Fall 11-2007

KOSOVA ECONOMIC OUTLOOK

Agron Parduzi

UNIVERSITY FOR BUSINESS AND TECHNOLOGY

Theses:

KOSOVA ECONOMIC OUTLOOK

Prepared for the degree "Bachelor of Management, Business, and Economics"

Under the supervision
of

Prof.Dr. Thomas Schröck

Submitted to

University for Business and Technology – UBT
In cooperation with
Vienna University
And Oakland University

By:

Agron Parduzi

Agron Parduzi
November/2007

List of contents:

***A.* – Kosovo Economic Outlook –**

Glossary

Tables:

Agron Parduzi
November/2007

GLOSSARY

CAP - Common Agricultural Policy (EU)

CEFTA - Central Europe Free Trade Area (now including Western Balkans)

KCBS - Kosovo cluster Business Project (USAID funded)

MAFRD - Ministry of Agriculture, Forestry and Rural Development

PILLAR IV EU funded part of UNMIK government

UNMIK - United Nations Mission in Kosovo

USAID - United States of Agency for International Development

VAT - Value Added Tax

WTO - World Trade Organization

BPK Banking and Payments Authority of Kosova

EU European Union

FRY Federal Republic of Yugoslavia

HBS Household Budget Survey

HIPC Heavily Indebted Poor Countries

KCB Kosova Consolidated Budget

KTA Kosova Trust Agency

LOI Letter of Intent

LFS Labor Force Survey

MDRI Multilateral Debt Relief Initiative

MFE Ministry of Finance and Economy

PIP Public Investment Program (Donor funded)

PISG Provisional Institutions of Self-Government

POE Publicly Owned Enterprise

PRGF Poverty Reduction and Growth Facility

SDR Special Drawing Right

SOE Socially Owned Enterprises

SOK Statistical Office of Kosova

SRSG Special Representative of the Secretary-General

UNMIK United Nations Interim Administration Mission in Kosova

– Kosovo Economic Outlook –

1. Overall Economic Trends – From Consolidation to Sustainability

The extensive economic reforms undertaken since 1999 are finally having an impact on the private sector performance. For the first time since 1999, clear signs of sustainable economic growth are visible, and the private sector carries that growth. In addition, as a result of successful privatisation and industrial restructuring, Kosovo again is starting to export the products of its traditional industries where potential for further growth is large. The agricultural sector is also showing signs of growth and improved competitiveness.

Now the fruits of reforms have begun to ripen. In the past several years, many observers stated an ironic disparity between the strong success in the conduct of economic reforms in Kosovo and the weak performance of Kosovo's private sector. While UNMIK and the local institutions of Kosovo, assisted by bilateral and multilateral donors, have managed to create the foundations of a modern economic system, the performance of Kosovo's economy remained weak. However, all major assessments of the economy were aware of the deep-rooted nature of Kosovo's economic problems. Thus, it was obvious that even with extensive reforms, as they indeed were, results would not occur overnight. Long-term socio-political instability in Kosovo left a legacy of inadequate skills and education, inadequate institutional capacity (which may take years to develop under the best of circumstances), insufficient capital investments and dilapidated socially-owned enterprises.

Economic performance in 2006 was positive. Notwithstanding a significant reduction in foreign assistance and public expenditures, Kosovo's GDP is estimated to have grown by about 3%. Clearly, this time growth was not driven by increased public expenditure or donor spending, but by a better performance of the private sector. Several economic indicators also signalled improved economic performance. After a fall in 2005, Kosovo's exports grew remarkably in 2006 by 54%, with a modest growth of imports by 5%.

Furthermore, the rate of non-housing private investment grew impressively by 61% and lending to the private sector also increased. If the momentum of economic reforms is sustained, GDP should continue to grow, probably at an accelerated rate. Macroeconomic stability was maintained in 2006, albeit challenged by a number of fiscal initiatives that could have jeopardized it. The rate of inflation stood near zero, in spite of accelerating economic activity. Government spending was kept within the prescribed and sustainable levels, in line with a Letter of Intent which the Government signed with the International Monetary Fund (IMF) in 2005. However, maintaining reasonable spending has not been easy, partly due to pressures to increase social benefits for war invalids and families of deceased soldiers. There were also attempts for altering the pension scheme and employment hikes in the public sector, all of which would have negative effects on fiscal sustainability.

The importance of maintaining a sustainable and pro-growth expenditure structure can hardly be overestimated. This norm is especially important in the light of the expected status resolution, which will bring new fiscal liabilities: Kosovo is likely to assume a portion of the old Yugoslav debt and will have to incur additional spending to finance the new public bodies that will be established following the transfer of further competencies from UNMIK and progress in the decentralization process. On the other hand, some of the existing sources of public revenue, such as those derived from the presence of UNMIK and its staff, cannot be sustained in the long run.

Remarkable reforms took place on several fronts, especially in privatisation and regional economic integration. The privatisation process continued at the remarkably fast pace that was set already in 2005. Privatisation brought significant cash and investment commitments. The process of liquidation of insolvent enterprises gathered speed and is now well under way. Importantly, the privatisation process has been both very fast and highly transparent, probably more so than any privatisation in the whole region. At the same time, the Kosovo Trust Agency made very significant progress in incorporating the Publicly Owned Enterprises (POEs), a crucial task for improving their corporate governance. In 2006, Kosovo marked new milestones on its regional integration agenda; most notably it became a member of the enlarged Central Europe Free Trade Area (CEFTA).

Finally, the Government has made noteworthy progress in facilitating the project to develop Kosovo C power plant, which would be the largest investment in the history of Kosovo whose contribution to GDP and public budget will be massive. Kosovo's economic development hinges on maintaining and building upon the economic foundations, which have so far been put in place. Kosovo's economic development is still most severely constrained by interruptions in the electricity supply, weak capacity of public institutions, and the lack of adequate skills in the labour market. While there are a number of other obstacles to Kosovo's economic growth, the ones above underpin the factors that create the most binding constraints to economic growth. Devising a well-informed, prioritised, sequenced, and achievable strategy to remove those constraints and committing resources to its implementation will be essential for Kosovo's economic future. The government will not only have to maintain the fiscal stability and progress achieved on other reform fronts, but will have to undertake bold steps ahead by staying in the same path. In particular, efforts to secure uninterrupted power supply and to further improve the financial viability of KEK should remain on top of the agenda as this is an immediate and serious obstacle to foreign and domestic investment alike.

In the fiscal realm, public investment has to be given the top priority, expenditures on public salaries have to be contained, and social expenditures should carefully target poverty reduction. Tax structure has to remain simple, but strong efforts have to be made to improve internal revenue collection. Furthermore, if the capacity of public institutions is to be improved, a new salary scheme should be considered to allow higher pay for key staff while keeping the overall amount of spending on public salaries within reasonable limits. At the same time, the Government has to ensure merit-based hiring and promotion policies within the public sector.

1.1. The Macroeconomic Situation

Following a year of stagnation, GDP growth in Kosovo rebounded to a rate of 3.0% in 2006. The growth improved despite the decrease in foreign assistance from 21.9 to 20.5% of GDP and a reduction in government spending from 31.2 to 27.7%. It is estimated that the rate of diasporas remittances also increased in this period from 12.6 to 14.0%. Thus, the net change in foreign inflows and government spending is equal to 3.5% of GDP.

Evidently, the growth in the GDP is mostly attributed to the growth of the domestic private sector. While GDP still largely depends on foreign inflows, the recent growth in the private sector should be viewed with some optimism, especially since it was accompanied by balanced fiscal policy.

The adoption of Euro and prudent macroeconomic policy has enabled price stability in the last six years. According to the IMF, a combination of feeble economic growth, reduced donor funds and the downsizing of the international presence have all contributed to a decrease in the general level of prices. The deflation, which set out in 2004, continued into 2005. Together with the GDP growth, the trend was reversed in 2006, but the preliminary estimates reveal a very moderate inflation of 0.7%.[2] The price of certain non-tradeables, such as rent, has gone down in the last couple of years in response to the gradual decline of the donor factor. No noticeable decrease, though, in the cost of labour was observed.

Substantial growth in public revenues and private investment are further signs of improved macroeconomic performance. In 2006, public revenue amounted to 31.4% of GDP, representing a 3.3pp increase from the 2005 level. Revenue increases are the result of improved administrative capacities of tax collecting authorities, additional tax on PTK profits, and stronger economic activity. Moreover, budgetary spending in 2006 was maintained within the proposed limits. The IMF praised Kosovo in their February 2007 Aide Memoire for significant improvements in the conduct of macroeconomic and structural policies. Furthermore, preliminary estimates show the 61% increase in non-housing private investment, from €176 million in 2005 to €284 million in 2006.

In order to continue this momentum and further improve investment climate, the Government will have to maintain a sound fiscal policy and will have to advance the structural reforms that have been initiated. – The two major sources of growth in Kosova today are aid-related activities (primarily government and other services) and other domestic activities (notably agriculture, construction, light industry, and trade). By 2007, these activities will dominate the economy, sustaining an annual growth rate of 5 –

[1] *Aide Memoire of the IMF Staff Mission to Kosovo, July 2005.*
[2] *Aide Memoire of the IMF Staff Mission to Kosovo, February 2007.*

6 percent, in line with the experience of other post-conflict economies in the region. In the near term, however, the contribution of domestic activities will not be sufficient to offset the impact of the decline in aid, as official transfers are projected to fall from over 50 percent of GDP in 2002 to 23 percent by 2004. This is expected to cause a slowdown in growth to 4-4½ percent in 2003-04 (Table 1). Performance in later years would depend crucially on the success of structural reforms, namely setting up effective economic institutions, repairing the infrastructure, and creating an environment conducive to productive private investment. As regards the balance of payments, the tapering off of reconstruction activity and fall in aid flows will depress imports. Growing exports and some pick up of remittances are expected to keep the external current account in broad balance. Since Kosova is using the Euro, inflation is projected to remain low. At an average of 3 percent per annum, however, it is expected to exceed the Euro area level of inflation.

Table .1: *Share of the government in Kosova's economy (in percent of GDP)*

Table 1	**2000**	**2001**	**2002 Est.**
Kosova Consolidated Budget (KCB) expenditures (incl. municipalities)	15.7	16.0	27.0
KCB + public investment program (PIP)	60.1	49.6	47.6
KCB + PIP + government services Provided by donors	100.4	87.4	77.9

In this table measures, it is not included the public investment program (PIP), which has so far been financed entirely by donor grants. Once this is added, the share of the government reaches about 50 percent of GDP.

1.2. Unemployment

A very high unemployment rate continues to be the most alarming symptom of Kosovo's economic performance. In 2005, 318,319 persons registered as unemployed with the Kosovar Public Employment Services. The corresponding unemployment rate is between 42.0-43.7%.[3] Perhaps, most worrisome is the fact that (according to the Ministry of Labour and Social Welfare), close to 90% of the unemployed are long-term unemployed, many of whom have low prospects of finding a job in the near future. That the number of registered unemployed grew by 5.7% from 2004 to 2005 is a demonstration of the problem's persistence. Since the employment in the public sector is not foreseen to grow by any substantial numbers, most employment will obviously have to be created within the private sector. Yet, the foreseen short-term economic growth rates will not be sufficient to make a dent in the unemployment levels.

However, the number of registered unemployed is not an accurate indicator of unemployment, as it is not unusual for individuals to register as unemployed in order to receive social benefits, albeit they work in the informal sector. On the other hand, according to the Ministry of Labour and Social Welfare there are cases of individuals who fail to register as unemployed when jobless and looking for work. There is no estimate on the number of persons in either of the two groups. Moreover, the 2005 Labour and Employment report lacks any data on wage levels, thus not permitting an assessment of labour competitiveness.

The lack of detailed statistics notwithstanding, it can be safely stated that high unemployment rate in Kosovo is largely attributable to a lack of opportunities and inadequate skills and education of the working age population. The immediate cause of high rates of unemployment (as was previously mentioned) is a small and sluggishly growing private sector. In turn, there is almost a consensus among experts that one of the main constraints on the growth of the private sector is the quality of education and skills of Kosovo's labour force. The vast majority of registered unemployed (59%) are classified as unskilled, while only 1% of the unemployed has a university degree.

[3] *The lab our market statistics are drawn from the Labor and Employment Kosovo 2005, which is an annual publication of the Ministry of Labor and Social Welfare.*

The comparatively larger number of unskilled individuals in the working age population to those with university degrees only in part explains the difference in unemployment rates for the two groups. In addition, the job placement rate is much larger for more educated and better skilled individuals. For instance, in 2005 the job placement rate for unskilled individuals was 1.3%, while it was 13.1% for those with a university degree. Thus, individuals with more years of education and vocational training are in a much better position to find a job. Consequently, education and vocational training policies ought to be at the core of Kosovo's development planning.

Current employment opportunities are largely concentrated in the tertiary (trade and services) sector of the economy with some improvement in the secondary (industrial) sector, continuing to favour the best educated**.** The number of vacancies registered with Kosovar public employment services in 2005 was 7,121, which is 15% less than in 2004. The share of vacancies in the secondary sector increased from 11% in 2004 to 15% in 2005, signalling a likely growth in industrial activity. Following successful privatization of a number of industrial enterprises, this trend has probably continued in 2006, although it cannot be verified since the employment statistics have not yet been published for the year.

1.3. External Trade

The improved performance of the private sector in 2006 was reflected on the trade balance: imports grew only modestly (5%), while exports marked a notable growth (54%). In 2006, the total value of imports was €1,241 and that of exports was €77 million. While the export/import coverage ratio decreased from 5.3% to 4.1% between 2004 and 2005, the growth in exports in 2006 resulted in a new ratio of 6.2%. In spite of these improvements, Kosovo's still has one the lowest export/import coverage in the world. The imbalance is largely financed by foreign assistance and diaspora remittances, leaving Kosovo highly dependent on foreign inflows. Notwithstanding a significant growth in 2006 in the exports of mining and processed metal products, the export structure continues to be dominated by scrap metals. The exports of scrap iron decreased in 2006, but the loss was almost doubly offset by the growth in the exports of scrap copper and aluminium. The growth in the exports of lead (€4.5 million) and zinc (€3.5 million) is a sign of recovery of the mining industry.

Noteworthy is also the growth in the exports of reinforcement steel, which is the result of successful privatisation of a former SOE. On the other hand, the statistics reveal a fall in the exports of Kosovarian wine. Kosova increased its exports significantly to Serbia, Montenegro, Switzerland, Italy, Bulgaria, and Slovenia. Conversely, its exports to Greece and Macedonia dropped by about €1.6 and €1.4 million respectively. The geographic pattern in Kosovo's exports is already showing a heavy orientation towards the members of the enlarged Central European Free Trade Agreement (CEFTA). Hence, Kosovo's accession to CEFTA should serve as a catalyst for continued expansion of exports to the region. As the destination to 56% of Kosovo's exports and the origin of 48% of its imports, CEFTA members as a group are clearly the dominant trade partner. Kosovo's primary industry has traditionally sold its products in the region (primarily in the former Yugoslavia). Coupled with the accession to CEFTA, the revival of the primary industry through the privatisation process should lead to further growth in exports to the region. In addition to providing duty free access, CEFTA provides mechanisms to remove non-tariff barriers, which have rendered exports difficult in the past years. Moreover, free and unimpeded access to markets for the products of Kosovo's primary industries will provide additional incentives for foreign direct investment.

a) Effect on Amount of Tax Paid by Importers

By taking the Customs data for 2005, and analyzing the imports by category and country, it was possible to list those countries that showed average values below the cost of production in Kosovo. A set of *minimum values* were established as follows:

Table .2: *Lowest Possible Values at Border (in €/kg) Minimum values Basis*

HT Milk	0.40	Hungarian milk price
Yoghurt	0.55	Average of all import prices
Milk Powder	1.70	World Price (OECD)
Butter	1.50	World Price (OECD)
Cheese	1.80	Bulgarian derived import price

For each category, countries showing average values below this were grouped together and the total *declared value* of the imports were calculated. These are labeled the *cheap product exporters*. Taking the same quantity imported a new total value was calculated using the minimum value. All imported dairy produce is subject to duty at 10% and VAT at 15%. Under free trade arrangements, Albania, Bosnia and Herzegovina, Macedonia, Montenegro and Serbia are exempt from duty, but subject to VAT. In order to analyze the losses from possible nderinvoicing, the *Cheap product exporting countries* were divided into 2 groups:

- *Dutiable: Bulgaria, Croatia, Czech Republic, Hungary, Slovakia, and Slovenia10*
- *Non-dutiable: Bosnia and Herzegovina, Macedonia, and Serbia Montenegro*

Table .3: *Dairy Imports and Tax Paid for Low Value Dairy Imports (in 000 €)*

Value of imports from cheap product exporters	Declared value	Adjusted to minimum value
Dutiable	€ 13,525	€ 18,955
Non-dutiable	€ 995	€ 1,560
Total import value	€ 14,520	€ 20,515
Tax paid at border:		
Dutiable (26.5%)	€ 3,584	€ 5,023
Non-dutiable (15%)	€ 149	€ 234
Total Tax paid	**€ 3,733**	**€ 5,257**
Difference = tax avoided		**€ 1,524**

Source: EPO analysis based on UNMIK Customs 2005 data

A total of €3.7m was raised in revenue from those countries with low values, or 80% of total volume of dairy imports. If the real values are applied as calculated in this paper, value for customs purpose increases by 40% and the net increase in taxes collected is €1.5m.

1.4. *Fiscal and Budget Position*

The 2006 Budget was financed 100% from own sources of revenues, including cash balances carried over from prior years**.** Notable improvements were achieved in 2006 both in revenue collections and expenditure management.
The capacity to maintain and build upon these fiscal achievements will be one of the key determinants of Kosovo's economic growth. Based on a preliminary report prepared by the Treasury Department in the Ministry of Finance and Economy, Budget revenues in 2006 were €712.9 million, exceeding the annual plan by 16.4%. The main revenue collecting agencies are:

- UNMIK Customs Service with 64% contribution to the general revenues, amounting to € 456.4 million, or 107.3% of the annual plan.
- Tax Administration of Kosovo (TAK) with 23% contribution to the general revenues, €164.1 million, or 130% of the annual plan. TAK has showed the biggest increase in relative terms, albeit from low levels.
- Municipality Own Source Revenues comprise 4.8% of total revenues, € 34.6 million, or 101.6% of the budget plan.
- Non-tax revenues with 8.1% contribution to the general revenues, € 57.57 million, or 113.6% of annual plan.

In general, 2006 was satisfactory in terms of revenue collection given that the annual plan for all components has been exceeded. With regard to domestic taxes, €29 million of the increase was due to extraordinary payments of surcharges and tax debts from one large taxpayer. These extraordinary payments should fall to €7 million in 2007. On border taxes, an improved control at the borders had a significant impact on the revenue collected by Customs. In fact, net border revenues increased by 7% to €456 million, despite the loss of a €20 million car imports revenue boost in 2005. This was in line with growth in measured import values. So while a large part of the growth in revenues is probably due to factors other than economic growth, those factors, on average, are likely by and large to persist into 2007.

It is therefore reasonable to expect 2007 revenues, excluding the €81 million for the mobile telephony license, to equal or exceed the 2006 figure. With respect to tax policy, there were no fundamental changes in the legislation in 2006, but few adjustments were made:

(1) UNMIK Regulation No 2006/4 removed the exemption from customs duties granted to NGOs with public benefit status, harmonizing the terminology of various tax exemptions and aligning the treatment of NGOs with respect to other taxes (UNMIK Regulation No 2005/40 abolished the VAT exemption for NGOs with public benefit status).

(2) The excise tax code has been amended by UNMIK Regulation No. 2006/8 with the purpose to change the excise tax rates of certain goods (coffee and soft drinks) from ad valorem to fixed rates on quantities and to introduce lower rates for home and small producers of alcohol.

(3) UNMIK Regulation 1999/3 was amended again in the beginning of 2007 to expand the list of raw materials and inputs exempted from the customs duty (UNMIK Regulation 2007/12). The purpose of this change was to further encourage local production by decreasing the costs of inputs that local firms use in their production processes. The new list took into account all the legitimate requests submitted by the business community.

(4) Taking into consideration the revenue effects of the bilateral free trade agreements and the incoming CEFTA agreement, the customs duty on fuel products was removed and the loss of revenue of was compensated with a slight increase of the excise tax on petroleum products.

According to the same report, in 2006 an amount of €635.45 million was spent, representing 87.37% of total annual appropriations. The expenditure structure by the level of government looked as follows: Central Government: €301.52 million, or 47.4% of total expenditures; Reserved Powers: €170.26 million, or 26.80%; Municipalities: €163.67 million, or 25.80%. Of the total €635.45 million, €202.83 million were spent on wages and salaries, €124.65 million on goods and services, €18.36 million on utilities, €155.43 million on subsidies and transfers, and the remainder of €133.18 million was capital expenditure.

In general, the 2006 Budget was executed in a prudent fashion. The 2006 Budget Mid-Year Review addressed urgent funding requirements whereby increases of expenditure for some budget organizations were offset by saving in others. The 2006 Mid-Year Review Administrative Direction included also a provision which implements the Government decision on "modified hiring freeze" for all civil servants with the exception of few protected categories of employment.

The Kosovo Consolidated Budget was under-executed in the past two years and capital expenditure has been the most under-spent item in the KCB. Specific actions should be taken for improving overall performance of capital spending in Kosovo. The solution to the problem of capital under-spending requires comprehensive approach to improving the capital management process, which goes beyond the budget and project execution processes to also include the project preparation and selection process and the monitoring and evaluation process.

Negotiations with the IMF on a new "Letter of Intent" continue. Compliance with IMF recommendations remains a major medium/long term challenge in the face of upwards pressures on expenditure, including those potentially related to the status settlement. The introduction and implementation of a number of social benefits laws would constitute a serious burden to the Kosovo Budget.

The 2007 budget is a "pre-status" budget with relatively minor exception of inclusion of a €3.3 million contingency fund to address immediate post status issues. It is consistent with policy commitments and fiscal policies embedded in the Letter of Intent and the Government's "three E's" priorities – economy, energy and education. It provides for €717.5 million in expenditures as follows: PISG €359.0 million, reserved powers €194.1 million and municipalities €164.3 million. This level of expenditure was agreed with the IMF and represents a 2% nominal increase over the 2006 Budget. Given the uncertainties over the timing of status resolution and potential donor support, it was not yet possible to fully assess the funding needs to address post status requirements. In fact, the post status funding requirements and challenges would be address in the context of the Medium Term Expenditure Framework. Work is ongoing on the 2007-10 MTEF, which will be presented at a planned donor conference for Kosovo.

The MTEF contains a three-year prioritised Public Investment Plan (PIP), with a detailed list of appraised capital projects, and a forecast of the resources that are available to meet them. The PIP was formulated to apply strict economic rules in determining priority government expenditures on capital investment projects. In this process, Ministries and other budget organizations prepare detailed project proposals that need to fit into the overall strategic objectives of the government. In addition to enhancing the efficiency of investments, the PIP introduces transparency and prevents possible abuse of public funds.

1.5. External Economic Relations and Regional Integration

One of the top policy priorities for UNMIK has been the integration of Kosovo into the regional and European Union institutions. Kosovo's people and leaders see their future economically and politically integrated into the European Union and regional integration is an important step in that direction. Regional integration is an important building block of regional stability and economic prosperity. Economic cooperation in the region can produce significant economic synergies, which are far beyond the capacity of any individual state or territory.

UNMIK and the Government have made enviable progress to render Kosovo an integral part of all regional economic initiatives. Thus, Kosovo is a party to the enlarged Central European Free Trade Agreement (CEFTA), the European Common Aviation Area (ECAA), the Energy Community Treaty (EnCT), and takes part in the South East Europe Transport Observatory (SEETO), the Electronic South East Europe (eSEE) initiative and the European Charter for Small Enterprises (ECSE). These initiatives will have an impact on key economic activities including, but not limited to international trade, energy, transport, tourism, investment promotion, information society, civil aviation, and business environment.

On behalf of Kosovo, UNMIK signed four bilateral Free Trade Agreements (FTAs) which are now replaced by CEFTA. Following a declaration of intent in May 2003 to follow the Stability Pact Memorandum on Trade Liberalisation and Facilitation, UNMIK began to negotiate bilateral FTAs with the full involvement of the Government. In three years, Kosovo signed free trade agreements with Albania, Macedonia, Bosnia and Herzegovina, and Croatia.

Trade between Kosovo and Serbia and Montenegro has not been subject to customs duties after 1999. These achievements were deepened in 2006 by the decision to create a regional single free trade area through the enlargement of CEFTA. With the accession to CEFTA, Kosovo's businesses can benefit from the customs duty free access to the single market of about 30 million people. CEFTA also provides institutional mechanisms for resolving trade disputes, removal of non-tariff barriers to trade and provides a basis for the liberalisation of public procurement and trade in services.

The Energy Community Treaty (EnCT) creates a single energy market between the European Union and South East Europe. Its aim is to improve energy efficiency and supply stability through unimpeded trade in electricity and coordinated energy investments. The Treaty creates energy market institutions in line with the EU *acquis communautaire.* It enhances incentives for investment in Kosovo's energy sector. Provided the enormous investment potential in the development of lignite based power generation in Kosovo, the importance of the Treaty can hardly be overestimated.

The Southeast Europe Transport Observatory (SEETO) aims at coordinating transport route policies and investments in the region. Kosovo participates fully in these activities. In 2006 Kosovo submitted its contribution for the SEETO Multi Annual Plan, which outlines regional transport infrastructure priorities and financing needs. Further progress was made in harmonizing policies in the railways sector with the objective of creating some positive momentum for the development of this sector which in the region fares too poorly.

On 9 June 2006, UNMIK signed, on behalf of Kosovo, the European Common Aviation Area Agreement (ECAA). The agreement creates a single civil aviation market of 35 countries on the European continent, with a potential market of 500 million people. It deals with a number of different civil aviation issues including: aviation security, airport security, air traffic management, environmental protection, passenger protection, and competition rules. There is no doubt that this Agreement improves Kosovo's access to, probably, all of Europe. It will lower the cost and quality of flying.

The European Charter for Small Enterprises' (ECSE) Western Balkans and Moldova Forum was created with the aim of including the Western Balkans and Moldova in the ongoing European initiative to improve the business environment for small enterprises, which alone supply more than 50% of jobs within the EU. The Charter provides an institutional framework for regional cooperation in the development of SME policies. It also aims to strengthen the political-level commitment for small enterprise development. Provided that 99.7% of all registered businesses in Kosovo belong to the categories of micro and small enterprises, the Charter clearly provides a well-targeted policy focus.

Bilateral investment protection agreements and other initiatives have been initiated with the aim of improving Kosovo's investment climate. Through UNMIK, Kosovo has now bilateral investment protection agreements with Albania and Turkey in order to provide additional mutual guarantees to investors and thereby further reduce investment-associated risks. Also, UNMIK (on behalf of Kosovo) and Albania signed an agreement on mutual cooperation in the field of tourism to further improve investment in this particular business sector. Finally, Kosovo started taking part in the Investment Compact for Southeast Europe in 2006.

This initiative is designed to improve business and investment climate in the region, focussing on the following: a) evaluation and monitoring of progress in investment reform; b) support to the implementation of investment reforms; c) support to structuring the dialogue between public and private sectors; d) and political support for investment.

Kosovo is also a part of the initiative aimed at creating the electronic information society – the electronic South East Europe (eSEE). The goal of this initiative is to facilitate the introduction of legislative and policy framework in the area of internet and other information technologies. The importance of improving internet penetration and the stimulation of wide application of information technology does not need any explication.

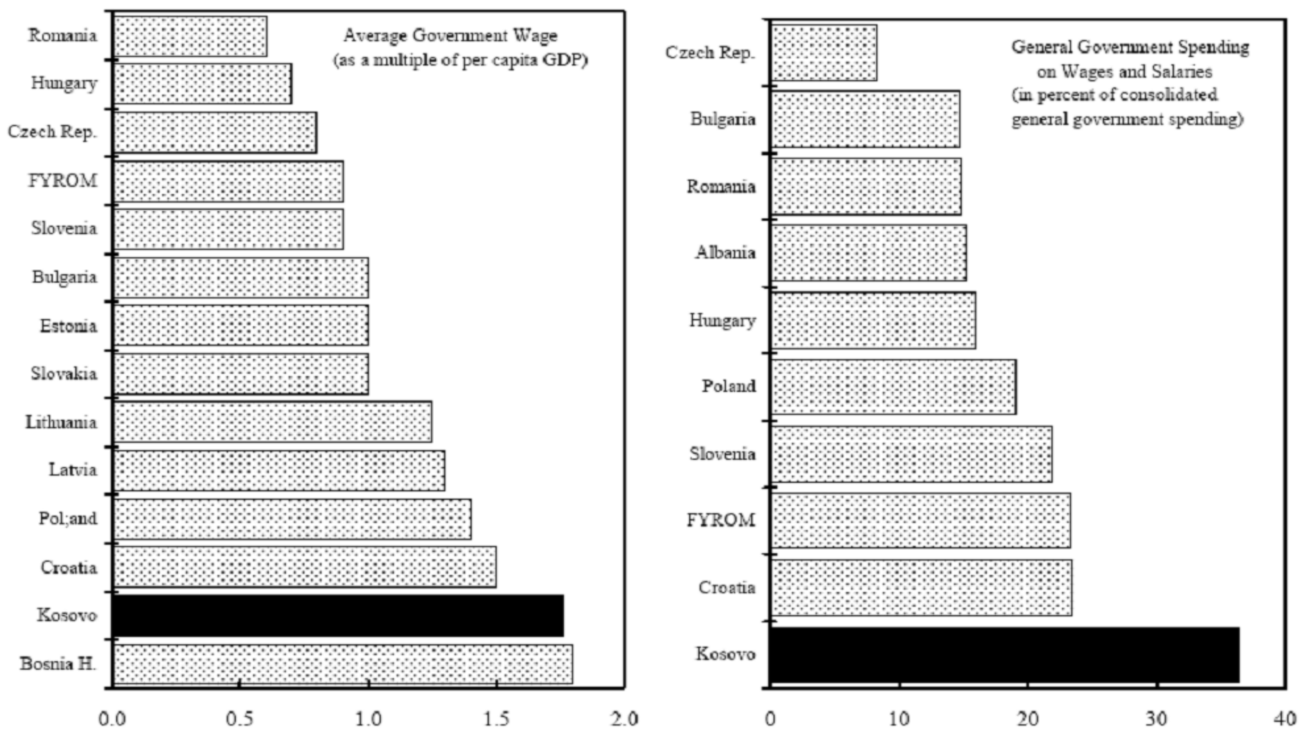

Figure1. International comparison of current expenditure & Central Government wage bill (In percent of GDP)

The key to medium-term fiscal sustainability is current expenditure discipline. Budget Spending jumped from € 220 million in 2000 to € 380 million in 2002, partly on account of the energy sector emergency. Demands for large wage hikes, in particular, are out of line with economic fundamentals: the total government wage bills in Kosova, as well as the average government wages, are already at or above the level in comparable economies.

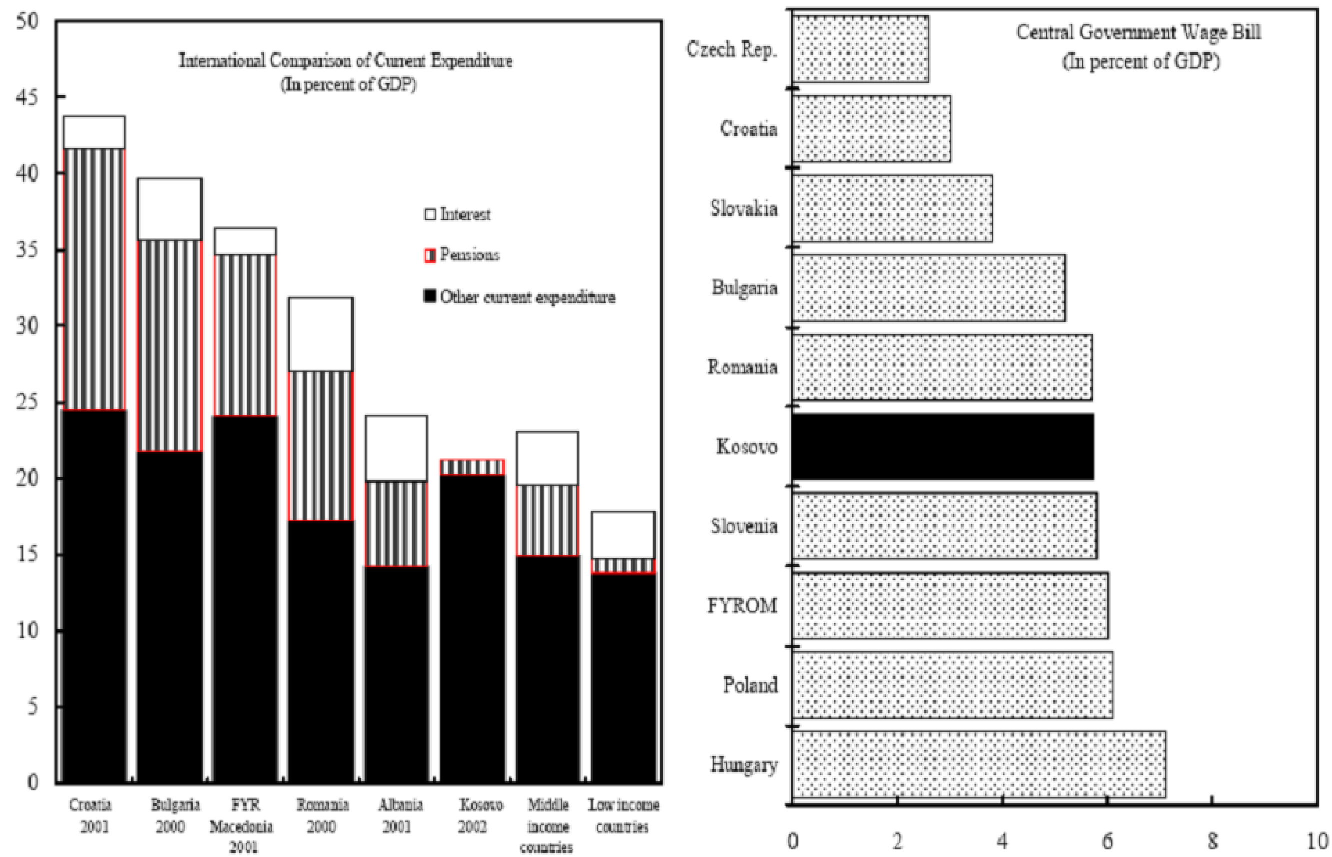

Figure2. Average Government Wages as a multiple of per capita GDP) & General Government Spending on Wages and Salaries (in percent of consolidated general government spending)

Therefore, during the coming years, average public wage increases should be limited to about the rate of inflation, and measures should be taken to reduce overstaffing in the civil service, thus:

- allowing greater wage differentiation within the same wage bill envelope;
- pension increases should be kept strictly in line with the cost of the basic food basket, as provided for in the legislation;

Agron Parduzi
November/2007

- maintenance expenditures should be kept up, but savings in spending on goods & services should be generated through better public expenditure management,
- appropriate procurement procedures, and stronger internal audit;
- subsidies to public enterprises should be rapidly reduced by accelerating their restructuring and improving collection rates.

1.6. Public Governance

The Office of the Auditor General (OAG) has further promoted good governance in the management of budgetary and other public funds. The OAG was established in 2003 to, *inter alia*, promote high standards of transparency, accountability and integrity in financial management and performance of public administration. The Office has been building up capacity to carry out audits with its own staff, with substantial financial support from the European Union Pillar of UNMIK and the European Agency for Reconstruction. The OAG is now working effectively and has carried out 130 audits in between January 2006 and June 2007.

As a crucial reform to strengthen corporate governance, the incorporation of Publicly Owned Enterprises (POEs) is far advanced. The Kosovo trust agency (KTA) has incorporated Post and Telecommunications of Kosovo (PTK), Prishtina International Airport, KEK, Kosovo Railways,tow Districts Heating Companies (Termokos and Gjakova) into Joint Stock Companies registered in the Kosovo Business Registry. A separate electricity transmission system operator (KOSTT) was spun off the Kosovo Energy Corporation (KEK) and incorporated at the same time. Moreover, a Kosovo Landfill Management Company (KLMC) was incorporated. With the financial support of donors, the water sector incorporation implementation started in December 2006, and a European Agency for Reconstruction-led selection committee is identifying the consultancy company to engage in the incorporation of the Waste and Irrigation Sector. For all of the incorporated POEs, regular Boards of Directors are now functioning, appointed by the KTA Board. Prishtina International Airport, KEK JSC and Post and Telecommunications of Kosovo JSC have established committees (Audit and Finance, Human Resources and Remuneration, Corporate Governance and Compliance) as stipulated in the by-laws, to the primary legislation establishing these public enterprises.

All POE management positions, including the Managing Directors, have been kosovarised by appointing local experts. In the context of preparing post-status transition, the European Union Pillar and the Government have cooperated to ensure that corporate governance post-status is secured according to international standards. The conceptual discussions have been supported by the European Union through TAIEX programme experts, and subsequently legislation has been drafted by UNMIK and the Government.

2. *Sector Developments*

2.1. Financial Sector

The Kosovo banking system continued its growth and the expansion of services. In 2006, total outstanding loans increased by 24%; deposits also increased by 10.7%. A positive development is also a significant increase in the maturity of bank loans. At the same time, the sector preserved its stability, which is reflected in a growing asset/liabilities ration. The financial sector in Kosovo continues to be dominated by commercial banks, while the share of insurance companies, pension funds and other financial intermediaries is still minor.

Commercial banks manage 89% of the total financial assets and the remainder is shared between insurance companies (5%), pension funds (1%) and other financial intermediaries (5%).[4] At end of 2006 the number of banks operating in Kosovo was six (there were 7 in 2005), two with full foreign ownership and four with majority domestic ownership. In the first months of 2007, a large Slovenian banking institution took over the two largest domestically-owned banks.
At the end of 2006, the total banking sector assets amounted to €1,163.3 million (about €178.9 million more than at end-2005), that represents 51.7% of the Kosovo GDP. The two banks with foreign stakeholders continue to increase their dominance in the banking sector by managing 71.2% of the total banking sector assets and they continue to be the key players in the sector.

[4] *Other financial intermediaries are mainly micro-lending institutions involved exclusively in lending activity with no deposit-taking authorization; the Kosovo Pension Saving Trust (KPST) is considered to be part of General Government – defined as a social security entity – and consequently is not included in the financial sector* ***Source: http://www.wto.org***.

Banks are continuing to expand their lending activity. The outstanding amount of loans by the end of 2006 reached €636.6 million or 24.0% more than in 2005. The main beneficiaries of the loans remain the non-financial corporations (mainly private SMEs) that account for 77.0% of total banking loans. Loans granted to the trade sector are still dominant. However, the growth of 31.5% was recorded for loans granted to the production sector, which is a sign of the revival of activity in this sector. Another positive sign is the increase of the number of medium-term loans, demonstrating better confidence in the banking sector and the domestic economy, as well as, on the corporate side, of a growing demand for financing equipment needs. As many as 52.8% of the total loans granted in 2006 had a maturity of more than 2 years.

Deposits in the commercial banks have continued to grow. The outstanding amount of deposits was €926.4 million (39.2% of GDP) representing an increase of 10.7% compared to 2005. The key depositors continue to be the households, with 55.8% of the total banking deposits. The second largest depositors are the public and private non-financial corporations, composing 23.5% and 13.4% of the total banking deposits respectively. One publicly-owned company, PTK, still holds a large stake of market with about 20% of total deposits. With respect to maturity, the banking deposits are mainly composed of short-term deposits (transferable and with maturity of up to 1 year), representing 88.0% of the total amount deposited in the banks.

The banks expanded their operating network and banking products offered to clients, such as loans of up to 10 years of maturity and mortgage loans. At the end of 2006, the banking industry counted 220 branches or sub-branches and employed 2,416 persons. Moreover, the number of the ATM and POS terminals increased from 102 to 123 and 1406 to 1470, respectively.

The introduction of e-banking in 2005 showed very positive results in 2006, since 3,316 accounts were using e-banking at the end of 2006, compared to only 837 at the end of 2005. In addition, one local bank started issuing certificates of deposit. If, in general, the financial services offered by the banking industry supply the usual needs of most of the customers, these services, nevertheless, are still mostly the basic ones.

The selected indicators reveal that the banking sector in Kosovo is liquid and solvent. At the end of 2006, the loan-to-deposit ratio in the banking sector was 68.7%. In addition, due to the implementation of the CBAK amended Banking Rule XXI on the increase of minimum capital to €5 million by the end 2006, the Capital Adequacy Ratio is 16.7%, safely above the minimum ratio of 12.0% as defined by the CBAK Rule.[5]

In March 2006, CBAK revoked the license of Credit Bank of Prishtina (CBP) after reviewing that the CBP no longer fulfilled the minimum requirements for capital and liquid assets necessary to protect its depositors. The liquidation process of CBP is ongoing; all depositors received immediate refunds of up to €3,500, which implies that 97% of the number of depositors will be fully and quickly paid back. Further payments were made in conjunction with asset recovery. Despite the closure of this domestic bank, the other banks continued to operate effectively and no contagion effect was evident during the period.

At the end of 2006 there were nine insurance companies operating in Kosovo. Their total assets amounted to €62.9 million, about 15.7% more than in 2005. Six out of nine companies are mainly in foreign ownership and the other three in full domestic ownership. Consequently, the foreign ownership is dominant in insurance sector as well, managing almost 70.0% of the total insurance sector assets. The core activity of the insurance companies in Kosovo is TPL insurance (Third Party Liability, i.e. namely car insurance), accumulating 71.2% of the total premiums received. The remainder is composed from border policies and other (non TPL) policies.

As a result, there are still large potential uncovered risks and large opportunities for insurance companies to expand their supply. In 2006 all six supplementary pension funds ceased their activity as a consequence of voluntary termination. The supplementary pension funds were operating within different public corporations (such as KEK, CBAK, etc.). With the request of each fund, the CBAK Governing Board approved the license revocation of the existing funds and their liquidation is in process.

[5] *Capital Adequacy Ratio is the ratio of total banking capital to risk-weighted assets.*

On the other side, in November 2006 the CBAK Governing Board approved the permanent license to supplementary private pension fund 'Slovenian-Kosovar Fund'. This is the first private pension fund to operate in Kosovo.

2.2. Private Sector Development

Total lending has increased across all sectors signalling higher overall business activity and new investments. The year-on-year growth in bank landing recorded in June 2006 was as high as 32.3%. At the same time, the share of non-housing loans to non-financial corporations increased from 76% to 78%. More loans and their substantially longer-term structure are good indicators of increased investment activity in the private sector. Moreover, the IMF has also estimated a growth of private investment in 2006 from €397 to €526 million, or 32%. Growth was particularly strong in the category of non-housing private investment, an estimated 61%.[6] In addition to investment statistics, data from the Agency for Business Registration reinforce the indicators of increased private sector activity. The number of registered businesses grew by more than 5000, with growth occurring across all business sectors. Taking into account the reduction in public expenditure and foreign aid, it is clear that the investment growth was neither driven by fiscal policy nor foreign inflows, which could be a sign of its sustainability.

Growth is especially significant in mining, fruits and vegetables, processed food, wood products, products of chemical and metal industries, reflecting a structural change away from trade and simple services towards industrial production. One indicator of structural changes is reflected in the structure of traded goods. For instance, a comparison of export data shows that about 50% of the growth in exports (close to €12 million) is production based (excluding scrap metal).[7] Likewise, financial sector data also signal some structural changes. The comparisons of loan structure between June 2005 and June 2006 show an increased share of loans to industry by 3%, 1% increase in lending to the construction sector, and a 3% drop in landing to the trade sector.

[6] *Aide Memoire of the IMF Staff Mission to Kosovo, 19-27 February 2007, p. 7.*
[7] *Source of data: UNMIK Customs 2005 and 2006.*

In spite of these positive developments the structure of the private sector in Kosovo is still too heavily oriented towards trade and low-value-added services. Kosovo exports less per capita than any other country in Europe and is too heavily dependent on Diaspora remittances and other sources of foreign inflows. Even without a formal study, it is easy to notice an overabundance of investment in restaurants, food, clothing, and other consumer goods stores. Opportunities for such investments are largely driven by the presence of international mission staff, foreign aid, and remittances.

Local entrepreneurs react to the incentives provided by these inflows. The lack of regulations and the natural "herding behaviour" of investors lead to over-investment and quick erosion of profits. Many of these businesses make negative profit in the economic sense. If some positive earnings can be made, they are often due to tax evasion. Most often such investments only provide a sense of employment to their owners. The factors that gave rise to the build up of such investments are bound to fade away leaving behind sunk costs in dilapidated capital and, probably, an accumulation of skills that might not fit the needs of more productive business activities.

The development of a strong private sector rests upon a supportive legal and regulatory framework, as well as quality institutional and physical infrastructure. The development of a vibrant and competitive private sector requires substantially more support from the public sector than macroeconomic stability, fiscal discipline, and privatisation.

Developed institutional infrastructure will provide those essential services to the private sector, which would not be provided or would be underprovided if left to market forces alone. For instance, these are the services that expedite the conduct of compulsory administrative procedures, overcome information asymmetries and coordination failures, facilitate the creation of knowledge and technological development, etc. UNMIK and several bilateral and multilateral donor institutions have been providing assistance to develop business-support capacities within Kosovo's public institutions.

The international community and the Kosovo Government have continued their efforts to build business support capacity within public institutions. Within the Government of Kosovo, most of the competencies for building business support institutional capacity rest with the Ministry of Trade and Industry. Consequently, this Ministry has been the primary beneficiary of international assistance targeted to this end, specifically to (i) the establishment of the Investment and Export Promotion Agency of Kosovo; (ii) the Small and Medium Enterprise (SME) Agency of Kosovo; (iii) capacity building of the Agency for Standardization of Kosovo; and (iv) capacity building of the Ministry of Trade and Industry's (MTI) Trade Department to analyse trade flows and develop trade policies.

Notable progress was made in 2006 in building the institutional infrastructure for business support. With the support of the European Agency for Reconstruction (EAR), the EU Pillar of UNMIK and the World Bank, the Investment Promotion Agency of Kosovo (IPAK) was established. The funding for the Agency staff and some of its operations is allocated from the budget of the Ministry of Trade and Industry (MTI). The Agency now has its own premises, a formally appointed Managing Director, and the essential staff. The EAR continues to provide significant technical assistance to the Agency aimed at supporting its operations and capacity building. With the support of the Austrian Development Agency, a representative office of IPAK for Austria and Germany was opened in Vienna. Assisted by the EAR, the SME Support Agency was created, as part of the MTI organization. The SME Agency has been assigned a mandate of implementing Government support programs to the SMEs.

However, significant capacity building is still required to enable these institutions to perform their key functions. The IPAK has been mandated not only with investment promotion, but export promotion as well. This mandate necessitates the creation of adequate information systems for potential investors, capacity to conduct promotional activities, the ability to compete with counterpart agencies in the region, as well as a number of other equally important activities. At this stage, IPAK is able to perform only a small number of its responsibilities. A similar diagnosis could be given for the SME Agency. The Agency has a very ambitious agenda, even if without defined priorities, qualified staff, or funding to implement much of it.

Likewise, the Agency for Standardization will have to play a very important role in the introduction of standards for products and production processes. Without the adoption of these standards, many Kosovar companies will not be able to export to the European Union and many other countries. Then again, the Standardization Agency is not yet equipped to perform these tasks. Building the capacities of these institutions requires continued, and perhaps, intensified attention of both the Kosovo Government and the International Community. Moreover, significant assistance has also been provided to the Ministry of Agriculture Forestry and Rural Development (MAFRD) to build essential institutional support to the agriculture sector.

Specifically, donors have assisted MAFRD in the development of an agriculture sector strategy (*The Green Book)*, as well as the development of the necessary institutions and procedures to render meet exports from Kosovo possible. An important milestone towards meeting the EU requirements for meat exports has been the establishment of the Kosovo Veterinary Services (KVS). However, before Kosovo can begin serious exports of meat and plant products, it will have to further strengthen the capacity of its veterinary and phytosanitary inspections and support institutions.

2.3. Privatisation and Incorporation

One of the key activities of the European Union Pillar of UNMIK has been the privatisation of socially-owned enterprises (SOEs). Over 500 business enterprises in Kosovo were identified as SOEs. These enterprises operated in all sectors of the economy, including commercial real estate, hotels, mining and mineral processing, construction and building materials, metal processing, textiles, wineries and vineyards, and retail and wholesale trade. The KTA conducts privatisation in two ways: spin-off and liquidation.

The main method for privatisation is the spin-off procedure, whereby assets of an SOE are transferred to a new company ("NewCo") and the NewCo shares are then sold to an investor in a competitive bidding process. This method helps to preserve the activities of SOEs that are still going concerns. There are ordinary spin-offs, in which only the highest price counts, and special spin-offs, where additional conditions are attached to the selection of the winning bidder.

The second method of privatisation is liquidation, which is especially useful when an SOE has long since stopped trading and its debts far exceed the value of its assets. The privatisation process accelerated rapidly in 2006 and in the first part of 2007. By June 2007, 510 NewCos had been tendered in total, 287 sales contracts had been signed (270 with ordinary spin-off and 17 with special spin-off), over €321 million were received and banked, of which €64 million is entitled to employees, over €124 million and over 6,500 employees was contractually agreed in guaranteed investment and employment a condition of the sale.

The amount of special spin-off investment evaluated until June 2007 was about €46 million and the number of employees hired was about 3,500. As of May 2007, 84 SOEs were approved by KTA for liquidation, but so far no final distributions have been made to claimants because of a large number of complicated claims received. Overall there are about 600 enterprises to be liquidated, with more than 150,000 claims expected. Several categories of claims are assessed:

- Albanian workers dismissed in the period between 1990 and 1999 seeking all lost salaries until their return to their workplace,
- Serbian and other minorities unable or unwilling to return to work post-conflict for lost salaries,
- claims by workers to be owners of particular SOEs,
- claims pre and post conflict arising from complicated barter and other commercial transactions, and
- Pre-conflict claims for loans made to SOEs.

In January 2007, new liquidation legislation was enacted and it is considered that this legislation will contribute to the liquidation program making faster progress. A liquidation steering committee has been established in accordance with the instructions issued by the Managing Director of the KTA. A subcommittee called the Liquidation Practitioners Subcommittee has also been established in order to coordinate the efforts of the regional liquidation committees.

These committees are developing liquidation best practices together with legal analyses and policies to assist in the claims resolution process as well as providing expert guidance on liquidation procedures. Presently, they are working effectively and are making excellent progress on the development of systems and reports to ensure that the liquidation program can be monitored and controlled.

2.4. Agriculture

Despite falling production in a couple of segments of agricultural production, the sector as a whole continued a modest growth in 2006. While there is no complete data on the level of agricultural production in 2006, evidence for growth is strong. Overall agricultural exports increased from €7.75 million to €9.86 million, mainly in processed vegetables (doubling from €1 million to €2 million). Furthermore, imports of agricultural inputs and capital goods increased by 12%, (imports of fertiliser were €9 million, animal feed €6 million, agricultural equipment €2 million and seeds and planting material €2 million). The imports of agricultural production inputs and capital goods continue to enjoy zero VAT rate. Higher loans to the sector are yet another sign of stronger economic activity therein. Loans to agriculture grew from €12.5 million to €16.5 million. Nevertheless, this amount still represents only 3% of total bank lending.

Three agricultural sub-sectors did especially well in 2006: vegetable, meat and dairy. As reflected in the export figures, the vegetable sector expended its production and capacity to compete in foreign markets. It is also estimated that the production of meat, specifically sheep meat, increased in 2006, leading to a small growth in exports. The dairy herd also increased. The Kosovo Dairy Processors Association estimated that sales increased by 10 to 15% in 2006, with the total estimated value of €10 million. Dairy imports remained the same as in 2005, at €21 million. Yet, the processors complained that they were unable to compete effectively against imported cheese, which sold at a cheaper price than the local ones. The Customs Service tightened up on widespread under-invoicing, leading to some improvements in the competitiveness of the local products. In addition, poor and inconsistent product quality stifles the expansion of local production.

Farmers with contracts to supply processors have continued to be well supported by the banks. Approximately 700 pregnant heifers were imported in 2006, further improving the herd structure. Problems of over-supply of milk in the summer persist, and farmers are becoming cautious about expanding herds. Efforts have been made to get European Union approval for lamb meat exports to the EU. The approval process is progressing slowly, as the Kosovo Veterinary Services need to implement a number of systems to obtain this approval. It is hoped that by 2008, Kosovo might export as much as 30,000 lambs for the Easter market in Greece and Italy. Kosovo did manage to export live lambs to Bosnia in 2006.

On the other hand, the production of cereals, wine, and eggs suffered from unfavourable conditions. Agricultural imports increased from €287 million to €319 million, or 11%. The increase in imports was dominated by cereals, as a result of lower domestic yields, costing an extra €12 million. Imports of cereals more than doubled from 75,000 tons in 2005 to 160,000 tons in 2006. The price of wheat rose steadily in 2006 driven by a shortfall in production in North America, a decline in world stocks and the increased demand for cereals for the production of bio-fuel.

Wheat prices rose from the range of 12 to 15 cts per kg to 21 cts in March 2007, and maize prices jumped from 14 cts per kg to 18 cts. Furthermore, wine exports fell from €1.5 million to €1.3 million, but are expected to pick up following privatisation of the two exporting wineries – Rahovec and Suhareka. Egg production suffered in 2006 due to worries over Avian Flu and demand fell nearly 50% of normal from 250 million per year to 140 million. A ban on most imports from countries reporting the disease created a dent in imports from 50 million per year to ¼ million. The result was a shake out in the industry with less than efficient going out of business. Those that survived could realise higher profits as wholesale prices rose from 5.5 cts to 7 cts. Privatisation in the agricultural sector was accelerated in 2006. Up to and including wave 26 in July 2007, approximately 160 agriculture-related enterprises were tendered, with a value of approximately €75 million.

[8] *As reported by Kosovo Feed Miller and Poultry Association, 2006.*

During the past six months, the majority of enterprises have been agricultural land for cereal production, livestock farms, poultry farms and orchards. The Ministry of Agriculture Forestry and Rural Development produced the Rural Development Plan 2007-13, that feeds into the Kosovo Development Strategy and Plan. The Plan sets out how the sector can be reconstructed and where government and donors should best put their resources. The MAFRD is adjusting the plan to fit in with budgetary realities and possible future aid flows, especially from the EU's Instrument of Pre-Accession (IPA). The Ministry has also started the process to set up a rural fund to provide supplementary grants to support measures outlined in the Rural Plan. The Fund is expected to start operation on a pilot basis in 2007.

2.5. Energy and Mining

Of the sectors that have potential, energy and mining is the one with a clear comparative advantage. Kosovo has large reserves of lignite (around 14 billion tons), based on which, according to a recent World Bank study,[9] it can develop up to an additional 4000 MW of power generation capacity. Ore mining is revived through the successful privatisation of Ferronikeli, which will start full production in mid 2007. Equally important will be the success of the ongoing efforts to revive the most essential assets of the Trepca mining complex, and the privatisation of some smaller mining enterprises.

The Independent Commission for Mines and Minerals (ICMM) has sought to actively advertise Kosovo's impressive geological endowment globally to help attract foreign direct investment to develop this key component of the economy. These efforts show first results: During 2006, a total of 57 Exploration and Mining Licences were issued. Mining Royalties and other fees amounting to almost € 2.65 million were collected in 2006 to the benefit of the Kosovo Consolidated Fund. ICMM has also elaborated an integrated programme of technical programmes to update and expand the geological knowledge of Kosovo.

[9] *REBIS: GIS – Final Report, PwC Consortium, Funded by the EU CARDS Programme, 31 December 2005.*

The programmes include a Kosovo-wide Airborne Geophysical Survey, the establishment of a major suite of geological maps and the initiation of a regional stream sediments geochemical survey, beginning in 2006 in the most prospective areas of Kosovo. Kosovo's legal and regulatory framework in the mining sector, which is viewed very positively by potential foreign investors, needs to be safeguarded and any amendments need to be fully compliant with the relevant EU directives. Furthermore, additional efforts need to be undertaken to strengthen the administrative capacity of the Ministry for Energy and Mining (MEM), in particular in view of the technical and managerial skills that will be required for successfully completing the Kosovo C project.

UNMIK, on behalf of Kosovo, signed the Energy Community Treaty (EnCT) in October 2005, and has been the first Party to finalize its internal procedures. The EnCT entered into force in July 2006. The objective of the EnCT is to create a single energy market for electricity and natural gas between South East Europe and the EU energy market. To date, the energy sector of Kosovo is dominated by the vertically integrated Kosovo Energy Corporation (KEK). Since 1999, after years of under-investment, around €1 billion were mobilized from donors and the KCB to improve the performance of KEK. However, after deduction of expenditure for electricity imports and the repairs following the 2003 lightning strike in Kosovo B, only some €300 million can be considered as 'real investments', i.e. some €50 million per year.

These investments need to be considered small in international comparison but have resulted in a stabilizing effect, although clearly insufficient to provide for a sustainable electricity supply infrastructure. However, KEK has gradually been increasing its annual generation since the end of 1999. In 2000 for example, annual output from the Kosovo A and B plants as well as the Gazivoda/ Ujimani hydor power plant amounted to 1914 GWhs. By the end of 2006, however, the figure was 3972 GWhs – an annual average increase of just under 13%. Revenue collection for energy delivered remains the Achilles heel of the company. An international turn around management (TAM) team provided by the Irish company ESBI was introduced between 2004 and 2006, and executive authority was handed over to a new local management team on 15 October 2006.

In order to increase revenue collection rates, KEK successfully introduced the "ABC" policy. Unlike the previous load-shedding scheme, which treated all customers equally, the ABC scheme differentiates between best-paying (class A), average-paying (class B) and worst-paying (class C) customers. The ***ABC*** categorization is made at the level of the 10 kV feeders, on an economic basis: those feeders that have low commercial losses and/ or high payment rates are ranked as category ***A*** feeders, average losses/low payment rates as category ***B*** and high losses/low payment rates as category **C** feeders. KEK has aimed to maintain a load-shedding of 24:0 for category *A* (i.e. 24 hours electricity supply), 5:1 for category *B*, and 4:2 or whatever else is achievable for category *C*. The scheme was implemented as of 5 December 2005 and has so far resulted in a gross increase in revenue collection for KEK.

In 2006 for example, the gross level of collections amounted to € 99.5 million (or an average of €8.3 million per month) compared to € 87.4 the previous year (an average of €7.3 million per month); a year-on-year increase of just under 14%. KEK is planning on migrating the ABC scheme from the 10kV feeder level to the 0.4 kV secondary network levels, which would enable KEK to perform individual disconnections of non-paying customers. Progress has also been made in efforts to unbundle and incorporate KEK. A separate transmission entity was incorporated at the end of December 2005. KEK was, therefore, transformed into two Joint Stock Companies, KEK JSC and KOSTT JSC, to allow for a separation of the transmission entity in conformity with the EnCT. KOSTT is fully operational as of 1 July 2006, and KEK is paying monthly the costs of KOSTT for transmission network maintenance and for power system operation. The further unbundling of KEK, in particular in relation to its mining operations, is currently being evaluated.

Kosovo's Transmission System Operator, KOSTT, was included in the South Europe Transmission System Operators Task Force in October 2006 when, pursuant to strong lobbying by the European Union pillar of UNMIK, the ETSO Steering Committee unanimously decided that KOSTT fulfils the requirements of Full Member in the SETSO TF. However, KOSTT is still being excluded from the technical working groups of the SETSO TF, notably the Cross Border Trade (CBT) Mechanism, the Network access and congestion management mechanism and the forthcoming Balancing Energy

Tools Mechanism for SEE (BETSEE), which are essential for the regional regulation of electricity transits and the associated revenue streams through the KOSTT network. Furthermore, KOSTT is at present still not being compensated by EMS for transit charges in accordance to the agreements on CBT/ITC Inter-TSO compensation scheme, which continues to result in significant losses. The Energy Regulatory Office (ERO) made progress on development and adoption of the secondary legislation such as the Rule on Pricing and the Tariff Methodology, the Rule on Dispute Settlement Procedure, the Rule on Licensing of Energy activities in Kosovo, the Rule on General Condition of Energy Supply and the Rule on Disconnection and Reconnection of Customers in the electricity sector in Kosovo. In addition ERO issued the Tariff Application Guidelines, the Manual of Reporting and finalized the tariffs review. The tariffs review resulted in the approval of unbundled tariffs (separate for generation, distribution and supply) for the year 2007 for KEK and a transmission tariff for KOSTT (Kosovo Transmission System and Market Operator).

It also issued the Rule on Authorization Procedure for the Construction of New Generation Capacities, the Rule on Administrative Measures and Fines and the Rule on Confidentiality of Information, as well as 21 licenses to all existing energy enterprises that operate in Kosovo and approved the Transitional Market Rules, the "Grid Code" and the "Metering Code". The construction of the Kosovo C power plant will be the largest private investment ever undertaken in Kosovo. On 15 August 2006, the MEM, supported by the World Bank, formally launched a process to develop this opportunity by issuing a request for expression of interest (EOI) for the construction of a new power plant (Kosovo C) and the development of a new coalmine (Sibovc SW) to supply both existing generation units and the new power plant.

A Project Steering Committee (PSC) carried out the pre-qualification process, to which ten companies/consortia responded, four of which met the selection criteria and thus qualified as prospective bidders. The total cost of construction of Kosovo C project is estimated to be up to €3.5 billion. The new lignite-fuelled power plant with an estimated installed capacity of up to 2100 MW will be built over two phases, with the first phase foreseen to produce about 1000 MW of generating capacity.

Barring any unforeseen delays, operation of this first phase is anticipated to start in 2014 to 2015, while the second phase of approximately the same capacity would begin operating four years after the first phase. The new plant is expected to create hundreds of jobs at the power generation facility and the related lignite-mining operation; it will also catalyze the creation of jobs in unrelated sectors. While the construction of the plant necessitates the participation of foreign investors and foreign engineering companies, local companies will be subcontracted, thus creating direct and indirect jobs during the construction process. In addition, the plant will make use of local resources for its maintenance and other services. Moreover, once operational the new power plant will make a significant contribution to Kosovo's GDP, its balance of payments, and public revenues. Therefore, the construction of the new power plant will indirectly also contribute to job-creation in a number of unrelated sectors.

In order to ensure continued coal supply beyond 2010, at which time the existing coal reserves will be depleted, KEK has started the opening of the new Sibovc SW mine. KEK has meanwhile received limited mining license for the field, covering around 45% of the entire license area. The Complementary Mining Plan (CMP) foresees that preparatory removal of overburden needs to start in November 2008, following the refurbishment of KEK's mining equipment in Overburden Systems I - III. Following the review of the state of play and the refurbishment schedule of the Overburden Systems (as laid out in the CMP), it has been revealed that the planned schedule in the CMP does not sufficiently reflect the duration of delivery periods of certain equipment under present market realities.

Therefore, the SRSG approved an accelerated competitive procurement process which will allow an earlier contract signature for Overburden Systems II and III, thus reducing the risk of a future coal supply gap. The EAR financed refurbishment of Overburden System I has equally been delayed due to the fact that the available budget proved insufficient to successfully complete the first tender. In view of the delays in the refurbishment of the mining equipment and with a view to open the Sibovc SW mine as anticipated in the CMP, KEK is to start operations in the Sibovc SW field with existing mining equipment as of mid 2007.

2.6. Transport

The development of the transport sector is clearly a prerequisite of Kosovo's economic development. This is a sector where large public, and perhaps even private, investments should take place in the coming years. While there has been limited progress in the building of new transport infrastructure, important institutional achievements happened throughout 2006. The focus in 2006 was on the roads, in particular Routes 6 and 7, even though important developments can be reported for railways and the Prishtina Airport. Routes 6 and 7 are part of the regional core network adopted in 2003. Route 6 runs from Skopje via Prishtina to Serbia and into Montenegro, Route 7 from Durres via Prishtina into Serbia through Merdare. An important achievement in 2006 was the completion of the study on the "Sustainability of the Roads Sector" which provided policy makers with clear recommendations on financing options for roads.

The main recommendations of this study were related to maintenance spending (to be maintained at €22 million per year), rehabilitation/ reconstruction spending (to be brought up to €17 million per year), and new investment (preferably not to be financed from the KCB but through external funding). An important feasibility study was completed for the two main axes which are part of the regional core network – Route 6 and Route 7. The study was conducted by independent consultants and provided a comprehensive economic and environmental assessment based on international standards. This study will help the authorities make the right decisions about the timing of implementation of road segments (upgrading and/or widening of existing lanes or new road alignment) for Routes 6 and 7.

Kosovo's Minister of Transport and Communications presented the feasibility study for routes 6 and 7 to representatives of the European Commission, EBRD, EIB, World Bank, SEETO and other institutions and made a case for funding assistance for this project. Discussions on this issue are still ongoing. A World Bank funded study that was completed in the first half of 2007 assessed the viability and options for Public-Private Participation in the roads sector. The study found that due to low traffic –

volumes in Routes 6 and 7, the only present location with sufficient traffic volume to make stand-alone toll motorways feasible is in the vicinity of the Pristina. The study listed a set of actions that need to be taken in order to prepare the enabling institutional infrastructure for public-private partnerships. Kosovo's participation in the transport regional initiatives, in particular Southeast Europe Transport Observatory (SEETO), intensified. The Second Annual Meeting on the Ministers of Transport took place in the end of 2006. This meeting reaffirmed the continued commitment of participating parties for close cooperation in the area of transport. The ministers signed a resolution on further cooperation in the development of the regional railway network.

Another important decision taken by the SEETO Steering Committee in the first part of 2007 was to open the Regional Core Network to modification proposal from the parties. Kosovo submitted a proposal for the addition of a new branch to the northern part of Route 6 which runs from Prishtina to Peja and into Montenegro. This proposal, alongside other proposal from the region, will be reviewed by SEETO and a final decision on the modification of the core network is expected by 2009. As a consequence of substantial improvements in infrastructure and procedures over the past years, Prishtina International Airport (PIA) in August 2007 obtained a Conditional Certificate from the Icelandic Civil Aviation Authority.

This is a major step forward for airport because it confirms that PIA meanwhile meets the international aviation standards in most of its areas of operation. Another positive development was the decision to begin the procedure for a concession of the airport. A Steering Committee was established to oversee the process and work is ongoing.

3. *Outlook and Policy Priorities: Maintaining and Improving Achievements*

The economic framework established gradually since 1999 has served Kosovo well in a period when, after years of turmoil and conflict, stability was the paramount objective. If, in a stable political context, the positive developments achieved so far will be maintained and consolidated, they have the potential to bring Kosovo's economy on a sustainable growth path. Our view of the medium term economic outlook for Kosovo has not changed significantly since the previous Kosovo Economic Outlook published in 2006.[10] Kosovo still needs a well-defined and widely-shared vision that will foster clarity, unity and continuity and will provide a clear sense of direction and purpose. It will help align incentives and peoples' reactions to those incentives and it will encourage the mobilisation of resources and their efficient allocation.

It will give Kosovo and its people a sense of strategic orientation and will provide potential investors with a clear signal as to where the economy is going and what the policymakers' intentions are. The resolution of Kosovo's status will in several ways improve the conditions for economic growth, in particular in areas like the attraction of Foreign Direct Investment, accession to international economic institutions and to external borrowing. Nevertheless, status alone will not substantially change the performance of the economy if not accompanied by efforts to maintain and improve the achievements made so far. More specifically, the following areas will require continued attention:

- Safeguarding the macroeconomic stability must be a cornerstone of economic policy. To a large extent, macroeconomic stability in the last eight years has been underpinned by the adoption of the Euro as the official currency and the inability of the public sector to borrow from international financial institutions or commercial lenders. The Euro has served Kosovo well and, given that for the foreseeable future its benefits will far outstrip its costs, it seems only logical to keep it as the official currency in use.

[10] *Available at the EU pillar website:* http://www.euinkosovo.org.

Over the past year, significant progress has been made to update the Medium-Term Expenditure Framework (MTEF) so that it serves as an effective public expenditure management instrument that ranks public projects by their importance, analyses their financial impact and identifies the financing gap with a view to present it to interested donors. The impact assessment procedure through which legislative proposals are analysed in terms of their direct and indirect costs for the budget, expected benefits and financial sustainability, should be further strengthened. Finally, a revival of the initiative to formulate a comprehensive development plan will provide a longer planning perspective for the MTEF.

- Efforts to consolidate an effective civil service that can respond effectively to the challenges of a dynamic economy ought to continue. Rapid economic development requires commensurate improvements in the quality of the civil service. As public policies in Kosovo become more complex, the skills of the civil service need to be upgraded. Improving the policy process and the quality of policies is one thing – effective implementation is a lot more difficult and is closely related to the quality of the people who work in the public sector. In particular, resources should be focussed on attracting and retaining competent civil servants rather than inflating staff numbers.

- As far as the regulatory framework is concerned, care should be taken to safeguard its independence and strengthen its effectiveness. In particular, the regulators that have been established in the last few years to oversee the strategic sectors dominated by public enterprises should be safeguarded from political interference during the transfer to domestic supervision in the framework of the status definition process. Both organizational and financial independence is important for the well-functioning of the regulators – the challenge in the next few years will be to guarantee and strengthen this independence. A lot of progress has been marked in financial sector under international administration. The challenge in the future will be to maintain effective banking supervision and to adopt prudent policies that encourage citizens to save more and banks to lend more and at lower interest rates without compromising the safety of customer deposits in commercial banks.

- Further steps are necessary towards regional integration by strengthening Kosovo's participation in the existing initiatives and acceding into new ones. The process of approximation and harmonization with the EU should continue apace. CEFTA-related activities are going to intensify in the second half of 2007 and will offer Kosovo an opportunity to resolve effectively a number of trade-related problems it has with neighbouring territories. In particular, non-tariff barriers which have always been a serious problem for Kosovo's traders, not least because of the unresolved political status, are expected to be dealt with in a cooperative fashion by discussing the issues in the multilateral forums that CEFTA will create.

- The full inclusion of Kosovo's energy sector institutions, notably the Transmission System and Market Operator (KOSTT), in all regional mechanisms has to be ensured Kosovo's inclusion in this initiative is important because it will provide Kosovo with an opportunity to have easier access to the regional market for its expected large energy exports. In the area of investment, Kosovo ought to grasp the opportunities offered through its participation in the Investment Compact for South East Europe initiative (ICSEE) and the European Charter for Small Enterprises for Western Balkans and Moldova.

- Further improvements in the area of energy, and in particular the performance of KEK, ought to be carried out. In the area of electricity, the challenge in the short run will be two-fold. First, improvements in KEK's performance should continue towards the final objective of supplying uninterrupted electricity and making KEK a financially self-sustainable company so that it ceases to be a burden on the government budget. The good corporate governance structures that have been established should be safeguarded and strengthened and, in parallel, the improvement of the management should continue. In addition, continued progress with billing and collection rates should be maintained. A lot of institutional will and commitment from all quarters of government is needed to achieve this. Therefore it is essential that a number of institutions be effectively involved and coordinated. Second, the huge and cheap lignite resources that Kosovo boasts should be appropriately harnessed in order to turn around, not only the situation of electricity supply, but also the largely negative current account.

A project of the magnitude of Kosovo C will require a lot of work in establishing an institutional and legal framework and setting up transparent and competitive procedures for the dealings of public institutions with private actors that guarantee speed, probity, environmental and social protection and maximum benefits for the citizens of Kosovo.

- Dynamic activities are expected in the area of transport also, especially in the road transport sub-sector. The Ministry of Transport and Communications has completed the feasibility studies for the two main road axes: Route 7 from Vermice to Merdare and Route 6 from Hani Elezit to Peja. These axes have been included in the regional core transport network which has been developed in cooperation with regional countries and the EU. Discussions of the two feasibility studies between the Kosovo authorities and the European Commission, the World Bank and other international financial institutions are underway and are expected to lead to donor support to the government's road construction activities. Success in this area too needs to be safeguarded by completing the legal and institutional framework and developing the institutional capacities that are necessary for the undertaking of such large-scale projects.

- Finally, Kosovo's socio-economic development will strongly hinge on extensive improvement in all areas of education and the development of relevant skills. While education obviously is only one factor affecting economic development, there is a clear link between the two. Notably, labour market data for Kosovo demonstrates a strong correlation between the level of education and rate of unemployment. While unemployment is very low among Kosovars with university degrees, it is the highest in the region among the unskilled segment of the labour force. Lack of adequate skills can be noticed both in the private and public sectors. These observations should not be surprising provided the legacy of boycotts of the formal education system (by the majority of the Kosovo Albanian population) during the Milosevic's era. In addition, school enrolment rates are still significantly lower than those in transition countries, especially at the university level. An assessment of key obstacles to better education outcomes ought to be completed.

4. Conclusion -

In conclusion (firstly), international donors ought to devote more technical and financial resources to assist the Kosovo public institutions in developing and implementing plans to improve education and relevant skills of the local population. Maintaining and improving the achievements, and promoting them vis-à-vis domestic and foreign investors, is essential for keeping Kosovo on the path towards sustainable social progress and economic prosperity. Despite the understandable public focus on status resolution, Kosovo's political leadership and institutions should further push the economic issues they are designed to deal with. Any distractions could undo some of the achievements that have been reached so far and will cause progress to slip back. The prospects for a better economic future are real and they are grounded on the sound foundations that have been laid in the last eight years. Many low income countries (e.g. Kosova) policies discourage businesses and enterprises. Property rights are often difficult to enforce and in many cases weak judicial systems make contract enforcement virtually impossible. In recent years IMF realized that such issues need to be addressed if a macroeconomic framework is to be sustainable. Of course that macroeconomic stability is important for the low income members while it has become increasingly apparent over these years. Most of the poorer countries that have put in place policies to reduce inflation and crate the conditions for growth have experienced higher growth rates (always with the IMF's advices and encouragements).

---

[13] *Available at the EU pillar website:* http://www.euinkosovo.org.

Despite the fact that the path of Kosova's transition was and continues to be not an easy one, Kosova has experienced a higher growth as well. In a complex and unique political situation in which Kosova finds itself, it is a general impression that a lot has been achieved as far as creating institutions and policies. However, there is still a long way to go. Based on WB (World Bank), IMF' and European Commotion – recommendations, Government objectives and current necessities, the study concluded that there is an immediate need to: Reduce the unacceptably high level of unemployment, focus on reconstruction, private investment, import-competing, export sectors, privatizing socially owned enterprises, and support the overall improvement in competitiveness, adjust economy costs in line with its underlying productivity, limit the growth of budgetary wage bill, redeploy the size of civil service with the aim of reducing it, improve physical infrastructure, and to rise human capital, improve fiscal policy management, cut the deficit of KCB (not to exceed 3% of GDP), maintain low rate of tax regime, provide more effectively the administration of social transfers in line with initial intention of providing a safety net for those most in need (disability pensions, the war invalid benefit, and the early retirement benefit for minors), implement monitoring system ensuring tighter allocation of budget, to enhance non-tax revenue, improve the effectiveness of the public investment program (PIP), and information in donor coordination statistics, privatize all the total assets of SOE by KTA (mainly based on the client plan for the future development of the social enterprise to be privatized) , and to improve the governance of public enterprises (such as: PTK and Prishtina –

International Airport), moreover, pending the assignment of an international dialling code(second mobile operator), so the tendency to avoid possibilities for monopolistic behaviour must be high, strengthen the regulatory and supervisory abilities, introduce more foreword-looking approach in assessing the risks facing the banking system, and to create a more comprehensive financial statistics. The above mentioned points show also the IMF and WB role in Kosova, which is to be appreciated with respect to the fact that it has strengthen the capacity in both human and institutional resources, designed appropriate macroeconomic policy, tax policy, revenue administration, expenditure management, financial sector sustainability, more specifically it has assisted in policies relating to the government's budget, the management of money and credit, government and consumer spending, business investment, exports and imports, output (GDP), employment and inflation, financial sector policies, including the regulation and supervision of banks and other financial institutions, and structural policies that affect macroeconomic performance, such as those governing labor markets, the energy sector and trade, which all reflects to a possible better balance of payments.

Bibliography:

[1] *Source of data: Aide Memoire of the IMF Staff Mission to Kosovo, February 2007.*

[2] *Aide Memoire of the IMF Staff Mission to Kosovo, July 2005.*

[3] *Aide Memoire of the IMF Staff Mission to Kosovo, February 2007.*

[4] *The lab our market statistics are drawn from the Labor and Employment Kosovo 2005, which is an annual publication of the Ministry of Labor and Social Welfare.*

[5] *The aggregate data on trade for 2006 have not been officially published yet. For the purpose of preparing this report, we relied on unofficial statistics from UNMIK Customs and the "Annual Foreign Trade Report 2006" of the Ministry of Trade and Industry.*

[6] *Other financial intermediaries are mainly micro-lending institutions involved exclusively in lending activity with no deposit-taking authorization; the Kosovo Pension Saving Trust (KPST) is considered to be part of General Government – defined as a social security entity – and consequently is not included in the financial sector.* ***Source: http://www.wto.org***.

[7] *Capital Adequacy Ratio is the ratio of total banking capital to risk-weighted assets.*

[8] *Aide Memoire of the IMF Staff Mission to Kosovo, 19-27 February 2007, p. 7.*

[9] *Source of data: UNMIK Customs 2005 and 2006.*

[10] *Source of data: CBAK Bulletin, Structure of Financial Sector, no. 4, Prishtina 2006, p. 22.*

[11] *As reported by Kosovo Feed Miller and Poultry Association, 2006.*

[12] *REBIS: GIS – Final Report, PwC Consortium, Funded by the EU CARDS Programe, 31 December 2005.*

[13] *Available at the EU pillar website:* http://www.euinkosovo.org.

References:

1. http://www.mti-ks.org/
2. http://www.wto.org.
3. http://www.mti-ks.org/?cid=1,236
4. http://www.mti-ks.org/repository/docs/006ceftaconferenceilirciko.pdf
5. http://www.mti-ks.org/?cid=1,236,205
6. http://www.mti-ks.org/repository/docs/CEFTAMAINTEXT2006.pdf
7. http://www.mti-ks.org/?cid=1,312
8. http://www.mti-ks.org/?cid=1,295
9. http://cefta.literal.si/eng/cefta/zemljevid/index.html-l2
10. http://en.wikipedia.org/wiki/Central_European_Free_Trade_Agreement
11. http://www.iisd.org)
12. http://www.georgetown.edu/users/mlb66/AD.pdf
13. http://people.brandeis.edu/~cbown/papers/steel_mfn.pdf
14. http://www.britannica.com/eb/article-247600/money
15. http://www.imf.org/external/pubs/ft/exrp/what.htm#box4
16. http://www.imf.org/external/np/exr/facts/tech.htm