INTERNATIONAL MONETARY FUND

IMF Country Report No. 18/368

REPUBLIC OF KOSOVO

2018 ARTICLE IV CONSULTATION—PRESS RELEASE; AND STAFF REPORT

December 2018

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 2018 Article IV consultation with the Republic of Kosovo, the following documents have been released and are included in this package:

- A **Press Release** including a statement by the Chair of the Executive Board.
- The **Staff Report** prepared by a staff team of the IMF for the Executive Board's consideration on lapse of time basis following discussions that ended on October 30, 2018, 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 November 30, 2018.
- An **Informational Annex** prepared by the IMF staff.

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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December 18, 2018

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IMF Executive Board Concludes 2018 Article IV Consultation with Kosovo

On December 17, 2018, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation[1] with Kosovo, and considered and endorsed the staff appraisal without a meeting.[2]

Following three years of robust economic growth, the economy is expected to continue to grow at 4.0 percent in 2018, led by investment, consumption, and services exports. Inflation is projected to remain subdued at 0.9 percent. The budget deficit under the fiscal rule definition is expected to be around 1½ percent of GDP, well within the fiscal rule ceiling of 2 percent. Adding investment exempted from the deficit rule, the overall deficit is expected to reach 3 percent of GDP, which is also accompanied by a widening of the current account deficit to 7 percent of GDP. The banking system remains sound and financial deepening continues.

For 2019, growth is expected to increase to 4.2 percent supported by a temporary increase in public investment, and over the medium term to remain at its potential of 4 percent on the back of robust domestic demand and exports. Stronger reform progress, especially in labor market and governance areas, could lead to higher growth. However, there is an increased risk that spending pressures and tax revenue shortfalls could further crowd out productive spending or potentially increase the fiscal deficit and undermine confidence. Although the proposed new power plant would alleviate energy bottlenecks and provide an impulse to growth, it would widen the current account deficit during the construction phase and—depending on its financial arrangements—could significantly increase public debt.

Executive Board Assessment

Prudent fiscal and financial policies helped preserve macro-financial stability, while growth remains robust. The economy continues to grow at a healthy clip, outpacing Kosovo's

[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] The Executive Board takes decisions under its lapse of time procedure when the Board agrees that a proposal can be considered without convening formal discussions.

neighbors. Fiscal discipline has been maintained, reflected in a 2018 budget deficit that is expected to remain well-below the fiscal rule's ceiling, while financial soundness indicators continued to improve. Despite some progress in regaining competitiveness, the external position remains moderately weaker than implied by fundamentals and desirable medium-term policy settings. Reserves are low in regional comparison, but at comfortable levels using standard metrics. Together with a government bank balance of 4.5 percent of GDP at the CBK they provide sufficient cushion for external, fiscal or liquidity shocks.

However, structural challenges remain largely undented, and should be at the forefront of the policy agenda. An underdeveloped private and export sector, widespread informality, reliance on remittances are mirrored in high unemployment and inactivity rates, and a large trade deficit. Tackling these deep-rooted challenges through structural fiscal, financial sector, product and labor market reforms remain a priority to create the jobs and growth needed to reduce unemployment, outward migration, and the still wide income gap with the rest of Europe. However, in a complex political environment important structural reforms have stalled and pressures to introduce fiscally costly, populist initiatives have increased.

The fiscal rule remains an appropriate anchor for fiscal policy and underpins the 2019 budget, though execution risks are significant. It accommodates large pension increases and space for other wage and social benefit initiatives, relying on large and uncertain gains from reforms in tax administration and war veteran benefits. While the authorities are committed to adjust spending in case of revenue shortfalls, this should be reinforced by limiting specific non-priority spending until the targeted revenue gains have been realized. Financing needs to be diversified to reduce roll-over risks and avoid crowding out credit to the private sector, while the central bank's holdings of government securities are to be gradually reduced.

Revenue administration reforms should be accelerated to strengthen revenue collection and improve the business environment. Revenue remains some 10 percent below the regional average and the tax base is narrow, limiting the space for productive spending. In line with earlier Fund advice, the tax and customs administration need to be overhauled to reduce the high informality and large tax gaps and tax debts. The ambitious revenue targets included in the 2019 budget lend more urgency to these reforms. Further, to protect tax revenues, any changes to the import VAT collection should include strong safeguards, and the granting of new tax expenditures be avoided, and existing ones reviewed. There is also room to increase tax rates in the medium term, given that they are still low by regional standards.

Fiscal risks need to be contained to avoid crowding out pro-growth spending within the limits of the fiscal rule. To contain social benefit pressures, it is essential to move ahead with war veteran reforms and resist introducing new benefits schemes, such as for teachers, the police, and other types of benefits, while any pension increase should be limited to the basic pension only. To contain wage bill pressures, public administration and health care reforms should be (re-) designed to fit within the limits of the wage bill rule. To contain contingent liabilities, plans to restructure public enterprises need to move ahead and any government support for the new power plant through guarantees or financing need to be consistent with the fiscal rule and public debt sustainability. Planned pension reforms need to protect the second pillar and be carefully designed to avoid creating sizeable unfunded liabilities in the medium term.

Spending efficiency needs to be significantly enhanced to improve outcomes and support growth, including through strengthening fiscal institutions and governance. Social benefit reform would create space for much-needed investment to reduce human and physical capital gaps. Yet, any additional space for spending on education, health, the judiciary, active labor market policies, and infrastructure needs to be complemented by efficiency-enhancing reforms to improve outcomes in these areas. In addition, accelerating reforms to strengthen fiscal institutions, such as tax administration, public procurement, public investment and public enterprise management will be important not only to improve spending efficiency, but also to enhance transparency and accountability as well as reduce corruption vulnerabilities.

Policies should pivot from spending initiatives to removing structural constraints to growth and job creation. To lower wage and non-wage cost and improve productivity, it is critical to restrain wage and social benefit growth and implement policies to promote female labor force participation; to upgrade skills and reduce mismatches through better access and quality of education and vocational training; and to reduce infrastructure bottlenecks. Reforms to strengthen the rule of law and reduce red tape should also help in this regard. Fiscal initiatives such as the public salary law and excessively generous maternity/parental benefits, as well as a large minimum wage hike, would not only be costly but also undermine these efforts, providing another reason why they should be avoided or redesigned.

The financial sector remains sound, but access could be further improved. With double-digit credit growth, the authorities need to remain vigilant for possible pockets of risk and differentiate between healthy financial deepening and potentially excessive credit growth. While improving, credit depth remains low in regional comparison. Structural impediments to lending should be further reduced, including by fully implementing the law on enforcement procedures, accelerating the resolution of commercial cases, and strengthening property rights.

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

Kosovo: Selected Economic Indicators, 2016–19

Population: 1.8 million — GDP per capita: € 3,566

Gini index: 0.265 — Poverty rate: 20.8 percent

Quota (current): SDR 82.6 million

Main products and exports: Minerals, base metals, agricultural products

	2016	2017	2018	2019
	Act.	Act.	Proj. 1/	Proj.
Output				
Real GDP growth (percent)	4.1	4.2	4.0	4.2
Employment				
Unemployment rate 2/	27.5	30.5	29.4	…
Labor force participation rate 2/	41.3	42.9	40.4	…
Prices				
Consumer prices (period average)	0.3	1.5	0.9	1.4
Terms of Trade (percent)	100	98	100	98
Public finance (percent of GDP)				
Revenue and grants	26.3	26.2	26.1	26.9
Expenditure	27.6	27.5	29.0	32.0
Overall balance, excluding IFI- and privatization-financed capital projects (Fiscal rule definition)	-1.2	-1.2	-1.5	-1.9
Overall balance	-1.3	-1.2	-2.8	-5.0
Total public debt 3/	14.3	16.3	17.0	19.6
Stock of government bank balance	3.5	4.5	4.5	4.5
Financial sector				
Non-performing loans (percent of total loans) 4/	4.9	3.1	2.6	…
Credit to the private sector (eop, percent change)	10.3	11.5	10.3	9.5
Effective bank lending rate (eop) 4/	7.2	6.8	7.0	…
Balance of payments (percent of GDP)				
Current account balance	-7.9	-6.4	-6.9	-8.3
Foreign direct investment	2.9	3.9	2.1	3.1
Reserves in months of imports	3.9	3.8	3.5	3.1
External debt	18.9	21.2	20.8	21.6

Sources: Kosovo authorities and IMF staff estimates.

1/ Assumes that revenue shortfalls and social spending overruns are offset by lower investment spending.

2/ 2018 is as of June 2018.

3/ Includes guarantees.

4/ 2018 is as of September 2018.

INTERNATIONAL MONETARY FUND

REPUBLIC OF KOSOVO

STAFF REPORT FOR THE 2018 ARTICLE IV CONSULTATION

November 30, 2018

KEY ISSUES

Context. The near-term outlook is broadly positive, with robust growth and low inflation. However, growth potential remains constrained by weak external competitiveness, high informality, low labor force participation, and a large infrastructure gap. In a complex political environment, the structural reform progress has been slow and fiscal risks have increased.

Key Policy Recommendations

- **Fiscal policy**. Continue to observe the fiscal rule, improve the productivity of spending, and contain fiscal risks by: (i) reforming existing social benefits and avoiding any new untargeted schemes; (ii) keeping public sector wages within the limits of the wage bill rule; and (iii) accelerating revenue administration reforms. Advance structural reforms to increase space for spending in priority sectors. Keep public debt within sustainable levels and limit contingent liabilities from large projects and public enterprises.

- **Governance**. Strengthen fiscal institutions (tax administration, publicly-owned enterprises, public procurement, investment framework), anti-corruption institutions, and the rule of law (investor protection, property rights, contract enforcement) to enhance accountability and transparency.

- **Structural reforms**. Focus reforms on closing human and physical capital gaps by investing in education, health, and infrastructure. Reduce unemployment and inactivity in the labor market by upgrading skills and reducing skills mismatches, reforming social benefits, and containing wage pressures. Reduce the costs of doing business and improve governance by strengthening the rule of law, improving access to credit, and reducing red tape.

- **Financial sector**. Promote financial deepening and inclusion by further reducing structural impediments to lending. Address remaining deficiencies in AML/CFT framework and ensure its effectiveness.

Approved By
Thanos Arvanitis and Daria Zakharova

Discussions were held in Pristina on October 17 – 30, 2018. The staff team comprised Ms. Eble (head), Ms. Luca and Mr. Zhang (all EUR), Mr. Evans (FAD), Ms. Hakobyan (SPR), and Messrs. Vermeulen and Thaci (Resident Representative Office). Mr. Mehmedi (OED) also joined policy discussion meetings. Ms. Liu and Ms. Madaraszova contributed to the preparation of this report from headquarters, and Ms. Kernja to the organization of the mission.

CONTENTS

CONTEXT 4

RECENT DEVELOPMENTS, OUTLOOK AND RISKS 4

EXTERNAL STABILITY ASSESSMENT 6

POLICY DISCUSSIONS 7

A. Fiscal Policy: Making Efficient Use of Fiscal Space and Containing Fiscal Risks 7

B. Structural Reforms: Reducing Unemployment, Increasing Competitiveness and Improving Governance 15

C. Financial Sector: Safeguarding System Stability and Financial Deepening 17

OTHER ISSUES 20

STAFF APPRAISAL 20

FIGURES

1. Recent Economic Developments, 2012-18 23
2. Fiscal Developments, 2013-19 24
3. Labor Market, 2017 25
4. Banking Sector Overview, 2014-18 26

TABLES

1. Selected Economic Indicators, 2015-23 27
2. Consolidated Government Budget, 2015-23 (millions of euros) 28
3. Consolidated Government Budget, 2015-23 (percent of GDP) 29
4. General Government Cashflow, 2015-23 30
5. Balance of Payments, 2015-23 31
6. Central Bank and Commercial Bank Survey, 2015-23 32
7. Selected Financial Soundness Indicators, 2015-18 33

ANNEXES

I. Implementation Status of the 2017 Article IV Recommendations ____ 34
II. Risk Assessment Matrix ____ 36
III. External Sector Assessment ____ 37
IV. Debt Sustainability Analysis ____ 44
V. Governance Challenges Facing Kosovo ____ 54
VI. Determinants of Labor Force Participation and Employment ____ 70

CONTEXT

1. Notwithstanding some progress in recent years, Kosovo continues to face significant challenges. Policies under the Fund-supported program that expired in August 2017 helped restore fiscal credibility, preserve financial stability, and strengthen the business climate. Prudent fiscal and financial policies have helped maintain macro-financial stability since. However, Kosovo's structural challenges remain significant, witnessed in high unemployment and inactivity rates (about 30 and 60 percent respectively; and even higher for youth and women), widespread informality, heavy reliance on remittances, and large trade deficits reflecting narrow domestic production and export bases. Despite robust growth over the last years and an improvement in social indicators, Kosovo remains one of the poorest European countries, and the only one classified as a "Fragile State" in Europe.[1]

2. Reflecting a complex political situation, much needed reforms have stalled, and populist policies are on the rise. The ruling coalition has a thin parliamentary majority and coalition parties are often divided on key issues. Discussions to normalize relations with Serbia, the conversion of Kosovo Security Force into a regular army, EU visa liberalization, impending indictments by a special war crimes tribunal and the recent imposition of a 100 percent tariff on imports from Serbia and Bosnia following the failed bid to join Interpol top the political agenda and carry significant political risks. As a result, progress with structural reforms to enhance growth, improve labor market outcomes and strengthen governance has been limited since the last Article IV (*see Annex I—Implementation Status of the 2017 Article IV recommendations*). Meanwhile, there are strong pressures from all parties to advance fiscally costly populist initiatives.

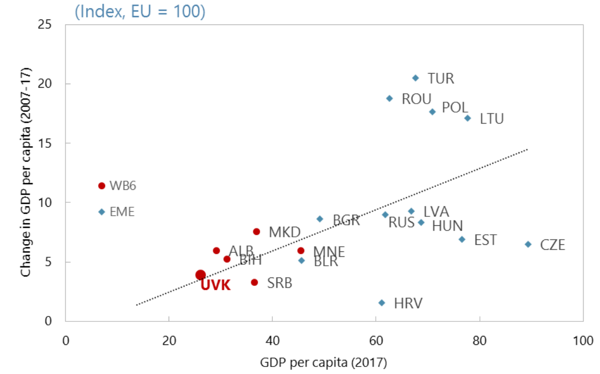
RECENT DEVELOPMENTS, OUTLOOK AND RISKS

3. Economic activity has continued to grow at a healthy clip, led by domestic demand, which is expected to continue in 2019 (Table 1, Figure 1). Growth is expected at 4 percent in 2018, led by public investment, consumption, and services exports, financed by continued strong bank lending and remittance inflows. In 2019, growth is projected to increase to 4.2 percent, supported by a temporary increase in public investment. Headline inflation remained subdued at 0.7 percent in the first nine months of 2018 but has started to pick up due to higher food and energy prices and is expected to average 0.9 percent this year and 1.4 percent in 2019. Credit to the private sector remained robust on the back of lower borrowing rates and improvements in contract enforcement. The 2018 budget execution is expected to be largely on target and the fiscal deficit within the limits of the fiscal rule.

[1] In accordance with the World Bank classification. However, Kosovo is an upside outlier within this group (its CPIA at 3.6 is well above the 3.2 ceiling) and earns this classification only because of the presence of UN peacekeeping forces.

4. **The medium-term outlook is favorable, but higher job-rich growth is needed to reduce unemployment and the income gap with regional peers**. Based on current policies, growth is projected to stay at its potential of 4 percent on the back of robust domestic demand—driven by remittances and FDI—and exports. With GDP per capita in PPP terms at just 26 percent of the EU average (76 percent of the region) and higher population growth, much stronger growth is needed to reduce the very high level of unemployment and achieve income convergence. Inflation is expected to gradually converge to the EU average as the gains from domestic competition and cost consolidation in the non-tradeable goods sector level out. The current account deficit is expected to gradually decline as import-intensive projects wind down and export diversification continues.

Income convergence
(Index, EU = 100)



Sources: World Development Indicators and IMF staff calculations.

Kosovo: Selected Macroeconomic Indicators[1/]

		Projections					
	2017	2018	2019	2020	2021	2022	2023
				(in percent)			
Real GDP growth	4.2	4.0	4.2	4.0	4.0	4.0	4.0
Contributions							
Consumption	1.5	5.6	2.9	3.9	3.8	3.3	3.3
Investment	1.5	2.8	2.6	0.7	0.5	1.3	1.1
Exports	4.0	-0.2	2.1	1.9	1.9	1.8	1.9
Imports	-2.8	-4.3	-3.5	-2.4	-2.2	-2.4	-2.3
CPI inflation (period avg.)	1.5	0.9	1.4	1.7	1.8	1.9	2.0
Bank credit to the private sector	11.5	10.3	9.5	8.9	8.3	7.5	7.1
				(in percent of GDP)			
Fiscal Balance Ex-PAK ex-IFI capital projects	-1.2	-1.5	-1.9	-1.9	-1.9	-1.9	-1.9
Total public debt	16.3	17.0	19.6	22.2	24.2	26.1	27.4
Stock of government bank balances	4.5	4.5	4.5	4.5	4.5	4.5	4.5
Current account balance, incl. official transfers	-6.4	-6.9	-8.3	-7.9	-7.2	-7.0	-6.6

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

1/ The baseline does not include the impact of the power plant project (due to uncertainties on timing and the financial arrangements), which could cost about 20 percent of GDP with construction over 5 years.

5. **Risks to the outlook are tilted to the downside** *(see Annex II – Risk Assessment Matrix)***:**

- *Domestic risks* mainly relate to spending pressures and tax revenue shortfalls that could further crowd out productive spending, potentially increase the fiscal deficit and undermine confidence. While the proposed new power plant (with construction costs of about 20 percent of GDP) would close the domestic energy supply gap and provide an impulse to growth, it would widen the current account deficit during its construction and—depending on its financial arrangements—likely significantly increase public debt. Other domestic risks include renewed political uncertainty that could undermine confidence and further halt reforms.

- *On the external side*, weaker-than-expected growth in the EU could result in lower remittance and FDI inflows, and therefore slower growth in Kosovo. Also, while portfolio flows are relatively limited, a normalization of EU monetary policy or tighter global financial conditions could increase government financing pressures by reducing demand for government securities from domestic banks.

Authorities' Views

6. The authorities largely concurred with staff's risk assessment but expect stronger baseline growth. They project growth to reach 4¾ percent in 2019 and about 5 percent in the medium term, driven by higher public investment financed with IFI loans and privatization receipts. The construction of a new power plant is considered an upside, and not included in the authorities' nor staff's baseline projections.

EXTERNAL STABILITY ASSESSMENT

7. The external position at end-2017 is moderately weaker than implied by the fundamentals and desirable policy settings (*see Annex III— External Sector Assessment*). Standard methodologies indicate that the real effective exchange rate remains overvalued in the range of 9-10 percent (compared to 12-15 percent in the 2017 Article IV assessment). This improvement has been largely achieved by containing wage spending, and from some progress with structural reforms.

8. Despite some improvements, several other indicators continue to point to significant competitiveness challenges. Kosovo's trade deficit (26 percent of GDP) continues to remain the highest in the region, with its goods export share lagging behind other Western Balkan countries, despite a noticeable increase in diversification across products and trade partners in recent years. Unemployment at around 30 percent is the highest, and labor force participation at 40 percent the lowest, in the region. Increases in gross wages have not been accompanied by corresponding gains in labor productivity. Finally, Kosovo continues to attract the lowest FDI in the region.

9. International reserve coverage remains broadly adequate. Gross reserves at 18 percent of GDP in 2017 remain broadly adequate both against traditional and IMF-developed reserve adequacy metrics as well as against additional criteria to mitigate fiscal and bank liquidity shocks in the context of full euroization.[2] Based on current policy intentions, reserves are expected to decline to around 14 percent of GDP by 2023, driven primarily by the transfer of privatization proceeds held in deposits at the Central Bank of Kosovo (CBK) to the budget for infrastructure investment.

[2] Reserves, as a percent of GDP, remain somewhat more limited under a more conservative definition which excludes deposits of the privatization agency (PAK) and the pension fund (KPST) held at the CBK.

Continued adequate reserve coverage will require redirecting CBK's investments from Kosovo government securities to international reserve assets and retaining the government bank balance of 4.5 percent of GDP held at the CBK.

Authorities' Views

10. The authorities broadly concurred with the external sector assessment. They agreed with staff's assessment of competitiveness challenges and that reforms to address them could slow down in an environment of renewed political uncertainty. Regarding reserve coverage and the CBK's holdings of Kosovo government securities, they stressed that this will continue to be guided by the CBK's investment strategy of ensuring the safety, liquidity and return on its investment, subject to the 25 percent single exposure limit. Given current market conditions, they view a gradual reduction of the CBK's holdings of Kosovo government securities as a medium-term priority, while emphasizing the need to generate positive returns to fund the operations of the central bank.

POLICY DISCUSSIONS

Discussions focused on three main challenges: (i) entrenching macro-fiscal stability by continuing to observe the fiscal rule, implementing efficiency-improving fiscal reforms and strengthening fiscal governance; (ii) accelerating structural reforms to reduce unemployment and improve competitiveness; and (iii) safeguarding financial sector stability and financial deepening.

A. Fiscal Policy: Making Efficient Use of Fiscal Space and Containing Fiscal Risks

Kosovo: Key Fiscal Indicators 2015–23

(In percent of GDP)

	2015	2016	2017	2018	2019		2020	2021	2022	2023
				Proj. 3/	Draft budget	Proj. 3/	Projections			
Fiscal rule balance	-1.8	-1.2	-1.2	-1.5	-1.9	-1.9	-1.9	-1.9	-1.9	-1.9
IFI/donor financed investment 1/	0.0	0.0	0.0	0.0	1.7	1.1	1.2	1.1	1.1	0.7
Privatization proceeds (PAK) financed investment 1/	0.0	0.0	0.0	1.3	2.0	2.0	0.8	0.0	0.0	0.0
Overall balance	-1.9	-1.4	-1.3	-2.9	-5.8	-5.1	-4.0	-3.1	-3.1	-2.7
Overall cyclically adjusted balance	-1.8	-1.3	-1.4	-2.9	-5.9	-5.3	-4.0	-3.1	-3.1	-2.7
Fiscal impulse 2/	4.0	-0.5	0.1	1.5	3.0	2.4	-1.3	-0.9	0.0	-0.4
Memorandum items:										
Total public debt	13.0	14.3	16.3	17.0		19.6	22.2	24.2	26.1	27.4
of which: domestic debt	6.7	8.2	9.6	10.7		12.5	14.9	17.1	18.7	20.0

Source: IMF staff estimates and projections.

1/ IFI/donor and privatization proceeds financed investments are exempted from the 2 percent of GDP deficit ceiling until 2025 or earlier if debt reaches 30 percent of GDP.
2/ Positive fiscal impulse means an increase in fiscal stimulus.
3/ Based on current legislation, revenue trends, and the 2019 draft budget. It assumes gains of 0.6 percent of GDP from debt collection and tax compliance which will require implementation of strong reforms in revenue administration.

Fiscal Policy

11. The execution of the 2018 budget is broadly on track (Tables 2 and 3, Figure 2). The budget deficit (under the fiscal rule definition) is expected to be around 1½ percent of GDP, well within the fiscal rule ceiling of 2 percent, with some revenue shortfalls and social benefit spending overruns offset by lower budget-financed investment. Adding investment exempted from the fiscal rule ceiling, the overall deficit is expected to reach 3 percent of GDP.

12. The draft 2019 budget is in line with the fiscal rule, but multiple initiatives could challenge its implementation. The budget targets a deficit of 1.9 percent of GDP (under the fiscal rule definition), keeps the wage bill constant as a share of GDP, and the bank balance at 4.5 percent of GDP. It increases allocations to priority sectors such as health, education, and the judiciary, but also accommodates higher (permanent) spending on pension benefits and space for other wage and social benefit initiatives. Taken together, these measures would increase consumption spending by 1½ percent of GDP at the expense of on-budget investment. To finance this, the budget relies on ambitious gains from higher tax debt collection and improved compliance of some 1 percent of GDP. Further, the budget assumes ¼ percent of GDP in savings from war veteran benefit reform, which may not materialize. At the same time, there are strong pressures to move ahead with several (unbudgeted) fiscal initiatives which could cost between 3–4 percent of GDP in the short term.

13. The budget targets an acceleration in donor/PAK-financed investment. This could add 4 percent of GDP to the overall deficit and bring total investment spending to 11 percent of GDP in 2019, implying a fiscal expansion of some 3 percent of potential GDP. In the past, capacity constraints have limited actual capital spending to lower-than-planned volumes. Given the expected lower investment spending outturn—combined with high import content of infrastructure investments and labor market slack—the domestic demand impact would be largely contained, with a somewhat limited pass-through effect on growth.

Kosovo: Key Fiscal Risks

	Measure	Status 1/	Fiscal impact 2/ ST	Fiscal impact 2/ MT
Spending				
Wages	Wage hike for the PM, Cabinet and its advisors, and judiciary	Implemented retroactively for 2018	0.1-0.2	0.1-0.2
	Salary law for public sector	DL passed first reading	0.8-1.3	0.9-1.0
	Health insurance employer contributions	Possible 2020 implementation	n.a	0.3
Social benefits	Special pensions for education workers in the 1990s	DL passed first reading	0.1	0.1
	Police pension reform	DL under review	<0.1	<0.1
	Revised parental benefits; new maternity benefits for unemployed	DL under review	0.2-0.3	0.2-0.3
	Disability benefit reform	CD under review	n.a.	n.a.
	Pension reform	CD under review	n.a.	n.a.
	Child allowance	Resolution adopted by parliament	0.7-0.8	0.6-0.8
Revenue				
Tax Policy	CIT and PIT DLs	DL passed first reading	n.a.	n.a.
Tax administration	VAT collection reform 3/	DL adopted by GoK	1.0-1.1	0.0
Contingent liabilities				
Guarantees	Financing, input supply and demand guarantees for new power plant 4/	GoK in discussion	n.a.	5-20
	Guarantees for debt contracted by POEs	CD on state debt adopted by GoK	0.3-0.7	0.3-1.0
Transfers	Transfers to POEs to cover losses/investment needs	GoK in discussion	0.1-0.4	0.1-0.6
PAK financing	Reimbursement of financing provided by the liquidation fund	Law in force since May 2018	0.3	0.3-0.4

Source: IMF staff estimates.

1/ DL and CD stand for draft law and concept document, respectively.

2/ Full year impact in percent of GDP. (n.a.) denotes that the fiscal impact is not yet known. Short-term (ST) are costs in the first year or one-off costs. Medium-term (MT) represents the annual costs in steady-state.

3/ Costs associated with the deferral scheme. Additional leakage due to changes in the VAT collection mechanism could be significant, but difficult to quantify.

4/ Represents cumulative (and not annual cost) as a share of 2018 GDP. The private party is seeking sizable sovereign guarantees, possibly up to the full amount of the project (20 percent of GDP). Note there is high uncertainty over the financing terms.

14. To comply with the fiscal rule—which remains an appropriate anchor from a fiscal sustainability and developmental perspective—and support growth, staff advised measures to limit risks to revenue and offset spending pressures, while protecting productive spending. In particular:

- **Revenue administration reforms to reduce high informality, tax gaps, and tax debts**. Total tax debt amounts to about 5 percent of GDP, and tax gaps to around 35 percent of GDP, as estimated by the World Bank.[3] To meet the ambitious revenue gains from tax administration reforms foreseen in the 2019 budget, collections need to be reinforced by setting quantitative and strategic performance targets, widening the tax filing requirements and late filing penalties, and improving the productivity of audits. Moreover, to support the 2019 debt collection target of ¼ of the collectable tax debt stock, collection should be centralized in one single office at TAK headquarters to improve oversight, the process systematized and complemented by automatic write-off of uncollectible debt, and enforcement actions taken on a timely basis. On the other hand, any changes to the import VAT (about ⅓ of total revenue) should retain

[3] World Bank, 2014 and Business and Strategies Europe (BSE), 2017.

collection with Customs and include proper safeguards[4] to minimize potentially large revenue risks. To protect the tax base, it is key to avoid granting new exemptions or tax holidays.

- **Reforms to effectively contain current spending pressures and avoid crowding out pro-growth spending**:

  - To contain rapidly growing *social benefit pressures*, it is key to move ahead with the long overdue war veteran benefit reform (with spending in 2018 about ½ percent of GDP above the legal ceiling of 0.7 percent). It is also important to avoid introducing new untargeted benefit schemes, including the proposed early retirement scheme for the police and pension supplements for teachers who worked during the 1990s, as these would undermine the fairness and financial soundness of the social benefit system. Following a sharp increase in the "contributory" pension only two years ago (benefits increased by 23 percent, on average), any further pension benefit increase should be limited to the basic pension exclusively to reduce the incidence of old age poverty and bring the benefit amount closer to the social assistance scheme.

  - To contain *wage bill pressures*, public administration and health care reforms need to be designed to fit within the limits of the wage bill rule. In this regard, the public salary law should be reconsidered given its large fiscal costs, including the proliferation of discretionary allowances and continued unequal pay for equal work because of grandfathering and exemptions to the new wage grid for special groups. Widening of the contribution base and efficiency-improving reforms (see para. 15) ahead of the introduction of health insurance in 2020 is key to ensure the financial viability of the system.

  - To contain *fiscal risks from publicly-owned enterprises*, it is important that the restructuring of loss-making and inefficient companies moves quickly ahead, including by rightsizing employment, aligning wages with productivity, and improving oversight.

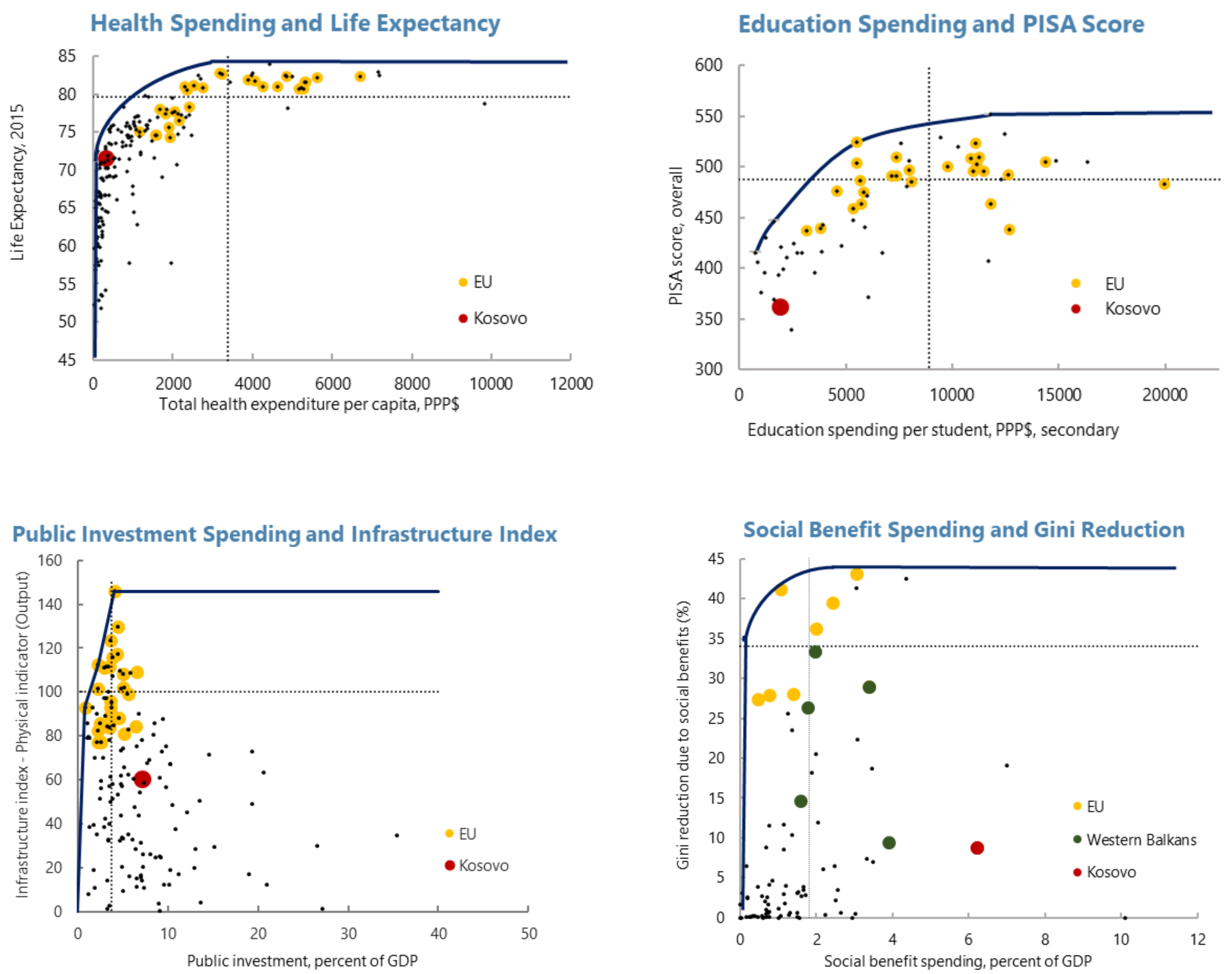
- **Contingency measures to meet the deficit target**. The draft budget includes a commitment to adjust spending equivalent to any revenue shortfalls from the tax administration reform. Staff advised to reinforce this commitment by identifying specific non-priority spending items upfront (that is, spending not allocated to priority sectors such as health, education, and infrastructure) and releasing their appropriations only upon realization of the additional revenue, based on continuous monitoring and verification of those revenues.

15. This needs to be coupled with reforms to improve the low efficiency of public spending to also ensure better economic and social outcomes. In light of the increased budget allocations to priority sectors discussed above, low spending efficiency—reflected in poor education,

[4] Amongst others, this includes applying strict eligibility criteria (taxpayer's compliance record, liquidity and solvency tests, etc.), securing deferred payments by a bank guarantee or collateral (customs warehouses), and making the eventual rollout conditional on a successful pilot.

health and social outcomes, as well as in a wide and only slowly closing infrastructure gap[5] despite comparatively high investment spending in the past few years—needs to be urgently addressed. In particular, the public investment framework requires further strengthening through better project selection, execution, cost-benefit analysis and ex-post audits to maximize the growth impact. In this context, staff strongly advised to spread the spending of privatization proceeds over multiple years—rather than frontloading it to 2019—to ensure an efficient use of such resources as part of the medium-term investment plan. This would also preserve financial buffers for counter-cyclical policies, should needs arise. Social benefit amounts and eligibility criteria need to be reviewed to address double dipping and labor market disincentives, and to target benefits to the poor.

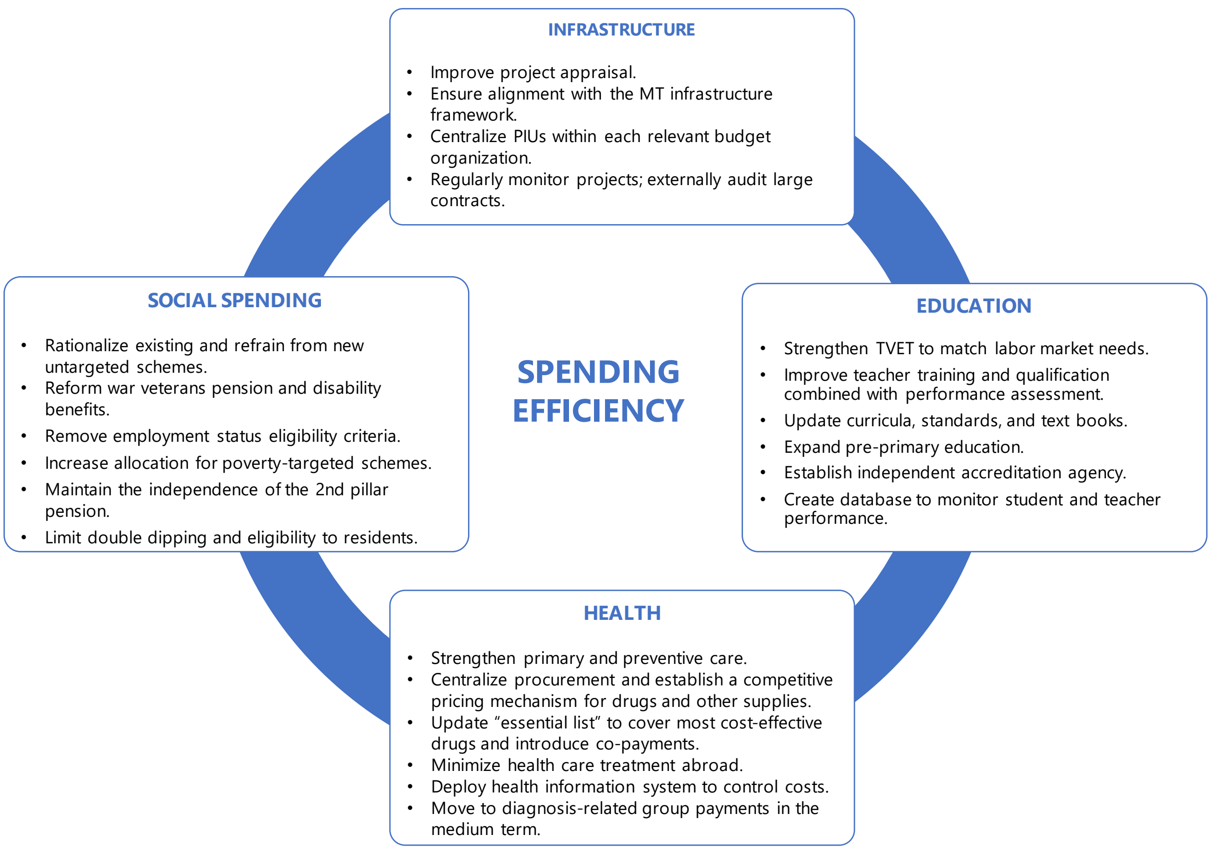
Kosovo: Spending Efficiency



Sources: IMF FAD Expenditure Assessment Tool (EAT), 2018; IMF Staff Calculations, 2018; IMF WEO, 2018; World Bank ASPIRE Database, 2018; World Bank EdStats Database, 2018; World Bank Health and Nutrition Database, 2018.
Note: Dashlines are the average of EU, solid lines are the distribution of frontier countries.

[5] Despite relatively high public investment, the public capital stock is 20 percent below the average of Western Balkan countries, and 60 percent below the EU average.

Kosovo: Reforms to Improve Spending Efficiency



16. **In the medium term, the fiscal space for priority donor/IFI-financed investment will narrow down as total debt approaches 30 percent of GDP (debt ceiling under the investment clause)**. This debt limit needs to be respected to keep public debt on a sustainable path, even in the event of moderate shocks (see *Annex IV—MAC DSA*) given Kosovo's euroized economy, with limited buffers and policy tools to deal with unforeseen events. In this context, any issuing of guarantees should be carefully considered, contingent debt from public enterprises and local government included under the ceiling, and the existing conservative approach in issuing and recording guarantees retained, including the requirement to obtain parliament approval and to count guarantees in full as debt.

17. **To limit medium-term fiscal risks, the authorities need to move carefully on initiatives that could have long-term costs**. In particular,

- **Pension and social benefit reform**. Plans to reform the first pillar pension and social benefit system need to be part of a comprehensive plan to rationalize costly categorical benefit schemes, while strengthening social assistance for the poor. Any changes to the first pillar should carefully designed to avoid creating large unfunded liabilities in the medium to long-term given population aging. At the same time, the second pillar pension system should be protected.

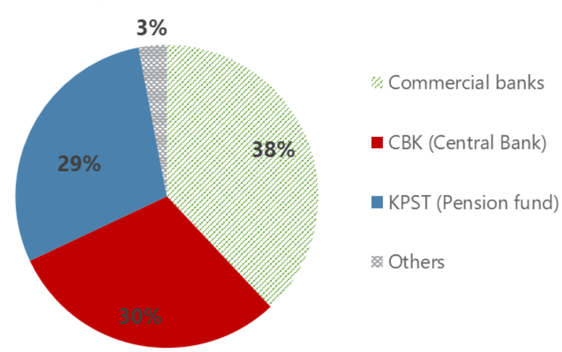
- **Power plant project**. While structured as a PPP, the risk allocation of this large investment (20 percent of GDP) is skewed towards the government.[6] The project therefore carries significant fiscal risks and would crowd out fiscal space given the debt brake in the fiscal rule's investment clause of 30 percent of GDP and the overall debt ceiling of 40 percent of GDP. It is thus critical to secure the most cost-effective solution for Kosovo's energy supply, including by improving energy efficiency, and that any project is structured to ensure its financial and economic viability. Tariffs should be set at cost recovery levels (to avoid subsidies), while any impact of tariff increases on the poor need to be mitigated with well-targeted transfers under the *social assistance* scheme. Any additional government support through financing or guarantees should be minimized and consistent with public debt sustainability without crowding out other priority investments.

18. With competing spending pressures over the coming years, tax reforms need to be considered given Kosovo's still low revenue mobilization by regional standards. Revenue collection is some 10 percentage points below the average for emerging Europe with a narrow tax base, leaving ample scope to mobilize more revenue beyond projected gains from tax administration reform.[7] Ongoing tax reforms provide an opportunity to review tax exemptions and rates as well as revenue collected at the municipal level, particularly from property tax.

Financing

19. Financing should be diversified to reduce roll-over risks and avoid crowding out credit to the private sector (Table 4). Until late 2017, government debt issuance was largely absorbed by the CBK through secondary market purchases, while the pension fund KPST has absorbed the bulk since 2018. However, with a normalization of EU monetary policy and banks already at their current exposure limits, it will be more difficult to place further government debt in the domestic market. To reduce potential financing risks, financing sources should be

Government Securities by Holder
(End of September 2018) 1/



1/ The total stock of governmnet securities at the end of September 2018 was €663.5 million.
Sources: MoF, IMF staff calculation

[6] The commercial agreement envisages the government assuming supply, financing, and market risks (by guaranteeing to purchase all output and a fixed rate of return), leaving only construction and operational risks with the private party. Explicit guarantees for the power purchase and supply agreements (lignite, water, ash and gypsum disposal) in case of payment or performance breaches alone are expected to add up to 5-6 percent of GDP.

[7] Note that per GFSM 2014, KPST contributions are not government revenue because KPST is an independent body and not a government unit.

diversified by widening the investor base, exploring new instruments (e.g., retail or external bonds), and further extending the maturity profile (averaging 2 years) of domestic debt. Any external placement in the medium term needs to be preceded by careful assessment of market conditions, progress in reducing country risk, and the development of a comprehensive debt management strategy. At the same time, CBK's holdings of government securities should be gradually reduced, the bank balance of 4.5 percent of GDP maintained (even though the draft budget envisages a drop in the bank balance to 3.5 percent of GDP in 2021), and the exposure limits of the private pension fund KPST respected. To reduce financing risks, the government may also have to target a tighter fiscal deficit than currently mandated under the fiscal rule.

Fiscal Institutions and Governance

20. Strengthening fiscal institutions and governance will also contribute to higher tax collection and spending efficiency and reduce corruption vulnerabilities (*see Governance Assessment—Annex V*). The draft law on public enterprises, which aims to improve financial oversight and accountability as well as the financial performance of the sector, is a welcome step in this direction. Further, electronic procurement should be rolled out as envisaged, while the scope to widen the coverage of centralized procurement assessed and capacity constraints addressed to ensure value-for-money. Regarding the tax administration, the recent introduction of an automatic risk-based VAT refund system and plans to strengthen debt collection by setting performance targets and centralizing the collection function at HQ would also enhance governance. The authorities need to also undertake cost-benefit assessments of tax expenditures and annually publish estimates of the revenue foregone from such expenditures as part of the budget documents to increase transparency.

Kosovo: Key Recommendations to Strengthen Fiscal Governance

Tax expenditures	• Regulate all tax expenditures in primary legislation, with clear criteria, and rationalize existing ones • Quantify costs of tax expenditure and report them annually with the budget • Strengthen enforcement of the public consultation procedures to increase transparency of the policy making and keep lobbying in check
Revenue administration	• Set publicly available performance targets and regularly publish outcomes • Strengthen HQ control over key tax administration functions • Scale up tax debt collection while ensuring equal treatment • Align resources with compliance risk
Public procurement	• Widen coverage of centralized procurement and improve "value for money" • Make e-procurement mandatory • Strengthen capacity of the Central Procurement Agency and improve transparency and accountability of the Procurement Review Body
Publicly-Owned Enterprises (POEs)	• Strengthen joint oversight of POEs by the Ministry of Finance and Ministry of Economic Development • Improve the timeliness and focus of the POE Monitoring Unit's reports to deepen financial risk analysis, and ensure such information is available for the budget process • Ensure independent supervisory boards and run POEs on a commercial basis • Publish POEs financial statements on timely basis audited by reputable companies
Public Investment Framework	• Improve project appraisal and selection • Undertake ex-post review and external audits of large-scale projects • Ensure alignment of national strategies with the budget

Authorities' Views

21. The authorities concurred with staff's assessment. They agreed that the fiscal rule (i.e. deficit and wage bill ceilings, and bank balance floor) remains an appropriate anchor for fiscal policy and are firmly committed to preserving it, as reflected in the 2019 budget. Regarding strengthening the tax administration, they welcomed all staff recommendations and committed to their implementation in 2019. On spending pressures, they were of the view that they could be contained or otherwise absorbed by built-in buffers. In addition, safeguards have been put in place to reduce spending equivalent to any shortfall in revenues from tax administration reforms. Any guarantees for the power plant, if deemed necessary, will be contained within the existing debt limit rules.

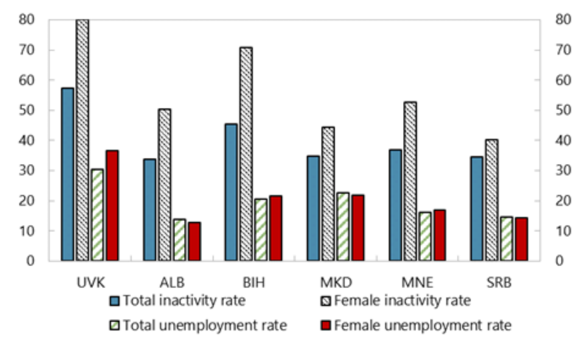
22. However, they differed in views regarding the ramp-up in public investment and possible financing pressures. Regarding public investment, they pointed out that the use of privatization proceeds is tied to viable projects and that demand pressures will be contained given spare capacity. Regarding financing, they are confident that new domestic debt issuance can be absorbed in the near term, albeit possibly at a higher cost. The authorities are planning to diversify sources of financing in the medium term, possibly including by tapping the Eurobond market in 2020.

B. Structural Reforms: Reducing Unemployment, Increasing Competitiveness and Improving Governance[8]

Labor Market

23. Kosovo's labor market is characterized by low labor force participation and high unemployment rates (Figure 3). Poor labor market outcomes can be explained by a number of factors, including high public-sector wages, an above average minimum wage, as well as factors driving up reservation wages, such as the design of social benefits and large remittances inflows (*see Annex VI*).

Inactivity and Unemployment Rates, 2017



Sources: Haver Analytics and IMF staff calculations

24. Reforms to improve labor market outcomes should be at the forefront of the policy agenda. Action plans and sector strategies to reduce skill mismatches and upgrade skills have been adopted, but reforms to increase preschool enrollment rates, improve the quality of teaching staff, modernize curricula and textbooks, upgrade vocational education and training programs, and improve labor market intermediation remain at an early stage. Implementation of

[8] An in-depth coverage of structural reforms is available in the Staff Report for the 2017 Kosovo Article IV Consultation.

these reforms should thus be accelerated. In addition to removing adverse labor market incentives in the design of social benefits (e.g., employment-linked eligibility criteria and high benefit amounts), policies should also focus on promoting female labor force participation—given the wide gender gap in unemployment and inactivity rates—by expanding affordable childcare and reducing any gender bias in hiring.

25. Several fiscal policy initiatives under consideration, however, would undermine these efforts. Proposed excessively generous maternity/parental benefits for mothers risk further undermining women's position in the labor market. The new public salary law will increase wages in the public sector, thereby raising pressure on private sector wages. Such initiatives would also crowd out more productive spending in the budget, undermining efforts to boost competitiveness and growth. Also, a proposed minimum wage hike would further drive up labor cost, and risks pushing more low-skilled and young workers into informality. In this context, staff advised that the rules-based minimum wage setting mechanism established in 2013 should be re-established.

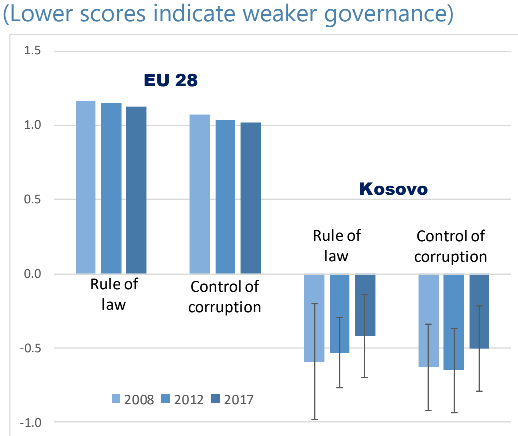
Business Climate and Governance

26. Private sector development is also held back by human and physical capital gaps. Emigration of skilled labor further adds to the skills shortages and mismatches discussed above and is a key concern for firms that already face difficulty in filling vacancies. In addition, Kosovo still has a wide infrastructure gap relative to other countries in the region and the EU, including in energy supply. Addressing this is key to supporting investment in the tradable sector.

27. Better governance will also improve the business climate and help attract needed investment (*see Annex V*)**.** Reducing informality, including through revenue administration reforms as discussed above, should help level the playing field among businesses. Strengthening the rule of law, including in the areas of contract enforcement and property rights, will facilitate access to cheaper financing. It will also be key to move forward with the new law on risk-based inspections, implement the law on licensing requirements, and reduce administrative burdens to bring down the cost of doing business.

Governance Indicators 1/

(Lower scores indicate weaker governance)



Source: Worldwide Governance Indicators, D. Kaufman (Natural Resources Governance Institute and Brookings Institutions), and A. Kraay (World Bank), 2018.

1/ Scores range from -2.5 to 2.5, with higher values corresponding to better governance. Vertical lines show the 90 percent confidence interval.

Authorities' Views

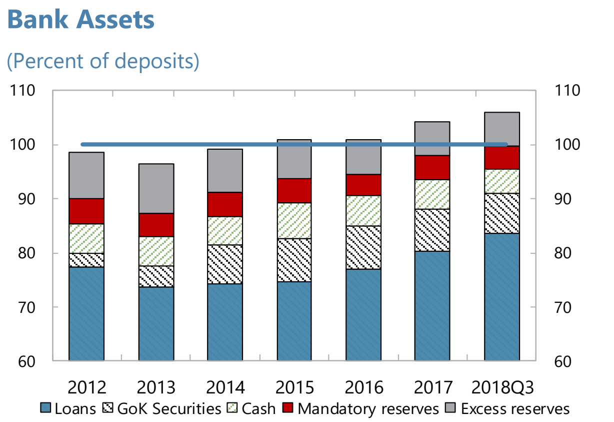
28. The authorities broadly concurred with the staff's assessment. They agreed that labor market conditions need to be improved and are undertaking a range of measures, with a focus on reducing skills shortages and mismatches by improving education, vocational training, and labor market intermediation. The authorities believe that the public sector competes with the private sector over employment in a healthy way and noted that the minimum wage hike proposal was contained. The authorities also noted that private vocational schools at all education levels are developing fast in Kosovo, which will further alleviate labor market supply bottlenecks. In parallel, they are working on closing the domestic energy supply gap as well as on reducing informality and strengthening governance.

Kosovo: Key Recommendations to Strengthen Rule of Law

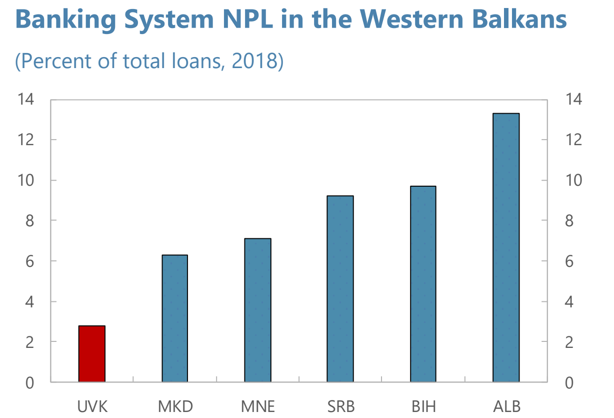
Contract Enforcement	• Implement the amended law on enforcement procedures (reform the PEA tariff structure and staff the independent PEA inspection unit within the Ministry of Justice) • Train PEAs and recruit new PEAs to fill the remaining 30 positions • Prioritize large commercial cases, accelerate reduction of the court case backlog • Prepare the ground for the creation of a commercial court by 2020 • Make transparency an underlying principle of contract enforcement
Property Registration and Cadaster System	• Establish a fully functioning cadaster system that covers all of Kosovo; and provide banks access to the recently-established agriculture registry • Complete the privatization of public houses and provide proper titles to homeowners • Undertake reforms to strengthen Kosovo Cadaster Agency's institutional framework and upgrade its technical infrastructure
Judiciary Reforms to fight Organized Crime and High-level Corruption	• Adopt revised laws on asset confiscation and whistle-blowers in line with EC recommendations • Improve quality of reports submitted by the Anti-Corruption Agency to prosecution • Implement without delay the newly adopted law on state prosecutor • Adopt revisions to the criminal code and criminal procedures code • Bring legal framework on declaration of assets in line with EU standards • Address AML/CFT gaps in the legal framework and implementation, and complete recommendations from the PECK I and PECK II assessments

C. Financial Sector: Safeguarding System Stability and Financial Deepening

29. Kosovo's financial sector remains broadly sound, though liquidity is tightening (Tables 6 and 7, Figure 4). Reported capital and liquidity buffers are ample, and banks' capacity to absorb shocks remains strong. NPLs, below 3 percent of total loans, are the lowest in the region, reflecting robust growth in economic activity, dividends from past reforms to strengthen collateral enforcement, and continued write-off of NPLs. With continued strong credit growth, the loan-to-deposit ratio has increased, albeit from a low base, and with a slowdown in deposit growth (mainly in corporate deposits), liquidity is expected to tighten, especially when monetary policy in the Euro area starts normalizing. Competition for lending opportunities further compresses interest margins, though the impact on bank profits is partly offset by volume growth, higher fee income and lower operational cost. The insurance sector (3 percent of the financial system) is recovering and has returned to profitability since mid-2017, even though 3 out of 15 insurance companies are undercapitalized.



Source: Central Bank of Kosovo.



Source: Central banks' websites.

Kosovo: Key Financial Stability Indicators
(In percent)

	Actual value	Regulatory requirement	WB average
Regulatory capital to risk weighted assets	16.1	12.0	17.5
NPL to total loans	2.6	N.A.	7.9
ROA	2.1	N.A.	2.0
Liquid assets to short-term liabilities	36.3	25.0	35.1

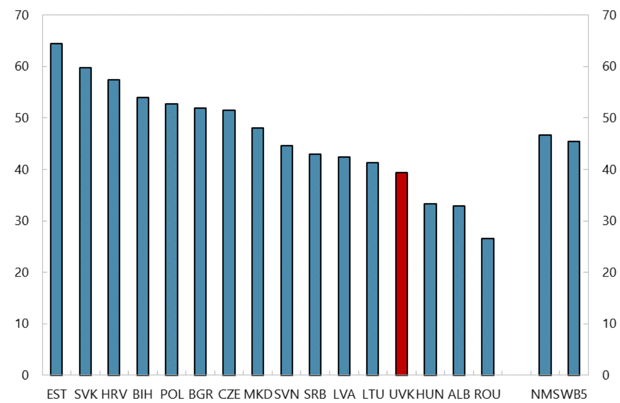
Sources: IMF staff calculations.

30. Robust credit growth has continued to support the economy, but the authorities need to remain vigilant to pockets of risk. While credit penetration remains low by regional standards, it has continued to increase (mainly to trade and construction), facilitated by both low interest rates, an easing of credit standards, and KCGF guarantees of loans to SMEs. In this environment, differentiating between healthy financial deepening and potentially excessive credit growth is key. With strong growth in property lending (beyond mortgages, this includes commercial and residential construction loans, consumer credit used for housing finance, suppliers' credit) amid signs of a supply overhang in the capital, the authorities should closely monitor the market and develop a housing price index or create a centralized registry of property valuations to convey the price signal of the property market.

31. Remaining structural impediments to lending need to be reduced to facilitate further financial deepening. Building on earlier reforms to strengthen contract enforcement, the authorities should focus on fully implementing the law on enforcement procedures, accelerating the resolution of commercial cases (for example, by having more specialized judges, prioritizing commercial cases, and creating a commercial court), and strengthening property registration and the cadaster system (Annex V). In addition, legislation regulating and widening the range of activities of micro-financial institutions (MFIs) is currently before parliament, and the CBK is working on regulation allowing for the creation of investment funds. These changes need to be designed to ensure fair competition between MFIs and the banking system, while safeguarding prudential and consumer protection standards.

Western Balkans: Credit Depth

(Bank credit to the private sector in percent of GDP, 2017)



Source: IFS and IMF staff calculations.

32. The authorities further strengthened the supervisory framework. This includes widening co-operation with authorities in the region and the ECB for joint inspections of foreign owned banks and exchange of information. Further, the CBK has drafted a plan to incorporate the Basel III framework, prepared for IFRS9 implementation in 2019, intends to develop macroprudential instruments for non-bank financial institutions, and has drafted risk-based supervision manuals for the pension and insurance sectors.

33. The CBK also plans to develop a new medium-term reform strategy. With nearly all 2012 FSAP recommendations implemented (see 2017 Article IV) the CBK has requested a Financial Sector Stability Review (FSSR) in early 2019 that would inform its new 5-year strategy and planned legislative changes. The latter includes ongoing revisions to the banking law and possible revisions to the CBK law.

34. The Peck II assessment provides an opportunity to address any remaining deficiencies in the AML/CFT framework and improve its effectiveness. The preliminary outcome of the PECK II assessment shared with staff signals that the legislative framework has improved since the PECK I assessment in 2014, but outstanding shortcomings, including third-party reliance issues and customer due diligence process, remain to be addressed. In terms of effectiveness, the preliminary results indicate that the authorities' have made progress in implementing the legal framework, but efforts should continue. Addressing outstanding shortcomings and ensuring the effective implementation of the regime would also support anti-corruption efforts.

Authorities' Views

35. The authorities agreed with staff's views on the health of the financial sector, though have a more sanguine view on credit growth and risk. The authorities stressed that credit growth reflects healthy financial deepening and low credit penetration relative to its peers, and a reduction in interest rates widening access to previously credit-constrained sectors such as agriculture and manufacturing. They expect interest rates to decline further amid strong competition and improvements in contract enforcement, which coupled with still ample deposits will facilitate continued strong credit growth. Further, the authorities are closely monitoring developments in the real estate market, but assess risks as contained given low NPL ratios in this sector and that loan growth comes from a low base. They expressed interests in developing a house price index.

OTHER ISSUES

36. Data remain adequate for surveillance purposes. Fiscal and financial sector data are of good quality and are timely and available. The authorities however need to make further efforts to implement recommendations provided in the recent past to improve the quality and timeliness of real sector data. Strengthening the capacity of statistical agencies would help in this regard.

STAFF APPRAISAL

37. Prudent fiscal and financial policies helped preserve macro-financial stability, while growth remains robust. The economy continues to grow at a healthy clip, outpacing Kosovo's neighbors. Fiscal discipline has been maintained, reflected in a 2018 budget deficit that is expected to remain well-below the fiscal rule's ceiling, while financial soundness indicators continued to improve. Despite some progress in regaining competitiveness, the external position remains moderately weaker than implied by fundamentals and desirable medium-term policy settings. Reserves are low in regional comparison, but at comfortable levels using standard metrics. Together with a government bank balance of 4.5 percent of GDP at the CBK they provide sufficient cushion for external, fiscal or financial shocks.

38. However, structural challenges remain largely undented, and should be at the forefront of the policy agenda. An underdeveloped private and export sector, widespread informality, reliance on remittances are mirrored in high unemployment and inactivity rates, and a large trade deficit. Tackling these deep-rooted challenges through structural fiscal, financial sector, product and labor market reforms remain a priority to create the jobs and growth needed to reduce unemployment, outward migration, and the still wide income gap with the rest of Europe. However, in a complex political environment important structural reforms have stalled and pressures to introduce fiscally costly, populist initiatives have increased.

39. The fiscal rule remains an appropriate anchor for fiscal policy and underpins the 2019 budget, though execution risks are significant. It accommodates large pension increases and space for other wage and social benefit initiatives, relying on large and uncertain gains from reforms in tax administration and war veteran benefits. While the authorities are committed to adjust spending in case of revenue shortfalls, this should be reinforced by limiting specific non-priority spending until the targeted revenue gains have been realized. Financing needs to be diversified to reduce roll-over risks and avoid crowding out credit to the private sector, while the central bank's holdings of government securities are to be gradually reduced.

40. **Revenue administration reforms should be accelerated to strengthen revenue collection and improve the business environment**. Revenue remains some 10 percent below the regional average and the tax base is narrow, limiting the space for productive spending. In line with earlier Fund advice, the tax and customs administration need to be overhauled to reduce the high informality and large tax gaps and tax debts. The ambitious revenue targets included in the 2019 budget lend more urgency to these reforms. Further, to protect tax revenues, any changes to the import VAT collection should include strong safeguards, and the granting of new tax expenditures be avoided, and existing ones reviewed. There is also room to increase tax rates in the medium term, given that they are still low by regional standards.

41. **Fiscal risks need to be contained to avoid crowding out pro-growth spending within the limits of the fiscal rule**. To contain *social benefit pressures*, it is essential to move ahead with war veteran reforms and resist introducing new benefits schemes, such as for teachers, the police, and other types of benefits, while any pension increase should be limited to the basic pension only. To contain *wage bill pressures*, public administration and health care reforms should be (re-) designed to fit within the limits of the wage bill rule. To contain *contingent liabilities*, plans to restructure public enterprises need to move ahead and any government support for the new power plant through guarantees or financing need to be consistent with the fiscal rule and public debt sustainability. Planned pension reforms need to protect the second pillar and be carefully designed to avoid creating sizeable unfunded liabilities in the medium term.

42. **Spending efficiency needs to be significantly enhanced to improve outcomes and support growth, including through strengthening fiscal institutions and governance**. Social benefit reform would create space for much-needed investment to reduce human and physical capital gaps. Yet, any additional space for spending on education, health, the judiciary, active labor market policies, and infrastructure needs to be complemented by efficiency-enhancing reforms to improve outcomes in these areas. In addition, accelerating reforms to strengthen fiscal institutions, such as tax administration, public procurement, public investment and public enterprise management will be important not only to improve spending efficiency, but also to enhance transparency and accountability as well as reduce corruption vulnerabilities.

43. **Policies should pivot from spending initiatives to removing structural constraints to growth and job creation.** To lower wage and non-wage cost and improve productivity, it is critical to restrain wage and social benefit growth and implement policies to promote female labor force participation; to upgrade skills and reduce mismatches through better access and quality of education and vocational training; and to reduce infrastructure bottlenecks. Reforms to strengthen the rule of law and reduce red tape should also help in this regard. Fiscal initiatives such as the public salary law and excessively generous maternity/parental benefits, as well as a large minimum

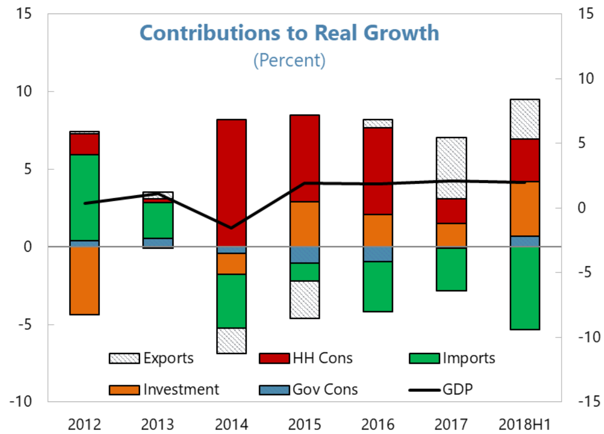
wage hike, would not only be costly but also undermine these efforts, providing another reason why they should be avoided or redesigned.

44. The financial sector remains sound, but access could be further improved. With double-digit credit growth, the authorities need to remain vigilant for possible pockets of risk and differentiate between healthy financial deepening and potentially excessive credit growth. While improving, credit depth remains low in regional comparison. Structural impediments to lending should be further reduced, including by fully implementing the law on enforcement procedures, accelerating the resolution of commercial cases, and strengthening property rights.

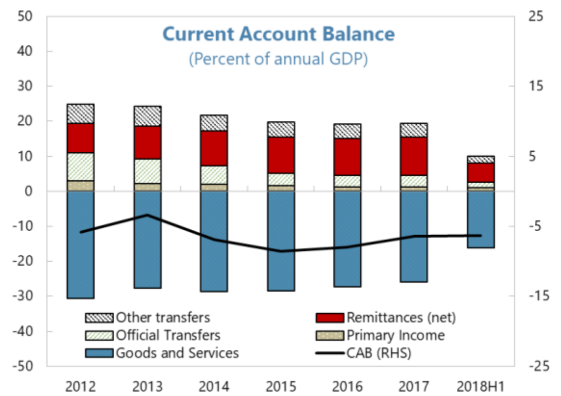
45. It is recommended that the next Article IV consultation takes place on the standard 12-month cycle.

Figure 1. Kosovo: Recent Economic Developments, 2012–18

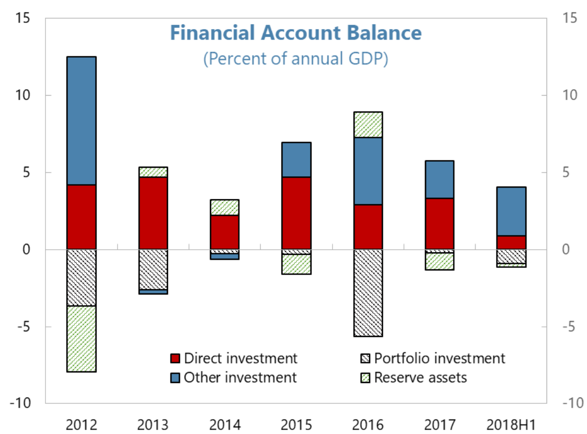
Growth remains robust and broad-based, driven by consumption, investment and service exports.



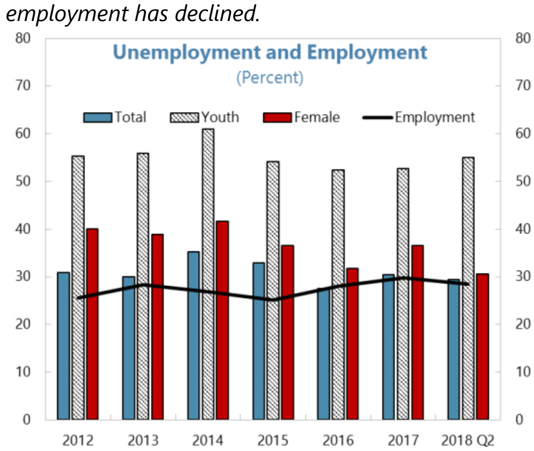
However, the current account deficit remains large due to a sizable negative trade balance...



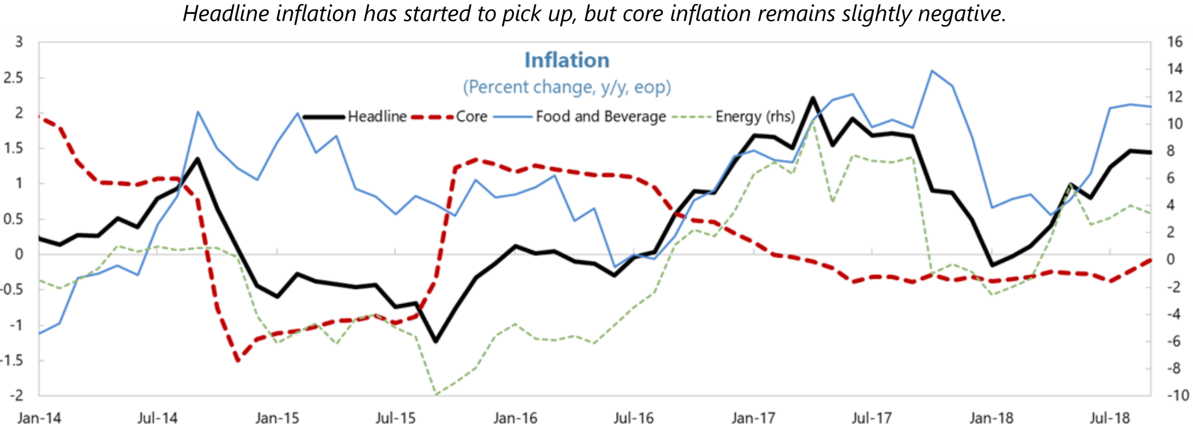
... but continued to be financed by FDI and other investment.



Unemployment has improved slightly, although employment has declined.



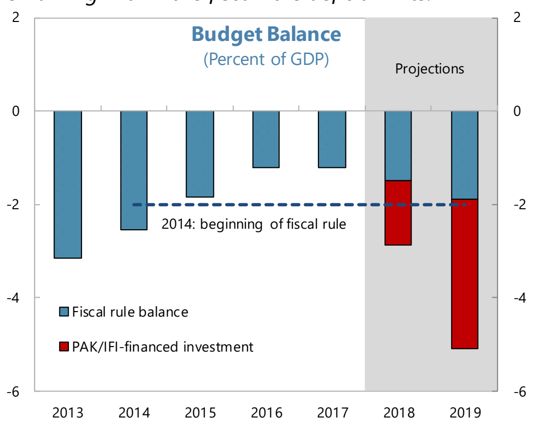
Headline inflation has started to pick up, but core inflation remains slightly negative.



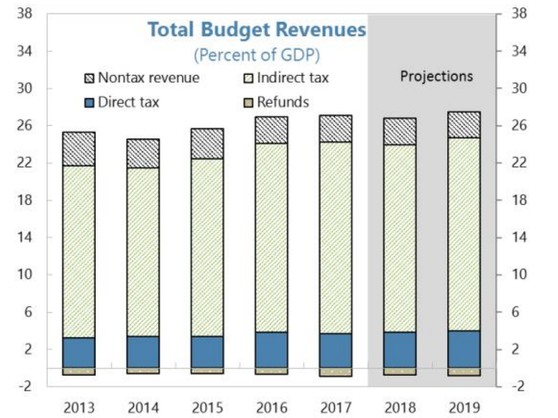
Sources: Haver Analytics; Kosovo Agency of Statistics; Central Bank of Kosovo; Haver; WEO; IMF staff estimates.

Figure 2. Kosovo: Fiscal Developments, 2013–19

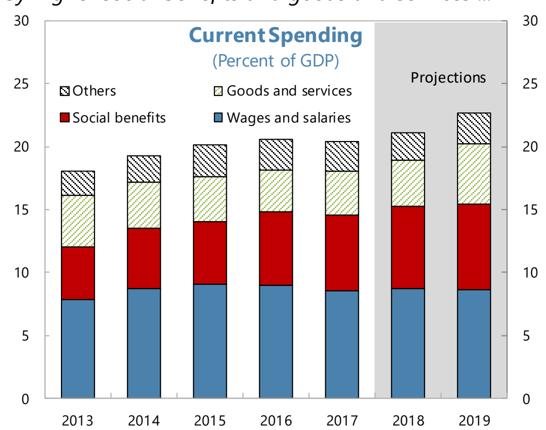
In 2018, the budget deficit is projected to widen, while remaining within the fiscal rule deficit limits.



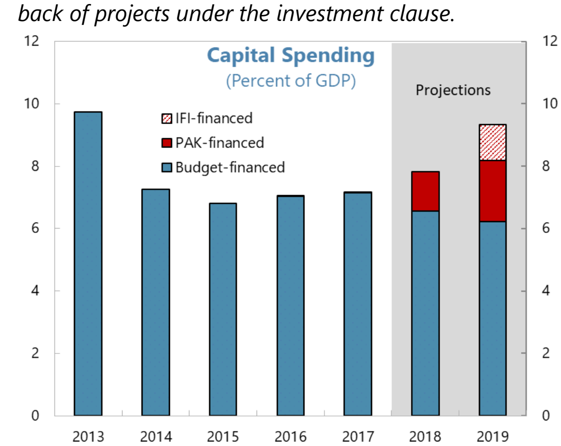
Total revenue collection is projected to stay close to the 2017 level…



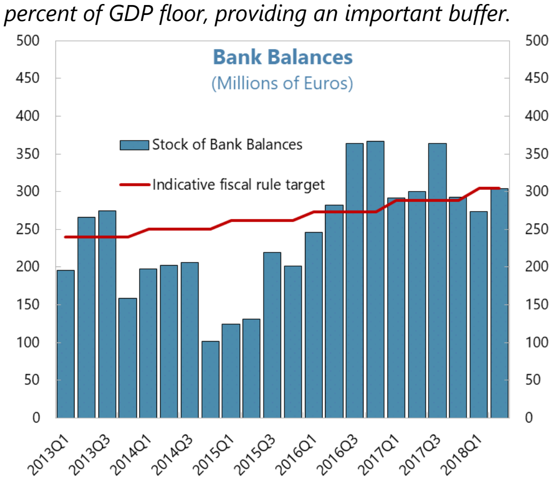
… while current spending will continue to increase driven by higher social benefits and goods and services …



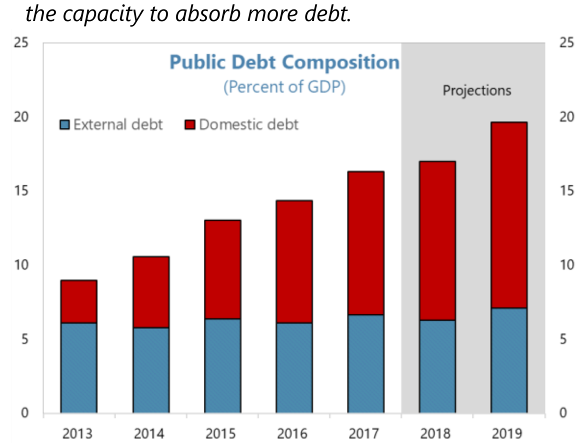
… and capital spending is projected to recover on the back of projects under the investment clause.



The bank balance has been largely kept above the 4.5 percent of GDP floor, providing an important buffer.



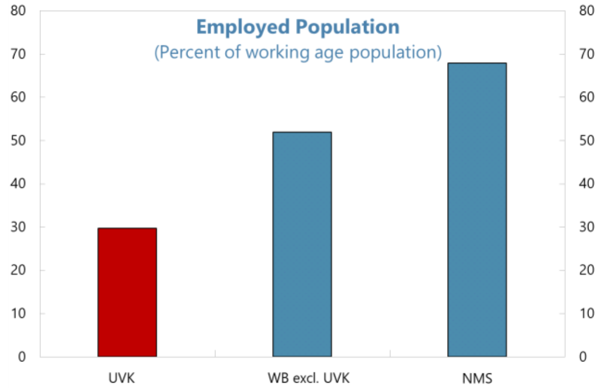
Domestic debt has been on a steady increase, reducing the capacity to absorb more debt.



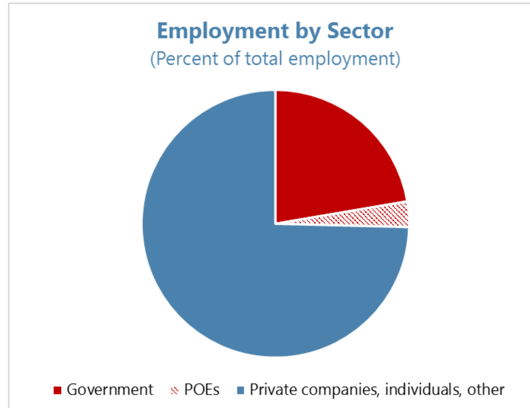
Sources: Kosovo authorities, IMF staff estimates.

Figure 3. Kosovo: Labor Market, 2017

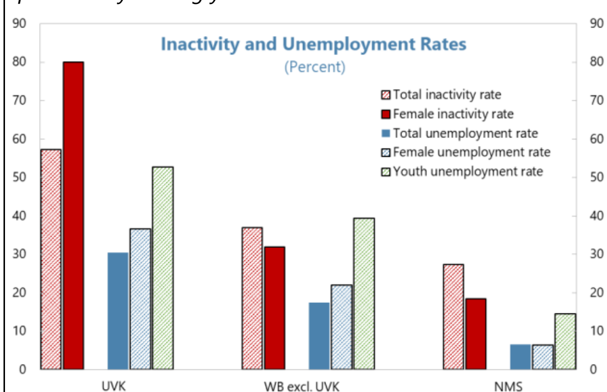
Kosovo has by far the lowest employment in the region…



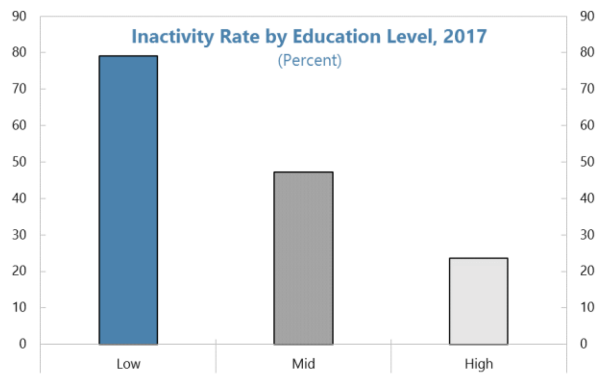
… with a large share employed in the public sector ……



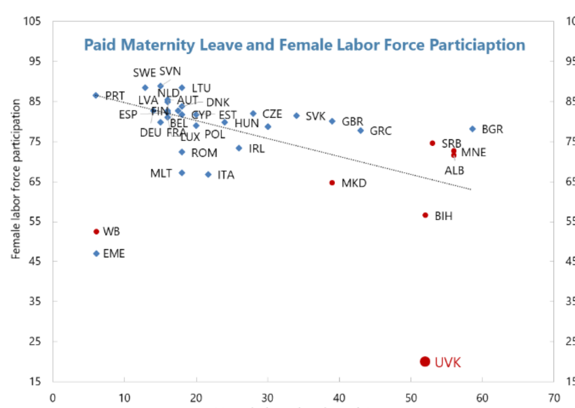
… and very high inactivity and unemployment rates, particularly among youth and women…



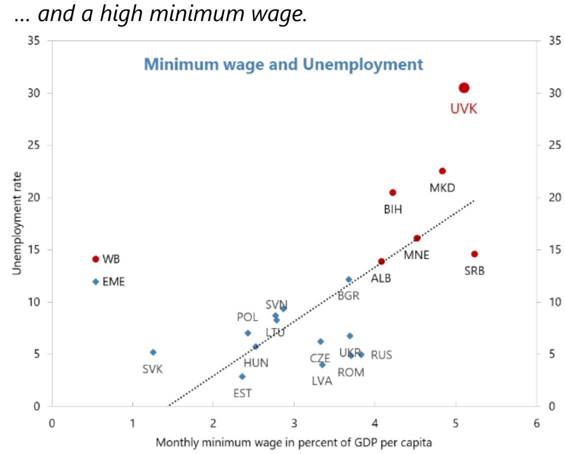
… on account of low education attainment,…



…with excessive social benefits…



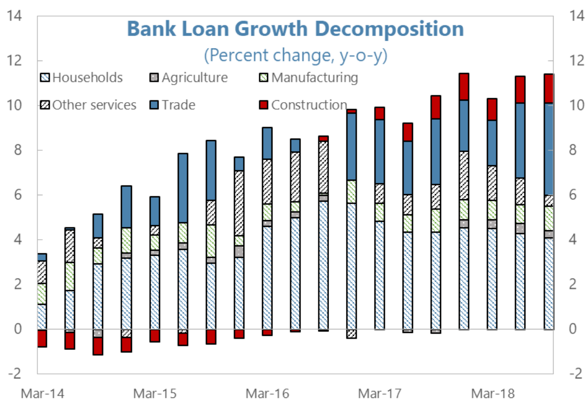
… and a high minimum wage.



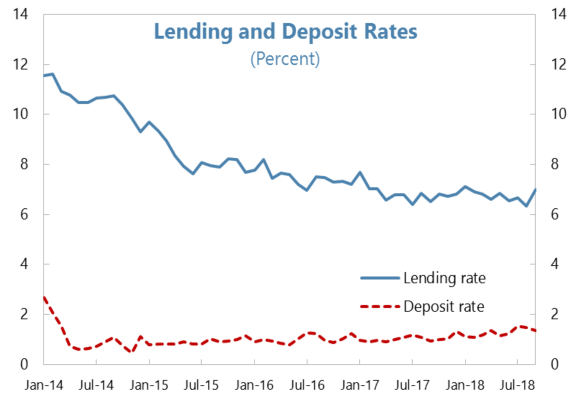
Sources: KAS; OECD; ILO; Eurostat; SEE Jobs Gateway Database; WEO and IMF staff estimates.

Figure 4. Kosovo: Banking Sector Overview, 2014–18 1/

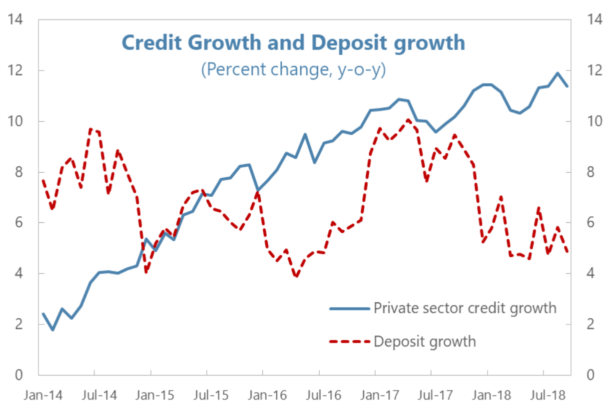
Credit growth remains robust, mainly due to growth in lending to the trade and construction sectors ...



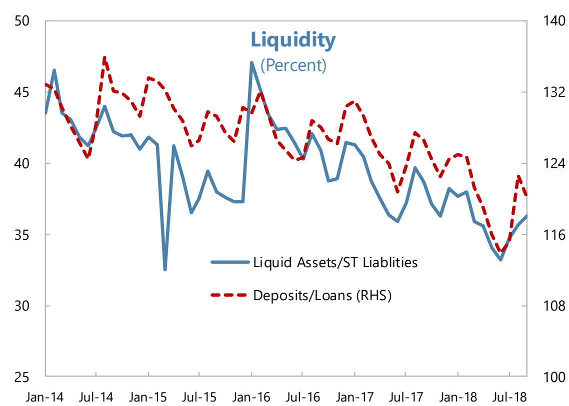
... supported by relatively low lending rates at around 6 to 7 percent ...



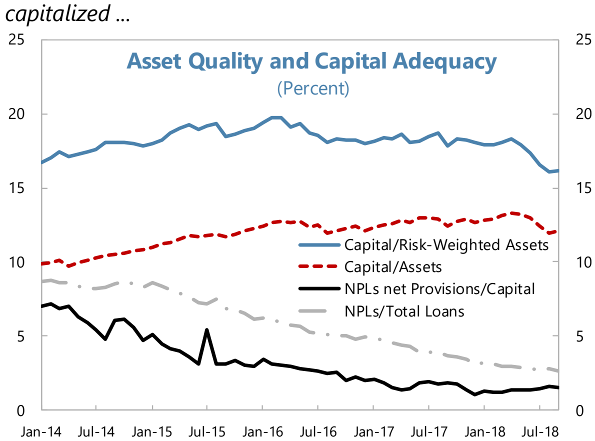
With deposit growth lagging credit growth ...



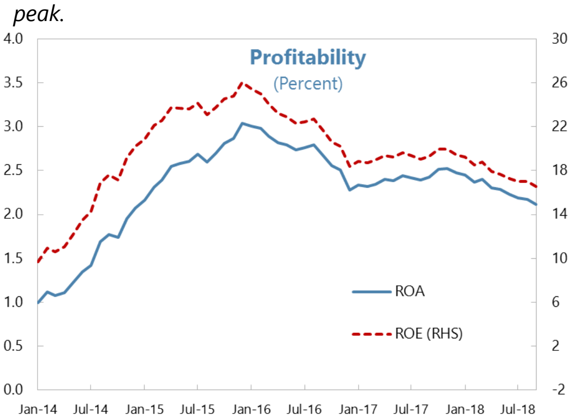
... liquidity in the banking system has started to decline.



Asset quality further improved, and banks remain well-capitalized ...



... and profitable, despite some decline since the 2015 peak.



1/ Based on data available as of end of September 2018.

Sources: Central Bank of Kosovo, IMF staff estimates.

Table 1. Kosovo: Selected Economic Indicators, 2015–23
(Percent, unless otherwise indicated)

	2015	2016	2017	2018	2019	2020	2021	2022	2023
				Projections					
Real GDP growth	4.1	4.1	4.2	4.0	4.2	4.0	4.0	4.0	4.0
Contribution to growth (percentage points of GDP)									
Consumption	4.7	4.7	1.5	5.6	2.9	3.9	3.8	3.3	3.3
Private	5.6	5.6	1.6	4.9	1.7	3.8	3.5	2.9	2.9
Public	-1.1	-1.0	-0.1	0.7	1.2	0.0	0.3	0.4	0.4
Investment	2.9	2.1	1.5	2.8	2.6	0.7	0.5	1.3	1.1
Net Exports	-3.5	-2.7	1.2	-4.4	-1.4	-0.6	-0.3	-0.6	-0.4
Exports	-2.4	0.5	4.0	-0.2	2.1	1.9	1.9	1.8	1.9
Imports	-1.1	-3.2	-2.8	-4.3	-3.5	-2.4	-2.2	-2.4	-2.3
Official unemployment (percent of workforce) 1/	32.9	27.5	30.5	29.4	…	…	…	…	…
Social Indicators									
Private consumption per capita (constant 2016 LCU)	2,775	2,926	2,954	3,101	3,137	3,257	3,367	3,459	3,555
Poverty headcount ratio at $5.50 a day (2011 PPP) (% of population)	21.5	20.8	…	…	…	…	…	…	…
Poverty headcount ratio at national poverty lines (% of population)	17.6	…	…	…	…	…	…	…	…
Price changes									
CPI, period average	-0.5	0.3	1.5	0.9	1.4	1.7	1.8	1.9	2.0
GDP deflator	0.2	0.4	1.4	1.3	1.0	1.6	1.8	1.9	2.1
Real effective exchange rate (average; -=depreciation) 2/	-2.2	0.9	0.6	-0.5	…	…	…	…	…
Terms of Trade	90	100	98	100	98	97	96	96	95
General government budget (percent of GDP)									
Revenues and grants	25.1	26.3	26.2	26.1	26.9	26.2	26.0	25.7	25.5
Expenditures	27.0	27.6	27.5	29.0	32.0	30.2	29.1	28.9	28.2
Of which: Wages and salaries	9.0	9.0	8.6	8.7	8.7	8.6	8.6	8.6	8.5
Subsidies and transfers	7.4	8.0	8.0	8.3	8.8	8.6	8.5	8.4	8.2
Capital and net lending	6.8	7.1	7.2	7.8	9.3	8.0	7.0	6.9	6.3
Overall Balance Ex-PAK ex-IFI capital projects (Fiscal rule) 3/	-1.8	-1.2	-1.2	-1.5	-1.9	-1.9	-1.9	-1.9	-1.9
Overall balance excluding PAK current spending 3/	-1.8	-1.3	-1.2	-2.8	-5.0	-3.9	-3.0	-3.0	-2.6
Stock of government bank balances	3.5	3.5	4.5	4.5	4.5	4.5	4.5	4.5	4.5
Total public debt 4/	13.0	14.3	16.3	17.0	19.6	22.2	24.2	26.1	27.4
Balance of Payments (percent of GDP)									
Current account balance, incl. official transfers	-8.6	-7.9	-6.4	-6.9	-8.3	-7.9	-7.2	-7.0	-6.6
Of which: Official transfers 5/	3.5	3.4	3.1	3.9	3.6	3.2	3.1	2.8	2.6
Of which: Remittance inflows	11.5	11.4	11.8	11.8	11.8	12.1	12.1	11.8	11.7
Financial account	-5.4	-3.3	-5.1	-5.6	-7.0	-6.6	-5.8	-5.7	-5.2
Of which: Direct investment, net	-4.7	-2.9	-3.9	-2.1	-3.1	-3.1	-3.1	-3.0	-3.0
Portfolio investment, net	0.3	5.7	0.2	1.1	1.0	1.5	1.8	2.2	2.2
Errors and Omissions	2.7	4.4	1.5	1.5	1.5	1.5	1.5	1.5	1.5
Savings-investment balances (percent of GDP)									
National savings	15.5	15.7	18.6	18.9	19.6	19.9	20.1	20.6	21.1
Public savings	4.9	5.7	5.8	5.0	4.1	4.0	3.9	3.7	3.6
Private savings	10.6	10.0	12.8	14.0	15.5	15.9	16.3	16.9	17.6
Investment	27.6	27.1	28.2	29.7	31.5	31.0	30.4	30.5	30.4
Public investment	6.8	7.1	7.2	7.8	9.3	8.0	7.0	6.9	6.3
Private investment	20.8	20.0	21.1	21.9	22.2	23.1	23.4	23.6	24.0
Current account, excl. official transfers	-12.1	-11.3	-9.6	-10.8	-11.9	-11.1	-10.2	-9.9	-9.2
Financial Sector									
Non-performing loans (percent of total loans) 2/	6.2	4.9	3.1	2.6	…	…	…	…	…
Bank credit to the private sector (percent change)	7.3	10.3	11.5	10.3	9.5	8.9	8.3	7.5	7.1
Deposits of the private sector (percent change)	7.3	8.7	5.3	6.3	6.0	6.6	6.7	6.8	7.0
Regulatory capital/risk weighted assets 2/	19.0	17.9	18.1	14.6	…	…	…	…	…
Memorandum items:									
GDP (millions of euros)	5,807	6,070	6,414	6,757	7,108	7,514	7,959	8,434	8,955
GDP per capita (euros)	3,278	3,403	3,566	3,727	3,890	4,079	4,287	4,506	4,747
GNDI per capita (euros)	3,815	3,944	4,147	4,395	4,577	4,817	5,068	5,323	5,609
Real GDP growth per capita	6.1	3.4	3.4	3.2	3.4	3.2	3.2	3.2	3.2
Population (millions)	1.8	1.8	1.8	1.8	1.8	1.8	1.9	1.9	1.9

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

1/ 2018 as of June 2018.
2/ 2018 as of September 2018.
3/ For fiscal rule purposes, only projects post-July 2015 apply.
4/ Includes guarantees, but no longer includes former Yugoslavia debt which has been reclassified as a contingent liability.
5/ Total foreign assistance excluding capital transfers.

Table 2. Kosovo: Consolidated Government Budget, 2015–23 1/

(Millions of euros, excluding donor designated grants)

	2015	2016	2017	2018		2019		2020	2021	2022	2023
				Budget 4/	Proj. 5/	Draft budget	Proj. 5/	Projections			
Revenue and grants	1,456	1,595	1,682	1,817	1,763	1,949	1,910	1,970	2,070	2,170	2,281
Of which: debt collection/compliance gains for the central administration						*41*	*41*				
Of which: improved collection at the local level						*15*	*0*				
Of which: base effects						*22*	*0*				
Revenue	1,455	1,595	1,682	1,810	1,763	1,939	1,900	1,970	2,070	2,170	2,281
Taxes	1,269	1,424	1,496	1,607	1,571	1,731	1,702	1,760	1,847	1,935	2,032
Direct taxes	196	234	238	267	259	289	281	290	307	326	346
Personal income tax	101	124	137	146	148	163	161	166	176	187	198
Corporate income tax	66	81	75	84	84	91	93	94	100	106	112
Property tax	20	25	22	33	23	30	24	25	27	29	30
Interest, dividend (profit) tax	8	0	0	0	0	0	0	0	0	0	0
Other	2	4	3	4	4	4	4	4	4	5	5
Indirect taxes	1,107	1,229	1,315	1,386	1,362	1,492	1,476	1,528	1,601	1,675	1,756
VAT	611	694	756	819	810	905	896	933	990	1,045	1,104
Excise	361	403	432	446	429	465	459	477	496	516	536
Customs	135	130	126	111	120	120	119	114	111	110	111
Other	0	2	1	10	3	2	3	3	4	4	4
Tax refunds	-34	-39	-58	-46	-50	-50	-56	-58	-62	-65	-69
Nontax revenues	187	171	186	202	192	208	198	210	223	235	248
Grants	0.3	0	0	7	0	11	11	0	0	0	0
Expenditure	1,568	1,678	1,766	2,104	1,957	2,364	2,273	2,268	2,317	2,435	2,527
Current expenditure	1,172	1,249	1,307	1,410	1,428	1,595	1,611	1,670	1,761	1,857	1,958
of which: PAK-related current expenditures	6	6	6	11	7	2	7	8	9	9	9
Wages and salaries	525	544	550	590	590	616	616	649	682	721	764
Goods and services	204	202	226	265	251	337	337	335	355	376	399
Subsidies and transfers	427	485	512	526	563	609	626	647	675	705	737
Pension and social assistance	292	354	383	...	440	...	484	497	516	537	558
Other transfers and subsidies	135	131	129	...	123	...	142	150	159	168	179
Current reserves	0	0	0	5	0	5	5	5	5	5	5
Interest payment	16	19	19	24	24	28	27	35	44	49	53
Capital expenditure and net lending	395	429	459	695	529	770	662	598	556	579	568
Budget-financed capital expenditure and net lending	395	426	459	546	443	509	442	451	469	483	501
Capital expenditure (budget financed)	395	434	468	546	443	509	442	451	469	483	501
Net lending	0	-7	-9	0	0	0	0	0	0	0	0
PAK-financed capital expenditure	0	0	0	86	86	140	140	60	0	0	0
IFI-financed capital expenditure	0	2	0	62	0	121	81	87	87	96	67
Primary balance	-96	-63	-66	-268	-174	-391	-340	-267	-208	-220	-197
Overall balance	-112	-82	-85	-288	-194	-415	-363	-298	-247	-265	-246
Ex-PAK ex-IFI capital projects (Fiscal rule) 2/	**-106**	**-74**	**-78**	**-122**	**-101**	**-144**	**-135**	**-143**	**-151**	**-160**	**-170**
Ex-PAK-related current expenditures	-106	-76	-78	-277	-187	-413	-356	-290	-238	-256	-237
Statistical discrepancy	0.9	13.6	11.5	...	...	...	...	...	...	...	...
Financing	106	63	67	281	187	414	356	290	238	256	237
Foreign financing	14	-22	47	68	-4	125	66	14	11	53	34
Drawings/ Borrowings, incl. official financing	7	7	8	30	18	54	36	15	4	0	0
Donor financing for new projects	0	2	0	62	0	121	81	87	87	96	67
IMF financing	35	35	97	0	0	0	0	0	0	0	0
Amortization/ Repayments	-29	-66	-58	-24	-22	-50	-51	-88	-80	-43	-33
Domestic financing	193	94	99	240	204	294	306	294	247	224	226
Domestic borrowing (net)	121	99	95	105	99	135	158	226	240	216	218
Privatization revenues	61	0	0	86	86	140	140	60	0	0	0
Own-source revenue (- = increase)	11	-5	-6	0	0	8	0	0	0	0	0
Other financing			9		19	11	8	8	8	8	8
Accumulation of Assets (- = increase)	-101	-10	-79	-28	-12	-5	-16	-18	-20	-21	-23
Memorandum items											
Bank balance of the general government	202	212	292	319	304	324	320	338	358	380	403
Of which: ELA	46	46	46	...	46	...	46	46	46	46	46
Total public debt 3/	758	871	1,046	1,189	1,149	1,468	1,397	1,669	1,929	2,199	2,452
External debt	370	372	428	509	426	659	505	551	572	626	660
Domestic debt	388	499	618	680	723	810	892	1,118	1,357	1,574	1,792
Of which: guarantees	10	20	44	...	50	...	60	60	60	60	60
Contingent liabilities: debt of the former Yugoslavia	333	311	287	...	198	...	181	162	141	117	97

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

1/ Does not yet reflect the GFSM 2014 methodology.

2/ For fiscal rule purposes, IFI and PAK-financed projects post-July 2015 are excluded from the fiscal deficit. In the authorities' presentation, the fiscal rule deficit also excludes expenditures from carried-forward own-source revenue (OSR). Following methodology agreed during the SBA, IMF staff assumes no carried-forward OSR.

3/ The stock of public debt no longer includes the former Yugoslavia debt, which has been reclassified as a contingent liability.

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/ Based on current legislation, revenue trends, and the 2019 draft Budget. It assumes gains of EUR 41 million from debt collection and tax compliance which will require implementation of strong reforms in revenue administration.

Table 3. Kosovo: Consolidated Government Budget, 2015–23 1/

(Percent of GDP, excluding donor designated grants)

	2015	2016	2017	2018		2019		2020	2021	2022	2023
				Budget 4/	Proj. 5/	Draft budget	Proj. 5/	Projections			
Revenue and grants	25.1	26.3	26.2	26.9	26.1	27.4	26.9	26.2	26.0	25.7	25.5
Of which: debt collection/compliance gains for the central administration						*0.6*	*0.6*				
Of which: improved collection at the local level						*0.2*	*0.0*				
Of which: base effects						*0.3*	*0.0*				
Revenue	25.1	26.3	26.2	26.8	26.1	27.2	26.7	26.2	26.0	25.7	25.5
Taxes	21.8	23.5	23.3	23.8	23.3	24.3	23.9	23.4	23.2	22.9	22.7
Direct taxes	3.4	3.9	3.7	4.0	3.8	4.1	4.0	3.9	3.9	3.9	3.9
Personal income tax	1.7	2.0	2.1	2.2	2.2	2.3	2.3	2.2	2.2	2.2	2.2
Corporate income tax	1.1	1.3	1.2	1.2	1.2	1.3	1.3	1.3	1.3	1.3	1.3
Interest, dividend (profit) tax	0.1	0.0	0.3	0.5	0.3	0.4	0.3	0.3	0.3	0.3	0.3
Property tax	0.3	0.4	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Other	0.0	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1
Indirect taxes	19.1	20.2	20.5	20.5	20.2	20.9	20.8	20.3	20.1	19.9	19.6
VAT	10.5	11.4	11.8	12.1	12.0	12.7	12.6	12.4	12.4	12.4	12.3
Excise	6.2	6.6	6.7	6.6	6.3	6.5	6.5	6.3	6.2	6.1	6.0
Customs	2.3	2.1	2.0	1.6	1.8	1.7	1.7	1.5	1.4	1.3	1.2
Other	0.0	0.0	0.0	0.1	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Tax refunds	-0.6	-0.6	-0.9	-0.7	-0.7	-0.7	-0.8	-0.8	-0.8	-0.8	-0.8
Nontax revenues	3.2	2.8	2.9	3.0	2.8	2.9	2.8	2.8	2.8	2.8	2.8
Grants	0.0	0.0	0.0	0.1	0.0	0.1	0.1	0.0	0.0	0.0	0.0
Expenditure	27.0	27.6	27.5	31.1	29.0	33.2	32.0	30.2	29.1	28.9	28.2
Current expenditure	20.2	20.6	20.4	20.9	21.1	22.4	22.7	22.2	22.1	22.0	21.9
of which: PAK-related current expenditures	0.1	0.1	0.1	0.2	0.1	0.0	0.1	0.1	0.1	0.1	0.1
Wages and salaries	9.0	9.0	8.6	8.7	8.7	8.6	8.7	8.6	8.6	8.6	8.5
Goods and services	3.5	3.3	3.5	3.9	3.7	4.7	4.7	4.5	4.5	4.5	4.5
Subsidies and transfers	7.4	8.0	8.0	7.8	8.3	8.5	8.8	8.6	8.5	8.4	8.2
Pension and social assistance	5.0	5.8	6.0	...	6.5	...	6.8	6.6	6.5	6.4	6.2
Other transfers and subsidies	2.3	2.2	2.0	...	1.8	...	2.0	2.0	2.0	2.0	2.0
Current reserves	0.0	0.0	0.0	0.1	0.0	0.1	0.1	0.1	0.1	0.1	0.1
Interest payment	0.3	0.3	0.3	0.3	0.4	0.4	0.4	0.5	0.5	0.6	0.6
Capital expenditure and net lending	6.8	7.1	7.2	10.3	7.8	10.8	9.3	8.0	7.0	6.9	6.3
Budget-financed capital expenditure and net lending	6.8	7.0	7.2	8.1	6.6	7.1	6.2	6.0	5.9	5.7	5.6
Capital expenditure (budget financed)	6.8	7.1	7.3	8.1	6.6	7.1	6.2	6.0	5.9	5.7	5.6
Net lending	0.0	-0.1	-0.1	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
PAK-financed capital expenditure	0.0	0.0	0.0	1.3	1.3	2.0	2.0	0.8	0.0	0.0	0.0
IFI-financed capital expenditure	0.0	0.0	0.0	0.9	0.0	1.7	1.1	1.2	1.1	1.1	0.7
Primary balance	-1.7	-1.0	-1.0	-4.0	-2.6	-5.5	-4.8	-3.6	-2.6	-2.6	-2.2
Overall balance	-1.9	-1.4	-1.3	-4.3	-2.9	-5.8	-5.1	-4.0	-3.1	-3.1	-2.7
Ex-PAK ex-IFI capital projects (Fiscal rule) 2/	**-1.8**	**-1.2**	**-1.2**	**-1.8**	**-1.5**	**-2.0**	**-1.9**	**-1.9**	**-1.9**	**-1.9**	**-1.9**
Ex-PAK-related current expenditures	-1.8	-1.3	-1.2	-4.1	-2.8	-5.8	-5.0	-3.9	-3.0	-3.0	-2.6
Overall cyclically adjusted balance	-1.8	-1.3	-1.4	-4.3	-2.9	-5.9	-5.3	-4.0	-3.1	-3.1	-2.7
Statistical discrepancy	0.0	0.2	0.2	...	...	...	...	...	...	...	...
Financing	1.8	1.0	1.0	4.2	2.8	5.8	5.0	3.9	3.0	3.0	2.6
Foreign financing	0.2	-0.4	0.7	1.0	-0.1	1.8	0.9	0.2	0.1	0.6	0.4
Drawings, incl. official financing	0.1	0.1	0.1	0.4	0.3	0.8	0.5	0.2	0.0	0.0	0.0
Amortization	-0.5	-1.1	-0.9	-0.4	-0.3	-0.7	-0.7	-1.2	-1.0	-0.5	-0.4
Donor financing for new projects	0.0	0.0	0.0	0.9	0.0	1.7	1.1	1.2	1.1	1.1	0.7
IMF financing	0.6	0.6	1.5	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Domestic financing	3.3	1.5	1.5	3.6	3.0	4.1	4.3	3.9	3.1	2.7	2.5
Domestic borrowing (net)	2.1	1.6	1.5	1.6	1.5	1.9	2.2	3.0	3.0	2.6	2.4
Privatization revenues	1.1	0.0	0.0	1.3	1.3	2.0	2.0	0.8	0.0	0.0	0.0
Own-source revenue (- = increase)	0.2	-0.1	-0.1	0.0	0.0	0.1	0.0	0.0	0.0	0.0	0.0
Other unidentified financing	0.0	0.0	0.1	0.0	0.3	0.2	0.1	0.1	0.1	0.1	0.1
Accumulation of Assets (- = increase)	-1.7	-0.2	-1.2	-0.4	-0.2	-0.1	-0.2	-0.2	-0.3	-0.3	-0.3
Memorandum items											
Bank balance of the general government	3.5	3.5	4.5	4.7	4.5	4.5	4.5	4.5	4.5	4.5	4.5
Of which: ELA	0.8	0.8	0.7	...	0.7	...	0.6	0.6	0.6	0.5	0.5
Total public debt 3/	13.0	14.3	16.3	17.6	17.0	20.6	19.6	22.2	24.2	26.1	27.4
External debt	6.4	6.1	6.7	7.5	6.3	9.2	7.1	7.3	7.2	7.4	7.4
Domestic debt	6.7	8.2	9.6	10.1	10.7	11.4	12.5	14.9	17.1	18.7	20.0
Of which: guarantees	0.2	0.3	0.7	...	0.7	...	0.8	0.8	0.8	0.7	0.7
Contingent liabilities: debt of the former Yugoslavia	5.7	5.1	4.5	...	2.9	...	2.5	2.2	1.8	1.4	1.1
Nominal GDP (millions of euros)	5,807	6,070	6,414	6,757	6,757	7,123	7,108	7,514	7,959	8,434	8,955

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

1/ Does not yet reflect the GFSM 2014 methodology.

2/ For fiscal rule purposes, IFI and PAK-financed projects post-July 2015 are excluded from the fiscal deficit. In the authorities' presentation, the fiscal rule deficit also excludes expenditures from carried-forward OSR. Following methodology agreed during the SBA, IMF staff assumes no carried-forward OSR.

3/ The former Yugoslavia debt has been reclassified as a contingent liability and is no longer included in the stock of public 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/ Based on current legislation, revenue trends, and the 2019 draft Budget. It assumes gains of 0.6 percent of GDP from debt collection and tax compliance which will require implementation of strong reforms in revenue administration.

Table 4. Kosovo: General Government Cashflow, 2015–23
(Millions of euros, unless otherwise indicated)

	2015	2016	2017	2018	2019	2020	2021	2022	2023
				Projections					
Financing Needs	498	473	491	576	785	830	841	755	790
Fiscal deficit (overall balance, ex-PAK-related current expenditure)	107	76	78	187	356	290	238	256	237
Amortization	290	387	333	376	413	522	583	477	530
External	29	66	58	22	51	88	80	43	33
Domestic	261	321	275	354	362	434	503	435	497
Fiscal reserve (change in bank balance)	101	10	79	12	16	18	20	21	23
Financing Sources	497	459	479	576	785	830	841	755	790
External	43	44	106	18	117	102	91	96	67
Donor financing	7	9	8	18	117	102	91	96	67
Donor financing (including project loans before 2015)	7	7	8	18	36	15	4	0	0
IFI- project loans (Investment clause)	0	2	0	0	81	87	87	96	67
Bond placements	0	0	0	0	0	0	0	0	0
IMF disbursements	35	35	97	0	0	0	0	0	0
Domestic	454	415	373	558	668	728	750	659	723
Securities	382	420	370	453	520	660	742	651	716
Privatization revenues	61	0	0	86	140	60	0	0	0
Commercial banks (loans/ drawings on deposits)	0	0	0	0	0	0	0	0	0
Own source revenue	11	-5	-6	0	0	0	0	0	0
Other financing sources	0	0	9	19	8	8	8	8	8
Statistical discrepancy	1	14	12	0	0	0	0	0	0
Memorandum items:									
Government bank balance (stock)	202	212	292	304	320	338	358	380	403
Government bank balance (stock), percent of GDP	3.5	3.5	4.5	4.5	4.5	4.5	4.5	4.5	4.5
PAK Deposits with CBK (stock)	487	461	471	385	245	185	185	185	185
Public domestic debt, net of guarantees (stock)	378	479	574	673	832	1,058	1,297	1,514	1,732
Commercial banks	226	239	243	231	240	249	258	268	277
CBK (Central Bank)	27	130	194	189	171	161	151	151	151
KPST (Pension fund) 1/	90	79	95	185	225	265	305	345	385
PAK (Privatization fund) 2/	0	0	0	0	0	0	0	0	0
Others 3/	35	31	42	69	195	383	583	750	919

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

1/ KPST Law caps GoK debt holding at 30 percent of its assets.
2/ PAK is allowed to invest in GoK securities only since May 18, 2018 and currently holds no securities.
3/ Residual covered by other investors and/or additional KPST purchases of government securities, a possible Eurobond placement (to be shown as public external debt), or a lower fiscal deficit (to be shown as lower financing needs).

Table 5. Kosovo: Balance of Payments, 2015–23
(Millions of euros, unless otherwise indicated)

	2015	2016	2017	2018	2019	2020	2021	2022	2023
				Projections					
Current account	-497	-481	-413	-467	-591	-592	-570	-594	-590
Balance on Goods and Services	-1,652	-1,652	-1,660	-1,942	-2,102	-2,192	-2,265	-2,363	-2,452
Trade Balance	-2,109	-2,291	-2,464	-2,774	-2,998	-3,164	-3,319	-3,485	-3,652
Exports, f.o.b.	322	308	378	354	374	396	420	446	475
Imports, f.o.b.	2,432	2,599	2,843	3,128	3,371	3,560	3,739	3,931	4,127
Services Balance	457	639	804	832	896	972	1,054	1,123	1,200
Receipts	952	1,131	1,331	1,407	1,510	1,626	1,750	1,868	1,999
Payments	494	492	527	575	615	653	697	745	799
Primary Income	93	75	85	168	153	168	185	206	225
Compensation of employees, net	206	194	217	238	255	273	292	311	332
Investment income, net	-112	-117	-128	-67	-98	-101	-102	-101	-103
Secondary Income	1,062	1,096	1,162	1,307	1,358	1,432	1,510	1,562	1,637
Government, net	203	207	202	264	255	241	244	240	236
Other transfers, net	859	889	960	1,043	1,103	1,190	1,266	1,322	1,401
Capital account	26	14	-12	-14	-13	-12	-13	-13	-13
Financial account	-312	-199	-330	-381	-498	-493	-465	-482	-470
Direct investment, net	-272	-177	-250	-140	-219	-234	-247	-256	-267
Assets	37	43	38	44	42	43	42	42	42
Liabilities	309	220	288	184	260	276	289	298	309
Portfolio investment, net	19	344	15	74	70	112	141	183	201
Other investment, net	-133	-264	-165	-274	-273	-345	-375	-420	-415
Reserve assets	74	-101	70	-41	-77	-26	15	11	11
Net errors and omissions 1/	159	268	95	100	105	111	118	125	133
Overall balance	0	0	0	0	0	0	0	0	0
				(In percent of GDP)					
Current account, excl. official transfers	-12.1	-11.3	-9.6	-10.8	-11.9	-11.1	-10.2	-9.9	-9.2
Current account, incl. official transfers	-8.6	-7.9	-6.4	-6.9	-8.3	-7.9	-7.2	-7.0	-6.6
Balance on Goods and Services	-28.5	-27.2	-25.9	-28.7	-29.6	-29.2	-28.5	-28.0	-27.4
Exports of Goods and Services	21.9	23.7	26.7	26.1	26.5	26.9	27.3	27.4	27.6
Imports of Goods and Services	50.4	50.9	52.5	54.8	56.1	56.1	55.7	55.4	55.0
Primary Income	1.6	1.2	1.3	2.5	2.2	2.2	2.3	2.4	2.5
Secondary Income	18.3	18.1	18.1	19.3	19.1	19.1	19.0	18.5	18.3
Official	3.5	3.4	3.1	3.9	3.6	3.2	3.1	2.8	2.6
Other	14.8	14.6	15.0	15.4	15.5	15.8	15.9	15.7	15.6
Capital account	0.4	0.2	-0.2	-0.2	-0.2	-0.2	-0.2	-0.2	-0.1
Financial account	-5.4	-3.3	-5.1	-5.6	-7.0	-6.6	-5.8	-5.7	-5.2
Direct investment, net	-4.7	-2.9	-3.9	-2.1	-3.1	-3.1	-3.1	-3.0	-3.0
Portfolio investment, net	0.3	5.7	0.2	1.1	1.0	1.5	1.8	2.2	2.2
Other investment, net	-2.3	-4.3	-2.6	-4.1	-3.8	-4.6	-4.7	-5.0	-4.6
Reserve assets	2.2	-3.0	2.0	-1.1	-2.0	-0.6	0.4	0.2	0.2
Net errors and omissions 1/	2.7	4.4	1.5	1.5	1.5	1.5	1.5	1.5	1.5
Memorandum items:									
Public debt service to export ratio (percent)	3.1	5.3	4.1	1.9	3.3	4.9	4.1	2.2	1.6
Public debt service to exports and remittances (percent)	2.0	3.6	2.8	1.3	2.3	3.4	2.9	1.5	1.1
External public and private debt (percent of GDP) 2/	18.6	18.9	21.2	20.8	21.6	21.8	21.7	21.9	21.9
Net foreign assets of CBK 3/	1,046	895	939	937	856	887	967	1,000	1,021
Gross international reserves 3/	1,245	1,082	1,168	1,165	1,084	1,115	1,195	1,228	1,249
Gross international reserves in months of imports 3/	4.8	3.9	3.8	3.5	3.1	3.0	3.1	3.0	2.9
Gross international reserves, excl. PAK and KPST deposits at CBK 3/	708	605	683	764	824	915	995	1,027	1,049

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

1/ Errors and omissions are thought to be mostly comprised of unidentified private remittances and unidentified FDI.

2/ The former Yugoslavia debt has been reclassified as a contingent liability and is no longer included in the stock of public debt.

3/ CBK's NFA and GIR data have been revised to exclude the CBK's holdings of Kosovar government securities.

Table 6. Kosovo: Central Bank and Commercial Bank Survey, 2015–23
(Millions of euros, unless otherwise indicated)

	2015	2016	2017	2018	2019	2020	2021	2022	2023
				Projections					
Depository Coporations									
Net foreign assets 1/	1,582	1,493	1,418	1,384	1,260	1,269	1,332	1,375	1,427
Net domestic assets	1,925	2,218	2,535	2,833	3,166	3,394	3,579	3,805	4,047
Central Bank									
Net foreign assets 1/	1,046	895	939	937	856	887	967	1,000	1,021
Foreign assets 1/	1,303	1,162	1,243	1,237	1,127	1,093	1,121	1,141	1,163
Foreign liabilities	256	266	303	301	271	206	154	142	142
Net domestic assets	-598	-492	-464	-421	-344	-378	-459	-493	-515
Net claims on central government	-599	-493	-474	-422	-345	-379	-461	-494	-516
Claims on central government	155	244	355	354	306	231	169	157	157
Liabilities to central government	754	737	828	775	651	609	629	651	673
Of which: PAK (privatization) fund	487	461	471	385	245	185	185	185	185
Of which: Government balances	195	199	274	294	310	328	348	370	393
Claims on other sectors	1	1	10	1	1	1	1	1	1
Monetary base	400	356	428	469	466	465	464	464	465
Liabilities to other depository corporations	316	296	332	348	338	328	318	308	298
Deposits included in broad money	83	60	97	121	128	137	146	156	166
Other items, net 2/	48	48	48	47	46	44	43	42	41
Commercial banks									
Net foreign assets	536	598	479	448	404	382	366	376	406
Assets	740	775	710	689	655	644	637	657	697
Liabilites	-204	-177	-231	-241	-251	-261	-271	-281	-291
Net domestic assets	2,524	2,709	2,999	3,254	3,510	3,771	4,039	4,299	4,562
Claims on the CBK	316	295	331	348	338	328	318	308	298
Net claims on the central government	221	234	234	219	229	238	247	257	266
Claims on central government	226	239	243	231	240	249	258	268	277
Liabilities to central government	-6	-6	-10	-11	-11	-11	-11	-11	-11
Net claims on other public entities	-31	-46	-48	-51	-53	-57	-60	-64	-68
Claims on other public entities	1	3	2	3	3	3	3	3	3
Liabilities to other public entities	-32	-49	-50	-53	-56	-59	-63	-67	-71
Credit to private sector	2,018	2,227	2,483	2,737	2,996	3,262	3,534	3,797	4,066
Deposits of the private sector	2,550	2,773	2,919	3,104	3,289	3,505	3,741	3,993	4,272
Demand deposits	1,381	1,624	1,754	1,863	1,976	2,105	2,248	2,401	2,569
Time deposits	1,170	1,150	1,165	1,241	1,313	1,399	1,493	1,593	1,703
Other items, net 2/	509	534	559	598	625	649	664	681	695
Memorandum items:									
Gross international reserves, excl. PAK and KPST deposits at CBK 1/	708	605	683	764	824	915	995	1,027	1,049
Deposits of the private sector (12-month percent change)	7.3	8.7	5.3	6.3	6.0	6.6	6.7	6.8	7.0
Credit to the private sector (12-month percent change)	7.3	10.3	11.5	10.3	9.5	8.9	8.3	7.5	7.1
Deposits of the private sector (percent of GDP)	43.9	45.7	45.5	45.9	46.3	46.6	47.0	47.3	47.7
Credit to the private sector (percent of GDP)	34.8	36.7	38.7	40.5	42.2	43.4	44.4	45.0	45.4
Mandatory reserves of commercial banks at the CBK 3/	119	114	136	145	153	163	174	186	199
Excess reserves of commercial banks at the CBK 3/	197	183	196	204	185	165	144	122	99

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

1/ Data have been revised to reclassify the CBK's holdings of Kosovar government securities as claims on the central government.

2/ Includes shares and other equity.

3/ Projections are made using the 2017 ratio of mandatory reserves to deposits.

Table 7. Kosovo: Selected Financial Soundness Indicators, 2015–18 1/

(Percent, unless otherwise indicated)

	2015	2016	2017	2018
Structure				
Number of banks	10	10	10	10
Foreign	8	8	8	8
Share of total assets	89.9	88.7	88.1	87.2
Domestic	2	2	2	2
Share of total assets	10.1	11.3	11.9	12.8
Capital adequacy				
Regulatory capital to risk weighted assets	19.0	17.9	18.1	16.1
Tier 1 capital to risk weighted assets	16.7	15.9	16.2	14.6
Capital to assets	12.2	12.1	12.6	12.1
Asset quality				
NPL to total loans 2/	6.2	4.9	3.1	2.6
NPL net of provisions to capital	3.0	2.0	1.1	1.5
Large exposures to capital	63.5	65.6	81.7	86.0
Sectoral breakdown of loans				
Agriculture	3.0	2.7	2.2	2.2
Manufacturing	10.0	10.0	9.8	10.1
Trade	34.9	34.3	32.7	32.5
Other services	13.3	11.7	12.5	12.4
Construction	4.9	4.6	5.5	5.8
Households	34.0	35.8	36.2	36.4
Liquidity				
Liquid assets to total assets	29.2	31.7	28.9	27.4
Deposits to loans	130.3	130.4	124.4	120.1
Liquid assets to short-term liabilities 3/	37.3	41.5	38.2	36.3
Profitability				
Return on average assets	2.6	2.3	2.5	2.1
Return on average equity	23.7	18.4	19.4	16.6
Interest margin to gross income	75.8	75.3	71.2	78.8
Non-interest expense to gross income	51.6	46.7	46.5	47.9
Market risk				
Net open currency position to tier 1 capital	1.8	4.4	1.2	1.0

Sources: Central Bank of the Republic of Kosovo

1/ 2018 as of September 2018. Calculations do not include the bank (BKP) in liquidation process.

2/ Loans classified as doubtful or loss.

3/ Short-term liabilities are deposits, short-term borrowing, and other liabilities (up to one year maturity).

Annex I. Implementation Status of the 2017 Article IV Recommendations

Areas	Recommendations	Status
Fiscal policy: Improve efficiency of spending and broaden revenue	**Mixed compliance**	
	Comply with the fiscal rule and diversify sources of financing	***Good compliance***. The 2018 budget is on track to meet the fiscal rule deficit and wage bill ceilings; and the bank balance has been kept above 4.5 percent of GDP (except for two months). PAK legislation was modified to allow it to invest in government securities.
	Contain current spending (reform social benefits; resist wage and benefit pressures)	***Weak compliance.*** Current spending is set to increase by ¾ percent of GDP this year, in part due to non-implementation of social benefit reforms, such as of the war veteran scheme. While the wage bill is expected to stay within the wage bill rule limit, wage hikes for high-level public officials absorbed the space for hiring in priority sectors such as the judiciary and health.
	Strengthen public investment framework; Increase IFI-financed investment	***Partial compliance***. Despite some progress, including the adoption of a roadmap for the National Development Strategy, and the definition of procedures for selection and classification of capital projects (adoption is pending resolution of technical issues), progress has been slow. To improve transparency in project selection, fiscal reporting, and multi-year commitments, existing tools and budget execution practices (PIP, KFMIS) need to be upgraded. Despite having widened NAO's mandate, no ex-post audits of major investment projects have been initiated. The absorption of donor-financed investment under the investment clause has been zero, though key bottlenecks around the staffing of PIUs and expropriation have largely been addressed.
	Strengthen tax administration, avoid new exemptions, and explore scope for additional revenue	***Partial compliance***. Implementation has been slow in key areas: performance management, return filing enforcement, debt management, and risk-based audit. New tax exemptions for IT and spare parts have been introduced. The VAT refund system was automatized with risk-based audits resulting in a sharp increase in the share of VAT refund requests processed (from 62 to claimed 90 percent) within the best practice benchmark of 30 days, though could be improved for exporters.
Improve labor productivity and reduce high unemployment	**Weak compliance**	
	Advance reforms to reduce skill mismatches	***Weak compliance***. Action plans and sector strategies to improve education and labor market outcomes have been adopted, but reforms to increase preschool enrollment rates, improve the quality of teaching staff, modernize curricula and textbooks, upgrade vocational education and training programs, strengthen accreditation and professional standards, and improve labor market intermediation remain at an early stage.

Areas	Recommendations	Status
	Keep minimum wage increases in check	***Partial compliance***. The rules-based minimum wage setting mechanism has been abolished by removing the preconditions and formula from the 2013 administrative instruction (SB under the 2012-13 SBA), clearing the way for large discretionary increases. Notwithstanding, so far the authorities have abstained from any increases.
Improve governance and business climate	**Mixed compliance**	
	Implement procurement and bankruptcy laws	***Partial compliance.*** While capacity constraints (staff/IT) delayed the rollout of e-procurement and wider use of centralized procurement, these are being addressed with the support of donors. Paper bids will no longer be allowed as of 2019. With 2 out of 5 members suspended on corruption charges, the functioning of the Procurement Review Body (PRB) is at risk. The new bankruptcy law has been underutilized, in part due to limited professional capacities, unawareness among firms, and weak claims enforcement.
	Strengthen effectiveness of the anti-corruption regime	***Partial compliance***. A new law on the prevention of conflict of interest in public functions has been adopted. Revisions to the criminal code extending the statute of limitations and penalties for corruption and organized crime charges and increasing the ban from public office for convicts are awaiting second reading in parliament. Draft laws on asset confiscation and the protection of whistleblowers have been submitted to parliament. However, revisions to the criminal procedures code strengthening provisions on search and confiscation, admissibility of evidence, and time limit for investigations have yet to be submitted to parliament. A package of laws to strengthen asset declaration and give more robust powers to the Anti-Corruption Agency is pending the findings of the ongoing functional review of the justice system.
	Restructure POEs and improve their governance	***Partial compliance***. A draft law on POEs has been prepared that aims to tighten governance of POEs and give the government as shareholder the tools to restructure POEs, remove board members, harmonize remuneration, etc. The responsible ministry is working with donors to design a restructuring plan to contain losses in the public telecommunication company and restore its medium-term viability.
Financial Sector: Access to credit	**Mixed compliance**	
	Reduce structural bottlenecks to lending	***Mixed compliance***. Broad-based credit growth in part reflects the easing of supply constraints as reforms make the claims enforcement system more effective. Yet, further steps are needed to strengthen contract enforcement and reduce information asymmetries.

Annex II. Risk Assessment Matrix [1/]

	Source of Risks and Relative Likelihood	Impact if Realized	Recommended Policy Response
Global Risks	High **Rising protectionism and retreat from multilateralism**	Medium / Low • Escalating trade tensions could dampen growth in Kosovo's trading partners, leading to reduced demand for exports and weaker investment, and translating in turn into lower domestic growth.	• Avoid erecting new trade barriers • Increase efforts to reach new trade agreements with key partners and become a WTO observer with the goal of becoming a WTO member in the medium term.
	High **Sharp tightening of global financial conditions**	Medium • Even though Kosovo does not have external market access, higher interest rates could increase financing pressures and cost of public debt by reducing demand for domestic government securities, mainly from foreign-owned banks.	• Strengthen public debt management and diversify sources of financing • Lengthen the maturity of public debt • Utilize IFI financing for infrastructure projects • Target a tighter fiscal position
	Medium **Weaker-than-expected global growth**	Medium / Low • Weaker growth in the Euro Area could reduce consumption and investment and increase the current account deficit through lower remittance/FDI inflows from the Diaspora.	• Adopt structural reforms that improve competitiveness • Reduce the dependency on remittances-financed domestic demand by increasing exports and domestic production
	High **Intensification of the risks of fragmentation/ security dislocation**	Low • The previous EU refugee crisis had no impact on Kosovo, as refugees sought resettlement in EU countries.	• Continue to monitor the situation and be ready to collaborate with the EU and neighboring countries to design and implement any response
Domestic Risks	High **Pressure on the budget from populist policies and ambitious revenue collection targets**	High / Medium • Proposed public sector wage and social benefits initiatives, especially if implemented concurrently, would undermine fiscal sustainability, budget composition and labor market incentives. • Gains from tax administration reforms included in the budget combined with potential changes to import VAT collection carry significant revenue risks.	• Restrain new and reform existing social benefits • Accommodate the reform of public administration and health insurance within the limits of the wage bill rule • Restructure POEs and strengthen their governance • Avoid further base erosion through new tax exemptions • Accelerate tax administration reforms
	High **Risks related to the construction of a new power plant**	High / Medium • Guarantees required under the contract and demanded by investors would increase government debt and crowd out space for donor-financed investment. Further, the current account deficit would widen due to the large import content of investment and labor. • On the upside, the construction would close the domestic energy supply gap and boost growth through investment (€1.2bn) and employment (10,000 jobs).	• Structure the project to ensure its financial viability and secure the most cost-effective solution • Ensure that the private sector carries the majority of risks, and any government guarantee should be consistent with public debt sustainability without crowding out other, priority IFI-financed investment • Keep government spending, if any, within the limits of the fiscal rule • Set tariffs at cost-recovery level and mitigate the impact of tariff increases on poor households by providing well-targeted transfers
	High / Medium **Political instability**	High / Medium • Renewed political instability could translate into slow reform progress and a deterioration in investor and consumer confidence that would depress economic activity. It could also create the platform for populist policies that could weaken the composition of the budget.	• Strengthen political credibility by moving forward with reforms that would promote job creation, and improve the business climate, including by strengthening governance, transparency and accountability. • Refrain from moving ahead with costly, untargeted initiatives.

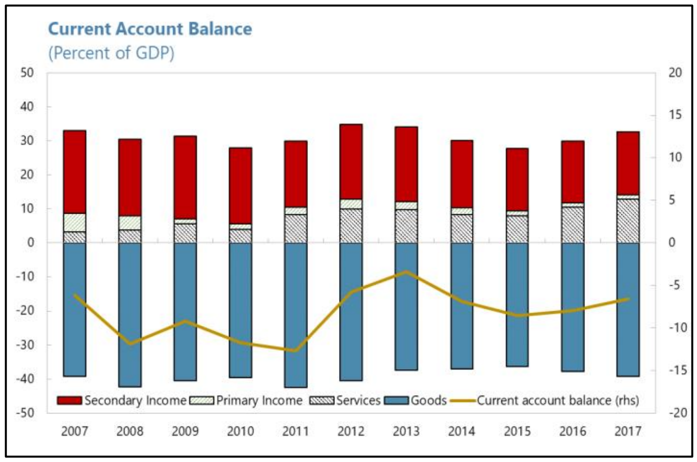
[1/] The Risk Assessment Matrix (RAM) shows events that could materially alter the baseline path. (The scenario most is likely to materialize in the view of IMF staff.) The relative likelihood is the staff's subjective assessment of the risks surrounding the baseline. ("Low" is meant to indicate a probability 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 III. External Sector Assessment

The EBA-Lite model results indicate that Kosovo's external position is moderately weaker than implied by fundamentals and desirable policy settings. Adjusting for Kosovo's specific circumstances, the current account gap is estimated at -1.9 percent and the real effective exchange rate is overvalued by 9.6 percent. This, combined with large trade deficits, low FDIs, low export market shares, high unemployment, and wage increases beyond productivity growth further indicate a competitiveness gap, even though some progress in regaining competitiveness has been made since the 2017 Article IV. Going forward, the priority is to accelerate the implementation of structural reforms, reduce the infrastructure gap, improve governance and the rule of law and raise labor market efficiency. Reserves—while the lowest in the region—have remained at a broadly adequate level depending on the measurement, including to deal with fiscal financing and bank liquidity shocks.

A. External Balance

1. Kosovo's current account deficit improved in 2017 but is expected to deteriorate in 2018. The current account deficit has narrowed to 6.4 percent of GDP in 2017, from 7.9 percent of GDP in 2016. Early signs of a higher current account deficit have emerged in the first half of 2018, owing to temporary weak exports due to the slowdown in metals production,[1] and strong imports growth. The current account deficit has increased by 11.4 percent year-on-year in January-July 2018.

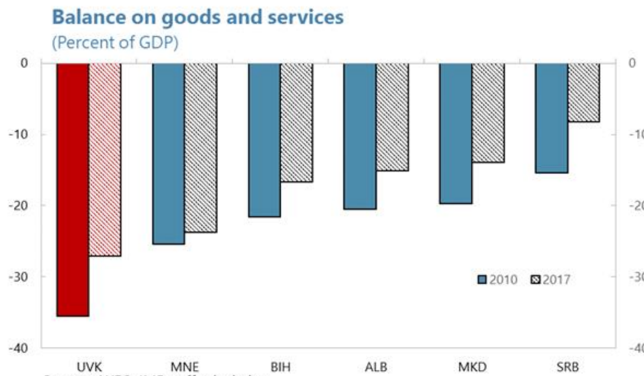


2. Kosovo's goods export performance has improved albeit from a very low base, while services exports have accelerated. Trade in goods has expanded in 2017, with exports up by 23 percent and imports by 9.4 percent. Because of larger volume of imports, the trade deficit in goods increased by 0.7 percentage points of GDP. The increase in exports was broad-based and included some traditional export products such as metals which have underperformed in recent years due to depressed global prices, but also new products such as fruits and beverages. Propelled by a surge in travel and tourism exports comprising 80 percent of total receipts, the services balance reached a surplus of 12.5 percent of GDP in 2017 compared to 7.9 percent of GDP in 2015. The positive trends in exports growth were somewhat reversed in January-July 2018, increasing the deficit in goods and services by 18.7 percent year-on-year. *As such, the trade deficit which stood at 25.9 percent of GDP in 2017 remains large, compared to the regional average of 13 percent.*

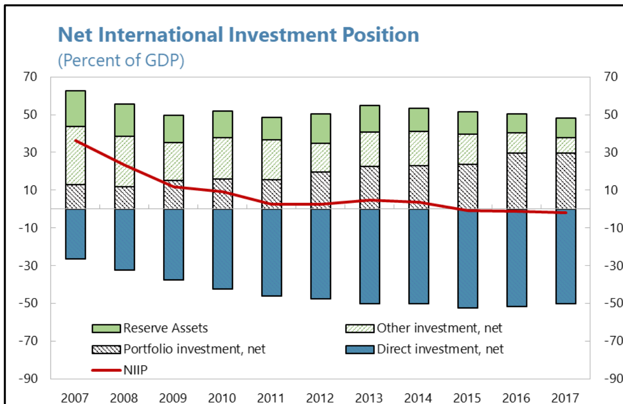
[1] The largest export company "New Co Ferronikeli" was bought by London-based 'NKL Limited' in July. During 2018 the company worked at low capacity and stopped production for two months.

3. The trade deficit has been funded by remittances and FDIs. Both recorded and unrecorded (included in errors and omissions) remittances have been at around 12–14 percent of GDP in the last 3 years, and a similar trend is expected in 2018. FDI inflows have reached 4.5 percent of GDP in 2017, up from 3.6 percent in 2016. However, FDI inflows have declined by 45 percent year-on-year in January-July 2018, driven by lower reinvestment of earnings and debt instruments.

4. The net international investment position (NIIP) continued to deteriorate. The NIIP, at -2 percent of GDP at end-2017, continued to deteriorate, driven by FDI inflows and external borrowing. Foreign liabilities reached 77 percent of GDP, with more than 70 percent of this stock comprising FDI liabilities. The rate of growth of the NIIP deficit is expected to continue as new IFI-financed investment projects accelerate.



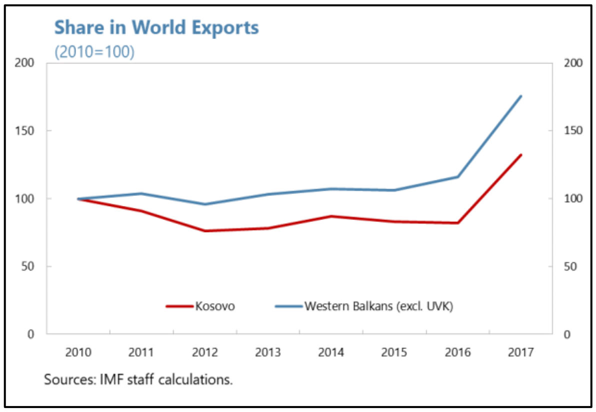
Sources: WEO, IMF staff calculation.



Source: IMF staff calculations.

B. Export and Labor Market Competitiveness

5. Kosovo's export shares show that further policy efforts are needed to create a supportive environment for investment in export sectors. Kosovo's export market share rose sharply in 2017, but relative to other Western Balkan countries remains low and has grown less quickly. In fact, Kosovo's export market share has declined since 2010 and remained stagnant between 2012 and 2016. It picked up in 2017, largely reflecting a strong demand from the EU and Western Balkan countries. The Western Balkan countries increasingly became an important destination market, accounting for almost half of Kosovo's exports (up from 35 percent in 2013), followed by the EU at 25 percent (down from 40 percent in 2013). *Nevertheless, Kosovo's export diversification has increased noticeably, especially across products, converging with the regional average. Increased diversification would help mitigate potential shocks emanating from a single product or trade partner.*



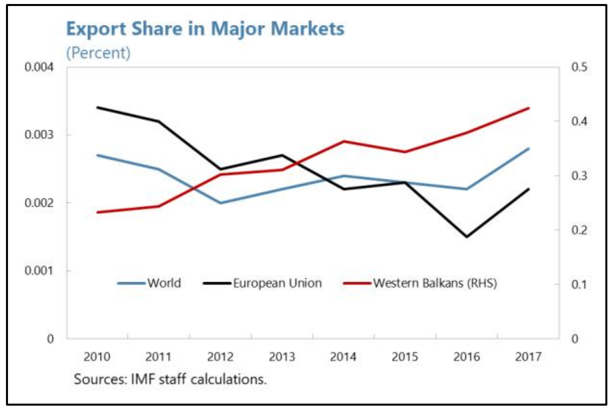


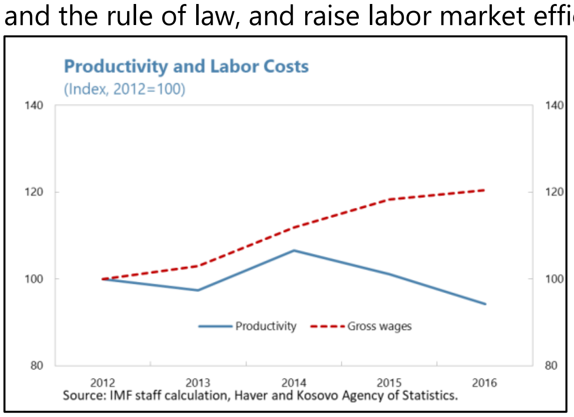
Table 1. Kosovo: Export Diversification

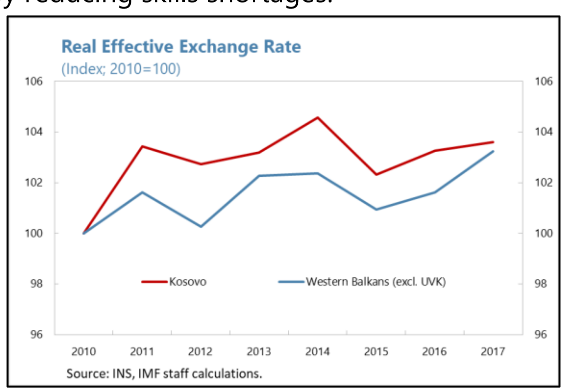
	Kosovo		Western Balkans	
	2010	2017	2010	2017
Diversification Index (across products)	2.8	1.8	1.7	1.8
Number of products	189	198	235	219
Diversification Index (across partners)	1.9	1.7	2	2.1
Number of partners	75	94	109	124

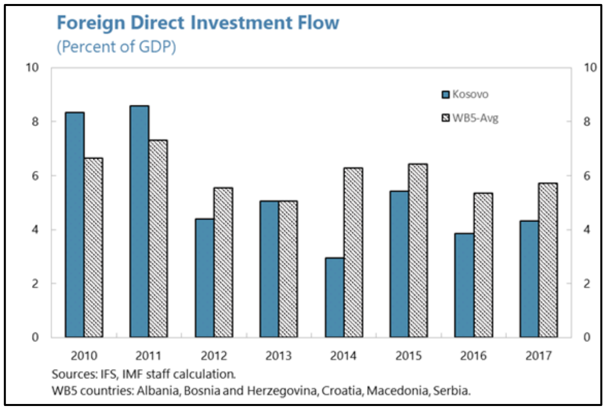
Notes : Higher index values indicate less diversification. The diversification index is constructed using disaggregated exports data at the SITC 3-digit level.

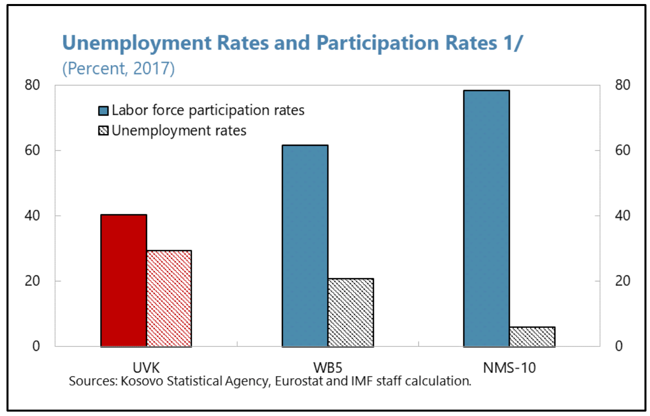
Sources : Kosovo Agency of Statistics, IMF staff calculations

6. Other indicators also raise competitiveness concerns. Since 2010, the REER has appreciated by 3.6 percent, which compares with the appreciation of 3.2 percent in other Western Balkan countries. Further, unemployment with about 30 percent is the highest in the region, and labor force participation rate with 40 percent the lowest. Despite this, monthly gross wages have continuously increased in the last five years and were not accompanied by corresponding increases in labor productivity. Finally, Kosovo continues to remain one of the least attractive countries for FDIs in the region. To address these gaps, the authorities should complete key infrastructure projects to reduce transportation costs and address energy sector reliability, improve governance and the rule of law, and raise labor market efficiency by reducing skills shortages.









C. Real Exchange Rate Assessment

7. To assess exchange rate competitiveness, the Fund's standard multilaterally consistent exchange rate assessment methodology is adjusted to Kosovo's specific circumstances. The assessment relies on two methodologies of the EBA-lite framework, the current account and external sustainability approaches.[2] 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.

8. The current account model of the EBA-lite framework suggests that the external position has improved but remains moderately weaker than implied by medium-term fundamentals and desirable policy settings. To assess Kosovo's external position, the EBA-lite Current Account model is adjusted to Kosovo's specific circumstances. In particular, the current account is adapted to include one-third of errors and omissions that are mainly associated with unrecorded remittances. The CA norm is estimated at -4 percent of GDP which implies a REER overvaluation of 9.6 percent (compared to an overvaluation of 15.2 percent in the 2017 Article IV assessment). The CA gap is therefore estimated at -1.9 percent of GDP, out of which 2.1 percentage points are attributed to the identified policy gaps resulting from fiscal policy (1.5 percent), private sector credit (0.4 percent) and reserves (0.3 percent) vis-à-vis medium term objectives.

Table 2. Kosovo: External Sector Assessment Summary
(In percent, except for elasticity)

	CA Norm	Adjusted Underlying CA	CA Gap	REER Gap
EBA-lite (CA approach)	-4	-5.9	-1.9	9.6
External Sustainability	-4.1	-5.9	-1.8	9
REER Elasticity	-0.2			

Source: Fund staff calculations.

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

9. The External Sustainability approach also indicates an external position moderately weaker than fundamentals. Given Kosovo's investment needs and the expectation of continued FDI inflows and IFI borrowing to finance priority infrastructure projects, a realistic benchmark is to stabilize the NIIP at around -45 percent of GDP in 2037. This is in line with the current level of Albania and Bosnia and Herzegovina, but well above the average regional level. Stabilizing the NIIP at -45 percent of GDP implies a CA norm of -4.1 percent of GDP and a real exchange rate overvaluation of 9 percent (compared to 12.4 percent in the 2017 Article IV assessment).

D. Reserve Adequacy Assessment

10. Kosovo's gross international reserves (GIR) are calculated using the information from the CBK balance sheet and the CBK survey. In particular, GIR are defined as the sum of nonresidents' currency and deposits, securities, monetary gold and SDR, reserve position in the Fund, and other items. Unlike the standard definition of GIR, the CBK applies a conservative approach by deducting the deposits of the Privatization Agency of Kosovo (PAK) and the Kosovo Pension Saving Trust (KPST) at the CBK from GIR, as it would not be desirable for CBK to utilize their deposits to tackle balance of payment needs and financial sector risks.

11. Against traditional rules of thumb, GIRs appear adequate. Standard rules of thumb suggest that reserves should cover at least three months of imports, 100 percent of short-term external debt, and 20 percent of broad money (M2). *GIR levels currently exceed these metrics comfortably and are comparable to other fully dollarized/euroized economies. However, using the more conservative definition of reserves that excludes PAK and KPST deposits, GIRs fall slightly short on one of these metrics and are borderline with respect to short-term debt and broad money.*

Table 3. Kosovo: Traditional Reserve Adequacy Metrics
(Based on end-2017 reserve levels)

	Target Level	UVK Actual	UVK Actual adjusted 1/	Montenegro	El Salvador
Import cover (months of next year's imports)	3	3.8	2.2	3.7	3.9
Reserves to short-term external debt (%)	100	181.5	106.2	285	137
Reserves to Broad Money (%)	20	39.3	23	35	28.6

Source: Fund staff calculations.

1/ Adjusted metrics use the more conservative definition of GIR that excludes PAK and KPST deposits at the CBK.

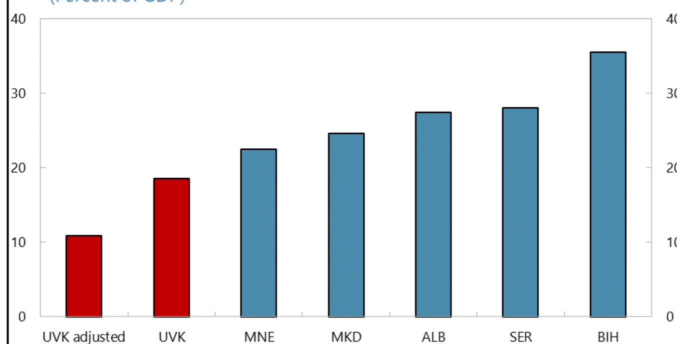
12. Kosovo's GIR are estimated to be broadly adequate using an IMF-developed multidimensional metric adjusted to fit Kosovo's circumstances, depending on the definition of GIR. The standard RA metric formula for an economy with fixed exchange rate (IMF, 2011, Assessing Reserve Adequacy, IMF Policy Paper) has been modified to reflect Kosovo's reliance on remittance inflows (R) in addition to export revenues, and to account for the risk of domestic capital outflows in a euroized economy by including total deposits (D):[3]

$$RA = 10\% (X+R) + 30\% STD + 15\% D + 20\% OPL,$$

where X is export revenues, STD is short-term external debt, BM is broad money and OPL is other external liabilities. Short-term external debt includes short-term external private debt, which covers short-term financial liabilities of deposit-taking corporations and other sectors, and short-term external public debt, which consists exclusively of the next year amortization. Other external liabilities include medium and long-term financial (debt and equity) liabilities of general government and other sectors.

The modified RA metric puts Kosovo's reserve adequacy at about 14 percent of GDP by end-2017. Gross international reserves reached 18 percent of the GDP in 2017 and are expected to decline to 17 percent in 2018. *Therefore, reserves are above the comfortable levels, covering 135 percent of the metric in 2017 and 127 percent (estimated) in 2018.[4] Using more conservative definition of GIR, reserves cover 79.2 percent of the metric in 2017 and 83.6 percent in 2018. By both standards, reserves in percent of GDP are the lowest in the region.*

Gross International Reseves, 2017
(Percent of GDP)



Sources: IFS, IMF staff calculations.

Table 4. Kosovo: Reserve Adequacy Metrics

	2015	2016	2017	2018	2019	2020	2021	2022	2023
GIR (millions of euros)	1245	1082	1168	1165	1114	1155	1220	1238	1245
Percent of RA modified metric	162	133.9	135.4	127.4	114.4	112.5	113.6	109.1	103.3
Adjusted GIR (millions of euros)	708	605	683	764	824	915	995	1027	1050
Percent of RA modified metric	92.1	74.9	79.2	83.6	84.6	89.1	92.6	90.5	87.1

Source: Fund staff calculations.

13. Kosovo has sufficient reserves to deal with fiscal financing and bank liquidity shocks. Since Kosovo is a unilaterally euroized economy, we also assess reserve adequacy for fiscal financing and bank emergency liquidity assistance (ELA).

[3] We increase the weight on total deposits from 10 to 15 percent to account for the fact that in a euroized economy the central bank has no lender of last resort capabilities.
[4] 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").

- A rule of thumb for the minimum size of fiscal reserves is one month of spending plus debt service (Wiegand, 2013) which in case of Kosovo implies a reserve buffer of around €180 million (3 percent of GDP). Actual fiscal reserves are well above this benchmark: end-2017 fiscal reserves (excluding bank ELA, which cannot be used by the government) were €246 million or 4 percent of GDP.

- The first line of defense against liquidity shocks in the financial system are banks' own liquid assets, which currently average around 40 percent of short-term liabilities. ELA reserves are comprised of CBK capital and the Treasury's deposit in the special reserve fund (SRF) for ELA and amount to around €100 million. For the two domestically owned banks, own liquid assets and ELA funds are near 100 percent of deposits in each bank, and they cover 65 percent of the combined deposits of both banks. Hence, the ELA reserves would be sufficient to withstand a very severe funding shock in the domestically owned banks.[5] Moreover, ELA reserves plus banks' own liquid assets cover more than 50 percent of total deposits in any of the large foreign subsidiaries which would be expected to also receive support from their parents when liquidity needs arise.

[5] Withdrawals of 20 percent of term deposits and 40 percent of demand deposits are considered a very severe funding shock. Such withdrawals would imply a decline of 30 percent of domestic banks' combined deposits.

Annex IV. Debt Sustainability Analysis

General government debt as a share of GDP remains within sustainable levels, but is on an upward trajectory, largely driven by high primary deficits to accommodate IFI financed infrastructure projects. Gross financing needs are increasing to more than 10 percent of GDP in the medium term despite further increases in the average maturity of the outstanding debt. Possible vulnerabilities result from the increasingly reduced capacity of the domestic market to absorb higher government debt, as Kosovo does not have external market access. Continued compliance with the fiscal rule remains the key anchor to preserve fiscal sustainability. Extending the maturity of debt and diversifying the sources of financing remain key policy priorities to contain financing risks.

A. Key Assumptions

1. The DSA analysis is fully consistent with the macroeconomic framework baseline. Growth is projected to be at 4 percent in 2018 and the medium term, slightly above the growth in 2013–17, on account of higher execution of infrastructure projects. 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 rule deficit ceiling throughout the projection period.

2. Public debt includes only general government debt and explicit guarantees issued by the government. Debt by POEs (estimated at around 5-7 percent of GDP) is not included, given the lack of detailed budgetary information. Contingent liabilities with respect to PAK financing (about 1.5 percent of GDP)[1] or any contingent liabilities associated with the possible development of the power plant project are also not included. The share of the domestic debt is almost two-thirds of total debt. The external public debt is largely owed to multilaterals, namely the IDA, EIB, EBRD and the IMF. Debt contracted under former Yugoslavia (which Kosovo does not recognize, or service) is not included in total debt, but treated as a contingent liability to be possibly discussed when relationships with Serbia normalize.

3. Financing assumptions. For domestic debt, the average maturity would gradually increase from 2.2 to 3.5 years, as the stock of short-term debt is projected to decrease from currently 15 percent of total debt to 3 percent, and as the maturity of medium and long-term debt would be gradually extended. IFI financing reflects the financial terms currently provided. Further, the privatization fund PAK would transfer some 286 million of earlier privatization proceeds to the budget over the years 2018-2020. Provisions made to maintain a prudent buffer of 4.5 percent of GDP in government deposits with the CBK would require additional financing of 1.4 percent of GDP over the projected period.

[1] This reflects potential legal obligations of PAK to reimburse claims related to privatization.

B. Public DSA

4. Under the baseline scenario, general government debt is projected to increase over the medium term but remain within sustainable levels. The debt stock is expected to increase from 16 percent of GDP in 2017 to 27 percent of GDP by 2023, assuming a rapid increase in absorption of IFI financing for new capital investments, particularly to implement regional connectivity projects within the Western Balkans Investment Framework context.

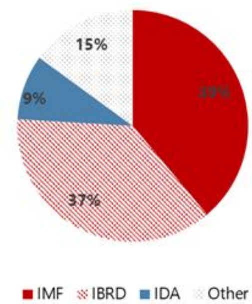
5. While gross financing needs would remain below the sustainability threshold, they are high. Gross financing needs are at 9.6 percent on average over the period 2018-2023, compared to 7.2 percent during 2013–2017, despite an assumed lengthening of maturity, given the increase in the public debt stock. Further, possible vulnerabilities may result from the increasingly reduced capacity of the domestic market to absorb higher government debt, as Kosovo does not have external market access. Therefore, efforts to increase the average maturity of domestic debt stock should continue. The government should also aim to diversify the sources of financing by expanding the investor base (to include more public entities, individuals, private businesses, and insurance companies, which currently hold less than 5 percent of the total domestic debt) while reducing the CBK holdings of government securities and without increasing the exposure limit for KPST to more than 30 percent of its assets. Simultaneously, other new instruments could be explored, such as retail or external bonds, provided Kosovo makes progress in reducing country risk and improves its international market access. Private financing of public infrastructure projects could offer an attractive option if well designed and supported by a sound PPP framework set in place to limit fiscal risks.

6. Additional standardized tests indicate that public debt is sensitive to contingent liability shocks. Should guarantees be requested for the new power plant project, this could lift debt above the 30 percent of GDP ceiling considered prudent for Kosovo. Similarly, contingent liabilities shocks associated with the POEs (modeled at 5 percent of GDP) and the financing of PAK (1.5 percent of GDP) would have a large impact on the debt profile. A materialization of the former-Yugoslav debt (estimated at 4.5 percent of GDP at the end–2017, but assumed to decline over time as Serbia would continue to service it) does not have a significant impact on the current debt path. The standard heat map and debt profile vulnerabilities analysis further suggest that public debt held by non-residents constitutes a limited vulnerability at the beginning of the forecast period, declining over time as the composition of debt increasingly shifts toward domestic debt (baseline scenario). The alternative scenarios of primary balances at the historical or 2017 level however show a more favorable debt profile since the baseline scenario assumes an increase in the primary deficit to accommodate higher investments to close the infrastructure gap.

C. External DSA

7. The external debt-to-GDP ratio is expected to remain stable at around 22 percent of GDP over the medium term. External public borrowing will increase from 6.3 percent of GDP in 2018 to 7.4 percent of GDP by 2023, on account of IFIs-financed investments, while external private borrowing is expected to remain at 14.5 percent of GDP. Most external public debt continues to be held by multilateral creditors (86 percent of total external public debt). About 60 percent of external public debt is denominated in euros, followed by SDRs (IMF and IDA loans). The large gross financing needs reflect the assumption that all private debt is of a short-term nature, as it largely consists of short-term credit from foreign parent banks.

External Public Debt by Creditor, 2017



8. External debt remains sustainable under a range of shocks. Standardized stress tests indicate that external debt is mainly sensitive to a current account shock. This scenario permanently increases the non-interest current account by one-half standard deviation in 2019–23 (around 1½ percent of GDP). In the absence of offsetting non-debt-creating flows, external debt increases by about 7 percentage points to 29 percent of GDP by 2023, and increases gross financing needs in 2023 by 4 percentage points of GDP relative to the baseline. This scenario highlights potential risks to the current account deficit such as, a sharp contraction in remittances and/or a drop in commodity exports. However, in the case of remittances any decline is expected to be largely offset by a contextual decline in imports.

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

(Percent of GDP unless otherwise indicated)

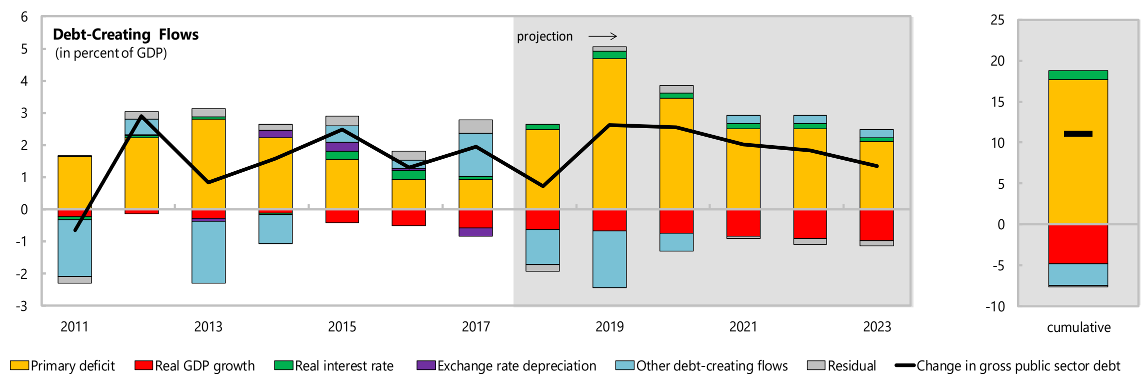
Debt, Economic and Market Indicators [1/]

	Actual			Projections					
	2011-2015 [2/]	2016	2017	2018	2019	2020	2021	2022	2023
Nominal gross public debt	9.2	14.3	16.3	17.0	19.7	22.2	24.2	26.1	27.4
Of which: guarantees	0.1	0.3	0.7	0.7	0.8	0.8	0.8	0.7	0.7
Public gross financing needs	5.7	7.6	6.4	8.3	10.8	10.8	10.3	8.7	8.6
Real GDP growth (in percent)	3.2	4.1	4.2	4.0	4.2	4.0	4.0	4.0	4.0
Inflation (GDP deflator, in percent)	2.4	0.4	1.4	1.3	1.0	1.6	1.8	1.9	2.1
Nominal GDP growth (in percent)	5.7	4.5	5.7	5.3	5.2	5.7	5.9	6.0	6.2
Effective interest rate (in percent) [4/]	3.0	2.6	2.2	2.4	2.5	2.6	2.7	2.7	2.7

As of November 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							
	2011-2015	2016	2017	2018	2019	2020	2021	2022	2023	cumulative	debt-stabilizing primary balance [10/]
Change in gross public sector debt	1.4	1.3	2.0	0.7	2.6	2.5	2.0	1.8	1.3	11.1	
Identified debt-creating flows	1.3	1.0	1.5	0.9	2.5	2.3	2.1	2.0	1.5	11.3	
Primary deficit [5/]	2.1	0.9	0.9	2.5	4.7	3.4	2.5	2.5	2.1	17.7	-0.6
Primary (noninterest) revenue and grants	25.4	26.3	26.2	26.0	26.8	26.2	26.0	25.7	25.4	156.1	
Primary (noninterest) expenditure [5/]	27.5	27.2	27.1	28.5	31.5	29.6	28.4	28.2	27.5	173.8	
Automatic debt dynamics [6/]	-0.1	-0.2	-0.7	-0.5	-0.4	-0.6	-0.7	-0.8	-0.9	-3.8	
Interest rate/growth differential [7/]	-0.2	-0.2	-0.5	-0.5	-0.4	-0.6	-0.7	-0.8	-0.9	-3.8	
Of which: real interest rate	0.0	0.3	0.1	0.2	0.2	0.2	0.2	0.2	0.1	1.0	
Of which: real GDP growth	-0.2	-0.5	-0.6	-0.6	-0.7	-0.7	-0.8	-0.9	-1.0	-4.8	
Exchange rate depreciation [8/]	0.1	0.1	-0.3	…	…	…	…	…	…	…	
Other identified debt-creating flows	-0.7	0.3	1.3	-1.1	-1.7	-0.6	0.3	0.3	0.3	-2.6	
Privatization/Own source revenues (+ reduces financing needs) (negative)	-0.5	0.1	0.1	-1.3	-2.0	-0.8	0.0	0.0	0.0	-4.0	
Contingent liabilities	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Increase in bank balance (+ increases financing needs)	-0.2	0.2	1.2	0.2	0.2	0.2	0.3	0.3	0.3	1.4	
Residual, including asset changes [9/]	0.1	0.3	0.4	-0.2	0.1	0.2	-0.1	-0.2	-0.2	-0.2	



Source: IMF staff.

1/ Public sector is defined as general government and includes public guarantees, defined as guaranteed loans and international loans subordinated by the Ministry of Finance to companies providing essential public services.

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/ Excludes PAK-related current expenditure.

6/ 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).

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

8/ The exchange rate contribution is derived from the numerator in footnote 6 as $ae(1+r)$.

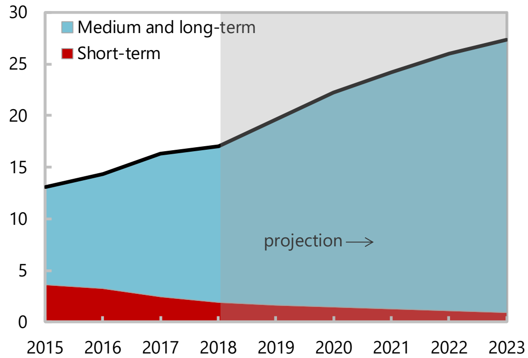
9/ Includes changes in the stock of guarantees, asset changes, and interest revenues (if any). For projections, includes exchange rate changes during the projection period.

10/ 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.

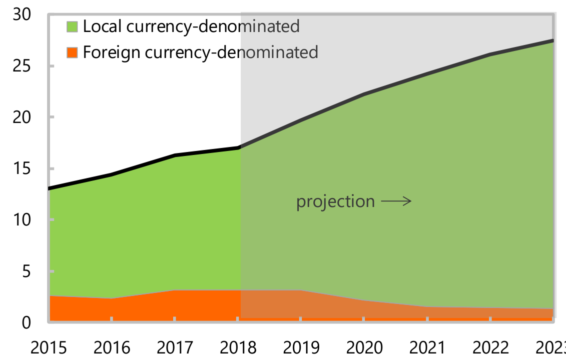
Figure 2. Kosovo: Public DSA — Composition of Public Debt and Alternative Scenarios

Composition of Public Debt

By Maturity
(in percent of GDP)



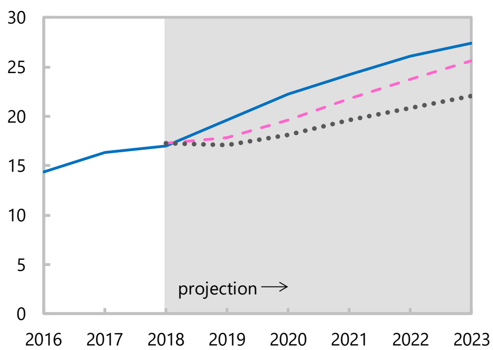
By Currency
(in percent of GDP)



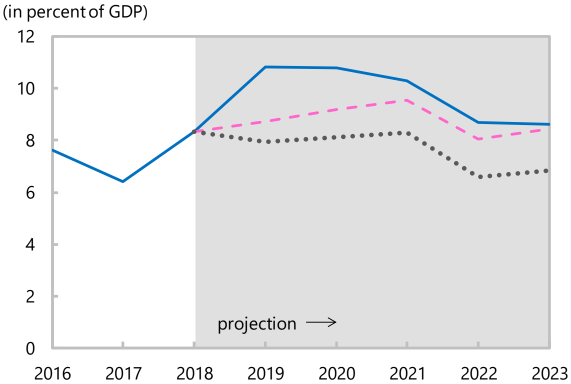
Alternative Scenarios

Baseline Historical Constant Primary Balance

Gross Nominal Public Debt
(in percent of GDP)



Public Gross Financing Needs
(in percent of GDP)



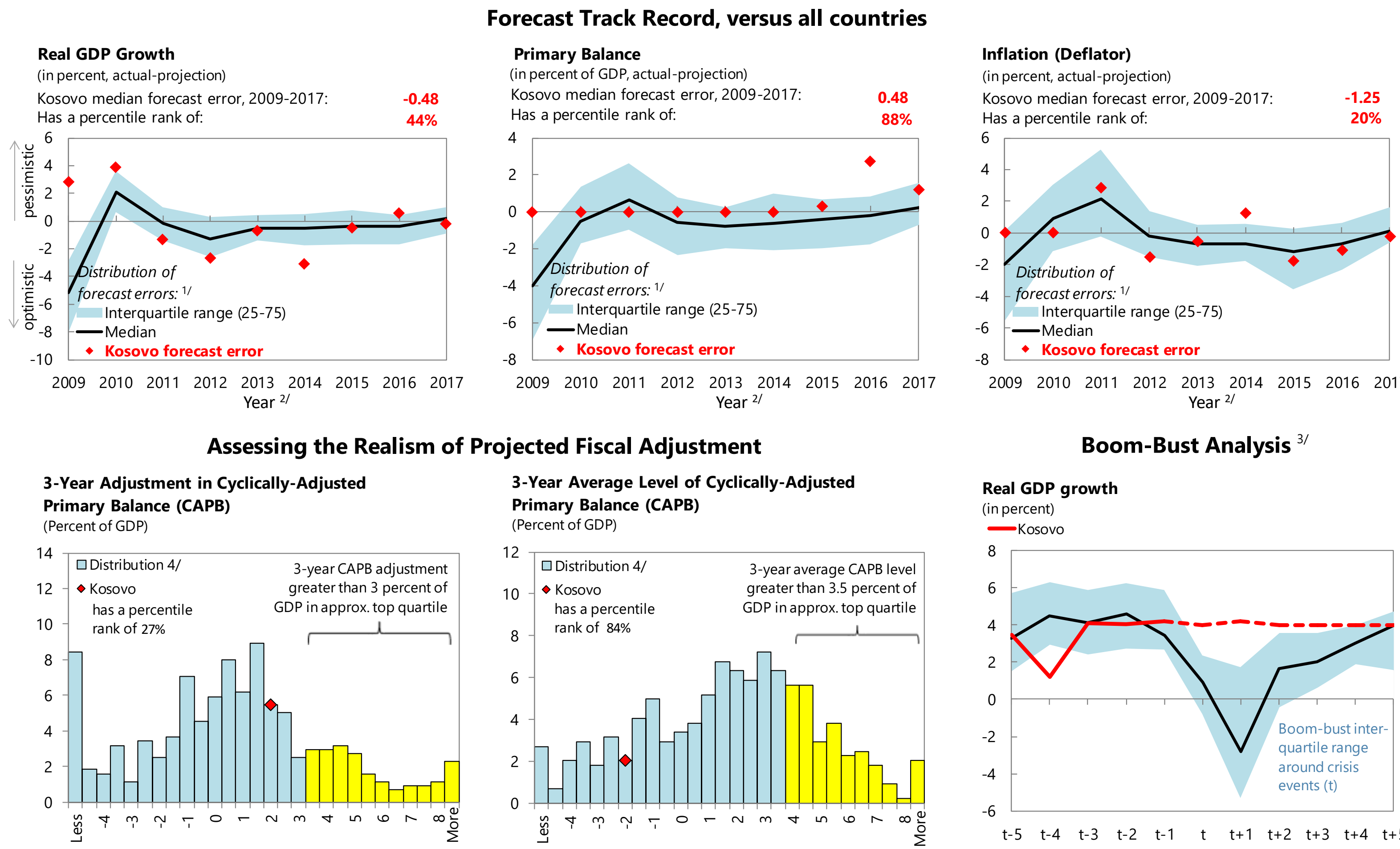
Underlying Assumptions
(in percent)

Baseline Scenario	2018	2019	2020	2021	2022	2023
Real GDP growth	4.0	4.2	4.0	4.0	4.0	4.0
Inflation	1.3	1.0	1.6	1.8	1.9	2.1
Primary Balance	-2.5	-4.7	-3.4	-2.5	-2.5	-2.1
Effective interest rate	2.4	2.5	2.6	2.7	2.7	2.7
Constant Primary Balance Scenario						
Real GDP growth	4.0	4.2	4.0	4.0	4.0	4.0
Inflation	1.3	1.0	1.6	1.8	1.9	2.1
Primary Balance	-2.5	-2.5	-2.5	-2.5	-2.5	-2.5
Effective interest rate	2.4	2.5	2.7	2.8	2.7	2.7

Historical Scenario	2018	2019	2020	2021	2022	2023
Real GDP growth	4.0	3.6	3.6	3.6	3.6	3.6
Inflation	1.3	1.0	1.6	1.8	1.9	2.1
Primary Balance	-2.5	-1.7	-1.7	-1.7	-1.7	-1.7
Effective interest rate	2.4	2.5	2.7	2.7	2.6	2.5

Source: IMF staff.

Figure 3. Kosovo: Public DSA — Realism of Baseline Assumptions



Source : IMF Staff.

1/ Plotted distribution includes all countries, percentile rank refers to all countries.

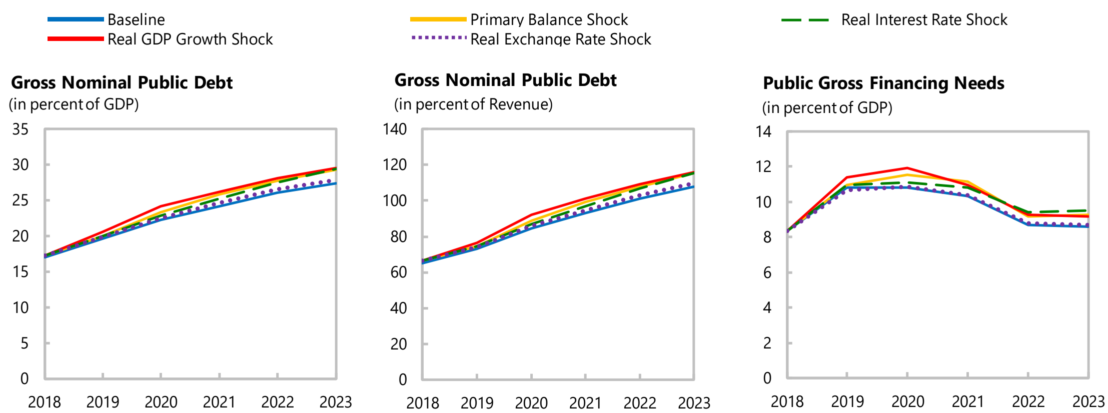
2/ Projections made in the spring WEO vintage of the preceding year.

3/ Kosovo has had a positive output gap for 3 consecutive years, 2015-2017. For Kosovo, t corresponds to 2018; for the distribution, t corresponds to the first year of the crisis.

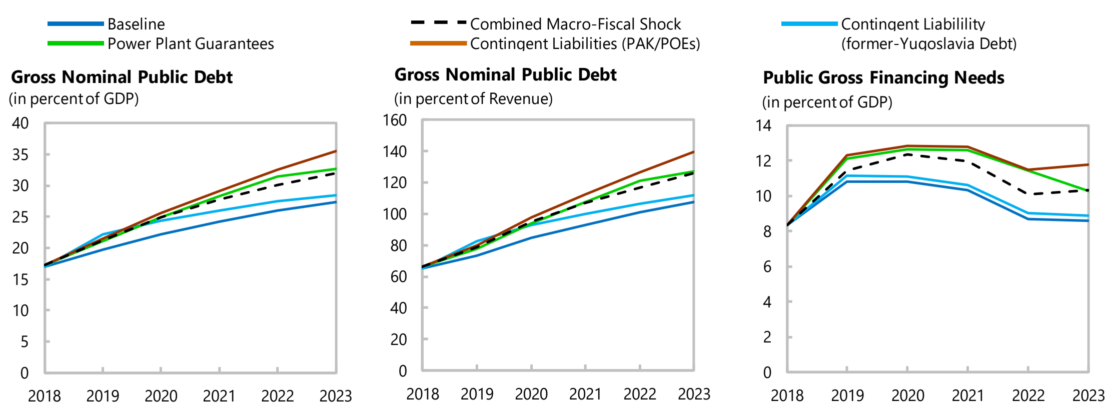
4/ Data cover annual obervations from 1990 to 2011 for advanced and emerging economies with debt greater than 60 percent of GDP. Percent of sample on vertical axis.

Figure 4. Kosovo: Public DSA — Stress Tests

Macro-Fiscal Stress Tests



Additional Stress Tests



Underlying Assumptions
(in percent)

Primary Balance Shock	2018	2019	2020	2021	2022	2023
Real GDP growth	4.0	4.2	4.0	4.0	4.0	4.0
Inflation	1.3	1.0	1.6	1.8	1.9	2.1
Primary balance	-2.5	-4.7	-4.1	-3.0	-2.5	-2.3
Effective interest rate	2.4	2.5	2.6	2.8	2.7	2.7
Real Interest Rate Shock						
Real GDP growth	4.0	4.2	4.0	4.0	4.0	4.0
Inflation	1.3	1.0	1.6	1.8	1.9	2.1
Primary balance	-2.5	-4.7	-3.4	-2.5	-2.5	-2.1
Effective interest rate	2.4	2.5	3.6	4.2	4.4	4.5
Combined Shock						
Real GDP growth	4.0	3.2	3.0	4.0	4.0	4.0
Inflation	1.3	0.7	1.4	1.8	1.9	2.1
Primary balance	-2.5	-5.1	-4.2	-3.0	-2.5	-2.3
Effective interest rate	2.4	2.6	3.5	4.1	4.4	4.5
Power Plant Guarantees						
Real GDP growth	4.0	4.5	4.7	4.5	4.7	4.7
Inflation	1.3	1.3	1.9	2.1	2.2	2.4
Primary balance	-2.5	-5.9	-4.6	-3.7	-3.7	-1.8
Effective interest rate	2.4	2.5	3.6	4.2	4.5	4.6

Real GDP Growth Shock	2018	2019	2020	2021	2022	2023
Real GDP growth	4.0	3.2	3.0	4.0	4.0	4.0
Inflation	1.3	0.7	1.4	1.8	1.9	2.1
Primary balance	-2.5	-5.1	-4.2	-2.5	-2.5	-2.1
Effective interest rate	2.4	2.5	2.7	2.8	2.7	2.7
Real Exchange Rate Shock						
Real GDP growth	4.0	4.2	4.0	4.0	4.0	4.0
Inflation	1.3	6.0	1.6	1.8	1.9	2.1
Primary balance	-2.5	-4.7	-3.4	-2.5	-2.5	-2.1
Effective interest rate	2.4	2.6	2.6	2.7	2.6	2.7
Contingent Liability (former-Yugoslavia debt)						
Real GDP growth	4.0	4.2	4.0	4.0	4.0	4.0
Inflation	1.3	0.7	1.4	1.8	1.9	2.1
Primary balance	-2.5	-4.7	-3.4	-2.5	-2.5	-2.1
Effective interest rate	2.4	2.5	2.6	2.7	2.7	2.7
Contingent Liabilities (PAK/POEs)						
Real GDP growth	4.0	3.2	3.0	3.0	3.0	3.0
Inflation	1.3	1.0	1.6	1.8	1.9	2.1
Primary balance	-2.5	-4.7	-3.4	-2.5	-2.5	-2.1
Effective interest rate	2.4	2.5	2.7	2.8	2.9	2.9

Source: IMF staff.

Figure 5. Kosovo: Public DSA Risk Assessment

Heat Map

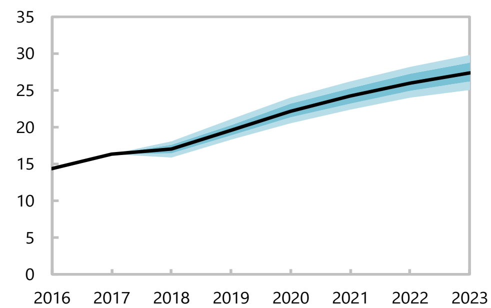
Debt level 1/	Real GDP Growth Shock	Primary Balance Shock	Real Interest Rate Shock	Exchange Rate Shock	Contingent Liability shock (PAK/POEs)
Gross financing needs 2/	Real GDP Growth Shock	Primary Balance Shock	Real Interest Rate Shock	Exchange Rate Shock	Contingent Liability Shock (PAK/POEs)
Debt profile 3/	Market Perception	External Financing Requirements	Change in the Share of Short-Term Debt	Public Debt Held by Non-Residents	Foreign Currency Debt

Evolution of Predictive Densities of Gross Nominal Public Debt

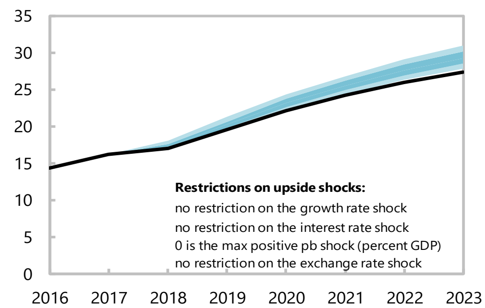
(in percent of GDP)

Baseline Percentiles: 10th-25th 25th-75th 75th-90th

Symmetric Distribution



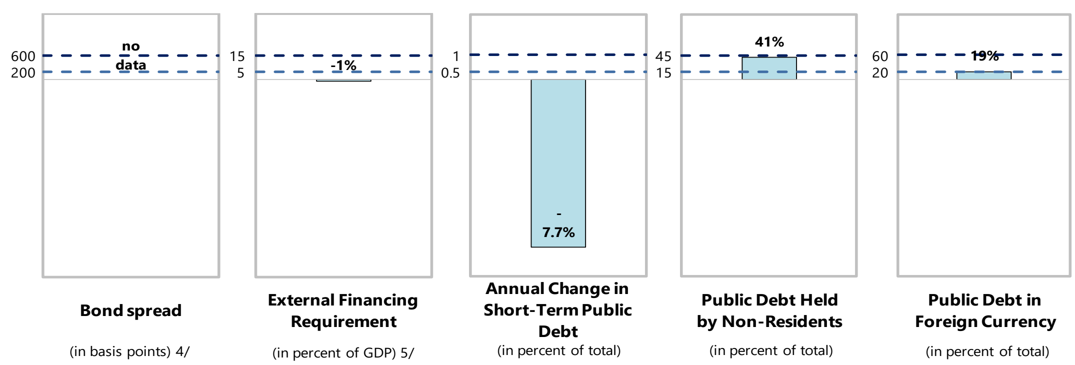
Restricted (Asymmetric) Distribution



Debt Profile Vulnerabilities

(Indicators vis-à-vis risk assessment benchmarks, in 2017)

Kosovo Lower early warning Upper early warning



Source: IMF staff.

1/ The cell is highlighted in green if debt burden benchmark of 70% is not exceeded under the specific shock or baseline, yellow if exceeded under specific shock but not baseline, red if benchmark is exceeded under baseline, white if stress test is not relevant.

2/ The cell is highlighted in green if gross financing needs benchmark of 15% is not exceeded under the specific shock or baseline, yellow if exceeded under specific shock but not baseline, red if benchmark is exceeded under baseline, white if stress test is not relevant.

3/ The cell is highlighted in green if country value is less than the lower risk-assessment benchmark, red if country value exceeds the upper risk-assessment benchmark, yellow if country value is between the lower and upper risk-assessment benchmarks. If data are unavailable or indicator is not relevant, cell is white.
Lower and upper risk-assessment benchmarks are:

200 and 600 basis points for bond spreads; 5 and 15 percent of GDP for external financing requirement; 0.5 and 1 percent for change in the share of short-term debt; 15 and 45 percent for the public debt held by non-residents; and 20 and 60 percent for the share of foreign-currency denominated debt.

4/ Long-term bond spread over German bonds, an average over the last 3 months, 03-Aug-18 through 01-Nov-18.

5/ External financing requirement is defined as the sum of current account deficit, amortization of medium and long-term total external debt, and short-term total external debt at the end of previous period.

Table 1. Kosovo: External Debt Sustainability Framework, 2015–2023

(In percent of GDP, unless otherwise indicated)

	Actual					Projections						
	2015	2016	2017			2018	2019	2020	2021	2022	2023	**Debt-stabilizing non-interest current account 6/**
Baseline: External debt	18.6	18.9	21.2			**20.8**	**21.6**	**21.8**	**21.7**	**21.9**	**21.9**	**-4.2**
Change in external debt	1.6	0.3	2.2			-0.4	0.8	0.2	-0.1	0.2	0.0	
Identified external debt-creating flows (4+8+9)	4.3	4.2	1.4			4.1	4.4	4.0	3.2	3.2	2.8	
Current account deficit, excluding interest payments	8.4	7.8	6.3			6.7	8.1	7.7	7.0	6.9	6.5	
Deficit in balance of goods and services	28.5	27.2	25.9			28.7	29.6	29.2	28.5	28.0	27.4	
Exports	21.9	23.7	26.7			26.1	26.5	26.9	27.3	27.4	27.6	
Imports	50.4	50.9	52.5			54.8	56.1	56.1	55.7	55.4	55.0	
Net non-debt creating capital inflows (negative)	-4.7	-2.9	-3.9			-2.1	-3.1	-3.1	-3.1	-3.0	-3.0	
Automatic debt dynamics 1/	0.6	-0.6	-0.9			-0.6	-0.7	-0.7	-0.7	-0.7	-0.7	
Contribution from nominal interest rate	0.2	0.2	0.2			0.2	0.2	0.2	0.1	0.1	0.1	
Contribution from real GDP growth	-0.8	-0.7	-0.7			-0.8	-0.8	-0.8	-0.8	-0.8	-0.8	
Contribution from price and exchange rate changes 2/	1.2	-0.1	-0.4			...	...	...	...	...	...	
Residual, incl. change in gross foreign assets (2-3) 3/	-2.6	-3.9	0.8			-4.5	-3.6	-3.7	-3.4	-3.0	-2.8	
External debt-to-exports ratio (in percent)	84.9	79.9	79.4			79.8	81.5	81.1	79.5	79.9	79.1	
Gross external financing need (in millions of EUR) 4/	1287	1241	1184			1380	1636	1724	1759	1814	1872	
in percent of GDP	20.0	18.5	16.4			17.2	19.7	19.4	18.5	17.9	17.3	
Scenario with key variables at their historical averages 5/				10-Year Historical Average	10-Year Standard Deviation	**20.8**	**20.2**	**18.9**	**18.4**	**18.2**	**18.3**	**-5.9**
Key Macroeconomic Assumptions Underlying Baseline												
Real GDP growth (in percent)	4.1	4.1	4.2	3.6	1.0	4.0	4.2	4.0	4.0	4.0	4.0	
GDP deflator in EUR (change in percent)	-16.3	0.2	3.4	1.1	8.7	6.4	-0.4	3.0	2.4	2.8	2.5	
Nominal external interest rate (in percent)	0.9	1.0	1.0	0.9	0.4	0.9	0.8	0.7	0.6	0.5	0.4	
Growth of exports (in percent)	-15.1	12.6	21.2	10.8	14.6	8.2	5.6	8.7	8.0	7.5	7.4	
Growth of imports (in percent)	-14.3	5.3	11.2	5.2	12.8	15.4	6.2	7.1	5.9	6.3	5.8	
Current account balance, excluding interest payments	-8.4	-7.8	-6.3	-8.3	3.0	-6.7	-8.1	-7.7	-7.0	-6.9	-6.5	
Net non-debt creating capital inflows	4.7	2.9	3.9	5.4	2.2	2.1	3.1	3.1	3.1	3.0	3.0	

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).

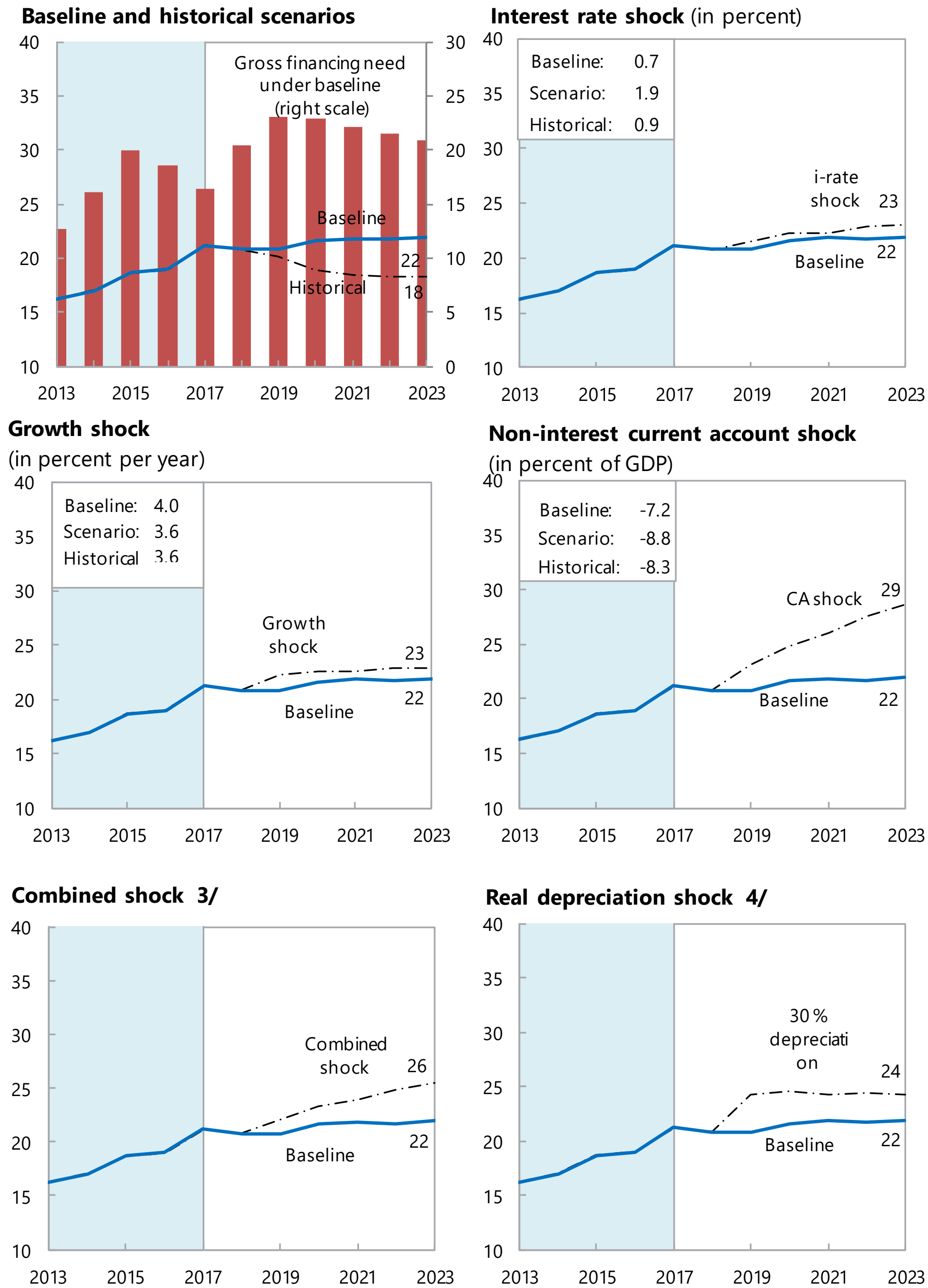
3/ For projection, line includes the impact of price and exchange rate changes.

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 6. Kosovo: External Debt Sustainability Bound Tests 1/ 2/
(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 are applied to interest rate, growth rate, and current account balance.
4/ One-time real depreciation of 30 percent occurs in 2019.

Annex V. Governance Challenges Facing Kosovo

Vulnerabilities in the fiscal institutional framework (tax policy, revenue administration, procurement, public investment, POEs, etc.) hamper effective revenue collection and reduce the efficiency and efficacy of government spending, thus reducing fiscal space for priority pro-growth spending within a sustainable fiscal envelope. Similarly, despite recent improvements in qualitative indicators, the perception of weak rule of law (investor protection, property rights, contract enforcement) and a large informal economy continue to deter private sector investment and create an uneven playing field amongst businesses, thus negatively affecting economic growth. Furthermore, the institutional framework to effectively fight high level corruption—a key milestone in the EU accession process—remains weak.

This annex identifies the principal macro-critical governance challenges facing Kosovo. It provides for each area (i) indicators of inefficiencies that could be related to governance and presents why addressing them is macro-critical; (ii) an assessment of the institutional weaknesses that give rise to governance concerns and increase vulnerabilities to corruption; and (iii) key recommendations on how to address them.

A. Fiscal Governance

Tax Expenditures

Issues:

The current tax laws allow for targeted discretionary tax expenditures (such as tax exemptions under the VAT law, and tax breaks and other incentives under the CIT/PIT laws) and some flexibility in implementing the reduced VAT rate, that can be exercised in secondary legislation.[1]

Exemptions weaken the neutrality of the VAT system, distort production decisions, and take companies out of the VAT net, which is at odds with the objective of formalizing business activity. Similarly, exemptions and incentives provided under the income tax may lead to important revenue losses and inefficiencies.

Institutional Weaknesses:

Some eligibility criteria for tax exemptions and incentives are relegated to secondary legislation and not anchored in the primary legislation, leaving *de jure* discretion for the Minister of Finance. The use of this discretion has *de facto* been limited, in part because secondary legislation generally

[1] The VAT law leaves to secondary legislation discretionary powers over VAT exemptions on imports (Art. 29.3), expanding/reducing list of reduced-rate products (Art. 26.3) but only within the list set out under Annex III of the VAT law, and expanding/reducing the list of exemptions in the public interest (Art. 27.3). Similarly, the CIT and PIT laws allow tax breaks and other incentives to be defined in secondary legislation issued by the Minister (Art. 7.4, and respectively, Art. 8.1.27).

requires a public consultation process and a fiscal impact assessment (though not consistently enforced). A broad range of key tax policy decisions, such as, which goods and services under the list set out in the law are subject to the reduced VAT rate or benefit of import VAT exemptions are regulated by ministerial decisions. Names of beneficiaries of tax expenditures are currently published,[2] but their costs are not regularly published. Studies are conducted internally, but there is currently no requirement for a consistent policy gap/tax expenditure assessment that can be used to evaluate whether the incentives are achieving the intended purpose.

Key Recommendations:

- Regulate all tax expenditures in primary legislation, with clear criteria; and avoid the introduction of new tax expenditures and rationalize existing ones.
- To increase transparency of the policy making process and keep lobbying in check, strengthen the enforcement of the public consultation procedures, including by publishing all the underlying documentation and justification for and fiscal impact assessment of any changes to the tax code.
- Continue to publish comprehensive lists of beneficiaries and the specific criteria under which they have qualified.
- As part of the annual budget, present a report of tax expenditures arising from exemptions and reduced rates as well as any other types of tax incentives given to businesses and households.[3]
- Every two to three years, review the costs and benefits of selected tax expenditures and if their beneficiaries still meet the qualification criteria.

Revenue Administration

Issues:

The low domestic tax collection reflects not only high import dependency, but also a large tax gap and scope for significant improvements in tax collection efficiency. The World Bank in 2014 found that an estimated VAT gap of 34 percent of GDP was attributed largely to low VAT collection from domestic suppliers; and that the PIT gap was three times what was collected at that time (World Bank 2014). A 2017 EU-funded study estimated the size of Kosovo's informal economy at 31.7 percent – showing a small reduction from a similar 2015 study (BSE 2017). The ratio of tax arrears to annual tax revenue collections is almost three times higher than the international good practice benchmark and debt collection is weak with no monitoring of the net debt stock to

[2] For instance, the 2017 Annual Report of TAK reports a list of businesses that have benefited from VAT exemptions on raw materials and IT equipment.

[3] The majority of EU countries submit detailed tax expenditure reports with their annual budget documents (EC 2014).

accurately measure tax debt collection. A shift to a more risk-based approach for VAT refunds started in June 2018 with faster refunds, and implementation is ongoing.[4] New sub-legal acts and a recently established electronic tracking system have improved the refund process – though with scope for further easing requirements for exporters, and as of end-August 2018, the authorities claimed that 90 percent of VAT refund claims were paid out within the international good practice benchmark of 30 days, an improvement from 62 percent in 2017. While there have been incremental changes, there are problems in maintaining the accuracy of the taxpayer register. Some new tax services have been introduced and e-filing is widely used.

Strengthening the tax administration is macro-critical to support revenue collection to create space for productive spending within the limits of the fiscal rule, to reduce the costs of doing business, and to create a level playing field across all taxpayers.

Institutional Weaknesses:

- Ministry of Finance (MoF) oversight over the tax administration and customs currently mainly focuses on nominal revenue collections. Beyond a nominal revenue collection target, there is no performance plan set by the Minister for TAK and customs that would provide more comprehensive guidance on government expectations and help the Minister execute better-informed and transparent oversight of revenue administration.

- TAK headquarter oversight over local offices is ineffective. As local offices are relatively small and responsible for most tax administration functions, their performance quality is affected by insufficient specialized skills and capacity to deal with more complex cases. Heads of local tax offices have relatively high discretion over directing work of their staff, increasing risk for non-transparent decision-making.

- Resources are not properly aligned with needs. In 2017, 38 percent of field staff were responsible for over 80 percent of the overall annual tax collections. During the same year, TAK performed 1,444 tax audits and assessments resulting in €53 million and 37,240 compliance visits yielding €1.6 million.

- Audit procedures are weak. Only some 70 percent of audit cases are selected at the central level, based on risk analysis, many of which are subsequently reviewed in the regional tax offices and not submitted to tax audit. A large proportion of field resources is allocated to low-value compliance visits instead of tax audits. The number of different verification checks (visits) is very high and the outcome of such checks is not measured.

- Debt enforcement is too widely distributed across all regional offices, and the effectiveness of collections varies and is prone to collusion with taxpayers, especially when debt notices are hand-delivered by the inspectors processing the debt case. Debt collection and enforcement

[4] The authorities claim that only refund requests from high-risk taxpayers are being audited, and deadlines for reimbursement have been shortened (7 days for low-risk taxpayers, 21 days for medium-risk taxpayers, and 30 days for high-risk taxpayers).

processes have not been sufficiently automated and systematized and there is a reluctance to write off debts that have passed statute of limitations as allowed by the law. The lack of a centralized stock and flow database makes measurement of tax debt collection challenging.

- While the VAT refund process has lessened refund time, exporters are still required to have a credit status for three consecutive months to qualify for a refund.
- Tax payers are not sufficiently informed of policy and regulatory changes by TAK and customs.

Key Recommendations:

- Set publicly available quantitative and strategic performance targets for TAK and customs and regularly publish outcomes.
- Develop a comprehensive reporting and analysis framework that informs how TAK and customs operational resources are allocated and measures their impact.
- Redesign work processes to ensure strong management control guided by four eyes principle[5] is applied over operational decisions like assessment of additional tax during audit and verification, selection of taxpayers for audits and checks, applying penalties, etc.
- Align resource allocation to compliance risk and workload by consolidating TAK offices, rationalizing overhead, and reassigning staff in line with needs. Further, improve the VAT refund process, particularly by shortening the credit-refund period for exporters.
- Improve field verifications of VAT refunds so that they are narrowly focused on risks related to VAT refund and completed quickly.
- Significantly scale up tax debt collection and ensure equal treatment, including by automatizing and systematizing collection processes into a single national office, and writing-off uncollectible debts based on transparent criteria.
- Improve public information campaign for individuals and businesses of existing TAK and customs policies, laws, and regulations, including any changes.

Public Procurement

Issues:

Kosovo adopted a new Law on Public Procurement in 2016 to strengthen the procurement process by tightening governance criteria, but implementation remains slow.

[5] The four-eyes principle means that a certain activity, i.e. a decision, transaction, etc., must be approved by at least two people.

Full implementation of the procurement reform is macro-critical to reduce costs and improve the quality of public spending within the limits of the fiscal rule.

Institutional Weaknesses:

- Criteria for contract awards do not consider the *best price-quality ratio* and full product life-cycle costs criteria. As such, 98 percent of public contracts were awarded in 2017 according to the lowest-price criterion, rather than best price-quality ratio.

- The rollout of e-procurement has been delayed to end-2018/beginning 2019. Since January 2017, the use of *e-procurement* has been mandatory for all contracting authorities, while still allowing for a parallel hard copy system. Since July 2018, all centralized procurement requires electronic submission and since September 2018, all high value contracts of all contracting authorities require electronic submission. While most modules of the e-procurement system are currently in place, including e-tendering, which is the core module, monitoring of contract management, e-auctioning and e-reverse auctioning have not yet been implemented.

- The implementation of *centralized procurements* has also been facing some obstacles. Centralized procurement is mandatory for all items on the list issued by the MoF and applies to agencies accountable to the Assembly with fewer than 50 employees. Starting July 5, 2018, all procurement by the Central Procurement Agency (CPA) is done electronically. However, the list of goods in value terms, accounts for about 10 percent of total public procurement (2016 – AG report).[6] In 2018 there are significant delays in the procurements performed by the CPA, partly because the administrative instructions on centralized procurement were issued only in April 2018, with a delay of more than 3 months.

- *Oversight* remains weak, with the Procurement Review Body (PRB) not fully staffed. Currently, its board functions only with 3 out of 5 members after two members were suspended in June 2017 on corruption charges.

Key Recommendations:

- Implement the remaining e-procurement modules.

- Widen the coverage of centralized procurement to include more economically meaningful goods and services and improve value for money, and back this up by a significant increase in the CPA's staff and other resources.

- Fully transpose the EU criteria for price-quality rules in awarding contracts.

- Strengthen the functioning of PRB by filling vacancies in the Board should they arise (remove suspended board members following conviction or after a certain time limit) and improve

[6] The latest list adopted on April 13, 2018 did not expand the list of goods significantly.

transparency and accountability in decision making (including by fast-tracking the implementation of the e-procurement module on bid protests).

Publicly-Owned Enterprises (POEs)

Issues:

Public services (energy, telecom, railway and bus transport, water supply, sewage and waste) are managed by 16 non-financial central level and 44 local level POEs, which account for around 5 percent of GDP in terms of revenue and employ around 11,000 people (3.1 percent of total employment). Overall, 8 of the 16 central level companies have accounting losses, and dividend payments from the others to the budget have been zero since 2015. POE debt amounts to approximately 5 percent of GDP, presenting a contingent liability for the state. Excessive employment and wages burden the companies' balance sheets, while significant under-investment in capital (0.2 percent of GDP in 2017), raises concerns about their medium-term viability. Financial management and control are weak, with all 9 POEs audited by the Auditor General in 2017 receiving a modified opinion (NAO 2017).

Improving the economic efficiency of POEs is macro-critical to ensure that public services are being delivered in the most cost-efficient way to reduce the costs of doing business, as well as to limit any contingent liabilities to the state.

Institutional Weaknesses:

- Financial management and oversight of the POEs is weak as assessed in the 2016 PIMA and the 2017 Auditor General's report. Weaknesses include: delays and inaccuracies in financial reporting, difficulty to follow up on project costs and implementation progress, weak management of risks due to the lack of strategic documents, minimal managerial accountability, and an absence of guidelines or standard procedures for oversight and monitoring of POEs.

- Coordination between the Ministry of Economic Development (MED) and the MoF to assess fiscal risks is limited. Procedures for inter-ministerial coordination for monitoring POEs could be improved and the key documents (e.g. MTEF and budget) lack detailed information on POE fiscal risks.

- MED's POE Policy and Monitoring Unit does not publish in a timely fashion detailed information that would facilitate the budget process. Consolidated reports have limited financial and no fiscal risk discussion. Annual reports and audited financial statements are often published with long lags. There are no clear deadlines for the publishing of audited financial statements, and publication has often been delayed due to board vacancies and related lack of quorum.

- The MoF has no substantial role in oversight.

- Debt issuance by POEs neither requires government approval nor is monitored at the central level.

- The independence of POE boards could be improved, many are overstaffed, and performance management is weak.

- There is no robust process in place to require POEs to undertake financial or operational reforms, though the draft POE law seeks to address these weaknesses.

Key Recommendations:

- Enshrine the oversight of financial risks posed by POEs as one effective joint function of the MoF and MED. Clearly differentiate oversight from ownership function and establish the necessary coordination mechanisms with line ministry to perform both. Codify regular coordination of the inter-ministerial committee on POEs, such as by systematically sharing documentation and data.

- Improve the quality and timeliness of the POE Monitoring Unit's reports by increasing the focus on financial and fiscal risks analysis, and ensuring such information is available for the budget process.

- Enforce timely production by POEs of annual, bi-annual, quarterly, and monthly financial and operational statements compliant with international accounting standards and audited externally by reputable companies, and following financial standards approved by the MoF.

- Include the review and approval of annual financial plans, financial statements, requests for financial support, and any debt issuance of POEs under the oversight function of the MoF for fiscal and financial assessment. The MoF should be given a clear legal mandate to analyze such data, propose limits on and approve issuance of POE debt and guarantees,[7] and to disclose related fiscal risks in annual budget documents. Quasi-fiscal operations, such the difference in energy costs and cost recovery should be explicitly reported. Identify one department within the MoF with adequate staffing to conduct financial oversight of fiscal risks.

- The MED and the planned POE agency should develop unified standards for planning and reporting, oversee performance appraisals of POEs and their boards with power to dismiss members, assess strategies, recommend compensation, and undertake other key oversight tasks, such as requiring the timely publication of financial statements and other documents.

- Improve the corporate governance of the POEs by : (i) setting clear performance objectives and targets, and linking these objectives to a set of key performance indicators measuring their financial and non-financial performance including management incentives; (ii) adopting clear and transparent procedures for appointment and dismissal of POEs' management (e.g. creating

[7] MoF should set an annual nominal ceiling for POE guarantees in the budget or public financial management law. Other good practices could be developed such as i) granting guarantees conditional to the payment of a fee by the recipient or ii) creating a guarantee reserve fund, when the amount of the guarantee is sizeable.

an independent nomination committee that includes members from civil society and academia, using a competitive appointment process, and requiring conflict of interest to be disclosed); (iii) introducing public disclosure of the nomination process, and strict dismissal standards to avoid the risk of arbitrary dismissal for political reasons; (iv) applying adequate valuation and remuneration systems (e.g. incentive-based and linked to performance monitoring); and (v) bringing high professionalism and integrity requirements for board directors and senior management of POEs.

- Strengthen the ability of POE inter-ministerial commission and proposed POE Agency to require POEs to undertake financial and/or operational reforms within an agreed timeline if they fail to meet performance targets such as those set in business plans, and necessarily if there is a negative financial trend. Actions may include dismissal of board members, restructuring of POEs, or privatization.

Public Investment Framework

Issues:

The annual capital budget in Kosovo is, at 9 percent of GDP and 35 percent of total public spending, high by international standards. Despite this large-scale investment, the overall capital stock has remained 60 percent below the EU average and 20 percent below the average of the Western Balkan countries. In addition, the absorption of donors/IFIs-financed projects under the investment clause—which are subject to higher oversight standards—has been zero for several years and the execution of the capital budget remains low (total capital spending was under-executed by some 35 percent in 2017 largely due to not implementing IFI projects). While PPPs can be considered in areas where the private sector is likely to bring operational and financial efficiencies, this requires rigorous cost-benefit analysis of structuring a project as a PPP compared to on-budget financed projects.

Reforming the Public Investment Framework is macro-critical to increase the quality and amount of much needed public investment to raise potential GDP growth.

Institutional Weaknesses:

- Despite recent reform efforts, addition of new projects lack a thorough economic and fiscal cost-benefit analysis to support appraisal and selection. The draft administrative instruction on capital expenditure that introduces a scoring system for selecting investment projects in line with Fund advice is being finalized.

- Oversight of project implementation is weak, both at national and municipal level.

- There are no *ex-post* audits of major investment projects.

- Donor assistance remains largely off-budget, deviates from Kosovo's PIM framework. The obligation to deposit the donor grants into the treasury single account and record them in the

KFMIS, is not occurring despite the Budget Law including a provision repeating the obligation within the Law on Public Financial Management and Accountability to do so.

- Since the expiration of the SBA in August 2017, only one semi-annual report on donor-financed projects under the investment clause has been submitted to parliament (in April 2018; the previous one was submitted in March 2017).

- Donor-funded projects are not integrated in the Public Investment Program (PIP) system and should align with budget and accounting standards.

- The Budget Department does not have the capacity to carry out a rigorous scrutiny of Budget Organizations' capital investment proposals, or a quality control of the data entered in the PIP.

- Projects maintenance and operating costs are not integrated in the PIP, hence not fully reflected in the budget.

- PPP investments (currently only one exists, with the airport) are not disclosed in the budget, and the PPP selection and approval process is not fully integrated with the Public Investment Framework and MTBF.

Key Recommendations:

- Improve project appraisal and selection, including by finalizing and adopting the administrative instruction on capital expenditure that regulates project selection and classification, as well as an economic and financial viability study carried out by an independent, reputable agency.

- Ensure that donor-funded projects are appraised and selected within the same project pipeline as the rest of projects and finance them through the Treasury Single Account in agreement with the donor.

- Move to multi-annual commitments. Make project budgeting more credible by showing projected operation and maintenance costs in the total cost of new capital projects.

- Ensure quarterly monitoring as well as ex-post reviews and audits of large-scale projects by reputable auditors and publish the findings.

- Reinforce the strategic role of the budget process to ensure alignment of national strategies with the budget and to strengthen the gatekeeping role of the budget department.

- Reinstate monitoring and reporting procedures and ensure that the semi-annual reports and the budget disclose externally-financed projects under the investment clause, other externally-financed projects (outside the investment clause), and major domestically-financed projects.

- Introduce rigorous scrutiny of capital investment project proposals and of data entered into the PIP, including publication of analysis.

- Tighten criteria for the use of the Contingency Reserve contained in the Article 29 of the PFMA, by precisely defining the terms “urgent” or “unforeseen expenses”.[8]

- Integrate PPPs into the overall PIM framework, and improve the budgeting, accounting and reporting of PPP operations, including long-term commitments and contingent liabilities. Increase transparency of budget documentation by including an annex for PPP investments.

B. Rule of Law

Contract Enforcement

Issues:

Kosovo’s inefficient legal enforcement system of commercial claims hinders bank lending and growth. The authorities have taken steps to solve the problem, including by introducing a private bailiff system in 2014. It has helped resolve close to 19,000 cases with a recovery value of some €162 million (2½ percent of GDP) at an average recovery rate of just above 22 percent. To close legal loopholes that led to excessive appeals to enforcement decisions, an amended law on enforcement procedures came into force in May 2017 that: (i) tightened the criteria and time limits for appeals; (ii) strengthened oversight of private bailiffs; and (iii) revised the fee structure to incentivize the pursuit of larger, more complex cases. However, the courts’ backlog of unenforced judgments remains large in Kosovo (52,335 cases as of end July 2018[9]). An administrative instruction establishing a new office regulating the audit and assessment of free legal professions within the Ministry of Justice has been approved by the government. The office will also be tasked with oversight of private enforcement agents. However, its operationalization is pending the recruitment of new staff, expected before January 2019.

Weak contract enforcement is macro-critical because it reduces access to credit, increases the cost of doing business, and discourages investment through higher risk premiums and lower availability of bank financing, negatively impacting growth.

Institutional Weaknesses:

- Kosovo’s courts have low institutional capacity, weak processes and management, reflected in a substantial case backlog and heavy caseload per judge. As of June 30, 2018, there were 264,193 pending cases, and the backlog in percent of inventories ranged from 25.7 to 71.7percent in different case types. During 2017-2018, there were 129 appointed judges (out of 450 positions). Judges’ performance is evaluated by the number of cases, which discourages the resolution of more complex and time-consuming commercial cases as judges can select cases individually. Commercial cases are handled by the Economic Department of Pristina’s Basic Court

[8] The Contingency Reserve was intended to be used to provide budget advancements to some investment projects that would be approved during the same year by the parliament.

[9] Source: Quarterly Report on Courts of the Kosovo Judicial Council

that is burdened by significant capacity constraints (there are only 5 specialized judges in the lower court, and only 1 in the appellate court).

- The performance fee for private enforcement agents is fixed in nominal terms for debts below €1,000 and set in percentages for higher debts based on an administrative instruction that predates the amended law. This structure disincentivizes PEAs to pursue more complex cases for which the effective remuneration may be too low. While the new law calls for negotiated performance fees, the regulation determining the lower and upper bounds has not yet been adopted. In 2017, only 20 percent of the 36,850 received cases were resolved by PEAs, with recoveries amounting to 26 percent of the total value of the resolved cases.

- The enforcement framework has a small number of enforcement agents (42 compared to a target of 72 implied in the law that stipulates 1 PEA per 25,000 inhabitants), inadequate supervision and a tendency to frontload enforcement fees. All of these factors result in inefficiencies and high transaction costs that affect the performance of the entire system.

- The 30-day time limit for the court to issue a decision for objections to enforcement decisions has not been respected. There are still some 7,800 appeal cases awaiting a decision, with a value of some €150 million.

Key Recommendations:

- Implement the amended law on enforcement procedures, by adopting the administrative instruction on the PEA tariff structure, and by completing the necessary recruitment to staff the independent PEA oversight unit at the Ministry of Justice. In addition to strengthening PEA oversight, deter malpractices by raising the fines imposed by the PEA disciplinary committee, and enforcing suspension and disbarment for major offences.

- Address capacity constraints through training and recruitment of new PEAs to fill the remaining 30 positions.

- Prioritize the resolution of large, complex commercial cases, and follow (or where possible, proceed simultaneously) with an acceleration in the reduction of the backlog of regular cases. In this regard, increase the number of specialized judges and support staff for the Economic Department of Pristina's Basic Court.

- In parallel, prepare the ground for the creation of a commercial court by 2020, as envisaged by the authorities.

- Make transparency an underlying principle in contract enforcement, by making use of public registers, registers of bad debtors, and openness of procedures. Improve resource allocation by increasing transparency of the backlogs of cases per judge or chamber. Allow PEAs to access information such as from the cadaster system, civil registry, and tax administration. Introduce an electronic monitoring and oversight system for the Council of Private Enforcement Agents.

Property Registration and Cadaster System

Issues:

Lack of adequate property registration makes it difficult to acquire, use and transfer property in Kosovo. Many firms and households do not hold property titles for their assets. The land market efficiency has increased, with the time to register a transaction dropping from 30 days before the Real Estate Cadaster and Registration Project (RECAP) to under 10 days as of December 2017. The authorities have implemented the Kosovo Land Information System (KCLIS), in all Municipal Cadastral Offices (MCOs) except the three municipalities in the North.

Completing the cadaster is macro-critical because without proof of ownership, and thus collateral, firms and households have restrained access to finance and investment in the economy is deterred.

Institutional Weaknesses:

- The cadaster system is weak. Currently, with World Bank support, only 30 percent of the cadaster zones have been reconstructed. The authorities plan to work together with the World Bank to complete another 30 percent of the cadaster zones in the next four years. By then the cadaster system will cover all urban areas.
- Kosovo's land and property markets need further development to clarify ownership and titles, facilitate the price-discovery mechanism, and allow reliable market-based valuations of the properties.
- Municipal cadaster offices have limited capacity to deliver quality services on municipal land administration.

Key Recommendations:

- Establish a fully functioning cadaster system that covers all of Kosovo; and provide banks access to the recently-established agriculture registry.
- Complete the privatization of public houses and provide proper titles to homeowners.
- Undertake reforms to strengthen Kosovo Cadaster Agency’s institutional framework and upgrade its technical infrastructure.

Judiciary Reforms to Fight Organized Crime and High-level Corruption

Issues:

The Anti-Corruption Agency (ACA), since its establishment in 2006, has sent more than 900 cases to the prosecution. However, the number of indictments remains low – in 2017 alone, the prosecution filed indictment in less than 30 cases out of more than 100 referrals received from the Agency. While the number of preliminary confiscations of assets has increased, there are still few final confiscations of assets. Out of €101 million in total assets seized, frozen, and confiscated during 2015–17, only €3 million were final confiscations. Further, only 42 high level corruption cases are being recorded, resulting in 33 indictments (o/w 23 corruption and 10 organized crime) and 5 final convictions for corruption only (EC 2018b). A new AML/CFT law was adopted in June 2016. Since then, the CBK has made progress in its implementation, including by providing detailed guidance on the definition and identification of beneficial ownership that strengthened due diligence requirements for financial institutions, and by moving towards a risk-based approach to AML/CFT supervision. However, the AML/ CFT law is still not fully in line with EU acquis and international standards.[10] Following a first PECK assessment of Kosovo's AML/CFT framework in 2013–14,[11] a second PECK assessment has been conducted, with a final report expected by end-2018.

Strengthening anti-corruption institutions to increase their effectiveness and protect their independence from political pressures, is macro-critical. Rent-seeking and cronyisms undermine trust in government, lower firm productivity by raising transaction costs, and generate income and wealth inequality that are both unfair and harmful to the economy (IMF 2016). Also, progress in the fight of high level of corruption is a key requirement for advancing Kosovo's EU accession process (EC 2018a, EC 2018b).

Institutional Weaknesses:

- The ACA lacks sufficient tools and resources for effective verification of declarations submitted by public officials. There is no efficient system in place to investigate unjustified wealth – by verifying the declaration, origin, and control of property of public officials and gifts received by official persons.

- The investigation periods are very short by international standards (In Kosovo, 2 years to investigate, occasionally extended by half year. Other countries apply no time limit.)

- The Special Prosecution Office (SPO) does not have enough specialized staff with technical expertise to investigate and prosecute high-level financial and procurement corruption cases.

- Financial investigations are still not systematically launched in cases of corruption and organized crime.

[10] See EC progress reports (2018, 2017, 2016).

[11] Kosovo is not a member of the United Nations, the Council of Europe, the FATF or an FATF-style regional body and hence cannot benefit from the formal regional and international review mechanism for the implementation of anti-corruption (AC) and AML/CFT best practices and standards. The PECK I project was designed to address this gap by developing an assessment methodology to evaluate Kosovo's compliance with European and international standards (GRECO, FATF and EU Directives).

- The law provisions on the confiscation of proceeds from crime are too cumbersome and complex to use and contain unreasonably short terms for investigation.

- While the preliminary findings of the PECK II assessment[12] point to an overall improvement with good effectiveness, remaining gaps are in the areas of third-party reliance issues and customer due diligence process. Shortcomings in the legal framework include: (i) the unclear system of supervision by the FIU and central bank; (ii) extensive reporting requirements for NGOs; (iii) the lack of provision allowing the prosecutor or court to continue freezing of a suspicious transaction in line with FIU orders; and (iv) the narrower scope of some definitions compared with those required by FATF recommendations.[13] Shortcomings in implementation include preventive measures (ambiguity of customer due diligence measures, tipping-off provisions, etc.) and registration system for legal persons and legal arrangements.

Key Recommendations:

- Adopt the revised laws on extended power of asset confiscation and whistle-blowers in line with EC recommendations. As currently drafted, the law on whistle-blowers extends the scope of application, currently limited to the public sector, to include also private sector companies with minimum 100 employees. The draft law on asset confiscation changes the burden of proof from the prosecution to the defendant and extends the scope of asset confiscation to third parties under the bona fide buyer principle.

- The quality of the reports submitted by the ACA to prosecution must be improved and closer cooperation and exchange of information with other agencies is necessary to verify asset declarations.

- Implement the newly adopted law on state prosecutor, which adjusts the eligibility criteria for new hires to promote new talents and merit-based recruitment of new prosecutors to the SPO, and the law on the prevention of conflict of interest in the discharge of a public function.

- Adopt revisions to the criminal code and criminal procedures code to strengthen, in line with EC recommendations, provisions on search and confiscation, admissibility of evidence, time limit for investigations (increasing it to 2+2 years), integrity (immediate suspension and removal of public officials indicted and convicted of corruption), and overall efficiency regarding the appeals procedures (by making the court of appeals act as a final court).

- Amend legal framework on declaration of assets to bring it in line with international best practices, while also giving more robust powers to the Anti-Corruption Agency. In this process,

[12] The PECK II assessment was carried out against the GRECO and FATF/MONEYVAL adjusted methodologies and practices specifically tailored to Kosovo. The assessment did not include a peer-review of the quality and consistency of the report with other assessments carried out against the FATF standard.

[13] See EC, 2018a. This pertains for instance to the definition of 'Lawyer', 'Terrorist act', 'Financial institution', 'Casino', 'Accountant', 'Politically Exposed Person', and 'beneficial owner', which are narrower than required by the FATF and the EU Directive on AML/CFT.

incorporate results from the functional review of the justice system immediately as they become available (this will inform a National Strategy for the Rule of Law Sector that is expected to be completed in June 2019).

- Address AML/CFT gaps in the legal framework and implementation and execute remaining recommendations from the PECK I assessment and additional recommendations from the PECK II assessment. In the area of third-party reliance, provide regulation and conditions for determining the countries in which the third party can be based, and regulate third-party financial institutions and Designated Non-Financial Businesses and Professions (DNFBPs) to perform certain customer due diligence measures or to introduce business. In addition, the due diligence process needs to be enhanced to cover wire transfers through non-bank financial institutions, use reliable information and take measures in high-risk situation in establishing beneficial ownership, obtain information on the principal place of business if the address is different from the address of the registered office, adopt risk management procedures prior to customer verification, and include provisions to prevent tipping-off. Finally, bring the AML/CFT Law in line with international standards by clarifying the supervisory competencies, cooperation and coordination between the central bank and FIU; revisiting the reporting requirements for NGOs; strengthening the provisions allowing the court/prosecutor to continue freezing assets on FIU orders; and aligning definitions with FATF standards.

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Annex VI. Determinants of Labor Force Participation and Employment[1]

With a nearly 30 percent unemployment rate and 60 percent inactivity rate,[2] labor market issues in Kosovo are macro-critical by constraining private sector income, tax receipts, potential output, and broad-based sustainable growth. Both cross-country and micro-level analysis suggest negative effects of relatively high public sector wages on employment, while in Kosovo inactivity and unemployment are positively correlated with household income from social benefits and remittances.

A. Background

Despite progress in recent years, Kosovo's labor market is still characterized by extremely low labor force participation and high unemployment rates by regional standards. Only 42.8 percent of the working age population was either employed (29.7 percent) or actively looking for jobs (13.1 percent) in 2017. This compares to 51.9 percent and 11.0 percent in the rest of Western Balkans (WB) and 68.0 percent and 4.7 percent in New Member States (NMS). Unemployment continues to remain high at 30 percent, with youth unemployment exceeding 50 percent. Although the inactivity rate has declined by 6 percentage points since 2012, labor market outcomes in Kosovo still lags behind the countries in the region.

This note examines the key factors behind the unfavorable labor market outcomes in Kosovo, and the role of policies and institutions—after controlling for demographics—explaining individuals' decisions to participate in the labor market (Table 1). The existing literature identifies a number of factors that determine labor market outcomes, including shifts in the age structure of the population, the expected return to work relative to nonparticipation, as well as labor market policies and institutions, namely minimum wage laws, employment protection regulation, unions and collective bargaining and mandated benefits. Afonso et al. (2014), Lamo et al. (2011) and Telegdy (2013) provide evidence for the spillover effects from public sector wages to private sector wages, suggesting public wage setting is an important mechanism through which the government can affect the labor market.

B. Empirical Results

Aggregate Cross-Country Analysis

The cross-country panel approach is used to examine the influence of labor market policies and other factors on employment and participation. The country-level sample includes data from 31 European countries for the period of 2006 to 2016. A reduced-form model links employment and labor force participation rates to factors that may affect the decision to supply labor, controlling for

[1] Prepared by Brooks Evans (FAD), Shushanik Hakobyan (SPR) and Zhongxia Zhang (EUR).

[2] Inactive refers to individuals that are neither employed nor seeking work.

differences across countries that are constant over time and shocks that affect countries equally. Building on Atoyan and Rahman (2017) and IMF (2018), the empirical specification is:

$$L_{i,t} = \beta^{Z} Z_{it} + \beta^{M} GDPpc_{it} + \beta^{X} X_{it} + c_{i} + \tau_{t} + \varepsilon_{it},$$

where L denotes the participation rate or employment-to-population ratio in country i at time t, Z comprises determinants of labor supply such as educational attainment, remittances, share of prime age population, and number of children (per working age population), X represents the set of policies and institutions. The key variables of interest, including public sector wage premium, minimum wages, duration of maternity leave, and family/children expenditures, are lagged by one period in the regressions to address the endogeneity issue. c_i and τ_t are country and time fixed effects, respectively.

In the baseline specification, the estimated coefficients for common control variables have the expected sign, and most are statistically significant (Table 3). Higher education levels are associated with higher employment and higher labor force participation. Remittances are not statistically significant, but the sign is negative for the Western Balkan countries. A favorable demographic profile with a larger share of prime age population is likely to boost both employment and labor force participation. On the other hand, a higher number of children per working age population is associated with lower labor force participation as child care obligations discourage parents from working. Finally, GDP per capita is weakly significant and positively associated with labor force participation.

The first set of results suggests that public sector wages could negatively affect employment. We re-run the regression and control additionally for the lagged ratio of public sector to national average wage. The estimated coefficient on the public sector to average wage ratio is negative and statistically significant, suggesting that higher public-sector wage premium could adversely affect employment, by likely diverting job seekers away from the private sector and increasing wage pressure on private sector employers.

Next, we find that higher minimum wage is associated with lower employment. The estimated coefficient on monthly minimum wage to GDP per capita is negative and weakly significant, consistent with Betcherman (2012) and IMF (2016). In particular, a one percent increase in the minimum wage to GDP per capita ratio decreases the employment-to-population ratio by 1.78 percent. The findings suggest that higher minimum wage relative to labor productivity is associated with lower employment. Kosovo already has the highest minimum wage to GDP per capita ratio (Figure 3 panel chart 6). The proposed minimum wage increase from 170 to 250 euros per month could further put the minimum wage above the desirable labor productivity level.

We do not find a statistically significant relationship between the duration of maternity leave and labor market outcomes. One explanation is the possible nonlinearities observed in the data; Kosovo's maternity leave duration of 52 weeks is well above the EU average of 21 weeks. The effect of maternity leave duration on employment and participation may be nonlinear: extremely long duration of maternity leave usually causes de-skilling of female workers, which adversely influences employment and participation (Figure 3 panel chart 5).

Finally, we find that higher public spending on family/children benefits is associated with lower employment and participation. Public expenditure on family or children are used as a proxy for social benefits. The estimated coefficients are negative and significant, suggesting that higher social benefits are likely to have an adverse impact on employment. A one percent increase in the family/children expenditures (as percent of GDP) is expected to decrease the employment-to-population ratio by 2.19 percent. In Kosovo nearly half of the social benefit schemes are conditioned on being unemployed or having no stated labor income. This, combined with high benefit levels, including that households can receive multiple social benefits at the same time, act as deterrents to activity (Table 2).

Micro Level Analysis

The cross-country analysis described above is complemented by examining the evidence from Kosovo's 2017 Household Budget Survey (HBS). The empirical analysis models the decision of an individual to be unemployed or inactive (i.e. not participate in the labor market) as a function of individual characteristics (age, gender, marital status, education, and location), and household characteristics, such as household's main income source (public or private sector wage, social transfers and remittances), monetary amounts for main income categories (labor, social transfers, and remittances), and household structure (i.e. only adults, adults with children, 3–generation households). The sample is restricted to prime age population (aged 25-55) in unemployment regressions and to working age population (aged 15-65) in inactivity regressions.

The estimates from a logistic regression to explain the high level of unemployment in Kosovo are broadly in line with the findings from the aggregate cross-country analysis (Table 4). The probability of being unemployed is higher for female and younger individuals, as well as those who are not married and live in certain regions such as Mitrovice, Ferizaj and Prishtine. Individuals in households with the main source of income being public or private sector wages are equally less likely to be unemployed, so are people living in certain regions such as Peje. The likelihood of unemployment also decreases with household's labor income. Most importantly, individuals living in a household with larger remittances income are more likely to be unemployed. Household composition does not appear to influence individual's decision to be unemployed. These results suggest that large remittances increase the probability of being unemployed.

We find similar results for the likelihood of inactivity in the labor market. The likelihood of inactivity is negatively correlated with age, being male and married, with higher educational attainment and living in urban areas and certain regions (Mitrovice and Prishtine). The likelihood of inactivity also decreases with household's labor income. Individuals living in Peje, Prizren and Ferizaj are more likely to be inactive, as are those in households that who indicate social benefits or pensions being their main source of income. More importantly, individuals in households with higher social transfer income are more likely to be inactive. Contrary to the results from unemployment regressions, household composition appears to play a greater role in the decision to participate in the labor market.

Finally, we use the 2017 Labor Force Survey (LFS) to examine the wage differential between public and private sector workers in Kosovo by estimating Mincerian wage regression. The dependent variable is the natural logarithm of labor income. The key variable of interest which measures the wage premium (or discount) for public sector workers is a dummy variable that takes a value of 1 when the individual is employed in the public sector, and a value of 0 otherwise.

The results from Mincerian wage regressions suggest the existence of a public-sector wage premium of around 30–40 percent. The coefficient for the public-sector dummy is positive and statistically significant in all specifications both when public sector includes SOEs and when it does not (Table 5). According to this analysis, the public sector had an estimated premium of 30–43 percent in 2017. These results are robust to other specifications, such as restricting the sample to the formal sector. These results suggest that the public sector is likely exerting pressure on private sector wages and increasing the reservation wage which could adversely affect wage competitiveness, and consequently employment and growth.

C. Policy Recommendations

- **Minimum wage policy**. Set minimum wages based on developments in inflation and real effective exchange rate by re-introducing the formula setting and binding preconditions for minimum wage adjustments to avoid large discretionary increases that would undermine efforts to reduce the high level of unemployment, competitiveness gap and informality.

- **Public sector wage policy**. Set public sector wage increases taking into account developments in living costs, private sector wages and competitiveness, and impact on the private sector labor market, consistent with the wage bill rule that limits the growth in the wage bill to nominal GDP. In this connection, the wage bill rule should be used as a policy *ceiling* and not as a target for public sector wage increases.

- **Social benefits**. Strike an appropriate balance between equity and efficiency. Mandated benefits such as paid maternity leave can reduce economic efficiency by limiting the ability of employers and workers to voluntarily negotiate the optimal compensation package. For example, Blau and Lawrence (2013) show that the expansion of family-friendly policies can also have unintended side effects, including a reliance on part-time employment for women and lower female representation in high-level positions.

- **Active Labor Market Policies**. Design ALMPs to focus on: (1) specific vocational training to meet the demand from employers; (2) job search assistance to help workers to overcome sectoral and spatial mismatches; (3) streamlining onerous laws and regulations to facilitate job creation by firms. These are effective measures based on international experience (McKenzie 2017). Finally, education is key to address structural problems, including skill mismatches.

Table 1. Kosovo: Comparison of Key Determinants of Labor Market Outcomes

	Kosovo (2017)	EU average (2017)
Higher education ratio	1.7	3.4
Remittances inflows (% of GDP)	11.8%	0.4%
Prime age population (% of total population)	68.7%	41.1%
Number of children per working age population	0.32	0.24
GDP per capita (EUR)	3,566	30,229
General government wage/ average wage	1.2	1.4
Monthly minimum wage to GDP per capita	4.8%	3.4%
Maternity leave duration (#. of weeks)	52	21
Family/ children expenditure (% of GDP)	0.5%	2%

Sources: Eurostat and IMF staff calculations

Table 2. Kosovo: Social Schemes and Employment Conditionality

Scheme	**Average benefit amount, € per month (spending/beneficiaries, 2017)**	**Conditional on employment status?**
Basic pension	78	No
Disability pension	82	Yes
TREPCA early retirement benefits	105	No
"Contributory" Basic pension	178	No
Social assistance scheme	91	Yes
War invalid pensions	247	No
Previously KPC pensions	228	No
Services / Social-School 0-18 years	108	No
Services / Social-Family Housing within the Relationship	344	No
Services / Social-Family Housing outside the Relationship	233	No
Pensions for the Blind	231	No
KSF pensions	364	Yes
Women after child birth	268	Yes
Veterans pension	170	Yes
Family pension	75	Yes
Invalidity Work Pension	75	Yes
Pensions for Paraplegic and Tetraplegic	225	Yes
Victim Support Scheme	230	No
Political Prisoner Lump-sum	…	No

Source: IMF staff based on data from the authorities.

Table 3. Kosovo: Panel Regressions on Determinants of Employment and Labor Force Participation

	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)	(10)
Dependent variable			Employment					Labor force participation		
Higher education ratio 1/	1.208	1.527	2.635***	1.458	2.698***	1.140**	1.264***	1.684***	1.246**	1.479***
	(0.733)	(1.073)	(0.749)	(0.873)	(0.771)	(0.436)	(0.390)	(0.315)	(0.552)	(0.343)
Remittances, lagged	0.527	3.436*	-0.752**	8.534**	-0.400	0.293	0.837	-0.207	1.196	-0.216
	(0.734)	(1.661)	(0.349)	(3.438)	(0.405)	(0.373)	(0.669)	(0.328)	(2.248)	(0.324)
Remittances * Western Balkans dummy variable, lagged	-0.585					-0.360				
	(0.769)					(0.383)				
Prime age population share	1.912***	1.231**	1.558**	1.121***	1.845***	0.807***	1.049***	1.055***	1.011***	0.940**
	(0.477)	(0.565)	(0.617)	(0.306)	(0.542)	(0.249)	(0.358)	(0.311)	(0.251)	(0.344)
Number of children per working age population	-0.274	-0.131	0.0144	0.0536	-0.210	-0.190*	-0.350**	-0.186	-0.280***	-0.314***
	(0.168)	(0.171)	(0.163)	(0.125)	(0.221)	(0.0952)	(0.129)	(0.143)	(0.0723)	(0.110)
GDP per capita	0.000208	0.000215	0.000266	0.000255***	0.000229	6.88e-05*	-1.19e-05	1.78e-05	1.26e-05	5.11e-05
	(0.000139)	(0.000132)	(0.000175)	(8.80e-05)	(0.000151)	(4.04e-05)	(7.72e-05)	(5.75e-05)	(5.52e-05)	(6.45e-05)
General government wage/ economy average wage, lagged		-4.046***					-0.288			
		(0.841)					(0.450)			
Minimum wage to GDP per capita, lagged			-1.775*					-0.842		
			(0.931)					(0.514)		
Maternity leave duration, lagged				0.0940					-0.159	
				(0.126)					(0.0989)	
Family/ Children expenditure (% of GDP), lagged					-2.189**					-0.0685
					(0.951)					(0.630)
Constant	-40.70*	-6.787	-32.80	-20.62	-38.36*	20.37*	18.34	9.974	20.47*	20.09
	(20.77)	(20.50)	(26.26)	(13.32)	(19.98)	(11.50)	(13.43)	(13.24)	(11.27)	(13.25)
Observations	191	116	137	108	151	220	134	159	128	175
R-squared	0.405	0.685	0.524	0.755	0.595	0.325	0.640	0.450	0.610	0.524
Number of countries	31	20	23	21	27	31	20	24	21	27

Robust standard errors in parentheses

*** p<0.01, ** p<0.05, * p<0.1

Note: 1/ higher education ratio is defined as population of secondary and tertiary education divided by population of primary and below education.

Table 4. Kosovo: Determinants of Unemployment and Inactivity

	Unemployment			Inactivity		
	(1)	(2)	(3)	(4)	(5)	(6)
Age	-0.349***	-0.386***	-0.394***	-0.408***	-0.423***	-0.423***
	(0.0570)	(0.0593)	(0.0597)	(0.0149)	(0.0153)	(0.0153)
Age squared	0.00387***	0.00427***	0.00436***	0.00497***	0.00518***	0.00518***
	(0.000736)	(0.000766)	(0.000772)	(0.000182)	(0.000188)	(0.000188)
Male	-2.312***	-2.418***	-2.427***	-1.863***	-1.880***	-1.881***
	(0.102)	(0.105)	(0.107)	(0.0647)	(0.0650)	(0.0650)
Married	-0.340***	-0.373***	-0.354***	-0.228***	-0.220***	-0.215**
	(0.128)	(0.128)	(0.131)	(0.0839)	(0.0840)	(0.0843)
Secondary education	0.364	0.294	0.410	-0.279	-0.264	-0.241
	(0.437)	(0.444)	(0.457)	(0.213)	(0.213)	(0.214)
Tertiary education	-0.483	-0.465	-0.395	-2.358***	-2.274***	-2.295***
	(0.451)	(0.459)	(0.472)	(0.249)	(0.249)	(0.250)
Urban	-0.132	0.0521	0.0210	-0.199***	-0.152***	-0.160***
	(0.0905)	(0.0933)	(0.0947)	(0.0576)	(0.0581)	(0.0584)
Region						
Gjilan	0.126	0.249	0.186	0.153	0.184*	0.176
	(0.179)	(0.187)	(0.187)	(0.110)	(0.111)	(0.111)
Mitrovice	1.274***	1.432***	1.389***	-0.812***	-0.779***	-0.816***
	(0.166)	(0.173)	(0.177)	(0.119)	(0.120)	(0.120)
Peje	-0.630***	-0.863***	-0.812***	0.525***	0.524***	0.528***
	(0.208)	(0.215)	(0.216)	(0.111)	(0.112)	(0.112)
Prizren	-0.0871	0.150	0.0976	0.561***	0.604***	0.615***
	(0.184)	(0.184)	(0.187)	(0.105)	(0.106)	(0.106)
Prishtine	1.024***	1.265***	1.218***	-0.565***	-0.522***	-0.564***
	(0.157)	(0.163)	(0.166)	(0.107)	(0.108)	(0.108)
Ferizaj	0.479***	0.547***	0.513***	0.354***	0.378***	0.379***
	(0.169)	(0.178)	(0.181)	(0.108)	(0.109)	(0.109)
Household main income source						
Public sector wage	-2.965***		-1.372***	0.0451		0.342
	(0.384)		(0.424)	(0.231)		(0.242)
Private sector wage	-2.979***		-1.564***	-0.151		0.0999
	(0.375)		(0.410)	(0.226)		(0.234)
Social transfers	-0.450		-0.307	0.602**		0.296
	(0.405)		(0.421)	(0.243)		(0.242)
Remittances	-0.309		-0.716	0.222		0.161
	(0.430)		(0.458)	(0.247)		(0.257)
Household composition						
Elderly only/Child & Elderly				-1.349***	-1.619***	-1.619***
				(0.386)	(0.383)	(0.391)
Adult & Child	0.0457	0.0992	0.0790	-0.213***	-0.230***	-0.229***
	(0.142)	(0.145)	(0.146)	(0.0810)	(0.0817)	(0.0818)
Adult & Elderly	0.240	0.258	0.264	-0.315***	-0.567***	-0.567***
	(0.167)	(0.182)	(0.185)	(0.0903)	(0.101)	(0.101)
3-Generations	0.0907	0.249	0.246	-0.340***	-0.599***	-0.594***
	(0.149)	(0.168)	(0.171)	(0.0802)	(0.0935)	(0.0938)
Household income						
Log labor income		-0.334***	-0.255***		-0.0423***	-0.0401***
		(0.0190)	(0.0245)		(0.0100)	(0.0133)
Log social transfers		0.00532	-0.00978		0.0739***	0.0701***
		(0.0163)	(0.0170)		(0.0107)	(0.0112)
Log remittances		0.0926***	0.0888***		0.0121	0.0138
		(0.0210)	(0.0246)		(0.0110)	(0.0129)
Pseudo R2	0.330	0.355	0.365	0.289	0.293	0.294
Observations	3,416	3,416	3,416	7,831	7,831	7,831

Sources: IMF staff estimates based on the 2017 Household Budget Survey.

Notes: Regressions are estimated by OLS. Standard errors are robust and shown in parentheses. * p<0.1, ** p<0.05, *** p<0.01.

Table 5. Kosovo: Estimates of the Public-Private Wage Gap

	Public (1)	Public and SOE (2)
Public sector	0.301***	0.428***
	(0.010)	(0.010)
Age	0.029***	0.024***
	(0.003)	(0.003)
Age squared	-0.000***	-0.000***
	(0.000)	(0.000)
Male	-0.084***	-0.034***
	(0.012)	(0.011)
Married	0.010	0.003
	(0.014)	(0.013)
Education		
Secondary	0.037	0.108
	(0.112)	(0.099)
Tertiary	0.169***	0.173***
	(0.022)	(0.022)
Urban	0.062***	0.086***
	(0.009)	(0.009)
Observations	8,861	8,861
R-squared	0.202	0.295

Sources: IMF staff estimates based on the 2017 Labor Force Survey.
Notes: Regressions are estimated by OLS. Standard errors are robust and shown in parentheses. * p<0.1, ** p<0.05, *** p<0.01.

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INTERNATIONAL MONETARY FUND

REPUBLIC OF KOSOVO

STAFF REPORT FOR THE 2018 ARTICLE IV CONSULTATION—INFORMATIONAL ANNEX

November 29, 2018

Prepared By	The European Department (in consultation with other departments)

CONTENTS

FUND RELATIONS ______ 2

RELATIONS TO OTHER INTERNATIONAL FINANCIAL INSTITUTIONS ______ 5

STATISTICAL ISSUES ______ 6

FUND RELATIONS

(As of October 31, 2018)

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	194.43	235.38
Reserve Tranche Position	20.07	24.29

SDR Department:	**SDR Million**	**Percent Allocation**
Net cumulative allocation	55.37	100.00
Holdings	54.08	97.67

Outstanding Purchases and Loans:	**SDR Million**	**Percent Quota**
Stand-By Arrangements	131.89	159.67

Latest Financial Arrangements:

Type	**Date of Arrangement**	**Expiration Date**	**Amount Approved (SDR Million)**	**Amount Drawn (SDR Million)**
Stand-By	July 29, 2015	August 4, 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		24.59	54.29	43.11	9.90
Charges/Interest	0.68	2.52	1.87	0.83	0.11
Total	0.68	27.11	56.16	43.94	10.01

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 2015-17Stand-By Arrangement. The last Article IV consultation was concluded on February 2, 2018. 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:

Statistics

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

- E-GDDS (April 2017)

Fiscal Sector

- Tax Administration – Compliance Risk Management (June 2017), IT Modernization (June 2017), Immediate Tax Administration Reform Plans (October 2017), Data Analysis and Statistics (November 2017), Compliance Risk Management (November 2017), Performance Management (February 2018), IT Modernization (April 2018), TADAT (June 2018), Reform Action Plan (August 2018), Strengthening Tax Audit (November 2018), Strengthening VAT Refund Procedures (November 2018), Compliance Risk Management (November 2018)

- Public Financial Management - Public Investment (December 2015, April and October 2017, March 2018), Classification of investment expenditure and multi-annual budgeting (May 2017), and medium-term expenditure framework (October 2017)

- Expenditure Policy - Enhancing Social Protection Cash Benefits (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)

- Strengthening the Forward-looking Approach of Banking Supervision (early warning system) and Operationalizing the Macroprudential Policy Framework (February 2018)

Resident Representative

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

RELATIONS TO OTHER INTERNATIONAL FINANCIAL INSTITUTIONS

EBRD: https://www.ebrd.com/work-with-us/project-finance/project-summary-documents.html?1=1&filterCountry=Kosovo

European Investment Bank:
http://www.eib.org/en/projects/pipelines/?d=&f=&st=&r=3&c=XK&se=

World Bank: http://www.worldbank.org/en/country/kosovo/projects

STATISTICAL ISSUES

I. Assessment of Data Adequacy for Surveillance
General: Data provision is adequate for surveillance. However, the statistical agencies still suffer from considerable shortages of financial and human resources.
National Accounts: Through intensive TA from the European Commission (Twinning Project), 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 2008 SNA/ESA2010. 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. Both CPI and HICP are used to measure consumer inflation, the latter enabling comparisons between member states within the EU. Kosovo receives TA from Eurostat.
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.

<table>
<tr><td colspan="2">Monetary and Financial Statistics: 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.</td></tr>
<tr><td colspan="2">Financial Sector Surveillance: The CBK 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.</td></tr>
<tr><td colspan="2">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.</td></tr>
<tr><td colspan="2">II. Data Standards and Quality</td></tr>
<tr><td>The country participates in the enhanced General Data Dissemination System (e-GDDS) and a National Summary Data Page regularly disseminates e-GDDS data to the public since May 11, 2017.</td><td>Kosovo has not had a Data ROSC.</td></tr>
</table>

Kosovo—Table of Common Indicators Required for Surveillance
(As of November 13, 2018)

	Date of Latest Observation	Date Received/ Reported Online	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]	09/30/2018	Oct/2018	M	M	M
Reserve/Base Money	09/30/2018	10/29/2018	M	M	M
Broad Money	09/30/2018	10/29/2018	M	M	M
Central Bank Balance Sheet[1]	09/30/2018	10/29/2018	M	M	M
Consolidated Balance Sheet of the Banking System	09/30/2018	10/29/2018	M	M	M
Interest Rates[2]	Sept/2018	Oct/2018	M	M	M
Consumer Price Index	Oct/2018	11/13/2018	M	M	M
Revenue, Expenditure, Balance and Composition of Financing[3]—General Government[4]	Sept/2018	11/9/2018	M	M	M
Revenue, Expenditure, Balance and Composition of Financing[3]—Central Government	Sept/2018	11/9/2018	M	M	M
Stocks of Central Government and Central Government-Guaranteed Debt[5]	09/30/2018	11/9/2018	Q	Q	Q
External Current Account Balance	Aug/2018	Oct/2018	Q	Q	Q
Exports and Imports of Goods	09/30/2018	10/29/2018	M	M	M
GDP/GNP[8]	06/30/2018	09/28/2018	Q	Q	Q
Gross External Debt	06/30/2018	Oct/2018	Q	Q	Q
International Investment Position[6]	06/30/2018	Oct/2018	Q	Q	Q

[1] CBK's NFA and GIR data have been revised for the period 09/2015 - 07/2018 to exclude the CBK's holdings of Kosovar government securities. CBK balance sheet and survey data have been revised for the period 09/2015 - 07/2018 to reclassify the CBK's holdings of Kosovar government securities as claims on the central government.

[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 and extra budgetary funds) and local governments (municipalities).

[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] GNDI data not available.