Policies for business in the Mediterranean Countries

SERBIA AND MONTENEGRO

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Introduction

The transition of Serbia and Montenegro[1] to democracy and a market economy began under very difficult economic and social conditions. These conditions were the result of more than five decades of inefficient economic management and a decade of regional conflicts and international isolation that followed the break-up of the Socialist Federal Republic of Yugoslavia in 1991. By 2000, recorded per capita GDP was less than half of its 1989 level, external debt exceeded 130 percent of GDP, and annual inflation was over 113 percent[2]. The authorities began to stabilize and transform the economy by tightening macro-economic policies and recommencing market-oriented structural reforms, combining their own efforts with the strong support of the international community. In general, the reform process started earlier in Montenegro, while political events in Serbia prevented substantial reform before early 2001 when the newly elected republican government took office.

The renewed transition of Serbia and Montenegro to a market economy is based on: restoring macroeconomic stability and external balance; stimulating near-term growth and creating the basis for a sustainable supply response; improving the social well-being of the more vulnerable elements and building human capacity; improving governance and building effective institutions.

The pre-reform private sector environment in Serbia and Montenegro was not business-friendly owing to a variety of factors, including: the collapse of the rule of law; lack of regulatory legislation in many fields; lack of access to credit due to the poor state of the banking sector; non-transparent tax systems with a high level of corruption in state administration; loss of foreign markets due to international sanctions; and the poor state of physical infrastructure.

Over the past two years, the governments of both Serbia and Montenegro have made progress in business-enabling reforms, including liberalization and deregulation of foreign trade and investment, simplification of the tax regime, and modernization of labour legislation. However, despite such progress, significantly higher domestic private investments have yet to be realized. The recent sharp increase in foreign direct investment has primarily come through privatizations in a few attractive sectors, with the high sales prices of some major firms partly reflecting the artificial erection of tariff and other barriers to competition.

The financial sector in both republics was in a very poor state for a long time prior to 2000[3]. During the 1990s, there was no notable activity in credit markets

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[1]The Federal Republic of Yugoslavia completed its constitutional transition to Serbia and Montenegro in February 2003. The province of Kosovo is under U.N. administration according to UN Security Council Resolution UNSC-1244.

[2] www.worldbank.org.yu

[3] Ibidem

and mobilization of resources for new investments was negligible. Much of the system, and particularly the largest banks, suffered from a chronic lack of liquidity. Public confidence in the sector was almost entirely lost due to recurrent shocks (freezing of private foreign currency savings, hyperinflation).
Both republics have made concerted efforts to restore the viability of the banking sector, improve supervision, privatize publicly-owned institutions and attract foreign banks to enter the market. Initial work has also begun on areas in the non-bank financial sector, including modernization of the stock exchange, and improved regulation of insurance companies.
Kosovo's economic situation is influenced by the uncertainty of its political status. On June 10, 1999, the United Nations Security Council adopted Resolution 1244 (UNSCR 1244), which provides the legal framework for Kosovo's current status. Until a political solution to the Kosovo crisis was still lacking, UNSCR 1244 affirmed the sovereignty and territorial integrity of Serbia and Montenegro (SAM) but also called for 'substantial autonomy' for Kosovo. UNSCR 1244 authorized the establishment of "an international civil presence in Kosovo in order to provide an interim administration" which has been implemented through the creation of the United Nations Mission in Kosovo (UNMIK).

1. Serbia

After a decade of neglected investment, sanctions and war, the Government has achieved remarkable economic results in 2001 thanks to an ambitious and rapid economic reform programme. Macroeconomic stability and a considerable economic growth (5% of GDP in 2001 and 3.5% of GDP in 2002- GDP in 2001 was 10,861 million USD[4]-) was achieved during 2001 and, unlike in any other transition country, there has not been a major downturn in the first year of transition; budget deficit has been kept under control (less than 4% of GDP in 2003); inflation is improved compared to the previous period (in 2000 it was 113%, in 2001 was 39% and in 2002 14.8%.[5]).
Foreign debt has been reprogrammed and in 2003 it was equal to approximately 70% of GDP[6], down from 140% in 2000. This still presents a major burden on the economy, but debt sustainability depends on the ongoing negotiations with the London Club and other bilateral creditors with the aim of bringing the value of debt down to less than 60% of GDP.
The monetary policy has been controlled and stable, resulting in an increase in foreign currency reserves and domestic credits. The increase in money supply

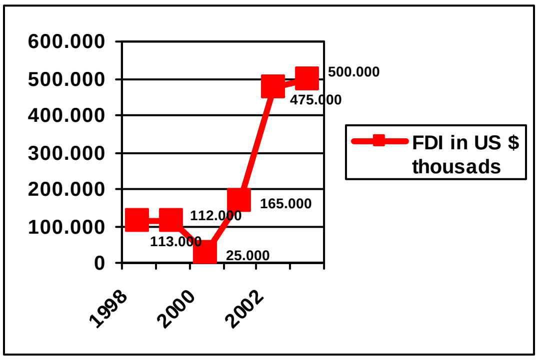
[4] Serbian Chamber of Commerce
[5] Ministry of International Economic Relations Republic of Serbia, *Donor Co-ordination Meeting Reforms-Updated Statement,* Brussels 18th November 2003 www.mier.sr.gov.yu
[6] Sources: Bank Austria Creditanstalt Economics Department, NBS, IMF

was based on foreign currency transactions, with the limited domestic assets increased. Interest rates have been falling during the past period, with an expansion in lending to households and economy. There are good prospects for increased banking activity, as a result of the banking reforms and new laws on mortgage and bankruptcy.

Thanks to the successful privatisation programme and post privatisation agreements, Foreign Direct Investments (FDI) has performed well in both Serbia and Montenegro (see the following graph).

Stimulating domestic private and public savings, as the basis for further investment, remains the biggest challenge: the total level is lower than necessary to generate sustained and dynamic growth in the medium term, as well as to reconstruct the infrastructure.

Foreign Direct Investments in Serbia and Montenegro



Source: World Development Indicators database

1.1 Domestic enterprises

Serbia initiated the process of transition four years ago. A study reported in the ASECU (Association of South Eastern Europe Economic Universities) Conference in Belgrade in 2003[7], analyzed the investment climate and the obstacles to economic growth, bearing in mind the level of GDP and the large numbers unemployed in the country (approximately 30%). This research shows that the most problematic factors affecting the operation and growth of the enterprises business are:

1) economic policy uncertainty,
2) cost of financing,
3) unfair competition,
4) tax rates

[7] Fabris Nikola, Jelena Galić *Improving a Business Environment in the Process of Transition of Serbia and Montenegro* www.ecinst.org.yu

5) macroeconomic instability.

1) E**conomic policy uncertainty** is caused by the abrupt turns in economic policy which impose increased costs on enterprises and aggravate the planning and contracting of long-term business projects. The situation is also complicated by the fact that, due to a slim majority in the Parliament, the Government is often forced to agree on a political compromise, which is sometimes unannounced and unexpected. There is also great uncertainty as to whether the state union of Serbia and Montenegro will survive after a three-year "probation" period.

2) The **financial system** has dramatically improved in comparison to three years ago. Consumer credits appeared; short–term credits are more accessible; payment system operations were transferred from the Bureau for Settlement and Payment Transfers to commercial banks and new foreign banks were opened.

However, the financial system still does not function in a satisfactory manner: interest rates are still too high (higher than those in the developed market economies); long–term credits barely exist; the mortgage market has not yet established itself; there are still problems relating to the provision of bank guarantees and there is no reliable information system.

Most problems faced in this sector arise from three factors: inadequate laws and regulations (and an inefficient judicial system), the absence of specified institutions and low credibility of the financial system. The new system–related laws were adopted (which may spur the development of the financial system), such as: the **Law on Financial Leasing**[8], **Law on Pledge** and **Law on the Securities Market**. It is important to adopt the new **Law on Investment Funds** and new **Mortgage Law** as soon as possible (it is expected that it will improve the functioning of the securities market and promote the development of the capital market). With these new laws, relationships between authorized participants on the financial market with respect to the protection of investors, appearance of new financial institutions and the tightening of financial discipline will also be improved.

To restore confidence and increase the efficiency of local banks, the National Bank and the Agency for Bank Rehabilitation and Deposit Insurance (together with the Federal Ministry of Finance and the Republic Ministry of Privatization) devised measures for the restructuring and rehabilitation of the banking sector. In order to increase the competitiveness of the current banking system, it is necessary to attract as many foreign banks to the domestic market as possible without setting special requirements (the refinancing of domestic banks as a precondition for the appearance on the domestic market).

[8] For this report, it was difficult to find the texts of the laws in the English version. They are available in Serbian language at www.sluzbenilist.co.yu

The privatization process can help the development of the financial market. Limitations on trading in privatized shares (set by the previous **Privatization Law**) have been abolished by the new Law.
The **Law on the Guarantee Fund** has recently been adopted, but this fund has not yet established itself in practice. The basic function of this fund will be to guarantee a portion of the credit that is extended by banks to SMEs. It can be expected that this fund will influence a significant increase in the accessibility of credit, as well as the lowering of the interest rate due to the lessening of the risk. Therefore, this fund should become operative as soon as possible.
3) The problem of **unfair competition** can be considered from two aspects. The first aspect refers to inadequate laws and regulations and the second to a widespread grey economy acting as unfair competition against the enterprises that carry on their business legally.
The **Antimonopoly Law** stipulates the actions and acts which, through i) the abuse of a monopoly, or a dominant position, or ii) the conclusion of a monopoly agreement, distort competition and cause disruptions on the unified market.
The facilities of a large great number of Yugoslav (Serbian) enterprises were designed for the former Yugoslav market. After the collapse of former Yugoslavia many producers found themselves in a monopoly position, or may hold a monopoly position in the future. Some key sectors such as: telecommunications, power generation and distribution, rail transport, public utilities, imports of oil and oil products, etc. are characterized by a pure monopoly (only one firm), while most other sectors are characterized by an oligopolistic market structure. The situation is relatively satisfactory only in the areas of agriculture, trade, foodstuffs and textile industries. Due to such a situation, the prices in some sectors are set at an unreasonably high level.
Smuggling and the widespread **grey economy** represent unfair competition for the firms doing their business above board[9]. According to the estimates, its share in GDP ranges from 35% to 45%. The elimination of smuggling and improvement of the customs service are one of the highest priorities.
4) The fourth problem for enterprises is the **tax system.** A **tax reform** can be regarded as a great contribution of fiscal policy. So, a uniform rate of sales tax has been introduced; the number of forms of taxation has been halved and the tax rates for most products have been lowered, while at the same time enlarging the tax base. Tax reliefs have been introduced for large investors, for the employment of new workers, for the purchase of fixed assets, as well as for investing in underdeveloped regions. Although the tax system has been significantly improved, many enterprises hold that the tax rates are still too high and that they should be lowered still further. This refers primarily to two

[9] Fabris Nikola, Jelena Galić *Improving a Business Environment in the Process of Transition of Serbia and Montenegro* www.ecinst.org.yu

forms of taxation: i) Sales tax and ii) Taxes and contributions on wages and salaries.
Most other forms of taxation are at similar levels like in other countries in transition. In the opinion of a large number of enterprises, the rate of sales tax of 20% is not an incentive and encourages the grey economy. Also, in the Draft of the new **Law on the Imposition of VAT** it is stipulated that the tax rate should remain unchanged. Despite the fact that this form of taxation is not higher than in most other economies in transition, given an underdeveloped economy, one should consider seriously its reduction by 15- 17%. This can also be supported by the fact that the rate of VAT in Montenegro is 17%, and if there is a difference in the rates of VAT between Serbia and Montenegro, it is clear that there will be no single market.
5) The last problem is the **macro-economic policy instability**. High inflation (the inflation rate was 112% in 2000, 40% in 2001, 14%in 2002, 7.8% in 2003[10]) , frequent changes in the exchange rates (the exchanges rate euro/dinar was 58.67 in 2000, 59.71 in 2001, 61.52 in 2002, 68.31 in 2003[11]), etc., was characteristic of the proceeding period. Despite the fact that inflation and the budget deficit were drastically decreased, full confidence in national currency has not yet been restored.

1.2 Improving Small and Medium Enterprises

The priority objective of the Government **Strategy for the Development of Small and Medium-sized Enterprises and Entrepreneurship** is to create a framework for the development of a sustainable, internationally competitive and export oriented SME sector[12]. To secure economic and social growth will be reflected in: an increase in the standard of living and a reduction in the gap between average incomes in Serbia and EU member states; significant employment increases; stronger and steadier regional development; strengthening of international trading links, especially with EU member states; an increase in available resources for other sectors, such as education, health and pension funds.

[10] Ambasciata d'Italia a Belgrado, *Repubblica di Serbia e Montenegro Scheda paese 2004* www.italy.org.yu
[11] Ibidem
[12] Republic of Serbia The Government of Serbia, A Strategy for the Development of Small and Medium-sized Enterprises and Entrepreneurship in the Republic of Serbia 2003-2008, Belgrade, 16 January 2003 unpan1.un.org

1.2.1 Priorities to improve SMEs

Although the process of privatisation has commenced, the Serbian economy is still dominated by large-scale and inefficient socially owned enterprises and much of Serbia's industrial plant is obsolete. In Serbia SMEs comprise some 99% of all enterprises and they have the potential to make a significant contribution to the economic revival that is so badly needed.

By the end of 2007, the **Government Strategy for Development of SMEs and Entrepreneurship** shall identify three priorities for improvement of the SME sector:

1) Removing the legal and regulatory barriers
2) Improving access to capital for SMEs
3) Improving competitiveness of enterprises

1) The SME sector, both sole traders and companies face many complex procedures and regulations at the start-up stage, in day-to-day operations and in the event of the cessation of the enterprise. Compliance with rules is imposing a heavy burden and costs on the restricted financial, management and personnel resources of SMEs. Important first steps have been made. In 2002, an amendment to the **Federal Law on enterprises** was initiated ("Off. Gazette FRY" No. 36/2002) and the **Law on private entrepreneurs** was changed ("Off. Gazette RS" No. 35/2002). It provides for a simplified registration procedure through cancellation of previous mandatory inspection controls for the majority of activities, and works on the creation of completely new, unique registration system. Moreover, regulatory procedure regarding labour law was amended and a group of taxation regulations was adopted to stimulate investments and employment of new employees. There are several other important laws in the final phases of creation or adoption, such as the **Law on construction and planning**, **Law on secured transactions**, **Law on leasing**, **Bankruptcy Law** and **Law on Guarantee Fund.** The central position in the process of creating a favourable legal and SME-friendly environment is held by the Inter-Ministerial Working Group for creation of proposals for simplified terms and procedures for establishment and development of small and medium-sized enterprises and private entrepreneurship (Inter-Ministerial Working Group on Deregulation) which has a mandate to co-ordinate deregulation measures by relevant ministries.

2) The Government of the Republic of Serbia and relevant ministries have undertaken numerous initiatives to improve access to capital for SMEs including the Republic Labour Market Bureau's Self-employment Programme and the Development Fund of the Republic of Serbia. The Republic Guaranty Fund is a new initiative by the Ministry of Economy and Privatisation designed to facilitate approval of bank loans to SMEs.

Although the Government initiatives are significant and helpful, they can only provide a fraction of the capital resources that will be required to achieve the

National SME Strategy objectives. Although their deposits are increasing again, the Serbian banks have no tradition of SME lending. Intensifying the operations of the commercial banks with SMEs will require both more financial resources and changes in bank attitudes to SMEs.
3) Many external and internal factors influence the competitiveness of enterprises, in particular: management capabilities and innovation.
Management capabilities is one of the priorities. A full range of services based on delivery of information, business advice and training programmes for management development will be provided through the Regional Agencies and Centres for the Development of the SME Sector. However, the Regional Agencies alone will not be in a position to provide all of these services directly, as the range can be very extensive. Private consultancy services for SMEs are not widely available in the Republic of Serbia at present, particularly outside of Belgrade, and it will be a major function of the Regional Agencies and Centres to act as a catalyst for their development.
Concerning the second factor, in recent years survival has been the main issue for many of the enterprises in the Republic of Serbia and resources have not been generally available for reinvestment in product and services development and upgrading. The Ministry for Science, Technology and Development will create a legal framework for the development of the Republic of Serbia as an innovative society. This framework will regulate the establishment and work of innovation centres, business and technological incubators and scientific and technological parks, knowledge transfer and transfer of results from R&D (research and development) projects into enterprises in order to develop innovative and internationally competitive products and intellectual property protection. The Ministry of Culture and Public Information and the Committee against "pirating" will be heavily involved in the battle against "pirating", a specific problem of intellectual property protection[13].

1.2.2 Supports for SMEs

The entities who support SME are:

- **The Republic Agency for Development of Small and Medium Enterprises** (Central Agency) is responsible for implementing SME strategy, informing Government on SME issues, promoting the SME sector and supporting Regional SME Agencies and coordinating their activities.
- **Regional SME Agencies, Centres and Offices for Development of SMEs and Entrepreneurship.**
- **Advocacy for SMEs** Established in 2001, the SME Advisory Board (SMEAB) is the new national forum where Government and SME

[13] Ibidem

representatives work together to resolve the issues that need to be tackled so that the SME sector can forge ahead.

2. Montenegro

A similar program of Serbia of improvements to the business climate has been undertaken in Montenegro. These include **new business registration procedures** which have significantly reduced the time for a basic start-up, and a new **Bankruptcy Law**[14] that aims to make the process faster and more efficient, and permits the use of licensed trustees from the private sector. A **Law on Private Sector Participation in Delivery of Public Services** sets the stage for the use of concessions, such as BOT and other devices to permit greater private sector involvement. The remaining capital controls on foreign transactions are expected to be phased in shortly.

The largest **bank**, Montenegrobanka, was sold in July 2003 after many assets and liabilities related to sovereign lending had been lifted out. The privatization of Podgoricka Banka, the last bank with a direct majority ownership of the state, is underway[15]. The offshore banks that had been registered in Montenegro, but produced little if any benefit to the legal economy in that republic, have now had their licenses revoked by the Ministry of Finance. All correspondent banking relationships with licensed banks have been terminated, and offices of these banks in Montenegro are under investigation. A **Law on Anti-Money Laundering** was also adopted in 2003. A recent Basel II Core Principles Assessment gave a positive assessment of banking supervision in Montenegro, with the Central Bank now moving to address those issues where compliance was not strong. With the closure of private Ekos bank in 2003, the liquidation of Jugobanka, and the assets lift and subsequent sale of Montenegrobanka, the central bank considers all banks to be liquid and in compliance with capital requirements. The transparent privatization of Podgoricka Banka and the creation of a viable mechanism for recovering the maximum amount from carved out assets and liabilities of restructured banks represent important near-term benchmarks in banking reform. A deposit insurance scheme is expected to be initiated in mid-2004, but capital is needed to finance the insurance fund. A new **Insurance Law** has also been drafted.

Privatization has occurred through the issuance of vouchers under the **Mass Voucher Privatization (MVP) program** and through direct sale via tenders and auctions. About 40 percent of industry remains in state hands, although the Government's target is to sell several large companies by the end of 2003.

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[14] It was difficult to find the texts of the laws in English version also for Montenegro. They are available only in Serbian.

[15] www.worldbank.org.yu

In 2002, the Government sold 54 percent of the oil company Jugopetrol Kotor. Tenders have been prepared for large enterprises including major units of the giant aluminium conglomerate (KAP), the Niksic steel company, and the tobacco company. A tender for the state telecommunications monopoly was not taken up, possibly reflecting general problems with the global telecommunications market. The MVP program unfortunately generated many problems, since it fragmented ownership, which in turn blocked changes in corporate governance and made it more difficult to bring in strategic investors with fresh capital. The bulk of the shares for most firms remained with the Government and its share funds, including the Pension Fund. The Government is designing a program to address these issues, partially through assistance to companies to cover redundancy costs, through restructuring of state debt, and through the reorganization provision of the new bankruptcy law.

2.1 Strategy for Support to the Development of SMEs

Consistent with the objectives of its **'Economic Development Strategy for 2002-2005'** the Government of the Republic of Montenegro aims for the current strategy[16] are:

1. To increase the number of registered private sector SMEs
2. To achieve a greater diversity and integration of economic activity, increasing the proportion of SMEs based in production and non-trade services.
3. To significantly increase the proportion of SMEs relative to micro-enterprises in the total enterprise population.
4. To increase competitive SME activity in economic sectors where the Republic of Montenegro is currently reliant on imported goods and services and increase the contribution of SMEs to export earnings.
5. To increase the participation of domestic SMEs in foreign strategic alliances and joint ventures.

The Government of the Republic of Montenegro recognises that it cannot work alone to achieve its SME development objectives. The successful implementation of the strategy requires the concerted and co-ordinated efforts of a range of stakeholders, including Government, international lending institutions, foreign donors, commercial banks and other financial institutions, non-governmental organisations, business representative organisations, business consultancy and advisory service suppliers and individual SMEs themselves.

At the current time, levels of **entrepreneurial activity** in Montenegro are extremely low. In order to address this problem and to enable Montenegro to

[16] National Agency for Development of Small and Medium Sized Enterprises, *Policy Strategy for Support to the Development of Small and Medium Sized Enterprises* www.nasme.cg.yu

begin to compete in the international market economy, it is vital that steps are taken to promote entrepreneurship.

The emergence of a competitive SME sector requires not only the creation of new attitudes towards entrepreneurship, but also the development and application of **modern business skills** in areas such as management, finance and accounting, marketing and human resource development.

In order to realise the full potential of entrepreneurship it is vital that businesses are able to **compete on a fair and equal basis.** In order to achieve this purpose the Government proposed to implement rigorous programmes of education for public officials engaged in the implementation and administration of new legislation, including the new enterprise and tax laws; to introduce new administrative procedures in relation to enterprise legislation and regulations; to introduce more stringent monitoring and evaluation procedures in respect of new and existing legislation.

The Government is also committed to achieving an appropriate **balance of regulation**, consistent with its social policy obligations and the need to promote economic transition and growth, and recognising that the costs of compliance for small firms are proportionately higher than for large firms. It is important to streamline business registration procedures, in particular to reduce the average registration period for new business.

The Government of the Republic of Montenegro has already taken significant steps towards **simplifying taxation measures** that impact on SMEs, including the revision of excise taxes and the revision of taxes on personal income and corporate profits. During the period of the strategy it is proposed to examine the case for further revisions to tax laws aimed at reducing the burden for SMEs and encouraging significantly improved levels of voluntary compliance. In developing new tax measures, including potential tax breaks, reduced thresholds, streamlined assessment and payment mechanisms etc.

Access to information (about new products and processes, competitors, trends, new markets and customers) has become increasingly important in determining competitiveness. This has left businesses in Montenegro with a double disadvantage, having lost markets previously established within the Former Republic of Yugoslavia and endured a prolonged period of economic sanctions during which access to new international markets was not possible. As a consequence, businesses in Montenegro must make up ground quickly if they wish to compete successfully for domestic and foreign markets. In order to assist businesses in this process, the Government proposes to establish a network of Regional Business Information Centres (RBICs). The government also proposes to establish a European Information and Correspondence Centre (EICC). The EICC will be established in Podgorica and will provide further services to businesses in the form of information on European standards and markets and the organisation of European trade events, including inward and outward trade missions.

The Government of the Republic of Montenegro recognises that lack of access to **affordable sources of finance** is a major constraint for SMEs wishing to invest and grow, particularly for start-up and early stage businesses that need to borrow for periods in excess of one year. To facilitate access to affordable finance the Governments proposes to continue efforts to restructure the commercial banking sector; to cooperate with international lending institutions that express a willingness to establish new credit lines in the Republic of Montenegro; to increase competition in the supply of micro-finance through further cooperation with international lending institutions and non-governmental organisations active in the area; to create enabling legislation and efficient taxation instruments to encourage the formation and growth of new SME and micro-finance institutions.

3. Kosovo

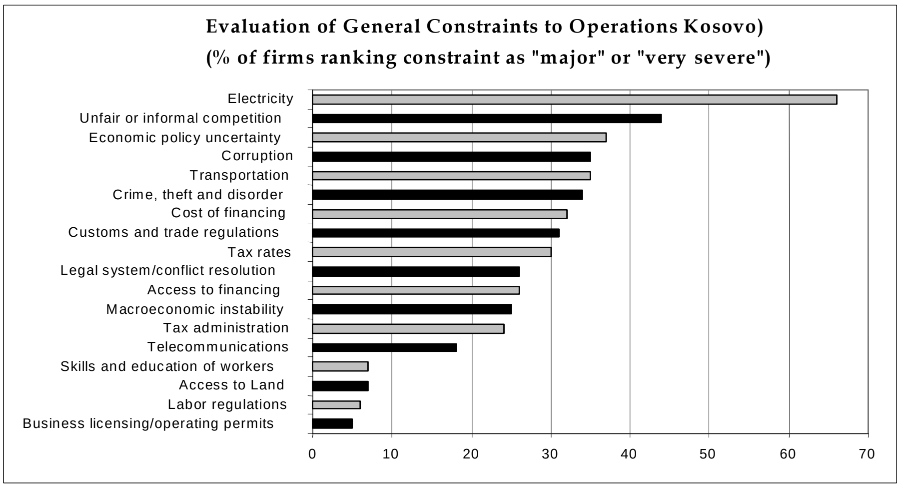
3.1 Business Environment

After the recent war, the stabilization of the economic framework in Kosovo started with the adoption of the Deutsche Mark, and subsequently the Euro and with the maintenance of a liberal trade regime. Significant progress has also been made in building the domestic revenue base, although this remains narrowly based on a VAT introduced in 2001 and tariffs and excises collected at the border. As is common in many post-conflict environments, Kosovo experienced robust, double-digit growth rates in 2000 and 2001. This has resulted in average GDP per capita doubling from less than $400 in 2000 to about $640 in 2002 and almost US$790 in 2003[17]. Growth has, however, began to slow in the following years. Very large increases in USD denominated GDP figures in 2003 are due predominantly to exchange rate movements rather than strong domestic growth. New estimates prepared during 2003 by the Kosovo Ministry of Finance and Economy (MFE) with assistance from the IMF indicate that, after the initial reconstruction boom, growth has slowed to approximately 4 to 5 percent per annum.

The business environment in Kosovo is better than many transition countries. Yet Kosovo still needs to overcome the legacy of conflict and continue the transition to a market economy. One of the most important obstacles to economic growth in Kosovo is the unresolved issue of sovereignty. Resolution of final status will be critical to encourage the levels of Foreign Direct Investment that will be required to restructure major industries such as energy and mining. Resolution of final status is also needed to provide greater certainty regarding the enforceability of legal contracts necessary for private investment, especially for significant FDI flows.

[17] www.worldbank.org

A recently completed Investment Climate Survey[18] found that domestic and foreign investors generally regard the business environment as positive. Most firms indicate satisfaction with macro-economic stability, labour regulations, skills of the workforce, and administration of business licenses and operating permits. The most significant constraints identified are operational in nature. Unreliable electricity supply is clearly seen as the main obstacle to growth. Firms report an average of 90 days per year with power outages and estimate that production and sales losses, and the purchase of alternative supplies, are equivalent to about 9 percent of an average firm's annual sales. Many firms in the formal economy identify competition with those operating informally as a concern. Corruption is also cited as a constraint. Problems are seen as being particularly acute in some municipalities.



Source: World Bank 2003

In the short-term, **SMEs** are likely to continue to be the main economic actors. The enterprise sector in Kosovo is comprised of about 30,000 formal businesses, with many more operating in the informal sector. Further growth in the SME sector, and particularly the capacity of the sector to take advantage of improving export opportunities, is likely to depend on improved product quality, reliability of supply, and larger scale production. As the overall environment in Kosovo changes, however, the SME sector will increasingly need to move away from activities, such as construction and retail services, which are heavily dependent on remittances and donor assistance. Currently very few firms are engaged in significant value-adding. Improving financial sector intermediation is likely to be an essential element in ensuring that SMEs are able to access investment financing. Lending to business has been growing strongly as the financial sector develops, but margins remain high and smaller

[18] Ibidem

firms face difficulties in accessing credit outside informal systems. The weak enforcement of creditor rights is a particular issue constraining lending. The rebound in small scale agriculture suggests that this sector could particularly play a key role in Kosovo's economy. **Agriculture** will be critical to provide employment opportunities, with family farms currently providing employment for the overwhelming majority of the two thirds of the population that live in rural areas.

Privatization of socially-owned enterprises (SOEs) is vital to improve economic efficiency, but has proved a particular challenge. Of more than 500 SOEs, there is scope for about 75 to 100 to be sold as on-going businesses. The privatization process in Kosovo has proved highly political. After almost three years of impasse, the Kosovo Trust Agency (KTA) was established in June 2002 and enacted regulations that will allow the sale or liquidation of SOEs, with proceeds to be held in trust to meet potential claims. While three rounds of privatization have been completed, covering some 30 SOEs, the process was suspended in October 2003[19].

Restructuring of large publicly-owned companies (POE) that dominate the **energy and mining sectors** is vital for medium-term growth and to encourage investment. Prior to the conflict, the mining industry was a key source of foreign currency and provided employment for more than 17,000 people. With little capital investment for a decade, however, infrastructure is dilapidated. The sector of energy is dominated by the Korporata Energjetike e Kosovo (KEK) and remains under the political control of UNMIK. Problems include dilapidated infrastructure, large technical and non-technical losses including pilferage of electricity, poor billing and collection, overstaffing and low productivity and inefficient labour practices.

Conclusions

The reform process in Serbia and Montenegro has made significant progress in many areas particularly in macroeconomic stabilization, trade liberalization and bank resolution. Major efforts have been made to open the country to foreign trade and investment and adopt the practices of a modern market economy. Ultimately, the goal is to invigorate the growth process, so as to increase income levels, reduce poverty and provide jobs for the unemployed. The economic reform is also oriented to harmonize the internal laws for accession to the European Union but the unsolved problem of Kosovo's status remains the major obstacle to this project.

[19] Ibidem