INTERNATIONAL MONETARY FUND

IMF Country Report No. 222

REPUBLIC OF KOSOVO

2013 ARTICLE IV CONSULTATION

July 2013

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 2013 Article IV Consultation with the Republic of Kosovo, the following documents have been released and are included in this package:

- **Staff Report** for the 2013 Article IV Consultation, prepared by a staff team of the IMF, following discussions that ended on June 10, 2013, with the officials of the Republic of Kosovo on economic developments and policies. Based on information available at the time of these discussions, the staff report was completed on June 28, 2013. The views expressed in the staff report are those of the staff team and do not necessarily reflect the views of the Executive Board of the IMF.
- **Informational Annex**
- **Press Release** summarizing the views of the Executive Board as expressed during its July 15, 2013 discussion of the staff report that concluded the review.
- **A Statement by the Executive Director for the Republic of Kosovo**

The documents listed below have been or will be separately released.

Selected Issues Paper

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

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REPUBLIC OF KOSOVO

STAFF REPORT FOR THE 2013 ARTICLE IV CONSULTATION

June 28, 2013

KEY ISSUES

Growth and Competitiveness. Kosovo has shown considerable resilience to external turbulence, posting one of the highest growth rates in the Western Balkans during 2007–12. Resilience owes to limited financial and export linkages to crisis countries, and robust remittances and FDI inflows from the Diaspora. While these inflows support incomes and boost domestic demand, they finance mostly investment in the non-tradable sector and consumption, and contribute little to the built-up of productive capacity. Policies that could promote self-sustained growth include improvements in governance and the business climate, investments in infrastructure and education, and wage restraint.

Fiscal Sustainability. Kosovo's fiscal position is strong: the budgetary stance is sustainable, the government's cash buffers are expected to be restored by the end of this year, and public debt is low. The challenge ahead is to preserve this strength while addressing pressing social and capital spending needs. A rules-based fiscal framework would assist these efforts from 2014. Government revenue is collected mostly from VAT, excises, and trade taxes, which is adequate for now given the import-heavy, transfer-dependent nature of the economy. However, the tax structure will need to adapt as integration with the European Union advances and as the economy shifts more toward domestic production.

Financial Sector Development. The banking sector has grown rapidly in the last decade, starting from a low base. A saturation point appears to have been reached, however, and further progress will require strengthening the legal and institutional environment. Notwithstanding their fast growth, banks have avoided funding imbalances typical for many banking sectors in Central and Eastern Europe. The 2012 Financial Sector Assessment Program (FSAP) found the banking sector resilient to a wide range of shocks, including turbulence in the euro area. Commendable steps have been taken to strengthen the financial safety net.

Previous Staff Advice. In the past two years, macroeconomic policies have been conducted in the context of a Staff-Monitored Program (in 2011) and a Stand-By Arrangement (from 2012). Many recommendations from the 2011 Article IV consultation were incorporated into the programs' design. In particular, the government has restored a sustainable fiscal stance, progress has been made with the preparation and costing of spending initiatives and the financial safety net has been strengthened. Further, the authorities have taken worthy initiatives to strengthen competitiveness and enhance public infrastructure. Progress is fragile, however, and could be undone by adverse political developments.

The discussions on the 4th review under Kosovo's Stand-By Arrangement are documented in a separate report.

Approved By
Poul M. Thomsen and Dhaneshwar Ghura

Discussions were held in Pristina, May 28-June 10, 2013. The mission met with Prime Minister Hashim Thaçi, Minister of Finance Besim Beqaj, Central Bank Governor Bedri Hamza, other ministers, senior officials, private sector representatives, and envoys representing the international community. The staff team comprised Mdms. Budina, Madrid (both EUR) and Fayad (SPR), and Messrs. Wiegand (EUR, head) and Crivelli (FAD). Messrs. Sulemane (Resident Representative) and Thaçi (Economist in the Resident Representative's Office) assisted the mission. Mr. Yalvac (EOD) attended some final meetings. Ms. Le and Mr. Scott (both EUR) assisted with the preparation of the document.

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BACKGROUND

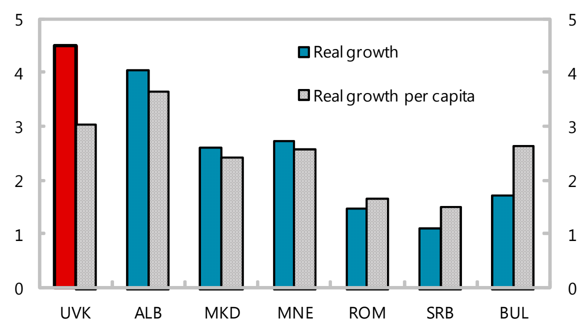
A. The Setting

1. **Since the 2011 Article IV consultations, Kosovo has taken important steps toward normalizing international relations.** The International Civilian Office overseeing Kosovo's supervised independence ended operations in 2012. In December 2012, the EBRD offered membership to Kosovo, the third large multilateral organization to do so after the World Bank and the IMF. In April 2013, Kosovo and Serbia signed a normalization agreement that includes a mutual commitment not to block one another's efforts to join the EU. Around 100 states have recognized Kosovo, up from about 70 in 2011. The domestic political environment has remained stable, albeit at times tense.

2. **Limited export and financial linkages to crisis countries have contained the impact of the euro area crisis**.

- ***Growth performance.*** Annual real GDP growth averaged 4½ percent between 2007 and 2012, despite the headwinds from the global financial crisis and euro area turbulence. With this, real growth was among the highest in the region, although real incomes were affected negatively by secular price increases for imported food stuffs and energy (Box 1).[1] At around 35 percent, unemployment remains very high, although much of it reflects arguably informal employment.

Western Balkans: Growth, 2007-12



Source: World Economic Outlook (WEO).

- ***Resilience.*** Kosovo's solid performance owes mostly to the near-absence of financial or export linkages to crisis countries, and its exposure instead to Germany and Switzerland, countries in which two-thirds of the Diaspora reside (Boxes 2, 3). Remittances and FDI from the Diaspora have held up well, and have therefore continued to support domestic demand.[2] By contrast, a robust tradable sector that could support self-sustained growth has yet to emerge.

3. **In the past two years, macroeconomic policies have been conducted in the context of a Staff-Monitored Program (in 2011) and a Stand-By Arrangement (from 2012).** Major advances

[1] High economic growth reflects also in part population growth. With a median age of 26.3 years, Kosovo's population is Europe's youngest.

[2] Kosovo arguably also benefited from the appreciation of the Swiss Franc during 2009–11 that increased the euro value of remittances from Switzerland.

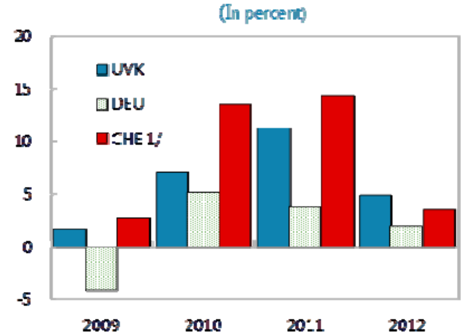
have been made in this period to restore a sustainable fiscal stance, anchor fiscal policy, improve the preparation and costing of spending initiatives, and strengthen the financial safety net (Box 4). Further, the government is on-track to restore its cash buffers, provided the sale of the telecommunications company PTK proceeds as planned. The authorities have also taken worthy initiatives to strengthen competitiveness and enhance public infrastructure. Progress is fragile, however, and could be undone by adverse political developments. The Stand-By Arrangement—that the authorities are treating as precautionary in 2013—expires toward the end of the year.

B. Recent Economic and Financial Developments

4. Following buoyant growth in 2011, the economy slowed in 2012 and developed unevenly in the early months of 2013.

- ***Real growth*** exceeded 5 percent of GDP in 2011, driven by strong investment and private consumption (Tables 1, 2). The economy slowed in 2012, however, especially during the year's second half, with FDI and, correspondingly, private investment contracting. The slowdown was accompanied by a deceleration in credit growth from almost 15 percent in 2011 to 4½ percent (Table 3). Nonetheless, at almost 2½ percent, estimated real growth remained the strongest in the region. Growth appears to have been uneven in the early months of 2013: credit, tax collection and imports all point to stronger demand in the first quarter, but more muted activity in April and May.

Nominal GDP growth, 2009-2012
(In percent)



Source: WEO.
1/ Swiss nominal GDP converted into Euros.

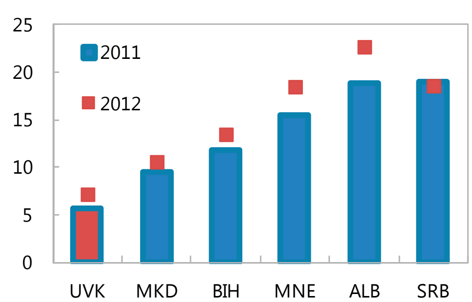
- The ***current account deficit*** (excluding official transfers) narrowed from more than 20 percent in 2011 to 15 percent in 2012, reflecting primarily weaker imports (Table 4). The trade deficit remained large at about 35 percent of GDP in 2012.[3]

- ***Consumer price inflation*** moved in line with import prices, notably for food. Core inflation remained contained at around 2 percent, consistent with Kosovo's use of the euro.

5. The banking sector has remained liquid, profitable, and well capitalized, although financial strength differs across banks (Table 5).

- ***Non-performing loans*** increased from 5.7 percent at end-2011 to around 7½ percent in late 2012 and early 2013.

Non-performing Loans to Total Gross Loans



Source: IMF Financial Soundness Indicators (FSI)

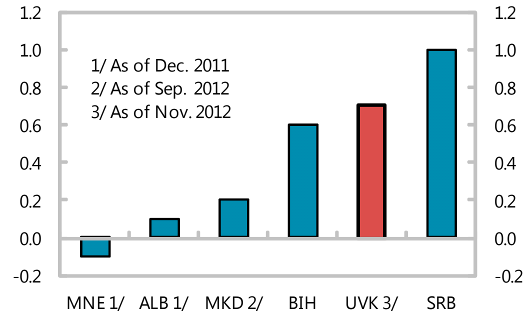
[3] The trade balance is the more reliable measure, as the split between transfers and FDI is somewhat artificial. Both originate with the same source (the Diaspora), are non-debt creating, and differ only by the activity they finance—consumption or FDI—with insufficient date to allow for a clear distinction.

The increase has been concentrated in the corporate sector, arguably reflecting weaker economic activity. NPLs are low compared to the region, however, and are almost fully provisioned.

- ***Profitability***, as measured by return on assets, halved between end-2011 and early 2013, but remained solid compared to peers. The decline reflects higher loan-loss provisions and lower credit growth.

- ***System-wide capital adequacy*** fluctuated around 18 percent for most of 2011 and 2012. It dropped to around 15 percent in late 2012, as tighter capital rules under the new banking law—which requires deduction of related lending from capital and additional capital buffers for operational risk—took effect.

Return on Assets, 2012
(percent)



Sources: Financial Soundness Indicators (FSI); National authorities and IMF staff estimates.

OUTLOOK AND RISKS

6. The baseline outlook is for a gradual strengthening in activity, in line with expected developments in Diaspora host countries.

- Staff projects ***real GDP growth*** of about 2½ percent in 2013, still significantly below the long-term average. Domestic demand is projected to strengthen somewhat, supported by stronger Diaspora inflows. Exports are also expected to recover, reflecting higher global demand for metals, although their contribution to growth remains small. CPI inflation is projected to decline gradually to below 2 percent, reflecting lower prices for imported food stuffs. The authorities saw upward risk to the growth projections, pointing to anecdotal evidence of import substitution for consumption goods suggesting higher domestic production.

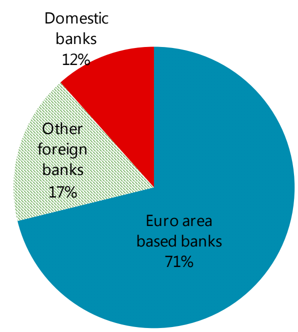
- ***In the medium-term,*** staff projects real growth of about 4½ percent, in line with Kosovo's average performance of recent years. Although growth would remain driven primarily by domestic demand, staff projects the very gradual build-up of an export sector, as efforts to enhance competitiveness bear some fruit. This would yield a modest improvement in the external balance.

7. Risks to the outlook relate mostly to the external environment in the short-term, and to domestic politics in the longer term (Box 5).

- ***Contagion from Diaspora host countries.*** The key short-term risk is a deterioration in economic conditions in Diaspora host countries that would curtail remittances and FDI, with negative repercussions for growth—by dampening domestic demand—the public finances—through lower border tax receipts—and financial stability—as remittances both fund deposits and are used to repay loans.

- ***Bank lending.*** A related risk are restrictive lending policies of subsidiaries of euro area parent banks—Kosovo's three largest banks are headquartered in the euro area. Such policies could be triggered by pressures to preserve capital for the consolidated banking group. However, a possible decline in their lending activity could be compensated in part by Turkish and Albanian banks that have gained market share recently.[4]

Share of Loans to Industry, 2012



Sources: Central Bank of Kosovo; and IMF staff calculations.

- ***Political risk.*** The biggest threat to medium-term prospects are policies that would undermine macroeconomic stability and competitiveness. While policy implementation has been remarkably disciplined in the past two years, the risk of policies that react to short-term political pressures but can do harm in the longer term is considerable, especially in the context of electoral campaigns. A case in point are the public sector wage increases of 30-50 percent in the wake of the 2010 campaign that forced Kosovo's previous SBA irrecoverably off-track.

POLICY DISCUSSIONS

A. Kosovo's Growth Model and Competitiveness

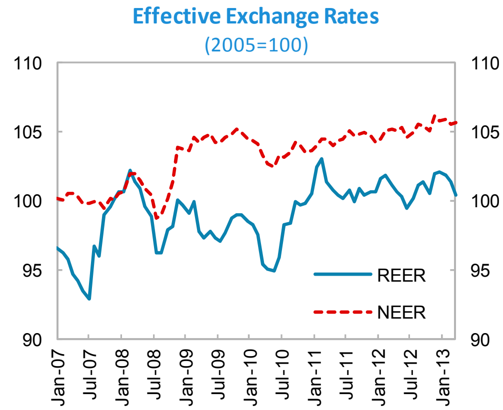
8. **The authorities and staff agreed that Kosovo's economy is excessively dependent on inflows from the Diaspora** (Figure 1). While these inflows support incomes, they finance mostly consumption and investments in non-tradables, such as real estate or services, and contribute little to the build-up of productive capacity. Goods exports are less than 10 percent of GDP and concentrated in sectors with a low-value added component, notably metals. This lopsided structure exposes the economy not only to developments in Diaspora's host countries, it also casts doubt on the growth model's long-term sustainability should the Diaspora become less attached to Kosovo.

9. **While data limitations complicate the assessment of external competitiveness, staff argued that the available indicators paint an unfavorable picture** (Box 6, Figure 2).[5] The CPI-based real effective exchange rate (REER) has changed little since the 2011 Article IV consultation, but its evolution reflects mostly import prices and is therefore of little relevance for

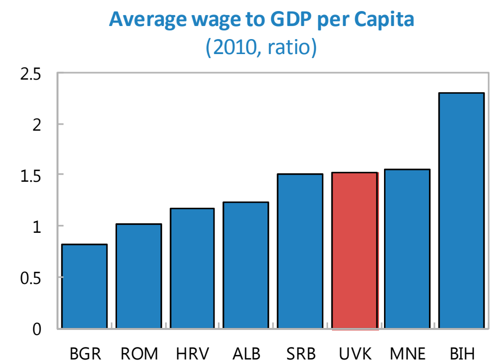
[4] See Box 1 of IMF Country Report 13/113 for details. Other banking risks widespread in Emerging Europe are less pronounced: banking subsidiaries are largely deposit funded, hence there is no risk of parental funding withdrawal. Asset-side exposure to parents is also minimal, in part because the new banking law prescribes that related party exposures—including placements with the group—be deducted in full from capital.

[5] Data are generally adequate for surveillance and data compilation continues to improve. However, there remain weaknesses in several areas, including the production-side GDP, labor market data, and external sector statistics. See the informational annex on statistical issues for details.

competitiveness.[6] Wages are modest in nominal terms but elevated once scaled with a measure of productivity, suggesting REER overvaluation.[7] Lack of wage competitiveness is reinforced by structural impediments, such as a deficient public infrastructure, weak governance, and a difficult business environment. Unsettled relations with Serbia and incomplete international recognition also deter investors.



10. There was agreement that a coherent strategy is needed to improve competitiveness, foster the development of a tradable sector, and lay the basis for self-sustained growth. Key pillars of such a strategy should include (i) investments in infrastructure and education, (ii) reforms to strengthen the business climate, (iii) initiatives to support the development of small- and medium-sized enterprises (SMEs), and (iv) wage restraint and the maintenance of flexible labor markets—which are especially critical in view of Kosovo's unilateral euroization that limits the authorities' means to react to shocks.



Source: IMF staff calculations.

11. The strategy could build on steps the authorities are already taking, notably:

- ***Almost 40 percent of the government budget is spent on capital expenditures,*** including the authorities' ambitious highway construction program. The government is also working with the World Bank on upgrading energy supply.

- ***Initiatives to streamline business registration and protect investors*** that helped Kosovo gain about 30 ranks in the World Bank's 2013 'Doing Business' survey. The government has also initiated a development strategy for SMEs aimed at improving access to finance and enhancing their competitiveness, in cooperation with donors.

- ***Improvements in the regional political climate and closer integration with the European Union (EU).*** In particular, the authorities expect to enter into negotiations for an association and stability agreement with the EU in the second half of 2013 or early 2014.

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[6] The CPI-based REER can even mislead: the increase in imported food prices from 2006/07 arguably enhanced the competitiveness of domestic food producers, but appreciated the REER (for the large share of food in the CPI basket).

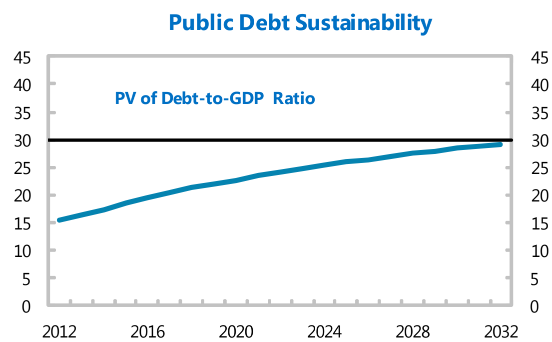
[7] There is some evidence that remittances increase reservation wages. In this case, elevated wage levels would reflect real factors rather than nominal rigidities, and could *not* be addressed through nominal devaluation (that would in any case require Kosovo to give up the use of the euro).

Staff noted that the success of these initiatives could be undermined by inconsistent, countervailing measures, such as outsized public sector wage increases.

B. Fiscal Sustainability

12. In the past two years, Kosovo has restored a sustainable fiscal stance (Table 6).

- ***Structural adjustment.*** The government implemented adjustment of about 2½ percent of GDP in 2011-13 through a mix of revenue measures and expenditure-saving structural reforms, notably in the energy sector. The resulting fiscal stance is sustainable, provided capital spending—which has fluctuated considerably in recent years, reflecting in part ambitious infrastructure projects—converges to around 10 percent of GDP.



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

- ***Fiscal rule.*** To lock in the adjustment achieved under the SBA, fiscal policy will from 2014 be anchored by a fiscal rule that is expected to be enacted in early July. The fiscal rule sets a ceiling for the general government deficit of 2 percent of GDP, consistent with keeping gross public debt at or below 30 percent of GDP. Capital projects are exempt from the ceiling provided (i) they are financed from privatization receipts and (ii) the government bank balance exceeds a minimum threshold of 4½ percent of GDP.[8]

- ***Financing.*** In the medium-term, the fiscal deficit is expected to be financed primarily through the issuance of securities. The government T-bill market—set up only in 2012—has been off to a good start, with net issuance of 1½ percent of GDP in 2012, maturities of up to one year, and nominal yields between ½ and 3½ percent. T-bills have been purchased mostly by domestic banks. However, it may take a few years until the market will be sufficiently deep to cover the government's financing needs in a sustainable manner.

13. The authorities and staff discussed challenges to revenue policy. Staff argued that the government revenue structure was efficient, but would require reform as Kosovo integrates more closely with the EU and shifts toward self-sustained growth.

- ***Structure.*** Government revenue is heavily tilted toward indirect taxes, with more than 80 percent of receipts stemming from VAT, excises, and customs duties. This structure is well aligned with the import-heavy, transfer-dependent nature of Kosovo's economy and has proven revenue effective, owing in large measure to Kosovo's well-designed VAT system (Box 7).

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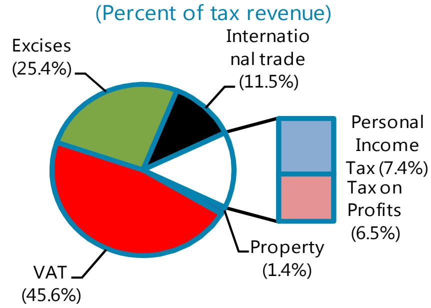
[8] See Box 3 of the staff report on the 4th review of the SBA.

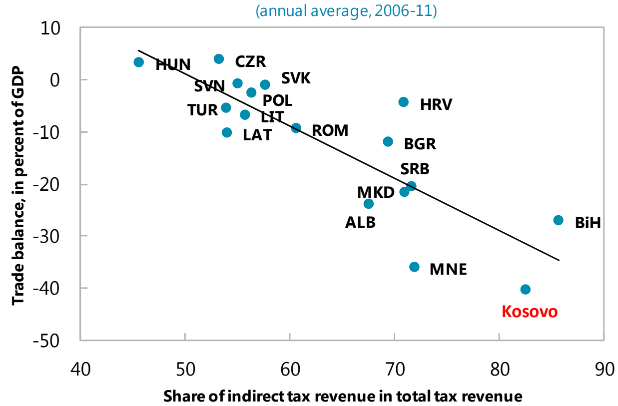
- ***Challenges.*** Staff suggested that challenges ahead include (i) replacing customs duties as integration with the EU advances, and (ii) shifting gradually to direct taxation as domestic production increases. The revenue loss from trade taxes could be replaced, at least in the short term, with VAT, as Kosovo's VAT rate is among the lowest in the region. Strengthening direct taxation, while desirable, is politically and administratively more difficult. Options include broadening the income tax base, reviewing relatively low direct tax rates, and strengthening the local governments' use of property taxes.

Kosovo: Tax structure, 2006-2011
(Percent of tax revenue)



Source: World Economics Outlook (WEO); and country authorities.

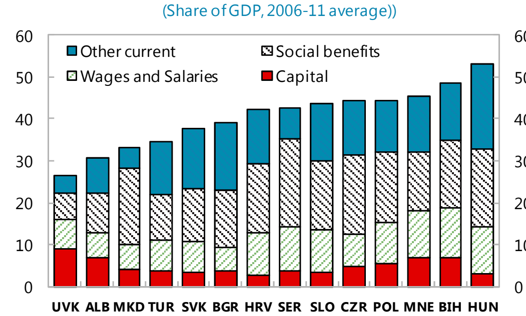
Revenue Structure and Structure of the Economy
(annual average, 2006-11)



- ***Authorities response.*** The authorities largely concurred with staff's analysis, but emphasized the importance of phasing gradually in tax losses from upcoming free trade agreements—notably with Turkey and the EU. They also pointed to lowering the VAT threshold as an alternative to rate hikes, arguing that capacity in tax administration had increased to a point where this was feasible.

14. **There was agreement that the public sector's expenditure structure is conducive to growth, but may be difficult to sustain in view of pressing social needs.** Government spending is modest compared to peers, and heavily tilted toward public investment. While this structure is supportive of economic development, it may be unavoidable that the current spending envelope would, over time, become gradually more similar to that of neighboring countries.[9] Staff emphasized the need to manage this process in an orderly manner, rather than reacting ad hoc to spending pressures.

Goverment Spending
(Share of GDP, 2006-11 average))



Sources: World Economics Outlook (WEO); and country authorities.

15. **More generally, staff urged to continue the practice of careful budgetary planning and costing to**

[9] The relatively small share of social spending reflects in part Kosovo's three-pillar pension system—only a modest public "Pillar I" pension is paid out of the budget, while most peers have PAYG-based pension systems. The World Bank is analyzing public spending patterns in the context of its ongoing Public Expenditure Review.

prevent unfunded spending initiatives. While under the SBA, spending initiatives proceed only after thorough costing—examples include health reform and increases in the basic pension—there have repeatedly been proposals for benefits with unknown budgetary impacts. Staff pointed to examples of neighboring countries where poorly designed benefits had created budgetary burdens exceeding the financial capacity of the sovereign.

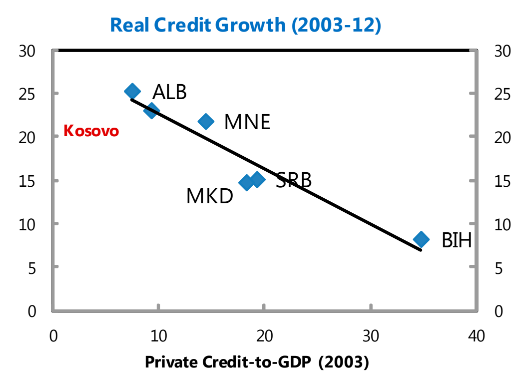
16. The authorities and staff discussed the adequate level of the government's bank balance with the central bank. In Kosovo's unilaterally euroized economy, the bank balance is the main tool to safeguard an adequate level of reserves, and therefore to insure both the public sector and the financial system against liquidity shocks.

- ***SBA yardstick.*** The yardstick for bank balance adequacy under the SBA—derived from a rule-of-thumb for reserves in countries with a fixed exchange rate—is purposely ambitious, and results in a recommended balance of about 7 percent of GDP. The authorities noted that the bank balance had to be approved with each budget, and that a high level was difficult to defend politically, given urgent capital and social spending needs. They argued that the minimum inscribed into the fiscal rule legislation—4½ percent of GDP—was more feasible.

- ***Alternatives.*** While staff saw indeed room for lowering the yardstick relative to the level recommended under the SBA (Box 8), it encouraged exploring options to fund a higher portion of reserves from other sources than government deposits, with a view to "depoliticizing" cash buffers. The proposal of the 2012 FSAP to fund increases in the emergency liquidity assistance (ELA) facility for banks through a bank premium is a step in this direction. The authorities agreed, and have started preparatory work on an ELA bank premium (¶18).

C. Financial Sector Development

17. While Kosovo's banking sector has grown rapidly in the last decade, weaknesses in contract enforcement pose an obstacle to future financial development (Box 9, Figure 3). Kosovo emerged from Yugoslavia's civil war without a functioning banking sector. In the 2000s, Kosovo caught up rapidly: credit and deposit growth was among the highest in the region, intermediated primarily by subsidiaries of euro area based parent banks, and aided by Kosovo's unilateral adoption of the euro. The process has slowed recently, however, suggesting that a saturation point may have been reached. Moreover, other segments of the financial system—in particular insurance and securities markets—remain underdeveloped. Progress on efficiency—as measured by the loan-deposit interest rate spread—has been slow. Banks reported that weak contract enforcement contributed to intermediation



Source: International Financial System ; and IMF staff calculations.

spreads and inhibited the development of new banking products, such as longer-term mortgage lending.[10]

18. The authorities and staff followed up on the analysis and policy recommendations of the 2012 FSAP mission.

- ***Resilience to shocks.*** The FSAP results suggest resilience of the banking system to a wide range of shocks, including turbulence in the euro area (Box 10). Pockets of vulnerability remain, however, primarily from loan and deposit concentrations in some banks, maturity-mismatches, and external assets exposures.

- ***Supervision.*** While the FSAP commended the central bank for a high degree of professionalism in banking supervision, it noted a relatively narrow focus on credit risk. Staff argued—and the authorities agreed—that this focus was adequate for now, but that a gradual move to comprehensive risk-based supervision was desirable. Staff also argued in favor of the development of a macro-prudential policy framework, given Kosovo's unilateral euroization and the absence of an independent monetary policy.

- ***Legal and institutional framework.*** The FSAP noted significant progress since the 2011 Article IV consultation, notably passage of the Banking Law in 2012 that enhances bank governance standards and resolution powers, and the establishment of a special reserves fund (SRF) for ELA under the exclusive control of the central bank. The FSAP recommended steps to further strengthen the crisis management framework, in particular funding future increases of the ELA facility through a bank premium.

Most recommendations have since been taken up in the context of the SBA. For technically more challenging proposals—including risk-based supervision, the macro-prudential policy framework, and the ELA bank premium—technical assistance is required and is expected to be delivered in the next 12 months.

STAFF APPRAISAL

19. Kosovo's economy has performed remarkably in the face of headwinds from the global financial crisis and euro area turbulence. Since the onset of the financial crisis in 2007, annual real GDP growth has never been less than two percent, and average growth has been among the highest in the Western Balkans. The resilience owes to a confluence of circumstances, however, that is unlikely to be sustained. Kosovo's economy depends heavily on FDI and remittances from the Diaspora that lives mostly in Germany and Switzerland. As these economies have held up well,

[10] The CBK's 2012 Financial Stability Report found credit risk costs to be a major component of interest rate spreads. Further, the World Bank's 2012 Insolvency and Creditor Rights assessment noted legal and institutional weaknesses. The authorities are working with the World Bank on improving the property registry and NPL resolution, and with USAID on strengthening the court process for contract enforcement and on establishing a mortgage market.

Diaspora inflows have been stable, and have therefore continued to support household incomes and domestic demand. Kosovo's concentrated external exposure would turn into a risk, however, should the prospects for the Diaspora host countries change, or in case the Diaspora would become less attached to Kosovo. Insuring against such risks requires the development of a robust tradable sector that could support self-sustained growth.

20. Since the 2011 Article IV consultation, Kosovo has taken important steps toward building a more competitive economy. The strengthening of the investor climate, investments in public infrastructure, cautious public sector wage policies since 2011, SME development, and a rules-based framework for setting minimum wage levels[11] all point in the right direction, as do recent steps to normalize cross-country relations within the region and integrate Kosovo closer with the EU. While there are some indications that these efforts are already bearing fruit—notably anecdotal evidence about import substitution for consumption goods—enhancing competitiveness and building a tradable sector is a long-term process that requires patience and stamina from policymakers. Kosovo's competitiveness strategy could usefully be reinforced by efforts to strengthen education and training.

21. Kosovo has also made large strides toward fiscal sustainability. In the past two years, a sustainable budgetary stance has been restored through a mix of revenue measures and expenditure-saving structural reforms. Future budgets would be guided by the rules-based fiscal framework. However, the framework needs to be complemented by sound fiscal practices, notably the careful costing and planning of spending initiatives, with respect to both social spending—where policymakers need to resist temptations to react ad-hoc to spending pressures—and investment projects, such as the government's ambitious highway construction program. Otherwise, unfunded expenditure obligations could rapidly put fiscal achievements at risk. Avoiding such an outcome is a common responsibility of all stakeholders.

22. Upcoming challenges to revenue policy require careful preparation. The public sector relies heavily on indirect taxation, which is appropriate for now given the transfer-dependent, import-heavy structure of the economy. Looking ahead, however, customs duties will need to be replaced as Kosovo integrates more closely with its neighbors, including the EU; and the government will need to strengthen its ability to tax the domestic economy as Kosovo's growth model shifts from dependence on transfers to domestic production. The recommendations of an IMF technical assistance mission from 2011 on tax policy—increasing environmental taxes and tobacco excises, broadening the tax base and increasing progressivity, and gradually raising income and property taxes from current low levels—remain topical.[12]

23. The government's bank balance is a critical prudential buffer that needs to be guarded carefully. The floor on the bank balance inscribed in the rules-based fiscal framework of 4½ percent

[11] See Box 4 of the staff report on the 4th review of the SBA for details.

[12] See Box 5 of IMF country report 12/100 for more details.

of GDP is at the lower range of levels that can be considered adequate. The government should aim at exceeding this floor when anticipating large payment obligations, such as multi-year investment projects or debt servicing obligations. The government and the central bank should also continue to explore options to fund a portion of reserves from non-government sources, notably a premium on banks to fund future increases of the special reserves fund for emergency liquidity assistance.

24. Kosovo's financial sector has grown rapidly in the past decade, but appears to have reached a saturation point where further progress requires strengthening institutions. Banking sector depth is now at or even above levels of countries with similar characteristics. At the same time, credit intermediation spreads remain high, reflecting high credit risk and slow and incomplete contract enforcement by the judicial system.

25. Persistent supervisory vigilance, exercised by a strong and independent central bank, is critical to preserve banking sector stability. Banks display generally adequate capital buffers and profitability, a modest level of non-performing loans, and high liquid reserves. They have also avoided funding imbalances typical for many other countries in Emerging Europe. Looking ahead, a gradual move to comprehensive risk-based supervision and the development of a macro-prudential policy framework are called for to contain financial risks. Commendable steps have been taken to strengthen the financial safety net; priorities ahead include the establishment of a permanent funding mechanism for the SRF.

26. It is recommended that the next Article IV consultation with Kosovo to take place in accordance with the provision of Decisions No. 14747-(10/96)

Box 1. Kosovo's Growth Record in Perspective

Kosovo's economy grew on average by 4.3 percent per year in the past decade (2003-2012), which places Kosovo at the top of the region. The comparison looks even more favorable when slightly different base periods are chosen.

Nonetheless, **there is a widespread perception that growth has been insufficient to generate satisfactory improvements in living standards.** Several factors may contribute to this perception.

- ***Population growth.*** At 1.5 percent, Kosovo's annual population growth was the highest in the region. *Per-capita* real GDP grew by 2.8 percent in 2003-12, which does not stand out.

- ***Adverse import price developments.*** The consumer price index grew faster than the GDP deflator (2.3 percent vs. 1.2 percent annual average), as import price inflation reduced the population's purchasing power. Kosovo was affected worse by this relative price change than neighboring countries. A rough indicator for the improvement in average living standards is real per-capita GDP growth adjusted for the differential between the increases in the CPI and the GDP deflator.[1] This indicator places Kosovo at the bottom of the region.

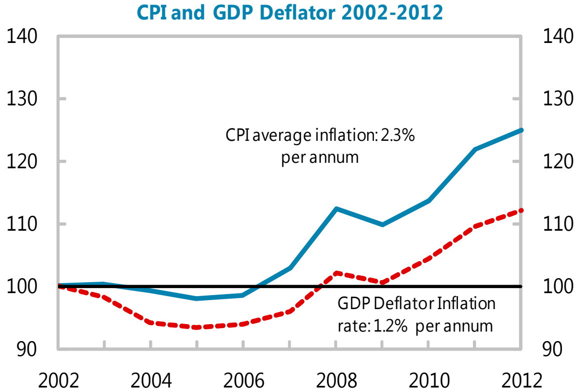
Growth and Living Standards, 2003-2012

Average 2003-2012	ALB	MKD	MNE	ROM	SRB	BUL	**UVK**
GDP growth	4.7	3.3	3.6	3.5	2.7	3.5	**4.3**
Pop growth rate	*0.5*	*0.2*	*0.1*	*-0.2*	*-0.4*	*-0.7*	***1.5***
GDP per capita	4.3	3.0	3.5	3.7	3.1	4.3	**2.8**
GDP deflator change	*3.3*	*3.3*	*5.6*	*10.9*	*10.1*	*5.3*	***1.2***
Average Inflation	*2.5*	*2.4*	*4.1*	*7.6*	*10.0*	*5.3*	***2.3***
Difference CPI and GDP Defl. Chang	*-0.8*	*-0.9*	*-1.4*	*-3.3*	*0.0*	*0.0*	***1.1***
Adjusted GDP per capita	5.0	3.9	5.0	7.0	3.1	4.2	**1.7**

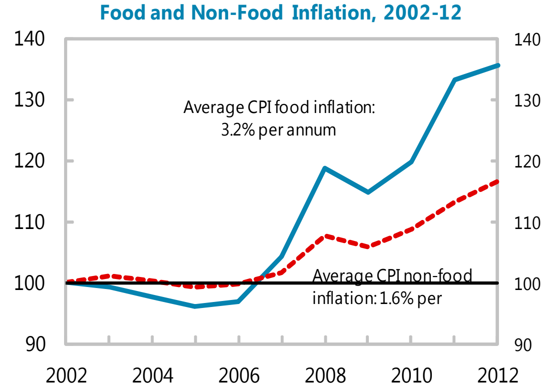
Source: IFS; and IMF Staff Computations

- ***Higher prices for food and energy.*** Food and energy prices increased by even more than the average CPI, especially from 2007. These items tend to be consumed disproportionately by lower-income households, suggesting that poorer Kosovars fared worse than the average population.

CPI and GDP Deflator 2002-2012



Food and Non-Food Inflation, 2002-12



Sources: Kosovo authorites; and IMF staff calculations.

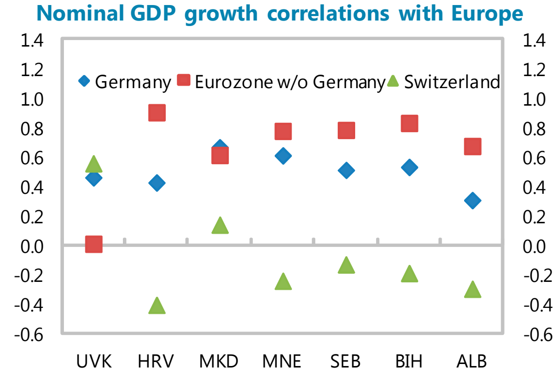
1/ An alternative would be to analyze directly real consumption. The CPI-based approach was chosen as the CPI index is considered more reliable than the consumption deflator.

Box 2. Kosovo's External Environment and Growth

Kosovo has been less affected by recent adverse external developments than its peers. In the wake of the global financial crisis, Kosovo's economic growth slowed but remained positive, while most Western Balkans slipped into recession.

A key factor for Kosovo's resilience has been its exposure to Germany and Switzerland, and the near-absence of economic and financial linkages to crisis countries. This pattern is born out by simple cross-country growth correlations for 2001-2011.[1/] Economic activity is correlated with that of Germany and Switzerland, but uncorrelated with economic activity in the rest of the euro area. By contrast, growth of other Western Balkan countries is highly correlated with activity in the euro area excluding Germany.

Nominal GDP growth correlations with Europe

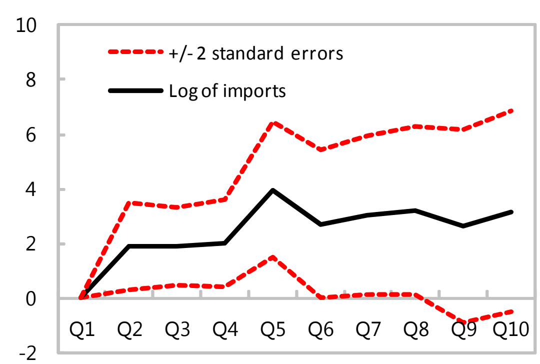


Sources: World Economic Outlook and IMF staff calculations.

This resilience relates to remittances and other inflows from the Diaspora, about 60 percent of which resides in Germany and Switzerland (see also Box 3). Recorded remittances—that, at about 14 percent of GDP, are the highest in the Western Balkans—financed about 40 percent of the trade deficit during 2004-2012. These flows have remained fairly resilient both in 2008-09 and in 2012.

Kosovo's dependence on—and vulnerability to—developments in host countries is confirmed by vector-autoregressions. A shock to quarterly growth in Germany affects Kosovo's imports by a factor or about three (imports are used as a proxy for domestic demand). There are also significant impacts on credit and deposit growth.[2/]

Spillovers from a shock to activity in Germany 1/



Sources: Statistical Agency of Kosovo, IMF staff calculations.

1/Shows an impulse-response function tracing out the accumulated impact (in percent) of a one percent shock to the GDP growth rate of Germany on Kosovo's imports (in logs).

[1/] Data are for the annual growth in nominal GDP, expressed in euro.

[2/] Based on a VAR model for quarterly nominal growth of readily available, high-frequency indicators for the Kosovar economy (imports, bank credit to private sector, and deposits in the banking system), and Germany's GDP (as a proxy for economic conditions in Diaspora host countries), estimated for 2002Q4–2012Q4.

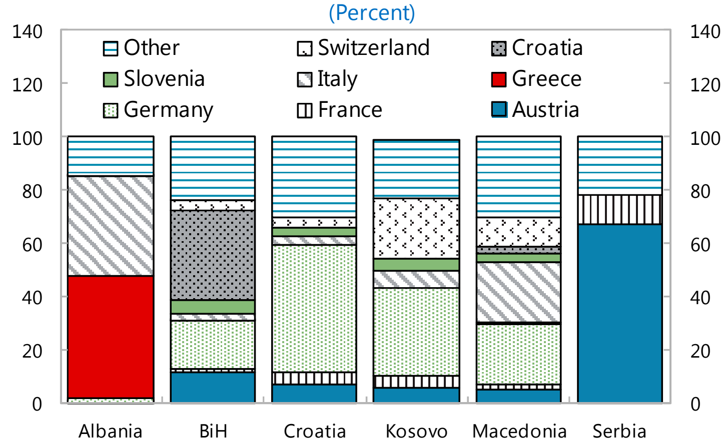
Box 3. Determinants of Remittances

Remittances play a key role supporting economic activity in Kosovo. An understanding of the factors driving remittances is therefore key for analyzing growth dynamics.

The elasticities of remittances to changes in host- and home country conditions are estimated, using panel data for 6 Balkan countries for 1999-2011. Specifically, remittances are regressed on home and host country GDP per capita. Host country GDP is proxied with euro area (EA) GDP, as Balkan emigrants are unevenly spread across different EA countries. Germany was the main source for remittances to Croatia, Kosovo and to a lesser extent BiH and Macedonia, while the majority of Serbia's remittances originate from Austria. Remittances from Greece and Italy are high for Albania and Macedonia.

Decomposition of Remittances by Source Country, 2011

(Percent)



Sources: World Bank Bilateral Remittances Matrix and Central Bank of Kosovo.

***Host* country per capita income is the main driver of remittances.** There is also evidence for an altruistic motive to remittances, as shown in the positive coefficient on the income gap variable (column 2) and the negative coefficient on home country GDP per capita (column 1): emigrants' remittances are stronger at times when home country income levels are lower. The results are preserved if one proxies for host country with Germany's GDP per capita instead of EA GDP per capita.

Determinants of Migrants' Remittance Transfers in the Balkans, 1999-2011

Dependent variable: Remittances per Capita$_t$	(1)	(2)
Home Country GDP per capita$_{(t-1)}$	-0.49*	
Host Country GDP per capita	2.67**	
Host-Home GDP per Capita diff$_{(t-1)}$		1.75**
Observations	68	68
R-squared	0.22	0.29
Country FE	YES	YES

[a] *significant at 10 percent level; **significant at 5 percent level; ***significant at 1 percent level.

[b] All variables are expressed in logarithmic terms. Regressions include constants and are estimated with robust standard erros. In equations including home country GDP on the right side, we use lagged values to attenuate reverse causality bias.

[c] We control for home and host real interest rates in regression (1) and for their differential (host-home) in regression(2) to capture the investment motive to remittances. The latter has the expected negative sign but is statistically insignificant.

Box 4. Status of 2011 Article IV Recommendations

Most recommendations were incorporated into Kosovo's SMP (2011) and SBA (2012/13). Actions taken include:

Fiscal Policy

- A ***sustainable fiscal stance***—consistent with stabilizing public debt at about 30 percent of GDP—was restored in the context of a 3-year consolidation program.(*) Adjustment measures included structural reforms to reduce current spending—notably subsidies to the energy sector—and revenue measures, based on recommendations of a 2011 FAD TA mission.
- A ***rules-based fiscal framework*** was submitted to the assembly in March 2013, and is expected to be enacted in early July.(*) It would anchor fiscal policy from 2014.
- New spending initiatives are preceded by ***fiscal impact assessments*** covering a period of at least 5 years.(*) These include *inter alia* possible war veteran benefits and highway R6 to Macedonia.
- The government is on-track to ***restore cash buffers***, provided the sale of the telecommunications company PTK to a German-American conglomerate advances as planned.
- A ***government debt market*** was established in 2012 and has evolved favorably, although its depth does not yet suffice to cover the government's financing needs. The Pension Fund Law was amended in April 2012 to limit exposure of the pillar II pension fund to public debt.(*)

Financial Sector Policies

- A new ***banking law***, passed in April 2012, strengthens prudential rules and enhances the ability of the central bank to resolve financial institutions.(*)
- An ***emergency liquidity assistance*** (ELA) facility for banks was set up and funded. The Law on Public Financial Management and Accountability was amended in June 2012 to grant the Central Bank exclusive control over the ELA facility.(*)
- Amendments to the ***deposit insurance*** law, passed in December 2012, enhance the target size of the deposit insurance fund (DIF), and allow the use of DIF-resources for P&A transactions.(*)

Competitiveness and Private Sector Developments

- The assembly passed a package of twelve laws to ***streamline business registration*** and ***protect investors.*** Kosovo's rank in the World Bank's Doing Business improved from #126 in 2012 to #98 in 2013.
- The ***privatizations*** of PTK (telecommunications) and KEDS (energy distribution) aim at enhancing infrastructure, as do the construction of highway R7 to Albania (scheduled to be completed in 2013) and R6 to Macedonia (scheduled to start in late 2013)
- Secondary legislation is in preparation to introduce a rules-based setting of ***minimum wage*** levels.(*)

(*) Covered by conditionality under the SMP or SBA, respectively.

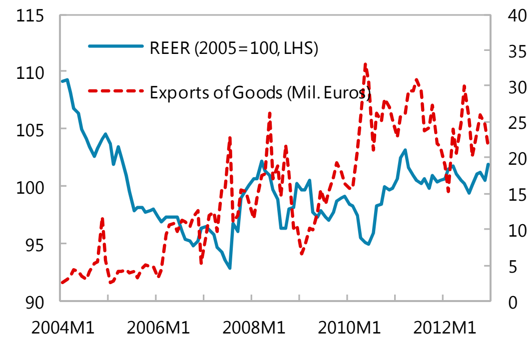
Box 5. Risk Assessment Matrix[1/]

Risk	*Impact If Realized*
1. Domestic policies … that would undermine macroeconomic stability and/or external competitiveness.	**Medium-High** The risk of policies that react to short-term political pressures but can do harm in the longer term is considerable, especially in the context of electoral campaigns. The impact would be more on medium-term growth prospects than on the short-term outlook.
2. Protracted period of slower European growth Larger than expected deleveraging or negative surprise on potential growth.	**Medium** Slower growth in the host countries of Kosovo's Diaspora—including Germany—would depress remittances and other inflows, thus dampening domestic demand.
3. Restrictive lending policies … by banking subsidiaries with parents located in the euro area.	**Medium-Low** The impact may be mitigated by Turkish and Albanian banks seeking to gain market share.
4. Financial stress in the euro area re-emerges. … triggered by stalled or incomplete delivery of national and euro area policy commitments.	**Low** Kosovo has almost no financial or export links to crisis countries.

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 RAM reflects staff views on the source of risks and overall level of concern as of the time of discussions with authorities.

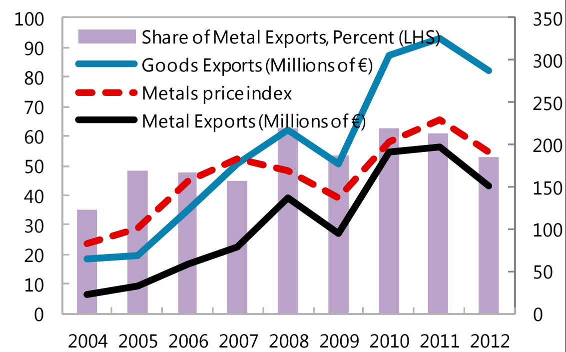
Box 6. External Competitiveness

Standard indicators are of limited usefulness for assessing Kosovo's external competitiveness. The CPI-based REER depreciated by some 4.5 percent in 2004-2012, but it is heavily influenced by import prices—notably for food—and provides only limited information on production cost. Exports of goods increased on average by 25 percent per year in the same period, and Kosovo's export shares both in the EU and worldwide increased, but this reflects mostly price increases for metals, Kosovo's main export commodity. A unit labor cost REER measure does not exist.



Sources: Authority data and Information Notice System (INS).

A more promising approach is to analyze directly wages. While nominal wages remain relatively low, labor costs—as proxied by average wages relative to GDP per capita—appear elevated relative to peers. Kosovo's GDP per capita is the lowest in the Balkans, arguably reflecting low labor productivity. Less than 10 percent of the working age population had tertiary education and less than 40 had secondary education in 2009, reflecting in part the disruption of education to ethnic Albanians in the 1990s.



Sources: Authorities data.

Weaknesses in the business environment further impede competitiveness. In 2013, the World Bank ranked Kosovo #98 (out of 185 countries) in terms of "ease of doing business". However, Kosovo's rank improved by some 30 spots compared to 2012. Improvements were the largest in subcategories where Kosovo did poorly in 2012, such as investor protection, ease of dealing with construction permits, and ease of starting a business. Challenges remain with contract enforcement and electricity shortages. Despite recent improvements, public infrastructure is still lacking, notably in energy and transport.

	DB 2013 Rank	1-yr Improvement
Getting Credit	23	0
Paying Taxes	44	4
Registering Property	76	-2
Resolving Insolvency	87	-1
Protecting Investors	100	76
Getting Electricity	116	6
Trading Across Borders	124	9
Starting a Business	126	44
Enforcing Contracts	138	1
Dealing with Construction Permits	144	33

Box 7. Tax Revenue Structure and Trade Liberalization

While Kosovo's tax-to-GDP ratio is comparable to the average in Southeastern Europe (SE), its tax system relies disproportionately on indirect taxation. Average tax revenue[1/] for the period 2006–2011 was about 22 percent of GDP. More than 80 percent of tax revenue came from indirect taxes, a share that was only exceeded by Bosnia and Herzegovina. By contrast, the contribution of direct taxes (including income and property taxes), was about half the regional average.

A large portion of indirect taxes is collected at the border, specifically all excises and three-quarters of VAT, lessening the risk of evasion. VAT productivity in Kosovo is above average for both the region and a sample of small open economies.[2/] While VAT performance is expected to be stronger in economies with a heavier reliance on international trade,[3/] Kosovo's well-designed VAT system (single rate, very limited exemptions) supports revenue productivity.

Table 1. Tax structure, selected European countries, 2006-2011 1/
(In percent of GDP, general government)

	Tax Revenue	Direct Taxes	Indirect Tax	Trade Taxes	VAT c-efficiency 1/
Kosovo	**21.7**	**3.8**	**15.4**	**2.5**	**0.56**
Albania	19.4	4.2	12.2	0.9	0.49
Bosnia & Herzegovina	23.3	3.4	17.9	2.1	0.79
Bulgaria	22.1	6.8	15.0	0.3	0.60
Croatia	22.3	5.8	15.3	0.5	0.66
Czech Republic	20.1	8.5	10.7	0.0	0.46
Hungary	26.1	10.4	11.9	0.0	0.40
Latvia	20.0	8.7	10.6	0.2	0.40
Lithuania	19.2	8.1	10.7	0.0	0.43
Macedonia	20.3	4.5	12.8	1.6	0.52
Montenegro	24.9	5.6	16.3	1.6	0.66
Poland	21.3	8.5	12.0	0.0	0.43
Romania	18.4	6.7	10.9	0.3	0.41
Serbia	25.0	6.9	16.0	1.9	0.67
Slovak Republic	17.0	6.0	9.8	0.0	0.47
Slovenia	22.9	8.7	12.3	0.3	0.58
Turkey	19.1	6.7	10.0	0.3	0.34
Unweighted average 2/	21.3	6.8	12.8	0.6	0.52

Sources: Government Financial Statistics (IMF), and country documents.
1/ VAT collection in percent of total consuption, divided by the standard VAT rate
2/ Excluding Kosovo

Kosovo's share of trade taxes is the largest in the region, which would create budgetary pressures in the event of further trade liberalization. Import duties account for about 2.5 percent of GDP and 11.5 percent of tax revenue, revenues that would be put at risk by steps towards free trade.[4/] Econometric evidence suggests that countries have struggled to make up for revenue losses from trade taxes.[5/]

A gradual reform of Kosovo's taxation system is called for. While preserving the integrity of indirect taxes is crucial, a broadening of the income tax base, avoiding unnecessary tax expenditures or exemptions, and a review of the very low rates for both corporate and personal income taxes is necessary.[6] In addition, the adoption of a modern recurrent property tax would improve its revenue productivity.

[1/] Excluding revenue from social security contributions.
[2/] Including a sample of 31 countries with populations below 5 million.
[3/] See L. Ebrill, M. Keen, J. Bodin, and V. Summers, "The Modern VAT," IMF, 2001.
[4/] M. Keen and T. Baunsgaard, "Tax revenue and (or?) trade liberalization," Journal of Public Economics, 2010.
[5/] Panel regressions for 17 countries for 1992-2010 find no robust evidence of that trade taxes would have been replace with domestically raised taxes. The estimated equation takes the form $D_{it} = \alpha_i + \beta_0 D_{it-1} + \beta_1 T_{it} + \beta_2 X_{it} + \mu_t + \varepsilon_{it}$ where D is domestic tax revenue, T is trade tax revenue, expressed in percent of GDP, and X is a vector of control variables. Estimators used are fixed-effects, difference- and system-GMM. All regressions include country- and year-dummies.
[6/] See M. Grote et al., "Kosovo: Reform Proposals Towards a More Balanced and Revenue-Productive Tax System," FAD Technical Assistance Report, 2011.

Box 8. Euroization, FX Liquidity Needs and Precautionary Cash Buffers

Kosovo is one of only three IMF members that have unilaterally adopted the euro.[1/] As a result, *every* liquidity need is in foreign exchange (FX), and cannot be satisfied by domestic liquidity generation or access to ECB facilities. Self-insurance against liquidity shocks requires holding FX reserves.

FX reserves are freely available central bank assets denominated in FX. In Kosovo, *all* central bank assets are in FX, hence free availability is the only identifying criterion. The Central Bank of Kosovo (CBK) considers assets *not* freely available if they correspond to funds on which non-government entities have a claim, such as commercial banks' reserves or deposits of the Kosovo privatization fund.

This renders reserves easier to identify from the liability side of the central bank's balance sheet. In Kosovo, reserves are limited to (i) the central bank's capital, (ii) Kosovo's SDR allocation received in the context of the 2009 quota increase, and (iii) the government's deposits with the central bank. As (i) and (ii) are fixed in the short-term, (iii), i.e. the government's bank balance (BB), is the main instrument to ensure reserves adequacy.

How large should the government's BB be? Under the SBA, "BB adequacy" is computed as[2/]

$$BB = 1\ month\ of\ expenditures + 10\% \begin{pmatrix} bank \\ deposits \end{pmatrix} + 30\% \begin{pmatrix} public\ short \\ term\ debt \end{pmatrix} - SDR\ alloc. - CB\ capital$$

The first and third terms are fiscal buffers to cover the government's own liquidity needs, while the second term is a financial buffer to insure against liquidity strains in banks.

The formula puts the recommended BB at about 7 percent of GDP—a purposely ambitious threshold. The government has noted that cash buffers of this magnitude are difficult to defend politically. There are two responses to this concern.

One is that **a lower BB requirement could be defended as well.** In particular, more than two-thirds of bank deposits are held with subsidiaries of euro area based banks. In case of liquidity strains, these subsidiaries would and should arguably turn to their parents who have access to ECB facilities rather than the CBK. Requiring a reduced liquidity buffer for non euro-area based banks would reduce the minimum BB to 4½-5 percent of GDP.[3/]

Another option is to "depoliticize" reserves by financing a larger portion from other depositors than the government. Specifically, banks could pay a commitment fee to have access to ELA, as recommended by the FSAP.

[1/] The other two are Montenegro and San Marino. Eight IMF members have unilaterally adopted the U.S. dollar, among them Ecuador, El Salvador, and Panama. Two have adopted the Australian Dollar.

[2/] The formula is derived from a rule-of-thumb for reserves adequacy in economies with a fixed exchange rate. See IMF Board Paper SM/11/31, 2011, "*Assessing Reserve Adequacy*".

[3/] 4½ percent of GDP is also the minimum BB requirement inscribed into the rules based fiscal framework.

Box 9. Financial Sector Development

During the last decade, Kosovo's banking sector has grown quickly. The banking system has expanded from six banks to nine (mostly foreign) banks, and private credit as a share of GDP has increased more than six fold. On the other hand, non-bank financial institutions and securities markets are small. The public securities market established in 2012 is still nascent.

	Deposit money bank assets to GDP (%)	Non-bank financial institutions' assets to GDP (%)	Mutual fund assets to GDP (%)	Insurance company assets to GDP (%)	Stock market capitalization to GDP (%)	Outstanding domestic private debt securities to GDP (%)	Outstanding domestic public debt securities to GDP (%)
2003 (or earliest available)							
Kosovo	5.3	1.5	0.0	1.4	0.0	0.0	0.0
SEE5	20.6	N/A	N/A	4.1	5.9	N/A	N/A
ECA	20.6	1.1	0.3	2.3	6.2	N/A	20.5
2010 (or latest available)							
Kosovo	32.3	1.2	0.0	1.9	0.0	0.0	0.0
SEE5	57.7	N/A	0.0	3.9	25.7	N/A	N/A
ECA	50.3	0.2	0.7	2.9	19.1	0.2	17.8

Source: Central Bank of Kosovo, World Bank Global Financial Development Database.
SEE5 comprise Albania, Bosnia and Herzegovina, Macedonia, Montenegro, and Serbia.
ECA comprise middle-income countries in Europe and Central Asia.

While still lagging the rest of the Balkans, Kosovo's banking *depth* now appears to be above its structural fundamentals. Whereas in 2003 Kosovo was below its proxy benchmark (i.e., Albania's expected median[1/]) for private sector credit and deposit depth, by 2011 banking depth was higher than income per capita and population characteristics would indicate.[2/]

In terms of banking *reach* and *efficiency,* the picture is mixed. *Reach*, as measured by the number of bank accounts, appears to be roughly in line with Kosovo's benchmark, while the number of bank borrowers seems low (which is reflected in large exposures). By contrast, Kosovo's banking *efficiency*, as measured by the interest rate spread, is below its benchmark (i.e., the spread is higher than expected), reflecting arguably weak contract enforcement and structural characteristics such as bank concentration.

1/ Feyen and Kibuuka, *FinStats 2013: A ready-to-use tool to benchmark financial sectors across countries—User Guide and Benchmarking Methodology*, October 2012 (Version 3.0).

2/ As Kosovo is not yet benchmarked in Finstat, Albania, which has similar GDP per capita and population size and structure, can serve as a proxy, although adjusting for Kosovo's more dense and younger population would indicate somewhat lower benchmarks.

Box 10. Financial Sector Assessment Program (FSAP) Stress Tests

The FSAP's macro-stress tests were based on a scenario of severe euro area deterioration that would impact Kosovo's banks through a decline in remittances and FDI, lower values of banks' holdings of European sovereign debt, higher counterparty risk from exposures to euro area banks, and a reduction in credit due to deleveraging by foreign-owned banks. Specifically, GDP would decline by 2 percent, yields on European sovereign bonds would increase on average by 130 bps, and there would be an average increase in the default probability of European banks to which Kosovo banks are exposed of 140 percent. All stress tests were based on banks' risk exposures as of June 2012.

The macro stress tests found the banking system to be generally resilient, although there are pockets of vulnerability:

- ***The two largest banks are resilient.*** The impact of higher losses on capital adequacy was partially mitigated by a projected reduction in risk-weighted assets.
- The ***remaining four locally incorporated banks*** are more vulnerable. Some banks' capital ratios would fall below the 12 percent minimum, although the additional capital need would be only 0.2 of GDP.

Sensitivity tests were also conducted, showing again a high degree of resilience. The tests covered credit concentration, interest rate, foreign exchange, and liquidity risks. Some banks are vulnerable due to highly concentrated portfolios and to interest rate risk, while exchange rate risk is negligible. Notable results include:

- A ***default of the three largest borrowers*** for each bank would cause the banks' CAR to fall below 12 percent (0.2 percent of GDP additional capital needed).
- The ***default of a parent bank on its liabilities to the subsidiary*** has one bank's CAR to fall below 12 percent (0.1 percent of GDP in additional capital needed). Coupled with the adverse scenario, the recapitalization need is 0.7 percent of GDP.
- A ***parallel shift of 200 basis points in interest rates*** would bring two banks—representing more than 25 percent of the system—below the 12 percent CAR minimum (0.1 percent of GDP additional capital needed).
- ***The simultaneous withdrawal of the three largest private deposits*** would cause one small foreign bank to have a liquidity shortfall (requiring liquidity assistance of around 0.1 percent of GDP).
- ***A severe liquidity event*** (i.e., 30 percent outflow, combined with a 20 percent haircut on liquid assets) would cause 4 banks—3 of which are foreign—to have liquidity shortfalls. Total liquidity assistance needed would be equivalent to 2.2 percent of GDP. Up to 1 percent of GDP could be covered by the ELA fund, the amount would increase to 2 percent of GDP if CBK equity and reserves are included. However, this result does not take into account that some foreign-owned banks may be able to borrow from their parents.

Table 1. Kosovo: Main Indicators, 2010–18

(Percent, unless otherwise indicated)

	2010	2011	2012	2013	2014	2015	2016	2017	2018
			Est.			Projections			
Real growth rates									
GDP	3.2	5.2	2.3	2.6	4.2	4.5	5.0	4.5	4.5
GDP per capita	1.7	3.8	0.9	1.1	2.7	3.0	3.4	3.0	3.0
Consumption	1.9	2.6	1.1	2.5	3.0	3.3	3.3	2.9	3.1
Investment	12.3	11.3	-3.2	5.2	3.4	5.2	7.9	7.5	6.4
Exports	13.0	10.1	-0.5	4.8	12.1	11.8	11.7	9.7	9.2
Imports	8.5	5.3	-4.1	4.6	4.4	5.5	6.3	5.7	5.2
Official unemployment (percent of workforce)	...	...	35.1 1/	...	...	...	...	...	...
Price changes									
CPI, period average	3.5	7.3	2.5	2.1	1.8	1.5	1.5	1.5	1.5
CPI, end of period	6.6	3.6	3.7	1.5	1.7	1.5	1.5	1.5	1.5
Import prices	6.5	6.3	1.0	-1.8	-1.0	-0.2	0.5	0.6	-0.2
GDP deflator	3.7	5.8	2.5	2.2	2.0	2.0	2.0	2.0	2.0
Real effective exch. rate (average; -=depreciation)	-0.7	3.5	-0.1	...	...	...	...	...	...
Real effective exch. rate (end of period; -=depreciation)	0.8	0.8	1.4	...	...	...	...	...	...
General government budget (percent of GDP)									
Revenues, incl. interest income	27.1	27.3	26.4	26.9	26.0	26.3	26.5	26.5	26.8
Primary expenditures	29.5	28.9	28.7	30.0	28.7	27.9	28.0	28.0	27.9
Of which									
Wages and salaries	7.3	8.1	8.1	8.4	8.3	8.3	8.3	8.3	8.3
Subsidies and transfers	6.3	5.7	5.8	5.9	5.9	5.9	5.9	5.9	5.9
Capital and net lending, incl. highways	11.7	11.5	11.0	11.3	10.2	9.4	9.4	9.4	9.4
Capital expenditures on highways	2.9	5.4	5.6	5.2	4.8	4.0	3.5	0.0	0.0
Overall balance	-2.6	-1.8	-2.6	-3.4	-3.0	-2.0	-2.0	-2.0	-2.0
Debt financing, net	0.3	-0.1	3.1	1.4	1.7	2.2	1.8	1.7	2.4
Privatization	0.0	0.0	0.9	5.8	0.0	0.8	0.8	0.1	0.1
Stock of government bank balances	5.7	3.3	4.3	7.9	6.1	6.7	6.8	6.2	6.4
Financing gap	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Savings-investment balances (percent of GDP)									
Domestic savings	-3.8	-4.9	-3.6	-3.7	-2.4	-0.7	1.4	3.4	5.1
Transfers excluding general government (net)	15.4	14.6	15.8	15.7	15.2	14.5	13.8	13.3	12.7
Net factor income	1.6	2.4	3.1	3.1	3.1	3.1	3.0	3.0	2.7
National savings	13.2	12.1	15.3	15.1	16.0	16.9	18.3	19.6	20.5
Investment	32.7	32.7	30.9	29.5	28.2	28.0	28.8	29.6	30.4
Current account, excl. official transfers	-19.5	-20.6	-15.6	-14.4	-12.2	-11.1	-10.5	-10.0	-9.8
Current account balance, incl. official transfers	-12.0	-13.8	-7.6	-10.5	-8.7	-8.3	-8.6	-8.4	-8.0
Of which: official transfers 2/	7.4	6.7	8.0	3.9	3.5	2.8	1.9	1.6	1.8
Net foreign direct investment	7.7	7.9	4.3	10.3	6.5	6.7	7.0	7.1	6.9
Portfolio investment, net	-1.1	-1.2	-3.7	-3.4	-1.7	-2.2	-1.1	-1.5	-1.2
Bank credit to the private sector	12.6	14.7	4.5	5.3	9.9	...	...	...	...
Deposits of the private sector	23.1	11.4	10.9	11.4	10.2	...	...	...	...
Non-performing loans (percent of total loans)	5.2	5.7	7.5	7.6 3/	...	...	...	...	...
Regulatory capital/risk weighted assets	18.8	17.6	14.4	14.8 3/	...	...	...	...	...
GDP (millions of euros)	4,291	4,776	5,012	5,256	5,588	5,959	6,383	6,806	7,251
GDP per capita (euros)	2,418	2,655	2,761	2,852	2,988	3,139	3,312	3,480	3,653
GNDI per capita (euros)	2,830	3,107	3,282	3,388	3,535	3,691	3,871	4,046	4,217
Population (thousands) 4/	1,775	1,799	1,816	1,843	1,870	1,899	1,927	1,956	1,985

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

1/ Data for the first half of 2012.

2/ Total foreign assistance excluding capital transfers.

3/ April 2013.

4/ Series updated according to Kosovo Agency of Statistics (2013), *Estimation of Kosovo population, 2012*, Pristina, Kosovo.

Table 2. Kosovo: Real Growth, 2010–18

(Percent, unless otherwise indicated)

	2010	2011	2012	2013	2014	2015	2016	2017	2018
			Est.	Projections					
	(Real growth, percent)								
Consumption	1.9	2.6	1.1	2.5	3.0	3.3	3.3	2.9	3.1
Private	3.0	3.1	1.4	2.5	3.2	3.2	3.2	2.9	3.0
Public	-4.5	-0.2	-0.9	2.6	2.2	3.9	3.8	3.2	3.4
General government	-1.1	2.1	3.9	8.9	3.0	5.9	5.5	5.0	4.9
Donor sector 1/	-11.2	-6.0	-13.9	-17.9	-1.4	-5.1	-4.8	-6.8	-6.0
Investment	12.3	11.3	-3.2	5.2	3.4	5.2	7.9	7.5	6.4
Private	11.7	10.1	-5.8	3.4	9.3	10.0	9.0	8.8	7.3
Public	13.5	13.6	1.4	8.1	-6.1	-3.7	5.5	4.6	4.3
General government	14.8	14.6	1.8	8.6	-6.1	-3.5	6.0	5.0	4.6
Donor sector 1/	-6.5	-5.9	-6.8	-6.5	-6.2	-10.3	-10.2	-10.1	-10.0
Exports	13.0	10.1	-0.5	4.8	12.1	11.8	11.7	9.7	9.2
Imports	8.5	5.3	-4.1	4.6	4.4	5.5	6.3	5.7	5.2
GDP	3.2	5.2	2.3	2.6	4.2	4.5	5.0	4.5	4.5
Memorandum item:									
GDP (millions of euros)	4291	4776	5012	5256	5588	5959	6383	6806	7251

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

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

Table 3. Kosovo: Central Bank and Commercial Bank Survey, 2008–14

(Millions of euros, unless otherwise indicated)

	2008	2009	2010	2011	2012	Projections 2013	2014
			Central Bank				
Net foreign assets	1,111	1,088	1,108	1,095	1,239	1,283	1,308
Foreign assets	1,111	1,198	1,247	1,235	1,469	1,513	1,539
Of which: Securities	541	530	199	25	286	326	346
Deposits	529	522	854	1,059	1,034	1,038	1,044
Foreign liabilities	0	110	139	140	230	230	230
Net domestic assets	-1,111	-1,088	-1,108	-1,095	-1,239	-1,283	-1,308
Net claims on the central government	-870	-681	-813	-797	-838	-838	-838
Liabilities	-870	-681	-813	-797	-838	-838	-838
Of which: KTA (privatization) fund	406	-451	-522	-265	-549	-549	-549
Of which: Government balances (program definiti	-414	-178	-233	-160	-216	-413	-341
Commercial banks	-137	-233	-204	-210	-302	-344	-368
Other institutions	-64	-131	-46	-39	-51	-51	-51
Other items, net	-39	-43	-46	-48	-47	-49	-51
			Commercial banks				
Net foreign assets	325	444	508	509	491	590	581
Assets	401	584	710	666	634	743	748
Liabilites	76	140	202	156	142	152	167
Net domestic assets	815	949	1,206	1,399	1,625	1,767	2,018
Credit to private sector	1,183	1,289	1,451	1,664	1,740	1,832	2,014
Claims on the CBK	137	233	203	220	294	344	368
Net claims on the central government	-1	-165	-12	-1	59	125	220
Net claims on other public entities	-264	-123	-120	-128	-74	-78	-83
Other items, net	-240	-286	-317	-355	-394	-456	-502
Liabilities to the private sector	1,140	1,393	1,714	1,908	2,116	2,357	2,598
Demand deposits	384	441	545	598	694	779	855
Time deposits	756	951	1,169	1,311	1,422	1,578	1,743
Memorandum item:							
Gross international reserves	670	625	686	626	892	943	968
			(12-month percent change)				
Liabilities to private sector	25.8	22.2	23.1	11.4	10.9	11.4	10.2
Loans to the private sector	32.7	8.9	12.6	14.7	4.5	5.3	9.9
			(Percent of GDP)				
Total private sector deposits	28.9	34.7	39.9	40.0	42.2	44.8	46.5
Credit to the private sector	30.0	32.2	33.8	34.8	34.7	34.9	36.0

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

Table 4. Kosovo: Balance of Payments, 2009-18

(Millions of euros, unless otherwise indicated)

	2010	2011	2012	2013	2014	2015	2016	2017	2018
				Projections					
Goods and services balance	-1,565	-1,793	-1,728	-1,745	-1,709	-1,711	-1,746	-1,789	-1,831
Goods	-1,752	-2,059	-2,073	-2,125	-2,158	-2,250	-2,387	-2,517	-2,645
Exports	305	325	287	306	360	408	460	520	586
Imports	-2,057	-2,384	-2,360	-2,431	-2,518	-2,658	-2,847	-3,036	-3,231
Services	187	266	345	380	449	539	641	727	814
Receipts	573	619	637	672	746	844	957	1,053	1,149
Payments	-386	-353	-292	-292	-297	-305	-316	-325	-335
Income	68	113	154	162	174	184	195	206	198
Compensation of employees (net)	172	208	214	223	232	241	251	261	271
Investment income	-104	-95	-60	-61	-58	-57	-56	-55	-73
Interest payments on public debt	-9	-9	-8	-14	-12	-11	-10	-9	-28
Transfers	982	1,021	1,194	1,031	1,048	1,034	1,003	1,010	1,051
Official transfers	320	322	402	205	197	169	121	107	129
Other transfers (net)	663	699	793	826	851	865	882	903	922
Of which: inflows of remittances	584	585	605	619	644	670	698	729	758
Current account	-515	-659	-380	-553	-487	-494	-549	-574	-582
Capital and financial account	298	419	140	353	287	294	349	374	382
Capital account	21	42	13	2	0	0	0	0	0
Of which: WB Trust Fund	0	10	0	0	0	0	0	0	0
Financial account, incl. CBK	277	377	127	351	288	294	348	374	382
Foreign direct investment, net	331	379	213	542	366	399	447	486	503
Commercial banks, excl. FDI	-44	7	102	-98	9	-22	30	-2	19
General government	21	-6	83	-5	-22	-27	-60	-58	-12
Drawings	22	5	94	9	0	0	0	0	0
Repayments	-11	-11	-11	-14	-22	-27	-60	-58	-12
Other	10	0	0	0	0	0	0	0	0
Other sectors, excl. FDI 1/	9	-18	-33	-43	-39	-66	-55	-41	-81
Central Bank of Kosovo	-41	15	-237	-44	-26	10	-13	-12	-47
Reserve assets	-53	61	-267	-50	-26	10	-13	-12	-47
Government balances (program definit	-55	73	-56	-197	73	-58	-36	11	-38
Other reserve assets, incl. SDRs	2	-12	-211	147	-98	68	22	-23	-10
Non-reserves assets	13	-46	30	7	0	0	0	0	0
Liabilities 2/	0	0	0	0	0	0	0	0	0
Net errors and omissions 3/	217	241	239	200	200	200	200	200	200
Overall balance	0	0	0	0	0	0	0	0	0
Financing gap	0	0	0	0	0	0	0	0	0
Memorandum items:									
Current account, excl. official transfers	-835	-982	-781	-758	-684	-663	-670	-681	-711
(in percent of GDP)	-19.5	-20.6	-15.6	-14.4	-12.2	-11.1	-10.5	-10.0	-9.8
Current account, incl. official transfers	-515	-659	-380	-553	-487	-494	-549	-574	-582
(in percent of GDP)	-12.0	-13.8	-7.6	-10.5	-8.7	-8.3	-8.6	-8.4	-8.0
Official transfers (percent of GDP)	7.4	6.7	8.0	3.9	3.5	2.8	1.9	1.6	1.8
Debt service to export ratio (percent)	2.3	2.1	2.1	2.9	3.1	3.0	5.0	4.3	2.3
Net foreign assets of commercial banks	508	509	491	590	581	603	573	575	556
Net foreign assets of CBK	1,108	1,095	1,239	1,283	1,308	1,298	1,312	1,323	1,370
Gross international reserves of the CBK	686	626	899	943	968	958	881	893	940

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

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

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

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

Table 5. Kosovo: Selected Financial Soundness Indicators, 2007–13

	2007	2008	2009	2010	2011	2012	2013 Apr.
Capital adequacy							
Regulatory capital/risk weighted assets 1/	17.5	16.5	18.1	18.8	17.6	14.4	14.8
Tier 1 capital/risk weighted assets 1/	16.2	15.3	15.2	15.8	14.8	11.8	12.2
Capital to assets	11.2	11.2	9.8	10.1	10.2	10.0	10.9
Asset quality							
NPL ratio 2/	4.1	3.3	4.3	5.2	5.7	7.5	7.7
NPL net of provisions to capital	2.8	3.0	2.9	3.7	4.6	7.3	7.1
Large Exposures to capital	38.3	56.5	64.6	72.4	77.8	80.1	N.A.
Sectoral breakdown of loans							
Agriculture	3.2	3.2	3.0	2.6	2.4	2.5	2.6
Manufacturing	10.6	8.0	11.5	11.0	10.1	9.5	9.5
Trade	41.6	38.8	37.4	37.1	37.8	37.8	37.8
Other services	16.5	20.7	14.6	12.0	11.7	11.6	11.7
Construction	5.6	5.5	6.9	7.5	7.0	7.2	7.2
Households	22.5	23.7	26.7	29.8	30.7	31.2	30.9
Liquidity							
Liquid assets/total assets 3/	33.2	30.0	37.4	37.5	32.6	34.1	32.3
Deposits to loans	124.3	117.1	129.7	126.1	119.4	123.7	120.7
Liquid assets to short-term liabilities 4/	33.0	35.0	47.0	46.2	39.6	40.8	38.8
Profitability							
Return on average assets 5/	3.2	2.3	1.6	1.6	1.6	0.8	1.0
Return on average equity 5/	32.3	20.6	15.5	16.8	16.9	8.7	10.2
Interest margin to total income	58.4	57.8	55.3	55.5	56.9	55.3	54.3
Non-interest expense to total income 6/	12.6	14.2	16.4	16.6	18.0	23.7	22.4
Interest margin to gross income	69.9	74.1	74.4	74.5	75.2	74.2	73.9
Non-interest expense to gross income 7/	68.2	75.0	79.2	74.3	76.8	87.3	85.2
Market risk							
Net open currency position to tier 1 capital	NA	13.1	12.4	-0.1	2.5	0.7	N.A.

Source: Central Bank of the Republic of Kosovo.

1/ As of Dec. 2012, new capital adequacy rules include an additional capital 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, as well as balances with commercial banks and securities.
4/ Short-term liabilities are deposits, and short-term borrowing and other liabilities (i.e., 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/ Non-interest expense including general and administrative costs.

Table 6. Kosovo: Consolidated Government Budget, 2011–18 1/

(Excluding donor designated grants; percent of GDP)

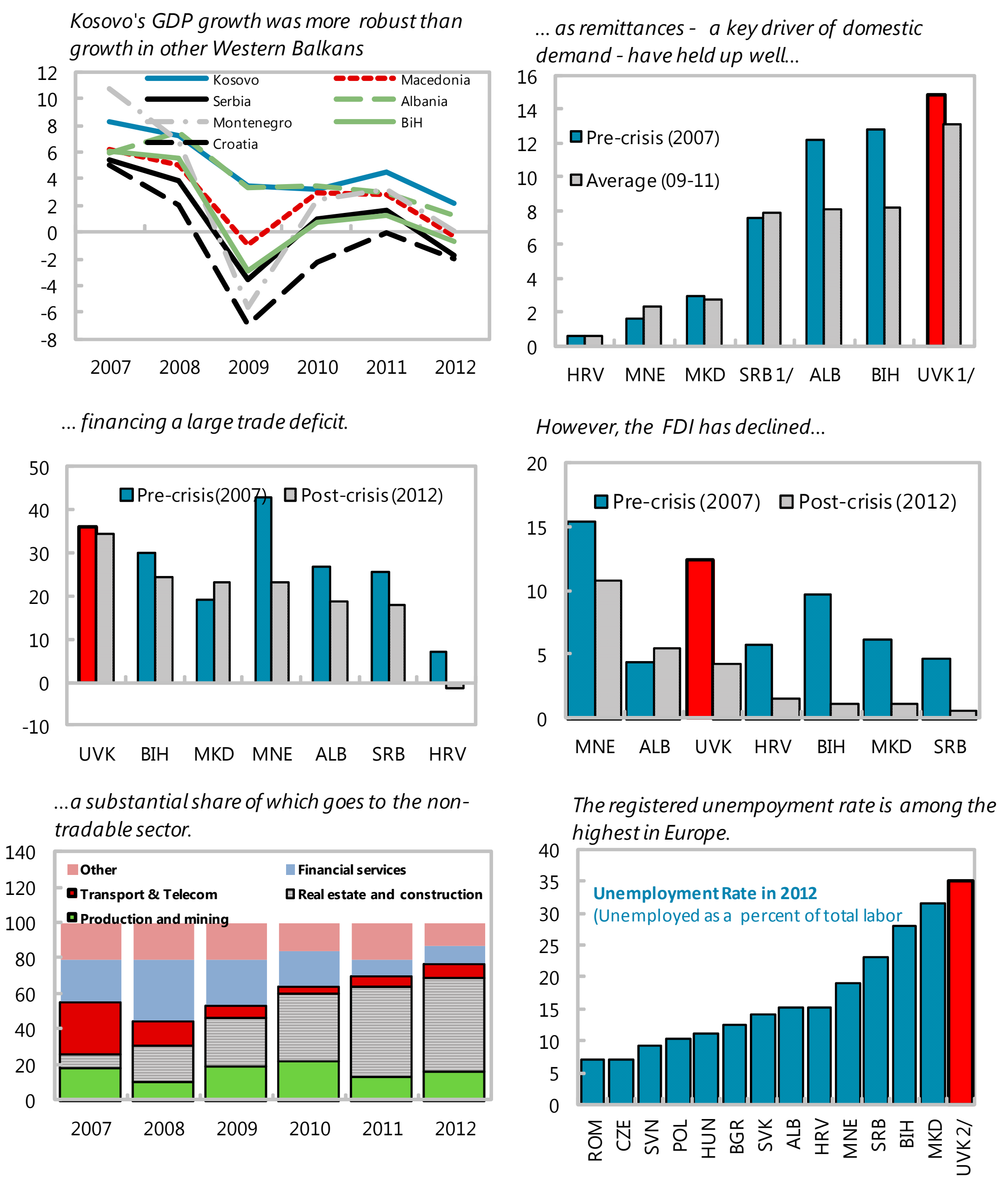
	2011	2012	2013	2014	2015	2016	2017	2018
			Proj.	Projections				
Total primary revenue and grants	27.3	26.4	26.9	25.9	26.2	26.4	26.4	26.4
Total primary revenue	26.7	25.6	26.8	25.9	26.2	26.4	26.4	26.4
Taxes	22.4	22.2	22.5	22.6	22.8	23.0	23.0	23.0
Direct taxes	3.2	3.4	3.5	3.5	3.8	3.9	4.0	4.0
Indirect taxes	19.9	19.4	19.6	19.8	19.8	19.8	19.8	19.8
Tax refunds	-0.6	-0.7	-0.7	-0.7	-0.7	-0.7	-0.7	-0.7
Nontax revenues	4.3	3.4	4.4	3.3	3.4	3.4	3.4	3.4
Of which:								
Dividends	1.3	0.9	0.8	0.0	0.0	0.0	0.0	0.0
Grants	0.5	0.7	0.1	0.0	0.0	0.0	0.0	0.0
Budget support	0.4	0.7	0.0	0.0	0.0	0.0	0.0	0.0
Trust fund at the World Bank	0.1	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Project grants	0.1	0.0	0.1	0.0	0.0	0.0	0.0	0.0
Primary expenditure	28.9	28.7	30.0	28.7	27.9	28.0	28.0	27.9
Of which:								
PAK-related expenditures	...	0.1	0.2	0.2	...	...	...	...
Primary expenditure excluding PAK	...	28.6	29.8	28.5	...	...	...	...
Current expenditure	17.4	17.7	18.6	18.6	18.6	18.6	18.6	18.6
Wages and salaries	8.1	8.1	8.3	8.3	8.3	8.3	8.3	8.3
Goods and services	3.7	3.8	4.3	4.2	4.3	4.3	4.3	4.3
Subsidies and transfers	5.7	5.8	5.9	5.9	5.9	5.9	5.9	5.9
Pension and social assistance	3.7	4.0	4.5	4.5	4.5	4.5	4.5	4.5
Other transfers and subsidies 2/	1.9	1.8	1.4	1.4	1.4	1.4	1.4	1.4
Reserve	0.0	0.0	0.1	0.1	0.1	0.1	0.1	0.1
Capital expenditure and net lending	11.5	11.0	11.3	10.2	9.4	9.4	9.4	9.4
Capital expenditure	10.9	10.8	11.4	10.3	9.5	9.5	9.5	9.5
Highways	5.4	5.6	5.2	4.8	4.0	3.5	0.0	0.0
R7	...	4.8	4.1	0.0	0.0	0.0	0.0	0.0
R6	...		0.5	4.3	3.5	3.0	0.0	0.0
Expropriations	...	0.8	0.5	0.5	0.5	0.5	0.0	0.0
Other capital spending	5.5	5.2	6.3	5.5	5.4	6.0	9.5	9.5
Net lending	0.6	0.2	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1
Primary balance	-1.7	-2.4	-3.1	-2.8	-1.7	-1.6	-1.5	-1.5
Primary balance net of PAK	0.0	-2.3	-3.0	-2.6	-1.7	-1.6	-1.5	-1.5
Interest income, net	-0.1	-0.2	-0.3	-0.2	-0.3	-0.4	-0.5	-0.5
Overall balance	-1.8	-2.6	-3.4	-3.0	-2.0	-2.0	-2.0	-2.0
Financing	1.8	2.6	3.4	3.0	2.0	2.0	2.0	2.0
Foreign financing	0.0	1.7	-0.1	-0.4	-0.4	-0.9	-0.9	-0.2
Drawings, incl. official financing	0.2	1.9	0.2	0.0	0.0	0.0	0.0	0.0
Amortization	-0.2	-0.2	-0.3	-0.4	-0.4	-0.9	-0.9	-0.2
Domestic financing	1.8	0.9	3.5	3.4	2.5	2.9	2.9	2.2
Domestic borrowing (net)	0.0	1.4	1.5	2.1	2.6	2.7	2.6	2.6
Privatization revenues	0.0	0.9	5.8	0.0	0.8	0.8	0.1	0.1
o/w PAK privatization	0.0		0.0	0.0	0.0	0.0	0.0	0.0
WB subscription	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Other financial assets (net)	0.0	0.0	-0.1	0.0	0.0	0.0	0.0	0.0
Own-source revenue (– = increase)	0.0	-0.3	0.1	0.0	0.0	0.0	0.0	0.0
o/w PAK related	0.0	0.0	0.2	0.2	0.0	0.0	0.0	0.0
Bank balance (prog.; – = increase)	1.8	-1.1	-3.7	1.3	-1.0	-0.6	0.1	-0.5
Financing gap	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Memorandum items:								
Bank balance of the general government	3.3	4.3	7.9	6.1	6.7	6.8	6.3	6.4
Of which: ELA	0.0	0.9	0.9	0.8	0.8	0.7	0.7	0.6
Minimum bank balance (fiscal rule)	...	...	...	4.5	4.5	4.5	4.5	4.5
Recommended bank balance (SBA)	5.7	5.9	6.7	6.8	7.1	7.2	7.0	7.0
Nominal GDP (millions of euros)	4,776	5,012	5,256	5,588	5,959	6,383	6,806	7,251

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

1/ Does not yet reflect the GFSM 2001 methodology to ensure consistency within a program context.

2/ Including capital transfers to public enterprises.

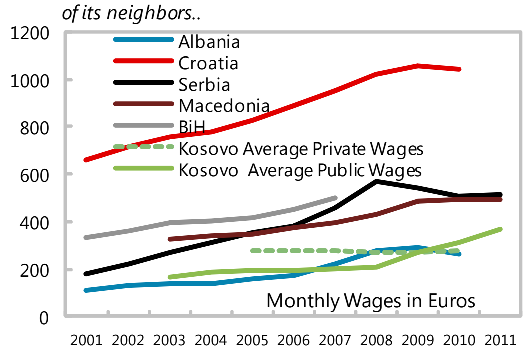
Figure 1. Kosovo: Real and External Sector Developments, 2007-12



Sources: World Economic Outlook; and Kosovo Statistics Office.
1/ Average for 2009 - 2012 data.
2/ Data for the first half of 2012.

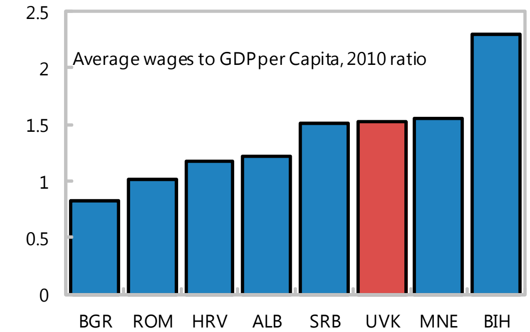
Figure 2. Kosovo: Labor Markets, Governance, Business Environment, and SMEs

Kosovo nominal wages are low compared to most of its neighbors..



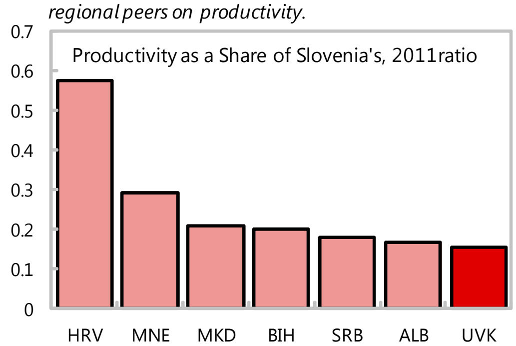
Sources: ILO and Kosovo Statistical Agency.

...but low wages reflect low productivity...



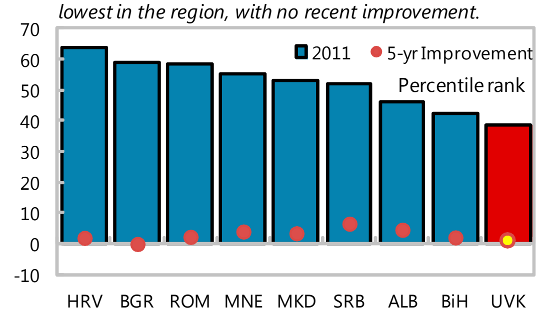
Source: IMF staff calculations.

...with Kosovo ranking unfavorably compared to its regional peers on productivity.



Source: IMF staff calculations.

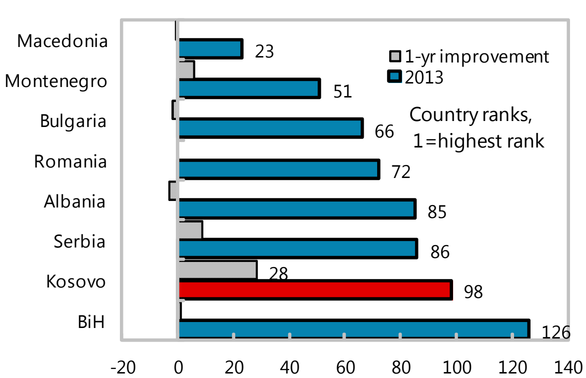
Governance indicators rank Kosovo among the lowest in the region, with no recent improvement.



Sources: World Bank Worldwide Governance Indicators Database.

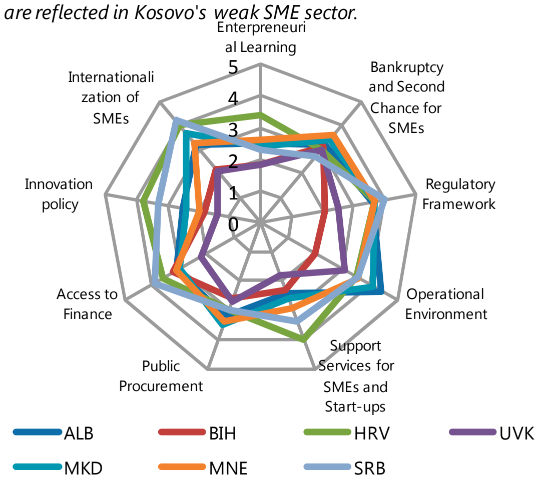
Note: Index includes subcomponents of government effectiveness, regulatory quality, rule of law, voice and accountability and control of corruption.

Despite improvements over the last year, structural weaknesses impeding ease of doing business



Sources: World Bank; and Doing Business Survey.

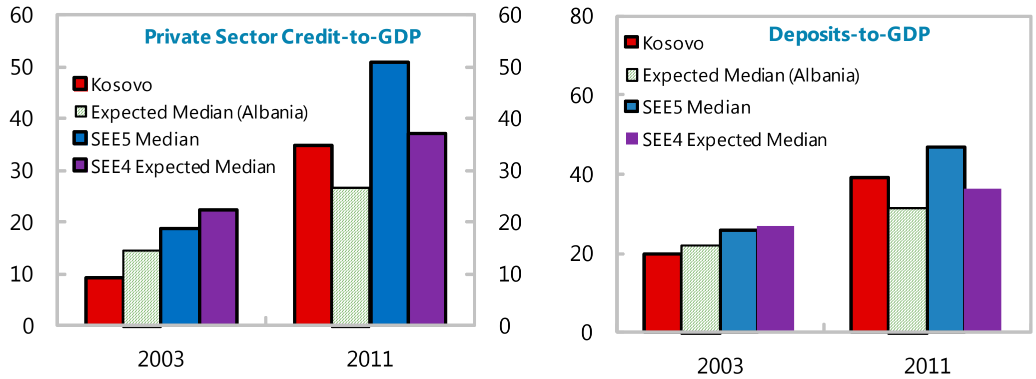
... and delays in developing SME policy compared to peers are reflected in Kosovo's weak SME sector.



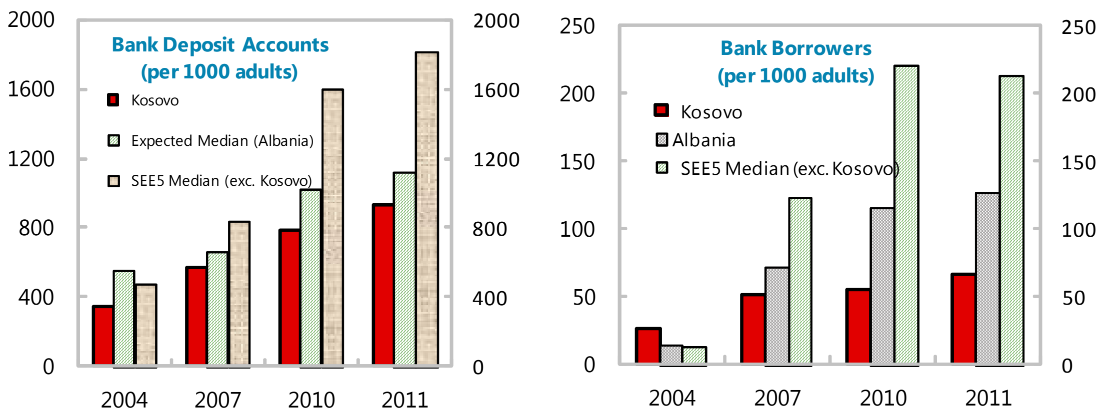
Source: SME Policy Index, OECD 2012.

Figure 3. Kosovo: Financial Sector Depth, Reach, and Efficiency

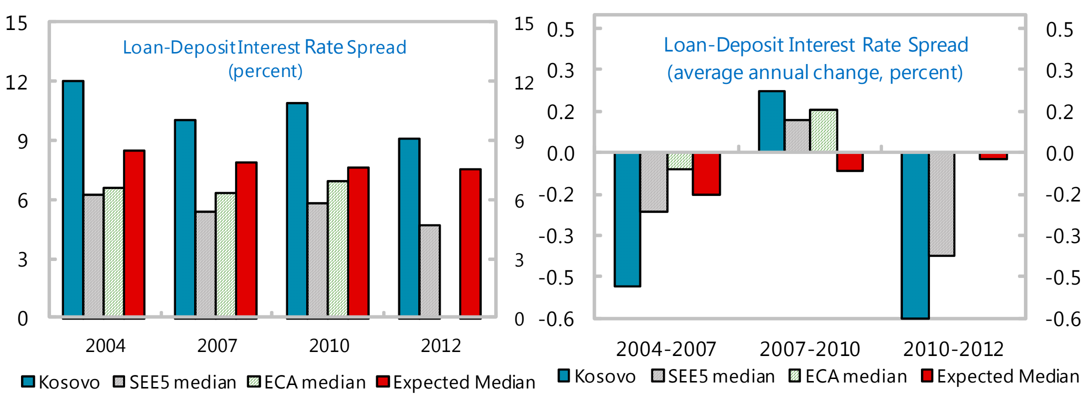
Kosovo's banking sector depth has increased.



However, reach (access) appears to be below potential.



Efficiency is quite low (reflected in higher spreads).



Sources: IMF IFS and FAS; World Bank's Finstat Database; and IMF staff calculations.

Table A1. Kosovo: External Debt Sustainability Framework, Baseline Scenario, 2009-2032 1/

(In percent of GDP, unless otherwise indicated)

	Actual			Historical 6/ Average	Standard 6/ Deviation	Est.	Projections								
	2009	2010	2011			2012	2013	2014	2015	2016	2017	2012-2017 Average	2022	2032	2018-2032 Average
External debt (nominal) 1/	**17.2**	**16.3**	**14.6**			**15.6**	**14.7**	**13.4**	**12.2**	**10.4**	**8.9**	**12.5**	**9.7**	**13.0**	**10.8**
o/w public and publicly guaranteed (PPG)	17.2	16.3	14.6			15.6	14.7	13.4	12.2	10.4	8.9		9.7	13.0	
Change in external debt	-3.7	-0.9	-1.7			1.0	-0.8	-1.3	-1.3	-1.7	-1.5		0.4	0.2	
Identified net debt-creating flows	**2.6**	**4.0**	**5.2**			**3.5**	**0.3**	**2.1**	**1.5**	**1.4**	**1.2**		**4.5**	**8.6**	
Non-interest current account deficit	**9.2**	**11.8**	**13.6**	**9.8**	**3.1**	**7.4**	**10.3**	**8.5**	**8.1**	**8.4**	**8.3**	**8.5**	**11.3**	**15.6**	**12.5**
Deficit in balance of goods and services	35.4	36.5	37.5			34.5	33.2	30.6	28.7	27.4	26.3	30.1	26.9	27.0	26.9
Exports	17.3	20.5	19.8			18.4	18.6	19.8	21.0	22.2	23.1		20.5	20.0	
Imports	52.8	56.9	57.3			52.9	51.8	50.4	49.7	49.6	49.4		47.4	47.0	
Net current transfers (negative = inflow)	-24.5	-22.9	-21.4	-22.5	1.5	-23.8	-19.6	-18.8	-17.3	-15.7	-14.8	-18.3	-13.3	-11.0	-12.6
o/w official	-8.1	-7.4	-6.7			-8.0	-3.9	-3.5	-2.8	-1.9	-1.6		-1.7	-0.6	
Other current account flows (negative = net inflow)	-1.7	-1.8	-2.5			-3.3	-3.3	-3.3	-3.3	-3.2	-3.2		-2.4	-0.4	
Net FDI (negative = inflow)	**-6.4**	**-6.9**	**-6.9**	**-4.8**	**3.2**	**-3.7**	**-9.8**	**-6.1**	**-6.3**	**-6.6**	**-6.8**	**-6.5**	**-6.8**	**-6.8**	**-6.8**
Endogenous debt dynamics 2/	**-0.2**	**-0.9**	**-1.5**			**-0.1**	**-0.2**	**-0.4**	**-0.4**	**-0.4**	**-0.3**	**-0.3**	**0.0**	**-0.2**	**-0.1**
Contribution from nominal interest rate	0.2	0.2	0.2			0.2	0.2	0.2	0.2	0.2	0.1		0.4	0.4	
Contribution from real GDP growth	-0.7	-0.5	-0.8			-0.3	-0.4	-0.6	-0.6	-0.6	-0.4		-0.4	-0.5	
Contribution from price and exchange rate changes	0.4	-0.6	-0.9			...	...	...	...	...	...		...	...	
Residual, including assets, errors, and omissions (3-4) 3/	**-6.3**	**-4.9**	**-7.0**			**-2.5**	**-1.2**	**-3.3**	**-2.7**	**-3.2**	**-2.7**	**-2.6**	**-4.0**	**-8.4**	**-5.4**
o/w exceptional financing	0.0	0.0	0.0			0.0	0.0	0.0	0.0	0.0	0.0		0.0	0.0	
PV of external debt 4/	...	...	14.8			14.2	13.7	12.8	11.8	10.4	9.1		8.7	10.8	
In percent of exports	...	...	75.1			77.1	73.5	64.5	56.3	46.7	39.5		42.6	53.8	
PV of PPG external debt	**...**	**...**	**14.8**			**14.2**	**13.7**	**12.8**	**11.8**	**10.4**	**9.1**		**8.7**	**10.8**	
In percent of exports	**...**	**...**	**75.1**			**77.1**	**73.5**	**64.5**	**56.3**	**46.7**	**39.5**		**42.6**	**53.8**	
In percent of government revenues	**...**	**...**	**55.4**			**55.5**	**50.9**	**49.1**	**44.9**	**39.2**	**34.4**		**32.9**	**40.6**	
Debt service-to-exports ratio (in percent)	**2.2**	**2.3**	**2.2**			**9.6**	**17.8**	**15.6**	**12.0**	**13.0**	**11.8**		**13.0**	**109.7**	
PPG debt service-to-exports ratio (in percent)	**2.2**	**2.3**	**2.2**			**2.4**	**2.7**	**3.1**	**3.0**	**5.0**	**4.3**		**7.5**	**7.6**	
PPG debt service-to-revenue ratio (in percent)	**1.3**	**1.8**	**1.6**			**1.8**	**1.8**	**2.3**	**2.4**	**4.2**	**3.7**		**5.8**	**5.7**	
Total gross financing need (billions of euros)	0.1	0.2	0.3			0.3	0.2	0.3	0.3	0.3	0.3		0.7	5.6	
Non-interest current account deficit that stabilizes debt ratio	12.9	12.7	15.4			6.4	11.1	9.8	9.4	10.2	9.8		10.8	15.4	
Key macroeconomic assumptions															
Real GDP growth (in percent)	3.5	3.2	5.2	4.7	2.0	2.3	2.6	4.2	4.5	5.0	4.5	3.9	4.6	4.5	4.6
GDP deflator in euro terms (change in percent)	-1.7	3.7	5.8	1.1	3.6	2.5	2.2	2.0	2.0	2.0	2.0	2.1	2.0	2.0	2.0
Effective interest rate (percent) 5/	0.8	1.2	1.2	0.4	0.6	1.6	1.5	1.5	1.5	1.4	1.4	1.5	4.2	3.0	3.7
Growth of exports of G&S (euro terms, in percent)	22.1	26.4	7.5	21.9	31.2	-2.1	5.9	13.1	13.2	13.2	11.0	9.0	5.6	6.6	5.7
Growth of imports of G&S (euro terms, in percent)	-1.9	15.6	12.0	10.0	7.7	-3.1	2.7	3.4	5.3	6.7	6.3	3.5	6.3	6.6	6.4
Grant element of new public sector borrowing (in percent)	...	...	...	...	...	...	49.1	11.5	11.5	11.5	11.5	19.0	11.5	11.5	12.0
Government revenues (excluding grants, in percent of GDP)	28.6	26.0	26.8			25.6	26.8	26.0	26.3	26.5	26.5		26.5	26.5	26.6
Aid flows (in billions of euros) 7/	0.0	0.0	0.0			0.0	0.0	0.0	0.0	0.0	0.0		0.0	0.0	
o/w Grants	0.0	0.0	0.0			0.037	0.003	0.0	0.0	0.0	0.0		0.0	0.0	
o/w Concessional loans	0.0	0.0	0.0			0.0	0.0	0.0	0.0	0.0	0.0		0.0	0.0	
Grant-equivalent financing (in percent of GDP) 8/	...	...	...			...	0.1	0.0	0.0	0.0	0.0		0.3	0.2	0.2
Grant-equivalent financing (in percent of external financing) 8/	...	...	...			...	64.6	11.5	11.5	11.5	11.5		11.5	11.5	12.0
Memorandum items:															
Nominal GDP (billions of euros)	4.0	4.3	4.8			5.0	5.3	5.6	6.0	6.4	6.8		9.5	18.1	
Nominal dollar GDP growth	1.7	7.1	11.3			4.9	4.9	6.3	6.6	7.1	6.6	6.1	6.7	6.6	6.7
PV of PPG external debt (in billions of euros)			0.7			0.7	0.7	0.7	0.7	0.7	0.6		0.8	1.9	
(PVt-PVt-1)/GDPt-1 (in percent)						0.1	0.1	-0.1	-0.2	-0.7	-0.6	-0.2	0.8	0.9	0.7
PV of PPG external debt (in percent of GDP)	...	...	14.8			14.2	13.7	12.8	11.8	10.4	9.1		8.7	10.8	
PV of PPG external debt (in percent of exports)	...	...	75.1			77.1	73.5	64.5	56.3	46.7	39.5		42.6	53.8	
Debt service of PPG external debt (in percent of exports)	...	...	2.2			2.4	2.7	3.1	3.0	5.0	4.3		7.5	7.6	

Sources: Country authorities; and staff estimates and projections.

1/ Data on private external debt is unavailable.

2/ Derived as [r - g - ρ(1+g)]/(1+g+ρ+gρ) times previous period debt ratio, with r = nominal interest rate; g = real GDP growth rate, and ρ = growth rate of GDP deflator in euro terms.

3/ Includes exceptional financing; changes in gross foreign assets; errors and omissions, and valuation adjustments. For projections also includes contribution from price and exchange rate changes.

4/ Assumes that PV of private sector debt is equivalent to its face value.

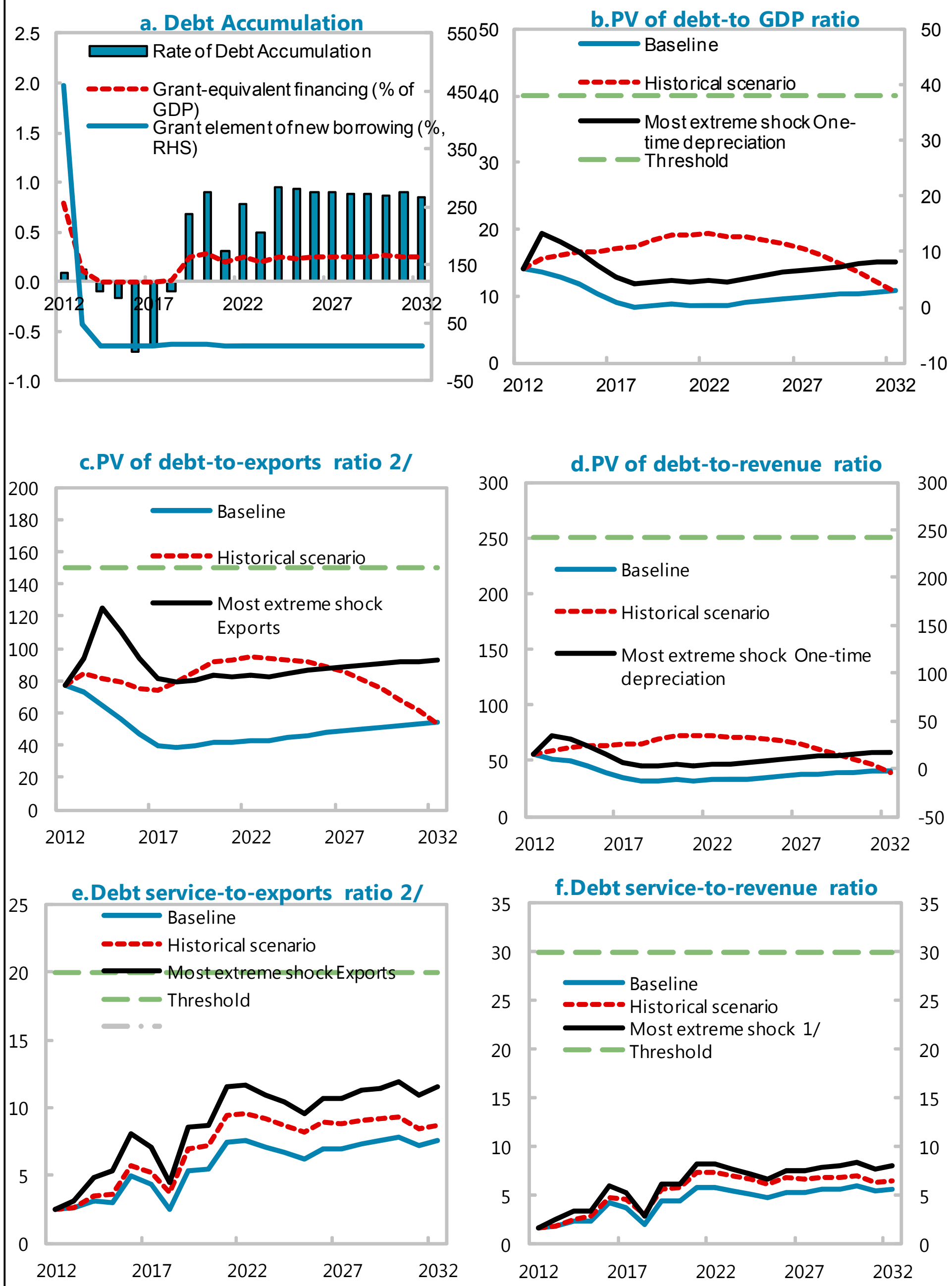
5/ Current-year interest payments divided by previous period debt stock.

6/ Historical averages and standard deviations are generally derived over the past 10 years, subject to data availability.

7/ Defined as grants, concessional loans, and debt relief.

8/ Grant-equivalent financing includes grants provided directly to the government and through new borrowing (difference between the face value and the PV of new debt).

Figure A1. Kosovo: Indicators of Public and Publicly Guaranteed External Debt under Alternatives Scenarios, 2012-2032 1/



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

1/ The most extreme stress test is the test that yields the highest ratio in 2022. In figure b. it corresponds to a Exports shock; in c. to a Exports shock; in d. to a Exports shock; in e. to a Exports shock and in figure f. to a Exports shock.

2/ The magnitude of the export shock reflects the variability of prices of metals, which represented 76 percent of Kosovo's exports in 2010.

Table A2. Kosovo: Public Sector Debt Sustainability Framework, Baseline Scenario, 2009-2032

(In percent of GDP, unless otherwise indicated)

	Actual					Estimate	Projections								
	2009	2010	2011	Average 5/	Standard Deviation 5/	2012	2013	2014	2015	2016	2017	2012-17 Average	2022	2032	2018-32 Average
Public sector debt 1/	17.2	16.3	14.6			17.0	17.6	18.3	19.3	19.8	20.3		25.2	31.6	
Change in public sector debt	-3.7	-0.9	-1.7			2.4	0.6	0.6	1.0	0.5	0.5		0.9	0.5	
Identified debt-creating flows	0.5	1.7	0.1			1.0	-3.2	2.0	0.1	-0.1	0.6		0.5	0.1	
Primary deficit	0.6	2.6	1.6	-0.2	3.5	2.4	3.1	2.7	1.6	1.5	1.4	2.1	0.9	0.8	0.9
Revenue, grants, and interest income	28.6	26.9	27.3			26.4	26.9	26.0	26.3	26.5	26.5	26.4	26.5	26.5	26.6
of which: grants	0.0	0.9	0.5			0.7	0.1	0.0	0.0	0.0	0.0		0.0	0.0	
Primary (noninterest) expenditure	29.2	29.5	28.9			28.7	30.0	28.7	27.9	28.0	28.0	28.6	27.5	27.3	27.5
Automatic debt dynamics	-0.2	-0.9	-1.5			-0.5	-0.5	-0.7	-0.7	-0.8	-0.7	-0.6	-0.5	-0.7	-0.6
Contribution from interest rate/growth differential	-0.8	-0.5	-0.9			-0.4	-0.4	-0.7	-0.7	-0.8	-0.6		-0.5	-0.7	
of which: contribution from average real interest rate	-0.1	0.0	0.0			-0.1	0.0	0.0	0.1	0.1	0.2		0.6	0.6	
of which: contribution from real GDP growth	-0.7	-0.5	-0.8			-0.3	-0.4	-0.7	-0.8	-0.9	-0.9		-1.1	-1.4	
Contribution from real exchange rate depreciation	0.6	-0.4	-0.6			-0.1	0.0	0.0	0.0	0.0	0.0		...	...	
Other identified debt-creating flows	0.0	0.0	0.0			-0.9	-5.8	0.0	-0.8	-0.8	-0.1		0.0	0.0	
Privatization receipts (negative)	0.0	0.0	0.0			-0.9	-5.8	0.0	-0.8	-0.8	-0.1		0.0	0.0	
Recognition of implicit or contingent liabilities	0.0	0.0	0.0			0.0	0.0	0.0	0.0	0.0	0.0		0.0	0.0	
Debt relief (HIPC and other)	0.0	0.0	0.0			0.0	0.0	0.0	0.0	0.0	0.0		0.0	0.0	
Other (specify, e.g. bank recapitalization)	0.0	0.0	0.0			0.0	0.0	0.0	0.0	0.0	0.0		0.0	0.0	
Residual, including asset changes	-4.1	-2.6	-1.9			1.4	3.8	-1.3	1.0	0.6	-0.1	0.9	0.4	0.4	0.4
Other Sustainability Indicators															
PV of public sector debt	...	...	14.8			15.7	16.6	17.6	19.0	19.7	20.5		24.3	29.3	
PV of contingent liabilities (not included in public sector debt)	...	...	...			...	...	...	...	...	...		...	...	
Gross financing need 2/	1.0	3.1	2.0			2.8	5.1	6.2	5.3	6.2	5.8		8.2	9.2	
PV of public sector debt-to-revenue and grants ratio (in percent)	...	...	54			59	62	68	72	75	77		91	110	
PV of public sector debt-to-revenue ratio (in percent)	...	...	55			61	62	68	72	75	77		91	110	
Debt service-to-revenue and grants ratio (in percent) 4/	1.3	1.7	1.6			1.7	7.4	13.4	13.9	17.9	16.7		27.3	31.6	
Debt service-to-revenue ratio (in percent) 4/	1.3	1.8	1.6			1.8	7.4	13.4	13.9	17.9	16.7		27.3	31.6	
Primary deficit that stabilizes the debt-to-GDP ratio	4.3	3.5	3.4			0.0	2.5	2.0	0.6	1.0	0.9	1.2	0.0	0.3	0.1
Overall balance	-0.8	-2.8	-1.8			-2.6	-3.4	-3.0	-2.0	-2.0	-2.0	-2.5	-2.0	-2.0	-2.0
Key macroeconomic and fiscal assumptions															
Nominal GDP (local currency)	4.0	4.3	4.8			5.0	5.3	5.6	6.0	6.4	6.8		9.5	18.1	
Real GDP growth (in percent)	3.5	3.2	5.2	4.7	2.0	2.3	2.6	4.2	4.5	5.0	4.5	3.9	4.6	4.5	4.6
Average nominal interest rate on public debt (in percent)	0.8	1.2	1.2	0.4	0.6	1.6	2.0	2.1	2.4	2.8	3.1	2.3	4.7	4.2	4.5
Average nominal interest rate on forex debt (in percent)	0.8	1.2	1.2	0.4	0.6	1.6	1.5	1.5	1.5	1.4	1.4	1.5	4.2	3.0	3.7
Interest on domestic debt (percentage of previous year stock, in percent)	...	...	...	...	...	...	7.4	5.0	5.0	5.0	5.0	5.5	5.0	5.0	5.0
Average real interest rate (in percent)	-0.4	0.3	-0.3	-1.8	1.3	-0.4	0.0	0.1	0.5	0.7	1.1	0.3	2.6	2.1	2.5
Real exchange rate depreciation (in percent, + indicates depreciation)	2.9	-2.7	-4.0	1.2	4.0	-0.6	...	...	...	...	...	...	...	...	...
Inflation rate (GDP deflator, in percent)	-1.7	3.7	5.8	1.1	3.6	2.5	2.2	2.0	2.0	2.0	2.0	2.1	2.0	2.0	2.0
Growth of real primary spending (deflated by GDP deflator, in percent)	25.4	4.1	3.3	3.8	8.3	1.7	7.0	-0.2	1.7	5.2	4.5	3.3	4.6	4.4	4.5
Grant element of new external borrowing (in percent)	...	...	...	...	...	...	49.1	11.5	11.5	11.5	11.5	19.0	11.5	11.5	12.0

Sources: Country authorities; and staff estimates and projections.

1/ Covers general government. Gross debt concept is used.

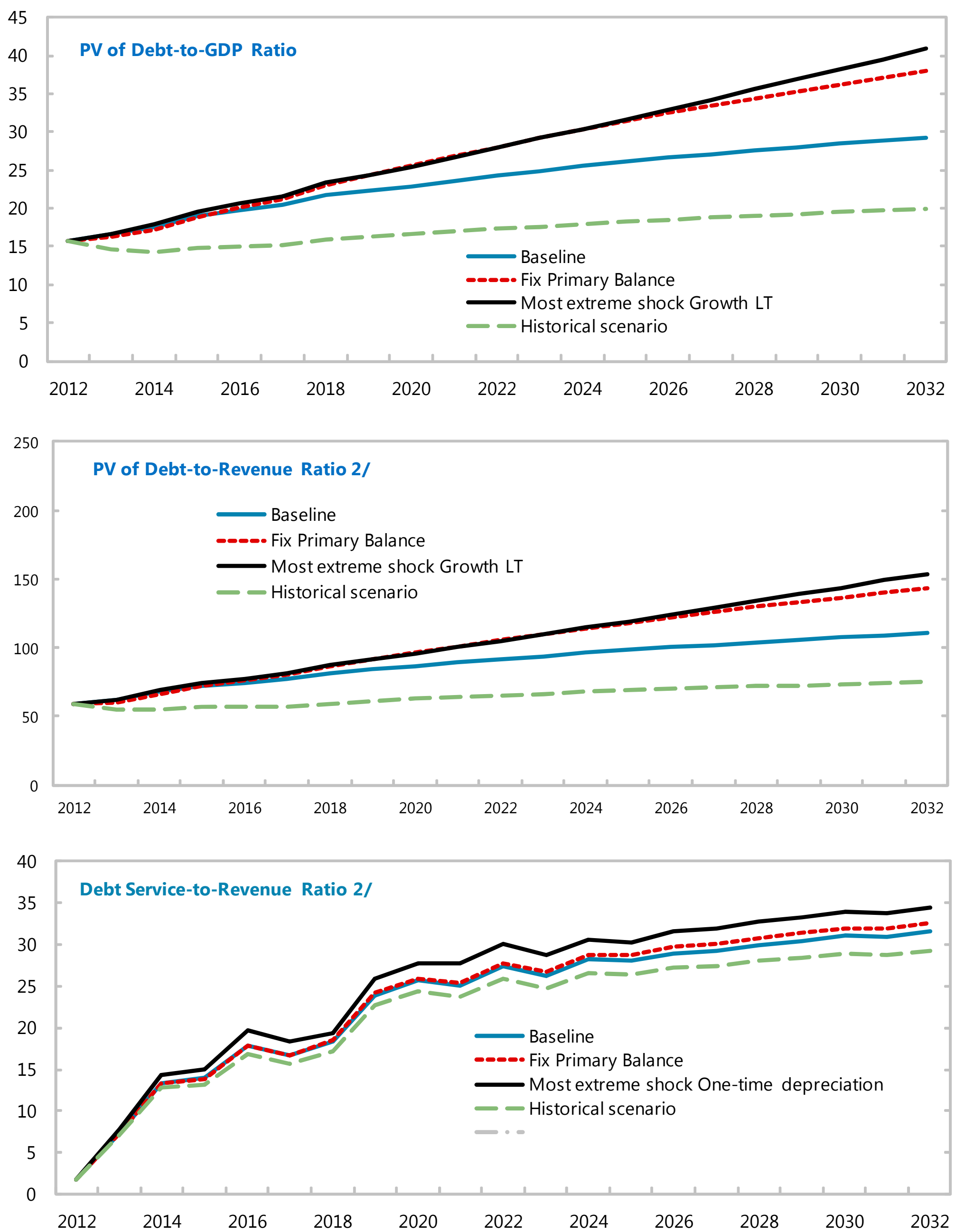
2/ Gross financing need is defined as the primary deficit plus debt service plus the stock of short-term debt at the end of the last period.

3/ Revenues excluding grants.

4/ Debt service is defined as the sum of interest and amortization of medium and long-term debt.

5/ Historical averages and standard deviations are generally derived over the past 10 years, subject to data availability.

Figure A2. Kosovo: Indicators of Public Debt Under Alternative Scenarios, 2012-2032 1/



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

1/ The most extreme stress test is the test that yields the highest ratio in 2022.

2/ Revenues are defined inclusive of grants.

INTERNATIONAL MONETARY FUND

REPUBLIC OF KOSOVO

STAFF REPORT FOR THE 2013 ARTICLE IV CONSULTATION—INFORMATIONAL ANNEX

June 28, 2013

Prepared By

The European Department
(In Consultation with Other Departments)

CONTENTS

FUND RELATIONS

(As of May 31, 2013)

Membership Status

Joined: June 29, 2009.

General Resources Account:	**SDR Million**	**Percent Quota**
Quota	59.00	100.00
Fund holdings of currency	141.82	240.37
Reserve Tranche Position	14.17	24.01

SDR Department:	**SDR Million**	**Percent Allocation**
Net cumulative allocation	55.37	100.00
Holdings	53.86	97.28

Outstanding Purchases and Loans:	**SDR Million**	**Percent Quota**
Stand-by Arrangements	96.98	164.37

Latest Financial Arrangements:

Type	**Date of Arrangement**	**Expiration Date**	**Amount Approved (SDR Million)**	**Amount Drawn (SDR Million)**
Stand-By	April 27, 2012	Dec 26, 2013	90.97	78.22
Stand-By	July 21, 2010	Jan 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				
	2013	2014	2015	2016	2017
Principal	2.35	9.38	12.99	39.11	33.16
Charges/Interest	0.52	0.97	0.87	0.62	0.22
Total	2.86	10.35	13.86	39.73	33.37

[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.

Implementation of HIPC Initiative: Not Applicable

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

Safeguards Assessments

The latest safeguards assessment of the Central Bank of the Republic of Kosovo (CBK) has been completed on June 25, 2012. It found that the majority of previous safeguards recommendations have 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. Going forward, the department should now be subject to an external quality review. To safeguard Fund disbursements used for budget financing, the authorities have committed in the MEFP to continue existing practice of (i) using the CBK as the sole investment manager; and (ii) holding all government accounts at the CBK. Separately, to protect the CBK's financial autonomy, treatment of any losses incurred as a result of emergency liquidity assistance was clarified in the law.

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 Central Bank of the Republic of Kosovo is not part of the European System of Central Banks. Kosovo is an Article XIV member and has not yet accepted the obligations of Article VIII of the Articles of Agreement.

Previous Article IV Consultation:

Kosovo is on a 24-month consultation cycle during the Stand-By Arrangement. The last Article IV consultation—which was the first in Kosovo's history—was concluded on July 6, 2011.

Fourth Review under the Stand-By Arrangement

Discussions took place in Pristina, May 28-June 10, 2013.

FSAP and ROSC Participation:

An FSAP mission was conducted during September 19–October 2 2012. The FSSA included the ROSC for compliance with Basle 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 under EBD/99/80 and, since September 2008, to Kosovo under EBD/08/95. 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 (August 2011, September 2012, Feb-March 2013)
- CPI Statistics (Feb-March 2013)

Fiscal Sector

- IT systems and Taxpayer Compliance (HQ Missions: Feb. 2011; expert visits: Feb. 2011)
- Tax Policy and Administration (Sep. 2011)
- Tax Administration (Mar. 2012, Feb. 2013)
- Fiscal Federalism (Sep. 2011)
- Public Financial Management (Regional PFM advisor: Feb. 2013)
- Fiscal rule and monitoring of accounts payable (Jun. 2012)
- Resource regime for mining (Sep. 2012)
- Rules-based fiscal framework (Feb. 2013)

Monetary and Financial Sectors

- FSAP mission (Sep.-Oct. 2012)
- Central Bank asset management (Mar. 2012, May 2013)
- Central Bank Law (May 2012)
- Bank supervision and regulations (Sep. 2011)
- Financial stability analysis, including stress testing (Aug. 2011)
- Monetary and forex operations (Jun. 2011)
- Payments and settlements (Apr. 2011)

External Sector

- Balance of Payments Statistics (Mar. 2012)

Resident Representative: Mr. Sulemane took up his post in October 2010.

JOINT IMF-WORLD BANK MANAGEMENT ACTION PLAN

Title	Products	Provisional Timing of Missions	Expected Delivery Date
1. Fund work program	TA on CBK asset management	May 22-June 4 2013	
	Fourth Review SBA	May 28-June 10 2013	15 July 2013
	Staff visit on the 2014 Budget	September 2013	End-September 2013
	Fifth review SBA	November 2013	December 2013
	TA on Revenue administration	Up to six short-term expert visits through end-April 2014	
	TA on crisis management TA on macro prudential framework (macro modeling)	July 2013	
	TA on stress testing	August 2013	
	TA on Bank Resolution	August 2013	
	TA on risk-based banking supervision	October 2013	
	TA to the CBK on External sector	November 2013	
	TA on national accounts	Planned for March 2014	
		Four missions by the regional national	

		accounts advisor planned for June, September, 2013 and January and April 2014	
2. Bank work program	Public Sector Modernization Project (PSMP) PFR TA and partial capitalization of DIFK Social Security Note Poverty Report LFS Report Study on Economic Mobility, Labor Markets and Gender in Kosovo Report and note as part of Smart Safety Nets Analytical and Advisory Services Strengthening Capacity of the Health Financing Agency New Kosovo Power Station and Environmental Cleanup Project	October 2013 June , August 2013 Expected to be completed in 2014 June 2013 July 2013 July 2013 … Missions: May, 2013; and Q4 of CY 2013 July-August 2013 September 2013	ongoing Expected end-2013 Expected July 2013 Expected July 2013 Expected July 2013 September 2013 September 2013 Expected June 2013Summary note – June 2014 ongoing 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 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. GDP data based on the production approach are available, but publication lags are long. Kosovo should also start publishing quarterly GDP data and a monthly index of industrial production.
Labor Markets: There is limited and unreliable data on the labor force and wages given the large share of the informal economy. A household survey is currently underway, with preliminary data for the first half of 2012 having been published in May 2013.
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. The current weights, introduced in January 2012, are based on the data from Household Budget Survey (HBS) and National Accounts (NA) data by expenditure approach for 2010. These weights will be used through December 2013. The Kosovar CPI's item classification fully conforms to Classification of Individual Consumption According to Purpose (COICOP).
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 Dec. 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 June 28, 2013)

	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	04/30/2013	05/31/2013	M	M	Q
Central Bank Balance Sheet	04/30/2013	05/31/2013	M	M	Q
Consolidated Balance Sheet of the Banking System	04/30/2013	05/31/2013	M	M	Q
Interest Rates[2]	04/30/2013	05/31/2013	M	M	Q
Consumer Price Index	05/31/2013	6/15/2013	M	M	M
Revenue, Expenditure, Balance and Composition of Financing[3] – General Government[4]	04/31/2013	05/24/2013	M	M	M
Revenue, Expenditure, Balance and Composition of Financing[3]– Central Government	04/31/2013	05/24/2013	M	M	M
Stocks of Central Government and Central Government-Guaranteed Debt[5]	03/31/2013	06/18/2013	Q	Q	Q
External Current Account Balance	12/31/2012	4/16/2013	Q	Q	Q
Exports and Imports of Goods[8]	02/28/2013	4/17/2013	M	M	M
GDP/GNP[9]	2011	12/20/2012	A	A	A
Gross External Debt	12/31/2012	4/16/2013	Q	Q	Q
International Investment Position[6]	12/31/2012	4/16/2013	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

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Press Release No. 13/272
FOR IMMEDIATE RELEASE
July 23, 2013

IMF Executive Board Concludes 2013 Article IV Consultation with Kosovo

On July 15, 2013, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with Kosovo.[1]

Kosovo's economy has displayed resilience in the face of headwinds from the global financial crisis and euro area turbulence. Since the onset of the financial crisis in 2007, annual real GDP growth has never been less than two percent, and has averaged 4½ percent between 2007 and 2012, one of the highest growth rates in the region. The resilience owes primarily to the near-absence of financial or export linkages to crisis countries, and Kosovo's exposure instead to Germany and Switzerland, countries in which two-thirds of the Diaspora reside. Remittances and FDI from the Diaspora have held up well, and have therefore continued to support domestic demand and finance a wide trade deficit. Unemployment remains very high at around 35 percent, although much of it reflects arguably informal employment.

Consumer price inflation has moved in line with import prices, notably for food, but core inflation has remained contained at around 2 percent, consistent with Kosovo's unilateral adoption of the euro. The banking sector has remained liquid, profitable, and well capitalized, although financial strength differs across banks.

In the past two years, macroeconomic policies have been conducted in the context of a Staff-Monitored Program (in 2011) and a Stand-By Arrangement (from 2012). In this period, the

[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. 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.

authorities have restored a sustainable fiscal stance, improved the preparation and costing of spending initiatives, and strengthened the financial safety net. From 2014, fiscal policy would be anchored by a rules-based fiscal framework, expected to be enacted in July of this year. Further, the government is on-track to restore its cash buffers, provided the sale of the telecommunications company PTK proceeds as planned later this year. The authorities have also taken initiatives to strengthen competitiveness and enhance public infrastructure. The Stand-By Arrangement—that the authorities are treating as precautionary in 2013—expires toward the end of the year.

Executive Board Assessment

Executive Directors commended Kosovo's resilience to external turbulence, owing mainly to prudent policies and robust remittances and FDI inflows from the diaspora. Directors noted that looking ahead, it will be important to reduce dependence on these inflows and develop a robust tradable sector that can support self-sustained growth.

Directors welcomed the efforts to enhance competitiveness. They encouraged continued commitment to improving the business climate, strengthening investments in public infrastructure and education, and increasing regional integration. Maintaining wage restraint and flexible labor markets and initiatives to support small- and medium-sized enterprises will reinforce these efforts.

Directors recognized the important steps taken by the authorities to restore fiscal sustainability. The challenge ahead is to preserve this strength while addressing pressing social and capital spending needs. In this context, Directors welcomed the development of a rules-based fiscal framework that will anchor fiscal policy from 2014. They stressed that careful budgetary planning and costing of spending initiatives, while resisting ad hoc spending pressures, will remain critical.

Directors considered the heavy reliance on indirect taxes to be appropriate given the economy's transfer-dependent structure. However, they emphasized that revenue policy would need to adjust as Kosovo integrates more closely with its neighbors and as the growth model shifts from dependence on transfers to domestic production. Directors agreed that the government's bank balance with the central bank needs to be guarded carefully as a critical prudential buffer to insure the economy against fiscal and financial shocks.

Directors noted that the banking system is liquid, profitable, and well capitalized. They also noted with satisfaction progress made with implementing key FSAP recommendations. To promote further financial sector development, Directors saw a need to strengthen the legal and institutional environment, in particular to expedite contract enforcement by the judicial system. To further reduce risks in the banking system, Directors recommended a gradual move to comprehensive risk-based supervision, the development of a macro-prudential policy framework, and the creation of a permanent funding mechanism for the special reserve fund for emergency liquidity assistance.

Kosovo: Main Indicators, 2010–14

	2010	2011	2012	2013	2014
			Est.	Projections	
Real growth rates					
GDP	3.2	5.2	2.3	2.6	4.2
GDP per capita	1.7	3.8	1.4	1.1	2.7
Consumption	1.9	2.6	1.1	2.5	3.0
Investment	12.3	11.3	-3.2	5.2	3.4
Exports	13.0	10.1	-0.5	4.8	12.1
Imports	8.5	5.3	-4.1	4.6	4.4
Price changes					
CPI, period average	3.5	7.3	2.5	2.1	1.8
CPI, end of period	6.6	3.6	3.7	1.5	1.7
GDP deflator	3.7	5.8	2.5	2.2	2.0
Real effective exch. rate (average; -=depreciation)	-0.7	3.5	-0.1	…	…
Real effective exch. rate (end of period; -=depreciation)	0.8	0.8	1.4	…	…
General government operations (percent of GDP)					
Revenues, incl. interest income 1/	27.1	27.3	26.4	26.9	26.0
Primary expenditures	29.5	28.9	28.7	30.0	28.7
Of which					
Wages and salaries	7.3	8.1	8.1	8.4	8.3
Subsidies and transfers	6.3	5.7	5.8	5.9	5.9
Capital and net lending, incl. highways	11.7	11.5	11.0	11.3	10.2
Capital expenditures on highways	2.9	5.4	5.6	5.2	4.8
Overall balance	-2.6	-1.8	-2.6	-3.4	-3.0
Debt financing, net	0.3	-0.1	3.1	1.4	1.7
Privatization	0.0	0.0	0.9	5.8	0.0
Stock of government bank balances	5.7	3.3	4.3	7.9	6.1
Financing gap	0.0	0.0	0.0	0.0	0.0
Savings-investment balances (percent of GDP) 2/					
Domestic savings	-3.8	-4.9	-3.6	-3.7	-2.4
Transfers excluding general government (net)	15.4	14.6	15.8	15.7	13.2
Net factor income	1.6	2.4	3.1	3.1	3.1
National savings	13.2	12.1	15.3	15.1	16.0
Investment	32.7	32.7	30.9	29.5	28.2
Current account, excl. official transfers	-19.5	-20.6	-15.6	-14.4	-12.2
Balance of payments (percent of GDP)					
Current account balance, incl. official transfers	-12.0	-13.8	-7.6	-10.5	-8.7
Of which: official transfers 3/	7.4	6.7	8.0	3.9	3.5
Net foreign direct investment	7.7	7.9	4.3	10.3	6.5
Portfolio investment, net	-1.1	-1.2	-3.7	-3.4	-1.7
Banking sector (percentage change)					
Bank credit to the private sector	12.6	14.7	4.5	5.3	9.9
Deposits of the private sector	23.1	11.4	10.9	11.4	10.2
Non-performing loans (percent of total loans)	5.2	5.7	7.5	7.6 4/	…
GDP (millions of euros)	4,291	4,776	5,012	5,256	5,588
GDP per capita (euros)	2,418	2,655	2,761	2,852	2,988

1/ Projections assume grants of EC and IDA.

2/ Savings-investment of the economy including donor sector

3/ Excluding capital transfers

4/ April 2013.

Statement by Mr. Johann Prader and Mr. Omer Yalvac on Republic of Kosovo

July 15, 2013

On behalf of our Kosovar authorities, we thank staff and Management for the fruitful policy discussions and support during the 2013 Article IV consultations and the fourth review under the Stand-by Arrangement. These exchanges of views are very helpful for the authorities when designing their policies.

Since the last review in April, there have been very positive developments in terms of relations with the European Union (EU). On April 19, 2013, the governments of Kosovo and Serbia completed an agreement that would allow both countries to apply for EU membership, a significant improvement towards normalizing relations. Following this major step, there were rounds of talks between delegations from both countries. On June 28, 2013, the European Council announced the decision to begin negotiations for a Stabilization and Association Agreement (SAA) between the Republic of Kosovo and the EU. The SAA is the first contractual agreement between the Republic of Kosovo and the EU which provides a perspective for Kosovo's full membership. The start of negotiations for an SAA with the EU bodes well for the country's economic prospect.

The Article IV report's findings illustrate that the economy has performed strongly, despite headwinds from the global financial crisis and turbulence in the euro area. Growth has continued to stay over 2 percent since 2007 and average growth has been the highest among peer countries. Macroeconomic fundamentals have been strengthened with the support of the Stand-by Arrangement. Very limited financial and export linkages to countries most affected by the euro area crisis and strong remittances from Germany and Switzerland have positively contributed to Kosovo's growth prospects.

Growth Outlook

The economy is expected to gradually accelerate throughout 2013 and continue along the path to 4.5 percent growth over the next few years. In the coming period, favorable demographics, the strong banking sector, remittances, and foreign direct investment will be important pillars for strong growth performance. There are encouraging signs in terms of an increase in domestic production, which substitutes imports for domestic consumption. Improvements in competitiveness and continued support from the Diaspora are expected to boost the economy's medium-term growth prospects.

The authorities are mindful of the need to increase the economy's productive capacity for sustainable growth. To this end, the authorities have committed to strengthening infrastructure, improving the business climate, and increasing regional integration. In order to improve infrastructure, budget spending has focused mainly on capital expenditures. With regard to the business climate, the authorities continue to develop the business environment beyond achieving a significant improvement in the World Bank's 2013 Doing Business survey. As an important step, the Kosovar authorities have initiated a development strategy for small and medium enterprises (SMEs) which could improve their access to finance and enhance competitiveness. For more regional integration, the authorities are gearing their efforts towards entering into negotiations for a Stabilization and Association Agreement with the EU.

Fiscal Policy

The authorities have been cognizant of the importance of strong fiscal balances in a highly uncertain global environment. Fiscal adjustment was implemented through a mix of revenue and expenditure measures. The authorities are keen on maintaining the sustainable fiscal stance with the help of prudent policies in capital spending. To this end, a rules-based fiscal rule will be in place starting from July 2014. The rule has been designed to keep the general government deficit as well as gross public debt under control. In order to support the economy's growth potential, capital projects are exempt from the ceiling; depending on the privatization receipts and the level of the government bank balance. The authorities attach utmost importance to the level of the government bank balance, which is critical to safeguarding an adequate level of reserves that would insure both the public and financial system against liquidity shocks. Taking Kosovo's development needs and prudent fiscal policies into consideration, 4.5 percent of GDP seems to be feasible for the adequate level of government bank balance. Nevertheless, the authorities are aware of the need for targeting higher levels due to multi-year investment projects or debt servicing obligations.

Financial Sector

The 2012 FSAP findings revealed that the banking sector has remained liquid, profitable, and well-capitalized. Although there is an increase in non-performing loans (NPLs), they are comparably low and almost fully provisioned. The banking authority is monitoring the risks stemming from weaker economic activity. The return on assets is one of the highest in the region. The capital adequacy ratio of the system is around 15 percent, the effect of tighter capital rules under the new banking law. The banking subsidiaries of euro area banks are largely deposit-funded and there is limited risk of deleveraging. Lending activity is also expected to be supported by new banks in the system.

The authorities are closely following the 2012 FSAP recommendations to strengthen the oversight of the financial sector. In this regard, the authorities have started numerous initiatives in supervision and in the legal and institutional framework. Recently, they began a study on an emergency liquidity assistance facility for banks through a bank premium. They are also working with other international organizations and donors on improving the property registry and NPL resolution, the court process for contract enforcement, and establishing a mortgage market. Once completed, these initiatives will positively contribute to the growth performance and the banking sector.

Structural Reforms

The authorities are keen on strengthening the competitiveness of the economy. Despite improvements in many areas, public infrastructure – notably energy and transport – are the main challenges to a better investment environment. The high level of capital spending is expected to close the gap and improve public infrastructure. Additionally, the authorities have learned the lesson of the huge public sector wage increases related to the 2010 election campaign and therefore pay due regard to the importance of cautious public sector wage policies and a rules-based framework for setting wage levels to improving competitiveness.

Program Performance and Next Steps

The authorities have shown strong commitment to the program targets. All end-April quantitative performance criteria were met. All continuous performance criteria and most applicable structural benchmarks were also met. Although indicative targets on the nonaccumulation of domestic payments arrears by the central and general governments were not met, they were missed only by small margins and corrective actions were taken. The authorities are ready to take further measures, as needed, to safeguard compliance with the program targets.

The authorities are keen on maintaining sound fiscal policies. The 2013 budget execution has been in line with program targets. In order to keep up with the targets, the authorities have submitted the mid-year budget to the assembly, in line with prior actions and supporting measures. The fiscal rule, which is a critical pillar for the program, is planned to be finalized by parliament in early July 2013 to be in place for the 2014 budget. Under the guidance of the rules-based fiscal framework, the 2014 budget will be submitted to the assembly in line with program targets.

The authorities continue to further strengthen financial sector surveillance in parallel with FSAP recommendations. The authorities will improve the crisis management framework and institutional capacity. The establishment of the National Council on Financial Stability and Crisis Management will be instrumental in following up and working on key FSAP recommendations.

The authorities are attaching utmost importance to competitiveness and structural reforms. With regard to improving infrastructure, they are committed to the preparation of the planned highway R6 to Macedonia by limiting risks to public finances and safeguarding economic viability. In order to limit risks stemming from wages, the authorities will issue an administrative instruction in coordination with the Fund and World Bank staff. The Kosovar authorities will continue projects with international organizations and donor institutions to improve access to finance for SMEs.