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July 27, 2015

**Statement by Mr. Haarsager and Mr. Weller on Republic of Kosovo
(Preliminary)
Executive Board Meeting
July 29, 2015**

We support the proposed SBA and its focus on reversing the deterioration in Kosovo's fiscal accounts and making the composition of spending more conducive to balanced growth. A reduction of wage costs, in conjunction with efforts to address business climate impediments, will also be needed to improve Kosovo's competitiveness and transition the economy away from excessive reliance on the non-tradable sector as an engine of growth.

The reductions in the wage bill and VAT reforms proposed by the staff are welcome in view of sharp increases in current spending, the large decline in revenue-to-GDP, and the inflation of public wages. We are especially pleased, as noted by Messrs Canakci and Mehmedi, that public sector wages will be held constant in nominal terms through end-2016, and shrink as a percentage of GDP. We note, however, that the VAT increase includes a number of exemptions that could undermine the revenue potential of this initiative. *Can the staff elaborate on the nature of the exemptions and the resulting foregone revenue? In light of the recent increase in subsidy spending, we would also appreciate the staff's view of the scope for reducing this expenditure item.* We do not object to the front-loaded trajectory of consolidation, the absence of which would lead to a large breach in the fiscal rule, but note that despite a fiscal consolidation of 1.5 percent/GDP in 2015, staff forecasts a 0.5 percentage point increase in GDP growth. *Are fiscal multipliers fairly low in Kosovo?*

The decrease in current expenditure should allow a needed replenishment of the government's depleted bank balance and reorientation of spending to capital investment. We are receptive to the proposed relaxation of the fiscal rule to permit an increase in donor-financed infrastructure spending above the deficit ceiling. Greater external borrowing should be matched, however, by continued improvements in the capacity of the government to evaluate the economic and social returns of investment projects. We appreciate the various safeguards proposed by the staff to ensure good use of fiscal space and preserve debt sustainability.

Remittances have helped to support growth and offset a large trade deficit, but they have also driven reservation wages to uncompetitive levels, undermining private sector job creation. The staff's rules-based wage setting mechanism will help to prevent large discretionary public wage increases. However, the mechanism must be structured in a way that avoids excessive upward wage rigidity that could pose a fiscal burden and further damage competitiveness. We note, in addition, that even if the authorities succeed in restraining public wage growth, strong remittance inflows will continue to put upward pressure on overall reservation wages. *Are there other policy measures that could reduce reservation wage levels?* We strongly support the staff's proposed procurement reforms, which should help to reduce corruption and improve the business environment.

We welcome steps taken by the authorities to improve risk-based financial supervision, and encourage them to address the structural barriers that impede private sector lending. In light of Kosovo's euroized economy and the central bank's inability to print money, it is important for the authorities to have ample reserves to provide emergency liquidity assistance (ELA) to financial institutions, if needed. In this respect, we are pleased that the central bank has committed to adopt a new ELA framework consistent with international standards. *How will ELA reserves be sourced/financed?*