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MASTER'S THESIS

THE ANALYSIS OF THE DETERMINANTS OF FINANCIAL AND ECONOMIC DEVELOPMENT IN KOSOVO

Ljubljana, January, 2015 DUKAGJIN SHYLEMAJA

AUTHORSHIP STATEMENT

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INTRODUCTION

1 BACKGROUND OF THE STUDY

Kosovo declared its independence on February 2008, and so far has been recognized by approximately 100 countries (Ministry of Foreign Affairs, 2013 Republic of Kosovo). Even though United Nations (hereinafter: UN), the Organization for Security and Cooperation in Europe (hereinafter: OSCE) are present, Kosovo is not a member of any of the organizations. Political system in Kosovo is that of a parliamentary democracy, namely, the assembly is the primary legislative institution directly elected for four-year terms. Kosovo has declared its intentions toward EU integration and now has signed Stabilization and Association Agreement (hereinafter: SAA). Kosovo currently has no heavy armed defense army, while NATO, KFOR, and EU's rule of law mission in Kosovo, EULEX, make the security and defense bodies in Kosovo (European Commission, 2012, Feasibility Study for a Stabilization and Association Agreement between the European Union and Kosovo).

Judiciary system in Kosovo faces many drawbacks and challenges starting from its independence, effectiveness and accountability. In addition to a lack of security and protection for judges, witnesses and prosecutors, there is also a lack of professional staff and corruption is present in the judicial sector. According to the Feasibility Study for a Stabilization and Association Agreement between the EU and Kosovo, conducted in 2012 by the European Commission, the enforcement of judgments, in civil and criminal cases, is assessed as weak.

The goal of this master thesis is to analyze the main characteristics of the banking system of Kosovo. We will analyze the banking system, the activities of commercial banks, and the market they operate on. We will also evaluate the impact that the financial crisis had on Kosovo's banking sector and Kosovo's economic development.

The master thesis gives a more detailed analysis on the structure of the banking system in Kosovo, licensed commercial banks and a history of their activities, and an analysis on the structure of assets, loans, deposits, interest rates, financial ratios and other important indicators. Moreover, this master thesis analyzes the risks of the banking sector and some of the latest regulatory measures, the problem of asymmetry of information and interest rates trends, the structure of new and existing businesses in Kosovo and the business environment in general. The most important part is to find out the reasons why Kosovo banks are not diversifying their activities in various industries but rather get involved in trade crediting and construction business.

This master thesis aims to explore the data available on the banking sector in Kosovo and analyze the development of the production sector; identify the factors that determine interest rates in Kosovo which can be macroeconomic factors such as inflation, budget deficits, bank or market specific factors or institutional factors. In general, interest rates are driven by different factors with political and economic stability being the most important ones.

In the first chapter, this master thesis gives an overview of Kosovo's current economic and political situation and describes a short history of main financial sector developments throughout the years. In the second chapter, this master thesis also contains a literature review section to discuss the issue of judicial efficiency, investor protection and their impact on the economic development and growth of a country and specifically its impact to the level of interest rates in a country. This master thesis evaluates the role of contract enforcements for economic development in developing countries. It is believed that banks charge higher interest rates when their lending activity is concentrated in countries with weak enforcement of legal contracts. The objective of chapter three is to understand the working environment for Kosovo banks, the risks they face, rule of law, role of institutions, and investor protection. Chapter four talks briefly about the global financial crisis and its origins. It analyzes the impact that the global financial crisis had on Kosovo, focusing more in Foreign Direct Investments (hereinafter: FDI), remittances, and other important factors.

2 LITERATURE REVIEW: DETERMINANTS OF FINANCIAL AND ECONOMIC DEVELOPMENT

The country composition and structure, including its legal and economic situation are key determinants of the level of debt financing for companies as a means of growth. However, different countries impose different laws and regulations, and as such, have different law enforcement levels. This, to a large extent, provides the means of security for creditors and investors in a country's economy. During the past decades, we have observed different financial crises and situations that have affected and shifted the structure of financing of firms operating in countries throughout the world. Creditors' and investors' motivations to invest in a firm or country depend highly on how protected they will be and how strongly the enforcement of contracts is going to take place.

Various scholars, such as La Porta, Lopez-de-Silanes, Shleifer, and Vishny, Bay and Goyal, Demirguc-Kunt and Maksimovic, Laeven and Manjoni, which will be discussed throughout this chapter, have created models to test whether different variables and indicators, such as the creditor and shareholder rights, property rights, efficiency of the judiciary system, composition of the market economy of the banking sectors (pure competition versus monopoly), credit costs and others, inflation, industry, and other variables influence the amount of debt financing, the loan size, its maturity, loan spread, interest rate spreads and the decision to invest in a firm.

2.1 Legal determinants

A good investment climate in a country is often a result of a good judicial system, leading to lower interest rates. Investors feel more protected if the judicial system is transparent and effective. In this case, the recovery of a loan is more likely to happen and banks are faster to collect collateral and recover larger amounts of loans, which leads to further bank lending. However, the Laeven and Manjoni (2003) explain that even though there exists strong evidence (La Porta et al., 1997; Demirguc-Kunt & Maksimovic, 1998; and Galindo, 2001) of a correlation between the judiciary system and the level of the external finance, there are no clear situations analyzed that would explain the cost of the finance involved in this case (Laeven & Manjoni, 2003, p. 18).

2.1.1 Investor protection

La Porta, Lopez-de-Silanes, Shleifer, and Vishny (1998) discuss legal rules that protect corporate shareholders and creditors in 49 countries. The correlation between the ownership of large public companies and the investor protection is elaborated. The authors argue that despite the fact 'that securities are recognized by their cash flows, where debts have the promised flow of interest and equities enable its owners to acquire dividends' (La Porta, 1997, p. 3) securities are explained by more than just the money flows but also by the rights that securities bring to their owners. Critical issues rise up when the company managers act in their own interest leading to difficulties for the company to raise external financing. The incentive for investors (shareholders) to invest in a company, at this point, is that they receive dividends and have the right to vote out directors. Creditors get paid because they exercise the power to repossess collateral. The authors continue to argue that even though security holders are entitled to specific rights, it is not necessary that they will possess the same rights in different jurisdiction areas where securities were issued. As such, they claim that some of the traditional views on securities are incomplete. Djankov et al. (2008) point out the importance to evaluate the significance of private enforcement versus public enforcement of securities that protect investors.

Considering the legal protections for investors throughout the world, La Porta et al. (1998) explain that the differences in the legal protections determine how firms are financed so differently in different jurisdiction areas. In recent years, economists have examined the costs and benefits of alternative legal rules regarding the rights of investors. Additionally, there are no systematic data on the different laws and their enforcement in different countries (Galindo 2001, p. 17). However, La Porta et al. (1998) explain the investor rights law patterns in 49 countries and their differences.

To explain this pattern, La Porta et al. (1998) suggest that most laws come from few legal families or traditions, such as the common and the civil law. Civil tradition is composed of three families: French, Scandinavian, and German, which have spread around the world through "imitation, imperialism and outright borrowing" (La Porta et al., 1998, p. 5).

Through this example, the authors explain the comparison of laws in different countries. The authors compile data on the investor laws and their enforcement in 49 countries that have publicly traded companies operating in their countries. For shareholders, for the purpose of the analysis, some of the rules which were examined by the authors cover voting powers, easiness of participating in corporate voting, and legal protections against expropriation by management. On the other hand, for creditors, the authors have considered the key creditor's rights which cover the basic right for security of the loan, the ability to grab assets in case of a loan default, and the inability of management to seek protection from creditors unilaterally (La Porta et al., 1998, p. 5).

Aiming to describe the easiness for the shareholders to exercise their power against company management, when comparing the data, the authors concluded that differences in the laws depend on their origin, where civil laws gave investors less legal rights compared to the common laws. Furthermore, authors suggest that countries with poor laws and poor reinforcement could add mandatory distribution of capital to investors in order to increase investor protection.

High ownership concentration may offer incentives for managers to work while a dispersion of ownership may diversify the risk. According to Shleifer and Vishny (1997), a high ownership concentration could lead to the belief that there is little investor protection.

Bay and Goyal (2009) further explain that banks and lenders respond to a financial crisis by changing their issuance strategic planning. This happens mostly in countries with weak protection of creditors. Furthermore, the authors mention that the level of enforceability of the contracts is of higher value than the creditor rights that influence the loan contracting. The paper starts with the description of the data used in the model. The variables used include the amount of loan, the time loans were issued (1994 – 2003), and the property rights protection (corruption, risk of expropriation from private property, and the risk that contracts may be disclaimed). Corruption may affect the view of the investors towards a particular country negatively since it reduces the government and business efficiency. According to the findings, countries react to different legal systems differently. Some industries experience different results compared to others. The enforcement in this case is most important to foreign banks compared to local banks. But this issue is debatable and the effect of foreign lenders is not very clear.

2.1.2 Legal families

La Porta et al. focus also on the roots of the laws and their characteristics that define laws. Moreover, they discuss the history and influences of the laws in different countries. Usually scholars have defined legal families as those that entail a historical background and legal system, working methodology of jurists, legal institutions and other legal characteristics. Based on these, scholars have identified two traditions of law: civil and common law. The civil law, the oldest law, has always relied on scholars' research to formulate the rules and these laws usually contain three families: French, German and Scandinavian. French law, according to La Porta et al., has been the most influential law since it was written during the Napoleon area and has had an extended influence among Europe. Out of the sample analyzed, 21 countries apply laws in the French civil tradition (La Porta et al., 1998, p. 27).

La Porta et al. (2008) explicate that countries which have a French legal origin regarding tax administration have higher numbers of tax payments in comparison to other legal traditions. Authors claim that the difference between the common and civil law is since the civil law encourages private solutions to a problem, thus reducing the costs.

On the other hand, the German Commercial Code was written during Bismarck's area and some of the Asian countries adopted it in their legal system. Six countries in the sample are of this family of laws. Also, the Scandinavian codes are not as practical anymore thus leaving La Porta et al. (1998) with only 4 countries to use for the sample (La Porta et al., 1998, p. 21).

The common law family consists of the laws of England which are created from models of jurisdiction decisions. Here, the judges resolve disputes and it is spread in the countries that Britain colonized, such as USA, Canada, Australia, India, etc. The sample includes 18 countries where laws are based on the common law tradition (from the total 49 countries analyzed).

2.1.3 Legal rules

For the sake of the study, La Porta et al. have focused mainly on the laws that are related to investor protection and the bankruptcy/regulations laws with focus on the relation between the company vs. investors and creditors. However, there is little data about the merger and take over rules, which have experienced several changes in Europe and belong to company

laws, anti-trust laws, security laws, stock exchange laws, and banking regulations (La Porta et al. 1998, p. 11).
In addition, there is little information on the disclosure rules which belong to the same laws as the merger and takeover rules leaving out the usage of the security exchange and banking and financial institution regulations.

As La Porta et al. (1998, p. 13) explain, countries have many differences in the investor protection rules these differences can lead to different investment patterns for various countries. The authors are skeptical that some of the firms may opt out some of the rules even though this may be costly for them to do so since investors may not accept these non-standard contracts. They argue that more restrictive rules can protect the shareholders better. La Porta et al. (1998) also argue that more flexible rules have their benefits as well. In addition, some countries may impose regular rules first and then adjust them accordingly to protect themselves. Also, countries mostly have adopted their legal system involuntarily.

Laeven and Manjoni (2003) analyze the relationship between loan spreads and the quality of the countries' legal systems. They encountered difficulties in their research because countries did not keep records of the comparable average rates on loans. Also annual reports of some banks did not match the data reported from the official institutions (such as the Bankscope). They analyze the role of the property rights and the rule of law in the countries, inflation rates, level of liquidity required, and levels of economic development. To determine whether the countries with better judicial systems have lower interest rates, regression analysis with correlation among variables is performed. The results confirm that there is a high correlation between the judicial system and interest rate spreads. However, bank concentration and the presence of a public credit register do not have a correlation with the banks' spread.

Demirgüç-Kunt and Maksimovic (1998) use another index as a variable which describes country reliance on legal systems to resolve disputes. This is considered a good indicator to describe the use of long-term debt even though it may be misleading because companies cannot compensate the lack of certain legal protection areas. Another variable used in the financial model is the government intervention through subsidies and grants which may prevent free movement of the market because of the distortions it may create through the government financial incentives for particular sectors.

2.2 Shareholder rights

In most cases, the main focus of the shareholder rights encompasses the voting rights and dividends. If shareholder rights are linked to the dividends, shareholders have bigger control of the company because they have substantial ownership of its cash flow. The principal one-share-one-vote is not always honored and countries can have different types of shares issued, such as shares without voting rights, high voting and low voting shares. Also, companies can restrict the number of votes a shareholder can exercise. La Porta et al. (1998, p. 15) explain how some countries have laws that require shareholders to be present when voting, while in some countries shareholders can mail their voting preference.

Some countries oblige that shareholders deposit their shares prior to shareholders meetings until few days after so that shareholders are not able to sell the shares. On the other hand, some countries allow for cumulative voting for directors enabling the minority shareholders to have a bigger representation on the board of directors. Aside from these rights, some countries give the right to minority shareholders to take directors' decision to court. Furthermore, La Porta et al. (1998, p. 16) argue that some countries allow shareholders to buy new issues of stock usually at prices below market for favored investors. Also, the higher the percentage is to call an extraordinary meeting, the harder it is for the minority shareholders to challenge the management.

Results suggest that most countries do not favor outside shareholders as 22 percent of the countries analyzed have one-share one-vote. About 27 percent give minorities a right of proportional board representation and 18 percent permit voting by mail. About 53 percent have some oppressed minorities mechanism and only 53 percent give minority shareholders a right to buy new shares. These findings are indicators that generally legal environment is not strongly protective for all the shareholders, especially for the minority shareholders (La Porta et al. 1998, p. 17).

The other tables used to describe the findings suggest that the law origin matters for most countries. Some of the legal family variables used, such as one-share one-vote and cumulative voting are very similar among the countries analyzed while the differences for the other variables are more considerable. Common law countries favor highly the shareholder protection. Their regulations protect the shareholders in most of the areas except for the right to buy new issued shares. Overall, these countries offer the best incentives for investors. To elaborate the findings further, French civil law countries showed the worst protection for the shareholders. These findings indicate that there is a big difference between the civil law and common law countries with respect to the shareholder protection (La Porta et al., 1998, p. 14).

La Porta et al. (1998) explain that German civil law does not offer much protection either. These findings mostly suggest that the major differences arise when the law origin is compared across countries. They also analyze countries based on the per capita income levels but the findings do not change in initial results.

Djankov et al. (2008) calculate an anti-self-dealing index, to predict various stock market outcomes, for 72 countries focusing on private enforcement measures to managing a specific self-dealing transaction. Authors explain that the rights of shareholders to vote on self-dealing transactions are important and argue that this index is better than the index of anti-director rights constructed by La Porta et al. (1997, 1998). The anti-self-dealing index is greater in common law countries than in those of French civil ones. Djankov et al. (2008) explain the effects of their findings in regards to measurement of shareholder protection, interpretation of legal origin, and design of regulatory strategies.

2.2.1 Creditor rights

In general, creditor protection laws are more complex relative to the laws that guarantee shareholder rights because different incentives are involved. There are different types of creditors whose interests may diverge when it comes to bankruptcy. Some of the senior creditors will get their collateral despite what happens in the firm while other creditors could hope for the firm to recover in order to become profitable so that they can retrieve money from the profit (Galindo 2001, p. 8).

Djankov et al. (2007) look at creditor protection through the efficiency of debt enforcement. La Porta et al. (1998) analyze the two methods involved with a defaulting firm; liquidation and reorganization. The authors analyze the rights of senior secured creditors, where the most basic right is the one of collecting collateral in case of a defaulted loan. The difference between the two strategies, liquidation vs. reorganization, is the outcome of liquidation for the society which is perceived as socially adverse. Five variables are used in the analysis. Some organizations, when reorganizing, use the right of stay on firm assets which prevents creditors from recollecting the assets. This right gives more power and protection to managers and unsecured creditors. Other countries allow secured creditors to collect their assets for possession when the firm is being reorganized before the reorganizing is finished. Another variable is related to the right to collateral for the secured creditors when reorganizing. This leaves the secured creditors without the right to possess collateral when reorganization is occurring (La Porta et. al, 1998, p. 22).

Firm management may be entitled to the rights to call for reorganization without secured creditors' approval (this is exercised in the US). Other countries have stricter rules to filing for reorganization. Additionally, management has the power to maintain the status quo by keeping the resolution of reorganization procedures on hold (La Porta et al., 1998, p. 23).
La Porta et al. (1998) illustrate that most firms in most countries are obliged to keep a fair level of capital to avoid liquidation. Overall, it seems that countries more frequently protect creditors relative to shareholders. As in the case of shareholders, the law origin matters when protecting creditors.

Countries with common law are considered to offer better protection for creditors than countries with civil law even though German civil law countries offer higher protection for some of the measures used by La Porta et al. (1998, p. 24). An interesting finding is that the protection of creditors is higher in poorer countries due to the need for secured lending due to the lack of other financial opportunities.

The tests from Bae and Goyal (2009) show that there is little evidence to demonstrate that loan volumes were affected by the changes in the creditor right effectiveness and changes in the property rights protection during the crisis period. One of the variables most affected is the loan maturity, which decreased during the financial crisis for the East Asian countries. On the other hand, during the crisis period, banks reacted through increasing the interest rate spread. To summarize the findings, contract enforceability and behavior of loan contractors due to differences in creditor rights are considerably higher during financial crises when monitoring and re-contracting costs are of great significance to lenders. In addition to these findings, the tests show that creditor rights matter only for loan spreads. Countries with different creditor rights do not necessarily have differences in loan size and maturity. The major differences come as a result of differences in the enforcement of contracts where countries with weaker enforcement contracts have different loan policies.

2.3 Law enforcement

Bae and Goyal (2009) examine the situation in 48 countries to determine whether the differences in their legal systems have an effect on the loans issued to borrowers. As observed, loan maturity and age depend on the level of enforceability of the contract at a significant level. Poor enforcement affects the banks directly which affects the structure and the price of a loan.

To analyze the strength of law enforcement in selected countries, La Porta et al. (1998, p. 25) have used five variables; “efficiency of the judicial system, rule of law, corruption, risk of expropriation meaning outright confiscation or forced nationalization by the government, and likelihood of contract repudiation by the government”.

A strong rule of enforcement in a country may sometimes substitute for weak protection of investors. Furthermore, the authors analyze the accounting standards because of its role in the corporate governance. These standards oblige firms and investors to obey the laws through financial contracting.

Law enforcement, among a set of other controls, has an important role in measuring the size of credit market (Galindo & Micco, 2001). The paper from La Porta et al. (1998)

states that Scandinavian countries are ranked at the top for the law enforcement and country differences are a result of different legal families. The findings though do not support the logic that qualitative law enforcement replaces the quality of law. Findings also show that richer countries encompass higher quality law enforcement.

La Porta et al. (1998, p. 27) test the idea that countries with poor investor protection have a higher concentration of ownership of shares. This happens because the shareholders need more capital to monitor the managers and because investors may desire to buy corporate shares at low prices which decrease the incentive for the company to issue shares. Higher concentration replaces the poor shareholder protection in a country. The French civil law countries show the highest concentration of ownership of shares with German civil law countries having the lowest. Most common law countries are in the middle. The results show that ownership concentration can replace the poor protection of investors.

La Porta et al (1998, p. 28) concluded that countries that had better accounting standards had lower percentage of ownership concentration. However, countries with higher ownership concentration incur costs, such as undiversified core investors and low chances of raising equity financing from minority investors because of the fear of expropriation by managers.

Law enforcement is different around the world depending on their applied legal system. It is found to be strongest in Scandinavian countries and German civil law countries, followed by common law countries while it is the weakest in the French civil law countries. Countries tend to create substitute mechanisms to replace the poor investor protection, such as increasing the concentration of ownership of shares within a corporation (La Porta et al. 1998, p. 34).

One of the main ideas posed is whether the low level of investor protection can hurt countries. King and Levine (1993) and Levine and Zervos (1997) have argued that debt and equity markets add to economic growth while La Porta et al. (1997) argue that countries with poorer investor protection have smaller debt and equity markets.

Demirgüç-Kunt and Maksimovic (1998) analyze the differences in legal and financial systems among countries and their level of external financing. Demirgüç-Kunt and Maksimovic (1998) explain that countries with a higher score on the efficiency index have a higher level of long term external financing because corporations in these industries have lower profit rates. Furthermore, the authors explain that market imperfections, such as informational asymmetries influence that companies acquire less external financing. The paper reviews literature to explain if the underdevelopment of the legal and financial systems mitigates the corporations' opportunities for growth through external financing.

Demirgüç-Kunt and Maksimovic (1998) made comparisons between 30 developed and developing countries, by estimating a predicted rate at which firms can grow if they rely on retained earnings and short-term credit only. They suggest that an effective legal system is crucial for both creditors and investors in order to have a developed financial market because investors have to rely on the legal system in order to control any opportunistic behavior by firm managers (Demirgüç-Kunt & Maksimovic 1998, p. 2108). An effective legal system and law enforcement can prevent violations from corporate insiders, which lead investors and creditors to increase their investments and lending. This increases opportunities for firms to raise their capital.

In addition, developed financial markets and a sustainable stock market diminish the company's internal capital because it allows the company to increase external funding. Demirgüç-Kunt and Maksimovic (1998) explain that several scholars have researched on this topic by comparing the financial status of developed and developing countries to determine their capacity to increase the level of debt and equity while the sole purpose of this paper is to elaborate if there is a link between the financial and legal systems and institutions and their capacity to obtain debt and equity financing (Demirgüç-Kunt & Maksimovic 1998, p. 2109).

Bae and Goyal (2009); Jappelli, Pagano and Bianco (2001), discuss the relevance of the cost of enforcing contracts to the credit market through a model which includes the model of opportunistic debtors and inefficient courts. The prediction is that through increased enforcement of contracts, the lending will increase as a consequence but it affects the interest rates by a fair amount depending on the type of the court system. The data used in this model includes only the Italian provinces.

2.3.1 Size of firms and financial development

A financial model is used by Demirgüç-Kunt and Maksimovic (1998, p. 2109) to explain the differences and arguments supporting their thesis. There is another phenomenon that seems to be evident. Not all sizes of firms are affected equally by the established financial markets and legal systems. Those companies that are able to increase their capital through internal retained earnings, they are affected the least. At this point, those companies that have limited resources for growth and do not have access to external financing are constrained.

Also the level of the investment and the amount of cash flow makes a huge difference whether the company is operating in capital-intensive industries. If a firm is operating in a market that is not developed, new entry companies that require high capital for investment may not be able to achieve it through internal financing due to its growth stage and market structure. However, in a developed country with an efficient competition, companies whose technology is capital intensive may have internal sources to finance their growth relative to developing countries which have market imperfections.

On the other hand, according to Demirgüç-Kunt and Maksimovic (1998), companies that operate in developing countries face higher costs for external financing due to the high insecurity and risks involved within their unstable financial and economic market. Authors explain the financial model used and the equations that depict the growth level compared to the growth needs and financing opportunities. The 30 countries that are developed and countries at a developing stage are analyzed through comparison of their GDP. In addition, firm growth is analyzed compared to the economic growth of each country used in the sample. All the variables are described and their impact on the topic is explained.

The inflation rate is an indication of the stability of the government in managing the economy (Demirgüç-Kunt & Maksimovic 1998, p. 2112) which is widely different among the countries analyzed, "from a high of 327.6 percent in Brazil to a low of 1.5 percent in Japan." For this reason, the authors have left out or used to a lower extent variables that are dependent on the price and may change drastically relative to the inflation. Ratios are used instead. Same as La Portaet al. (1996), the authors analyze the legal enforcement for the sample countries but do not agree with the findings from the report which assumes that legal protection is highly related to the long-term debt.

As these variables are analyzed, Demirgüç-Kunt and Maksimovic (1998, p. 2115) explain that the findings suggest that most of countries from the sample experience a faster and bigger growth when they use some form of external financing relative to the firms that use internal financing as a means of growth. However, the authors assume that close to 50% of the firms from the countries analyzed have means of financing for capital investment that is not directly related to outside financing.

Also most firms in most countries are involved in short-term financing relative to long-term debt for several reasons explained below. For instance, in Australia, close to 60% of companies need external financing in order to increase their capital and capacity (Demirgüç-Kunt & Maksimovic 1998, p. 2116).

Out of this percentage, 17% of them grow solely through short-term debt. Results suggest that most of the countries prefer short-term debt over long-term debt in offering means for firm growth and is considered to be more important. Three categories of countries from the sample of developing countries are created. Brazil and Mexico have the highest inflation rates and neither short-term debt nor long-term financing are a way of eliminating constrains on firm growth. Some different developing countries prefer short-term over long-term debt, such as Turkey, Malaysia, etc. Furthermore, other countries that fall in the third category, such as India, Korea, Pakistan, etc. have similar importance of the short-term debt and long-term debt as do the developed countries.

Among the findings from the analysis of this model, the authors conclude that 44% of the loans are for working capital in the 48 countries tested with finance being the second reason (20%) (Bae & Goyal 2009, p. 12). On the other hand, 12 percent of the loans are taken for acquisitions. Lower loan spreads are observed in countries with stronger creditor protection and property protection. However, even though some countries have weak enforcement of contracts, they tend to lend loans to firms with larger size. According to the findings, loan maturity and spreads are higher in countries with weak creditor rights.

2.3.2 Firm characteristics

Comparing the firm profits, smaller profit firms require a longer time to grow and are in higher need of long-term external financing in terms or debt or equity. On the other hand, developed countries show that their firms can grow at a fast rate without needing long-term financing. Laeven (2003) talks about several examples of developing and developed countries that specify the characteristics of the firms and their relationship to the length of financing relative to the growth rate and speed.

Demirgüç-Kunt and Maksimovic (1998) analyze if the differences in the legal and financial systems explain the different patterns of the externally financed growth firms. They assume that the more developed the market, the greater the growth rate will be compared to the predicted growth rate. The assumption is that the firms that grow greater than the predicted rate do not need external long term financing. Market capitalization can diminish the risk of new projects efficiently due to the larger market but this may cause an implication for this assumption because all the firms that are analyzed by Demirgüç-Kunt and Maksimovic (1998) are publicly traded companies.

As described by Bae and Goyal (2009, p. 16), the law and order variable describes that countries with developed legal and financial systems are highly correlated. Yet, there is not a significant correlation between law and order and the level of external financing for the firms. Also there is no significant correlation between the efficiency of the legal system and the growth rate. On the other hand, the GDP variable and the efficiency of the legal system are positively correlated.

The variables used to describe characteristics of the legal and financial systems may affect directly or indirectly the firm growth. Directly it may affect the firm because the legal and financial systems influence the possibility to obtain external financing. On the other hand, indirectly these systems may increase costs in terms of lower profits through external financing. One main finding from the analysis using the financial model is that firms in the countries with larger banking sectors use more external financing. As such, an efficient stock market eases the financing constraints. Subsidies may distort the market but do not help in the firm's growth rate and diminish the efficient allocation of capital (Demirgüç-Kunt & Maksimovic 1998, p. 2123).

Another complication is the ratio of fixed asset. There is no clear evidence and it is not clearly presented that countries with capital-intensive companies require external financing to grow at the same rate as countries with companies that do not invest in their assets to the same extent. On the other hand, efficiency of the legal system is highly and positively correlated with the firm growth, as predicted by the model. Access to external financing may create efficient competition even when there are not any new entries when the competition is imperfect. Demirgüç-Kunt and Maksimovic (1998) explain that there are outliers (high inflation rates in Brazil, Mexico and Turkey) in the analysis and this makes it more difficult since the sample size is relatively small (30 countries).

Demirgüç-Kunt and Maksimovic (1998) explain that an active stock market and efficient legal system enhance the firm growth. Yet, the size of the stock market itself is not crucial relative to the level of activity of the market. High compliance with legal norms increases ratings thus increasing the chances for external financing.

Bay and Goyal (2009) explain the level of property rights protection as a great determinant of how loans are structured and how they are spread over the businesses and individuals in a country since property rights protection directly affects the lender's incentive for monitoring the contract. A weak protection of property rights might lead to increased loan interest and higher credit risk. In addition, this increases the repossessing collateral process time.

Beside higher interest rates on loans spread throughout countries with weak property and creditor rights due to the risk involved, the size of the loan is affected at the same time. In addition, loan maturity will be affected in countries with weaker protection because lenders tend to issue more short-term debt to protect them. On the other hand, loans issued in countries with stronger enforcement of contracts have longer maturity, larger size, and lower spread (Galindo 2001, p. 17).

Among other variables that affect the debt is the firm size. Larger firms are recognized as having lower default risk. Firms with higher profitability also tend to have lower default risk, and as such, less contracting costs. Leverage tangibility and growth of firms also play a role in the level of debt and risk. The results from this analysis show that as the contract enforcement increases, the amount of the loan and its maturity increase while the loan spread diminishes. However, loan size and maturity do not have consistent relations with creditor rights. Also, loans for financial borrowers are smaller relative to loans for non-financial borrowers.

Bae and Goyal (2009) explain that there are two types of borrowers when deciding not to repay the loan; the ones who are not able to make the payments because of the failure of the project or investment and the ones who are not willing to repay because the benefits from the non-payment are greater than the costs of the sanctions. This, as such, is allowed or possible in the countries with poor enforcement of the contracts. No matter what the legal system is, it is quite possible that even countries with the same legal system to impose different regulations for the enforcement of the contracts.

The judicial system is elaborated furthermore by Bae and Goyal (2009). The effectiveness of the judicial system is calculated through the amount of the collateral that the lenders expect to collect when the case is over. The main objective of the courts is to force the borrowers to repay the remaining part of the loan or to ease the process of recovering the collateral by the lenders. If the enforcement is weak, there is an opportunity for the borrowers to take advantage of the system and increase the risk of not paying back the loans to lenders. Borrowers are motivated to default knowing there will not be harsh sanctions applied.

When cases of default are taken to the court, lenders and borrowers both incur processing costs. This also impacts the decision whether a borrower will agree to repay the loan when the lenders generate the claim or will agree to not take the case to the court. Jappelli, Pagano, and Bianco (2001) analyze different situation where the lenders or banks have incentives to increase the interest rate due to the possibility of loan default. To remain profitable and be able to pay the court fees and expenditures when cases are taken to court, banks directly have an incentive to protect themselves through higher interest rates. The judiciary system and the enforcement process affect the lenders' and borrowers' incentives to increase rates and to default the loan, respectively. Aside from the judiciary system, the market economy of the banks influences the loan characteristics, maturity, size, amount and interest rates (Jappelli, Pagano & Bianco 2001, p. 1). If the market is composed of a free market economy, banks are pressured to lower the interest rates and change their collateral (inside or outside) strategy. In different cases, the borrowers may have access to larger size of loans but at a higher interest rates (once the inside collateral is secured by the lenders).

Under perfect competition, improving the efficiency of judicial system leads to decrease of credit rationing and increase of lending (Jappelli, Pagano & Bianco 2001, p. 13). The effects on the interest rates depend on the possibility of recovery and reform; when talking about better chances of internal collateral recovery, the interest rates will rise while the effects are not as clear for the external collateral. These observations are valid for the banking system operating under prefect competition.

2.3.3 Monopoly banking system

To evaluate the case of monopoly of local banks, Jappelli, Pagano, and Bianco (2001, p. 13) considered several situations. Since the banking system is monopolistic, the demand for loans is inelastic. The results show that the correlation between the lending rates and the collateral-loan ratio is positive. Monopolistic banks can charge higher interest rates to borrowers who pledge more collateral. Under monopoly, if there is an improvement of a judicial system, the lending and interest rates increase. Comparing the perfect competition and monopoly markets, the interest rates are affected differently, either they rise or fall.

Jappelli, Pagano, and Bianco (2001) have used data from 27 judicial districts and with credit data extracted from 97 Italian provinces. Indicators and variables used include the length of judicial trials from 1984-1998 where the enforcement cost is related directly to the length of the trial. Another indicator used is the number of civil suits pending per thousand inhabitants. This model is compared to other national analyzes that were performed by the Bank of Italy (1994) which included the insolvent borrowers. Aside from judicial efficiency, Jappelli, Pagano, and Bianco (2001) take into account variables from the credit performance market to test their hypothesis. Such variables include outstanding loans, credit rationing indicators, interest rates on short-term loans to non-financial companies, ratio of non-performing to total loans and the Herfindhal index. These variables are taken from the Italian public register database.

The findings from these tests show that the amount of lending in the judicial districts is negatively correlated with the length of the trials. The authors perform regression analysis which shows a positive correlation between the judicial districts, lending and overdraft credit. The results show that provinces and judicial districts with better legal enforcement have higher amounts of lending and less credit ratio. As a consequence, improvements in judicial systems increase the lending amount and vice versa (Jappelli, Pagano & Bianco, 2001, p. 18). Authors also mention that other scholars have conducted similar tests to validate their theories about the positive correlation between the judicial systems and the amount of lending (Brazil & Argentina; Cristini, Moya & Powell, 2001). Similarly, Meador (1982) and Jaffee (1985) in USA have analyzed the household credit and found that countries with longer and costlier foreclosure processes have higher mortgage interest rates.

Laeven and Manjoni (2003) analyze the interest rate spreads for 106 countries at the country level and for 32 countries at the level of individual banks to test whether the judicial efficiency affects the lending spread. The results of the model show that the efficiency of the judicial system and inflation rate is the main reason for the changes in interest rate spreads. If a country aims to decrease the costs of financial intermediation, it should improve its judicial system and judicial enforcement of debt contracts. The authors analyze the loan spreads relative to the quality of the countries' legal systems. The findings suggest that the judicial system and the inflation are the two most important variables that affect the interest rate spreads. In addition, an improvement in the economics of the judicial system increases by large the amount of loans in public and reduce the interest rate spreads. These improvements are critical to the reduction of cost of the financial intermediation (Laeven & Manjoni, 2003, p. 22).

Galindo (2001) analyzes the situation in the Latin American countries where the credit accessibility is a major difficulty. The main problems causing financial difficulties for the firms operating in these countries to grow further include: poor access to financing, policy instability, street crime, fluctuating exchange rates, inflation, and at a lesser extent, taxes and regulations.

Institutions are the most important stakeholders in explaining the decrease in financial credit for companies in Latin American countries. Since credit contracts involve creditors, debtors and contract enforcing institutions, it is very important that the institutions ensure that both parties obey the rules set forth in the contract. The test performed and the findings from these tests show that, in general, Latin American countries impose weak creditor rights and thus have very weak creditor protection. This protection is lower than described by international standards. The situation of weak creditor protection is a result of both lack of regulations and overall low enforcement of the laws applied in these countries. In order to have a better access to credit financing, these countries must impose stricter rules towards creditor protection (Galindo 2001, p. 17).

2.4 Corruption

Corruption, as a bad and complex phenomenon, has its source in bureaucratic and political institutions and destroys the economic and social development of the country. It originates from and varies according to a country's social and cultural history. According to the World Bank group publication of 2009 on helping countries to combat corruption, the corruption is defined as the abuse of the public office in favor of private gain.

It is considered as abused of public offices if and when its officials agree to accept bribes, use public office in favor of private gain through preferential treatment such as nepotism, thievery of state assets, or change of direction of state revenues. Abuse of public offices is also when private individuals offer bribes with aim to prevent enactment of public policies and processes in support of their own profits. According to the same publication of the World Bank Group, examples of the corruption are bribery and money laundering.

According to Shah and Schacter, the three main types of corruption: 1) petty corruption, also called administrative or bureaucratic corruption, which are everyday corruption activities by public officials who abuse their office such as accepting bribe and in return award favors for personal gain, 2) grand corruption where the high levels of a state abuses public offices; and 3) state capture/influence where the private individuals and public officials re involved to abuse the state for their own purposes (Shah &Schacter, 2004, Combating Corruption: Look Before You Leap).

A country with good investment climate is often a result of a good judicial system, leading to lower interest rates. Investors feel more protected if the judicial system is transparent and effective.

Closing up the findings of this chapter, common law countries offer better protection for both creditors and shareholders, while French civil law countries offer the weakest protection. German civil law countries lie in the middle offering considerable protection while Scandinavian countries are also in the middle. These differences are mainly because these laws come from different legal families.

Article 102 of the Constitution of the Republic of Kosovo states, that courts in Kosovo should adjudicate judicial cases based on Law and Constitution. This means that Kosovo is a civil law country since the judicial system is based on laws, constitution, and statues and not on case precedents (Constitution of the Republic of Kosovo, 2008). La Porta et al. (1998) suggest that countries, in general, give limited rights to investors. The investor protection is highly related to the origin of law. Common law countries tend to favor investors more while the investor protection is weaker in the civil law countries, especially in the French civil law countries.

According to Bae and Goyal (2009), loan maturity and spreads are higher in countries with weak creditor rights. To sum up, the judicial inefficiency has its costs in the economy. The model of Bae and Goyal (2009) concludes that improvements in the judicial system of a country increase the lending volume and decrease the credit rationing. As far as interest rates go, they can either increase or decrease depending on the composition of the economy and the structure of the banks.

3 KOSOVO OVERVIEW

3.1 Banking sector development

The banking sector in Kosovo, in the last five years, has undergone through important developments. Since 1999, Kosovo started gradually shifting from a cash based economy toward a cashless economy. The public confidence has increased and the range of products and services that commercial banks offer has widened. Following the financial crisis of 2008, numerous studies and reports perceive the banking system in Kosovo as sustainable. There are 8 commercial banks operating in Kosovo, of which 6 are of foreign ownership and control about 89 percent of total banking market assets (hereinafter: CBK, 2013). Among other financial institutions, there are 13 insurance companies currently operating in Kosovo and the pension system assets are mainly managed by the Kosovo Pension Saving Trust and a small percentage is managed by Slovenian-Kosovo Pension Fund. The microfinance institutions have a small share of the financial sector and are mainly focused on financing small businesses and households (CBK, 2013).

Having a developed banking system is vital for economic development since it contributes to economic growth by its impact on sustainable development of businesses and general public, which in turn lead to a better quality of life. The banking sector has a great importance in any country’s economic and social development, thus, it should be given great attention. A sound banking sector, through competitiveness and efficient operation of banks in a market, is crucial in attracting foreign direct investments, smoothing the unemployment rate, thus generating more income for people. Before making a long term investment, investors analyze the stability of a country’s banking system. Competition is considered to be stronger when there are more similar size companies. Herfindahl Index is often used as an indicator to reflect this concentration (CBK, Financial Stability Report 2012).

Kosovo is a poor but open economy. Economic integration with the European Union has increased consistently over years. Most of trade is done with members of European Union (hereinafter: EU) and Central European Free Trade Agreement (hereinafter: CEFTA). Developing countries should ensure adequate conditions that would lead to economic growth and sustainable development. This way, FDI and other investments would encourage innovation and growth.

The international actors and the Kosovars themselves perceived corruption as a major problem in Kosovo. According to media and public discussions, corruption is at very high levels (UNODC, 2013, Business, Corruption and Crime in Kosovo).

The financial sector in Kosovo is mainly dominated by banks. Since 2000, this sector grew very fast. According to International Monetary Fund (hereinafter: IMF), assets of financial sector as a share of GDP increased from 33 percent in 2003 to 74 percent in June 2012. Kosovo's currency is Euro and was adopted as legal tender in January 2002. The benefits of this were that Kosovo had a stable currency in place and had the preconditions to develop an efficient financial sector. It was believed that adoption of Euro would have an impact in lowering inflation rates and giving advantage to Kosovars over the region in attracting foreign investment (IMF, 2013, Republic of Kosovo: Financial System Stability Assessment).

According to CBK, Kosovo has a stable and positive growth rate and stable macroeconomic situation and financial state. Even though Kosovo's economic growth is expected to increase during 2014, the recent Euro crisis in some of the European countries would make this growth less steep. This is due to the negative impact that decreasing economic growth will have on exports, remittances, and FDI. The banking system seems to have maintained a stable liquidity position, high capitalization level and high quality loan portfolio (CBK, 2013, Annual Report 2012).

3.2 Central Bank of Kosovo

The CBK was established in 1999 as the Banking and Payments Authority of Kosovo (hereinafter: BPK) to "license, regulate and supervise the financial sector and establish a properly functioning payments system" (Kosovo Assembly, 2008, Law on the CBK). Through technical assistance and advice from international organizations, CBK has managed to adopt banking rules and regulations in accordance with international banking standards and Basel criteria.

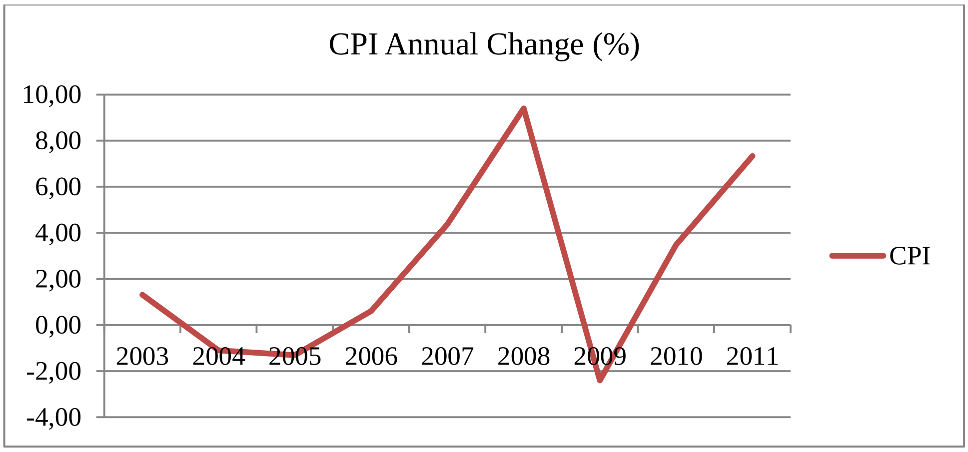
CBK, as a successor of BPK, does not issue currency, thus, it has no monetary or credit power in the classical sense. It is responsible for Euro supply and it ensures that Kosovo's economy is supplied with adequate quantity based on market demand. The Law on the CBK defines the principal objectives as to: "a) foster the soundness, solvency and efficient functioning of a stable market-based financial system, encouraging market emergence of safe financial instruments; and b) without prejudice to this, support the general economic policies in Kosovo with a view to contributing to an efficient allocation of resources in accordance with the principle of an open market economy" (Kosovo Assembly, 2008, Law on the CBK).

The law classifies CBK as banker, financial adviser, and fiscal agent to the Ministry of Economy and Finance and other Government institutions. Furthermore, CBK has regulatory and supervisory powers for the entire financial sector in Kosovo which includes banking sector, insurance sector, and pension funds and other financial institutions. In accordance with Basel Core Principles and Pillar 2 of Basel II for banks, CBK adapted the risk based approach, which enables CBK to focus more on those assets in the banking system that has the greatest risks (CBK, 2013). The aim is to create an effective supervision of the financial sector.

According to 2011 population census, Kosovo population is around 1.8 million, Prishtina and Prizren being the cities with the highest population. Fertility rate is among the highest in the region (34,000persons), while mortality rate is on average 6,800 persons under Kosovo Agency of Statistics (hereinafter: KAS), 2013 Estimation of Kosovo Population 2012.

Kosovo’s economic organization is in line with its European ambitions, largely oriented toward market economy. Besides this ambition, the private sector is challenged from high levels of corruption, fiscal evasion, informal practices, thus, affecting competition and normal economic development of the private sector, under IMF, 2013 - Mission Reaches Staff-Level Agreement on Fourth Review under the SBA with Kosovo.

Figure 1. Consumer Price Index Annual Change



Source*: 2012 Kosovo Agency of Statistics, Annual Changes of Prices, Consumer Price Index Annual Change,* Figure 5.

Official currency is Euro and Kosovo has benefited from the stability of its currency in use, but on the other hand this has constrained policy instruments disposable to affect the fragile economy. On average, inflation rate in Kosovo has been steady and kept within healthy margins at around 2.4 percent. As can be seen in Figure 1, the highest inflation rate in Kosovo has been marked in 2008 (9.4 percent), while the lowest was in 2009 (-2.4 percent). Due to very high reliance on imports, food and energy prices are biggest contributors to inflation changes (KAS, 2013 Annual Changes of Prices in Percent).

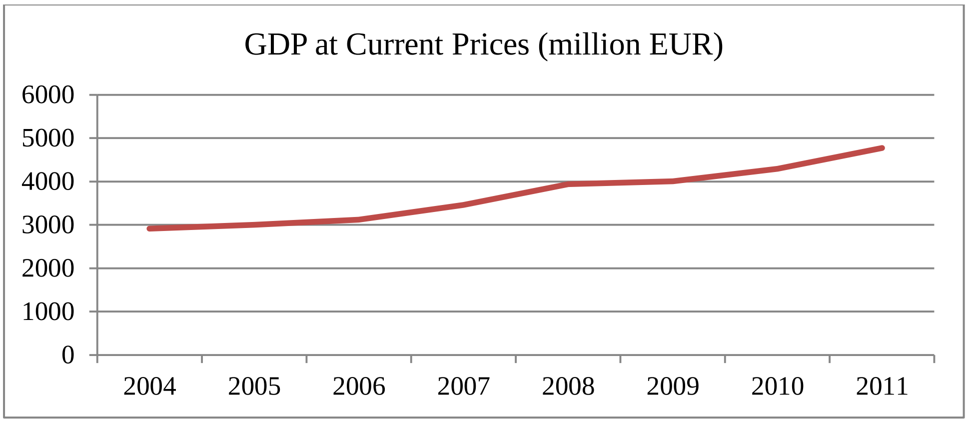
Kosovo's fiscal stability has been preserved and largely in line with IMF practices, even though there was an expansionary fiscal policy since 2011 (IMF, 2013 IMF Mission Reaches Staff-Level Agreement on Fourth Review under the SBA with Kosovo).

Consumption structure of households in Kosovo remains largely oriented toward fulfilling basic needs, as 45 percent of the total household consumption goes to food while 30 percent of it goes to shelter. Even though general consumption in Kosovo has increased for 18 percent in 2012, a family in Kosovo on average consumes 7.6 thousand EUR while one person spends 1.3 thousand EUR yearly. In a survey done by ASK, half of the respondents would have extreme difficulties to cover an unexpected expense of 500 EURs (KAS, 2013, Results of Household Budget Survey).

In total, Kosovo has 479,000 students of which 49,000 or 10 percent of them belong to higher education. There are a balanced number of female and male students, 48 percent and 52 percent, respectively. Another interesting fact is that 96 percent of the property in Kosovo is owned by males. Furthermore, 70 percent of respondents would not be able to cover a week holiday outside their homes (KAS, 2013, Results of Household Budget Survey).

Kosovo is a member of World Bank while in 2009 it also became a member of IMF with a quota of 0.027 percent (IMF, 2009 Kosovo Becomes the IMF's 186th Member). As a member of IMF, Kosovo has had two Stand by Agreements while the first one was interrupted due to the lack of fiscal discipline on expenditures by the Government of Kosovo. In November 2012, Kosovo became the 66th member of the European Bank for Reconstruction and Development (hereinafter: EBRD).

Figure 2. GDP at Current Prices



Source: *2012 Kosovo Agency of Statistics, GDP in Current Prices by Years*, p. 2.

EBRD is expected to foster transition to market economy by helping private and public sector through: direct financing, policy dialogue and technical assistance (EBRD, 2012 Kosovo to Become Member of the EBRD). EBRD has already published its strategy for Kosovo, while it has provided a 5 million EUR loan to Turk Ekonomi Bankasi (hereinafter: TEB) in Kosovo for lending to enterprises and households for investments in renewable and energy efficiency projects (EBRD, 2013 EBRD and TEB to Improve Energy Efficiency in Kosovo). In addition, Kosovo also joined the European Investment Bank and the European Bank for Reconstruction.

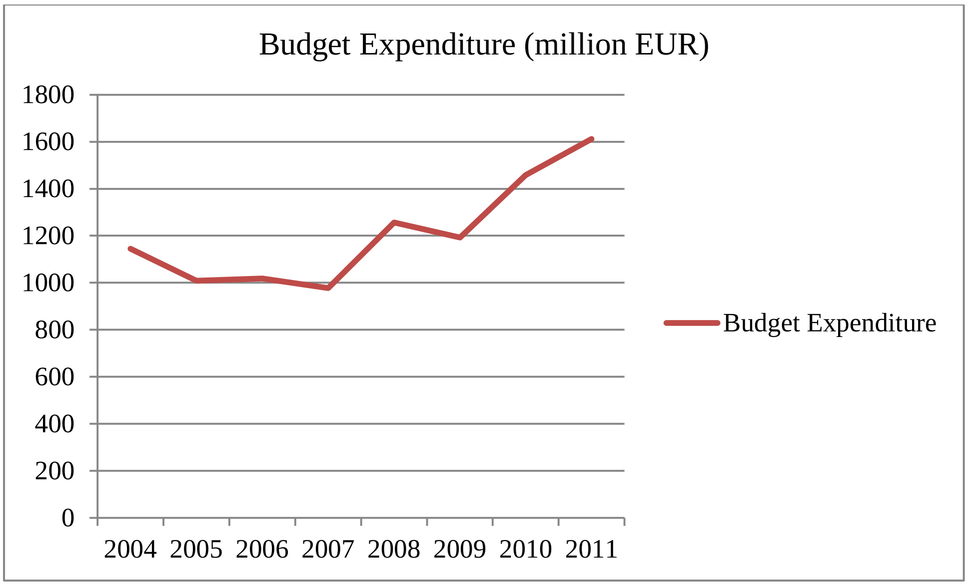
GDP at current prices in Kosovo was 4.9 billion EUR in 2012 (as can be seen in Figure 2), while GDP growth has been 5.2 percent on average from 2006 to 2011. In 2011, Kosovo had the highest GDP growth in the region (5 percent) which was mainly driven by higher government consumption and investment. GDP was characterized by large negative exports, -1.6 billion or 35 percent of total GDP in 2011. Consumption structure comprises of household consumption (84 percent) and public consumption (14 percent). The large negative exports in the GDP structure comes from incapability of Kosovo’s economy to fulfill even the most basic needs such as food (KAS, 2013 Structure of GDP by Expenditure Approach).

In 2012, the economic slowdown that characterized Europe affected the Balkan region and Kosovo’s economy as well. In general, exports declined while imports slowed down following the decline of foreign investments and remittances. External trade account shows that trade deficit was 191 million EUR in 2012. Kosovo main exports were: 1) base metals and other related materials (43 percent); 2) mineral products (8.2 percent); 3) plastic rubber and related articles (7.3 percent). Main imports were: 1) mineral products (18.2 percent); 2) prepared foodstuff, beverages and tobaccos (11.4 percent), 3) machinery, appliances and electric stuff (7.5 percent) (KAS, 2013 Economics Statistics External Trade Statistics December 2012). The trade deficit is largely financed from remittances of Kosovar diaspora living mainly in Europe. This makes Kosovo double dependent on economic developments in Europe.

Even though Kosovo is not a member of World Trade Organization (hereinafter: WTO), in 2007 Kosovo signed CEFTA agreement. CEFTA agreement was formed between non-EU countries in the SE Europe aiming to remove barriers for trade by establishing a free-trade zone among member states by creating favorable trade conditions, stimulating trade and economic cooperation among the member states and intensification of economic relations for mutual benefit and for contributing towards EU Integration, developing trade relation with EU and for integrating multilateral trade system. However, Kosovo has had many problems with CEFTA agreement due to politics. Even though Kosovo declared its independence and changed its stamps, Serbia and Bosnia blocked all Kosovo’s exports even for transit purposes (GAP Institute, 2011 CEFTA In or Out) but with the Brussels Agreements this obstacle has started to diminish.

Unemployment rate is considered to be very high at 35.1 percent. There was a large debate regarding the methodology used of assessing the unemployment rate as in the previous years, unemployment rate was considered to be even higher, at 45 percent. Participation rate of workforce, measured as a percentage of working age population (15- 64 year old), is characterized with very high gender imbalances: males make 54.5 percent while females make only 18.6 percent. On the other hand, young people aged 15-24 years old make 22.6 percent of the workforce while the highest unemployment rate which is measured as percentage of unemployment rate among active population of age, 15-64 years, is found among youth and is considered to be 60.2 percent. Furthermore, female unemployment is 44.4 percent compared to male unemployment at 32 percent. While 29.8 percent of work places are generated in urban areas and 20.2 percent in rural ones, unemployment in rural areas is 40.1 percent versus 28.5 percent in urban areas. Remittances cause market inefficiencies as they increase reservation wage and reduce incentive to work (KAS, 2013 Labor Force Survey).

Figure 3. Budget Expenditure



Source: *2013 Kosovo Agency of Statistics 2012, Revenue, Expenditure and Net Financing Capacity of Central Government*, p. 15.

Households' main sources of income come from salaries and wages in the public sector (25 percent) and private sector (22 percent). Other sources of income are household businesses (12 percent), remittances (9 percent), pensions (8 percent), and social benefits (6 percent)

(KAS, 2013, Results of Household Budget Survey). Poverty rate is very high and people who live with less than 1.55 EUR in 2011 were considered to be 29.7 percent of population, while 10.2 percent of population lived in extreme poverty or with less than 1.02 EUR a day. People who live in extreme poverty have increased with 2 percentage points compared to 2010, while almost two third of those who live in extreme poverty live in rural areas. On average, Gini coefficient, which measures the income inequality, shows that inequality has been decreasing over the years, while it has been relatively low (27.6 out of 100) and more pronounced in urban areas (KAS, 2013 Consumption Poverty in the Republic of Kosovo 2011).

Due to an expansionary fiscal policy, average salaries on the public sector have increased from 30 to 50 percent in 2011. Net wages have reached to 368 EUR, but the productivity measured as ratios of wage to GDP per capita remains far behind the regional countries (IMF, 2011). Even though wages in the private sector have remained lower, the artificial increase of wages in the public sector probably has damaged competitiveness of the private sector as it makes more challenging to hire staff on market wages. Figure 3 shows the budget expenditures throughout the years.

3.3 Supply side - financial sector

With regard to market structure, the banking sector remains an oligopoly where currently there are 8 banks operating, of which 6 are foreign banks and dominate 89 percent of the market. Even though competition is increasing, the banking system concentration is high as market remains largely dominated by three banks. The biggest three banks owned 74.5 percent of the total market assets in 2011, while due to pressure from smaller banks concentration slightly decreased to 71.8 percent in 2012. The concentration rate, measured by Herfindahl-Hirschman Index (hereinafter: HHI), declined by 129 points in 2012, while concentration rate overall remained high with 1,972 points. A decreasing trend was also recognized on concentration of loans and deposits (CBK, 2013 Financial Stability Report 2012).

3.3.1 Sector overview

Banking system is at the heart of the financial system in Kosovo as it represents 74.6 percent of the total assets of the financial sector. Kosovo banking sector has had a constant and aggressive growth, even though growth rate slowed by 6.6 percentage points in 2012 from 12.7 percent in 2011.

The main factor contributing to this slowdown was balances with other commercial banks. The total assets make 54 percent of GDP reaching 2.65 billion EUR. Loans, besides being the main asset of the banking sector, together with cash and balances with CBK were also the main contributor of assets growth; while in previous years, investment in securities was the main contributor. The second biggest assets of the banking sector are investments abroad with 21.9 percent of the total assets (CBK, 2013, Other Depository Corporations Balance Sheet).

The rest of the total financial sector assets, which account for 24.5 percent, are made of pension fund, insurance companies, microfinance institutions, and financial auxiliaries. Pension fund makes the most of this share with 659.1 million EUR, while it had a remarkable growth of 19.5 percent in 2012. Most of the money is invested in overseas shares and securities, while only 5 percent is invested in the domestic market (CBK, 2013 Pensions Funds Survey).

Assets of insurance companies also marked an impressive growth of 16.5 percent amounting to 120.2 million EUR in June 2012. Even though the number of microfinance institutions increased by 2 (to a total of 19) in 2012, the assets of microfinance institutions compared to the total sector assets have decreased by 4.1 percent due to a lower number of loans issued. The sector of microfinance institutions recorded a 2.4 million EUR loss in June 2012 (CBK, 2013 Other Financial Intermediaries Survey; CBK, 2013 Financial Stability Report 2012).

Growth of the lending activity of the banking system remained positive, 9.3 percent in 2012. Loans of the banking system make still 36.2 percent of the GDP equaling to 1.77 billion EUR, while they make67 percent of total banking system assets. The slowed down lending came mainly as a result of an increased risk perception of the economic environment, therefore, banks tightened the lending criteria to businesses. Lending to businesses makes up 76 percent of the total loans. Even though business lending seems promising to the much needed domestic industry, the non-promising fact is that trade sector dominates the total loans with 51.3 percent. The second largest borrowing sector is industry comprised of mining, manufacturing and construction with 24.8 percent; while vital sectors such as agriculture has the lowest rate of lending with only 4 percent (CBK, 2013 ODC loans- by economic sector).

Agriculture sector has the highest interest rates, while only one bank dominates almost the total loans issued for the sector. In terms of loans maturity, the midterm loans over two years remain typical of the banking system representing 70 percent of total loans, while loans with two to five years maturity make 43 percent of total loans (CBK, 2013 ODC loans by maturity). Even though, small and medium enterprises increased their demand for credit compared to larger ones, banks rather kept a conservative credit policy, by tightening credit requirements and criteria during the application process (CBK, 2013 Financial Stability Report 2012).

Of total 2.6 billion liabilities of banking sector, deposits make 2.1 billion EUR and those are mainly domestic ones. Parallel with credit slowdown, deposits kept a similar tempo by suffering a growth slowdown of 4.1 percentage points amounting to 2.1 billion EUR. Deposits remain of vital importance to the banking system as they are the main source of funding for banks. Households make 72.1 percent of deposits in the banking system, while enterprises make only 19.6 percent. In general, even though enterprises have a smaller share in total deposits, public enterprises deposits have affected the deposits growth mostly. This slowed growth has put pressure to the banking system to seek foreign sources of funding. Another source of banking fund is made of shareholder's capital which is 9.6 percent. Due to the general deposit slowdown, banks were pushed to increase borrowing from abroad mainly their parenting companies. On the other hand, debt and subordinated debt has decreased activity (CBK, 2013 Other Depository Corporations Balance Sheet).

3.3.2 Profitability and efficiency

As a result of the slowdown in banking activity and an increase of the provision for bad loans, profitability of the banking sector has deteriorated. Net profit in total is 10.2 million and fell by 31.2 percent in 2012 compared to 2011. Even though income continued to increase, 124.2 million or 8.2 percent in 2012, the return on equity (ROE) fell to 8.1 percent from 12.9 percent. Return on average assets (ROAA) declined to 0.8 percent from 1.2 percent and return on average equity (ROAE) declined from 12.9 percent to 8.1 percent. The fall in profitability affected also efficiency indicators, as cost to income ratio increased from 85.4 percentage points to 89.9 percent. In addition, due toa slower increase in banking assets, average value of assets managed by an employee decreased by 2.9 percentage points. However, revenues to assets slightly improved as ratio of income to total assets increased by 0.1 percentage points and average number of loans issued per employee increased by 1.1 percentage points (CBK, 2013 Financial Stability Report 2012; CBK, 2013 Other Depository Corporations Survey).

3.3.3 Risks

According to CBK, the banking sector in Kosovo is stable based on several indicators. The banking system, as the heart of the financial sector in Kosovo, despite a small increase of non-performing loans, has continued to maintain a stable liquidity position, high capitalization level and high quality loan portfolio (CBK, 2013 Financial Stability Report 2012, p. 3).

While there has been negative development in the profit indicators, the banking system has managed three main risks in a successful way: liquidity risks, credit risks, and solvency risks. Loans to deposits ratio has increased to 83.2 percent. In addition, low concentration level of deposits and the higher level of liquidity reserves suggest a low level of liquidity risk of the banking system in Kosovo. Stable sources of funding of the banking system, such as deposits comprising 80 percent of liabilities of commercial banks, and careful management of liquid assets have contributed to such stability (CBK, 2013 Financial Stability Report 2012).

An important indicator with regard to liquidity is the ratio between liquid assets and total assets. Even though this indicator decreased, it is considered that the value of liquid assets is high. Core liquid assets account for 22.6 percent of total assets and decreased by 1.7 percentage points, while broad liquid assets fell by 0.9 percentage points to 28.9 percent. This fall came mainly due to the fall in investment abroad of the banking sector. Furthermore, the ratio between liquid assets and short-term liabilities decreased, but in general bank liquidity is considered to be high and satisfactory. Core liquid assets to short-term liabilities decreased by 2.8 percentage points to 28.3, while broad liquid assets to short-term liabilities decreased by 1.9 percentage points to 36.2 percent. The following indicators still show that the structure of liquid assets is sufficiently secure. About 8.1 percent of total assets are investments in securities and those are mainly invested in: government bonds (76.1 percent), financial corporation bonds (10 percent) and non-financial corporation bonds which are quite secure financial products.

However, low exposures to risk have caused lower returns and, therefore, lower profitability. Another factor which lowers liquidity risk and profitability is liquidity reserve. Banks in Kosovo have higher levels of liquidity reserves compared to minimum requirements. The total value of the banking system reserves were 310.3 million EUR or 70 percent above the required minimum. Banks gain interests on these reserves only for the required minimum reserves and not for the excess (CBK, 2013 Financial Stability Report 2012).

3.3.4 IMF assessment on sector's stability

The banking system in Kosovo is largely safe from systematic risk. Weak points in the system need to be carefully managed as the concentration in the system is large and damages can have shocking effects to the economy. The weak sides in the banking system come as a result of a fragile open economy of Kosovo, which is easily affected by developments in the global economy, especially as a result of high reliance on remittances and effects on exports. The dependency on remittances poses double risk for the banking sector, as they affect the credit quality and are used for loan payments. At the same time deposits, as the main source of the banking system, also depend on remittances. In addition, due to a very high level of trade deficit, inflation is mainly imported and therefore can easily affect interest rates and real income which in turn may affect loan payment capacities. To further increase the dependence of the banking system on global developments, three biggest banks in Kosovo are foreign owned, while two of them rely on outside markets for deleveraging plans in order to improve capital adequacy ratio (IMF 2013, Republic of Kosovo: Financial System Stability Assessment).

Sources of funding in the banking system are mainly deposits, while there are limited possibilities to obtain additionally access to capital. Due to the small size of the economy, large levels of informality sector and small production sector, there are very limited possibilities to diversify across different sectors, corporations, and individuals (IMF 2013, Republic of Kosovo: Financial System Stability Assessment).

Kosovo employed Euro as its official currency; therefore, its monetary policy is inexistent. IMF suggests that in order to overcome this problem, a macro prudential framework should be established to act counter cyclically to the risks of the banking system. From operational aspect, this framework should set targets for preventing excessive liquidity and leveraging risks. In addition, different reserve requirements and loan-to-income and revenues ratios may be employed. Lastly, financial markets and issuance of T-bills are at the infantile stage of development (IMF 2013, Republic of Kosovo: Financial System Stability Assessment).

According to the macro-tests, the banking system in general is able to recover in the case of a worsening situation in the euro-zone. Small and medium-sized and large foreign subsidiaries would be more exposed. The four smallest banks would not be able to keep the required Capital Adequacy Ratio (hereinafter: CAR) of 12 percent in case of euro zone crises, and capital needed to bring the ratio to the adequate levels would amount to 0.2 percent of GDP. Even though one of the large foreign bank subsidiaries is more exposed, due to low inter-linkage between banks effect would be mitigated. However, due to high concentration of pension fund (3 percent) put as deposits in this bank, the pension fund can be affected more seriously. Therefore, CBK is recommended to increase its supervisory activity with regard to credit growth, provisions, and assessment of risk exposure to the parenting companies of Kosovo commercial banks (IMF 2013, Republic of Kosovo: Financial System Stability Assessment).

Due to highly concentrated portfolio coming from common corporate borrowers, findings of sensitivity test suggest that in case of a crisis, CAR would fall below the required levels. Even a bank, with a market share of 10 percent, would easily go below this level in case that just 5 of large corporate borrowers default. In addition, banks are also sensitive to the increase of non-performing loans in the trade sector. Due to the maturity mismatch between interest-sensitive assets and liabilities, a 2 percentage points change in interest rates of all maturity, would deteriorate the CAR below the required level for two large banks owning 25 percent of the market share (IMF 2013, Republic of Kosovo: Financial System Stability Assessment).

3.3.5 Measures needed to undertake

The progress of the CBK in promoting growth and stability sector has been impressive mainly due to a professional work and integrity of the CBK authorities. However, professional work of the CBK is challenged due to the lack of proper legal framework and security issues especially in the North of Kosovo. To promote further the system's stability, CBK should carefully manage the quality and growth of loans of small banks, while being aware of parenting companies' exposure to risks. Special attention with regard to enforcement should be given to new regulation on large exposures. Banks should be able to have quick access to the lender of last resort facilities, as concentrated withdrawals of large depositors may pose risks in some of the banks (IMF 2013, Republic of Kosovo: Financial System Stability Assessment).

In addition, there should be coordination between different laws in the regulatory framework due to the need of building institutions quickly after war. CBK needs to take a wide supervisory activity that should include other forms of risks besides the current focus on credit risk. Special attention should be put on interest rate risks and potential risks spread from parent companies (IMF 2013, Republic of Kosovo: Financial System Stability Assessment).

According to the IMF, the Kosovo's authorities should also develop a comprehensive financial safety net. In order to minimize the cost caused to taxpayers in the case of a systemic failure, existing legal and regulatory framework should be updated. This update should guarantee that the Special Reserve Fund (hereinafter: SRF) remains at required levels, and also prevents risk taking behaviors. In addition, the current deposit coverage of 2,000 EUR should be increased but only if deposit insurance fund size increases. All the banks should keep contributing, while these contributions should be available to repay insured deposits (IMF 2013, Republic of Kosovo: Financial System Stability Assessment).

In the presence of a concentrated market with few commercial banks, where competition is very much needed, microfinance institutions can fill this vacuum and increase competitive pressure. Microfinance institutions can especially help segments which banks are less prone to lending such: agriculture, households, and small businesses. Taking these factors into consideration, regulatory framework should be such that gives incentive to the healthy sector growth (IMF 2013, Republic of Kosovo: Financial System Stability Assessment).

3.3.6 Credit risk

Even though non-performing loans (hereinafter: NPLs) to total loans ratio has been steadily increasing, the credit risk remains low. The NPLs to total loans ratio increased to 6.5 percent but still remains the lowest in the region, increasing by 0.6 percentage points mainly due to the credit growth slowdown and not as a result of a significant increase in the total NLPs. The value of NLPs amounts to 113 million representing a 20.7 percent increase compared to 51.5 percent increase in the previous year. Growth of the total loans increased by 9.3 percent. Manufacturing and hotel services sector represent the largest number of NPLs. When comparing the number of NPLs for trade and household sectors, the trade sector remains in much worse position with 9 percent of total loans being NPLs and household loans with only 2.5 percent of non-performing loans (CBK, 2013 Financial Stability Report 2012).

3.3.7 Concentration risk

The amount of large exposure increased to 182.7 million EUR or 38.2 percent, while Tier 1 capital increased to 72percent. This suggests an increase in concentration risk (CBK, 2013 Financial Stability Report 2012).

3.3.8 Solvency risk

Degrees of capitalization and capital quality have remained at satisfactory level. The capital adequacy ratio surpasses the minimum level required by the CBK by 5.2 percentage points which remains similar to the previous year. In addition, shareholders capital makes 60 percent of the total capital (CBK, 2013 Financial Stability Report 2012).

3.3.9 Payment infrastructure

The infrastructure consisting of branches, sub ranches, ATMs, and POS-s have been growing, thus, increasing the quality of services and effectiveness. In 2012, ATM money withdrawals increased by 11% summing up to 673 million EUR. POS payments had an even more impressive increase of 24% summing up to 150 million EUR. Lastly, e-payments had the largest increase of 26% summing up to 1.4 billion EUR but still the usage of electronic banking service lags behind the region (CBK, 2013 Payment System).

There seems promising signs in the development of the payments system as it has increased security, sustainability and efficiency due to supervisory measures. This has led to the increased number and value of the transaction processed through the Kosovo payment system. The issuance of the Government of the Republic of Kosovo securities has increased and as well as the ground for the capital market development. In addition, CBK is almost finishing the implementation of the new payment system which enables real-time settlement of urgent payments, thus, reducing risks from lagging settlements (CBK, 2013 Financial Stability Report 2012).

3.4 Interest rates

Loans and deposits interest rates in Kosovo are higher than the average interest rates in the EU, while interest rate spread (lending rate minus deposit rate) is the highest in the region (10.2 percent). In comparison to regional countries, interest rate spread in Kosovo is higher than in: 1) Macedonia by 7.3 percent; 2) Montenegro by 3.7 percent; 3) Albania by 3.7 percent; and 4) Serbia by 2.4 percent (World Bank, 2013 World Development Indicators).

3.4.1 Interest rates determinants and trends in Kosovo

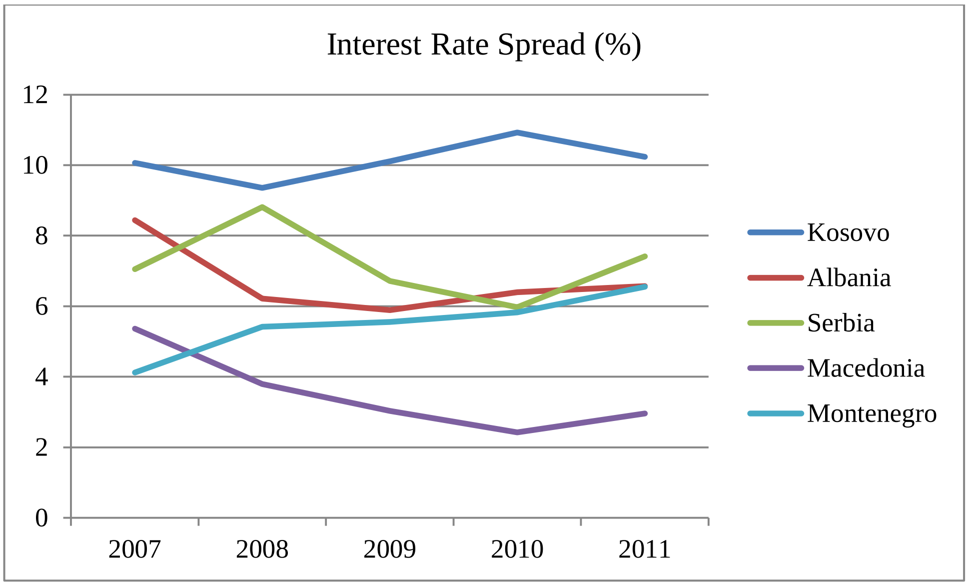
There are a number of factors which may determine the interest rates in general. These factors vary from market conditions, operational efficiency, institutional circumstances and banking regulations. Specifically, there are many reasons why Kosovo has the highest interest rate spread such as lack of national currency (Kosovo cannot use monetary policy and quantitative easing as a mean of providing cheaper funding source which in turn would decrease the risks in the system), problems with cadastral system which makes it difficult for banks to assess the real value of the collateral therefore they minimize the risk by increasing interest rates, the tendency of businesses to avoid taxes (they report lower profits and cash flows therefore their loan payments capacities are undermined by banks), increase of risk due to weak contract enforcement, lack of proper credit information system, and highly concentrated market (Ministry of Trade and Industry, 2012 Access to Finance).

As mentioned in the second chapter, having an efficient judicial system is very important. Laeven and Manjoni (2003) claim that if a country aims to decrease the costs of financial intermediation, it should improve its judicial system and judicial enforcement of debt contracts. This would lead to lower interest rate spreads.

Figure 4 show that Kosovo has the highest interest rate spread in the Balkan region which is an indication that there might be possibilities to consider lowering the interest rates on loans.

In addition, Morina and Toçi (2007) calculated intermediation rate with regard to lending activity of banks in Kosovo for the period of 2005-2011. Their study found that operational cost even though had a dominating position until 2008; it has gradually decreased and was surpassed by risk costs. A factor behind increasing risk cost is the increasing trend of the non-performing loans and loan-loss provision. In 2005, the operational cost was 5 percent. Due to increasing efficiency, these costs decreased by 1.3 percent in 2011 while risk costs stood at 6.3 percent. In addition to increasing risk costs, an increasing trend was marked also on financing cost mainly represented from interest rates on deposits as they represent the main source of financing. In overall, the financing costs stand third. Lastly, regulatory costs consisting of tax costs and regulatory reserves of the banking system have had a decreasing trend mainly due to the halved tax on corporate income tax entering into force in 2009.

Figure 4. Interest Rate Spread



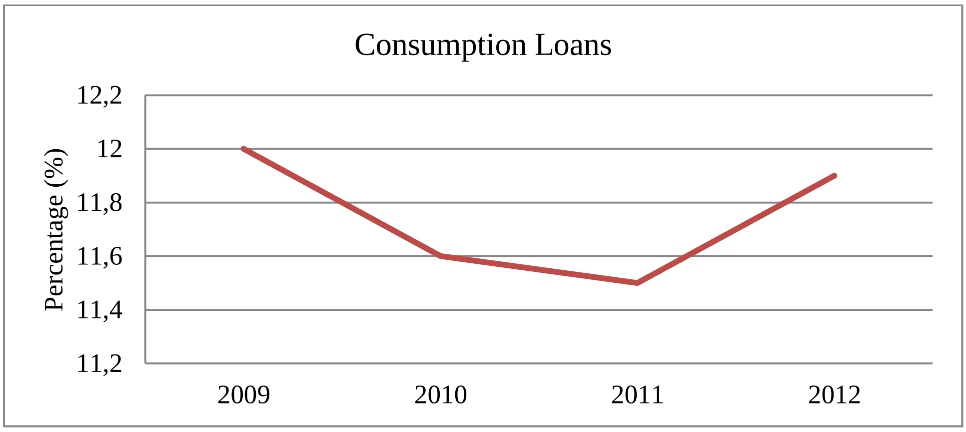
Source: *2013 The World Bank, World Development Indicators*, indicator code FR.INR.LNDP

In 2009, Bankwatch of GAP Institute has found that the differences between the interest rates offers in Kosovo were not significant. While comparing 2009 interests' rates with 2013, on average, loan and deposit interest rates have marked a slight downward trend. Compared to 2011, personal and business loan interest rates have increased, while interest rates for cars, housing and deposits have marked a downward trend. In 2010, loan interest rates have remained the same with 2009 and isolated from the financial crisis, but interest rates on deposits have dropped. In 2010, loan interest rates have varied from 10 percent to 24 percent, while these rates have remained almost the same in 2010 varying from 9 percent to 24 percent. While comparing year 2011 with 2010, loan interest rates and product tariffs have remained the same with those of 2010 (GAP Institute for Advanced Studies, 2013 Bankwatch # 8).

3.4.2 Personal loans

Comparing 2013 with 2009, interest rates on personal loans have on average dropped for only 0.1 percentage points. Interest rates on personal loans in 2011were only 11.5percent, while in 2009 these interest rates have reached the peak with 12.0 percent.

Figure 5. Consumption Loans



Source: 2013 *GAP Institute, Bankometri no. 8, Interest rates on consumption loans,* p. 13.

Compared to other banks, on average Turk Ekonom i Bankasi (TEB) has had the lowest interest rates on personal loans with 11.2 percent. From 5 banks of which have reported their interest rates in 2013, Raiffeisen Bank has the highest interest rates with 12.9 percent followed from Pro Credit Bank with 11.9 percent. Three other banks have reported equal interest rates of 11.5 percent (GAP Institute for Advanced Studies, 2013 Bankwatch # 8).

Data from the CBK show that except in 2011, household consumption loans had a stable yearly trend of around 175 million EUR new loans issued per year. Seasonal effects seemed to be strong, with May being the month when lending activity peaked. Lastly, correlation coefficient between effective interest rates (EIR) and new loans issued seems not to be that strong and was 0.5 (CBK 2013, ODC Effective Interest Rates).

3.4.3 Business loans

On average, business loans nominal interest rates have peaked in 2009 at 13.8 percent, while the bottom was reached in 2010 at 12.7 percent. The downwarding trend came mainly due to lower nominal interest rates from smaller banks such as Banka per Biznes and NLB Prishtina. In 2013, NLB Prishtina had the lowest nominal interest rate of 12.5 percent (GAP Institute for Advanced Studies, 2013 Bankwatch # 8).

Business loans had a constant increasing trend since 2010. Even though agriculture loans had the highest growth of 8% in 2012, their participation in the total outstanding business loans was only 4%. The largest share of loans was taken by services with 74%, followed by industry, mining and construction at 24%.

3.4.4 Housing loans

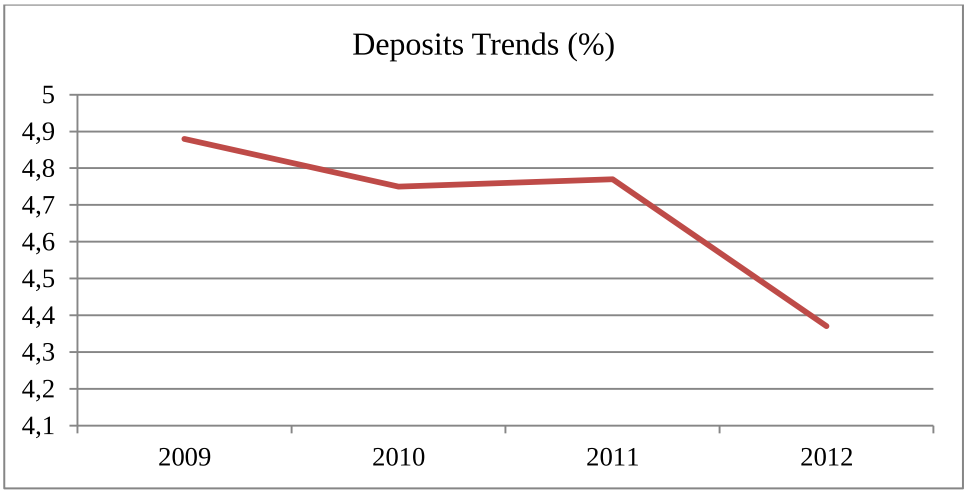
Housing loans nominal interest rates were the highest in 2009 and the lowest in 2013. In 2013, Banka Kombetare Tregtare had the lowest interest rate of 9.5, while Raiffiessen Bank had the highest nominal interest rate of 10.6 percent (GAP Institute for Advanced Studies, 2013 Bankwatch # 8).

3.4.5 Deposits

As we can see in Figure 7, there has been a slight down warding trend on deposits interest rate and this trend has come mainly due to Pro Credit Bank nominal interest rate. In 2013, Banka per Biznes had the highest nominal interest rate on deposits with 5.2 percent (GAP Institute for Advanced Studies, 2013 Bankwatch # 8).

Data from CBK show that the decreasing trend on effective interest rates on deposits was followed with a constant increase on outstanding amounts of deposits in commercial banks.

Figure 6. Deposits Trends



Source: 2013 *GAP Institute, Bankometri 8, Interest Rates on Deposits*, p. 17.

3.4.6 Effect of asymmetric information on high interest rates in Kosovo

According to a study done by the GAP Institute, banking system in Kosovo is characterized by very low levels of transparency both on client-bank direction and also on bank-client direction (GAP Institute for Advanced Studies, 2013 Bankwatch # 8).

Recently, steps have been undertaken in order to improve the legislature framework regarding this issue. A positive step toward improving the legal framework, the quality and access to information of the banking system has been undertaken with the approval of the Credit Registry Regulation, on February 24, 2012. The CBK has improved the Credit Registry by improving the quality of collection and distribution of information from credit providers about the credit takers records. Now, banks will have better information of credit takers regarding features such as: credit history, collateral, period when loan was taken, loan’s purpose, outstanding amount of payment, payment delays, etc. This improvement will enable banks to have more exact information about the profile of the credit takers. In addition, businesses would also benefit from this as information would help them for self-screening purposes, so those with sound record would benefit from lower interest rates (CBK, 2013).

Another factor that would probably affect interest rates and increase the level of competition among banks would be an improvement of the quality and access to information of clients toward banking system prices. So far, banks have provided very limited information on their web-sites regarding the cost and benefits generated from banking services and products. Furthermore, banks have reported independently their nominal interest rates, administrative costs and other costs. This was further complicated when it is taken into account that banks in Kosovo on average report 0.5-2.0 percent lower interest rates compared to those used in practice. All these factors have caused additional costs to businesses as they needed to spend time in order to get and elaborate the information about the credit price (GAP Institute for Advanced Studies, 2013 Bankwatch # 8).

CBK has undertaken legal steps in order to solve this problem. In November 2012, CBK approved the Regulation on Effective Interest Rate and Disclosure Requirements for Banks, Micro financial Institutions and Non-Bank Financial Institutions. This regulation obliges the above mentioned institutions to publish the Effective Interest Rates (hereinafter: EIR) on their websites and EIR will include all the costs calculated in the price. EIR disclosure on banks’ website will save time (cost) of businesses interested to take credit. It will also improve the competitiveness between banks leading to lower interest rates (GAP Institute for Advanced Studies, 2013 Bankwatch # 8).

3.5 Demand side - businesses and business environment

Businesses in Kosovo operate in a very difficult environment, thus, affecting especially new businesses as they are more fragile and less financially consolidated. High levels of corruption and nepotism, informal practices and fiscal evasion are some of the factors that damage competition deteriorate financial well-being of new businesses which in turn affect their credit rating.

3.5.1 Structure of new businesses

Since 2009, there was an increasing trend of new businesses in Kosovo. There were approximately 9600 new businesses registered in 2012 which compared to 2009 increased by 28 percent from 7505 businesses. This upward trend continued in the first quarter of 2013. The number of new businesses opened increased by 22 percent from 2543 to 3101.

Continuously, the number of new businesses opened for trade purposes dominated the entrepreneurship activity with approximately 3000 new trade businesses out of 9600 in 2012. Processing industries, construction businesses and estate agencies were next with approximately 900 new businesses in the each group. Businesses in agriculture, hunting and forestry, transport and communication were next with approximately 800 new businesses being opened in 2012. It should be noted that among all these new businesses, businesses in agriculture, hunting and forestry have had the most significant increase (145 percent) when comparing 2012 with 2011.

In addition, construction and real estate businesses increased by 47 percent. Among trade companies, real estate agencies, agriculture, transport and communication, registered in the first quarter of 2013,employed 1 to 4 employees (KAS, 2013 Statistical Report on Economic Enterprises in Kosovo).

Only 701 out of 3101 of newly registered businesses in the first quarter of 2013 are non-individual ones while the rest are individual businesses. In the category of non-individual businesses, real estate agencies account for 31 percent, followed by trade companies which account for 24 percent. Even though the non-individual businesses are dominated by these two categories, 80 percent of trade businesses are individual ones. Statistics indicate that non-individual companies tend to employ more people. Around 8 percent of non-individual companies employ more than 5 people compared to only 1 percent of individual ones Furthermore, among 3101 of the new businesses registered in the first quarter of 2013, 99 percent of them employed up to 9 employees, 0.52 percent employed 10-16 employees, 2 businesses employed from 50-249 employees, and only 1 business employed above 250employees (KAS, 2013 Statistical Report on Economic Enterprises in Kosovo).

Most of the companies registered in the first quarter of 2013 are located in Prishtina (817 businesses), followed by Ferizaj (250 businesses) and Prizren (204 businesses). On the other hand, also most of the businesses closed down are located in Prishtina, Prizren and Gjilan (KAS, 2013 Statistical Report on Economic Enterprises in Kosovo).
The legal structure of companies is dominated by individual businesses (77.4 percent), limited liability partnerships come second (20.8 percent) and other forms of legal structures make the rest. Among all newly created businesses, 99.6 of their capital is originated as national or only 10 out of 3101 new businesses have a foreign capital source of funding (KAS, 2013 Statistical Report on Economic Enterprises in Kosovo).

3.5.2 Structure of existing businesses

From 2008 to 2011, the number of active enterprises registered at Tax Administration of Kosovo has varied from 41 to 42 thousand businesses. In this calculation, the activities of agriculture, forestry, fishing, finance and public administration are not included. The number of people employed has varied from 89 to 123 thousand employees, but according to many assessments this number may not be real due to the high level of informal activity in the economy of Kosovo. Of all these activities, trade businesses have dominated with approximately 50 percent followed by processing industries and business services (10 percent approximately). Trade enterprises were the largest employers with approximately 40 thousand employees (31 percent). Processing industry followed with 20 thousand employees (17 percent approximate) and transport and communication with 11 thousand employees (8.8 percent approximate) (KAS, 2013 Statistical Report on Economic Enterprises in Kosovo).

The average wage in all the sectors has varied from 270 to 290 EUR, while the highest wages were recorded in the post and telecommunication sectors (average 538 EUR), followed by production and energy distribution (504 EUR). On the other hand, the lowest paid sectors are restaurant and hotels (an average of 220 EUR), followed by the processing industry (244EUR) and trade enterprises (252 EUR) (KAS, 2013 Statistical Report on Economic Enterprises in Kosovo).

If we compare the sectors according to revenues generated from their selling activities, trade sector takes 55 percent of total revenues, construction businesses come second with 12.8 percent and the third is the processing industry. Sectors with lower generated revenues are other services (0.9 percent), hotels and restaurants (1 percent) and mining industry 3 percent. Regarding expenses, trade sector dominates with 55 percent of total expenses, followed by construction (12.9 percent) and processing industry (12.1 percent). Lowest expenses are marked in hotels and restaurants and other services (0.5 percent) and business services (2.1 percent) (KAS, 2013 Statistical Report on Economic Enterprises in Kosovo).

3.5.3 Business environment

This part of this chapter will summarize the results of World Bank Doing Business Report which in general measures how on easiness, respectively difficulty, for a local entrepreneur to open and run a small to medium-size business when complying with applicable laws and regulations (The World Bank 2013, Economy Profile: Kosovo Doing Business 2013, p.4).

In addition, World Bank finding will be supplemented with other reports and research findings with regard to specific issues. This chapter will briefly provide information with regard to 11 aspects of doing business such as: starting a business, obtaining construction permits, getting electricity, registering property, getting credit, protecting its investors, paying taxes, trading across borders, enforcing contracts, resolving insolvency and employing workers. Economies are ranked within an index range from 1 to 185; while the higher the ranking the better the business environment is considered to be (The World Bank 2013).

Kosovo was ranked as the 98th country in the world for the easiness of doing business, marking an impressive increase of 28 places. While an increase has been significant, Kosovo is still among the lowest ranked compared to the regional countries such as: Macedonia (40), Croatia (84), and Albania (85). Only Bosnia and Herzegovina is left far behind ranked at 126.

3.5.4 Starting a business

In principle this indicator measures: a) procedure to legally start and operate a company; b) time required to complete each procedure; and c) cost required to complete each procedure. According to the report, starting a business in Kosovo requires nine legal procedures, in average it takes 5 days and costs 23 percent of income per capita while requires minimum paid capital of 0 percent. Kosovo is ranked as the 126 out of 185. While Eastern Europe and Central Asia average1 stands at 60, Albania and Croatia are ranked at 60 respectively 80. Bosnia and Herzegovina is ranked at 162. Compared to the previous year, Kosovo has improved in this indicator for 44 places (from 170 to 126).
The number of procedures decreased for a day (The World Bank 2013).

[1]From now on when referring to the region’s or regional average it means Eastern Europe and Central Asia

3.5.5 Dealing with construction permit

This indicator measures procedures, time and cost of building a commercial storehouse in the largest business city, connects it to utilities and registers the property in order to use it as a collateral and transfer to another entity. According to this report, dealing with construction permits requires 16 procedures which takes up to 156 days and costs 2986 percent of income per capita. With this regard, Kosovo is ranked among the lowest in the list of 185 countries, standing at 144. It is ranked 18 places below the region average, but neighborhood countries such as Albania, Serbia and Bosnia and Herzegovina lack behind. The trends over the last four years show that numbers of procedures have remained constant while they are below region's average. After having a constant trend, days have remarkably dropped only in 2012, while cost had a significant decrease in 2011 and the downward trend is still continuing. With regard to changes over time, Kosovo improved its ranking for 33 places. The improvement was a result of time shortening for 145 days and cost decrease as a percentage of per capita income for 510 percentage points (The World Bank 2013).

3.5.6 Getting electricity

This indicator records the procedures required for a new business to obtain enduring electricity and supply for a storehouse, while also it includes time and cost of getting it. According to the report, it requires 7 procedures, takes 48 days and costs 915 percent of income per capita to obtain electricity and supply for a storehouse. The overall ranking of Kosovo in this indicator is 116, while its 7 places better ranked than the region's average. In addition, countries like Serbia, Croatia and Macedonia are ranked higher than Kosovo, whereas Albania and Bosnia and Herzegovina are ranked lower. Kosovo has improved 6 places compared to the previous year and currently it takes the shortest time in the region to get electricity. Compared to the previous year, procedures have remained at the same number, time has shortened for 12 days while the cost has decreased by 101 percentage points (The World Bank 2013). Beside access to electricity, Kosovo still faces power cuts while electricity technical and non-technical losses go to 36% (ZRRE, 2013 RaportiVjetor 2012). Kosovo has privatized distribution network and supply function in May 2013, but it failed for many times to tender the building of a new lignite power plant.

3.5.7 Getting credit

This indicator assesses the infrastructure quality of information system and legal rights of the borrowers and lenders. The depth of credit index measures the regulations and accessibility of credit information through public or private credit registries, whereas, the strength of legal rights index measures whether there exists any sort of mechanism that would assist in lending regarding collateral and bankruptcy laws (The World Bank 2013).

Kosovo is ranked as 23rd and is equal to Macedonia, while leaving behind all the regional countries and countries of Eastern Europe and Central Asia by 30 places. Further, with regard to depth of credit, Kosovo has scored 5 and 8 on the strength of legal rights. In addition, Kosovo has remained in the same position in this indicator compared to the previous year. Public registry covers 22 percent of adults, while private bureau does not exist in Kosovo. With regard to the legal rights, Kosovo is ranked lower than the region, while depth of credit is ranked in the same level (The World Bank 2013). Even though there was not any significant change in Doing Business Report ranking, lending activity of Other Depository Corporations (ODCs) to residents slowed down from 12% growth in 2011 to 5% growth in 2012 (CBK, ODCs Income Statement). According to the CBK, this came as a result of negative perceptions toward economic developments within the country. These perceptions proved right as GDP growth was only 2.3% compared to 5.2% in 2011 (IMF, 2013 World Economic Outlook Database).

3.5.8 Paying taxes

The indicator is about measuring taxes and contributions and also administrative burden of paying them. These measures are taken based on a case scenario including a medium-size company and use a set of financial statements and assumptions about transactions made over the year. As in other indicators, there are three components measured: the number of annual payments, time and total tax rate. According to the data, a medium-size company in Kosovo makes 33 tax payments in a year, it spends 164 hours filing, preparing and paying taxes and it pays 15.4 percent of its profit (9.1 percent profit tax and 5.6 percent labor tax and contributions) to the tax authorities. Among all kinds of taxes, the longest time of a tax to pay in Kosovo is: Value Added Tax (90 days), social security (42 days) and corporate income tax (32 days). Globally, Kosovo is ranked quite high at 44th place, thus, being 56 places above the region’s average.

In addition, Macedonia and Croatia are ranked higher, while the rest of the regional countries ranked below. Compared to the previous year, Kosovo has improved its ranking for 4 places, but this is due to the changes in other countries. Further, even though compared to the region, Kosovo had lower number of payments in 2010, now the regional average is lower than the one from Kosovo. This is due to the decreasing average in the number of payments in the region and the unchanged number in Kosovo. With regard to the time it takes to pay taxes, Kosovo is approximately 100 hours below the region in average, and 30 hours above the best regional performing country. With regard to total tax rate, Kosovo had a significant decrease in 2011, thus being ranked equally with the best regional performance and far better than regional average (The World Bank 2013).

According to Progress Report 2013 of European Commission, a number of steps have been undertaken in order to improve compliance with taxation. Furthermore, with regard to administrative and operational capacity there was an increase in the number of online payments (European Commission, 2013 Kosovo* Progress Report). As a result, Tax Administration increased its revenue by 9% or 283 million Euro where VAT dominated with 45.8%, Corporate Tax 22.8%; Tax Deducted at Source 21.7%; Tax on Individual Businesses 9.1% etc. (Tax Administration of Kosovo, 2012). With all these improvements, there are still challenges with regard to enforcement of tax legislation as the informality in the economy and tax evasion is still high.

3.5.9 Trading across borders

This indicator measures "the time and cost (excluding tariffs and the time and cost for sea transport) associated with exporting and importing a standard shipment of goods by sea transport, and the number of documents necessary to complete the transaction" (The World Bank 2013).

Documentation requirements and procedures at the customs and at port are measured. In addition, the indicator measures time and cost of inland transport and other trade logistic costs. In order to export a standard container of goods in Kosovo, 8 documents are required, it takes 15 days and it costs $1,775. Kosovo stands at 124th place on global ranking and it has improved for 11 places compared to the previous years. The improvement came due to: a) the reduction in days that it takes to export and import (17 to 15 days to export respectively 16 to 15 days to import); and b) cost to export and import decreased by $495 respectively $470. The cost components of imports include: customs clearance and technical control, ports and terminal handling, and transportation handling. Kosovo stands behind regional average and all other regional countries. Documents required to export are greater than the region's average, and have remained constant over years. Time to export has dropped just in 2012, and is shorter than the region's average.

Further, decrease in cost needed to export in 2012 improved Kosovo's position compared to the region's average. Documents required to import are equal to the regions' average, while days to import are shorter. Lastly, same as with the export cost, in 2012, import costs lowered compared to regional average. Kosovo's budget is mostly oriented toward infrastructure. In 2013, among 51 central institutions, Ministry of Infrastructure got 17% of the national budget (Ministry of Finance, 2013 Ligji per Buxhetin e Republikes se Kosoves 2014). Even though, much is spent on the road infrastructure, the quality and safety do not meet the required standards. In addition, Kosovo still lacks behind European standards, especially with regard to the establishment of multimodal transport. Railway system lacks human capacity and financial resources while regulators cannot join international regulation bodies (European Commission, 2013 Kosovo Progress Report).

3.5.10 Registering property

This indicator records the whole procedure of buying a property from a business until selling it to another buyer. The whole transaction is considered to be complete when the buyer can use the property, use it as collateral and is able to sell it. In order to complete this transaction in Kosovo, it requires 8 procedures, takes 33 days and costs 0.6 percent of property value. Kosovo is ranked at 76th place which is 17 places above region's average. Countries like Croatia, Bosnia and Herzegovina and Albania are ranked behind, while Macedonia and Serbia are ranked higher than Kosovo.

Compared to the previous years, Kosovo has improved for only two places, but this is due to the changes in others countries positions. In Kosovo, none of the reforms was conducted with regard to the required procedures, time or cost. Further, compared to the region's performance, there are more procedures required to register a property, while the cost is far below than that of the region. In overall, the three dimensions have kept a constant trend during the last four years (The World Bank 2013).

In general, property rights infrastructure is very weak in Kosovo due to an underdeveloped legislation and implementation institutions. Some progress has been made with the reach of agreement between Kosovo and Serbia on cadastral record (Kosovo Ministry of Foreign Affairs, 2013, Prime Minister Statement at UN Security Council). In addition, with regard to the banking sector, in 2013, there was a significant increase of 49% of mortgages for loan purposes totaling to 1.3 billion EUR. (European Commission, 2013 Kosovo Progress Report).

3.5.11 Resolving insolvency

This indicator studies the time, cost and outcome of insolvency proceedings involving domestic entities. It does not measure insolvency proceedings of individuals and financial institutions (The World Bank 2013). According to the results, it takes on average 2 years to resolve insolvency and it costs 15 percent of the debtor's estate. The average recovery rate is 34.7 cents. Standing at 87th place, Kosovo is ranked only 7 places below the region's average, while Croatia and Serbia are the countries below and the rest are ranked higher. All the components of the indicators have remained unchanged compared to the previous years, even though Kosovo ranked a place above. Compared to the region's time needed to resolve insolvency, it is shorter in Kosovo while it costs about 2 percent more. Recovery rate is the lowest in Kosovo compared to the regional best performance and even global one (The World Bank 2013). Overall, Kosovo has a large number of unresolved cases in judiciary, thus, it suffers from poor efficiency (European Commission, 2013 Kosovo* Progress Report).

3.5.12 Enforcing contracts

This indicator "measures the efficiency of the judicial system in resolving a commercial dispute before local courts" (The World Bank 2013). Specifically, the report took a case scenario of sales contract breach between two domestic businesses. Kosovo stands at 138th place.

To enforce a contract, it takes 420 days, it costs 33 percent of the value of the claim and it requires 53 procedures. All these components have not changed since last year. Kosovo is ranked far below (79 places) region's average and it is also ranked below every single country in the region. With regard to the time needed, Kosovo is almost equal with the region's average but it takes approximately 250 days longer than regional's best performance. It costs approximately 9 percent more in Kosovo to enforce a contract compared to the region's average and approximately 20 percent more to the region's best performance.

Lastly, with regard to components of this indicator, it requires approximately 16 procedures more to enforce a contract in Kosovo compared to the region and 30 procedures more to the region's best performance. All the components have remained unchanged since 2010 (The World Bank 2013). The "alarming" state of contract enforcement is identified also in the Progress Report 2013 which led to high interest rates on loans and an increase on non-performing loans (European Commission, 2013 Kosovo Progress Report).Bae and Goyal (2009) explain that poor enforcement affects the banks directly which affects the structure and the price of a loan.

3.5.13 Protecting investors

"Doing Business measures the strength of minority shareholder protections against director's use of corporate assets for personal gain—or self-dealing" (The World Bank 2013).

This indicator is measured along the three dimensions of investor protection: a) transparency of related party index; b) liability of self-dealing or director's liability index; c) ability of shareholders to sue directors and officers for misbehavior. Globally, Kosovo is ranked at 100th place listed 40 places below the region's average. However, Kosovo's improvement compared to the previous year has been impressive, as it ranked up for 74 places. In the extent of disclosure, Kosovo got 6 points[2] and improved for 3 points. Regarding director liability index, Kosovo improved for 4 points scoring to 6 points. Ease of shareholder suit index has remained the same over the years, scoring only 3 points.

Lastly, strength of investor protection index improved for 2.3 points, scoring to 5 points, but it ranked below region's average and best performance and far below global best performance. Compared to the region, disclosure index has scored better, while with regard to liability regime, Kosovo has scored lower. Lastly, with regard to the ease of access to internal corporate documents, Kosovo scored lower than the region (The World Bank 2013). This year, the Assembly of Kosovo approved the Law on Foreign Investment which according to the Ministry of Trade is going to improve the protection of foreign investors in accordance with the latest practices and EU legislation (Ministry of Trade, 2013). As Bae and Goyal (2009) state, investor protection would be higher if there is a transparent and effective judicial system in place.

3.5.14 Corruption

Corruption is present in Kosovo in the public and private sectors. It creates unfavorable conditions for businesses to work and thus undermines companies' efficiency. There is a lack of enforcement of trade regulations and these way businesses operate informally and evade taxes and other state duties (UNDP, 2012, Kosovo Human Development Report, p.63). The Perception Corruption Index in 2011 was 2.9 on a scale of 0 to 10, placing Kosovo on 112nd (Transparency International, 2011, Perception Corruption Index). Corruption, especially bribery, increases overall costs to a business.

The consequences of corruption are highly detrimental as it averts investment and slows economic growth. Additionally, it reduces the efficiency and effectiveness of public administration and distorts public expenditures. Corruption increases wealth of some individuals at the expense of the society and stimulates inequality where the poor are the ones who suffer the consequences and reduces the effectiveness and efficiency of public administration and distorts public expenditures. (World Bank Group, 2009, Helping Countries Combat Corruption).

3.5.15 Fiscal evasion

According to a recent study from Riinvest Institute, a large number of businesses operating in Kosovo claim that unfair competition, as a consequence of informality and fiscal evasion, is among the top barriers in doing business. As the data show, only around 65.6%

[2] Maximum is 10 points for the next indicators mentioned under protecting investors

of businesses report their sales officially to the relevant authorities, leaving around 34.4 % to be evaded. An interesting fact is regarding general perception on inspections. A big percentage of respondents, about 62.7%, believe that they can easily get away without being caught if they want to cheat (Riinvest Institute, 2013, To pay or not to Pay: A business perspective of informality in Kosovo).

Allingham and Sandmo (1972) show how someone makes a decision to comply and argue that the level of tax evasion depends on tax, audit, and fines. Later studies from Frey and Feld (2002) and Sandmo (2004) find that fiscal evasion is motivated from a psychological contract between the parties and in order for this contract to be enforced, rewards and punishments should be introduced.

3.5.16 Cadastral system

Cadastral issues in Kosovo are still among the factors that commercial banks use to reason themselves for high interest rates. Since there are problems with ownership certificates, contracts cannot be enforced and banks cannot take as collateral apartments or houses that customers offer when they apply for a credit facility. In this way, interest rates remain at high levels since there is no way to claim ownership (Kosovo Foundation for Open Society Project & Riinvest Institute, 2012, Banking Sector: Facilitator or Barrier).

3.6 Worldwide Governance Indicators

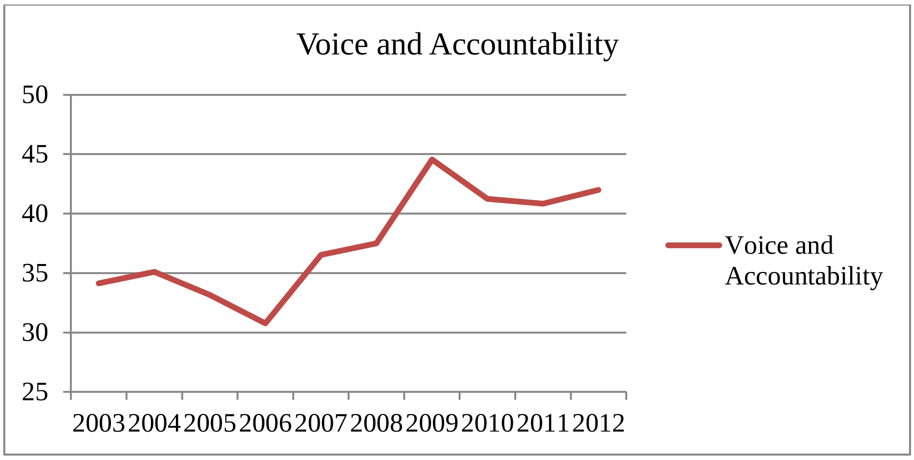
The Worldwide Governance Indicators (hereinafter: WGI) dataset summarizes aggregate and individual governance indicators for 215 countries for the period 1996-2012. This dataset is not an official view of World Bank or countries represented but incorporate data from different non-governmental organizations, private sector companies, international organizations, and other survey institutes. WGI dataset uses different types of source data such as surveys of households and firms, commercial business information providers, non-governmental organization, and public sector organizations.

These indicators report on six dimensions of governance: voice and accountability, political stability and absence of violence, government effectiveness, regulatory quality, rule of law, and control of corruption. For the purpose of this thesis, we will use the percentile rank among all countries (which ranges from 0, the lowest, to 100, the highest) to make comparisons between Kosovo and other countries. The line graphs for each of the indicators show Kosovo's percentile rank (which show the percentage of countries worldwide that rank lower than Kosovo). The higher the figures are the better the governance scores (Kaufmann, Kraay, Mastruzzi, WGI, 2013).

3.6.1 Voice and accountability

This indicator includes perceptions of citizens in being able to participate when selecting their government as well as freedom of expression, freedom of association, and free media. Figure 7 shows data for Kosovo from 2003 to 2012. Starting in 2009, Kosovo seems to be performing better, above 40th percentile, even though the line drops in 2010 and there is a slight increase in 2011 and 2012.

Figure 7. Voice and Accountability – Kosovo

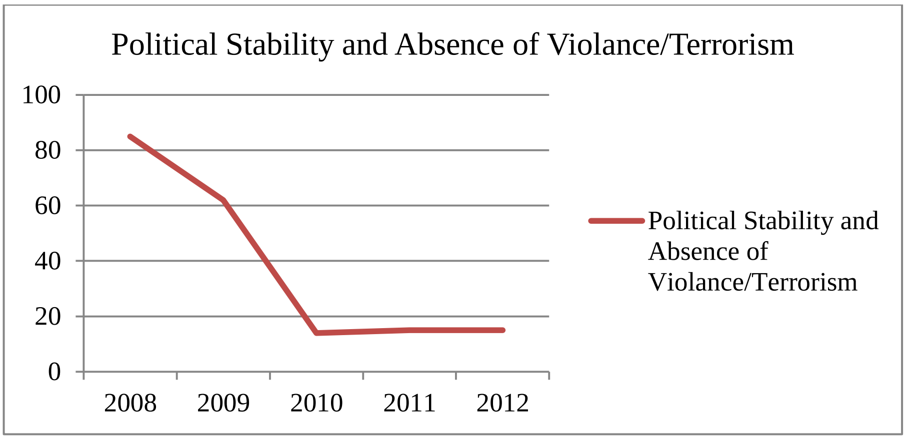


Source: *Own compilation from WGI dataset, 2013.*

3.6.2 Political stability and absence of violence / terrorism

This indicator is about perceptions of citizens of the likelihood that the government will be destabilized or overthrown including violence and terrorism. As can be seen from Figure 8, Kosovo does not stand in a good position by being below the 20th percentile.

Figure 8. Political Stability and Absence of Violence/Terrorism – Kosovo

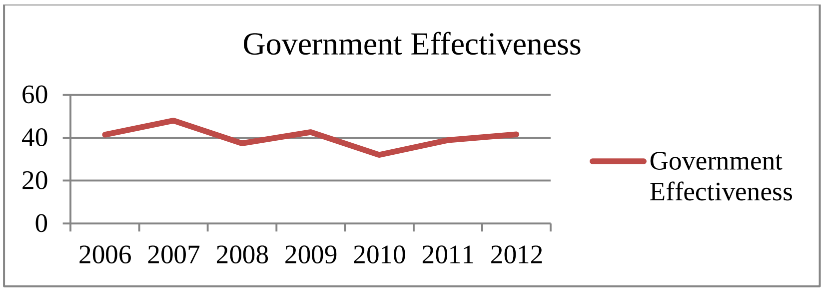


Source: *Own compilation from WGI dataset, 2013.*

3.6.3 Government effectiveness

This indicator measures perceptions of citizens on the quality of public services offered, quality of civil service and the degree of its independence from politics, quality of policy formulation and implementation, and how much is a government committed and its credibility to such commitment. Figure 9 below about government effectiveness in Kosovo shows that Kosovo's citizens had higher perceptions in earlier years (2006, 2007, 2009) than they do now.

Figure 9. Government Effectiveness – Kosovo

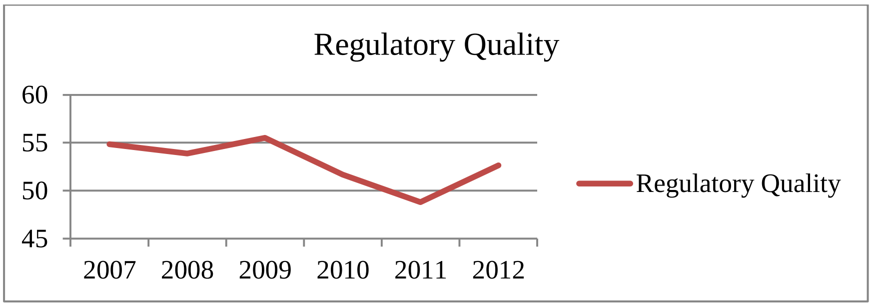


Source: *Own compilation from WGI dataset, 2013.*

3.6.4 Regulatory quality

Regulatory Quality indicator reflects the perceptions of citizens on the ability of the government to formulate and implement policies and regulations that promote private sector development. Even though at this indicator Kosovo ranks above 50th percentile, if we look at data from 2007 we see a down-warding trend (see Figure 10).

Figure 10. Regulatory Quality– Kosovo

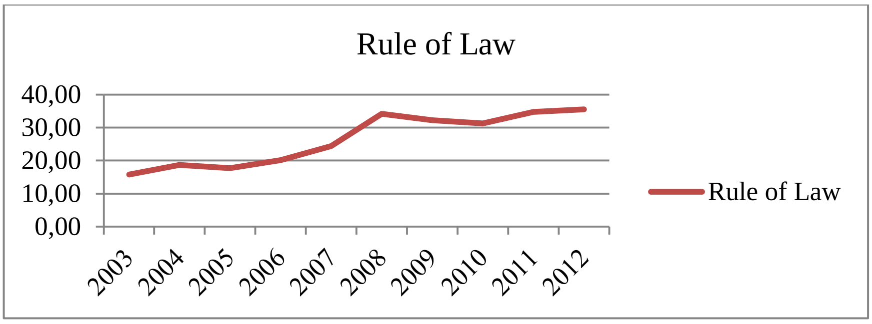


Source: *Own compilation from WGI dataset, 2013.*

3.6.5 Rule of law

The indicator on rule of law measures perceptions of citizens to the extent to which agents have confidence in and abide by the rules of society, and in particular the quality of contract enforcement, property rights, the police, and the courts, as well as the likelihood of crime and violence. From Figure 11, we see an up warding trend and this might seem as a positive sign. However, Kosovo seems to be still below 40th percentile which makes us think that it has a long way forward to improve on this indicator.

Figure 11. Rule of Law – Kosovo

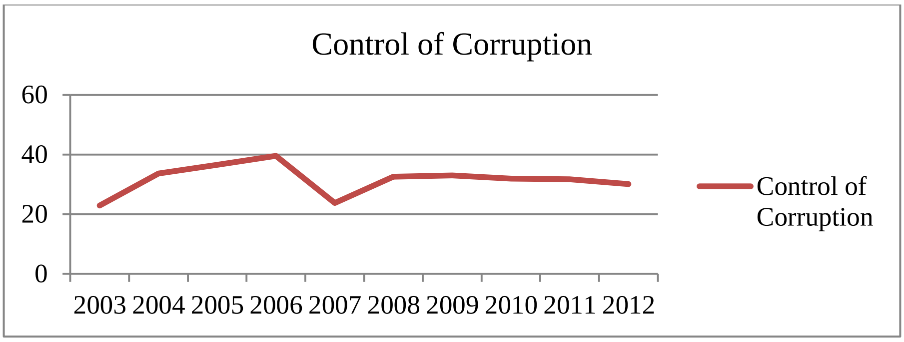


Source: *Own compilation from WGI dataset, 2013.*

3.6.6 Control of corruption

This indicator captures perceptions of the extent to which public power is exercised for private gain, including both petty and grand forms of corruption, as well as "capture" of the state by elites and private interests. Data on Kosovo from 2003 depict not a very good 'picture'. Even though there is an increase in control of corruption during 2005-2006, figures show a down-warding trend in the recent years (see Figure 12).

Figure 12.Control of Corruption – Kosovo



Source: *Own compilation from WGI dataset, 2013.*

4. THE GLOBAL FINANCIAL CRISIS

This chapter provides a short chronological overview of the crisis, from the Lehman Brothers bankruptcy filing in September 2008 to the approval of the rescue package by the U.S. Congress. The role of the credit rating agencies and their conflict of interest in rating financial institutions are also analyzed. Measures that have been taken to ensure better regulation in the aftermath of the crisis will be evaluated. Massive infusions of liquidity gradually reversed credit freeze and restored investor confidence.

Due to the global nature of the modern financial markets, the crisis affected investors and economies in Europe and across the world. Considering that a significant number of immigrants from Kosovo live in Western Europe and send money transfers to their families back home, volatile labor markets translated into lower remittances for Kosovo. The crisis had noticeable effects on the levels of remittances and FDI in Kosovo and the region.

4.1 Origins of the crisis

The global financial crisis that started to unfold in late 2008 led to one of the worst recessions of the world economy. A multitude of factors contributed to the crisis that initially started in the U.S. and engulfed almost all economies worldwide. The relatively lax requirements for housing mortgages in the US led to a boom in the housing market. Moreover, high leverage (high debt/equity ratio) pushed banks to pursue bigger risks at a greater profit margin (Bianco, 2008, p.7).

Banks and other financial institutions loaned out high amounts to people with low or bad credit. This eventually evolved in a more complicated process involving many players in the financial system and the rise of securitization – the packaging and selling of asset backed securities (e.g. sub-prime mortgages). In other words, securitization refers to the process of transforming non-liquid non-negotiable assets into liquid, negotiable, and tradable assets.

Specifically, banks would take a number of loans that had similar characteristics (such as quality and maturity), repackage them, and sell them to investors. Securitization perverted the principles of prudent banking as lenders had minimal incentives to conduct rigorous credit analysis. The loans would stay in the banks' balance sheet for a very short period of time before being packaged and sold off to another investor. Diversification would reduce the risk if a low-grade mortgage was packaged together with mortgages from other area. Hence, the main motivation for banks to pursue securitization was to free up capital and pass on the risk to investors. This process also masked the true status of many loans, which did not have good grades. Once the housing bubble burst, investors and banks were left holding many mortgages that became illiquid (U.S. Senate Permanent Committee on Investigations, 2011, Wall Street and the financial crisis: Anatomy of a financial collapse).

Moreover, the deregulation of the financial markets that characterized most of the 1990s and early 2000s fueled the financial crisis and limited the power of the US government to prevent the fallout from the crisis. A deregulation wave started in the 80s culminating in the repeal of Glass-Steagall Act of 1993, which had created the Federal Deposits Insurance Corporations and separated commercial banking from securities industry in the United States. The repeal of Glass-Steagall was a major step in the deregulation process since banks or affiliated securities firms could then gamble with depositors' money held in commercial banks. The repeal of the act helped securities firms to convert into bank holding companies and banks to acquire security firms. Even though the act did not forbid specific actions, it would have reduced the systemic component of the risk in financial markets by separating securities and commercial banks (U.S. Senate Permanent Committee on Investigations, 2011, Wall Street and the financial crisis: Anatomy of a financial collapse, p.321).

Former U.S. Secretary of the Treasury Timothy Geithner summarized this problem: "Our framework for financial regulation is riddled with gaps, weaknesses and jurisdictional overlaps, and suffers from an outdated conception of financial risk. In recent years, the pace of innovation in the financial sector has outstripped the pace of regulatory modernization, leaving entire markets and market participants largely unregulated." (Geithner & Summers, 2009).

Financial markets are different from other markets due to the need for special regulation and monitoring. The 2008/09 crisis accentuated the need for regulation, because of the systemic risk of finance stemming from the high level of interconnectedness of financial institutions. The opaque nature of finance calls for regulation but at the same time makes regulation difficult (U.S. Senate Permanent Committee on Investigations, 2011, Wall Street and the financial crisis: Anatomy of a financial collapse, p.42).

Leverage played a significant role during the crisis. The bank had had cheap, readily available credit for a decade which was the rocket fuel driving economies. A large part of daily securities trading depended on borrowing - using securities as collateral. However, as financial markets rapidly declined during crisis, owners of securities (e.g. financial institutions) and entire financial system was subjected to massive margin call, which fueled market declines as everyone was forced to sell at same time. Therefore, "deleveraging" created a negative feedback loop by undermining confidence and unprecedented credit contraction (freeze). Even short-term credit to most creditworthy institutions became scarce as fears of further exposure to risks continued to spread (Geithner and Summers, 2009).

Throughout the 1990s developing countries started to save instead of continuing to spend and this created surplus savings that could be used by others such as corporations in industrialized countries. Corporations invested heavily in IT leading to the dot-com bubble. In spite that the US Federal Reserve lowered interest rates, yet corporations were reluctant to invest as they had invested too much already. Lower Fed rates were an incentive for US consumers to buy houses leading to increases of house prices. Raghuram Rajan, former chief economist at the International Monetary Fund who cautioned on the excessive risks of the banks prior to the crisis, writes “The flood of money lapping at the doors of borrowers originated, in part, from investors far away who had earned it by exporting to the United States and feeding the national consumption habit” (Rajan, 2011).

Unregulated shadow financial system refers to large non-bank financial institutions (e.g. insurance, hedge funds) that perform many of same functions as banks, are inter-connected like banks but are not subjected to regulatory monitoring (e.g. “prudential oversight”) or similar requirements (e.g. capital adequacy, disclosure). The proliferation of such institutions exacerbated the crisis as it made monitoring and regulation very difficult, allowing for predatory and too risky activities.

Another element that played a role in exacerbating the crisis was the importance of the rating agencies. The United States Senate concluded in a report on financial crises that the inaccurate credit ratings have had contribute to the financial crisis by disguising the true risk of many mortgage related securities. Furthermore, the report argues that the inflated AAA credit ratings have introduced risk into the U.S. financial system and may be considered to have constituted a key cause of the financial crisis.

The other factors which are responsible for the inaccurate credit ratings include used rating models that failed to take account of relevant mortgage performance data; unclear and biased criteria used to create ratings; a failure to apply updated rating models to existing rated transactions; and a failure to provide adequate human resources to perform rating and surveillance services, despite record revenues (U.S. Senate Permanent Committee on Investigations, 2011, Wall Street and the financial crisis: Anatomy of a financial collapse, p.5).

Credit Rating Agencies were supposed to give unbiased assessments of the risk profile of securities in order to help economic agents to invest. However, due to a combination of lack of transparency in reporting financial statements and methodological mistakes by the

Credit Rating Agencies, in the moment immediately before the late 2000s financial crisis many agencies gave good ratings to financial institutions that were completely compromised by excessive leveraging. These faulty ratings distorted the way economic agents perceived risk in the marketplace and distorted investments (Bianco, 2008, p.9).

4.2 Response to the crisis

The response to the crisis was massive as there was serious risk of contagion and prolonged economic depression. The US Federal Reserve injected over $1 trillion into the inter-bank market in order to restore confidence. By proving liquidity to banks, the Fed strived to prevent a major recession. There was widespread panic in the market since financial institutions did not know to what extent other institutions were exposed to bad loans, which contributed to the credit freeze. Through the injection of liquidity, the Fed hoped to resume inter-bank lending and restore trust in order to provide credit to the economy at large. The Fed used a multitude of tools to achieve its goals including open-market operations, repurchase agreements, facilitating access to the “discount window”, and lowering the interest rates (the Fed funds rate). Additionally, the US government assured that deposits up to $250,000 per account would be guaranteed. Also, the US government nationalized large, failing financial institutions such as AIG, Fannie & Freddie Mac (U.S. Senate Permanent Committee on Investigations, 2011, Wall Street and the financial crisis: Anatomy of a financial collapse, p.44).

TARP program helped to stabilize the U.S. financial system, revive economic growth, and prevent foreclosures which where avoidable. The US Congress authorized $700 billion for this program in order to aid a speedy recovery from the crisis (US Department of Treasury, 2013). As of May 31, 2013, Treasury has recovered almost 95 percent of the funds disbursed through the program and is now winding down its remaining TARP investments (US Department of Treasury, 2013).

Although this came to a high cost to the taxpayers, the government achieved objectives serving as lender-of-last-resort. The financial system was gravely endangered but did not collapse as massive infusions of liquidity gradually reversed credit freeze. Slowly Investor confidence was restored and predictions of economic depression subsided as the economy stabilized. The fact that most of taxpayer-financed rescue funds (hereinafter: TARP) have been recovered points to the necessity and impact of such intervention.

There have been different suggestions on what to do in order to prevent future crises. The so-called “resolution authority” of the government would ensure smooth functioning of financial markets. This authority would allow the government to step in and take over (or liquidate in an orderly manner) financial institutions that are about to fail and could cause systemic consequences. Henry Kaufman suggests that the government should limit the size of financial institutions before they become “too-big-to fail” (Kaufman, 2008). This would prevent moral hazard by such institutions as they would need to exercise greater care when they know that the government would not bail them out merely due to their size.

4.3 Impact of financial crisis in Kosovo

4.3.1 Kosovo’s economy

Economic growth has been steady and generally at rates above those in neighboring countries with an average growth rate of 3.4 percent during 2009–2013. This has largely been attributable to public investments in post-conflict reconstruction, donor assistance, and remittances (The World Bank Group in Kosovo, 2013, Kosovo country snapshot, p.5).

The impact of the crisis in the Balkans was mainly noticed in a fall of the FDI and remittances. Volatile labor markets in Western Europe affected working immigrants and as a consequence the money transfers to their home countries. GDP growth in Kosovo slowed down to 4.4 percent, from an estimated 5.4 percent in 2008. Exports of goods declined by 16 percent and FDI dropped by almost 22 percent in the same year. Remittances also experienced a fall by 8 percent (Ministry of Economy and Finance, 2013).

4.3.2 Kosovo’s banking system

The crisis affected the capital of different European investors who had expressed interest in investing in Kosovo. However, it is important to note that the crisis did not significantly affect the financial sector due to Kosovo’s limited outside exposure. The value of the invested funds of the publicly managed pension fund experienced a worrisome loss, but this was recovered in the aftermath of the crisis. Pension Savings Trust, which had holdings in the crashing international stock markets, lost 22.3 million EUR in September 2008 (Beqiri, 2008).

Half of Kosovo's 1.8 million people are 25 or younger. Half of those under 30 are unemployed. This situation is exacerbated by the fact that every year more than 30,000 young people enter the job market. It is estimated that fewer than 8,000 find work. This makes the situation dire and highlights the need for increased FDI and remittances that would be used for investment. However, there are structural problems with Kosovo's economy as most small and medium enterprises are trading firms or retailers that import food, clothing, and other essential goods. Very little is produced in Kosovo for domestic consumption or export leading to an unhealthy dependence on imports. Remittances are hence used to pay for imports instead of bolstering the domestic economy (Synovitz, 2013).

The World Bank maintains that Kosovo has weathered the euro crisis fairly well, with relatively strong fiscal fundamentals, a healthy banking sector, and economic growth rates consistently above those prevailing in neighboring countries. The Government has focused its reform efforts on reducing the high rates of unemployment and poverty; strengthening public institutions and infrastructure; and reinforcing the business climate (The World Bank Group in Kosovo, 2013).

The World Bank gives an optimistic, but cautious view of the current situation and the effects of the financial crisis. It states that spillovers from the worsening Eurozone crisis have been less severe in Kosovo than in neighboring countries. The World Bank expected remittances and FDI to remain stable. "In particular, remittances (recorded as "transfers" in the balance of payments), foreign direct investment (FDI), and other non-debt-creating flows from Kosovars living in Germany and Switzerland are expected to remain relatively stable. FDI inflows are expected to surge over the medium-term horizon, reflecting considerable investor interest in the telecommunications and energy sectors (The World Bank Group in Kosovo, 2013, Kosovo country snapshot, p.5).

The International Monetary Fund (IMF) notes the resilience of Kosovo's economy despite the financial crisis; annual real growth GDP has never been less than two percent since the onset of the crisis. Nevertheless, the IMF called for caution and a decrease on the dependence on remittances. There is a need to build a robust tradable sector that could support self-sustained growth and reduce Kosovo's dependence on its Diaspora. "However, adverse price developments—notably a secular increase of prices for imported food that compressed real incomes—have prevented the full benefits of Kosovo's growth to be passed on to the population" (IMF, 2013).

Figure 13. Remittances Received in Kosovo

Source: *2012 Central Bank of Kosovo, Annual Report 2011*, Figure 62.

Nevertheless, the IMF calls for caution and a decrease on the dependence on remittances as Kosovo Diaspora will in the future become less attached to Kosovo which will shrink remittances received. Thus, Kosovo should look into building a more robust tradable sector that would lead to sustainable growth in the future(International Monetary Fund, 2013, Republic of Kosovo: Concluding statement of the 2013 Article IV consultation mission).Even though the share of GDP fell from 17.5 percent to below 13 percent between 2004 and 2010, it is still high by regional and global standards (The World Bank, 2011). In its 2011 annual report, the Central Bank of Kosovo recognizes that remittances are mainly used for consumption (CBK, 2011, Annual Report 2011, p.27).

As seen in Figure 13, CBK reported that remittances, which were estimated at EUR 584.8 million in 2011, are mainly used for consumption. The share of remittances in the GDP fell from 17.5 percent in 2004 to below 13 percent in 2010. Countries which comprise the biggest share of remittances are EU member states, such as Germany (33.2%), Switzerland (23.1%), Italy (7%), Austria (5.5%), Slovenia, USA, Sweden, etc. (CBK, 2011, Annual Report 2011, p.64).

CONCLUSION

Several scholars, such as La Porta, Lopez-de-Silanes, Shleifer, and Vishny, Bay and Goyal, Demirguc-Kunt and Maksimovic, Laeven and Manjoni, have done scientific research and various analyses to explain the correlation between different variables and the level of external financing. Findings have been different for these tests because of the variety of the countries involved and their financial and legal system. The level of investor protection and the origin of the legal family of the law were shown to be very important for determining the level of external financing. For some countries, this did not always hold so.

The level of contract enforcement was shown to be one of the crucial factors influencing debt financing. In addition, the market economy played a substantial role as to how lenders (banks) formulate their strategic plans with respect to the loan maturity, size, spread and interest rates. Depending on the development stage of the markets, lenders tend to shift their focus among different industries. Overall, countries which have stronger contract enforcement and better judicial system tend to do better in external financing as an instrument for the companies to grow.

In this thesis, we have provided a Kosovo overview and factors behind the supply and demand of credit structure determinants. From a supply perspective, the main reasons why banks in Kosovo are not financing new businesses are the risks that banks perceive that new businesses bear when they start operating. Risk is becoming the main cost factor in determination of intermediation rate with regard to lending activity. The increase in risk cost has come due to slow economic growth and a difficult business environment which in turn affected increase of the non-performing loans. There are several reasons why interest rates remain high in Kosovo, such as a lack of proper credit information system, high levels of fiscal evasion and informal practices, lack of proper cadastral system, etc.

With regard to demand side, businesses in Kosovo operate in a very difficult environment, thus, affecting especially new businesses as they are more fragile and less financially consolidated. High levels of corruption and nepotism, informal practices and fiscal evasion are some of the factors that damage competition deteriorate financial well-being of new businesses which in turn affect their credit rating. In addition, Kosovo trading conditions are among the worse in the world and this factor affects the businesses opportunities and credit rating of a company as well.

Furthermore, most of the workforce in Kosovo is low-skilled and new workplaces are low value added. In lack of other indicators, new businesses are mainly evaluated based on their ideas and their human potential and this fact on average puts new businesses in a disadvantaged position with regard to credit access. Lastly, 80 percent of new businesses are individual; therefore, their credit access is more difficult as risk diversification is very low. On one side, only four percent of loans granted are given to agriculture businesses and interest rates toward this sector are higher. On the other side, agriculture makes 10 percent of new businesses and this year this sector’s businesses had an increase of 27 percent.

There are a number of policy implications and instruments that institutions can use in order to improve new businesses’ access to finance. First of all, in general there is a need to strengthen the rule of law and contract enforcement. Institutions should ensure a healthy business environment where corruption and fiscal evasion should be minimized, while also invest in improvement of the cadastral system. Second, Kosovo needs to attract new banks in the sector and increase competition as a way of decreasing interest rate. In addition, Kosovo should improve the quality of education as a way of generating more innovative business ideas. Lastly, there should be considered options such as creation of credit lines with special focus to new businesses and increases financial support for businesses incubators and grants.

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APPENDIX

LIST OF APPENDICES

APPENDIX A: Acronyms

BPK	Banking and Payments Authority of Kosovo
CBK	Central Bank of Kosovo
CEFTA	Central European Free Trade Agreement
EBRD	European Bank for Reconstruction and Development
EU	European Union
EULEX	European Union Rule of Law Mission
FDI	Foreign Direct Investment
GDP	Gross Domestic Product
IMF	International Monetary Fund
NATO	North Atlantic Treaty Organization
OSCE	Organization for Security and Cooperation in Europe
ROAA	Return on Average Assets
ROAE	Return on Average Equity
ROE	Return on Equity
SAA	Stabilization and Association Agreement
UN	United Nations
WB	World Bank
WTO	World Trade Organization