate that majority (81%) of enterprises which have received bank credits report that credit conditions are very unfavorable. In this context, the majority (74.2%) of enterprises report that annual credit interest rate was 10-15%, whereas around 14% of enterprises report that they have paid even higher rates of interest. Only around 11% of enterprises have received loans with interest rates lower than 11%. These data indicate rigid financing conditions which is presented in the perceived business barriers of these enterprises as well (Strategy of Industry, Riinvest 2010).

The average lending rate for 2010 was 14.4%

Likewise, official data of Kosovo financial sector 2010 presented in the report of the Central Bank of Kosovo (CBK) are in accordance with the perceptions of enterprises and as such do not give optimistic indications with regards to lowering of credit interest rates, which would consequently enable increase of the rate of investments. In terms of interest rates, during 2009 Kosovo was leading the list of regional countries with whom we aim to compete, whereas 2010 trend indicates similar rates in Kosovo compared to the previous year. In 2009, average interest rates for loans were 14.45, while all regional countries have had lower rates (Albania – 12.9%, Macedonia – 11.9%, Serbia – 10.29%, Croatia – 10.18%). In 2010 as well, Kosovo was the leader of the regional countries with regards to interest rates on loans having average interest rates of 14.3%, which is not a significant decline. When we analyze segments of the credit market, businesses are those with the highest load of interest rates on loans because credit interest rates for businesses on average were 16.7%, whereas for households they were 12.2%.

In terms of banking market competition, Kosovo is at the bottom of the region with regards to number of banks operating in the market. In the region, the average number of banks operating in the market is around 20, whereas in Kosovo this number is 8. On the other hand, even though the rate of nonperforming loans has increased, Kosovo still continues to have the lowest rate of nonperforming loans in the region with 4.5% of nonperforming loans in 2010. Comparing regional countries, Montenegro has the highest rate of nonperforming loans by 16.8%, followed by Albania by 12%, Serbia – 12% and Bosnia and Herzegovina by 8.7%. On the other hand, the banking sector in Kosovo has achieved profit of €19.4 Million, which represents an increase by 56.8% compared to the previous year. With regards to credit volume, Kosovo has increased its credit volume by 9.7%, an increase rate lower than that of the previous year, whereas from regional countries only Serbia had a higher rate of increase by 26.2%. A similar situation is indicated in terms of banking deposits as well (Financial Stability Report, CBK 2010).

Aforementioned indications from the banking sector data present a positive market performance of the Kosovo banking sector; however, if this performance is in accordance with private business development and with a sustainable long-term economic development, which would reflect a long-term development of the banking sector as well, remains a question which answer should reflect economic development at higher rates because actual interest rates on loans are not a progressive generator of the enterprise development in the country.

To have a more realistic view regarding the banking market, other influencing factors should be analyzed as well. Interest rates on loans are determined from some important factors such as operating costs and rate of credit risk as two most important factors. While operating costs have to do with operating capacities of banks and economies of scale in each bank, credit risk includes other aspects, which are not controlled by the banks itself but are related to economic and legal environment where they operate. In this context, it should be mentioned that problems with the judicial system in Kosovo increase the risk of contract implementation with businesses and problems of cadastral systems that disable bonding of properties as potential mortgage for long term loans with lower interest rates. All these factors impact the profit margin of banks or the difference between interest rates on loans and interest rates on deposits, which in the conditions of market economy should tend to be minimized.

Overall, credit risk in Kosovo continues to be perceived as higher than in other countries of the region. However, if this risk is really high in the Kosovo banking market and why it is continuing to be perceived as such, it opens a debate which impacts some areas that influence interest rates on loans such as: competition in the banking market in Kosovo, efficiency of judicial system and current situation of the cadastral system in one side, enterprise capacities and significance they give to the fulfillment of basic requirements for qualifying for a loan on the other side.

All these indications open up a dilemma: positive performance of the banking sector in Kosovo is facilitating sustainable economic development in the country or it is creating a long term financial overload on the private enterprises, which may risk expanding into the financial liquidity trap?

Kosovo remains the country with lowest rate of non-performing loans in the region, with a rate of 4.5%

SUMMARY OF ROUNDTABLE COMMENTS

Isa Mustafa (LDK)

- There is lack of strategy for economic development. Regarding PTK privatization, the argument that PTK should be privatized because public management is not efficient, is not a strong argument because we have to address this with more effective corporate governance and not with overloaded staff. A cost-benefit analysis should be undertaken in order to have privatization process that supports proper economic development.
- Economic growth should achieve higher rates in order for unemployment and poverty to be reduced, because the actual economic growth does not translate into real growth in terms of reducing poverty and unemployment.
- With regards to budget unsustainably we risk the overall stability of the financial sector by using CBK treasury fund.
- All these economic issues, which should be discussed in the parliament, fail to be properly discussed because there is no thoughtful debate, but there is tendency for over voting in all issues.

Naim Rrustemi (AAK)

- Inefficient rule of law is a common denominator to all issues. The debate in the parliament is impossible because there is no proper debate.

Safet Gerxhaliu (KOSOVO CHAMBER OF COMMERCE)

- I would add to this roundtable some more issues such as:
 - o The image of Kosovo and its importance for the economic development
 - o Importance of internal and external partnership
- What can business and SME's do that politics can not

Haxhi Arifi (Tradeunions)

- We should debate, coordinate, and translate the theory into practice.
- Agriculture should be a governmental priority because there are possibilities for economic growth.

Shpend Ahmeti (FER)

- The political situation in the country disables addressing economic challenges.
- Our goal should be the focus on 2012 +

Visar Ymeri (VETEVENDOSJE)

- As a society we should not embrace privatization 100, but we should find a balance, which can create social cohesion.

Avni Dervishi (AKR)

- In order to push forward economic development, we should follow the examples of other countries that have previously dealt with these issues.

About Friedrich-Ebert-Stiftung

As a private non-profit organization, the Friedrich-Ebert-Stiftung is committed to the ideas and basic values of social democracy. **Social Democracy** is based on social, human and civil rights and seeks to reinforce them. It broadens and consolidates the basis of political democracy by including social justice, democratization of society, social security, sustainable development and international solidarity. It strives to secure equal opportunities in life and the right to have a say in the affairs of their community for all citizens, both men and women.

The main areas of our work are: **Promoting democracy and supporting civil society** by assisting representatives of political institutions and civil society organizations as well as journalists, academics and trade unions. **Also we help to advance the decentralization process and local democratic governance by supporting the debates on concepts of Good Governance** at the local level and encouraging active participation of all ethnic communities in local government. Moreover, FES supports a **socially just and sustainable economic development** by means of enabling the social dialogue between government, trade unions and employers' organizations. Another aim is to promote **regional and international** integration by reviewing the European integration process with stakeholders. In addition, progressive policy proposals for Kosovo's integration at the regional and the international level are debated with civil society organizations and decision-makers.



Prishtina Office
 Kosovo, Prishtina, Mujo Ulqinaku str. 4/10
 Tel: + 381 38 609 900 & 609 901
 Fax: + 381 38 609 902
 E-Mail: contact@fes-prishtina.org
 Web: www.fes-prishtina.org

About Riinvest Institute

The Institute for Development Research - Riinvest has been operating since 1995 as a non-profit research organization, with a mission to promote modern economic development in Kosovo based on a philosophy of entrepreneurship. Between 1997 and 1999, Riinvest conducted research activities oriented towards the growth of knowledge and information on domestic and international factors influencing Kosovo's economy and their successful reconstruction. Since 2001, our main activities have included research on policies and policy advocacies on expansion of the business environment and construction of conditions towards economic viability.

We are **the first think-tank** functioning in Kosovo as a **development research institute**. We promote modern economic development based upon a philosophy of entrepreneurship. We have been producing **economy** related publications and reports, including the most noted authors and professionals, and including topics of high significance. **We have formed strong partnerships with organizations around the world**. We organize seminars, conferences, round tables and meetings of great economic and business value for Kosovo. **Our know-how and experience allows us to be experts** in every single sector of the economy. We have been publishing on our country's history in economy, trade, entrepreneurship and business over the past two decades.



Kosovo, Prishtina, Zona Industriale, 10000
 Universiteti AAB-Riinvest, Godina 2, K 4
 Tel: + 381 38 601 320 & 601 321
 Fax: + 381 38 601 321
 e: riinvest@riinvestinstitute.org
 web: www.riinvestinstitute.org