INTERNATIONAL MONETARY FUND

IMF Country Report No. 22/5

REPUBLIC OF KOSOVO

2021 ARTICLE IV CONSULTATION—PRESS RELEASE AND STAFF REPORT

January 2022

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 2021 Article IV consultation with the Republic of Kosovo, the following documents have been released and are included in this package:

- A **Press Release**.
- 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 November 3, 2021, 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 December 20, 2021.
- 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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International Monetary Fund
Washington, D.C.

PRESS RELEASE

PR22/04

IMF Executive Board Concludes 2021 Article IV Consultation with the Republic of Kosovo

FOR IMMEDIATE RELEASE

Washington, DC – January 12, 2022: 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.

Kosovo's economy is rebounding from its deepest recession in a decade, driven by improved vaccination rates, renewed mobility, policy actions and extraordinary support from the diaspora. After contracting 5.3 percent in 2020, real GDP is projected to grow by 7.5 percent in 2021.

The fiscal response to the pandemic provided lifelines for households and firms and cushioned the impact of the shock on those most affected by the pandemic. On the back of a strong rebound in revenues, the fiscal policy stance tightened to an almost balanced position in 2021 from a deficit of close to 8 percent of GDP in 2020. However, its drag on the economy was more than offset by extraordinary diaspora inflows and sustained increases in net credit to the private sector. Inflation in 2021 is forecast to have increased to more than 5 percent (year-on-year) due to higher energy and food prices, which rebounded to their pre-pandemic levels. With strong capital and liquidity buffers and low NPLs, the banking sector has been resilient overall.

Economic activity is forecast to grow at 3.8 percent in 2022, driven partially by strong economic momentum in 2021. Uncertainty around the outlook remains high, and the pandemic continues to represent the main downside risk. Long-term scarring from the pandemic is now expected to be lower than that projected in the 2020 Article IV consultation, as diaspora flows have been more resilient than expected. Structural policies, such as diversifying Kosovo's growth engines, tackling informality, and creating the conditions for greener economic growth, could mitigate these longer-term effects of the pandemic.

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

Executive Board Assessment[2]

In concluding the 2021 Article IV consultation with Kosovo, Executive Directors endorsed the staff's appraisal, as follows:

Kosovo's people and its economy experienced a return to a certain degree of normality in 2021. Increased vaccination rates allowed a relaxation of stringency measures, supported mobility, and created the conditions for a resumption of diaspora travel. While the health system continued to cope reasonably well, still-binding supply constraints are a reminder of the need to expand the sector's capacity more decisively. Though uncertainty appears to have subsided with respect to 12 months ago, it remains high.

The fiscal response to the pandemic has been broadly adequate. The use of lifelines for households and firms, wage bonuses for essential workers, employment support, and child and maternity allowances for vulnerable households adequately cushioned the impact of the shock on those most affected by the pandemic. While the fiscal policy stance tightened in 2021 on the back of a strong rebound in revenues, its drag on the economy was more than offset by extraordinary diaspora inflows and sustained increases in net credit to the private sector.

Fiscal policy needs to return to a more supportive stance in 2022. The projected normalization of diaspora inflows calls for a relaxation of the fiscal stance of around 2 pp of GDP; this will require additional expenditures, mainly in the form of investment projects of about 1-1.5 pp of GDP. The relaxation of the fiscal stance would help sustain the recovery by cushioning the projected softening of external inflows, while keeping the deficit within the fiscal rule limits.

The focus, composition, and transparency of public spending needs strengthening, including to support economic resilience. While the objective to intensify vaccinations is both appropriate and commendable, intended policy actions under the "Economic Revival Program" need to be better defined, new social transfer programs should be more targeted, and the growth of existing transfers needs to be contained. While across the board wage hikes are currently not expected, the new law on public salaries should contain the wage bill within its legal ceiling. Public investment should be geared towards increasing economic resilience and preparing the economy for a renewed spike of cases.

Continued fiscal contingency planning is needed in the face of still-high uncertainty. Options for risk mitigation, on top of the reserves already in the 2022 budget, include anticipated public debt placements and contingent bilateral and multilateral financing. Other fiscal risks include the ongoing revision of the law on salaries and the indexation of war veteran benefits, which continue to breach their 0.7 percent of GDP legal ceiling. The upbeat GDP growth and revenue projections in the budget

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[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.

for 2022 call for the preparation of an alternative fiscal scenario based in the consensus growth forecast to identify potential financing needs as well as expenditure programs that need containing.

The commitment to stick to the fiscal rule as the guide for medium-term policy is appropriate. This will anchor public debt below the 40 percent of GDP legal debt ceiling through the medium term. Other medium-term fiscal priorities include expanding the tax base, strengthening fiscal transparency, and expanding the investor base of government debt. Importantly, the revenue windfall provided by the diaspora should be used to close social and economic infrastructure gaps and diversify growth engines.

The CBK's decision to gradually unwind its pandemic-related support measures in 2021 was warranted. While the financial system has remained resilient overall and the increase in aggregate NPLs is expected to be limited, strengthening credit risk monitoring is essential to ensure that bank-by-bank provisioning reflects the underlying change in asset quality, and that capital buffers are sufficient to absorb write-downs and keep the flow of credit. The supervisor authority's capacity to evaluate the ECL frameworks of regulated entities in the context of IFRS-9 implementation needs to continue improving.

The recommendations of the 2019 FSSR and those of the 2020 Safeguards Assessment need to be implemented. The resumption of CBK Board operation will allow the implementation of FSSR and SA recommendations, including to ensure that the financial stability function reports directly to the Executive Board; that the CBK's governance is reviewed to assess the effectiveness of decision-making bodies and the appropriateness of membership in key committees; and that the audit and risk committees are strengthened, including through expanding their scope to the oversight of financial reporting and risk management activities.

The new SDR allocation can be used to strengthen the CBK's ability to provide liquidity support to banks. The SDR allocation would enhance international reserves, which are projected to fall below 100 percent of the IMF RA metric in the medium term, and thus support the CBK's lending facilities. On competitiveness, Kosovo's external position was assessed to be moderately weaker than the level implied by fundamentals and desirable policy settings in 2021.

Gaps in physical infrastructure, labor force skills, and institutional quality limit FDI flows, leaving diaspora inflows as the main growth engine. Diversifying the sources of economic growth requires improving infrastructure, public investment management, investment composition, POEs' management and performance, and for the education system to meet the needs of the economy.

Kosovo's high levels of informality negatively affect competition, working conditions and firm size, limiting economic growth. Simplified tax procedures, improved secondary education, and enhanced financial inclusion will help sustain and expand recent formalization gains. In the medium-term, formalization gains will be tied to improving the efficiency of the judicial system and tackling corruption.

Kosovo's intentions to reduce carbon emissions are commendable. A credible climate and environment mitigation strategy should be centered around carbon pricing, while allocating its proceeds to investment in green projects and to mitigate the impact of higher energy prices on vulnerable households. In the near term, the priority is to make progress in the installation of filters in the largest lignite-based energy generation plant in collaboration with the EU.

The next Article IV consultation with Kosovo is expected to be conducted on the standard 12-month cycle.

Kosovo: Selected Economic Indicators, 2018–26

	2018	2019	2020	2021	2022	2023	2024	2025	2026
				Est.		Projections			
Real GDP growth	3.4	4.8	-5.3	7.5	3.8	3.8	3.6	3.5	3.5
Contribution to growth (percentage points of GDP)									
Consumption	4.3	5.8	2.3	4.3	2.4	2.0	2.3	2.5	2.5
Investment	2.0	-0.1	-2.3	2.4	1.6	1.6	1.1	1.1	1.2
Net Exports	-3.1	-0.3	-5.3	0.3	-0.3	0.2	0.1	-0.1	-0.2
Official unemployment (percent of workforce) 1/	29.5	25.7	26.0	25.8	...	...	...	...	...
Price changes									
CPI, period average	1.1	2.7	0.2	3.2	3.9	2.4	2.2	2.1	2.0
GDP deflator	1.5	1.0	1.4	2.9	3.5	2.6	2.2	1.9	1.7
General government budget (percent of GDP)									
Revenues and grants	26.4	27.0	25.6	29.2	28.5	28.3	28.2	28.2	28.1
Expenditures	29.2	29.9	33.5	29.6	30.9	30.7	30.6	30.6	30.6
Overall Balance (Fiscal rule) 2/	-1.5	-0.8	-6.6	0.2	-1.3	-1.6	-1.4	-1.4	-1.7
Overall balance	-2.8	-2.9	-7.9	-0.4	-2.4	-2.4	-2.3	-2.4	-2.5
Stock of government bank balances	4.5	5.1	3.4	5.5	5.5	5.2	4.9	4.6	4.5
Total public debt 3/	17.0	17.7	24.3	24.3	25.3	26.1	26.9	27.8	29.0
Balance of Payments (percent of GDP)									
Current account balance, incl. official transfers	-7.6	-5.7	-7.0	-7.0	-6.5	-5.9	-5.8	-5.7	-5.6
Of which: Official transfers 4/	3.4	3.4	4.1	3.6	3.3	3.1	3.1	3.0	3.0
Of which: Remittance inflows	12.0	12.1	14.5	15.6	15.0	14.2	13.0	12.6	12.3
Financial account	-5.0	-2.3	-8.3	-3.9	-4.0	-3.3	-3.4	-3.4	-3.1
Of which: Direct investment, net	-3.4	-2.7	-4.2	-4.7	-3.6	-3.6	-3.6	-3.7	-3.7
Of which: Portfolio investment, net	-3.0	0.8	-1.2	1.5	0.6	1.8	1.9	2.0	2.2
Errors and Omissions	2.8	3.5	-1.6	2.6	2.2	2.4	2.2	2.0	2.3
Financial Sector									
Non-performing loans (percent of total loans)	2.5	1.9	2.5	...	...	...	...	...	...
Bank credit to the private sector (percent change)	10.8	10.0	7.1	13.4	11.0	8.5	7.5	7.0	6.2
Deposits of the private sector (percent change)	9.3	15.6	10.9	9.3	9.0	8.2	7.2	7.0	6.8
Regulatory capital to risk weighted assets	17.0	15.9	16.5	...	...	...	...	...	...
Memorandum items:									
GDP (millions of euros)	6,672	7,056	6,772	7,493	8,049	8,571	9,076	9,569	10,072
Real GDP growth per capita	3.6	5.6	-5.7	7.1	3.4	3.4	3.2	3.1	3.1

Sources: Kosovo authorities; and IMF staff estimates and projections.
1/ 2021 as of Q2 2021.
2/ The "fiscal rule" caps the overall fiscal deficit at 2 percent of GDP, excluding investment financed with privatization receipts and donor financing contracted after 2015, as well as PAK-related current expenditure; the IMF calculates expenditures from carried-forward own-source revenue (OSR) as the difference in the municipal OSR stock.
3/ Includes guarantees and beginning in 2020, Euro 120 million of debt with KPST. It does not include contingent debt of former Yugoslavia.
4/ Total foreign assistance excluding capital transfers.

INTERNATIONAL MONETARY FUND

REPUBLIC OF KOSOVO

STAFF REPORT FOR THE 2021 ARTICLE IV CONSULTATION

December 20, 2021

KEY ISSUES

Context. After contracting more than 5 percent in 2020, Kosovo's economy is projected to have recovered by 7.5 percent in 2021, thanks to mobility normalization, extraordinary diaspora inflows, and strengthened confidence. Improved vaccination rates supported these trends and mitigation and recovery measures provided lifelines to those most affected by the pandemic. Though GDP growth is expected to normalize in 2022, the new omicron variant is a reminder that the pandemic continues to represent the main downside risk.

Key Recommendations:

- **Fiscal policy.** A positive fiscal impulse of around 2 percent of GDP is needed in 2022 to cushion the projected softening of diaspora inflows, while keeping the deficit within the fiscal rule. Fiscal support should be mainly provided through larger public investment to improve economic resilience. Planned measures under the 2022 recovery package need to be better defined, and the new social transfer programs need to be more targeted. Importantly, the new law on public salaries should contain the wage bill within its legal ceiling. The commitment to stick to the fiscal rule as the guide for medium-term policy needs to be combined with continued efforts to expand the tax base, strengthen fiscal transparency, and prioritize expenditure to close social and economic infrastructure gaps and diversify growth engines.

- **Financial policy.** Following the phase-out of pandemic-related support measures, credit risk monitoring should be strengthened to ensure that banks maintain prudent levels of provisions and capital buffers. The appointment of directors to the Central Bank Board creates the conditions for the implementation of the 2019 Financial Sector Stability Review and 2020 Safeguard Assessment recommendations.

- **Structural reforms.** Strengthening public investment management and the performance and oversight of public-owned enterprises, improving the efficiency of the justice system, and closing infrastructure and skills gaps are needed to diversify growth engines, tackle informality, and improve governance. Greening Kosovo's growth requires a credible strategy centered around carbon pricing.

Approved By	
Mahmood Pradhan (EUR) and Gavin Gray (SPR)	The discussions took place remotely during October 20 – November 5, 2021. The team consisted of Gabriel Di Bella (head), Si Guo, Ezgi Ozturk, Francisco Roldan, Wei Zhao (all EUR), Oana Luca (SPR) and was assisted by Stephanie Eble, Selim Thaci and Amanda Edwards (Resident Representative Office). Merita Kernja and Agnesa Zalezakova assisted in the preparation of the report. The mission met with Prime Minister Kurti, Minister of Finance, Labor and Transfers Murati, Central Bank Governor Mehmeti, other senior officials and representatives of trade unions and the business and donor communities. Mr. Korbi (OED-World Bank) participated in most meetings.

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CONTEXT: MOBILITY NORMALIZATION, EXTRAORDINARY DIASPORA SUPPORT AND IMPROVED EXPECTATIONS, THE KEYS OF THE RECOVERY

1. **A decline in the number of new COVID-19 cases and increased vaccination rates have allowed a relaxation of stringency measures and supported mobility, which has returned to more normal levels**:

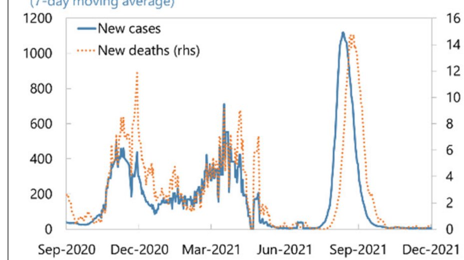
- Except for a sudden surge and equally rapid decrease in August-September 2021, the number of new cases has remained low since May.

- The government has already secured vaccines to cover 70 percent of the population through COVAX, bilateral donations and budgetary purchases; and has allocated funds in the 2022 budget to procure additional vaccines for booster shots and to further expand coverage. After a sluggish start, the pace of vaccinations accelerated in mid-2021, and as a result, Kosovo's vaccination ratio is now among the highest of the Western Balkans.

- While mobility has largely normalized, some restrictions remain in place, including on the number of people allowed in gatherings, and the hours of operation of restaurants and other establishments. For indoor activities, vaccination certificates are required.

Kosovo: COVID-19 New Cases and Deaths

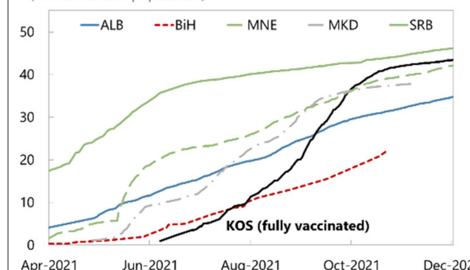
(7-day moving average)



Sources: Johns Hopkins Center for Systems Science and Engineering, COVID-19 Database.

Fully Vaccinated Population

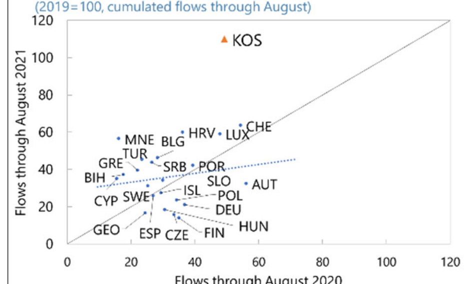
(Percent of total population)



Sources: Our World in Data.

Number of Tourists from Abroad

(2019=100, cumulated flows through August)



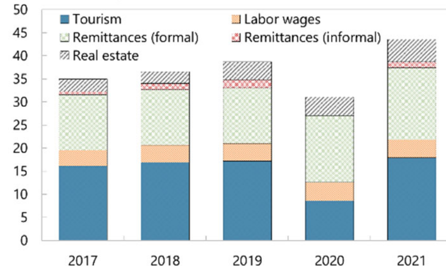
Sources: Haver Analytics; and IMF staff calculation.

2. **A more stable political environment provides an opportunity to effectively contain the health crisis and revitalize the reform process.** Following a number of short-lived and caretaker administrations over 2019-20, the government that took office in March 2021 has a clear majority in Parliament. This provides a window to focus on combating the pandemic and passing critical legislation.

3. **After contracting 5.3 percent in 2020, GDP is projected to have rebounded by 7.5 percent in 2021 on renewed mobility and extraordinary support from the diaspora.** Diaspora inflows (remittances, tourism, compensation of seasonal migrants, and real estate

investment) averaged 37.5 percent of GDP in 2018-19, plummeted to 31 percent in 2020, but overshot their pre-pandemic level in 2021, reaching about 43 percent of GDP. In particular, the number of visitors from abroad surpassed by a large margin its pre-pandemic level of 2019, making Kosovo a unique case in Europe. Moreover, renewed mobility and political stabilization have improved expectations about the future and strengthened confidence, further supporting demand (Box 1).

Diaspora Flows
(Percent of GDP)



Sources: CBK; and IMF staff calculations.

Increase of 2021 Fiscal Revenues
(Percent of GDP)

Revenue Increase	4.2
Cyclical Recovery	1.2
Formalization Gains	1.1
Excise Tax Increases	0.5
One-off POE Dividends	0.4
Diaspora Travel Overshoot	0.8

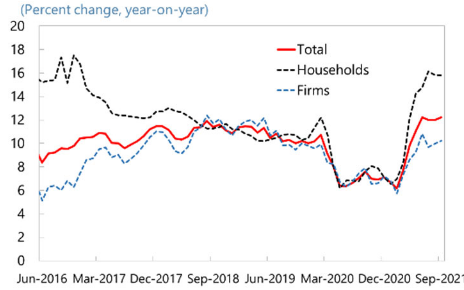
Sources: Kosovo Ministry of Finance; and IMF staff calculations.

4. The contribution of policies to economic activity in 2021 has been mixed:

- **The fiscal policy stance tightened.** A strong recovery in fiscal revenues together with broadly unchanged levels of nominal spending are projected to have brought the fiscal position to a small deficit of 0.4 percent of GDP in 2021, compared to 7.9 percent of GDP in 2020. The increase of fiscal revenues (of about 4 pp of GDP, excluding grants) was explained by the cyclical recovery, formalization gains, excise tax increases, one-off dividends from Public-owned Enterprises (POEs), and the effect of the diaspora travel overshoot on taxes tracking consumption. In turn, the expenditure-to-GDP ratio declined on the back of double-digit nominal GDP growth (of 10.7 percent) and low absorption of the investment budget, in part due to the absence of a functioning Board at the Procurement Review Body (PRB) since March 2021, and a reassessment of priorities by the new government.

- **Financial policies allowed credit to keep flowing.** Regulatory forbearance measures in early 2021, improved expectations, and strong diaspora inflows supported credit growth, which after some deceleration in 2020, picked up in 2021, in particular to households.[1]

Private Sector Credit Growth
(Percent change, year-on-year)



Sources: CBK; and IMF staff calculations.

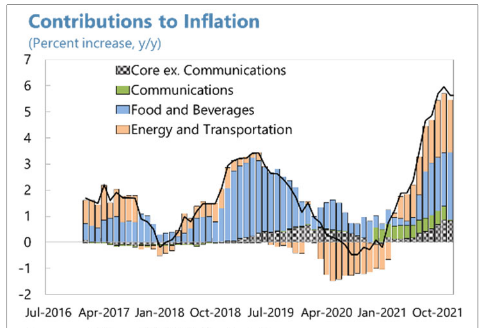
Mitigation and Recovery Measures 2020-2021
(Euro million)

	2020	2021
Total	**296**	**420**
(percent of GDP)	*4.3*	*5.6*
Wages and Salaries	**34**	**20**
Goods and Services	**29**	**38**
Utilities	**0**	**0**
Subsidies and Transfers	**231**	**262**
Employment Support	17	50
Support to Firms	150	108
Support to Households	16	50
POE support	12	30
Other	37	24
Capital Spending	**2**	**100**

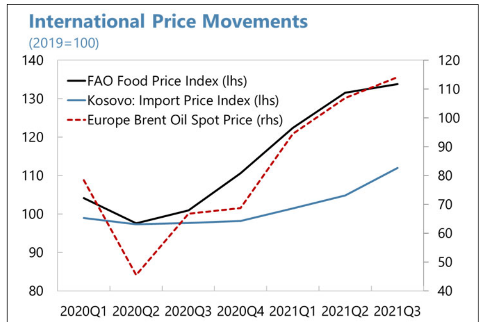
Sources: Kosovo Ministry of Finance; and IMF staff calculations.

[1] While support from net bank credit was broadly in line with expectations, larger diaspora inflows more than offset the larger fiscal tightening; this led to a stronger real GDP growth rebound than expected at the time of the 2020 Article IV consultation (4.5 percent).

5. Mitigation and recovery budgetary programs adequately targeted those most affected by the pandemic. The 2021 Economic Revival Program (ERP-21) extended most of 2020's measures (including lifelines for households and firms, the expansion of healthcare capacity, and wage bonuses for essential workers), but it also added new measures, such as employment support, child and maternity allowances, support for POEs to improve their management and operation, and a blanket reserve for additional capital expenditures. While the execution of the current expenditure components of the ERP-21 has been in line with expectations, investment absorption has been low.



Sources: KAS; and IMF Staff calculations.



Sources: EIA; FAO; KAS; and IMF staff calculations.

6. Inflation in 2021 is projected to have increased to more than 5 percent on higher energy and food prices. Base effects explained most of the increase as energy and food prices rebounded to pre-pandemic levels. A one-off increase in communication tariffs also played a role. Although households have so far remained insulated from the increase of electricity prices in Europe, a few firms in the export-oriented mining sector have been severely affected.[2] Core inflation has remained low, but it has begun to creep up in 2021:H2. In turn, nominal wages recovered by 6 percent (y/y) through October 2021 after contracting 4 percent in 2020.

7. The size of the current account deficit (CAD) in 2021 remained similar to that in 2020. The CAD is projected to have reached 7 percent of GDP, as the expansion in the value of imports and other debits was offset by the recovery in exports of goods and services and remittances. Non-traditional exports (mainly furniture) expanded briskly, though from a low base, while traditional nickel exports suffered in 2021:H2 due to the higher European electricity prices. The CAD was financed by increased unofficial diaspora inflows, reflected in larger errors and omissions of about 2.5 percentage points (pp) of GDP, and by stronger FDI. Rebuilt fiscal buffers and the new SDR allocation led to stronger Central Bank of Kosovo (CBK) international reserves, whose size is assessed to be adequate using the IMF's reserve adequacy (RA) metrics. In turn, the results of the EBA-lite methodology suggest that the external position in 2021 is projected to be moderately weaker than implied by medium-term fundamentals and desirable policy settings (Annex III).

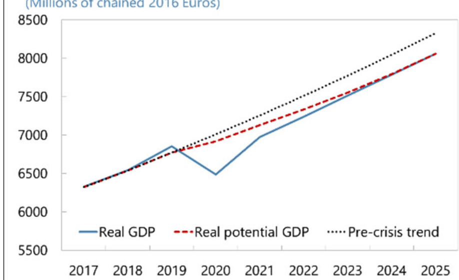
[2] Kosovo's abundant lignite reserves and coal-based generation have kept electricity costs down for households and most firms. A few large firms that have a choice over their electricity generation source were exposed to the large spike in European electricity prices, forcing the largest nickel exporter to temporarily shut down production in October 2021. While domestic electricity generation covers about 90 percent of Kosovo's demand, the increase in the value of electricity imports may lead to a tariff increase in 2022.

THE OUTLOOK: GROWTH TO NORMALIZE IN 2022 AMID STILL-HIGH UNCERTAINTY

8. **Absent negative pandemic-related surprises, real GDP growth is expected to slow to a more normal pace in 2022.** While activity will be buoyed by 2021's economic momentum, staff's GDP growth projection of 3.8 percent is based on the following assumptions: (i) no strict lockdowns and an increase in vaccination rates to at least 70 percent of the population; (ii) a return of diaspora inflows to their pre-pandemic norm after their overshoot in 2021; (iii) a fiscal impulse of at least 2 pp of GDP; and (iv) continued expansion in net bank credit to the private sector. Inflation (y/y) is projected to remain high in 2022:H1, but to decelerate thereafter to 2.5 percent by end-2022 as base effects disappear. The CAD is projected to narrow slightly to 6.5 percent of GDP as pent-up consumption demand peters out.

9. **Pandemic-induced long-term scarring is now projected to be lower than originally envisaged.** Diaspora inflows have proved to be more resilient than expected, helping sustain contact-intensive activities. Accordingly, the output loss compared to the pre-crisis trend is now expected at about 3.3 percent in 2025, i.e., ½ of that projected in the 2020 Article IV Consultation. A smaller medium-term output loss remains as on-and-off implementation of stringency measures is expected to still limit somewhat contact intensive activities, while factor reallocation will be gradual given institutional, human capital and infrastructure gaps.

Headline and Potential GDP
(Millions of chained 2016 Euros)



Sources: KAS; and IMF staff calculations.

10. **While lower than in early 2021, uncertainty remains high, and downside risks are prevalent** (Annex I). New virus variants may lead to a surge in cases, disrupting economic activity and setting growth back, especially if they affect the strongly seasonal diaspora travel. High regional electricity prices can negatively affect traditional nickel exports by 1 – 2 pp of GDP in 2022. Budget implementation could suffer if PRB normalization takes longer than expected, and the quality of public expenditure composition may deteriorate if the new law on public wages leads to generalized wage hikes. In turn, inflation can be higher than expected if imported inflation proves to be persistent and domestic electricity tariffs are increased. On the upside, the increase in diaspora inflows observed in 2021 may prove to be more permanent than envisaged by staff, and lead to stronger activity.

Authorities Views

11. **While the authorities were more optimistic about the strength of the economic upswing, they agreed with staff that the pandemic continues to represent the main downside risk.** They agreed that increased mobility played a key role in the recovery and emphasized that good progress in vaccinations allowed the return of diaspora travel. They

noted that they projected real GDP growth to reach about 10 and 8 percent in 2021 and 2022 respectively, due to the positive effect of policies, a continuation of strong diaspora inflows, higher public and private investment, and continued growth in non-traditional exports. They argued that an ambitious program of government actions will play a catalytic role in expanding economic activity and lead to real GDP growth of more than 7 percent per year in 2022-24. They concurred with staff that the pandemic remains the main downside risk but emphasized that the continuation of the vaccination program should mitigate it. The authorities also agreed with staff that inflation will remain persistently high in 2022:H1, but that it will gradually ease thereafter.

POLICY DISCUSSIONS: PIVOTING FROM EMERGENCY RESPONSE TO STRUCTURAL TRANSFORMATION

A. Fiscal Policy: Backstopping the Recovery While Shifting Expenditure Composition to Support Growth and Resilience

12. Fiscal policy needs to return to a more supportive stance in 2022. Staff pointed out that the projected softening of diaspora inflows will result in lower fiscal revenues of around 0.8 pp of GDP; this, together with an increase in expenditures of about 1 – 1.5 pp of GDP, mainly for investment projects, will provide a fiscal impulse of around 2 pp of GDP that would help sustain the recovery by cushioning the projected softening of external inflows, while keeping the deficit within the fiscal rule limits. [3]

Public Wage Bill, and Subsidies and Transfers
(Percent of GDP)

Sources: KAS; and IMF staff calculations.
Note: The jump in 2020 includes extra-payment to frontline workers.

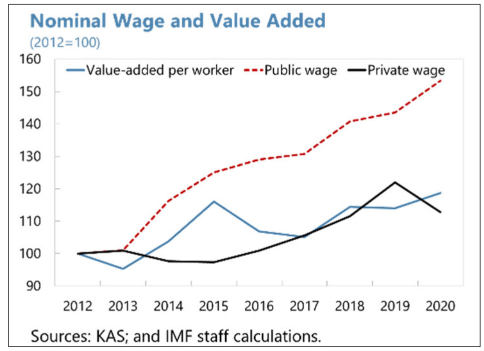
13. The transparency, focus, and composition of public spending should be strengthened, including to support economic resilience. In this regard, staff emphasized that,

- **The intended policy actions under the Economic Revival Program for 2022 (ERP-22) could be better defined.** A blanket allocation for this program in the budget for 2022 together with other contingency reserves amount to about 2 percent of GDP.[4] Staff

[3] The "fiscal rule" caps the overall fiscal deficit at 2 percent of GDP, excluding investment financed with privatization receipts and donor financing contracted after 2015. Parliament suspended its implementation for 3 years (2020-22) to create room for pandemic-related fiscal support.

[4] This includes a blanket allocation for subsidies and transfers under the ERP-22 of 1.3 percent of GDP, and allocations for contingencies of 0.7 percent of GDP (0.1 percent of GDP for salaries and allowances, 0.2 percent of GDP for goods and services, 0.3 for subsidies and transfers, and 0.1 percent of GDP for capital spending).

agreed that a contingency reserve to address pandemic-related downside risks is appropriate but urged the authorities to broadly define the ERP-22's intended policy actions and beneficiaries.



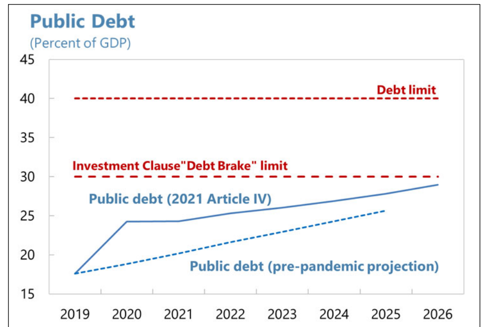
- **The wage bill needs to remain within its legal ceiling.** While the budget for 2022 does not envisage across the board wage hikes, the new draft law regulating public wages is expected to be discussed by Parliament in 2022:H1. Staff argued that the new law should strengthen transparency and compensation fairness but be based on wage coefficients that do not unsustainably increase the total wage bill.

- **New social transfer programs need to be more targeted, and the growth of existing transfers contained.** The budget for 2022 envisages new child and maternity allowances of 0.6 percent of GDP. Staff argued that while there is fiscal space to expand the coverage of households benefitting from social transfers, these transfers need to be targeted to low-income, vulnerable, households. In addition, staff emphasized that the certification of war veterans should be finalized, and that the budgetary envelope for their benefits needs to be insulated from the expected increase in minimum wages.

- **Public investment should be geared at increasing economic resilience.** The combined share of investment envisaged for education and health in the budget for 2022 represents only about 11 percent of the total (0.6 percent of GDP). Staff argued that a modest investment reallocation (e.g., from defense to social infrastructure) can help expand the health system's capacity and the access to computers for households and schools. This would help Kosovo cope with a renewed spike of cases without resorting to costly stringency measures and would limit the damage to education if virtual learning needs to be reinstated.

14. Continued fiscal contingency planning is essential in the face of still-high uncertainty. If the pandemic surprises on the downside, staff underscored that the fiscal deficit can be allowed to increase beyond the fiscal rule ceiling. While replenished fiscal buffers and the new SDR allocation would constitute the first line of defense to a decline in fiscal revenues, staff noted that to further mitigate this risk the authorities could anticipate public debt placements and explore contingent bilateral and multilateral financing. These actions would add to the implementation of further mitigation programs on the expenditure side, which should be financed by the contingency reserves already in the 2022 budget. Staff noted that other fiscal risks include the ongoing revision of the law on salaries (which can add 1 pp of GDP to the wage bill) and an increase in war veteran benefits, which continue to breach their 0.7 percent of GDP legal ceiling. Given the upbeat GDP growth and revenue projections in the budget for 2022, staff argued that preparing an alternative scenario based on, for example, the more conservative consensus growth forecast, can help the authorities identify potential financing needs as well as expenditure programs that need containing. On the upside, staff acknowledged that the fiscal revenue base may be higher if the overshoot in diaspora inflows of 2021 proves to be permanent; and that an allocation for expropriations in the budget for 2022 (of 0.7 percent of GDP) can facilitate the absorption of donor-financed investment projects.[5]

15. The authorities' commitment to stick to the fiscal rule as the guide for policy in the medium-term is appropriate. While the authorities' plan is to reinstate the fiscal rule in 2023, staff expect its *de-facto* reinstatement already in 2022 based on investment implementation projections that consider the historical track record. The use of the fiscal rule as a guide for policy will anchor public debt below the 40 percent of GDP legal ceiling through the medium-term (Annex II). Staff also discussed other medium-term fiscal priorities. In this regard,



Sources: Kosovo Ministry of Finance; and IMF staff calculations.

- **Staff urged to continue efforts to expand the tax base.** Numerous exemptions and special regimes weaken the tax base, and the implementation of the FTA with Turkey and the EU Stabilization and Association Agreement (SAA) will reduce customs revenues by 1 pp of GDP through 2026. Staff argued that rationalizing exemptions and increasing excise taxes, including on coal, could raise 0.5 – 1 pp of GDP to offset customs revenue losses. Staff welcomed efforts to improve tax administration and encouraged the authorities to intensify tax debt collections. Moreover, staff emphasized the importance of measuring and publishing tax expenditures as an annex to each year's budget.

- **Staff welcomed progress on e-procurement and urged to further strengthen fiscal transparency.** The e-procurement system covers 100 percent of expenditures since early 2020, and all procurement stages, including bids, since August 2021. Moreover, the auditor general's report of the 2020 budget concluded that most budget organizations provided the necessary data to analyze pandemic-related spending.[6] To further strengthen transparency and avoid conflicts of interest, staff encouraged the authorities to finalize the new law on beneficial ownership transparency that will lead to the creation and publication of the Beneficial Ownership Transparency Registry.

- **Staff emphasized the need to improve spending efficiency and to use the windfall provided by the diaspora to close infrastructure gaps and diversify growth engines.** Staff noted that many of the initiatives in the "Program of the Government of Kosovo

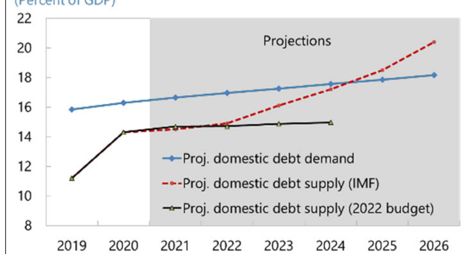
[5] The implementation of donor-financed investment projects has been constrained in a few cases by the absence of a budget allocation to pay for needed land expropriations.

[6] The audit can be found at https://www.zka-rks.org/wp-content/uploads/2021/09/RaportiVjetoriAuditimit_2020_Eng.pdf . The audit report on the performance of COVID-19-related spending is under preparation with expected completion in 2022.

2021-25" are likely to result in recurrent social benefits and other transfers (Box 2). While acknowledging that supporting social cohesion is essential, staff called for a more balanced approach. In this regard, staff argued that reallocating expenditures to improve and expand social infrastructure in education and health will support human capital formation and ease labor reallocation, which together with expanded and greener physical infrastructure, including on energy generation, can increase the attractiveness of Kosovo as an FDI destination.

- **While the government's balance sheet strengthened significantly in 2021, staff encouraged the authorities to expand the investor base of government debt.** The replenished fiscal buffers (estimated to have reached 5.5 percent of GDP at end-2021) and the projected absence of a financing gap provide an opportunity to initiate the process to obtain a rating for Kosovo's government securities. This action would help expand the size and liquidity of the domestic public debt market, which remains thin and may reach its satiation point in 3-5 years (Appendix II).

Domestic Government Debt Demand and Supply
(Percent of GDP)



Sources: IMF staff calculations.
Note: Domestic debt excludes the scheduled reimbursement from the gover
to the KPST on replenishing the pension saving.

Authorities Views

16. While the authorities concurred with most of staff's recommendations, they emphasized that they expect government policies to jumpstart a virtuous circle of higher growth and stronger fiscal revenues. They agreed on the positive role played by ERP-21 implementation and indicated that the under-execution of the investment program in 2021 reflected investment reprioritization following national and local elections. The authorities highlighted that budget execution will be more supportive of activity in 2022 and clarified that measures linked with ERP-22 will be finalized as the areas that need additional support become clearer. On social transfers, they acknowledged staff's concern about targeting, but emphasized that the cost of new schemes will not be high. They agreed on the importance of public investment in education and health and highlighted that the budget for 2022 includes an allocation to build new kindergartens that will help close pre-school education gaps. On fiscal risks, the authorities reassured staff that war veteran benefits will be decoupled from minimum wage increases and that the drafting of the new law on salaries will consider the impact on the wage bill. While acknowledging that growth projections in the budget for 2022 are stronger than consensus, they were confident that planned government policies will preserve economic momentum and help sustain a trend of high growth rates initiated in 2021, contributing to maintain the strong fiscal revenue performance. On medium-term priorities, they agreed that the tax base should be expanded and pointed out that technical work on tax policy changes and on measuring tax expenditures is ongoing. The authorities acknowledged that the market for government securities remains thin and that they are considering the various options highlighted by staff to expand its depth.

B. Financial Policies: Unwinding Emergency Support While Strengthening Credit Monitoring

17. Kosovo's financial sector continues to be resilient overall, but pockets of vulnerabilities remain. Credit to the private sector is dominated by banks, with microfinance institutions (MFIs) mainly focused on short-term financing to micro and small-sized businesses (MSBs).

- **Banks' aggregate performance has been robust throughout the pandemic**. This positive outcome was predicated on strong pre-pandemic capital and liquidity buffers, appropriate CBK policies, and the stronger-than-expected economic rebound. However, a few smaller banks remain vulnerable. These banks have experienced fast lending, in particular to the construction sector, but have lower-than-average capital buffers and provisions.

- **After a contraction in both lending and profitability in 2020, MFI's performance improved in 2021.** The main risks facing the sector stem from their client base (mainly small businesses, which have generally been more affected by the pandemic) and their reliance on external loans for funding.

18. Given the more normal economic conditions, the CBK's decision to gradually unwind its pandemic-related support measures in 2021 was warranted. Staff noted that NPLs in 2020-21 increased marginally *vis-à-vis* their pre-pandemic level of 2019, even as regulatory forbearance measures expired.[7] Despite this limited aggregate increase, staff recommended to strengthen credit risk monitoring to ensure that bank-by-bank provisioning reflects the underlying change in asset quality, and that capital buffers are sufficient to absorb write-downs and keep the flow of credit. Staff pointed out that, if needed, the CBK should agree on action plans with affected banks to restore their financial health with some flexibility on the timeframe. For more resilient banks, the CBK can consider a gradual resumption of dividend payments, after assessing their capital trajectory in a forward-looking setting. In this regard, staff emphasized that the CBK should continue to develop its capacity to evaluate the expected credit loss (ECL) frameworks of regulated entities in the context of IFRS-9 implementation.

19. Implementing the recommendations of the 2019 Financial Sector Stability Review (FSSR) and those of the 2020 Safeguards' Assessment (SA) is essential. Staff welcomed Parliament's decision to fill vacancies at the CBK Board in November 2021 but noted that the long delay to take this action (of around 18 months) prevented the CBK to adopt its budget and implement needed reforms. As Board operation resumes, staff urged the authorities to accelerate the implementation of FSSR and SA recommendations, including to ensure that the financial stability function reports directly to the Executive Board; that the

[7] Only about 1 percent of total loans remained under COVID-related forbearance as of October 2021.

CBK's governance is reviewed to assess the effectiveness of decision-making bodies and the appropriateness of membership in key committees; and that the audit and risk committees are strengthened, including through expanding their scope to the oversight of financial reporting and risk management activities (Annex IV).

20. Given the comfortable level of fiscal buffers, the new SDR allocation can be used to strengthen the CBK's ability to provide liquidity support to banks. While Kosovo's banks generally maintain high liquidity ratios, the size of the CBK's Emergency Liquidity Assistance (ELA) window (€92 million), and that of repo and overnight liquidity facilities (€100 million) are insufficient to respond to systemic events of even a modest magnitude. Staff argued that the SDR allocation can be kept available to finance pandemic-related budget expenditures should downside risks materialize in the near term, but that they should add to the CBK's bank lending facilities in the medium-term. This is important as foreign reserves are likely to fall below 100 percent of the IMF RA metric in the medium term (Annex III).[8]

Authorities Views

21. The authorities agreed with staff about the banking sector's strength and on the positive role that policies played to mitigate the pandemic's impact on financial stability. They concurred with staff that losses after lifting supervisory relief measures will be limited and that banks have sufficient capital buffers to absorb them. The authorities added that they did not foresee the adoption or further extension of relief measures, unless downside risks materialize, and that they will return to the standard practice of engaging with banks on a case-by-case basis to decide on dividend payment approvals. The CBK acknowledged staff's concern about risks stemming from certain smaller banks, and emphasized that they will continue to monitor developments closely. On MFIs, the CBK agreed that MSBs in contact-intensive sectors were the most affected by the pandemic, but reassured staff that external donor support to MFIs remains stable. The authorities agreed that delays to fill Board vacancies slowed down the adoption of FSSR and SA recomendations, but committed to accelerate their implementation going forward. On the use of the SDR allocation, they concurred with staff to keep it available for contingent budget financing in the short-term, but to use it to strengthen the CBK's ability to lend to banks in the medium-term.

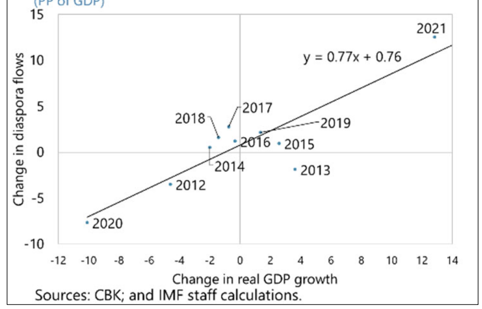
C. Structural Policies: Diversifying Growth Engines to Accelerate Income Convergence

22. Gradual improvements in institutions, infrastructure, and the policy framework as well as sustained increases in diaspora inflows have helped Kosovo narrow the pre-

[8] The Ministry of Finance and the CBK agreed to prepare a Memorandum of Understanding (MOU) if the SDR allocation is used for budgetary financing.

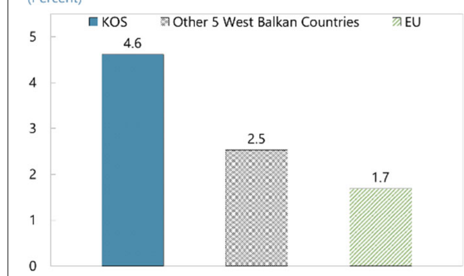
pandemic income gap with advanced economies. While staff reiterated many of the recommendations of the 2018 and 2020 Article IV consultations, this year's discussions focused on structural policies to: (i) gradually diversify Kosovo's growth engines; (ii) tackle informality; and (iii) create the conditions for greener economic growth.[9]

Diaspora Flows and GDP Growth
(PP of GDP)



Sources: CBK; and IMF staff calculations.

Average Real GDP Growth Rate, 2010-2019
(Percent)



Sources: WEO; and IMF staff calculations.

Diversifying Kosovo's Growth Engines

23. Kosovo's growth model relies heavily on the diaspora. While lower COVID-19 cases and higher vaccination rates have enabled the resumption of diaspora travel, its increasing economic role has been facilitated by the improvement of air transport infrastructure, and by the expansion of the hospitality industry (hotels, restaurants, retail, and entertainment). While diaspora inflows have contributed to higher pre-pandemic growth rates than for peers, their upside for long-term economic growth is likely to eventually subside for several reasons: (i) the growth of diaspora inflows is bound to gradually converge down to the growth rate of the advanced host economies where the diaspora resides; (ii) long-term productivity growth in hospitality is slower than in modern manufacturing and high value-added services, and the skills set required from workers is generally lower; (iii) certain hospitality activities are more prone to small firms in the informal sector; and, (iv) the ties between the diaspora and the motherland tend to become more diffuse with the passage of time.

24. Gaps in physical infrastructure, labor force skills, and institutional quality continue to limit the size and composition of FDI flows, leaving diaspora inflows as the main growth engine. Kosovo's many strengths, including proximity to the EU, a young labor force, relatively low wages, few limits on capital flows, and trade agreements with the EU and other international partners, have not yet led to a diversification of FDI flows, which remain concentrated in real estate, banking, and mining. This severely limits the country's growth upside and the speed of economic convergence.

25. Diversifying the sources of economic growth and accelerating convergence calls for a better investment environment:

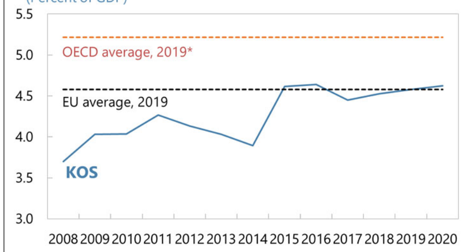
- **Closing the economic infrastructure gap requires improving public investment management, investment composition, and POEs' performance.** While Kosovo has improved road and broadband internet infrastructure, there are areas where progress has

[9] More detailed technical analyses are included in Appendices I to IV.

been less significant, including on water provision and electricity generation. As privatization revenues decline as a source of public investment financing, improving the composition of public investment and the absorption capacity of donor-financed projects will be essential. In this regard, staff reiterated the importance to advance in the implementation of the IMF's Public Investment Management Assessment (PIMA) recommendations to increase the efficiency, quality, and growth focus of infrastructure spending (Annex V). Staff pointed out that the "4-year Government Program" can place more emphasis on closing the infrastructure gap. In addition, improving the management and operation of POEs remains essential to increase the quality of public services in communications, water, and electricity provision.

Budgetary Expenditure in Education

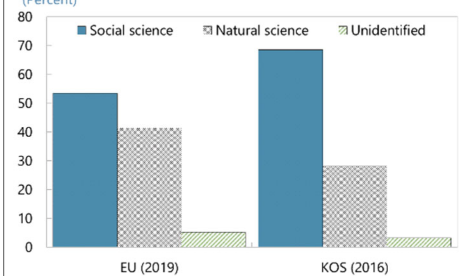
(Percent of GDP)



Sources: Eurostat; KAS; OECD; and IMF staff calculations.
*/ Most recent data available for Costa Rica is 2017.

University Students by Fields of Study

(Percent)



Sources: Eurostat; Kosovo authorities; and IMF staff calculations.

- **Strengthening human capital calls for improving social infrastructure and for the education system to meet the needs of the economy.** While public education spending has increased in GDP terms and is now comparable with the EU average, the quality of education still compares unfavorably with peers as reflected in PISA scores that remain the lowest in the Western Balkans. The pandemic has further eroded education quality, as virtual education was constrained by insufficient access to computers by schools and households. Moreover, university enrollment is biased towards social sciences, with natural, applied, and formal sciences attracting considerably less interest. In line with this, firms refer to a skills gap as an obstacle to doing business. Staff emphasized that supporting vocational education, improving teacher preparation, updating curricula, and strengthening the collaboration between higher education and businesses remain priorities. In the near term, improving students' access to computers is essential to preserve education quality in case virtual learning needs to be reinstated.

Authorities Views

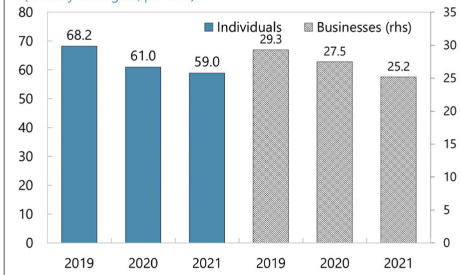
26. The authorities acknowledged the importance of closing infrastructure and skills gaps to attract FDI and diversify Kosovo's growth engines. They pointed out that they intend to prepare a list of key infrastructure projects and accelerate their implementation in close coordination with donors. They highlighted that the allocation for kindergartens in the budget for 2022 will help close existing gaps in preschool education. On skills mismatches the authorities explained that they are rolling out measures to better align enrollment by major in public universities with expected market demand by firms.

Tackling Kosovo's Informality

27. Kosovo's high levels of informality negatively affect competition, working conditions and firm size, limiting economic growth. According to both the World Bank and the EU, Kosovo's informal sector amounts to over a third of total employment. High informality erodes the tax base limiting funding for education, health, and infrastructure; hampers fair market competition as it places tax complying businesses at a disadvantage; limits firm productivity, size, and economies of scale due to restricted access to finance; and negatively affects labor conditions and social and customer protection.

Paper-based Payment Transactions

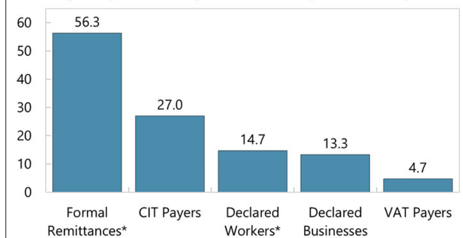
(January to August, percent)



Sources: Central Bank of Kosovo and IMF Staff Calculations.

Change in Different Economic Categories, 2021

(January to September, compared to the same period in 2019, percent)

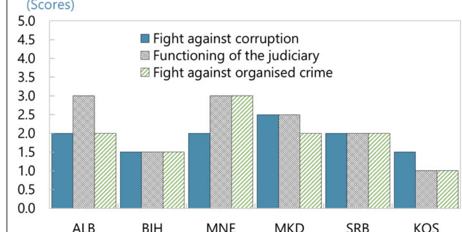


Sources: CBK; TAK; and IMF staff calculations.

*/ Data refers to change from January to August in 2021 compared to the same period in 2019.

State of Progress in Rule of Law, 2021

(Scores)



Sources: European Commission, Progress Reports, 2021.

Notes: The scores are on a five-point scale: (1) at an early stage, (2) some level of preparation, (3) moderately prepared, (4) good level of preparation, and (5) well advanced.

28. Staff contended that the pandemic brought about formalization gains. Government lifelines to businesses promoted employment formalization as the condition to access them included requiring workers to have formal employment contracts of at least 1-year duration. In addition, stringency measures and social distancing forced households and businesses to reduce cash-based transactions and increase digital payments, reducing tax avoidance. Finally, sustained progress in tax administration, supported by IMF technical assistance, continued to reduce tax evasion.

29. Simplified tax procedures, improved secondary education and enhanced financial inclusion will help sustain and expand recent formalization gains. Simplified tax procedures and enhanced monitoring and enforcement reduce the costs of formalization while increasing those of being informal. In addition, improved quality, and enrollment in secondary education, including technical and vocational training, has been found to be negatively associated to informality. In turn, linking taxes paid to services supplied by the state raises transparency, trust, and awareness about the benefits of formalization. Finally, enhancing financial inclusion and electronic payments make tax avoidance more difficult.

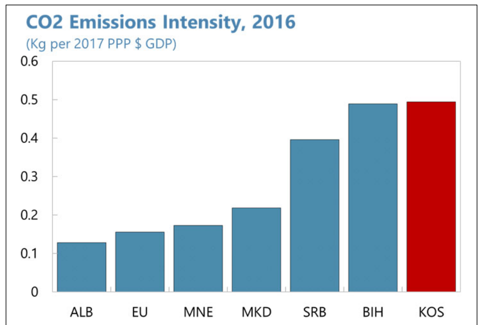
30. In the medium-term, formalization gains will be tied to improving the efficiency of the judicial system and tackling corruption. A high volume of backlog cases has become an obstacle to contract enforcement, increasing the cost of formality, and negatively impacting Kosovo's business environment and FDI flows. In this regard, staff emphasized that passing the draft Law on Commercial Courts, which among other reforms will increase the number of commercial judges and courts, is critical to improve the efficiency of the justice system.[10] In addition, staff urged the authorities to continue strengthening their anti-corruption and rule of law efforts and address remaining deficiencies in the AML/CFT framework (Annex V).

Authorities Views

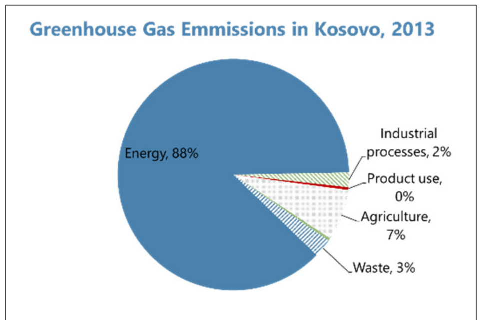
31. The authorities highlighted that reducing informality is one of their overarching policy priorities. They concurred with staff about the positive effect that policy actions had on formalization gains and highlighted that Kosovo's tax administration agency (TAK) has been increasingly conducting risk and cluster-based checks and enforcement measures to increase compliance and reduce informality. They agreed on the role of digital payments to promote formalization, and they have proposed to lower the threshold required for electronic payments. They recognized the negative impact of the heavy backlog of cases on the business climate and expect the situation to gradually improve after the Law on Commercial Courts is adopted. The authorities acknowledged the need for steady progress on improving the AML/CFT framework and pointed out that they view the real estate and construction sectors as particularly challenging, given their widespread informality and prevalence of cash payments.

Greening Kosovo's Economic Growth

32. Lignite-based electricity generation is the main contributor to greenhouse gas (GHG) emissions in Kosovo. While per capita emissions are relatively low due to the small share of manufacturing in GDP, the lignite-based electricity generation is behind the economy's high carbon intensity as measured by carbon emissions per unit of output. Moreover, the reliance on air-polluting energy generation has had a costly impact on health, in particular in the capital, Pristina. The World Bank assessed the health cost of air pollution at around 2.5-4.7 percent of GDP in 2016.



Sources: World Development Indicators.



Sources: Ministry of Environment and Spatial Planning, 2018.

33. Kosovo's intention to reduce carbon emissions is commendable, and staff urged the authorities to turn plans into action. Staff noted that Kosovo's "Climate Change Strategy (2018-27)" and "Climate Change Action Plan (2019-21)" appropriately set emission mitigation objectives but lack a clear roadmap for reduction targets and supportive measures. Staff emphasized that a credible climate and environment mitigation strategy should be centered around carbon pricing, while allocating its proceeds to investment in

[10] The EU also supports the passing of this law and has recommended, among other issues, that secondary legislation ensures equal compensation for all judges.

green projects and to mitigate the impact of higher energy prices on vulnerable households. Moreover, staff added that revenue-neutral policies (such as feebates) can be applied at the sectoral level. In the near term, staff urged the authorities to make progress in the installation of filters in "Kosovo B" (the largest lignite-based energy generation plant) in collaboration with the EU.

Authorities Views

34. The authorities agreed on the need to reduce GHG emissions and environmental pollution. They noted that progress has been made in improving the energy efficiency of municipal buildings. They emphasized that many legislative initiatives on climate, energy and air pollution were delayed due to the pandemic but that, as the emergency is left behind, they intend to resume work on a draft law on climate change. They concurred with staff that the decarbonization strategy would need to be in line with their strategic investment program on energy generation. Finally, the authorities agreed on the need to swiftly begin the work to install filters on "Kosovo B", but since this will require temporarily shutting down the plant, they are discussing with the EU on the right phasing of works.

STAFF APPRAISAL

35. Kosovo's people and its economy experienced a return to a certain degree of normality in 2021. Increased vaccination rates allowed a relaxation of stringency measures, supported mobility, and created the conditions for a resumption of diaspora travel. While the health system continued to cope reasonably well, still-binding supply constraints are a reminder of the need to expand the sector's capacity more decisively. Though uncertainty appears to have subsided with respect to 12 months ago, it remains high.

36. The fiscal response to the pandemic has been broadly adequate. The use of lifelines for households and firms, wage bonuses for essential workers, employment support, and child and maternity allowances for vulnerable households adequately cushioned the impact of the shock on those most affected by the pandemic. While the fiscal policy stance tightened in 2021 on the back of a strong rebound in revenues, its drag on the economy was more than offset by extraordinary diaspora inflows and sustained increases in net credit to the private sector.

37. Fiscal policy needs to return to a more supportive stance in 2022. The projected normalization of diaspora inflows calls for a relaxation of the fiscal stance of around 2 pp of GDP; this will require additional expenditures, mainly in the form of investment projects of about 1-1.5 pp of GDP. The relaxation of the fiscal stance would help sustain the recovery by cushioning the projected softening of external inflows, while keeping the deficit within the fiscal rule limits.

38. The focus, composition, and transparency of public spending needs strengthening, including to support economic resilience. While the objective to intensify vaccinations is both appropriate and commendable, intended policy actions under the "Economic Revival Program" need to be better defined, new social transfer programs should be more targeted, and the growth of existing transfers needs to be contained. While across the board wage hikes are currently not expected, the new law on public salaries should contain the wage bill within its legal ceiling. Public investment should be geared towards increasing economic resilience and preparing the economy for a renewed spike of cases.

39. Continued fiscal contingency planning is needed in the face of still-high uncertainty. Options for risk mitigation, on top of the reserves already in the 2022 budget, include anticipated public debt placements and contingent bilateral and multilateral financing. Other fiscal risks include the ongoing revision of the law on salaries and the indexation of war veteran benefits, which continue to breach their 0.7 percent of GDP legal ceiling. The upbeat GDP growth and revenue projections in the budget for 2022 call for the preparation of an alternative fiscal scenario based in the consensus growth forecast to identify potential financing needs as well as expenditure programs that need containing.

40. The commitment to stick to the fiscal rule as the guide for medium-term policy is appropriate. This will anchor public debt below the 40 percent of GDP legal debt ceiling through the medium term. Other medium-term fiscal priorities include expanding the tax base, strengthening fiscal transparency, and expanding the investor base of government debt. Importantly, the revenue windfall provided by the diaspora should be used to close social and economic infrastructure gaps and diversify growth engines.

41. The CBK's decision to gradually unwind its pandemic-related support measures in 2021 was warranted. While the financial system has remained resilient overall and the increase in aggregate NPLs is expected to be limited, strengthening credit risk monitoring is essential to ensure that bank-by-bank provisioning reflects the underlying change in asset quality, and that capital buffers are sufficient to absorb write-downs and keep the flow of credit. The supervisor authority's capacity to evaluate the ECL frameworks of regulated entities in the context of IFRS-9 implementation needs to continue improving.

42. The recommendations of the 2019 FSSR and those of the 2020 SA need to be implemented. The resumption of CBK Board operation will allow the implementation of FSSR and SA recommendations, including to ensure that the financial stability function reports directly to the Executive Board; that the CBK's governance is reviewed to assess the effectiveness of decision-making bodies and the appropriateness of membership in key committees; and that the audit and risk committees are strengthened, including through expanding their scope to the oversight of financial reporting and risk management activities.

43. The new SDR allocation can be used to strengthen the CBK's ability to provide liquidity support to banks. The SDR allocation would enhance international reserves, which are projected to fall below 100 percent of the IMF RA metric in the medium term, and thus support the CBK's lending facilities. On competitiveness, Kosovo's external position was assessed to be moderately weaker than the level implied by fundamentals and desirable policy settings in 2021.

44. Gaps in physical infrastructure, labor force skills, and institutional quality limit FDI flows, leaving diaspora inflows as the main growth engine. Diversifying the sources of economic growth requires improving infrastructure, public investment management, investment composition, POEs' management and performance, and for the education system to meet the needs of the economy.

45. Kosovo's high levels of informality negatively affect competition, working conditions and firm size, limiting economic growth. Simplified tax procedures, improved secondary education, and enhanced financial inclusion will help sustain and expand recent formalization gains. In the medium-term, formalization gains will be tied to improving the efficiency of the judicial system and tackling corruption.

46. Kosovo's intentions to reduce carbon emissions are commendable. A credible climate and environment mitigation strategy should be centered around carbon pricing, while allocating its proceeds to investment in green projects and to mitigate the impact of higher energy prices on vulnerable households. In the near term, the priority is to make progress in the installation of filters in the largest lignite-based energy generation plant in collaboration with the EU.

47. The next Article IV consultation with Kosovo is expected to be conducted on the standard 12-month cycle.

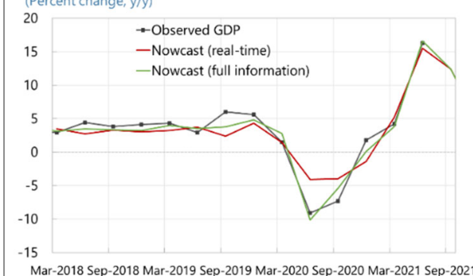
Box 1. Assessing the Strength of the Recovery: Nowcasting Kosovo's GDP

The pandemic highlighted the importance of having timely and reliable indicators on the strength of economic activity. This proved to be particularly important to measure the impact of mobility restrictions and recoveries, and to assess the appropriate size and timing of economic policies as well as their impact. While Kosovo's data is sufficient for surveillance, it lacks the range and depth available in more developed economies. In this context, staff implemented a nowcasting framework for Kosovo's GDP to weigh what available high frequency data conveyed about the strength of the recovery. The challenges for its implementation in Kosovo included the mixed data reporting frequencies, missing data and series of different length, and different reporting times for different data series.

The output of the nowcasting framework quite accurately estimated the size and timing of Kosovo's GDP recovery. High frequency indicators used in the framework include industrial production indices, remittances, electricity consumption, price indices, budget revenues, business turnover and SWIFT messages on trade finance. The results show that both the "real-time nowcast" (which estimates the GDP growth rate in period *t* using available information up to *t*) and the "full information nowcast" (which estimates the growth rate in all periods using the entire sample) track observed GDP quite accurately, though the "full information nowcast" naturally shows a better fit given the larger information set used in its estimation.

Nowcasts of Kosovo GDP

(Percent change, y/y)



Sources: IMF staff calculations.

In a context of high uncertainty, Kosovo's nowcasting proved very helpful in policy discussions. This was particularly the case in 2020:Q4 and 2021:Q1, when there were conflicting data signals on the size of the output contraction in 2020, and the timing of the start of the recovery. While preliminary data seemed to suggest that the recovery had accelerated strongly in 2020:Q4, the nowcasting output was consistent with continued weakness, a result that was confirmed later by further data releases. This helped inform staff policy advice to the authorities at a moment of heightened uncertainty.

Box 2. The Program of the Government of Kosovo, 2021-25

The "Government Program" announced in May 2021 covers a wide array of areas, ranging from securing vaccines to the integrity of justice institutions. The economic policy section of the program includes job creation, tackling informality, improving the business environment, supporting investment and entrepreneurship, improving infrastructure, and social welfare, while preserving the sustainability of public finances. Some of the employment and household support measures have been included in the revised budget for 2021 as part of the Economic Revival Program.

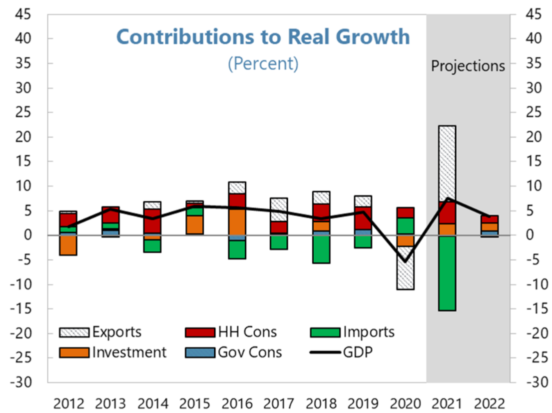
Many of the initiatives in the "Government Program" will result in an increase of recurrent budgetary spending. Although the implementation timing and cost of many initiatives remains to be determined, the annualized cost of the measures included in the revised budget for 2021 is around 1.3 percent of GDP. The preliminary estimate of the annualized cost of initiatives affecting recurrent spending is about 2 – 2.5 percent of GDP. The government also announced that the program would target road and railway infrastructure, but the detail of projects, financing and implementation timing remains to be determined.

Initiative	Annual Cost (preliminary, percent of GDP)	In 2021 Budget?
Labor and employment	**0.87**	
Support hiring during the recovery	0.15	Yes
Support youth employment	0.15	Yes
Support seasonal employment for low income households	n.a.	No
Fight informality through an increase of labor inspectors	0.04	No
Raise minimum wage [1/]	0.53	No
Assistance to households	**1.56**	
Assistance to households that lost their family head due to COVID	0.06	Yes
Introduction of child allowances	0.81	Yes
Payments for women after childbirth	0.37	Yes
Elderly state housing	n.a.	No
Affordable housing for 4000 families.	0.32	No
Build 160 new kindergartens [2/]	n.a.	No
Transfers or subsidies to firms	**0.21**	
Support for young enterprises	0.07	Yes
Support businesses in purchasing machinery	0.14	No
Minimum prices for agricultural products	n.a.	No

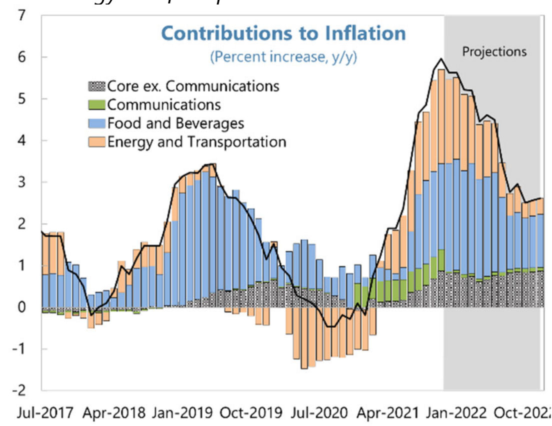
1/ Only if transfers to war veterans are indexed to minimum wage increases.
2/ The budget for 2022 has an allocation to build kindergartens of €5 million (around 0.1 percent of GDP).

Figure 1. Kosovo: Recent Economic Developments

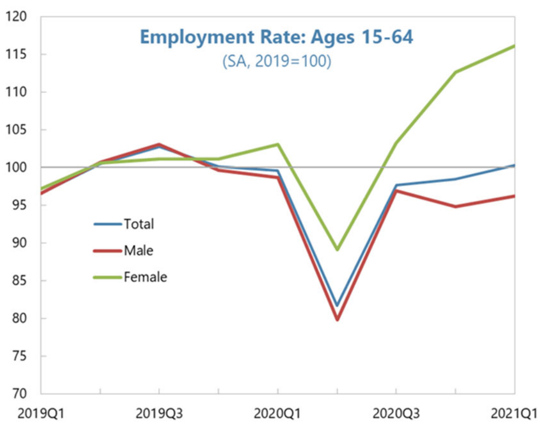
Economic activity rebounded strongly in 2021 led by private consumption and investment…



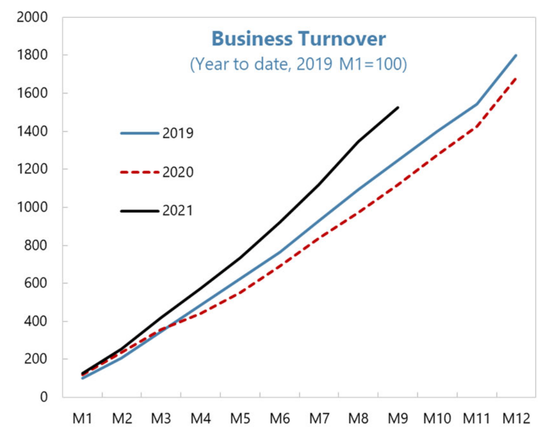
…while inflation has picked up, mainly due to a recovery in global energy and food prices.



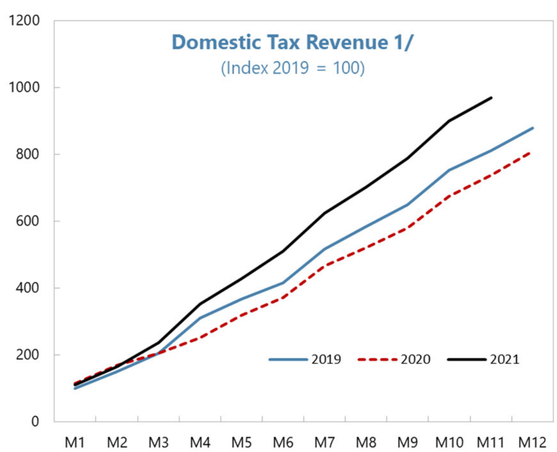
Employment quickly rebounded to its pre-pandemic levels…



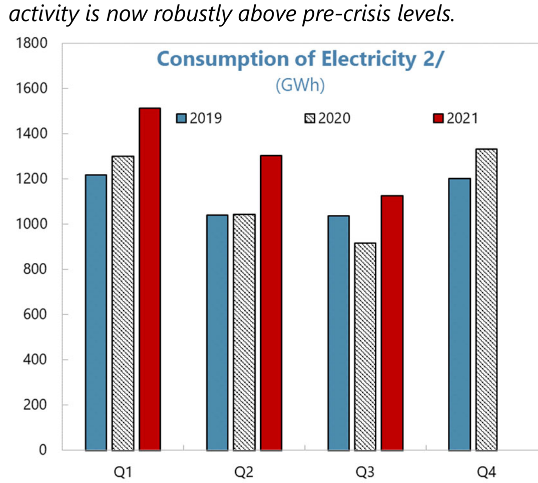
…while business turnover surpassed them.



The economic recovery fueled the growth of domestic tax revenues…



…and high frequency indicators suggest that economic activity is now robustly above pre-crisis levels.



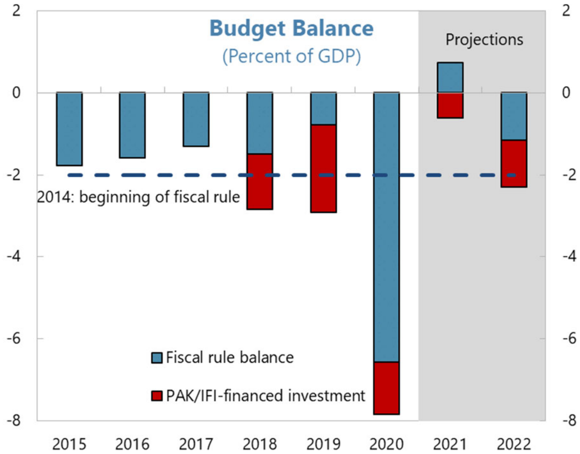
Sources: Haver Analytics; Kosovo Agency of Statistics; Central Bank of Kosovo; Kosovo Energy Corporation; Kosovo Company for Distribution and Supply; WEO; and IMF staff estimates.

1/ Domestic tax revenues is calculated as the sum of direct tax revenues and in-country VAT revenues.

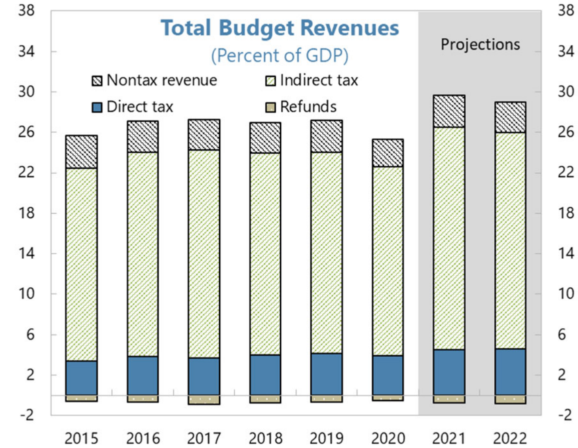
2/ Data includes consumers 220 - 110kV; total consumption does not include technical losses, commercial losses and transmission losses.

Figure 2. Kosovo: Fiscal Developments

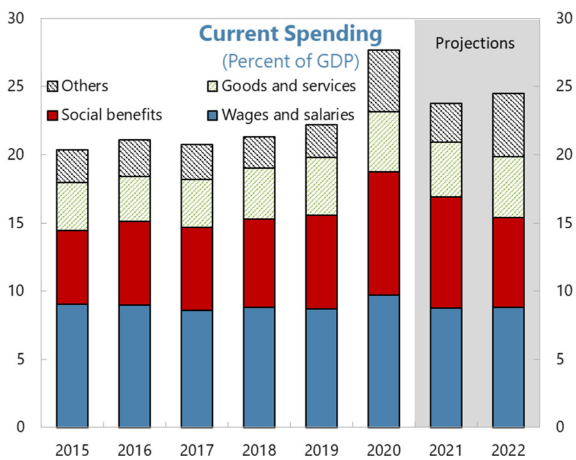
The fiscal position strengthened in 2021,



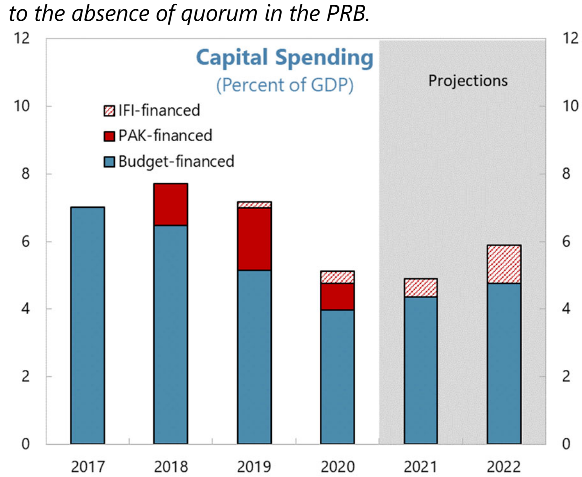
... on the back of a robust recovery in fiscal revenues,



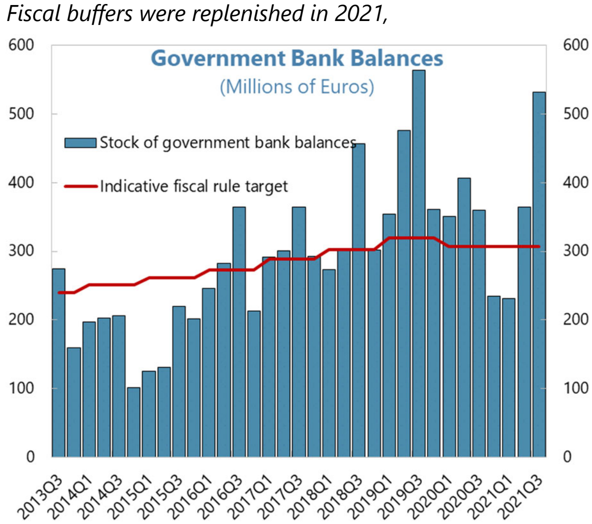
... and expenditure consolidation.



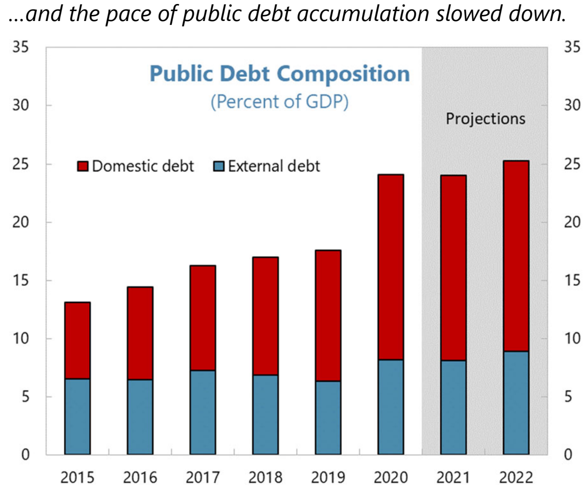
Public investment remained subdued in 2021, in part due to the absence of quorum in the PRB.



Fiscal buffers were replenished in 2021,



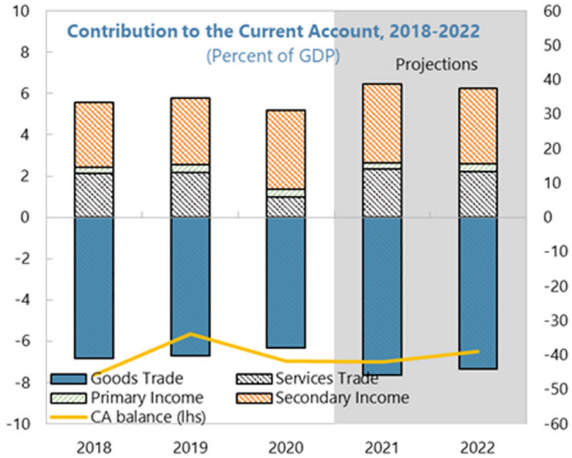
...and the pace of public debt accumulation slowed down.



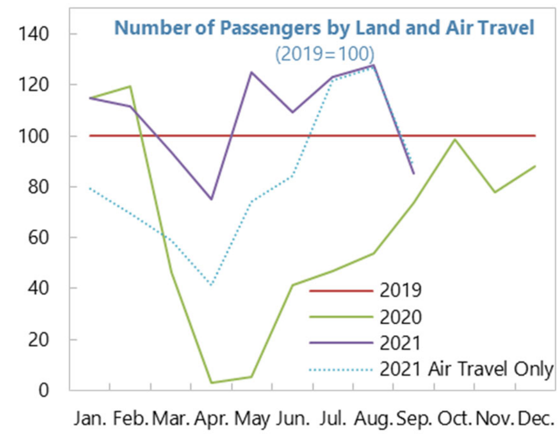
Source: Ministry of Finance, Central Bank of Kosovo, and IMF staff calculations.

Figure 3. Kosovo: External Sector Developments

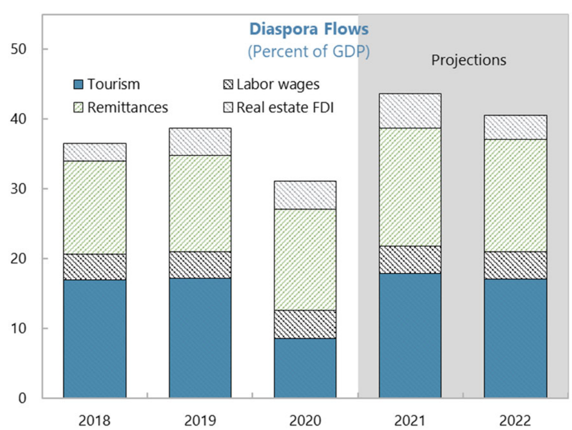
The current account balance in 2021 is projected to remain broadly unchanged vis-à-vis 2020.



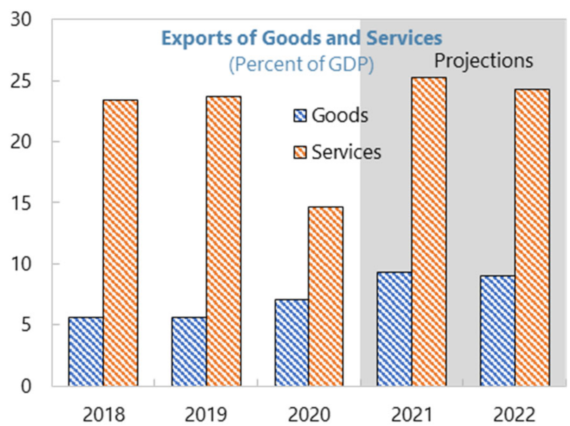
Travel by the diaspora surpassed pre-pandemic levels…



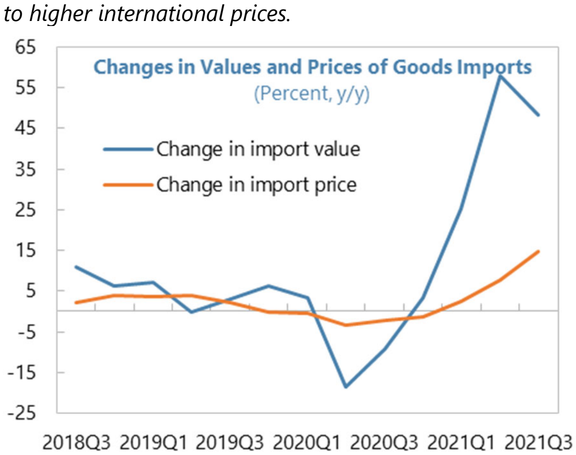
…boosting service exports and FDI in real estate. Remittance flows were also robust.



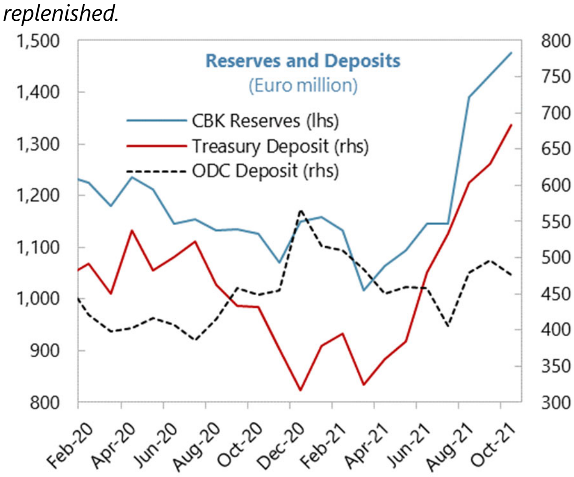
Exports of goods rose strongly, though still from a low base. .



Goods imports rose sharply on recovered demand and due to higher international prices.



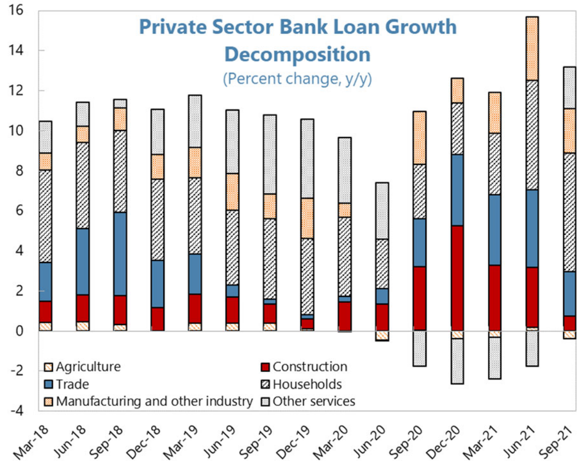
International reserves recovered as fiscal buffers were replenished.



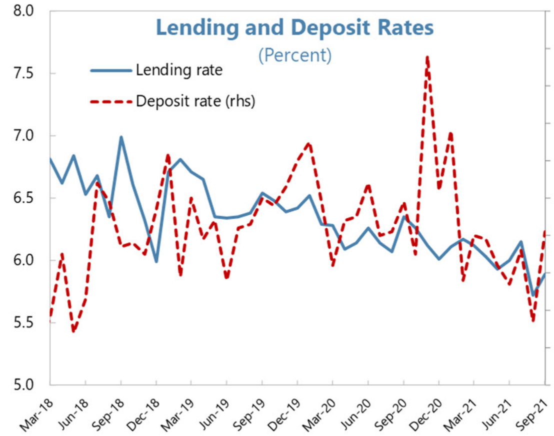
Source: Haver Analytics; KAS; Ministry of Finance Labor and Transfers, Pristina International Airport; WEO and IMF staff estimates.

Figure 4. Kosovo: Banking Sector Overview

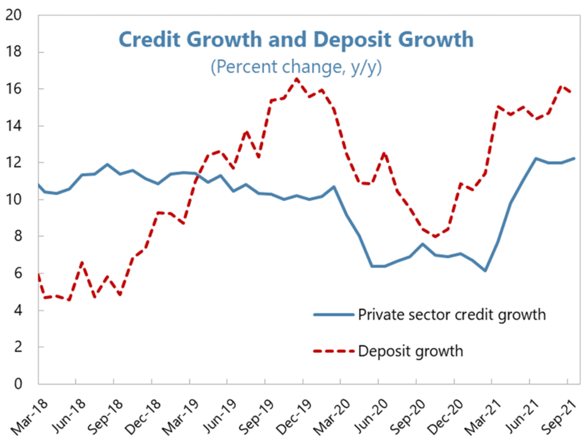
Private sector credit growth accelerated in 2021 to double digits rates,



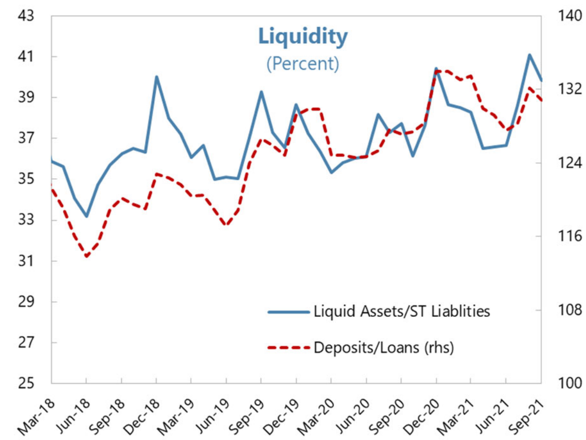
with lending rates that remained low.



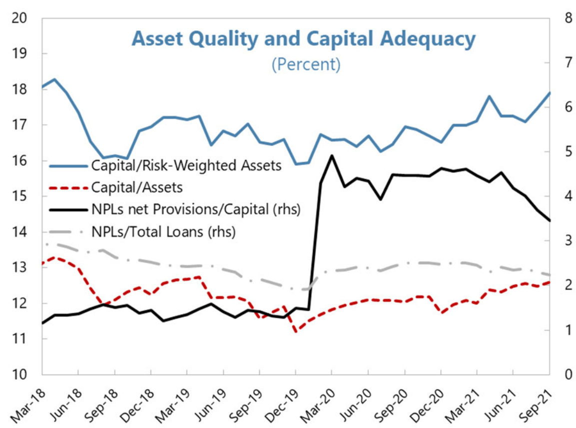
Deposit growth continued to be robust in 2021…



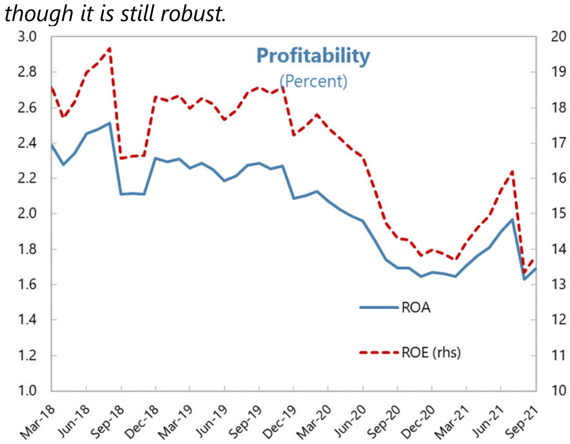
…and Banks' liquidity continued to rise.



NPLs remain low, and banks' capital buffers steady.



Profitability declined vis-à-vis the pre-pandemic level though it is still robust.



Sources: Central Bank of Kosovo, IMF staff estimates.

Table 1. Kosovo: Selected Economic Indicators, 2018-26

(Percent, unless otherwise indicated)

	2018	2019	2020	2021	2021	2022	2023	2024	2025	2026
			Est.	2020 Article IV	2021 Article IV			Proj.		
Real GDP growth	3.4	4.8	-5.3	4.5	7.5	3.8	3.8	3.6	3.5	3.5
Contribution to growth (percentage points of GDP)										
Consumption	4.3	5.8	2.3	2.3	4.3	2.4	2.0	2.3	2.5	2.5
Private	3.5	4.6	2.0	1.9	4.4	1.6	1.6	1.9	2.1	2.1
Public	0.8	1.2	0.3	0.4	-0.1	0.9	0.4	0.4	0.4	0.4
Investment	2.0	-0.1	-2.3	1.5	2.4	1.6	1.6	1.1	1.1	1.2
Net Exports	-3.1	-0.3	-5.3	0.8	0.3	-0.3	0.2	0.1	-0.1	-0.2
Exports	2.5	2.2	-8.6	3.4	15.5	-0.1	1.0	1.4	1.3	1.4
Imports	-5.6	-2.5	3.3	-2.6	-15.2	-0.2	-0.8	-1.3	-1.4	-1.6
Real growth rate (percent)										
Consumption	4.7	6.2	2.4	2.1	4.2	2.5	2.1	2.4	2.6	2.7
Private	4.4	5.6	2.5	2.0	5.0	1.8	1.9	2.3	2.5	2.6
Public	7.0	10.1	2.1	2.4	-1.0	7.0	3.3	3.2	3.1	3.0
Investment	6.3	-0.2	-7.4	4.9	7.8	5.2	5.1	3.5	3.5	3.7
Exports	9.1	7.6	-29.2	14.5	70.1	-0.2	2.9	4.3	3.9	4.3
Imports	10.9	4.5	-6.0	4.5	27.8	0.3	1.3	2.1	2.3	2.7
Official unemployment (percent of workforce)	29.5	25.7	26.0	...	...	...	...	...	...	...
Price changes										
CPI, period average	1.1	2.7	0.2	0.3	3.2	3.9	2.4	2.2	2.1	2.0
GDP deflator	1.5	1.0	1.4	-0.3	2.9	3.5	2.6	2.2	1.9	1.7
General government budget (percent of GDP)										
Revenues and grants	26.4	27.0	25.6	26.6	29.2	28.5	28.3	28.2	28.2	28.1
Expenditures	29.2	29.9	33.5	32.5	29.6	30.9	30.7	30.6	30.6	30.6
Of which: Wages and salaries	8.8	8.7	9.8	9.1	8.9	8.8	8.7	8.7	8.6	8.6
Subsidies and transfers	8.3	8.9	12.8	10.8	10.9	10.6	10.5	10.5	10.5	10.5
Capital expenditure	7.9	7.6	5.7	6.8	5.3	6.3	6.5	6.5	6.5	6.5
Overall Balance (Fiscal rule) 1/	-1.5	-0.8	-6.6	-4.9	0.2	-1.3	-1.6	-1.4	-1.4	-1.7
Overall balance	-2.8	-2.9	-7.9	-5.9	-0.4	-2.4	-2.4	-2.3	-2.4	-2.5
Stock of government bank balances	4.5	5.1	3.4	3.6	5.5	5.5	5.2	4.9	4.6	4.5
Total public debt 2/	17.0	17.7	24.3	28.7	24.3	25.3	26.1	26.9	27.8	29.0
Balance of Payments (percent of GDP)										
Current account balance, incl. official transfers	-7.6	-5.7	-7.0	-6.4	-7.0	-6.5	-5.9	-5.8	-5.7	-5.6
Of which: Official transfers 3/	3.4	3.4	4.1	3.1	3.6	3.3	3.1	3.1	3.0	3.0
Of which: Remittance inflows	12.0	12.1	14.5	13.9	15.6	15.0	14.2	13.0	12.6	12.3
Financial account	-5.0	-2.3	-8.3	-5.6	-3.9	-4.0	-3.3	-3.4	-3.4	-3.1
Of which: Direct investment, net	-3.4	-2.7	-4.2	-3.2	-4.7	-3.6	-3.6	-3.6	-3.7	-3.7
Portfolio investment, net	-3.0	0.8	-1.2	0.3	1.5	0.6	1.8	1.9	2.0	2.2
Other investment, net	0.1	-1.8	-3.5	-2.9	-2.3	-2.0	-2.1	-2.1	-2.3	-2.2
Reserve change	1.3	1.3	0.7	0.2	1.6	1.1	0.7	0.5	0.6	0.7
Errors and Omissions	2.8	3.5	-1.6	0.9	2.6	2.2	2.4	2.2	2.0	2.3
Savings-investment balances (percent of GDP)										
National savings	24.0	25.4	22.7	20.3	23.0	23.9	24.8	24.9	25.1	25.3
Public savings	5.0	4.4	-2.8	0.7	4.8	3.9	4.1	4.2	4.2	4.0
Private savings	19.0	21.0	25.6	19.6	18.2	20.0	20.7	20.7	20.9	21.3
Investment	31.6	31.0	29.7	29.8	30.0	30.4	30.7	30.7	30.8	30.9
Public investment	7.9	7.6	5.7	6.8	5.3	6.3	6.5	6.5	6.5	6.5
Private investment	23.7	23.5	24.0	23.0	24.7	24.1	24.2	24.2	24.2	24.5
Current account, including. official transfers	-7.6	-5.7	-7.0	-6.4	-7.0	-6.5	-5.9	-5.8	-5.7	-5.6
Financial Sector										
Non-performing loans (percent of total loans)	2.5	1.9	2.5	...	...	...	...	...	...	...
Bank credit to the private sector (percent change)	10.8	10.0	7.1	9.1	13.4	11.0	8.5	7.5	7.0	6.2
Deposits of the private sector (percent change)	9.3	15.6	10.9	4.1	9.3	9.0	8.2	7.2	7.0	6.8
Regulatory capital to risk weighted assets	17.0	15.9	16.5	...	...	...	...	...	...	...
Memorandum items:										
Foreign Reserves (millions of euros, IMF Definition)	1,164	1,142	1,149	1,004	1,272	1,353	1,405	1,446	1,497	1,559
Foreign Reserves (% of ARA metric)	136	121	116	94	108	107	103	99	95	93
GDP (millions of euros)	6,672	7,056	6,772	7,101	7,493	8,049	8,571	9,076	9,569	10,072
GDP per capita (euros)	3,715	3,959	3,784	3,913	4,171	4,462	4,733	4,992	5,242	5,495
Real GDP growth per capita	3.6	5.6	-5.7	4.1	7.1	3.4	3.4	3.2	3.1	3.1
Population (million)	1.8	1.8	1.8	1.8	1.8	1.8	1.8	1.8	1.8	1.8

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

1/ The "fiscal rule" caps the overall fiscal deficit at 2 percent of GDP, excluding investment financed with privatization receipts and donor financing contracted after 2015, as well as PAK-related current expenditure; the IMF calculates expenditures from carried-forward own-source revenue (OSR) as the difference in the municipal OSR stock.

2/ Includes guarantees and beginning in 2020, Euro 120 million of debt with KPST. It does not include contigent debt of former Yugoslavia.

3/ Total foreign assistance excluding capital transfers.

Table 2. Kosovo: Consolidated Government Budget, 2018-26[1/]

(Including donor designated grants and PAK operations; millions of Euros)

	2018	2019	2020	2021		2022		2023	2024	2025	2026
	Act.	Act.	Act.	2021 Budget	Proj.	2022 Budget	Proj.	Proj.	Proj.	Proj.	Proj.
Revenue and grants	**1,775**	**1,905**	**1,736**	**2,055**	**2,185**	**2,365**	**2,290**	**2,426**	**2,564**	**2,700**	**2,835**
Revenue	1,766	1,885	1,693	2,032	2,180	2,342	2,287	2,426	2,564	2,700	2,835
Taxes	1,564	1,662	1,507	1,791	1,930	2,103	2,043	2,158	2,272	2,383	2,492
Direct taxes	268	292	267	326	343	399	372	400	428	456	485
of which: Personal income tax	153	166	158	176	190	219	206	221	236	252	267
of which: Corporate income tax	87	95	85	110	114	136	124	133	142	152	161
of which: Property tax	24	27	23	35	37	41	40	44	47	50	54
Other	4	5	1	5	2	2	2	2	2	3	3
Indirect taxes	1,344	1,415	1,273	1,513	1,641	1,763	1,738	1,830	1,920	2,007	2,092
VAT	799	846	770	929	1,014	1,103	1,086	1,157	1,226	1,293	1,363
Excise	419	435	398	454	492	532	521	551	582	614	648
Customs	124	130	102	126	132	126	128	118	107	96	77
Other	2	4	3	4	3	2	3	4	4	4	4
Tax refunds	-48	-46	-33	-48	-55	-59	-67	-72	-76	-80	-85
Nontax revenues	203	223	186	241	250	239	244	268	292	317	343
Other revenue	8	7	3	...	5	...	7	8	9	10	10
Grants	8	19	43	23	5	23	3	0	0	0	0
Budget support	0	12	34	11	5	11	3	0	0	0	0
Project grants (DDGs)	8	8	9	12	0	12	0	0	0	0	0
Expenditure	**1,966**	**2,111**	**2,270**	**2,529**	**2,216**	**2,748**	**2,486**	**2,628**	**2,776**	**2,926**	**3,083**
Current expenditure	1,433	1,578	1,886	1,974	1,819	2,042	1,976	2,071	2,186	2,299	2,431
Wages and salaries	592	617	661	646	667	671	708	747	785	825	866
Goods and services	250	298	302	384	300	404	362	386	408	431	453
Subsidies and transfers	558	628	868	864	820	893	850	900	950	1,000	1,060
Current reserves	0	0	0	33	0	21	21	0	0	0	0
DDGs and other expenditure	6	5	0	12	0	12	0	0	0	0	0
Interest payments	19	23	27	35	32	41	35	39	42	44	51
Interest - internal	7	11	17	...	17	12	19	21	24	25	30
of which: on external debt	12	12	10	...	15	...	16	18	18	19	21
Other net PAK expenditure	8	6	24	...	0	...	0	0	0	0	0
Capital expenditure	533	534	384	553	397	706	510	557	591	626	652
Budget-financed	435	366	270	343	340	492	410	480	500	530	570
PAK-financed	84	132	54	18	0	21	0	0	0	0	0
External	15	36	60	206	57	193	100	77	91	96	82
Non-Investment Clause	11	21	31	83	16	80	8	8	8	8	4
of which: "Investment Clause"	0	13	26	111	41	113	92	69	83	88	78
Fiscal balances											
Primary balance	-176	-188	-512	-439	-3	-342	-165	-168	-175	-185	-201
Overall balance	**-191**	**-207**	**-534**	**-473**	**-31**	**-384**	**-196**	**-202**	**-213**	**-226**	**-248**
"Fiscal rule" deductions from the overall balance	90	151	128	135	47	140	92	69	83	88	78
Overall balance ('Fiscal rule" definition) 2/	**-101**	**-55**	**-447**	**-338**	**16**	**-243**	**-104**	**-133**	**-130**	**-137**	**-170**
Overall cyclically adjusted balance	-201	-255	-430	...	28	...	-159	-186	-209	-226	-248
Statistical discrepancy	3	1	1	...	0	...	0	0	0	0	0
Financing	**188**	**205**	**533**	**473**	**31**	**386**	**196**	**202**	**213**	**226**	**248**
Foreign financing (net)	-10	-10	127	275	55	222	105	42	52	38	12
Budget Support	0	0	156	180	78	130	50	0	0	0	0
External Financing for Projects	12	39	59	204	61	204	105	83	97	104	91
Amortization of external debt	-22	-50	-89	-109	-84	-112	-50	-41	-46	-66	-79
Domestic financing (net)	199	216	406	198	-24	166	91	160	161	188	236
Net Domestic debt issuance	105	115	170	200	125	120	112	152	155	185	243
Change in CBK deposits	48	43	211	-27	-153	37	-25	5	5	5	-5
PAK Deposits	83	113	84	24	25	26	5	5	5	5	5
Other Financing (Net POE and other)	17	13	15	24	4	9	4	3	1	-1	-2
Equity (Privatization)	17	44	12	...	0	...	0	0	0	0	0
Memorandum items											
Overall balance (MOF) 3/	-190	-208	-518	-473	-36	-384	-203	-210	-222	-236	-258
Pandemic-related fiscal measures	...	...	296	420	310	163	...	...	...	...	...
Bank balance of the general government	300	362	233	284	412	412	442	442	442	442	452
Of which: ELA	46	46	46	46	46	46	46	46	46	46	46
Total public debt 4/	1,143	1,247	1,643	1,999	1,822	2,228	2,039	2,233	2,440	2,662	2,918
External debt	463	452	557	837	612	992	717	759	811	848	861
Of which: onlending	55	50	43	...	39	...	35	31	30	32	34
Of which: guarantees	44	43	32	...	32	...	32	32	32	32	32
Domestic debt	680	795	1,085	1,162	1,210	1,236	1,322	1,474	1,629	1,814	2,057

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

1/ It does not yet reflect the GFSM 2014 methodology.

2/ The "fiscal rule" caps the overall fiscal deficit at 2 percent of GDP, excluding investment financed with privatization receipts and donor financing contracted after 2015, as well as PAK-related current expenditure; the IMF calculates expenditures from carried-forward own-source revenue (OSR) as the difference in the municipal OSR stock.

3/ Excludes DDGs, revenues held in trust, and additional net PAK expenditure.

4/ The stock of public debt no longer includes the former Yugoslavia debt, which has been reclassified as a contingent liability. Beginning in 2020, it includes Euro 120 million of debt with KPST.

Table 3. Kosovo: Consolidated Government Budget, 2018-26[1/]

(Including donor designated grants and PAK operations; percent of GDP)

	2018	2019	2020	2021		2022		2023	2024	2025	2026
	Act.	Act.	Act.	2021 Budget	Proj.	2022 Budget	Proj.	Proj.	Proj.	Proj.	Proj.
Revenue and grants	**26.4**	**27.0**	**25.6**	**28.0**	**29.2**	**28.1**	**28.5**	**28.3**	**28.2**	**28.2**	**28.1**
Revenue	26.3	26.7	25.0	27.7	29.1	27.9	28.4	28.3	28.2	28.2	28.1
Taxes	23.2	23.6	22.3	24.4	25.8	25.0	25.4	25.2	25.0	24.9	24.7
Direct taxes	4.0	4.1	3.9	4.4	4.6	4.7	4.6	4.7	4.7	4.8	4.8
of which: Personal income tax	2.3	2.3	2.3	2.4	2.5	2.6	2.6	2.6	2.6	2.6	2.7
of which: Corporate income tax	1.3	1.3	1.3	1.5	1.5	1.6	1.5	1.6	1.6	1.6	1.6
of which: Property tax	0.4	0.4	0.3	0.5	0.5	0.5	0.5	0.5	0.5	0.5	0.5
Indirect taxes	20.0	20.1	18.8	20.6	21.9	21.0	21.6	21.3	21.2	21.0	20.8
VAT	11.9	12.0	11.4	12.7	13.5	13.1	13.5	13.5	13.5	13.5	13.5
Excise	6.2	6.2	5.9	6.2	6.6	6.3	6.5	6.4	6.4	6.4	6.4
Customs	1.8	1.8	1.5	1.7	1.8	1.5	1.6	1.4	1.2	1.0	0.8
Tax refunds	-0.7	-0.6	-0.5	-0.7	-0.7	-0.7	-0.8	-0.8	-0.8	-0.8	-0.8
Nontax revenues	3.0	3.2	2.8	3.3	3.3	2.8	3.0	3.1	3.2	3.3	3.4
Other revenue	0.1	0.1	0.1	...	0.1	...	0.1	0.1	0.1	0.1	0.1
Grants	0.1	0.3	0.6	0.3	0.1	0.3	0.0	0.0	0.0	0.0	0.0
Budget support	0.0	0.2	0.5	0.1	0.1	0.1	0.0	0.0	0.0	0.0	0.0
Project grants (DDGs)	0.1	0.1	0.1	0.2	0.0	0.1	0.0	0.0	0.0	0.0	0.0
Expenditure	**29.2**	**29.9**	**33.5**	**34.4**	**29.6**	**32.7**	**30.9**	**30.7**	**30.6**	**30.6**	**30.6**
Current expenditure	21.3	22.4	27.8	26.9	24.3	24.3	24.6	24.2	24.1	24.0	24.1
Wages and salaries	8.8	8.7	9.8	8.8	8.9	8.0	8.8	8.7	8.7	8.6	8.6
Goods and services	3.7	4.2	4.5	5.2	4.0	4.8	4.5	4.5	4.5	4.5	4.5
Subsidies and transfers	8.3	8.9	12.8	11.8	10.9	10.6	10.6	10.5	10.5	10.5	10.5
Current reserves	0.0	0.0	0.0	0.4	0.0	0.3	0.3	0.0	0.0	0.0	0.0
DDGs and other expenditure	0.1	0.1	0.0	...	0.0	...	0.0	0.0	0.0	0.0	0.0
Interest payments	0.3	0.3	0.4	0.5	0.4	0.5	0.4	0.5	0.5	0.5	0.5
of which: on external debt	0.2	0.2	0.1	...	0.2	...	0.2	0.2	0.2	0.2	0.2
Other net PAK expenditure	0.1	0.1	0.4	...	0.0	...	0.0	0.0	0.0	0.0	0.0
Capital expenditure	7.9	7.6	5.7	7.5	5.3	8.4	6.3	6.5	6.5	6.5	6.5
Budget-financed	6.5	5.2	4.0	4.7	4.5	5.9	5.1	5.6	5.5	5.5	5.7
PAK-financed	1.2	1.9	0.8	0.2	0.0	0.2	0.0	0.0	0.0	0.0	0.0
External	0.2	0.5	0.9	2.8	0.8	2.3	1.2	0.9	1.0	1.0	0.8
Non-Investment Clause	0.2	0.3	0.5	1.1	0.2	1.0	0.1	0.1	0.1	0.1	0.0
of which: "Investment Clause"	0.0	0.2	0.4	1.5	0.5	1.3	1.1	0.8	0.9	0.9	0.8
Fiscal balances											
Primary balance	-2.6	-2.7	-7.6	-6.0	0.0	-4.1	-2.1	-2.0	-1.9	-1.9	-2.0
Overall balance	**-2.8**	**-2.9**	**-7.9**	**-6.4**	**-0.4**	**-4.6**	**-2.4**	**-2.4**	**-2.3**	**-2.4**	**-2.5**
"Fiscal rule" deductions from the overall balance	1.3	2.1	1.9	1.8	0.6	1.7	1.1	0.8	0.9	0.9	0.8
Overall balance ('Fiscal rule" definition) 2/	**-1.5**	**-0.8**	**-6.6**	**-4.6**	**0.2**	**-2.9**	**-1.3**	**-1.6**	**-1.4**	**-1.4**	**-1.7**
Overall cyclically adjusted balance	-3.0	-3.6	-6.3	...	0.4	...	-2.0	-2.2	-2.3	-2.4	-2.5
Statistical discrepancy	0.0	0.0	0.0	...	0.0	...	0.0	0.0	0.0	0.0	0.0
Financing	**2.8**	**2.9**	**7.9**	**6.4**	**0.4**	**4.6**	**2.4**	**2.4**	**2.3**	**2.4**	**2.5**
Foreign financing (net)	-0.2	-0.1	1.9	3.8	0.7	2.6	1.3	0.5	0.6	0.4	0.1
Budget Support	0.0	0.0	2.3	2.5	1.0	1.5	0.6	0.0	0.0	0.0	0.0
External Financing for Projects	0.2	0.6	0.9	2.8	0.8	2.4	1.3	1.0	1.1	1.1	0.9
Amortization of external debt	-0.3	-0.7	-1.3	-1.5	-1.1	-1.3	-0.6	-0.5	-0.5	-0.7	-0.8
Domestic financing (net)	3.0	3.1	6.0	2.7	-0.3	2.0	1.1	1.9	1.8	2.0	2.3
Net Domestic debt issuance	1.6	1.6	2.5	2.7	1.7	1.4	1.4	1.8	1.7	1.9	2.4
Change in CBK deposits	0.7	0.6	3.1	-0.4	-2.0	0.4	-0.3	0.1	0.1	0.1	0.0
Change in GG Deposits at the CBK (TSA)	-0.5	-1.0	1.9	-0.7	-2.4	0.1	-0.4	0.0	0.0	0.0	-0.1
PAK Deposits	1.2	1.6	1.2	0.3	0.3	0.3	0.1	0.1	0.1	0.1	0.0
Other Financing (Net POE and other)	0.3	0.2	0.2	0.3	0.1	0.1	0.1	0.0	0.0	0.0	0.0
Equity (Privatization)	0.3	0.6	0.2	...	0.0	...	0.0	0.0	0.0	0.0	0.0
Memorandum items											
Overall balance (MOF) 3/	-2.8	-2.9	-7.6	-6.4	-0.5	-4.6	-2.5	-2.5	-2.4	-2.5	-2.6
Pandemic-related fiscal measures	...	...	4.4	5.7	4.1	1.9	...	...	...	...	...
Bank balance of the general government	4.5	5.1	3.4	3.9	5.5	4.9	5.5	5.2	4.9	4.6	4.5
Of which: ELA	0.7	0.7	0.7	...	0.6	...	0.6	0.5	0.5	0.5	0.5
Total public debt 4/	17.0	17.7	24.3	27.2	24.3	26.5	25.3	26.1	26.9	27.8	29.0
External debt	6.9	6.4	8.2	11.4	8.2	11.8	8.9	8.9	8.9	8.9	8.5
Of which: onlending	0.8	0.7	0.6	...	0.5	...	0.4	0.4	0.3	0.3	0.3
Of which: guarantees	0.6	0.6	0.5	...	0.4	...	0.4	0.4	0.3	0.3	0.3
Domestic debt	10.1	11.3	16.0	15.8	16.2	14.7	16.4	17.2	17.9	19.0	20.4

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

1/ It does not yet reflect the GFSM 2014 methodology.

2/ The "fiscal rule" caps the overall fiscal deficit at 2 percent of GDP, excluding investment financed with privatization receipts and donor financing contracted after 2015, as well as PAK-related current expenditure; the IMF calculates expenditures from carried-forward own-source revenue (OSR) as the difference in the municipal OSR stock.

3/ Excludes DDGs, revenues held in trust, and additional net PAK expenditure.

4/ The stock of public debt no longer includes the former Yugoslavia debt, which has been reclassified as a contingent liability. Beginning in 2020, it includes Euro 120 million of debt with KPST.

Table 4. Kosovo: Central Government Cashflow Table, 2018-26

(Millions of Euros, unless otherwise indicated)

	2018	2019	2020	2021	2022	2023	2024	2025	2026
		Act.				Proj.			
Financing Needs	533	501	822	277	516	577	603	622	678
Overall balance	-191	-207	-534	-31	-196	-202	-213	-226	-248
Amortization	342	294	289	246	320	375	390	396	430
External	22	50	89	84	50	41	46	66	79
Domestic	320	245	200	162	271	334	345	330	352
Financing Sources	530	499	822	277	516	577	604	622	678
External Debt	12	39	215	139	155	83	97	104	91
Budget Support	0	0	156	78	50	0	0	0	0
of which: IMF	0	0	52	...	...	...	...	...	...
of which: other including EU and IFIs	...	...	...	160	57	37	0	0	1
External Financing for Projects	12	39	59	61	105	83	97	104	91
Investment Clause (2016 and after)	0	14	26	41	92	69	83	88	78
Non-Investment Clause	11	21	31	16	8	8	8	8	4
Disbursements for on-lending	0	4	3	4	5	6	7	7	8
Domestic Debt	518	460	606	138	362	495	506	518	588
Gross Domestic Debt Placements	425	360	370	287	382	486	500	515	595
KPST one-off financing	12	0	0	0	0	0	0	0	0
Other Financing (Net POE)	17	13	15	4	4	3	1	-1	-2
Commercial Bank Deposits	0	0	-1	0	0	0	0	0	0
Equity (Privatization, PAK and other)	17	44	12	0	0	0	0	0	0
CBK deposits (-=increase)	48	43	211	-153	-25	5	5	5	-5
PAK deposits	83	113	84	25	5	5	5	5	5
TSA	-35	-70	127	-178	-30	0	0	0	-10
Errors and Omissions	3	1	1	0	0	0	0	0	0

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

Table 5. Kosovo: Balance of Payments, 2018-26

(Millions of Euros, unless otherwise indicated)

	2018	2019	2020	2021	2022	2023	2024	2025	2026
		Act.				Proj.			
Current account	-509	-399	-472	-525	-523	-507	-527	-543	-565
Balance on Goods and Services	-1,882	-1,914	-2,182	-2,375	-2,468	-2,494	-2,522	-2,592	-2,688
Goods Balance	-2,738	-2,840	-2,573	-3,424	-3,542	-3,617	-3,712	-3,837	-4,009
Exports, f.o.b.	377	393	475	697	724	763	817	871	917
Imports, f.o.b.	3,114	3,233	3,048	4,121	4,266	4,380	4,529	4,708	4,925
Services Balance	856	926	392	1,050	1,073	1,124	1,190	1,245	1,320
Receipts	1,562	1,675	995	1,895	1,955	2,056	2,177	2,286	2,416
Payments	706	749	603	845	882	933	988	1,041	1,096
Primary Income	113	161	164	130	183	197	210	212	217
Compensation of employees, net	237	257	262	277	298	317	336	354	373
Investment income, net	-121	-92	-95	-144	-111	-116	-122	-138	-152
Secondary Income	1,260	1,354	1,545	1,720	1,762	1,789	1,786	1,837	1,907
Government, net	226	237	277	270	266	266	281	287	302
Other transfers (including remittances), net	1,034	1,118	1,269	1,450	1,496	1,523	1,504	1,550	1,605
Capital account	-11	-9	17	36	20	21	22	23	24
Financial account	-336	-163	-561	-292	-323	-280	-305	-328	-311
Direct investment, net	-226	-188	-287	-351	-292	-310	-329	-357	-371
Assets	46	66	59	66	62	50	52	54	57
Liabilities	272	255	346	417	354	360	381	411	428
Portfolio investment, net	-200	59	-82	111	47	153	171	192	218
Other investment, net	3	-129	-239	-175	-164	-179	-193	-219	-224
Reserve assets	87	95	46	123	86	56	46	56	66
Net errors and omissions 1/	184	245	-106	197	181	207	201	193	230
Overall balance	0	0	0	0	0	0	0	0	0
					(In percent of GDP)				
Current account, incl. official transfers	-7.6	-5.7	-7.0	-7.0	-6.5	-5.9	-5.8	-5.7	-5.6
Balance on Goods and Services	-28.2	-27.1	-32.2	-31.7	-30.7	-29.1	-27.8	-27.1	-26.7
Exports of Goods	5.6	5.6	7.0	9.3	9.0	8.9	9.0	9.1	9.1
Exports of Services	23.4	23.7	14.7	25.3	24.3	24.0	24.0	23.9	24.0
Imports of Goods	46.7	45.8	45.0	55.0	53.0	51.1	49.9	49.2	48.9
Imports of Services	10.6	10.6	8.9	11.3	11.0	10.9	10.9	10.9	10.9
Primary Income	1.7	2.3	2.4	1.7	2.3	2.3	2.3	2.2	2.2
Secondary Income	18.9	19.2	22.8	23.0	21.9	20.9	19.7	19.2	18.9
Capital account	-0.2	-0.1	0.3	0.5	0.2	0.2	0.2	0.2	0.2
Financial account	-5.0	-2.3	-8.3	-3.9	-4.0	-3.3	-3.4	-3.4	-3.1
Direct investment, net	-3.4	-2.7	-4.2	-4.7	-3.6	-3.6	-3.6	-3.7	-3.7
Portfolio investment, net	-3.0	0.8	-1.2	1.5	0.6	1.8	1.9	2.0	2.2
Other investment, net	0.1	-1.8	-3.5	-2.3	-2.0	-2.1	-2.1	-2.3	-2.2
Reserve assets	1.3	1.3	0.7	1.6	1.1	0.7	0.5	0.6	0.7
Net errors and omissions 1/	2.8	3.5	-1.6	2.6	2.2	2.4	2.2	2.0	2.3
Memorandum items:									
Public debt service to export ratio (percent)	1.8	3.0	6.7	3.8	2.5	2.1	2.1	2.7	3.0
Public debt service to exports and remittances (percent)	1.3	2.1	4.0	2.6	1.7	1.5	1.5	2.0	2.2
External public and private debt (percent of GDP) 2/	30.5	31.2	37.2	36.9	36.6	36.7	37.0	37.6	37.4
Net foreign assets of CBK 3/	934	938	969	1,049	1,142	1,206	1,272	1,335	1,396
Gross international reserves 3/	1,164	1,142	1,149	1,272	1,353	1,405	1,446	1,497	1,559
Gross international reserves in months of prospective imports 3/	3.5	3.8	2.8	3.0	3.1	3.1	3.0	3.0	3.0
Gross international reserves, excl. PAK and KPST deposits at CBK 3/	769	864	901	1,091	1,177	1,233	1,279	1,336	1,402

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 exclude CBK's holdings of Kosovar government securities.

Table 6. Kosovo: Central Bank and Commercial Bank Survey, 2018-26

(Millions of Euros, unless otherwise indicated)

	2018	2019	2020	2021	2022	2023	2024	2025	2026
		Act.				Proj.			
Depository Coporations									
Net foreign assets	1,422	1,577	1,812	1,932	1,979	2,097	2,213	2,336	2,484
Net domestic assets	2,857	3,209	3,689	3,899	4,317	4,709	5,073	5,457	5,829
Central Bank									
Net foreign assets	934	938	969	1,049	1,142	1,206	1,272	1,335	1,396
Foreign assets	1,240	1,219	1,223	1,344	1,426	1,478	1,519	1,570	1,632
Foreign liabilities	306	281	254	296	284	272	247	235	235
Net domestic assets	-430	-420	-212	-406	-444	-451	-471	-478	-483
Net claims on central government	-432	-421	-213	-408	-445	-453	-472	-480	-485
Claims on central government	349	316	314	272	260	248	223	211	211
Of which: government securities	189	184	201	210	210	210	210	210	210
Liabilities to central government	781	738	527	680	705	700	695	690	695
PAK (privatization) fund	388	275	191	166	161	156	151	146	141
Government deposits	375	444	317	495	525	525	525	525	535
Of which: bank balance	302	361	258	337	362	386	408	431	453
IMF subscription	18	18	18	18	18	18	18	18	18
Claims on other sectors	2	1	1	1	1	1	1	1	1
Monetary base	455	468	706	591	647	703	749	804	860
Liabilities to other depository corporations	343	415	566	498	548	598	638	688	738
Deposits included in broad money	112	53	139	93	99	105	110	116	122
Other items, net 1/	49	51	53	52	52	53	54	56	56
Commercial banks									
Net foreign assets	488	639	843	884	837	892	941	1,000	1,087
Assets	692	866	1,114	1,156	1,100	1,160	1,217	1,284	1,370
Liabilities	-204	-227	-271	-272	-263	-269	-276	-283	-283
Net domestic assets	3,286	3,629	3,900	4,305	4,761	5,160	5,544	5,935	6,312
Claims on the CBK	343	415	558	498	548	598	638	688	738
Net claims on the central government	247	275	240	290	305	320	340	360	380
Claims on central government	257	287	254	310	325	340	360	380	400
Liabilities to central government	-10	-13	-14	-20	-20	-20	-20	-20	-20
Net claims on other public entities	-55	-88	-140	-159	-170	-181	-191	-201	-212
Claims on other public entities	4	3	4	0	0	0	0	0	0
Liabilities to other public entities	-59	-92	-143	-159	-170	-181	-191	-201	-212
Credit to private sector	2,751	3,028	3,242	3,675	4,078	4,423	4,757	5,088	5,405
Deposits of the private sector	3,190	3,688	4,089	4,468	4,871	5,270	5,648	6,044	6,455
Demand deposits	1,913	2,225	2,597	2,932	3,203	3,476	3,736	4,005	4,285
Time deposits	1,277	1,463	1,492	1,536	1,668	1,794	1,913	2,039	2,170
Other items, net 1/	584	580	655	721	726	782	837	891	943
Memorandum items:									
Gross international reserves, excl. PAK and KPST deposits at CBK	769	864	901	1,091	1,177	1,233	1,279	1,336	1,402
Deposits of the private sector (12-month percent change)	9.3	15.6	10.9	9.3	9.0	8.2	7.2	7.0	6.8
Credit to the private sector (12-month percent change)	10.8	10.0	7.1	13.4	11.0	8.5	7.5	7.0	6.2
Deposits of the private sector (percent of GDP)	47.8	52.3	60.4	59.6	60.5	61.5	62.2	63.2	64.1
Credit to the private sector (percent of GDP)	41.2	42.9	47.9	49.0	50.7	51.6	52.4	53.2	53.7
Required reserves of commercial banks	287	327	367	416	454	491	526	562	600
Excess reserves of commercial banks	143	187	302	188	201	214	219	232	244

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

1/ Includes shares and other equity.

Table 7. Kosovo: Selected Financial Soundness Indicators, 2018-21[1/]

(Percent, unless otherwise indicated)

	2018	2019	2020	2021
Total Assets (% GDP) 2/	62.7	67.5	79.2	76.9
Capital adequacy				
Regulatory capital to risk weighted assets	17.0	15.9	16.5	17.9
Tier 1 capital to risk weighted assets	15.5	14.2	14.8	16.2
Capital to assets	12.2	11.2	11.7	11.8
Asset quality				
NPL to total loans	2.5	1.9	2.5	2.2
NPL net of provisions to capital	1.5	1.5	4.6	3.4
Large exposures to capital	65.9	81.8	89.5	76.4
Liquidity				
Liquid assets to total assets	29.0	28.8	30.1	30.6
Deposits to loans	122.8	129.2	133.9	131.8
Liquid assets to short-term liabilities	40.0	38.7	40.4	39.8
Profitability				
Return on average assets	2.3	2.1	1.7	1.7
Return on average equity	18.3	17.2	14.0	13.8
Interest margin to gross income	78.4	80.6	79.2	76.0
Non-interest expense to gross income	48.2	48.1	46.1	44.0
Market risk				
Net open currency position to tier 1 capital	3.8	4.7	3.5	1.8

Sources: Central Bank of the Republic of Kosovo.

1/ Figures shown for 2021 correspond to Q3.

2/ Includes all other depository corporations.

Table 8. Kosovo: Indicators of Fund Credit, 2018-26

	2018	2019	2020	2021	2022	2023	2024	2025	2026
		Act.				Proj.			
Repayments (in SDR millions)									
Principal	3.5	24.6	54.3	43.1	9.9	10.3	20.7	10.3	0.0
Charges and interest 1/	2.6	2.5	2.1	1.2	0.5	0.4	0.2	0.1	0.0
Total repayment obligations based on existing and prospective credit									
In millions of SDRs	6.1	27.1	56.4	44.3	10.4	10.8	20.9	10.4	0.0
In millions of Euros	7.4	33.7	66.6	53.2	12.5	12.8	24.8	12.3	0.0
In percent of gross international reserves	0.6	2.9	5.8	4.2	0.9	0.9	1.7	0.8	0.0
In percent of exports of goods and services	0.4	1.6	4.5	2.1	0.5	0.5	0.8	0.4	0.0
In percent of debt service	21.5	54.3	67.5	53.5	19.0	21.8	38.6	14.3	0.0
In percent of GDP	0.1	0.5	1.0	0.7	0.2	0.1	0.3	0.1	0.0
In percent of quota	7.3	32.8	68.2	53.6	12.6	13.0	25.3	12.6	0.0
Outstanding Fund credit based on existing and prospective credit									
In millions of SDRs	131.9	107.3	94.3	51.2	41.3	31.0	10.3	0.0	0.0
In millions of Euros	160.5	133.1	111.4	61.5	49.3	36.8	12.2	0.0	0.0
In percent of gross international reserves	13.8	11.7	9.7	4.8	3.6	2.6	0.8	0.0	0.0
In percent of exports of goods and services	8.3	6.4	7.6	2.4	1.8	1.3	0.4	0.0	0.0
In percent of debt service	467.4	214.9	113.0	61.9	75.0	62.8	19.1	0.0	0.0
In percent of GDP	2.4	1.9	1.6	0.8	0.6	0.4	0.1	0.0	0.0
In percent of quota	159.7	129.9	114.2	62.0	50.0	37.5	12.5	0.0	0.0
Net use of Fund credit (millions of SDRs)									
Disbursements and purchases	0.0	0.0	41.3	0.0	0.0	0.0	0.0	0.0	0.0
Repayments and repurchases	3.5	24.6	54.3	43.1	9.9	10.3	20.7	10.3	0.0
Memorandum items:									
Gross international reserves (in millions of Euros)	1,164	1,142	1,149	1,272	1,353	1,405	1,446	1,497	1,559
Exports of goods and services (in millions of Euros)	1,938	2,068	1,470	2,592	2,680	2,819	2,994	3,157	3,333
Debt service (in millions of Euros) 2/	34	62	99	99	66	59	64	86	99
Quota (in SDR millions)	82.6	82.6	82.6	82.6	82.6	82.6	82.6	82.6	83.6

Source: IMF staff estimates and projections.

1/ Based on the projection as of December 1, 2021. Charges and interest calculations are preliminary.

2/ Total public external debt service, including IMF repayment.

Annex I. Risk Assessment Matrix[1]

	Source of Risks and Relative Likelihood	Impact if Realized	Recommended Policy Response
Global risks	Uncontrolled COVID-19 local outbreaks and subpar or volatile growth in affected countries. (High)	• New waves of infections materialize, requiring costly containment efforts, reducing diaspora travel, and prompting persistent behavioral changes rendering some activities unviable. If vaccination rate is high and vaccination proves sustainably effective against new variants, confidence and activity could be boosted; activity could also be boosted if the extraordinary diaspora inflows of 2021 prove to be permanent. (High) • Supply disruptions and longer-than-expected vaccine deployment (combined with lower policy space) prompts a reassessment of Kosovo's growth prospects. (High)	• Strengthen contingency planning. Use external support where possible to finance additional healthcare spending and other support measures but be prepared to reprioritize spending and reduce tax expenditures if deficit reducing measures are needed. • Accelerate broad-based structural reforms to boost competitiveness and gradually reduce the dependency on diaspora-related flows.
	Global resurgence of the COVID-19 pandemic (High)	• The recovery in countries where the diaspora resides proves more sluggish than anticipated (including due to new variants), limiting tourism flows and remittances. Travel restrictions could also play a role in curtailing diaspora-related travel. (High)	• Strengthen contingency planning. Build fiscal and external buffers until the future local, regional, and global paths of the pandemic are more accurately understood.
Domestic risks	Lack of anchor for fiscal policy (Medium)	• The lack of a medium-term anchor for public debt may erode confidence, limiting new financing sources. (Medium)	• A credible medium-term plan to return to the fiscal rule would anchor public debt. Set plausible revenue targets and curb recurrent expenditure growth to preserve fiscal buffers at reasonable levels.
	Fiscal and Structural Reforms lag (Medium)	• Budget expenditures biased towards recurrent spending, including a wage bill and veteran benefits above their legal limits, constrain pro-growth expenditures. Insufficient progress in the implementation of reforms leaves the diaspora as the only engine for growth (High).	• Revisit the "4-year Program" to make it more pro-growth and address the pandemic-induced structural transformation and resilience needs. Restart structural reforms in line with 2020 Article IV recommendations.
	Social discontent and political instability. (Low)	• Social tensions erupt as a response to socio-economic hardship. Growing political polarization and instability weaken policymaking and confidence. (High)	• Continue to implement the EU-SAA to improve the rule of law and governance. Improve the business environment to support growth in exports and investment.
	Intensification of financial sector vulnerabilities. (Low)	• A large surge in non-performing loans could lower capital adequacy levels, affecting the stability of smaller banks and the ability of the system to extend credit to the private sector (High)	• The CBK needs to tightly monitor the quality of loan portfolios and show flexibility if gaps arise in the capital position of some banks. • Quorum in the CBK Board needs to be restored to allow the CBK to swiftly implement or adapt regulations if needed.

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

Annex II. Debt Sustainability Analysis

Following a jump in 2020, the public debt ratio is projected to remain broadly unchanged at about 24 percent of GDP in 2021 due to the strong rebound in fiscal revenues and lower-than-expected expenditure execution. Gross financing needs are projected to decline to less than 4 percent of GDP in 2021, and to average about 6 percent of GDP over the forecast horizon. Debt is assessed to be sustainable in both the baseline and stress scenarios. Risks result from shocks to growth and contingent liabilities, and from an increasingly reduced capacity of the domestic market to absorb higher government debt, as Kosovo does not have external market access. Containing recurrent spending and diversifying the sources of financing remain key policy priorities to contain financing risks.

A. Key Assumptions

1. **Macroeconomic assumptions.** After contracting 5.3 percent in 2020, real GDP is expected to recover by 7.5 percent in 2021, on the back of normalized mobility, improved expectations, and extraordinary diaspora inflows. Absent negative pandemic-related shocks, GDP growth is projected to gradually converge to potential (around 3.5 percent) by 2025. The GDP deflator will increase by 2.9 percent in 2021 (1.4 percent in 2020) mainly due to the rebound in commodity prices, and to gradually decline to 2 percent over the medium term.

2. **Primary Balance.** After a strong primary deficit of 7.6 percent of GDP in 2020, the fiscal position will be broadly balanced in 2021 due to the cyclical rebound in revenues and a low implementation of the investment budget. For 2022-26, the analysis assumes that fiscal policy will be broadly guided by the fiscal rule deficit ceiling (excluding donor-financed projects) of 2 percent of GDP.

3. **Public debt.** Public debt consists of general government debt and explicit government guarantees. Implicit contingent liabilities of the Privatization Agency (PAK) of about 1.5 percent of GDP, debt of Public-owned Enterprises (POEs) of 5-7 percent of GDP are excluded.[1]At end-2020, domestic debt comprised 2/3 of total debt. External public debt is largely owed to multilaterals (IDA, EIB, EBRD, and the IMF) and denominated in SDRs and Euro.

4. **Financing assumptions.** Financing needs in 2021 are projected to be covered by official budget support from IFIs and the EU (78 million), earmarked donor financing (61 million), and net issuance of domestic government bonds (125 million). The analysis assumes that budget support from donors will gradually decline and that external financing for capital projects will be around 1 percent of GDP per year on average. Government's bank balances (5.5 percent of GDP at end-2021) are assumed to gradually decline to their legal floor of 4.5

[1]PAK contingent liabilities reflect potential legal costs related to the privatization of socially owned enterprises (SOEs).

percent of GDP by 2026. The residual financing is assumed to be filled with net domestic debt placements. The average maturity of domestic debt is assumed to gradually increase from about 3.1 years in 2019 to 4.2 years in 2026, in line with the authorities' plans. The share of euro-denominated debt is expected to increase from 90 percent of total in 2020, to 99 percent by 2026, as SDR-denominated debt is repaid.

B. Public DSA

5. Under the baseline scenario, the public debt ratio is projected to remain well below the 40-percent-of-GDP debt ceiling.[2] Indeed, the debt ratio is projected to increase from 17.6 percent of GDP in 2019 to about 30 percent of GDP in 2026, on account of IFIs' budget support injections, domestic debt accumulation and a moderate increase in the absorption capacity of donor financing for investment projects. These assumptions are also consistent with the investment clause expiring in 2025.

6. Gross financing needs are projected to remain below the sustainability threshold. While gross financing needs (GFNs) jumped to around 12 percent of GDP in 2020, they will decline to less than 4 percent of GDP in 2021 given the strong consolidation in the fiscal position. Over 2022-26 GFNs are projected to be around 6-7 percent of GDP as the fiscal deficit increases back to the fiscal rule deficit ceiling. Using the fiscal rule as the guide for policy and gradually increasing the average maturity of domestic debt should contribute to manage vulnerabilities arising from absence of external market access. However, the government should aim to diversify the investor base (to include individuals, private businesses, and insurance companies, which currently hold less than 5 percent of total domestic debt), while reducing CBK holdings and limiting the private pension fund Kosovo Pension Saving Trust's (KPST) exposure to no more than 30 percent of its assets. Along these lines, the government issued €11 million in retail bonds, a positive step towards diversifying the investor base.

7. Standardized tests indicate that the public debt ratio is likely to remain at manageable levels over the forecast horizon. Standardized GDP growth shocks result in the public debt ratio reaching 41 percent of GDP by 2026, and GFNs that peak at 10 percent of GDP in 2023. Under a combined macro-fiscal shock scenario (real GDP growth, primary balance, real exchange rate, and real interest rate) the public debt ratio reaches 44 percent of GDP in 2026, whereas the GFNs peak at 13.7 percent in 2022, higher than that at in 2020.

8. Stress tests also show that public debt is sensitive to contingent liability shocks. Contingent liabilities stemming from POEs (modeled at 5 percent of GDP) and PAK (1.5 percent of GDP), as well as from financial sector shocks would lift the debt ratio above the

[2] The current fiscal rule on debt limit includes: (1) a general limit on public debt at 40 percent of GDP; (2) a "debt-brake" mechanism, such that when debt exceeds 30 percent of GDP, the "investment clause" will expire and all capital expenditure (including capital expenditure financed by donors and privatization receipts) will be counted towards the 2-percent-of-GDP deficit ceiling.

40-percent-of-GDP legal debt ceiling over the medium-term. Whether these shocks would lead to financing stress depends on a variety of circumstances: For example, if shocks stem from a realization of PAK or POEs contingent liabilities, such liabilities are likely to be converted into government bonds without immediate financing stress; if, however, stress results from lower fiscal revenue, some expenditure reduction and reallocation may be needed.

C. External DSA

9. The external debt-to-GDP ratio is expected to remain broadly unchanged in the projection period. External debt increased by 6 percentage points (pp) of GDP in 2020, of which public external debt increased 2 pp of GDP in 2020 (given external budget support disbursements during the pandemic), and private external debt increased by 4 pp of GDP (in the form of long-term debt to the energy sector and other private debt). Over 2022-26, the external debt ratio is expected to remain broadly constant at below 37.5 percent of GDP. The analysis also shows that external debt remains sustainable under a host of standardized shock scenarios.

Annex II. Figure 1. Kosovo: Public DSA — Baseline Scenario

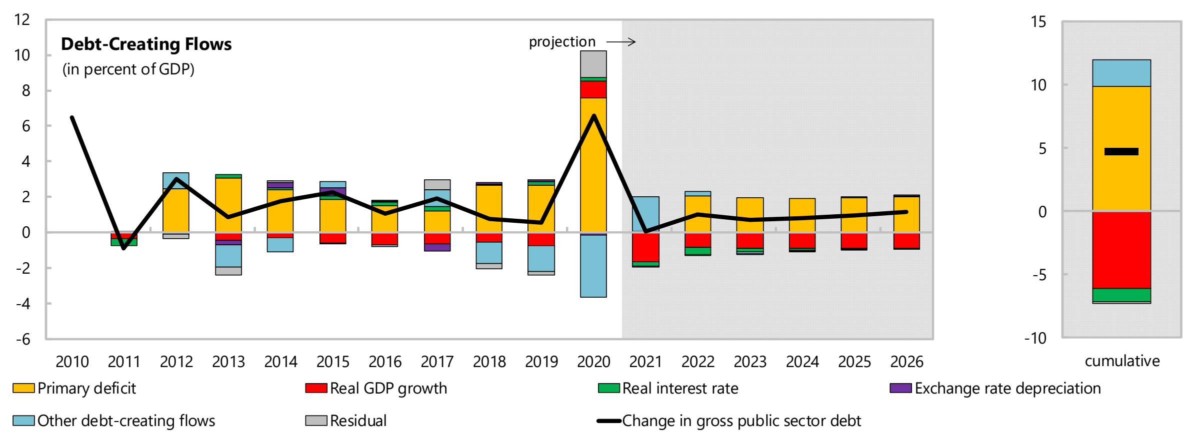
(Percent of GDP unless otherwise indicated)

Debt, Economic and Market Indicators [1/]

	Actual			Projections						As of November 15, 2021		
	2014-2018 [2/]	2019	2020	2021	2022	2023	2024	2025	2026			
Nominal gross public debt	14.5	17.7	24.3	24.3	25.3	26.1	26.9	27.8	29.0	Sovereign Spreads		
Of which: guarantees	0.4	0.6	0.5	0.4	0.4	0.4	0.3	0.3	0.3	EMBIG (bp) 3/		n.a.
Public gross financing needs	7.8	7.1	12.1	3.7	6.4	6.7	6.6	6.5	6.7	5Y CDS (bp)		n.a.
Real GDP growth (in percent)	4.6	4.8	-5.3	7.5	3.8	3.8	3.6	3.5	3.5	Ratings	Foreign	Local
Inflation (GDP deflator, in percent)	1.0	1.0	1.4	2.9	3.5	2.6	2.2	1.9	1.7	Moody's	n.a.	n.a.
Nominal GDP growth (in percent)	5.6	5.8	-4.0	10.7	7.4	6.5	5.9	5.4	5.3	S&Ps	n.a.	n.a.
Effective interest rate (in percent) [4/]	2.4	2.1	2.2	2.0	1.9	1.8	1.8	1.7	1.8	Fitch	n.a.	n.a.

Contribution to Changes in Public Debt

	Actual			Projections							
	2014-2018	2019	2020	2021	2022	2023	2024	2025	2026	cumulative	debt-stabilizing primary balance [9/]
Change in gross public sector debt	1.5	0.5	6.6	0.1	1.0	0.7	0.8	0.9	1.2	4.7	
Identified debt-creating flows	1.5	0.8	5.1	0.1	1.1	0.7	0.9	0.9	1.1	4.9	
Primary deficit	1.9	2.7	7.6	0.0	2.1	2.0	1.9	1.9	2.0	9.9	-0.9
Primary (noninterest) revenue and grants	26.1	26.9	25.6	29.1	28.4	28.3	28.2	28.2	28.1	170.3	
Primary (noninterest) expenditure	28.0	29.6	33.1	29.1	30.5	30.2	30.1	30.1	30.1	180.2	
Automatic debt dynamics [5/]	-0.3	-0.5	1.0	-1.9	-1.3	-1.1	-1.0	-1.0	-0.9	-7.1	
Interest rate/growth differential [6/]	-0.4	-0.6	1.1	-1.9	-1.3	-1.1	-1.0	-1.0	-0.9	-7.1	
Of which: real interest rate	0.2	0.2	0.2	-0.3	-0.4	-0.2	-0.1	-0.1	0.0	-1.0	
Of which: real GDP growth	-0.6	-0.8	1.0	-1.6	-0.9	-0.9	-0.9	-0.9	-0.9	-6.1	
Exchange rate depreciation [7/]	0.1	0.1	-0.1	…	…	…	…	…	…	…	
Other identified debt-creating flows	-0.2	-1.4	-3.5	2.0	0.3	-0.1	-0.1	0.0	0.1	2.1	
Privatization/ other financing (negative)	-0.2	-0.8	-0.4	-0.1	-0.1	0.0	0.0	0.0	0.0	-0.1	
Contingent liabilities	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Change in GG Deposits at the CBK (negative)	0.0	-0.6	-3.1	2.0	0.3	-0.1	-0.1	-0.1	0.0	2.2	
Residual, including asset changes [8/]	0.1	-0.2	1.5	-0.1	-0.1	0.0	0.0	0.0	0.0	-0.1	



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 essen

2/ Based on available data.

3/ Long-term bond spread over German bonds.

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

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

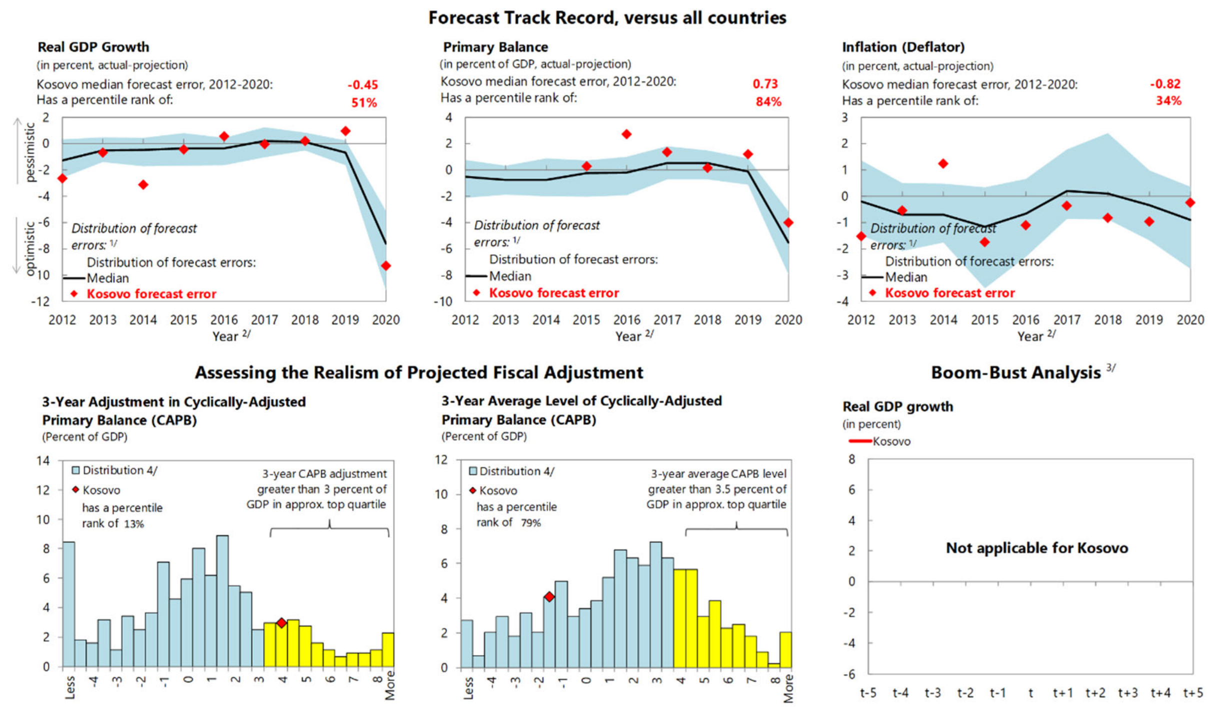
6/ The real interest rate contribution is derived from the numerator in footnote 5 as r - π (1+g) and the real growth contribution as -g.

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

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

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

Annex II. Figure 2. Kosovo: Public DSA — Realism of Baseline Assumptions

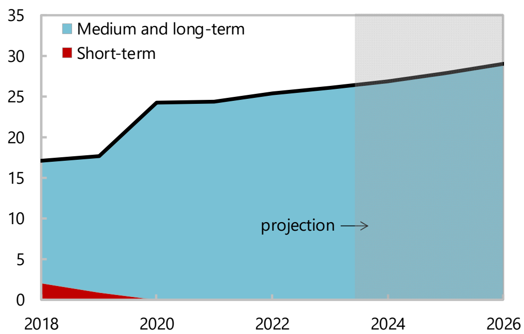


Source : IMF Staff.
1/ Plotted distribution includes all countries, percentile rank refers to all countries.
2/ Projections made in the spring WEO vintage of the preceding year.
3/ Not applicable for Kosovo, as it meets neither the positive output gap criterion nor the private credit growth criterion.
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.

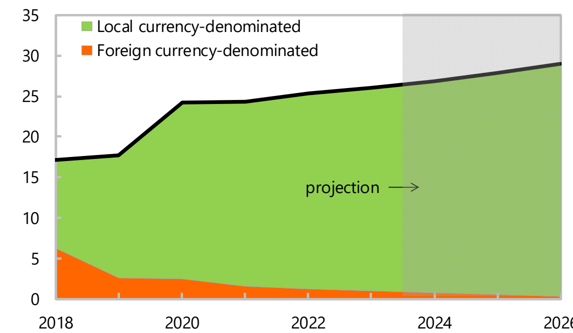
Annex II. Figure 3. Kosovo: Public DSA — Composition of Public Debt and Alternative Scenarios

Composition of Public Debt

By Maturity
(in percent of GDP)



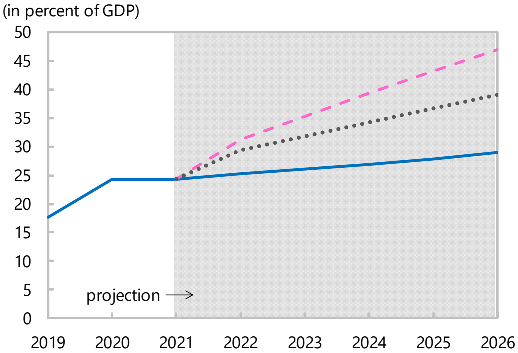
By Currency
(in percent of GDP)



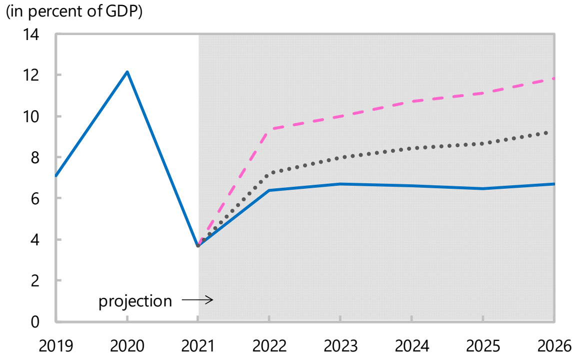
Alternative Scenarios

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)

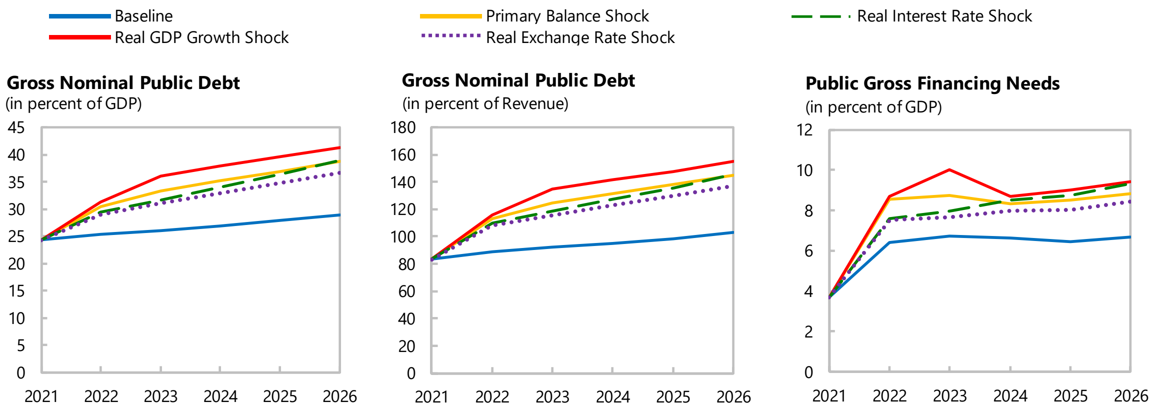
Baseline Scenario	2021	2022	2023	2024	2025	2026
Real GDP growth	7.5	3.8	3.8	3.6	3.5	3.5
Inflation	2.9	3.5	2.6	2.2	1.9	1.7
Primary Balance	0.0	-2.1	-2.0	-1.9	-1.9	-2.0
Effective interest rate	2.0	1.9	1.8	1.8	1.7	1.8
Constant Primary Balance Scenario						
Real GDP growth	7.5	3.8	3.8	3.6	3.5	3.5
Inflation	2.9	3.5	2.6	2.2	1.9	1.7
Primary Balance	0.0	0.0	0.0	0.0	0.0	0.0
Effective interest rate	2.0	1.8	1.7	1.7	1.6	1.6

Historical Scenario	2021	2022	2023	2024	2025	2026
Real GDP growth	7.5	3.6	3.6	3.6	3.6	3.6
Inflation	2.9	3.5	2.6	2.2	1.9	1.7
Primary Balance	0.0	-2.8	-2.8	-2.8	-2.8	-2.8
Effective interest rate	2.0	1.8	2.2	2.5	2.6	2.9

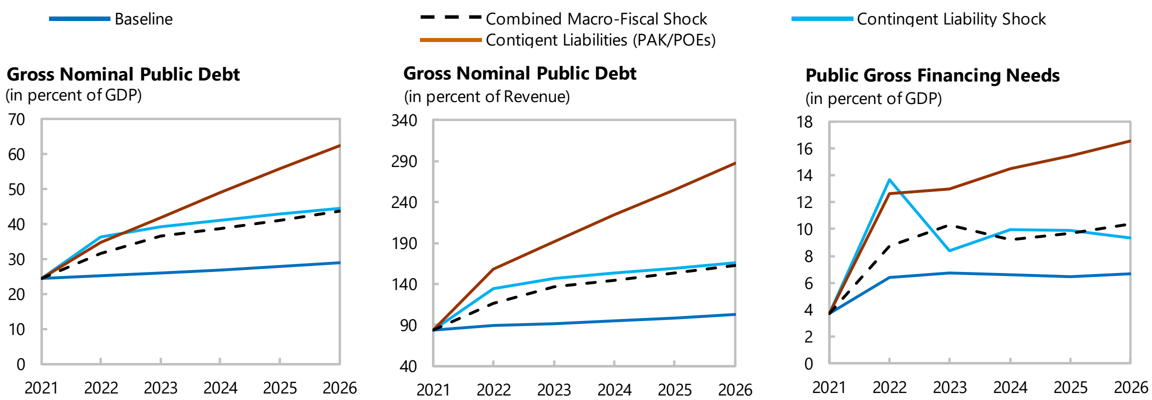
Source: IMF staff.

Annex II. Figure 4. Kosovo: Public DSA — Stress Tests

Macro-Fiscal Stress Tests



Additional Stress Tests



Underlying Assumptions

(in percent)

Primary Balance Shock	2021	2022	2023	2024	2025	2026
Real GDP growth	7.5	3.8	3.8	3.6	3.5	3.5
Inflation	2.9	3.5	2.6	2.2	1.9	1.7
Primary balance	0.0	-3.0	-2.9	-1.9	-1.9	-2.0
Effective interest rate	2.0	1.8	1.8	1.8	1.7	1.7
Real Interest Rate Shock						
Real GDP growth	7.5	3.8	3.8	3.6	3.5	3.5
Inflation	2.9	3.5	2.6	2.2	1.9	1.7
Primary balance	0.0	-2.1	-2.0	-1.9	-1.9	-2.0
Effective interest rate	2.0	1.8	2.5	3.1	3.4	3.7
Combined Shock						
Real GDP growth	7.5	0.4	0.4	3.6	3.5	3.5
Inflation	2.9	2.6	1.7	2.2	1.9	1.7
Primary balance	0.0	-3.4	-4.6	-1.9	-1.9	-2.0
Effective interest rate	2.0	1.8	2.6	3.2	3.4	3.7

Real GDP Growth Shock	2021	2022	2023	2024	2025	2026
Real GDP growth	7.5	0.4	0.4	3.6	3.5	3.5
Inflation	2.9	2.6	1.7	2.2	1.9	1.7
Primary balance	0.0	-3.4	-4.6	-1.9	-1.9	-2.0
Effective interest rate	2.0	1.8	1.8	1.9	1.7	1.8
Real Exchange Rate Shock						
Real GDP growth	7.5	3.8	3.8	3.6	3.5	3.5
Inflation	2.9	6.1	2.6	2.2	1.9	1.7
Primary balance	0.0	-2.1	-2.0	-1.9	-1.9	-2.0
Effective interest rate	2.0	1.8	1.7	1.7	1.6	1.7
Contingent Liability Shock						
Real GDP growth	7.5	0.4	0.4	3.6	3.5	3.5
Inflation	2.9	2.6	1.7	2.2	1.9	1.7
Primary balance	0.0	-7.9	-2.0	-1.9	-1.9	-2.0
Effective interest rate	2.0	2.2	2.2	2.1	1.9	1.8

Source: IMF staff.

Annex II. Table 1. Kosovo: External Debt Sustainability Framework, 2016-2026

(In percent of GDP, unless otherwise indicated)

	Actual							Projections						
	2016	2017	2018	2019	2020			2021	2022	2023	2024	2025	2026	Debt-stabilizing non-interest current account 6/
1 **Baseline: External debt**	33.4	32.9	30.5	31.2	37.2			**36.9**	**36.6**	**36.7**	**37.0**	**37.6**	**37.4**	**-5.4**
2 Change in external debt	-0.7	-0.5	-2.3	0.7	6.0			-0.3	-0.2	0.1	0.3	0.6	-0.2	
3 Identified external debt-creating flows (4+8+9)	3.0	0.5	2.7	1.3	4.1			-0.2	1.6	1.0	0.9	0.7	0.7	
4 Current account deficit, excluding interest payments	7.7	5.2	7.4	5.4	6.6			6.8	6.3	5.7	5.6	5.5	5.4	
5 Deficit in balance of goods and services	27.4	25.8	28.2	27.1	32.2			31.7	30.7	29.1	27.8	27.1	26.7	
6 Exports	23.8	27.3	29.1	29.3	21.7			34.6	33.3	32.9	33.0	33.0	33.1	
7 Imports	51.2	53.1	57.3	56.4	53.9			66.3	64.0	62.0	60.8	60.1	59.8	
8 Net non-debt creating capital inflows (negative)	-2.9	-3.3	-3.4	-2.7	-4.2			-4.7	-3.6	-3.6	-3.6	-3.7	-3.7	
9 Automatic debt dynamics 1/	-1.8	-1.4	-1.3	-1.4	1.7			-2.3	-1.1	-1.1	-1.0	-1.0	-1.1	
10 Contribution from nominal interest rate	0.2	0.3	0.3	0.2	0.4			0.2	0.2	0.2	0.2	0.2	0.2	
11 Contribution from real GDP growth	-1.8	-1.5	-1.1	-1.4	1.7			-2.5	-1.3	-1.3	-1.2	-1.2	-1.3	
12 Contribution from price and exchange rate changes 2/	-0.3	-0.1	-0.5	-0.3	-0.4			...	...	...	...	...	...	
13 Residual, incl. change in gross foreign assets (2-3) 3/	-3.7	-1.0	-5.0	-0.7	1.9			-0.1	-1.8	-0.9	-0.6	-0.1	-0.8	
External debt-to-exports ratio (in percent)	140.1	120.2	105.0	106.4	171.2			106.6	110.0	111.7	112.3	114.0	113.1	
Gross external financing need (in millions of euros) 4/	1326.1	1222.8	1484.1	1365.2	1514.9			1655.2	1743.0	1788.0	1879.8	1962.5	2055.9	
in percent of GDP	22.0	19.2	22.2	19.3	22.4	10-Year	10-Year	22.1	21.7	20.9	20.7	20.5	20.4	
Scenario with key variables at their historical averages 5/								**36.9**	**37.6**	**38.9**	**40.3**	**42.0**	**42.9**	**-5.9**
						Historical	Standard							
Key Macroeconomic Assumptions Underlying Baseline						Average	Deviation							
Real GDP growth (in percent)	5.6	4.8	3.4	4.8	-5.3	3.6	3.4	7.5	3.8	3.8	3.6	3.5	3.5	
GDP deflator in US dollars (change in percent)	0.8	0.4	1.5	1.0	1.4	1.7	1.8	2.9	3.5	2.6	2.2	1.9	1.7	
Nominal external interest rate (in percent)	0.7	1.0	0.9	0.8	1.1	1.1	0.3	0.7	0.7	0.7	0.6	0.6	0.5	
Growth of exports (US dollar terms, in percent)	12.9	20.8	11.6	6.7	-28.9	6.5	15.5	76.3	3.4	5.2	6.2	5.4	5.6	
Growth of imports (US dollar terms, in percent)	5.6	9.2	13.2	4.2	-8.3	4.4	7.3	36.0	3.7	3.2	3.8	4.2	4.7	
Current account balance, excluding interest payments	-7.7	-5.2	-7.4	-5.4	-6.6	-6.9	2.6	-6.8	-6.3	-5.7	-5.6	-5.5	-5.4	
Net non-debt creating capital inflows	2.9	3.3	3.4	2.7	4.2	4.1	1.7	4.7	3.6	3.6	3.6	3.7	3.7	

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

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

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

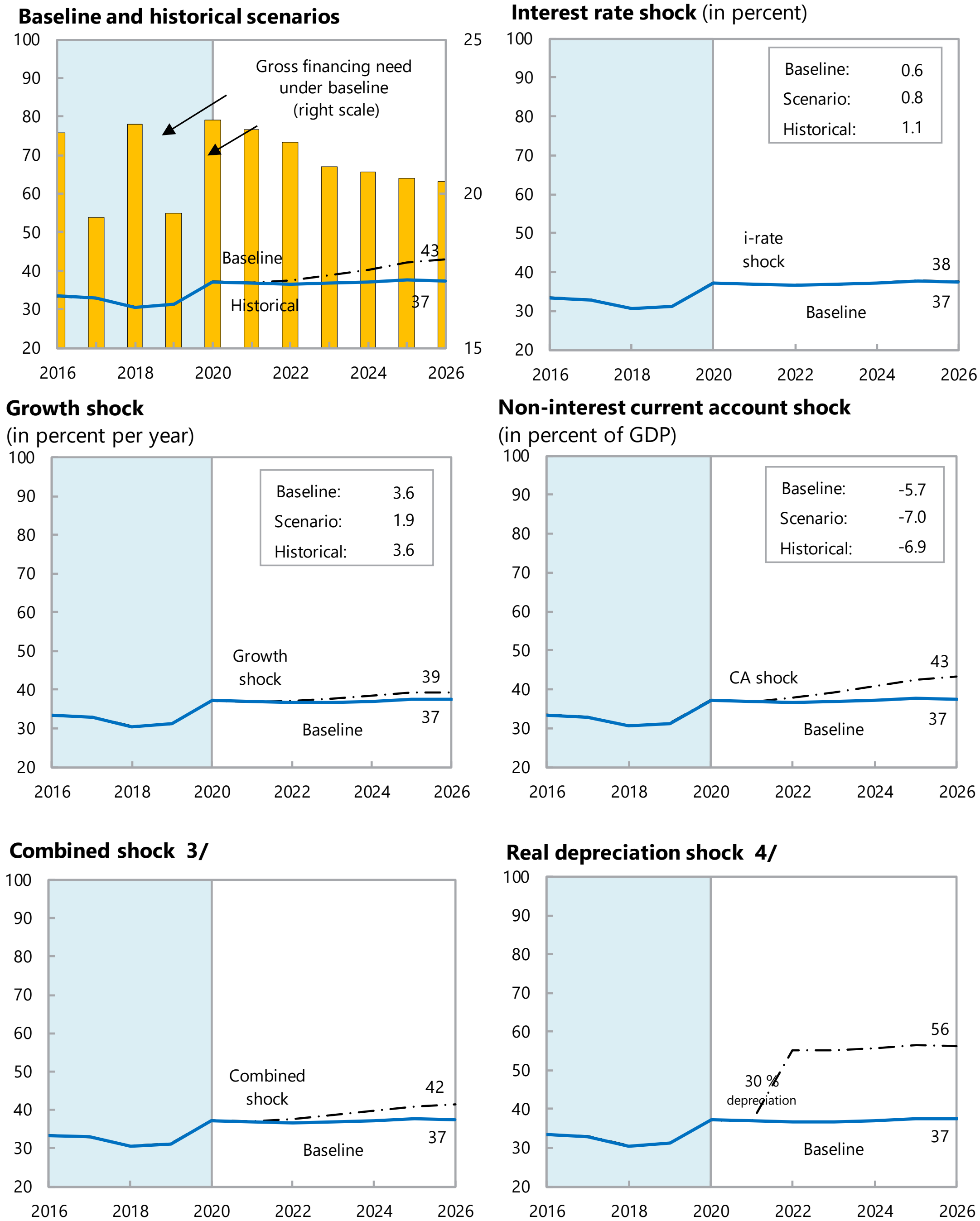
4/ Defined as current account deficit, plus amortization on medium- and long-term debt, plus short-term debt at end of previous period.

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

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

Annex II. Figure 5. 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 applied to real interest rate, growth rate, and current account balance.

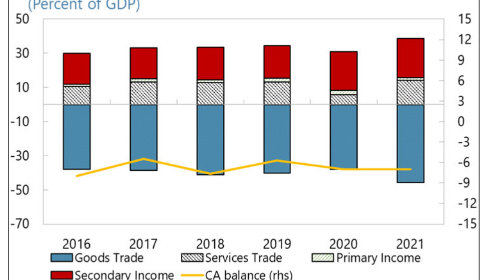
4/ One-time real depreciation of 30 percent occurs in 2021.

Annex III. External Sector Assessment

The external position in 2021 is assessed to be moderately weaker than the level implied by fundamentals and desirable policy settings. The structural pattern of Kosovo's external sector, namely, the trade and current account deficits financed by FDI, remittances and public external loans, is likely to persist in the medium term. Given the replenishment of fiscal buffers and the new SDR allocation, the level of gross international reserves in 2021 is above 100 percent the level considered adequate based on the IMF's reserve adequacy metrics, but it is projected to decline to below 100 percent in the medium term.

A. External Balance

Contribution to the Current Account, 2016-2021
(Percent of GDP)



Source: IMF staff calculations.

1. Kosovo's current account deficit is projected to have remained broadly unchanged at 7 percent of GDP in 2021. This is the case as the strong growth in goods and services exports as well as remittances is projected to be offset by the growth in the value of goods imports.

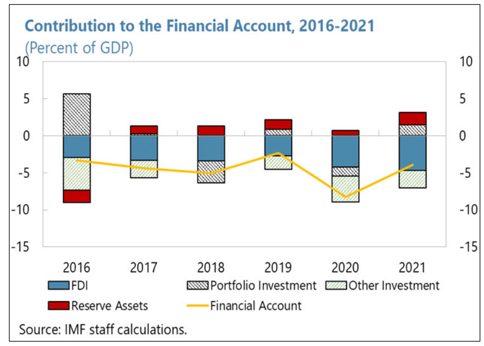
2. The wider trade deficit was explained by the recovery of economic activity. The goods trade deficit is projected to have widened to 45.7 percent of GDP in 2021, from 38 percent of GDP in 2020 and 40.3 percent of GDP in 2019. In particular the growth of goods imports reflected the recovery of domestic consumption, investment demand, and higher commodity prices. Goods exports are projected to have grown by 47 percent (y/y), but from a small base, led by basic metals and furniture. The temporary shut-down of a large nickel exporter in October 2021 will be reflected in a decrease of exports of about 0.4 percent of GDP.

3. The surplus in the balance of services is projected at about 14 percent of GDP on strong diaspora tourism inflows. This compares with 5.8 percent in 2020 and 13 percent in 2019. The increased surplus *vis-à-vis* its pre-pandemic level reflects the extraordinary level of diaspora tourism in the summer of 2021, on the back of low infection rates and increased vaccinations.

4. Primary and secondary income balances held up well in 2021. Relative to the pre-pandemic level of 2019, private transfers are projected to increase by 3.5 pp of GDP in 2021. The primary income balance is projected to decline somewhat (by about 0.5 pp of GDP) in 2021 relative to 2019 due to higher investment income debits.

5. The current account deficit in 2021 will be mainly financed by FDI inflows, public external loans, and informal remittances. More specifically:

- Net FDI inflows benefitted from reinvested earnings by foreign bank subsidiaries and continued inflows to the real estate sector. The former can be explained by the temporary restrictions on banks' dividend payments during the pandemic, and the latter by renewed inflows from the diaspora. Net FDI inflows are projected to be around 4.7 percent of GDP for 2021, higher than 2020 (4.2 percent) and 2019 (2.7 percent).



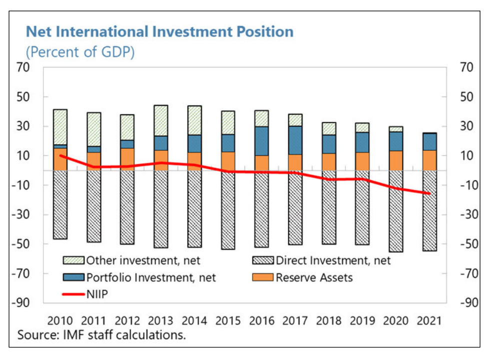
- Portfolio investment is projected to be around 1.5 percent of GDP in 2021, fueled by the investment in foreign assets by KPST.

- Other investment. The increase in SDR holdings in August 2021 led to additional net inflows of 1.3 percent of GDP, while external public debt excluding the SDR allocation is projected to be broadly unchanged in 2021. Adding the increase in private external debt, net other investment inflows are projected to be 2.3 percent of GDP.

- The errors and omissions are projected to be 2.6 percent of GDP, reflecting an increase in informal remittances and unrecorded tourism spending by the diaspora.

6. **Gross International Reserves (GIRs) are projected to increase by 1.6 pp of GDP in 2021 mainly on the back of replenished fiscal buffers.** The increase in government deposits at the CBK (from about 3.5 percent of GDP in 2020 to 5.5 percent in 2021) and the new SDR allocation contributed to this outcome.

7. **The Net International Investment Position (NIIP) deteriorated significantly with respect to its pre-pandemic level of 2019.** Indeed, the NIIP is projected to decline from -5.8 percent of GDP in 2019 to -15.8 percent of GDP in 2021, in line with the sizable current account deficits in both 2020 and 2021.



8. **In the medium term, current account deficits are projected to narrow as the pent-up consumption demand peters out and both diaspora inflows and fiscal policy normalize.** The structural pattern of Kosovo's current account, namely deficits in the goods trade balance and surpluses in the services, primary and secondary income accounts is likely to persist. This structure is mainly shaped by flows originating from the Kosovar diaspora. The NIIP is expected to continue declining.

B. Real Exchange Rate (EBA-Lite) Assessment

9. Kosovo's external position in 2021 is assessed to be moderately weaker than the level implied by medium-term fundamentals and desirable policy settings. The cyclically adjusted current account balance (CAB) is estimated at -6.9 percent of GDP, compared to a norm of -5 percent of GDP from the CA model, yielding a CA gap of -1.9 percent of GDP for 2021, equivalent to a REER overvaluation of 7 percent. The implementation of the external sustainability (ES) approach results in a similar conclusion.[1, 2] A large portion of the current account gap is attributed to model residuals, reflecting CA-related factors that are not accounted by the model, such as the size of remittances and the tourism spending that were not officially reported.

Kosovo: EBA-Lite Results (percent of GDP)

	CA Model	ES Model
2021 CA (Projected)	-7.0	
Cyclical contribution (from model)	-0.1	
Cyclically adjusted CA	-6.9	
CA Norm (from model)	-5.0	
Adjustments to CA norm	0.0	
Adjusted CA Norm	-5.0	
CA Gap	**-1.9**	**-1.8**
of which, Relative policy gap	6.6	
CA/REER elasticity	-0.3	
REER Gap (%)	**6.6**	**6.4**

Sources: IMF staff calculations.

C. Reserve Adequacy Assessment

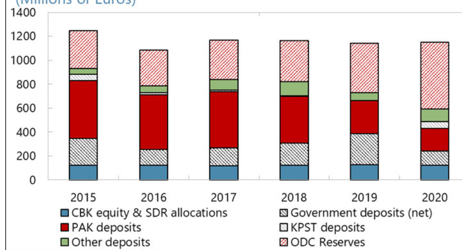
10. CBK's GIRs are mainly funded by government deposits and commercial banks' reserves. GIRs are projected to have risen to €1.27 billion at end-2021 (€1.15 billion as of end-2020) on higher government deposits and the new SDR allocation. The increase in these items is expected to offset the reduction in commercial bank, PAK and KPST's deposits placed at the CBK.

[1] In 2021, Kosovo's output gap is estimated to be around -2.5 percent of GDP. Normally, for an individual economy, the cyclically adjusted CAB would be lower than unadjusted CAB when the output gap is negative. However, what matters for the cyclical adjustment of CAB is the individual economy's output gap relative to rest of the word. In 2021, Kosovo's output gap is slightly higher (i.e., output is closer to its potential) than the rest of the world average. For this reason, the estimated the cyclically adjusted CAB for Kosovo is slightly higher than the headline CAB.

[2] The results from the "REER model" suggest a smaller REER gap, but the short time series available for Kosovo (14 years) make the conclusions from this approach less robust. The EBA-lite methodology can be found at https://www.imf.org/en/Publications/Policy-Papers/Issues/2019/07/03/The-Revised-EBA-Lite-Methodology-47088.

11. GIR adequacy using standard rules of thumb is projected to improve in 2021. Kosovo’s GIR adequacy is assessed using standard and alternative GIR definitions (Table 3):

CBK Reserve Assets: Sources of Funding
(Millions of Euros)



Source: IMF staff calculations.
Notes: Government deposits are net of holdings of government securities. Other deposits include trasferable deposits, deposit insurance fund deposits, insurance companies deposits, etc.

- **Standard definition:** It includes the sum of nonresidents’ currency and deposits, securities, monetary gold and SDR, reserve position in the IMF, and other items.

- **Conservative definition** (CBK’s definition): Standard GIR net of PAK and KPST deposits.

Annex III. Table 1. Kosovo: Traditional Reserve Adequacy Ratios

	2017	2018	2019	2020	2021	2022	2023	2024	2025	2026
					Projections					
Standard Definition of GIR										
Import cover (months of next year’s import:	3.7	3.5	3.8	2.8	3.0	3.1	3.1	3.0	3.0	2.9
Reserves to short-term external debt (%)	168	167	152	147	150	154	153	152	150	150
Reserves to Broad Money (%)	39	36	31	27	28	27	26	25	24	24
Conservative (CBK) Definition of GIR										
Import cover (months of next year’s import:	2.1	2.3	2.8	2.2	2.5	2.7	2.7	2.7	2.7	2.6
Reserves to short-term external debt (%)	98	110	115	115	128	134	134	135	134	135
Reserves to Broad Money (%)	23	24	23	21	24	24	23	22	22	21

Sources: CBK; IMF staff calculations.

12. GIRs are estimated at about 108 percent of the level considered to be adequate by IMF reserve adequacy metrics[3] IMF (2011) suggests the following reserve adequacy (RA) metrics for an economy with fixed exchange rate:

$$RA = 10\%\ X + 30\%\ STD + 10\%\ BM + 20\%\ OPL,$$

where X is export revenues, STD is short-term external debt, BM is broad money and OPL is other external liabilities.[4] Using more conservative GIR definitions, the coverage of the IMF RA metric is lower (Table 4). To complement the analysis above, a modified RA metric can be used to reflect Kosovo’s reliance on remittance inflows (R) and to account for the risk of domestic deposit (D) outflows in a euroized economy: [5]

[3] IMF (2011) Assessing Reserve Adequacy, IMF Policy Paper.

[4] Short-term external debt includes short-term financial liabilities of banks and other sectors. Medium and long-term financial debt and equity includes liabilities originated from the general government and FDI.

[5] The weight on total deposits was increased from 10 to 15 percent to reflect the absence of a lender of last resort.

Annex III. Table 2. Kosovo: Reserve Adequacy Metrics for Dollarized and Euroized Economies

	2017	2018	2019	2020	2021	2022	2023	2024	2025	2026
					Projections					
Standard GIR (millions of euros)	1168	1164	1142	1149	1272	1353	1405	1446	1497	1559
Percent of RA metric	144	136	121	116	108	107	103	99	95	93
Percent of RA modified metric	113	106	94	88	84	83	80	77	75	73
Conservative GIR (millions of euros)	683	769	864	901	1091	1177	1233	1279	1336	1402
Percent of RA metric	84	90	92	91	93	93	91	87	85	83
Percent of RA modified metric	66	70	71	69	72	72	70	68	67	66

Sources: CBK; IMF staff calculations.

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

The use of this modified RA metric results in Kosovo GIRs at below 100 percent of the level considered adequate.

13. In the medium term, GIRs are projected to decline to below the level considered as adequate by IMF RA metrics. In line with this, staff recommended that the new SDR allocation be used to support international reserves in the medium term.

14. Kosovo has adequate capacity to absorb a moderate fiscal financing or bank liquidity shocks. As a euroized economy lacking a lender of last resort, reserve adequacy should also be assessed by their capacity to mitigate shocks to fiscal financing and for banks' emergency liquidity assistance (ELA).

15. Fiscal buffers. Kosovo's legal framework calls for government deposits of at least 4.5 percent of GDP, which is lower than the projected size of deposits at end-2021 (5.5 percent of GDP). Fiscal buffers are also sufficient when using other indicators of fiscal reserves (e.g., one month of spending plus debt service).

16. Bank liquidity buffers. Kosovo banks generally have high liquidity ratios, and it is expected that the largest banks would receive liquidity support from their parent groups in emergency times. However, banks' ability to respond to a system-wide liquidity shock is limited by (i) some liquid assets are in the form of government bonds, which may not be immediately tradable; (ii) the coverage of the deposit insurance is not high enough to substantially reduce the risks of bank runs. The CBK recently launched a repo and overnight liquidity facilities for banks (with capacity €100 million) to complement the ELA (€92 million). However, these resources are insufficient to respond to systemic wide shocks.

Annex IV. 2019 FSSR Main Recommendations and Implementation Status

Recommendations	Status
Short Term (within 12 months of FSSR):	
• Restart the process to appoint a fourth non-executive member to the Central Bank Board in accordance with the central bank law.	• **Complete.** Two (out of three) vacancies at the CBK Board have been filled in December 2021.
• Review the effectiveness of the operation of the Central Bank Board.	• **Incomplete.** A TA mission on central bank governance took place in June-August 2021 to review the effectiveness of decision-making bodies at the CBK, including membership of key committees.
• Enhance the composition of the Executive Board and review its effectiveness.	• **In progress.** The CBK has just initiated the process to supplement the Executive Board with a fourth voting member to ensure balanced decision-making and the representation of all departments.
• Review and update the organizational structure of the CBK and refresh documented roles and responsibilities to ensure the structure is clear.	• **Incomplete.** A TA mission on central bank governance took place in June-August 2021 to review the CB structure and incorporate the findings from the previous missions.
• Remove any remaining doubt concerning the protection of CBK staff while discharging their duties in good faith.	• **Not yet started.** The CBK has not amended its internal rule on the indemnification of staff costs in legal proceedings by providing unconditional support for staff in these circumstances.
• Require full professional history of directors and senior management, as well as for principal shareholders of the proposed bank in applications for licenses.	• **In progress.** The draft law on banks will require the entire business and professional history for the directors and senior management.
• Intensify efforts with the ECB to participate in the Raiffeisen supervisory college and to be party to its resolution and recovery plans.	• **In progress.** The CBK has made multiple attempts to participate the Raiffeisen supervisory college, but so far has not heard from their counterparts.
• Establish supervisory procedures during periods of stress and conduct periodic tests on the operational procedures for granting of ELA.	• **In progress.** The Banking Supervision Department is planning to conduct a liquidity crisis simulation exercise in order to test the capacity of the current framework to deal with potential liquidity assistance requests from banks.
• Update the premium rate pricing of the mandatory MTPL product and develop a process to regularly review the pricing as risk factors evolve.	• **In progress.** In 2019, the CBK has allowed insurance companies to adjust the MTPL tariff in line with inflation. A new risk-based model for pricing the MTPL tariffs is being developed in cooperation with the World Bank.

Recommendations	Status
• Assess the viability for the insurance industry of continuing to apply the taxes and fees, and obligations to pay for claims related to uninsured drivers.	• **In progress.** Starting from 2019, the insurance industry is no longer required to pay a 1 percent premium contribution to the Red Cross. The 5 percent tax on gross premium was eliminated.
• Implement the risk-based insurance supervision manual that has been developed.	• **In progress.** The risk-based supervision manual was approved on January 1, 2020. IMF TA on risk-based supervision implementation, diagnostics and training will support CBK's capacity in this area.
• Review the CBK's institutional arrangements and governance in support of financial stability and macroprudential policy.	• **In progress.** Currently, decision-making itself is reserved to a small Executive Board consisting of the Governor and two Deputy Governors. The Governor (instead of a Deputy Governor) has so far exercised executive responsibilities for macroprudential oversight.
• Complete a full review of macroprudential data gaps and develop a strategy to close them.	• **In progress.** The review of the macroprudential data gaps has started. The review will be followed by the strategy to close the gaps derived from the review.
• Ask the Government to establish a cross-agency task force on the development of capital markets.	• **Not yet started.**
• Establish a National Strategy on Financial Inclusion.	• **In progress.** The CBK has developed a strategy for consumer protection and financial literacy, but there is no comprehensive financial inclusion strategy at the national level.
• Harmonize reporting of FSIs and address remaining methodological issues.	• **In progress.** The CBK has implemented the recommendation "increasing periodicity of 4SR to monthly". The CBK is working on addressing the other issues found by the FSSR assessment.
Medium Term (within one to three years of FSSR):	
• Integrate stress tests exercises with the financial stability area and communicate the results to the banks.	• **In progress.** There are planned TA missions under the FSSR TA roadmap for 2021 and 2022. The Economic Analysis and Financial Stability Department (EAFSD) and the Banking Supervision Department (BSD) have integrated the stress test models into a single model, which is compiled by the EAFSD with direct contribution from the BSD. The next stage includes the communication and discussions of the results with banks.

Recommendations	Status
• Develop tools for a more thorough assessment of credit risk, based on granular data from the Credit Registry.	• **Incomplete.** The Credit Registry, which operates within the CBK, records detailed credit information at the individual loan level. Currently, there is no plan to use such data for credit risk assessment.
• Reconsider crisis management processes for the insurance industry, particularly appointing CBK employees as administrators and liquidators.	• **In progress.** The CBK has appointed its employees as administrators and liquidators mainly due to the lack of necessary profiles in the market. The CBK has tried in the past to recruit liquidators from the market, but the interested candidates did not meet the required conditions. Therefore, the CBK is committed to implementing the recommendation over a longer period, but in cases where potential external candidates will not meet the required criteria, it will continue to use internal resources.
• Amend the central bank law to strengthen the legal basis for CBK's macroprudential policy powers.	• **Incomplete.** The CBK intends to provide macroprudential policy with a stronger legal foundation through amendments to the law on banks and associated regulations. However, an amendment to the central bank law has not been initiated.
• Ensure methodological consistencies of monetary statistics with international standards.	• **In progress.** The authorities received TA from the IMF on Monetary and Financial Statistics (MFS) in August 2019. Priority recommendations are being implemented.

Annex V. Implementation of Past Article IV Recommendations

Areas	Recommendations	Status
	Partial Progress	
Fiscal policy and governance: Improve productivity of spending, broaden revenue, and strengthen fiscal institutions	Return to the "fiscal rule"	Even though the original 2020 budget was drafted to meet the fiscal rule deficit, the wage bill ceiling, and the bank balance floor, as a temporary measure in response to the COVID-19 pandemic, the fiscal rules were relaxed through end-2021 to increase the fiscal rule deficit ceiling to 6.5 percent of GDP and reduce the floor on bank balances to 3 percent of GDP. Emergency legislation allowed the use of PAK funds for COVID-19 relief spending. The draft 2022 budget projections foresee the return to the fiscal rule in 2023.
	Audit of COVID-related spending	The office of the Auditor General conducted a large-scale audit of COVID-related spending and published a report in August 2021. An additional audit report on the performance of COVID-related spending is under preparation with expected completion in 2022.
	Keep public sector wages within the limits of the wage bill rule	The Law on Salaries was repealed. The adjustment of wages is within the limits of the wage bill rule for 2019-21. However, the new Law on Salaries have not yet been drafted and risks remain that the new law will set wage coefficients inconsistent with the wage bill ceiling.
	Reform social benefits schemes and avoid any new untargeted schemes	The long overdue war veteran benefit reform remains stalled, with spending in 2020 about 0.4 percent of GDP above the legal ceiling of 0.7 percent. Since the Law for Economic Recovery in 2020, no new exemptions have been introduced. However, even though a working group on tax reform has been created, no concrete reform efforts have been announced.
	Improve the efficiency of spending and the public investment framework	The absorption of donor-financed investment under the "investment clause" continues to be insufficient. Overall execution of capital projects continued to be slow, with high seasonality in the last quarter of the year. No ex-post audits of major investment projects have been initiated, and the public investment framework needs strengthening to ensure alignment of national strategies with the budget through multi-annual planning.
	Strengthen fiscal institutions and governance	The 2021 MTEF enhanced the analysis of fiscal risks but continued to rely on optimistic revenue projections. It also contains substantial uncommitted financing. E-procurement is now fully functional.

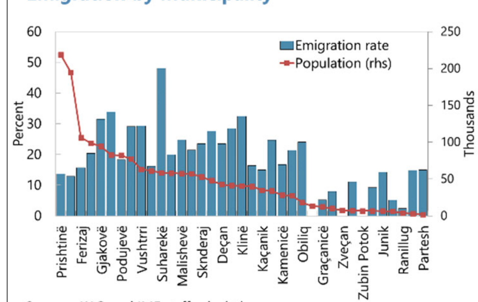
Areas	Recommendations	Status
Labor market	**Limited Progress**	
	Upgrade skills and reduce skills mismatches, and reform social benefits	Broad plans to increase the number of teachers and provide scholarships have been announced. The scholarship program for math and IT education has been launched. Furthermore, reforms to modernize curricula and textbooks, upgrade vocational education and training programs, strengthen accreditation and professional standard, and improve labor market intermediation remain at an early stage.
Reduce the costs of doing business and improve governance	**Partial/Limited Progress**	
	Strengthen the rule of law, including in the areas of contract enforcement and property rights	Progress has been made in terms of private enforcement agents and amendments to the Law on Execution Procedure. However, there has been no new recruitment of PEAs to fill in remaining positions and the PEA monitoring unit is yet to be created. The creation of a commercial court is still underway. The reform of property registration and cadaster system has seen progress with the implementation of the Kosovo Geoportal where data is updated regularly (http://geoportal.rks-gov.net/en/search). More is to be done to strengthen the Kosovo Cadaster Agency's institutional framework and technical infrastructure and complete privatization of public houses.
	Judiciary reforms to fight organized crime and high-level corruption	Kosovo has made limited progress, including on the investigation and prosecution of high-level cases and asset confiscation. As overall effectiveness of these measures remains low, strong political and criminal justice responses are critical to achieve meaningful progress in this area. The draft law on confiscation of unjustifiable property has been adopted by the government, but a final document needs to be discussed by the assembly before implementation can begin. The amended Law on the State Prosecutor has been partially implemented, with only 15 out of a planned number of prosecutors being recruited to the Special Prosecution Office. The Assembly adopted the revised Criminal Code but has yet to adopt the new Criminal Procedure Code, which would address existing issues hindering the efficiency of criminal justice. In addition, the authorities should strengthen the efficiency of the asset confiscation regime, build on the ongoing functional review of the rule of law sector to reform rule of law institutions, and improve the administration of justice hampered by the COVID-19 pandemic.

Areas	Recommendations	Status
	Partial Progress	
Financial sector: access to credit	Reduce structural impediments to lending	Broad-based credit growth before the 2020 COVID-19 pandemic reflected in part the easing of supply constraints as reforms made the claims enforcement system more effective. Yet, further steps such as creating a commercial court (a law on which is currently under discussion) and developing a housing price index are needed to strengthen contract enforcement and reduce information asymmetries.
	Address remaining deficiencies in the AML/CFT framework	Technical compliance has improved in some areas and progress has been made under PECK II and III on drafting and implementing reforms to the legal framework and institutional capacities. Nevertheless, the effectiveness of the AML/CFT regime remains highly unsatisfactory. A divided supervisory framework impedes the effectiveness of the AML/CFT supervision in the financial sector and the volume of money laundering and terrorist financing (ML/TF) cases ultimately prosecuted and adjudicated remains negligibly low. With regards to TF and proliferation, continuous non-compliance with international sanctions regimes persists. In particular, the legislative framework on the prevention of ML/TF still needs to be aligned with the FATF standards and the EU *acquis*, including with respect to the introduction of sanctions for TF, requirements for beneficial owner identification and implementation on targeted financial sanctions mechanisms. Progress is needed to implement asset recovery legislation and improve processing of economic crime cases.

Appendix I. Macroeconomic Implications of a Large Diaspora[1]

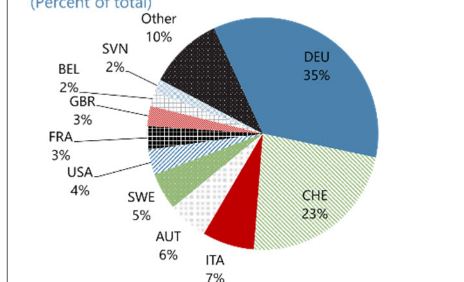
Background

1. **Kosovo's economy and growth model are heavily dependent on its large diaspora.** Strong emigration since the 1990s (specially to advanced European economies and the U.S.) is reflected in a migrant-resident ratio within the 30-40 percent range, one of the world's highest (IMF, 2021). Hospitality services targeted at Kosovars living abroad represent a substantial portion of the country's exports of services and is reflected in the strong seasonal pattern of economic activity in the summer months and other holidays. Formal and informal remittances also prop up domestic incomes significantly. This paper describes the macroeconomic consequences of a large diaspora.



Emigration by Municipality

Sources: KAS; and IMF staff calculations.

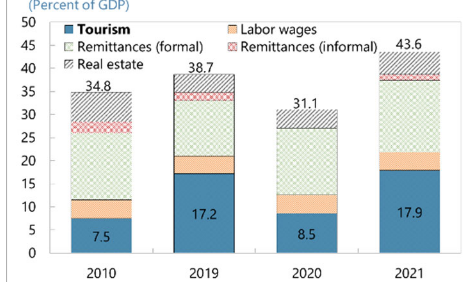


Host Countries of the Disapora

(Percent of total)

Sources: KAS; and IMF staff calculations.

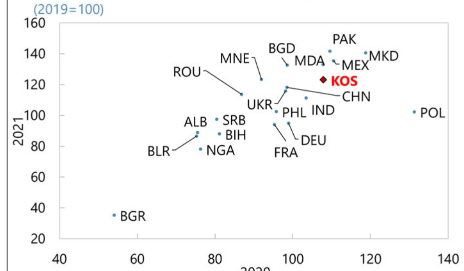
2. **Strong ties between the diaspora and the motherland helped Kosovo during the pandemic.** Over 2020-21 diaspora inflows held up better than envisaged, helping cushion the shock and supporting the recovery. Remittances and compensation of seasonal migrants largely surpassed their pre-pandemic level in both 2020 and 2021. In turn, the recovery of tourism flows in 2021 was much stronger than that in traditional tourism-exporting countries. The number of visitors from abroad received by Kosovo through September 2021 increased with respect to its pre-pandemic level of 2019, compared to significantly lower levels for all other European countries.



Diaspora Flows

(Percent of GDP)

Sources: KAS; CBK; and IMF staff calculations.



Formal Remittances and Foreign Compensation

(2019=100)

Sources: Haver Analytics; and IMF staff calculations.

Notes: The calculation is based on Q1 and Q2 cumulated data for 2019-2021.

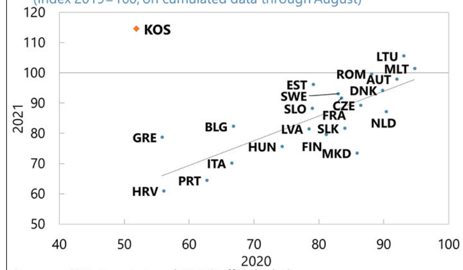
3. **While diaspora inflows have contributed to higher growth rates than for peers, their upside for long-term growth is likely to gradually subside.** Kosovo's population growth and emigration flows have softened *vis-à-vis* their levels in the late 1990s and early 2000s. Against this backdrop, the growth of diaspora inflows is bound to gradually converge down to that of the advanced host economies where the diaspora resides. Moreover, the ties between the diaspora and the motherland will likely weaken over time. While ties of first-generation migrants are strong and resilient, it is less clear whether the ties of first- and second-generation Kosovars born abroad will be as strong, including whether they

[1] Prepared by Francisco Roldan (EUR).

will keep the habit of spending their vacation time in Kosovo. These factors will lead to less dynamic diaspora inflows and puts an expiration date on a growth model based on these flows.[2]

Exports of Services

(Index 2019=100, on cumulated data through August)



Sources: CBK; Eurostat; and IMF Staff Calculations.
Note: Data for HRV is through June.

The Macroeconomics of a Large Diaspora

4. **This section presents a simple model of a small open economy with a large diaspora.** The model builds from Mendoza (1995) and includes resident (R) agents and diaspora (D) agents. Diaspora agents live abroad but can travel to the home country and send remittances. The home economy is standard and features production of both tradable and non-tradable goods with sector-specific capital and labor. Both R and D agents can hold capital in each sector. The model interprets diaspora agents' investment in non-tradable goods as including real estate, analogous to what occurs in Kosovo. Investment adjustments costs allow the model to sustain multiple ownership of capital in different sectors.

5. **In the model, the line between tradable and non-tradable goods is blurred.** As D agents can travel to the home country they can also consume non-tradable goods. This means that, in the resource constraint of the small open economy, non-tradable production is split up between domestic consumption, inputs into the production of capital, as is standard, and consumption by the diaspora. This last term changes the dynamics of the economy as consumption by the diaspora is financed by foreign inflows, or in other words, the non-tradable good is "exported". From an accounting perspective, the current account of the balance of payments is not reflected in the transactions of tradable goods only, as non-tradable goods offer an alternative way of settling international claims via the diaspora.

The Model's Results

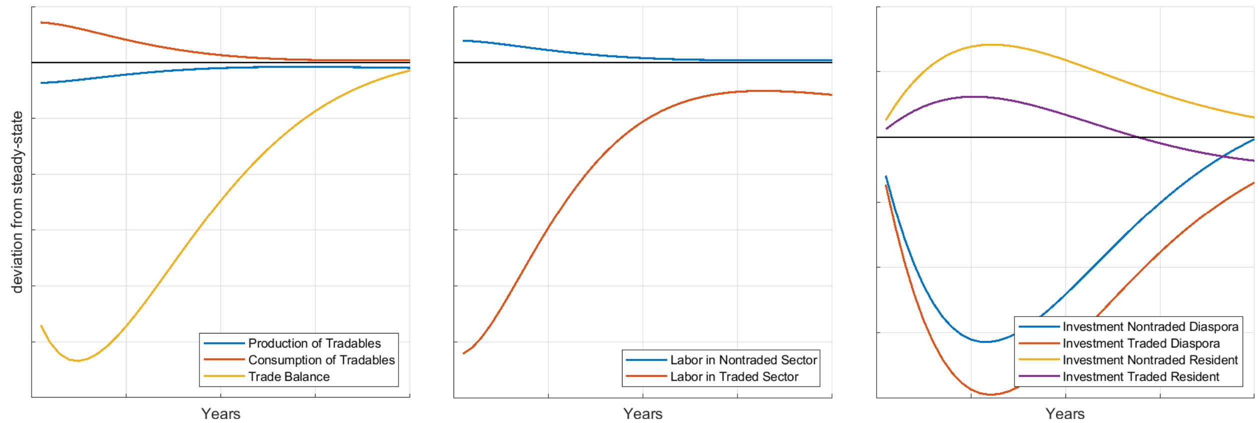
6. **A positive shock to diaspora inflows increases investment in the non-tradable goods sector.** Figure 1-a shows the economy's reaction to a positive shock to remittances. The increased diaspora inflows lead to higher domestic consumption, a deterioration of the trade balance, and an increase in investment in the non-tradable goods sector. In the long-term, the shock results in an increase in the stock of capital in the non-tradable goods sector and decreased capital in the tradable-goods sector.

7. **The model shows how diaspora inflows lead to an economic structure biased towards non-tradable goods production.** Investment is biased towards to nontraded industries as the

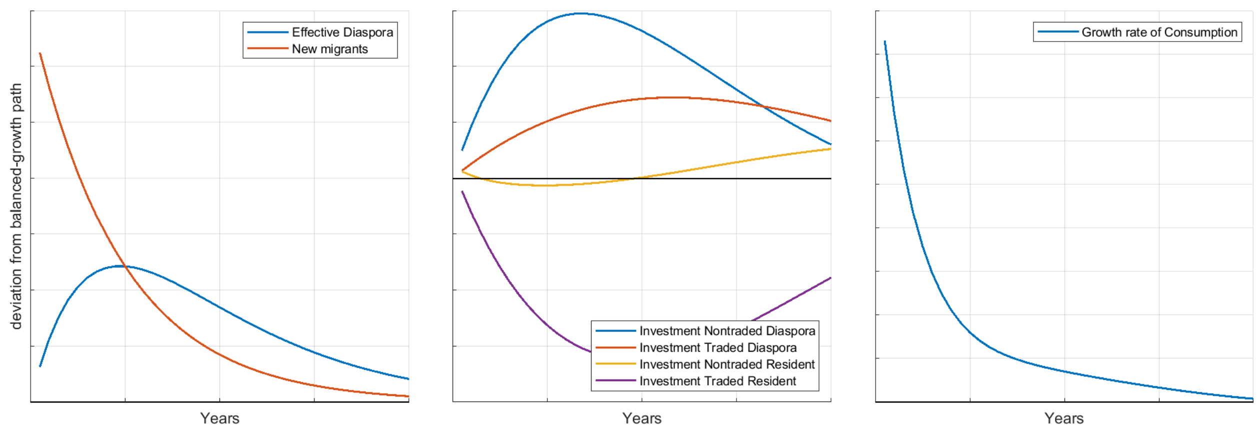
[2] Also, see Sorbe et. al. (2018) on the limits of productivity growth in service-based economies.

Figure 1. The Model's Results

1-a. Response to a Positive Shock to Diaspora Inflows



1-b. Economic Transition from a Small to a Large-Sized Diaspora



Sources: IMF staff calculations.

relative price of non-tradable goods is propped up by the consumption of diaspora agents. In other words, non-tradable good prices can only remain high to the extent that production is "exported" to the diaspora. Conversely, the high relative price for non-tradable goods reduces the incentive to invest in the tradable goods sector, resulting in a capital allocation that is slanted against tradable goods exports.

8. **The model also analyzes the effect of new migration and of the gradual erosion of diaspora ties with the motherland.** While the number of diaspora agents is replenished by new migrants, the erosion of ties is modeled as a depreciation rate of the "effective" number of migrants.[3] This sets the stage to three phases of diaspora-led growth: an initial phase in which fast growth in the size of the diaspora allows the economy to sustain high growth rates; a second phase, where

[3] The model assumes that the migrants affect the domestic economy through diaspora inflows and consumption of the non-tradable good, but that migration itself has no other economic impact. In Kosovo, recent migration is more pronounced among the youth.

diaspora inflows growth begins to soften as the increase in flows from new migrants is partially offset by decreased flows from migrants with weakened ties with the motherland; finally, in the long run, the stock of effective migrants is constant, and thus diaspora inflows, and the domestic economy, grow only as fast as the growth rate of the host country. Figure 1-b illustrates these dynamics by assuming that the economy starts with a diaspora's size that is significantly below that in the balanced-growth path.

Conclusions

9. This note shows how diaspora inflows affect the domestic economy's structure and growth. Diaspora inflows lead to factor allocation and production that are biased towards non-tradable goods. In the balanced growth path, diaspora inflows will not grow more than that of the host country, and thus, per capita income convergence for the domestic economy will stop. Continued convergence requires a diversification of the sources of growth. As diaspora-led growth will gradually peter out, Kosovo should use large diaspora inflows to close physical and social infrastructure gaps that would create the conditions for stronger FDI and, thus, of new sources of growth. Stronger FDI can be attracted, for example, by creating effective ties with diaspora entrepreneurs, and by decisive progress in international integration, including through the implementation of the Kosovo -EU Stabilization and Association Agreement.

References

Mendoza E., (1995), "The terms of Trade, the Real Exchange Rate, and Economic Fluctuations", International Economic Review, 1995, vol. 36, issue 1, 101-37.

Sorbe S., P. Gal, and V. Millot, (2018), "Can productivity still grow in service-based economies?", OECD Economics Department Working Papers, No. 1531, Paris.

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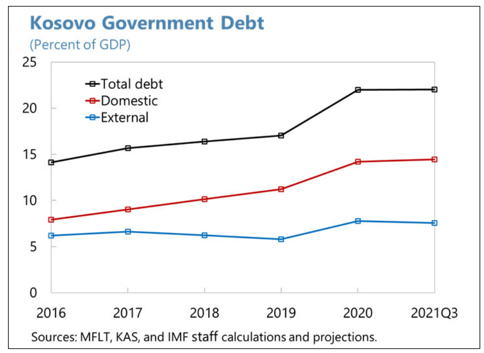
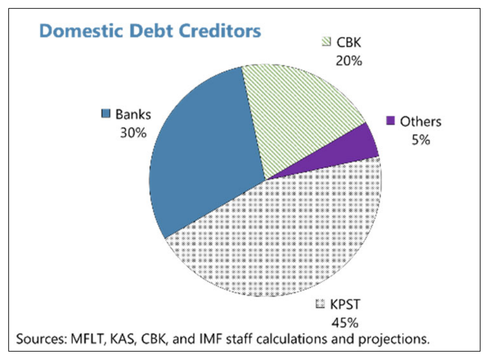
Appendix II. Expanding the Market for Government Securities[1]

Background

1. The pandemic has highlighted the importance of fiscal space as the factor that allows or constrains fiscal policy implementation in times of stress. Advanced economies deployed large fiscal stimulus programs taking advantage of very elastic demand of government securities. In contrast, many emerging and low-income economies saw their fiscal firepower constrained by relatively inelastic demand of government debt when higher deficits were needed. In addition, while the central banks of advanced economies and many emerging economies implemented quantitative easing (QE) programs to preserve financial market stability, providing a *de facto* backstop for the demand of government securities, other economies were constrained by market or institutional conditions to follow this route.





2. In the case of Kosovo, expanding the investor base of government debt is critical for reducing financing risks and further enabling countercyclical fiscal policy. Kosovo's government debt market is shallow. Domestic bonds are mostly held by the Kosovo Pension Saving Trust (KPST), commercial banks, and to a lower extent, by the Central Bank of Kosovo (CBK). For all these market players, demand of government securities is limited by either legal or risk management constraints. In addition, Kosovo has never issued in external markets, and thus its external debt consists of budget support loans or project financing with official bilateral or multilateral institutions. This narrow investor base not only limits the government's ability to provide fiscal support when needed but also creates financing risks as the demand for government securities is approaching its satiation point. Moreover, Kosovo's unilaterally euroized economy constraints the capacity of the Central Bank to implement QE type programs in times of stress.

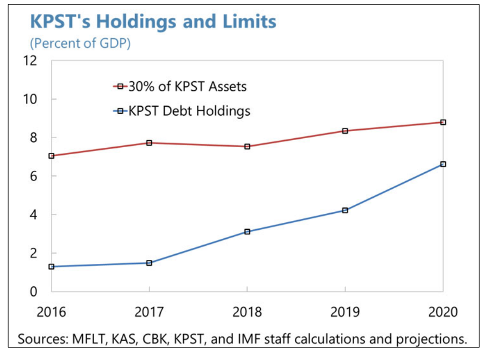
Kosovo's Government Debt: Demand and Supply

3. Assessing the future size of government debt demand requires analyzing the risk and legal constraints facing different market players:

- **KPST can increase its government debt holdings by 4 percentage points (pp) of GDP through 2026.** By law, KPST's exposure to Kosovo's government securities cannot exceed 30

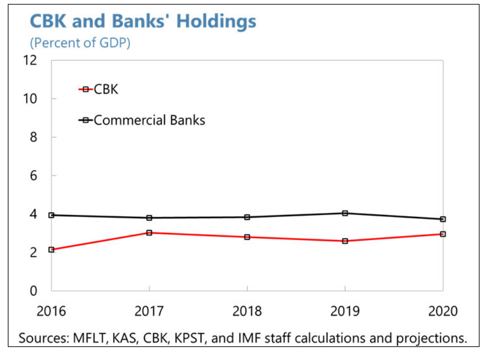
[1] Prepared by Si Guo (EUR).

percent of its assets. As of 2021, KPST's total assets were about 30 percent of GDP, of which 6.5 percent of GDP (22 percent of KPST's assets) was invested in government debt. Based on demographic projections and KPST's actuarial information, its asset-to-GDP ratio will grow by around 1 pp of GDP per year in 2022-26. This caps the size of its government debt holdings at around 10-11 percent of GDP by 2026, i.e., about 4 pp of GDP higher than its current holdings.



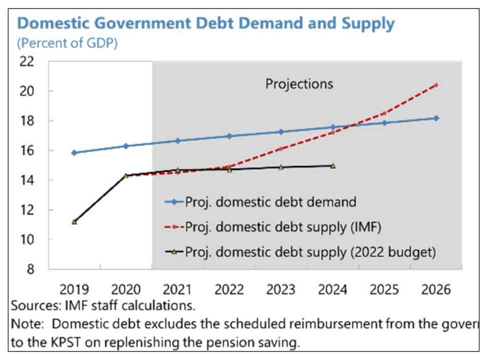
Sources: MFLT, KAS, CBK, KPST, and IMF staff calculations and projections.

- **Commercial banks' government debt holdings will likely stay unchanged in GDP terms.** The risk management policies of the parent companies of the largest banks operating in Kosovo (subsidiaries of banks headquartered in the EU) limit their exposure to Kosovo's government securities as the absence of a sovereign risk rating results in a 100 percent capital risk weight. Accordingly, commercial banks' demand will at most stay unchanged at 4 percent of GDP.



Sources: MFLT, KAS, CBK, KPST, and IMF staff calculations and projections.

- **CBK's holdings of government debt will either remain constant or decline in GDP terms.** While CBK's current holdings (3 percent of GDP) are lower than the legal cap (25 percent of the CBK's reserves), its future holdings will likely not increase in order to preserve the quality and liquidity of international reserves.



Sources: IMF staff calculations.
Note: Domestic debt excludes the scheduled reimbursement from the gover
to the KPST on replenishing the pension saving.

4. Under the 2021 Article IV Consultations' fiscal baseline, the projected supply of domestic government debt will exceed the market's absorption capacity as soon as 2024-25. The supply of government securities assumes: (i) an overall fiscal deficit of 2.4 percent of GDP per year (on average) over 2022-26, which after excluding donor-financed investment is well within the fiscal rule deficit ceiling; and (ii) a gradual decline in government deposits to 4.5 percent of GDP by 2026, in line with its legal floor. Even under these moderate assumptions, the projected supply of government securities will exceed demand (the sum of the projected debt holdings of KPST, commercial banks, the CBK, and other smaller investors) sometime in 2024-25.[2] Alternatively, the 2022 budget assumes that the stock of domestic public debt will remain about constant in GDP terms through 2024, but it also assumes that the fiscal deficit will be financed to a larger extent by still-uncommitted external budget support.

[2] Domestic debt considered in this note excludes government debt of €120 million originated in the government's commitment to refund KPST for early withdrawals of pension savings in December 2020.

Filling the Gap: Possible Options

5. The excess liquidity in the financial sector suggests that there may be options available to address the projected excess supply of government debt. Although government securities carry higher yields than bank deposits with similar maturities, the lack of financial products and the shallow debt market constrain the demand by households and non-financial corporates. While the long-term solution is to develop Kosovo's capital market, interim measures to expand the investor base for government securities include:

- **Increase the supply of short-term treasury bills.** The maturity of all government debt instruments is currently 2 years or more. While this limits roll-over risks, the complete absence of the government in the short-term end of the yield curve leaves the market with no reference in this segment. A limited increase of short-term treasury-bills may also be attractive for liquidity management for banks and non-financial corporates.

- **Obtaining a good sovereign risk rating.** A sovereign rating of BBB- (and above) would reduce the capital risk weight of Kosovo's government securities, allowing banks to increase their demand. Whether Kosovo's fundamentals would allow a good sovereign risk rating is uncertain, but what is certain is that starting to build a track record is an action that can be taken immediately. A sovereign rating would also allow the government to tap the Eurobond market, a segment where Kosovo is still not present, unlike other Western Balkan countries.

Table 1. Economic Fundamentals: Kosovo in Context, 2019

	Kosovo	Economies with B- to BB+	Economies with BBB- to BBB+	Economies with A- and above
Gov. Debt (% GDP)	18	63	55	55
3-yr Fiscal Balance (% GDP)	-2.4	-3.3	-2.3	-0.8
GDP Per Capita (in $)	4,432	6,700	16,209	41,809
Reserves (months of imports)	3.8	5.1	7.6	6.1
CA Balances (% GDP)	-5.7	-3.1	1.3	2.3
Governance Index	-2.1	-1.6	1.1	6.4
Default History (share)	-	16%	11%	0%
Number of Economies	1	43	19	41

Sources: World Bank; Haver Analytics; S&P; and IMF staff calculations. Reference year for statistics in this table is 2019.

- **Issuing retail bonds.** This option would give households direct access to the government debt market. Along these lines, the government recently issued a so-called "diaspora bond" to cater to individuals, including from the diaspora, but at a scale that is still too small to be impactful (€11 million).

Table 2. Economic Fundamentals: Kosovo and Peers

	Kosovo	Albania	Bosnia and Herzegovina	Montenegro	North Macedonia	Serbia
Gov. Debt (% GDP)	18	67	32	79	41	53
3-yr Fiscal Balance (% GDP)	-2.4	-1.8	1.6	-4.7	-2.2	0.5
GDP Per Capita (in $)	4,432	5,356	6,120	8,911	6,022	7,412
Reserves (months of imports)	3.8	8.1	9.0	5.1	5.1	6.1
CA Balances (% GDP)	-5.7	-7.6	-3.1	-14.3	-3.3	-6.9
Governance Index	-2.1	-0.5	-2.3	0.7	-0.1	-0.5
Default History	-	-	-	-	-	-
S&P Rating as of Dec-2019	NA	B+	B	B+	BB-	BB+

Sources: World Bank; Haver Analytics; S&P; and IMF staff calculations. Reference year for statistics in this table is 2019.

Sovereign Ratings and Eurobond Issuance

6. **Having a sovereign risk rating is necessary to issue in the Eurobond market.** Bond pricing is highly correlated with ratings. Tables 1 and 2 show a few economic fundamentals that the literature identifies as variables affecting sovereign risk ratings.[3] Compared to peers, Kosovo's advantages lie on its low public debt ratio and a track record of no defaults, while disadvantages include its institutional quality and absence of independent monetary policy. That said, the significant strengthening of the government's balance sheet in 2021 suggests that the time may be right to start the process to obtain a sovereign risk rating. The absence of a financing gap and the rebuilt fiscal buffers may result in a better rating than the one that could be obtained in less favorable circumstances.

7. **Simple econometric analysis can be used to assess the relation between economic fundamentals and sovereign ratings.** Along these lines, an OLS regression model is proposed to tentatively ascertain in which sovereign risk category Kosovo would fall. The sample covers 103 countries, with the regression having the standard form, $R_i = \beta X_i + \varepsilon_i$, where R_i denotes the country i's S&P rating at end-2019 (scaled from 3 for "SD" rating to 24 for "AAA" rating), and X_i denotes economic fundamentals, including public debt-to-GDP ratio, the 3-year average fiscal balance-to-GDP ratio, GDP per capita; the foreign reserves-to-imports ratio, the current account balance-to-GDP ratio, the World Bank Governance Index, and a dummy variable for default history.[4] While results are

[3] See Teker et al. (2013) for a review.

[4] All explanatory variables are statistically significant, and their coefficients are of the expected sign. Other potential explanatory variables such as export-to-GDP ratio, import-to-GDP ratio, real GDP growth rates, and external debt-to-GDP ratio were found to be not statistically significant at the 10% level.

only indicative, the model suggests that Kosovo's sovereign risk rating would likely fall within the B to BB- range.

8. Though predicting the yield of a hypothetical Eurobond issuance is difficult, the analysis suggests that it might be pricier than domestic debt of similar maturity. Table 3 shows that when using San Marino (BB+) and Montenegro (B) as possible benchmarks, domestic debt may still be cheaper for Kosovo given underwriting fees and the cost of carry for issuing Eurobonds. However, relative costs may change if Kosovo's domestic bond market tightens.

Table 3. Comparison of Coupon Rates

Country	Issuance Date	Maturity	Coupon	Type
San Marino (BB+)	Feb-21	3	3.3%	Eurobond
Montenegro (B)	Dec-20	7	2.9%	Eurobond
Kosovo	Oct-21	3	1.6%	Domestic
Kosovo	Aug-21	7	3.2%	Domestic

Sources: S&P; Fitch; CBK; and IMF staff calculations.

Policy Implications

9. The projected excess supply of domestic public debt suggests that the government should start exploring ways to expand its investor base. In addition to implementing policies to support the long-term development of the capital market (through, for example, strengthening investor protection, enhancing regulatory powers, and developing the market's infrastructure), the government can consider near term policies such as adjusting the maturity structure of domestic bonds, tapping the retail market, and starting the process to obtain a sovereign risk rating. Meanwhile, prudent fiscal policy and exploring alternative external bilateral and multilateral financing sources can help slow down the pace of increase of domestic debt and buy more time to diversify the investor base.

10. Obtaining a sovereign risk rating would allow Kosovo to issue in the Eurobond market and may strengthen fiscal policy discipline. Although the current financing cost of issuing external bonds would likely be higher than for domestic bonds, having a sovereign risk rating and a track record of continued improvement in economic fundamentals will eventually help attract more investors into Kosovo's government securities, and in time, can help Kosovo's corporates issue abroad as well. The incentive to avoid sovereign risk rating downgrades could also play a positive role in keeping fiscal discipline.

References

Teker, D., Pala, A., and Kent, O., (2013). "Determination of Sovereign Rating: Factor Based Ordered Probit Models for Panel Data Analysis Modelling Framework", International Journal of Economic and Financial Issues, 3 (1):122-132.

Appendix III. Informality Trends in Kosovo[1]

1. **The size of Kosovo's informal sector is estimated at over a third of employment and GDP, well above the EU average and at the upper end of the Western Balkans.** Despite policy efforts in Kosovo and the region, informality levels have remained persistent.[1] Commonly cited key drivers behind Kosovo's high informality rates are a lack of trust in official institutions, corruption, prolonged litigation and inefficient justice administration, society's acceptance of informality, weak enforcement and sparsely used sanctions, and the prevalence of cash-based transactions. Kosovo's low tax rates are not considered to be a driving factor.[2]

2. **Formalization is a policy priority in Kosovo, with three key motivating factors:**

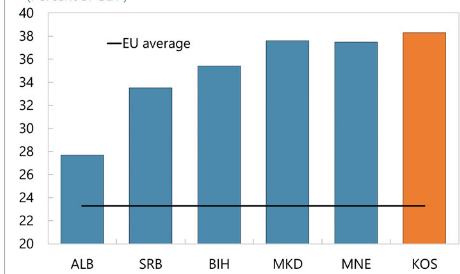
- **To create greater fiscal space**. Informality reduces the tax base. Kosovo's tax revenues and social contributions to GDP are significantly below the regional average. Low revenues constrain the provision of public goods (such as education, health, and infrastructure), and policies to promote economic growth and development.

- **To promote fair market competition and higher growth.** Other things equal, informality puts tax compliant businesses at a disadvantage. Business owners and senior managers rank 'competition from the informal sector' as the biggest obstacle to doing business in Kosovo (World Bank, 2019). Formalization tends to be associated with greater productivity, as it enables greater economies of scale, due to better access to financing and capital accumulation.

- **To improve labor conditions, social and customer protection.** Informal workers often lack a safe work environment, and access to social protection including

Informality in the Western Balkans

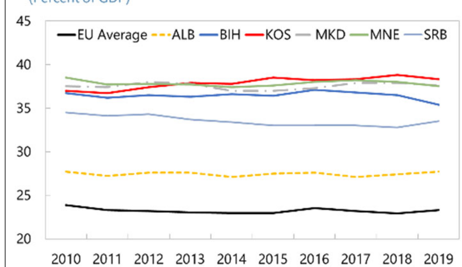
(Percent of GDP)



Sources: The Global Informal Workforce; and IMF staff calculations.

Informal Economy Estimates, 2010-19

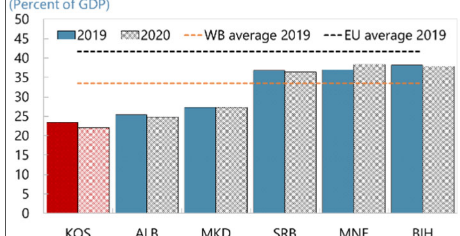
(Percent of GDP)



Sources: The Global Informal Workforce; and IMF staff calculations.

Government Revenue: Taxes incl. Social Contributions

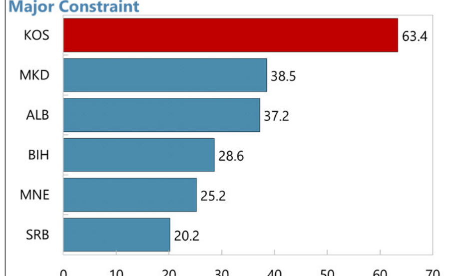
(Percent of GDP)



Sources: IMF WEO Oct-2021; and IMF staff calculations.

Note: KOS figures don't include mandatory pillar 2 contributions of around 2.7% of GDP. EU weighted average doesn't include Austria, Lithuania, and Malta due to data availability.

Firms Identifying Practices of Informal Competitors as a Major Constraint



Sources: Enterprise Surveys 2019.

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[1] Prepared by Amanda Edwards (EUR).

[2] This note defines informality as those activities that would add to tax revenue if they were recorded. Informal activities are, by definition, not recorded or under-reported, as participants often do not want to be accounted for, making its measurement challenging.

pensions. During the pandemic, informal workers have had less access to government lifelines. Formalization is also associated with greater customer protection

Table 1. Informality in the Western Balkans, percent (2019)

Country	Informal employment in percent of total employment	Informal sector in percent of GDP
Kosovo	>35	30-35
Albania	30-35	30-35
Bosnia and Herzegovina	30-35	30-35
Montenegro	30-35	30-35
Serbia	20	23-30
North Macedonia	<20	20-40
EU average	17	23

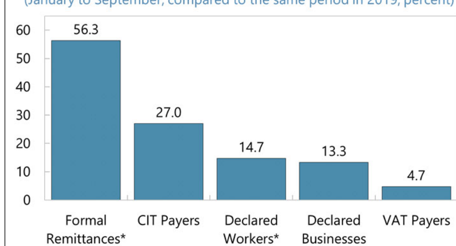
Sources: European Commission; World Bank; ILO; and IMF staff calculations.

3. There is evidence suggesting some formalization gains during the pandemic amid mobility restrictions and policy actions. A number of factors may have played a role in this regard: Informal activity (which in Kosovo is prevalent in construction, restaurants, trade, and transport) has been severely disrupted by the pandemic. However, fewer tax inspections, reduced earnings, and redundancies may have acted as incentives to lower tax compliance. On the other hand, government support measures (unemployment benefits, hiring subsidies) provided incentives to formalize activities. For example, businesses that were eligible to receive such subsidies only included those where contracts for newly hired young employees would be at least 1-year long. In addition,

- **Formal remittances steeply increased during the pandemic** due to the travel restrictions, which impeded the informal delivery in cash or in kind. While informal remittances picked-up amid the eased travel restrictions, the level of formal remittances has remained high.

- **The number of declared employees and businesses, and consequently taxpayers, has also increased** compared to 2019, despite the steep economic contraction in 2020, even in sectors that have been severely impacted by the pandemic, such as

Change in Different Economic Categories, 2021
(January to September, compared to the same period in 2019, percent)



Sources: CBK; TAK; and IMF staff calculations.
*/ Data refers to change from January to August in 2021 compared to the same period in 2019.

Increase of Declared Employees Following ERP Policies 2020-21:

Return to work of those who lost their jobs during the pandemic	1,013
Support for formalized employees	4,066
Support for women's employment	4,882
Total	**9,961**

Sources: Tax Administration of Kosovo.

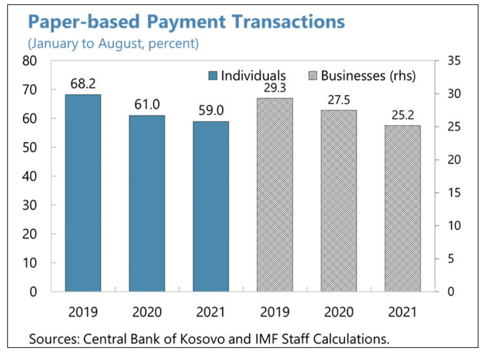
Newly Declared Employees due to TAK Visists:

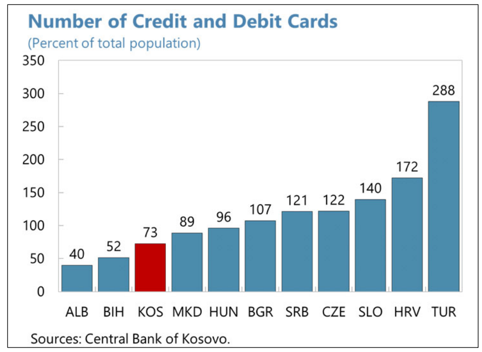
2019	2,880
2020	2,276
2021 Jan-Aug	2,762

Sources: Tax Administration of Kosovo.

hotels and restaurants. These increases were supported by long-standing policy action to reduce tax avoidance and evasion by Kosovo's Tax Administration Agency (TAK).

- **Digital payments continued to increase, though from a small base.** The number of financial accounts, payment cards and digital payments continued increasing, and paper-based transactions declined. However, compared to peers, Kosovo's level of payment digitalization is still relatively low.





4. In order to sustain and increase recent formalization gains, IMF (2019) and IMF (2021) suggest concrete policy actions. Although there is no one-size fits all solution due to the multifaceted nature of informality, the following actions have been shown to have a positive effect on formalization:

- **Increase the efficiency and fairness of the justice system.** Reduced corruption, shorter processing times and greater effectiveness in the justice system can help to make formality less costly and risky. A draft law currently under discussion may support these efforts as it proposes to increase the number of commercial courts in order to speed up and improve the justice administration.

- **Simplify tax procedures and enhance monitoring and enforcement.** A tax system that is easy to navigate and that is enforced by continuous monitoring and sanctions, such as penalties and fines, makes informality more costly. Smaller firms can, for instance, have access to simplified tax procedures.[3] The tax rate level is the least cited "biggest obstacle of doing business in the country" in Kosovo compared to other countries in the region (World Bank, 2019). Firms that are not sufficiently productive to pay taxes can be assisted through technical and business administration training to raise productivity or relocate to other economic activities.

- **Strengthen and enhance completion of secondary, technical, and vocational education.** Research suggests that improved access to quality education, particularly at the secondary, technical, and vocational levels, helps to lower informality. A larger share of Kosovo's employers compared to that in other Western Balkan countries refer to an inadequately educated workforce as a major or severe obstacle to their current operations (World Bank, 2019).

[3] In recent years, various countries including the US have introduced the 'simplified corporation'. In Colombia, within five years of the reform such companies now employ at least 2.5 million people and revenues and social contributions have increased.

- **Link taxes to services in order to raise transparency and awareness.** Explicitly linking the amount of taxes paid by each taxpayer to the services provided can help to raise transparency, awareness, and trust, and highlight the social value of economic formalization.[4]

- **Increase financial inclusion and electronic payments**. Schneider and Williams (2013) found that increasing electronic payments by 10 percent annually for at least four consecutive years can reduce the size of the informal sector by up to 5 percent. Policies to support financial inclusion (financial and digital literacy, regulatory support for mobile banking) can help with that. Moreover, the second most frequently identified major constraint by firms in Kosovo after competition from the informal sector is access to finance (World Bank, 2019).

[4] In the UK, e.g., residents receive regular updates of how much of their individual total occupancy taxes was spent on each local service, such as the local school, library, waste collection, etc., strengthening accountability and trust. An assessment for China based on a six-city sample (Ahmad et al. 2020) showed that linking simple area-based taxes on occupancy to basic services (including basic education) can help to raise revenues quickly and thus help to create an environment conducive to greater formality.

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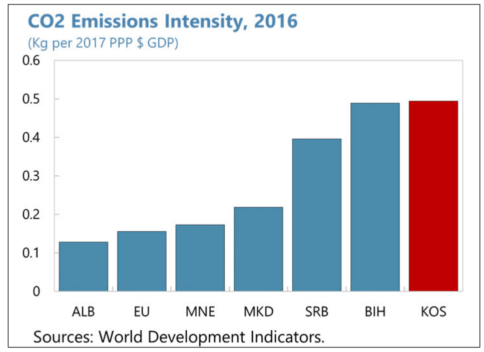
Appendix IV. Mitigating Climate Change and Protecting the Environment in Kosovo[1]

Background

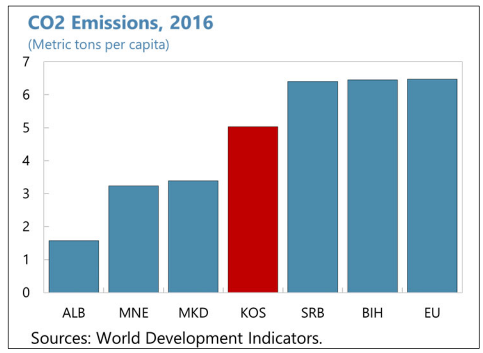
1. **Kosovo's economy is characterized by high carbon intensity and environmental spillovers as well as by low air quality from energy generation and residential heating.** The need to for alignment with the EU climate and environmental commitments is imminent and requires setting reduction targets and identifying policy measures for the years to come, also with a view to achieving carbon neutrality by 2050. The exit from the pandemic provides an opportunity for a green recovery and for setting ambitious climate goals.

2. **For Kosovo, addressing climate change and environment pollution is macro-critical.** Greenhouse gas emissions (GHG) have been on the rise and are significant relative to the size of the economy. It is estimated that the carbon intensity of the economy, as measured in CO2 emissions per unit of output, is the highest in the Western Balkans and about four times the average of the EU. At the same time, per capita emissions are relatively low and close to the world average of 4.4 tons per capita due to a low share of manufacturing in GDP.

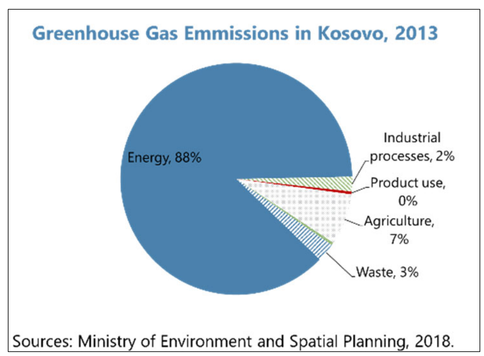
3. **The main contributor to GHG emissions is energy generation.** About 93 percent of Kosovo's energy production comes from two lignite-fired power plants, "Kosovo A" and "Kosovo B". Other sources of GHG emissions since the early 2000s have been attributed to illegal construction in hazard zones, failure to adhere to building codes, inadequate land use and municipal planning, unsustainable water management and agronomic practices, deforestation, and destruction of slopes by mining activities (MESP, 2018).



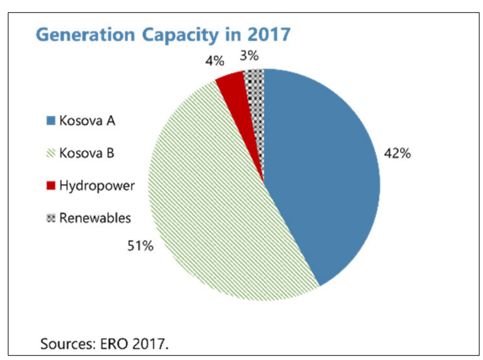
Sources: World Development Indicators.



Sources: World Development Indicators.



Sources: Ministry of Environment and Spatial Planning, 2018.



Sources: ERO 2017.

4. **Kosovo's GHG emissions from lignite-based power plans have had a costly impact not only on climate but also on health.** Coal combustion

[1] Prepared by Oana Luca (SPR).

in the power sector is mainly responsible for 96 percent of sulfur dioxide (SO_2) emissions, 36 percent of fine particulate matter with a diameter of 10 micrometers (PM_{10}), 24 percent of fire particulate matter with a diameter of 2.5 micrometers ($PM_{2.5}$), and 57 percent of nitrogen oxides (NO_x) (MFK, 2021). Moreover, the burning of fossil fuel for heating in the residential sector is the main cause for the high concentration of harmful $PM_{2.5}$, one of the leading causes of illness and death associated with respiratory, pulmonary and heart diseases. The ambient concentrations of $PM_{2.5}$ in Kosovo exceed the World Health Organization air quality guideline value of 10 μg/m3 and the European Union (EU) limit value of 25 μg/m3. Altogether, the health cost of air pollutants in Kosovo is estimated at 2.5 to 4.7 percent of GDP in 2016 (World Bank, 2019).

Kosovo's Climate Agenda: Context and Challenges

5. **Globally, action to reduce GHG emissions is urgent.** GHG emissions must be cut by 30-60 percent below baseline levels (i.e., levels with no new policies or tightening of existing policies) in 2030 to stay on track with climate stabilization targets and to contain temperature increases to below 2 degrees Celsius. Recent research shows that to attain that level, new measures must be phased in on top of existing policies equivalent to a global carbon tax of around $75 per ton or more by 2030, and even higher further on (Batini et al, 2021).

6. **In this spirit, the European Union adopted the ambitious New Green Deal in 2020.** The new plan has much more ambitious targets to cut GHG emissions, by 55 percent relative to 1990 levels by 2030, compared to 40 percent previously. In line with the New Green Deal, the Western Balkan countries signed the Sofia Declaration on the Green Agenda in November 2020 in which they commit to introduce carbon pricing instruments and market-based renewables support schemes, as well as phase out coal subsidies, with a view to achieving carbon neutrality by 2050 (Box 1).[2]

7. **Although Kosovo is not part of any international convention on climate change or the environment, it is subject to certain obligations as a member of the Energy Community (2006) and as a signatory of the EU-SAA (2016) and the Sofia Declaration (2020).** Under the Energy Community, Kosovo has commitments with respect to national GHG emissions monitoring and reporting systems, and about the National Energy and Climate Plans (NECPs). Although compilation of a GHG inventory is progressing, legislation defining national policies, measures and projections has not been adopted yet. Under the SAA, Kosovo is part of the SAA Energy and Environment Committee and should develop national plans for the reduction of GHG emissions; in this regard, while the EU's "Large Combustion Plants Directive" and the "Industrial Emissions Directive" call for Kosovo to install filters in the largest lignite-based electricity generation plans, progress has been slow. More recently, Kosovo's participation in the Sofia Declaration on the Green Agenda, commits the country to a path of carbon neutrality by 2050.

[2] The Sofia Declaration can be found at https://www.rcc.int/docs/546/sofia-declaration-on-the-green-agenda-for-the-western-balkans-rn .

8. Kosovo's vision on climate mitigation is laid out in the "Climate Change Strategy (2018-27)" and the "Climate Change Action Plan (2019-21)". These documents cover key sectors (energy, buildings, minerals, industry, transport, waste management, agriculture, forest, and nature conservation) and set the foundation for Kosovo's climate mitigation agenda. However, they do not include clearly defined commitments and reduction targets, and a national system for policies, measures and projections is still missing. A draft law on climate change is under preparation and expected to be completed by 2022 to set the legal basis for an NECP (Energy Community, 2021).

A Roadmap Ahead

9. The work to address climate change and environment pollution should start immediately. Priority areas include completing a system for annual GHG accounting nationwide and at the sectoral level, setting sectoral reduction targets for 2030 and 2050, developing supporting policies that internalize the cost of GHG emissions and tilt the energy mix toward renewables, and strengthening standards for air quality.

10. A credible climate and environment mitigation strategy for Kosovo must be centered around carbon pricing. By charging the carbon content of fossil fuels and their emissions, carbon pricing provides across-the-board incentives, is cost-effective, provides a price signal for investment, raises revenue, has domestic environmental co-benefits, and is straightforward to administer (Batini et al, 2021). It can also be reinforced by measures at the sectoral level such as regulations and feebates, which can avoid significant increases in energy prices.[3] Revenues from carbon pricing can be recycled to growth-supporting green investments, and to mitigate the impact on the most affected to ensure that benefits are equitably distributed.

11. In the medium term, boosting energy efficiency and diversification away from lignite is priority. In addition to implementing carbon pricing, including on electricity tariffs, energy efficiency can be increased by improving energy performance of existing buildings, reducing electricity losses in the distribution system, and increasing the share of renewables in the energy mix. Electricity prices in Kosovo are the lowest in Europe (€30.8/MWh in 2019; ERO, 2020). While this level reflects low generation costs due to abundant lignite reserves and low capital amortized costs, it does not account for the cost of pollution. Moreover, the few renewable energy projects charge feed-in tariffs that seem unjustifiable high. Looking ahead, the impact of additions to the electricity generation matrix may result in higher tariffs, depending on long-term supply agreements with investors. The goal should be to

Feed-in Tariffs applicable to Renewable Energy, 2019

Renewable Energy	Euro/Mwh
Wind	85.0
Photovoltaic	136.4
Small Hydro Power Plants	67.5
Biomass	71.3

Sources: ERO Annual Report 2019.

[3] Feebates are revenue neutral tax-subsidy schemes, which apply a sliding scale of fees on products or activities with above average emission rates and a sliding scale of rebates on products or activities with below average emission rates.

replace feed-in tariffs with market-based mechanisms to strengthen incentives to invest in renewable energy.

Box 1. Sofia Declaration on the Green Agenda for the Western Balkans (November 2020)

Key climate actions in the Sofia Declaration include:

- **Align with the EU Climate Law** once it is adopted with a vision of achieving climate neutrality by 2050.
- **Set forward-looking 2030 energy and climate targets** in line with the Energy Community framework and EU *acquis*; and develop and implement integrated Energy and Climate Plans with measures to reduce GHG emissions in the Western Balkans by integrating climate action into all relevant sectoral policies.
- **Prepare and implement climate adaptation strategies** to increase resilience through climate proofing of investments and to ensure greater integration of climate change adaptation with disaster risk reduction.
- **Align with the EU Emissions Trading Scheme**, and work towards introducing other carbon pricing instruments to promote decarbonization and develop a similar mechanism to the European Climate Pact in the region.
- **Revise all relevant legislation to support decarbonization** of the energy sector and secure full enforcement, notably through the Energy Community; and cooperate in the preparation of an assessment of the socio-economic impact of decarbonization at individual economy and regional level with a view to a just transition.
- **Prioritize energy efficiency and improve it in all sectors** and support private and public buildings renovation schemes, secure appropriate financing, and full enforcement of the Energy Performance of Building Directive.
- **Increase the share of renewable energy sources** and provide the necessary investment conditions, in line with the EU and Energy Community acquis and target; strive to decrease and gradually phase-out of coal subsidies, strictly respecting state aid rules; and actively participate in the Coal Region in Transition initiative for the Western Balkans.

12. Tackling air pollution is a key priority. In this regard, the focus should be on enforcing regulation for emissions and investing to install filters in "Kosovo B". In the residential sector, a feebate mechanism could be used to encourage reductions in pollution by rewarding heating efficiency of buildings and the adoption of clean efficient stoves, while green investment funds could be deployed to expand district heating.

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INTERNATIONAL MONETARY FUND

REPUBLIC OF KOSOVO

STAFF REPORT FOR THE 2021 ARTICLE IV CONSULTATION—INFORMATIONAL ANNEX

December 20, 2021

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

CONTENTS

FUND RELATIONS

(As of November 30, 2021)

Membership Status:
Joined: June 29, 2009; Article XIV.

General Resources Account:	**SDR Million**	**Percent Quota**
Quota	82.60	100.00
Fund holdings of currency	123.64	149.69
Reserve Tranche Position	20.07	24.29

SDR Department:	**SDR Million**	**Percent Allocation**
Net cumulative allocation	134.54	100.00
Holdings	127.74	94.45

Outstanding Purchases and Loans:	**SDR Million**	**Percent Quota**
Stand-By Arrangements	19.80	23.97
Emergency Assistance [1]	41.30	50.00

Latest Financial Arrangements:
Arrangements:

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

Outright Loans:

Type	Date of Arrangement	Expiration Date	Amount Approved (SDR Million)	Amount Drawn (SDR Million)
RFI	Apr 10, 2020	Apr 15, 2020	41.30	41.30

Overdue Obligations and Projected Payments to Fund [2]
(SDR Million; based on existing use of resources and present holdings of SDRs):

[1] Undrawn outright disbursements (RFI and RCF) expire automatically 60 days following the date of commitment, i.e. Board approval date.

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

	Forthcoming				
	2021	2022	2023	2024	2025
Principal	9.9	9.90	10.33	20.65	10.33
Charges/Interest		0.49	0.42	0.24	0.04
Total	9.9	10.39	10.75	20.89	10.37

Implementation of HIPC Initiative: **Not Applicable**

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

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

As of February 4, 2015, the Post-Catastrophe Debt Relief Trust has been transformed to the Catastrophe Containment and Relief (CCR) Trust.

Safeguards Assessments

The update safeguards assessment, conducted in connection with the Rapid Financing Instrument approved in April 2020 found that the CBK continues to maintain broad operational controls and all recommendations from the previous safeguards assessment have been implemented. However, the CBK Board vacancies have resulted in the lack of a quorum since June 2020 and the absence of a functioning Board poses substantial governance and oversight risks for the central bank.[3] The CBK Act protects the autonomy of the central bank, and the audit mechanisms and financial reporting practices continue to be aligned with international standards. The implementation of the risk management framework is advancing.

Exchange Arrangements

The de jure and de facto exchange rate arrangements are 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 has accepted the obligations of Article VIII Section 2, 3, and 4, and maintains an exchange system that is free of multiple currency practices and restrictions on making of payments and transfers for current international transactions, 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

The last Article IV consultation was concluded on October 7th, 2020. Going forward, it is expected that Kosovo will be on a 12-month cycle.

[3] The quorum was restored after two (out of three) Board vacancies were filled in November 2021.

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. A FSSR mission was completed in May 2019.

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 (November 2018; March, June and October 2019; February and November 2020);

- Monetary and Financial Statistics (August 2019);

Fiscal Sector

- Tax Administration - Compliance Risk Management (November 2018); Review Process of Tax Administration Reform (March 2019); Tax Administration Modernization (January 2020); Tax Debt Collection (May 2020); IT Reform Implementation (September 2020); Tax Administration Reform Progress (March 2021), Tax Audit Reform, (February 2021), Developing an independent fiscal oversight options paper (January 2021); Tax Diagnostic Mission (April 2021);

- Public Financial Management - Medium-Term Expenditure Framework and Fiscal Management (February 2019; September 2020); Budget Costing and Fiscal Risk Management (November 2019); Fiscal Risk Disclosure (October 2020); Technical Assistance on Monitoring of Expenditure Arrears and Multi-Annual Commitments. (April 2021), Management of Fiscal Risks Related to Publicly Owned Enterprises (POEs) (March 2021);

- Pension System Diagnostic Assessment and Policy Advisory (March 2021);

Monetary and Financial Sectors

- Financial Sector Stability Review (January, April and October 2019); IFRS9 Implementation (July 2020); Follow up Technical Assistance on Insurance Supervision (April 2021), Central Bank Governance, (June 2021).

Resident Representative

Ms. Eble from regional office for the West Balkans took up her post on June 14, 2019 and oversees Kosovo’s local office.

RELATIONS WITH 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: https://www.worldbank.org/en/country/kosovo/overview

STATISTICAL ISSUES

(As of November 20, 2021)

I. Assessment of Data Adequacy for Surveillance
General: Data provision is adequate for surveillance. However, the Kosovo Agency of Statistics (KAS) still experiences 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 lag 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 (GFS): 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. GFS are broadly compiled following the GFSM 2014 framework, but they still do not cover the extrabudgetary units' data. In addition, the budget classification is not consistent with the 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.
Monetary and Financial Statistics: Monetary data are compiled broadly consistent with the IMF's *Monetary and Financial Statistics Manual and Compilation Guide 2016* (*MFSMCG*). The CBK reports monetary data on a monthly and timely basis, using Standardized Report Forms for the central bank, other depository corporations, and other financial corporations, which are published in the *International Financial Statistics*. Due to difficulties with obtaining adequate source data needed for estimation of Euro currency in circulation, the CBK ceased compiling currency in circulation in 2006, underreporting broad money. The CBK reports some series of the Financial Access Survey, including the two indicators adopted by the UN to monitor Target 8.10 of the Sustainable Development Goals (commercial bank branches per 100,000 adults and ATMs per 100,000 adults).
Financial Sector Surveillance: The CBK reports Financial Soundness Indicators (FSIs) monthly prior to 2019 and quarterly thereafter, according to the *Financial Soundness Indicators Compilation Guide*. 7 core FSIs and 10 encouraged FSIs for deposit takers are available through the IMF's FSI webpage.
External Sector Statistics: CBK provides to STA quarterly balance of payments and international investment position data following the sixth edition of the *Balance of Payments and International Investment Position Manual* (*BPM6*) staring with 2013: Q1 reference data. Authorities also participate in: a) the Coordinated Direct Investment Survey with inward and outward data starting with 2010; b) the Coordinated Portfolio Investment Survey with annual data starting from December 2010 and semiannual data starting from June 2013, including encouraged items (currency of denomination, sector of the holder, sector of the issuer, and cross-sector classification); and the Quarterly External Debt Statistics. Direction of trade data are available on a monthly basis. Overall, the accuracy, periodicity, and timeliness of external sector statistics have improved due to authorities' efforts and with technical assistance from STA. The authorities are currently working towards reporting the international reserves and foreign currency liquidity template.

II. Data Standards and Quality	
The country participates in the enhanced General Data Dissemination System (e-GDDS) and a National Summary Data Page regularly disseminates e-GDDS data to the public since May 11, 2017.	Kosovo has not had a Data ROSC.

Kosovo—Table of Common Indicators Required for Surveillance
(As of November 20, 2021)

	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]	Oct/2021	Nov/2021	M	M	M
Reserve/Base Money	Oct/2021	Nov/2021	M	M	M
Broad Money	Oct/2021	Nov/2021	M	M	M
Central Bank Balance Sheet[1]	Oct/2021	Nov/2021	M	M	M
Consolidated Balance Sheet of the Banking System	Sep/2021	Oct/2021	M	M	M
Interest Rates[2]	Sep/2021	Oct/2021	M	M	M
Consumer Price Index	Oct/2021	Nov/2021	M	M	M
Revenue, Expenditure, Balance and Composition of Financing[3]—General Government[4]	Q2/2021	Sep/2021	Q	Q	Q
Revenue, Expenditure, Balance and Composition of Financing[3]—Central Government	Nov/2021	Nov/2021	D	D	M
Stocks of Central Government and Central Government-Guaranteed Debt[5]	Q3/2021	Oct/2021	Q	Q	Q
External Current Account Balance	Aug/2021	Oct/2021	M	M	M
Exports and Imports of Goods	Aug/2021	Oct/2021	M	M	M
GDP/GNP[8]	Q2/2021	Nov/2021	Q	Q	Q
Gross External Debt	Q3/2021	Oct/2021	Q	Q	Q
International Investment Position[6]	Q3/2021	Sep/2021	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.