

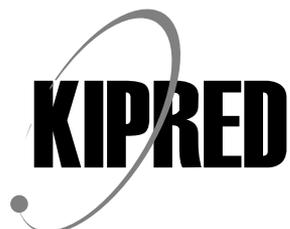
Stock Exchange in Kosova: Why and How?

Prishtina, February 28th 2005



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Summary

The purpose of this paper is to analyze the need and importance of the establishment of a stock exchange (SE) in Kosovo. It first analyses problems caused in Kosovo's economy due to the nonexistence of a stock exchange and its impact in main macroeconomic and other indicators, such as the privatization and post-privatization process, investments, monetary policy, the current use of the Kosovo Pensions Savings Fund (KPST) and other funds, current information and transaction costs.

The paper provides some insights in support of the idea that the establishment of a stock exchange will help solve a series of economic problems, with the main effect in fostering privatization and supporting post-privatization through the financing of newly privatized companies, the creation of monetary policy instruments, the creation of fundraising and investment incentives, reduction of information and transaction costs, reduction of information risk for local and foreign potential investors, better use of Kosovo Pension Savings Trust fund and overall economic growth and development.

The research has identified the main obstacles towards the establishment of a stock exchange, which include: lack of legal framework for SE operation, small market size, relatively low level of law enforcement, limited number of joint stock companies and lack of professional staff. The paper discusses mitigating factors and outlines what needs to be done in order for these problems to be overcome.

1. Introduction

This study intends to outline the economic prospects that have been deteriorating due to the nonexistence of a Stock Exchange (SE) in Kosova and potential benefits that may arise from its establishment. The second part of the paper discusses the main constraints which need to be overcome during the process ahead of the establishment of a stock exchange in Kosova. This is the first paper to tackle the issue of the establishment of a stock exchange in Kosova and it therefore attempts to provide an earnest explanation of the question.

The motivation to study this topic is based in the existing stage of the financial system in Kosova and the importance that an organized stock exchange may play in further fostering economic development, growth and stability. The recent, postwar financial sector in Kosova is new and in its first stage of establishment as a promoter of economic development. Kosova has one 'Central Bank' (Banking and Payments Authority of Kosovo), and seven commercial banks, but the financial market is at its infancy stage, with no transaction of debt securities and no equity market. Kosova is undergoing a transition process towards a market economy and its economic institutions need to be developed further. There is a large need for raising funds and investments in Kosova, therefore it is important to determine the role and impact of a stock exchange in achieving an increase in investments, assisting the privatization of socially owned enterprises (SOE) and the development of a market-oriented economy.

The recent, United Nations-sponsored benchmarks for Kosova focus on fostering financial markets,¹ establishment of an Investment

It is important to determine the role and impact of a stock exchange in increasing investments.

Promotion Agency in Kosova and the creation of investment climate.² Therefore, this research intends to give further insights and incentives to policy-makers and other relevant government and other agencies in Kosova to work towards the achievement of those benchmarks by creating an economic infrastructure, and fostering economic development, growth and stability.

Successful operation of a Financial/Equity Market in Kosova is expected to influence economic development by facilitating the following:

1 Standards for Kosova, point 7.5 of benchmarks for Economy

2 Standards for Kosova, point 2.1 and 2.2 of benchmarks for Economy

- Mobilizing funds for fostering investments in Kosova through investment in new joint stock companies (JSC) and other companies to be listed in the stock exchange.
- Creating the possibilities to raise funds through Venture Capital (mutual funds) and enhance further investments. 'The stock market carries out a vital function in allowing firms to be able to raise often large-scale funds for expansion and development. Without a market for trading company shares, the opportunities for companies to grow and contribute to the economic well being of the country as a whole would be seriously impaired.'³
- Creating financial instruments, which along the required reserves for commercial banks, will enable BPK to play its monetary policy.
- Creating the possibility for the treasury to issue treasury securities to finance government debt (T-Bills, T-Notes, T-Bonds, Municipal bonds etc.) and financing necessities according to government's project priorities.
- It has an indirect effect in the improvement of accounting practices due to its regulatory system and due to needs for publishing correct and reliable financial data by the companies to be listed in the SE.
- Increasing the volume and quality of business information or increasing informational efficiency.
- Increasing the operational efficiency by minimizing participant's (investors) transaction costs.
- Facilitating foreign portfolio investments in Kosova by providing needed mechanism (the market) to invest in securities and shares.
- Creating a wider range of investment possibilities (investment in derivatives, investment on margin, etc).
- Providing higher investments through SE will imply bigger and faster economic growth. A positive and fast economic growth implies higher income and higher level of living standards.

The main goals of this study are to⁴:

- identify the main economic problems due to nonexistence of SE in Kosova and what could be the role of SE in solving those problems;
- explain the effects that the establishment of SE can have in fostering privatization and long term investments;

3 Biz ed "Mind your business - 24 May 2004"; *Financial Markets - The news. Internet.*
http://www.bized.ac.uk/current/mind/2003_4/240504.htm

4 Being the first paper which discusses development of financial market and establishment of Stock Exchange in Kosova, these could be considered as one of the directions this paper will shed some light, and push for further analysis

- discuss the existing legal framework regarding financial market activity, and indicate legislation needs and other steps for the further development of a financial market and the establishment of an SE;
- identify and discuss main constraints preventing the establishment of an SE as problems which must be better addressed towards creation of a developed market economy.
- initiate further research and discussion about specific issues and constraints mentioned by the findings of this paper (with the main focus on the creation of SE).

The next section of this paper provides a brief theoretical background about stock exchanges and their impact on the economy. It is followed by a problem analysis section, which tries to explain problems related to the nonexistence of a stock exchange in Kosova. The following section

This paper analyses problems caused in the economy of Kosova due to the nonexistence of a stock exchange and its impact in main macroeconomic and other indicators.

discusses the possible benefits resulting from the opening of SE. A brief explanation on the SE effects on economic growth is presented in section five. Section six discusses the main constraints that must be overcome for an exchange to be established in Kosova. Finally, conclusions and recommendations are to be found at the last section.

In addition, references, abbreviations and an appendix are included.

2. Theoretical background

2.1. SE, a brief history

The emergence and evolution of exchanges are tied to the very emergence and development of the market economy. Exchange is a specific type of market and has emerged only after exchangeable goods appeared, which initially were securities bearing the form of bills. With the foundation of the Amsterdam Exchange in 1631, exchanges as organized institutions started to expand all over West Europe. In addition to securities, also the first real merchandise began to appear as subject of trade. In the course of the 1970s and 1980s, new financial instruments, derivatives, emerged as a tool for the elimination of increased risks arising with the growing financial instability, and the turn of this century is directly linked to the current capital market

globalization process. Currently there are over 160 stock exchanges in the world and the globalization process is pushing them to cooperate closely and even merge.

2.2. What is a Stock Exchange and how is it organized?

SE is an organized market which offers a mechanism for sellers and buyers of securities to meet and transact their securities. SE is a secondary market where the securities and shares previously issued at primary market are traded. Depending on the physical place where the transaction takes place, the SE can be organized in two types: over the counter (OTC) and on the floor SE. OTC is organized in a very complex communications network of dealers and has no fixed address. On the other hand, trading on the floor is organized in a particular place where seller and buyer of securities can meet and exchange their securities (bonds, stocks, etc). Each SE is organized in its way and almost no two SEs have the same structure.

2.3. Why do SEs exist?

SE is a market economy mechanism which helps sellers and buyers of securities meet and transact their securities and property rights. The main role of SE is in enabling fundraising for investment projects by trading securities and shares in an open and regulated market. It enables portfolio investments for the potential domestic and foreign investors. Also, it enables risk diversification by applying portfolio diversification based on the preferences of each investor. In both developed and developing countries the SE is used as a mechanism to attract foreign portfolio investments and that is expressed depending on the level of openness of the SE towards foreign investments. SE in transition economies were mainly reopened for the purpose of mass privatization of formerly state or public companies.

The sale of property and property rights exists in Kosova as well, but it does not take place in an organized, regulated and continuous market and no sale of securities is applied yet. In fact, the Kosovo Trust Agency (KTA) is a stock exchange of its kind (or better said it plays that role) in the ongoing privatization process in Kosova, and it operates under very strict rules and procedures. The only difference is that KTA makes the one time sale of 'newco'⁵ into newly privatized companies by applying an auction method and there does not exist a continuous sale of shares.

⁵ 'newco' - is called new company which is result of applying spin-off method, where only assets of old SOE are transferred to newco, while liabilities remain with the old SOE. Spin-off method will be explained in the further text

3. Problem analysis

This section emphasizes the current economic problems in Kosova which have arisen due to the nonexistence of SE.

The main problems that can be identified to be related to nonexistence of SE are:

- Privatization related problems and lack of post-privatization investments.
- Lack of investments and fundraising mechanism.
- Lack of foreign investments.
- Lack of market for conducting Open Market Operations by BPK.
- Macroeconomic implications caused by investing Kosovo Pension Savings Trust (KPST) funds abroad.
- Large information and transaction costs.

All these abovementioned problems and many others manifest their impact on the economic development of Kosova in different ways. This study tackles some of these problems by searching the impact of SE establishment on solving them. Due to the lack of sufficient economic data related to this issue, this study uses a qualitative rather than quantitative approach.

3.1. Privatization-related problems and lack of post-privatization investments

*What are the consequences of the privatization process in Kosova if it occurs without using SE as the market?*⁶

The privatization process in Kosova is characterized by many problems, and this paper tries to focus on the main ones. The value of enterprises sold so far was not real at all, and this can be explained in two ways. If we look at the value of the physical assets such as factory buildings and other buildings in general, then the stock price for these companies was undervalued⁷. On the other hand, if we consider the business proficiency and profitability of privatized SOEs so far, then no proper valuation has been done based on financial statements on their business activities and their

⁶ This question is focused on technical and financial problems without tackling the political and juridical problems related with the ongoing privatization process in Kosova

⁷ This occurs because no potential investor has any proper financial or business data to value the real price of company, and because of high uncertainty the stock (company) price is undervalued

prospects⁸. Under the Spin-off method,⁹ we only have the buying price offered by potential buyers and no initial selling price at all. A small difference occurred after the introduction of the Spin-off Special method, used in the sale of three companies during the third privatization wave.¹⁰

The next problem is over-bureaucratization and the lack of transparency by the KTA in the current privatization process.¹¹ This problem increases uncertainty and lack of trust in the mechanism which manages the privatization process and hence has a negative impact in attracting potential investors.

One of the most important problems with the ongoing privatization process is that the SOEs were sold to a limited number of new owners (in many cases only one new owner) with limited financial capacity, and this creates problems with the future functioning and expansion of the company. Problems with expansion are mainly due to the lack of financial sources to refinance technological improvements of existing companies. These can be identified as post-privatization problems, which cannot be overcome easily under existing circumstances without an established and well functioning SE.

Anecdotal evidence has shown that most private persons or companies that won a tender and bought an SOE made the purchase partially by using existing funds and partially with the support of loans from commercial banks. However, most new owners are usually not in a position to invest in new technology and know-how. In this case, new owners have no financing sources, nor can they get new financing from the bank. Most companies have two possible solutions to pursue. First, the newly privatized company continues to work with less than half capacity and even with difficulties in paying back its loan. This situation is unfavorable for the company because it cannot update old technologies and improve its productivity. Second, if and when the new owner learns that he cannot generate enough profit to cover his loan, he may make a deal with the bank to sell factory facilities or use them for purposes other than pro-

⁸ This is because in a modern market economy where SE operate, any decision for the evaluation of potential investments and stock price is based in analyzing at least three years financial statements about the assets, liabilities and economic performance of the stock, and other related prospects. In Kosovo the accounting standards are not very well developed and there is not a single SOE that produces reliable financial information to base our judgment on the value of a stock

⁹ How will privatization work in Kosovo, - Kosovo Trust Agency (KTA), www.kta-kosovo.org
KTA's Spin-off method for privatization

¹⁰ The Spin-off Special method was used for the privatization of 'Feronikel', 'Perparimi' and 'Uji i Kllokotit' companies and it establishes (beside other specifics) the lowest possible price under which the company cannot be sold.

¹¹ 'Transparency and Monitoring of Privatization' - RIINVEST discussion table, Grand Hotel Prishtina, September 29, 2004

duction. This would not be a problem if most or all workers could be laid off and no production would resume. There are also other possible scenarios which need further analysis. One of them is to demolish the factory and to construct new buildings in their place, making the main purpose of privatization the purchase of the land. That is what will reportedly happen with the 'Fazita' company, according to the statements of the new owners.

An important post-privatization problem emphasized by new owners of newly privatized SOEs is that since many newly privatized SOEs have become joint stock companies, new shareholders see no possibility of selling their shares because there is no continuous SE or organized market where these shares can be continuously traded. This situation emphasizes other problems discussed in the following section on lack of investments and fundraising mechanism.

3.2. Lack of investments and fundraising mechanism

The nonexistence of SE in Kosova means that businesses in Kosova are completely dependent on commercial banks as an external financing source to finance their short-term and long-term productive investments. This section gives an overview of financing situation and problems which currently exist in Kosova's economy because of the exclusive dependence on the banking sector as the sole external financing source.

Despite the credit risk from 1.8%, and the business and political risks involved in the private sector investments, bank lending showed a positive trend of growth. The share of credit to total assets in commercial banks increased from only 3% in 2000 into 40.2% in 2003, increasing further to 45.1% in July 2004. Ratio of loans to deposits was 45% in 2003, and increased to 51.09% in July 2004, yet the percentage of outstanding loans to GDP at the end of 2003 was at the modest level from 12.75% in 2003.

The nonexistence of SE in Kosova means that businesses in Kosova are completely dependent on commercial banks as an external financing source.

The table below presents comparisons for some indicators of the situation of the financial system in Kosova with other countries of the region for the year 2002. The figures are presented as percentage of GDP:

Year 2002	Kosova	Albania	B&H	Croatia	FYROM	Slovenia	Turkey	Greece	CEE*	EU*
Deposits / GDP (%)	33.4	40.1	39.6	70.6	24.3	59.6	50.8	90.7	44	73
Loans / GDP (%)	6.6	5.9	25.9	51.1	20.4	41.3	15.4	109.3	34	102
Interest spread	12.0	7.9	9.8	9.6	8.8	5.2	n/a	5.3	7	3

Source: Kosovo Economic Memorandum - World Bank, Report No 28023- KOS, 17 May 2004
 * Source for CEE and EU data for 2003: Banking in CEE, Economics Department Bank-Austria, April 2004¹²

Yet, the existing financial system in Kosova (commercial banks and Micro Financial Institutions - MFIs) is not ready to initiate or support large investment projects. The majority of deposits in commercial banks, being short-term deposits of less than a year maturity, have resulted in about 80% of loans to be of a short-term nature, and therefore cannot be used to finance long-term investment.¹³ An important constraint that determines the lack of long-term investments in Kosova is the lack of sufficient capital and long-term liabilities by commercial banks. Hence, the nonexistence of SE in Kosova means no opportunity for commercial banks to issue bonds and get long-term financing sources.

The lending nominal interest rates in commercial banks in Kosova range from 13.9 %– 14.37%,¹⁴ which are relatively high compared to European Union (EU) countries and other transition economies. This is a very discouraging factor that directly causes less incentive for long-term investments in productive capacities. Also, fees and commissions charged from commercial banks for their services are very high (1.5% to 2% of total loan amount) and in many cases overload lending activities by making investments through lending costly and unattractive. The decrease in the investing incentive of companies happens because the investments through lending are very expensive and not profitable, hence those companies are not able to compete in the market.

12 http://www.hvbgroupp.com/system/galleries/download/research/euenlargement/xplizit_banking-in-cee_4-04.pdf, "Banking in CEE", *Economics Department Bank-Austria*, April 2004, p. 4

13 Annual Report 2003, BPK March 2004, p. 19

14 Monthly Statistics Bulletin No. 35, BPK July 2004, p. 36

Another negative factor of the existing financial possibilities is the very short or no grace period offered by the commercial banks for investment projects. Lack of a grace period means that the borrower must start paying back the loan before he is able to put into function new machinery or gain returns from the investment. This is especially important in the case of investments in factories and machinery, in which investments take longer to become operational.

Another crucial problem is that the existing banking sector in Kosova does not support start-up businesses and the implementation of new ideas. This is mainly due to the lack of credit history of newly established companies.¹⁵

In summary, one of the main reasons why the nonexistence of SE represents a problem is the fact that this leads to the absence of large long-term investments and fundraisings, which is impossible without the successful operation of SE. The current banking sector in Kosova does not support large long-term investments due to its short-term deposits and lack of funds.

Finally, the nominal interest rate for bank deposits in Kosova is between 1.75% - 3.53%, while the nominal interest rate for loans is between 13.9 - 14.37% depending on the maturity. This implies an average spread of over 11%, which is considered extremely high when compared to EU interest rate gap of 3% or to the Central Eastern Europe (CEE) gap of 7%. The nonexistence of SE support the idea that this spread will not decline in the short- to medium-term, hence being one more reason for the lack of long-term investments.

3.3. Lack of foreign portfolio investments

The benefits accrued to Kosova from foreign investments have thus far been very low. With an estimated 30-40 million euro investments in the past five years of the post-war period, Kosova has the lowest rate of foreign investment in the region. The privatization process that started in 2003 was blocked for months afterwards, which has already made a negative impact in attracting possible foreign investments in the private sector. It resumed with the third privatization wave (July 2004). Most analysts agree that in the near future the access of Kosova's economy to foreign capital markets and financing will be limited primarily mainly due to

The benefits accrued to Kosova from foreign investments have thus far been very low.

¹⁵ Lack of credit history increases uncertainty about the potential investments and therefore existing commercial banks in Kosova are not yet able or willing to provide long term investments for such risky investments

Kosova's undetermined political status and the lack of guarantee for any possible financial assistance in loans from the World Bank, the European Bank for Reconstruction and Development or other international financing sources.

The main criteria for determining an incentive of potential investor to invest are rate of return and risk connected to that investment. The main reason that keeps foreign investors away from investing in a particular foreign market is information risk. The information risk is the risk that is caused by the lack of information for the potential investment. In other words, when a potential foreign investor knows little or nothing about a country then information risk is extremely high. That is exactly the case with Kosova today, where most foreign potential investors know little about Kosova (or better say they think there is still a war going on or ready to start at any time) and therefore they will not only hesitate but refuse to invest. This attitude can change only when investors gain better information on Kosova's economic prospects and investment possibilities.

The nonexistence of an SE implies a lack of specific investment information to potential foreign investors hence making potential portfolio investment prospects very expensive and unattractive. Also, the nonexistence of SE in Kosova means that there exists no mechanism to provide a market place and liquidity for transaction of equity and long term debt, and it is reasonable to assume that no foreign investor will want to invest in a place where there is no equity market (SE) in which these investments could be sold and liquidated at any given period of time. Here it must be noted that this argument applies to portfolio investments and not to foreign direct investments, which in fact do not need any SE.

3.4. Lack of market for conducting Open Market Operations by BPK

Initially it is necessary to briefly explore the current monetary policy situation in Kosova. Then the relationship between the establishment of a stock exchange in Kosova and its effect in introduction and development of monetary policy instruments should be analyzed.¹⁶

The Banking and Payments Authority of Kosova (BPK) plays the role of a central bank, by regulating and supervising the financial system: commercial banks, insurance companies and pension funds. Kosova uses the EURO as legal tender, which

16 UNMIK Regulation No. 1999/4, "On the currency permitted to be used in Kosovo", September 2 1999. p. 1

could be one of the factors that determined current stability of prices and almost zero inflation. On the other hand it should be mentioned that Kosova can only use EURO as its currency but has no right to issue it.

Yet, BPK cannot be considered as the lender of last resort. According to UNMIK Regulation 2001/24, BPK cannot extend credit to commercial banks or other clients.¹⁷ This means that BPK has no Discount Window¹⁸ through which it can play its monetary policy. The only policy instrument that BPK has is the Required Reserves assigned to commercial banks¹⁹ for their deposits. The Required Reserve rate is 10% of deposits, where 5% should be kept with the BPK and the other 5% should be kept in the vault of each commercial bank.

Although the Required Reserves is the only monetary policy instrument currently applied by BPK, it nonetheless does not serve its purpose as it should. The main reason that the Required Reserves instrument is insufficient for monetary policymaking is because it is not a flexible instrument that can be changed often. One cannot change Required Reserves every week, month, or even every year. For instance, the United States Federal Reserve changed required reserves from 12% to 10% in 1992, and made no change for the following 12 years. Similarly, the European Central Bank (ECB) does not use Required Reserves as an important policy instrument. A disadvantage of using Reserve Requirements to control the money supply and interest rates is that raising the requirements can cause immediate liquidity problems for banks with low excess reserves.²⁰ Some other countries (Canada, Switzerland, Australia and New Zealand) have eliminated Required Reserves as a monetary policy tool at all.²¹ In Kosova the Required Reserves are 10% of total deposits, set by the BPK upon the establishment of the banking system after the war, and the rate has not changed since. The main instrument of the central banks to conduct monetary policy is Open Market Operations (OMO), which is impossible to apply without the existence of SE. OMO represent the most important monetary policy tools because they are the pri-

17 UNMIK Regulation No. 2001/24 “Amending UNMIK Regulation No. 1999/20 on The Banking and Payments Authority of Kosovo”, p. 20, section 59

18 Discount Window is a monetary policy instrument used by all central banks as one of possibilities for central banks to lend certain amounts of money to commercial banks in order to help them maintain required reserves and enough liquidity. These loans are of a very short-term nature (overnight or maximum up to three days) and are given with an extremely low interest rate, hence the name Discount Window

19 [BPK] “Rule XVII On the Minimum Required Liquidity Reserves Maintained with The Banking and Payments Authority of Kosovo authorized under Section 46 of [UNMIK] Regulation 1999/21”, p.1

20 Frederik S. Mishkin: *The Economics of Money, Banking and Financial Markets* - sixth edition, Columbia University, p. 450

21 Ibid, p. 451

mary determinants of changes in interest rates and the monetary base, the main source of fluctuations in the money supply.²²

As we see from the current situation, there can be almost no effective monetary policy in Kosovo without major changes first in the legal framework and then in the establishment of necessary monetary policy mechanisms and instruments. Referring back to the Standards for Kosovo document and its stated requirement that ‘basic economic legislation is in place and enforced’²³, the abovementioned facts could be considered to be a strong incentive for changes in economic legislation with the main focus in developing new market mechanisms and new policy instruments.

3.5. Macroeconomic implications caused by investing KPST funds abroad

In the post war situation new funds started accumulating, creating new potential investment sources. One such fund is the pension fund, which started accumulating its funds in 2002 and until 2004 has accumulated around 85 million euro, or over 45 million a year. This fund is managed by the Kosovo Pension Savings Trust (KPST) and almost all that money is invested in foreign financial markets.²⁴ This amount of money which is taken out of the country is not only improperly invested²⁵, but it also reduces overall monetary aggregates in Kosovo hence creating macroeconomic implications. When calculating the multiplication effect of money $\left(\frac{1}{r} M_t\right)$ ²⁶ using 10% required reserves, we find that the decreasing effect on currency in circulation caused by KPST money export from Kosovo is about €50 million.²⁷ With the increase of this fund and further money export abroad, the decline of money in circulation (economic liquidity) will accelerate, hence rendering economic transaction and business activity very difficult. A similar outcome is caused by investing Kosovo Consolidated Budget (KCB) fund abroad, but since this fund is higher (about €170 million) then

22 Ibid, p. 439

23 Standards for Kosovo: Economy - point 1. - UNMIK - PISG

24 Due to the *high* investment risk in Kosovo (even though no one has measured this investment risk because no ranking agency has ranked investment possibilities in Kosovo yet), it is required that public funds (in this case pension funds) be invested in less riskier markets outside of Kosovo.

25 Improperly - means that the rate of return is not the highest possible since this money is deposited with other commercial banks under low interest rate.

26 (M_t/r) is the money multiplier. The money multiplier is an index used to measure currency in circulation. M_t is the base money or in our case is 85 million euro KPST fund, r is reserves requirement percentage or 10% in Kosovo.

27 Another issue here is that there exists no particular valid figure about what is the real money turnover in Kosovo. SO far, neither the BPK nor any other institute was able to produce these important statistics, therefore only possible measure for calculating money multiplier is required reserves from 10 percent

its impact in decline of liquidity in Kosova's economy is also larger (about €1.7 billion). However, due to the latest budget trend (100 million euro deficit for 2005) this fund is foreseen to fade till the end of 2005.

Considering the fact that Kosova is using the EURO as currency but has no right to issue it and as the decline of currency in circulation shows, it is no wonder why economic activity has declined and why there is continuously less money in circulation. This implies that the amount of KPST and KCB money invested abroad may have a negative impact in overall macroeconomic stability in Kosova, and this problem needs further analysis.

Usually pension funds are invested in long-term securities and in mutual funds, based in particular portfolio diversification as of investment policies of those funds. To make those investments in securities and mutual funds, it is necessary to have a mechanism (SE) where the potential investor can identify those securities to invest on. Hence, the nonexistence of an organized equity market in Kosova is one of the constraints why accumulated funds from pension contribution schemes and central budget are not invested internally but are deposited or invested abroad with a lower rate of return.

3.6. High information and transaction costs

When assessing costs, the research follows two different directions. First, it assesses opportunity costs related to the nonexistence of SE in Kosova and second, how much it will cost to establish a stock exchange?

It is very important to mention that transaction costs and especially information costs currently in Kosova are quite significant due to the lack of an organized SE.²⁸ This implies that opportunity costs are even higher. Opportunity costs are costs generated from the profit lost by not investing in the most profitable companies.²⁹ Because there is no equity market in Kosova which provides investment opportunities in the most profitable companies (there is no financial information available for any potential investment) then many profitable projects cannot find their needed financial sources, even though there is available liquidity ready to be invested in profitable companies and projects.

²⁸ It is believed that because there is no specific place (a market) where potential seller of property can meet a potential buyer, the transaction and especially information costs, which include searching the market for the best offer, are very high.

²⁹ For further elaboration see reports on the transition economies where establishment or reestablishment of SE enabled massive privatization programs.

Regarding the question on how much would it cost to open a SE in Kosovo, further analyses are needed, but in general it depends on the size of SE, the volume and variety of services that SE would be ready to perform. One may expect the establishment cost would initially be relatively large, and after the establishment phase is completed the maintenance costs would be relatively lower.

4. Potential solutions

After having discussed the main problems related to the nonexistence of SE in Kosovo, this study further discusses the effects that the establishment of SE may achieve in providing solutions for the above problems. This section analyzes the advantage of having an SE from a number of aspects.

4.1. SE's effect in Privatization and Post-privatization

The establishment of SE could have a direct positive impact in fostering the privatization process in Kosovo by offering many technical possibilities which do not currently exist.

First, the SE would provide a market mechanism which would make it possible to evaluate the real market value (stock price) of the SOEs under privatization. With the impact of the market mechanism, where price is determined by supply and demand, the market economy would acquire mechanisms to determine the prices of the SOEs to be privatized, hence the valuation problems in the current privatization process would diminish. Some argue that the price the present companies were sold at was too low and the SE would help determine the real market price.

Second, the whole privatization process could be facilitated and accelerated by the establishment of SE, something similar to the other transition economies which have successfully completed their transition phases from state owned to private companies.

The possibility that SE offers in raising additional capital for the newly created joint stock companies (JSC) from privatization process is of a great significance. SE is the place where new JSCs can increase their financing by issuing new shares or by selling corporate bonds, hence getting long-term financing. Long-term financing is not possible through bank loans in the existing financial environment in Kosovo. SE could offer the possibility that privatized companies could belong to many new owners,

instead of only one or a few, and therefore by having more financial sources they create the possibility to increase their business performance by investing in new technology and know-how. The liquidity trap could be easily overcome by issuing new shares internally or externally, or by issuing corporate bonds.

SE could provide greater opportunities for the transfer of property from POEs to Joint Stock Companies (JSC), since it is easier to find financing by collecting money from many small pockets rather than expecting one or few big bidders to pay a large sum. SE opening could bring more foreign investments in the privatization of SOEs, much more than the existing level, as it is known from the experiences from other countries such as Hungary.

Establishment of SE means that there is a market where one can buy property rights and also sell them if needed. Also, sale of shares of POEs and large SOEs through listing at SE would make it possible for a portion of the companies to be bought by Kosovar investors and hence keep part of the property within Kosovar ownership. Kosovar ownership is seen as more stable investment because investors intend to stay and further invest in Kosova, which may not be the case with foreign investors.³⁰

The experiences of other transition economies after the establishment of a SE and its effect in privatization process are not the aim of this study, but it is important to briefly summarize that all transition economies established or reestablished their stock exchanges mainly because of the massive privatization process. They have managed to privatize almost all of their socially owned or state-owned enterprises, including most of the banks, and that can be interpreted as a mainly successful story.

SE would create a market where one can buy property rights and also sell them if needed.

Some transition economies experienced complications in their stock exchange operation, with a rapid increase in capitalization in the first stage and with a diminishing role of SE after the privatization phase. But most of them resumed with an increase of importance of their SE after the stabilization period. A better picture of the latest developments in SEs of other transition economies is showed in graphs presented separately in the attachment of this paper.

One should focus on the fact that conditions in transition economies were very different from those in Kosova. Other transition economies do not use euro as their cur-

³⁰ So far most of the companies are sold to Kosovars but with introduction of large SOEs and POEs, there will not be enough investment funds in the hands of only one or few potential Kosovar investors to invest in these large SOEs and POEs

rency, most of them went through inflation and some countries even experienced hyperinflation problems. The problems related to inflation are not evident in Kosovo and that can be mainly attributed to use of EURO currency as a mean of payment and value. But it is important that transition economies achieved to cross the divide between transition and emerging economies. As Bonin (2002) states, 'Finally, an interesting aspect of these developments is that the pace of movement is probably much more rapid than most observers anticipated when transition started. A decade ago, the process was expected to be long and slow; few observers would have predicted that the term "transition economy" would in many instances be obsolete at the end of the first decade.'³¹

4.2. SE as a mechanism for long-term investment and fundraising

Under the assumption that people are rational decision-makers and operate under the principle of profit maximization, by establishment of a liquid SE, many current depositors would chose to invest in securities that yield higher rate of return having as incentive the spread between deposit interest rate and the rate of return offered by investing in securities. Of course that would depend upon the risk level of securities offered in the SE and the willingness of potential investors to bear higher risk for higher rate of return.

One of the roles played by financial markets in affecting investments is mainly though risk diversification. Fisher (2003) finds that the existence of new financial instruments (derivatives) does make a major contribution to reallocating risk in the economy towards those most prepared to bear it, for a price, and that does increase market stability and efficiency. Financial markets not only allow risk diversification on the parts of savers, they also facilitate risk diversification that affects technological change. Better financial systems improve the probability of successful innovation and thereby accelerate economic growth.³²

Another role that SE can play as a mechanism for long-term investment and fundraising is in improving resource allocation in the new technologies and more profitable companies. Isaksson pointed out that 'besides the quantitative effect on capital accumulation from savings mobilization (pooling), better savings mobilization can improve resource allocation and boost technological innovation. Mobilization also

31 John Bonin and Paul Wachtel, "Financial Sector development in transition economies: Lessons from the first decade" *BOFIT Discussion Papers 2002* No. 9

32 Stanley Fischer, "The Importance of Financial Markets in Economic Growth", *Citigroup*, August 2003, p.6 and p.7

means the creation of small denominated instruments, which provide opportunities for households to hold diversified portfolios, invest in efficient scale firms, and to increase asset liquidity.³³

Kosovars are often reported as dynamic entrepreneurs. A well organized equity market could provide new incentives for investment in the most profitable business fields. Many profitable investments³⁴ require a long-term commitment of capital, but investors might not want to tie up their savings for such long periods. A liquid equity market allows savers to sell their shares easily if they so desire, therefore making shares relatively more attractive investments. Such flexibility raises the incentives to make long-term investments and improve economic sustainability.

4.3. SE as Foreign Portfolio Investments Promotion Mechanism

The establishment of an SE will open up Kosova to foreign investors and would attract foreign portfolio investments. An increase in the overall foreign investments would directly impact economic growth.³⁵ Bekaert et al. (2000) found that when emerging market countries enact policies that open up equity markets to foreign investors, they experience a one to two percent annual increase in economic growth.

According to the coordinator for donations and investments in the Kosova Government, there is interest among foreign investors to invest in Kosova. ‘The main potential economic field that foreign investors are interested at is agriculture and especially vinery and grapes (American investors), paper factories and power plants using wind as energy source (German investors), mining (especially “Ferronickel” plant and mines, the surroundings of Mitrovica where “Trepça” is located), etc.³⁶ Yet the main constraint for foreign investments remains information risk and uncertainty due to the lack of the final status.’³⁷

The establishment of a SE in Kosova would cause the information risk to decline because potential investors would have a better opportunity to learn about Kosova’s

33 Anders Isaksson, “Financial Markets, Economic Growth and Poverty”, p. 8
<http://www.sida.se/Sida/articles/11200-11299/11270/finDev.pdf>

34 Ross Levine, “Stock Markets, Economic Development, and Capital Control Liberalization”, *Investment Company Institute* Volume 3 / No. 5, December 1997, p.2.

35 Geert Bekaert, Campbell Harvey and their co-author Christian Lundblad, June 2000, “Emerging Equity Markets and Economic Development”. *Nber working paper* No. 7763

36 Interview with Mrs. Makfire Mustafa, Coordinator for Donations and Investments, Ministry of Culture, Youth, Sports and Nonresidential Issues, PISG. Prishtina, September 9th 2004.

37 Ibid.

market and its portfolio investment prospects.³⁸ Also, SE itself offers more liquidity for any possible investment.³⁹ A combined and flexible SE could provide possibility for foreign investors to sell their shares or their direct investments by listing the company in the continuous market of SE or by using one time sale procedures, just like KTA is doing with SOEs, depending from the type of investment. It is unlikely that foreign investors will come and invest in Kosova's SOEs (or any other JSC) if they do not see any possibility to sell their investments and withdraw whenever they see fit. It is normal to assume that any investor will want to withdraw (sell out) when trying to avoid investment risks or when better investment opportunities arise in another country.

4.4. SE role in creating Monetary Policy Instruments

The main monetary policy instrument in most developed countries is Open Market Operations, conducted by central banks such as Open Market Committee of the Federal Reserve System (the Fed). Opening an SE in Kosova has a crucial role in creating the pre-conditions for BPK to play its important role in conducting monetary policies in Kosova through Open Market Operations. Hence, an established and well regulated stock exchange in Kosova could provide BPK as the regulatory body for financial system in Kosova and conductor of monetary policies with the needed mechanism.

SE would lower the information risk because potential investors would have a better opportunity to learn about Kosova's market and its portfolio investment prospects.

Someone may argue that the sole establishment of SE in Kosova is not enough to create monetary policy instruments, and this claim is correct because SE would represent only the mechanism (the market) where these instruments can operate. Yet, the establishment of SE is the first necessary step (or the first half of the project) towards achieving this goal, while the second half is to create those monetary instruments, such as treasury securities.

³⁸ It is well known that each company to be listed in a stock exchange must fulfill some preliminary conditions, one of them is complete and correct information about its financial situation based in standard accounting techniques, then its achievements and plans for the future. Listed companies provide information through their prospects which should usually be published quarterly or annually. As we know such information are not provided currently. It is assumed this information will reduce uncertainty and hence decline information risk.

³⁹ We assume that by offering a place where supply for ownership rights can meet demand for those rights, or simply by offering a market where seller of securities can meet potential buyer for securities, it is rationale to assume that stock exchange offers more liquidity to potential investors rather than without its existence.

4.5. SE and use of KPST and KCB Funds

The establishment of SE could create investment possibilities for the pension fund to keep a certain percentage of its currently 60 million euro as internal investment in Kosova (as part of portfolio diversification) and increase overall investments in Kosova instead of investing abroad with a low rate of return. This investment of pension fund money would increase overall liquidity not only for the SE itself, but also for the economy in general, because it would not impact in decline of monetary aggregates as one of the main macroeconomic problems currently in our economy. A potential investment of KPST fund in business activities in Kosova through long-term investments in the SE would contribute to economic development and continuous growth.⁴⁰

It is known that one of the main investors that generate investment in the developed economies are institutional investors such as pension funds and insurance companies. Total percentage share of Pension Funds investments in total investments in USA fluctuates from 45% to 65% depending from business cycle of USA's economy and overall national security. This fact is an important indicator which expresses importance of these funds in further fostering development of financial market and stock exchange and providing more liquidity in the SE.

Similarly to developed economies, an increasing pension fund in Kosova could be used to enhance economic growth⁴¹ through investing these savings in Kosova's economy through portfolio investments at SE.

4.6. SE effect in Information and Transaction Costs

The establishment of SE in Kosova would increase the level of business information flow for all participants in SE, including newly privatized companies, and directly reduce information costs which are estimated to be at a very high level now.

There are dozens of research papers which support creation of SE as a mechanism which imply reduction of transaction and information costs as one of the main effects, hence increasing productivity and having direct positive influence on economic growth. 'Rene Stulz emphasizes that, by lowering information and transaction

40 Continuous growth because there will be an increase in funds in consistency, and those funds would provide continuous investment potential, which will continue to positively impact economic growth.

41 Asli Demirguc-Kunt and Ross Levine, "Financial Structure and Economic Growth: Perspectives and Lessons" Chapter 1, p. 9

costs, overall financial development can facilitate the efficient flow of capital and thereby influence economic growth.⁷

Talking about how much the establishment of SE will cost and who will cover these costs is an important issue that needs further analysis. But it is important to empha-

SE would improve business information flow and directly reduce information costs for all participants in SE, including newly privatized companies.

size that because of its importance there are some indications that commercial banks in Kosovo would participate in SE establishment (as shareholders).

5. Se and its effect on economic growth

The question of the effect of stock exchanges on economic growth has drawn the attention of many economists and researchers. Hence, many economists have focused their research in determining the cause-effect relationships between the establishment of Stock Exchange and economic growth promotion.

Many economists study the correlation between SE establishment and economic growth. Randall et al. (1999) found a positive correlation between market capitalization and future economic growth. Turnover velocity as a better indicator of the effect of stock markets on growth,⁴² suggests that a higher turnover velocity granger causes growth, but only for high and low income countries. Filer et al. (1999) found that for lower income countries the linkage is quite strong and that, 'having a more active stock market is associated with substantially higher growth rates. An increase of one standard deviation in stock market activity in a low income country is associated with 2.5 pp (57% at the mean) increase in growth rate.'⁴³

Some economists have conducted comparative analyses on the effects of exchanges on economies. Baier et al. (2003) found out that 'countries grow faster relative to the rest of the world after a stock exchange opens. The evidence also indicates that a more efficient allocation of resources rather than more capital accumulation is the primary channel through which a stock exchange affects output growth.'⁴⁴ Furthermore they

⁴² Because it has been purged of forward-looking price effects.

⁴³ Randal K. Filer, Jan Hanousek and Nauro F. Campos, "Do Stock Markets Promote Economic Growth", *working paper* No. 267, September 1999, p. 10 - 11

⁴⁴ Scott L. Baier, Clemson University; Gerald P. Dwyer Jr. Federal reserve Bank of Atlanta; and Robert Tamura, Clemson University, "Does Opening A Stock Exchange Increase Economic Growth?" - Federal reserve bank of Atlanta, Working Paper 2003- 36, p. 21 - 22

argue that ‘suppressing a stock exchange or impeding its operation is a good way to reduce economic growth.’

Stock markets contribute to economic development by enhancing the liquidity of capital investments.⁴⁵ Levine concludes that countries whose stock markets were more liquid in 1976 - countries with higher trading-to-volatility ratio - grew faster over the next 18 years than countries with less liquid markets. In his further analysis on stock market versus banks effect in economic growth, Levine figured out that ‘countries with both liquid stock markets and well developed banks grew much faster than countries with both illiquid markets and underdeveloped banks.’⁴⁶

6. Current constraints for the establishment of stock exchange

This section analyzes some constraints regarding the establishment of a successful SE in Kosova. The main constraints are:

- Lack of relevant financial legislation;
- Relatively small market size;
- Relatively low level of law enforcement;
- Lack of professional financial staff;
- Limited number of joint stock companies in Kosova;
- Lack of popularity of SE in Kosova.

The resolution of the abovementioned constraints should be the first step towards the establishment of SE in Kosova. This section should not be seen as a contradiction to the previous sections but rather a delineation of the needed steps to overcome these constraints in order to establish an SE in Kosova. Thus by briefly studying the related constraints, the aim of this research is to focus academics and policymakers towards finding solutions or mitigating these obstacles on the way to achieve a better and developed market-oriented economy.

45 Ross Levine, “Stock Markets, Growth, and Tax Policy”, *Journal of Finance*, September 1991; and Ross Levine, “Financial Development and Economic Growth: Views and Agenda”, *Journal of Economic Literature*, June 1997

46 Ross Levine, “Stock Markets: A Spur to Economic Growth”, <http://www.imf.org/external/pubs/ft/fandd/1996/03/pdf/levine.pdf>, p. 6.

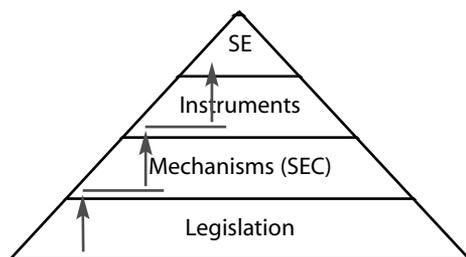
6.1. Lack of financial legislation for SE opening

Kosova is administered by UN Interim Administration Mission under UN SC Resolution 1244. As mentioned in the introduction, Regulation 2001/24 'Amending UNMIK Regulation 1999/20 on the Banking and Payments Authority of Kosovo,' places the responsibility for licensing, supervision and regulation of financial institutions in Kosovo on the BPK. So far the financial institutions in Kosovo are regulated through rules issued by the Governing Board of BPK. Yet, BPK cannot license, supervise and regulate any SE.

The main problem regarding the legal structure is that there is no legislation that foresees the establishment and function of SE in Kosova. In fact there exists no draft, and not even a discussion about what law is needed for establishment of SE. This is one of the first elementary constraints with regard to SE opening in Kosova.

The process of establishing an SE in Kosova looks like a pyramid, where the legislation is the first step and presented at the bottom of pyramid, followed by establishment of Mechanisms or institutions and Instruments, while on the top is SE which is also one of the mechanisms.

This process is presented in the figure 3 below



There is no licensing and supervisory mechanism for SE established in Kosova yet. In fact it is reasonable that a Securities Exchange Commission (SEC) does not exist because there is no legal framework for its establishment. This mechanism is directly related to the creation of legal infrastructure for establishment of SE. The establishment of SE cannot proceed without previously having the Law on SEC and having the SEC being operational. The SEC should be the only authorized institution to license the SE opening and play the regulatory and supervisory body for well functioning of SE. Until this mechanism is in place and operating, no one can even imagine establishing any SE in Kosova, even one with simple operations.

6.2. Relatively low level of law enforcement

Law enforcement is one of the main and crucial components, which determines risk level in a country. This implies that law enforcement is also one of the main factors to attract or deter foreign investments, hence impacting overall national economic success. Beck et al (2000) ‘the component of the overall financial development explained by the legal rights of outside investors and the efficiency of the legal system in enforcing contracts is strongly and positively linked to firm, industry and national economic success’.⁴⁷

The low level of law enforcement is one of the main problems not only for the establishment of SE but also for normal life and other business activity in Kosova. Without elaborating further on this matter, it is necessary to emphasize that without improvement of law enforcement in Kosova, it will not be possible to move forward any of the economic or political projects, hence that would be a big handicap for establishment and proper functioning of SE.⁴⁸

6.3. Relatively small market size

With its small GDP from only €1,317 million in 2003, with an underdeveloped private sector and dysfunctional SOE and POE sector, most economists rank Kosova in a small size market regarding the establishment of SE. The smaller the market size means the less liquid that market is. Lack of market liquidity caused by small market size is an important determinant which prevents foreign investors from being engaged at an SE. That is one of the important constraints regarding the establishment of SE, because it cannot be easily dealt with. It is crucial that the equity market be as liquid as possible. More developed equity market may provide liquidity that lowers the costs of the foreign capital that is essential for development, especially in low income countries like Kosova that cannot generate sufficient domestic savings (WIDER (1990), Bencivenga et al. (1996), and Neusser and Kugler (1998)).⁴⁹

It will be very difficult to increase the market size of Kosova because the only way is

47 Thorsten Beck, Asli Demirguc-Kunt, Ross Levine and Vojislav Maksimovic, “Financial Structure and Economic Development”, (in Asli Demirkuc-Kunt and Ross Levine, *Financial Structure and Economic Growth: Perspectives and Lessons*, p. 12). Internet <http://www.csom.umn.edu/Assets/3595.pdf>

48 Due to lack of law enforcement any SE opening would face problem of ‘inside information’, which would make SE operation not confident and diminish any incentive for JSCs to be listed in SE.

49 Cf. Randall K. Filer, Jan Hanousek and Nauro F. Campos, “Do Stock Markets Promote Economic Growth”, *Working Paper* No. 267. September 1999, p.14

to be integrated in regional and European markets, initially using Free Trade Agreements and by potentially joining the EU. This is a long and difficult process which is related first to setting the final status for Kosovo and then other political and economic changes towards joining the EU. Yet, Levine (1996) concludes that 'Stock Market size - as measured by dividing market capitalization by GDP - is not a good predictor of economic growth, while greater stock price volatility does not necessarily predict poor economic performance'.⁵⁰ Thus the small market size does not mean there is no possibility to establish a functional SE, but rather the possible SE will be relatively illiquid. Yet, the possibility of joining the EU in the near future would make the prospects for solving the market size problem more promising.

6.4. Lack of professional financial staff

One of the current constraints in establishing a SE is the lack of a professional staff regarding the financial and other risk analysis. Obviously, neither a business nor any other financial institution is imaginable without a professional staff. Because there is no trade of securities in Kosovo it is reasonable to assume there are no securities dealers available in Kosovo's labor market. That is also because the University of Prishtina does not prepare young professionals to deal with securities or any other particular work in financial and equity markets, and who could be able to conduct financial and investment risk analysis necessary for SE to properly operate. A mitigating factor is that commercial banks in Kosovo are in process of training their staff to be able to conduct various financial and risk analyses for investments.

Also, another very important factor is that there are Kosovars who live in western countries and who work as dealers and agents in foreign SEs and are willing to give their contribution in establishing SE in Kosovo. In fact, there are currently some ongoing efforts by expatriated Kosovars in convincing PISG and relevant institutions to support the idea for establishing SE in Kosovo. These professionals are committed to bring all their experience and knowledge back to Kosovo and share it with young investment professionals.

6.5. Limited number of Joint Stock Companies (JSC)

By considering the correlation between SE opening and the development of Joint Stock Companies one may conclude that SE is a complement to JSC development,

50 Ross Levine, "Stock Markets: A Spur to Economic Growth", Finance & Development / March 1996, <http://www.imf.org/external/pubs/ft/fandd/1996/03/pdf/levine.pdf>, p. 3

just the same way as JSC are the main reason why the SE should exist. This is the main reason why this study considers the limited number of JSCs to be one of the constraints for opening an SE. The following text provides some descriptive statistics on the situation of JSCs in Kosova.

Currently in Kosova, most of the existing companies are sole proprietorships and JSCs are not well developed. That is mainly a continuation of traditional private investment initiative in economic development where almost all private companies were (and still are) established by a sole entrepreneur, who is at the same time the manager of the company. In 2004 there were 255 JSCs registered with the Business Registration Office at Ministry of Trade and Industry (MTI). This constitutes a mere 0.42% of the total registered businesses in Kosova.⁵¹ Also, there were 48 JSCs and one Holding Company registered in the Kosovo Trust Agency's (KTA) database, of them 44 in Gjakova, three in Peja and one in Gjilan. These used to be SOEs and were privatized during the 1990s according to the Privatization Law of the former Yugoslavia of 1988.⁵² Some of these JSCs may be interested in being listed at SE and hence raising additional funds by either issuing new shares or bonds.

Almost all private companies are established by a sole entrepreneur, who is at the same time the manager of company.

This low level of joint stock companies in Kosova is mentioned also in other publications. The Survey of 300 enterprises in Kosova (2003) states that,

the very low use of the joint stock company legal format (8 respondents out of 300 use it) is a cause of concern. The joint stock company is required by many foreign investors entering into joint venture partnerships. It is also easier in many instances to raise finance with the joint stock company.⁵³ It is the predominant legal format in the modern economy. There is a need to make the Kosovar business community aware of the benefits of the joint stock company.

A mitigating factor, as inferred from a discussion with Ahmet Shala, Deputy Managing Director SOEs at KTA, is that a successful progress of privatization process in Kosova till the second half of 2005 will create many new JSCs from the old SOEs, and their primary need will be to raise additional funds for the improvement of existing technologies. The only way to do so would be to issue IPOs at SE because their

⁵¹ These data represent only the number of registered businesses without being updated for the number of businesses that have been closed ever since. Updated information about the real existing businesses is not yet available.

⁵² Law known as Ante Markovic's Law on Privatization.

⁵³ 'Survey of 300 enterprises in KOSOVO - FEBRUARY 2003', March 2003, BY: UBO CREATIONS

capacities to make needed investments from internal sources is vulnerable and may not succeed.⁵⁴

6.6. Lack of popularity of SE in Kosova

Before the publication of this paper, the establishment of SE in Kosova was not explored at all. Also, due to the lack of interest, no empirical data has been produced on the possibilities for establishing an SE. Therefore, even though this paper is supported by findings from other studies, all conclusions and recommendation given here lack support from direct empirical models.

Anecdotal evidence suggests that most Kosovars think that in order to invest in a SE one should have millions of euros, because there is an impression that one needs to be rich in order to be a shareholder. This opinion is wrong. It is known from the experience of other SE operations that usually, the initial price of a share is somewhere between \$0.25 and \$1. But investors invest in block(s) of shares. It means that in order to invest one does not need to be wealthy. Research conducted by interviews of many employees in relevant ministries and other financial institutions in Kosova and daily discussions about SE with many people, shows there is a huge shortage of knowledge by Kosovars regarding the SE operations and possibilities to invest through SE. This problem would minimize real investment potential and potential investors will need longer time to adjust with new possibilities to invest.

Lack of knowledge about SE operations may be considered one of the constraints that would need long time and large efforts to educate potential investors on how to use the SE to make best use of their funds (to gain the best rate of return) from investing in stock or securities, instead of keeping their money outside of the market.⁵⁵

7. Conclusions

Findings from this analysis suggest that the establishment of an SE in Kosova would

54 Mr Ahmet Shala is Deputy Managing Director SOEs at KTA, and a member of board on privatization process managed by KTA.

55 In a discussion with Mr. Naser Grajçevci, Director of Department for SME development at MTI, he emphasized that in SE opening process, MTI's main role would be in education of potential investors and companies regarding the SE operations, hence facilitating and guaranteeing the successful operation of SE in Kosova. This should be considered as a very important mitigating factor for the abovementioned constraint.

play an important role in driving higher savings and fostering long-term investments. Another conclusion is that in order to create monetary policy instruments in Kosovo it is crucial to develop a financial market (SE) where BPK can use Open Market Operation as its main monetary policy tool.

The establishment of an SE provides possibility for better use of funds such as KPST fund and of the fund accumulated from sale of SOEs through the privatization process. Without operation of a liquid and developed SE, these funds will continue to be invested abroad and hence creating illiquidity in Kosovo's fragile economy.

One of the main effects of SE could be in the post-privatization process, where SE in Kosovo could provide an important possibility for additional fund-raising⁵⁶ in short-term post privatization process, necessary for investing in new technologies and know-how.

The establishment of SE in Kosovo provides needed mechanisms for the government to issue debt for financing projects of strategic importance for Kosovo or simply to finance short-term debt, by issuing government securities. Currently this is not the case but based in cyclical economic development we may expect to face deficit situation in the near future.

The establishment of an SE in Kosovo may help generate foreign portfolio investments through incentives provided by a high rate of return and small information and other risks, and through the market mechanism which provides enough liquidity.

SE increases business information flow, in particular by providing information about the most productive industries and hence stimulating profitable investments. This implies an increase in economic productivity and sustainable growth.

There is no legislation which establishes and regulates any Licensing and Supervisory mechanism of SE in Kosovo. Lack of supervisory mechanism (SEC), which is directly related to lack of legislations, is an immediate constraint in SE opening.

Small market size could be constraint on level of liquidity that SE in Kosovo could offer because market size cannot be increased easily.

Kosovo has a shortage of professional staff who could be engaged in financial and risk

⁵⁶ It might be important long term financing source, because the existing banking system in Kosovo does not provide long term finance for investment projects and there are no investment funds from International Financial Institutions.

management analysis and product sales, needed for normal operation of SE. A mitigating factor is that many commercial banks are training their staff to be able to conduct these investment analyses.

Limited number of joint stock companies in Kosova is a factor that restricts establishment of SE in a very short term, but ongoing privatization process is creating larger number of JSC that could be potentially listed at SE.

A shortage of background information in Kosova about SE functioning and possible benefits from SE could be considered as one of constraints regarding the establishment of an SE.

8. Recommendations

There is a need to work further towards the establishment of a Stock Exchange with all relevant legislation, mechanisms and instruments, which in fact represent a Structural Reform towards the Market Economy in Kosova.

For licensing, supervising and regulating operations of SE, Kosova's Parliament should approve a separate Law that establishes a Securities Exchange Commission (SEC), and empowers it to supervise and regulate the SE. A separate section in the Law on Establishment of SEC should foresee the organizational structure of SEC, its Board and employment procedures for its Managerial Staff.

It is very important to work towards capacity building by offering professional training to new financial analysts and specialists to be engaged in daily operation of SE and other risk management analysis.

In order to achieve better results from establishment of SE and increase investment incentives, it is particularly necessary to develop a marketing strategy that should be very intensive and initially overwhelming. People should be informed that if someone wants to invest, one does not need to have a lot of money and this is basic and important information for the potential investors within Kosova.

8.1. Possible strategies and expected outcomes

Three possible strategies and expected outcomes are presented in a table where strengths and weaknesses of each of three strategies are shown.

	Strategy one - DO NOTHING	Strategy two - Establish a limited ¹ SE	Strategy three - Establish a complete ² SE
Strengths	No establishment and other costs related to SE.	Possibility for longer term financing (especially for banks and government), conduction of monetary policy by BPK, easier access to financial means for the banks and government projects, etc.	Possibility for longer term financing (especially for banks and government), conduction of monetary policy by BPK, Easier access to financial means for financing new and successful business ideas of the existing businesses, facilitates post-privatization investment in newly privatized companies, increase information efficiency level, decrease transaction costs, enables portfolio investments from internal and external investors, increases liquidity and stability of SE itself by providing more possible investment combinations etc.
Weaknesses ³	All the problems identified in the analysis due to nonexistence of SE	Establishment and maintaining costs, lack of legislation, lack of professional staff, lack of SEC, relatively small market size, relatively low level of law enforcement.	Establishment and maintaining costs, lack of legislation, lack of professional staff, lack of SEC, relatively small market size, lack of JSCs, relatively low level of law enforcement, lack of popularity of SE.
Suggestion	Not a good choice	Possible choice - in a short run	Go for it

1. Limited SE means if Kosova develops only financial market where debt securities are traded but no trade of stock or commodities takes place.
2. Complete SE means a complex SE, where not only debt securities but also stock and commodities will be traded.
3. Weaknesses of the second and third strategy are mainly of a short term nature and can be overcome in a medium run by the government intervention or other relevant stakeholders.

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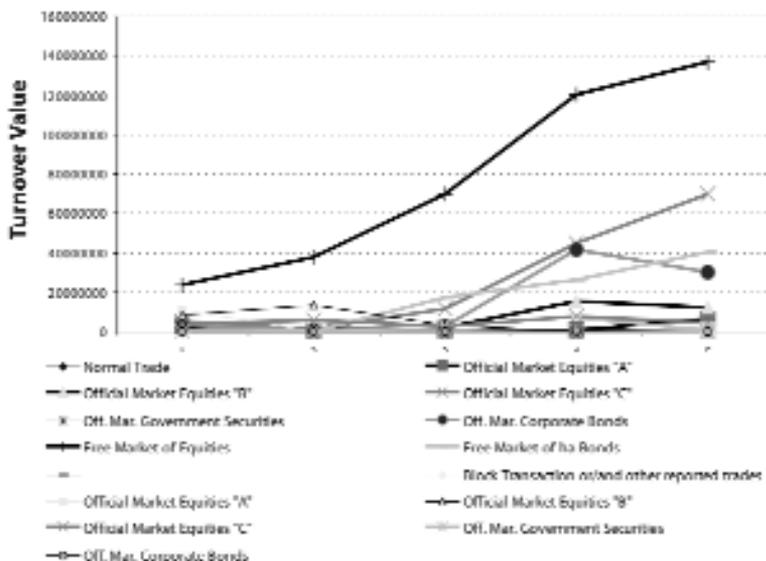
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10. Abbreviations

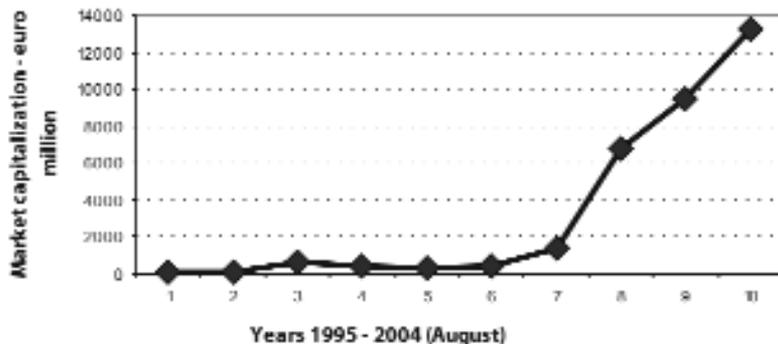
BPK	Banking and Payment Authority of Kosova
CD	Certificate of Deposit
CEE	Central East Europe
ECB	European Central Bank
EU	European Union
FDI	Foreign Direct Investments
Fed	Federal Reserves System
FM	Financial Market
FTA	Foreign Trade Agreement
GDP	Gross Domestic Product
IMF	International Monetary Fund
IPO	Initial Public Offerings
JSC	Joint Stock Company
JV	Joint Venture
KCB	Kosovo Consolidated Budget
KFOR	Kosovo Force
KPST	Kosovo Pension Savings Trust
KTA	Kosovo Trust Agency
MFE	Ministry of Finance and Economy
MFI	Micro Finance Institutions
MTI	Ministry of Trade and Industry
NASDAQ	National Accounts S D Automated Quotes
NBER	National Bureau of Economic Research
NCD	Negotiable Certificate of Deposits
NYSE	New York Stock Exchange
OTC	Over The Counter
POE	Public Owned Company
PTK	Post Telecommunication of Kosova
SE	Stock Exchange
SEC	Securities Exchange Commission
SOE	Socially Owned Company
TFP	Total Factor Productivity
UN	United Nations
UNMIK	United Nations Interim Administration Mission in Kosovo
UP	University of Prishtina
WIDER	World Institute for Development Economics Research

11. Appendix

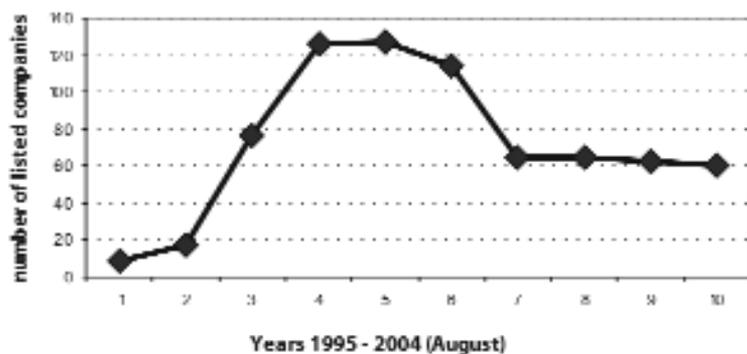
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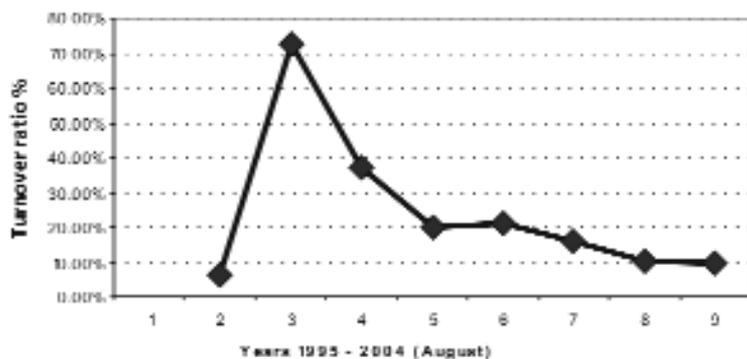
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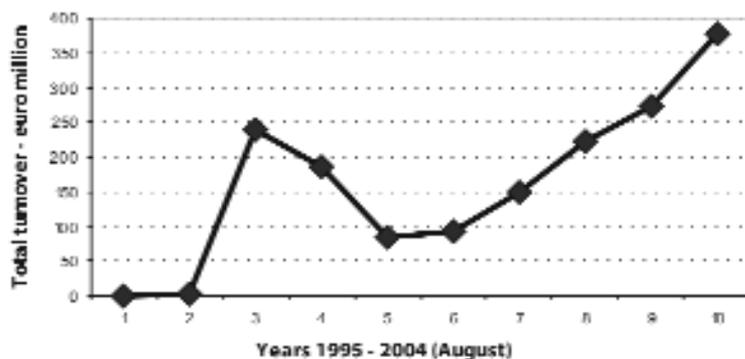
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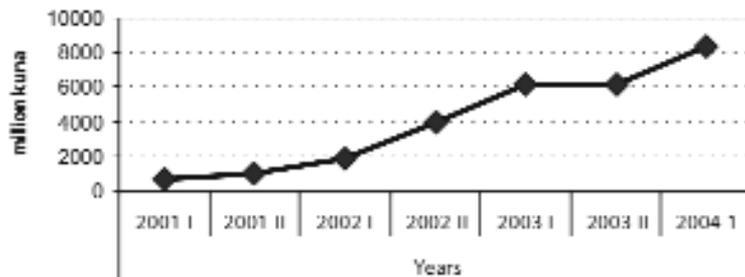
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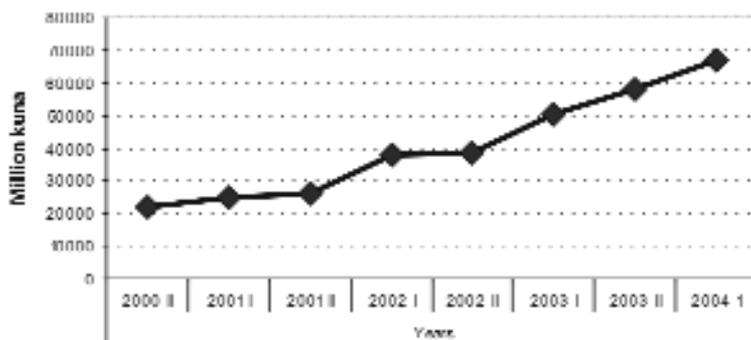
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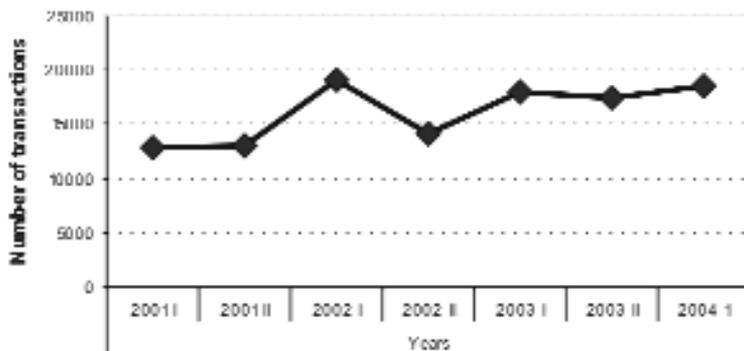
Zagreb SE total turnover 2001 - 2004 (semiannually)



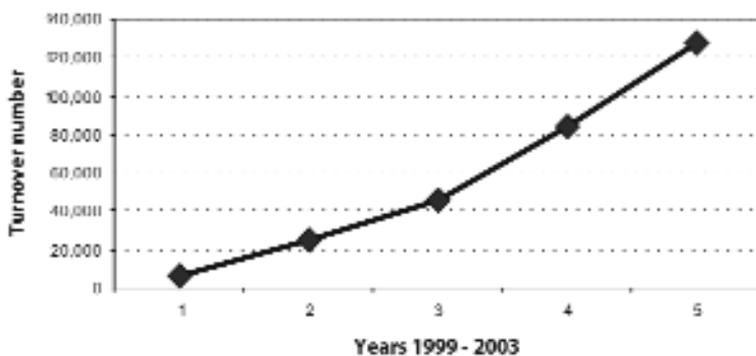
Zagreb SE Market capitalization 2000/II - 2004/I



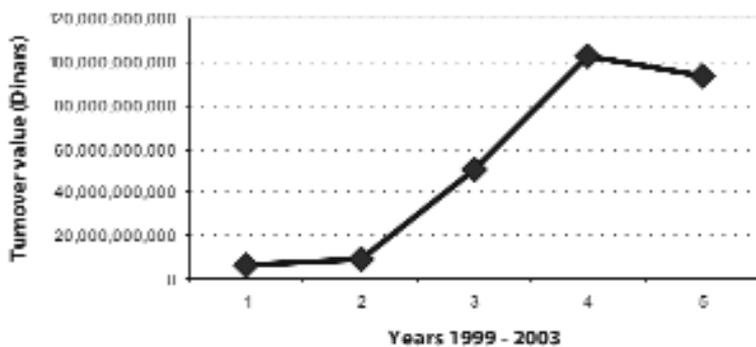
Zagreb SE 2001/I - 2004/I



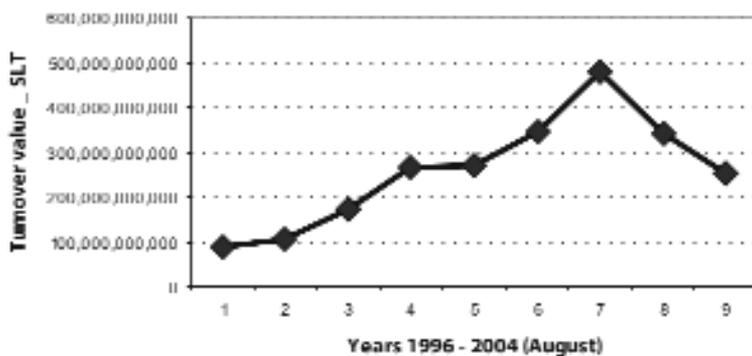
Belgrade SE turnover 1999 - 2003



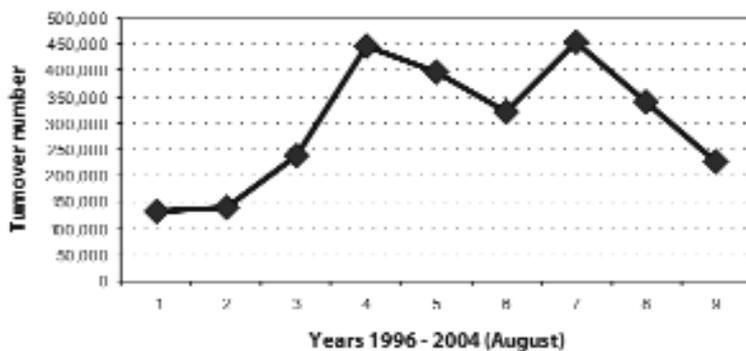
Belgrade SE turnover 1999 - 2003



Ljubljana SE 1996 - 2004



Ljubljana SE 1996 - 2004



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