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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 the Kosovo authorities, we would like to thank staff for the excellent report on the first review under the Stand-by Arrangement (SBA) and for the constructive dialogue and valuable advice during the recent missions to Pristina. The authorities appreciate the quality of engagement with Fund staff, which has been tremendously beneficial, and express their appreciation to Fund management and the Executive Board for their continued support. The authorities broadly agree with staff's assessment outlined in the report.

In recent weeks, the opposition parties have managed to stall parliamentary activity to protest against two recently agreed international accords and have organized several demonstrations demanding the annulment of these two agreements. The government and the opposition parties are continuing their dialogue and the authorities are confident that the current political tensions will subside and an agreement on resolving the dispute in the Parliament will be reached. With the current coalition enjoying a strong majority in the Parliament, the authorities remain committed to address any potential risks to the program.

Macroeconomic developments and outlook

Kosovo's economy is performing well thanks to prudent macroeconomic policies. The authorities' cautious stance is reflected in the medium-term projections. Although 2014 GDP growth was revised down to 1.2 percent, largely reflecting the sharper-than-expected slowdown in public consumption and total investment, which were both driven by the long political stalemate following the 2014 June elections, economic growth for 2015 and 2016 is projected to be higher compared to the estimates at the time of the program approval.

The latest high-frequency indicators and data signal an accelerated pace of economic growth for 2015. Foreign direct investments (FDIs) increased by 114.2 percent y/y at the end of September, reversing the previous year's negative trend. During the same period, exports also surged by 5.6 percent y/y, remittances were strong and robust (increased by 12 percent), while credit growth to the private sector accelerated by 8.3 percent y/y at the end of October. While staff has revised upward their 2015 growth projection to 3.5 percent (from 3.2 percent previously), the authorities are more upbeat and expect GDP growth for 2015 to reach 3.8 percent. Supported by continued remittances, an increase in consumption, and a surge in public investment as a result of the ramping up of the construction of the highway which links Pristina to Skopje, and the new donor-financed capital projects which will commence this year, GDP growth in 2016 is projected to reach 4.2 percent.

Low energy and import prices (a key component of the CPI basket) have kept inflation low but the recent VAT increase should boost prices in the medium term. The authorities expect a deflation of 0.5 percent for 2015, and an inflation of 0.4 percent this year. The current account deficit (CAD) is expected to increase to around 9 percent of GDP in 2016, as the Brezovica resort project and new donor-financed investments will trigger an increase in imports. Nevertheless, the non-debt creating financing sources for the CAD, such as remittances, official transfers, and FDI, are stable. Over the medium term, the authorities expect that large investment projects and the implementation of structural reforms will lead to a surge in exports and an improvement in the trade and current account deficits.

Program implementation

The authorities are showing strong commitment to meet the program targets under the Fund-supported program and have achieved an over-performance on all the quantitative performance criteria (PCs). To this end, all end-August PCs and indicative targets were met with comfortable margins. The fiscal balance turnout at end-August was 2 percent of GDP higher than the PC, driven by a very strong tax performance, while the floor on the government bank balance was 1.5 percent of GDP higher than the program target. At the same time, the ceiling on current expenditures of the general government was met comfortably due to the authorities' efforts to streamline current spending and the strict monitoring of budgetary execution and employment in the public sector.

Strong ownership of the structural reforms is evident. All structural benchmarks (SBs) for the first review pertaining to the financial sector and public procurement were met. In addition, with the support of Fund staff, the Parliament adopted a public sector wage bill rule, well ahead of the original schedule (structural benchmark, March 15, 2016).

The 2016 budget, a prior action, was adopted by the Parliament in line with program targets and the objectives as defined in the Memorandum of Economic and Financial Policies. The Parliament also approved the candidates for the Privatization Agency of Kosovo (PAK) whose Board subsequently approved the transfer of privatization funds from the PAK to the government (€61.3 million or around 1.1 percent of GDP), double the amount foreseen in the program (second prior action).

Regardless of the authorities' concerted efforts, the PAK was not able to transfer 0.1 percent of GDP in tax obligations to the government due to legal constraints and challenges..

Although the PAK is an independent agency reporting to the Parliament, the government is committed to find a quick resolution to this issue so that the transfer of the tax obligations from the PAK to the Tax Administration of Kosovo takes place. .

We would like to reiterate that while the non transfer of the tax obligations is unfortunate, the authorities' genuine efforts in solving this issue and the fact that this amount, based on the preliminary data, is not expected to be needed to meet any fiscal targets (for end-December) should not obscure the otherwise strong program performance and implementation. We thank staff and management for their understanding on this issue and for subsequently moving forward with the review.

Fiscal policy

The authorities have met their fiscal objectives for 2015 and the fiscal adjustment envisioned under the program is proceeding better than planned. The increases in excise taxes on alcohol and tobacco in April and July and the new VAT law, which came into effect in September (which also incorporates a rate increase from 16 percent to 18 percent), coupled with other measures adopted in the context of the 2015 supplementary budget, have delivered revenues in line with the authorities' projections. Based on the preliminary data (final data for program purposes will be available at the beginning of February), at the end of December, tax revenues were over 9 percent higher compared to the same period of last year. At the same time, the authorities have mobilized non-tax revenues. The sale of new telecommunication licenses has been finalized and generated 0.3 percent in revenue proceeds while the PAK Board has transferred to the government 1.1 percent of GDP in privatization funds. Additionally, in light of the strict monitoring of execution, great progress has been achieved in rationalizing current spending which we expect to be lower at end-December relative to the revised mid-year budget review and staff report..

Against the backdrop of a strong-fiscal consolidation path, underpinned by measures on both the revenue and expenditure side, fiscal adjustment for 2015 should turn out better than programmed. Based on the preliminary data, the 2015 year-end fiscal deficit was below 2 percent of GDP, much lower than the 2.4 percent of GDP target at the time of program approval, and in line with the fiscal rule in place. Importantly, the fiscal buffers have also improved considerably and the government bank balances at the central bank, based on preliminary data, are expected to have reached over 3.5 percent of GDP by the end of 2015 (from 1.8 percent of GDP level in July), even without the IMF disbursement which was planned for end-December. The authorities are fully committed to attain the 1.6 percent of GDP deficit target in 2016. The 2016 budget, which is a prior action for the completion of the first review, was approved on December 21, entails fiscal consolidation measures in the amount of 0.5 percent of GDP, in addition to keeping public sector wages constant in nominal terms. In this context, the excise tax on tobacco has been increased while cuts in current spending and savings in pension schemes have been approved and legislated..

With the aim of tackling unproductive current spending, improving the budget structure, containing increases in the wage bill, and creating more space for growth-enhancing capital expenditures, the Parliament has approved a public wage rule (a structural benchmark for the second review) which will guide the wage-setting process and link wage growth in the public sector to the overall productivity dynamics. The wage rule, which was developed in coordination with staff, will come into effect in 2018 and will cap increases in the overall wage bill (of both central and local governments) at nominal GDP growth with no exceptions. The rule-setting mechanism will improve competitiveness and ensure that Kosovo's wage bill to GDP ratio stays at reasonable levels.

In line with the program objectives and with the aim of providing financing for growth-enhancing capital projects, the authorities have modified the investment clause of the fiscal rule which allows for new donor financed capital projects, in addition to privatization-financed projects, 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 low level of public debt and high infrastructure needs, the new donor-financed projects, expected to be worth about 1 to 2 percent of GDP each year, will go towards high growth dividend projects in sectors such as infrastructure, agriculture and irrigation, information technology, and education.

The authorities have recently created the National Investment Committee in charge of preparing and prioritizing infrastructure projects and seeking financing from multilateral and bilateral institutions. At the same time, they remain committed to improving the quality of investment and ensuring that only projects with the highest economic and social benefits are implemented. In this context, Fund technical assistance has been requested on conducting a comprehensive assessment of Kosovo's public investment management institutions and practices.

Financial sector

Banks in Kosovo are well capitalized, liquid, and profitable. The system's capital adequacy ratio stands at 18.6 percent (end of October), among the highest in the region, while non-performing loans (NPLs) have been declining and are now at 6.8 percent (the lowest level since 2011), and are fully provisioned. Profitability is also very strong, with return on equity at 25.7 percent. The weighted interest rate on loans has dropped by around 50 percent in the last three years to 8.2 percent. Consequently, the interest rate spread has declined by 2 percentage points y/y to 7.3 percent.

Enhancing the financial safety net, further strengthening the banking system supervision and increasing access to finance remain at the core of financial sector policies. In this vein, the Central Bank of the Republic of Kosovo (CBK) has adopted a new regulation on emergency liquidity assistance (ELA). The new regulation on ELA (structural benchmark), which is the product of a fruitful collaboration with staff, is in line with international standards and governs the conditions, processes, and modalities of any emergency liquidity assistance provided to banks. The ELA regulation will not only bolster Kosovo's financial safety net but will also safeguard CBK resources.

At the same time, the CBK has made considerable progress towards a full rollout of risk-based supervision. The risk-based supervision manual for banks has been completed and approved by the CBK while the on-site examination of one bank has been finalized (structural benchmark). The CBK will fully adopt the risk-based supervision for all banks by mid-March.

While credit to households and nonfinancial corporations surged by 8.2 percent y/y at the end of October and interest rate spreads have decreased, the authorities acknowledge that credit penetration in the country remains at only around 35 percent of GDP and more efforts are required to leverage the high liquidity in the banking sector. Lengthy court proceedings, weak enforcement of contracts, and high collateral requirements are some of the binding constraints. The authorities appreciate the analysis of the recent Fund TA mission in Pristina which has identified the obstacles to more effective enforcement of civil and commercial courts claims. Going forward, the authorities' focus will be on improving the performance of the enforcement system, addressing the existing gaps in the Law on Enforcement Procedures, strengthening the private bailiffs system, and in promoting residential mortgage lending by banks.

The Kosovo authorities remain committed to working with staff to further develop the macroprudential policy framework, especially by supporting the CBK's Macroprudential Advisory Committee to enhance the policy toolkit available, and further strengthen the contingency planning and crisis management capacities.

We are glad to note that the recent Fund mission on safeguards assessment finds that the CBK has in place an effective system of controls and its vault operations are appropriate. The report also acknowledges that the CBK has implemented almost all the recommendations from the 2012 assessment. The CBK is working with staff to enhance the CBK's risk management system.

Structural Reforms

The implementation of the structural reform agenda is off to a very good start. The centralized procurement process has been launched with the issuing of centralized bids for three common goods (fuel, air plane tickets, and office supplies). Two other centralized tender bids (wood and coal) have been awarded and two others on heavy fuel and tires have been launched. The new law on procurement has been adopted by Parliament, and the government will soon issue a decree making e-procurement mandatory for all central level agencies. In this context, a pilot project covering six agencies has been launched this month. All in all, these measures should enhance the oversight and control of the public procurement process, improve governance, ensure a level-playing field, and generate efficiency gains.

On the energy sector, the authorities are continuing with their efforts to address the long-standing issues such as consistent energy shortages, which are a byproduct of the existing old and unreliable power plants, and low production capacity. In collaboration with the World Bank, the tendering process for building a new thermo-power plant (500MW) is under way and an international consortium has been selected as a preferred bidder. The authorities expect the tendering process to be successfully completed by mid-this year and the construction to commence by the end of 2016. The construction of the new power plant, which will comply with the EU's Industrial Emissions Directive, could potentially create up to 10,000 temporary jobs during the construction phase and 500 permanent positions once the power plant begins operations.

Kosovo's business environment rates relatively well in the regional context and the recently published World Bank's Doing Business Report ranks Kosovo 66th. While improvements have been made in facilitating starting a business and dealing with construction permits, the authorities acknowledge that further reforms are required in tackling the constraints in getting electricity, enforcing contracts, and resolving insolvency to attract FDI and boost investment.