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# Surviving Low Interest Rates Central Banks in Kosovo and Other Western Balkan Countries

Republic of Kosovo

Si Guo

SIP/2023/027

*IMF Selected Issues Papers* are prepared by IMF staff as background documentation for periodic consultations with member countries. It is based on the information available at the time it was completed on December 20, 2022. This paper is also published separately as IMF Country Report No 23/55.

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**Surviving Low Interest Rates: Central Banks in Kosovo and Other Western Balkan Countries.**  
Prepared by Si Guo

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**ABSTRACT:** Interest income from foreign reserves is one of the main revenue sources for most emerging market central banks. For central banks in the Western Balkan region, the low global interest rates during 2008–2021 negatively affected their revenues, and the impact was more pronounced for central banks in Kosovo, Montenegro, and Bosnia and Herzegovina because they cannot use seigniorage to finance their operations. This paper explores how these central banks coped with the long period of low-interest rates. The main finding is that the decline in interest income from foreign reserves was partially compensated by higher fees, commissions, and other regulatory revenues.

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SELECTED ISSUES PAPERS

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Central Banks in Kosovo and  
Other Western Balkan Countries**

Republic of Kosovo



# REPUBLIC OF KOSOVO

## SELECTED ISSUES

December 20, 2022

Approved By  
**European Department**

Prepared By Si Guo. Sabiha Mohona provided research assistance.

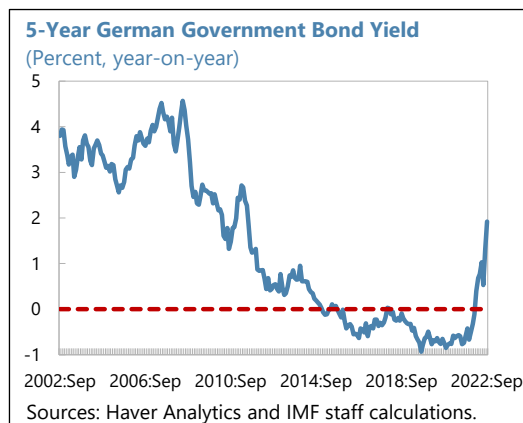
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# SURVIVING LOW INTEREST RATES: CENTRAL BANKS IN KOSOVO AND OTHER WESTERN BALKAN COUNTRIES<sup>1</sup>

**1. Financial strength is a key ingredient of central bank *de facto* independence.** While charters and laws around the globe establish central bank *de jure* independence, *de facto* independence depends on several factors including the degree of fiscal dominance and the central bank's demonstrated financial strength, among others. In some cases, fiscal dominance and financial weakness are linked (Miguel and Neumeyer, 1995; Stella, 2005). Financially weak central banks can be less effective in carrying their functions. For example, to avoid an increase in quasi-fiscal deficits, they may be more reluctant to change policy rates. But even when the central bank's mandate is constrained by the exchange rate framework (e.g., in dollarized economies), financial weakness may still impair the effective implementation of central bank mandates. For example, a central bank relying on budget transfers to finance its operations may be more prone to undue influence from the government, which would affect its *de facto* independence (Archer and Boehm, 2013).

**2. Lower global interest rates reduced central bank revenues, especially in emerging market economies.** Central banks in emerging economies invest most of their foreign exchange assets in financial instruments denominated in reserve currencies. Before the GFC, interest income from foreign reserves was the largest revenue source for many of these central banks (Ize, 2006). With the post-GFC decline in global interest rates, interest income fell significantly, and with it, a key source of central bank funding to finance their operating expenses.



**3. Low global interest rates especially affected central bank revenues in unilaterally euroized economies, or in countries with currency boards; in the western Balkans this includes Kosovo, Montenegro, and Bosnia and Herzegovina.** This group is particularly affected as their central banks cannot use seigniorage to finance their operations. This note explores how these central banks coped with the long period of low interest rates, including a broad discussion of the measures taken to balance the books, and discusses the implications of the ongoing increase in global interest rates.<sup>2</sup>

<sup>1</sup> Prepared by Si Guo. Sabiha Mohona provided research assistance.

<sup>2</sup> Seigniorage refers to the profits by issuing currency, especially the difference between the face value of coins and their production costs.

## A. The Central Banks' Financial Situation: An Overview

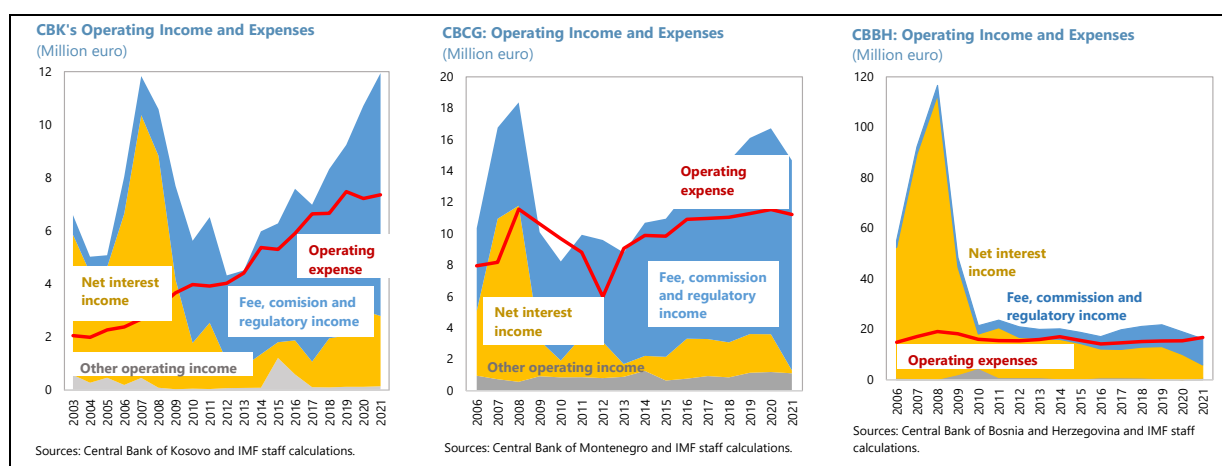
### 4. The assets of the central banks of Bosnia and Herzegovina (CBBH), Kosovo (CBK) and Montenegro (CBCG) mainly comprise foreign reserves, as they do not lend domestically.

Foreign reserves are mostly denominated in euros, including cash, foreign government securities, and deposits. The CBK and CBCG also hold euro-denominated domestic government securities. These securities are not considered as foreign reserves (IMF, 2019; IMF, 2021) because they are less liquid than typical reserve assets. Central bank liabilities of these countries mainly include deposits from commercial banks and governments.

Year	Bosnia and Herzegovina		Kosovo		Montenegro	
	2007	2021	2007	2021	2007	2021
<b>Assets</b>	<b>32.8</b>	<b>51.0</b>	<b>31.2</b>	<b>21.0</b>	<b>19.1</b>	<b>38.6</b>
Foreign assets 1/	32.5	49.8	31.1	14.1	17.2	31.8
Domestic claims on government	0.0	0.0	0.0	2.7	0.0	1.1
Gold	0.0	0.9	0.0	0.0	0.0	0.0
Other assets 2/	0.3	0.3	0.1	4.2	1.9	5.7
<b>Liabilities</b>	<b>30.9</b>	<b>48.4</b>	<b>30.2</b>	<b>20.2</b>	<b>17.5</b>	<b>37.0</b>
Domestic banknotes and coins	11.8	21.5	0.0	0.0	0.0	0.0
Due to commercial banks	18.3	22.4	3.3	7.4	12.9	21.7
Due to government and other public entities	0.4	4.4	26.6	8.6	3.3	10.5
Other liabilities	0.3	0.0	0.2	4.2	1.2	4.8
<b>Equity and Reserves</b>	<b>1.9</b>	<b>2.7</b>	<b>1.0</b>	<b>0.8</b>	<b>1.6</b>	<b>1.6</b>

Sources: Central bank financial statements and staff calculations.  
 1/ Foreign assets include cash, deposits placed at non-resident financial institutions, and foreign securities.  
 2/ Other assets mainly include fixed assets, intangible assets, and assets related to IMF lending programs.

### 5. The post-GFC decline in global interest rates led to a significant decrease in income of all three central banks. A closer examination shows that the decline was entirely driven by the lower post-GFC net interest income (from both domestic and foreign sources). Net interest income even turned negative for all three central banks in 2021.



## B. How Did Central Banks Absorb the Shock of Lower Interest Income?

**6. A large part of the decline in net interest income was compensated by increases in fees, commissions, and regulatory income.** In 2021, the sum of net fees, commissions and other regulatory income represented more than 100 percent of the operating expenses at the CBK and CBCG, and about 60 percent at the CBBH. The increases in fees, commissions and regulatory income reflected both the increases in unit rates and financial deepening in these economies.

**7. Negative remuneration on excess reserves also led to additional central bank income.** Remuneration rates were set broadly in line with short-term interest rates in the euro area, which were negative between 2014 and mid-2022. From a central bank's perspective, the income from negative remuneration could only offset the negative return on foreign reserves funded by excess reserves, while the negative return on foreign reserves funded by mandatory reserves and government deposits still had to be borne by the central bank.<sup>3</sup>

Central Bank Personnel Costs					
	Year	Unit	Bosnia and Herzegovina	Kosovo	Montenegro
Total Personnel Costs	2014	% GDP	0.07	0.07	0.19
	2019	% GDP	0.05	0.07	0.17
Change in Total Personnel Costs	2014-19	%	-2	40	26
Change in the Number of Employee	2014-19	%	4	17	5
Change in Personnel Costs per Employee	2014-19	%	-5	19	20
Change in Nominal GDP per Capita	2014-19	%	30	34	43
Nominal Personnel Costs per Employee	2019	euro	27,166	21,138	22,618
Nominal GDP per Capita	2019	euro	5,136	3,959	7,959

Sources: Central bank financial statements and IMF staff calculations.

**8. Both the CBK and CBCG accrued interest income from domestic government securities.** Interest spreads of these securities over German government bonds averaged 280 bps (Kosovo) and 420 bps (Montenegro) during 2018–22. The CBK started to hold Kosovo government securities in 2015. As of end-2021, government securities only represented 13 percent of total assets, but generated 2/3 of the CBK's gross interest income.

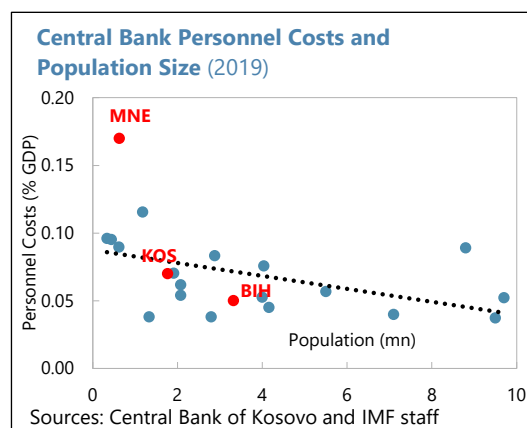
Central Bank (Monetary Authority) Personnel Costs in 2019 (Percent of GDP)	
<b>No separate legal tender</b>	
El Salvador	0.07
<b>Kosovo</b>	<b>0.07</b>
<b>Montenegro</b>	<b>0.17</b>
Ecuador	0.22
San Marino	0.43
<b>Currency board</b>	
Bulgaria	0.04
<b>Bosnia and Herzegovina</b>	<b>0.05</b>
Hong Kong SAR	0.07
Brunei	0.09

Sources: Fitch; Haver Analytics and IMF staff calculations.

<sup>3</sup> Although negative remuneration on excess reserves have been implemented by many central banks in Europe, central banks usually pay zero or positive interest rates on mandatory reserves and government deposits.

**9. On the expenditure side, personnel cost-to-GDP ratios over 2014–19 were broadly flat at the CBK but declined at the CBBH and CBCG.**

While the number of employees increased in all three central banks, compensation per employee grew slower than GDP per capita. Assessing the appropriateness of personnel costs is not straightforward. Different central banks have different mandates, which can affect their costs. For example, neither the CBK nor the CBCG has to print banknotes, which lead to costs in other central banks.<sup>4</sup> Studies also document a negative correlation



between the population size of a country and the scale of its public sector (normalized by population) due to the economies of scale (Alesina and Wacziarg, 1998). This correlation suggests that central bank personnel cost-to-GDP ratios in smaller countries may be higher than in larger economies. Comparing personnel costs of these three central banks with central banks in economies with similar exchange rate regimes or comparable population sizes suggest that personnel costs of the CBK and CBBH are similar to those of peers, while personnel costs of the CBCG are higher.<sup>5</sup>

**10. In other western Balkan economies (Albania, North Macedonia, and Serbia), all of which have less constraining exchange rate regimes, the declines in interest income from foreign reserves were not compensated by any substantial increases in fees, commissions, and other regulatory income.** This is the case as banknotes in circulation can be treated as a special type of “equity” buffer, reducing the pressure for raising other revenues to finance operational expenses (Pajdo, 2017). In addition, in Albania, interest income from domestic assets mitigated the decline in equity. In North Macedonia, lower interest income was cushioned by valuation gains from the central bank’s gold reserves. In Serbia, currency depreciation during 2008–16 led to valuation gains on international reserves.

## C. Rising Interest Rates in 2022

**11. Rising global interest rates in 2022 will help ease central bank financial pressures.**

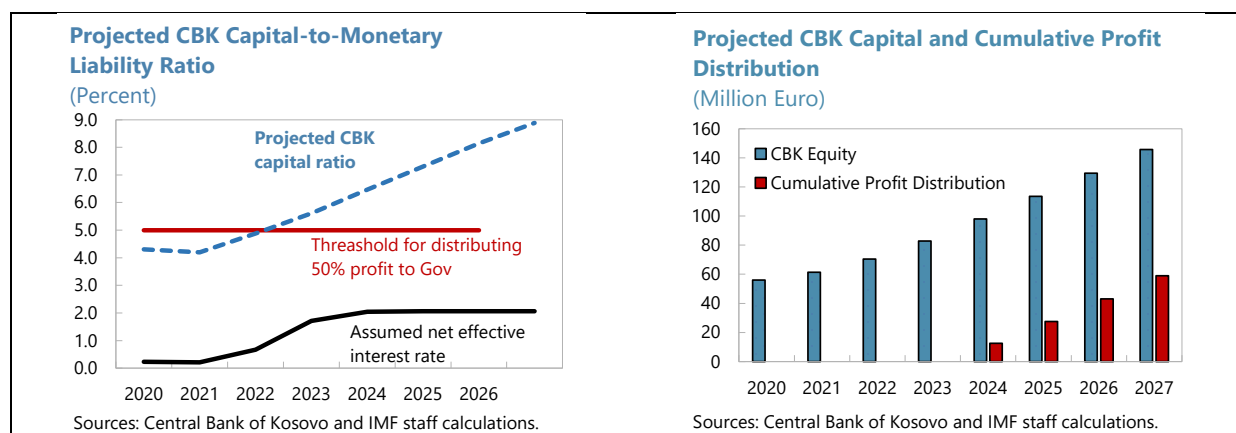
Central bank interest income from foreign reserve assets will rise with increases in euro area interest rates. In the case of the CBK, its charter requires transfer of 50 percent of its distributable earnings to the Ministry of Finance when its equity exceeds 5 percent of its monetary liabilities. Under the baseline assumption that the net effective return on the CBK’s assets will be 150–200 bps higher by 2024 relative to that observed in 2021, staff projects that the rise in net income earnings will bring

<sup>4</sup> Galan and Sarmiento (2005) document four key responsibilities affecting central banks’ costs: financial supervision, currency operation, banknotes printing and coin minting, and payment system operation.

<sup>5</sup> Only 6 economies (El Salvador, Ecuador, San Marino, Bulgaria, Hong Kong SAR and Brunei) meet the selection standard of having an exchange rate arrangement of “no separate legal tender” or “currency board” and having published financial statements. For the comparison of personnel costs conditional on population sizes, the sample includes 21 European countries with population from 0.3 to 10 million.



equity to above the 5 percent threshold in late 2023 or early 2024, up from 4.2 percent in 2021.<sup>6</sup> The assessed profits are projected at around €15 million per year (0.2 percent of GDP of 2022).



## D. Policy Implications

**12. While central banks should not set positive profits as a policy target, the practical implementation of this principle can lead to challenges.**<sup>7</sup> In all three central banks (CBK, CBBH and CBCG) analyzed in this note, post-GFC declines in net interest income from foreign reserves were substantial and prolonged. Financing their operations required raising income from other sources.

**13. Alternatively, central bank reliance on budgetary support to finance their operations can create additional challenges.** Most central banks in the region have legislation allowing or requiring the recapitalization of central banks by the budget when equity buffers fall below certain thresholds; this is a positive element. However, central banks facing constrained income streams should avoid becoming dependent on budgetary support to finance their operations, as this may lead to political constraints and even policy expectations that are against central bank policy goals (Archer and Boehm, 2013). Moreover, a few central banks are required to make transfers to the budget, even when they have losses.

**14. Investing in domestic government securities should only occur in the context of an overall prudent fiscal policy.** In both Kosovo and Montenegro, the interest rate spreads of domestic government securities over those of the euro area helped mitigate the decline in central banks' interest income from foreign reserves. However, domestic government securities in these two countries do not have the same liquidity profile as those from the euro area. Therefore, from the central bank's perspective, the tradeoff of holding domestic government securities is the higher interest income versus the liquidity risk. This liquidity risk can be minimized, however, if domestic

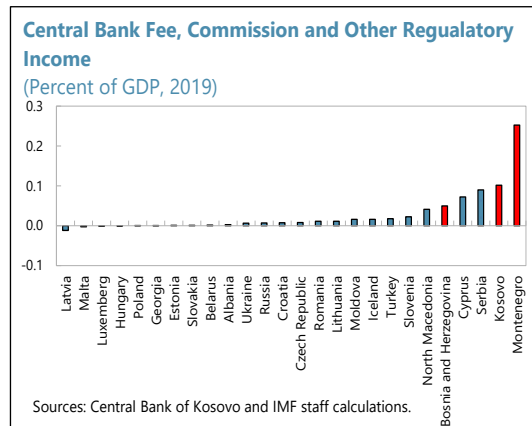
<sup>6</sup> This follows the projected short-term interest rate path in the euro area in the IMF's World Economic Outlook published in October 2022.

<sup>7</sup> Goncharov, Ioannidou and Schmalz (2021) document that statistically central banks prefer reporting slightly positive profits to slightly negative profits.

governments maintain a prudent fiscal policy and central bank holdings are kept as a relatively low share of total assets.<sup>8</sup>

**15. The appropriate level of fees, commissions and other regulatory income is difficult to establish.**

Among emerging economies in Europe, Montenegro and Kosovo have the highest fees, commissions, and other regulatory income as share of GDP. Charges on financial intermediation can eventually be interpreted as taxes on capital income. On one hand, taxing capital income would distort saving and investment, which goes against the classical view on the need for low optimal capital income taxes. On the other hand, lower charges on financial intermediation can raise concerns on inequality (because capital income is mostly earned by the better off) and financial sector externality (Claessens et al. 2010).<sup>9</sup> Therefore, whether it is desirable for central banks to rely on fees, commissions, and regulatory income to finance their operation remains an open question.



**16. As interest rates started to rise in 2022, the windfall profits from higher interest income should be preserved.** In the case of Kosovo, saving the windfall profits now will reduce financial pressures in the next low interest rate cycle. In addition, because Kosovo is unilaterally euroized, a strong equity position is important as a buffer for policy interventions (e.g., lending through the emergency liquidity assistance window, ELA). Ideally, profits can be saved into a designated account managed by the CBK on behalf of the Minister of Finance (including the ELA window), to be used to cover possible fiscal and quasi-fiscal costs arising from interventions to assist banks in times of crisis.

<sup>8</sup> In the case of Kosovo, the CBK is prohibited from lending to the government directly. However, the CBK is allowed to purchase Kosovo government securities in the secondary market.

<sup>9</sup> See also a summary on optimal capital income tax in Boadway and Keen (2003).

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