INTERNATIONAL MONETARY FUND

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# REPUBLIC OF KOSOVO

May 2015

## 2015 ARTICLE IV CONSULTATION—STAFF REPORT; PRESS RELEASE; AND STATEMENT BY THE EXECUTIVE DIRECTOR FOR KOSOVO

Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. In the context of the 2015 Article IV consultation with Kosovo, the following documents have been released and are included in this package:

- The **Staff Report** prepared by a staff team of the IMF for the Executive Board's consideration on May 20, 2015, following discussions that ended on March 31, 2015, with the officials of Kosovo on economic developments and policies. Based on information available at the time of these discussions, the staff report was completed on May 5, 2015.
- An **Informational Annex** prepared by the IMF.
- A **Press Release** summarizing the views of the Executive Board as expressed during its May 20, 2015 consideration of the staff report that concluded the Article IV consultation with Kosovo.
- A **Statement by the Executive Director** for Kosovo.

The policy of publication of staff reports and other documents allows for the deletion of market-sensitive information.

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INTERNATIONAL MONETARY FUND

# REPUBLIC OF KOSOVO

## STAFF REPORT FOR THE 2015 ARTICLE IV CONSULTATION

May 5, 2015

## KEY ISSUES

**Context**: Following a six-month political stalemate, the largest two parties reached an agreement in December to form a *grand coalition*, which enjoys a comfortable majority in parliament. The remittances-fueled growth is set to continue in the near term, but deep challenges remain in view of Kosovo's narrow export and productive base, low employment ratios, and incomes that are among the lowest in Europe.

**Fiscal Policy**: Following very generous pre-electoral promises, gradual fiscal adjustment is required to preserve the credibility of the fiscal rule and safeguard low public debt levels. Measures should focus on arresting the rapid growth in unproductive current spending, so as to reduce the deficit while creating space for priority areas such as infrastructure, education, and health.

**Financial Sector**: The banking sector has remained well-capitalized, liquid, and profitable. Good progress has been made in enhancing banking supervision as well as the Emergency Liquidity Assistance (ELA) framework. Given low credit penetration, the main challenge is to harness available liquidity so that banks can further support investment and growth: this will require improvements in the weak judiciary, as well as tackling the sizable informal economy.

**Structural Issues**: The key structural challenge is to address the large wage and non-wage competitiveness gap. Gradually deflating high public sector wages will help with the former. As for the latter, the focus should be on tackling the large skills gap by enhancing educational quality—particularly vocational training—and complementing *de jure* improvements in the business environment with *de facto* progress. Upgrading energy infrastructure, including a new power plant, is important to avert a future energy crisis.

**Previous IMF advice**: Implementation of Fund advice remained strong throughout the Stand-By Arrangement, which expired in December 2013. However, measures contrary to the spirit of the arrangement were taken immediately after the program's expiry. This is the first Article IV consultation since July 2013.

Approved By
**Thanos Arvanitis and Dan Ghura**

Discussions were held in Pristina on March 19–31, 2015. The staff team comprised Mr. Miniane (Head), Mr. Cipollone and Mr. Weiss (all EUR), Mr. Misch (FAD) and Ms. Zdzienicka (SPR), and Messrs. Lakwijk and Thaci (Resident Representative Office). Mr. Mehmedi also joined policy discussion meetings. The mission met with the Prime Minister, Finance Minister, Governor of Central Bank, other senior officials, banks, private sector representatives, unions and parliamentarians.

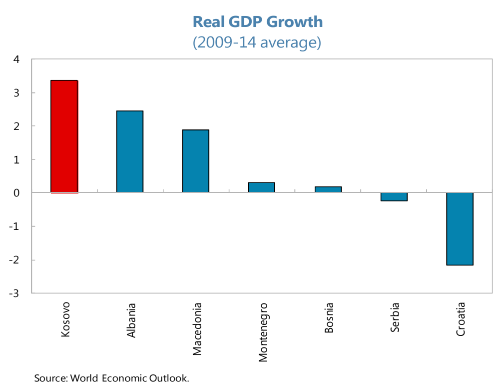
## CONTENTS

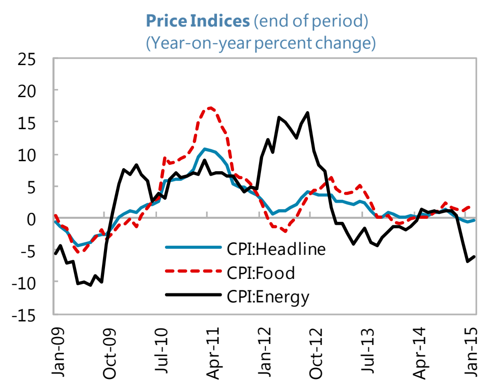
# CONTEXT, OUTLOOK, AND RISKS

**1. Kosovo enters 2015 with a stable government**. A six-month political stalemate following the inconclusive June 2014 elections ended with the formation of a *grand coalition*. The government holds a comfortable majority in parliament, and past experience has shown that such coalitions can be stable and conducive to effective policy-making.

**2. Since the 2013 Article IV consultation, some progress has been made in normalizing international relations**. At present, the Republic of Kosovo has been recognized by 108 UN member states and 23 EU member states. Under the EU-sponsored dialogue, there has been progress in normalizing relations with Serbia. However, lack of full international recognition remains an obstacle to greater political integration and economic development. Kosovo is a potential EU candidate and a Stabilization Association Agreement (SAA)—the first step toward official candidature—could be signed this year or next.

**3. Despite political uncertainty last year, economic performance has remained resilient**. In 2014, GDP growth is estimated at about 2¾ percent, somewhat lower than in 2013 but still near Kosovo's five-year average of 3.5 percent (the highest in the Western Balkans). Steady remittances helped, as witnessed by consumption growing at close to 4 percent. This year, growth in Germany—the main Diaspora country—the full-year impact of large wage increases granted before last year's elections (see below), and a ramp up in highway construction should again support growth of circa 3 percent, despite a gradual, multi-year pullback from the donor sector as Kosovo graduates from acute nation-building needs. As in other countries in the region, low energy prices and ties to developments in the euro area have pushed inflation into negative territory (-0.3 percent y/y in March). Modest inflation is expected for the year as a whole, at best.




**4. The trade and current accounts remain in large deficit, but financing is stable and reserves are ample**. Given the narrow productive base, most consumption and investment goods are imported, fueling a very high trade deficit (about 30 percent of GDP). Financing sources are relatively stable and generally non-debt creating, with the main contribution coming from remittances, official transfers, and FDI—the last is also largely associated with the Diaspora. Gross international reserves of some 18 percent of GDP are ample relative to a conservative variant of the Fund's adequacy metric, which suggests reserve buffers equivalent to 12 percent of GDP (Annex II).

5. **Medium-term growth prospects appear insufficient to significantly lift incomes and improve labor outcomes**. Barring reforms, medium-term economic growth will remain dependent on the same remittance-based model and would not be expected to exceed the recent 3.5 percent average. With income per capita of €3,000, one of the lowest in Europe, higher growth is needed to accelerate convergence towards the Western Balkans average. Higher growth would also be needed to generate jobs in the context of very high unemployment (30 percent), very low employment (40 percent), and fast population growth.

6. **Risks to the short-term outlook remain evenly balanced** (Annex III).

- Upside risk in the next 12 months: stronger impact on consumption from last year's public wage increase. The impact on consumption of the large wage increase last year, which has been modest so far, could surprise positively now that uncertainty related to the political stalemate is resolved.

- Downside risks in the next 12 months: renewed emigration and possible disruptions to electricity supply. A recent emigration wave, facilitated by easier border entry into Serbia and reflective of a lack of hope among segments of the population, has now calmed down but could begin anew, as it unpredictably did six months ago. Separately, further breakdowns in the two old power plants would result in new electricity cuts and possibly higher tariffs to pay for imports.

- In the medium term, the risk of a "new mediocre" in Europe would affect Kosovo via lower remittances from Diaspora countries as well as lower exports. On the upside, implementation of the government's ambitious structural reform agenda could lift potential growth above the baseline.

- Exposure to regional risks. Intensification of Russia/Ukraine tensions will not have any direct impact, but may affect Kosovo indirectly via the Diaspora residing in high-income European countries. Similar indirect channels would apply with regards to developments in Greece.

### Authorities' views

7. **The authorities broadly shared this assessment**. In their view, growth could reach 4 percent this year, although they view any differences with staff's forecast at this stage as within the range of uncertainty. They also agreed with the risks presented, although they are more sanguine about positive confidence effects in the short term coming from implementation of their reform agenda. They also see upside risks in the near term from the euro area, given euro depreciation, lower oil prices, and the impact from ECB's quantitative easing. Looking towards the medium term, they remain concerned by modest growth prospects, agreeing that higher medium-term growth is needed to meaningfully lift incomes and provide jobs for many in society. In fact, they see

addressing infrastructure impediments and boosting the productive and export capacity of the economy as the number one economic challenge and priority facing the country.

# REPORT ON THE DISCUSSIONS

## A. Public Finances

**8. The budget situation has deteriorated**. Before the June elections, the government awarded a 25 percent increase in public sector wages and social pensions, promised new benefits for war veterans and prisoners of war, and signed a generous collective agreement on labor relations. Combined, these measures have triggered a sharp increase in current spending, and the authorities managed to contain last year's fiscal deficit excluding PAK spending at 2.4 percent of GDP[1] only thanks to a 2 percent of GDP under-spending of the capital budget.

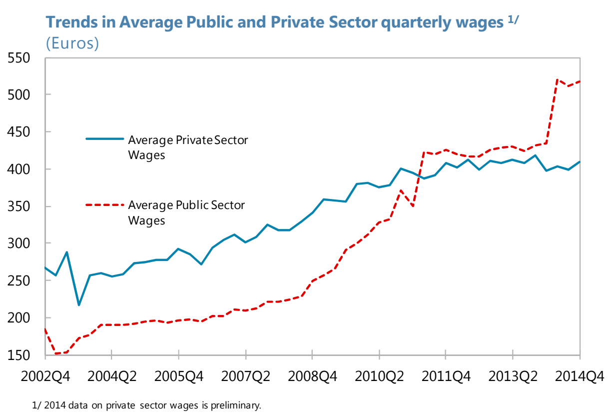
**9. Staff warned that this year's deficit will be significantly higher than budgeted**. Given the long time needed to form the new government, parliament decided to approve a "technical" budget that had been prepared by the caretaking administration several months prior. The problem is that this budget relies on overly optimistic revenue assumptions. Assuming more realistic revenue outcomes, and given the full year effect of the pre-electoral promises together with the expected ramp up in spending on the new route to Macedonia,[2] the deficit could reach 3.5 percent of GDP this year. In fact, the deficit would have been higher were it not for recent decisions to increase excise rates on a number of goods and to hold off on filling some open vacancies in the public sector, both of which staff support.

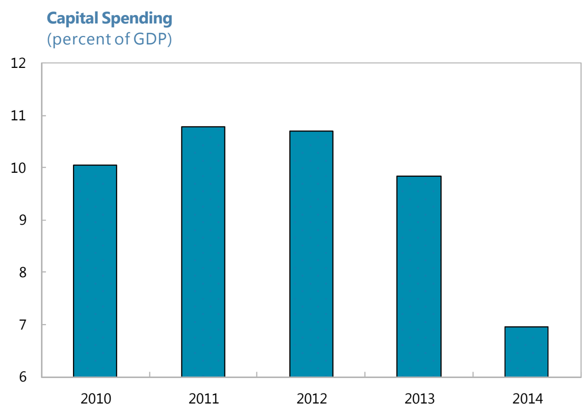
**10. Fiscal deficits are expected to remain elevated in the medium term**. Under the baseline scenario, the deficit is projected to steadily increase and reach 4.7 percent of GDP in 2020. This is because there are a number of one-off revenues that are expected to taper off after 2016, while net interest payments may increase as debt is accumulated. Under this baseline, public debt would steadily creep up to over 30 percent of GDP by 2020 (Annex IV). Moreover, this baseline scenario includes a number of risks (possibly up to 1−1½ percent of GDP), including potentially higher-than-budgeted costs of implementing the collective agreement, uncertainty over the final bill of the war veterans package, erosion in tax bases from trade agreements and, last but not least, the possibility that the transformation of Kosovo's Security Forces into Armed Forces would trigger additional spending.

[1] This is GDP as forecasted in the 2014 budget, which is what counts for the fiscal rule. The outturn was above the fiscal rule's 2 percent limit but within the ex-post margin allowed by the rule. Note that the deficit was slightly higher when measured in percent GDP as forecasted by Fund staff.

[2] The road connecting Pristina with the Albania border was finalized in 2013 at a cost of some 20 percent of GDP. Usage so far has been below predictions. Construction on the road connecting Pristina to the Macedonia border started in 2014 and is expected to be completed in 2017–18, at a cost of some 12 percent of GDP. This road is thought to be more economically useful, given that much of Kosovo's trade happens with Skopje.

**11. Beyond deficits, staff drew attention to the worsened composition of the budget**. Given large pre-electoral packages before the 2011 and 2014 elections, current spending is expected to increase by 4.3 percentage points of GDP in 2010–15, mostly due to the wage bill (2.7 percentage point of GDP) and pensions (1.7 percentage points of GDP). Since independence, public sector wages have more than doubled, vastly outpacing productivity, private sector wages, or public wages in other Western Balkan countries. To accommodate this sharp increase in current spending, capital spending has been substantially cut over the same period (4 percentage point of GDP), despite Kosovo's urgent development needs. Moreover, education spending has remained low compared to peers and is in fact on a declining path.




**12. Staff recommended a gradual consolidation path to preserve the credibility of the fiscal rule and safeguard low public debt**. Should the deficit this year exceed the 2 percent limit (see above), the fiscal rule would require that deficits over 2015–18 average 2 percent.[3] Staff thus urged the authorities to consolidate gradually so as to preserve the credibility of the rule. At the same time, staff emphasized that the *quality* of adjustment is equally important: consolidation should focus on arresting unsustainable trends in current expenditure (including via a

| | 2015 | 2016 |
|---|---|---|
| **Overall balance (excluding PAK) before measures** | **-3.5%** | **-3.7%** |
| Increase the excise rate on gasoline from EUR 0.385/lt. to EUR 0.445/lt. in 2015 | 0.2% | 0.4% |
| Increase property tax rate (to 0.5% on average) in 2016 | | 0.3% |
| Increase VAT from 16% to 18% & refrain from other changes | 0.4% | 0.9% |
| **Total revenue measures (by year)** | **0.6%** | **1.6%** |
| Tripling rather than quintupling agricultural subsidies in 2015 | 0.4% | 0.4% |
| Freeze spending on goods and services | | 0.2% |
| Freeze public wage bill | | 0.5% |
| Freeze subsidies and transfers | | 0.4% |
| **Total spending measures (by year)** | **0.4%** | **1.4%** |
| **Total increase of the balance after measures** | **1.0%** | **3.0%** |
| **Overall balance (excluding PAK) after measures** | **-2.5%** | **-0.7%** |

[3] The main elements of the fiscal rule are: (i) the headline deficit excluding both spending of the privatization agency as well as spending from own source revenues carried-forward shall not exceed 2 percent of GDP (as forecasted in the budget); (ii) any excessive deficit should be corrected within the next 3 years, so that the average deficit over the four-year period equals 2 percent; and (iii) provided Treasury cash balances including funds for bank emergency liquidity assistance are above 4.5 percent of GDP, the government may use privatization funds to finance capital projects above the 2 percent deficit ceiling.

continued freeze of public wages and benefits in 2015–16[4]) while preserving the budget for priority areas such as infrastructure, education, and health. Given Kosovo's generally low tax rates, staff also saw merit in a uniform increase in the VAT rate. Instead, the government is planning to introduce differentiated VAT rates as well as zero rate exemptions on some goods: these are not only distortionary, they also mean a missed opportunity to raise needed tax revenue.

**13. More broadly, staff recommended the introduction of a rules-based framework to guide public wage decisions**. A rule that caps growth in the public wage bill relative to some well-defined macro-indicator(s) could be a useful complement to the fiscal rule, helping to prevent the large discretionary jumps in wages seen in recent years. Staff analysis (Box 1 and Annex III) shows that such a rule would have delivered significantly more modest and sustainable increases than those actually observed. While such rules have disadvantages, notably their rigidity and potential pro-cyclicality, staff argued that these are outweighed by the positives in a country like Kosovo. At the same time, staff argued that a public wage rule should not be seen as a substitute for the long delayed reform of the civil service.

**14. Sources of funding should be diversified by tapping international markets**. The shallow domestic market could be stretched if it were to finance a deficit of 3.5 percent of GDP this year. In this context, staff recommended that, in addition to gradual fiscal adjustment, Kosovo seek external market financing. While Kosovo has never borrowed from external markets, and would thus need to go through the process of obtaining a credit rating, the country's still low public debt should serve it in good stead, notably given significant global liquidity. External funding could in fact help not only to finance the deficit, but to rebuild fiscal buffers to bring them back to prudent levels.[5]

### Authorities' views

**15. The authorities broadly concurred with staff's assessment**. They agreed that, on current policies, the 2015 deficit is likely to be around 3½ percent of GDP, and that there are risks that could drive the deficit even higher. In addition, they shared the view that the composition of the budget has worsened significantly. To redress unsustainable trends in public wages, the authorities are considering a reform of public wage determination processes along the lines recommended by staff. On VAT, the authorities felt that lower rates and exemptions on some products are needed to stimulate investment in growth sectors. Should the need for additional revenue arise, they would consider raising the main rate to 19 percent.

[4] The 2015 budget already freezes wages/benefits in nominal terms. A renewed freeze in 2016 would be justified considering the 25 percent jump in 2014. Of note, the equally large increases in public wages in 2011 were followed by nominal freezes in both 2012 and 2013, under Fund-supported programs.

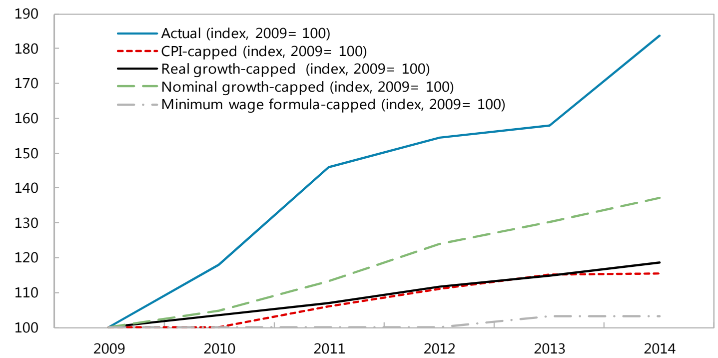
[5] Reserves for pure fiscal financing are currently below levels staff would consider prudent (see Annex II).

## Box 1. Wage and Indexation Mechanism[6]

**In Kosovo, increases in public sector wages have been excessively large for political reasons, resulting in adverse economic consequences**. In this context, a rule that caps growth of the public sector wage bill relative to some transparent macroeconomic indicator could have significant advantages. In Kosovo's case, there are at least four possibilities for rules-based mechanisms: (i) wages could be tied to inflation to account for changes in cost of living; (ii) wages could be tied to real GDP as an imperfect proxy of labor productivity; (iii) wages could be tied to nominal GDP growth as a proxy for changes in the cost of living and labor productivity; and (iv) wages could be changed based on the current formula used for the adjustment of the minimum salary.[7]

**Simulations of the proposed rule-based mechanisms show that, had such a rule been in place in 2009–2014, growth in the public sector wage bill would have been much lower than actually observed**. Despite the drawbacks of such rules, such as their pro-cyclicality, the benefits from restraining public wage growth as observed in Kosovo would have more than compensated.

**Actual vs. simulated increases of the public wage bill under alternative rules-based mechanisms**




Source: Kosovo authorities; and IMF staff estimates.

**16. At the same time, they felt the fiscal rule does not give enough recognition to Kosovo's development needs**. The authorities expressed their strong commitment to macro-fiscal stability, pointing to the freeze in wages at 2014 levels and the recent increase in excise taxes. More generally, they committed to finding additional savings, so as to bring deficits back in line with the fiscal rule. However, they feel the fiscal rule's 2 percent deficit ceiling is too tight for a country like Kosovo with high development needs and very low public debt. In addition, they see provisions in the fiscal rule that allow for privatization proceeds to finance capital spending above the 2 percent deficit ceiling provided cash buffers are prudent as being of limited use. This is because they inherited a deficit above 2 percent as well as low cash buffers, so the clause cannot be activated. More generally, usable privatization receipts are now slightly above 1 percent of GDP, not enough to finance needed development projects. In this context, they expressed interest in working together with the Fund to expand the investment clause in the fiscal rule, so as to allow for IFI-financed growth-enhancing projects alongside those financed with (limited) privatization receipts.

**17. The authorities welcomed advice to broaden financing sources**. They concurred that Kosovo's low public debt levels should help it obtain market financing on reasonable terms, and will

[6] See Annex I "Containing the Public Wage Bill and Transfers in Kosovo."

[7] Adjustments of the minimum wage are based on a fairly complex algorithm that was introduced during the last program, with a view to balance social considerations and the need to preserve competitiveness.

seek advice on how to proceed along these lines. However, they saw significant untapped potential from IFI financing, and are initiating discussions with the various IFIs to deepen cooperation.

## B. Financial Sector

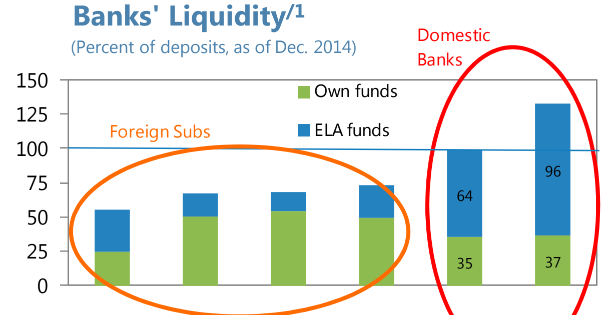
**18. The banking sector remains healthy**. Kosovo banks are generally well-capitalized, liquid, and profitable. The system's capital adequacy ratio (18.2 percent) is among the highest in the region, with all banks, both domestic and foreign, above the regulatory minimum. Banks' aggregate liquid assets cover roughly 41 percent of short-term liabilities, a key consideration in a euroized economy. Profitability has improved and is adequate despite only moderate economic growth. In 2014, all banks were profitable, with overall return on equity of about 20 percent. NPLs are somewhat elevated at 8.4 percent of total loans but stable and fully provisioned.

**19. Staff welcomed progress made on strengthening banking supervision**. In particular, the CBK has moved steadily toward risk-based supervision, a key recommendation of the 2012 FSAP (Annex VI).[8] With help from Fund technical assistance, the CBK has strengthened the depth of its off-site monitoring and analysis, developed an on-site examination model, and tested the new framework at two systemic banks, with plans to roll the new framework out to all banks by the end of 2015. Still, staff recommended that the CBK continue to train its supervisors and deepen its analytic and supervisory capacity, including by further refining supervision manuals and procedures, extending supervision to cover risks on a consolidated basis as applicable, and assessing prudential ratios. Separately, bank supervision will also benefit from memoranda of understanding for the exchange of information signed with home supervisors, a key step given that Kosovo's banking sector is 90 percent foreign-owned by assets.

**20. The authorities have also made efforts to strengthen the emergency liquidity assistance (ELA) framework**. With the CBK lacking the ability to issue its own currency, its ELA reserves are critical. Staff estimates that current levels of ELA reserves are more than ample; together with the banks' own resources, the system could withstand a very severe run on deposits (Annex II). Still, staff welcomed the central bank's proactive efforts to seek letters of comfort from parent banks stating that parents would work with their subsidiaries in the event of a crisis. In addition, the draft ELA regulation that would govern conditions, processes, and modalities of any emergency assistance provided to banks is generally in line with best practice.

**Banks' Liquidity/1**

(Percent of deposits, as of Dec. 2014)




1/ Only foreign subsidiaries and domestically-owned banks.
Source: staff calculations.

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[8] In addition, the authorities are working on a new draft legislation to make AML/CFT issues a component of CBK supervision.

**21. Despite these gains, more is needed to bolster Kosovo' crisis management framework**. A Crisis Prevention Council (CPC) comprised of the CBK Governor, Finance Minister, and the Chair of the Parliament Budget Committee has been recently established to discuss financial stability issues in Kosovo and to ensure better coordination in the event of crisis. These are important steps, but staff called for full operationalization of the CPC. In particular, the council should have formal meetings at regular intervals, rather than meet informally and on an ad-hoc basis as is the case now. In addition, the council should include the Deposit Insurance Fund of Kosovo (DIFK).

**22. The main challenge facing the financial system is better access to credit to support growth**. Despite banks' healthy liquidity ratios, Kosovo has the lowest level of credit penetration (33 percent credit-to-GDP) in the Western Balkans. This is partly a function of demand—many potential borrowers do not see investment opportunities or an attractive investment environment in Kosovo—but structural factors are also holding back lending. Difficult debt collection procedures, uncertain court processes, and high informality have influenced conservative lending stances and led to both high interest rate spreads (currently about 850 bps) and high collateral requirements. In this context, banks are overly focused on short-term trade financing and personal loans to government employees rather than loans to private enterprises than could help to grow a more dynamic economy.

**Western Balkans Credit Depth**
(credit/GDP, Q314; MNE 2013, HRV 2012)


**23. Tackling this challenge will require a multi-pronged effort**. Recent improvements to collateral recovery enforcement through the introduction of private bailiffs should help and are welcome, as are plans to develop more effective NPL recovery and write-off procedures. However, with the current backlog of bank cases stretching up to five years, more work is needed to make court proceedings more efficient, specialized, and timely. Efforts are ongoing, but they are at their early stages and will take time to bear fruit. In addition, legal system improvements are needed to provide more confidence in the rule of law in Kosovo (discussed below). A still-developing microfinance sector could also more efficiently support credit to households and SMEs.

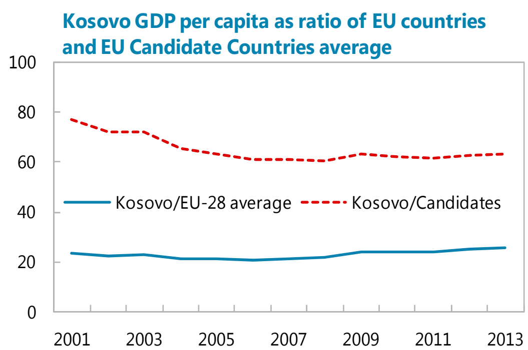
### Authorities' Views

**24. The authorities shared the staff assessment on the health of the banks, and appreciated Fund advice and technical assistance in improving CBK supervision and the ELA framework**. They expect the draft regulation on the latter to be passed soon. The CBK considers its transition to risk-based supervision a success and that its new staffing level is sufficient. The authorities agree on the need to further develop their macroprudential oversight capacity and have plans to do so, but see the CPC's current informal setup as sufficient to exchange views and, if necessary, coordinate between Kosovo's financial authorities.

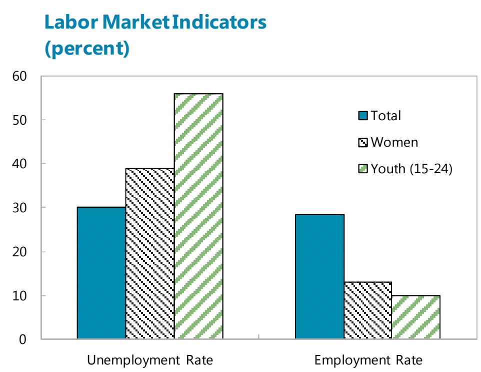
**25. The CBK agreed that bank lending needs to deepen to support Kosovo's development**. In this vein, they saw the constraints squarely on the side of high informality levels and a slow judiciary, rather than on the banks' side. They expect the introduction of private bailiffs to have a positive effect in the clearing of bad loans, and hence in giving banks confidence to lend more freely. In their view, private bailiffs were needed because the process of reforming the judiciary from within, to which they are committed, will naturally take time to bear fruit.

## C. External Sustainability, Competitiveness, and Structural Reform

**26. The limited progress in raising incomes and improving labor market outcomes is disappointing**. With GDP per capita currently at €3,000, the income gap with the EU remains very large and is closing slowly, while that with EU candidate countries has widened. In addition, labor market outcomes are among the most disappointing in Europe, with unemployment at 30 percent despite extremely low labor participation, particularly among women and the young. In these conditions, it is perhaps unsurprising that so many have emigrated to EU countries in recent months.

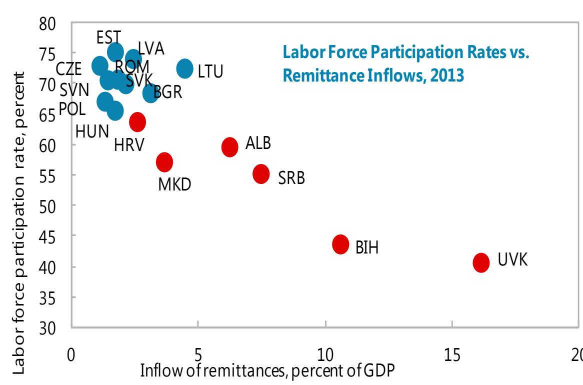



Sources: World Economic Outlook; national authorities.




Source: National authorities.

**27. Staff argued that domestic costs are too high given current productivity levels**. Strong remittance inflows, close to 20 percent of GDP, have pushed reservation wages beyond levels that domestic productivity can sustain. In fact, Kosovo wages adjusted for productivity are among the highest in the region, not helped by large, ad hoc wage increases in the public sector. In addition, remittances (as well as widespread donor presence) have tended to stimulate consumption and investment biased towards non-tradables. This bias can be clearly seen in the data (Figure 4): in Kosovo, more than 80 percent of FDI is directed towards non-tradables, manufacturing accounts for less than 12 percent of GDP, and the trade deficit last year exceeded 30 percent of GDP. All in all, staff believes Kosovo suffers

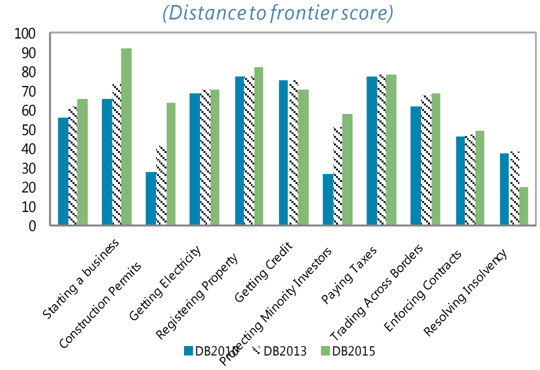


from a significant real exchange rate overvaluation, on the order of 15–20 percent (text box). In this context, wage restraint in the public sector is important: with the general government providing one in four jobs in the formal sector, containing wage costs will have a direct positive impact on overall competitiveness. The fact that the public sector now offers both greater job security and higher wages than the private sector makes it very hard for firms to attract talent.

**28. A credible energy pricing policy can help address energy constraints that have become a growing impediment on development**. Kosovo currently relies on two old and unreliable electricity power plants, and the system is operating with no redundancy. Electricity imports can help fill temporary gaps, which is why the planned transmission line to/from Albania is important. However, imports are not a long-term fix given their higher cost and constraints in the country-to-country transmission lines. Hence, the country is faced with the urgent need to build a new power plant. With no space in the budget to accommodate its construction (estimated cost: 20 percent of GDP), credible commitments that future tariffs will be set at high enough levels to satisfy the return on investment are critical to attract foreign private investment.

**29. To raise medium-term prospects, the weak business environment and rule of law will need to be bolstered**. The World Bank's overall Doing Business Indicator, which is now close to the Western Balkans average, has improved in several areas, e.g., construction permits, but deteriorated in others. But *de jure* improvements need to be matched by progress on the ground that economic actors can feel. It is particularly worrisome that perceptions of corruption remain widespread. In this context, staff was encouraged by the adoption of the new public sector procurement law, which follows international best practice, as well as the soon to follow e-procurement. Still, the challenge will be in the implementation of the law, and the ability to prosecute those who break it.

**Kosovo: 2010–2015**
**Doing Business Indicators**
*(Distance to frontier score)*




Improvements in the AML/CFT framework, notably by further strengthening the Financial Intelligence Unit, which has increased its activity, will also help combat corruption. The anti-corruption and AML/CFT assessments conducted as part of the Project against Economic Crime in Kosovo (PECK) are welcome and the authorities are encouraged to undergo a comprehensive AML/CFT assessment against the revised 2012 FATF standard.

## Box 2. External Sector Assessment

**Given lack of competitiveness, a narrow export base, and concomitant dependence on imports, the trade and current account deficits are expected to remain at a high level**. The narrow export base and large imports, including energy and machineries, are key drivers of the large trade imbalances (a deficit exceeding 30 percent of GDP). Over the medium term, the current account deficit is expected to narrow slightly on account of lower import growth and growing remittance inflows, but will remain high at 10.5 percent of GDP in 2020.

**The assessment of the real exchange rate points to significant overvaluation**. The two CGER methodologies used in Kosovo's case, the macroeconomic balance the external sustainability, find very similar results, even if these should be interpreted with caution given limited data availability.[1] In the medium term, the results of the above-mentioned methodologies can be summarized as follows:

- The macroeconomic balance approach points to an overvalued real exchange rate of 15 percent.
- The external stability approach also indicates an overvaluation of about 18 percent, assuming a stabilizing medium-term positive net foreign liabilities position in the range of 3 percent of GDP.
- Of note, the current account norm estimated for Albania, the closest comparator, is very close to that found here for Kosovo.

**Other indicators support the view of a significant competitiveness gap**. In particular, wages in the public sector now exceed those in the private sector, making it very hard for the latter to attract the talent it needs to compete. Similarly, the fact that some much FDI is driven not by foreign investors but by the Kosovar Diaspora gives it a clear non-tradable bias: more than 80 percent of FDI is currently going to low-productivity non-tradables such as construction and domestic services, rather than to potentially higher-productivity tradables. The fact that exports have been falling as a share of GDP (despite their low absolute level) is, in itself, a clear and direct indication that Kosovo has a competitiveness problem.

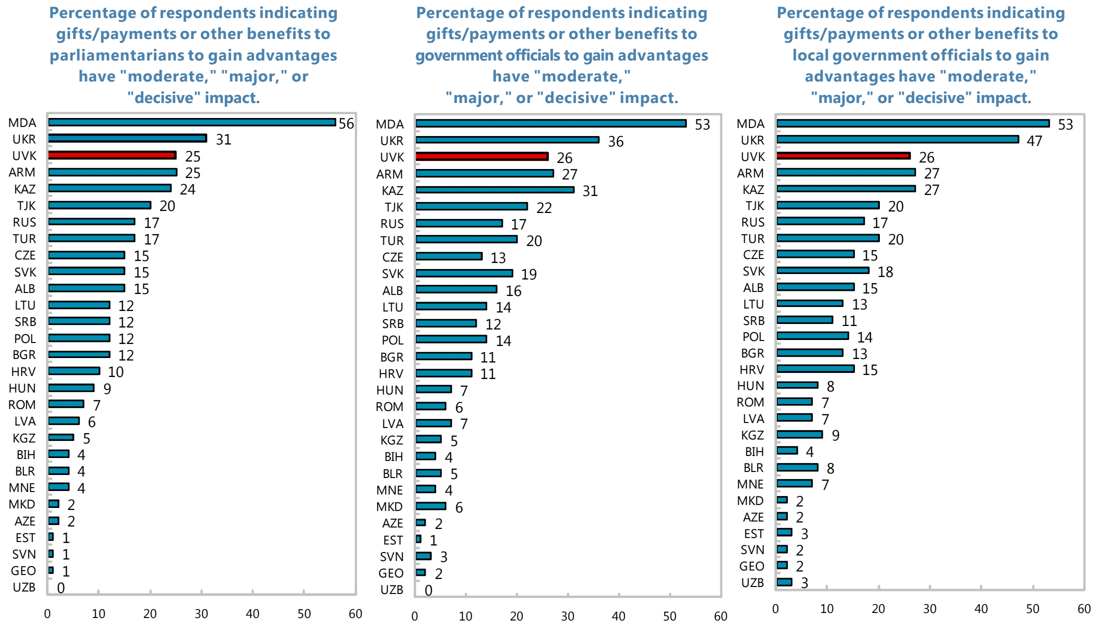
### Real Exchange Rate Assessment

(percent of GDP, unless otherwise indicated)

| | Macroeconomic Balance Approach | External Stability Approach |
|---|---|---|
| CA Norm | -4.0 | -3.1 |
| Underlying CA projection /1 | -7.4 | -7.4 |
| Current Account Gap | 3.4 | 4.3 |
| Real Exchange Rate | +15 | +18 |
| *Estimated overvaluation (+) in percent* | | |

[1] Lack of data also precludes estimation of the equilibrium exchange rate method.

**Firm Survey**




Source: World Bank.

**30. Raising access and quality of education is another urgent priority, particularly in light of low employment**. Currently, Kosovo spends less on education than its peers, and a disproportionately large share of the spending goes to wages. While there is a quality deficit at all educational levels, consensus among experts puts the focus on improving access to and quality in pre-primary and primary education. Similarly, curricula in vocational programs are seen as un-aligned to market needs, and the programs disconnected from the business world.

## Authorities views

**31. The authorities broadly agreed with the staff assessment**. They currently lack estimates of real exchange rate overvaluation, and felt these were very useful to benchmark the competitiveness gap. In this light, they concurred that public sector wage restraint is needed not just for fiscal sustainability but for competitiveness purposes.

**32. The authorities are confident of progress in the energy sector**. In their view, the transmission line to Albania will bring significant benefits, as Kosovo and Albania are not synchronized in terms of peak energy needs and hence are natural “partners” for an electricity market. At the same time, they acknowledged that electricity imports are not a full substitute for the new power plant, and that the bidding for this plant is facing some hurdles. Nonetheless, they are working very closely with the World Bank and are confident of a breakthrough in negotiations.

**33. Tackling corruption is one of their key priorities**. They see the new procurement law as a major step forward, as the government is the number one purchaser and economic actor in the country. Current work to improve the debarment process for those who break procurement laws will aid in the implementation, and work is ongoing to implement e-procurement. Finally, they admitted to gaps in their judiciary, but felt that tremendous progress had been achieved in the seven years since independence in close cooperation with the EU's rule of law mission.

# OTHER ISSUES

**34. Data is adequate for supervision purposes, but the national accounts and activity indicators should be improved**. Fiscal and financial sector data is timely and of good quality. Real sector data needs to be improved in terms of coverage, quality, and timeliness, though it remains adequate for surveillance issues. A recent STA diagnostic mission has provided recommendations in this regard.

**35. There are no restrictions on payments and transfers for current international transactions, or measures that would give rise to multiple currency practices**. The authorities are considering whether to accept the obligations under Article VIII, but have yet to reach a decision.

# STAFF APPRAISAL

**36. While steady remittances have kept growth going despite external and domestic headwinds, addressing Kosovo's competitiveness gap within a strong policy framework remains critically important for robust future growth**. Recent growth performance has been better than some of Kosovo's neighbors, helped by steady remittances from the Kosovo Diaspora which has supported both consumption as well as domestic investment. However, without strong reform efforts, medium-term growth prospects are likely to remain below what the economy needs to generate enough jobs and raise the income standards of the population.

**37. A gradual fiscal adjustment focused on deflating current spending is needed to contain the growing deficit and preserve the credibility of the fiscal rule**. Policies went off-track following expiration of the successful Stand-By Arrangement in December 2013. In the run-up to the June 2014 elections, the authorities significantly increased public wages and benefits and met the fiscal rule only with deep cuts in much-needed capital spending. This year, the full year effect of these large commitments, together with higher spending on road infrastructure, are expected to push the budget deficit to about 3½ percent of GDP. While recognizing Kosovo's development needs, gradual fiscal adjustment is needed to preserve the credibility of the fiscal rule and safeguard low public debt. But just as fiscal adjustment is important, so is the quality of this adjustment. Any consolidation should target unproductive current spending and leave space open for spending on things that Kosovo urgently needs, such as development projects, education, and health services. As such, the decision in the 2015 budget to keep public sector wages at 2014 levels was appropriate and should be carried forward. Recently approved increases in excise taxes are also welcome, as they bolster the state's resources to face higher obligations in a relatively non-distortionary manner. Additional measures may be needed this year and next; a proper VAT reform and other tax measures that yield a meaningful increase in revenues could be an important option.

38. **In this context, a clear rule that limits public sector wage growth relative to specific macroeconomic indicators would be a useful complement to the fiscal rule**. Such a rule would help to prevent repeated discretionary jumps in public sector wages that have exceeded productivity gains and diverted funds from priority items. Moreover, growth in Kosovo should ultimately come from the private sector. Limiting public sector wages would enable private companies to compete on more equal terms when it comes to attracting skilled workers.

39. **Kosovo's banks are well-capitalized, liquid, and profitable, reducing financial risks**. Non-performing loans are stable at just above 8 percent and well provisioned. The authorities have recently taken appropriate measures to improve bank supervision, strengthen the emergency liquidity assistance framework (including by seeking letters of comfort from parents of foreign subsidiaries), and coordinate with foreign supervisors. Incipient efforts to oversee macroprudential policy are steps in the right direction and should be deepened.

40. **Further efforts are needed to remove impediments to bank lending**. Due to the economy's high levels of informality and an inefficient legal system, interest rate spreads are high (although they have been declining) and banks apply high collateral requirements. The authorities are taking steps to address some of these problems: establishing timelines for writing off bad loans, planning a bankruptcy law, and initiating a strategy to lower informality. But these initiatives are in their early stages and will take time. The authorities should also improve the capacity of the court system to deal with financial cases and clearing court backlogs. The introduction of private bailiffs is a move in the right direction.

41. **Raising the productive and export capacity of the economy requires decisive implementation of structural reforms**. This is key if the country is to gradually narrow the income gap and provide jobs for one of the youngest populations in Europe. Specifically, the country needs to tackle its significant wage and non-wage competitiveness gap. For the former, wage restraint in the public sector will help. For the latter, a multi-pronged effort will be required:

- *Attend to Kosovo's aging energy infrastructure*. In the years ahead, the old power plants may not be able to provide a reliable and predictable supply of electricity to the private sector, presenting a key obstacle to development. For the project to have any chance of success, the authorities will need to credibly commit to setting tariffs at cost-recovery levels once the new plant is completed.

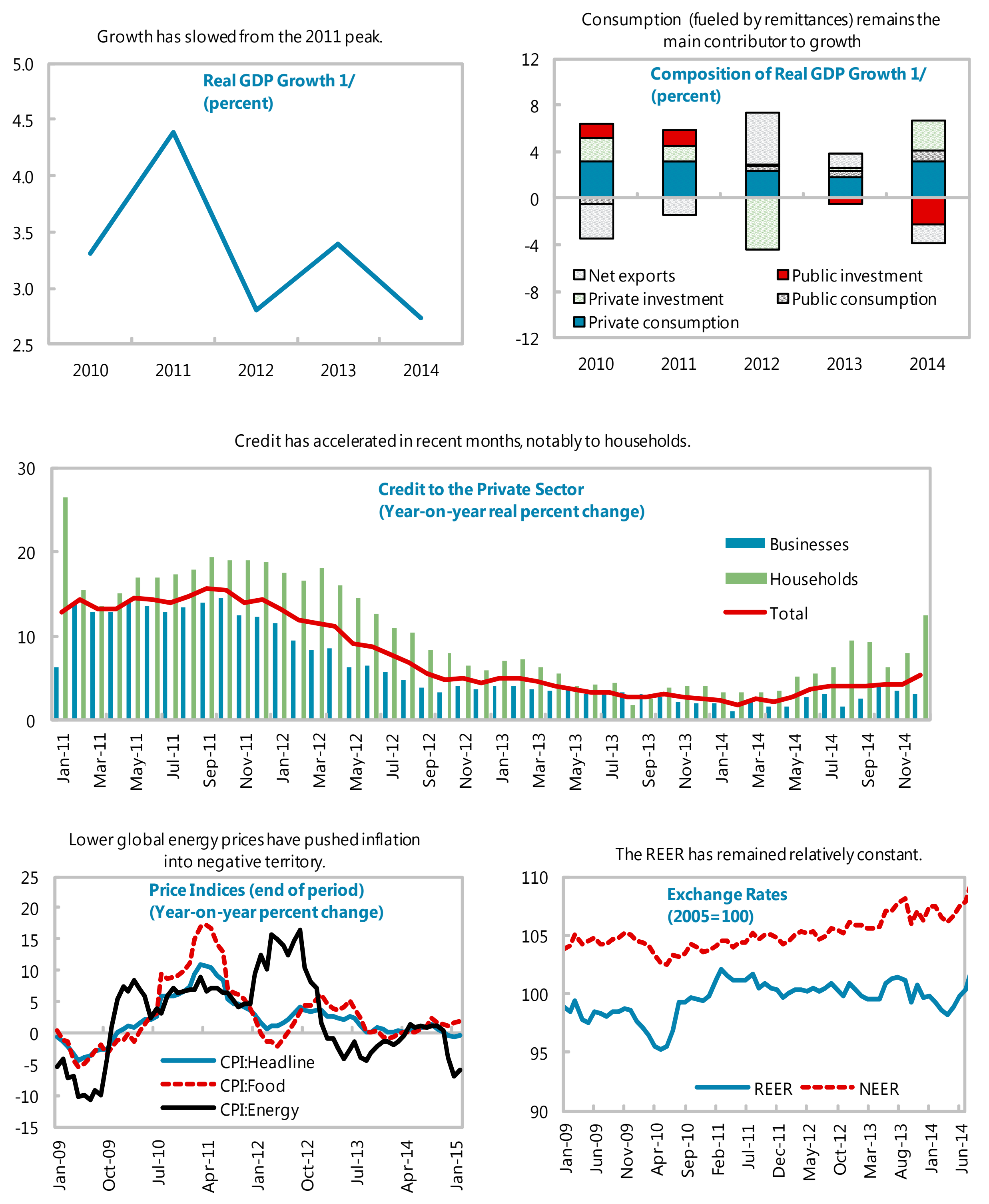
- *Reducing skills mismatches*. The authorities should expand access to pre-primary education and improve the quality of education across all levels, with a particular focus on vocational training.

- *Continue to improve governance and the business environment*. This means strengthening the rule of law and applying the same standards to everyone. Much of Kosovo's *de jure* legal institutional framework has improved in recent years, but implementation has lagged and perceptions of corruption remain. The new public procurement law is a solid step in the right direction, but the test will be in its implementation and the prosecution of those who break it.

Strengthening and mobilizing the AML/CFT framework can complement efforts to investigate and prosecute corruption.

**42. It is recommended that the next Article IV consultation with the Republic of Kosovo take place on a 12-month cycle**.

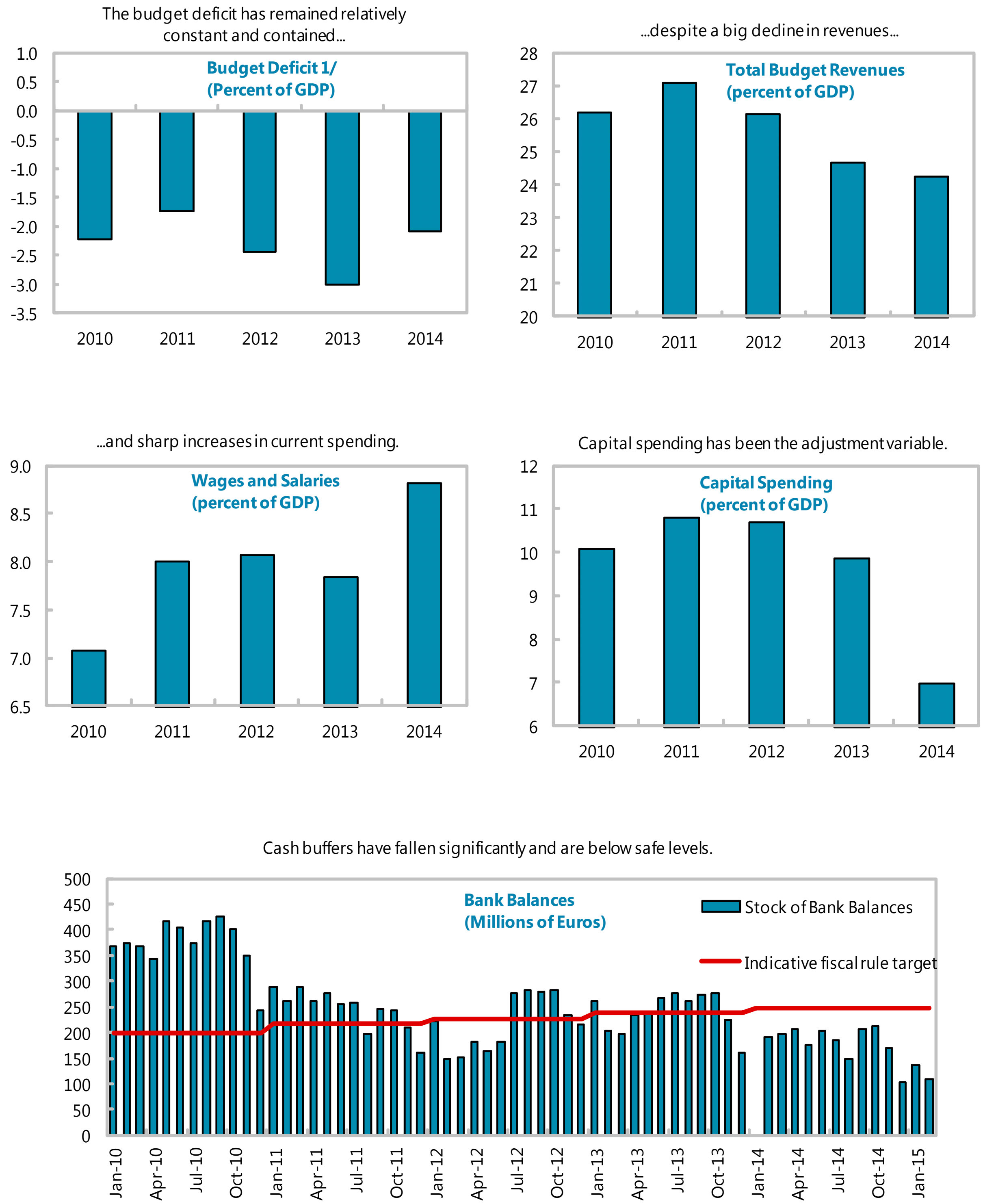
## Figure 1. Kosovo: Recent Economic Developments, 2009–14




Source: Central Bank of the Republic of Kosovo; and IMF staff estimates and projections.

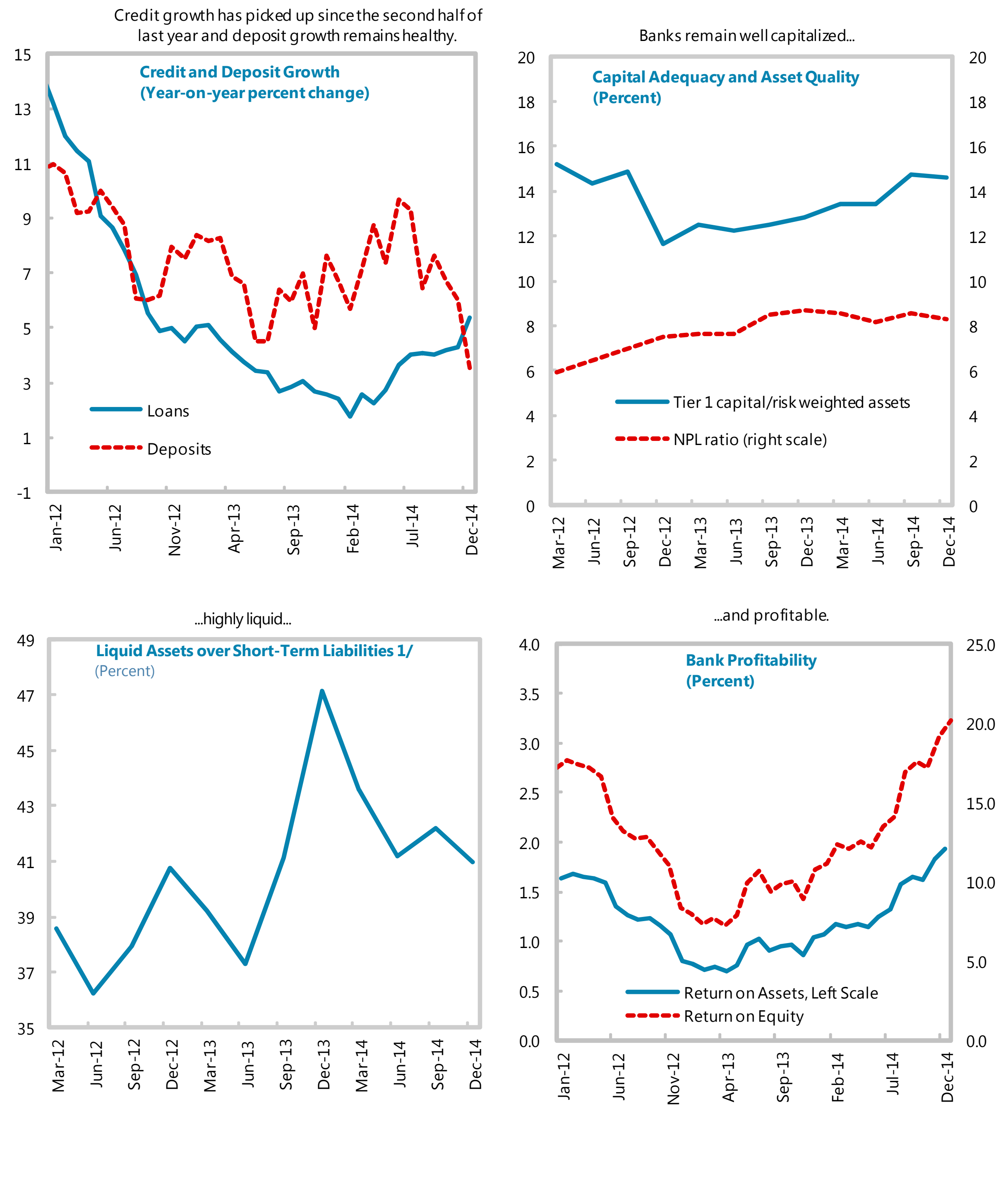
1/ 2014 annual data is an estimate.

## Figure 2. Kosovo: Recent Fiscal Developments, 2010–14




Source: Country authorities; and IMF staff calculations.
1/ Overall balance excluding PAK spending.

## Figure 3. Kosovo: Selected Banking Sector Indicators, 2012–14




Sources: Cental Bank of Kosovo; and IMF staff estimates.

1/ Liquid assets are cash, balances with CBK and commercial banks, and securities.

## Figure 4. Selected Labor Market Outcomes in Kosovo


Sources: Country authorities; OECD; Haver; World Economic Outlook; World Development Indicators World Bank; Eurostat; CEA; and IMF staff calculations.
1/ 2013 data is used.
2/ 2014Q2 data is used.
3/ Construction, Wholesale, retail trade, repair of motor vehicles etc., Hotels and restaurants, Transport, storage and communication, Financial intermediation, Real estate, renting and business activities, Public administration, defence, compuls.soc.security, Education, Health and social work, Other.
4/ Agriculture, hunting and forestry, Fishing, Mining and quarrying, Manufacturing, Electricity and water supply.
5/ Data as of 2010.
6/ Data as of 2007.
7/ Industry excluding construction.

## Table 1. Kosovo: Main Indicators, 2010–20

(Percent, unless otherwise indicated)

| | 2010 | 2011 | 2012 | 2013 | 2014 | 2015 | 2016 | 2017 | 2018 | 2019 | 2020 |
|---|---|---|---|---|---|---|---|---|---|---|---|
| | | | | | Est. | Projections | | | | | |
| Real growth rates | | | | | | | | | | | |
| GDP | 3.3 | 4.4 | 2.8 | 3.4 | 2.7 | 3.3 | 3.5 | 3.5 | 3.5 | 3.5 | 3.5 |
| Consumption | 3.7 | 3.7 | 2.6 | 2.2 | 3.9 | 3.2 | 3.3 | 3.4 | 3.4 | 3.4 | 3.4 |
| Investment | 10.9 | 7.9 | -12.9 | -0.3 | 0.9 | 5.1 | 3.4 | 3.4 | 3.5 | 3.5 | 3.5 |
| Exports | 12.5 | 3.3 | 0.5 | 2.5 | 1.9 | 3.6 | 1.5 | 1.9 | 2.3 | 2.7 | 3.1 |
| Imports | 9.1 | 3.5 | -7.7 | -1.5 | 3.9 | 4.2 | 3.5 | 3.0 | 3.5 | 3.9 | 4.4 |
| Official unemployment (percent of workforce) | ... | ... | 30.9 | 30.0 1/ | ... | ... | ... | ... | ... | ... | ... |
| Price changes | | | | | | | | | | | |
| CPI, period average | 3.5 | 7.3 | 2.5 | 1.8 | 0.4 | 0.3 | 1.4 | 1.6 | 1.8 | 1.9 | 1.8 |
| CPI, end of period | 6.6 | 3.6 | 3.7 | 0.5 | -0.4 | 1.5 | 1.5 | 1.8 | 1.9 | 2.0 | 2.2 |
| Import prices | 5.9 | 8.2 | 4.9 | 0.0 | -0.4 | -1.0 | 0.7 | 1.0 | 1.0 | 1.1 | 0.9 |
| GDP deflator | 4.7 | 4.8 | 2.2 | 1.8 | 0.6 | 0.4 | 1.6 | 1.7 | 2.0 | 2.1 | 2.2 |
| Real effective exch. rate (average; -=depreciation) | -0.8 | 3.4 | -0.7 | 0.0 | 1.6 | ... | ... | ... | ... | ... | ... |
| Real effective exch. rate (end of period; -=depreciation) | 0.8 | 0.8 | 0.6 | -1.1 | 7.2 | ... | ... | ... | ... | ... | ... |
| General government budget (percent of GDP) | | | | | | | | | | | |
| Revenues, incl. interest income | 26.4 | 27.1 | 26.1 | 24.6 | 24.2 | 25.8 | 25.7 | 25.4 | 25.4 | 25.4 | 25.4 |
| Primary expenditures | 28.7 | 28.7 | 28.5 | 27.6 | 26.6 | 29.3 | 29.3 | 29.3 | 29.3 | 29.3 | 29.3 |
| Of which: Wages and salaries | 7.1 | 8.0 | 8.1 | 7.8 | 8.8 | 9.6 | 9.6 | 9.6 | 9.6 | 9.6 | 9.6 |
| Subsidies and transfers | 6.1 | 5.6 | 5.7 | 6.0 | 6.7 | 7.8 | 7.8 | 7.8 | 7.8 | 7.8 | 7.8 |
| Capital and net lending | 11.4 | 11.4 | 10.9 | 9.7 | 7.3 | 8.0 | 8.0 | 8.0 | 8.0 | 8.0 | 8.0 |
| Overall balance excluding PAK 2/ | ... | ... | -2.4 | -3.0 | -2.5 | -3.6 | -3.7 | -4.2 | -4.3 | -4.4 | -4.5 |
| Debt financing, net | 0.4 | 0.0 | 3.1 | 1.3 | 1.6 | 1.9 | 1.3 | 1.6 | 2.2 | 2.2 | 2.2 |
| Privatization | 0.0 | 0.0 | 0.9 | 0.5 | 0.0 | 0.9 | 0.8 | 0.8 | 0.4 | 0.4 | 0.4 |
| Stock of government bank balances | 5.5 | 3.3 | 4.3 | 3.0 | 1.8 | 1.5 | 1.5 | 1.5 | 1.5 | 1.5 | 1.5 |
| Balance of Payments (percent of GDP) | | | | | | | | | | | |
| Current account balance, incl. official transfers | -11.7 | -13.7 | -7.5 | -6.4 | -7.1 | -7.3 | -8.0 | -8.0 | -7.9 | -7.5 | -7.2 |
| *Of which*: official transfers 3/ | 7.3 | 6.7 | 7.9 | 6.4 | 5.1 | 4.8 | 3.9 | 3.6 | 3.3 | 3.2 | 3.2 |
| Capital and financial account | 6.8 | 8.7 | 2.8 | 3.1 | 5.3 | 5.7 | 6.7 | 6.9 | 6.9 | 6.7 | 6.5 |
| Of which: Net foreign direct investment | 7.5 | 7.9 | 4.2 | 4.5 | 4.5 | 4.5 | 4.5 | 4.5 | 4.5 | 4.5 | 4.5 |
| Portfolio investment, net | -1.1 | -1.2 | -3.7 | -2.5 | -2.8 | -2.0 | -0.8 | -0.7 | -0.6 | -0.5 | -1.1 |
| Errors and Omissions | 4.9 | 5.0 | 4.7 | 3.2 | 1.8 | 1.6 | 1.3 | 1.2 | 1.0 | 0.8 | 0.7 |
| Savings-investment balances (percent of GDP) | | | | | | | | | | | |
| Domestic savings | -1.2 | -2.7 | -5.0 | -4.1 | -5.1 | -4.9 | -5.2 | -5.4 | -5.7 | -6.1 | -6.6 |
| National savings | 15.4 | 14.1 | 13.7 | 14.7 | 14.5 | 15.2 | 15.2 | 15.3 | 15.5 | 15.8 | 15.9 |
| Investment | 34.3 | 34.5 | 29.2 | 27.5 | 26.8 | 27.3 | 27.1 | 26.9 | 26.7 | 26.5 | 26.2 |
| Current account, excl. official transfers | -19.0 | -20.4 | -15.4 | -12.8 | -12.3 | -12.1 | -11.9 | -11.6 | -11.2 | -10.7 | -10.3 |
| Non-performing loans (percent of total loans) | 5.2 | 5.7 | 7.5 | 8.7 | 8.5 | ... | ... | ... | ... | ... | ... |
| Bank credit to the private sector | 12.6 | 14.7 | 4.5 | 2.7 | 3.9 | 4.0 | 5.3 | 5.5 | 5.9 | 6.1 | 6.2 |
| Deposits of the private sector | 23.1 | 11.4 | 10.9 | 8.0 | 7.2 | 6.2 | 7.2 | 7.4 | 7.7 | 7.8 | 8.0 |
| Regulatory capital/risk weighted assets | 18.8 | 17.6 | 14.4 | 16.8 | 17.8 | ... | ... | ... | ... | ... | ... |
| *Memorandum items* | | | | | | | | | | | |
| Total public debt (percent of GDP) 4/ | 16.1 | 14.6 | 17.1 | 17.6 | 18.5 | 20.3 | 22.2 | 24.6 | 27.1 | 29.6 | 32.1 |
| GDP (millions of euros) | 4402 | 4815 | 5059 | 5327 | 5506 | 5712 | 6004 | 6322 | 6671 | 7048 | 7459 |
| GDP per capita (euros) | 2480 | 2672 | 2799 | 2935 | 2989 | 3055 | 3164 | 3282 | 3412 | 3552 | 3703 |
| GNDI per capita (euros) | 2891 | 3123 | 3323 | 3488 | 3575 | 3670 | 3811 | 3962 | 4126 | 4302 | 4489 |
| Population (thousands) 5/ | 1775 | 1802 | 1807 | 1815 | 1842 | 1870 | 1898 | 1926 | 1955 | 1984 | 2014 |

Sources: Kosovo authorities; and IMF staff estimates and projections.

Note: Forecasts are based on staff's understanding of current policies, not on a reform scenario.

1/ Data for H1 2013, as published in Kosovo Labor Force Survey, July 2014.

2/ Projected balance does not conform with the fiscal rule.

3/ Total foreign assistance excluding capital transfers.

4/ Includes former Yugoslav debt, not recognized by Kosovo.

5/ Series updated according to Kosovo Agency of Statistics (2013), Pristina, Kosovo.

## Table 2. Kosovo: Real Growth, 2010–20

(Percent, unless otherwise indicated)

| | 2010 | 2011 | 2012 | 2013 | 2014 | 2015 | 2016 | 2017 | 2018 | 2019 | 2020 |
|---|---|---|---|---|---|---|---|---|---|---|---|
| | | | | | Est. | | | Projections | | | |
| GDP | 3.3 | 4.4 | 2.8 | 3.4 | 2.7 | 3.3 | 3.5 | 3.5 | 3.5 | 3.5 | 3.5 |
| Consumption | 3.7 | 3.7 | 2.6 | 2.2 | 3.9 | 3.2 | 3.3 | 3.4 | 3.4 | 3.4 | 3.4 |
| Private | 3.5 | 3.6 | 2.7 | -2.4 | 3.6 | 3.5 | 3.6 | 3.6 | 3.6 | 3.6 | 3.6 |
| Public | -2.9 | 0.1 | 2.2 | 3.3 | 5.7 | 1.8 | 2.0 | 2.0 | 2.0 | 2.3 | 2.5 |
| General government | 5.5 | 2.2 | 4.6 | 3.9 | 8.8 | 3.2 | 3.7 | 3.6 | 3.6 | 3.7 | 3.7 |
| Donor sector 1/ | -16.1 | -4.6 | -3.9 | 1.4 | -4.3 | -3.1 | -4.6 | -4.8 | -5.3 | -4.8 | -4.1 |
| Investment | 10.9 | 7.9 | -12.9 | -0.3 | 0.9 | 5.1 | 3.4 | 3.4 | 3.5 | 3.5 | 3.5 |
| Private | 9.9 | 6.1 | -19.7 | 2.0 | 14.5 | 2.3 | 3.4 | 3.5 | 3.5 | 3.5 | 3.5 |
| Public | 13.0 | 11.8 | 1.1 | -4.1 | -22.5 | 12.3 | 3.3 | 3.3 | 3.3 | 3.4 | 3.5 |
| General government | 14.1 | 12.5 | 1.3 | -4.0 | -23.2 | 13.0 | 3.7 | 3.6 | 3.6 | 3.7 | 3.7 |
| Donor sector 1/ | -7.0 | -5.0 | -3.8 | -5.2 | -2.2 | -4.7 | -6.6 | -5.9 | -6.9 | -6.1 | -6.2 |
| Exports | 12.5 | 3.3 | 0.5 | 2.5 | 1.9 | 3.6 | 1.5 | 1.9 | 2.3 | 2.7 | 3.1 |
| Imports | 9.1 | 3.5 | -7.7 | -1.5 | 3.9 | 4.2 | 3.5 | 3.0 | 3.5 | 3.9 | 4.4 |
| Memorandum item: | | | | | | | | | | | |
| GDP (millions of euros) | 4402 | 4815 | 5059 | 5327 | 5506 | 5712 | 6004 | 6322 | 6671 | 7048 | 7459 |

Sources: Kosovo authorities; and IMF staff estimates and projections.

Note: Forecasts are based on staff's understanding of current policies, not on a reform scenario.

*1/ Donor sector includes UNMIK, EULEX, KFOR, and other donor spending.*

## Table 3. Kosovo: Consolidated Government Budget, 2010–20 1/

(Excluding donor designated grants: millions of euros; cumulative from the beginning of the year)

| | 2010 | 2011 | 2012 | 2013 | 2014 | 2015 | 2016 | 2017 | 2018 | 2019 | 2020 |
|---|---|---|---|---|---|---|---|---|---|---|---|
| | | | | | Est. | Projections | | | | | |
| Total primary revenue and grants | 1,152 | 1,303 | 1,322 | 1,313 | 1,334 | 1,476 | 1,546 | 1,606 | 1,694 | 1,790 | 1,895 |
| Total primary revenue | 1,115 | 1,277 | 1,284 | 1,313 | 1,333 | 1,476 | 1,545 | 1,606 | 1,694 | 1,790 | 1,895 |
| Taxes | 907 | 1,072 | 1,112 | 1,121 | 1,162 | 1,283 | 1,323 | 1,393 | 1,470 | 1,553 | 1,644 |
| Direct taxes | 140 | 151 | 170 | 174 | 188 | 245 | 229 | 241 | 254 | 268 | 284 |
| Indirect taxes | 796 | 949 | 975 | 985 | 1,007 | 1,072 | 1,131 | 1,190 | 1,256 | 1,327 | 1,404 |
| Of which: VAT | 455 | 541 | 549 | 560 | 560 | 595 | 625 | 658 | 695 | 734 | 777 |
| Tax refunds | -28 | -28 | -33 | -37 | -33 | -34 | -36 | -38 | -40 | -42 | -45 |
| Nontax revenues | 208 | 205 | 172 | 192 | 171 | 192 | 222 | 213 | 224 | 237 | 251 |
| Of which: Dividends | 85 | 60 | 45 | 43 | 15 | 30 | 32 | 33 | 35 | 37 | 39 |
| Grants | 38 | 26 | 37 | 0 | 1 | 1 | 1 | 1 | 0 | 0 | 0 |
| Budget support | 30 | 19 | 37 | 0 | 0 | 1 | 1 | 1 | 0 | 0 | 0 |
| Project grants | 3 | 3 | 0 | 0 | 1 | 0 | 0 | 0 | 0 | 0 | 0 |
| Primary expenditure | 1,265 | 1,382 | 1,441 | 1,469 | 1,464 | 1,672 | 1,758 | 1,851 | 1,953 | 2,064 | 2,184 |
| *Of which*: | | | | | | | | | | | |
| PAK-related expenditures | | | 6 | 7 | 5 | 10 | 11 | 11 | 12 | 13 | 13 |
| Current expenditure | 762 | 832 | 888 | 950 | 1,059 | 1,214 | 1,276 | 1,344 | 1,418 | 1,498 | 1,586 |
| Wages and salaries | 311 | 385 | 408 | 417 | 485 | 550 | 578 | 609 | 642 | 679 | 718 |
| Goods and services | 182 | 177 | 191 | 216 | 206 | 212 | 222 | 234 | 247 | 261 | 276 |
| Subsidies and transfers | 268 | 270 | 289 | 318 | 368 | 448 | 471 | 495 | 523 | 552 | 585 |
| Pension and social assistance | 166 | 178 | 198 | 225 | 347 | 313 | 329 | 347 | 366 | 387 | 409 |
| Other transfers and subsidies 2/ | 103 | 92 | 91 | 93 | 21 | 134 | 141 | 149 | 157 | 166 | 175 |
| Reserve | 0 | 0 | 0 | 0 | 0 | 5 | 5 | 6 | 6 | 6 | 7 |
| Capital expenditure and net lending | 503 | 550 | 553 | 518 | 404 | 458 | 481 | 507 | 535 | 565 | 598 |
| Capital expenditure | 443 | 520 | 541 | 524 | 404 | 458 | 481 | 507 | 535 | 565 | 598 |
| Highways | 123 | 259 | 281 | 215 | 94 | 120 | 120 | 150 | 214 | 0 | 0 |
| R7 | ... | ... | 281 | 215 | 38 | 0 | 0 | 0 | 0 | 0 | 0 |
| R6 | ... | ... | 0 | 0 | 56 | 120 | 120 | 150 | 214 | 0 | 0 |
| Expropriation | ... | ... | 0 | 0 | 21 | 30 | 30 | 30 | 27 | 0 | 0 |
| Other capital spending | 320 | 261 | 260 | 309 | 289 | 308 | 331 | 327 | 294 | 565 | 598 |
| Net lending | 60 | 30 | 12 | -6 | 0 | 0 | 0 | 0 | 0 | 0 | 0 |
| Primary balance | -112 | -79 | -119 | -156 | -129 | -196 | -212 | -245 | -259 | -273 | -289 |
| Primary balance net of PAK | | | -113 | -149 | -124 | -186 | -201 | -233 | -247 | -261 | -276 |
| Interest income, net | 14 | -6 | -10 | -11 | -12 | -18 | -24 | -31 | -40 | -50 | -63 |
| Overall balance | -98 | -84 | -129 | -167 | -142 | -214 | -236 | -275 | -299 | -323 | -352 |
| Overall balance excluding PAK 3/ | -98 | -84 | -123 | -160 | -136 | -203 | -225 | -264 | -287 | -311 | -339 |
| Financing | 110 | 86 | 130 | 168 | 135 | 203 | 225 | 264 | 287 | 311 | 339 |
| Foreign financing | 16 | 2 | 83 | -8 | -18 | -14 | -48 | -31 | 7 | 7 | 4 |
| Drawings, incl. official financing | 28 | 13 | 94 | 6 | 4 | 10 | 10 | 20 | 20 | 20 | 20 |
| Amortization | -11 | -12 | -11 | -14 | -22 | -24 | -57 | -50 | -12 | -13 | -15 |
| Domestic financing | 93 | 85 | 47 | 176 | 153 | 186 | 172 | 178 | 165 | 172 | 182 |
| Domestic borrowing (net) | 0 | 0 | 73 | 78 | 104 | 120 | 126 | 133 | 140 | 148 | 157 |
| Privatization revenues | 0 | 0 | 45 | 26 | 0 | 50 | 50 | 50 | 30 | 30 | 31 |
| Own-source revenue (– = increase) | -5 | 0 | -15 | 14 | -9 | 0 | 0 | 0 | 0 | 0 | 0 |
| Bank balance (prog.; – = increase) | 98 | 84 | -56 | 57 | 58 | 16 | -4 | -5 | -5 | -6 | -6 |
| Unidentified Financing | | | | | | 32 | 101 | 116 | 114 | 132 | 153 |
| Memorandum items: | | | | | | | | | | | |
| Bank balance of the general government | 244 | 160 | 216 | 159 | 101 | 86 | 90 | 95 | 100 | 106 | 112 |
| *Of which:* ELA | | 0 | 0 | 46 | 46 | 46 | 46 | 46 | 46 | 46 | 46 |

Sources: Kosovo authorities; and IMF staff estimates and projections.

Note: Forecasts are based on staff's understanding of current policies, not on a reform scenario.

1/ Does not yet reflect the GFSM 2001 methodology.

2/ Including capital transfers to public enterprises.

3/ Projected balance does not conform with the fiscal rule.

## Table 4. Kosovo: Consolidated Government Budget, 2010–20

(Excluding donor designated grants; percent of GDP)

| | 2010 | 2011 | 2012 | 2013 | 2014 | 2015 | 2016 | 2017 | 2018 | 2019 | 2020 |
|---|---|---|---|---|---|---|---|---|---|---|---|
| | | | | | Est. | Projections | | | | | |
| Total primary revenue and grants | 26.2 | 27.1 | 26.1 | 24.6 | 24.2 | 25.8 | 25.7 | 25.4 | 25.4 | 25.4 | 25.4 |
| Total primary revenue | 25.3 | 26.5 | 25.4 | 24.6 | 24.2 | 25.8 | 25.7 | 25.4 | 25.4 | 25.4 | 25.4 |
| Taxes | 20.6 | 22.3 | 22.0 | 21.0 | 21.1 | 22.5 | 22.0 | 22.0 | 22.0 | 22.0 | 22.0 |
| Direct taxes | 3.2 | 3.1 | 3.4 | 3.3 | 3.4 | 4.3 | 3.8 | 3.8 | 3.8 | 3.8 | 3.8 |
| Indirect taxes | 18.1 | 19.7 | 19.3 | 18.5 | 18.3 | 18.8 | 18.8 | 18.8 | 18.8 | 18.8 | 18.8 |
| Tax refunds | -0.6 | -0.6 | -0.7 | -0.7 | -0.6 | -0.6 | -0.6 | -0.6 | -0.6 | -0.6 | -0.6 |
| Nontax revenues | 4.7 | 4.3 | 3.4 | 3.6 | 3.1 | 3.4 | 3.7 | 3.4 | 3.4 | 3.4 | 3.4 |
| *Of which*: | | | | | | | | | | | |
| Dividends | 1.9 | 1.2 | 0.9 | 0.8 | 0.3 | 0.5 | 0.5 | 0.5 | 0.5 | 0.5 | 0.5 |
| Grants | 0.9 | 0.5 | 0.7 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 |
| Budget support | 0.7 | 0.4 | 0.7 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 |
| Project grants | 0.1 | 0.1 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 |
| Primary expenditure | 28.7 | 28.7 | 28.5 | 27.6 | 26.6 | 29.3 | 29.3 | 29.3 | 29.3 | 29.3 | 29.3 |
| *Of which*: | | | | | | | | | | | |
| PAK-related expenditures | ... | ... | 0.1 | 0.1 | 0.1 | 0.2 | 0.2 | 0.2 | 0.2 | 0.2 | 0.2 |
| Primary expenditure excluding PAK | ... | ... | ... | ... | ... | ... | ... | ... | ... | ... | ... |
| Current expenditure | 17.3 | 17.3 | 17.5 | 17.8 | 19.2 | 21.3 | 21.3 | 21.3 | 21.3 | 21.3 | 21.3 |
| Current expenditure excluding PAK | ... | ... | 17.4 | 17.7 | 19.1 | 21.1 | 21.1 | 21.1 | ... | ... | ... |
| Wages and salaries | 7.1 | 8.0 | 8.1 | 7.8 | 8.8 | 9.6 | 9.6 | 9.6 | 9.6 | 9.6 | 9.6 |
| Goods and services | 4.1 | 3.7 | 3.8 | 4.0 | 3.7 | 3.7 | 3.7 | 3.7 | 3.7 | 3.7 | 3.7 |
| Subsidies and transfers | 6.1 | 5.6 | 5.7 | 6.0 | 6.7 | 7.8 | 7.8 | 7.8 | 7.8 | 7.8 | 7.8 |
| Pension and social assistance | 3.8 | 3.7 | 3.9 | 4.2 | 6.3 | 5.5 | 5.5 | 5.5 | 5.5 | 5.5 | 5.5 |
| Reserve | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.1 | 0.1 | 0.1 | 0.1 | 0.1 | 0.1 |
| Capital expenditure and net lending | 11.4 | 11.4 | 10.9 | 9.7 | 7.3 | 8.0 | 8.0 | 8.0 | 8.0 | 8.0 | 8.0 |
| Capital expenditure | 10.1 | 10.8 | 10.7 | 9.8 | 7.3 | 8.0 | 8.0 | 8.0 | 8.0 | 8.0 | 8.0 |
| Highways | 2.8 | 5.4 | 5.6 | 4.0 | 1.7 | 2.1 | 2.0 | 2.4 | 3.2 | 0.0 | 0.0 |
| R7 | ... | ... | 5.6 | 4.0 | 0.7 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 |
| R6 | ... | ... | 0.0 | 0.0 | 1.0 | 2.1 | 2.0 | 2.4 | 3.2 | 0.0 | 0.0 |
| Expropriations | ... | ... | 0.0 | 0.0 | 0.4 | 0.5 | 0.5 | 0.5 | 0.4 | 0.0 | 0.0 |
| Other capital spending | 7.3 | 5.4 | 5.1 | 5.8 | 5.3 | 5.4 | 5.5 | 5.2 | 4.4 | 8.0 | 8.0 |
| Net lending | 1.4 | 0.6 | 0.2 | -0.1 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 |
| Primary balance | -2.6 | -1.6 | -2.4 | -2.9 | -2.4 | -3.4 | -3.5 | -3.9 | -3.9 | -3.9 | -3.9 |
| Primary balance net of PAK | ... | ... | -2.2 | -2.8 | -2.3 | -3.3 | -3.4 | -3.7 | -3.7 | -3.7 | -3.7 |
| Interest income, net | 0.3 | -0.1 | -0.2 | -0.2 | -0.3 | -0.2 | -0.3 | -0.5 | -0.7 | -0.9 | -1.0 |
| Overall balance | -2.2 | -1.8 | -2.6 | -3.1 | -2.6 | -3.6 | -3.9 | -4.4 | -4.6 | -4.7 | -4.9 |
| Overall balance excluding PAK 2/ | ... | ... | -2.4 | -3.0 | -2.5 | -3.5 | -3.7 | -4.2 | -4.4 | -4.6 | -4.7 |
| Financing | 2.4 | 1.8 | 2.6 | 3.2 | 2.5 | 3.5 | 3.7 | 4.2 | 4.4 | 4.6 | 4.7 |
| Foreign financing | 0.2 | 0.0 | 1.6 | -0.1 | -0.2 | -0.2 | -0.8 | -0.5 | 0.1 | 0.1 | 0.0 |
| Drawings, incl. official financing | 0.5 | 0.3 | 1.9 | 0.1 | 0.2 | 0.2 | 0.2 | 0.3 | 0.3 | 0.3 | 0.3 |
| Amortization | -0.3 | -0.2 | -0.2 | -0.3 | -0.4 | -0.4 | -1.0 | -0.8 | -0.2 | -0.2 | -0.2 |
| Domestic financing | 2.1 | 1.8 | 0.9 | 3.3 | 2.8 | 3.2 | 2.9 | 2.8 | 2.5 | 2.4 | 2.4 |
| Domestic borrowing (net) | 0.0 | 0.0 | 1.4 | 1.5 | 1.9 | 2.1 | 2.1 | 2.1 | 2.1 | 2.1 | 2.1 |
| Privatization revenues | 0.0 | 0.0 | 0.9 | 0.5 | 0.0 | 0.9 | 0.8 | 0.8 | 0.4 | 0.4 | 0.4 |
| Own-source revenue (– = increase) | -0.1 | 0.0 | -0.3 | 0.3 | -0.2 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 |
| Bank balance (prog.; – = increase) | 2.2 | 1.7 | -1.1 | 1.1 | 1.0 | 0.3 | -0.1 | -0.1 | -0.1 | -0.1 | -0.1 |
| Unidentified Financing | | | | | | 0.5 | 1.6 | 1.9 | 1.8 | 2.0 | 2.3 |
| Memorandum items: | | | | | | | | | | | |
| Bank balance of the general government | 5.5 | 3.3 | 4.3 | 3.0 | 1.8 | 1.5 | 1.5 | 1.5 | 1.5 | 1.5 | 1.5 |
| *Of which:* ELA | | 0.0 | 0.0 | 0.9 | 0.8 | 0.8 | 0.8 | 0.7 | 0.7 | 0.7 | 0.6 |
| Minimum bank balance (fiscal rule) 3/ | ... | ... | ... | ... | 4.5 | 4.5 | 4.5 | 4.5 | 4.5 | 4.5 | 5.5 |
| Total public debt 4/ | 16.1 | 14.6 | 17.1 | 17.6 | 18.5 | 20.2 | 22.1 | 24.5 | 27.1 | 29.8 | 32.4 |
| Nominal GDP (millions of euros) | 4,401.9 | 4,814.6 | 5,058.7 | 5,327 | 5,505.7 | 5,712.0 | 6,004.0 | 6,321.6 | 6,670.9 | 7,047.9 | 7,458.5 |

Sources: Kosovo authorities; and IMF staff estimates and projections.

Note: Forecasts are based on staff's understanding of current policies, not on a reform scenario.

1/ Including capital transfers to public enterprises.

2/ Projected balance does not conform with the fiscal rule.

3/ Indicative target only.

4/ Includes former Yugoslav debt, not recognized by Kosovo.

## Table 5. Kosovo: Balance of Payments, 2010–20

(Millions of euros, unless otherwise indicated)

| | 2010 | 2011 | 2012 | 2013 | 2014 | 2015 | 2016 | 2017 | 2018 | 2019 | 2020 |
|---|---|---|---|---|---|---|---|---|---|---|---|
| | | | | | Est. | Projections | | | | | |
| Goods and services balance | -1,565 | -1,793 | -1,728 | -1,684 | -1,749 | -1,829 | -1,921 | -2,009 | -2,110 | -2,228 | -2,353 |
| Goods | -1,752 | -2,059 | -2,073 | -1,992 | -2,068 | -2,141 | -2,238 | -2,335 | -2,443 | -2,578 | -2,728 |
| Exports | 305 | 325 | 287 | 305 | 309 | 307 | 319 | 332 | 351 | 368 | 384 |
| Imports | -2,057 | -2,384 | -2,360 | -2,297 | -2,376 | -2,448 | -2,558 | -2,667 | -2,794 | -2,946 | -3,113 |
| Services | 187 | 266 | 345 | 308 | 319 | 312 | 317 | 325 | 333 | 350 | 375 |
| Receipts | 573 | 619 | 637 | 622 | 644 | 651 | 664 | 681 | 698 | 725 | 758 |
| Payments | -386 | -353 | -292 | -314 | -325 | -339 | -346 | -356 | -365 | -375 | -383 |
| Income | 68 | 113 | 154 | 122 | 188 | 195 | 198 | 195 | 189 | 188 | 177 |
| Compensation of employees (net) | 172 | 208 | 214 | 219 | 224 | 233 | 242 | 252 | 262 | 272 | 272 |
| Investment income | -104 | -95 | -60 | -97 | -35 | -37 | -44 | -57 | -72 | -84 | -95 |
| Interest payments on public debt | -9 | -9 | -8 | -9 | -9 | -12 | -19 | -32 | -48 | -61 | -77 |
| Transfers | 982 | 1,021 | 1,194 | 1,222 | 1,167 | 1,216 | 1,243 | 1,306 | 1,392 | 1,509 | 1,642 |
| Official transfers | 320 | 322 | 402 | 342 | 282 | 272 | 232 | 226 | 217 | 225 | 238 |
| Bilateral donors | 63 | 62 | 62 | 56 | 47 | 39 | 6 | 9 | 13 | -13 | 0 |
| UNMIK | 37 | 29 | 27 | 25 | 25 | 24 | 23 | 22 | 21 | 20 | 20 |
| EULEX | 100 | 103 | 110 | 107 | 100 | 98 | 96 | 98 | 98 | 98 | 98 |
| Grant from WB Trust Fund for interest | 2 | 4 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 |
| Budget support | 34 | 23 | 37 | 0 | 0 | 1 | 1 | 1 | 0 | 0 | 0 |
| Other, net | 82 | 101 | 165 | 153 | 112 | 110 | 105 | 96 | 84 | 120 | 120 |
| Other transfers (net) | 663 | 699 | 793 | 880 | 885 | 944 | 1,011 | 1,081 | 1,175 | 1,283 | 1,404 |
| Workers' remittances (net) | 493 | 489 | 519 | 552 | 571 | 597 | 629 | 659 | 710 | 785 | 881 |
| Inflows of remittances | 584 | 585 | 605 | 621 | 659 | 678 | 708 | 742 | 801 | 873 | 962 |
| Other (net) | 170 | 210 | 274 | 328 | 314 | 347 | 382 | 421 | 465 | 498 | 523 |
| Current account | -515 | -659 | -380 | -339 | -393 | -418 | -481 | -508 | -529 | -531 | -534 |
| Capital and financial account | 298 | 419 | 140 | 167 | 293 | 328 | 400 | 435 | 463 | 472 | 481 |
| Capital account | 21 | 42 | 13 | 35 | -2 | -2 | -2 | -2 | -2 | -2 | -2 |
| Financial account, incl. CBK | 277 | 377 | 127 | 133 | 295 | 330 | 401 | 437 | 465 | 474 | 483 |
| Foreign direct investment, net | 331 | 379 | 213 | 241 | 249 | 259 | 271 | 285 | 301 | 318 | 337 |
| Commercial banks, excl. FDI | -44 | 7 | 102 | -47 | -43 | -1 | 53 | 52 | 57 | 61 | 17 |
| General government | 21 | -6 | 83 | -9 | -6 | 0 | 34 | 21 | 30 | 79 | 92 |
| Drawings 1/ | 22 | 5 | 94 | 3 | 8 | 23 | 58 | 78 | 81 | 91 | 105 |
| Repayments | -11 | -11 | -11 | -11 | -14 | -23 | -24 | -57 | -50 | -12 | -13 |
| Other | 10 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 |
| Other sectors, excl. FDI 2/ | 9 | -18 | -33 | 90 | 78 | 23 | 40 | 75 | 103 | 44 | 62 |
| Central Bank of Kosovo | -41 | 15 | -237 | -142 | 17 | 48 | 4 | 4 | -26 | -28 | -25 |
| Reserve assets | -53 | 61 | -267 | 21 | -145 | 42 | -1 | 0 | -30 | -34 | 0 |
| Government balances (program def.) | 98 | 84 | -56 | 57 | 58 | 16 | -4 | -5 | -5 | -6 | -6 |
| Other reserve assets, incl. SDRs | -151 | -23 | -211 | -36 | -202 | 27 | 3 | 4 | -25 | -28 | 6 |
| Non-reserves assets | 13 | -46 | 30 | -163 | 161 | 6 | 5 | 5 | 4 | 5 | -25 |
| Liabilities 3/ | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 |
| Net errors and omissions 4/ | 217 | 241 | 239 | 171 | 100 | 90 | 81 | 73 | 66 | 59 | 53 |
| Overall balance | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 |
| | | | | | (In percent GDP) | | | | | | |
| Financing gap | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 |
| Goods and services balance | -35.6 | -37.2 | -34.2 | -31.6 | -31.8 | -32.0 | -32.0 | -31.8 | -31.6 | -31.6 | -31.5 |
| Exports | 19.9 | 19.6 | 18.3 | 17.4 | 17.3 | 16.8 | 16.4 | 16.0 | 15.7 | 15.5 | 15.3 |
| Imports | -55.5 | -56.8 | -52.4 | -49.0 | -49.1 | -48.8 | -48.4 | -47.8 | -47.4 | -47.1 | -46.9 |
| Current account, excl. official transfers | -19.0 | -20.4 | -15.4 | -12.8 | -12.3 | -12.1 | -11.9 | -11.6 | -11.2 | -10.7 | -10.3 |
| Current account, incl. official transfers | -11.7 | -13.7 | -7.5 | -6.4 | -7.1 | -7.3 | -8.0 | -8.0 | -7.9 | -7.5 | -7.2 |
| Official transfers | 7.3 | 6.7 | 7.9 | 6.4 | 5.1 | 4.8 | 3.9 | 3.6 | 3.3 | 3.2 | 3.2 |
| Other transfers | 15.1 | 14.5 | 15.7 | 16.5 | 16.1 | 16.5 | 16.8 | 17.1 | 17.6 | 18.2 | 18.8 |
| Capital and financial account | 6.8 | 8.7 | 2.8 | 3.1 | 5.3 | 5.7 | 6.7 | 6.9 | 6.9 | 6.7 | 6.5 |
| **Memorandum items:** | | | | | | | | | | | |
| Current account, excl. official transfers | -835 | -982 | -781 | -681 | -675 | -690 | -713 | -734 | -746 | -757 | -772 |
| Current account, incl. official transfers | -515 | -659 | -380 | -339 | -393 | -418 | -481 | -508 | -529 | -531 | -534 |
| Debt service to export ratio (percent) | 2.3 | 2.1 | 2.1 | 2.2 | 2.4 | 3.7 | 4.4 | 8.8 | 9.3 | 6.7 | 7.9 |
| Net foreign assets of CBK | 1,108 | 1,095 | 1,239 | 1,392 | 1,375 | 1,328 | 1,324 | 1,319 | 1,346 | 1,374 | 1,399 |
| Gross international reserves of the CBK | 686 | 626 | 892 | 850 | 995 | 952 | 954 | 954 | 984 | 1,018 | 1,048 |

Sources: Kosovo authorities; and IMF staff estimates and projections.

Note: Forecasts are based on staff's understanding of current policies, not on a reform scenario.

1/ Includes both identified and unidentified financing.

2/ Including trading companies, insurance companies, and pension funds.

3/ Includes SDR allocations and IMF account at historical value.

4/ Projections of errors include unidentified private remittances and other capital based on average historical levels.

## Table 6. Kosovo: Central Bank and Commercial Bank Survey, 2010–20

(Millions of euros, unless otherwise indicated)

| | 2010 | 2011 | 2012 | 2013 | 2014 | 2015 | 2016 | 2017 | 2018 | 2019 | 2020 |
|---|---|---|---|---|---|---|---|---|---|---|---|
| | | | | | Est. | | | Projections | | | |
| Central Bank | | | | | | | | | | | |
| Net foreign assets | 1,108 | 1,095 | 1,239 | 1,392 | 1,375 | 1,328 | 1,324 | 1,319 | 1,346 | 1,374 | 1,399 |
| Foreign assets | 1,247 | 1,235 | 1,469 | 1,610 | 1,593 | 1,546 | 1,542 | 1,537 | 1,563 | 1,592 | 1,617 |
| *Of which:* Securities | 199 | 25 | 286 | 561 | 581 | 601 | 621 | 641 | 661 | 681 | 701 |
| Deposits | 854 | 1,059 | 1,034 | 896 | 860 | 792 | 768 | 743 | 750 | 758 | 763 |
| Foreign liabilities | 139 | 140 | 230 | 218 | 218 | 218 | 218 | 218 | 218 | 218 | 218 |
| Net domestic assets | -1,108 | -1,095 | -1,239 | -1,392 | -1,375 | -1,328 | -1,324 | -1,319 | -1,346 | -1,374 | -1,399 |
| Net claims on commercial banks | -204 | -210 | -302 | -333 | -346 | -319 | -316 | -311 | -336 | -362 | -392 |
| Claims on commercial banks | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 |
| Liabilities to commercial banks | -204 | -210 | -302 | -333 | -346 | -319 | -316 | -311 | -336 | -362 | -392 |
| Net claims on the central government | -813 | -797 | -838 | -773 | -743 | -722 | -721 | -721 | -723 | -723 | -718 |
| Claims on central government | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 |
| Liabilities to central government | -813 | -797 | -838 | -773 | -743 | -722 | -721 | -721 | -723 | -723 | -718 |
| *Of which:* KTA (privatization) fund | -522 | -586 | -549 | -550 | -578 | -572 | -567 | -562 | -558 | -553 | -548 |
| *Of which*: Government balances (program definition) | -244 | -160 | -216 | -159 | -101 | -86 | -90 | -95 | -100 | -106 | -112 |
| Net Claims on other sectors | -45 | -39 | -51 | -238 | -238 | -238 | -238 | -238 | -238 | -238 | -238 |
| Claims on other sectors | 0 | 1 | 1 | 1 | -186 | -186 | -186 | -186 | -186 | -186 | -187 |
| Liabilities to other sectors | -46 | -39 | -51 | -239 | -52 | -52 | -52 | -52 | -52 | -52 | -51 |
| Other items, net 1/ | -46 | -49 | -48 | -48 | -48 | -49 | -49 | -49 | -49 | -51 | -52 |
| Commercial banks | | | | | | | | | | | |
| Net foreign assets | 508 | 509 | 491 | 573 | 615 | 615 | 563 | 511 | 454 | 393 | 476 |
| Assets | 710 | 666 | 634 | 748 | 802 | 818 | 781 | 744 | 702 | 656 | 754 |
| Liabilites | -202 | -156 | -143 | -175 | -188 | -203 | 218 | 233 | 248 | 263 | 278 |
| Net domestic assets | 1,522 | 1,754 | 2,025 | 2,145 | 2,313 | 2,461 | 3,228 | 3,527 | 3,865 | 4,233 | 4,500 |
| Claims on the CBK | 203 | 220 | 301 | 333 | 346 | 319 | 316 | 311 | 336 | 362 | 392 |
| Net claims on the central government | -12 | -1 | 59 | 99 | 187 | 291 | 445 | 615 | 775 | 951 | 1,006 |
| Claims on central government | 0 | 0 | 60 | 100 | 187 | 291 | 445 | 615 | 775 | 951 | 1,006 |
| Liabilities to central government | -12 | -1 | -1 | -1 | 0 | 0 | 0 | 0 | 0 | 0 | 0 |
| Net claims on other public entities | -120 | -129 | -74 | -73 | -76 | -79 | -83 | -88 | -93 | -98 | -104 |
| Claims on other public entities | 6 | 2 | 1 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 |
| Liabilities to other public entities | -127 | -130 | -76 | -73 | -76 | -79 | -83 | -88 | -93 | -98 | -104 |
| Credit to private sector | 1,451 | 1,664 | 1,740 | 1,786 | 1,855 | 1,930 | 2,032 | 2,144 | 2,270 | 2,407 | 2,557 |
| Deposits of the private sector | 1,714 | 1,908 | 2,116 | 2,286 | 2,451 | 2,603 | 2,790 | 2,997 | 3,226 | 3,478 | 3,755 |
| Demand deposits | 545 | 598 | 694 | 841 | 899 | 953 | 1,020 | 1,095 | 1,178 | 1,269 | 1,369 |
| Time deposits | 1,169 | 1,311 | 1,422 | 1,445 | 1,553 | 1,650 | 1,770 | 1,902 | 2,048 | 2,209 | 2,386 |
| Other items, net 1/ | 316 | 355 | 401 | 432 | 476 | 494 | 518 | 545 | 577 | 611 | 649 |
| Memorandum item: | | | | | | | | | | | |
| Gross international reserves | 686 | 626 | 892 | 850 | 995 | 952 | 954 | 954 | 984 | 1,018 | 1,048 |
| Deposits of the private sector (12-month percent change) | 23.1 | 11.4 | 10.9 | 8.0 | 7.2 | 6.2 | 7.2 | 7.4 | 7.7 | 7.8 | 8.0 |
| Credit to the private sector (12-month percent change) | 12.6 | 14.7 | 4.5 | 2.7 | 3.9 | 4.0 | 5.3 | 5.5 | 5.9 | 6.1 | 6.2 |
| Deposits of the private sector (Percent of GDP) | 38.9 | 39.6 | 41.8 | 42.9 | 44.5 | 45.6 | 46.5 | 47.4 | 48.4 | 49.3 | 50.3 |
| Credit to the private sector (Percent of GDP) | 33.0 | 34.6 | 34.4 | 33.5 | 33.7 | 33.8 | 33.8 | 33.9 | 34.0 | 34.2 | 34.3 |

Sources: Central Bank of the Republic of Kosovo; and IMF staff estimates and projections.

Note: Forecasts are based on staff's understanding of current policies, not on a reform scenario.

1/ Includes shares and other equity.

## Table 7. Kosovo: Selected Financial Soundness Indicators, 2010–14

| | 2010 | 2011 | 2012 | 2013 | 2014 |
|---|---|---|---|---|---|
| Capital adequacy | | | | | |
| Regulatory capital to risk weighted assets 1/ | 18.8 | 17.6 | 14.2 | 16.7 | 17.8 |
| Tier 1 capital to risk weighted assets 1/ | 15.8 | 14.8 | 11.6 | 12.8 | 14.6 |
| Capital to assets | 10.1 | 10.2 | 10.0 | 9.7 | 10.8 |
| Asset quality | | | | | |
| NPL to total loans 2/ | 5.2 | 5.7 | 7.5 | 8.7 | 8.3 |
| NPL net of provisions to capital | 3.7 | 4.6 | 7.4 | 7.8 | 4.7 |
| Large exposures to capital | 72.4 | 77.8 | 80.4 | 107.4 | 97.1 |
| Sectoral breakdown of loans | | | | | |
| Agriculture | 2.6 | 2.4 | 2.5 | 2.6 | 2.4 |
| Manufacturing | 11.0 | 10.1 | 9.5 | 9.7 | 10.0 |
| Trade | 37.1 | 37.8 | 37.8 | 36.9 | 35.8 |
| Other services | 12.0 | 11.7 | 11.6 | 12.4 | 12.8 |
| Construction | 7.5 | 7.0 | 7.2 | 6.6 | 6.0 |
| Households | 29.8 | 31.0 | 31.4 | 31.8 | 33.0 |
| Liquidity | | | | | |
| Liquid assets to total assets 3/ | 37.5 | 32.6 | 34.3 | 37.8 | 38.3 |
| Deposits to loans | 126.1 | 117.6 | 122.6 | 130.8 | 129.3 |
| Liquid assets to short-term liabilities 4/ | 46.2 | 39.6 | 40.8 | 47.1 | 41.0 |
| Profitability | | | | | |
| Return on average assets 5/ | 1.6 | 1.6 | 0.8 | 1.0 | 1.9 |
| Return on average equity 5/ | 16.9 | 16.9 | 8.3 | 10.8 | 20.2 |
| Interest margin to total income | 55.5 | 56.9 | 55.6 | 54.3 | 62.2 |
| Non-interest expense to total income 6/ | 16.6 | 18.0 | 23.9 | 22.2 | 12.9 |
| Interest margin to gross income 7/ | 74.4 | 75.2 | 74.7 | 73.1 | 76.1 |
| Non-interest expense to gross income 7/ 8/ | 76.6 | 77.3 | 87.8 | 84.5 | 66.8 |
| Market risk | | | | | |
| Net open currency position to tier 1 capital | -0.1 | 2.5 | 0.7 | 2.3 | 1.8 |

Source: Central Bank of the Republic of Kosovo.

1/ As of Dec. 2012, new capital adequacy rules include an additional requirement for operational risk, higher risk-weights for assets rated B- or less, and a deduction for related party loans.
2/ Loans classified as doubtful or loss.
3/ Liquid assets are cash and balances with the CBK, balances with commercial banks, and securities.
4/ Short-term liabilities are deposits, short-term borrowing, and other liabilities (up to 1 year maturity).
5/ Profits are before taxes and extraordinary items.
6/ Non-interest expenditure from fees, commissions, provisions, and depreciation (i.e., excluding general and administrative expenses).
7/ Gross income is net interest income plus non-interest income.
8/ Non-interest expense including general and administrative costs.

# Annex I. Containing the Public Wage Bill and Transfers in Kosovo

## Past Increases in the Public Wage Bill

**Significant increases of public wages before elections are a repeated occurrence in Kosovo**. Prior to the 2011 elections, the government raised base wages by 50 percent, resulting in an increase of the total wage bill of around 27 percent. In 2014, again prior to elections, the government implemented across-the-board salary increases of 25 percent. In addition, social pensions were increased by 25 percent. In part because of these measures, current spending is projected to grow by close to 4 percent of GDP between 2013 and 2015 on an annualized basis.

**In Kosovo, the political incentives of governments to increase wages in pre-election periods are especially strong**. First, given that the central and local governments provide almost a quarter of all formal jobs, a large share of voters directly benefit from wage increases. Second, there are many voters that benefit indirectly. With unemployment rates exceeding 30 percent and relatively low labor market participation rates (around 60 percent of the working age population is economically inactive), the employment-to-working age population ratio is only 28 percent. This suggests that in Kosovo, one or even several voters depend on the income of each employee in the public sector.

**To a lesser extent, increased hiring in pre-election periods has also pushed up the wage bill**. Between January 2010 and November 2014, the increase in overall employment by the central and local governments amounted to around 5,100 staff, with 85 percent of this increase hired during the 11 months prior to the 2010 and 2014 elections. In fairness, the increase partly reflects the creation of new institutions and the transfer of competencies to the authorities.

**Increases in the public wage bill undermine long-run growth prospects and policy credibility**. First, spending on public wages narrows fiscal space as it comes at the expense of growth-friendly spending. Second, public wage increases spillover to the private sector, further undermining competitiveness. Third, high public wages make it hard for the private sector to attract talent, as the government offers both greater job security and, currently, slightly higher wages. Finally, unchecked public wage bill increases put compliance with the fiscal rule and the authorities' credibility at risk.

## Policy Options to Contain Wage Increases in the Future

**In principle, two complementary institutional remedies may prevent significant wage increases in Kosovo**. First, budgetary procedures could be changed to make it harder for the government to increase public wages by executive fiat. Second, a rules-based framework could determine ceilings for public sector wage increases. Ideally, both remedies would be combined.

**The law on public financial management and accountability could be modified to wrestle wage decisions away from the government and entrust them to parliament**. The law allows for reallocation of spending within certain limits during the fiscal year and without approval of the parliament.[1] In principle, such provisions are useful, if overspending in one area due to unforeseen and external circumstances can be financed by unforeseen under-spending in other areas. However, this regulation has been abused; in 2014, the government used such reallocations to accommodate higher than budgeted wage increases. The law could be amended so that reallocations for wages, salaries and benefits are not allowed without Assembly approval. This would make any public sector wage increase more 'democratic' and transparent. The drawback is that, prior to elections, parties are unlikely to oppose large wage increases in parliament. In other words, this mechanism might not prevent large pre-election relaxations, although it would force a parliamentary debate and vote.

**With respect to rules-based frameworks, other countries have applied wage caps and indexation**. Several mechanisms are summarized in Table 1. In Bosnia and Herzegovina, public sector wages are tied to lagged economy-wide wages, whereas Moldova applies a simple CPI-based index for low public sector wages. However, there is no obvious model for Kosovo: in an ideal world, public sector wage growth would be tied to public sector labor productivity—which Kosovo is impossible to measure due to data constraints—while still taking into account private sector wages.

## Table 1. Select International Approaches to Wage Indexation

| Country | Description |
|---|---|
| Australia | Allocations for public wages are based on a standard model that adjusts the budget by an index that measures the general price increases and pay increases in the wider labor market and deducts a standardized efficiency dividend amounting to 1.25 percent of the wage bill of most government agencies. |
| Bahrain | 3 percent base increment plus individual performance related awards. |
| Barbados | Indexed to CPI and real GDP growth. |
| Belgium | Indexed to adjusted CPI (excludes cigarettes, alcohol, and fuel prices). |
| Bosnia and Herzegovina | Indexed to economy-wide wages from two years before. |
| Latvia | Only for judges, indexation to average earning from two years before. |
| Luxembourg | Indexed to CPI, suspended in 2007 and reintroduced in 2010. |
| Moldova | Monthly indexation. Salaries up to two minimum wages are indexed to CPI. |
| Panama | Indexed to basic food basket, with the basket revised every two years. |

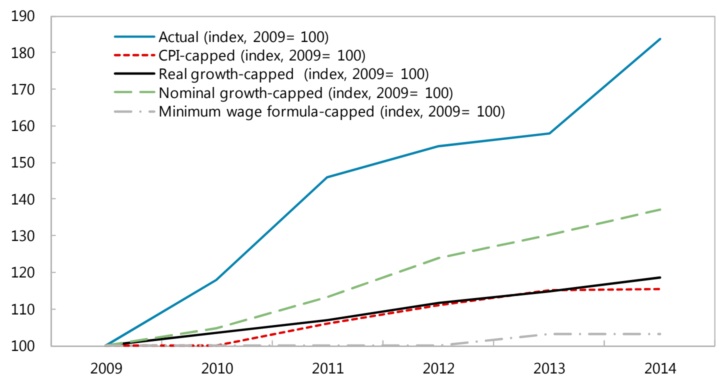
Sources: Note on Best Practice in Determining Public Sector Wage Increases; Annex to the General Note on Indexation of Public Sector Wages; and IMF staff compilation.

[1] See Article 30 of Law No. 05/L-048 on public financial management and accountability.

**Wage indexation has, however, a number of disadvantages**. First, wage indexation limits the ability of the government to use fiscal policy for macroeconomic management. For instance, under inflation indexation, the public sector wage bill increases at a time when fiscal restraint may be needed. Second, indexation may potentially lock in undesirable public sector wage levels and structures, reducing the public sector's capacity to address these inefficiencies.

**While recognizing these drawbacks, rules-based mechanisms have a big advantage: to prevent the 'explosion' of the public sector wage bill**. Despite data limitations in Kosovo, there are at least four possibilities for rules-based mechanisms in Kosovo. Wages could be tied to: (i) inflation to account for changes in cost of living; (ii) real growth as an imperfect proxy of labor productivity; (iii) nominal growth as a proxy for changes in the cost of living and labor productivity; else (iv) wages could be changed based on the formula used for the minimum wage in Kosovo. These mechanisms provide a cap on wage increases, but do not imply automatic wage increases. Had the rules been in place over 2009–14, any of these mechanisms would have implied significantly lower growth of the public wage bill than was actually observed. Applying the rule governing minimum wages to public sector wages would have implied the lowest increase of the public sector wage bill, as wage increases would have only occurred in one year.

**Actual vs. simulated increases of the public wage bill under alternative rules-based mechanisms**




Source: Kosovo authorities; and IMF staff estimates.

## Conclusions

**In Kosovo, public sector wage increases in the recent past have been excessively large, entailing adverse economic consequences**. Amending the law on public financial management to require parliamentary approval for wage (and benefits) decisions could help to prevent this. Implementation would be easier than a more complex and time-consuming rules-based framework. This option would also strengthen the budget process. However, requiring parliamentary approval without a rules-based framework makes large wage increases more difficult but far from impossible.

**By contrast, a rules-based framework provides detailed prescriptions for adjustments of public wages and should be considered in Kosovo**. Any rules-based mechanism that is feasible in practice has severe drawbacks; in a setting with moderate wage increases, such mechanisms should therefore be refrained from. However, in Kosovo, where public sector wage increases have been very large, the benefits of preventing similar occurrences in the future outweigh these drawbacks. Similar rules-based frameworks could be used to cap spending on social assistance.

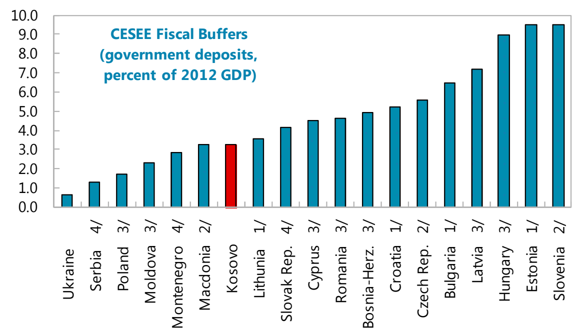
# Annex II. Liquidity Buffers and Reserve Adequacy in a Euroized Country

*Considering Kosovo is a unilaterally euroized economy, we look at reserves for BOP purposes and also at reserves for fiscal financing and for bank emergency liquidity assistance (ELA). Kosovo has sufficient reserves to deal with bank liquidity and overall BOP shocks, but not fiscal financing shocks.*

## A. Fiscal Reserves

**Fiscal reserves are defined here as funds needed to allow spending to continue in the temporary absence of debt issuance in case markets are closed or too expensive to access**.

**Cross country experience is not particularly informative about an appropriate target size for Kosovo's fiscal reserves**. Only government deposits—not fiscal reserves—can be readily observed, and they vary widely. This is because government deposits can serve as budget buffers but also bank backstops; there are also substantial differences in central bank liquidity availability.




1/ for end-2011; 2/ for March 2012; 3/ for April 2012; 4/ for May 2012
Source: IMF Staff esitmates.

**A target for Kosovo's fiscal reserves should relate to revenue and spending levels**. A useful rule of thumb for the minimum size of fiscal reserves is one month of spending. In Kosovo, this would imply a buffer of around €150 million (2.7 percent of GDP) for spending, including debt service. Such a buffer would allow the government to finance itself for about 5 months without debt issuance. This appears sufficient to guard against shocks in the relatively new domestic debt market. Permanently maintaining higher fiscal reserves than suggested by the rule of thumb to guard against surprises would be unnecessarily costly.

**Actual fiscal reserves are significantly below the benchmark of €150 million**. Excluding funds earmarked for bank ELA which are not usable by the government, end-2014 fiscal reserves were just €55 million. This exceeded day-to-day working balances (€50 million) by only a small margin.

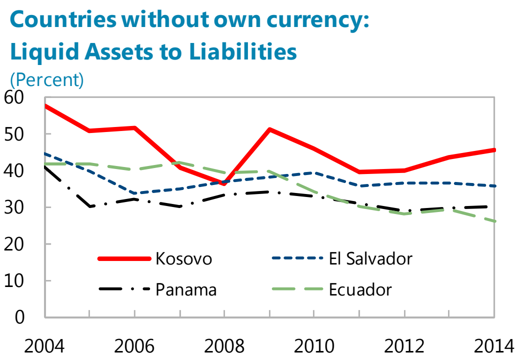
## B. Bank ELA Reserves

**The CBK's ability to provide liquidity assistance is constrained**. The CBK cannot print money to provide ELA and its capacity to lower required reserves (currently set at 10 percent of deposits) to inject liquidity is limited and there may be banks whose liquidity needs exceed the reduction in their required reserves and would have difficulty getting external funding. The CBK would need to borrow from liquid banks in the system, from abroad, or use the reserves that have been designated for ELA to provide that liquidity support. However, the first two options are not fully under the CBK's control and so its ability to provide liquidity support is dependent on its ELA reserves.

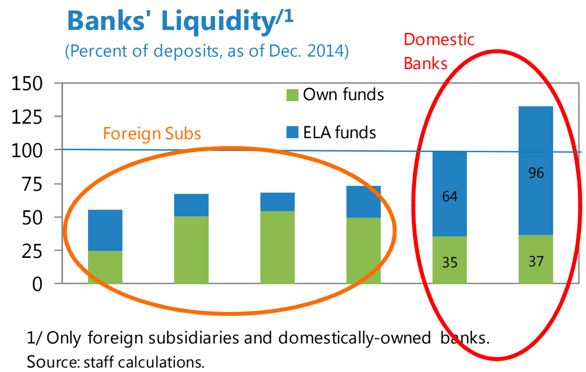
**The banks are currently very liquid, which militate against risks**. The first line of defense against liquidity shocks are banks' own liquid assets, which in Kosovo currently average around 48 percent of short-term liabilities (38 percent for domestic banks). This is quite high compared to other "fully dollarized" countries, where liquid assets to liabilities for the system range from 26 percent in Ecuador to 36 percent in El Salvador. While banks may become less liquid in the future, it should be noted that Kosovo imposes a high minimum liquid asset ratio of 25 percent.

**At this stage, ELA reserves appear more than adequate**. ELA reserves are comprised of CBK capital and the Treasury's deposit in the special reserve fund (SRF) for ELA and amounts to around €99 million.[1] For the two domestic banks, own liquid assets and ELA funds are near or above 100 percent of deposits of each bank, and they cover close to 80 percent of the combined deposits of both banks. Hence the ELA buffer would be more than sufficient to withstand a very severe funding shock in the domestic banks. Moreover, ELA reserves plus banks' own buffers now cover more than 50 percent of total deposits in any of the large foreign subsidiaries. This is notwithstanding the fact that these subsidiaries would be expected to receive support from their parents when liquidity needs arise, and to this end the central bank is commendably seeking letters of comfort from the parents.

[1] Withdrawals of 20 percent of term deposits and 40 percent of demand deposits would be considered a very severe funding shock (Schmieder et al, 2013). Currently, such withdrawals would imply a decline of 30 percent of domestic banks' combined deposits.

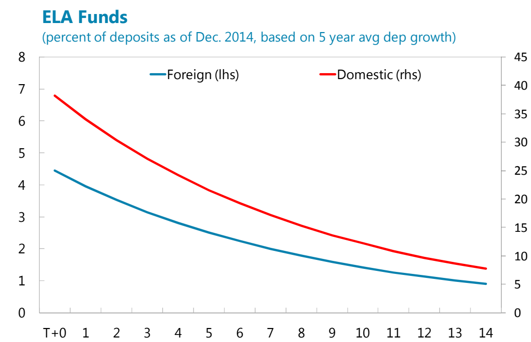



Source: IMF Monetary and Financial Statistics.




1/ Only foreign subsidiaries and domestically-owned banks.
Source: staff calculations.

**Coverage of existing ELA funds will decline over time**. The funds available for ELA are essentially fixed in nominal terms and so ELA coverage of deposits will decline as banks' liabilities grow over time. For this reason, the 2012 FSAP recommended that banks contribute funds for ELA, in line with deposit growth. While this is not an immediate concern, the authorities should consider how they might bolster deposit coverage in the medium term. This could be in the form of a fee or premium, or a liquid asset contribution. However, the former would tax banks' profits while the latter would potentially impose an opportunity cost on already liquid banks.




Sources: Central Bank of Kosovo and staff estimates.

**Because of this, the central bank could consider in the future pooling a portion of required reserves**. This would allow it to increase the funds under its control for ELA without increasing the contribution from the government or taxing already liquid banks. In case of a liquidity shock, there may be some banks that have excess funds but are unwilling to lend to illiquid banks. In such a case, the CBK could pool a portion of banks' required reserves and on-lend to solvent banks in need of liquidity assistance. Pooling even 1 percentage point of banks' 10 percent required reserve ratio would increase ELA liquidity coverage from 38 percent to 45 percent of domestic banks' combined deposits. This would cover 75 percent of the largest domestic bank's deposits and 112 percent of the other domestic bank.[2]

[2] Assuming the bank had been at the minimum required liquidity ratio, funds under control of the CBK would be sufficient to cover 100 percent of the largest domestic bank's short-term liabilities.

**To deal with extreme systemic shocks affecting all banks, however, the CBK would need to consider a larger fund or external support**. In the extreme case that all banks need liquidity support—for instance, a euro area-wide shock that prevents parent banks from supporting subsidiaries in Kosovo occurring at the same time as a domestic liquidity shock—there is little or no scope for pooling funds from within the banking system. As a "fourth line of defense" (after banks' own liquidity, parent bank support, and ELA reserves), the CBK would need either a larger contribution from the government, external support, or have established an ex-ante fund (or secured a contingent credit line) via fees or premiums.

## C. International Reserve Adequacy (RA)

**A country's RA has usually been assessed by the capacity to prevent and mitigate external shocks**. RA metrics usually encompass risks resulting from shocks to the current and capital accounts. The former consists of shocks to external demand or terms of trade while the latter includes external liabilities shocks or capital flight. The following components of the balance of payments might be considered as sources of risk:

- *Export revenues* (X) are a good approximation of potential losses arising from a negative external demand or terms of trade shock. Other external financing inflows, such as remittance, foreign aid or FDI might also reflect drains resulting from a deterioration in the external environment.

- *External short-term debt* (STD) and other external medium and long-term liabilities (OPL) indicate losses associated with the ability of foreigners to liquidate positions during periods of stress.

- *Liquid domestic assets*—measured by M2—capture losses from domestic capital outflows.

**Despite the absence of currency risk, euroized economies like Kosovo still need to deal with pressure stemming from financial obligations and external shocks**. This is particularly true when shocks might require liquidity that cannot be domestically generated. Moreover, euroized economies might also want to preserve buffers to mitigate the impact of external shocks on domestic absorption.

**Therefore, traditional RA metrics may still be used as a benchmark for these countries**. The main formula for pegs/dollarized economies in the latest Fund guidance on assessing reserve adequacy[3] is as follows:

$$RA = 10\%X + 30\%STD + 20\%OPL + 10\%M2^{4} \qquad (1).$$

- *Export revenue*. Potential export losses can be substantial. Kosovo's reliance on remittances suggests that the RA metric should be supplemented by this source of risk. Therefore, a 10 percent weight on total export-related plus remittances (R)[5] is used in this note.

- *Short-term debt and other liabilities*. Drains resulting from short-term debt and other liabilities have been important during past stress episodes. A euroized economy might also need liquidity buffers to cope with financial obligations to non-residents and mitigate the risk of liquidity and funding shocks. Therefore, *short-term external private debt*[6] supplements the amount of *short-term external public debt amortization* in the RA metrics with an unchanged 30 percent weight. A 20 percent weight on *other external liabilities*[7] is used as in the traditional metric.

- *Domestic liquid assets*. To account for the risk of domestic capital outflows, *total deposits* (D) are included in the RA metric. However, given that in a dollarized economy the central bank has no lender of last resort capabilities, we increase the weight from 10 percent to 20 percent here.

**The adjusted RA metric for Kosovo shows that gross international reserves are adequate**. Our alternative, more conservative metric:

[3] See IMF Policy Paper, "Assessing Reserve Adequacy—Specific Proposals."

[4] The metric is a simple sum of potential losses based on countries with fixed exchange rate regime experiences during the past stress episodes. Weights correspond to the value of an extreme (10th percentile) drain during the stress events.

[5] A 10 percent weight might seem excessive given the stability of remittance inflow. It would allow, however, to capture additional risks stemming from informal remittance inflows.

[6] Short-term external private debt covers short-term financial liabilities of deposit-taking corporations and other sectors reported in the international investment positions (IIP) statistics. Short-term external public debt consists exclusively of the next year amortization.

[7] Other external liabilities include medium and long-term financial (debt and equity) liabilities of general government and other sectors on the remaining maturity reported in the IIP statistics.

$$RA = 10\%(X+R) + 30\%STD + 20\%OPL + 20\%D \qquad (2),$$

puts Kosovo's projected reserve needs at about 12 percent of GDP at end-2014. Therefore, gross international reserves of about 18 percent of GDP (149 percent of the metric) remain comfortable.

## D. Conclusion

**Kosovo appears to have sufficient reserves to deal with bank liquidity and overall BOP shocks, but not shocks to fiscal financing**. The government should over-finance the deficit as much as markets will allow, to rebuild cash buffers to safe levels. Maintaining prudent ELA and BOP buffers requires continued effort, but this could also have the benefit of reducing the probability or severity of domestic and external shocks on output and welfare.

| **Type of Reserve** (shocks) | **Actual Reserves** (End-2014, unless otherwise noted) | | **Adequate Reserves** | |
|---|---|---|---|---|
| | (Euro millions) | (percent of GDP) | (Euro millions) | (percent of GDP) |
| Fiscal (closure of domestic securities market) | 55 | 1.0 | 150 | 2.9 |
| ELA (runs on domestic banks) 1/ | 98.5 | 1.8 | 8.5 | 0.2 |
| Gross international reserves (decline in BOP inflows and/or increase in outflows) 2/ | 994.6 | 18.1 | 668.2 | 12.1 |

1/ The adequate level of reserves for ELA is calculated as the funds needed in case of a very severe bank run (i.e., 40 percent of demand and savings deposits, and 20 percent of time deposits) on both domestic banks simultaneously, assuming banks are at their minimum liquidity ratio of 25 percent of short-term deposits. Data are as of December 2014.

2/ This definition of reserves corresponds to total official reserve assets reported to GDSS. It is the sum of foreign exchange assets plus SDRs plus the reserve position at the IMF minus the deposits of the privatization agency and pension funds, which are not under the control of the CBK or government.

# Annex III. Risk Matrix[1]

| | Risk | Likelihood | Impact | Recommended Policy |
|---|---|---|---|---|
| Downside Risks | ***Short Term***: **Further energy disruptions**: The two power plants are being repaired after recent accidents, but new accidents cannot be excluded given the plants' age. | **Medium** | **Medium** Additional power cuts will further disrupt economic activity, even if scheduled. | Should disruptions require electricity distributor to import electricity from the region, any additional costs from these imports should be passed-through to avoid quasi-fiscal costs. |
| | ***Medium Term***: **Protracted period of slower growth in the euro area**: Lower-than-anticipated potential growth and persistently low inflation from a failure to fully address crisis legacies, leading to secular stagnation and lower commodity prices. | **High** | **Medium** Lower than expected growth in the euro area and/or Switzerland would dent consumption and investment in Kosovo, given the role played by remittances from Kosovar Diaspora living abroad. | Limited room for short-term cyclical policies. Structural reforms, together with a budget geared towards productive spending, would be the best line of defense, even if the benefits would materialize only gradually. |
| Upside Risks | ***Short Term***: **Greater than expected impact on consumption from the 2014 wage and benefit increases**: Impact has been subdued so far, but this could be due to the June–December political crisis which is now resolved. | **Medium** | **High** | Any additional tax revenues should be saved to help with consolidation. |
| | ***Medium Term***: **Government implements its ambitious reform agenda**, in particular concluding a deal on the new energy plant, improving active labor market policies, and decisively tackling corruption. | **Low-Medium** | **Low (short term) – High (medium/long term)** | |

[1] The Risk Assessment Matrix (RAM) shows events that could materially alter the baseline path (the scenario most likely to materialize in the view of IMF staff). The relative likelihood is the staff's subjective assessment of the risks surrounding the baseline ("low" is meant to indicate a probability below 10 percent, "medium" a probability between 10 and 30 percent, and "high" a probability between 30 and 50 percent). The RAM reflects staff views on the source of risks and overall level of concern as of the time of discussions with the authorities. Non-mutually exclusive risks may interact and materialize jointly.

# Annex IV. Debt Sustainability Analysis

## Kosovo Public Sector Debt Sustainability Analysis (DSA) - Baseline Scenario

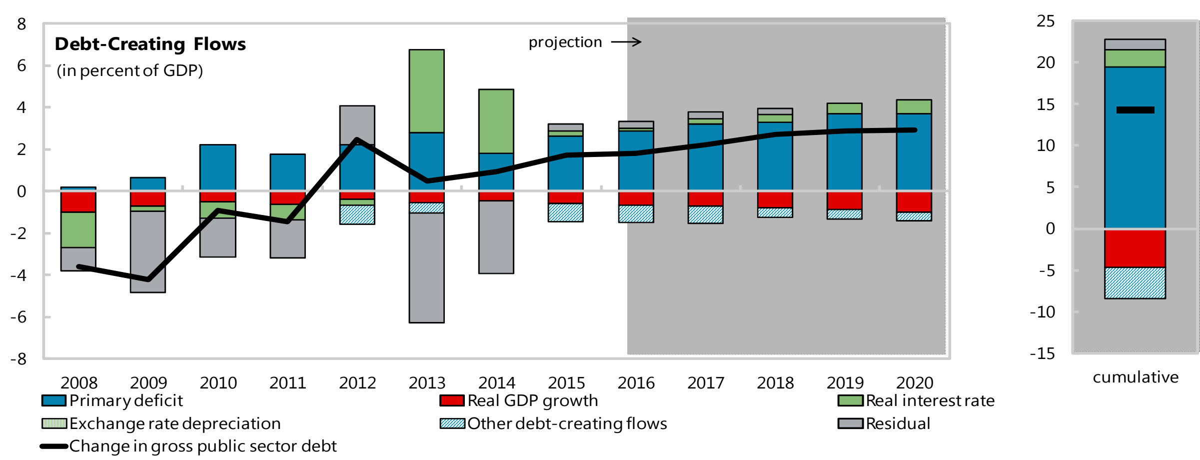
(in percent of GDP unless otherwise indicated)

### Debt, Economic and Market Indicators [1/]

| | Actual | | | Projections | | | | | | As of February 12, 2015 | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | 2008-2012 [2/] | 2013 | 2014 | 2015 | 2016 | 2017 | 2018 | 2019 | 2020 | Sovereign Spreads | | |
| Nominal gross public debt | 17.2 | 17.6 | 18.5 | 20.2 | 22.1 | 24.3 | 27.0 | 29.9 | 32.8 | EMBIG (bp) 3/ | | 276 |
| Public gross financing needs | 2.0 | 7.6 | 5.7 | 5.7 | 7.1 | 9.1 | 10.2 | 11.2 | 12.4 | 5Y CDS (bp) | | 258 |
| Real GDP growth (in percent) | 3.7 | 3.4 | 2.7 | 3.3 | 3.5 | 3.5 | 3.5 | 3.5 | 3.5 | Ratings | Foreign | Local |
| Inflation (GDP deflator, in percent) | 4.0 | 1.8 | 0.6 | 0.4 | 1.6 | 1.7 | 2.0 | 2.1 | 2.2 | Moody's | n.a. | n.a. |
| Nominal GDP growth (in percent) | 7.9 | 5.3 | 3.4 | 3.7 | 5.1 | 5.3 | 5.5 | 5.7 | 5.8 | S&Ps | n.a. | n.a. |
| Effective interest rate (in percent) [4/] | 0.0 | 0.1 | 0.3 | 1.7 | 2.3 | 2.9 | 3.6 | 4.1 | 4.6 | Fitch | n.a. | n.a. |

### Contribution to Changes in Public Debt

| | Actual | | | Projections | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|
| | 2008-2012 | 2013 | 2014 | 2015 | 2016 | 2017 | 2018 | 2019 | 2020 | cumulative | debt-stabilizing |
| Change in gross public sector debt | -1.5 | 0.5 | 0.9 | 1.7 | 1.8 | 2.2 | 2.7 | 2.9 | 2.9 | 14.3 | primary |
| Identified debt-creating flows | 0.5 | 5.7 | 4.4 | 1.4 | 1.5 | 1.9 | 2.4 | 2.9 | 2.9 | 13.0 | balance [9/] |
| Primary deficit | 2.0 | 2.8 | 1.8 | 2.6 | 2.9 | 3.2 | 3.3 | 3.7 | 3.7 | 19.4 | -0.8 |
| Primary (noninterest) revenue and gra | 26.6 | 24.6 | 24.2 | 25.8 | 25.7 | 25.4 | 25.4 | 25.4 | 25.4 | 153.2 | |
| Primary (noninterest) expenditure | 27.9 | 27.4 | 26.0 | 28.5 | 28.6 | 28.6 | 28.7 | 29.1 | 29.1 | 172.6 | |
| Automatic debt dynamics [5/] | -1.4 | 3.4 | 2.6 | -0.4 | -0.5 | -0.5 | -0.5 | -0.4 | -0.3 | -2.6 | |
| Interest rate/growth differential [6/] | -1.4 | 3.4 | 2.6 | -0.4 | -0.5 | -0.5 | -0.5 | -0.4 | -0.3 | -2.6 | |
| Of which: real interest rate | -0.7 | 4.0 | 3.1 | 0.2 | 0.1 | 0.2 | 0.4 | 0.5 | 0.6 | 2.1 | |
| Of which: real GDP growth | -0.7 | -0.5 | -0.5 | -0.6 | -0.7 | -0.7 | -0.8 | -0.9 | -1.0 | -4.7 | |
| Exchange rate depreciation [7/] | 0.0 | 0.0 | 0.0 | … | … | … | … | … | … | … | |
| Other identified debt-creating flows | -0.2 | -0.5 | 0.0 | -0.9 | -0.8 | -0.8 | -0.4 | -0.4 | -0.4 | -3.8 | |
| Privatization revenues (negative) | -0.2 | -0.5 | 0.0 | -0.9 | -0.8 | -0.8 | -0.4 | -0.4 | -0.4 | -3.8 | |
| Contingent liabilities | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | |
| Residual, including asset changes [8/] | -1.4 | -5.2 | -3.5 | 0.4 | 0.3 | 0.3 | 0.3 | 0.0 | 0.0 | 1.3 | |




Source: IMF staff.

1/ Public sector is defined as general government.

2/ Based on available data.

3/ Long-term bond spread over German bonds.

4/ Defined as interest payments divided by debt stock (excluding guarantees) at the end of previous year.

5/ Derived as $[(r - \pi(1+g) - g + ae(1+r)]/(1+g+\pi+g\pi))$ times previous period debt ratio, with r = interest rate; $\pi$ = growth rate of GDP deflator; g = real GDP growth rate; a = share of foreign-currency denominated debt; and e = nominal exchange rate depreciation (measured by increase in local currency value of U.S. dollar).

6/ The real interest rate contribution is derived from the numerator in footnote 5 as $r - \pi(1+g)$ and the real growth contribution as -g.

7/ The exchange rate contribution is derived from the numerator in footnote 5 as $ae(1+r)$.

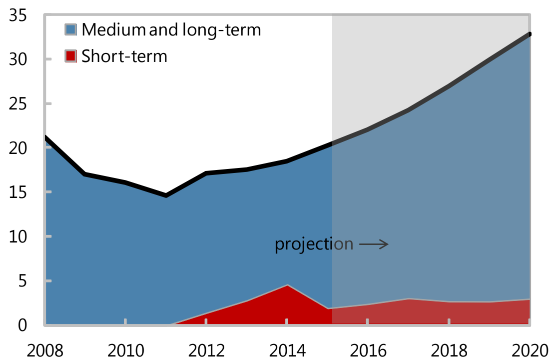
8/ Includes asset changes and interest revenues (if any). For projections, includes exchange rate changes during the projection period.

9/ Assumes that key variables (real GDP growth, real interest rate, and other identified debt-creating flows) remain at the level of the last projection year.

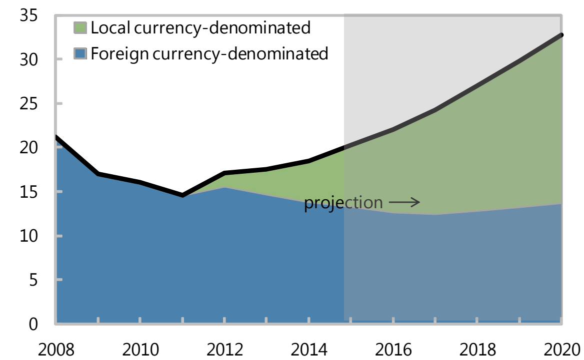
## Kosovo Public DSA – Composition of Public Debt and Alternative Scenarios

### Composition of Public Debt

**By Maturity**
(in percent of GDP)



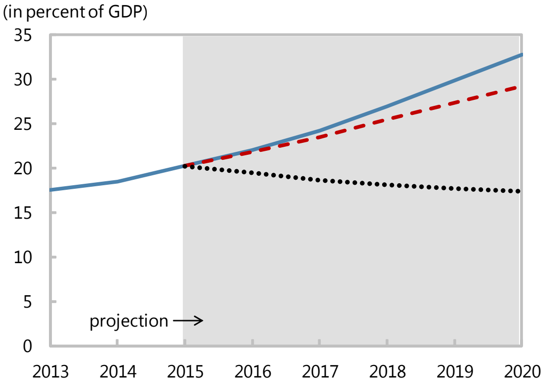

**By Currency**
(in percent of GDP)



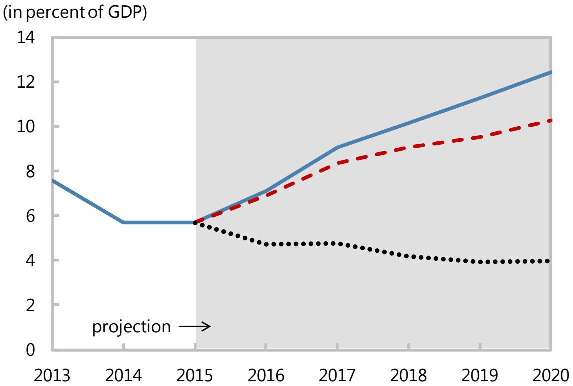

### Alternative Scenarios

Baseline    Historical    Constant Primary Balance

**Gross Nominal Public Debt**
(in percent of GDP)




**Public Gross Financing Needs**
(in percent of GDP)



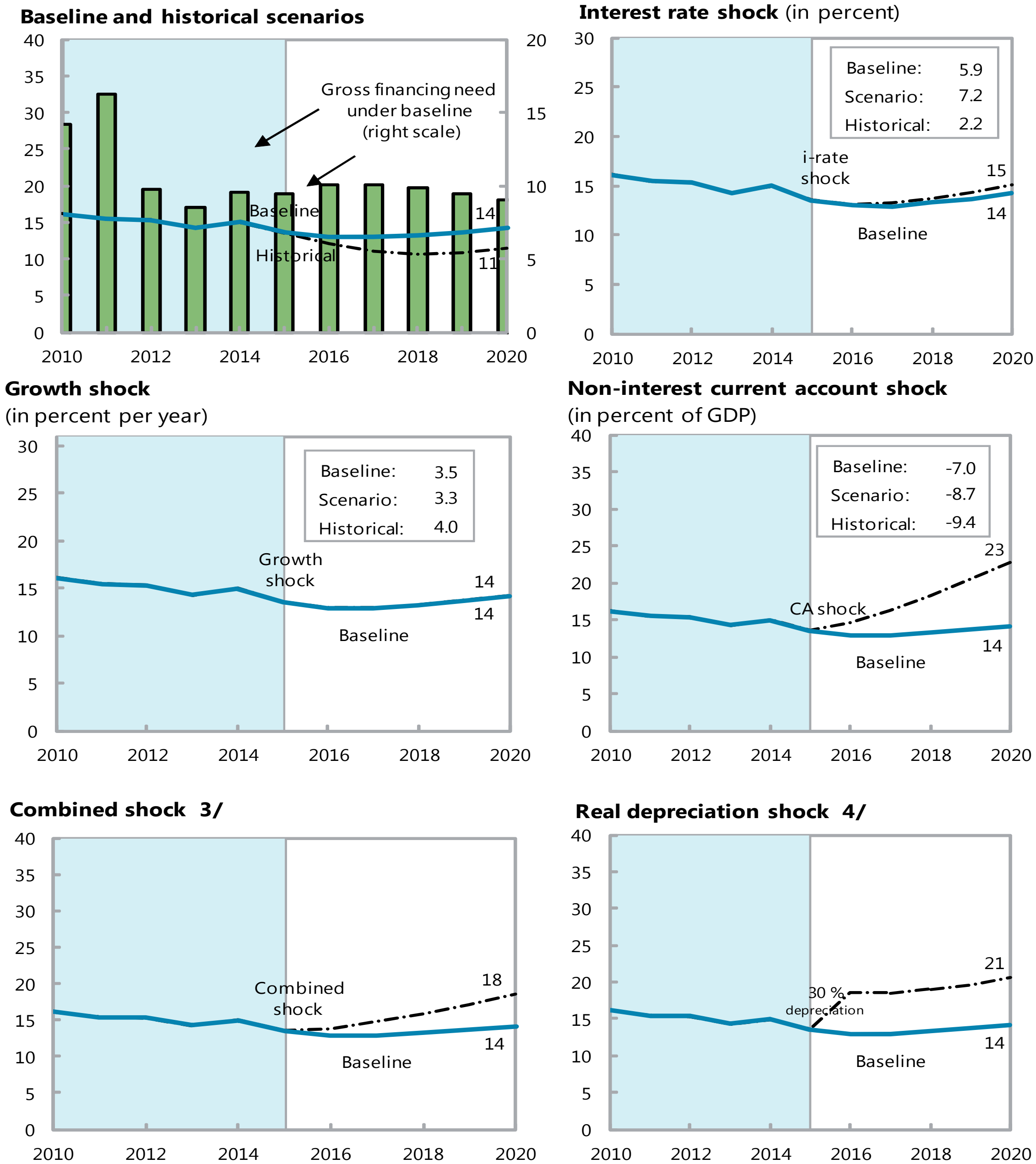

### Underlying Assumptions
(in percent)

| Baseline Scenario | 2015 | 2016 | 2017 | 2018 | 2019 | 2020 |
|---|---|---|---|---|---|---|
| Real GDP growth | 3.3 | 3.5 | 3.5 | 3.5 | 3.5 | 3.5 |
| Inflation | 0.4 | 1.6 | 1.7 | 2.0 | 2.1 | 2.2 |
| Primary Balance | -2.6 | -2.9 | -3.2 | -3.3 | -3.7 | -3.7 |
| Effective interest rate | 1.7 | 2.3 | 2.9 | 3.6 | 4.1 | 4.6 |
| **Constant Primary Balance Scenario** | | | | | | |
| Real GDP growth | 3.3 | 3.5 | 3.5 | 3.5 | 3.5 | 3.5 |
| Inflation | 0.4 | 1.6 | 1.7 | 2.0 | 2.1 | 2.2 |
| Primary Balance | -2.6 | -2.6 | -2.6 | -2.6 | -2.6 | -2.6 |
| Effective interest rate | 1.7 | 2.3 | 2.9 | 3.6 | 4.2 | 4.7 |

| Historical Scenario | 2015 | 2016 | 2017 | 2018 | 2019 | 2020 |
|---|---|---|---|---|---|---|
| Real GDP growth | 3.3 | 4.0 | 4.0 | 4.0 | 4.0 | 4.0 |
| Inflation | 0.4 | 1.6 | 1.7 | 2.0 | 2.1 | 2.2 |
| Primary Balance | -2.6 | -0.5 | -0.5 | -0.5 | -0.5 | -0.5 |
| Effective interest rate | 1.7 | 2.3 | 2.0 | 2.5 | 3.1 | 3.8 |

Source: IMF staff.

## Figure 1. Kosovo: External Debt Sustainability: Bound Tests 1/ 2/




Sources: International Monetary Fund, Country desk data, and staff estimates.

1/ Shaded areas represent actual data. Individual shocks are permanent one-half standard deviation shocks. Figures in the boxes represent average projections for the respective variables in the baseline and scenario being presented. Ten-year historical average for the variable is also shown.

2/ For historical scenarios, the historical averages are calculated over the ten-year period, and the information is used to project debt dynamics five years ahead.

3/ Permanent 1/4 standard deviation shocks applied to real interest rate, growth rate, and current account balance.

## Table 1: Kosovo: External Debt Sustainability Framework, 2010–20

(in percent of GDP, unless otherwise indicated)

| | Actual | | | | | | | Projections | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | 2010 | 2011 | 2012 | 2013 | 2014 | | | 2015 | 2016 | 2017 | 2018 | 2019 | 2020 | | Debt-stabilizing non-interest current account 6/ |
| **Baseline: External debt** | 16.1 | 15.4 | 15.3 | 14.3 | 15.0 | | | **13.5** | **12.9** | **12.9** | **13.3** | **13.7** | **14.2** | | -4.5 |
| Change in external debt | -0.1 | -0.7 | -0.1 | -1.0 | 0.7 | | | -1.4 | -0.6 | 0.0 | 0.3 | 0.4 | 0.5 | 0.0 | |
| Identified external debt-creating flows (4+8+9) | 2.3 | 5.1 | 1.4 | 1.6 | 2.2 | | | 2.3 | 3.0 | 3.1 | 3.0 | 2.6 | 2.1 | 0.0 | |
| Current account deficit, excluding interest payments | 11.3 | 13.3 | 7.1 | 5.9 | 6.6 | | | 6.8 | 6.9 | 7.0 | 7.4 | 7.0 | 6.6 | 4.5 | |
| Deficit in balance of goods and services | 35.6 | 37.2 | 34.2 | 31.6 | 31.8 | | | 32.0 | 32.0 | 31.8 | 31.6 | 31.6 | 31.5 | | |
| Exports | 19.9 | 19.6 | 18.3 | 17.4 | 17.3 | | | 16.8 | 16.4 | 16.0 | 15.7 | 15.5 | 15.3 | | |
| Imports | 55.5 | 56.8 | 52.4 | 49.0 | 49.1 | | | 48.8 | 48.4 | 47.8 | 47.4 | 47.1 | 46.9 | | |
| Net non-debt creating capital inflows (negative) | -7.5 | -7.9 | -4.2 | -4.5 | -4.5 | | | -4.5 | -4.5 | -4.5 | -4.5 | -4.5 | -4.5 | -4.5 | |
| Automatic debt dynamics 1/ | -1.6 | -0.2 | -1.5 | 0.2 | 0.1 | | | 0.1 | 0.7 | 0.6 | 0.1 | 0.1 | 0.1 | 0.1 | |
| Contribution from nominal interest rate | 0.4 | 0.4 | 0.4 | 0.4 | 0.6 | | | 0.5 | 1.1 | 1.0 | 0.5 | 0.5 | 0.5 | 0.7 | |
| Contribution from real GDP growth | -0.5 | -0.7 | -0.4 | -0.5 | -0.4 | | | -0.4 | -0.5 | -0.4 | -0.4 | -0.4 | -0.5 | -0.5 | |
| Contribution from price and exchange rate changes 2/ | -1.5 | 0.0 | -1.5 | 0.2 | -0.1 | | | ... | ... | ... | ... | ... | ... | -0.1 | |
| Residual, incl. change in gross foreign assets (2-3) 3/ | -2.4 | -5.8 | -1.5 | -2.6 | -1.5 | | | -3.8 | -3.7 | -3.1 | -2.7 | -2.2 | -1.7 | 0.0 | |
| External debt-to-exports ratio (in percent) | 80.9 | 78.7 | 83.9 | 82.0 | 86.5 | | | 80.7 | 79.0 | 80.6 | 84.3 | 88.3 | 92.4 | | |
| **Gross external financing need (in billions of US dollars) 4/** | 471.0 | 560.8 | 384.7 | 342.1 | 393.0 | | | 439.2 | 488.8 | 508.6 | 521.8 | 520.0 | 518.5 | | |
| in percent of GDP | 14.2 | 16.2 | 9.8 | 8.5 | 9.5 | 10-Year | 10-Year | 9.4 | 10.0 | 10.0 | 9.8 | 9.4 | 9.0 | | |
| **Scenario with key variables at their historical averages 5/** | | | | | | | | **13.5** | **12.0** | **11.1** | **10.7** | **10.8** | **11.4** | | -7.4 |
| **Key Macroeconomic Assumptions Underlying Baseline** | | | | | | Historical Average | Standard Deviation | | | | | | | For debt stabilization | |
| Real GDP growth (in percent) | 3.3 | 4.4 | 2.8 | 3.4 | 2.7 | 4.0 | 1.6 | 3.3 | 3.5 | 3.5 | 3.5 | 3.5 | 3.5 | 3.5 | |
| GDP deflator in US dollars (change in percent) | 9.9 | -0.1 | 10.6 | -1.4 | 0.5 | 1.9 | 5.4 | 8.9 | 0.9 | 0.8 | 0.8 | 0.8 | 0.9 | 0.9 | |
| Nominal external interest rate (in percent) | 2.5 | 2.7 | 3.0 | 2.9 | 4.1 | 2.2 | 1.3 | 4.1 | 8.6 | 8.3 | 4.1 | 4.4 | 4.9 | 4.9 | |
| Growth of exports (US dollar terms, in percent) | 32.6 | 2.5 | 6.0 | -2.9 | 2.7 | 11.8 | 13.6 | 9.1 | 1.9 | 2.1 | 2.4 | 2.8 | 3.2 | | |
| Growth of imports (US dollar terms, in percent) | 21.3 | 6.8 | 4.9 | -4.7 | 3.4 | 7.0 | 6.7 | 11.9 | 3.5 | 3.1 | 3.3 | 3.8 | 3.9 | | |
| Current account balance, excluding interest payments | -11.3 | -13.3 | -7.1 | -5.9 | -6.6 | -9.4 | 3.3 | -6.8 | -6.9 | -7.0 | -7.4 | -7.0 | -6.6 | | |
| Net non-debt creating capital inflows | 7.5 | 7.9 | 4.2 | 4.5 | 4.5 | 7.0 | 2.8 | 4.5 | 4.5 | 4.5 | 4.5 | 4.5 | 4.5 | | |

1/ Derived as [r - g - r(1+g) + ea(1+r)]/(1+g+r+gr) times previous period debt stock, with r = nominal effective interest rate on external debt; r = change in domestic GDP deflator in US dollar terms, g = real GDP growth rate, e = nominal appreciation (increase in dollar value of domestic currency), and a = share of domestic-currency denominated debt in total external debt.

2/ The contribution from price and exchange rate changes is defined as [-r(1+g) + ea(1+r)]/(1+g+r+gr) times previous period debt stock. r increases with an appreciating domestic currency (e > 0) and rising inflation (based on GDP deflator).

3/ For projection, line includes the impact of price and exchange rate changes.

4/ Defined as current account deficit, plus amortization on medium- and long-term debt, plus short-term debt at end of previous period.

5/ The key variables include real GDP growth; nominal interest rate; dollar deflator growth; and both non-interest current account and non-debt inflows in percent of GDP.

6/ Long-run, constant balance that stabilizes the debt ratio assuming that key variables (real GDP growth, nominal interest rate, dollar deflator growth, and non-debt inflows in percent of GDP) remain at their levels of the last projection year.

# Annex V. Status of 2013 Article IV Recommendations

| | 2013 Article IV Recommendations | Status |
|---|---|---|
| Fiscal policy | • Preserve—within a rule-based framework—a sustainable fiscal stance while addressing pressing social and investment needs.<br>• Maintain adequate level of government bank balances at the central bank.<br>• Adapt progressively tax structure toward domestic production. | **Partial Compliance**<br>• Deficits remain moderate and public debt low.<br>• A fiscal rule was adopted as of 2014, and the rule's 2 percent ceiling met last year.<br>• However, large spending commitments made over 2014 will make it hard to comply with the fiscal rule's ceiling in 2015 and beyond.<br>• Cash buffers have been substantially eroded and are below prudent levels. |
| Financial sector | • Strengthen regulatory and supervisory environments.<br>• Strengthen the financial safety net.<br>• Develop macroprudential policy framework. | **Good compliance**<br>• The CBK has been progressively moving toward risk-based supervision. Full adoption is expected this year or early next year.<br>• The CBK is in the plans of adopting a new legal framework for ELA that is, by and large, in line with best practice. Letters of comfort from parent banks of local subsidiaries are being sought.<br>• A macroprudential framework is being developed, but it is at an early stage. |
| Growth and Competitiveness | • Business climate.<br>• Investment in infrastructure and education.<br>• Regional integration.<br>• Preserving flexibility of labor market. | **Broad Compliance**<br>• Progress has been made to improve the business climate in a number of areas, but actual implementation is sometimes lacking.<br>• The new public sector procurement law is a good step to providing a more level and transparent playing field.<br>• Construction of highway R7 to Albania was completed in 2013 and that of R6 to Macedonia started in 2014.<br>• Education spending has declined as a share of GDP.<br>• A trade agreement with Turkey is expected to come on stream in 2016 and negotiations for a Stabilization and Association Agreement with the EU are ongoing. |

# Annex VI. Status of 2012 FSAP Key Recommendations

| 2012 FSAP Recommendations | Status |
|---|---|
| **Short Term (within 12 months of FSAP):** | |
| • Subject ELA granted to potentially insolvent systematically important institutions to very strict conditions. | • CBK took steps to operationalize this understanding, including by modifying the tripartite MOU on financial stability cooperation to clarify the responsibilities of the CBK and MOF in ELA. A draft ELA framework has been finalized that includes sufficiently strict collateral conditions. |
| • DIL should raise the DIFK target level to 8-9 percent of insured deposits and should only introduce higher deposit coverage as the fund increases. It should also clarify that all past and future contributions made by the government and KfW can be used to repay insured deposits. Banks' premiums should not be reduced or discontinued. | • In January 2013, DIFK set a working range of the DIF to 8–9 percent.<br>• Legislation was passed clarifying that contributions by the government and KfW can be used to repay insured deposits.<br>• The DIL has been amended so that bank premiums should not be reduced or discontinued. |
| • Amend the Banking Law to address the identified shortcomings in the bank resolution framework and obstacles to competition and development of the MFI sector. | • The CBK issued an opinion that the resolution framework should be defined only by the Banking Law and not through regulation and/or instruction. As such, the Banking Law has not been amended yet. However, amendments to the manual for the bank resolution framework are in the process of being drafted with IMF TA support with regard to procedures for liquidation, P&A, and administration.<br>• An MFI law has been drafted that prohibits non-profit MFIs from raising public funding for lending activities, but obstacles to competition for the microfinance sector remain. |
| • Reinstate Solvency I for all insurers; establish an investment regulation for life and non-life companies for their own surplus and reserves, as well as mandatory annual actuarial audit of provisions by a certified actuary; and retain two in-house actuaries. | • Draft regulation has been completed that would reinstate the Solvency I framework.<br>• Draft regulations on investments for life and non-life companies have been drafted.<br>• The draft law on insurance stipulates mandatory annual actuarial audit of provisions. |

| **Medium Term (within one to three years of FSAP):** | |
|---|---|
| • Institute a bank premium to fund ELA needs. | • The authorities consider a bank premium unnecessary at this time given ELA's ample coverage of domestic bank deposits and letters of support from foreign subsidiaries' parent banks that the CBK is in the process of obtaining. The authorities acknowledge that ELA reserves' deposit coverage could decline over time and have discussed future possibilities for bank contributions to ELA reserves if/when necessary. |
| • Put in place extraordinary funding arrangements for the DIFK.<br>• Adopt a legal framework for crisis management, contingency plans, and perform crisis simulations. | • DIFK concluded a loan agreement with the EBRD in September 2014 for a €10 million line of credit.<br>• The authorities are compiling an action plan for various aspects of IMF TA recommendations (Crisis Preparedness and Coordination, ELA, bank resolution, deposit insurance, and crisis management). The authorities have created a Crisis Prevention Committee, which includes an MOU for guidance, although it is largely informal and does not meet regularly. The authorities recently carried out a crisis simulation with the assistance of the World Bank. |
| • Revise the AML/CFT legislation to address its technical weaknesses. | • Although Kosovo's AML/CFT regime was partially assessed by the Project against Economic Crime (PECK), a joint initiative of the Council of Europe and the EU, the country should undergo a comprehensive AML/CFT assessment under the 2012 FATF standard. The CBK's AML/CFT unit now reports directly to a deputy governor and staff resources have been increased. The authorities are working on new draft legislation that will criminalize terrorist financing, improve statistics, and make AML/CFT issues a component of CBK supervision. |
| • Introduce risk-based supervision with attention to those risks resulting from systemic banks and their relation with their parent banks and groups, and enhance further the supervisory capacity of the CBK. | • The CBK's Bank Supervision Department has received extensive IMF TA over 2014–15 that has helped to gradually move it closer to risk-based supervision, bring regulations more in line with international standards, and enhance its staff's supervisory capacity. |

| | |
|---|---|
| • Enhance the stress testing framework to include macro scenario analysis as well as models specifying macrofinancial linkages. | • The CBK has made progress on enhancing its stress testing framework, including with the help of IMF TA since 2013. Stress tests now include interbank exposure and deposit concentration, and CBK staff is working to build macrofinancial linkages into their models. |
| • Develop and implement macroprudential policy using quantifiable indicators and policy instruments. | • The CBK has established a Macroprudential Policy Committee (MPC) that will monitor liquidity and conduct analysis, report and make recommendations to the CBK quarterly, and develop macroprudential tools. However, this is still in the early stages. |

INTERNATIONAL MONETARY FUND

# REPUBLIC OF KOSOVO

May 5, 2015

## STAFF REPORT FOR THE 2015 ARTICLE IV CONSULTATION—INFORMATIONAL ANNEX

Prepared By

The European Department
(in consultation with other departments and the World Bank)

## CONTENTS

# FUND RELATIONS

(As of March 31, 2015)

**Membership Status**:
Joined: June 29, 2009

| **General Resources Account**: | **SDR Million** | **Percent Quota** |
|---|---|---|
| Quota | 59.00 | 100.00 |
| Fund holdings of currency | 127.75 | 216.52 |
| Reserve Tranche Position | 14.17 | 24.01 |

| **SDR Department**: | **SDR Million** | **Percent Allocation** |
|---|---|---|
| Net cumulative allocation | 55.37 | 100.00 |
| Holdings | 52.12 | 94.13 |

| **Outstanding Purchases and Loans**: | **SDR Million** | **Percent Quota** |
|---|---|---|
| Stand-By Arrangements | 82.91 | 140.52 |

**Latest Financial Arrangements**:

| **Type** | **Date of Arrangement** | **Expiration Date** | **Amount Approved (SDR Million)** | **Amount Drawn (SDR Million)** |
|---|---|---|---|---|
| Stand-By | April 27, 2012 | December 26, 2013 | 90.97 | 78.22 |
| Stand-By | July 21, 2010 | January 20, 2012 | 92.66 | 18.76 |

**Projected Payments to Fund**[1]
(SDR Million; based on existing use of resources and present holdings of SDRs):

| | Forthcoming | | | | |
|---|---|---|---|---|---|
| | 2015 | 2016 | 2017 | 2018 | 2019 |
| Principal | 10.64 | 39.11 | 33.16 | | |
| Charges/Interest | 0.63 | 0.62 | 0.21 | 0.01 | 0.00 |
| Total | 11.28 | 39.72 | 33.37 | 0.01 | 0.00 |

**Implementation of HIPC Initiative**: **Not Applicable**

**Implementation of Multilateral Debt Relief Initiative (MDRI)**: **Not Applicable**

[1] When a member has overdue financial obligations outstanding for more than three months, the amount of such arrears will be shown in this section.

### Safeguards Assessments

The latest safeguards assessment of the Central Bank of the Republic of Kosovo (CBK) was completed in June 2012. It concluded that the majority of previous safeguards recommendations had been implemented. In particular, Audit Committee oversight has been strengthened and the Internal Audit Department has taken important steps towards full compliance with international standards.

### Exchange Arrangements

Kosovo does not issue a currency of its own, but uses the euro as legal means of payment. Kosovo is not part of the euro area and the CBK is not part of the European System of Central Banks. There are no restrictions on payments and transfers for current international transactions, or measures that would give rise to multiple currency practices. Kosovo is an Article XIV member. The authorities are considering whether to accept the obligations under Article VIII, but have yet to reach a decision.

### Previous Article IV Consultation

Kosovo was on a 24-month cycle during the previous Stand-By Arrangement. The last Article IV consultation was concluded on July 23, 2013. Going forward, it is expected that Kosovo will be on a 12-month cycle.

### FSAP and ROSC Participation

An FSAP mission was conducted during September 19–October 2, 2012. The FSSA included the ROSC for compliance with Basel Core Principles. Kosovo has not had a data or a fiscal transparency ROSC.

### Technical Assistance

Since 1999, the Fund has provided technical assistance and policy advice to UNMIK and, since September 2008, to Kosovo. Technical assistance has centered on the Fund's core competencies, notably in the areas of fiscal policy, the banking and payments systems, and macroeconomic statistics. Assistance has also contributed to developing key aspects of the legal and institutional framework needed for a market economy. More recently, TA has been provided on the following issues:

### Real Sector

- National Accounts Statistics (June, August–September, December 2013; April, September 2014; March 2015)
- Price Statistics (December 2013)

**Fiscal Sector**

- Tax Administration (February, April, October, December 2014; January 2015)
- Tax Compliance (March 2014)
- Government Finance Statistics (December 2014)

**Monetary and Financial Sectors**

- Contingency Planning for Crisis Preparedness and Management (September 2013)
- Risk-Based Supervision (January, March, April–May, July 2014; January 2015)
- Bank Intervention and Resolution (February–March 2014)

**Resident Representative**

Mr. Lakwijk took up his post on September 1, 2014.

# JOINT IMF-WORLD BANK MANAGEMENT ACTION PLAN

| Title | Products | Provisional Timing of Missions | Expected Delivery Date |
|---|---|---|---|
| 1. Fund work program | Staff Article IV visit | March 19–30, 2015 | May 15, 2015 |
| | TA on customs administration | April 14–27, 2015 | |
| | TA on risk-based supervision | April 22–May 12, 2015 | |
| | TA on tax administration | May 5–19, 2015 | |
| | TA on contingency planning and crisis management | July 1–12, 2105 | |
| | TA on government finance statistics | September 2015, January 2016 | |
| | TA on public financial management | To be determined | |

| | | | |
|---|---|---|---|
| 2. Bank work program | Kosovo Systematic Country Diagnostics | June 2015 | June 2015 |
| | Kosovo Energy PSIA | June 2015 | June 2015 |
| | Feasibility Study for Protection of Iber-Lepenc canal | April 2015 | April 2015 |
| | Strengthening Waste Management | May 2015 | May 2015 |
| | Employment Impact Study | May 2015 | May 2015 |
| | Growth and Shared Prosperity Report | ------ | June 2016 |
| | Diversifying Kosovo's Export and Product | October 2015 | October 2015 |
| | Efficient Infrastructure Sharing for Kosovo | ------- | November 2015 |
| | Innovative and Green Growth | ------- | December 2015 |
| | Public Sector Modernization Project (PSMP) | June 2015 | ongoing |
| | Real Estate and Cadaster Project | May 2015 | ongoing |
| | Clean-Up and Land Reclamation Project | April 2015 | June 2015 |
| | Agriculture and Rural Development Project | September 2015 | ongoing |
| | Financial Sector Strengthening and Market Infrastructure | September 2015 | ongoing |

# STATISTICAL ISSUES

| I. Assessment of Data Adequacy for Surveillance |
|---|
| **General**: Data provision is adequate for surveillance and for program monitoring. Performance criteria can be tested with accuracy. However, the statistical system still suffers from considerable shortages of financial and human resources. |
| **National Accounts**: Improvements have been made to the national accounts, but significant weaknesses remain. The quality and timeliness of annual nominal and real GDP data based on the expenditure approach has been improved and data is now published in an excel format on the web-site of the Kosovo Statistical Agency, but with a large lag. GDP data based on the production approach are available, but publication lags are long. Quarterly GDP data have begun to be published but improvements in methodology are required. Kosovo needs to improve existing and develop additional high-frequency (monthly) indicators, with priority given to indicators relevant to Kosovo's economy such as wholesale and retail trade data and services. |
| **Labor Markets**: Reliable labor force data is challenging given the large share of the informal economy. A household survey was first undertaken in early 2012 and has been published semiannually since, most recently in November 2014. |
| **Consumer Price Index**: A monthly Consumer Price Index (CPI) has been produced since 2002 and is published on a monthly basis (with a lag of 13 days). The index uses a Classification of Individual Consumption according to Purpose (COICOP)-compatible item classification with 352 elementary aggregates. A new index was introduced in December 2014, with new weights largely based on National Accounts data aimed at bringing the CPI more in line with the European Harmonized Index of Consumer Prices (HICP). It targets all products and services purchased by all households (resident and non-resident) in Kosovo. HICPs are available from January 2015 onward, with CPI available from May 2002 through November 2014. |
| **Government Finance Statistics**: Monthly reports on budget execution of the general government (central government and municipalities) on a cash basis are provided five weeks after the end of each month. However, budget classification is not consistent with GFSM 2001 because: (i) data is on cash basis, not accrual; (ii) lending for policy purposes (similar to subsidies) is included after calculating the primary balance; (iii) capital transfers should be included in current expenditure instead of capital expenditure; (iv) memorandum of understanding (MOU) should be properly classified depending on their final purpose; (v) annual budget documents should specify both current and capital spending related to individual projects. Monitoring of domestic arrears should be strengthened. |

| | |
|---|---|
| **Financial Sector Data**: Depository corporations (commercial banks and central bank) statistics starting as of December 2000 are published on monthly basis (with a lag of 25 days). Other financial corporations' statistics, starting as of June 2004, are published on quarterly basis (with a lag of 35 days). Data are broadly consistent with the IMF's *Monetary and Financial Statistics Manual (MFSM), 2000*. Due to difficulties with obtaining adequate source data needed for estimation of Euro currency in circulation, the CBK ceased compiling monetary aggregates in 2006. Financial soundness indicators are compiled according to the *Compilation Guide on Financial Soundness Indicators (FSI), 2007*, and available through STA FSI (starting with July 2010 data). Staff and other resources are currently sufficient. | |
| **External Sector Statistics**: CBK provides quarterly balance of payments data. Recently, CBK has revised its BOP data reflecting improvements in measurement of exports of services, remittances, and currency in circulation among other items. These revisions are now reflected in the data we report. Moreover, CBK has recently discontinued publishing trade data, which is now the responsibility of the Statistical Office of Kosovo (SOK). The latter data is available on a monthly basis. In October 2012, Kosovo started reporting quarterly IIP data to STA. Overall, the accuracy, periodicity, and timeliness of balance of payments statistics have improved due to authorities' efforts and with technical assistance from STA. | |
| **II. Data Standards and Quality** | |
| Participant in the General Data Dissemination (GDDS) since April 2011. | Kosovo has not had a Data ROSC. |

## Kosovo—Table of Common Indicators Required for Surveillance

(As of April 13, 2015)

| | Date of Latest Observation | Date Received | Frequency of Data[7] | Frequency of Reporting[7] | Frequency of Publication[7] |
|---|---|---|---|---|---|
| Exchange Rates | N/A | N/A | D | D | D |
| International Reserve Assets and Reserve Liabilities of the Monetary Authorities[1] | | | M | M | M |
| Reserve/Base Money | N/A | N/A | N/A | N/A | N/A |
| Broad Money | 02/28/2016 | 04/21/2015 | M | M | M |
| Central Bank Balance Sheet | 02/28/2016 | 04/21/2015 | M | M | M |
| Consolidated Balance Sheet of the Banking System | 02/28/2016 | 04/21/2015 | M | M | M |
| Interest Rates[2] | 02/28/2013 | 04/21/2013 | M | M | Q |
| Consumer Price Index | 02/28/2015 | 04/01/2013 | M | M | M |
| Revenue, Expenditure, Balance and Composition of Financing[3]—General Government[4] | 02/28/2015 | 04/01/2015 | M | M | M |
| Revenue, Expenditure, Balance and Composition of Financing[3]—Central Government | 02/28/2015 | 04/01/2015 | M | M | M |
| Stocks of Central Government and Central Government-Guaranteed Debt[5] | 12/31/2015 | 04/14/2015 | Q | Q | Q |
| External Current Account Balance | 12/31/2014 | 04/01/2015 | Q | Q | Q |
| Exports and Imports of Goods[8] | 02/28/2015 | 04/01/2015 | M | M | M |
| GDP/GNP[9] | 06/30/2014 | 02/26/2015 | Q | Q | Q |
| Gross External Debt | 12/31/2014 | 04/01/2015 | Q | Q | Q |
| International Investment Position[6] | 12/31/2014 | 04/01/2015 | Q | Q | Q |

[1] Includes reserve assets pledged or otherwise encumbered as well as net derivative positions.
[2] Both market-based and officially-determined, including discount rates, money market rates, rates on treasury bills, notes and bonds.
[3] Foreign, domestic bank, and domestic nonbank financing.
[4] The general government consists of the central government (budgetary funds, extra budgetary funds, and social security funds) and state and local governments.
[5] Including currency and maturity composition.
[6] Includes external gross financial asset and liability positions vis-à-vis nonresidents.
[7] Daily (D), weekly (W), monthly (M), quarterly (Q), annually (A), irregular (I), and not available (NA).
[8] Services data available on annual basis.
[9] GNDI data not available.

Press Release No. 15/234
FOR IMMEDIATE RELEASE
May 21, 2015

International Monetary Fund
700 19th Street, NW
Washington, D. C. 20431 USA

**IMF Executive Board Concludes 2015 Article IV Consultation with the Republic of Kosovo**

On May 20, 2015, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation[1] with Kosovo.

Growth in Kosovo has proven relatively resilient and stronger than in its Western Balkan neighbors, averaging slightly more than 3 percent over the last five years. Steady remittances from the Diaspora living in Advanced Europe continue to be a key driver of growth, supporting as they have private consumption and investment. Nonetheless, medium-term growth prospects of some 3½ percent per year, while reasonable, are not strong enough to steadily lift incomes towards regional standards, or to create enough jobs in a country with very high unemployment.

Kosovo continues to enjoy a low public debt, and last year's deficit complied with the fiscal rule's limit. However, promises made in the run up to the general elections could push this year's deficit above the limit. Moreover, the composition of the budget has worsened considerably, with unproductive current spending crowding out spending on infrastructure, education, and health.

Kosovo's banks remain liquid, well capitalized, and profitable. NPL ratios are slightly elevated at 8.4 percent, but are stable and fully provisioned. The central bank has made commendable progress in strengthening bank supervision as well as the framework for emergency liquidity assistance. However, there are obstacles to the provision of credit, despite high levels of liquidity in the banks. In particular, inefficient court proceedings on bank cases contribute to high interest margins and high collateral requirements. High levels of informality also deter credit provision via the concomitant lack of reliable financial statements.

Kosovo's productive and export capacity is low at present owing to the country's significant wage and non-wage competitiveness gap. The former is related to unsustainable wage pressures in the public sector, which make it difficult for the private sector to attract talent. The latter

[1] Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. A staff team visits the country, collects economic and financial information, and discusses with officials the country's economic developments and policies. On return to headquarters, the staff prepares a report, which forms the basis for discussion by the Executive Board.

involves a looming energy deficit, limited access to and quality of education and vocational training, and remaining issues in the business environment, including perceptions of corruption.

**Executive Board Assessment**[2]

Executive Directors welcomed the resilient performance of Kosovo’s economy, driven by private consumption and investment on the back of strong remittances. Meanwhile, low energy prices and developments in the euro area have kept inflation low. Directors noted, however, that the growing fiscal deficit and competitiveness gap weigh on medium-term prospects for growth, employment, and income convergence with neighboring countries. They stressed that strong policy action, including fiscal adjustment and broad based structural reforms, is critical to address these challenges in the period ahead.

Directors called on the authorities to preserve fiscal credibility and gradually strengthen buffers. Following last year’s large wage and benefit increases, they welcomed the initial steps taken this year to contain fiscal overruns. Directors agreed that additional measures would be needed to bring the 2015 deficit closer to the ceiling under the fiscal rule. They saw scope for further mobilizing revenues, particularly the value added tax. Directors also recommended improving the composition of the budget by containing increases in unproductive current spending, so as to create space for spending in priority areas such as infrastructure, education, and health care. They welcomed the authorities’ plan to develop a rules based mechanism for public wage setting consistent with productivity gains, and pointed to the benefits of a broader reform of the civil service. Directors also saw merit in revisiting the investment clause in the fiscal rule to allow for externally financed development projects, while preserving Kosovo’s good debt position.

Directors noted that Kosovo’s banking sector is generally healthy and well capitalized. They commended the authorities for the progress in strengthening the supervisory and regulatory framework, especially the adoption of risk based supervision. Continued efforts are necessary to further enhance the frameworks for emergency liquidity assistance, macroprudential policies, and crisis management. Directors also saw a need to improve access to credit and facilitate financial intermediation, supported by a more efficient judicial system.

Directors underscored that raising potential growth and improving labor participation and productivity remain key priorities for the country. They called on the authorities to expedite structural reforms in several areas to boost competitiveness and help spur private sector development and job creation. Specifically, Directors encouraged further steps to modernize energy infrastructure, address high labor costs, and improve education. Enhanced efforts are also

[2] At the conclusion of the discussion, the Managing Director, as Chairman of the Board, summarizes the views of Executive Directors, and this summary is transmitted to the country's authorities. An explanation of any qualifiers used in summings up can be found here: http://www.imf.org/external/np/sec/misc/qualifiers.htm.

needed to strengthen governance and the business environment more broadly. Directors welcomed the authorities' intention to remain closely engaged with the Fund, including through a possible new arrangement to help anchor their ambitious policy and reform agenda.

## Table 1. Kosovo: Main Indicators, 2010–20

(Percent, unless otherwise indicated)

| | 2010 | 2011 | 2012 | 2013 | 2014 | 2015 | 2016 | 2017 | 2018 | 2019 | 2020 |
|---|---|---|---|---|---|---|---|---|---|---|---|
| | | | | | Est. | | | Projections | | | |
| Real growth rates | | | | | | | | | | | |
| GDP | 3.3 | 4.4 | 2.8 | 3.4 | 2.7 | 3.3 | 3.5 | 3.5 | 3.5 | 3.5 | 3.5 |
| Consumption | 3.7 | 3.7 | 2.6 | 2.2 | 3.9 | 3.2 | 3.3 | 3.4 | 3.4 | 3.4 | 3.4 |
| Investment | 10.9 | 7.9 | -12.9 | -0.3 | 0.9 | 5.1 | 3.4 | 3.4 | 3.5 | 3.5 | 3.5 |
| Exports | 12.5 | 3.3 | 0.5 | 2.5 | 1.9 | 3.6 | 1.5 | 1.9 | 2.3 | 2.7 | 3.1 |
| Imports | 9.1 | 3.5 | -7.7 | -1.5 | 3.9 | 4.2 | 3.5 | 3.0 | 3.5 | 3.9 | 4.4 |
| Official unemployment (percent of workforce) | … | … | 30.9 | 30.0 1/ | … | … | … | … | … | … | … |
| Price changes | | | | | | | | | | | |
| CPI, period average | 3.5 | 7.3 | 2.5 | 1.8 | 0.4 | 0.3 | 1.4 | 1.6 | 1.8 | 1.9 | 1.8 |
| CPI, end of period | 6.6 | 3.6 | 3.7 | 0.5 | -0.4 | 1.5 | 1.5 | 1.8 | 1.9 | 2.0 | 2.2 |
| Import prices | 5.9 | 8.2 | 4.9 | 0.0 | -0.4 | -1.0 | 0.7 | 1.0 | 1.0 | 1.1 | 0.9 |
| GDP deflator | 4.7 | 4.8 | 2.2 | 1.8 | 0.6 | 0.4 | 1.6 | 1.7 | 2.0 | 2.1 | 2.2 |
| Real effective exch. rate (average; -=depreciation) | -0.8 | 3.4 | -0.7 | 0.0 | 1.6 | … | … | … | … | … | … |
| Real effective exch. rate (end of period; -=depreciation) | 0.8 | 0.8 | 0.6 | -1.1 | 7.2 | … | … | … | … | … | … |
| General government budget (percent of GDP) | | | | | | | | | | | |
| Revenues, incl. interest income | 26.4 | 27.1 | 26.1 | 24.6 | 24.2 | 25.8 | 25.7 | 25.4 | 25.4 | 25.4 | 25.4 |
| Primary expenditures | 28.7 | 28.7 | 28.5 | 27.6 | 26.6 | 29.3 | 29.3 | 29.3 | 29.3 | 29.3 | 29.3 |
| Of which: Wages and salaries | 7.1 | 8.0 | 8.1 | 7.8 | 8.8 | 9.6 | 9.6 | 9.6 | 9.6 | 9.6 | 9.6 |
| Subsidies and transfers | 6.1 | 5.6 | 5.7 | 6.0 | 6.7 | 7.8 | 7.8 | 7.8 | 7.8 | 7.8 | 7.8 |
| Capital and net lending | 11.4 | 11.4 | 10.9 | 9.7 | 7.3 | 8.0 | 8.0 | 8.0 | 8.0 | 8.0 | 8.0 |
| Overall balance excluding PAK 2/ | … | … | -2.4 | -3.0 | -2.5 | -3.6 | -3.7 | -4.2 | -4.3 | -4.4 | -4.5 |
| Debt financing, net | 0.4 | 0.0 | 3.1 | 1.3 | 1.6 | 1.9 | 1.3 | 1.6 | 2.2 | 2.2 | 2.2 |
| Privatization | 0.0 | 0.0 | 0.9 | 0.5 | 0.0 | 0.9 | 0.8 | 0.8 | 0.4 | 0.4 | 0.4 |
| Stock of government bank balances | 5.5 | 3.3 | 4.3 | 3.0 | 1.8 | 1.5 | 1.5 | 1.5 | 1.5 | 1.5 | 1.5 |
| Balance of Payments (percent of GDP) | | | | | | | | | | | |
| Current account balance, incl. official transfers | -11.7 | -13.7 | -7.5 | -6.4 | -7.1 | -7.3 | -8.0 | -8.0 | -7.9 | -7.5 | -7.2 |
| *Of which*: official transfers 3/ | 7.3 | 6.7 | 7.9 | 6.4 | 5.1 | 4.8 | 3.9 | 3.6 | 3.3 | 3.2 | 3.2 |
| Capital and financial account | 6.8 | 8.7 | 2.8 | 3.1 | 5.3 | 5.7 | 6.7 | 6.9 | 6.9 | 6.7 | 6.5 |
| Of which: Net foreign direct investment | 7.5 | 7.9 | 4.2 | 4.5 | 4.5 | 4.5 | 4.5 | 4.5 | 4.5 | 4.5 | 4.5 |
| Portfolio investment, net | -1.1 | -1.2 | -3.7 | -2.5 | -2.8 | -2.0 | -0.8 | -0.7 | -0.6 | -0.5 | -1.1 |
| Errors and Omissions | 4.9 | 5.0 | 4.7 | 3.2 | 1.8 | 1.6 | 1.3 | 1.2 | 1.0 | 0.8 | 0.7 |
| Savings-investment balances (percent of GDP) | | | | | | | | | | | |
| Domestic savings | -1.2 | -2.7 | -5.0 | -4.1 | -5.1 | -4.9 | -5.2 | -5.4 | -5.7 | -6.1 | -6.6 |
| National savings | 15.4 | 14.1 | 13.7 | 14.7 | 14.5 | 15.2 | 15.2 | 15.3 | 15.5 | 15.8 | 15.9 |
| Investment | 34.3 | 34.5 | 29.2 | 27.5 | 26.8 | 27.3 | 27.1 | 26.9 | 26.7 | 26.5 | 26.2 |
| Current account, excl. official transfers | -19.0 | -20.4 | -15.4 | -12.8 | -12.3 | -12.1 | -11.9 | -11.6 | -11.2 | -10.7 | -10.3 |
| Non-performing loans (percent of total loans) | 5.2 | 5.7 | 7.5 | 8.7 | 8.5 | … | … | … | … | … | … |
| Bank credit to the private sector | 12.6 | 14.7 | 4.5 | 2.7 | 3.9 | 4.0 | 5.3 | 5.5 | 5.9 | 6.1 | 6.2 |
| Deposits of the private sector | 23.1 | 11.4 | 10.9 | 8.0 | 7.2 | 6.2 | 7.2 | 7.4 | 7.7 | 7.8 | 8.0 |
| Regulatory capital/risk weighted assets | 18.8 | 17.6 | 14.4 | 16.8 | 17.8 | … | … | … | … | … | … |
| *Memorandum items* | | | | | | | | | | | |
| Total public debt (percent of GDP) 4/ | 16.1 | 14.6 | 17.1 | 17.6 | 18.5 | 20.3 | 22.2 | 24.6 | 27.1 | 29.6 | 32.1 |
| GDP (millions of euros) | 4402 | 4815 | 5059 | 5327 | 5506 | 5712 | 6004 | 6322 | 6671 | 7048 | 7459 |
| GDP per capita (euros) | 2480 | 2672 | 2799 | 2935 | 2989 | 3055 | 3164 | 3282 | 3412 | 3552 | 3703 |
| GNDI per capita (euros) | 2891 | 3123 | 3323 | 3488 | 3575 | 3670 | 3811 | 3962 | 4126 | 4302 | 4489 |
| Population (thousands) 5/ | 1775 | 1802 | 1807 | 1815 | 1842 | 1870 | 1898 | 1926 | 1955 | 1984 | 2014 |

Sources: Kosovo authorities; and IMF staff estimates and projections.

Note: Forecasts are based on staff's understanding of current policies, not on a reform scenario.

1/ Data for H1 2013, as published in Kosovo Labor Force Survey, July 2014.

2/ Projected balance does not conform with the fiscal rule.

3/ Total foreign assistance excluding capital transfers.

4/ Includes former Yugoslav debt, not recognized by Kosovo.

5/ Series updated according to Kosovo Agency of Statistics (2013), Pristina, Kosovo.

**Statement by Ibrahim Halil Canakci, Executive Director for Kosovo and Mentor Mehmedi, Advisor to the Executive Director**
**May 20, 2015**

The Kosovar authorities thank staff for their cooperation and constructive discussions during the 2015 Article IV consultation mission in Prishtina. They highly value the ongoing policy dialogue with the Fund and note that the Fund's policy analysis and advice are very useful in shaping their policy agenda. They broadly agree with staff's assessment and the main challenges facing the Kosovar economy.

After six months of a political stalemate following the June 2014 parliamentary elections, a grand coalition was formed, comprising the two largest political parties plus minorities. The current reform-oriented government holds a comfortable majority in parliament and is committed to effective policymaking. A key objective of the government's policy strategy for 2015–2017 is fostering private sector-induced growth, by maintaining and further strengthening macro-financial stability, improving the business environment, and accelerating structural reforms.

Since the 2013 Article IV consultation, there have been encouraging developments in the relations with the European Union (EU). On April 30, 2015, the European Commission adopted the proposal for a Stabilisation and Association Agreement (SAA) between the EU and Kosovo. The agreement, which is expected to come into effect in 2016, is the first contractual arrangement between the EU and Kosovo, and represents an important step in Kosovo's path towards EU membership. The SAA will serve as a platform for economic, political, and administrative reforms while opening up EU markets to Kosovo's companies and products. Concrete results have also been achieved in normalizing the relations with Serbia under the EU-sponsored dialogue, which began in 2013.

## Economic developments and outlook

Kosovo continues to be the highest growth performer in the Western Balkans, with a five-year average growth rate of over 3.5 percent. Despite the uncertain political situation last year, the economy is estimated to have grown by 3 percent in 2014 on the back of increased consumption and steady remittances. The authorities are more optimistic than staff regarding the outlook. They expect growth to accelerate to 3.8 percent this year, driven mainly by consumption, remittances, and increased investments, and then to further increase to 4.4 percent annually during 2016–2018. They also project a significant growth in exports of goods as well as import substitution, following the rising activity in the agriculture sector. Low inflation will continue throughout 2015, largely owing to imported disinflation from the EU and low energy prices. Inflation is expected to hover around 0.2 percent this year, while gradually climbing to 0.5 percent in 2016.

In the medium term, a strong banking sector, remittances, public investments, improved competitiveness, and foreign direct investment (FDI) will be important pillars for Kosovo's strong growth performance.

Indeed, there are important upside risks to the baseline scenario, specifically those related to certain large-scale investment projects. Last month, the government signed an agreement with a French-led consortium for the development of the Brezovica Resort project, a year-round ski vacation destination. The agreement envisions a phased investment of EUR 409 million (approximately 8 percent of GDP), with an initial investment of EUR 165 million during the first three years. Overall, the project is expected to create over 3,000 jobs while transforming this ski resort into the largest in the Western Balkans. At the same time, the tendering process for the development of new energy production capacities and the construction of a new thermo-power plant (600 MW) is under way (the investment of the new power plant is estimated at 20 percent of GDP). Additionally, the European Bank for Reconstruction and Development has agreed in principle to finance the rehabilitation of the railway that links Kosovo to Serbia and FYR Macedonia (approximately 2 percent of GDP).

There are encouraging signs of an increase in domestic production and some import substitution. Further import substitution and the diversification of exports could reduce the large and persistent trade deficit which stands at 32 percent of GDP.

**Fiscal Policy**

The authorities remain committed to safeguarding macro-fiscal stability. The medium-term fiscal objectives are designed to preserve the credibility of the fiscal rule, which sets an overall ceiling on the general government deficit at 2 percent of GDP, and the low level of public debt.

The authorities acknowledge that the 2015 budget relies on optimistic revenue projections, and have already taken the necessary measures to generate fiscal savings and address fiscal risks. Aside from the fiscal measures already taken such as an increase in the excise tax on tobacco, alcohol, vehicles, and heavy oil, the authorities are willing to work with the Fund to find additional fiscal measures (both on the revenue and spending sides) that would bring the deficit closer to 2 percent and preserve the credibility of the fiscal rule. An increase in the VAT rate, the introduction of a differentiated rate, and other modifications to the VAT system has already been approved by the government. On the spending side, the authorities have decided to maintain public sector wages in the 2015 budget at 2014 levels, in nominal terms, and also intend to carry this forward to 2016, in order to decrease public sector wages as a percentage of GDP, and hence contribute to an improved competitiveness and attractiveness of the private sector.

Further consolidation efforts which are targeted at unproductive current spending are being considered to improve the budget structure and create more space for growth-enhancing expenditures, such as infrastructure development projects. The authorities concur with staff on the need to address unsustainable upward trends in public wages that have outpaced productivity. The government is in the process of drafting a legal framework (law on salaries) which will govern the level of wages, salaries, and allowances for all public sector employees. The reform is intended to establish a rules-based mechanism which links the country's wages to its productivity dynamics and to preserve the competitiveness of the overall economy. The reform of public wage determination processes will be done in consultation with the IMF.

Tax administration—an area in which the Fund has provided technical assistance to the authorities—is being improved in order to broaden the tax base, encourage formality, and boost revenues. The Tax Administration of Kosovo (TAK) is preparing a new corporate strategy, while the IT system is being revamped and compliance is being strengthened. At the same time, the Customs Administration is modernizing its revenue collection system in accordance with the Customs EU Blueprint Guide. In their efforts to fight the informal economy and seek efficiency gains, the authorities also plan to merge the revenue-collecting agencies in the medium term.

Taking into consideration that Kosovo has one of the lowest levels of public debt in Europe (10.4 percent of GDP) and faces significant development needs, the authorities consider the fiscal rule's provision on capital spending as too tight and constraining development. While the provision in the fiscal rule allows for privatization proceeds to finance capital spending above the 2 percent deficit ceiling, contingent upon prudent cash buffers, this provision is of limited use, as usable privatization receipts are very low at less than 1 percent of GDP and expected to decrease further. Therefore, they are insufficient to finance the necessary development projects. At the current juncture, the authorities look forward to working with the Fund to expand the investment clause in the fiscal rule in order to allow for IFI-financed projects, alongside those funded with limited privatization receipts. In view of Kosovo's large infrastructure and social needs, IFI-financed projects would provide the desirable impetus for growth and job creation.

**Financial Sector**

The Kosovar banking sector (which is dominated by banks with foreign capital) remains stable, sound, and profitable. Kosovar banks follow a traditional banking model, are well-capitalized (18.2 percent capital adequacy ratio) and continue to be some of the most profitable in the region, with a 23.2 percent return on equity. Bank lending is predominantly financed by domestic deposits with a loan-to-deposit ratio of 73.4 percent.

Banks continue to have excess liquidity. Banks' aggregate liquid assets cover almost 45 percent of short-term liabilities, a key consideration in a euroized economy such as Kosovo. Non-performing loans are stable at 8.3 percent of total loans and are well provisioned at 116 percent. Credit growth is accelerating but remains moderate given the need for the financial sector to support growth. During 2014, lending increased by

4.2 percent compared to 2013. Similarly, deposits grew by 3.6 percent. While the interest rate on loans, both to households and financial corporations, has dropped considerably to single digits, interest rate spreads still remain high.

The authorities concur with staff that high levels of liquidity in the banks can be better utilized to support growth and increase access to finance. In particular, they agree that court proceedings on bank cases need to be made more efficient and predictable, so that banks can lend without imposing high interest margins and applying high collateral requirements (over 200 percent). The authorities have taken several measures to increase the efficiency of the court system and reduce the backlog in executing court cases. A private bailiff service is fully functional, and further legal reforms aimed at addressing issues such as streamlining commercial court processes and reducing high collateral requirements are being implemented. Write-off procedures for non-performing loans (NPLs) are also being revisited to make the NPL recovery process more effective. The Central Bank of the Republic of Kosovo (CBK) has requested the Fund's assistance in this regard.

The CBK has made great progress in strengthening the regulatory framework on banking supervision and oversight. A full-fledged risk-based supervision framework is in place and on-site examinations are being executed. The authorities have implemented most of the 2012 FSAP recommendations. The CBK has drafted a new legal framework for Emergency Liquidity Assistance which is in line with best practice and governs the conditions, processes, and modalities of any emergency assistance provided to banks. As rightly noted by staff, the CBK has also requested letters of comfort from parent banks of local subsidiaries. With the aim of enhancing the collaboration with foreign bank supervisors, formal agreements of cooperation have been signed with the German and Turkish authorities (the origin of most foreign banks) and discussions with the Austrian supervisory authorities have been initiated.

The Kosovar authorities remain committed to further developing the macroprudential toolkit and strengthening the crisis management framework.

**Structural Reforms**

Structural reforms remain essential to raise potential growth, boost productivity, and improve the flexibility and competitiveness of the Kosovar economy. Among the top priorities are tackling the energy constraints, reforming the labor market and education, and fostering a business-enabling environment. The National Economic Reform Program (NERP) which provides the blueprint for structural reforms aimed at boosting growth and jobs was submitted to the European Commission in January, and its implementation will be monitored by the Prime Minister's office.

Although Kosovo has one of the most significant deposits of lignite coal in Europe and has sufficient resources to power itself, it continues to face consistent energy shortages. The two existing power plants are old and unreliable, and the production capacity is inadequate to meet current demand. With the support from the World Bank, the authorities have embarked on a broad range of reforms aimed at addressing the energy problem, thus removing one of the impediments to growth. The tendering process for building a new thermo-power plant (600 MW) is under way. An international consortium has been selected and is expected to submit its financial proposal to the Inter-Ministerial Committee in May. The construction of the new power plant, which will comply with the EU's Industrial Emmissions Directive, could begin in 18 months, creating 10,000 temporary jobs during the construction phase and 500 permanent positions once the power plant begins operations. In addition, a 400 kilovolt transmission line between Kosovo and Albania, funded by the German development bank KfW, is under construction, and will produce cost savings while enhancing the reliability of the regional energy network.

The authorities acknowledge that improvements in the labor market reforms, complemented by reforms in education are crucial in view of the high unemployment and low labor participation rates. Further efforts are being made to better match the educational system and the labor market needs, especially by modifying the curricula framework for pre-university education. At the same time, the authorities intend to expand the vocational educational system complemented by active labor market policies.

The Kosovar business environment rates relatively well in a regional context. In the last three years, Kosovo has moved up over 40 positions in the World Bank's Doing Business Report, and is now ranked 75th. While improvements have been made in starting a business and dealing with construction permits, further reforms are required in tackling constraints in getting electricity, enforcing contracts, and resolving insolvency to attract FDI and boost investment.

Lastly, with the aim of improving governance and increasing the efficiency of public spending, the authorities have drafted a new public sector procurement law, in accordance with international best practice. The new legislation, which will be followed by the implementation of the e-procurement, planned for next year, will increase the efficiency in public sector spending while eliminating discretion and reducing corruption.

**Other remarks**

The authorities recognize that while the country stands in a solid fiscal and financial position, a possible program with the IMF would further strengthen Kosovo's macro-economic framework, boost the credibility of its policies, and enhance the trust and confidence of investors in the economy. In this vein, the Kosovar authorities have requested that the IMF send a mission team to Kosovo to begin negotiations on a possible program arrangement.