CENTRAL BANKING AUTHORITY OF KOSOVO
AUTORITETI QENDROR BANKAR I KOSOVËS
CENTRALNI BANKARSKI AUTORITET KOSOVA

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# CBAK BULLETIN

- **Balance of Payments of Kosovo**
- **Privatization in Kosovo**
- **Costs of Intermediation in the Kosovo Banking Sector**

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## ABBREVIATIONS:

| | |
|---|---|
| BEC | Broad Economic Categories; |
| BOP | Balance of Payments; |
| BPM5 | Balance of Payments Manual (5th edition); |
| c.i.f. | Cost, Insurance, Freight; |
| CA | Current Account; |
| CBAK | Central Banking Authority of Kosovo; |
| CEE | Central and East European Countries; |
| CEFTA | Central European Free Trade Agreement; |
| CIKIS | Community of the Kosovo Independent Syndicates; |
| CIS | Commonwealth of Independent States; |
| DEAS | Directorate for Economics Analysis and Statistics of the CBAK; |
| ECB | European Central Bank; |
| EG | Employment Guarantee; |
| EMU | European Monetary Union; |
| ESA | European System of Regional and National Accounts 1995; |
| EU | European Union; |
| EUR | Euro Currency; |
| f.o.b. | Free on board; |
| FDI | Foreign Direct Investment; |
| FTA | Free Trade Agreements; |
| FYROM | Former Yugoslav Republic of Macedonia; |
| GDP | Gross Domestic Product; |
| IC | Investment Commitments; |
| IMF | International Monetary Fund; |
| ITRS | International Transactions Reports System; |
| KEK | Kosovo Electric Company; |
| KFOR | NATO-led Kosovo Force; |
| KPST | Kosovo Pension Saving Trust; |
| KTA | Kosovo Trust Agency; |
| MEF | Ministry of Economy and Finance; |
| MTC | Money Transfer Companies; |
| NATO | North Atlantic Treaty Organization; |
| NewCo | New companies; |
| NIM | Net Interest Margin; |
| ODA | Other Donor Assistance; |
| ODC | Other Depository Corporations; |
| OECD | Organization for Economic Cooperation and Development; |
| OSCE | Organization for Security and Cooperation in Europe; |
| PIP | Public Investment Program; |
| POE | Publicly Owned Enterprises; |
| RIMS | Reconstruction Intervention Monitoring System; |
| SAD | Single Administrative Document; |
| SEE | South East Europe; |
| SLA | Service Level Agreement; |
| SNA | United Nations System of National Accounts 1993; |
| SOE | Socially Owned Enterprises; |
| SOK | Statistical Office of Kosovo; |
| SRSG | Special Representative of the Secretary General; |
| SSO | Special spin off; |
| TE | Transition Economies; |
| UN | United Nations; |
| UNMIK | United Nations Interim Administration Mission in Kosovo; |
| USD | United Stated Dollar; |
| y-o- y | Year on year. |

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**EDITORIAL**

This issue of the CBAK Bulletin is another in our recurring series reflecting on the developments in Kosovo economy. It contains three different topics elaborated in three chapters. The first chapter is devoted to BOP statistics aiming at improving the coverage and quality of economic statistics in Kosovo, as well as improving our understanding on key developments in the external sector. In addition, the bulletin is supplemented with two studies conducted by the DEAS staff. Namely, (i) the study on privatization process and (ii) the study on costs of intermediation in the Kosovo banking sector. The topics elaborated in the second and third chapter are sufficiently important as to merit more detailed treatment thus contributing to furthering the analysis of the Kosovo economy. The studies presented offer thoughts for further discussion, theoretical considerations are kept at minimum, and should be seen as work ongoing. The usual disclaimer applies to the studies – that the views expressed in the studies are the views of the author(s) and do not necessarily reflect the views of the CBAK – and extended versions of the studies may appear on the CBAK Working Paper Series.

In the first chapter, the CBAK publishes for the second consecutive year BOP statistics for Kosovo covering period 2004-2006. Apart from a portrayal of key developments in the external sector, special emphasis has been put on the methodology and compilation framework following international standards aiming at enhancing information availability to broader audience. Nevertheless, provided the complexity of the BOP statistics compilation process, the CBAK acknowledges possible statistical discrepancies that might appear. To sum up, year 2006 estimates reveal that the Kosovo current account deficit (including foreign assistance) accounts for 17.2% of GDP. This deficit is mainly as a result of import-oriented economy of Kosovo, with the goods deficit amounting at euro 1,141.2 million (around 50% of GDP). The main financing items of the Kosovo current account deficit remain transfers – mainly remittances from Kosovo Diaspora. Due to ongoing privatization process, foreign direct investments represent another important financing item of the current account deficit. However, a significant increase in investments abroad by financial sector (mainly CBAK) squeezed the capital and financial account balance to euro 18.1 million. Despite the effort for wider coverage of BOP transactions, the 'net errors and omissions' still account for euro 371.1 million in 2006.

In the second chapter of the bulletin the study on privatization process in Kosovo is presented. It is a survey-based study which has targeted privatized companies through the Special Spin-Off method. Nine companies privatized with this method were surveyed (out of 16). The focus of the survey was to explore investments to be undertaken, employment issues and export potential of the surveyed companies. Findings from the study perceive the process as a positive and promising. The study itself gives space for further analysis on the issues related to the process.

Finally, the third chapter looks at costs of intermediation in the Kosovo banking sector by elaborating mainly on the bank-specific characteristics that give rise to high interest rates and spreads. The study decomposes the intermediation costs in Kosovo banking sector for the period 2002-2005 based on the financial statement information and then compares the results with data for some countries in the region. This approach reveals that, in terms of the level, operational costs and provisions explain bulk of the intermediation costs. By employing a simple econometric exercise, the study attempts to identify the determinants of lending rates and spread. Findings suggest that, in terms of variation, operating costs, deposit rates, and to lesser extent market power and reserve requirements, have a positive impact on lending rates and spreads.

# 1. Balance of Payments of Kosovo in 2006

The negative trade balance represents the driving factor of the Current Account (CA) deficit. In 2006 the deficit was the highest in the region and in terms of volume and as share to GDP is worsening. Due to the international presence[1] in Kosovo as well as its impact on the Kosovo economy in general, the Kosovo balance of payments is computed including and excluding the foreign assistance. Kosovo CA deficit including foreign assistance is estimated at euro 389.3 million and accounts for 17.2% of GDP, while excluding foreign assistance the deficit is much higher, accounting for 25.8% of GDP, a 1.7 percentage points (pp) higher than the deficit in 2005.

Regarding the sources of the external imbalance, it is mainly driven by the high level of imports (55.2% of GDP). Current transfers (mainly remittances) and Foreign Direct Investments (FDI), mainly through the privatization process, are estimated to be the main financing items of the Kosovo CA deficit. Apart from that, some portion of the commercial bank loans is used to finance this deficit. For example, around 50% of the commercial bank loans are extended to the trading sector.

**Table 1.1. Balance of Payments of Kosovo,** in millions of EUR

| Description | 2004 | | | 2005 | | | 2006 | | |
|---|---|---|---|---|---|---|---|---|---|
| | Credit | Debit | Net | Credit | Debit | Net | Credit | Debit | Net |
| **1. CURRENT ACCOUNT** | **1,113.0** | **1,426.2** | **-313.2** | **1,149.7** | **1,500.6** | **-351.0** | **1,279.1** | **1,668.4** | **-389.3** |
| **A. Goods and services** | **212.3** | **1,188.6** | **-976.3** | **213.7** | **1,263.8** | **-1,050.1** | **284.8** | **1,443.4** | **-1,158.6** |
| 1. Goods | 56.9 | 1,024.0 | -967.0 | 56.3 | 1,072.2 | -1,015.9 | 110.8 | 1,251.9 | -1,141.2 |
| 2. Services | 155.4 | 164.6 | -9.2 | 157.4 | 191.6 | -34.2 | 174.0 | 191.5 | -17.5 |
| **B. Income** | **42.3** | **24.9** | **17.4** | **51.5** | **27.3** | **24.3** | **67.1** | **34.7** | **32.4** |
| 1. Compensation of employees | 26.9 | 11.9 | 15.0 | 27.0 | 8.9 | 18.0 | 26.6 | 10.9 | 15.7 |
| 2. Investment income | 15.4 | 13.0 | 2.4 | 24.5 | 18.3 | 6.2 | 40.5 | 23.8 | 16.7 |
| **C. Current transfers** | **858.4** | **212.7** | **645.7** | **884.5** | **209.6** | **674.9** | **927.2** | **190.2** | **737.0** |
| 1. Central government | 431.7 | 0.0 | 431.7 | 395.2 | 0.0 | 395.2 | 388.9 | 0.0 | 388.9 |
| 2. Other sectors | 426.7 | 212.7 | 214.0 | 489.3 | 209.6 | 279.7 | 538.3 | 190.2 | 348.1 |
| **2. CAPITAL AND FINANCIAL ACCOUNT** | **238.1** | **-97.4** | **140.6** | **81.7** | **15.1** | **96.8** | **44.2** | **-26.1** | **18.1** |
| **A. Capital account** | **2.4** | **0.0** | **2.4** | **2.0** | **0.0** | **2.0** | **3.2** | **0.0** | **3.2** |
| 1. Capital transfers | 2.4 | 0.0 | 2.4 | 2.0 | 0.0 | 2.0 | 3.2 | 0.0 | 3.2 |
| 2. Acquisition/disposal | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 |
| **B. Financial account** | **235.7** | **-97.4** | **138.2** | **79.7** | **15.1** | **94.8** | **41.0** | **-26.1** | **14.9** |
| 1. Direct investment | 9.6 | 9.1 | 18.6 | 63.2 | 16.8 | 80.0 | 211.7 | 30.6 | 242.3 |
| 2. Portfolio investment | 0.0 | -162.2 | -162.2 | 0.0 | -67.8 | -67.8 | 0.0 | -127.7 | -127.7 |
| 4. Other investment | 227.9 | 55.8 | 283.6 | 44.6 | 66.0 | 110.6 | -175.6 | 71.0 | -104.6 |
| 5. Reserve assets | -1.8 | 0.0 | -1.8 | -28.0 | 0.0 | -28.0 | 4.9 | 0.0 | 4.9 |
| **NET ERRORS AND OMISSIONS** | | | **172.6** | | | **254.2** | | | **371.1** |

As depicted in Table 1.1, goods and services deficit in 2006 amounted at euro 1,158.9 million. Only trade in goods deficit amounted at euro 1.141,2 million, or 50.3% of GDP. Origin of the trade deficit relies on soaring level of imports (euro 1.251,9 million) which in 2006 over 2005 grew with 16.8%, against 4.7% in 2005 over 2004. This increase may be partially attributed to the growth of imports of capital and intermediate goods as aftermath of increase in the economic activity in Kosovo, as well as the increase in oil prices that were reflected increase in the increase of import prices. Considering the low base, Kosovo exports in 2006 grew with 96.8% totaling at euro 110.8 million. However, the export/import coverage although improving, remains low at around 9% in 2006.

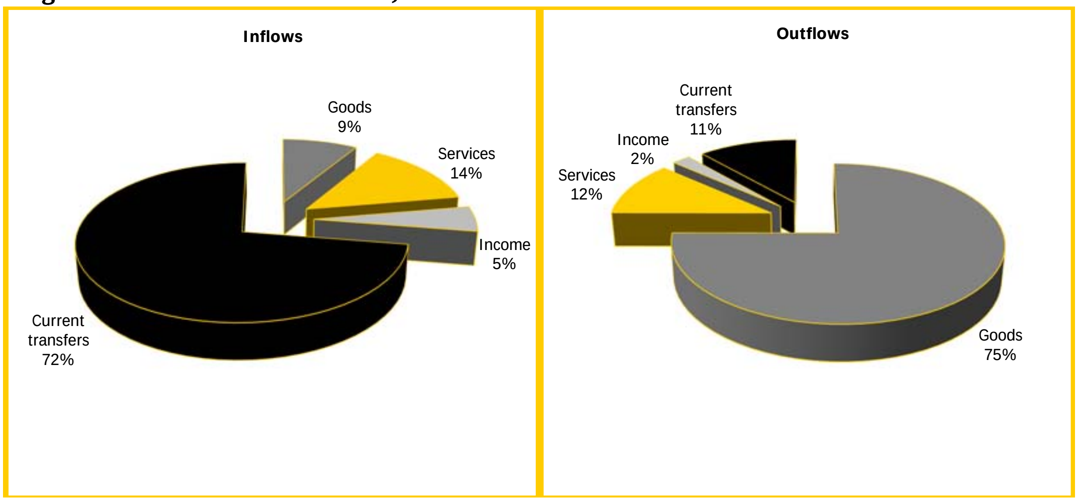
With the amount of euro 174.0 million as inflow (credit) and euro 191.5 million as outflow (debit), the net services in 2006 recorded a negative balance at euro -17.5 million. However, this balance shows a declining tendency compared to 2005. The decline over 2005 is attributed mainly to the increase in communication services provided.

[1] UNMIK and other donors assistance.

Net income for the year 2006 stood at euro 32.4 million, up from euro 24.3 million in 2005. The increase is attributed mainly due to the increase in investment income, while the category of compensation of employees remains broadly stable. The increase in investment income is due to the increase in portfolio and other investments abroad (mainly CBAK and KPST).

Net current transfers for the year 2006 stood at euro 737.0 million, recording a yearly growth of 9.2% compared to 4.5% in 2005. Current transfer of the central government show continuous decline (euro 388.9 million in 2006 over euro 431.7 million in 2004). Regarding current transfers in other sectors comprising worker remittances and other transfers (mainly pensions from abroad) they increased at euro 348.1 in 2006 from euro 279.7 million in 2005 and 214.0 million in 2004. Net worker remittances as the main item within current transfers in other sectors grew with 29.0%, standing at euro 293.4 million in 2006. The inflow of remittances (transfers from Kosovans living abroad) grew with 11.8% amounting to euro 467.1 million (or 20.6% of GDP); while the outflow of remittances (transfers of expatriates working in Kosovo) stood at euro 173.7 million, declining with 8.8%, which is a sizable faster decline when compared with decline in 2005 (-1.9%).

**Figure 1. 1. Structure of the CA, as of 2006**




As can be observed from Figure 1.1, within the structure of CA, the main channel through which money comes in Kosovo are current transfers (72% of all inflows), followed by goods and services, 9% and 14%, respectively. Income comprises 5% of total inflows within the current account structure. In the expenditure side, the main channel of money outflows is import of goods (75%), followed by services (12%), current transfers (11%) and income (2%).

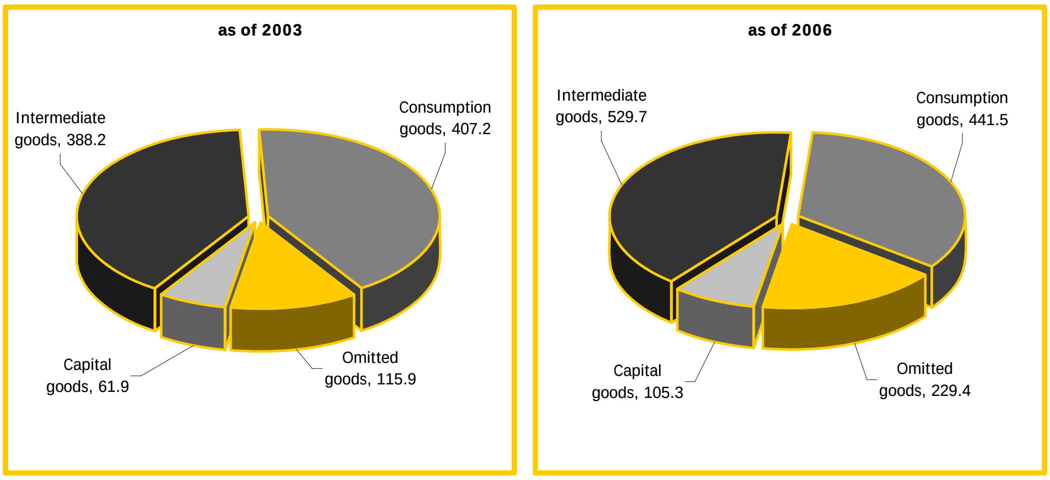
Despite the large net FDI inflows estimated at euro 242.3 million in 2006, capital and financial account balance remains at euro 18.1 million (euro 96.8 million in 2005). Portfolio and other investments in 2006 (mainly CBAK investments sourced from the privatization proceeds, and KPST funds) stood at euro -232.3 million, from euro 167.9 million in 2005. This to some extent offsets the positive impact of FDI financing of the CA deficit.

**Table 1. 3. Exports and Imports by Commodity Group, share to total**

| Description | Exports | | | Imports | | |
|---|---|---|---|---|---|---|
| | 2004 | 2005 | 2006 | 2004 | 2005 | 2006 |
| Base metals articles | 34.7 | 44.0 | 48.0 | 7.3 | 7.8 | 9.4 |
| Mineral products | 4.3 | 5.7 | 17.0 | 16.3 | 17.9 | 18.5 |
| Machinery, appl.and electrical materials | 16.1 | 11.6 | 6.9 | 11.0 | 11.2 | 11.7 |
| Leather and their articles | 10.3 | 10.9 | 6.5 | 0.1 | 0.1 | 0.2 |
| Beverages and tobacco | 6.7 | 8.1 | 5.6 | 15.6 | 14.1 | 13.8 |
| Vegetable products | 4.5 | 5.1 | 4.6 | 6.4 | 4.9 | 5.6 |
| Plastics, rubber and articles thereof | 6.5 | 1.7 | 2.9 | 4.0 | 4.4 | 4.6 |
| Transport means | 3.5 | 4.1 | 1.3 | 4.7 | 9.0 | 6.1 |
| Other | 13.4 | 8.8 | 7.2 | 34.6 | 30.6 | 30.1 |

It is important to note that the increase in imports to some extent reflects the increase in the economic activity in Kosovo. This can be shown by the evolution of imports by Broad Economic Categories (BEC) where the positive change can be recognized by the increase of imports of intermediate goods (in terms of volume) and capital goods (volume and share to total imports); while consumption goods as a share to total imports declined substantially.

**Figure 1. 2. Kosovo Imports by BEC, in EUR million**




Given that change in the structure of imports by BEC is not a short-run phenomenon, trying to stress changes in the structure of imports over the medium term, the year 2006 is compared with 2003 (Figure 1.2). While the consumption goods in 2003 accounted for 42% of total imports, in 2006 they declined to 34%, despite the growth by 8.4% in terms of volume. Despite the fact that intermediate goods show same proportion to total imports, in terms of volume they boosted by 36.5%, reaching euro 529.7 million in 2006. Increasing their share to 8% of imports in 2006 compared with 6% in 2003, capital goods recorded growth in terms of volume from euro 105.3 million in 2006 to 61.9 million in 2003.

**Trade by trading partners.** The structure of trading partners has not changed significantly during 2006. Neighboring countries, members of CEFTA (see Box 1), and EU countries remain the main trading partners of Kosovo. CEFTA countries absorbed 46.7% (euro 51.7 million) of total exports, representing the largest foreign market for Kosovo goods.

In terms of exports to individual countries, Serbia represents the largest market (18.9% of total Kosovo exports) in 2006. Exports to Albania more than doubled compared in 2006 accounting for 11.4% of total exports. Albania represents the second largest market for Kosovo goods. Sharp growth is noted also in the volume of exports to Montenegro (197.2%), which increased the share to total exports by 0.7pp. On the other hand, exports to FYROM declined by 10.1% during 2006, reducing the share of exports to FYROM in total Kosovo exports to 8.8% (from 19.2% in 2005).

Exports to the EU countries accounted for 38.2% of total exports (euro 42.3 million) representing the annual decline of 0.6pp, while in terms of the volume increased for euro 20.5 million. In addition, exports to other countries (mainly Switzerland, Turkey, etc.) expanded during 2006, growing from euro 4.6 million in 2005 to euro 16.7 million leading to the increase of the share of exports to these countries.

**Table 1. 4. Exports and Imports by Trading Partners, share to total**

| Description | Exports | | | Imports | | |
|---|---|---|---|---|---|---|
| | 2004 | 2005 | 2006 | 2004 | 2005 | 2006 |
| Total EU | 29.3 | 38.8 | 38.2 | 39.9 | 38.0 | 34.8 |
| Central Europe Free Trade Agreements (CEFTA) | 41.6 | 53.0 | 46.7 | 34.7 | 38.0 | 41.1 |
| Albania | 3.2 | 10.3 | 11.4 | 1.9 | 1.6 | 1.8 |
| Bosnia and Hercegovina | 2.7 | 6.1 | 4.6 | 1.2 | 1.6 | 1.4 |
| Croatia | 0.9 | 1.6 | 1.0 | 2.4 | 2.2 | 2.1 |
| Montenegro | 0.0 | 1.3 | 2.0 | 0.0 | 0.6 | 1.4 |
| FYROM | 17.0 | 19.2 | 8.8 | 14.0 | 19.0 | 19.7 |
| Serbia | 17.8 | 14.5 | 18.9 | 15.2 | 13.2 | 14.6 |
| Other | 29.1 | 8.2 | 15.1 | 25.4 | 24.0 | 24.1 |

CEFTA countries are the main trading partners also regarding the imports. These countries accounted for 41.1% of total imports in 2006, which represents the increase of 3.1pp compared to 2005. Among the neighboring countries, imports from FYROM represent the main source of Kosovo imports accounting for 19.7% of total imports, followed by imports from Serbia (14.6%). Imports from Montenegro, considering the low base, registered an annual increase of 177.7% in volume, following an annual decline of 91.2% in 2005. The considerable increase in both, exports and imports with Montenegro, indicates the intensification of the trade cooperation with this country. The increase in the volume is noted also in imports from other countries, such as China and Turkey that represents 5.7% and 7.4% of total Kosovo imports, respectively.

**BOX 1. Central European Free Trade Agreement (CEFTA)**

The Central European Free Trade Agreement (CEFTA) is a multilateral agreement on free trade in the region of the Central and South-East Europe. It entered into force in July 1994. Its main objective is to develop the economic relations among the member countries, ensure fair competitive conditions between the countries and a wider regional market. Countries initially assigned in CEFTA were the Czech Republic, Hungary, Poland, Slovakia and Slovenia, joined by Romania in 1997, Bulgaria in 1999, Croatia in 2003 and FYROM in 2006.

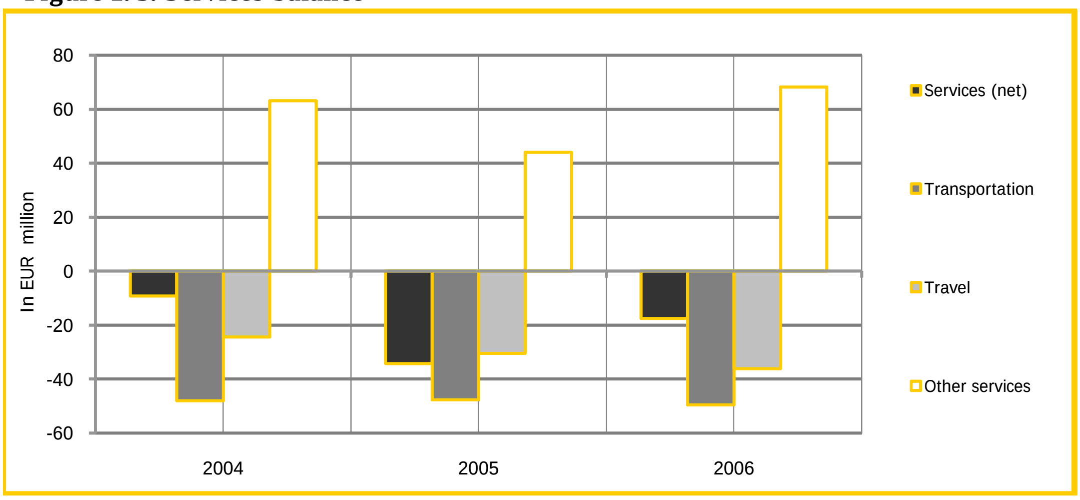
When the above mentioned countries joined the EU (apart from Croatia and FYROM), they left the CEFTA and, consequently , CEFTA was extended with other South-East European countries . In these terms, Albania, Bosnia and Herzegovina, Kosovo, Moldova, Montenegro, and Serbia signed the CEFTA agreement in December 2006 in Bucharest. The agreement was expected to be implemented in May 2007, replacing 32 bilateral and free trade agreements signed by the countries of the South-East Europe. The implementation of CEFTA was conditional on the ratification of this agreement by at least five parliaments of respective countries. While Kosovo, Albania, and Montenegro parliaments have ratified this agreement earlier, FYROM, Moldova and Croatia ratified the agreement in mid-May 2007; hence, the condition of the ratification by five countries has been fulfilled and thefull implementation of CEFTA started since end-July 2007.

Considering the important role that the CEFTA played in developing and improving trade relations between the member countries in the past, Kosovo has now made a further step towards the regional integration and EU association. In addition, joining the CEFTA is likely to promote export growth by giving Kosovo easier access to a larger regional market, as well as advancing the investment climate.

## 1.1.2. Services

Amounting at euro -17.5 million, services maintained the negative balance in 2006 indicating relatively high demand for services from abroad. However, the deficit was lower by 48.9 %, compared to the previous year. The main contributors to this deficit remain the deficit encountered in transport services and travel amounting at euro -49.6 million and euro -36.1 million, respectively. This was offset by the surplus in communications that amounted at euro 28.3 million.

**Figure 1. 3. Services balance**

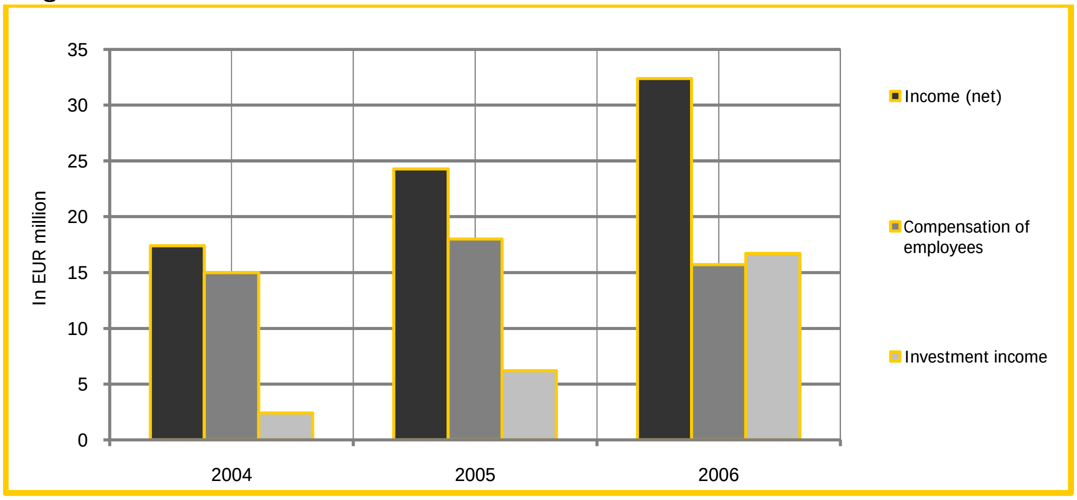


Transportation services that recorded a deficit of around euro 50 million, in 2006 against 2005 grew with 4.0%. Growing by 18.4% in 2006 over 2005, travel services maintained a trend similar to the previous years. While business travel has not changed from 2005, the services related to personal travel (e.g. tourism) grew by 19.8% compared to 2005. The category of other services maintained its positive balance, recording a surplus that is considerably higher than in 2005 (euro 24.0 million in 2006 compared to euro 0.2 million in 2005).

## 1.1.3. Income

Income account for the year 2006 stood at euro 32.4 million over euro 24.3 million in 2005. This increase is supported mainly from the increase in the investment income that in terms of share to total income increased to 51.6% (from 25.7% in 2005). Income from compensation of employees held steady and amounted at euro 19.2 million.

**Figure 1. 4. Income balance**



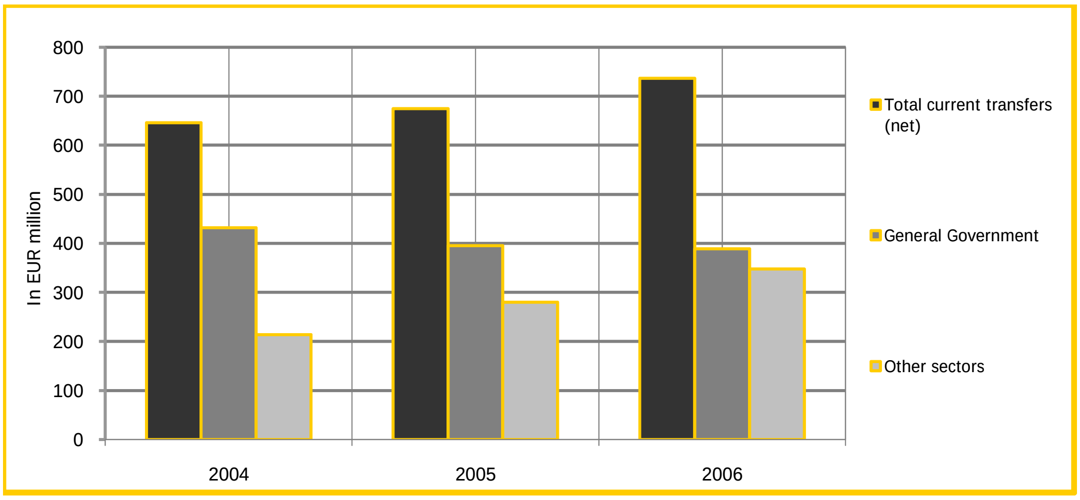

Net investment income reached euro 16.7 million in 2006, compared to euro 6.2 million in 2005, and euro 2.4 million in 2004. The increase in net investment income can be attributed to a faster increase in the income from investments abroad than in the income of non-residents from investments in Kosovo. The structure of the credit side of investments (inflows from investments abroad) comprises of the income from portfolio investments (income from interest only) that compose 58.8% of total investment income, while the remainder is represented by income from other investments (CBAK and ODC income from deposits in other countries) that compose 41.2%.

Within the structure of the debit side of investments, income from FDI in Kosovo represents the main source of investment income (89.9%). Investments in other forms (payments for interest on non-resident deposits in Kosovo) represent around 10% of total investment income; whereas yet there are no portfolio investments by non-residents in Kosovo.

### 1.1.4. Current transfers

Net current transfers amounted at euro 737.0 million in 2006, representing an annual increase of 9.2% that is higher than the increase of 4.5% in 2005. Actually, the amount of central government transfers totals at euro 388.9 million, down from euro 395.2 million in 2005 and euro 431.7 million in 2004. The increase in net current transfers derives from the increase in other sector transfers with 24.5% in 2006, a smoother increase when comparing with 30.7% increase in 2005 over 2004.

**Figure 1.5. Current transfers balance**



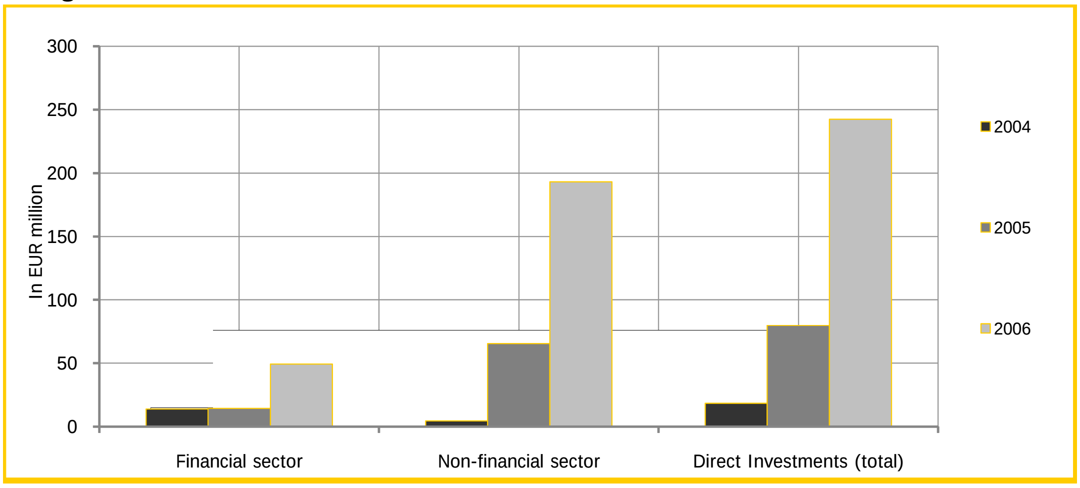

Amounting at euro 467.1 million, the remittances from Kosovans living abroad seems to be the main channel of money inflows in Kosovo (e.g. remmitances from Germany, Switzerland, UK, etc. As BOP data show, the inflow of remittances seems to be very stable source of financing of the Kosovo current account.

## 1.2. Capital and Financial Account

Capital and financial account for the year 2006 amounted at euro 18.1 million against euro 96.8 million in 2005. While the government sector held steady, the squeeze in the capital and financial account is mainly attributed to the financial sector placements abroad, even though non-financial sector inflows grew to euro 313.0 million in 2006 against euro 304.1 million in 2005.

Net FDI only in the Kosovo financial sector for the year 2006 stood at euro 49.3 million (Figure 1.6). This amount is comprised mainly from investments in equity capital (euro 28.5 million) and reinvested earnings. Having into consideration the fact that Kosovo financial system is dominated from foreign financial institutions, each flow in their earnings reflected in the overall BOP. During the year 2006 foreign financial institutions increased their share capital. However, the source for the increase might be partially attributed to the positive performance and partly as increase in capital requirements. This represents an increase in the foreign liabilities by euro 43.3 million in 2006 against euro 14.4 million in 2005.

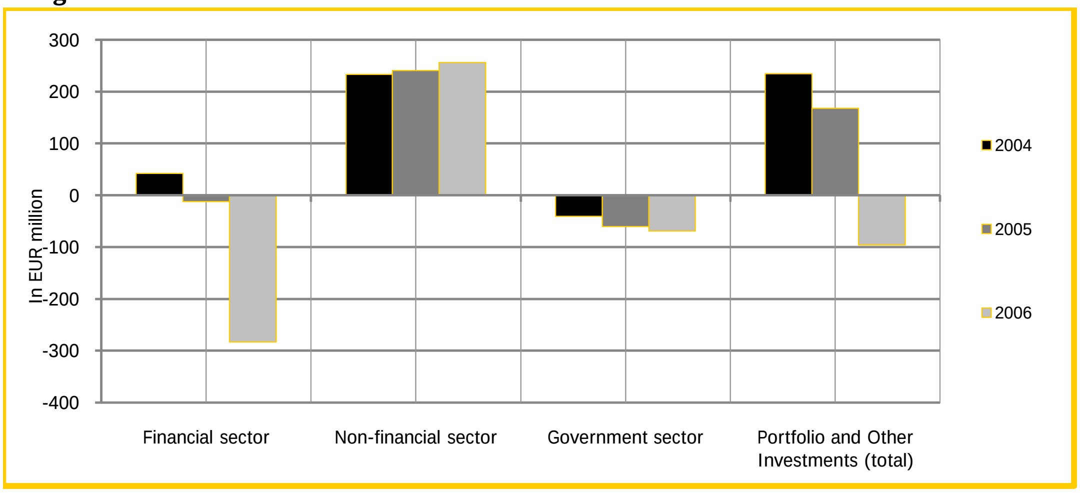
**Figure 1. 6. Direct Investment**




Financial sector net portfolio investments (investments in securities) and net other investments (investments in deposits) in 2006 recorded outflow of euro 283.2 million (Figure 1.6). The main player in this respect is CBAK, while commercial banks recorded less rapid increase. Only CBAK represented net outflow of euro 247.2 million in 2006, against euro 19.7 million in 2005.

Net FDI in non-financial sector in 2006 increased to euro 193.0 million from euro 65.6 million in 2005, mainly related to the privatization process. Namely, privatization revenues increased in terms of volume at euro 129.5 million in 2006 from euro 63.2 million in 2005. However, apart from the FDI related to the privatization, there are also some foreign investments in equity capital, either through shares bought or as a start-up capital amounting at euro 36.5 million in 2006. Since there are no portfolio investments, regarding the non-financial sector's other investments, it corresponds mainly due to the increase in the trade credits amounting at euro 62.1 million, up from euro 50.8 million and euro 48.6 million in 2005 and 2004, respectively.

**Figure 1. 7. Portfolio and Other Investments**




Apart from the CBAK, the KPST increased their investments abroad, making an outflow of euro 67.1 million in 2006 over euro 62.1 million in 2005. Actually, above 95% of the KPST accounts are invested abroad mostly in mutual funds. The KPST amounts comprise the money collected through social security scheme imposed by the Kosovo government.

## 1.3. BOP methodological notes

The Central Banking Authority of Kosovo (CBAK) is responsible for compiling the Balance of Payments Statistics for Kosovo. The legal basis for collecting and compiling BOP statistics rely on the UNMIK Regulation 2006/47 on Central Banking Authority of Kosovo. The main data sources for compiling BOP are commercial banks (through International Transaction Reporting System), Statistical Office of Kosovo (balance of trade statistics) and Enterprise Surveys. Data are supplemented with information received from other sources as well as own estimates. The compilation of BOP is made in accordance with the IMF Balance of Payments Manual, fifth edition (BPM5). The BOP statistics are published in several CBAK publications such as: CBAK annual report, CBAK Bulletin and CBAK Monthly Statistics Bulletin, and are updated accordingly.

Balance of payments is one of the key economic statistical information that systematically summarizes, for a specific period of time, the economic transactions of Kosovo residents with the rest of the world. Economic transactions are inward transactions (receipts) and outward transactions (payments). Receipts from the rest of the world are recorded in the credit side and include economic transactions such as exports of goods, exports of services, income flows, financial flows and transfers, which are offsetting entries to any one-sided transactions. Conversely, payments by domestic citizens to the rest of the world (non-residents) are recorded in the debit side and include economic transactions such as imports of goods, import of services, income flows, financial flows and transfers.

Conceptually, an economic transaction has two sides: something of economic value is provided and something of equal value is received through the double-entry recording system. When an economic value is provided (e.g. Kosovo exports) a credit entry is made, and when an economic value is received (e.g. Kosovo imports) a debit entry is made. Where something of economic value is provided without something of economic value in exchange the double entry system requires an offset to be imputed (a transfer entry) of equivalent value. For example, food imported as aid requires a debit entry for the goods item and a credit transfer as offset. The example below illustrates how the double entry system is applied. By definition, under the double-entry system credit entries must equal debit entries.

| Credit entries | Debit entries |
|---|---|
| Changes in all economic resources provided by Kosovans to non-residents, including: | Changes in all economic resources received by Kosovans from non-residents, including: |
| - Exports of goods and services | - Imports of goods and services |
| - Income receivable | - Income payable |
| - Transfers which are offsets to debit entries | - Transfers which are offsets to credit entries |
| - Increase in financial liabilities of the Kosovo to non-residents | - Increase in financial claims of Kosovo on non-residents |

**RESIDENCY CRITERIA**. Residents of Kosovo are legal entities registered and operating in Kosovo and natural persons whose domiciles (households) are located in Kosovo and who do not leave Kosovo for a period exceeding one year (except students and medical patients). Due to its specificity, special emphasis has been put on the treatment of UNMIK, KFOR, and other international staff in Kosovo.

1) **Treatment of UNMIK.** Based on the residency criteria as stated in the balance of payments manual (BOP5, paragraph 88), UNMIK is an international organization and, therefore, fulfills conditions to be classified as a nonresident of Kosovo. In this case, distinction should be made between the <u>UNMIK as institution</u> as well as <u>UNMIK staff</u>:

a. UNMIK as an institution is treated as nonresident in balance of payments transactions;
b. UNMIK international staff residency is determined on the basis on the length of their stay in Kosovo:
    i. UNMIK international staff with a contract for one year and more is treated as resident of Kosovo;
    ii. UNMIK international staff with a contract of less than a year is treated nonresident of Kosovo.

Records in BOP are made based on the study conducted by the UNMIK European Union Pillar "UNMIK's Impact on the Kosovo Economy" published in July 2006. Based on this publication, data for 2006 are forecasted. We updated data through actual figures based on the information provided directly from UNMIK to the CBAK.

The assumptions and estimates related to transactions of UNMIK as institutions and the staff is as follows:

a. Spending of UNMIK (as institution) for goods and services purchased from Kosovar companies are considered as exports of government services.
b. UNMIK international staff that are considered as residents spend around 14% of their salaries in Kosovo. The remaining part of 76% are send in their home countries (remittances) and 10% is spend for traveling abroad (travel services).
c. UNMIK international staff as nonresident (short-term international staff of UNMIK) spend 14% of their salary in Kosovo for living allowance.

Through a hypothetical example we tried to show implication of UNMIK in Kosovo's BOP, based on our above mentioned assumptions:

Assuming that UNMIK budget is €100, of which:

| | |
|---|---|
| — Wages to resident international staff | 55 |
| — Wages to nonresident international staff | 3 |
| — Wages to local staff | 17 |
| — Staff assessment income (Tax paid to UN) | 5 |
| — Imported goods | 8 |
| — Local goods | 2 |
| — Imported services | 6 |
| — Local services | 4 |
| Total UNMIK's Budget | 100 |

By applying the previous example into the double entry system, records in BOP will be as follows:

| | Credit | Debit |
|---|---|---|
| Current account | | |
| Travel Services | | |
| Short-term staff spending for living allowance (14% of salaries) | 0.4 | |
| Long-term staff spending for traveling abroad (10% of salaries) | | -5.5 |
| Government services | | |
| Spending of UNMIK (as institutions) for local goods and services | 6 | |
| Compensation of employees | | |
| Salaries of Short-term staff | | -3 |
| Current transfers | | |
| Total budget of UNMIK less imported goods & services | 85 | |

| | |
|---|---|
| Remittances (76% are send to their relatives abroad) | -41.8 |
| Tax paid to UN for resident staff (around 8.1% of Wages) | -5.8 |

Due to the mentioned treatment of UNMIK, its expenses for import of goods andimport of services are considered as nonresident–nonresident transactions and not recorded in BOP.

2) **Treatment of KFOR.** KFOR is a NATO led international force responsible for establishing a safe and secure environment in Kosovo. KFOR entered Kosovo on June 12, 1999 under a United Nations mandate, two days after the adoption of UN Security Council Resolution 1244. KFOR contingents are grouped into four multinational task forces and troops come from 35 NATO and non-NATO nations. Under international standards, KFOR is a military contingent and, therefore, a nonresident of Kosovo;

3) **Treatment of International Staff in Kosovo (excluding UNMIK).** In accordance with the SNA 93 and the BPM5 the international staff in Kosovo engaged in technical assistance or other activities on behalf of the Kosovo institutions is treated based on the length of their stay. The international staff of Foreign Liaison Offices and other offices of international organizations in Kosovo (diplomats, military personnel, and other employees of such organizations and their family members, who reside in Kosovo and enjoy immunity and diplomatic privileges) are treated as nonresidents of Kosovo.

**CURRENT ACCOUNT.** The Current Account comprises the acquisition and provision of goods and services, income, and current transfers between the country and the rest of the world.

1) **Goods.** The source of the data on international trade statistics is UNMIK customs service, processed by the SOK. The CBAK receives on a monthly basis the data on international trade statistics from the SOK, based on the SLA between the two institutions. CBAK makes adjustment for coverage and classification based on the supplementary information from other sources. Adjustments for coverage are made in the credit side for electricity, based on enterprise survey with KEK and for import of goods as donation provided from MEF for the year 2004 that were not included in SOK statistics. Adjustments for classification are made to valuate exports and imports in f.o.b. basis. The data on imports of goods are adjusted by application of c.i.f. / f.o.b. ratio of 6.5% (5% for transportation and 1.5% for insurance), excluding imports from neighboring countries which are valued at f.o.b. basis. Estimates are done by analyzing the value of c.i.f. to total value of imports of goods for a specific period, based on the information from SAD;
2) **Services.** Trade in services covers the provision of services by residents to non-residents and vice versa. The services component of the BOP consists of: transportation, travel, government services (not included elsewhere) and other services, which are subdivided into further items (communication, construction, insurance, financial, computer and information, royalties and license fees, other business services, personal services and government services);
   a. *Transportation.* Covers sea, air and other (i.e. rail, land and pipeline) transport. It includes the movement of passengers and freight and other related transport services, such as chartering of aircraft with crew, cargo handling, storage and warehousing, towing, pilotage and navigation, maintenance and cleaning, and commission and agents' fees associated with passenger/freight transportation. The passenger transport is estimated based on the number of average passenger air fares travelling through Prishtina Airport multiplied with the average cost of one ticket. The data on passenger transportation are retrieved from the Prishtina Airport. The value of freight transport services is estimated on the basis of difference between the value of imported goods at c.i.f. and f.o.b. values (debit side). The source of data is the information provided from Prishtina Airport. The

ratio of freight transport to the total amount of c.i.f. imports is considered to be 5%. Imports from neighboring countries are considered to be in f.o.b. basis. Receipts for commission and agent fees for transport related services as well airport landing fees are recorded in credit side;

b. *Travel services.* Cover services provided to non-residents during trips in Kosovo (credit), and provided to Kosovo residents during similar trips abroad (debit). The exceptions are those military and diplomatic personnel (i.e. KFOR and Liaison Offices), whose expenditure are recorded under government services.

c. *Business travel.* Covers all type of business activities such as carrier crews stopping off or lying over; government employees on official travel; employees of international organizations on official business (e.g. technical assistance); and employees doing work for enterprises that are not resident in the economies in which the work occurs. Business travel is estimated based on the data from enterprise surveys and data from ITRS.
Personal travel includes all travelers going abroad (coming in Kosovo) other than business travel. This includes also expenses for accommodation of UNMIK short-term staff in Kosovo (in credit side) and spending for travel abroad of UNMIK long term staff considered as residents of Kosovo (in debit side). It is assumed that the short-term international staff spends around 14% of their salaries in Kosovo for commodities. This estimate is done based on the study conducted by Economic Policy Office of UNMIK's Pillar 4. Another important source of information for personal travel is derived from Household Budget Survey regarding consumption by Kosovar diaspora during their visits in Kosovo. The expenditure of Kosovars going for vacation is done by combining the information from central banks in the region (Bank of Albania and Central Bank of Montenegro), as well as ITRS data.

d. *Government services (not included elsewhere).* Is a residual category covering government service transactions (including those of international organizations) not contained in the previous classifications. Government services include also all transactions by liaison offices, and export of goods and services to KFOR. Sources of the data are different such as ITRS, Liaison Offices, municipalities, etc.

e. *Other services.* Under this category are included exports and imports of communication services, construction services, insurance services, financial services, royalties and license fees, personal, cultural and recreational services and other business services. Source of data are enterprise surveys and ITRS.

3) **Income.** The income component relates to income earned from two factors of production: labor and capital. Consequently, the income consists of compensation of employees and investment income:

a. *Compensation of employees.* Covers wages, salaries and other benefits paid to non-resident workers in the country, or received by resident workers abroad. In this context, includes seasonal or other short-term workers (less that one year) and border workers who have centers of economic interest in their own economies. Compensation of employees paid to Kosovans working for international organizations, and KFOR are recorded under credit side (excluding local employees working for UNMIK which are recorded under current transfers). In the debit side are recorded salaries of UNMIK international employees with a contract for less than one year, and which are treated as a nonresident, since the amount is previously recorded under current transfers. The compensation of employees is calculated based on various sources of information including data collected directly from UNMIK, KFOR, MEF, Liaison Offices, and from other international organizations;

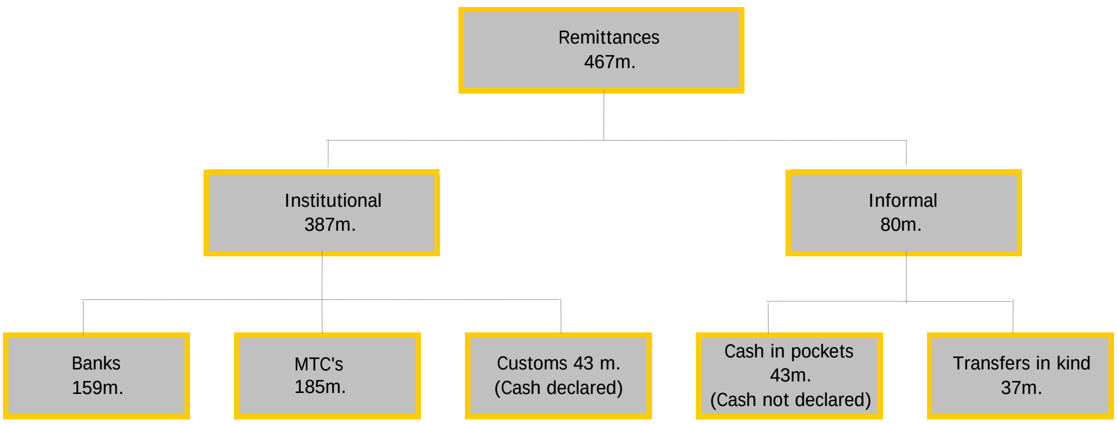
b. *Investment income.* Covers receipts and payments of income associated with external financial assets and liabilities. The main component of investment income represents income from direct investments, portfolio and other investments. The most typical form of income from abroad is interest earned from deposits or securities with foreign banks. In the debit side are included payments to direct investors in Kosovo like dividends, reinvested earnings, interest paid for loans borrowed from abroad, etc. The main sources of information on the investment income are reports of commercial banks, insurance companies and the CBAK;

4) **Transfers.** Transfers are offsetting entries for real resources or financial items provided without receiving in return any good, service, or financial item. Transfers are separately identified as either current or capital transfers;
   a. *Capital transfers* consist of transfers (1) involving ownership of fixed assets, (2) transfers of funds linked to, or conditional upon, acquisition or disposal of fixed assets, or (3) cancellation of liabilities by creditors without any counterparts being received in return.
   b. *Current transfers* are sub-divided into those of central government and other sectors;
      i. General government includes:
         (1) Grants to the Kosovo Consolidated Budget (Donor Designated Grants)
         (2) Donor aid, in kind (Public Investment Program)
         (3) Direct spending of the UNMIK and its pillars.
      ii. Other sectors – whose current transfers are further divided into:
         (4) Worker remittances (mainly migrants transfers); and
         (5) Other transfers – include insurance premiums and claims, pensions, some grants related to different institutions.

   The main data sources for the estimate of current transfers are UNMIK, MEF (donor coordination unit), ITRS, and Household Budget Survey (conducted from the SOK).

*Worker remittances.* Cover current transfers b**y** migrants who are employed in other economies and considered residents there. A migrant is a person who comes to an economy and stays for a year or more. Persons who stay in new economies for less than a year are considered nonresidents; their transactions are appropriate mainly to the component for compensation of employees (BPM5, paragraph 269 through 272).

*Estimate of inflows from Kosovo migrants living abroad* - The estimate of incoming remittances is done based on main channels of the flows. A variety of data sources is used to measure income flow. We focused mainly to identify registered flows coming through official channels (banks, MTCs and money declared at the Customs Authorities) and remittances coming through informal channels (not declared, such as cash that pass through customs, non-cash transactions like goods transferred from migrants living abroad (see scheme below).




*Estimate of outflows of resident foreigners.* In debit side of remittances, the estimate includes remittances related to (1) international staff - long term working for UNMIK and (2) other international staff engaged in other projects (i.e. PIP). It is estimated that resident foreigner's sends 76% of their salaries to their relatives. Data source in debit side are the budget of UNMIK and RIMS database of the Ministry of Economy and Finance for Official Development Aid spend in Kosovo.

*Other Donor Assistance (ODA) to the government.* Technical assistance is ongoing support of the international community to strengthen the institutional aspect of the Provisional Institutions of Self-Government (e.g. revenue collection, investment in physical and human capital, etc.). ODA to Kosovo has been mainly committed and disbursed through the following types of intervention: capital investment, technical assistance, supply of equipment, credit (investments in infrastructure), training and other. Records in BOP are made based on the study conducted by the Donor Coordination Center. The main assumptions and estimates related to ODA transactions and the staff are as follows:

1. 67 percent of wages are dedicated to international staff. All international staff are residents of Kosovo and they spend around 14% of their wages in Kosovo. The remaining part of 76% are send in their home countries (remittances) and 10% is spend for traveling abroad (travel services).
2. Wages to local staff are 13 percent from total wages.
3. From total goods and services 91.5% are imported goods.

**Table 1.5. Nature of ODA Spending**

| Description | 2004 | 2005 | 2006 |
|---|---|---|---|
| Wages of International Staff | 92,002 | 106,906 | 143,324 |
| Wages - local staff | 30,361 | 35,279 | 47,297 |
| Goods & Services | 77,081 | 30,586 | 41,006 |
| Imported | 70,529 | 27,987 | 37,520 |
| Local Produced | 6,552 | 2,600 | 3,485 |
| Capital Investments | - | 500 | 670 |
| **TOTAL** | 169,083 | 137,993 | 185,000 |

**CAPITAL ACCOUNT.** Under *capital account* are included some investments in construction made by KFOR and migrant transfers. The main source of information for migrants' transfers is ITRS.

**FINANCIAL ACCOUNT.** Covers transactions in foreign financial assets (claims on nonresidents) and foreign financial liabilities (liabilities to nonresidents). The four categories (direct investment, portfolio investment, other investment and reserve assets) are based primarily on the relationship between the parties, and secondly on the nature of the instrument involved.

1. **Direct investments -** is a category of international investment that, based on the equity ownership of at least 10%, reflecting a lasting interest by resident in one economy (the direct investor) in the resident enterprise in another economy (the direct investment enterprise). Using this criterion, a direct investment relationship can exist between a number of affiliated enterprises, whether the linkage involves a single chain or a number of chains. The components of direct investment transactions are:
   a. Equity capital - comprises investment in branches, shares in subsidiaries and associates (except non-participating preferred shares that are treated as debt securities), and other capital contributions;
   b. Reinvested earnings - consist of the off-setting entry to the corresponding current account income item: it is the direct investor's share of the undistributed earnings of its branches, subsidiaries and associates;
   c. Other capital - covers all other inter-affiliate financial transactions (borrowing and lending of funds), including debt securities and trade credit.

Following the recommendations of the IMF, ECB, Eurostat and OECD, direct investment flows are recorded on a directional basis (rather than the more usual assets/liabilities basis): direct investment abroad – as an asset, and direct investment in the reporting country – as a liability. Direct investment abroad covers net investment by parent companies resident in Kosovo in their foreign branches, subsidiaries and associated companies. Direct investment in Kosovo covers the net investment by foreign companies in their affiliates located in Kosovo. The CBAK uses different sources of information for the calculation of FDI. The main sources of information for the estimate of FDI in Kosovo are Kosovo Trust Agency (KTA), commercial banks reports to CBAK, and ITRS.

2. **Portfolio investment -** covers the acquisition and disposal of equity and debt securities, which cannot be classified under direct investment or reserve assets transactions. The securities involved are traded (or tradable) in organized and other financial markets. Debt securities cover bonds and notes, which have an original maturity term of more than one year, and money market instruments with original maturity of one year or less. Data on debt securities in the case of Kosovo includes investments in securities abroad from CBAK and commercial banks. The main sources of information on portfolio investment are the data provided by the CBAK, and commercial banks operating in Kosovo.
3. **Other investment -** covers assets and liabilities other than those classifiable to direct investment, portfolio investment or reserve assets. It comprises short and long-term loans, currency and deposits, trade credits and other assets and liabilities. Short-term trade credits comprise the advance payment by nonresidents for the future exports (on the liability side) and expected post-payments from nonresidents for exports (on the asset side). The estimate of trade credits is done by using the ratio of those two categories to total imports and exports reported in ITRS. Information about currency and deposits, loans and other assets are obtained from balance sheet of commercial banks, balance sheet of CBAK, MEF (government deposits abroad), balance sheet of other financial institutions, ITRS (deposits and loans of non-financial entities with abroad) and enterprise surveys (other accounts payable/receivable).
4. **Reserve assets -** consist of those external assets that are readily available to, and controlled by, monetary authorities for direct financing of payments imbalances, for indirectly regulating the magnitude of such imbalance through intervention in exchange markets to affect the currency exchange rate and/or for other purposes (BPM5, p. 424). Reserve assets consist of: Monetary gold, Special Drawing Rights, Reserve position in the Fund, foreign exchange (currency and deposits, and securities), other claims.
    - **a.** *Other foreign currency assets* refer to foreign assets of the monetary authorities that are not included in reserve assets, but as reserve assets, must be liquid foreign currency assets that meet the criteria of being available for use by the authorities in the time of a crisis. Following the reserve assets definition only two components of the CBAK foreign assets and liabilities meet the main characteristics of reserve assets (to be readily available and to be controlled by the CBAK): Euro in cash and reserve deposits of banks with CBAK. Consequently these components are classified in BOP as reserve assets. Data sources are obtained from balance sheet of the CBAK.

**NET ERRORS AND OMISSIONS.** The sum of the credit entries should in principle equal the sum of the debit entries over the period. In practice, because some transactions may not be captured or because of differences in coverage, valuation and timing of transactions, exact symmetry does not occur and the balancing item *net errors and omissions* is inserted to balance the overall account. Ideally, the scale of this item should be relatively small in relation to the combined value of all credit and debit transactions expressed in absolute terms.

# 2. Privatization in Kosovo: With focus in the Special Spin-Off method

Mimoza Mustafa[2]

## 2.1. Introduction

Broadly defined, privatization is the transfer or sale of any asset, organization, function, or activity from the public to the private sector. As one of the crucial elements of market-oriented reforms, privatization is essential in the transition process of a country for former socialist economies. Consequently, like in many transition economies, the privatization in Kosovo is seen as a vital instrument in restructuring the economy. This led to the necessity in establishing an independent body, the Kosovo Trust Agency (KTA), aiming at enhancing the value, feasibility and governance of Socially Owned Enterprises (SOEs) and Publicly Owned Enterprises (POEs) and managing the privatization process of Kosovo's dormant SOEs.

With the first privatization initiative in 2003, Kosovo becomes the last country in the region undergoing this transformation process (e.g., Albania started the process in 1992, Bosnia and Hercegovina in 1999, Bulgaria in 1994, FYROM in 1989, etc). Such delay was result of the conflicts in ex-Yugoslavia (1990-1999) with Kosovo being the closing point of the conflict.

For the purpose of this study our focal point will be the SOEs privatized through the Special Spin-Off method. Indeed, we will present some facts regarding the employment, export generation and potential private investments of firms undergoing privatization through this method. We introduce general concepts related to the privatization process in section 3.2. Section 3.3 provides facts and figures related to the overall process of privatization in Kosovo and some comparisons with the countries in the region. The results from a survey conducted with nine privatized companies are presented in section 3.4. Finally, based on survey results some conclusions are drawn.

## 2.2. General concepts

### 2.2.1. The mandate of KTA and aims of privatization

The KTA mandate is to protect or enhance the value, feasibility and governance of SOEs and POEs in Kosovo. In line with this, the KTA responsibility is the administration of POEs and the privatization of SOEs. The establishment of the Agency, its legal status and objectives are determined by the UNMIK Regulation No. 2002/12, amended by the UNMIK Regulation No. 2005/18. In addition, an important fact which relates to the KTA and the privatization process in general is the establishment of the Special Chamber of the Supreme Court of Kosovo. Based on the UNMIK Regulation No. 2002/13, the Chamber has the power to adjudicate claims relating to decisions or actions of the KTA.[3]

As privatization is one of the key elements of a country's transformation to a market economy, all transition economies at some point encouraged the privatization process with almost the same general objectives. In line with this, the KTA mission and authority over privatization process aims to foster longer-term economic restructuring and encourage development of the economy with utilization of its inactive

[2] Excellent cooperation of the survey respondents is greatly appreciated. I would like to thank Gani Gërguri, Michel Svetchine and Valentin Toçi for helpful comments. The usual disclaimer applies.

[3] For full text of the regulations see the UNMIK website http://www.unmikonline.org/regulations/unmikgazette/index.htm

and/or improperly managed potential inherited from the socialist past. Thus, general objectives can be summarized as follows:

- Establishment of the new property structure and increase of the economic efficiency;
- Encourage new investments and technology improvement;
- Management improvement/corporate governance;
- Export growth;
- Creation of new employment;
- Revenue maximization, etc.

### 2.2.2. Methods of privatization in Kosovo[4]

Being the last country in the region to embark in a privatization process, Kosovo has somehow benefited from different privatization experiences by examining and utilizing the advantages and disadvantages of the privatization methods used elsewhere. The two methods of privatization introduced in Kosovo are based on a spin-off scheme, ordinary spin-off and special spin-off.

***The spin-off procedure*** incorporates the creation of one or more new companies (NewCos) within a SOE, and transfer to these companies the rights and interests of all (or part) of the assets of the main enterprise. Enterprise past liabilities remain with the old enterprise. In this way, all the claims prior to privatization (ownership and creditor claims) are detached from the NewCo. The next step of the procedure involves the sell of the shares of the NewCo to domestic or foreign investor(s). This is conducted through a bidding process that complies with the general rules of the tender for spin-off privatization with possible specific requirements for a particular tender. The winning bidder should be the bidder with the highest bid price (the method known as ***ordinary spin-off***). But, dependent on the satisfaction of the tender specifics and its outcome in general, the KTA reserves the right to determine the winning bidder or to declare the tender unsuccessful. At the same time, the KTA is committed to perform in a transparent manner to ensure that fair price is received.

In addition to the ordinary spin-off procedure, companies with good prospects are to be sold through ***special spin-off (SSO)***. It is named 'special' since there are some requirements and commitments attached to this procedure, such as: employment guarantees (EG) and investment commitments (IC). Thus, in case of NewCo privatization through special spin-off, the KTA parallel with the price takes into account also the proposed activity, investment and employment as foreseen by the prospective investor(s) in their business plan. Hence, the method in itself aims at fulfilling some of the general objectives of the privatization process mentioned above.

It is worth mentioning that the privatization methods, ordinary and special spin-off, have a common characteristic so-called ***employees' entitlement***. Employees' entitlement means that former employees of the NewCo are entitled to benefit 20% from the privatization proceeds. The list of the beneficiary former employees will have to be finalized and approved by both, the old management with the involvement of the Community of the Kosovo Independent Syndicates/Bashkësia e Sindikatave të Pavarura të Kosovës (BSPK) and the KTA. Any claim against the published list is to be filed with the Special Chamber. Employees' entitlement indicates the social aspect of the privatization process in Kosovo, given the specific characteristics of the SOEs in case of ex-Yugoslavia.[5]

Aside from the abovementioned privatization methods, the KTA is entitled to manage the ***voluntary liquidation*** procedure. The procedure is applicable to enterprises that show no survival prospects. The

[4] For full reference visit the website: www.kta-kosovo.org

[5] Social property as such was meant to be a legal category of its own, different from private and state property. The main feature of social property was that nobody was entitled to acquire any kind of ownership on an asset qualified as social property. The supreme title-holder of social property was the society as such. [in Muharremi, R. (2005): The United Nations mission in Kosovo and the privatization of socially owned property, *Policy Research Series Paper,* No.1, Prishtina: KIPRED].

process should follow the liquidation procedures stated in the UNMIK Regulation 2005/48 on ‘the Reorganization and Liquidation of enterprises and their assets under the administrative authority of the KTA’. Similar to the spin-off procedure, the proceeds from the liquidation are kept in trust by the KTA.

## 2.3. Privatization process in Kosovo

Initially, the privatization process was supported and encouraged by local and international authorities in Kosovo. However, it was followed with a few obstacles that resulted on the suspension of the process for around a year.[6] Afterwards, in 2005 and 2006, the process may be considered as very progressive.

As of end-2006, 10 privatization waves were launched bringing to 22 the number of the total waves launched with over 350 NewCos tendered. Only in 2006, the bid results for eleven waves were announced, incorporating about 213 NewCos to be successfully privatized, of which 15 went through the Special Spin-Off method. According to the bid offers of the provisional winners, the amount to be accumulated from these sales is expected to be around euro 154.0 million. However, at end-2006 the number of the sale contracts signed reached 216, which is the total number of NewCos to be considered privatized completely.

The amount accumulated from the privatized companies was euro 275.0 million – amount deposited at the KTA account at the CBAK. The stock of privatization revenues in Kosovo reached at 11.3% of GDP, a level comparable with countries in the region (Table 2.1). As pointed out, 20% of the total privatization sales (about euro 55.0 million) should be committed to former employees. However, until December 2006 only about 5.5%, or nearly euro 10.0 million of the employees’ entitlement was already paid.

**Table 2.1. Privatization revenues in the region**

| Country | Privatization revenues (cumulative, as of 2005,% to GDP) |
|---|---|
| Albania | 11.4 |
| Bosnia dhe Hercegovina | n/a |
| Bulgaria | 21.5 |
| Croatia | 17 |
| Kosovo* | 11.3 |
| Macedonia, FYR | 14 |
| Romania | 9.5 |
| Serbia and Montenegro | n/a |
| Slovenia | 4.9 |
| **Average** | **12.8** |

Source: EBRD Transition Report (2006) and CBAK (2006)
* Data for Kosovo are as of end-2006

Among 216 contracts ratified up to end-2006, sixteen correspond to the companies privatized through the SSO method accounting for 30.0% of the total privatization proceeds. The amount of the investment commitments related to these contracts reaches euro 122.0 million, while the total number of the employment guarantee is around 6,300. The total number of employees before privatization in these companies was around 4,700, suggesting that with the realization of the corresponding SSO contracts the number of employees will increase. The implementation of the conditions within the time-limit set in the SSO contract is monitored and examined by the KTA.

[6] The time gap between the wave 3 and wave 4 announcements was about 1 year.

Before the privatization overall activity of the companies was very low. The poor condition was a consequence of the economic crises faced by former Yugoslavia in the late 80's, as well as the political situation in Kosovo during the 90's that resulted in the depreciation of the companies' assets in general and their technology in particular. Few of the SOEs were operating with their full capacity and there were no investments during this period. The condition of the SOEs remained as such up to the privatization initiative.[7]

Focusing in companies privatized through the SSO method makes it easier to draw conclusions on the outcomes related to privatization process in Kosovo. This because the SSO method integrates conditions and obligations that the potential owner of the company should implement, with respect to the future investments and employment. Thus, through the survey conducted we will attempt to raise and discuss some of the issues related to the economic development, as a result of a direct influence from the privatization process. Moreover, it supplements recent survey published by the KTA[8] whose results show 'real progress in the private sector'. The sample of the KTA survey included the companies not privatized through the SSO method, which were not subject to the special conditions.

## 2.4. Survey

The survey was conducted with nine newly privatized companies. It was structured in such way so we could extract some facts related to employment, revenue generation, export, foreign direct investments and potential future investments as an outcome of the privatization process through SSO method.

Only at the point of contract ratification the company is considered to be completely privatized, subject to the conditions stated in the signed contract. Thus, we limited ourselves in conducting the surveys with the companies whose contracts were already ratified. Despite the sixteen contracts being ratified up to end-2006, our survey sample consists of 9 SSO companies, what corresponds to the number of contracts ratified as of June 2006. The survey was conducted in September and early October 2006 (Table 2.2). Face-to-face interviews were conducted with general managers or owners. The companies are of different industries such as: construction material, metal processing, metal products, rubber and chemical industry, agro-food industry, etc.

### 2.4.1. Survey Results

The average period between the date when the winner of the tender is made public and the ratification of the contract is four months. This period also determines the time gap between the payment for the company and actual 'key delivery' ceremony (The Ferronikeli case was an exception). The total amount collected from the sale of the 9 SSO companies is euro 54.0 million. The investment commitment agreed with the contracts, meaning the investments to be accomplished within 2 years from the ratification of the contract, amounts at around euro 84.0 million. The employment guarantee (EG), as agreed in the contracts, reaches 3601 employees. This is the situation based on the contracts signed. Here after we will present the realization of the requirements attached to SSO contracts for all 9 SSO companies up to end-September 2006 (Table 2.2).

[7] Hashi I. (2001), The International Experience of Privatization and Lessons for Kosova, Working Paper, No. 2001.12, Staffordshire University; Riinvest (2001), Ndërmarrjet shoqërore dhe transformimi/privatizimi i tyre, Research report, Prishtina: Riinvest.
[8] KTA, Press Release, 31 May 2007.

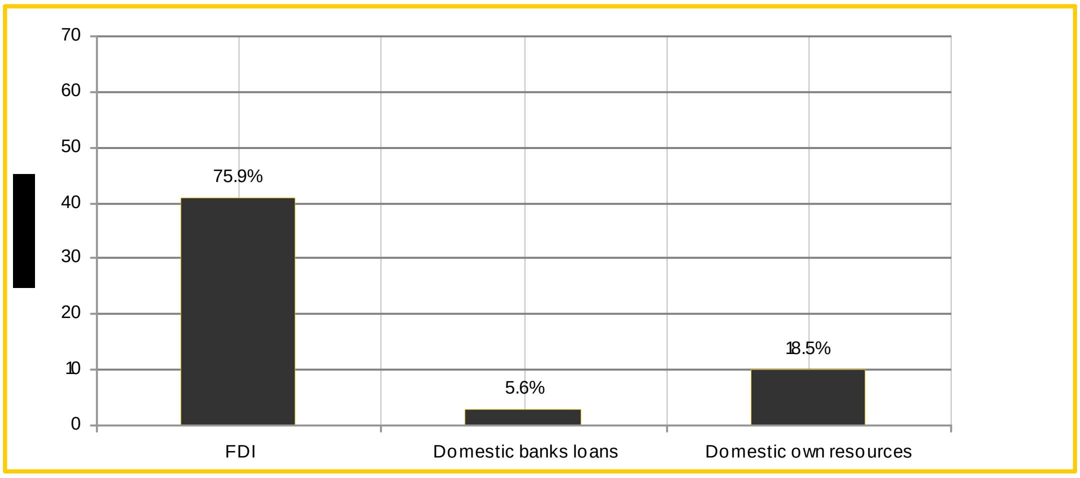
**Table 2.2. List of SSO privatized surveyed companies**

| Name of company (NewCos) | Amount paid | No of employees before privatization | Employment guarantee | Investment commitement |
|---|---|---|---|---|
| NewCo Perparimi | 1,198,749 | 103 | 15 | € 2,000,000 |
| NewCo Ferronikli LLC | 30,554,371 | 200 | 1,000 | € 20,000,000 |
| NewCo Silosi Flour Mill LLC | 1,000,000 | 217 | 358 | € 19,887,564 |
| NewCo IGK/GHI Ballkan LLC | 1,400,000 | 814 | 375 | € 6,000,000 |
| NewCo Llamkos Steel LLC | 4,151,000 | 400 | 500 | € 15,000,000 |
| NewCo Banja e Kllokotit Water Bottling Plant | 1,805,550 | 116 | 201 | € 3,100,000 |
| NewCo FAN | 2,310,000 | 312 | 236 | € 2,800,000 |
| NewCo Peja Brwery L.L.C. | 11,130,000 | 506 | 612 | € 15,206,000 |
| NewCo Sunflower Oil Factory L.L.C. | 460,000 | 204 | 169 | Commercialized |
| Total | 54,009,670 | 2,872 | 3,601 | € 83,993,564 |

Source: KTA (2006)

Regarding the ownership structure of the companies, the survey shows that 4 companies have full domestic ownership, 4 full foreign ownership and one with a mixed ownership (65% domestic and 35% foreign shares). Thus, 76.0% of the privatization proceeds from these 9 SSO companies are considered as FDI (see Figure 2.1 below). In general, the purchase of the SSO companies was mainly funded by ‘own funds’ (about 74.0%) and the rest was financed by bank loans. It is worth mentioning that only 5.6% of total amount paid to purchase these 9 SSO companies comes from the loans granted from banks operating in Kosovo.

**Figure 2. 1. Amount and share of financial sources from SSO surveyed companies**




Source: SSO Privatization Survey (2006)

**Investments.** Expansion of the private sector resulting from the privatization process rises the expectations for new investments in Kosovo. Given the poor condition of the companies before their privatization, the activity and profitability of the companies relates mostly on further investments. Only three of the companies declared to operate with their full operational capacities, while the remaining were only operating with limited capacity. The reasons behind the limited use of capacities are low demand, basic operating technology, as well as the negative impact of power shortages. Most of the surveyed companies stressed their needs to invest in the modern technology. Investments are mainly focused in upgrading the existing technology and in product improvement, rather than introducing new product lines. All surveyed companies confirmed the future plans for increasing the production capacities. Yet, the realization of these plans depends on companies' ability to expand their market share and to raise more financial resources.

According to the survey, around euro 30.7 million (or 30%) of the total investment commitments were carried out as of September 2006. About 70% of investments were financed by 'own funds' from the parent companies, while less than 30.0% were financed through bank loans (jointly, banks operating abroad and in Kosovo). As of September 2006, around euro 20.5 million invested in the SSO companies can be considered as FDI. With the first deadline to fulfill the IC requirement starting in March 2007 it is very rational that all the investments to date and, moreover, investments in the near future are related to commitments stipulated in the contracts of SSO companies.

Seven out of the nine respondents were optimistic regarding their ability to comply with their investment commitments on time. While managers of two surveyed companies stated that the foreseen amount of their investments will exceed their commitments. Related to the investments plans, financing is a matter of concern. None of the respondents gave a clear vision on the financial sources for these investments. Most of them expressed a preference for bank loans, yet remaining cautious when referring to the lending interest rates offered by the banking sector in Kosovo. Their criticism was addressed on the lack of corporate driven lending policies of the banks, and policies that would encourage larger investments by offering more feasible lending conditions to the potential investors.

**Employment.** Relevant to unfavorable state of the companies before privatization, the official workforce could also be qualified as active and inactive employment within the existing companies. Inactive employment refers to the employees not actively involved in the enterprises (such as employees on unpaid leave, part-time basis, etc.), but yet included in the employee lists. Our primary source to this information is fact-sheet of each company.[9]

Before privatization the 9 SSO companies employed around 2800 people. These companies guaranteed to employ 3600 persons indicating an increase of employment by around 28%. When recalling that about 15% of 2800 former employees were inactive (either in unpaid leave or part-time basis), the employment increase becomes more substantial. With an exception of few contracts stipulating that the employment guarantee criteria should be fulfilled within 2 years, in most of the contracts the EG should be satisfied within one year from the ratification date. Based on the survey, around 2000 employees were currently employed suggesting that more than half of the employment guarantee is already satisfied. None of the respondents revealed any particular employment plan to be implemented within a medium or long-term period, aside from the employment plan agreed by the contracts. As one would expect, the surveyed companies emphasized the strong links between increase in operational capacity or investments and increase in employment. However, this link would hold if investments are directed towards increasing the production capacities while maintaining the existing technology. If investments target the modern technology, then the respondents were hesitant towards the demand for new employment.

The matter of distributing the 20% of the company's sales value (employees' entitlement) to the former employees is facing some obstacles. This, mainly due to the delays in determining the final lists of employees which should be fully agreed and approved by KTA and BSPK. Up to the end of September 2006, only employees of two surveyed companies benefited from this entitlement. In both cases, it took more than a year after the ratification of the contract to distribute 20% of the sales value to former employees.

**Exports.** Since most of the contracts were signed and ratified during 2005-2006, it is way too ambitious expecting immediate improvements in the export growth in the privatization firms. At this point we should recall the low level of exports in Kosovo in general (about euro 56 million for year 2005 and euro 110 million for year 2006). Thus, at the present, there is no indication of the privatization process affecting the rapid export growth, however the survey reveals optimism regarding the future developments on the matter.

[9] The fact-sheet published by KTA contains the essential information on company to be privatized, such as: business, product, employment, market, etc.

At the moment only two of the interviewed companies are regularly exporting their products, NewCo Llamkos (97% of their total sales) and NewCo Balkan (50% of the total sales). NewCo Llamkos is one of the largest exporters in Kosovo, and together with the NewCo Balkan they do realize about 40% of the total Kosovo exports. While for Llamkos the main trading partners are countries in the region, the NewCo Balkan's export target is the EU area, such as Italy, Germany, etc. Other surveyed companies are not currently exporting their goods, though all of them declared that one of their future challenges is ability to export.

Regarding the exports perspective, certainly the NewCo Ferronikeli is the highest potential exporter in Kosovo. The management of the Ferronikeli revealed their plan to start their operations by March 2007 and enable full operation by end-2007. The Ferronikeli will lead the exports of Kosovo by exporting 100% of their production (no market in Kosovo for such products). The product will be sold through the world commodities market. The full production capacity level for Ferronikeli is to produce 10000 tons Ferro-Nickel Ingots per year. This would mean that around USD 280 million (euro 220.5 million) will be produced and exported yearly, growing export figures for 4-5 times more than the level attained now. The latter corresponds to the price of the product at the time of the interview. However, the historical prices of this commodity (Ferro-Nickel Ingots) show a very volatile trend.

## 2.5. Concluding remarks

The privatization in Kosovo is perceived as a positive process with respect to transformation of the socially-owned assets to private sector contributing to the development of an open market economy. The rapid evolution of the process during 2005 and 2006 is followed with the improvements in the activity of production companies. With the privatization process still ongoing and with most of the companies being just recently privatized, one can not expect a rapid growth in the level of production in Kosovo. Indeed, only three of the companies declared to operate with their full operational capacities. Moreover, not only old technology and financial constraints, but also power shortages are hampering the production and operational capacity of companies.

Four of the largest industrial companies are privatized by foreign investors who have financial means as well as the experience in that particular production field (NewCo Balkan, NewCo Ferronikeli, NewCo Llamkos and NewCo Silosi). Our survey reveals that around 76.0% of the revenues from the privatization of the 9 SSO companies can be considered as FDI. On the other hand, only about 6.0% of these revenues were financed by loans granted by banks operating in Kosovo. With regard to the investment commitments, about 30.0% of the amount committed from the 9 SSO companies is already invested. From this amount, about 30.0% is financed through banking loans, suggesting an increase of the banking sector support to the corporate development. Moreover this support highlights a positive effect of the participation of banking sector in privatization process, since it ensures further screening and monitoring of the investment projects, improving management and corporate governance in general. Concerning the financial means for the remainder of the investment commitments investors would prefer bank loans, although they remain reluctant due to presently high lending interest rates.

Employment guarantee within the SSO companies assures fixed number of employees for a period of two years. In practice there is an increase compared to the number of employees before privatization, moreover when recalling the inactive state of the employment in the enterprises before privatization. In a word, number of employees, before and after privatization, can not be appropriately comparable. Additionally, if we consider the current short-term employment contracts together with the senior workforce of the companies, the employment circumstances might change in the future, especially with respect to the employment structure being tailored to the needs of the new modern technology. Another important factor is the delay of the employees' entitlement (the benefit of 20% from the sales revenues), with the implementation periods of longer than a year. This entitlement is considered to fulfill the social aspect of the privatization process in Kosovo.

Already privatized companies are not yet export-oriented. However, they all do share the opinion of the necessity of introducing their products across the border and the survey results reveal an optimism and better position regarding the exports in the future. In order to achieve this, they should improve the quality of their products with the aim positioning them in line with international standards for such products.

## 3. Costs of Intermediation in the Kosovo Banking Sector

Valbona Morina and Valentin Z. Toçi[10]

### 3.1. Introduction

Aside from the substantial progress noticed in the banking sector in recent years, the lending rates and interest rate spreads have been observed to be high in Kosovo and other countries in the region, as opposed to those in western economies and advanced transition economies (TEs). High lending rates and spreads emanate from many factors and may be regarded as an obstacle to financial intermediation, which in turn may imply a disincentive to saving and investment, potentially harming economic growth.

Broadly speaking, the lending rates and spreads are determined by many interrelated factors such as macroeconomic stability, market structure, economies of scale, efficiency of the sector, funding costs (e.g., deposit rates), operating costs, regulatory costs (e.g., taxation and reserve requirements), etc. In addition, the credit risk perceived by bankers may give rise to the lending rates and spreads that may emerge from, among others, institutional failures such as legal institutions, information sharing institutions, transparency, governance, etc.

This study initially compares the interest rate spreads and earning margins of banks in Kosovo with countries in the region and other TEs. It then focuses on the intermediation cost structure of the banking sector in Kosovo that relates to lending to the domestic economy only, by decomposing funding, operational, risk and regulatory costs. To add some behavioral content to the analysis we employ a simple econometric exercise with panel data for 7 banks in Kosovo for the period 2002-2005 to investigate variation of bank-specific and market structure characteristics that determine variation in interest rates and spreads.

The results indicate that one of the most important components contributing to the high level of lending rates and the spread are operational costs and risk perception costs reflected in the level of provisioning. However, changes in provisioning are not reflected in changes in interest rates or spreads. While higher deposit rates are translated almost entirely into higher interest rates, reserve requirements have a positive impact too, although this impact is marginal. Even though larger banks have relatively lower operational costs, results suggest that bank size has a positive effect on both lending rates and the spread, indicating that economies of scale have not been utilized in order to lower interest rates. We also find some evidence that market power is positively correlated with lending rates.

### 3.2. Interest rate spread and earning margins

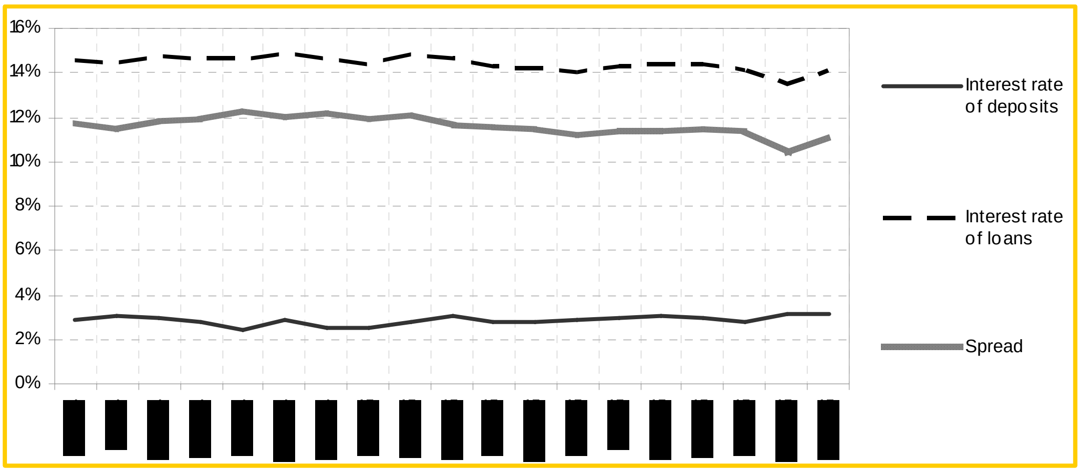
One of the commonly used measures of the banking sector efficiency is interest rate spread i.e., the difference between the interest rate that banks charge for loans and interest rate paid to savers. Lower spreads can be interpreted as an indication of the intermediation efficiency,[11] although this may not necessarily always be the case. For instance, low *ex post* spread may reflect excessive risk-taking originated by loan defaults. On the other hand, high spreads could possibly imply an excessive transfer to banks, inefficiency in intermediation in the local market, lack of competition, excessive risk, institutional failures, etc. Nevertheless, higher efficiency reflected in narrower spreads, as broadly recognized in the literature of banking, comes at cost for stability (a so-called efficiency-stability trade-off). Higher spreads may contribute

[10] We would like to thank Rudi Acx, Mentor Geci, Gani Gërguri, Arben Mustafa, Mimoza Mustafa, Edward Nolan and Michel Svetchine for comments. The usual disclaimer applies.
[11] Demirguc-Kunt, A. and H. Huizinga (1999): Determinants of commercial bank interest margins and profitability: Some international evidence, *The World Bank Economic Review,* 13: 379-408.

to the stability of the sector by ensuring profitability, increasing the franchise value of the sector presumably contributing to a decrease in excessive risk-taking on banks' side; while the opposite is true on the borrowers' side. For example, higher lending rates *ex ante* may induce borrowers to undertake riskier projects. It may also have detrimental effects on the demand for credit since high interest rates, coupled with high collateral requirements, make fewer projects qualify for bank loans. Hence, many profitable ventures may not be undertaken.

The Central Banking Authority of Kosovo (CBAK), starting from June 2004, publishes effective deposit rates and lending rates charged by commercial banks in Kosovo.[12] Figure 3.1 shows the weighted average of *ex ante* lending and deposit rates (over all maturities and products) for the period June 2004–December 2005. On average, for the 2004-2005 period the lending rates stood at 14.41% while the deposit rates at around 2.85%, making up the spread of 11.56 percentage points (pp). The interest rates, as appear in the statistics, are *ex ante* measures of the intermediation spread. These, for example, are agreed rates at the moment when contracts are made as they intend to measure market conditions at a point in time. How much interest is paid after the contract is not reflected in the data i.e., bad loans do not pay interest rate.

**Figure 3. 1. The effective interest rates on loans and deposits and the spread**




One *ex post* measure of the intermediation spread derived from the financial statements is the Net Interest Margin (NIM) showing the difference of 'actual' interest earned from lending and spent in deposit-taking and then relating this to assets. The NIM and *ex ante* interest rate spread for banking sector in Kosovo and TEs are shown in Table 3.1. The *ex ante* spread in Kosovo is the second highest in the region (after Romania) and above the average for Central and East European countries (CEE) and Commonwealth of Independent States (CIS); followed closely by Croatia and Serbia and Montenegro (SCG). For example, high interest rates and spreads in Romania and SCG may be attributed to macroeconomic instability and high inflation that the countries struggled for a decade of the transition period. In addition, the spread almost halved in the South East Europe (SEE) region compared to 1999, on average. The similar conclusion can be drawn if the NIM is compared. Again, Kosovo with NIM at 6.5% records the highest margin as compared to countries in the region and TEs.

[12] For details on the methodology see BPK (2004), *Monthly Statistics Bulletin*, No. 39.

**Table 3. 1. Interest rate spread and net interest margin in TEs**

| Description | Interest rate spread a) | | NIM b) | |
|---|---|---|---|---|
| | 1999 | 2004 | 1999 | 2004 |
| **Kosovo c)** | **na** | **11,56** | **na** | **6,5** |
| Albania | 12,2 | 6,5 | 1,7 | 2,7 |
| BiH | 15,2 | 6,6 | 1,7 | 3,5 |
| Bulgaria | 10,8 | 5,1 | 4,4 | 5,6 |
| Croatia | 9,2 | 10,1 | 4,2 | 3,1 |
| Macedonia, FRY | 8,7 | 5,5 | 3,0 | 3,1 |
| Romania | 20,5 | 15 | na | 4,3 |
| SCG | 32,3 | 11 | na | 4,7 |
| SEE average | 15,6 | 8,87 | 3.0 | 3,86 |
| CEE average | 5,6 | 4,9 | 3,49 | 2,79 |
| CIS average | 17,2 | 9,94 | 6,29 | 4,63 |

Source: EBRD 2005, Transition report and CBAK. Note: a) The difference between lending and deposit rates. From most countries lending and deposit rates are weighted averages across maturities. For some countries, weighted averages are not available and rates are quoted for the most frequently used instruments; b) Net interest revenue as a percent of total assets; c) Data for Kosovo are averaged for 2004-2005.

These measures (*ex ante* spread and the NIM) fail to account explicitly overhead expenditures, regulatory costs, risk costs, etc., that would cover entire costs of the banking business and are considered as contributing factors to the high costs of intermediation. One approach for decomposing intermediation costs is the method used by Hansen and Rocha (1986) using income statement data expressed in terms of ratios to total assets.[13] We utilize this method for countries in the region in order to ensure homogeneity and comparability of the data by avoiding as much as possible the differences in the accounting practices.

Table 3.2 contains the decomposition of the accounting data. Items 1 and 2 represent interest received from earning assets and interest paid on interest bearing liabilities respectively, divided by total assets. The difference between the two represents the interest margin. Item 4 represents net non-interest income such as income/expenditures from fees and commissions, income/expenditures in dealing securities, foreign exchange, etc., excluding operating costs and provisions. The sum of interest margin and other income gives the gross margin of banks in their operations. By subtracting operational costs (item 6) such as staff costs, administrative costs, fixed asset costs and similar from the gross margin, the net margin is obtained (item 7). Subtracting provisions (item 8) from the net margin we end up with profitability indicators of the banking sector in respective countries.

[13] Hanson, J. A. and R. Rocha (1986): High interest rates, spreads, and the cost of intermediation, *Industry and Finance Series 18*, Washington D.C.: World Bank.

**Table 3.2. Structure of Commercial Bank's Income Statement and Earning Margins**

(in thousand of EUR and as % of total assets)

| Description | Kosovo | | | | Croatia | Bulgaria | Montenegro |
|---|---|---|---|---|---|---|---|
| | 2002 | 2003 | 2004 | 2005 | 2005 | 2005 | 2005 |
| 1. Interest Received | 17,818 | 30,695 | 53,999 | 74,612 | 1,748,842 | 1,001,620 | 41,760 |
| | **4.03** | **5.81** | **7.77** | **8.41** | **4.96** | **5.96** | **6.00** |
| 2. Interest Paid | 3,470 | 5,279 | 9,978 | 15,389 | 800,271 | 306,470 | 14,011 |
| | **0.79** | **1.00** | **1.44** | **1.73** | **2.27** | **1.82** | **2.01** |
| 3. Interest Margin (1 - 2) | 14,348 | 25,416 | 44,021 | 59,224 | 948,571 | 695,150 | 27,749 |
| | **3.25** | **4.81** | **6.34** | **6.67** | **2.69** | **4.14** | **3.99** |
| 4. Other Income (net) | 14,596 | 18,899 | 19,929 | 20,286 | 405,159 | 334,214 | 29,255 |
| | **3.30** | **3.58** | **2.87** | **2.29** | **1.15** | **1.99** | **4.20** |
| 5. Gross Margin (3 + 4) | 28,944 | 44,315 | 63,950 | 79,510 | 1,353,731 | 1,029,364 | 57,004 |
| | **6.55** | **8.38** | **9.20** | **8.96** | **3.84** | **6.13** | **8.19** |
| 6. Operating Costs | 21,640 | 27,882 | 37,820 | 49,175 | 735,288 | 557,227 | 40,107 |
| | **4.90** | **5.28** | **5.44** | **5.54** | **2.09** | **3.32** | **5.76** |
| 7. Net Margin (5 - 6) | 7,304 | 16,433 | 26,130 | 30,335 | 618,443 | 472,138 | 16,897 |
| | **1.65** | **3.11** | **3.76** | **3.42** | **1.75** | **2.81** | **2.43** |
| 8. Provisions | 3,282 | 7,720 | 11,071 | 13,419 | 71,077 | 121,757 | 12,051 |
| | **0.74** | **1.46** | **1.59** | **1.51** | **0.20** | **0.72** | **1.73** |
| 9. Profits Before Tax | 4,022 | 8,713 | 15,059 | 16,916 | 547,366 | 350,381 | 4,846 |
| | **0.91** | **1.65** | **2.17** | **1.91** | **1.55** | **2.09** | **0.70** |
| 10. Profits After Tax | 2,716 | 6,801 | 12,955 | 13,527 | 441,422 | 298,719 | 4,184 |
| | **0.61** | **1.29** | **1.86** | **1.52** | **1.25** | **1.78** | **0.60** |
| A. Total assets in reported year | 441,710 | 528,552 | 694,734 | 887,497 | 35,245,118 | 16,796,648 | 695,757 |
| B. Loans | 59,324 | 161,847 | 314,974 | 456,508 | 20,576,818 | 9,397,225 | 375,941 |
| C. Loans/ total assets | **13.43** | **30.62** | **45.34** | **51.44** | **58.38** | **55.95** | **54.03** |

Source: Central banks in respective countries and own calculations

As can be observed from Table 3.2, interest margin is the highest in Kosovo (around 3.5pp higher compared to Croatia and 2.5pp higher compared to Bulgaria and Montenegro) mainly driven by higher interest received. An increasing trend from 2002 to 2005 is mainly due to the increase in loans to domestic economy as proportion of total assets that are characterized with higher interest rates. Also in terms of gross margin, Kosovo is substantially ahead compared to the countries in the region, especially Croatia and Bulgaria; while due to the high level of other income (mainly fee and commission income) in the banking sector, Montenegro does not fall far behind. Operational costs and provisions add a substantial proportion to the costs of intermediation. These indicators for Kosovo are comparable to Montenegro, but substantially higher compared to Bulgaria and Croatia. These costs may explain the higher interest rates which reflect cost inefficiencies and the risk perception of banks (or regulators) in their loan portfolio.

This approach generalizes the intermediation costs related to overall banking operations. For example, interest received when relating to total assets does not make the distinction between assets invested in low-risk low-return investments such as placements in banks abroad, government bonds and, on the other hand, assets invested in high-risk high-return loans in the domestic market. However, the comparison with other countries is close approximation, provided similarities in the ratio of loans to domestic economy to total assets ranging from 51.44% in Kosovo to 58.38 in Croatia (see Table 3.2, C). Also provisions relate to total banking operations and not explicitly to banks' lending activity in the domestic market. Considering this, in the next section we aim to decompose the intermediation costs in the Kosovo banking sector related to lending to domestic economy only.

### 3.3. Cost and income decomposition in the lending market

The decomposition of the intermediation costs is made into the *funding*, *operational*, *risk* and *regulatory* costs. This approach uses balance sheet and income statement information and under the set of assumptions approximates the intermediation costs related to the domestic economy only. The analysis follows the basic accounting identity:

$$II + NII = IE + C + Pv + Tax + P$$

where interest income *(II)* plus noninterest income *(NII)* equals interest expenses *(IE),* operating costs *(C),* provisions for loan losses *(Pv)*, taxes paid *(Tax)* and profit (*P*). However, this framework does not take into account behavioural effects of macroeconomic factors, institutional factors nor the bank and market-specific factors such as economies of scale, market power, etc., which may be reflected in all the cost/revenue components.

Regarding the institutional failures which to a great extent contribute to the risk i.e., difficulties in repossessing collateral, not much can be said at the present juncture. However, a recent study based on the World Bank Doing Business methodology finds that enforcement of creditor rights in Kosovo outperforms countries in the region and even advanced reformers in the CEE.[14] On macroeconomic factors, due to the use of euro, Kosovo is characterized by stable inflationary environment, although large external imbalances and low economic activity may increase the general risk perception.

**Ex-post lending rate**

Costs that incur to borrowers are the interest rate they pay for the loans they get plus fees and commissions. For example, *ex ante* interest rate does not reflect those loans that do not pay interest, have fallen in arrears, etc. To deal with this issue the ratio between the interest income from loans derived from monthly income statements (flow variable) and gross loans derived from monthly balance sheet (stock variable) is calculated. Then the monthly flow data are annualized and the ratio is averaged over one year (to smooth the effect of the problem when relating flow and stock data).

Banks in Kosovo usually charge a fee on each disbursed loan (processing/disbursement fee) which are generally around 1-2% of the disbursed amount. To capture this and other possible fees e.g., penalties for late loan re-payment, the ratio of the income from fees and commissions (flow variable) to gross loans (stock variable) is calculated. In order to capture only the income from fees and commissions related to lending to the domestic economy, the fee and commission item is multiplied by factor *A*; where *A* represents the share of lending to domestic economy in the total balance sheet for each period. It is assumed that the banking sector activity devoted only to lending to domestic economy is captured by this factor.[15]

**Ex-post cost decomposition**

Now turning to the cost structure, four elements are calculated: funding costs, operational costs, risk costs and regulatory costs. Deposits represent the most important source of bank lending activity. *Funding costs* or the 'actual' deposit rate is derived by calculating the ratio of interest expenditures on deposits and other

[14] See Business Condition Index in Kosovo (2005), USAID, KCBS and Integra Consulting.

[15] Another possible assumption for factor *A* may be interest income from loans to total income. However, the results do not change substantially.

borrowings to total outstanding debt to clients (*D*). Again, the former being a flow variable and the latter a stock variable, monthly flow data are annualized and the ratio averaged over one year.

*Operational costs* such as staff costs, administrative costs, etc. may be shifted to customers through higher interest rates. These costs are attributable to entire banking activities. To separate the operational costs related only to lending to domestic economy, we multiply the total operational costs with the factor *A*. Relating this to gross loans (*L*) may give us the operational costs devoted specifically to lending to domestic economy. This percentage is an additional contributing factor to the intermediation costs related to lending activity of commercial banks.

Provisions represent the risk that bankers/regulator perceive or assess in banks' portfolio and are an additional wedge to the intermediation costs. We derive the *risk costs* from the balance sheet data by dividing provisions for loan losses with gross loans to domestic economy on a monthly basis for the period 2002-2005. In addition, it is assumed that 95% of provisioning is attached to loans to domestic economy.

The *regulatory costs* cover taxation and mandatory reserves required by the central bank. Basically the same calculation logic is used for taxation, by relating provisioning for taxes (multiplied with factor *A*) with gross loans. Taxation and reserve requirement costs are expected to be less important in terms of the level. Zahler (2004) calculates the costs of intermediation stemming from reserve requirements and ends up with 0.01 percentage points.[16] After the 'actual' lending rate and all the cost components are calculated, the difference between the two reflects the *residual* (ε). This is composed of income from other banking operations and errors that result from assumptions made and combining the flow data from income statement and stock data from balance sheet.

The basic accounting identity is transformed in this form (see Box 2 for full derivation):

$$\frac{II}{L} + \frac{NII}{L} * A = \frac{IE}{D} + \frac{C}{L} * A + \frac{Pv}{L} * 0.95 + \frac{Tax}{L} * A + \frac{IE}{L} * A * 0.1 + \frac{P}{L} * A + \varepsilon$$

**Results**

As Table 3.3 indicates, the *ex post* lending rate during the observed period was slightly above 15% on average; while fees and commissions added to the borrowing cost around 3pp, which made the total cost of borrowing at around 18% (in 2005 the effective lending rate went down to 17%). *Ex post* intermediation cost components stood at around 10.53%, on average for the period under review. As a result, the spread after taking into account operational costs, risk and regulatory costs accounts for around 7.5pp, on average.

In terms of the level, the most important contributing factor to the spread is operating costs followed by the risk costs proxied by provisioning for loan losses. Operating costs explain about ½ of total costs (or above 5pp), followed by risk costs which add approximately additional 3.4pp. Funding costs and regulatory costs add additional 2pp, while bank profits explain about 1.3pp, on average. The data show some tendency of the *ex post* intermediation spread to narrow which is especially pronounced in 2005. This may be attributed to the decrease in lending rates and fees and increase in deposit rates. The increase in the deposit rates may be attributed to the increased competition between banks to collect more deposits since most of them are slowly approaching the prudential guideline of the loan to deposit ratio set by the CBAK. In addition, it may be attributed to an extension in the maturity of deposits. Also an increasing trend is apparent in risk costs which accounts for above 4pp in 2005.

[16] Zahler, R. (2004), Financial sector's role in economic development in Kosovo, unpublished, Zahler Co., Santiago, Chile.

**Table 3. 3. Intermediation cost decomposition**

| Description | 2002 | 2003 | 2004 | 2005 | Average |
|---|---|---|---|---|---|
| **Ex-post lending rate** | **18.87** | **18.07** | **18.04** | **17.05** | **18.01** |
| Lending rate | 15.72 | 14.68 | 15.26 | 14.81 | 15.12 |
| Fees and commisions | 3.16 | 3.39 | 2.78 | 2.24 | 2.89 |
| **Ex post Costs** | **8.20** | **9.96** | **11.27** | **12.70** | **10.53** |
| Funding costs | 0.87 | 1.11 | 1.65 | 2.04 | 1.42 |
| Operational costs | 4.89 | 5.26 | 5.43 | 5.52 | 5.28 |
| Risk costs | 2.07 | 3.13 | 3.75 | 4.58 | 3.38 |
| Regulatory costs | 0.37 | 0.46 | 0.44 | 0.55 | 0.46 |
| *o/w taxes* | 0.30 | 0.36 | 0.30 | 0.38 | 0.33 |
| *o/w reserves* | 0.08 | 0.10 | 0.14 | 0.17 | 0.12 |
| *Memorandum items* | | | | | |
| **Residual** | **10.68** | **8.12** | **6.77** | **4.35** | **7.48** |
| o/w Profit | 0.61 | 1.26 | 1.83 | 1.47 | 1.29 |

Operational costs as the most important component of the intermediation costs do not show a declining tendency. Consequently, a reduction of these costs would contribute to the improvement in efficiency of the sector. High operational costs may be due to high staff costs as well as costs attributed to the young and expanding market where financial institutions have to afford large initial costs. The risk costs have shown an increasing trend presumably reflecting some deterioration of the loan portfolio quality in some banks.

## 3.4. The determinants of lending rates and spreads

Regression analysis has been utilized to analyze the determinants of interest rates and spreads using fixed-effects panel data estimates.[17] Fixed-effects model corrects for the presence of unobserved heterogeneity among the banks, i.e. the model assumes that the slope coefficients are constant but intercept varies across cross-section observations. The data are composed of 7 cross-section observations of banks in Kosovo and monthly time series data for the period 2002-2005.[18] The regression equation has the following form:

$$y_{it} = \alpha_0 + \beta\, x_{it} + u_{it}$$

where $y_{it}$ is the dependent variable (*ex post* interest rate and spread) for bank $i$ at time $t$, $x_{it}$ is the vector of bank-specific and market structure explanatory variables: operational costs, deposit rate, provisions for loan loses, reserve requirements, market share (as a proxy for bank market power), logarithm of total assets (as a proxy for bank size) and time trend to take into account common trend. $u_{it}$ is the random error following usual properties.

[17] The fixed effects model is preferred against random effects model based on the Hausman test (*prob < chi2 is larger than 0.05*).
[18] At the outset we suggest the reader to take the results with care and only as indicative, given the small number of cross-section observations and short time-series dimension available.

Before embarking in regression results it is useful to present the correlation matrix of variables under review. As it is shown in Table 3.4, interest rate and spread are positively and significantly correlated with a higher market share and bank size. Also it can be noticed that some of the explanatory variables are correlated, for example larger banks have higher market share and have significantly lower operational costs.

**Table 3.4. Correlation matrix of variables**

| Description | Lending rate | Spread | Operational costs | Provisions | Reserves | Concentration | Logassets |
|---|---|---|---|---|---|---|---|
| Lending rate | 1 | | | | | | |
| Spread | 0.9353* | 1 | | | | | |
| Operational costs | 0.0232 | 0.0642 | 1 | | | | |
| Provisions | -0.0949* | -0.1488* | -0.045 | 1 | | | |
| Reserves | -0.0784 | -0.0565 | 0.1359* | -0.1759* | 1 | | |
| Concentration | 0.3144* | 0.3512* | -0.3086* | -0.0529 | -0.1790* | 1 | |
| Logassets | 0.2309* | 0.2044* | -0.3382* | 0.2175* | -0.3184* | 0.8298* | 1 |

Note: * denotes significance at 10% or higher.

The correlation matrix may be only indicative since not all the elements that determine interest rates and spreads are taken into account simultaneously. Provided monthly time-series data, explanatory variables are introduced with four lags. To keep the parsimony, only significant lags are reported. Table 3.5 presents the determinants of lending rates and interest rate spreads.

As expected, the operational costs have a positive effect on both, lending rates and interest rate spreads. The variable enters the regression with positive sign and is statistically significant at 1% level. For instance, 1pp increase in operational costs may increase the lending rates by approximately 0.3pp. One period lag of the operational cost variable is negative and is significant at one percent level. The explanation is that the longer-run impact of operational costs is smaller than the short-run impact.[19] The funding costs variable (*ex post* interest rate on deposits) enters with positive sign and is highly significant suggesting that higher rates paid to savers increase the lending rate - the increase is almost entirely shifted onto borrowers.

We also run the regression with first differencing ($\Delta y_{it} = \alpha_0 + \beta\ \Delta x_{it} + u_{it}$) for the possibility to eliminate unit root (specification 3 and 4). The operating cost and deposit rate variables remain positive and statistically significant at one percent level.

Provisioning for loan losses is statistically insignificant in all the specifications suggesting that it has no influence on the pricing behaviour of banks. It should be recognized that in terms of the level, provisions as a proxy for risk of the banks' loan portfolio, represent a substantial part of the intermediation cost (see Table 3.3). Nevertheless, the variation in provisioning is not reflected in interest rate and spread variation. This may be plausible to the extent that banks do not increase interest rates as their loan portfolio worsens, since it may further deteriorate the quality of their borrowers, e.g., a higher interest rates charged to borrowers may induce them undertake riskier projects. Also the increase in provisioning in some banks induced by the regulator may have not been passed on interest rates, given that the interest rates are largely determined by large players in the local market with substantial market share. More generally, due to competition, a bank which faces an increase of its delinquency rate cannot transfer this additional charge to its borrowers, and consequently has to accept a reduction of its own profitability.

[19] The short-run impact is measured by the coefficient on Operating costs, whereas the long-run impact is measured by the sum of Operating costs and Operating costs (t-1) coefficients. For details see Kennedy, P. E. (2005): Oh No! I Got the Wrong Sign! What Should I Do?, *Journal of Economic Education,* 4: 77-92.

**Table 3. 5. Determinants of lending rates and interest rate spread**

| Explanatory variables | | Dependent variables | | | |
|---|---|---|---|---|---|
| | | (1) | (2) | (3) | (4) |
| | | Interest rate | Spread | Interest rate | Spread |
| Time trend | | 0.04 | 0.05 | -0.005 | -0.006 |
| | | (0.04) | (0.04) | (0.02) | (0.02) |
| Operational Costs | | 0.33*** | 0.35*** | 0.22*** | 0.23*** |
| | | (0.09) | (0.09) | (0.08) | (0.09) |
| | (t-1) | -0.28*** | -0.26*** | - | - |
| | | (0.08) | (0.09) | | |
| | (t-2) | -0.23*** | -0.26** | - | - |
| | | (0.08) | (0.09) | | |
| Deposit Rate | | 0.89*** | - | 0.52*** | - |
| | | (0.15) | | (0.15) | |
| | (t-2) | 0.43*** | - | - | - |
| | | (0.14) | | | |
| Provisions for Loan Loses | | -0.12 | -0.15 | -0.32 | -0.23 |
| | | (0.14) | (0.14) | (0.21) | (0.21) |
| Reserve Requirements | | 0.04 | 0.05 | 0.01 | 0.01 |
| | | (0.05) | (0.05) | (0.05) | (0.05) |
| | (t-3) | 0.12*** | 0.13** | - | - |
| | | (0.04) | (0.05) | | |
| Market Share | | 0.16 | 0.27 | 0.46 | 0.54 |
| | | (0.47) | (0.47) | (0.77) | (0.78) |
| | (t-4) | 0.71* | 0.66 | - | - |
| | | (0.45) | (0.45) | | |
| LogAssets | | 4.59 | 2.07 | -0.001 | -0.001 |
| | | (11.18) | (11.29) | (0.001) | (0.001) |
| | (t-3) | 39.01*** | 39.10*** | - | - |
| | | (13.89) | (14.05) | | |
| | (t-4) | -28.32*** | -28.80*** | - | - |
| | | (10.07) | (10.20) | | |
| Intercept | | 43.98*** | 40.69*** | 1.10 | 1.29 |
| | | (10.12) | (9.54) | (3.89) | (4.18) |
| Observations | | 308 | 308 | 329 | 329 |
| Rbar sq | | 0.34 | 0.32 | 0.19 | 0.20 |

Note: ***, ** and * denote significance at 1%, 5% and 10%, respectively; Standard errors in parentheses.

Regulatory costs in both specifications are positive and significant (t-3) suggesting that the variation in reserves is correlated with the variation in interest rates and spread. Market power, theoretically, may have a positive impact on the lending rates. This is because the bank with high market share may monopolize the market in which smaller players are followers. Or in concentrated markets banks may collude in price setting at the expense of borrowers (market power hypothesis). On the other hand, the market may be concentrated because of the banks' superiority in efficiency and as such, this may be implicitly translated into lower interest rates and spreads (efficiency hypothesis). Our estimates for market concentration, as measured by the individual bank market share in total banking sector assets, suggest that higher concentration is positively correlated with higher lending rates. The variable enters with positive sign (t-4), however it should be interpreted with caution since it is statistically significant only in the first specification and at the 10% level.

To capture the economies of scale we introduced log of total assets. For example, as the size of the bank increases the economies of scale are exploited and borrowers benefit being charged lower interest rates (and spreads). The bank size proxy enters with positive sign (t-3) and is statistically significant at 1% level; while (t-4) with negative sign (see footnote 19). We find no evidence on the exploitation of economies of scale i.e., that larger banks, *ceteris paribus*, do not charge lower interest rates or spreads.

### 3.5. Concluding Remarks

Interest rates and spreads have been observed to be relatively high in Kosovo, namely in comparison with EU countries. Operational costs and provisions explain most of the intermediation costs. Indeed, according to the data collected, operational costs and provisions needs constitute a significant determinant of interest rates and spreads. It could be considered as a characteristic of a young banking sector, which has to cover its initial costs to expand its activities. It also evidences the global improvements to be expected in financial intermediation. Regarding the variation of interest rates, it seems that an increase of the funding costs (growth in the deposit rates) or an elevation of regulatory requirements (increase of liquidity reserve requirement) is almost entirely shifted into borrowers. On the contrary, and for the time being, a variation in provisions does not appear to lead immediately to an increase in interest rates and spreads, since an increase in provionning affects first the yearly net profit. Nevertheless, it could have an effect on the medium term.

All these comments shall be put in the perspectives with the characteristics of the local banking system, in which few banks operate, in which two large institutions holds more than two third of the marker share and exercise somehow a market power. Policies that favor an increase in competition in the banking sector may contribute to the reduction in intermediation costs. In the same way, cost rationalization and improvement in risk assessment techniques could encourage a reduction in interest rates.

Whatever competition could be, the best way to reduce interest rates in Kosovo, and considering that in the whole region they are much higher than in western Europe, is to decrease all the factors of uncertainty which incline bankers to maintain high protection needs, and consequently to request high margins. The ways how to reduce uncertainty are well known, but not so easy to implement at a large scale, at least on short term. This implies better performances in the judicial system, clarification of ownership and ability to take and enforce guarantees in all circumstances, improved and fair financial statements for companies, and better governance in both private and public sectors.

**Box 2. Decomposing intermediation costs**

Starting with bank income statement, where profit after taxes (P) is defined as interest income (II) plus noninterest income (NII), minus interest expenses (IE), minus operating cost (C), minus provision for loan losses (Pv), minus taxes paid (Tax) we have:

$$P = II + NII - IE - C - Pv - Tax$$

After rearranging this identity and dividing it by average loans (L) as scaling factor, and using average deposits (D), we have the following expression:

$$\frac{II}{L} - \frac{IE}{D} * \frac{D}{L} = \frac{C}{L} + \frac{Pv}{L} + \frac{Tax}{L} + \frac{P}{L} - \frac{NII}{L}$$

$$\frac{II}{L} - \frac{IE}{D} = \frac{IE}{D} * \frac{D}{L} - \frac{IE}{D} + \frac{C}{L} + \frac{Pv}{L} + \frac{Tax}{L} + \frac{P}{L} - \frac{NII}{L}$$

$$\frac{II}{L} - \frac{IE}{D} = \frac{IE}{L} * \left(1 - \frac{L}{D}\right) + \frac{C}{L} + \frac{Pv}{L} + \frac{Tax}{L} + \frac{P}{L} - \frac{NII}{L}$$

Given that: $D = R + L$ , R – required reserve and $1 - \frac{L}{D} = \frac{R}{D} = 10\%$ reserve requirement, we have:

$$\frac{II}{L} - \frac{IE}{D} = \frac{IE}{L} * 0.1 + \frac{C}{L} + \frac{Pv}{L} + \frac{Tax}{L} + \frac{P}{L} - \frac{NII}{L}$$

Multiplying the left hand side of the equation with factor A except for provisions and after rearranging the equation we have:

$$\frac{II}{L} + \frac{NII}{L} * A = \frac{IE}{D} + \frac{C}{L} * A + \frac{Pv}{L} * 0.95 + \frac{Tax}{L} * A + \frac{IE}{L} * A * 0.1 + \frac{P}{L} * A + \varepsilon$$

## 4. Statistical Appendix

Table 1.
**Kosovo of Balance of Payments, in EUR million**

| Description | 2004 | 2005 | 2006 |
|---|---|---|---|
| **1. CURRENT ACCOUNT** | **-313.2** | **-351.0** | **-389.3** |
| **A. Goods and services** | **-976.3** | **-1,050.1** | **-1,158.6** |
| 1. Goods | -967.0 | -1,015.9 | -1,141.2 |
| 2. Services | -9.2 | -34.2 | -17.5 |
| 2.1. Transportation | -48.0 | -47.7 | -49.6 |
| 2.2. Travel | -24.4 | -30.5 | -36.1 |
| 2.3. Communications | 11.7 | 7.1 | 28.3 |
| 2.4. Construction | -0.9 | -8.7 | -5.3 |
| 2.5. Insurance | -7.2 | -6.6 | -6.2 |
| 2.6. Financial services | -0.1 | -0.2 | -0.4 |
| 2.7. Computer and information | -3.5 | -4.8 | -4.4 |
| 2.8. Royalties and license fees | -0.2 | 0.0 | -0.2 |
| 2.9. Other business | -4.7 | -8.7 | -5.8 |
| 2.10. Personal, cultural and recreational | 0.0 | 0.0 | 0.0 |
| 2.11. Government | 68.1 | 65.9 | 62.2 |
| **B. Income** | **17.4** | **24.3** | **32.4** |
| 1. Compensation of employees | 15.0 | 18.0 | 15.7 |
| 2. Investment income | 2.4 | 6.2 | 16.7 |
| 2.1 Direct investment | -12.3 | -16.8 | -21.4 |
| 2.2 Portfolio investment | 5.3 | 16.3 | 23.8 |
| 2.3 Other investment | 9.4 | 6.8 | 14.3 |
| **C. Current transfers** | **645.7** | **674.9** | **737.0** |
| 1. Central government | 431.7 | 395.2 | 388.9 |
| 1.1 Other Donors | 169.1 | 138.0 | 185.0 |
| 1.2 UNMIK (Budget) | 262.6 | 257.2 | 203.9 |
| 2. Other sectors | 214.0 | 279.7 | 348.1 |
| 2.1 Workers' remittances | 162.9 | 227.5 | 293.4 |
| 2.1.1. Migrants abroad | 357.0 | 418.0 | 467.1 |
| 2.1.2. UNMIK staff- long term | -147.3 | -136.1 | -100.7 |
| 2.2 Other transfers | 51.1 | 52.2 | 54.7 |
| **2. CAPITAL AND FINANCIAL ACCOUNT** | **140.6** | **96.8** | **18.1** |
| **A. Capital account** | **2.4** | **2.0** | **3.2** |
| 1. Capital transfers | 2.4 | 2.0 | 3.2 |
| 2. Acquisition/disposal of non-produced, non-financial assets | 0.0 | 0.0 | 0.0 |
| **B. Financial account** | **138.2** | **94.8** | **14.9** |
| 1. Direct investment | 18.6 | 80.0 | 242.3 |
| In Kosovo | 18.6 | 80.0 | 242.3 |
| 1.1. Equity capital | 9.6 | 63.2 | 207.4 |
| 1.2. Reinvested earnings | 9.1 | 16.8 | 21.4 |
| 1.3. Other capital | 0.0 | 0.0 | 13.5 |
| 2. Portfolio investment | -162.2 | -67.8 | -127.7 |
| Assets | -162.2 | -67.8 | -127.7 |
| 2.1. Equity securities | 0.0 | 0.0 | 0.0 |
| 2.2. Debt securities | -162.2 | -67.8 | -127.7 |
| 4. Other investment | 283.6 | 110.6 | -104.6 |
| Assets | 227.9 | 44.6 | -175.6 |
| 4.1 Trade credits | 14.2 | 12.2 | 5.2 |
| 4.2 Loans | -11.7 | 6.9 | 0.4 |
| 4.3 Currency and deposits | 225.3 | 25.5 | -181.1 |
| 4.4 Other assets | 0.0 | 0.0 | 0.0 |
| Liabilities | 55.8 | 66.0 | 71.0 |
| 4.1. Trade credits | 49.2 | 51.9 | 62.8 |
| 4.2. Loans | 9.0 | 10.8 | 8.5 |
| 4.3. Currency and deposits | -2.4 | 3.4 | -0.2 |
| 4.4. Other liabilities | 0.0 | 0.0 | 0.0 |
| 5. Reserve assets | -1.8 | -28.0 | 4.9 |
| 5.4. Foreign exchange | -1.8 | -28.0 | 4.9 |
| **NET ERRORS AND OMISSIONS** | **172.6** | **254.2** | **371.1** |

Table 3.
**Trade Balance, in EUR million**

| Description | 2004 | 2005 | 2006 |
|---|---|---|---|
| **Exports** | | | |
| Live animals and animal products | 0.0 | 0.5 | 0.3 |
| Vegetable products | 2.6 | 2.9 | 5.1 |
| Animal or vegetable fats and oils - edible | 0.0 | 0.0 | 0.1 |
| Prepared foodstuffs, beverages and tobacco | 3.8 | 4.6 | 6.2 |
| Mineral products | 2.4 | 3.2 | 18.8 |
| Products of the chemical or allied industries | 1.0 | 1.2 | 1.2 |
| Plastics, rubber and articles thereof | 3.7 | 1.0 | 3.2 |
| Hides, skins, leather and articles thereof | 5.9 | 6.1 | 7.2 |
| Wood and articles of wood | 0.4 | 0.4 | 0.8 |
| Cellulosic material, paper and articles thereof | 0.4 | 0.4 | 0.7 |
| Textiles and textile articles | 1.4 | 0.6 | 0.7 |
| Footwear | 0.1 | 0.1 | 0.1 |
| Articles of stone, plaster, ceramic and glass | 1.8 | 0.4 | 0.7 |
| Pearls, precious, stones, metals, jewelry, etc. | 0.1 | 0.2 | 0.2 |
| Base metals and articles of base metal | 19.7 | 24.8 | 53.1 |
| Machinery, appliances, electrical equipment, etc | 9.2 | 6.5 | 7.7 |
| Transport means | 2.0 | 2.3 | 1.4 |
| Optical, medical and musical instruments | 1.1 | 0.4 | 0.3 |
| Arms and ammunition | 0.0 | 0.0 | 2.5 |
| Miscellaneous manufactured articles | 0.7 | 0.4 | 0.6 |
| Other | 0.5 | 0.3 | 0.0 |
| **Total** | **56.9** | **56.3** | **110.7** |
| **Imports** | | | |
| Live animals and animal products | 52.4 | 54.0 | 50.5 |
| Vegetable products | 68.1 | 57.2 | 73.0 |
| Animal or vegetable fats and oils - edible | 7.3 | 11.0 | 15.3 |
| Prepared foodstuffs, beverages and tobacco | 165.4 | 163.3 | 180.6 |
| Mineral products | 173.1 | 207.3 | 241.7 |
| Products of the chemical or allied industries | 98.0 | 91.1 | 107.7 |
| Plastics, rubber and articles thereof | 42.5 | 51.0 | 60.7 |
| Hides, skins, leather and articles thereof | 1.0 | 1.5 | 2.2 |
| Wood and articles of wood | 29.9 | 30.5 | 30.3 |
| Cellulosic material, paper and articles thereof | 33.4 | 23.5 | 27.6 |
| Textiles and textile articles | 31.2 | 35.9 | 45.1 |
| Footwear | 10.4 | 11.3 | 14.3 |
| Articles of stone, plaster, ceramic and glass | 54.9 | 51.5 | 57.0 |
| Pearls, precious, stones, metals, jewelry, etc. | 0.3 | 0.3 | 0.4 |
| Base metals and articles of base metal | 77.5 | 90.3 | 122.6 |
| Machinery, appliances, electrical equipment, etc | 116.8 | 129.2 | 153.3 |
| Transport means | 50.2 | 104.2 | 79.3 |
| Optical, medical and musical instruments | 15.1 | 15.3 | 14.3 |
| Arms and ammunition | 0.5 | 0.1 | 0.5 |
| Miscellaneous manufactured articles | 35.4 | 28.9 | 29.5 |
| Other | 0.0 | 0.1 | 0.1 |
| **Total** | **1,063.2** | **1,157.5** | **1,305.9** |

Source: UNMIK Customs Service and SOK.

Table 4.
**Trade Balance (by commodity groups), in EUR million**

| Description | 2004 | 2005 | 2006 |
|---|---|---|---|
| **Balances** | | | |
| Live animals and animal products | -52.4 | -53.6 | -50.1 |
| Vegetable products | -65.6 | -54.4 | -67.9 |
| Animal or vegetable fats and oils - edible | -7.3 | -11.0 | -15.3 |
| Prepared foodstuffs, beverages and tobacco | -161.6 | -158.7 | -174.4 |
| Mineral products | -170.6 | -204.1 | -222.9 |
| Products of the chemical or allied industries | -96.9 | -89.9 | -106.6 |
| Plastics, rubber and articles thereof | -38.8 | -50.0 | -57.5 |
| Hides, skins, leather and articles thereof | 4.9 | 4.6 | 5.1 |
| Wood and articles of wood | -29.5 | -30.1 | -29.5 |
| Cellulosic material, paper and articles thereof | -33.0 | -23.2 | -26.9 |
| Textiles and textile articles | -29.8 | -35.3 | -44.4 |
| Footwear | -10.2 | -11.1 | -14.2 |
| Articles of stone, plaster, ceramic and glass | -53.1 | -51.1 | -56.3 |
| Pearls, precious, stones, metals, jewelry, etc. | -0.1 | 0.0 | -0.2 |
| Base metals and articles of base metal | -57.7 | -65.5 | -69.5 |
| Machinery, appliances, electrical equipment, etc | -107.6 | -122.7 | -145.7 |
| Transport means | -48.2 | -101.9 | -77.9 |
| Optical, medical and musical instruments | -13.9 | -14.9 | -14.0 |
| Arms and ammunition | -0.5 | -0.1 | 2.0 |
| Miscellaneous manufactured articles | -34.7 | -28.6 | -28.9 |
| Other | 0.5 | 0.3 | -0.1 |
| **Total** | **-1,006.2** | **-1,101.2** | **-1,195.1** |

Source: UNMIK Customs Service and SOK.

Table 5.

**Adjustments to Trade in Goods, in EUR million**

| Description | 2004 | 2005 | 2006 |
|---|---|---|---|
| **Exports** | | | |
| Overseas trade statistics (f.o.b.) | 56.5 | 56.3 | 110.8 |
| Coverage adjustments | | | |
| Other adjustments[1] | 0.4 | 0.0 | 0.0 |
| Total coverage adjustments | **0.4** | **0.0** | **0.0** |
| **Total** | **56.9** | **56.3** | **110.8** |
| **Imports** | | | |
| Overseas trade statistics (c.i.f.) | -1,063.2 | -1,117.5 | -1,305.9 |
| of which from neighboar countries[2] | 330.7 | 401.3 | 475.6 |
| Coverage adjustments | | | |
| Donor import[3] | -5.0 | 0.0 | 0.0 |
| Unrecordet imports | n/a | n/a | n/a |
| Electricity (tranzit and other adjustments) | -3.4 | -1.2 | 0.0 |
| Total coverage adjustments | -8.4 | -1.2 | 0.0 |
| Clasification adjustments | | | |
| Freight | 36.6 | 35.8 | 41.5 |
| Insurance | 11.0 | 10.7 | 12.5 |
| Total clasification adjustments | 47.6 | 46.5 | 54.0 |
| Other adjustments | | | |
| Goods for procesing | 0.0 | 0.0 | 0.0 |
| Repairs on goods | 1.0 | 0.0 | 0.0 |
| Total other adjustments | 1.0 | 0.0 | 0.0 |
| **Total** | **-1,023.0** | **-1,072.1** | **-1,251.9** |

**1/** Other adjustments includes export of electricity based on data received directly by KEK. Starting from 2005 the amount of export for electricity is included in SOK trade statistics.

**2/** Imports from Albania, FRY Macedonia, Serbia and Montenegro.

**3/** Donor Imports are not included in the second half of 2004.

Source: UNMIK Customs Service, SOK and CBAK.

Table 6.
**Services, in EUR million**

| Description | 2004 | 2005 | 2006 |
|---|---|---|---|
| **Credit** | | | |
| Transport | 24.2 | 24.3 | 25.0 |
| Travel | 26.6 | 25.9 | 25.8 |
| Communications services | 27.0 | 31.0 | 48.2 |
| Construction services | - | - | - |
| Insurance services | 6.6 | 7.1 | 9.4 |
| Financial services | - | - | - |
| Computer and information services | - | - | - |
| Royalties and license fees | - | - | - |
| Other business services | 0.2 | 0.3 | 0.3 |
| Personal, cultural, and recreational services | - | - | - |
| Government services, n.i.e. | 70.9 | 68.8 | 65.2 |
| **Total** | **155.4** | **157.4** | **174.0** |
| **Debits** | | | |
| Transport | (72.1) | (71.9) | (74.6) |
| Travel | (51.0) | (56.4) | (61.9) |
| Communications services | (15) | (24) | (20) |
| Construction services | (0.9) | (8.7) | (5.3) |
| Insurance services | (14) | (14) | (16) |
| Financial services | (0.1) | (0.2) | (0.4) |
| Computer and information services | (3.5) | (4.8) | (4.4) |
| Royalties and license fees | (0.2) | 0.0 | (0.2) |
| Other business services | (4.9) | (9.0) | (6.1) |
| Personal, cultural, and recreational services | - | - | - |
| Government services, n.i.e. | (2.8) | (2.9) | (3.0) |
| **Total** | **-164.6** | **-191.6** | **-191.5** |
| **Balance** | | | |
| Transport | -48.0 | -47.7 | -49.6 |
| Travel | -24.4 | -30.5 | -36.1 |
| Communications services | 11.7 | 7.1 | 28.3 |
| Construction services | -0.9 | -8.7 | -5.3 |
| Insurance services | -7.2 | -6.6 | -6.2 |
| Financial services | -0.1 | -0.2 | -0.4 |
| Computer and information services | -3.5 | -4.8 | -4.4 |
| Royalties and license fees | -0.2 | 0.0 | -0.2 |
| Other business services | -4.7 | -8.7 | -5.8 |
| Personal, cultural, and recreational services | 0.0 | 0.0 | 0.0 |
| Government services, n.i.e. | 68.1 | 65.9 | 62.2 |
| **Total** | **-9.2** | **-34.2** | **-17.5** |

Table 7.
**Income, in EUR million**

| Description | 2004 | 2005 | 2006 |
|---|---|---|---|
| **Credit** | | | |
| Compensation of employees | 26.9 | 27.0 | 26.6 |
| Investment income | 15.4 | 24.5 | 40.5 |
| **Total** | **42.3** | **51.5** | **67.1** |
| **Debit** | | | |
| Compensation of employees | -11.9 | -8.9 | -10.9 |
| Investment income | -13.0 | -18.3 | -23.8 |
| **Total** | **-24.9** | **-27.3** | **-34.7** |
| **Balance** | **17.4** | **24.3** | **32.4** |

Table 8.
**Current Transfers, in EUR million**

| Description | 2004 | 2005 | 2006 |
|---|---|---|---|
| **Credit** | | | |
| Central government | 431.7 | 395.2 | 388.9 |
| Other transfers | 426.7 | 489.3 | 538.3 |
| **Total** | **858.4** | **884.5** | **927.2** |
| **Debits** | | | |
| Central government | 0.0 | 0.0 | 0.0 |
| Other transfers | -212.7 | -209.6 | -190.2 |
| **Total** | **-212.7** | **-209.6** | **-190.2** |
| **Balance** | **645.7** | **674.9** | **737.0** |

Table 9.
**Capital Account, in EUR million**

| Description | 2004 | 2005 | 2006 |
|---|---|---|---|
| **Credit** | | | |
| Capital transfers | 2.4 | 2.0 | 3.2 |
| Acquisition/disposal of nonproduced nonfinancial assets | 0.0 | 0.0 | 0.0 |
| **Total** | **2.4** | **2.0** | **3.2** |
| **Debits** | | | |
| Capital transfers | 0.0 | 0.0 | 0.0 |
| Acquisition/disposal of nonproduced nonfinancial assets | 0.0 | 0.0 | 0.0 |
| **Total** | **0.0** | **0.0** | **0.0** |
| **Balance** | **2.4** | **2.0** | **3.2** |

Table 10.
**Financial Account (by instruments), in EUR million**

| Description | 2004 | 2005 | 2006 |
|---|---|---|---|
| **Kosovos investment abroad (Kosovos assets = net debits)[1]** | | | |
| **Direct investment abroad** | | | |
| Equity capital | n/a | n/a | -4.3 |
| Reinvested earnings | n/a | n/a | n/a |
| Other capital transactions | n/a | n/a | n/a |
| Total direct investment abroad | 0.0 | 0.0 | -4.3 |
| **Portfolio investment abroad[2]** | | | |
| Debt securities | -162.2 | -67.8 | -127.7 |
| Total portfolio investment abroad | -162.2 | -67.8 | -127.7 |
| **Other Investments abroad (Kosovos assets = net debits)[3]** | | | |
| Trade credit | 14.2 | 12.2 | 5.2 |
| Loans | -11.7 | 6.9 | 0.4 |
| Currency and deposits | 225.3 | 25.5 | -181.1 |
| Other assets | 0.0 | 0.0 | 0.0 |
| Total other Investments abroad | 227.9 | 44.6 | -175.6 |
| **Reserve assets** | | | |
| Foreign Exchange | -1.8 | -28.0 | 4.9 |
| Total reserve assets | -1.8 | -28.0 | 4.9 |
| **Total** | **63.8** | **-51.2** | **-302.7** |
| | | | |
| **Investments in Kosovo (Kosovos liabilities = net credits)** | | | |
| **Direct investment in Kosovo** | | | |
| Equity capital | 9.6 | 63.2 | 211.7 |
| Reinvested earnings | 9.1 | 16.8 | 21.4 |
| Other capital transactions | 0.0 | 0.0 | 13.5 |
| Total direct investment in Kosovo | 18.6 | 80.0 | 246.6 |
| **Portfolio investment in Kosovo** | | | |
| Total portfolio investment abroad | **0.0** | **0.0** | **0.0** |
| **Other Investments in Kosovo (Kosovos liabilities = net credits)** | | | |
| Trade credit | 49.2 | 51.9 | 62.8 |
| Loans | 9.0 | 10.8 | 8.5 |
| Currency and deposits | -2.4 | 3.4 | -0.2 |
| Total other Investments in Kosovo | 55.8 | 66.0 | 71.0 |
| **Total** | **74.4** | **146.0** | **317.6** |
| | | | |
| **Net transactions (net credits less net debits)** | | | |
| **Direct investment** | | | |
| Equity capital | 9.6 | 63.2 | 207.4 |
| Reinvested earnings | 9.1 | 16.8 | 21.4 |
| Other capital transactions | 0.0 | 0.0 | 13.5 |
| Total net direct investment | 18.6 | 80.0 | 242.3 |
| **Portfolio investment** | | | |
| Debt securities | -162.2 | -67.8 | -127.7 |
| Total net portfolio investment | -162.2 | -67.8 | -127.7 |
| **Other Investments** | | | |
| Trade credit | 63.4 | 64.1 | 68.0 |
| Loans | -2.7 | 17.7 | 8.8 |
| Currency and deposits | 222.9 | 28.9 | -181.4 |
| Other assets | 0.0 | 0.0 | 0.0 |
| Total net other investment | 283.6 | 110.6 | -104.6 |
| **Reserve assets** | | | |
| Foreign Exchange | -1.8 | -28.0 | 4.9 |
| Total reserve assets | -1.8 | -28.0 | 4.9 |
| **Total** | **138.2** | **94.8** | **14.9** |

1/ Increase in assets and decrease in liabilities are recorded with sign minus, whereas decrease in assets and increase in liabilities are recorded with the sign plus.
2/ The asset side of portfolio investments includes resident transactions in securities issued by non-residents, whereas the liabilities side records the opposite.
3/Since Kosovo use Euro currency as a legal tender, this is considered as a foreign asset and in this sense Cash held by the CBAK is considered as investment in Kosovo. The same is applicable to ODC.

Table 11.
**Financial Account (by sectors), in EUR million**

| Description | 2004 | 2005 | 2006 |
|---|---|---|---|
| **Investments abroad** | | | |
| Monetary authority (CBAK) | 104.3 | -47.7 | -242.3 |
| Other Depository Corporations | -65.5 | -9.0 | -47.5 |
| Central government | -0.7 | 3.5 | 1.0 |
| Other sectors | 25.7 | 2.0 | -13.9 |
| **Total** | **63.8** | **-51.2** | **-302.7** |
| **Investments in Kosovo** | | | |
| Monetary authority (CBAK) | 4.9 | -2.1 | -3.0 |
| Other Depository Corporations | 17.1 | 29.1 | 57.1 |
| Central government | 0.0 | 0.0 | 0.0 |
| Other sectors | 52.4 | 119.0 | 263.5 |
| **Total** | **74.4** | **146.0** | **317.6** |
| **Total Investment** | | | |
| Monetary authority (CBAK) | 109.2 | -49.8 | -245.3 |
| Other Depository Corporations | -48.4 | 20.1 | 9.6 |
| Central government | -0.7 | 3.5 | 1.0 |
| Other sectors | 78.1 | 121.0 | 249.6 |
| **Total** | **138.2** | **94.8** | **14.9** |