Macro Dev

Macroeconomics & Development

MAY 2022 I N. 38

Kosovo: The Challenges of Building the Growth Model

Authors
Marion Hémar et Laura Marie

Translated by Samantha O'Connell

ÉDITIONS AFD
AGENCE FRANÇAISE DE DÉVELOPPEMENT

Contents

Summary

A small country in the Western Balkans, Kosovo unilaterally declared its independence from Serbia in 2008. It has since strengthened its independence and built its sovereignty, resulting in a gradual withdrawal of international peacekeeping missions. It has also managed to build strong democratic institutions, despite major political instability. Donor assistance has focused on strengthening institutions and good governance in order to foster convergence towards European Union standards. The victory of the opposition party Vetëvendosje (Self-determination) in February 2021, based on an ambitious program to fight against corruption, rationalize administration and implement social reforms, is encouraging. However, the country is still facing many challenges, in particular related to the structural weaknesses of the labor market and the massive emigration of its population due to the lack of economic opportunities. The Kosovar diaspora has nevertheless helped the country build its resilience: diaspora remittances boost demand-driven growth and contribute to balancing its external position. This situation compensates for the weakness of its productive base. But Kosovo needs to find new growth drivers, based primarily on attractiveness and productivity. Between 2008 and 2019, Kosovo's GDP increased by an average of 3.6% in real terms and stood at €7.5 billion in 2021 (Article IV 2021). The country's economy has been hard hit by the Covid-19 crisis, with a 5.3% recession in 2020, in particular through the channels of tourism and public and private investment. The economic resilience of the host countries of the diaspora has, however, helped maintain consumption through remittances. In 2021, the Government's measures to support the economy, combined with the continued support from the diaspora and the improvement in vaccination coverage, led to an upturn in growth to 7.5%.

1. Significant developments in the socio-political framework over the last decade

1.1 – After decades of instability and tensions, the country is now on the path to consolidating its independence and strengthening its institutional framework

Located in southeast Europe, present-day Kosovo is a landlocked territory covering 10,887 km^2, bordered by Albania and North Macedonia from the north to south, and Montenegro and Serbia in the north. The country experienced several periods of foreign rule, firstly Serbian (between the 11th and 14th century), then Ottoman for four centuries, before returning to Serbian rule. Kosovo's declaration of independence on 17 February 2008 followed a period of acute instability, marked by the Kosovo War (1998-1999), then an international presence to restore and maintain peace. **At the end of the war, Resolution 1244,[1] adopted in 1999 by the United Nations Security Council, established the United Nations Interim Administration Mission in Kosovo (UNMIK), placing Kosovo under UN administration**. This resolution considered Kosovo as a province of the present-day Serbia under the protection of the United Nations. Its objective was to support the construction of strong and autonomous democratic institutions within a peacekeeping framework. 45,000 troops were deployed by the KFOR force controlled by NATO and the armed groups were demilitarized. UNMIK, along with KFOR, had police and judicial powers. Discussions began to determine the future of Kosovo: the Federal Republic of Yugoslavia (then Serbia as of 2003), represented by President Tadić (2004-2012), categorically refused the independence of Kosovo which it considered as an integral part of its national territory. The various plans put forward nevertheless failed. No Security Council resolution managed to replace Resolution 1244 due to the political deadlock. **Kosovo unilaterally declared its independence on 17 February 2008 through a vote in Parliament.** France, the USA and a number of European countries recognized the independence of Kosovo, but the refusal of Serbia and 34 other countries (including Cyprus, Greece, Romania, Slovakia and Spain) to recognize the independence of Kosovo weighed heavily on its international legitimacy. Kosovo was thus still not recognized by the UN or European Union (EU) due to the vetoes of certain member countries. At the same time, the international military presence was considerably reduced, as well as the UNMIK mission. A specific mission to strengthen the rule of law was established in 2008: the EULEX mission,[2] assisted by an International Civilian Office (ICO) responsible for implementing the Ahtisaari Plan.[3] The Opinion of 22 July 2010 of the International Court of Justice (ICJ) confirmed that the independence of Kosovo was in full conformity with international law.

Kosovo's regional integration is hindered by the protracted political conflict with Serbia. The European Commission recognized Kosovo as a potential candidate in 2008. The country has since received extensive technical and financial assistance from the EU, which has contributed significantly to strengthening Kosovo's institutions. The process for Kosovo's membership of the European Union took a major step forward in 2015 with the conclusion of the Stabilization and Association Agreement (which entered into force in 2016). This treaty governs the relations between Kosovo and the European Union, thereby offering Kosovo the prospect of membership. It aims to foster cooperation between Western Balkan countries and the European Union and establishes financial assistance *via* the Instrument for Pre-accession Assistance (IPA), which stood at €602 million for 2014-2020. This assistance has mainly been allocated to strengthening democracy and governance, the rule of law and fundamental rights, as well as to the environment, energy and agriculture sectors. However, the non-recognition of Kosovo by five EU member countries until now blocks any possibility of the country's accession to the European Union.

1 This resolution authorizes a military and civilian deployment in the Serbian province of Kosovo under a peacekeeping operation. Resolution 1244 is still in force. It considers Kosovo as a province of Yugoslavia while recognizing substantial autonomy for this territory, which leads to believe that Kosovo would be part of Yugoslavia (which is succeeded by Serbia), which itself has its territorial integrity recognized. This resolution states that the international presence is established until the Security Council adopts a new resolution which will terminate the existing one. According to the resolution, the purpose of the mission is to facilitate the definitive settlement of the conflict, which makes the termination of this resolution conditional on the adoption of a peace and mutual recognition plan between Serbia and Kosovo.

2 The current mandate of the EULEX (European Union Rule of Law Mission in Kosovo) mission will end in 2023 (potentially renewable). However, its mandate was modified in 2018, removing the executive functions in favor of simply the monitoring, mentoring and advisory functions for Kosovo's correctional services. For further information, see https://www.eulex-kosovo.eu/

3 In April 2007, the United Nations Special Envoy Martti Ahtisaari, appointed in 2005 by the United Nations Secretary-General at the time, Kofi Annan, submitted a proposal to the Security Council for the settlement of the status of Kosovo (the "Ahtisaari Plan"). This plan aimed to create a multi-ethnic democracy and protect the rights of Kosovo's non-Albanian minorities. It proposed that Kosovo should become independent subject to a transitional period of international supervision. Kosovo pledged to implement the Ahtisaari Plan when it declared its independence.

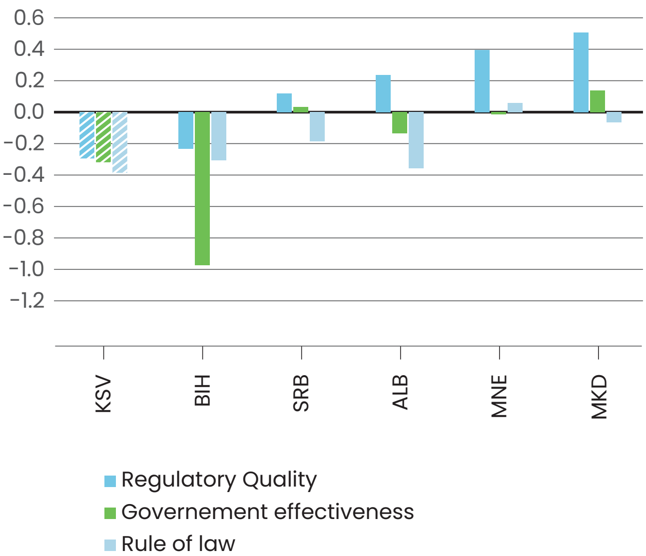
Since its independence in 2008, Kosovo has managed to create operational democratic institutions. The Parliament, which has legislative power and is elected by Kosovar voters, in turn elects the Prime Minister, the Head of Government (four-year mandate, elected by a two-thirds majority) and the President, the Head of State (five-year mandate). It is thereby a parliamentary regime whereby the Government, which holds the executive power, is accountable to Parliament. The representation of minorities is provided for in the Constitution: out of a total of 120 seats, 10 seats are reserved for the Serb minority and 10 seats are reserved for the other ethnic minorities in Kosovo (Roma, Ashkali, Egyptians, Bosniaks, Turks and Gorani). The American NGO Freedom House deems that the legislative elections are fair, credible and well administered (2021). However, it does consider Kosovo to be "partly free" due to the existing political and administrative malfunctions. It also highlights the need to strengthen the respect for civil and political liberties. In addition, the electoral results are controlled by the Central Election Commission (CEC), which is deemed to be transparent and impartial.

Public administration is complex and has expanded considerably since 2008. The European Commission considers that Kosovo institutions are at an "early stage" of accession (European Commission, 2021). Indeed, the administrative organization is fragmented and there is an overlap between the competences of the various departments. This situation fosters and perpetuates clientelism in the administration. For example, in 2022, Kosovo has 80 public agencies which account for a third of total public employment (*i.e.* 27,000 people). At the local level, the country has 38 municipalities which are the only local level of governance. The country is gradually applying a decentralization model, with the transfer of competences from the central level to the local level, such as the management of the education system (from kindergarten to high school), water and wastewater, and healthcare.

The victory of the opposition party Vetëvendosje (Self-determination) in February 2021 (with 51% of the votes), and the nomination of the reformist lawyer Vjosa Osmani as President of Kosovo, marked a historical turning point in this country characterized by very high political volatility over the last decade. Indeed, no government has managed to complete its mandate since the independence of Kosovo, which has led to four early general elections being held since 2008. The country also had four successive governments between 2019 and 2021. The Covid-19 crisis consequently took place with an interim government following the overthrow of the coalition government led by Prime Minister Albin Kurti through a no-confidence motion in March 2020, just two months after it was formed. The turnout for the general election in February 2021 stood at 48.8%, against 41.1% in 2017, reflecting a renewed political interest among the population.

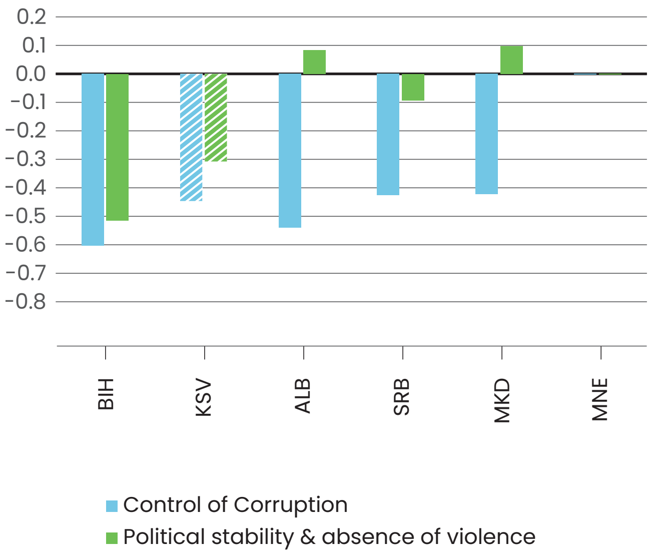
Strengthening the rule of law is a fundamental issue for Kosovo, where corruption exists at all levels and is subject to few legal proceedings. The Corruption Perceptions Index developed by the NGO Transparency International ranks Kosovo 87th worldwide in 2021 out of 180 countries (against 104th in 2020). Progress has been achieved, in particular concerning the Anti-Corruption Agency's competence for preliminary investigations and prosecutions, as well as the partial implementation of certain laws on the rule of law concerning the judicial system, corruption and organized crime (see graphs 1 and 2). The election of the opposition party Vetëvendosje in February 2021, based on an ambitious program for the fight against corruption and major reforms of the administration, could overturn this paradigm.

Graph 1 – Governance indicators underperform Western Balkan peers*



Source: World Bank (WGI), 2020
*The indexes range from -2.5 (worst performance) to 2.5 (best performance)

Graph 2 – Kosovo displays low regional corruption scores yet with an unstable political climate*



Source: World Bank (WGI), 2020
*The indexes range from -2.5 (worst performance) to 2.5 (best performance)

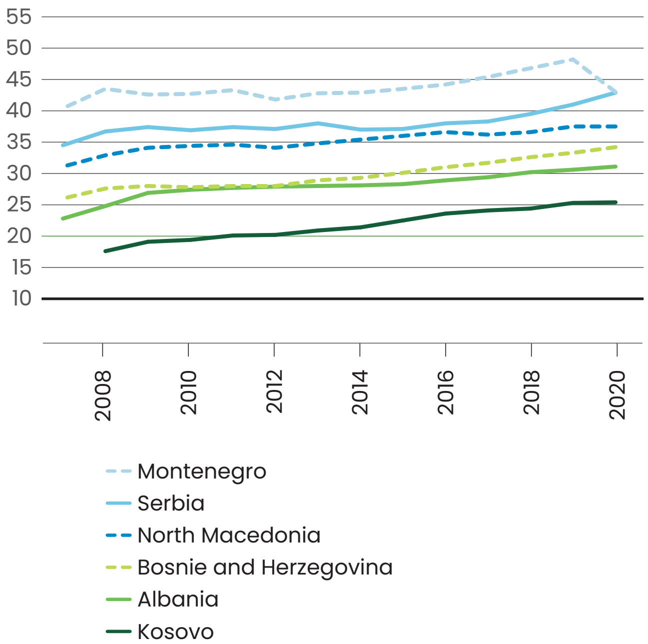
1.2 – Social indicators remain weak despite a marked improvement since 2008

Up until the crisis caused by the Covid-19 epidemic, economic growth was relatively dynamic and stable, with an average annual rate of 3.6% between 2008 and 2019. Per capita income rose to $4,640 in 2019 (Atlas method, World Bank) against $3,150 in 2010, as a result of an economic growth well above population growth. Kosovo has thereby been an upper middle-income country (UMIC) since 2019. While per capita income in PPP is increasing, it only amounts to 71% of the average for the Western Balkans (against 57% in 2000 and 66% in 2007), and only 26% of the EU average (see Graph 3), reflecting a convergence as yet partial.

The country, which has 1.8 million inhabitants, benefits from a young population (33% of the population is below the age of 19), but is experiencing negative demographic trends and major socioeconomic difficulties. In a context of demographic transition, the fertility rate is declining (1.97 children per woman in 2019) and the population is expected to decrease by 15% by 2050 to 1.65 million inhabitants (World Bank). Since the 1990s, the territory has faced a massive emigration of its population, in particular young people. The number of Kosovars currently living abroad is estimated at about 800,000, *i.e.* 46% of the current population. They mainly reside in Germany[4] (39%), Switzerland (23%), Austria (7%), Italy (7%) and Sweden (7%). They do, however, maintain strong ties with their country of origin. While diaspora remittances constitute a major source of revenue for the country (see Graph 4), the lack of economic opportunities in Kosovo contributes to the drain of labor, in particular the most skilled, which affects the country's development.

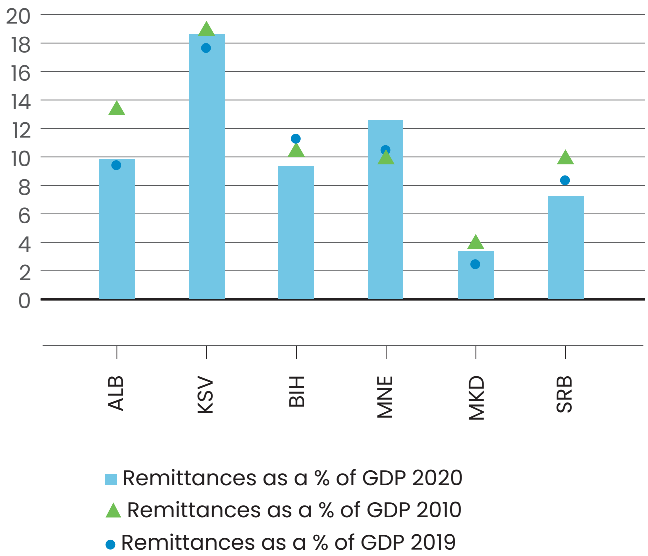
4 Germany has introduced incentives for labor migration and thereby encourages the Kosovo diaspora to settle there.

Graph 3 – Kosovo's GDP per capita remains lower than its Western Balkan peers - Share of GDP per capita in PPP compared to OECD average (in %)



Source: World Bank (WDI)

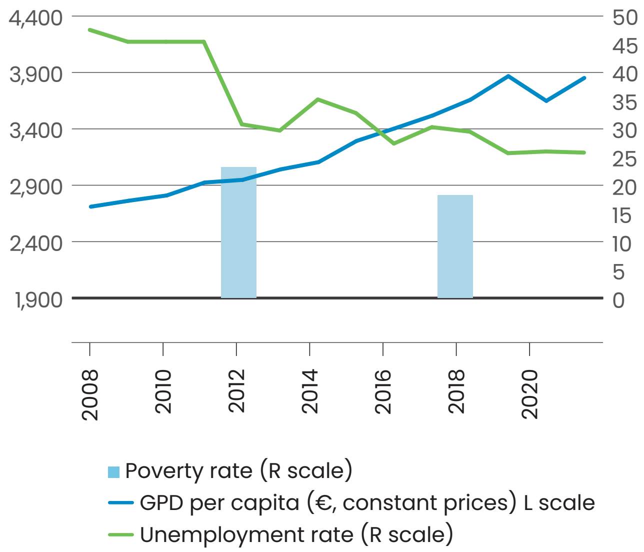
Graph 4 – Diaspora remittances as a share of GDP are particularly high



Source: World Bank (WDI)

Kosovo remains far below its regional peers in terms of socioeconomic development. The Human Development Index (HDI) for Kosovo is one of the lowest in the region, after Albania and Bosnia and Herzegovina. Its index stands at 0.741,[5] ranking it 85th worldwide. The poverty rate measured at the national poverty threshold (€1.80 a day) concerned 18% of the population in 2018 (against 23.7% in 2012) and 5.1% of the population was living in extreme poverty in 2017 (against 7.8% in 2012) (see Graph 5). Rural people are more affected by poverty: while 61% of the population was living in rural areas in 2017 against 39% in urban areas, poverty affected 19% of the rural population against 16% of the urban population.

Graph 5 – An improvement in social indicators since 2008



Source: World Bank (WDI)

5 2016 ranking, not included in the subsequent rankings

In response to the Covid-19 crisis, the Government took action by providing $180 million of direct financial support to households and companies. This support doubled the existing monthly social transfers for vulnerable households. Additional exceptional transfers have also been introduced for beneficiaries of social protection and pension schemes receiving less than €100 a month, as well as bonuses for workers in the health, security and trade sectors, and support for the payment of salaries and rents for companies (IMF, 2021). The resilience of remittances, which account for between 10 and 15% of households' gross disposable income, has played an important role as a safety net (see Graph 4). Diaspora remittances rose during the Covid-19 crisis, by 13% in 2020 compared to 2019. They were made more through official channels than in previous years. Indeed, before the introduction of mobility restrictions with the Covid-19 crisis, remittances were mainly made through unofficial channels with the diaspora returning to their country of origin and direct local spending. In 2021, in the current account of Article IV of January 2022, the IMF estimates that there has been a 14% increase in formal remittances compared to 2020.

Social safety nets are weak due to the high level of informality on the labor market. Among some 20 social programs covering pensions, family allowances and benefits for veterans, the Social Assistance Scheme is the only program to have the objective of reducing poverty, but it has a small budget (0.5% of GDP in 2020) and its targeting is inefficient: it is estimated that only 60% of the first income quintile benefit from welfare payments (IMF, 2018). There is no unemployment insurance scheme in Kosovo, which exacerbates the socioeconomic vulnerability of people who are excluded from the labor market in the event of a macroeconomic shock.

Income disparities at national level remain relatively low, resulting in a Gini coefficient of 25.5 in 2017. However, there are significant differences in access to basic public services between regions and between the various ethnic minorities (Serbs, Turks, Bosniaks, Roma, Ashkali, Gorani).

The health sector remains poorly resourced, although there has been an increase in life expectancy, from 67.8 years in 2000 to 69.6 years in 2008 and it reached 72.5 years in 2019. Healthcare spending amounted to 2.5% of GDP in 2018 and rose by 6% in 2020 compared to 2019, *i.e.* about €9.8 million (European Commission, 2020), but remains well below the OECD average (12.6%). In addition, the population remains highly exposed to air pollution, which is a major national health issue.

1.3 – A highly inefficient labor market

The labor market suffers from a number of weaknesses, starting with a lack of job creation. The low level of economic dynamism does not contribute to creating enough jobs to compensate for the arrival of new labor market entrants. This also contributes to maintaining the unemployment rate which is structurally high (25.9% at the end of 2020, against 25.7% in 2019). Significant wage differences between the private sector and public sector (€400 a month, against €570 on average in 2018, *i.e.* 70% of the public sector wage) contribute to creating a crowdingout effect to the detriment of the private sector, which is not dynamic enough. The public sector offers a higher salary and stable employment and thereby accounts for almost a quarter of total employment in Kosovo. The minimum monthly wage in Kosovo (€130 for people aged between 15 and 34 and €170 for people over 35) in relation to GDP per capita is particularly high in comparison with Eastern European countries, whereas the unemployment rate is the highest in the region.

The labor market participation rate is also one of the lowest in Europe: on average, only 38.3% of the population was employed or actively seeking work in 2020 (against 40.5% in 2019). In comparison, the average participation rate in the Western Balkans region stood at 45%, and 52% in the European Union in 2019. During the Covid-19 crisis, the Government introduced incentives to regularize informal workers, by offering aid to companies proportional to the number of employees. It is estimated that 14,000 workers have been formalized.

Table 1 – Deteriorated labor market indicators

	AT FIRST QUARTER 2021		
%	**Male**	**Female**	**Total**
Rate of participation in labor force	56.5	22.7	39.5
Employment to population ratio (employment rate)	42.8	15.9	29.3
Unemployment rate	24.2	29.7	25.8
Youth unemployment rate (15-24 years of age)	46.1	53.5	48.6
Share of "vulnerable" employment in total Employment	16.9	7.4	14.3

Source: Kosovo Agency of Statistics

The low level of human capital also hinders the strengthening of the labor market. Kosovo has the lowest score in Europe for the OECD's PISA (Program for International Student Assessment) (~360 on average, against ~420 for the Western Balkans in 2018), reflecting the poor quality of primary and secondary education.

There are major inequalities in access to the labor market between the various populations. Firstly, there is a low level of inclusion of women in the labor market, with a participation rate of women of working age at 22.7%, against 56.5% for men. This is in particular due to the lack of childcare facilities for pre-school children. A dedicated Agency for Gender Equality has been created for that purpose. The unemployment rate for women is much higher than for men. It stood at 29.7% in the first quarter of 2021, against 24.2% for men. Young people are also particularly excluded from the labor market. It is estimated that they are twice as exposed to unemployment as adults over the age of 24. Thus, 48.6% of the 15-24 year-olds participating in the labor market were unemployed. 29% of 15-24 year-olds in Kosovo were neither in employment nor in education and training (NEET), which reveals, inter alia, very few economic opportunities. Finally, it is estimated that 90% of the Roma, Ashkali and Egyptian communities are affected by unemployment (European Commission, 2019).

Consequently, informality predominates in Kosovo: it is estimated to account for between approximately 30 and 35% of GDP and over 35% of employment (IMF, Article IV 2021). The strong prevalence of informality, combined with a weak and unattractive private sector in comparison with the public sector, contributes to increasing the reservation wage[6] of Kosovar workers. This reduces incentives to participate in the labor market and is a factor in the decision to leave to work for higher salaries, mainly in Germany or Switzerland.

6 The reservation wage can be defined as the minimum wage a worker accepts to receive to work.

2.
A relatively robust growth rate with a private sector which faces strong development difficulties

2.1 – An economy that lacks diversification, driven by household consumption, which is itself boosted by diaspora remittances

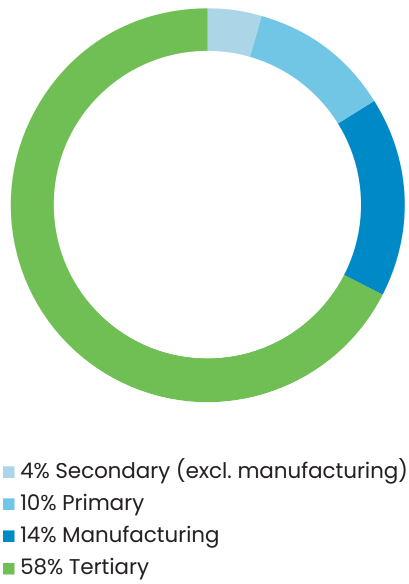
Up until the crisis related to the Covid-19 epidemic, economic growth had been dynamic, reaching an annual average of 3.6% between 2008 and 2019. Kosovo's growth model is based on private consumption, which is itself driven by diaspora remittances. Despite the apparently strong growth, the weaknesses of this model were seen during the international financial crisis in 2008 which was marked by prolonged unemployment in the diaspora's host European countries, thereby holding back consumption in Kosovo (IMF, 2013). In 2014, the slowdown in growth was related to the prolonged political deadlock in the aftermath of the general elections of 2014. The Covid-19 crisis led to a recession of 5.3% in 2020 (IMF, Article IV 2021), due to the contraction of exports of services and investments related to the impact of the lockdown measures and the global economic recession.

The service sector accounted for close to 58% of added value in 2019, against already 56% in 2009. The tertiary sector accounted for an average of close to 63% of GDP between 2009 and 2019. With no strong, competitive and diversified productive base, domestic consumption is primarily satisfied by imports. This external dependence has led to the development of transport and storage activities which account for a large part of the economy (15% of GDP in 2019). This is also the case for wholesale and retail trade (10% of GDP and 17.5% of employment) and tourism (7% of GDP).

The secondary sector contributed an average of 23% to GDP growth between 2009 and 2019. The share of the secondary sector in total added value rose from 13.8% in 2009 to 18.2% in 2019. This was mainly the result of the mining and construction activity, which employed 13.5% of workers in 2019. Kosovo is endowed with natural resources: it has the fifth largest lignite reserves in the world (11 billion tons), but also zinc, lead, silver, nickel, cobalt, copper and iron. The exploitation of these mining and mineral resources accounts for 45% of exports of goods (*i.e.* 2% of GDP, mainly iron and nickel). Kosovo's difficulties in developing its industrial and technological base, due to the predominance of the tertiary sector, lie in the weak performance of the manufacturing sector. Its share in added value has stagnated at around 14% over the last decade and only accounts for 12.4% of employment. The manufacturing sector's contribution to GDP growth is therefore more marginal and averaged 16% between 2009 and 2019.

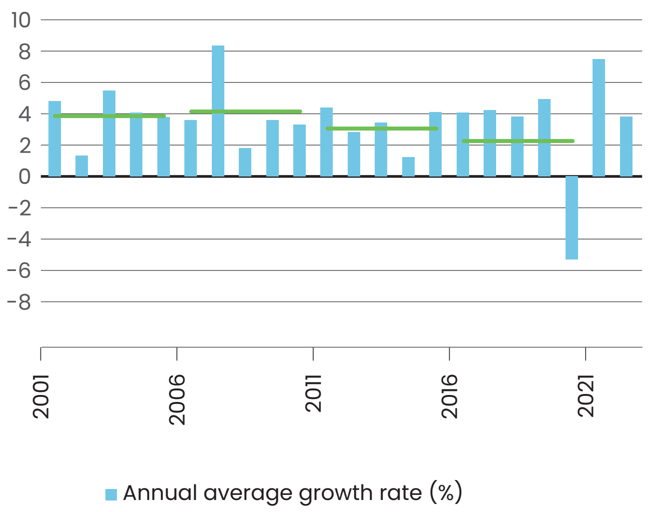
Finally, the share of the primary sector in GDP has fallen over the last decade, from 16.6% in 2009 to 9.5% in 2019. The productivity of the agriculture sector is particularly hindered by the significant fragmentation of land. The agriculture sector still employs 25% of workers, demonstrating the high labor intensity of the agriculture sector and therefore low productivity.

Graph 6 – A largely service-based economy (Breakdown of added value by sector)



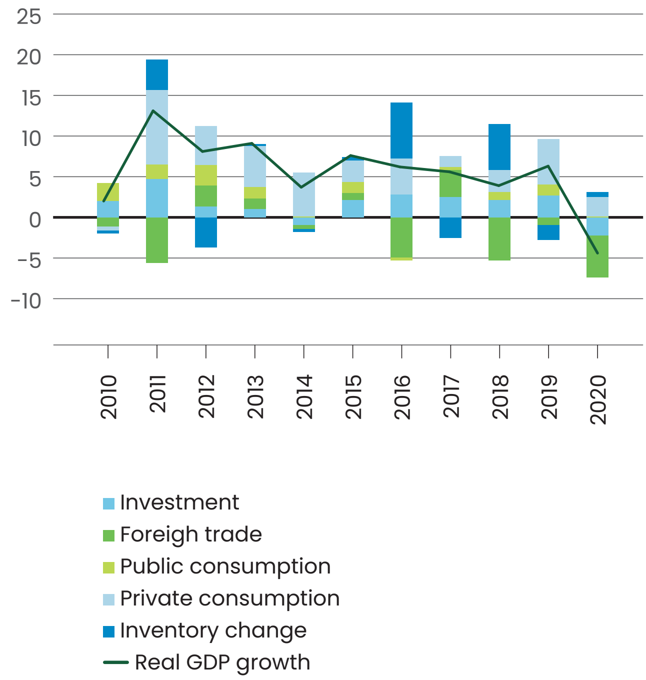
Source: United Nations Department of Economic and Social Affairs (UN DESA)

Graph 7 – Robust economic growth until the Covid-19 crisis



Source: IMF (WEO, Article IV)

Graph 8 – Economic growth is primarily driven by household consumption (%)



Source: Kosovo Agency of Statistics

Kosovo's productive base remains marked by the prevalence of informality (see section 1.3), in particular in the construction, retail trade, accommodation and transport sectors, but also in the agriculture sector.

Kosovo, like the other Western Balkan countries, is the source of a large diaspora established in Europe (firstly Germany and Switzerland) which makes a significant and regular contribution to the financing of the economy. These flows, which accounted for 43.6% of GDP in 2021 (against 38% and 31% of GDP in 2019 and 2020), materialize in the form of foreign direct investments (FDI), remittances and exports of services. This contribution is, in this respect, a major resource for Kosovo. However, these flows do not finance sectors with high added value as they focus on (i) the tourism sector (*via* the regular trips by the diaspora), (ii) real estate (*via* FDI flows) and (iii) financing private consumer spending, the main driver of the country's growth (*via* the remittances and the growth of credit). These diaspora remittances help smooth household consumption despite macroeconomic shocks. Indeed, remittances have increased, in spite of the Covid-19 crisis, (+13% in 2020 compared to 2019) and in 2021 exceeded the amounts seen in 2019. Between 2009 and 2019, private consumption accounted for an average of almost three-quarters of GDP growth. The contribution of public consumption has, however, been more limited (about 10%), in particular due to constraints in terms of budgetary balance. At the same time, total investment, which is more erratic, accounted for almost a quarter of growth.

In 2021, the Government's measures to support the economy, combined with the diaspora remittances and an improvement in vaccination coverage, led to an upturn in growth (+7.5%, IMF Article IV 2021).

With regard to the medium-term growth prospects, if there is not a new shock, real growth should gradually converge towards potential growth (about 3.5%) by 2025.

2.2 – Private sector development hampered by numerous barriers

The competitiveness of the economy is hampered by a relatively discouraging business environment, ineffective public investment and high administrative costs, compounded by widespread corruption. The business environment remains severely restricted, despite recent efforts which have allowed Kosovo to reach the 57th place (out of 190) in the Doing Business 2020 ranking, and in particular 12th in the "starting a business" category and 15th for "getting credit". The main constraint to the business environment identified by companies is the large presence of the informal sector: in 2019, 25% of the companies surveyed considered that it was the main constraint to the development of their activity (Enterprise Surveys, World Bank). The difficulties related to informality are especially to be found in problems regarding access to land, due to the abrupt transition between belonging to Serbia and Kosovo's declaration of independence. Indeed, the war of 1998-1999 led to the destruction of archives on property titles. The Kosovo Property Agency (KPA) subsequently handled all these requests, but the legality of all these property titles has still not been restored. The country thereby ranks 160th out of 190 for "dealing with construction permits", due to the existence of these numerous informal land titles.

The infrastructure deficit weighs on companies. The Doing Business 2020 report thereby ranks the country 90th in the category "getting electricity" and in 2019, 15% of companies considered that the most important constraint to business development was access to electricity (Enterprise Surveys, World Bank). Electricity supply is mainly dependent on two old lignite-fired thermal power plants and remains unreliable due to the inadequate capacity (~280 GWh per 1,000 inhabitants, against ~580 GWh on average in the EU in 2018, OECD 2021). There is limited road and rail transport infrastructure (~100 km of roads per 1,000 inhabitants, against over 600 on average in the EU and around 200 km of railway lines per 1,000 inhabitants, against over 800 on average in the EU in 2018, OECD 2021). While the public investment rate stood at 7.5% of GDP in 2019, the public capital stock was 20% lower than the average of Western Balkans countries and 60% lower than the European Union average in 2018. This reflects the low effectiveness of public expenditure and a development strategy that remains limited. The new Government has committed to continue the Pristina-Gjilan highway project and extend the Pristina-Mitrovica road network. The development of transport infrastructure is all the more important given the country's landlocked nature and its non-recognition by its Serb neighbor weighs heavily on its logistical capacities. These constraints affect the business environment and deter productive private investments, firstly by the manufacturing sector.

Private sector development is also hampered by labor market difficulties (see section 1.3). The scale of diaspora remittances and the high wage levels in the public sector push up the reservation wage: manpower is generally costly, unskilled and there is a scarcity of skilled labor. The new Government's program plans to increase the guaranteed minimum wage to €250 a month, while raising the income threshold at which income tax applies.

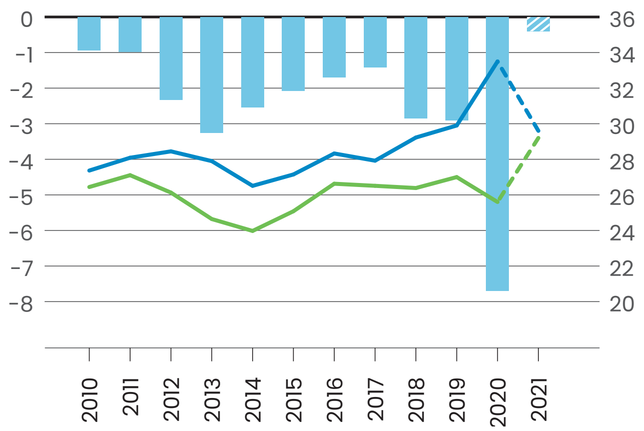
The private sector remains dominated by microenterprises, which have limited potential in terms of productivity gains, innovation and export. Micro, small and medium-sized enterprises account for 65% of total employment, including 36% for microenterprises alone. Difficulties in accessing financing are a barrier to the development of existing companies. In order to compensate for the relative reluctance of banks and support private sector credit, the Credit Guarantee Fund offers public guarantees for bank loans mainly to SMEs (covering 9% of the bank loans) and its coverage was extended during the Covid-19 crisis (increasing the guarantee from 50 to 80% of the loan amount). While bank lending to the private sector has experienced robust growth (+10% on average for 2017-2020), private investment has stagnated at around 20-22% of GDP since 2015.

3. Public accounts are generally sound and the debt ratio remains limited

3.1 – The budgetary rule has established the budgetary policy on solid ground

The consolidation of public finances undertaken by Kosovo since 2013 and supported by the IMF's Stand-by Arrangement programs has paid off. This has contained the budget deficit, meaning the budgetary rule has been respected with the introduction of a limit of 2% of GDP for the budget deficit (excluding investment expenditure, *i.e.* the "investment clause"). This fiscal consolidation has led to a reduction in the deficit in relative terms, resulting from an increase in revenue higher than the increase in public expenditure. However, the Covid-19 crisis has been accompanied by a deterioration of public accounts in Kosovo (see Graph 9), with a public deficit at 7.6% of GDP in 2020. According to IMF projections, the country could return to a sustainable trajectory in 2022, with a forecasted deficit of 0.4% of GDP in 2021. The budgetary rule was temporarily suspended during the health crisis.

Graph 9 – The Covid-19 crisis has significantly increased the budget deficit which should decline in 2021



Source: IMF (WEO, Article IV)

Public expenditure as a share of GDP has remained constant, but high, since 2010 and stood at 29.9% in 2019. Public expenditure is largely concentrated on public sector wages and social assistance expenditure, which absorb respectively 40% and 39% of current expenditure. A budgetary rule introduced in 2016 aims to limit public sector wage growth, which must not exceed nominal GDP growth.

Social assistance expenditure followed an upward trend between 2011 and 2019: its share in current expenditure rose from 21 to 39% over the period. This growth in social assistance expenditure is mainly related to the reform of the special pension scheme for war veterans. While the law sets a limit on the expenditure of this special scheme at 0.7% of GDP, the lack of clarity of eligibility criteria for the status of "veteran"[7] has led to a windfall effect. The expenditure of the special scheme thereby reached 1.1% of GDP in 2020. Generally speaking, only 7% of benefits directly target the poor (IMF, 2018), which largely accounts for the weak performance of the secondary distribution of income. Almost two-thirds of benefits are thus related to the age, health and family, irrespective of the level of income, and close to 30% of benefits are allocated to veterans.

To address the Covid-19 crisis, the Government adopted an economic stimulus plan (Mitigation and Recovery Package) of 4.3% of GDP in 2020. This has led to bonuses for health workers, transfers to the most vulnerable households at 1.6% of GDP and support to companies *via* wage subsidies. Consequently, there was a rise in expenditure to an exceptional level of 33.5% of GDP in 2020, *i.e.* an increase of €150 million to €2.3 billion. The support plan announced for 2021 amounted to 3.1% of GDP. The budgetary rule aiming to limit the public deficit to 2% of GDP (excluding investment expenditure financed by donors or revenue from the privatization of public enterprises) has been temporarily suspended until 2023. In addition, to mitigate the impact of the Covid-19 crisis on the economy, the Government has temporarily authorized Kosovars to make an early withdrawal of their retirement savings (by a maximum of 10% of the retirement account). It has also committed to replenish retirement savings

7 The absence of age and residence criteria results in a potential cumulation of pensions and salaries

accounts below €10,000 as of 2023. This should cost approximately €200 million and could weigh heavily on the State budget.

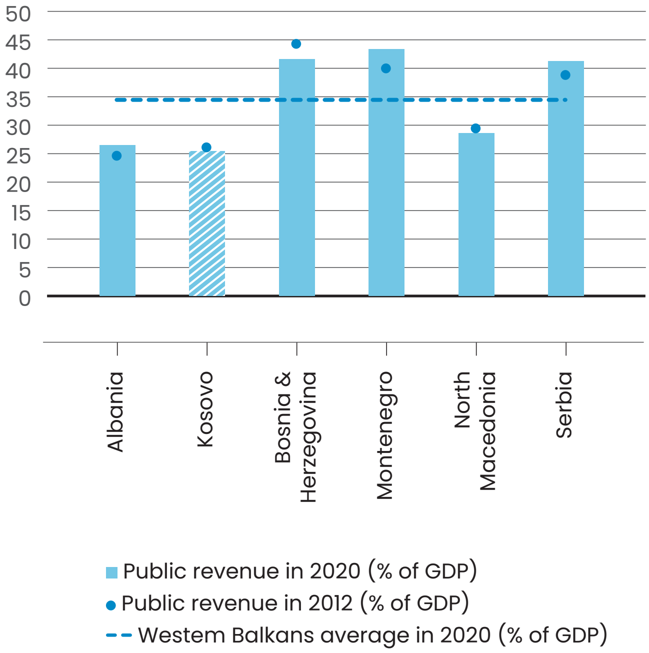
Public investment remains low, despite a flexible budgetary rule. Public investment expenditure amounted to €534 million, *i.e.* 7.6% of GDP, in 2019 and 25% of total expenditure. In 2015, Kosovo introduced an "investment clause" in its budgetary rule, which allows it to derogate from the budget deficit ceiling of 2% of GDP. The budgetary rule is considered to be respected if the deficit, excluding investment expenditure financed by international financial institutions and revenue from the privatization of public enterprises, remains at a level below 2% of GDP. Two conditions concerning the volume of public debt must also be respected: (i) public debt excluding debt related to public investment financing must not exceed 30% of GDP and (ii) total public debt must not exceed 40% of GDP.

The effectiveness of expenditure still remains limited. The public investment framework lacks a definition and a clear project selection, implementation and evaluation process which would make public expenditure more efficient. Similarly, investment expenditure suffers from significant under-execution (IMF 2021).

The privatization of public enterprises, which generates income and provides a temporary source of financing for investment expenditure, is making slow progress. 19 public enterprises are managed at central level (including 17 directly by the Ministry of the Economy). These enterprises lack transparency in terms of financial reporting and recruitment. They operate in the telecom, energy, water and waste sectors and account for 17% of GDP and 3% of total employment (10,000 people). In addition, 42 other public enterprises are managed at local level. The revenue from the privatization of public enterprises, held by the Privatization Agency of Kosovo (PAK) with the Central Bank of the Republic of Kosovo (CBK), has been used for investment expenditure in infrastructure.

The tax base remains limited, which constrains budget revenue. Public revenue as a share of GDP has remained constant over the last decade: it accounted for 27% of GDP in 2019, against 27.1% in 2010. It is thereby one of the lowest in the region, as it averaged 34.9% in the Western Balkans in 2019 (see Graph 10). The tax base in Kosovo is narrow due to the prevalence of informality, numerous tax exemptions and a low corporate tax rate (at 10%). In 2020, public revenue fell by approximately €160 million to 25.6% of GDP (*i.e.* €1.7 billion), due to the economic consequences of the Covid-19 epidemic. In 2021, revenue began to rise again and is estimated at 29.2% of GDP. In 2019, indirect taxes (VAT, excise, customs) accounted for 74% of the public revenue of the State. Revenue only from VAT accounted for 44% of total revenue. However, direct taxes (personal and corporate tax, property tax) only accounted for 15% of total public revenue, due to low taxation, a tax base reduced by the high level of informality and a weaker economic activity.

Graph 10 – The level of public revenue is low by regional comparison



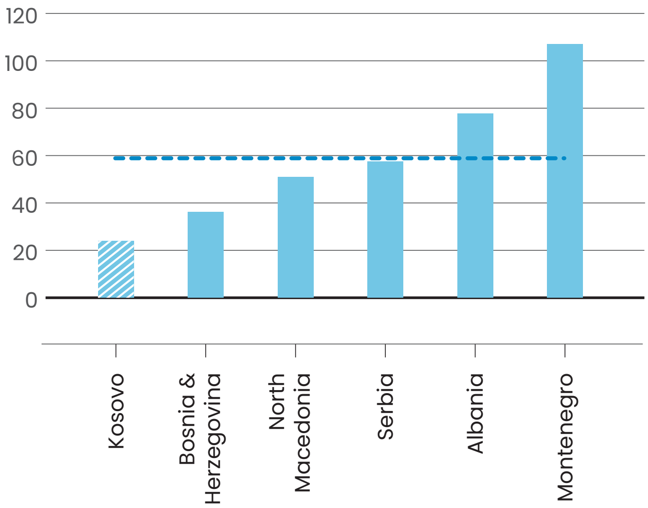
Source: IMF (WEO)

3.2 – Public debt remains under control and debt conditions are favorable

Kosovo's debt history is still recent, which results in a contained level of debt although it is increasing, as well as financing sources and instruments which are still not very diversified. The country has established an effective medium-term debt management strategy. **Public debt amounted to €1.6 billion in 2020, *i.e.* 24.3% of GDP, a sharp rise compared to 2019 (17.7% of GDP).** However, this level of debt remains the lowest in the Western Balkans region, which averaged 60% of GDP in 2020 (see Graph 11).

At the end of 2020, 66% of public debt was composed of domestic debt (€1.085 billion, *i.e.* 16.1% of GDP) and 34% of external debt (€557 million, i.e. 8.2% of GDP) (see Graph 12). The substantial financing needs related to the Covid-19 crisis have been largely financed by an increase in external debt with international donors.

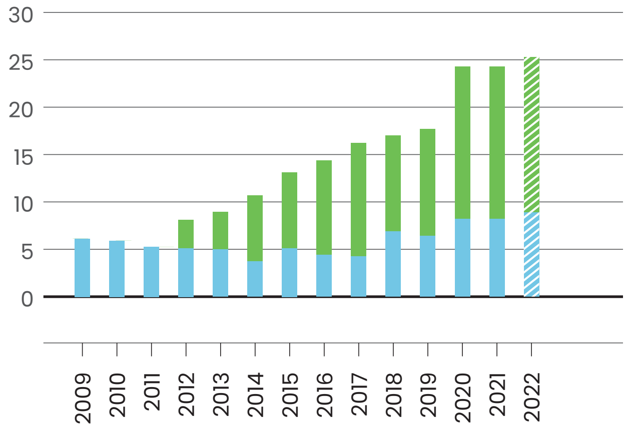
Graph 11 – A level of debt well below Western Balkan peers in 2020 (as a % of GDP)



Debt ratio
Average debt in the Western Balkans is represented by the blue line

Source: IMF (WEO)

Graph 12 – Level of debt contained but increasing



Public debt in local currency (% GDP)
Public debt denominated in foreign currency (% GDP)

Source: IMF (WEO, Article IV)

The budget rules set a limit for public debt at 40% of GDP, and at 30% of GDP taking the investment clause into account,[8] *i.e.* by removing the capital expenditure financed with loans from bilateral and multilateral donors (contracted after 2015).

Kosovo's debt management strategy is mainly based on the extension of maturities by developing the use of medium and long-term domestic instruments. Public debt is almost entirely in euros (92%), with the remainder denominated in USD and special drawing rights (SDR). For this reason and due to the euroization of Kosovo, the country's foreign currency risk exposure is extremely low. Kosovo's cost of public debt is low (0.4% of GDP of interest paid in 2020): the weighted average interest rate on debt stood at 2.06% in 2020. This low cost is due to (i) the concessional nature of external debt and (ii) Kosovo's dependence on the monetary policy with low rates of interest in the euro area, allowing a domestic debt with a low cost. Kosovo managed to extend the average maturity of its debt portfolio to 5.9 years in 2020,

8 Once this threshold of 30% has been reached, the investment clause would no longer apply and the expenditure provided for in this clause would be counted in the calculation of Kosovo's public debt.

against 5.3 years in 2019 and 3.5 years in 2016. Finally, Kosovo's debt is also characterized by a high fixed-rate debt ratio at 92%.

At the end of 2021, domestic public debt accounted for 66% of total public debt and 16% of GDP. This debt is entirely composed of medium and long-term Treasury instruments (2 to 10 years) and is denominated in euros. Under its strategy to extend the maturity of its debt portfolio, Kosovo has not issued short-term Treasury bills since 2019, which allowed to extend the maturity from 2 years in 2016 to 4.6 years in 2020. However, at this stage, the maturities remain relatively short, but the trend towards extending them should reduce refinancing risks in the medium and long term. At the end of 2021, the bulk of public debt was made up of 5-year Treasury instruments. Due to the accommodative monetary policy of the European Central Bank (ECB) since 2015, domestic interest rates driven by the interbank market are constantly decreasing and remain considerably low on average. Consequently, the interest expense on domestic debt amounts to less than 1% of public revenue.

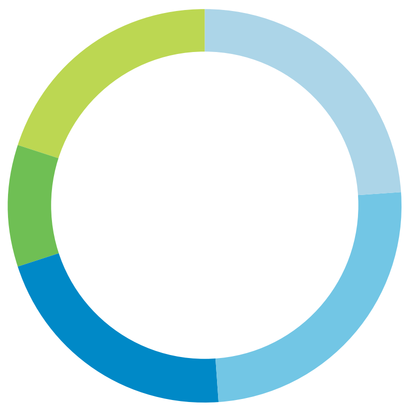
Domestic debt is mainly held by (i) the KPST pension fund, which has absorbed a large proportion of the bonds for 2017-2020 (45% of the total in 2020), (ii) commercial banks (30%) and (iii) CBK (20%) *via* buyback operations on the secondary market. Private companies and insurance companies only hold 5% of total domestic public debt. Despite abundant liquidity in the banking sector, the sovereign exposure of commercial banks remains under supervision (the majority of banks are subsidiaries of parent companies based abroad): the share of government bonds in proportion to total assets may thereby not exceed certain thresholds set internally in each bank. Similarly, the pension fund (KPST) is constrained by an exposure limit on sovereign securities which cannot exceed 30% of its total assets.

At the end of 2021, external public debt amounted to 34% of total public debt and 8.2% of GDP. It is mainly contracted on favorable terms from international donors. Kosovo remains largely dependent on bilateral and multilateral donors for its external financing. It does not have access to international capital markets (Eurobonds).

70% of the external debt is thereby held by the IBRD, IDA and IMF (see Graph 13). Kosovo benefits for the time being from access to the World Bank's IDA (International Development Association) concessional window, under its "Fragile State" status.

The nominal interest rate on external public debt stood at 1.9% in 2020, due to mainly concessional terms, and the external public debt service only absorbed 4.6% of public revenue in the same year.

Graph 13 – External public debt is entirely held by official donors (2020)



Source: Ministry of Finance of Kosovo

Since it became a member of the IMF in 2009, Kosovo has concluded three programs under the Stand-By Arrangements, the last of which terminated in 2017. In April 2020, Kosovo benefited from a $58.2 million Rapid Financing Instrument. Negotiations for a new program with the IMF (Stand-By Arrangement, for an amount ranging between €100 million and €200 million) had started under the government of Mr. Hoti in early 2020 and were interrupted. Kosovo would like to diversify its investor base *via* a potential Eurobond issue in the next two years.

Box 1 – Donor support during the Covid-19 crisis

The presence and commitment towards Kosovo of multilateral and bilateral donors was demonstrated in 2020. Several programs were concluded to help the country cope with the Covid-19 crisis:

- **IMF, April 2020:** Rapid Financing Instrument (€52 million)
- **IDA, June 2020: Covid-19 Emergency Project for Kosovo** (€46 million)
- CEB (Council of Europe Development Bank), August 2020: Public Sector Financing Instrument for Covid-19 Emergency Response (€35 million)
- EBRD (European Bank for Reconstruction and Development), August 2020: Vital Infrastructure Emergency Liquidity Loan (€30 million)
- **The CBK has also concluded an agreement with the ECB that gives it access to a €100 million ELA (Emergency Liquidity Assistance) credit line. In addition, the CBK has negotiated a refinancing line by repo (repurchase agreement) for an additional €100 million from the ECB, accessible as of 2022**

The IMF's debt sustainability analysis indicates that public debt is sustainable in both the baseline scenario and stress scenario. Kosovo's debt sustainability indicators are all positive. The debt service ratios to revenue and GDP are extremely low, due to the low level of debt and the low cost of debt. The successful strategy for the extension of maturities will be pursued in the coming years and has not been hindered by the Covid-19 crisis. Furthermore, there are no particular peak repayments in the repayment schedule for domestic and external debt. The possibility for Kosovo to issue bonds on international markets in the coming years would provide an additional source of financing required to finance the country's economic ambitions. It would also help diversify the investor base. It should be noted that the neighboring Western Balkans countries have issued one or several Eurobonds.

4.
A structural current account deficit mainly financed by FDI and donors

4.1 – Substantial diaspora remittances do not compensate for the large trade deficit

Kosovo's limited trade integration results in a heavy dependence on the European Union and a participation in international trade mainly *via* imports. **The balance of goods is structurally in deficit. It increased in 2021 to 45.7% of GDP, against 38% in 2020 and 40.3% in 2019.**

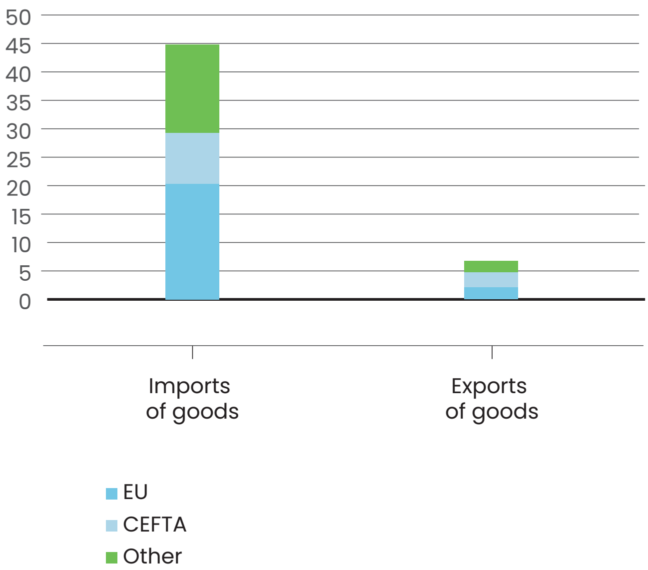
Kosovo's imports of goods have amounted to over 45% of GDP in recent years. Imports are mainly made up of machinery and transport equipment, manufactured goods and food products, as well as chemical products and mineral fuels. In 2021, imported goods amounted to 55% of GDP, reflecting the recovery in consumption, investment and the increase in prices in 2021.

Exports of goods remained low at 5.6% of GDP in 2019, 7% of GDP in 2020 and an estimated 9% of GDP in 2021. The exported goods are mainly made up of metals, minerals and agricultural products. They are mainly destined for Albania, North Macedonia and Italy.

The signing of the Stabilization and Association Agreement in 2015 has fostered growth in trade between Kosovo and the European Union. Kosovo is also included in the Central European Free Trade Agreement (CEFTA), which currently gathers six Western Balkan countries and Moldavia. These efforts for regional trade integration are a major vehicle for convergence towards the Community acquis. Indeed, the countries which initially founded the CEFTA (Czechoslovakia, Hungary, Poland) left it once their European Union membership had been formalized. The European Union is currently Kosovo's main trade partner for imports (45% of the total in April 2021) and the member countries of the CEFTA are the main market for Kosovo's exports, with 39% of the total in 2021, and 31% towards the European Union. Kosovo has diversified its export base and trade partners to a very limited extent over the last decade. However, there are still many obstacles to free trade between CEFTA members, in particular political, tariff and non-tariff barriers. One example is the imposition of customs duties by Kosovo on imports from Serbia and Bosnia & Herzegovina in 2018 (measure withdrawn in 2020).

The unilateral adoption of the euro, a strong currency in international trade, weighs especially heavily on Kosovo's competitiveness. The IMF assesses the real effective exchange rate overvaluation at approximately 7% (IMF, Article IV 2021). Conversely, Kosovo benefits from the adoption of the euro for its imports from countries that do not use the euro (Albania, North Macedonia, Serbia).

Grap 14 – Kosovo, which mainly depends on the EU and the CEFTA, is very largely a net importer of goods, April 2021 (% of GDP)



Sources: Ministry of Finance of Kosovo, IMF Article IV (2021)

Kosovo is, however, a net exporter of services, mainly through exports of services related to diaspora tourism (70% of total exports of services).

Kosovo's exports of services have almost doubled in relative terms, from 13.5% of GDP (€573 million) to 25.3% of GDP (€1.895 billion) between 2010 and 2019. This was due to the increased attractiveness for tourists, as well as the development of the information and communication technologies (ICT) sector. The pandemic led to a sharp decline in exports of services in 2020 (which fell to 14.7% of GDP), making the country one of the hardest hit by the collapse of tourism in Europe. Exports of services picked up in 2021 (to 25.3% of GDP), with the strong recovery of diaspora tourism.

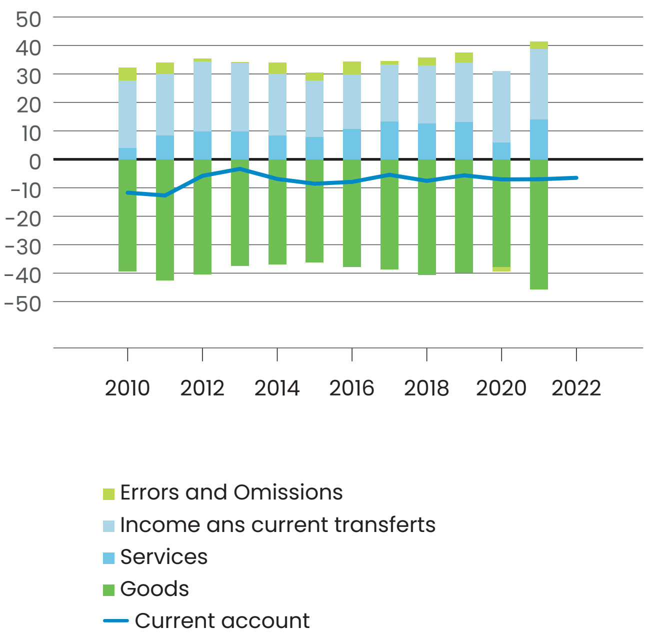
Consequently, while Kosovo is a net exporter of services, the poor performance of its exports of goods and its dependence on imports have led to **structural deficits in its trade balance (28.2% of GDP on average since 2012)**, *i.e.* the highest in the region. In 2020, the trade balance deficit increased, in connection with the Covid-19 pandemic and trade restrictions, and stood at 32% of GDP. For 2021, the trade deficit is expected to be at a similar level to 2020 according to IMF forecasts (Article IV 2021).

Flows from the diaspora and ODA are not sufficient to offset the trade balance deficit.

The surplus balances of the primary and secondary balances are not sufficient to offset the substantial trade balance deficit (-28% on average since 2012). The balance of secondary income, which is mainly made up of diaspora remittances and ODA (Official Development Assistance) flows, shows a significant surplus, at an average of 18.6% of GDP between 2015 and 2019. Kosovo's dependence on ODA has gradually declined, but it continues to have recourse to it to a greater extent than its peers in the region. ODA accounted for 8.9% of GNI in 2010, against an average of only 2.3% in the other Western Balkan countries (see Graph 16) and only accounted for 4.3% of GNI in 2019. Diaspora remittances showed great resilience during the Covid-19 crisis due to the strong links between Kosovars and their diaspora. Indeed, these flows increased from 16% of GDP in 2019 to 19% in 2020. Consequently, the balance of secondary income stood at 22.8% of GDP in 2020 (against 19.2% in 2019). Finally, the balance of primary income also shows a surplus (an average of 1.8% of GDP between 2015 and 2019).

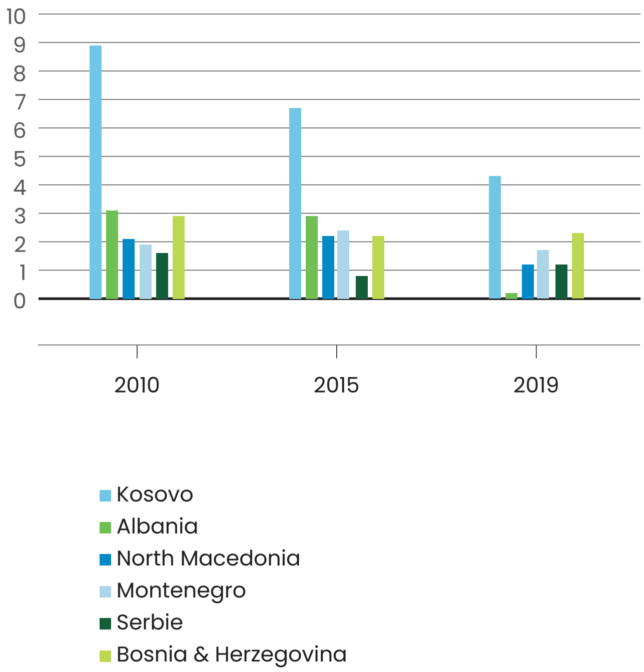
It should be noted that, according to the IMF's Article IV, the considerable errors and omissions are thought to mainly consist of diaspora remittances and FDI.

Graph 15 – Kosovo's current account balance is in deficit which reflects its low competitiveness and dependence on remittances (as % of GDP)



Sources: World Bank, IMF (Article IV)

Graph 16 – Kosovo benefits more from net ODA flows (as a % of GNI) by regional comparison



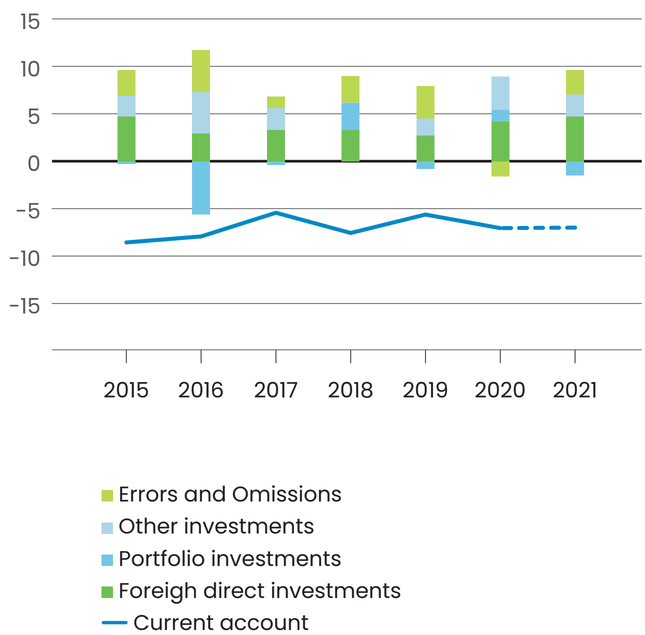
Source: World Bank (WDI)

During the Covid-19 crisis, the current account balance increased slightly to -7% of GDP as a result of the rise in the trade deficit, which reached 32.2% of GDP in 2020, against 27.1% in 2019. In 2021, the current account deficit is expected to remain at -7% of GDP and fall to around -5.5% of GDP by 2025.

4.2 – FDI and international donors are essential to cover the major need for external financing

Kosovo has a substantial external financing requirement,[9] which reflects a structural current account deficit and a high debt amortization. In 2020, the external financing requirement (EFR) reached 22.4% of GDP, *i.e.* $1.5 billion. It is expected to remain above 20% of GDP until 2025, mainly due to a substantial current account deficit related to the trade deficit. Kosovo is heavily dependent on imports, in particular due to the small size of the country. While the amortization of public external debt (a component of EFR) is low (official external debt on favorable terms) at around 1.5% of GDP in 2020, the amortization of private external debt is relatively high (€300 million, *i.e.* 4.2% of GDP). This contributes to a high EFR. Short-term external debt accounts for almost half of EFR, but is mainly made up of interbank

Graph 17 – The financial account is supported by net FDI flows and debt-creating flows(en % of GDP)



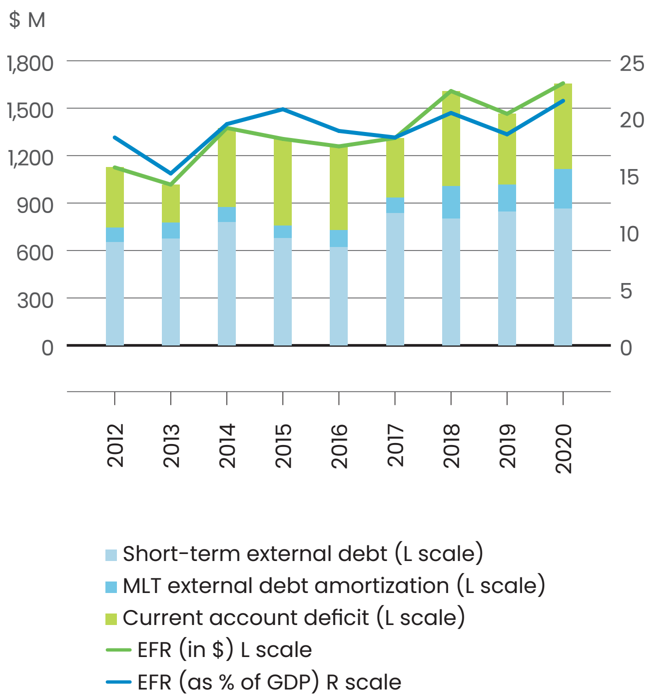
Source: IMF (BOPS, Article IV)

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

financing. It therefore has a low refinancing risk, as the banking system is predominantly made up of subsidiaries of foreign banks. These banks are mainly located in the euro area and therefore have access to capital markets and on favorable refinancing terms.

The EFR is mainly covered by inflows of FDI and debt-creating flows, and in particular budget support from donors. The Covid-19 crisis has had a strong impact on Kosovo's external balances and has required strong support from donors to cover the external financing gaps (in the form of loans and, to a lesser extent, grants). Consequently, in addition to withdrawals from the Government's account at the CBK (€200 million) and a domestic bond issue (€170 million) to cover the public financing requirement, the financing gap in 2020 was covered through support from the IMF (€52 million under the Rapid Financing Instrument), World Bank (€44 million), EU (€50 million corresponding to the first tranche of the macro-financial assistance for a total of €100 million), as well as from the Council of Europe (€17.5 million) and grants from the EU (€34 million).

Graph 18 – Breakdown of Kosovo's EFR

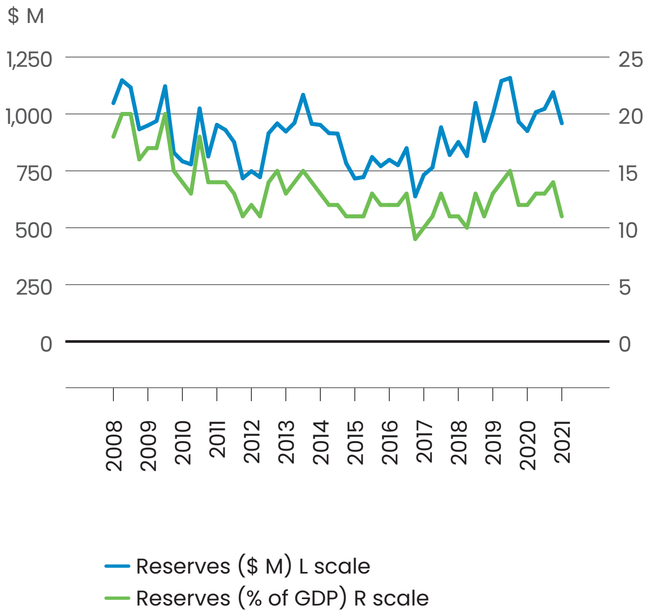


Source: World Bank (WDI, IDS)

Box 2 – The choice of euroization: a source of external stability requiring a rigorous management of reserves

Kosovo opted for a unilateral euroization in 2002, resulting in a loss of control of its monetary policy. The unilateral nature of the adoption of the euro in 2002 does not make Kosovo a member country of the Eurosystem, meaning it does not have access to the European System of Central Banks (ESCB). Kosovo is therefore dependent on the monetary policy decisions of the European Central Bank (ECB) and cannot conduct accommodative monetary policies (asset purchase policy, support for access to credit, monetization of the deficit), nor restrictive policies. It also cannot implement measures to offer liquidity or use its function as a lender of last resort. Indeed, Kosovo's money supply is dependent on inflows of foreign currency, meaning their supervision by the Central Bank of Kosovo (CBK) is essential. The CBK's foreign currency reserves are only derived from the excess reserves of commercial banks, deposits by the central government with the Central Bank, and IMF special drawing rights (SDR). Consequently, the liquidity of the banking system and the Government's leeway in terms of fiscal policy are intrinsically linked regarding the reserves. The retention of a high level of Government deposits at the CBK is the main source of reserves. This level, which stands at 4.5% of GDP, must be voted by the National Assembly every year during the approval of the budget. The CBK also secures a stock of mandatory reserves with each commercial bank and with the Privatization Agency of Kosovo.

Graph 19 – Trend in level of reserves (excl. gold)



Source: IMF (WEO)

The level of the stock of reserves has, however, decreased significantly in recent years, due to (i) the transfer of revenues from privatizations (which were among the deposits of the CBK) to the budget dedicated to infrastructure investments and (ii) more recently, the Covid-19 crisis which has made it necessary to draw on the reserves, for an amount equivalent to 3% of GDP. Their level has fallen and in January 2021 stood at €959 million (11% of GDP).

At the end of 2021, the foreign currency reserves stood at €1.27 billion in connection with the increase of Government deposits with the CBK (from 3.5% of GDP in 2020 to 5.5% of GDP in 2021) and the supplementary allocation of SDR (1.3% of GDP). At the end of 2021, while the level of the reserves was increasing, it remained limited, below the recommended level (at 84% of the ARA metric adapted to euroized economies, against 113% in 2017).

5.
The banking sector is healthy and contributes to financing the economy

5.1 – Balance sheet indicators remain robust

Kosovo's banking system is particularly liquid, which has strengthened its resilience to the Covid-19 crisis. It is also well capitalized and relatively profitable. Kosovo's banking sector is composed of 11 banks, 9 of which are subsidiaries or branches of foreign banks (mainly in Germany, Serbia, Slovenia, Turkey), providing these banks with extensive access to liquidity. The financing of banks mainly comes from (i) deposits (ii) interbank liquidity agreements (iii) financing *via* their parent company. Among these banks, the three main ones hold over half of the assets. However, this concentration, which is shown through the ratio of assets held by the three main banks, does appear to be gradually decreasing and fell from 56.8% to 55.8% between 2019 and 2020.

In connection with the growth in deposits, driven by inflows from the diaspora and confidence in **the banking system, the system is very liquid, with a liquid assets/total assets ratio of 30.6% in 2021** (against 28.8% in 2019). Deposits account for 80% of the total liabilities of banks and are divided between deposits by households (67%) and private companies (25%). Deposits increased by approximately 11% in 2020, and 40% of this increase is due to withdrawals from the KPST's pension account, exceptionally authorized under the economic stimulus plan (Economic Recovery Law). The sound capitalization of the banking sector resulted in a capital adequacy ratio of 17.9% at the end of September 2021, against 18.1% in 2017 and 16.5% in 2020. The profitability of the sector is increasing, with a return on assets (ROA) of 2.2% in September 2021 (1.7% in 2020) and a return on equity (ROE) of 13.8% in September 2021 (14% in 2020) (see Table 2).

While the Central Bank de facto has a limited capacity to inject liquidity into the economy, it does have a direct injection instrument *via* the ELA liquidity line, which was introduced in 2010 for solvent banks short of liquidity and insolvent banks but of critical size. The CBK can thereby allocate up to 100% of the Tier 1 capital. This mechanism is an element of comfort for the banking sector.

The share of non-performing loans (NPL) in total loans has declined under the impetus of measures taken in recent years to improve the quality of banks' portfolios: they accounted for 8.4% of bank loans in 2014, prior to starting on a downward trend bringing them to an average of 2.2% today. During the Covid-19 crisis, the CBK introduced three moratorium phases to limit the risks of defaults: during the first phase (3 months of moratorium), a moratorium request was submitted for 50% of the loans allocated, then for 20% during the second phase (1 year of moratorium). When these moratorium measures are lifted

Table 2 – The banking sector is liquid, profitable and well capitalized

	2017	2018	2019	2020	Q3 2021
Banking structure					
Total assets (% of GDP)		62.7	67.5	79.2	76.9
Solvency ratio					
Risk-weighted capital ratio	18.1	17	15.9	16.5	17.9
Profitability					
Return on assets (ROA)	2.5	2.3	2.1	1.7	1.7
Return on equity (ROE)	19.4	18.3	17.2	14	13.8
Composition and quality of assets					
Rate of non-performing loans	3.1	2.5	1.9	2.5	2.2
Liquidity					
Liquid assets/total assets	28.9	29	28.8	30.1	30.6

Source: IMF (Article IV)

and the loans are reclassified, there may be an increase in NPL. Certain banks whose loans focus specifically on sectors affected by the crisis (hotel industry, services) may find themselves in difficulty if there is an increase in NPL. However, the strong resilience of the financial sector makes it possible to rule out the hypothesis of a systemic risk, even in worst-case scenarios (CBK, 2020).

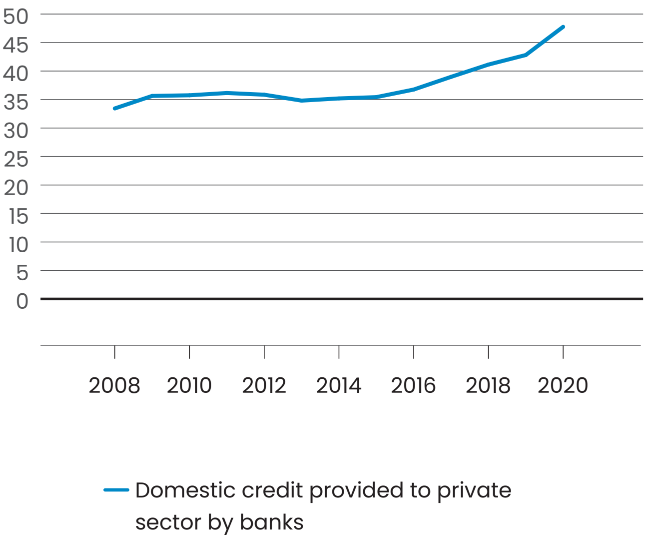
5.2 – Private sector credit is dynamic, but remains constrained by high administrative costs

Private sector credit, which accounted for 47.9% of GDP in 2020, has more than doubled over the last decade, with an annual average growth of 10% (see Graph 20). It supports household and business consumption, in particular in the sectors of trade (45% of total loans), manufacturing (15%) and construction (13%). Loans to the agriculture sector account for barely 3% of total loans. The Central Bank's measures in response to the Covid-19 crisis mentioned above led to a 7% increase in loans in 2020 year-on-year (YoY). In 2021, there was dynamic growth in private sector credit, at +13.4% according to the IMF (Article IV 2021).

However, the loans allocated by banks remain constrained by an incomplete dispute resolution environment and constraints on the collateralization of these loans. Some 7,000 disputes between banks and their clients were pending resolution in 2020, amounting to some €150 million, in particular due to ineffective contract enforcement mechanisms and the slowness of the justice system. This low level of effectiveness of the justice system is partly related to the limited capacity of Courts of Justice and the lack of training in commercial litigation for judges. A Commercial Court should be set up under the new Government's program.

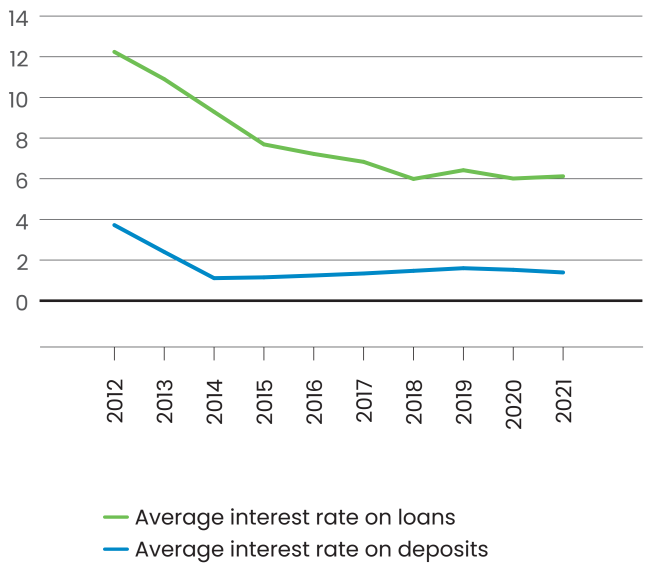
The average interest rates on loans are gradually decreasing, in continuity with the rate dynamics seen at the sovereign level and in connection with the low borrowing rates in the euro area. While they reached around 12% in 2012, they have since been halved and stood at 6.12% at the end of March 2021 (see Graph 21).

Graph 20 – Acceleration in private sector credit growth since 2016 (% of GDP)



Source: World Bank

Graph 21 – Average interest rates on loans have halved since 2012 (%)



Source: Kosovo Banking Association (March 2021)

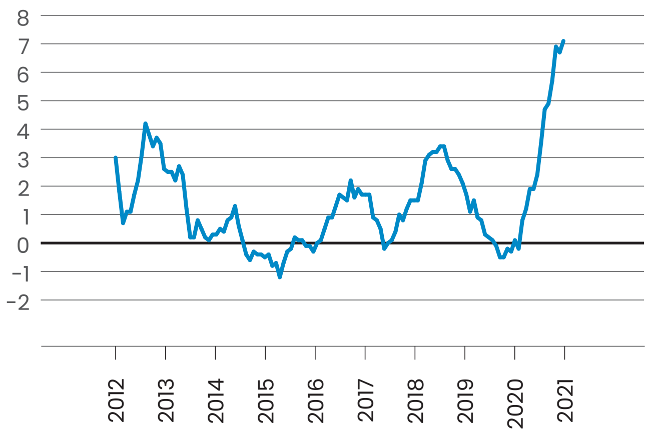
5.3 – Inflation in Kosovo, while contained to low levels, shows some volatility, compounded over the recent period

Inflation has remained subdued in recent years (below 3%). The increase in 2018-2019 was due to the introduction of customs duties of 100% on imports from Bosnia & Herzegovina and Serbia. The Covid-19 crisis led to price stability in 2020 (+0.2%), in line with the regional inflation dynamics.

The low level of structural inflation in Kosovo is mainly due to its dependence on European countries and their low inflation dynamics, or even a deflationary period. This regional dependence can be seen with the country's trade, the majority of which is with EU and Eastern European countries. This leads to a low imported inflation and low wage dynamics. This influence of a more developed Europe with a low inflationary impact on prices can be seen in the Western Balkans region, which also has low inflation.

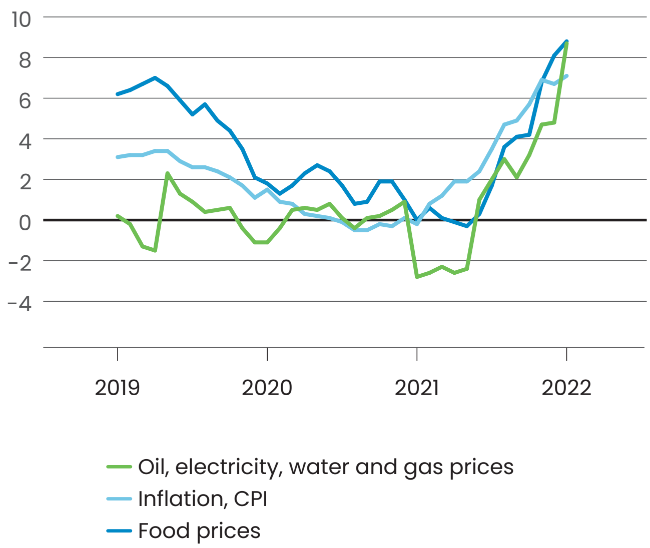
The second factor behind this structurally low inflation and this influence of Europe on the price index is the monetary aspect. Indeed, countries that have limited their monetary autonomy by aligning with the euro (Bosnia & Herzegovina, Kosovo, Montenegro and North Macedonia) have lower inflation dynamics than countries benefiting from autonomy in their monetary policy and a flexible exchange rate regime (Albania, Serbia).[10]

Graph 22 – Inflation structurally low but relatively volatile (%)



Source: Macrobond

Graph 23 – Inflation driven by food and energy prices (%)



Source: Macrobond

10 Kosovo and Montenegro are euroized economies, Bosnia & Herzegovina has introduced a currency board system and North Macedonia has adopted a de jure floating exchange rate regime, but as a de facto stabilized arrangement, with the Central Bank aiming to maintain an exchange rate pegged to the euro (61 denar for €1).

However, inflation picked up again in 2021 at 3.2%, in connection with the increase in the price of energy[11] and imported food products. The increase in price levels was particularly high in early 2022 (at 7% in January YoY), but may gradually fall during the year. The IMF (Article IV 2021) forecasts an inflation rate of 3.9% in 2022. These forecasts were made before the outbreak of the Russian-Ukrainian conflict, which could cause an additional increase in energy and food prices. Indeed, while Russian and Ukrainian imports are very low in Kosovo, accounting for around 1% of total imports,[12] Kosovo remains exposed to disruptions on global food commodity markets (20% of its total imports).

11 Indeed, Kosovo is particularly affected by the current energy crisis due to the obsolescence of its coal-fired power plants, which it is almost entirely dependent on for its power generation (98% of electricity is generated by its two old lignite-fired thermal power plants, Kosovo A and Kosovo B). Consequently, in the event of a failure or malfunction of these plants, the country is forced to import electricity, in particular from Albania.

12 AFD calculations

References

Association of Banks of Kosovo (2021), *Performance of the Banking Sector in Republic of Kosovo,* March.

Bertelsmann Transformation Index (BTI) (2020), *2020 Country Report, Kosovo,* https://bti-project.org/fileadmin/api/content/en/downloads/reports/country_report_2020_RKS.pdf

Central Bank of Kosovo (2020), Financial Stability Report N. 17, January.

European Commission (2020), *Economic Reform Program (2020-2022) of Kosovo**, https://data.consilium.europa.eu/doc/document/ST-7471-2020-INIT/en/pdf

European Commission (2020), Staff Working Document, *Kosovo* 2020 Report*, October, https://ec.europa.eu/neighbourhood-enlargement/sites/default/files/kosovo_report_2020.pdf

European Commission (2019), Staff Working Document, *Kosovo* 2019 Report*, https://ec.europa.eu/neighbourhood-enlargement/sites/default/files/20190529-kosovo-report.pdf

European Union (2021), *Government of Kosovo Program Assessment: The Kurti II Government Programme 2021-2025*, 31 May.

European Union (2017), *Assessment on the Extent of Informal Economy in Kosovo*, https://ec.europa.eu/neighbourhood-enlargement/sites/default/files/20180417-kosovo-report.pdf

Eurostat (2019), https://ec.europa.eu/eurostat/documents/3217494/10165279/KS-DK-19-001-EN-N.pdf/76651a29-b817-eed4-f9f2-92bf692e1ed9

Freedom House (2021), *Kosovo 2020 Report*, https://freedomhouse.org/country/kosovo/freedom-world/2020

Gallup (2019), *Gallup World Poll*, http://www.gallup.com/analytics/213617/gallup-analytics.aspx

International Bank for Reconstruction and Development and World Bank (2019), *Enterprise Surveys, Kosovo 2019 Country Profile*, www.enterprisesurveys.org/content/dam/enterprisesurveys/documents/country/Kosovo-2019.pdf

International Monetary Fund (2022), *Republic of Kosovo: 2021 Article IV Consultation-Press Release and Staff Report*, IMF Country Report N. 22/5. Republic of Kosovo: 2021 Article IV Consultation-Press Release and Staff Report (imf.org), January.

International Monetary Fund (2021), *Republic of Kosovo: 2020 Article IV Consultation-Press Release and Staff Report*, IMF Country Report N. 21/41, February, https://www.imf.org/en/Publications/CR/Issues/2021/02/17/Republic-of-Kosovo-2020-Article-IV-Consultation-Press-Release-Staff-Report-and-Statement-by-50104

International Monetary Fund (2018), *Republic of Kosovo: 2017 Article IV Consultation-Press Release and Staff Report*, IMF Country Report N. 18/30, https://www.imf.org/en/Publications/CR/Issues/2018/02/05/Republic-of-Kosovo-2017-Article-IV-Consultation-Press-Release-Staff-Report-and-Statement-by-45612

International Monetary Fund (2018), *Republic of Kosovo: Selected Issues*: Country Report 18/31, www.imf.org/en/Publications/CR/Issues/2018/02/05/Republic-of-Kosovo-Selected-Issues-45613

Kosovo Agency of Statistics (2014), *Kosovan Migration,* April.

Kosovo Government (2020), *Economic Reform Program 2021-2023*, https://mf.rks-gov.net/desk/inc/media/06B63BCF-DEA0-4DE7-98D1-C99E0912272C.pdf

Ministry of Finance (2021), *Labor Force Survey Q1 2020*, March.

Ministry of Finance, Labor and Transfers (2021), *Annual Bulletin on Public Debt 2020*, https://mf.rks-gov.net/desk/inc/media/46BF6C74-32C4-4483-A149-6391F1E06F0D.pdf

Ministry of Finance, Labor and Transfers (2021), Department for Macroeconomic Policy and International Financial Cooperation, *Quarterly Economic Bulletin* (October-December 2020).

Ministry of Finance, Labor and Transfers (2021), *State Debt Program*, https://mf.rks-gov.net/desk/inc/media/03D27205-ADB6-4919-80A8-D4F7B2299805.pdf

Ministry of Finance, Labor and Transfers and Kosovo Agency of Statistics (2020), *Kosovo International Trade Statistics*, August.

OECD (2021), *Multidimensional Review of the Western Balkans, Assessing Opportunities and Constraints of Kosovo*, June.

USAID (2017), *Climate Change Risk Profile Kosovo*, January, www.climatelinks.org/sites/default/files/asset/document/2017_USAID_Climate%20Change%20Risk%20Profile%20-%20Kosovo.pdf

World Bank (2021), *Western Balkans Regular Economic Report* 19, "Subdued Recovery". https://www.worldbank.org/en/region/eca/publication/western-balkans-regular-economic-report

World Bank (2019), *Air Pollution Management in Kosovo*, https://documents1.worldbank.org/curated/en/214511576520047805/pdf/Air-Pollution-Management-in-Kosovo.pdf

World Bank (2020), *Doing Business 2020, Economy Pro ile Kosovo*, www.doingbusiness.org/ content/dam/doingBusiness/country/k/kosovo/KSV.pdf

World Bank (2019), *Kosovo Country Report: Findings From the Skills Toward Employment and Productivity Survey*, March, https://documents.worldbank.org/en/publication/documents-reports/documentdetail/209751557432399449/kosovo-country-report-findings-from-the-skills-towards-employment-and-productivity-survey

World Bank (2019), *Kosovo Social Assistance Scheme Study: Assessment and Reform Options*, March, https://documents.worldbank.org/en/publication/documents-reports/documentdetail/994991557470271998/kosovo-social-assistance-scheme-study-assessment-and-reform-options

World Bank (2017), *Jobs Diagnostic Kosovo*.

World Bank and Kosovo Agency of Statistics (2019), *Consumption Poverty in the Republic of Kosovo*, May.

List of acronyms and abbreviations

CBK	Central Bank of the Republic of Kosovo
CEC	Central Election Commission
CEFTA	Central European Free Trade Agreement
ECB	European Central Bank
EFR	External financing requirement
ESCB	European System of Central Banks
EULEX	European Union Rule of Law Mission in Kosovo
FDI	Foreign direct investments
IBRD	International Bank for Reconstruction and Development
ICJ	International Court of Justice
ICO	International Civilian Office
ICT	Information and communication technologies
IDA	International Development Association
IDS	International Debt Statistics
IPA	Instrument for Pre-Accession Assistance
KFOR	Kosovo Force
KPA	Kosovo Property Agency
KPST	Kosovo Pension Savings Trust
NEET	Young people “neither in employment nor in education and training”
NPL	Non-performing loans
ODA	Official Development Assistance
PISA	Program for International Student Assessment
SDR	Special drawing rights
UNMIK	United Nations Interim Administration Mission in Kosovo
WEO	World Economic Outlook
WGI	Worldwide Governance Indicators

Agence française
de développement
5, rue Roland Barthes
75012 Paris l France
www.afd.fr

Éditions Agence française de développement publishes analysis and research on sustainable development issues. Conducted with numerous partners in the Global North and South, these publications contribute to a better understanding of the challenges faced by our planet and to the implementation of concerted actions within the framework of the Sustainable Development Goals. With a catalogue of more than 1,000 titles and an average of 80 new publications published every year, Éditions Agence française de développement promotes the dissemination of knowledge and expertise, both in AFD's own publications and through key partnerships. Discover all our publications in open access at editions.afd.fr. Towards a world in common.

Publication director Rémy Rioux
Editor-in-chief Thomas Mélonio
Graphic design MeMo, Juliegilles, D. Cazeils
Layout Luciole

Final date of writing: April 1st, 2022

Legal deposit 2nd quarter 2022
ISSN 2266-8187
Printed by the AFD reprographics department

To see other publications in the **MacroDev** series, visit: https://www.afd.fr/en/collection/macrodev