IMF Country Report No. 18/30

# REPUBLIC OF KOSOVO

February 2018

## 2017 ARTICLE IV CONSULTATION—PRESS RELEASE; STAFF REPORT; AND STATEMENT BY THE EXECUTIVE DIRECTOR FOR THE REPUBLIC OF KOSOVO

Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. In the context of the 2017 Article IV consultation with the Republic of Kosovo, the following documents have been released and are included in this package:

- A **Press Release** summarizing the views of the Executive Board as expressed during its February 2, 2018 consideration of the staff report that concluded the Article IV consultation with the Republic of Kosovo.
- The **Staff Report** prepared by a staff team of the IMF for the Executive Board's consideration on February 2, 2018, following discussions that ended on December 12, 2017, 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 January 19, 2018.
- An **Informational Annex** prepared by the IMF staff.
- A **Statement by the Executive Director** for the Republic of Kosovo.

The IMF's transparency policy allows for the deletion of market-sensitive information and premature disclosure of the authorities' policy intentions in published staff reports and other documents.

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Press Release No.18/35
FOR IMMEDIATE RELEASE
February 2, 2018

International Monetary Fund
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Washington, D.C. 20431 USA

**IMF Executive Board Concludes Article IV Consultation with Kosovo**

On February 2, 2018, the Executive Board of the International Monetary Fund (IMF) concluded the 2017 Article IV consultation[1] with Kosovo.

Kosovo has made significant progress since the 2015 Article IV consultation in ensuring fiscal discipline and strengthening the financial sector. The fiscal deficit has been kept well below the 2 percent of GDP fiscal rule ceiling, government bank balances are now above the minimum level of 4.5 percent of GDP, and public debt remains low. Banks remain healthy and credit growth has increased.

Notwithstanding, important structural challenges remain. Weak external competitiveness, high informality, low labor force participation and high unemployment, particularly among young workers, and a large infrastructure gap continue to constrain Kosovo's growth potential.

While medium-term growth is now projected at around 4 percent, more and better growth is needed to accelerate income convergence with the EU and reduce inequality. The fiscal deficit is expected to remain within the fiscal rule while accelerating IFI-financed investment. The trade deficit is expected to remain high, though on a declining path, but largely funded by non-debt creating inflows, namely remittances and FDI.

Kosovo does currently not engage in multiple currency practices or maintain exchange restrictions on payments and transfers for current international transactions, except for restrictions imposed solely for reasons of international or national security that have been notified to the Fund. Kosovo notified the IMF on January 11, 2018 that it has accepted the obligations of Article VIII, Sections 2, 3 and 4 of the IMF's Articles of Agreement.[2]

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[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.

[2] Under Article VIII, Sections 2, 3 and 4 of the IMF's Articles of Agreement, the IMF members undertake not to impose restrictions on the making of payments and transfers for current international transactions, and not to engage in any discriminatory currency arrangement or multiple currency

**Executive Board Assessment**[3]

Executive Directors agreed with the thrust of the staff appraisal. They welcomed Kosovo's strong economic performance and progress made under the recent Stand-By Arrangement to advance macro-financial stability through fiscal discipline and financial sector reforms. Directors noted, however, that important structural challenges remain and that continued commitment to sound policies and reforms is key to achieving durable and inclusive growth, and improving prospects for income convergence with regional peers.

Directors encouraged the authorities to accelerate structural reforms to boost productivity and private sector development, and address the high informality as well as unemployment, particularly among the youth. They agreed that priority needs to be given to reforming the education sector, enhancing the functioning of the labor market, fostering a business-friendly environment, and improving governance, particularly by strengthening the anti-corruption regime and implementing the procurement reforms. Directors noted that improving competitiveness will also require prudent income policies. In this regard, they recommended that any increases in the minimum wage be in line with the current rule-based minimum-wage-setting mechanism.

Directors commended the authorities for continued budget discipline and welcomed the adoption of the 2018 budget, which is aligned with the fiscal rule and strikes an appropriate balance between fiscal discipline and developmental needs. They emphasized that to support growth, the overall budget composition should continue to create fiscal space for growth-enhancing spending in education, health, and infrastructure without compromising capital spending. Directors encouraged the authorities to avoid large current spending increases, broaden the revenue base by strengthening tax administration, and bolster the public investment framework to accelerate the absorption of IFI financing for capital projects. Moving forward with reform of war veteran benefits will also be important.

Directors welcomed the progress made in strengthening the financial sector and reducing structural impediments to bank lending. They encouraged the authorities to maintain the reform momentum, including further strengthening the supervisory framework and continuing to improve access to credit while carefully monitoring developments in the real estate sector. Further enhancements to the AML/CFT framework and improving the performance of the insurance sector will also be helpful.

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practice, except for restrictions imposed solely for reasons of international or national security that have been notified to the Fund pursuant to Decision No. 144, or which have been approved by the IMF Executive Board.

[3] 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 summing up can be found here: http://www.imf.org/external/np/sec/misc/qualifiers.htm.

Directors welcomed Kosovo's acceptance of the obligations of Article VIII, Sections 2, 3, and 4, which will send a positive signal to investors.

**Kosovo: Select Economic Indicators, 2015-18**

Population: 1.8 million
Quota (current): SDR 86.2 million
Main products and exports: Minerals, base metals, agricultural and food products

| | 2015 | 2016 | 2017 | 2018 |
|---|---|---|---|---|
| | Act. | Act. | Proj. | Proj. |
| Output | | | | |
| Real GDP growth (percent) | 4.1 | 4.1 | 4.1 | 4.0 |
| Employment | | | | |
| Unemployment rate 1/ | 32.9 | 28.7 | 30.5 | |
| Prices | | | | |
| Consumer prices (period average) | -0.5 | 0.3 | 1.5 | 1.0 |
| Consumer prices (end of period) | -0.1 | 1.3 | 0.7 | 1.8 |
| Terms of Trade (percent) | 96 | 100 | 103 | 104 |
| Public finance (percent of GDP) | | | | |
| Revenue | 25.1 | 26.3 | 26.2 | 26.9 |
| Expenditure | 26.7 | 27.3 | 27.1 | 29.6 |
| Overall balance ex-PAK and ex-PAK and donor-financed capital projects (Fiscal rule) | -1.7 | -1.1 | -1.1 | -1.8 |
| Overall balance ex-PAK | -1.7 | -1.1 | -1.1 | -2.9 |
| Public debt (end of period) 2/ | 18.9 | 19.6 | 21.0 | 21.8 |
| Stock of government bank balances | 3.5 | 3.5 | 4.9 | 4.5 |
| Money and credit | | | | |
| Credit to the private sector (eop, percent change) | 7.3 | 10.3 | 10.5 | 10.1 |
| Effective bank lending rate (end of period) 3/ | 7.7 | 7.2 | 6.4 | |
| Balance of payments (percent of GDP) | | | | |
| Current account balance | -8.7 | -8.9 | -8.7 | -8.9 |
| Foreign direct investment | 4.7 | 3.0 | 5.0 | 5.0 |
| Reserves in months of imports | 3.0 | 2.9 | 3.1 | 3.3 |
| External debt stock (percent of GDP) 2/ | 24.7 | 24.5 | 24.9 | 24.9 |

Sources: Kosovo Agency of Statistics; Central Bank of Kosovo; Ministry of Finance; staff estimates and projections.

1/ 2017 is as of Q2 2017
2/ Includes debt of the former Yugoslavia that Kosovo does not recognize, service, or track.
3/ 2017 is as of July 2017

INTERNATIONAL MONETARY FUND

# REPUBLIC OF KOSOVO

## STAFF REPORT FOR THE 2017 ARTICLE IV CONSULTATION

January 19, 2018

## KEY ISSUES

**Context**. Kosovo has made significant progress since the 2015 Article IV consultation in ensuring fiscal discipline, strengthening the financial sector, and enhancing growth. Notwithstanding this progress, important structural challenges remain. Weak external competitiveness, high informality, low labor force participation and high unemployment, particularly among young workers, and a large infrastructure gap continue to constrain Kosovo's growth potential.

**Policy objectives**. Maintain macroeconomic and financial stability, while addressing structural problems to achieve stronger, more inclusive and private sector-led growth, necessary to catch up with regional peers and the EU.

**Policy recommendations**.

- **Structural Reforms**: Improve the quality of education, health, infrastructure and energy supply. Strengthen SOE governance and prepare selected companies for privatization. Implement procurement and bankruptcy laws, and strengthen anti-corruption regimes and transparency. Keep minimum wage increases in line with the current rule. Support these efforts with structural fiscal and financial sector reforms to accelerate growth (see below).

- **Fiscal Policy**: Keep the fiscal deficit and wage bill within the limits of the existing rules, which remain appropriate policy anchors. Enhance budget composition and efficiency by broadening the revenue base through measures to strengthen tax administration, improve the effectiveness of social assistance, limit public sector wage growth, and make space for higher spending on and improving management of infrastructure, health and education which are key for improving long-term growth and competitiveness.

- **Financial Sector**: Maintain financial system stability, continue to further strengthen the supervisory framework, and remove remaining structural impediments to expand private sector credit in productive sectors.

Approved By
**Thanos Arvanitis and Daria Zakharova**

Discussions were held in Pristina on November 29 – December 12, 2017. The staff team comprised Ms. Eble (head), Messrs. Cipollone and Weiss (all EUR), Mr. Evans (FAD), Ms. Morgan and Mr. Touna Mama (SPR), Mr. Blair (LEG), Ms. Popova (MCM), and Messrs. Vermeulen and Thaci (Resident Representative Office). Mr. Mehmedi (OED) also joined policy discussion meetings. Mr. Jovanovic and Ms. Madaraszova contributed to the preparation of this report from headquarters, and Ms. Kernja to the organization of the mission.

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**ANNEXES**

# CONTEXT

**1. Since the last Article IV in 2015, Kosovo has taken important steps under the Stand-by Arrangement that expired in August 2017 to foster fiscal sustainability, further strengthen financial stability, and advance some structural reforms** (Annex I). These have contributed to strengthening the recovery and improving confidence. Despite this progress, however, structural challenges remain significant. Kosovo is a small, unilaterally euroized economy characterized by high unemployment, extensive informality, and a narrow production and export base resulting in a large trade deficit—mainly financed by large and growing remittance flows. While the relatively high economic growth is helping to improve living standards, Kosovo remains one of the poorest European countries.

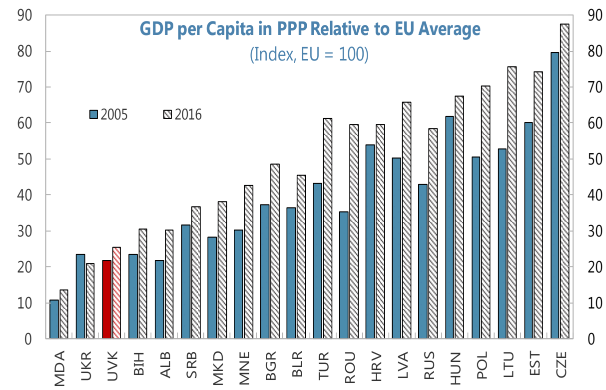
**2. A new government was appointed recently, pledging to support investment, fight corruption, and improve relations with neighboring countries**. Following early general election in June 2017 a new multi-party coalition government took office in September. However, its thin majority in parliament may affect the pace of reform implementation. Also, the impending issuance of indictments by a special war crimes tribunal expected to start in 2018 and the ratification of the border demarcation agreement with Montenegro—a key precondition for EU visa liberalization—may test the strength of the government coalition. Notwithstanding these risks, Kosovo has made some further progress in normalizing international relations, and is now recognized by almost two-thirds of UN member states.

# RECENT DEVELOPMENTS, OUTLOOK AND RISKS

**3. Growth continues at a healthy pace, led by investment and, more recently, growth in exports**. Real GDP growth has averaged about 4 percent per year since 2015, a relatively strong performance compared to Kosovo's Western Balkan peers. Staff project growth to continue at 4.1 percent in 2017, led by continued strong investment, export growth, and higher remittance inflows. While declining recently, unemployment remains the highest in Europe at just above 30 percent, particularly among the youth (50 percent).

**4. The policy framework has improved considerably**. The fiscal deficit has been kept well below the 2 percent of GDP fiscal rule ceiling, despite spending pressures, and government bank balances are above the minimum level of 4.5 percent of GDP. Banks remain healthy and credit growth has increased (Table 1, Figure 1). Inflation remains subdued and although headline is expected to pick up to 1.5 percent (largely driven by higher food and energy prices), core inflation has turned negative due to falling input prices for some non-tradable and consolidation in the retail sector resulting in lower prices.

5. **Medium-term growth prospects remain positive, although more is needed to accelerate income convergence with regional peers and the EU**. Under the assumption of a gradual pace of reform efforts, medium-term growth is projected at 4 percent, driven mainly by private consumption and investment, with exports (mainly minerals) making an increasing but still relatively minor contribution to growth. Reaching the authorities' objective of sustained growth above 5 percent and accelerating income-convergence with the EU—GDP per capita in PPP terms was just 20 percent of the EU average in 2016—will require faster reforms to address major bottlenecks in Kosovo's business climate, and to close physical and human capital gaps. With the economy growing at its current potential, inflation is projected to remain slightly above the euro area average of 1.8 percent throughout the projection period, reflecting productivity gains. The trade deficit is expected to remain large, though on a declining path, while largely funded by non-debt creating inflows, namely remittances and FDI. Even assuming a scaling up of donor-financed public investment to reduce the infrastructure gap, debt-to-GDP is projected to increase moderately over the next years, but will remain below the 30 percent threshold (Annex II).



Sources: IMF, *World Economic Outlook*; and IMF staff calculations.

**Selected Macroeconomic Indicators**

| | 2016 | 2017 | 2018 | 2019 | 2020 | 2021 | 2022 |
|---|---|---|---|---|---|---|---|
| | | projections | | | | | |
| Real GDP Growth (in percent) | 4.1 | 4.1 | 4.0 | 4.0 | 4.0 | 4.0 | 4.0 |
| *Contributions:* | | | | | | | |
| Consumption | 4.7 | 1.1 | 4.3 | 3.7 | 3.7 | 3.7 | 3.8 |
| Investment | 2.0 | 3.4 | 3.1 | 3.4 | 3.4 | 3.3 | 3.4 |
| Exports | 0.5 | 3.6 | 1.2 | 1.6 | 1.5 | 1.7 | 1.6 |
| Imports | -3.2 | -3.9 | -3.3 | -3.4 | -3.4 | -3.4 | -3.0 |
| CPI inflation (in percent, average) | 0.3 | 1.5 | 1.0 | 1.9 | 2.1 | 2.2 | 2.2 |
| | in percent of GDP | | | | | | |
| Fiscal balance excluding PAK and donor projects | -1.1 | -1.1 | -1.8 | -1.9 | -1.9 | -1.9 | -1.9 |
| Stock of government bank balances | 3.5 | 4.9 | 4.5 | 5.0 | 5.0 | 5.0 | 5.0 |
| Total public debt | 19.6 | 21.0 | 21.8 | 24.9 | 26.3 | 27.8 | 29.0 |
| Current account balance, incl. official transfers | -8.9 | -8.7 | -8.9 | -8.6 | -7.9 | -8.0 | -7.7 |

Source: IMF staff estimates; KAS.

6. **Risks to the outlook are balanced** *(see Risk Assessment Matrix—Annex III).*

- Weaker reform momentum, including on the back of political risks, could lower growth and keep unemployment and migration high. Tax compliance gains may fall short of target, and significant social spending pressures and low progress in mobilizing IFI and privatization financing could reduce productive spending.

- Weaker-than-expected growth in the EU and lower remittance inflows could result in lower consumption and investment (largely housing), and therefore slower growth. Also, high current account deficits and heavy reliance on remittances make Kosovo vulnerable to external shocks.

- At the same time, moving ahead with the new power plant and accelerated reform implementation that could help attract more FDI and possibly unlock large IFI financing for key capital projects are upside risks to the outlook.

***Authorities' Views***

**7. The authorities were more optimistic about the outlook and viewed staff's baseline scenario as too conservative**. In their view, growth could accelerate to 5.3 percent by 2020, and despite risks of further delays, moving ahead with the construction of a new power plant would provide a substantive boost to growth. They considered that the current coalition would be able to move ahead with important reforms to address structural challenges.

# EXTERNAL STABILITY ASSESSMENT

**8. The external position is weaker than implied by the fundamentals and desirable policy settings, but there has been some progress in strengthening competitiveness since the last Article IV**. Standard methodologies indicate that the real effective exchange rate remains stronger than justified by fundamentals and desired policies in the range of 12-14 percent (compared to 15-18 percent at the last Article IV). This modest improvement has been largely achieved by controlling public sector wages, consolidating the budget, and some progress with structural reforms (Annex IV).

**9. Notwithstanding, the trade deficit remains substantial, but is largely financed by non-debt creating capital inflows**. While the trade deficit has continued to remain at 28-30 percent of GDP at elevated levels, exports have been increasing steadily over the last three years, albeit from a very low base. However, the deficit is largely financed by FDI (5 percent of GDP), remittances (15 percent) and other non-recorded capital inflows. Despite a projected increase in IFI-financing, external debt is expected to remain low at around 25 percent of GDP.

**10. International reserve coverage remains broadly adequate**. Gross international reserves reached 12 percent of GDP in 2016 and are expected to increase to 13.5 percent in 2017. This covers more than 110 percent of a composite metric of reserve adequacy (ARA metric), important for a unilaterally euroized economy, like Kosovo, which needs liquidity buffers to mitigate the impact of external shocks on domestic absorption and pressures stemming from financial obligations and bank liquidity.

**11. Progress has been made in improving qualitative competitiveness indicators**. While recognizing measurement uncertainty, various indicators point to an improvement in Kosovo's standing in various rankings since 2014. Kosovo's improvement is more noteworthy in the areas of starting a business, registering property and trading across borders. This improvement however largely reflects the progress of adopting new legislation in line with EU directives, which has not been translated yet into *de-facto* improvement on the ground to support higher productivity and competitiveness.

***Authorities' Views***

12. **The authorities broadly concurred with the external sector assessment, but had a more sanguine view of reform implementation gaps**. The authorities stressed that substantial progress has been made in improving the business environment, as for instance reflected in Kosovo being ranked among the top 10 reformers globally in the World Bank's 2018 Doing Business Report, but noted that reform implementation is hampered by capacity constraints (in human capital, in particular). They welcomed the reduction in the overvaluation of the real exchange rate, but noted that the magnitude of this is unclear due to model uncertainty.

# POLICY DISCUSSIONS

*Discussions focused on measures to address the three key challenges facing Kosovo: (i) accelerating structural reforms to improve productivity and reduce high unemployment; (ii) improving the composition of the budget within the limits of the fiscal rule and the efficiency of spending; and (iii) safeguarding financial sector stability and financial deepening. All three areas are critical to improving competitiveness, achieving stronger and more equitable growth and supporting income convergence with regional peers and the EU.*

## A. Structural Reforms: Improving Investment Climate, Governance and Competitiveness

13. **Several structural issues are impeding growth and are also contributing to inequality**.[1] These include the perception of a weak "rule of law"[2] and a large informal sector that create an uneven playing field amongst businesses, deter investment, and support small-scale low value added production (instead of more competitive companies). Public enterprises remain relatively inefficient, with low productivity. High informality hampers access to bank financing and is associated with weak labor and working standards. These contribute to inequality, which is further exacerbated by the poor public health and education systems, as well as poorly targeted social benefits.

14. **The authorities are making some efforts to improve governance, but further decisive steps are needed**. The use of the e-procurement platform has been delayed and remains limited, although picking up in recent months. Therefore, efforts are needed to strengthen the system by expanding capacity and enforcing the mandatory use of e-procurement, while at the same time increasing the list of goods and services subject to centralized procurement. Also, the investigative capacity of the anti-corruption agency and the effectiveness of the asset declaration regime should

[1] While inequality as measured by the Gini coefficient is currently not very high, there is considerable scope for reducing it through policies that will have positive growth impetus and improve income distribution.

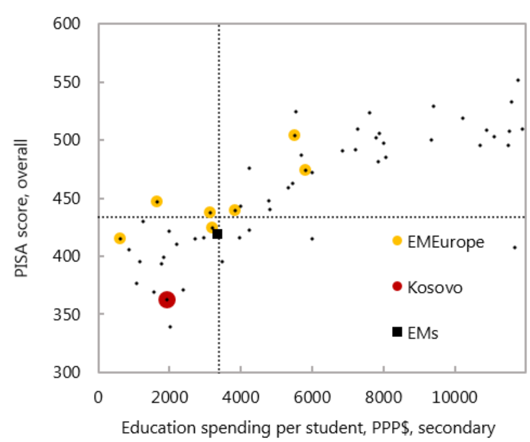
[2] In successive progress reports, the EC has pointed to weaknesses in the rule of law, judging Kosovo's justice system, and the fight against corruption and organized crime to remain at an early stage (EU Commission Staff Working Document Kosovo 2016 Report). Kosovo continues to perform poorly in rankings of perceptions-based governance indicators (e.g., Transparency International).

be strengthened. Enhanced capacity of the anti-corruption agency would make its investigation capacity more effective in supporting law enforcement agencies to meet their obligations. Asset declaration requirements should be as comprehensive as possible and cover all assets owned both domestically and abroad. Large public investment projects should be subject to ex-post audit.

**15. Plans to reduce the large inefficiency in public enterprises will improve governance, and should be fully carried out to put those companies into more productive use**. Reform priorities include improving governance by strengthening the independence of supervisory boards, timely publication of financial statements, external audits, and significantly reducing operating costs by rightsizing employment and reducing the excessively high wages. This should also pave the way for private sector involvement (e.g., PPPs, privatization) in the medium term, and developing a clear divestment strategy would be a first step. The Privatization Agency's institutional and governance structure should also be strengthened significantly to accelerate the slowed-down privatization/liquidation process.[3]

**16. Higher quality and better targeted education is needed to improve labor market outcomes**. The 2015 Program for International Student Assessment (PISA) score (Kosovo's first participation) ranks Kosovo low among participating countries. Decisive measures are needed to improve access and quality of education, including enhanced curricula for vocational programs. This would help to address the large skill mismatch, particularly among the most disadvantaged groups. The timely implementation, with the support of the EU, of the new Action Plans for increasing youth employment and for enhancing active labor market policies and job placement will also play a key role to increase labor participation and employment, including for women.

**Government Secondary Education Spending and PISA Outcome, Latest Value Available**




**17. In addition, any increases to minimum wages should be in line with the current rules-based minimum wage setting mechanism**. This rule links adjustments to developments in prices, private sector wages and competitiveness. While some increase in the minimum wage could reduce wage inequality, care should be given to avoid unwarranted increases beyond productivity gains. Against the backdrop of high unemployment, a large competitiveness gap, and widespread informality, large discretionary increases could disadvantage low-skilled workers and increase youth unemployment, leading to greater migration or increase in informal employment. In addition, it could generate fiscal pressures by e.g. raising expectations for higher social benefit amounts, thus crowding out higher priority spending in the budget.

**18. Addressing energy supply constraints and shortages is key to support investments in the tradable sector**. After several attempts over the last decade to replace one (Kosovo A) of the two aging lignite power plants, little progress has been achieved. The recent conclusion of the

[3] More than 50 percent of identified assets (around 10 percent of GDP) remain to be liquidated after almost a decade.

commercial agreement with a private firm is a first step to replace Kosovo's existing plant with a more reliable and higher capacity plant that is projected to be completed in 2023, assuming no further delays.

***Authorities' Views***

**19. The authorities agreed with the need to accelerate structural reforms and felt that their reform priorities are well-aligned with staff recommendations**. Strengthening the rule of law (including by new hiring in the judiciary), supporting private sector development, and closing skills and energy gaps are among their reform priorities. While agreeing that there is scope to further strengthen governance, including in public procurement and public enterprises, they felt that progress made in the 10 years since independence is not sufficiently recognized or captured in perception-based governance indicators.

**20. There was also broad agreement amongst various stakeholders, including employer representatives and trade unions, that inequality should be addressed**. It was agreed that improving public education and health, fighting informality, enforcing labor standards and better targeting social assistance are key priorities. Trade unions stressed that informal employees not only tend to get paid less but also risk being left without any other old age insurance except the basic pension benefits, and employers noted that the same standards and the rule of law should be applied to every company.

**21. The authorities were not convinced that an increase in the minimum wage beyond those implied by the current rule could undermine competitiveness and efforts to improve labor market outcomes**. Internal discussions on raising the minimum wage and changing the minimum wage setting mechanism are still ongoing. The authorities generally considered that the impact of higher minimum wages on the economy will be limited, and by reducing the underreporting of wages in the private sector it will increase revenue.

## B. Fiscal Policy: Supporting Economic Growth Through Macro-stability, and Structural Revenue and Expenditure Policies

**22. The existing "fiscal rule"[4] provides an appropriate anchor for fiscal policy (see Figure 2, Table 2).** The 2017 fiscal deficit is expected to be about 1 percent of GDP, and the 2018 budget targets a deficit (fiscal rule definition) of 1.8 percent of GDP, all below the fiscal rule's deficit ceiling. The budget also keeps the wage bill constant as a share of GDP, in line with the wage bill rule. Assuming the authorities will be able to execute IFI and privatization-financed investment (exempted from the fiscal rule's deficit ceiling) of about 1 percent of GDP to address the large infrastructure gap, this would bring the overall 2018 fiscal deficit to about 3 percent of GDP, from 1 percent in

[4] The fiscal rule places a cap of 2 percent of GDP on the fiscal deficit, excluding capital projects financed by privatization proceeds and donors. The exemption for donor-financed investments can be invoked until 2025, provided that debt remains below 30 percent of GDP.

2017. While this would result in a pro-cyclical stance, the high import-content of investment and the still high unemployment rate should keep domestic demand pressures broadly in check.

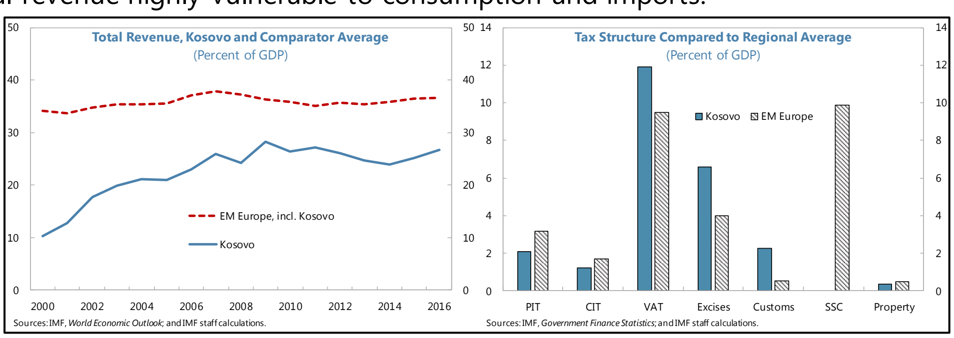
**23. Over the medium term, the authorities aim to maintain budget deficits below the fiscal rule's ceiling**, and—when including IFI and privatization-financed capital spending— at around 3 percent of GDP, on average. This would provide an appropriate balance between fiscal discipline and developmental needs, given the still low public debt of 22 percent of GDP (2017). It would also maintain bank balances at a prudent level of 4.5 percent of GDP. While the government debt is projected to increase in the medium term, the debt sustainability analysis shows that it is expected to remain within sustainable levels (Annex II).

**24. However, the 2018 budget is subject to risks and efforts would be needed to reach the deficit target**. The budget assumes about ¾ percent of GDP in gains from revenue administration reforms, which may not be realized. On the expenditure side, social spending could exceed the budget allocation by about ¾ percent of GDP, unless there is timely reclassification and verification of war veteran pension beneficiaries, and a tight administration of other social benefits. At the same time, there are pressures to move ahead with several new unbudgeted social spending initiatives, and while there might be scope to delay some investment, spending on Route 6 of some 2½ percent of GDP is expected to be needed in 2018.

**25. Also, the composition of the budget and the efficiency of its spending could be improved to ensure better outcomes and make space for scaling up of investment in education, health, and infrastructure—critical to improve productivity and growth.**

## Possible Revenue Measures

**26. There is considerable scope for improving revenue collection**. While total revenue has increased to 26 percent of GDP, it is still some 10 percentage points below the EM Europe average (or 6 percentage points if contributions to the second pillar pension system are included) and collected from a narrow base. Low tax revenue mobilization is due to low tax rates and high informality combined with weak collection efficiency. The tax gaps for VAT and PIT are estimated at one-third and two-third respectively of potential taxes collected and the CIT gap close to 20 percent.[5] Over three-quarters of Kosovo's revenue comes from indirect tax (led by VAT and excise), making fiscal revenue highly vulnerable to consumption and imports.




[5] IMF staff estimates and World Bank. 2014. "Republic of Kosovo Public Sector Revenues: Tax Policies, Tax Evasion, and Tax Gaps". Washington, DC.

**27. The focus should be on fighting informality by strengthening the tax administration**. The 2018 budget ambitiously targets some ¾ percent of GDP in tax compliance gains. To achieve this objective, collections should be reinforced by setting publicly available quantitative and strategic performance targets for the tax administration, allocating resources to activities that generate the highest yields (e.g. risk-based audits), improving the efficiency and productivity of audits, significantly scaling up tax debt collection, and requiring filing a tax return by every registered taxpayer, even if no tax is due.

**28. Tax policy, on the other hand, should seek to minimize exemptions and increase yields**. As individual tax rates are broadly in line with peer countries in the region, the focus should be on broadening the tax base.[6] The new property tax legislation paves the way towards higher yields—which is achievable if exclusions of taxable objects or other tax relief is kept to a minimum. As to indirect taxes, the VAT standard rate is regionally competitive. However, no new exemptions/reduced rate categories should be introduced as these tend to lower revenue (including by evasion), not reach the intended beneficiaries, and not increase growth. Continuing to increase excises on products, such as tobacco, in line with the current schedule are sound tax policies, especially since Kosovo has among the lowest tobacco excise rates in the region.

### Possible Spending Measures

**29. Pressures to increase current spending remain high**. Current spending has increased from 17½ percent in 2011 to an estimated 20 percent in 2017, due to continued spending increases on social schemes and a higher wage bill, largely due to a wage hike in 2014. While as a share of GDP current spending remains below European EMEs, Kosovo spends relatively more on untargeted and work dis-incentivizing social benefits and public wages, which are key factors worsening competitiveness and inequality.[7] Also, in terms of outcomes Kosovo ranks low in the poverty and inequality-reduction impact of benefit spending (Box 1).

**30. The wage bill should make space for hiring in priority sectors within the limits of the rule**. Staff recommends that across the board wage increases be restrained, given the already high public sector wage level. This would create space for priority hiring in the judiciary, health and education sectors, and to finance the health insurance scheme when it is eventually introduced. It would also reduce pressure from public sector wages on private sector wages, important for gaining price competitiveness and job creation, and reduce inequality between public-private sector employees.

**31. Social benefit programs should be reformed to more effectively address inequality, poverty and unemployment within the existing spending envelope**.[8] This includes strengthening mechanisms to ensure no double dipping, better means-testing, removing disincentives to remain

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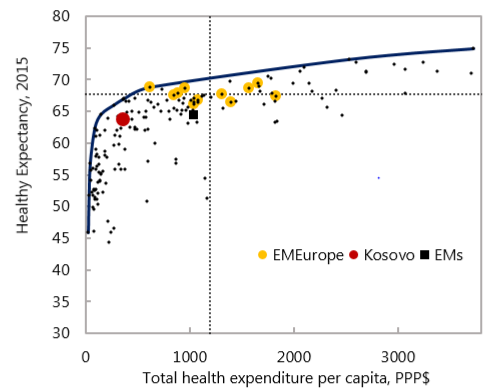
[6] The top PIT and CIT rates of 10 percent are roughly in-line with Western Balkan countries, except Albania and Serbia (both having higher levels of economic development).

[7] Some social benefits (e.g. war veteran pensions) require the recipient to be unemployed.

[8] Selected Issue Paper – Improving Social Benefit Effectiveness.

employed, tightly administering and enforcing eligibility of schemes, and making the system more equitable by e.g. aligning the disability threshold and payments for war veterans to those of the civilian disability scheme. Further, a credible re-classification and verification of war veterans, in line with the law should be completed in early 2018, which is necessary for current spending to stay within the budget envelope.[9] Staff urges not to introduce any non-contributory early retirement schemes for special groups as this would further weaken the fairness and financial soundness of the unfunded pension system.

**32. Efficacy of health and education spending should be improved**. Healthcare and education spending levels and outcomes are poor. While the 2018 budget allocation has increased, efficiency improving reforms in the health care system must also move forward to keep spending in check once the new insurance system is rolled out. Also, the contribution base must be broadened to secure sufficient revenue. Comprehensive education reforms should move ahead in earnest to upgrade skills and address mismatches, often quoted as one of the key impediments to growth.




**33. While capital spending is already high, there is scope for scaling up by improving the absorption of donor financing and strengthening its efficiency**. The authorities have ratcheted up spending including through large resources allocated to motorways (Routes 6 and 7). The implementation of other priority projects, however, has generally been limited by capacity constraints and low absorption of available IFI-financing. Scaling up public investment and improving its quality will raise potential GDP growth and accelerate income convergence toward EU levels (with an estimated growth dividend of up to 0.8 percent yearly).[10] This includes introducing a requirement for cost-benefit analysis of major capital projects, strengthening project appraisal, selection, preparation, and execution, adopting multi-year budgeting for investment projects, and ensuring ex-post independent audit and assessment of large-scale projects.[11]

[9] Spending on war veteran benefits in 2017 was 1 percent of GDP (compared to the 0.7 percent targeted), and may increase to 1.2 percent of GDP in 2018 in the absence of reform.

[10] Selected Issue Paper – Public Infrastructure: Challenges and Opportunities.

[11] Public Investment Management Assessment Reports April 2016 and May 2017 see for example https://www.imf.org/external/pubs/ft/scr/2016/cr16100.pdf

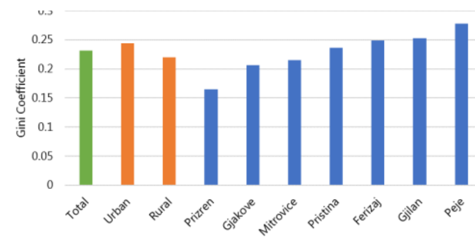
## Box 1. Income Inequality and Social Benefit Performance

**While income inequality is relatively low, spatial disparities remain, exacerbated by a weak labor market and high poverty**. There is some regional variation in inequality, which is higher in urban areas. As of 2015, 18 percent of the population was below the national poverty line of €1.82 a day, and poverty is considerably worse than the EME Europe average. Poverty and distributional gains are constrained by high unemployment (31 percent in 2017) and low participation (57 percent inactive); both indicators are worse among youth and women.

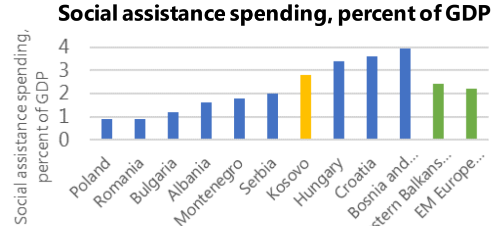
**A rapid expansion of social assistance in recent years, now high by regional standards, has skewed towards categorical benefits**. Pension and social assistance as a share of current expenditure increased from 21½ percent in 2010 to 36½ percent in 2016, and social assistance spending is now above the Western Balkans average. However, the composition of benefits over time has shifted away from poverty and inequality-focused benefits towards war-related benefits.

**As such, high social benefit spending has not translated into above-average distributional outcomes**. The impact of social benefits is constrained by a number of factors: (i) only around half of all households receive any benefit; (ii) adequacy is low, particularly for non-pension social benefits; and (iii) benefit and beneficiary incidence indicate a need to improve targeting.

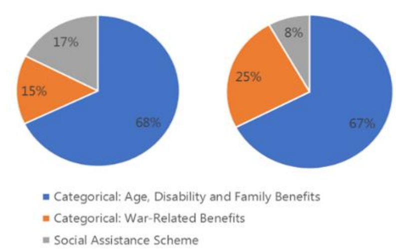
**Gini coefficient by region**




**Social assistance spending, percent of GDP**

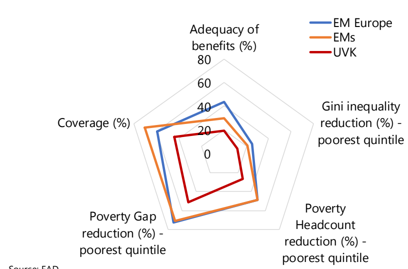



**Social benefit allocation in 2010 and 2017**



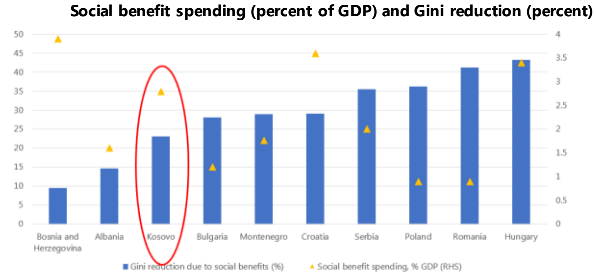

Source: IMF staff calculations based on data from authorities.

**Social benefit performance**




Source: FAD.

**Social benefit spending (percent of GDP) and Gini reduction (percent)**




Source: IMF staff calculations based on HBS 2015 and World Bank ASPIRE database.

Notes: For social benefit performance, the Gini and poverty reductions are simulations are based on the current year. Coverage is the percent of the households receiving social benefits, while adequacy is the share of welfare that social benefits represent.

## Financing

**34. Financing so far has been readily available, but the investor base should be diversified to minimize roll-over risks and support market development**. Financing of the fiscal deficit has been easily absorbed largely by banks operating in Kosovo and to a lesser extent by other institutional entities, despite the 100 percent risk-weightings on government paper for banks with EU-based parents (in the absence of a sovereign credit rating).[12] The authorities are gradually extending the maturity of all outstanding public debt (2-year average maturity), with recent 7-year issuances, which should reduce roll-over risks. However, a normalization of the euro area monetary policy may make it more difficult to sell bonds in the domestic market. Therefore, the investor base should be expanded and diversified so that costs and roll-over risks will be reduced.

***Authorities' Views***

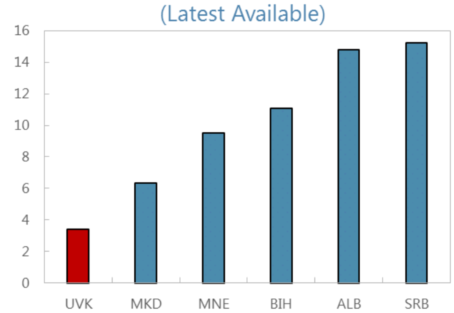
**35. The authorities broadly concurred with staff's assessment**. They agreed that the fiscal stance is appropriate given cyclical conditions, and that the fiscal rule continues to provide an important anchor to fiscal policy. In terms of risks to budget execution, they are confident that the revenue targets will be met, while any overspending related to social spending pressures could be offset by cutting capital spending to keep the deficit within the limits of the fiscal rule.

**36. They agreed with the need to strengthen the tax administration and reduce informality, but felt that staff's revenue projections underestimate related gains**. They also see room for improvement in the budget composition, but pointed out that it does not compare poorly to peers when adjusting for initial conditions, nothing that the high social benefit spending largely reflects legacies from the 1998-99 conflict. Nonetheless, they see scope to make the social benefit system more equitable, i.e. by improving the funding and eligibility for the social assistance and basic pension schemes. Laws are under preparation that would strengthen the administration, tighten eligibility, and improve the targeting and equity of social benefit schemes. Regarding the wage bill, they see limited space for additional priority hiring within the limits of the wage bill rule given the need to attract and retain skilled labor in the civil service by offering competitive salaries.

## C. Financial Sector: Supporting Economic Growth Through Stability and Financial Deepening

**37. Kosovo's largely foreign-owned banking system is broadly sound** (see Figure 3, Table 6). The banking sector remains well-capitalized and liquid, despite credit growth and a shift toward shorter deposit tenors with falling interest rates. It also remains profitable as lower interest income has been offset by higher fee income and lower operational costs. However, the implementation of IFRS9 will require more provisioning with little space to increase fees further. Aggregate asset

**NPL Ratio**
(Latest Available)



Source: Country authorities, IMF staff estimates.

[12] The CBK currently holds €190 million (35 percent of total government securities) on its balance sheet, purchased in the secondary market. The main reason for the CBK to buy T-bills is to have positive returns on its assets and, therefore, to mitigate the impact of euro area negative interest rates.

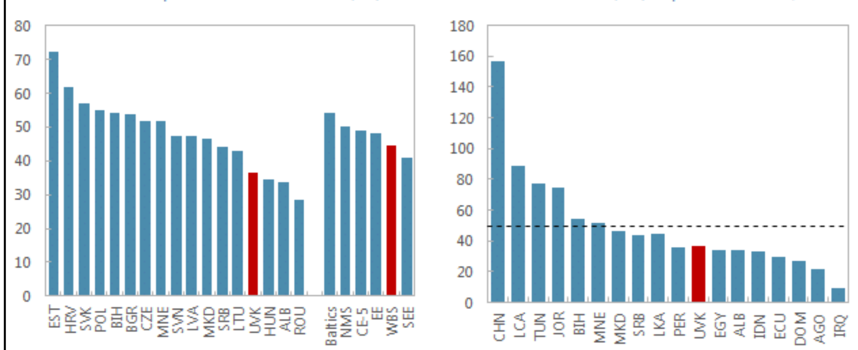
quality is strong by international comparison – the system's NPL ratio has halved in the past two years to below 3½ percent as banks have proactively collected on bad loans and the CBK has implemented stricter write-off standards.

**38. The authorities should continue efforts to refine bank oversight to bolster bank safety and soundness**. Most of the 2012 FSAP recommendations have been implemented (Annex V). Specifically, the authorities have adopted emergency liquidity assistance and macroprudential policy (MPP) frameworks in line with international best practice and adopted risk-based bank supervision. Current efforts to publish manuals for recovery and resolution and crisis management are also important, and the authorities should continue to operationalize their MPP framework. They should also move to complete work on an off-site bank examination manual, which can serve as an additional element of the CBK's analytic toolkit and help to alert the authorities to banking system risks.

**39. Credit growth has increased in recent years, following several years of weak lending, but credit penetration and lending to productive sectors remain low.**[13] Credit growth has averaged 9½ percent y/y since January 2016, with strong contributions from both the corporate and, especially, household sectors (about two-thirds and one-third of the system loans, respectively). This has been driven by plummeting interest rates (thanks to increased competition), healthier bank balance sheets, excess liquidity, reforms to strengthen contract enforcement (see below) and less risk aversion among EU subsidiaries' parent banks. However, at 38 percent of GDP, credit depth remains low relative to Kosovo's Western Balkan and income-level peers, as well as to its own macroeconomic fundamentals. Further, credit growth has been largest in unsecured consumer lending, while lending to productive sectors remains low.

**Western Balkans: Credit Depth**

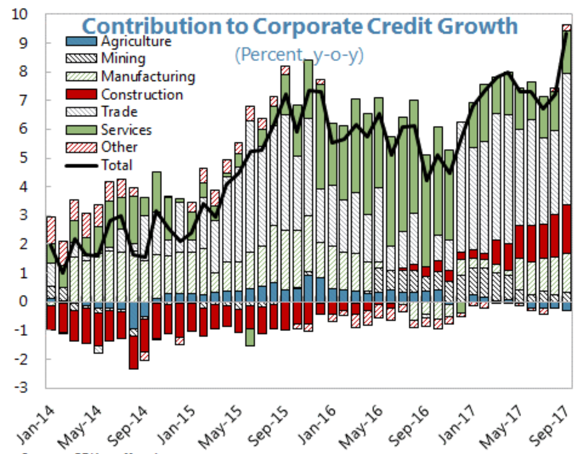
Bank credit to the private sector in CESEE (lhs) and at similar income levels (rhs) in percent of GDP, 2016 1/




Source: IFS, Conference Board TED, and Staff calculations.
1/ The rhs chart plot WBS against other countries across the world with a similar per capita income level (ranging $9,000 to $14,000 in constant 2014 PPP dollars) in 2016 or latest (2015).

[13] Selected Issue Paper – Financial Deepening in Kosovo.

**40. Further progress on structural reforms is needed to support more productive financial deepening**. The authorities have made significant progress in recent years to reduce structural impediments to lending, with a focus on strengthening the contract enforcement system. The authorities should now:



Source: CBK, staff estimates.

- Maintain momentum in implementing the amended Law on Enforcement Procedures, particularly regarding the reform of the PEA tariff structure and the establishment of an independent PEA inspection unit at the Ministry of Justice;
- Adopt pending legislation to automatically send certain types of property rights cases through an official arbitration process, thus clearing up more space in the court system;
- Accelerate the reduction of the still-large court case backlog and prioritize large commercial cases. Consideration could be given to establish a commercial court, the efficiency of which would benefit from smaller caseloads and specialized judges;
- Establish a fully functioning cadaster system that covers all of Kosovo; and provide banks access to the recently-established agriculture registry.

**41. It is also important that the authorities maintain supervisory vigilance amid strong and sustained consumer and construction lending**. While data is unavailable, anecdotal evidence suggests that a significant amount of unsecured consumer loans are used to purchase property given the inability to obtain a mortgage. The authorities should continue to closely monitor this sector and be vigilant of any pockets of vulnerability in view of possible excess supply in the market. They should also work toward developing a housing price index or creating a centralized registry of property valuations populated by real estate appraisers. This should be a priority, as 79 percent of the strong FDI inflows since 2015 have been directed toward the real estate and construction sectors (although construction loans comprise only about 5 percent of bank loans).

**42. Policy measures have helped to improve the insurance sector's health and performance**. The sector, while small (3 percent of system assets) and no systematic risk, in aggregate posted losses in recent years and experienced liquidity and capital shortfalls. However, the sector has returned to profitability this year following the adoption of Solvency I rules and regulation to limit distribution costs; the establishment of an arbitration procedure to resolve claims out of court; and the start of a gradual phasing-in of regulations on internal controls and risk management.

**43. The authorities continue to refine their AML/CFT framework**. The authorities adopted an AML/CFT law in June 2016 and supplementary regulations in November 2016. Since then, the CBK has made progress with its implementation, including issuing further guidance to banks on beneficial ownership. Also, the CBK is moving towards a risk-based approach to AML/CFT supervision. In the absence of membership in a FATF-style regional body, an AML/CFT assessment under PECK (a project established to strengthen capacities and sustainability of anti-economic crime efforts) will be carried out in 2018 to assess whether the AML/CFT regime is in line with best practice.

***Authorities' Views***

**44. The authorities shared staff's view of the soundness of the banking system and do not see any major pockets of vulnerabilities**. The CBK's stress tests suggest resilience to most types of shocks, with some sensitivity to a further steep fall in lending rates. The authorities viewed the strong growth in consumer and construction loans as reflective of pent-up demand, and emphasized that banks have strengthened their risk management. Given ample capital buffers, they are confident that banks can absorb losses from a potential real estate shock, even when accounting for indirect exposures through consumer credit. They consider that the expansion of the credit guarantee fund will be key to support an acceleration of credit for productive sector with an emphasis for SMEs. While credit has been growing at a healthy clip, the authorities agreed that significant scope for further credit deepening remains, and see improving access to finance as a priority. In terms of the main structural bottlenecks to credit provision, they see the contribution from demand and supply side constraints as balanced.

# OTHER ISSUES

**45. Article VIII acceptance**. Kosovo accepted Article VIII obligations on January 11, 2018. Kosovo notified the Fund at the time it became a member in 2009 that it intended to avail itself of transitional arrangements under Article XIV, Section 2. Staff has completed an assessment of the foreign exchange system and found that Kosovo does not maintain multiple currency practices or exchange restrictions, except for restrictions maintained solely for reasons of international or national security, which have been notified to the Fund pursuant to Decision No. 144. Staff will circulate a staff report to the Board noting Kosovo's acceptance of Article VIII obligations. The acceptance of Article VIII obligations will send a positive signal to the investor community about the liberalized foreign exchange system and thus help facilitate a favorable business climate.

**46. Data remain adequate for surveillance purposes**. Fiscal and financial sector data are of good quality and are timely and available. The authorities need to make further efforts to implement recommendations provided in the recent past to improve the quality and timeliness of real sector data. The authorities should also begin to publish donor inflow data for the national accounts.

# STAFF APPRAISAL

**47. Kosovo has made significant progress in recent years and sound financial and fiscal policies have helped to further strengthen the economy**. Since the 2015 Article IV consultations, the medium-term growth outlook has improved. While some progress in regaining competitiveness has been made, the external position remains weaker than implied by the fundamentals and desirable policy settings, and the key priority is to accelerate the implementation of structural reforms to increase productivity. Current levels of international reserves and the government's bank balance are adequate, which should help mitigate external and liquidity shocks, and the public-sector debt is low. Notwithstanding, given Kosovo's unilateral euroization maintaining macroeconomic and financial stability is key.

**48. But important structural challenges remain**. This includes an external competitiveness gap, high informality, weaknesses in governance, low labor force participation and high unemployment rates which continue to constrain Kosovo's growth potential. Resolving these structural problems should be a priority to reduce inequality and achieve stronger and more inclusive growth to reduce the still large income gap with regional peers and the EU.

**49. Reforms to improve the productivity of the economy to support private sector and export-led growth should be at the forefront of the policy agenda**. Kosovo needs to improve its governance and business climate, including by implementing the laws on procurement and bankruptcy procedures, strengthening the effectiveness of the anti-corruption regime and making large public investment projects subject to ex-post audits. Also, by moving ahead with the new power plant and prioritizing investment spending in the budget with multi-year commitments should help to address energy and infrastructure bottlenecks. Public enterprises should be restructured and their governance improved to pave the way for private sector involvement. To improve labor productivity and address high unemployment, planned reforms focused on addressing skill-mismatches by upgrading education should move ahead. On the other hand, any increases in the minimum wage should be in line with the current rule-based minimum wage setting mechanism and large discretionary increases avoided, given the still high level of unemployment, competitiveness gap and weak enforcement.

**50. The fiscal rule has served Kosovo well and should be maintained**. It has established an anchor for fiscal policy, and provides an appropriate balance between fiscal discipline and developmental needs, given the still low public debt and large infrastructure gap. Even though it allows for some pro-cyclical easing in 2018, given the openness of the Kosovo economy, this will have limited demand pressures.

**51. However, the composition of the budget and the efficiency of its spending should be improved over time**. This will help improve outcomes and make space for higher and more productive investment in education, health and infrastructure which are critical to increase productivity and ensure stronger and inclusive growth. To this end, social benefits should be better targeted to improve the distributional effect and pressures to introduce new schemes that further increase spending resisted. Therefore, finalizing the reform of the war veteran pension, in line with the law, and avoiding the introduction of unfunded early retirement schemes that undermine the fairness and financial soundness of the system is essential. Wage increases within the wage bill rule should be limited to make space for priority hiring and the introduction of the new health insurance scheme. Scaling up public investment, and improving its quality are essential, including making better use of IFI financing and strengthening the public investment framework.

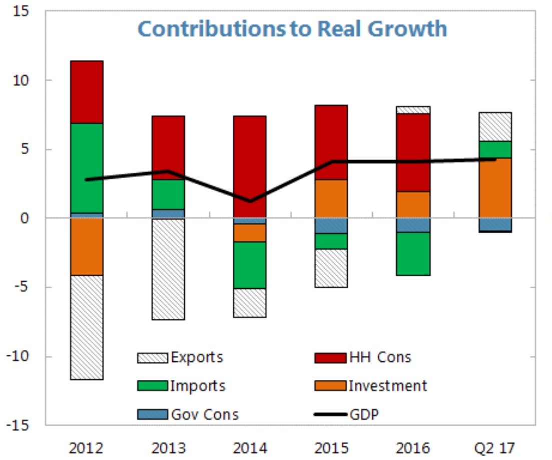
52. **Revenue administration reforms should move ahead in earnest to mobilize domestic revenue** by broadening the tax base and reducing the large informality, given the low revenue to GDP ratio. Introducing tax holidays or new exemptions should be avoided, while there is scope for additional revenue from excises and property taxes.

53. **The financial sector remains healthy but access is still limited**. Credit growth has increased in recent years, but credit penetration remains low and certain sectors, such as agriculture and SMEs, remain underserved by the banks, while the bulk of credit goes toward less productive sectors. The authorities should maintain the strong reform momentum of recent years in reducing structural bottlenecks to lending. They should also maintain vigilance for pockets of vulnerability in the context of strong credit growth, and continue to strengthen the supervisory framework.

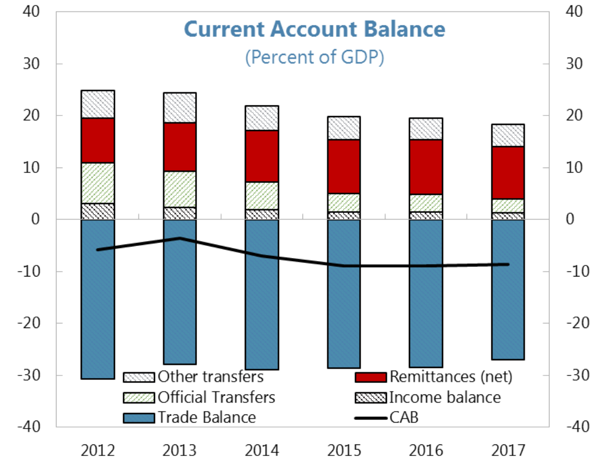
54. **It is recommended that the next Article IV consultation take place on the standard 12-month cycle.**

## Figure 1. Kosovo: Recent Economic Developments

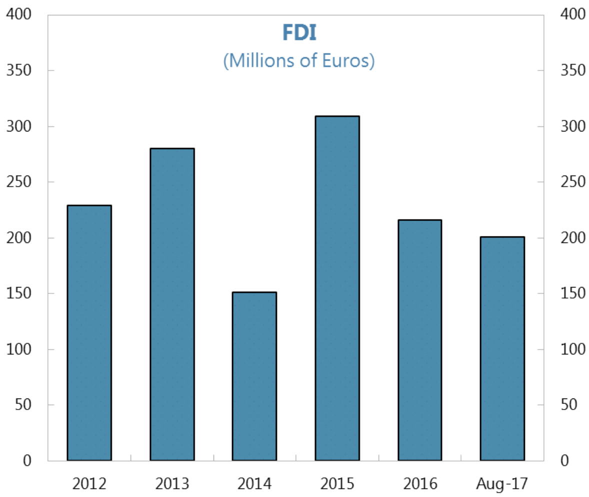
*Growth is largely driven by domestic demand, despite a sharp drop in private consumption in Q2 2017.*



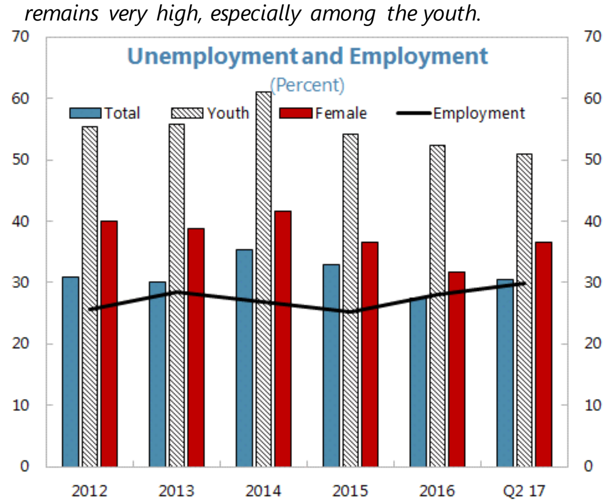

*The current account balance is dragged down by the trade deficit, even with large remittances and official transfers,..*



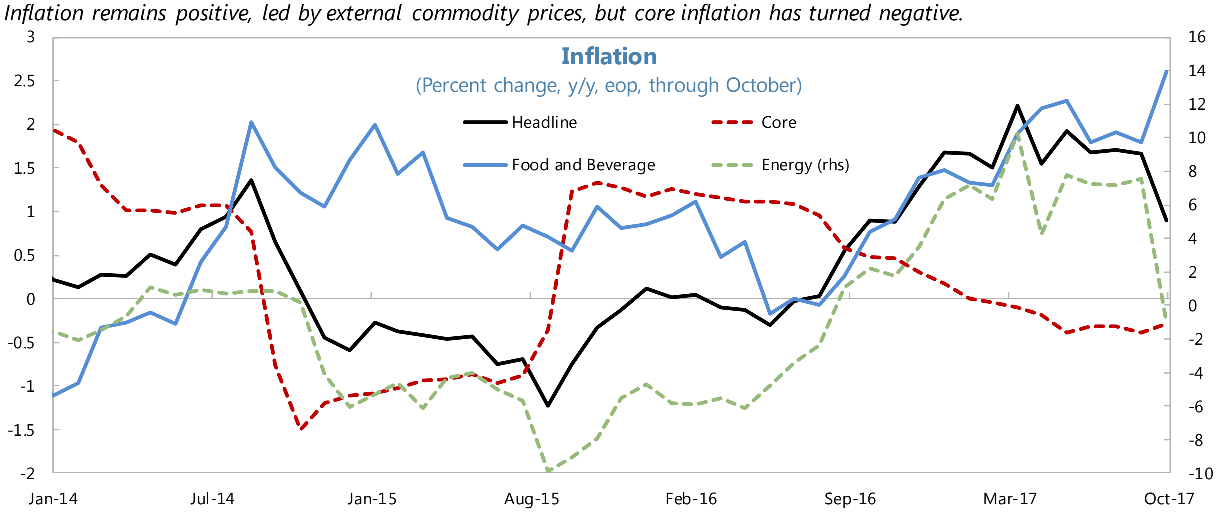

*...but financed primarily via non-debt creating flows, such as FDI.*




*Unemployment has fallen somewhat in recent years but remains very high, especially among the youth.*



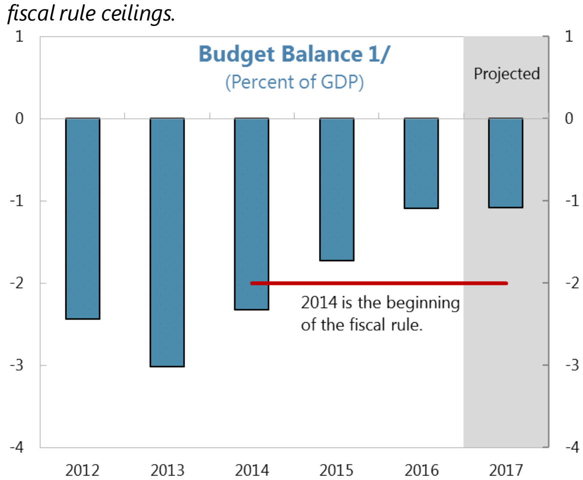

*Inflation remains positive, led by external commodity prices, but core inflation has turned negative.*



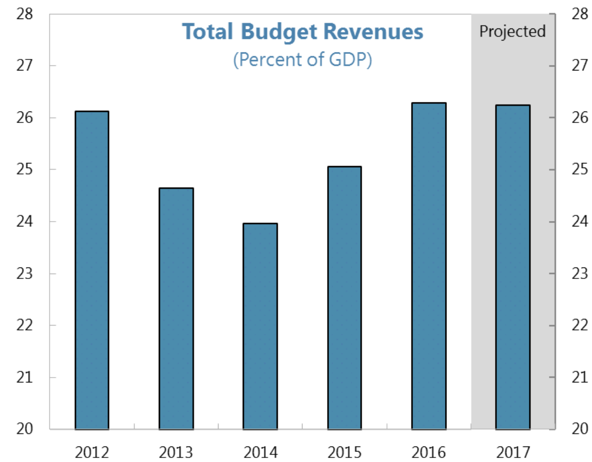

*Sources: Kosovo Agency of Statistics; Central Bank of Kosovo; KPST; and IMF staff estimates.*

## Figure 2. Kosovo: Fiscal Developments

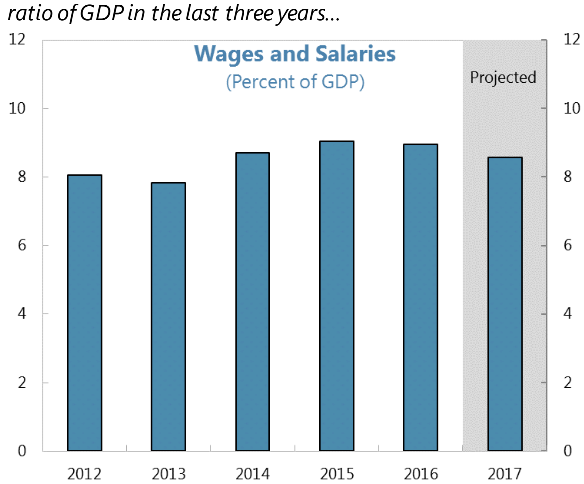
*Since 2014, the overall deficit has remained well within the fiscal rule ceilings.*



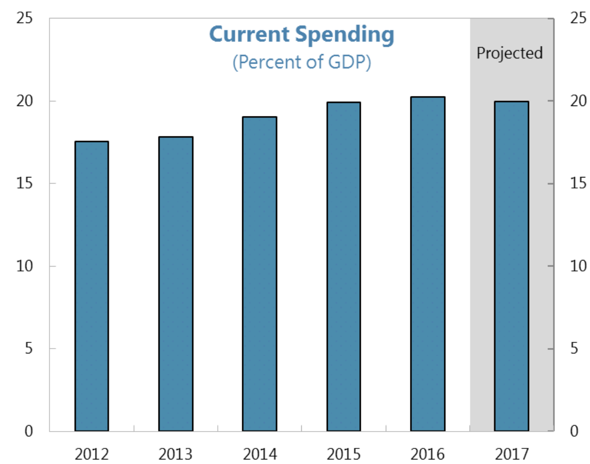

*Total revenues have continued to perform well in 2017.*



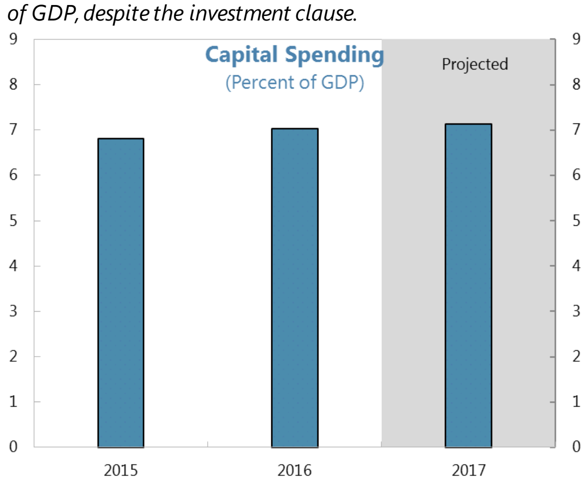

*While wages and salaries have remained broadly constant as ratio of GDP in the last three years...*



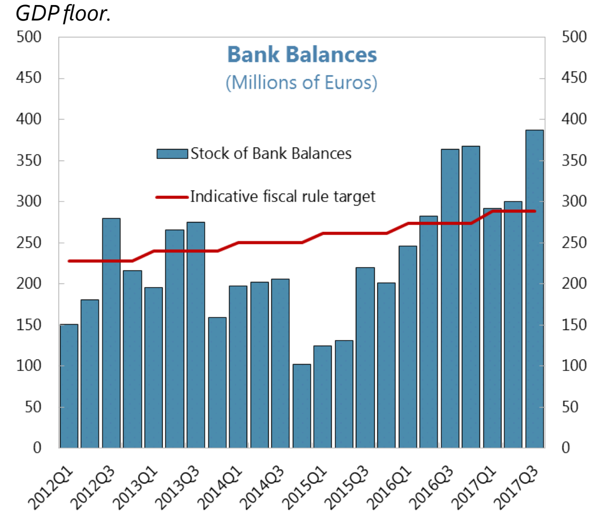

*.... current spending has continued to grow.*




*Capital spending execution has remained at about 7 percent of GDP, despite the investment clause.*

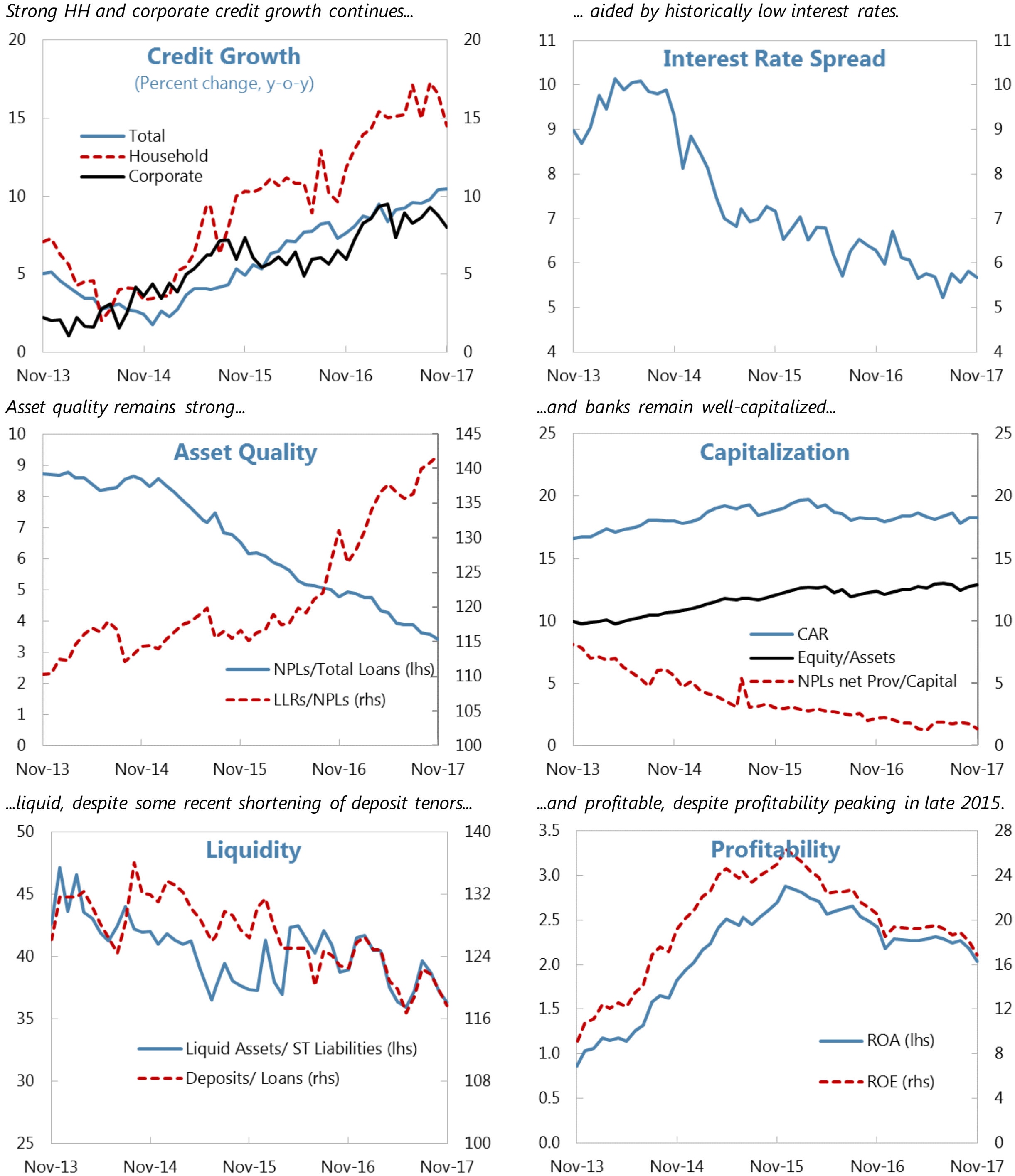



*Bank balances have been restored to above the 4.5 percent of GDP floor.*




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

## Figure 3. Kosovo: Banking Sector Overview




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

## Table 1. Kosovo: Select Economic Indicators, 2014-22
(Percent, unless otherwise indicated)

| | 2014 | 2015 | 2016 | 2017 | 2018 | 2019 | 2020 | 2021 | 2022 |
|---|---|---|---|---|---|---|---|---|---|
| | | | | | | Projections | | | |
| Real GDP growth | 1.2 | 4.1 | 4.1 | 4.1 | 4.0 | 4.0 | 4.0 | 4.0 | 4.0 |
| *Contribution to growth (percentage points of GDP)* | | | | | | | | | |
| Consumption | 7.2 | 4.6 | 4.7 | 1.1 | 4.3 | 3.7 | 3.7 | 3.7 | 3.8 |
| Private | 7.4 | 5.4 | 5.6 | 1.6 | 3.4 | 3.4 | 3.4 | 3.4 | 3.4 |
| Public | -0.5 | -1.1 | -1.0 | -0.5 | 0.9 | 0.2 | 0.3 | 0.3 | 0.4 |
| Investment | -1.3 | 2.8 | 2.0 | 3.4 | 3.1 | 3.4 | 3.4 | 3.3 | 3.4 |
| Net Exports | -5.5 | -3.9 | -2.6 | -0.3 | -2.1 | -1.8 | -1.9 | -1.7 | -1.4 |
| Exports | -2.1 | -2.8 | 0.5 | 3.6 | 1.2 | 1.6 | 1.5 | 1.7 | 1.6 |
| Imports | -3.3 | -1.1 | -3.2 | -3.9 | -3.3 | -3.4 | -3.4 | -3.4 | -3.0 |
| Official unemployment (percent of workforce) 1/ | 35.3 | 32.9 | 28.7 | 30.6 | ... | ... | ... | ... | ... |
| Price changes | | | | | | | | | |
| CPI, period average | 0.4 | -0.5 | 0.3 | 1.5 | 1.0 | 1.9 | 2.1 | 2.2 | 2.2 |
| GDP deflator | 3.3 | 0.2 | 0.4 | 1.5 | 1.2 | 1.7 | 1.8 | 1.9 | 2.1 |
| Real effective exch. rate (average; -=depreciation) | 1.3 | -2.2 | 0.9 | ... | ... | ... | ... | ... | ... |
| Real effective exch. rate (end of period; -=depreciation) | -1.1 | -1.0 | 0.6 | ... | ... | ... | ... | ... | ... |
| Terms of Trade | 84 | 96 | 100 | 103 | 104 | 106 | 108 | 109 | 109 |
| General government budget (percent of GDP) | | | | | | | | | |
| Revenues | 23.9 | 25.1 | 26.3 | 26.2 | 26.9 | 26.6 | 26.4 | 26.2 | 26.1 |
| Primary expenditures | 26.3 | 26.7 | 27.3 | 27.1 | 29.6 | 30.0 | 28.9 | 29.0 | 28.7 |
| Of which: Wages and salaries | 8.7 | 9.0 | 9.0 | 8.6 | 8.7 | 8.7 | 8.7 | 8.7 | 8.6 |
| Subsidies and transfers | 6.6 | 7.4 | 8.0 | 7.9 | 7.8 | 7.8 | 7.8 | 7.8 | 7.8 |
| Capital and net lending | 7.3 | 6.8 | 7.0 | 7.1 | 8.1 | 7.7 | 7.5 | 7.5 | 7.3 |
| Overall Balance Ex-PAK ex-IFI capital projects (Fiscal rule) 2/ | -2.3 | -1.7 | -1.1 | -1.1 | -1.8 | -1.9 | -1.9 | -1.9 | -1.9 |
| Overall balance excluding PAK current spending 2/ | -2.3 | -1.7 | -1.1 | -1.1 | -2.9 | -3.7 | -2.7 | -3.0 | -2.9 |
| Stock of government bank balances | 1.8 | 3.5 | 3.5 | 4.9 | 4.5 | 5.0 | 5.0 | 5.0 | 5.0 |
| Total public debt (percent of GDP) | 16.7 | 18.9 | 19.6 | 21.0 | 21.8 | 24.9 | 26.3 | 27.8 | 29.0 |
| Of which: Debt of the former Yugoslavia 3/ | 6.3 | 5.8 | 5.2 | 4.6 | 4.0 | 3.4 | 2.9 | 2.4 | 1.9 |
| Balance of Payments (percent of GDP) | | | | | | | | | |
| Current account balance, incl. official transfers | -7.0 | -8.7 | -8.9 | -8.7 | -8.9 | -8.6 | -7.9 | -8.0 | -7.7 |
| Of which: official transfers 4/ | 5.2 | 3.5 | 3.4 | 2.6 | 2.6 | 2.6 | 2.5 | 2.5 | 2.5 |
| Of which: remittance inflows | 11.2 | 11.5 | 11.4 | 11.2 | 11.1 | 11.0 | 10.9 | 10.7 | 10.5 |
| Capital and financial account | 3.2 | 4.4 | 2.1 | 7.2 | 6.7 | 6.7 | 5.9 | 6.0 | 6.1 |
| Of which: Net foreign direct investment | 2.2 | 4.7 | 3.0 | 5.0 | 5.0 | 5.0 | 5.2 | 5.2 | 5.0 |
| Portfolio investment, net | -0.2 | -0.8 | -6.1 | 0.4 | -0.3 | -1.3 | -1.5 | -1.5 | -1.2 |
| Errors and Omissions | 3.9 | 4.3 | 6.8 | 1.4 | 2.2 | 1.9 | 1.9 | 2.0 | 1.7 |
| Savings-investment balances (percent of GDP) | | | | | | | | | |
| National savings | 13.5 | 15.2 | 14.8 | 17.6 | 18.8 | 21.3 | 21.4 | 22.0 | 22.6 |
| Investment | 25.8 | 27.6 | 27.2 | 28.9 | 30.4 | 32.5 | 31.8 | 32.5 | 32.8 |
| Current account, excl. official transfers | -12.3 | -12.4 | -12.4 | -11.3 | -11.6 | -11.2 | -10.4 | -10.5 | -10.3 |
| Non-performing loans (percent of total loans) 5/ | 8.3 | 6.2 | 4.9 | 3.4 | ... | ... | ... | ... | ... |
| Bank credit to the private sector (percent change) | 5.3 | 7.3 | 10.3 | 10.5 | 10.1 | 10.4 | 9.4 | 9.1 | 8.7 |
| Deposits of the private sector (percent change) | 4.0 | 7.3 | 8.7 | 7.7 | 7.3 | 7.5 | 7.8 | 8.2 | 8.4 |
| Regulatory capital/risk weighted assets 5/ | 17.8 | 19.0 | 17.9 | 18.7 | ... | ... | ... | ... | ... |
| *Memorandum items:* | | | | | | | | | |
| GDP (millions of euros) | 5,567 | 5,807 | 6,070 | 6,414 | 6,749 | 7,135 | 7,556 | 8,011 | 8,508 |
| GDP per capita (euros) | 3,023 | 3,160 | 3,301 | 3,436 | 3,562 | 3,710 | 3,871 | 4,044 | 4,231 |
| GNDI per capita (euros) | 3,525 | 3,674 | 3,832 | 3,975 | 4,113 | 4,286 | 4,477 | 4,681 | 4,903 |
| Population (millions) | 1.8 | 1.8 | 1.8 | 1.9 | 1.9 | 1.9 | 2.0 | 2.0 | 2.0 |

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

1/ As of Q2 2017.

2/ For fiscal rule purposes, only projects post-July 2015 apply.

3/ Kosovo neither recognizes nor services nor tracks this debt.

4/ Total foreign assistance excluding capital transfers.

5/ 2017 as of November 2017.

## Table 2. Kosovo: Consolidated Government Budget, 2014-22 1/

(Excluding donor designated grants; millions of euro)

| | 2014 | 2015 | 2016 | 2017 | | 2018 | | 2019 | 2020 | 2021 | 2022 |
|---|---|---|---|---|---|---|---|---|---|---|---|
| | | | | Original Budget | Proj. | Budget 4/ | Proj. 5/ | Projections | | | |
| Revenue and grants (excluding donor designated grants) | 1,333 | 1,455 | 1,595 | 1,713 | 1,683 | 1,817 | 1,817 | 1,896 | 1,992 | 2,102 | 2,218 |
| Revenue | 1,333 | 1,455 | 1,595 | 1,713 | 1,683 | 1,810 | 1,810 | 1,896 | 1,992 | 2,102 | 2,218 |
| Taxes | 1,162 | 1,269 | 1,424 | 1,512 | 1,498 | 1,607 | 1,607 | 1,686 | 1,770 | 1,866 | 1,967 |
| Direct taxes | 188 | 196 | 234 | 251 | 241 | 267 | 267 | 280 | 294 | 310 | 326 |
| Indirect taxes | 1,007 | 1,107 | 1,229 | 1,305 | 1,315 | 1,386 | 1,386 | 1,455 | 1,527 | 1,611 | 1,699 |
| Tax refunds | -33 | -34 | -39 | -44 | -58 | -46 | -46 | -49 | -52 | -55 | -58 |
| Nontax revenues | 171 | 187 | 171 | 201 | 185 | 202 | 202 | 210 | 222 | 236 | 251 |
| Grants | 0 | 0 | 0 | 0 | 0 | 7 | 7 | 0 | 0 | 0 | 0 |
| Primary expenditure | 1,464 | 1,552 | 1,657 | 1,989 | 1,737 | 2,081 | 2,000 | 2,139 | 2,180 | 2,322 | 2,443 |
| Current expenditure | 1,059 | 1,156 | 1,230 | 1,275 | 1,280 | 1,387 | 1,387 | 1,463 | 1,546 | 1,637 | 1,738 |
| *of which:* PAK-related current expenditures | 5 | 6 | 6 | 11 | 7 | 11 | 11 | 12 | 13 | 14 | 9 |
| Wages and salaries | 485 | 525 | 544 | 572 | 550 | 590 | 590 | 621 | 656 | 693 | 736 |
| Goods and services | 206 | 204 | 202 | 225 | 224 | 266 | 266 | 281 | 297 | 315 | 335 |
| Subsidies and transfers | 368 | 427 | 485 | 473 | 506 | 526 | 526 | 556 | 588 | 623 | 662 |
| Pension and social assistance | 347 | 399 | 466 | | 486 | | 505 | 534 | 565 | 599 | 636 |
| Other transfers and subsidies | 21 | 29 | 19 | | 20 | | 21 | 22 | 23 | 24 | 26 |
| Current reserves | 0 | 0 | 0 | 5 | 0 | 5 | 5 | 5 | 5 | 5 | 5 |
| Capital expenditure and net lending | 404 | 395 | 426 | 715 | 457 | 695 | 613 | 677 | 634 | 685 | 705 |
| Budget-financed capital expenditure and net lending | 404 | 395 | 426 | 523 | 457 | 546 | 546 | 550 | 570 | 600 | 620 |
| Budget-financed capital expenditure | 404 | 395 | 434 | 534 | 468 | 546 | 546 | 550 | 570 | 600 | 620 |
| Expropriation | 21 | 27 | 27 | | 30 | | 25 | 0 | 0 | 0 | 0 |
| Other capital spending | 289 | 254 | 249 | | 258 | | 454 | 492 | 570 | 600 | 620 |
| Capital Reserves | | | 0 | | 0 | 0 | 0 | 0 | 0 | 0 | 0 |
| Net lending | 0 | 0 | -7 | -11 | -11 | 0 | 0 | 0 | 0 | 0 | 0 |
| PAK-financed capital expenditure | 0 | 0 | 0 | 87 | 0 | 62 | 42 | 0 | 0 | 0 | 0 |
| IFI-financed capital expenditure 2/ | 0 | 0 | 0 | 105 | 0 | 86 | 25 | 127 | 64 | 85 | 85 |
| Primary balance | -131 | -97 | -61 | -276 | -54 | -264 | -183 | -243 | -187 | -221 | -225 |
| Interest income, net | -6 | -10 | -11 | -23 | -23 | -24 | -24 | -30 | -33 | -31 | -30 |
| Overall balance | -136 | -107 | -73 | -299 | -77 | -288 | -206 | -274 | -220 | -251 | -255 |
| Ex-PAK ex-IFI capital projects (Fiscal rule) | -131 | -101 | -66 | -96 | -70 | -123 | -123 | -135 | -143 | -152 | -161 |
| Ex-PAK-related current expenditures | -131 | -101 | -66 | -288 | -70 | -277 | -195 | -262 | -207 | -237 | -246 |
| Statistical discrepancy | -5 | 6 | 4 | | ... | | ... | ... | ... | ... | ... |
| Financing | 136 | 94 | 62 | | 70 | | 195 | 262 | 207 | 237 | 246 |
| Foreign financing | -18 | 13 | -23 | | 74 | | 55 | 112 | -10 | 29 | 66 |
| Drawings, incl. official financing | 4 | 5 | 8 | | 10 | | 49 | 36 | 22 | 38 | 40 |
| Amortization | -22 | -28 | -66 | | -37 | | -19 | -50 | -96 | -94 | -59 |
| Donor financing for new projects | 0 | 0 | 0 | | 0 | | 25 | 127 | 64 | 85 | 85 |
| IMF financing | 0 | 36 | 35 | | 101 | | 0 | 0 | 0 | 0 | 0 |
| Domestic financing | 97 | 181 | 96 | | 97 | | 123 | 206 | 237 | 231 | 205 |
| Domestic borrowing (net) | 104 | 109 | 101 | | 97 | | 86 | 206 | 237 | 231 | 205 |
| Privatization revenues | 0 | 61 | 0 | | 0 | | 42 | 0 | 0 | 0 | 0 |
| Accumulation of Assets (- = increase) | 57 | -99 | -11 | | -101 | | 12 | -56 | -20 | -23 | -25 |
| Memorandum items: | | | | | | | | | | | |
| Bank balance of the general government | 102 | 201 | 212 | 329 | 313 | 301 | 301 | 357 | 377 | 400 | 425 |
| *Of which:* ELA | 46 | 46 | 46 | 46 | 46 | 46 | 46 | 46 | 46 | 46 | 46 |
| Total public debt | 931 | 1,099 | 1,189 | | 1,350 | | 1,475 | 1,777 | 1,987 | 2,226 | 2,465 |
| *Of which:* Debt of the former Yugoslavia 3/ | 351 | 337 | 316 | | 294 | | 271 | 246 | 219 | 189 | 158 |

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

1/ Does not yet reflect the GFSM 2001 methodology.

2/ For fiscal rule purposes, only IFI projects post-July 2015 apply.

3/ Kosovo neither recognizes nor services nor tracks this debt.

4/ Assumes tax compliance gains of 0.7 percent of GDP, a timely and full implementation of the war veteran pension law, and tight administration for all other budgeted social schemes.

5/ See footnote 4. Also, assumes a lower exectution of IFI and PAK financed investments, taking into account implementation capacity.

## Table 3. Kosovo: Consolidated Government Budget, 2014-22 1/

(Excluding donor designated grants; percent of GDP)

| | 2014 | 2015 | 2016 | 2017 | | 2018 | | 2019 | 2020 | 2021 | 2022 |
|---|---|---|---|---|---|---|---|---|---|---|---|
| | | | | Original Budget | Proj. | Budget 4/ | Proj. 5/ | Projections | | | |
| Revenue and grants (excluding donor designated grants) | 23.9 | 25.1 | 26.3 | 26.7 | 26.2 | 26.9 | 26.9 | 26.6 | 26.4 | 26.2 | 26.1 |
| Revenue | 23.9 | 25.1 | 26.3 | 26.7 | 26.2 | 26.8 | 26.8 | 26.6 | 26.4 | 26.2 | 26.1 |
| Taxes | 20.9 | 21.8 | 23.5 | 23.6 | 23.4 | 23.8 | 23.8 | 23.6 | 23.4 | 23.3 | 23.1 |
| Direct taxes | 3.4 | 3.4 | 3.9 | 3.9 | 3.8 | 4.0 | 4.0 | 3.9 | 3.9 | 3.9 | 3.8 |
| Indirect taxes | 18.1 | 19.1 | 20.2 | 20.3 | 20.5 | 20.5 | 20.5 | 20.4 | 20.2 | 20.1 | 20.0 |
| Tax refunds | -0.6 | -0.6 | -0.6 | -0.7 | -0.9 | -0.7 | -0.7 | -0.7 | -0.7 | -0.7 | -0.7 |
| Nontax revenues | 3.1 | 3.2 | 2.8 | 3.1 | 2.9 | 3.0 | 3.0 | 2.9 | 2.9 | 2.9 | 2.9 |
| Primary expenditure | 26.3 | 26.7 | 27.3 | 31.0 | 27.1 | 30.8 | 29.6 | 30.0 | 28.9 | 29.0 | 28.7 |
| Current expenditure | 19.0 | 19.9 | 20.3 | 19.9 | 20.0 | 20.5 | 20.5 | 20.5 | 20.5 | 20.4 | 20.4 |
| Wages and salaries | 8.7 | 9.0 | 9.0 | 8.9 | 8.6 | 8.7 | 8.7 | 8.7 | 8.7 | 8.7 | 8.6 |
| Goods and services | 3.7 | 3.5 | 3.3 | 3.5 | 3.5 | 3.9 | 3.9 | 3.9 | 3.9 | 3.9 | 3.9 |
| Subsidies and transfers | 6.6 | 7.4 | 8.0 | 7.4 | 7.9 | 7.8 | 7.8 | 7.8 | 7.8 | 7.8 | 7.8 |
| Pension and social assistance | 6.2 | 6.9 | 7.7 | | 7.6 | | 7.5 | 7.5 | 7.5 | 7.5 | 7.5 |
| Other transfers and subsidies | 0.4 | 0.5 | 0.3 | | 0.3 | | 0.3 | 0.3 | 0.3 | 0.3 | 0.3 |
| Current reserves | 0.0 | 0.0 | 0.0 | 0.1 | 0.0 | 0.1 | 0.1 | 0.1 | 0.1 | 0.1 | 0.1 |
| Capital expenditure and net lending | 7.3 | 6.8 | 7.0 | 11.1 | 7.1 | 10.3 | 9.1 | 9.5 | 8.4 | 8.6 | 8.3 |
| Budget-financed capital expenditure and net lending | 7.3 | 6.8 | 7.0 | 8.1 | 7.1 | 8.1 | 8.1 | 7.7 | 7.5 | 7.5 | 7.3 |
| Capital expenditure | 7.3 | 6.8 | 7.1 | 8.3 | 7.3 | 8.1 | 8.1 | 7.7 | 7.5 | 7.5 | 7.3 |
| Expropriations | 0.4 | 0.5 | 0.4 | | 0.5 | | 0.4 | 0.0 | 0.0 | 0.0 | 0.0 |
| Other capital spending | 5.2 | 4.4 | 4.1 | | 4.0 | | 6.7 | 6.9 | 7.5 | 7.5 | 7.3 |
| Net lending | 0.0 | 0.0 | -0.1 | -0.2 | -0.2 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 |
| PAK-financed capital expenditure | 0.0 | 0.0 | 0.0 | 1.4 | 0.0 | 0.9 | 0.6 | 0.0 | 0.0 | 0.0 | 0.0 |
| IFI-financed capital expenditure 2/ | 0.0 | 0.0 | 0.0 | 1.6 | 0.0 | 1.3 | 0.4 | 1.8 | 0.8 | 1.1 | 1.0 |
| Primary balance | -2.3 | -1.7 | -1.0 | -4.3 | -0.8 | -3.9 | -2.7 | -3.4 | -2.5 | -2.8 | -2.6 |
| Interest income, net | -0.1 | -0.2 | -0.2 | -0.4 | -0.4 | -0.3 | -0.3 | -0.4 | -0.4 | -0.4 | -0.3 |
| Overall balance | -2.4 | -1.8 | -1.2 | -4.7 | -1.2 | -4.3 | -3.1 | -3.8 | -2.9 | -3.1 | -3.0 |
| Ex-PAK ex-IFI capital projects (Fiscal rule) | -2.3 | -1.7 | -1.1 | -1.5 | -1.1 | -2 | -2 | -1.9 | -1.9 | -1.9 | -1.9 |
| Ex-PAK related current expenditures | -2.3 | -1.7 | -1.1 | -4.5 | -1.1 | -4.1 | -2.9 | -3.7 | -2.7 | -3.0 | -2.9 |
| Statistical discrepancy | -0.1 | 0.1 | 0.1 | | ... | | ... | ... | ... | ... | ... |
| Financing | 2.4 | 1.6 | 1.0 | | 1.1 | | 2.9 | 3.7 | 2.7 | 3.0 | 2.9 |
| Foreign financing | -0.3 | 0.2 | -0.4 | | 1.2 | | 0.8 | 1.6 | -0.1 | 0.4 | 0.8 |
| Drawings, incl. official financing | 0.1 | 0.1 | 0.1 | | 0.2 | | 0.7 | 0.5 | 0.3 | 0.5 | 0.5 |
| Amortization | -0.4 | -0.5 | -1.1 | | -0.6 | | -0.3 | -0.7 | -1.3 | -1.2 | -0.7 |
| Donor financing for new projects | 0.0 | 0.0 | 0.0 | | 0.0 | | 0.4 | 1.8 | 0.8 | 1.1 | 1.0 |
| IMF financing | 0.0 | 0.6 | 0.6 | | 1.6 | | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 |
| Domestic financing | 1.7 | 3.1 | 1.6 | | 1.5 | | 1.8 | 2.9 | 3.1 | 2.9 | 2.4 |
| Domestic borrowing (net) | 1.9 | 1.9 | 1.7 | | 1.5 | | 1.3 | 2.9 | 3.1 | 2.9 | 2.4 |
| Privatization revenues | 0.0 | 1.1 | 0.0 | | 0.0 | | 0.6 | 0.0 | 0.0 | 0.0 | 0.0 |
| Own-source revenue (- = increase) | -0.1 | 0.2 | -0.1 | | 0.0 | | -0.1 | 0.0 | 0.0 | 0.0 | 0.0 |
| Accumulation of Assets (- = increase) | 1.0 | -1.7 | -0.2 | | -1.6 | | 0.2 | -0.8 | -0.3 | -0.3 | -0.3 |
| Memorandum items: | | | | | | | | | | | |
| Bank balance of the general government | 1.8 | 3.5 | 3.5 | 5.1 | 4.9 | 4.5 | 4.5 | 5.0 | 5.0 | 5.0 | 5.0 |
| *Of which:* ELA | 0.8 | 0.8 | 0.8 | 0.7 | 0.7 | 0.7 | 0.7 | 0.6 | 0.6 | 0.6 | 0.5 |
| Total public debt | 16.7 | 18.9 | 19.6 | | 21.0 | | 21.8 | 24.9 | 26.3 | 27.8 | 29.0 |
| *Of which:* Debt of the former Yugoslavia 3/ | 6.3 | 5.8 | 5.2 | | 4.6 | | 4.0 | 3.4 | 2.9 | 2.4 | 1.9 |
| Nominal GDP (millions of euros) | 5,567 | 5,807 | 6,070 | 6,414 | 6,414 | 6,749 | 6,749 | 7,135 | 7,556 | 8,011 | 8,508 |

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

1/ Does not yet reflect the GFSM 2001 methodology.

2/ For fiscal rule purposes, only projects post-July 2015 apply.

3/ Kosovo neither recognizes nor services nor tracks this debt.

4/ Assumes tax compliance gains of 0.7 percent of GDP, a timely and full implementation of the war veteran pension law, and tight administration for all other budgeted social schemes.

5/ See footnote 4. Also, assumes a lower exectution of IFI and PAK financed investments, taking into account implementation capacity.

## Table 4. Kosovo: Balance of Payments, 2014-22
## (Millions of euros, unless otherwise indicated)

| | 2014 | 2015 | 2016 | 2017 | 2018 | 2019 | 2020 | 2021 | 2022 |
|---|---|---|---|---|---|---|---|---|---|
| | | | | Projections | | | | | |
| Goods and services balance | -1,610 | -1,665 | -1,726 | -1,730 | -1,824 | -1,908 | -1,970 | -2,105 | -2,224 |
| Goods | -2,059 | -2,109 | -2,291 | -2,463 | -2,594 | -2,762 | -2,910 | -3,138 | -3,300 |
| Exports | 324 | 322 | 308 | 390 | 425 | 454 | 485 | 524 | 574 |
| Imports | -2,383 | -2,432 | -2,599 | -2,854 | -3,019 | -3,216 | -3,395 | -3,662 | -3,873 |
| Services | 448 | 445 | 565 | 734 | 770 | 854 | 939 | 1,033 | 1,076 |
| Receipts | 904 | 938 | 1,038 | 1,246 | 1,297 | 1,396 | 1,499 | 1,620 | 1,737 |
| Payments | -456 | -493 | -473 | -512 | -527 | -543 | -560 | -587 | -661 |
| Income | 109 | 86 | 87 | 87 | 88 | 89 | 94 | 105 | 119 |
| Compensation of employees (net) | 200 | 206 | 194 | 198 | 202 | 206 | 208 | 209 | 211 |
| Investment income | -91 | -107 | -107 | -111 | -114 | -117 | -114 | -104 | -92 |
| Interest payments on public debt | -10 | -11 | -10 | -13 | -16 | -20 | -21 | -18 | -16 |
| Transfers | 1,109 | 1,062 | 1,096 | 1,088 | 1,133 | 1,203 | 1,282 | 1,362 | 1,447 |
| Official transfers | 292 | 203 | 207 | 168 | 177 | 186 | 192 | 204 | 216 |
| Other transfers (net) | 817 | 859 | 889 | 920 | 956 | 1,018 | 1,090 | 1,158 | 1,232 |
| Current account | -392 | -504 | -543 | -555 | -603 | -615 | -595 | -638 | -657 |
| Capital and financial account | 176 | 255 | 128 | 463 | 452 | 480 | 448 | 477 | 516 |
| Capital account | -2 | -2 | -2 | -2 | 2 | 2 | 3 | 0 | 1 |
| Financial account, incl. CBK | 178 | 257 | 130 | 465 | 450 | 478 | 445 | 477 | 515 |
| Foreign direct investment, net | 124 | 272 | 180 | 321 | 336 | 360 | 390 | 414 | 429 |
| Commercial banks, excl. FDI | 75 | 2 | -58 | 161 | 81 | 59 | 19 | 1 | -16 |
| General government | -17 | 13 | -20 | 74 | 55 | 112 | -10 | -56 | -18 |
| Drawings | 5 | 41 | 41 | 111 | 74 | 162 | 86 | 38 | 40 |
| Repayments | -22 | -28 | -61 | -37 | -19 | -50 | -96 | -94 | -59 |
| Other | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 1 |
| Other sectors, excl. FDI 1/ | -485 | -2 | -20 | 33 | 66 | 26 | 70 | 146 | 150 |
| Central Bank of Kosovo | 481 | -29 | 48 | -124 | -88 | -78 | -22 | -26 | -30 |
| Reserve assets (- = accumulation) | 57 | -89 | 4 | -141 | -93 | -117 | -28 | -31 | 0 |
| Government balances (program definition) | 57 | -99 | -11 | -101 | 15 | -58 | -20 | -23 | -25 |
| Program financing (- = increase) 2/ | 0 | -36 | -35 | -101 | 0 | 0 | 0 | 0 | 0 |
| Other reserve assets, incl. SDRs | 0 | 10 | 15 | -40 | -109 | -59 | -7 | -8 | 25 |
| Non-reserves assets | 424 | 26 | 34 | 20 | 6 | 39 | 5 | 4 | -30 |
| Liabilities 3/ | 0 | 35 | 10 | -2 | 0 | 0 | 0 | 0 | 0 |
| Net errors and omissions 4/ | 216 | 248 | 414 | 92 | 151 | 135 | 147 | 161 | 141 |
| Overall balance | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 |
| | | | | (In percent of GDP) | | | | | |
| Goods and services balance | -28.9 | -28.7 | -28.4 | -27.0 | -27.0 | -26.7 | -26.1 | -26.3 | -26.1 |
| Exports | 22.1 | 21.7 | 22.2 | 25.5 | 25.5 | 25.9 | 26.3 | 26.8 | 27.2 |
| Imports | -51.0 | -50.4 | -50.6 | -52.5 | -52.5 | -52.7 | -52.3 | -53.0 | -53.3 |
| Income (net) | 2.0 | 1.5 | 1.4 | 1.4 | 1.3 | 1.2 | 1.2 | 1.3 | 1.4 |
| Transfers (net) | 19.9 | 18.3 | 18.1 | 17.0 | 16.8 | 16.9 | 17.0 | 17.0 | 17.0 |
| Official | 5.2 | 3.5 | 3.4 | 2.6 | 2.6 | 2.6 | 2.5 | 2.5 | 2.5 |
| Other | 14.7 | 14.8 | 14.6 | 14.3 | 14.2 | 14.3 | 14.4 | 14.5 | 14.5 |
| Current account, excl. official transfers | -12.3 | -12.4 | -12.4 | -11.3 | -11.6 | -11.2 | -10.4 | -10.5 | -10.3 |
| Current account, incl. official transfers | -7.0 | -8.7 | -8.9 | -8.7 | -8.9 | -8.6 | -7.9 | -8.0 | -7.7 |
| Capital and financial account | 3.2 | 4.4 | 2.1 | 7.2 | 6.7 | 6.7 | 5.9 | 6.0 | 6.1 |
| Foreign direct investment, net | 2.2 | 4.7 | 3.0 | 5.0 | 5.0 | 5.0 | 5.2 | 5.2 | 5.0 |
| Other sectors, excl. FDI 1/ | -8.7 | 0.0 | -0.3 | 0.5 | 1.0 | 0.4 | 0.9 | 1.8 | 1.8 |
| Net errors and omissions 4/ | 3.9 | 4.3 | 6.8 | 1.4 | 2.2 | 1.9 | 1.9 | 2.0 | 1.7 |
| Overall balance | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 |
| Memorandum items: | | | | | | | | | |
| Debt service to export ratio (percent) | 2.6 | 3.1 | 5.2 | 3.1 | 2.0 | 3.8 | 5.9 | 5.2 | 3.2 |
| Debt service to exports and remittances (percent) | 1.7 | 2.0 | 3.4 | 2.1 | 1.4 | 2.7 | 4.2 | 3.7 | 2.3 |
| External debt (percent of GDP) | 23.4 | 24.7 | 24.5 | 24.9 | 24.9 | 25.6 | 24.5 | 23.9 | 23.7 |
| *Of which:* Debt of the former Yugoslavia 5/ | 6.3 | 5.8 | 5.2 | 4.6 | 4.0 | 3.4 | 2.9 | 2.4 | 1.9 |
| Net foreign assets of CBK | 1,045 | 1,073 | 1,025 | 1,148 | 1,236 | 1,314 | 1,337 | 1,363 | 1,393 |
| Gross international reserves of the CBK 6/ | 645 | 734 | 730 | 872 | 965 | 1,082 | 1,110 | 1,141 | 1,195 |
| Gross international reserves in months of imports 6/ | 2.7 | 3.0 | 2.9 | 3.1 | 3.3 | 3.5 | 3.4 | 3.2 | 3.2 |

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

1/ Including trading companies, insurance companies, and pension funds.
2/ Includes only program financing under the 2015-17 SBA.
3/ Includes SDR allocations and IMF account at historical value.
4/ Errors and omissions are thought to be mostly comprised of unidentified private remittances and unidentified FDI.
5/ Kosovo neither recognizes nor services nor tracks this debt.
6/ When calculating reserves, the CBK excludes claims on the government related to IMF financing.

## Table 5. Kosovo: Central Bank and Commercial Bank Survey, 2014-17

(Millions of euros, unless otherwise indicated)

| | 2014 | 2015 | 2016 | 2017 |
|---|---|---|---|---|
| | | | | Proj. |
| **Depository Coporations** | | | | |
| Net foreign assets | 1,579 | 1,609 | 1,623 | 1,595 |
| Net domestic assets | 1,275 | 1,450 | 1,684 | 1,872 |
| **Central Bank** | | | | |
| Net foreign assets | 1,045 | 1,073 | 1,025 | 1,148 |
| Foreign assets | 1,266 | 1,329 | 1,291 | 1,413 |
| *Of which:* Securities | 121 | 127 | 568 | 588 |
| Deposits | 983 | 1,046 | 403 | 504 |
| Foreign liabilities | 222 | 256 | 266 | 264 |
| Net domestic assets | -1,045 | -1,073 | -1,025 | -1,148 |
| Net claims on commercial banks | -316 | -316 | -296 | -306 |
| Claims on commercial banks | 0 | 0 | 0 | 0 |
| Liabilities to commercial banks | -316 | -316 | -296 | -306 |
| Net claims on the central government | -629 | -626 | -623 | -744 |
| Claims on central government | 102 | 128 | 114 | 172 |
| Liabilities to central government | -731 | -754 | -737 | -916 |
| *Of which:* KTA (privatization) fund | -558 | -487 | -461 | -455 |
| *Of which*: Government balances (program definition) | -102 | -201 | -212 | -313 |
| Net Claims on other sectors | -52 | -82 | -58 | -51 |
| Claims on other sectors | 0 | -30 | -6 | 2 |
| Liabilities to other sectors | -52 | -52 | -52 | -52 |
| Other items, net 1/ | -48 | -48 | -48 | -47 |
| **Commercial banks** | | | | |
| Net foreign assets | 534 | 536 | 598 | 446 |
| Assets | 716 | 740 | 775 | 663 |
| Liabilites | -182 | -204 | -177 | -217 |
| Net domestic assets | 2,320 | 2,524 | 2,709 | 3,021 |
| Claims on the CBK | 316 | 316 | 295 | 306 |
| Net claims on the central government | 187 | 221 | 234 | 304 |
| Claims on central government | 193 | 226 | 239 | 304 |
| Liabilities to central government | -5 | -6 | -6 | 0 |
| Net claims on other public entities | -65 | -31 | -46 | -49 |
| Claims on other public entities | 1 | 1 | 3 | 3 |
| Liabilities to other public entities | -65 | -32 | -49 | -52 |
| Credit to private sector | 1,881 | 2,018 | 2,227 | 2,460 |
| Deposits of the private sector | 2,378 | 2,550 | 2,773 | 2,987 |
| Demand deposits | 1,131 | 1,381 | 1,624 | 1,750 |
| Time deposits | 1,247 | 1,170 | 1,150 | 1,236 |
| Other items, net 1/ | 476 | 509 | 534 | 495 |
| **Memorandum item:** | | | | |
| Gross international reserves 2/ | 645 | 734 | 730 | 872 |
| Deposits of the private sector (12-month percent change) | 4.0 | 7.3 | 8.7 | 7.7 |
| Credit to the private sector (12-month percent change) | 5.3 | 7.3 | 10.3 | 10.5 |
| Deposits of the private sector (Percent of GDP) | 42.7 | 43.9 | 45.7 | 46.6 |
| Credit to the private sector (Percent of GDP) | 33.8 | 34.8 | 36.7 | 38.3 |

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

1/ Includes shares and other equity.

2/ When calculating reserves, the CBK excludes claims on the government related to IMF financing.

## Table 6. Kosovo: Selected Financial Soundness Indicators, 2012-17 1/

(percent, unless otherwise indicated)

| | 2012 | 2013 | 2014 | 2015 | 2016 | 2017 |
|---|---|---|---|---|---|---|
| Structure | | | | | | |
| Number of banks | | 9 | 9 | 10 | 10 | 10 |
| Foreign | | 7 | 7 | 8 | 8 | 8 |
| Share of total assets (percent) | | 89.6 | 90.2 | 89.9 | 88.7 | 88.1 |
| Domestic | | 2 | 2 | 2 | 2 | 2 |
| Share of total assets (percent) | | 10.4 | 9.8 | 10.1 | 11.3 | 11.9 |
| Capital adequacy | | | | | | |
| Regulatory capital to risk weighted assets 2/ | 14.2 | 16.7 | 17.8 | 19.0 | 17.9 | 18.2 |
| Tier 1 capital to risk weighted assets 2/ | 11.6 | 12.8 | 14.6 | 16.7 | 15.9 | 16.3 |
| Capital to assets | 10.0 | 9.7 | 10.8 | 12.2 | 12.1 | 12.9 |
| Asset quality | | | | | | |
| NPL to total loans 3/ | 7.5 | 8.7 | 8.3 | 6.2 | 4.9 | 3.4 |
| NPL net of provisions to capital | 7.4 | 7.8 | 4.7 | 3.0 | 2.2 | 1.3 |
| Large exposures to capital | 80.4 | 107.4 | 97.1 | 63.5 | 66.9 | 81.1 |
| Sectoral breakdown of loans | | | | | | |
| Agriculture | 2.5 | 2.6 | 2.4 | 3.0 | 2.7 | 2.3 |
| Manufacturing | 9.5 | 9.7 | 10.0 | 10.0 | 10.0 | 9.8 |
| Trade | 37.8 | 36.9 | 35.8 | 34.9 | 34.3 | 32.3 |
| Other services | 11.6 | 12.4 | 12.8 | 13.3 | 11.7 | 13.2 |
| Construction | 7.2 | 6.6 | 6.0 | 4.9 | 4.6 | 5.2 |
| Households | 31.4 | 31.8 | 33.0 | 34.0 | 35.8 | 36.5 |
| Liquidity | | | | | | |
| Liquid assets to total assets 4/ | 34.3 | 37.8 | 38.3 | 37.8 | 36.0 | 32.4 |
| Deposits to loans | 122.6 | 130.8 | 129.4 | 130.4 | 125.8 | 117.5 |
| Liquid assets to short-term liabilities 5/ | 40.8 | 47.1 | 41.0 | 37.3 | 41.5 | 36.3 |
| Profitability | | | | | | |
| Return on average assets 6/ | 0.8 | 1.0 | 1.9 | 2.9 | 2.2 | 2.0 |
| Return on average equity 6/ | 8.3 | 10.8 | 20.2 | 26.4 | 18.5 | 16.9 |
| Interest margin to total income | 55.6 | 54.3 | 62.2 | 68.6 | 69.3 | 64.9 |
| Non-interest expense to total income 7/ | 23.9 | 22.2 | 12.9 | 1.5 | 14.3 | 9.7 |
| Interest margin to gross income 8/ | 74.7 | 73.1 | 76.1 | 76.2 | 75.9 | 70.1 |
| Non-interest expense to gross income 7/ 8/ | 87.8 | 84.5 | 66.8 | 51.8 | 62.8 | 56.1 |
| Market risk | | | | | | |
| Net open currency position to tier 1 capital | 0.7 | 2.3 | 1.8 | 1.8 | 4.4 | 0.9 |

Source: Central Bank of the Republic of Kosovo, institutional public balance sheets, staff estimates.

1/ 2017 as of November 2017.

2/ As of December 2012, new capital adequacy rules include an additional requirement for operational risk, higher risk-weights for assets rated B- or less, and a deduction for related party

3/ Loans classified as doubtful or loss.

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

maturity).

6/ Profits are before taxes and extraordinary items.

7/ Non-interest expense including general and administrative costs.

8/ Gross income is net interest income plus non-interest income.

# Annex I. Implementation Status of the 2015 Article IV Recommendations

| Areas | Recommendations | Status |
|---|---|---|
| **Structural reforms to improve growth and competitiveness** | | **Weak compliance** |
| | Improve governance and business environment. | The PAK Board was nominated, but with 3 out of the 5 board members whose mandate has expired not yet replaced, the board does not currently have a quorum. The vacant seats of the Procurement Review Board (PRB) were also filled and the new legislation making e-procurement mandatory has been adopted, but only implemented in full yet. Laws on contract enforcement and bankruptcy procedures were passed, but implementation remains pending. Improvement in doing of business indicators. However, some of the improvements in the ranking on reflect changes to laws that have not been implemented yet. A new AML/CFT law was adopted in 2016 and its implementation is ongoing. |
| | Reduce labor skill mismatching. | No particular measures have been undertaken. With regard to education, the 2016 PISA assessment (the first one conducted in Kosovo) shows very weak results. |
| | Replace and upgrade energy infrastructure. | No substantial progress in this area yet**.** Discussion is ongoing between authorities, the winning bidder and the World Bank. The 400 Kv interconnection between Albania and Kosovo, which would help mitigate temporary supply fluctuations, was completed but not activated yet for political obstacles between Serbia and Kosovo. |
| **Fiscal policy** | | **Good compliance** |
| | Fiscal consolidation by compressing current spending and VAT reform. | The fiscal deficit has been reduced from 2.3 percent of GDP in 2014 to 1.1 percent in 2016 and it is expected to remain within the fiscal rule ceiling (below 2 percent) in 2017. However, despite GDP growth, current spending has increased by about 1 percent of GDP because of untargeted war veteran pension and other social benefits. The standard VAT rate was increased from 16 to 18 percent, while a reduced rate of 8 percent for a limited category of goods was introduced. |
| | Limit public wage growth by linking it to macroeconomic indicators. | The wage bill has remained fairly constant as a share of GDP during 2015-17. A rule-based mechanism to limit any future increases to nominal GDP growth was adopted in 2015 and has become effective with the 2018 budget. |
| **Financial sector** | | **Strong compliance** |
| | Improve bank supervision, strengthen Emergency Liquidity Assistance (ELA) framework. | On-site supervision of all banks following the risk-based manual has been completed. A new ELA regulation, in line with the best international practices, is in place. A macroprudential framework has been also adopted and the authorities are in the process of operationalizing it. |
| | Remove bank lending impediments. | An amended Law on Enforcement Procedures was passed, which should improve court operations, reduce existing bottlenecks to contract enforcement, and fully establish a unique account registry but still requires implementation; a manual on PEA supervision has been adopted; and the number of PEAs has been increased, although the number is still at 38 (compared to a target of 72). Regulations have been updated to facilitate NPL write-offs. Kosovo still lacks a fully functioning property registry. |

# Annex II. Debt Sustainability Analysis

*The general government debt is projected to gradually increase, but remain well within sustainable levels, largely driven by the primary deficit and IFI financing for large infrastructure projects within the WBIF context. Further increases in the average maturity of the outstanding debt will reduce gross financing needs while containing roll-over risks, when monetary policy in the euro area normalizes. Continued compliance with the fiscal rule remains the key anchor to preserve fiscal sustainability.*

## A. Key assumptions in the DSA

1. **The assumptions are fully in line with the macroeconomic framework baseline**. The fiscal deficit, excluding IFI-financed projects and projects financed by non-debt creating financial flows (privatization proceeds), is expected to remain within the 2-percent of GDP fiscal deficit rule ceiling throughout the projection period. A gradual increase (up to three years) in the average maturity of outstanding domestic debt is also assumed. IFI financing reflects the financial terms currently provided.

## B. Public DSA

2. **The general government debt covers both contracted and guaranteed debt of the general government**. Debt stock contracted by the state-owned enterprises are not included, given the lack of SOEs budgetary information. The share of the domestic debt is close to two-third of the total (large bank loans) The external debt is largely owed to multilaterals, namely the IDA, EIB and EBRD.

3. **General government debt is projected to slightly increase over the projection period but remain well within sustainable levels**. The debt stock is expected to increase from 20 percent of GDP in 2016 to 29 percent of GDP by 2022, assuming a rapid increase in absorption of IFI-financing for new capital investments, particularly to implement regional connectivity projects within the WBIF context.

4. **The main contributor to debt accumulation remains the primary balance and, to a lesser extent, higher real interest rates**. The primary deficit, including IFI-financed projects, is the large contributor to the debt accumulation. In line with the baseline of the macroeconomic framework, the DSA assumes a gradual increase in the domestic debt average maturity.

5. **The continued efforts to increase the average maturity of domestic debt stock should continue**. This would help the reduce the annual gross financing needs of currently 8 percent of GDP, and contain roll-over risks. However, the recent sharp increase in CBKs' holdings of public

debt[1] may limit this risk. Alternative scenarios (historical and constant primary balance) show a more favorable debt profile.

## C. External DSA

**6. Total external debt, which covers both public and private debt is expected to decline to 24 percent of GDP after having peaked at 25½ percent of GDP in 2019**. The large gross financing needs reflect the assumption that all private debt is of a short-term nature, largely short-term credit from foreign parent banks. It is also assumed a gradual decline of neither recognized nor serviced of the portion of the former Yugoslavia debt.

**7. The shock scenarios highlight the potential risks to the current account deficit**. A sharp contraction in remittances could have an adverse impact on the current account. However, any decline in remittances will be largely offset by a contextual decline in imports. In addition, sizable unrecorded remittances, now included in errors and omissions, would also substantially reduce the actual current account deficit if assumed as remittances.

[1] The CBK started purchasing Kosovo government securities in the secondary market in mid-2015. Now, it holds close to €190 million, about 35 percent of the outstanding stock and highly concentrated (up to 96.5 percent of a single T-bond).

## Figure 1. Kosovo: Public Sector Debt Sustainability Analysis (DSA) – Baseline Scenario

(in percent of GDP unless otherwise indicated)

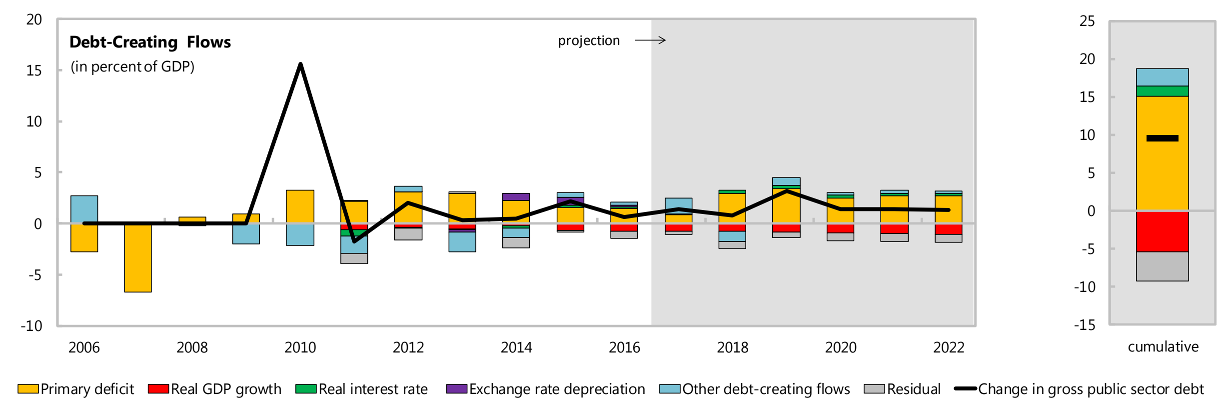
### Debt, Economic and Market Indicators [1]

| | Actual | | | Projections | | | | | |
|---|---|---|---|---|---|---|---|---|---|
| | 2012-2014 [2] | 2015 | 2016 | 2017 | 2018 | 2019 | 2020 | 2021 | 2022 |
| Nominal gross public debt | 16.3 | 18.9 | 19.6 | 21.0 | 21.8 | 25.0 | 26.3 | 27.8 | 29.1 |
| Public gross financing needs | 2.4 | 6.5 | 7.8 | 7.4 | 6.0 | 7.0 | 7.4 | 8.7 | 8.9 |
| Real GDP growth (in percent) | 3.9 | 4.1 | 4.1 | 4.1 | 4.0 | 4.0 | 4.0 | 4.0 | 4.0 |
| Inflation (GDP deflator, in percent) | 3.1 | 0.2 | 0.4 | 1.5 | 1.2 | 1.7 | 1.8 | 1.9 | 2.1 |
| Nominal GDP growth (in percent) | 7.1 | 4.3 | 4.5 | 5.7 | 5.2 | 5.7 | 5.9 | 6.0 | 6.2 |
| Effective interest rate (in percent) [4] | 1.4 | 1.7 | -1.7 | 1.9 | 2.8 | 3.1 | 3.1 | 3.0 | 3.0 |

| As of January 01, 2018 | | |
|---|---|---|
| Sovereign Spreads | | |
| EMBIG (bp) 3/ | | N/A |
| 5Y CDS (bp) | | N/A |
| Ratings | Foreign | Local |
| Moody's | n.a. | n.a. |
| S&Ps | n.a. | n.a. |
| Fitch | n.a. | n.a. |

### Contribution to Changes in Public Debt

| | Actual | | | Projections | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|
| | 2012-2014 | 2015 | 2016 | 2017 | 2018 | 2019 | 2020 | 2021 | 2022 | cumulative | debt-stabilizing |
| Change in gross public sector debt | 0.9 | 2.2 | 0.7 | 1.4 | 0.8 | 3.1 | 1.4 | 1.4 | 1.4 | 9.5 | primary |
| Identified debt-creating flows | 1.6 | 2.4 | 1.4 | 1.7 | 1.5 | 3.7 | 2.1 | 2.2 | 2.2 | 13.4 | balance [9] |
| Primary deficit | 2.7 | 1.6 | 1.5 | 0.8 | 3.0 | 3.4 | 2.5 | 2.7 | 2.7 | 15.1 | -0.5 |
| Primary (noninterest) revenue and grants | 24.7 | 25.1 | 26.3 | 26.2 | 26.7 | 26.5 | 26.3 | 26.2 | 26.0 | 157.9 | |
| Primary (noninterest) expenditure | 27.4 | 26.6 | 27.8 | 27.1 | 29.6 | 29.9 | 28.8 | 28.9 | 28.7 | 173.0 | |
| Automatic debt dynamics [5] | -0.4 | 0.4 | -0.4 | -0.7 | -0.5 | -0.5 | -0.7 | -0.7 | -0.8 | -4.0 | |
| Interest rate/growth differential [6] | -0.5 | -0.4 | -0.6 | -0.7 | -0.5 | -0.5 | -0.7 | -0.7 | -0.8 | -4.0 | |
| Of which: real interest rate | -0.1 | 0.2 | 0.1 | 0.1 | 0.3 | 0.3 | 0.3 | 0.2 | 0.2 | 1.4 | |
| Of which: real GDP growth | -0.4 | -0.7 | -0.7 | -0.8 | -0.8 | -0.8 | -0.9 | -1.0 | -1.0 | -5.4 | |
| Exchange rate depreciation [7] | 0.1 | 0.8 | 0.2 | … | … | … | … | … | … | … | |
| Other identified debt-creating flows | -0.8 | 0.5 | 0.3 | 1.6 | -1.0 | 0.8 | 0.3 | 0.3 | 0.3 | 2.3 | |
| Privatization/Drawdown of Deposits (+ reduces financing need) (negative) | -0.8 | 0.5 | 0.3 | 1.6 | -1.0 | 0.8 | 0.3 | 0.3 | 0.3 | 2.3 | |
| Contingent liabilities | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | |
| Please specify (2) (e.g., ESM and Euroarea loans) | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | |
| Residual, including asset changes [8] | -0.7 | -0.2 | -0.7 | -0.3 | -0.7 | -0.5 | -0.7 | -0.8 | -0.8 | -3.9 | |




Source: IMF staff.

1/ Public sector is defined as general government.

2/ Based on available data.

3/ Long-term bond spread over German bonds.

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

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

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

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

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

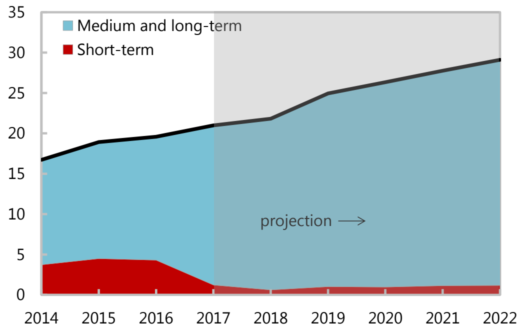
9/ Assumes that key variables (real GDP growth, real interest rate, and other identified debt-creating flows) remain at the level of the last projection year.

## Figure 2. Kosovo: Public DSA – Composition of Public Debt and Alternative Scenarios

### Composition of Public Debt

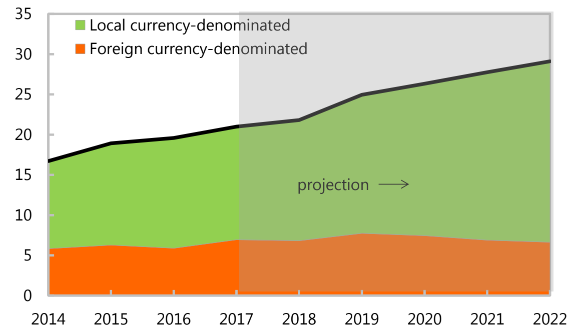
**By Maturity**

(in percent of GDP)




**By Currency**

(in percent of GDP)

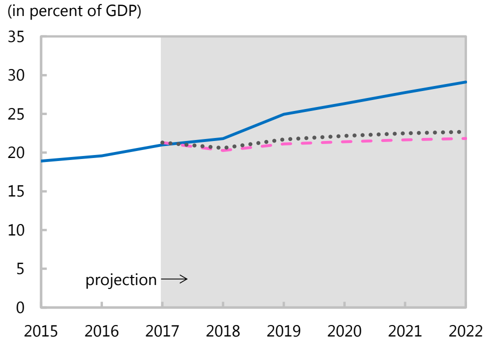



### Alternative Scenarios

Baseline | Historical | Constant Primary Balance | Public Investment Shock

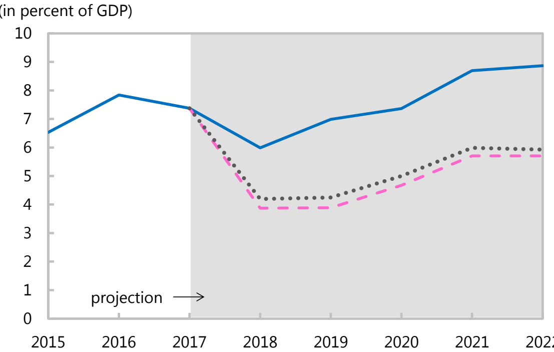
**Gross Nominal Public Debt**

(in percent of GDP)




**Public Gross Financing Needs**

(in percent of GDP)




### Underlying Assumptions

(in percent)

| **Baseline Scenario** | 2017 | 2018 | 2019 | 2020 | 2021 | 2022 |
|---|---|---|---|---|---|---|
| Real GDP growth | 4.1 | 4.0 | 4.0 | 4.0 | 4.0 | 4.0 |
| Inflation | 1.5 | 1.2 | 1.7 | 1.8 | 1.9 | 2.1 |
| Primary Balance | -0.8 | -3.0 | -3.4 | -2.5 | -2.7 | -2.7 |
| Effective interest rate | 1.9 | 2.8 | 3.1 | 3.1 | 3.0 | 3.0 |
| **Constant Primary Balance Scenario** | | | | | | |
| Real GDP growth | 4.1 | 4.0 | 4.0 | 4.0 | 4.0 | 4.0 |
| Inflation | 1.5 | 1.2 | 1.7 | 1.8 | 1.9 | 2.1 |
| Primary Balance | -0.8 | -0.8 | -0.8 | -0.8 | -0.8 | -0.8 |
| Effective interest rate | 1.9 | 2.7 | 3.1 | 3.2 | 3.2 | 3.2 |
| **Public Investment Shock** | | | | | | |
| Real GDP growth | 4.1 | 4.8 | 4.7 | 4.7 | 4.7 | 4.7 |
| Inflation | 1.5 | 2.7 | 3.2 | 3.3 | 3.4 | 3.6 |
| Primary Balance | -0.8 | -3.7 | -4.1 | -3.2 | -3.4 | -3.4 |
| Effective interest rate | 1.9 | 2.7 | 3.5 | 3.9 | 4.1 | 4.3 |

| **Historical Scenario** | 2017 | 2018 | 2019 | 2020 | 2021 | 2022 |
|---|---|---|---|---|---|---|
| Real GDP growth | 4.1 | 4.0 | 4.0 | 4.0 | 4.0 | 4.0 |
| Inflation | 1.5 | 1.2 | 1.7 | 1.8 | 1.9 | 2.1 |
| Primary Balance | -0.8 | -1.2 | -1.2 | -1.2 | -1.2 | -1.2 |
| Effective interest rate | 1.9 | 2.7 | 2.8 | 2.5 | 2.2 | 1.9 |

Source: IMF staff.

## Table 1. Kosovo: External Debt Sustainability Framework, 2014-2022

(In percent of GDP, unless otherwise indicated)

| | Actual | | | | | Projections | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | 2014 | 2015 | 2016 | 10-Year Historical Average | 10-Year Standard Deviation | 2017 | 2018 | 2019 | 2020 | 2021 | 2022 | **Debt-stabilizing non-interest current account 6/** |
| 1 **Baseline: External debt** | 23.4 | 24.7 | 24.5 | | | **24.9** | **24.9** | **25.6** | **24.5** | **23.9** | **23.7** | **-6.2** |
| 2 Change in external debt | -0.1 | 1.3 | -0.2 | | | 0.4 | 0.0 | 0.7 | -1.1 | -0.6 | -0.2 | |
| 3 Identified external debt-creating flows (4+8+9) | 682.8 | 845.0 | 874.2 | | | 2.7 | 3.0 | 2.6 | 1.8 | 1.9 | 1.8 | |
| 4 Current account deficit, excluding interest payments | 685.8 | 848.2 | 878.0 | | | 8.4 | 8.7 | 8.4 | 7.6 | 7.7 | 7.5 | |
| 5 Deficit in balance of goods and services | 28.9 | 28.7 | 28.4 | | | 27.0 | 27.0 | 26.7 | 26.1 | 26.3 | 26.1 | |
| 6 Exports | 22.1 | 21.7 | 22.2 | | | 25.5 | 25.5 | 25.9 | 26.3 | 26.8 | 27.2 | |
| 7 Imports | 51.0 | 50.4 | 50.6 | | | 52.5 | 52.5 | 52.7 | 52.3 | 53.0 | 53.3 | |
| 8 Net non-debt creating capital inflows (negative) | -2.2 | -4.7 | -3.0 | | | -5.0 | -5.0 | -5.0 | -5.2 | -5.2 | -5.0 | |
| 9 Automatic debt dynamics 1/ | -0.8 | 1.5 | -0.9 | | | -0.8 | -0.7 | -0.7 | -0.7 | -0.7 | -0.7 | |
| 10 Contribution from nominal interest rate | 0.2 | 0.2 | 0.2 | | | 0.2 | 0.2 | 0.3 | 0.3 | 0.2 | 0.2 | |
| 11 Contribution from real GDP growth | -0.3 | -1.1 | -1.0 | | | -1.0 | -1.0 | -0.9 | -1.0 | -0.9 | -0.9 | |
| 12 Contribution from price and exchange rate changes 2/ | -0.7 | 2.4 | -0.1 | | | ... | ... | ... | ... | ... | ... | |
| 13 Residual, incl. change in gross foreign assets (2-3) 3/ | -682.9 | -843.7 | -874.4 | | | -2.3 | -3.0 | -1.9 | -2.8 | -2.4 | -2.0 | |
| External debt-to-exports ratio (in percent) | 105.8 | 113.8 | 110.6 | | | 97.7 | 97.5 | 98.6 | 93.2 | 89.4 | 87.2 | |
| **Gross external financing need (in millions of EUR) 4/** | 903.1 | 1060.2 | 1176.0 | | | 1181.2 | 1245.3 | 1321.6 | 1384.0 | 1465.6 | 1494.8 | |
| in percent of GDP | 16.2 | 18.3 | 19.4 | | | 19.2 | 19.3 | 19.4 | 19.1 | 19.2 | 18.5 | |
| **Scenario with key variables at their historical averages 5/** | | | | | | **24.9** | **23.2** | **23.1** | **22.3** | **22.1** | **22.2** | **-6.9** |
| **Key Macroeconomic Assumptions Underlying Baseline** | | | | | | | | | | | | |
| Real GDP growth (in percent) | 1.2 | 4.1 | 4.1 | 4.0 | 1.8 | 4.1 | 4.0 | 4.0 | 4.0 | 4.0 | 4.0 | |
| GDP deflator in EUR (change in percent) | 3.3 | -16.3 | 0.2 | 9.1 | 30.6 | -2.6 | 0.8 | 1.7 | 1.9 | 1.7 | 1.6 | |
| Nominal external interest rate (in percent) | 0.8 | 0.9 | 0.7 | 0.8 | 0.2 | 0.9 | 1.0 | 1.2 | 1.1 | 1.0 | 0.8 | |
| Growth of exports (in percent) | 7.4 | 2.6 | 6.8 | 12.2 | 10.2 | 21.5 | 5.2 | 7.5 | 7.2 | 8.0 | 7.8 | |
| Growth of imports (in percent) | 7.9 | 3.0 | 5.0 | 7.1 | 8.0 | 9.6 | 5.4 | 6.0 | 5.2 | 7.4 | 6.7 | |
| Current account balance, excluding interest payments | -685.8 | -848.2 | -878.0 | -8.2 | 3.2 | -8.4 | -8.7 | -8.4 | -7.6 | -7.7 | -7.5 | |
| Net non-debt creating capital inflows | 2.2 | 4.7 | 3.0 | 4.4 | 1.6 | 5.0 | 5.0 | 5.0 | 5.2 | 5.2 | 5.0 | |

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

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

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

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

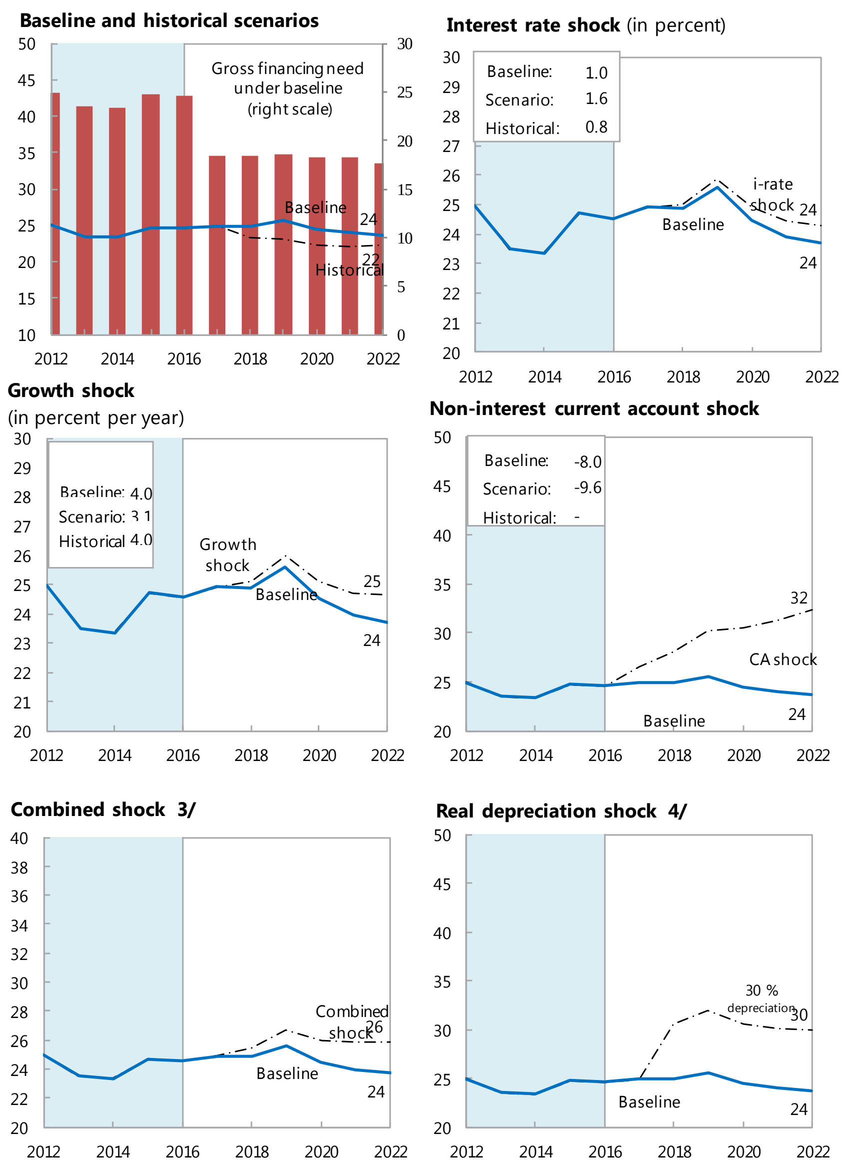
5/ The key variables include real GDP growth; nominal interest rate; dollar deflator growth; and both non-interest current account and non-debt inflows in percent of GDP.

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

## Figure 3. Kosovo: External Debt Sustainability Bound Tests 1/ 2/

(External debt in percent of GDP)

(External debt in percent of GDP)




Sources: International Monetary Fund, Country desk data, and staff estimates.
1/ Shaded areas represent actual data. Individual shocks are permanent one-half standard deviation shocks. Figures in the boxes represent average projections for the respective variables in the baseline and scenario being presented. Ten-year historical average for the variable is also shown.
2/ For historical scenarios, the historical averages are calculated over the ten-year period, and the information is used to project debt dynamics five years ahead.
3/ Permanent 1/4 standard deviation shocks applied to real interest rate, growth rate, and current account balance.
4/ One-time real depreciation of 30 percent occurs in 2010.

## Annex III. Risk Assessment Matrix 1/

| | Source of Risks | Relative Likelihood | Expected Impact | Recommended Policy Response |
|---|---|---|---|---|
| Downside Risks | | | **External Risks** | |
| | **Weaker-than-expected growth in key advanced economy.** Low productivity growth, a failure to fully address crisis legacies and undertake structural reforms, and persistently low inflation undermine medium-term growth. | High | **Medium**<br>Weaker growth in Germany or Switzerland could reduce consumption and investment and/or increase the current account deficit, given the large amounts of remittance/FDI inflows from the Diaspora. | The authorities should adopt structural reforms that improve competitiveness, and increase exports and domestic production to reduce the dependency from remittances. |
| | **Intensification of the risks of fragmentation/security dislocation** in part of the Middle East, Africa, Asia, and Europe. | High | **Low**<br>The previous EU refugee crisis bypassed Kosovo, as Kosovo is not a popular destination country. | The authorities should closely monitor the situation and be ready to collaborate with the EU and neighbor countries to design and implement any response. |
| | | | **Domestic Risks** | |
| | **Political instability**, including early elections: Slim majority of the new coalition government could hamper the reform process or lead to early elections. | Medium | **Medium/High**<br>Political uncertainty would translate into loss of confidence, slow reform progress and economic uncertainty. | The authorities should strengthen political credibility by moving forward with key measures that would promote job creation, increase transparency and fight corruption. |
| | **Pressure on the budget, through increases of social benefits,** such as through categorical social assistance programs and unfunded early retirement schemes, and lower fiscal revenue. | Medium | **Medium**<br>Poorly designed social benefits and revenue underperformance would undermine fiscal sustainability and labor market incentives. Also, revenue collection could fall short should gains from tax administration reforms not materialize. | Reform social benefit system. Tighten the war veteran pension schemes, and resist to new categorical social schemes and introduction of unfunded pension schemes. Move ahead with tax administration reforms. |

| | Source of Risks | Relative Likelihood | Expected Impact | Recommended Policy Response |
|---|---|---|---|---|
| | **Unaddressed energy issues**. The two aging power plants are beyond their economic lifespan, operate significantly below installed capacity, and will not be able to provide a reliable supply of electricity without adding new generation capacity. | Medium/High | **Medium/High**<br>Additional power cuts will further disrupt economic activity, while further undermining the weak business environment. | Following more than a decade of discussions, the authorities should accelerate protracted negotiations with its partners to replace Kosovo A to enable starting the groundwork as soon as possible. |
| **Upside Risks** | **Domestic Risks** | | | |
| | **Government implements and ambitious reform agenda**, including a comprehensive reform of social benefits, decisively tackling corruption, improved capacity for higher IFI financing for capital projects, and starting the implementation of the new power plant. | Low/Medium | **Low**<br>Impact would be low in the next 12-24 months, but could be significant in the medium term. | The authorities should build social and political consensus for reforms. Focus on the actual implementation of laws. |

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

# Annex IV. Competitiveness, Exchange Rate and Reserve Adequacy Assessment

*Large current account deficits and real exchange rate overvaluation indicate a competitiveness gap, even though lower than that estimated in 2015. Some progress in regaining competitiveness has been made since the 2015 Article IV by controlling public sector wages, which are closely correlated to private compensations, consolidating the budget, and moving ahead with structural reforms. Going forward, the priority is to accelerate the implementation of structural reforms, improve the composition of the budget, reduce the infrastructure gap and deepen access to financing to raise productivity. Reserves have remained at an adequate level.*

1. **The trade deficit has remained large, but funded by remittances and FDIs.** The trade deficit has remained in the range of 28-29 percent of GDP in the last 3 years. Exports of raw material have been increasing steadily, albeit from a very low base. Imports have continued to grow at the same pace of GDP, remaining close to 50 percent of GDP, fueled by large and stable remittances and FDIs. Both recorded and unrecorded (included in errors and omissions) remittances have been at around 14-17 percent of GDP in the last 3 years.

2. **The financial accounts have continued to improve, even though remaining limited.** FDIs is expected to reach 5 percent of GDP in 2017, up from 3 percent recorded in 2016. Disbursements from new IFI-financed projects have been zero in 2017. However, they are expected to accelerate in the coming years when the implementation of IFI-funded investment projects is expected to accelerate.

## I. Real Exchange Rate Assessment

3. **Standard methodologies indicate that the real effective exchange rate has remained overvalued.** In the Kosovo's case, the assessment relies on two methodologies, the current account and external sustainability approaches.[1] The current account EBA-lite model estimates the current account norm from a sample of emerging market economies; the external sustainability model assesses the CA deficit (surplus) needed to stabilize the NIIP at a certain level.

4. **Both analytical tools are slightly adapted to better fit Kosovo's case.** To take account of the large unrecorded remittances, the underlying current account has been adjusted to include one-third of errors and omissions, acknowledging that a large share of these flows is associated with remittances.

[1] The REER approach cannot be conducted given the limited time series availability.

5. **The results of the two methodologies point to a relatively stronger external position than in the 2015 Article IV.**[2] This improvement is achieved thanks to the timely implementation of fiscal adjustment and structural reform envisaged under the SBA-supported program 2015-17.

(i) <u>The CA norm under the EBA-lite model is estimated at -4.4 percent of GDP</u> (a fitted value of -2.5 percent of GDP plus an additional 1.9 percent of GDP to account for policy factors). The macroeconomic balance approach points to an overvaluation of 15.2 percent. However, these external imbalances are expected to decline in the medium-term, due to the projected expansion of the export base and slower import growth as domestic production expands.

(ii) <u>The external stability also indicates an overvaluation of the real exchange rate, but slightly lower than the CA model.</u> Given that Kosovo is likely to continue to receive FDI inflows and borrow from IFIs to implement the priority infrastructure projects (see SIP on Public Investment), a realistic benchmark is to reach an NIIP level at around -60 percent of GDP in 2035. This is in line with the current level of Albania, but well below the average regional level. Stabilizing the NIIP at -60 percent of GDP implies a CA norm of -5 percent of GDP and a real exchange rate overvaluation of 12.4 percent.

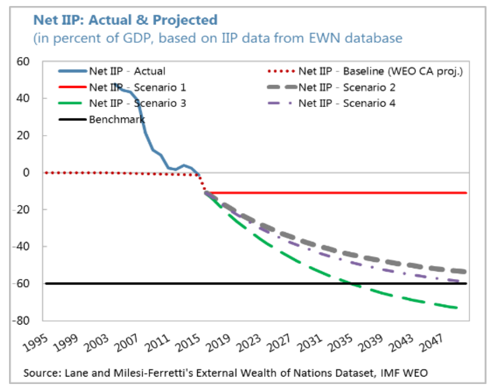



**Table 1. Kosovo: Exchange Rate Assessment Summary**
(in percent, except for elasticity)

| | CA Norm | Adjusted Underlying CA | CA Gap | RER Gap |
|---|---|---|---|---|
| EBA-lite (CA Approach) | -4.4 | -7.5 | -3.1 | 15.2 |
| External Sustainability | -5 | -7.5 | -2.5 | 12.4 |
| RER Elasticity | 0.2 | 0.2 | 0.2 | 0.2 |
| *Source:* Fund staff calculations. | | | | |

## II. Reserve Adequacy Assessment

6. **Reserves play a crucial role in mitigating external risks and reducing the likelihood of balance of payments crises.** The reserve adequacy (RA) models have been developed to better frame the discussion about the amount of foreign reserves needed to prevent risks and/or mitigate

[2] Kosovo Country Report No. 15/131 http://www.imf.org/en/Publications/CR/Issues/2016/12/31/Republic-of-Kosovo-Staff-Report-for-the-2015-Article-IV-Consultation-42953

external shocks impact when they materialize. Fully euroized (dollarized) economies need liquidity buffers to support domestic financial institutions, but also as a cushion for government financing.

**7. Adjusted RA metric for Kosovo shows that international gross reserves are adequate.** The following adjusted metric; [3] [4]

$$RA = 10\% (X+R) + 30\%STD + 15\%OPL + 15\%LPD$$

puts Kosovo's reserve adequacy at about 12 percent of GDP by end-2016 and 2017 (estimated). Gross international reserves reached 12 percent of the GDP in 2016 and are expected to increase to 13.5 percent of GDP in 2017. Therefore, reserves would remain at comfortable levels, covering 97 percent of the norm in 2016 and 110 percent (estimated) in 2017.[5] [6]

**Table 2. Kosovo: Reserve Adequacy**

(in percent of GDP, unless stated otherwise)

| | 2016 (actual) | 2017 (projected) |
|---|---|---|
| Gross International Reserves (GIR) | 12 | 13.5 |
| Adjusted Norm | 12.4 | 12.3 |
| GIR as a ratio of the Adjusted Norm (in percent) | 97 | 110 |

*Source:* Fund staff calculations.

[3] The following RA metric formula (RA = 10%X + 30%STD + 15%OPL + 10%M2) was suggested for an economy with fixed exchange rate (IMF, 2011, Assessing Reserve Adequacy, IMF Policy Paper). Specifically, X indicates export revenues, SDT indicates external short-term liabilities, OPL indicates other external medium- and long-term liabilities.

[4] IMF Country Report N. 15/131.

[5] Gross international reserves include: (i) reserve assets, (ii) SDR allocation, and (iii) IMF net disbursement, minus deposits of the privatization agency and pension funds, which are not under the control of government and CBK.

[6] Reserves in the range of 100-150 percent of the composite metric are considered broadly adequate for precautionary purposes (see IMF Policy Paper 2011, "Assessing Reserve Adequacy").

# Annex V. Status of Implementation of the 2012 FSAP Recommendations

| Recommendations | Status |
|---|---|
| **Short Term (within 12 months of FSAP):** | |
| • Ensure that costs associated with the legal defense of CBK employees sued while carrying out their official responsibilities are carried out ex ante. | • **Completed.** CBK developed instructions for legal representation when staff is sued for carrying out official duties in good faith. |
| • Subject ELA granted to potentially insolvent systematically important institutions to very strict conditions. | • **Completed.** CBK operationalized this understanding, including by modifying the tripartite MOU on financial stability cooperation to clarify the responsibilities of the CBK and MOF in ELA. |
| • DIL should raise the DIFK target level to 8-9 percent of insured deposits and should only introduce higher deposit coverage as the fund increases. It should also clarify that all past and future contributions made by the government and KfW can be used to repay insured deposits. Banks' premiums should not be reduced or discontinued. | • **Completed.** In January 2013, DIFK set a working range of the DIF to 8-9 percent to be reached within 14 years.<br>• Legislation was passed clarifying that contributions by the government and KfW can be used to repay insured deposits. |
| • Amend the Banking Law to address the identified shortcomings in the bank resolution framework and obstacles to competition and development of the MFI sector. | • **In progress.** A new Banking and Microfinance Law was passed in 2012 to enhance the CBK's supervisory and resolution powers. Kosovo has in place a good legal framework for problem bank supervision and resolution. The CBK also coordinates with other safety net providers (for instance, DIFK) as necessary.<br>• Obstacles to competition for the microfinance sector remain. The CBK is working on draft legislation in this area. |
| • Reinstate Solvency I for all insurers; establish an investment regulation for life and non-life companies for their own surplus and reserves, as well as mandatory annual actuarial audit of provisions by a certified actuary; and retain two in-house actuaries. | • **Completed.** Solvency I has been adopted.<br>• One actuary has been appointed in the CBK. |

| Recommendations | Status |
|---|---|
| **Medium Term (within one to three years of FSAP):** | |
| • Institute a bank premium to fund ELA needs. | • **Incomplete.** The authorities consider a bank premium unnecessary given ELA's sufficient coverage of domestic bank deposits and comfort letters from foreign subsidiaries' parent banks. |
| • Put in place extraordinary funding arrangements for the DIFK.<br><br>• Adopt a legal framework for crisis management, contingency plans, and perform crisis simulations. | • **In progress.** DIFK has concluded a series of agreements with the EBRD for credit lines.<br><br>• Kosovo has created a National Financial Stability and Crisis Management Committee (FSC), which includes an MOU for guidance, although it does not meet regularly, and conducted a crisis simulation with the assistance of the World Bank. The CBK is currently drafting a crisis management framework to be finalized by end-June 2018. |
| • Conduct a comprehensive review of the financial system legal and regulatory framework to remove inconsistencies, close gaps, and ensure coherence. | • **Completed.** Several legislative and regulatory initiatives have been adopted in the last few years. |
| • Revise the AML legislation to address its technical weaknesses. | • **Completed.** A new AML/CFT law was passed in May 2016, with subsequent regulation adopted by the CBK in November 2016. An AML/CFT assessment will be carried out in 2018 under the PECK II project. |
| • Introduce risk-based supervision with attention to those risks resulting from systemic banks and their relation with their parent banks and groups, and enhance further the supervisory capacity of the CBK. | • **Completed.** The CBK's Bank Supervision Department received extensive TA over 2014-16 that helped to roll out risk-based supervision to all banks in Kosovo, bring regulations in line with international standards, and enhance its staff's supervisory capacity. |
| • Enact and implement a regulation to introduce an out-of-court insurance dispute resolution mechanism (e.g., private arbitration with binding decision powers), to address the growing volume of consumer complaints against insurers and the lack of technical capacity of local courts to properly address insurance-related disputes. | • **Completed.** A new regulation to address this was introduced in March 2017, and implementation is in progress. |

| Recommendations | Status |
|---|---|
| • Enhance the stress testing framework to include macro scenario analysis as well as models specifying macro-financial linkages. | • **In progress.** The CBK utilizes such stress testing in its semiannual financial stability report. The CBK is also currently working, with the help of IMF TA, in further strengthening the stress testing framework as well as incorporating stress testing into its macroprudential policy framework. |
| • Develop and implement macroprudential policy using quantifiable indicators and policy instruments. | • **Completed.** The CBK adopted, with the assistance of IMF TA, a macroprudential policy framework, including quantifiable indicators and policy instruments. |

INTERNATIONAL MONETARY FUND

# REPUBLIC OF KOSOVO

## STAFF REPORT FOR THE 2017 ARTICLE IV CONSULTATION—INFORMATIONAL ANNEX

January 19, 2018

| Prepared By | The European Department<br>(in consultation with other departments and the World Bank) |
| --- | --- |

## CONTENTS

# FUND RELATIONS

(As of December 31, 2017)

**Membership Status**:
Joined: June 29, 2009; Article VIII (as of January 11, 2018).

| **General Resources Account**: | **SDR Million** | **Percent Quota** |
|---|---|---|
| Quota | 82.60 | 100.00 |
| Fund holdings of currency | 197.94 | 239.64 |
| Reserve Tranche Position | 20.07 | 24.29 |

| **SDR Department**: | **SDR Million** | **Percent Allocation** |
|---|---|---|
| Net cumulative allocation | 55.37 | 100.00 |
| Holdings | 55.84 | 100.86 |

| **Outstanding Purchases and Loans**: | **SDR Million** | **Percent Quota** |
|---|---|---|
| Stand-By Arrangements | 135.4 | 163.92 |

**Latest Financial Arrangements**:

| Type | Date of Arrangement | Expiration Date | Amount Approved (SDR Million) | Amount Drawn (SDR Million) |
|---|---|---|---|---|
| Stand-By | July 29, 2015 | August 04, 2017 | 147.50 | 135.40 |
| Stand-By | April 27, 2012 | December 26, 2013 | 90.97 | 78.22 |
| Stand-By | July 21, 2010 | January 20, 2012 | 92.66 | 18.76 |

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

| | Forthcoming | | | | |
|---|---|---|---|---|---|
| | 2018 | 2019 | 2020 | 2021 | 2022 |
| Principal | 3.51 | 24.59 | 54.29 | 43.11 | 9.90 |
| Charges/Interest | 2.37 | 2.16 | 1.60 | 0.70 | 0.09 |
| Total | 5.88 | 26.75 | 55.88 | 43.82 | 9.99 |

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

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

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

**Implementation of Catastrophe Containment and Relief (CCR): Not Applicable**

**Safeguards Assessments**

The update safeguards assessment, conducted in connection with the SBA approved in July 2015, found that the Central Bank of Kosovo's (CBK) governance practices are appropriate. The CBK's financial reporting system is adequate and the bank has established an effective system of controls in its reserves management and vault operations. The assessment made recommendations to strengthen the internal audit function, amend the CBK Law, and revise the external auditor selection and appointment policy. All the assessment's recommendations have since been implemented.

**Exchange Arrangements**

The de jure and de facto exchange rate arrangement is one of no separate legal tender. Since unilateral adoption of the euro, this currency is a legal tender in Kosovo and circulates freely. Kosovo is not part of the euro area and the CBK is not part of the European System of Central Banks. Kosovo is an Article VIII member and does not maintain exchange restrictions or multiple currency practices, except for restrictions maintained solely for reasons of international or national security, which have been notified to the Fund pursuant to Decision No. 144.

**Previous Article IV Consultation**

Kosovo was on a 24-month cycle during the previous Stand-By Arrangement. The last Article IV consultation was concluded on May 20, 2015. Going forward, it is expected that Kosovo will be on a 12-month cycle.

**FSAP and ROSC Participation**

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

**Technical Assistance**

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

**Real Sector**

- Government Finance Statistics (September 2015, April and October 2016; February and April 2017)

- E-GDDS (April 2017)

**Fiscal Sector**

- Tax Administration (June and October 2017)
- Merger Customs and Tax Administration (November 2015, March and November 2016, June 2016)
- Public Investment Management (December 2015 and April 2017)
- Social Security (January 2016)

**Monetary and Financial Sectors**

- Risk-Based Supervision (November 2015 and March 2016)
- Insurance Sector supervision and regulation (October 2016 and September 2017)
- Macroprudential Policy and Early Warning System (October and November 2017)

**Resident Representative**

Mr. Vermeulen took up his post on August 1, 2015.

# JOINT IMF-WORLD BANK MANAGEMENT ACTION PLAN

| Title | Products | Provisional Timing of Missions | Expected Delivery Date |
|---|---|---|---|
| 1. Fund work program | Staff Article IV visit | Nov 29 – Dec 12, 2017 | December 20, 2017 |
| | TA on tax administration | Nov 2017 – July 2018 (multiple missions) | |
| | TA on government finance statistics | Feb - Oct 2018 (multiple missions) | |
| | TA on public investment management | TBD | |
| | TA on insurance supervision | FY2019 | |
| | TA on central bank governance | FY2019 | |
| 2. Bank work program | Education System Improvement Project | Dec 04-08, 2017 | December 2019 |
| | Energy Efficiency and Renewable Energy Project | March 2018 | August 2020 |
| | Agriculture and Rural Development Project | February 2018 | June 2021 |
| | Kosovo Health Project | January 2018 | October 2019 |
| | Real Estate and Cadaster Project | Nov 28-Dec 08, 2017 | June 2018 |
| | Competitiveness and Export Readiness Project | January 2018 | October 2022 |

| | | | |
|---|---|---|---|
| | Water Security and Canal Protection Project | Nov 29-Dec 02, 2017 | April 2022 |
| | Improving Financial Protection and Quality of Care Project | January 2018 | July 2018 |
| | Youth Development Project | Nov 29-Dec 09, 2017 | FY20 Q1 |
| | Electricity Tariff Reform Project | ongoing | May 2018 |
| | Kosovo Power Project | December 2017 | [to be determined] |
| | Kosovo Digital Economy Project | Nov 27-Dec 03, 2017 | June 2018 |

# STATISTICAL ISSUES

| I. Assessment of Data Adequacy for Surveillance |
|---|
| **General**: Data provision is adequate for surveillance. 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. Compilation methods used for annual national accounts (ANA) are broadly in line with the international standards. The quality and timeliness of annual nominal and real GDP data has been improved, and data on GDP by economic activity and by expenditure are now published simultaneously in an excel format on the web-site of the Kosovo Statistical Agency with a delay of 10 months. Although quarterly national accounts series provide a first estimate of the annual GDP by April every year, it would be advisable to further reduce the time lag in the dissemination of ANA. Quarterly GDP data can be inconsistent with annual data (upon publication), requiring significant revisions, and improvements in methodology are required. Kosovo needs to improve existing and develop additional high-frequency (monthly) indicators, with priority given to indicators relevant to Kosovo's economy such as wholesale and retail trade data and services. |
| **Labor Markets**: Reliable labor force data is challenging given the large share of the informal economy, although quarterly labor data began to be published in 2016. |
| **Consumer Price Index**: A monthly Consumer Price Index (CPI) has been produced since 2002 and is published on a monthly basis (with a lag of 13 days). The index uses a Classification of Individual Consumption according to Purpose (COICOP)-compatible item classification with 352 elementary aggregates. A new index was introduced in December 2014, with new weights largely based on National Accounts data aimed at bringing the CPI in line with the European Harmonized Index of Consumer Prices (HICP). It targets all products and services purchased by all households (resident and non-resident) in Kosovo. HICP is now available from January 2010 onward. The HICP was rebased from 2002 to 2015 in January 2016. |
| **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 2014 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. While data is generally adequate. Strengthening monitoring and disclosure of arrears will be important. |
| **Financial Sector Data:** Monetary data are compiled broadly consistent with the IMF's *Monetary and Financial Statistics Manual*. The CBK reports monetary data monthly, using Standardized |

| | |
|---|---|
| Report Forms for the central bank, other depository corporations, and other financial corporations, which are published in the *International Financial Statistics*. Due to difficulties with obtaining adequate source data needed for estimation of Euro currency in circulation, the CBK ceased compiling currency in circulation in 2006, underreporting broad money. The CBK also reports Financial Soundness Indicators (FSIs) monthly according to the *Compilation Guide on Financial Soundness Indicators*. FSIs including all 12 core indicators and 7 encouraged indicators for deposit takers are available through IMF's FSI webpage. | |
| **External Sector Statistics**: CBK provides to STA quarterly balance of payments and international investment position data following the sixth edition of the *Balance of Payments and International Investment Position Manual* (*BPM6*) staring with 2013: Q1 reference data. Authorities also participate in: a) the Coordinated Direct Investment Survey with inward and outward data starting with 2010; b) the Coordinated Portfolio Investment Survey with annual data starting from December 2010 and semiannual data starting from June 2013, including encouraged items (currency of denomination, sector of the holder, sector of the issuer, and cross-sector classification); and the Quarterly External Debt Statistics. Direction of trade data are available on a monthly basis. Overall, the accuracy, periodicity, and timeliness of external sector statistics have improved due to authorities' efforts and with technical assistance from STA. The authorities are currently working towards reporting the international reserves and foreign currency liquidity template. | |
| **II. Data Standards and Quality** | |
| The country participates in the enhanced General Data Dissemination System (e-GDDS) and its metadata were posted on the Fund's Dissemination Standards Bulletin Board in 2001. A National Summary Data Page is available to regularly disseminate e-GDDS data to the public since May 11, 2017. | Kosovo has not had a Data ROSC. |

**Kosovo—Table of Common Indicators Required for Surveillance**
(As of January 5, 2018)

| | 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] | N/A | N/A | M | M | M |
| Reserve/Base Money | N/A | N/A | N/A | N/A | N/A |
| Broad Money | 09/30/2017 | 10/27/2017 | M | M | M |
| Central Bank Balance Sheet | Nov/2017 | 01/02/2018 | M | M | M |
| Consolidated Balance Sheet of the Banking System | 09/30/2017 | 10/27/2017 | M | M | M |
| Interest Rates[2] | Nov/2017 | 01/02/2018 | M | M | M |
| Consumer Price Index | Nov/2017 | 12/14/2017 | M | M | M |
| Revenue, Expenditure, Balance and Composition of Financing[3]—General Government[4] | Nov/2017 | 12/20/2017 | M | M | M |
| Revenue, Expenditure, Balance and Composition of Financing[3]—Central Government | Nov/2017 | 12/20/2017 | M | M | M |
| Stocks of Central Government and Central Government-Guaranteed Debt[5] | 10/30/2017 | 29/11/2017 | Q | Q | Q |
| External Current Account Balance | Oct/2017 | 12/29/2017 | Q | Q | Q |
| Exports and Imports of Goods[8] | 07/31/2017 | 09/14/2017 | M | M | M |
| GDP/GNP[9] | 06/30/2017 | 09/28/2017 | Q | Q | Q |
| Gross External Debt | 09/30/2017 | 11/29/2017 | Q | Q | Q |
| International Investment Position[6] | 09/30/2017 | 11/29/2017 | Q | Q | Q |

[1] Includes reserve assets pledged or otherwise encumbered as well as net derivative positions. While data are not reported for lack of capacity, authorities are working to start reporting these data in the near future.
[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.

**Statement by Michaela Erbenova, Executive Director for the Republic of Kosovo and Mentor Mehmedi, Advisor to the Executive Director**
**February 2, 2018**

On behalf of the Kosovar authorities, we would like to thank the mission team, led by Ms. Eble, for their constructive engagement and productive discussions during the Article IV mission in Pristina. We also express our appreciation for the helpful assessment of the Kosovar economy, the policy findings, and recommendations reflected in their in-depth reports. The authorities broadly agree with staff's assessment and look forward to continued close dialogue and cooperation with the Fund.

Kosovo has made significant progress in recent years, including under recent Fund arrangements, in preserving fiscal discipline and maintaining low debt levels, strengthening the health and resilience of the financial sector, and moving forward with the structural reform agenda. However, the low labor participation rate and high unemployment rate, specifically among women and youth, and structural impediments to growth and investment continue to weigh on long-term growth prospects. The multi-party coalition government formed in September is committed to accelerating the implementation of structural reforms with the aim of expediting the process of income and institutional convergence with the European Union (EU), as well as moving from a growth model driven by remittances and consumption to one driven by investment and the tradable sector. In this vein, key objectives of the government's policy strategy include safeguarding fiscal and financial stability while strengthening the rule of law, fighting corruption, enhancing the business and investment environments, and creating the conditions conducive to private sector-led growth.

**Recent economic developments and outlook**

Kosovo continues to enjoy the highest economic growth in the region. Initial estimates indicate that GDP growth reached 4.3 percent in 2017, higher than projected by staff and the authorities, driven primarily by investment and supported by consumption, remittances, and a steady recovery in exports. Stronger Euro Area growth and a broad-based surge in the production of tradable goods and services are stimulating export growth, albeit from a small base. Average inflation increased to 1.5 percent in 2017 on the back of a surge in prices for fuel, tobacco, food products, and household items, while the core inflation is projected to remain subdued due to falling input prices and consolidation in the retail sector.

The authorities are more optimistic than staff on the outlook assuming the current pace of reforms. They expect growth to reach 4.6 percent of GDP this year and increase to 4.9 percent and 5.3 percent of GDP in 2019 and 2020 respectively, fueled by stronger investment and export growth as donor-financed capital projects and measures to improve competitiveness begin to bear fruit. The current account deficit (CAD) remains elevated at 8.8 percent of GDP, financed by non-debt creating capital inflows, including remittances and net foreign direct investment.

The CAD is expected to hover around 9 percent of GDP in the medium-term as the increase in demand for imported capital goods, driven by the scaling up of capital investment, will weigh out the positive contribution of exports of goods and services.

While the authorities concur that risks to the outlook are balanced, they point out important upside risks to the baseline scenario. The recently signed contract with a private investor to build a 500-megawatt thermal power plant “Kosova e Re” (an investment valued at approximately 20 percent of GDP) could boost Kosovo’s growth by up to 2 percent of GDP in the medium-term. At the same time, the reforms being implemented to attract more private sector foreign and domestic investments and mobilize large international financial institution (IFI) financing for key capital projects could provide an important impetus to growth going forward.

**Fiscal policy**

The authorities are fully committed to safeguarding macro-financial stability while preserving the credibility of the fiscal rule and keeping public debt low. At the same time, concerted efforts are being made to improve the composition of the budget by containing unproductive current spending.

The implementation of a gradual and growth-friendly fiscal consolidation strategy in the last three years has kept current spending in check, while creating room for high priority spending and growth-enhancing capital investments. The positive fiscal performance continued through the end of 2017, although there is still room to improve the execution of the capital budget. According to provisional data, the fiscal deficit was lowered to 0.7 percent of GDP in 2017, well below the fiscal rule’s deficit ceiling, on the back of healthy tax and non-tax revenues, and the containment of spending. At the same time, bank balances increased to 5.3 percent of GDP, way above the prudent level of 4.5 percent of GDP.

The 2018 budget approved by Parliament in December is fully in line with the fiscal rule and staff’s suggestions, and strikes a good balance between fiscal prudence and development needs. The budget builds on conservative revenue projections and targets a deficit of 1.8 percent of GDP (excluding the Privatization Agency of Kosovo and IFI capital projects), while keeping the public wage bill constant as a share of GDP, in line with the wage rule. The public wage rule, which entered into force in January and represents an important achievement during the last Fund arrangement, ensures that public sector wages grow in line with productivity dynamics and prevents large discretionary increases in the public wage bill.

The budget structure has improved and on-budget capital spending is high (planned to increase to 8 percent of GDP this year). The authorities nonetheless acknowledge pressures to increase current spending. In this context, they concur that social benefit schemes need to be better targeted and means-tested to enhance spending efficiency and improve outcomes, including their distributional effect. In this vein, they are committed to strengthening mechanisms to eliminate double dipping, improve means-testing, remove disincentives to employment, and tightly administer and enforce eligibility criteria while making the system more equitable. The reform of war veteran pensions has proven socially sensitive and politically difficult. Nonetheless, the authorities recognize that the timely completion of the reclassification of war veterans, in line with the amended Law of War Veterans, is essential to ensure the scheme's fiscal sustainability and eliminate labor force participation disincentives. At the same time, they fully acknowledge the risks stemming from the introduction of non-contributory early retirement schemes for special groups and will refrain from introducing such schemes, therefore preserving the financial soundness of the pension system.

Despite low tax rates and a low labor tax wedge, total revenues have increased steadily in recent years, reaching over 26.6 percent of GDP in 2017. Notwithstanding the progress, there is scope to further mobilize domestic revenues by broadening the tax base, including through addressing existing tax gaps for value-added tax and personal income tax, and continuing to fight informality. Against this backdrop, specific tax and custom administration reforms are being implemented in line with the recent Fund's technical assistance mission report, including improvements in the areas of organization and performance management, compliance risk management, filing enforcement, debt collection, and tax audit.

Public debt remains low at 16.6 percent of GDP and the authorities continue to strengthen public debt management. The new public debt management strategy 2018-2022 approved by the Ministry of Finance last year aims at diversifying the investor base, extending the maturities, and minimizing roll-over risk. In view of the ramp-up in public investment, targeted policy measures are also being taken to enhance the public investment management framework through the implementation of recommendations from the Public Financial Management Assessment. Concurrently, the National Investment Committee is being strengthened, including through improving project selection and management processes in close collaboration with line ministries, and enhancing coordination between central and local authorities, with the aim of improving the absorption of donor financing and increasing public investment efficiency.

**Financial sector**

The largely foreign-owned banking sector remains well-capitalized, profitable, and liquid, owing to robust macroeconomic fundamentals and very strong prudential policies. The capital adequacy ratio increased to 18.2 percent by end-November, above the regulatory minimum of 12 percent, while non-performing loan ratio declined to a historical low of 3.4 percent of total loans with high provisioning coverage. At the same time, banking sector profitability remains high, with returns on equity and assets at 22.1 percent and 2.7 percent in November, respectively. Improved market conditions, lower interest rates, and advancements in tackling structural impediments to credit provision, which have started to bear fruit, have been the main forces behind the acceleration of credit growth to 11.2 percent last year aided by higher demand from both corporate and household sectors.

The Central Bank of Kosovo (CBK) has advanced financial sector reforms aimed at strengthening the financial safety net and banking supervisory framework, including through adopting the emergency liquidity assistance framework, rolling out the risk-based supervision, developing and operationalizing the macroprudential policy framework, and addressing weaknesses in the insurance sector. Thus, almost all the 2012 Financial Sector Assessment Program recommendations have been implemented. Going forward, the authorities are committed to further strengthening the supervisory framework, including by advancing the work on an off-site bank examination manual and refining the macroprudential policy framework. Concurrently, the CBK is moving towards a risk-based approach to AML/CFT supervision based on the recently adopted law, and is closely collaborating with staff on further improving the financial health and performance of the insurance sector.

Notwithstanding healthy credit growth, the authorities concur that at 38 percent, the credit-to-GDP ratio is lower than predicted by fundamentals, and better access to credit and financial deepening is needed to sustain the economic growth and support income convergence with the regional countries and the EU. Against this backdrop, notwithstanding the improvements in strengthening the insolvency regime, enhancing the credit registry, improving contract enforcement, and reducing the interest rate spreads, concerted efforts are under way to address other non-banking structural obstacles to credit, including slow court procedures, the large court case backlog, the weak cadaster system, and the nascent private contract enforcement mechanism. All in all, the authorities believe that these efforts will play a critical role in increasing credit penetration as well as channeling lending to productive sectors, including to manufacturing and agriculture.

**Structural reforms**

The authorities welcome staff's focus on structural reforms. While Kosovo's external position has somewhat improved in recent years, as confirmed by staff's External Sector Assessment, important structural bottlenecks continue to stifle competitiveness and productivity. In this regard, the authorities are cognizant that an accelerated implementation of structural reforms is essential to raise potential growth, reduce the trade deficit, boost job creation, improve the living standards, and eradicate poverty. The authorities' National Development Strategy (2016-2021) provides the blueprint for the structural reform agenda and its top priorities include fostering a business-friendly environment; improving governance; reforming the education sector; enhancing the functioning of the labor market; ensuring a close alignment of wages to productivity dynamics; and guaranteeing a sustainable supply of energy. Ultimately, the authorities believe that these measures will lead to reducing the high unemployment rate specifically among youth and women, reducing poverty, and supporting a private sector-led growth.

Kosovo has made substantial progress in improving its business environment as the country has moved up over 70 positions in the World Bank's Doing Business Index in the last five years, and is now ranked 40th overall and one of the top 10 reformers globally. The adoption of a comprehensive insolvency law and establishment of a clear, priority rules inside bankruptcy for secured creditors helped strengthen creditor rights. Going forward, the authorities agree that there is a need to bolster the anti-corruption framework, including by strengthening the Anti-Corruption Agency's capacities. Similarly, improving the public procurement process necessitates that the recent public procurement reform is fully rolled out and that the mandatory use of e-procurement is enforced at all levels of government.

While Kosovo's number of public-owned enterprises is very small and they play a limited role in the economy, they remain inefficient and policy measures are required to improve their corporate governance, enhance fiscal discipline, and seek greater private sector participation. While the labor market is flexible, a lack of a skilled supply of workers persists. Against this backdrop, the authorities are in process of upgrading all curricula for pre-university education and are working on reforming the vocational school system in cooperation with development partners, in particular for the IT and agricultural sectors. Similarly, efforts are being made to remove barriers to employment and reducing high rates of inactivity, especially among women, including through plans to provide greater and more affordable childcare and ensuring adequate maternity leave in the new labor law. The authorities agree with staff that increases to the minimum wage should be in line with the current rule-based minimum wage-setting mechanism to preserve economic competitiveness and support job creation, especially for the less skilled part of the labor force.

The construction of a supercritical thermal power plant "Kosova e Re," while addressing all environmental and social externalities, as well as the implementation of several other projects related to enhancing energy efficiency and renewable energy, aim to improve the reliability of the energy supply and removing one of the biggest constraints to growth and investment.

**Acceptance of obligations under Article VIII**

The authorities have decided to move from Article XIV status (a transitional status available to new member countries in the Fund) to Article VIII, and subsequently accepted Article VIII obligations on January 11, 2018. They welcome staff's findings that Kosovo is free from multiple currency practices and restrictions on the making of payments and transfers for current international transactions, except for sanction measures maintained solely for reasons of international or national security. The authorities trust that the acceptance of Article VIII obligations will send a positive signal to the investor community about the liberalized foreign exchange system and help facilitate a favorable business climate.