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Statement by Mr. Canakci and Mr. Mehmedi on Republic of Kosovo
Executive Board Meeting
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On behalf of our Kosovar authorities, we would like to thank management and staff for the constructive discussions and their support for a new 22-month Stand-by Arrangement (SBA) in the amount of SDR147.5 million (250 percent of quota). While Kosovo is in a solid fiscal and financial position, the new arrangement with the Fund will build upon the progress accomplished over the recent years while further strengthening the macro-economic framework and accelerating the implementation of structural reforms.

In this vein, the SBA will support the authorities' continued commitment and efforts to maintain fiscal stability through a front-loaded fiscal adjustment, in order to preserve the credibility of the fiscal rule and maintain low levels of public debt, improve the quality of the budget by increasing the share of more productive spending, rebuild government bank balances to prudential levels, and further enhance the financial safety net and banking system supervision. The program also envisages a realistic set of structural policy reforms that are aimed at expanding Kosovo's productive and export capacity through tackling the country's wage and nonwage competitiveness gap and improving the business environment and governance.

In order to address Kosovo's significant development needs, the program design also allows for a prudent increase in fiscal space for much needed development projects, through the modification of the existing investment clause within the broad-based fiscal rule, while preserving debt sustainability.

With a grand coalition in place which enjoys a comfortable majority in the parliament, and with no general elections scheduled until 2018, there is political commitment to move ahead with a comprehensive reform agenda which will lift Kosovo's growth potential and ensure inclusive and sustainable development. Indeed, at the beginning of 2015, the government approved its four year program which includes a comprehensive set of reforms, including the fiscal, financial and structural reforms that are part of the proposed SBA, illustrating the authorities' commitment to elevate their reform-agenda and program ownership, which is key to its successful implementation. The authorities remain committed to address any potential risks to the program.

A revised mid-year budget, a prior action for the program, has been approved by the parliament on July 16, including all the fiscal measures outlined in the Memorandum of Economic and Financial Policies.

Macro-economic developments and outlook

Kosovo has enjoyed a much more resilient economic growth than other Western Balkan countries, being the highest growth performer in the region with a five-year average growth rate of 3.5 percent. Nonetheless, income per capita remains low while the unemployment rate, especially among the youth, remains relatively high.

In 2014, economic activity slowed down due to political uncertainty and is estimated to have grown by 2.7 percent, mainly driven by remittances, particularly from Germany and Switzerland where most of the Diaspora resides, and consumption. The authorities are more upbeat than staff regarding the outlook. They expect growth to accelerate to 3.8 percent this year, supported by continued remittances, an increase in consumption due to the strong impact of last year's public wage increase, and an increase in public investment as a result of the construction of the highway which links Pristina to Skopje. Implementation of the ambitious reforms is expected to yield results in 2016 with a projected growth rate reaching 4.1 percent. The authorities' macroeconomic baseline scenario shows some upside risks, including the start of the Brezovica Resort project, a year round ski resort (approximately 8 percent of GDP), which is expected to generate considerable numbers of jobs and create new opportunities for SMEs.

Low energy and import prices (a key component of the CPI basket) have kept inflation low. A modest inflation of 0.2 percent is expected for this year, which will gradually climb to 1.3 percent in 2016. The current account deficit (CAD), including official transfers, is expected to narrow marginally to around 7.5 percent of GDP in 2015 but will then widen in 2016, as the Brezovica resort project and new donor-financed investments will trigger an increase in imports. However, the financing sources for the CAD are stable and non-debt creating, with the main contributions coming from remittances, official transfers, and FDI. With a considerable trade deficit, approximately 32 percent of GDP, the authorities' efforts are aimed at increasing domestic production and expanding the export base, which would ultimately reduce the trade imbalance and substitute some of the imports.

The Stabilization and Association Agreement (SAA) with the European Union (EU) has been approved by the EU Commission and is expected to come into effect in 2016. The SAA will serve as a blueprint for economic and administrative reforms while opening up EU markets to Kosovo's companies and products, and facilitating free trade.

Fiscal Policy

The authorities attach utmost priority to maintaining macro-fiscal stability and preserving the credibility of the fiscal rule which sets an overall ceiling on the general government deficit at 2 percent of GDP. In this context, fiscal adjustment will be at the core of the program in order to strengthen public finances, rein in current spending, and improve the composition of the budget.

The proposed SBA envisages a front-loaded fiscal adjustment in the order of 1.5 percent of GDP for this year, to bring down the fiscal deficit close to 2 percent of GDP, as envisaged with the fiscal rule. In the absence of corrective measures, the deficit this year would reach 3.9 percent of GDP due to last year's increases in public sector wages and too optimistic revenue projections. A further fiscal adjustment of 0.8 percent will be targeted in 2016 in order to attain an overall fiscal deficit of 1.6 percent of GDP.

Aside from the corrective measures taken in March, such as the increase in the excise taxes on tobacco, alcohol, vehicles, and heavy oil, further fiscal revenue measures have been legislated in the context of the mid-year budget review. The standard VAT rate has been increased from 16 to 18 percent while a differentiated rate (at 8 percent) for a limited category of goods and services has also been introduced and the net effect will yield 0.4 percent of GDP in annualized gains. Excise taxes on tobacco and gambling have been further increased and all these measures will yield more than 0.3 percent of GDP annually. On the expenditure side, current spending has been reined in by savings in transfers (0.2 percent of GDP) and goods and services (0.2 percent of GDP). The authorities have frozen the wage bill and have taken the decision not to fill vacancies this year, measures which will yield another 0.5 percent of GDP in fiscal savings. Public sector wages will be maintained constant in nominal terms also in 2016, thereof decrease public sector wages as a ratio to GDP from 9.6 percent to 8.8 percent.

A large part of the purchases under the SBA will be used to rebuild the low government bank balances at the central bank. In line with the methodology for assessing the adequacy of the cash balances, the program aims at restoring the bank balance to 4.5 percent of GDP by the end of 2016 (from the current level of 1.8 percent of GDP).

In order to tackle unproductive current spending, improve the budget structure, and create more space for growth-enhancing capital expenditures, the authorities will approve by the end of this year a public wage rule that will link growth in the public wage bill to a macroeconomic indicator. The wage rule will keep public sector wages in line with productivity dynamics and enhance the competitiveness of Kosovo's economy. Importantly, the rule is intended to prevent large discretionary increases in the public wage bill, as seen prior to the elections in 2014 and 2011. Due to the wage freeze in 2016, the rule is intended to be implemented with the 2017 budget.

With the aim of addressing Kosovo's large infrastructure needs and providing financing for growth-enhancing capital projects, the investment clause of the fiscal rule will also be modified to allow new donor-financed capital projects, in addition to privatization-financed investments, not to count as an excessive deficit against the fiscal rule. The amendment to the rule includes safeguards regarding the approval of the projects, vetting procedures and debt sustainability. Given Kosovo's large infrastructure gap and social needs, and a very low level of public debt (10.4 percent of GDP), the IFI-financed projects, aimed at sectors such as agriculture, road and railway infrastructure, health ,and IT will provide the desirable impetus for growth and job creation.

Several measures are being enacted with the objective of strengthening the tax administration and customs, including the medium-term goal of unifying these two revenue administrations, broadening the tax base, increasing compliance and preventing and reducing the informal economy. The operational departments of both Tax and Customs have been merged and the IT systems have been revamped, as to produce efficiency gains and narrow the tax gap. The authorities have requested Fund technical assistance on the full merger of the revenue-collecting agencies.

Financial Sector

Banks in Kosovo are well capitalized, liquid, and profitable and they follow a traditional banking model (loan-to-deposit ratio of 76.1 percent). The system's capital adequacy ratio stands at 19.2 percent (end of May), among the highest in the region, with all banks, both domestic and foreign, above the regulatory minimum. The aggregate liquid assets cover 43 percent of short-term liabilities, a key consideration in a euroized economy, and profitability remains high (return on equity at 27.2 percent). Non-performing loans (NPLs) have been declining and are now at 7.4 percent and are fully provisioned. While the interest rate on loans has dropped by around 50 percent in the last three years to 7.9 percent, interest rate spreads are still elevated.

While good progress has been made in improving the financial sector's regulatory and supervisory framework, in large part due to the Fund's technical assistance, further efforts are needed in strengthening the financial safety net, crisis preparedness and crisis management. As part of the program, the Central Bank of Kosovo (CBK) will approve a new legal framework for Emergency Liquidity Assistance (ELA), in line with best practices, which will govern the conditions, processes, and modalities of any emergency assistance provided to banks. Additionally, letters of comfort from parent banks of local subsidiaries have been received which stipulate that parent banks would work with their subsidiaries in the event of a liquidity crisis. Collaboration with foreign bank supervisors, including the Turkish, German, and Austrian supervisory authorities (the origin of most foreign banks) is also being enhanced as to identify risks and vulnerabilities.

Banking supervision and oversight will also be enhanced. The CBK will fully adopt risk-based supervision by mid-March next year, a key recommendation of the 2012 FSAP, which will strengthen financial stability and help the CBK to conduct better surveillance of banks and cover risks on a more consolidated basis.

Despite banks' ample liquidity, credit penetration in Kosovo remains low at 35 percent of GDP, mainly due to structural problems, including lengthy and costly court proceedings, difficult debt collection procedures, and high interest rate spreads and collateral requirements. In order to better utilize the high levels of liquidity in the banking sector, several policy actions are being envisioned in order to tackle the binding constraints to credit access and growth. A private bailiff system, recently introduced, will be further enhanced as to speed-up the enforcement of collateral recovery while the NPL recovery and write-off procedures will be revised. In order to address the current backlog of bank cases which stretch up to five years, measures are being considered to improve the courts' proceedings of commercial cases. In addition, the authorities, with the support of donors, are in the process of establishing a credit guarantee scheme for increasing access to credit for SMEs.

The Kosovar authorities remain committed and are working with staff to further develop the macroprudential toolkit and strengthening the crisis management framework. The recently created Macroprudential Advisory Committee will adopt its policy framework, with specific indicators, by the end of this year while plans to functionalize the National Committee for Financial Stability and Crisis Management are underway.

Structural Reforms

The authorities acknowledge that for Kosovo to move to a growth model which is driven by investment and the tradable sector, decisive reforms are needed to increase the productive and export capacity of the economy, strengthening the private sector, and improving competitiveness. The government approved its four year program at the beginning of the year while the Economic Reform Program 2015 (ERP), along with its action plan, was submitted to the European Commission in January and provides a platform for the implementation of structural reforms aimed at boosting growth and jobs. The authorities intend to focus their interventions on improving governance and the business environment, reducing skills mismatch, and ensuring an adequate supply of energy.

Measures are being implemented to improve the oversight and control of the public procurement process which will reduce the perception of corruption and provide a level and transparent playing field. In this regard, the procurement law will be amended to ensure its full compliance with international standards and make e-procurement mandatory for all central government agencies, beginning next year. The procurement process at the central level is also being centralized, with the tendering process for three main goods (fuel, office supply, and plane tickets) already initiated.

Despite major improvements in enhancing the business and investment environment in recent years, further reforms are being envisaged to tackle some of the remaining binding constraints to private sector growth such as resolving insolvency, enforcing contracts, and electricity supply. The National Council on Economic Development, a public-private dialogue mechanism which consists of representatives from the government institutions and the business community, has been reactivated and is meeting on a regular basis and coordinating these reform efforts.

In view of Kosovo's high unemployment rate and low labor participation rates, improving the labor market and enhancing the quality of education are essential. Aside from the introduction of the new public sector wage rule which will reduce labor costs and boost competitiveness, the education system curricula (for primary and secondary level) is being upgraded in order to make it responsive to the market needs and reduce skills mismatch. The vocational educational system is also being revamped, based on the German model, and a new Agency on Vocational Training has been established, coordinating the efforts of the Ministry of Education, the Ministry of Labor and chambers of commerce. Additionally, active labor market policies aimed at increasing female participation in the labor market are being designed.

Lastly, in collaboration with the World Bank, the authorities are moving forward with the energy reforms in order to ensure a sustainable and reliable energy supply. The tendering process for building a new thermo-power plant (600 MW) is in progress while the new regional transmission line with Albania will be completed next year.