KOSOVO

Highlights

- **Growth picked up in 2015.** Macroeconomic policy has been anchored by an IMF standby arrangement which has contributed to ongoing fiscal prudence and progress in structural reforms.
- **A Stabilisation and Association Agreement (SAA) between Kosovo and the European Union is in force.** The SAA entered into force on 1 April 2016. As the first contractual relationship between Kosovo and the European Union, the agreement is a milestone in Kosovo's EU approximation path.
- **A national development strategy is in place.** The strategy covers the years 2016-2021 and focuses on addressing the main obstacles to economic development and In addition, a single project pipeline of infrastructure projects has also been adopted.

Key priorities for 2017

- **The privatisation process needs to be kick-started.** Very little progress has occurred in recent years. The government should make a determined effort to bring some assets to sale in 2017 in order to demonstrate that Kosovo is open for investment.
- **The widening energy supply gap needs to be closed.** In addition to creating new generation capacity, energy efficiency and renewable energy measures can help mitigate current and projected power shortfalls, while enhancing environmental sustainability. This will require strengthening the existing regulatory frameworks and institutional capacity, and harmonising with EU legislation.
- **Investment climate obstacles should be tackled.** Kosovo continues to perform poorly on cross-country business environment rankings in areas such as resolving insolvency, obtaining construction permits and export licences. Concrete improvements in this area could bring major benefits to local businesses and could boost foreign direct investment (FDI).

Main macroeconomic indicators %

	2012	2013	2014	2015	2016 proj.
GDP growth	2.8	3.4	1.2	4.0	3.5
Inflation (average)	2.5	1.8	0.4	-0.5	0.2
Government balance/GDP	-2.6	-3.1	-2.6	-1.9	-2.0
Current account balance/GDP	-7.5	-6.4	-7.9	-8.7	-9.6
Net FDI/GDP [neg. sign = inflows]	-4.2	-4.5	-2.2	-4.9	-5.1
External debt/GDP	30.0	30.2	31.2	33.8	n.a.
Gross reserves/GDP*	n.a.	n.a.	n.a.	n.a.	n.a.
Credit to private sector/GDP	33.9	33.0	33.6	34.7	n.a.

*Kosovo uses the euro as its legal tender.

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Macroeconomic performance

The economy is recovering from a slow-down. Economic growth in 2015 is estimated at 4 per cent, boosted by strong domestic demand, with private consumption contributing half and gross capital formation the other half. Private investment was supported by an increase in FDI (at around 5 per cent of GDP, this was the highest level in the last four years), while a significant share of public investment was directed at the 65 km section of the highway connecting Pristina to the Macedonian border. Government consumption was slightly smaller than in the previous year as the country started implementing cost savings under the International Monetary Fund (IMF) programme. The recovery comes after economic growth had slowed markedly in 2014, to a mere 1.2 per cent. Private consumption was the major positive contributor to growth, but it is dependent on remittances, and the country has an unemployment rate of just below 33 per cent. Growth in the first half of 2016 was 3.5 per cent year-on-year, with similar growth drivers as in 2015.

The IMF programme is broadly on track but the second review is delayed. A 22-month, €185 million stand-by arrangement (SBA) was approved in July 2015. The programme has three broad objectives: (i) to preserve low public deficits and debt by containing current spending, while creating fiscal space for growth-enhancing capital spending; (ii) to remove key structural impediments to growth, including creating a more conducive environment for private activity and investment, upgrading Kosovo's infrastructure and strengthening bank intermediation; and (iii) to mobilise support from other multilateral and bilateral creditors. In January 2016 the IMF's Executive Board completed its first review under the programme, enabling the disbursement of about €35.6 million, which brought total disbursements under the SBA to about €71.2 million. Although several IMF missions have visited Kosovo to conduct the second review, as of October 2016 this had not been completed as the authorities needed additional time to identify measures to bring war veteran benefit spending to sustainable levels (see below).

Public debt levels are low by regional standards. At the end of June 2016 Kosovo's public debt (not including bilateral debt from the former Yugoslavia) was €822 million, or 13.8 per cent of GDP. Almost half of this debt is internationally owned, mostly by international financial institutions. It is possible that some extra fiscal space would be needed for the planned new Kosovo thermal power project (Kosovo C), expected to cost over €1 billion (more than 20 per cent of the country's GDP), depending on whether private sources of finance are sufficient to cover 100 per cent of the cost. The existing thermal power plants, Kosovo A and Kosovo B, are major sources of pollution, but it remains unclear if either or both will be upgraded or decommissioned.

Growth is expected to remain stable in the coming years, as necessary reforms advance. This growth, of about 3.5 per cent in 2017, is expected to be supported by remittance inflows, which should continue supporting private consumption, and critical investment in transport and energy infrastructure. In the medium term, Kosovo, as the poorest country in the Western Balkans region, also possesses the greatest catch-up potential. However, downside risks are substantial due to a range of internal problems, such as political instability, weak institutional capacity and high levels of informality and corruption. A key challenge for Kosovo will be to raise the productive and export capacity of its economy. This will require addressing the high level of structural unemployment and related skills mismatches, ensuring energy security and improving the business environment.

Major structural reform developments

A Stabilisation and Association Agreement (SAA) between Kosovo and the European Union is in place. The SAA entered into force on 1 April 2016. As the first contractual relationship between Kosovo and the European Union, the agreement is a milestone in Kosovo's EU approximation path. It serves as a framework for cooperation and political dialogue between Kosovo and the European Union, formalising the country's preferential access to EU markets in exchange for commitments on required reforms in a number of areas. During the first meeting of the EU-Kosovo SAA parliamentary committee, the first institutional body established under the treaty, the European Union stressed the need for reforms in areas such as the rule of law (the independence of the judiciary, political interference in the judicial process, and the fight against organised crime and corruption), economic governance and public administration.

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Further steps have been taken to improve the business environment. In January 2016 the government adopted its first national development strategy, covering the years 2016-2021. The strategy focuses on addressing the main obstacles to economic development and competitiveness. Current initiatives in this regard include: a new law on strategic investments with the aim of attracting more foreign investors in the country; the establishment of a centralised public procurement system which will generate savings and lead to a more transparent and level playing field; the phased introduction of e-procurement; help for local companies to certify their products so that they can export to the European Union; and the launch of a credit guarantee fund to support lending to companies by reducing the collateral demanded by commercial banks. The country's ranking on the World Bank's *Doing Business 2017* report has improved by four places to 60th position out of 190 economies, mainly due to improvements in the areas of paying taxes, starting a business and trading across borders. However, the rule of law and its implementation remain weak in many areas and the level of corruption is perceived to be high.

Progress on privatisation remains negligible. The privatisation agency, PAK, has been without a board of directors for months, and the whole privatisation process in the country has been at a standstill for some time. However, in December 2015 the government amended the law on privatisation agency to regulate the appointment of the board of directors and decision-making procedures. Several flagship projects have failed to advance. The government is attempting to formulate a strategy for reorganising the Trepca mining complex (the law which makes the government the major owner of Trepca was passed in October 2016), but any future sale is complicated by substantial creditor claims from Serbia. Also, a tender for a 99-year land lease for the flagship Brezovica ski centre project failed in June 2016, when it was announced that the winner of the tender, a French consortium led by MDP Consulting, was unable to provide the necessary financing. The project is also being contested by the Serbian authorities, who claim ownership over Brezovica's property.

Kosovo has adopted the European Union's Third Energy Package. In July 2016 the Energy Community secretariat closed its case against Kosovo, following the country's adoption of national laws transposing the Third Energy Package. The package comprises two directives and two regulations that concern common rules for the internal markets in electricity and natural gas, as well as the conditions for access to the network for cross-border exchanges in electricity, and the conditions for access to the natural gas transmission networks. Electricity supply remains a major problem for companies in Kosovo, weighing especially heavily on the industrial sector. Major challenges include modernising the transmission grid and reducing non-technical losses in distribution. The construction of the 400kV interconnection line between Albania and Kosovo, completed in June 2016, will enable Kosovo to exchange electricity with Albania to maximise the use of Albania's hydropower plants in winter and Kosovo's coal-fired plants in drier weather.

The banking sector remains stable. Banks are well capitalised, with the overall capital adequacy ratio at 18.1 per cent as of August 2016 (regulatory capital to risk-weighted assets). Non-performing loans (NPLs – which, according to Kosovo's central bank, do not include sub-standard loans) dropped to 5.1 per cent as of August 2016 from 8.3 per cent at the end of 2014, and are the lowest in the region. NPLs are also well provisioned at more than 100 per cent. Lending remains constrained, mainly because of the general weak economic environment, high levels of informality and lack of institutional capacity, but credit to the economy has picked up recently. Under the IMF programme, the authorities have taken key steps to make Kosovo's financial safety net stronger and its banks safer, by, among other things, adopting an emergency liquidity assistance framework, progressing towards risk-based supervision for all banks, and establishing a new macro-prudential policy framework.

Pension spending has been increased, raising concerns about sustainability. Among other measures, a new war veteran pension scheme was introduced in 2016. Although the numbers eligible for the scheme were expected to be around 12,000, the actual numbers receiving this pension exceed 28,000. This has raised significant doubts about the sustainability of the scheme.