Statement by Mr. Palotai on Republic of Kosovo
January 25, 2023

On behalf of the Kosovar authorities, we would like to thank the Mission Chief for Kosovo, Mr. Gabriel Di Bella and his team for very constructive and productive discussions and express our appreciation for preparing the comprehensive report and useful Selected Issues Paper.

Despite a challenging environment, economic fundamentals remain strong

The Kosovar economy recorded a very strong recovery from the pandemic in 2021 and the trend continued in the first quarter of 2022. However, Russia's invasion of Ukraine and the consequential increase in global food and energy prices, led to a high inflation, weighing on household incomes, causing diaspora remittances to decline in real terms, and disrupting the implementation of investment projects. Nonetheless, economic fundamentals remain strong, with the financial sector continuing to be resilient, and the fiscal position improving on account of disciplined and sound fiscal management. Furthermore, the authorities are progressing with designing and implementing important structural reforms.

The authorities' most recent estimates for 2022 suggest real GDP growth at around 4.1 percent (staff estimates GDP growth of 2-3 percent). While real growth was lower than in 2021, it is encouraging that the overall positive dynamics in economic activity continued, with significant increases in exports of goods (doubled to 11 percent of GDP in four years) and services (31 percent of GDP), as well as foreign direct investments among others.

At the same time, imports of goods and services are increasing as well, thus contributing to a relatively high negative balance in trade and services, which is somewhat mitigated by primary and secondary income, including remittances.

Medium-Term Outlook

With respect to the outlook, the authorities project an average growth rate of around 6 percent for the next three years (compared to staff projections of around 4 percent, in line with Kosovo's potential), mainly driven by a considerable increase in private and public investments, exports, and to a moderate extent by household consumption. Given the expectations for continued increase in the export of goods and services and a slower pace in the growth of imports, the authorities project a gradual improvement in the balance of trade and service.

The outlook, however, is exposed to internal and external downside risks. The drop in domestic energy production due to outdated capacities, fiscal risks from publicly owned enterprises, further increases in energy prices in Europe, and a slowdown in economic activity in countries where the Kosovo diaspora resides, are only some of the downside risks for the medium term. **In view of these uncertainties, the authorities have expressed interest in a precautionary Stand-By Arrangement which would help entrench Kosovo's good fiscal and financial position.**

Strong revenue performance and prudent fiscal management helped improve the overall fiscal position

On the fiscal front, the authorities continued their fiscal consolidation path they started in 2021. ***First***, **the primary budget balance declined** from -7.7 percent and around -1 percent of GDP in 2020 and 2021 respectively to -0.5 percent in 2022. The overall budget balance that is calculated based on the legally binding fiscal rule, will very likely be positive in 2022, for the first time since the introduction of the deficit rule in 2014[1]. ***Second*, fiscal reserves stood at or above adequate levels** (gross reserves were approximately 5.5 percent of GDP at the end of 2022), which is crucial given the absence of monetary policy (due to euroization). **Third, the stock of public debt declined** for the second year in a row, standing at around 19 percent of GDP.

On revenues, both tax and non-tax revenues recorded solid growth. While tax revenues increased by around 13 percent, it is encouraging that direct taxes continue to perform better, with an annual growth rate of 22 percent. Within direct taxes, corporate tax revenues increased the most (around 40 percent). Indirect taxes increased by around 12.7 percent, with excise revenues displaying a more modest increase due to higher prices and the impact on the quantity of imports. While indirect taxes are highly dependent on imports (except for the domestic portion of VAT), domestic tax collection during 2022 reflects a relatively good internal economic activity as well as an improved tax collection performance, including by reducing the informal economy.

On budget spending, recurring expenditures increased by around 13 percent, mainly on the back of subsidies and transfers towards the most vulnerable population to cope with inflation. Despite the increase in prices, wages and salaries have not increased to date, given that the Government was in the process of approving the law on salaries for employees in the public sector. This law attempts to create a uniform system of salaries in the public sector as well as to create a transparent and manageable system of salaries and bonuses where the main element is the basic salary. The law, which sets the coefficients for all positions in the public sector, was approved by the Assembly in December of 2022 and now the Government is working to complete the secondary legislation that will enable the implementation for this new law. While the exact cost of implementation is not known yet, given that the value of the coefficient has not been set yet, the approved wage bill with the budget for 2023 is higher than the actual spending for this category in 2022 by around 13 percent. Also, due to inflation, the execution of capital projects was lower than initially budgeted. Many of the projects were contracted before inflation, and once inflation hit, economic operators were not able to comply within the contracted budget. To address this legal gap, the Government prepared, and the Assembly approved in November, a specific law that attempts to address this issue, which eventually contributed to improved capex execution during the remaining period of the year. In addition to this law, the Government is also looking to address other issues that will make the execution of public investments more efficient.

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[1] The deficit rule limits the overall fiscal deficit at 2 percent of GDP. As per this rule, investments financed with privatization receipts and donor financing contracted after 2015, are excluded from the deficit calculation.

Strong capital and liquidity buffers and good asset quality enabled a good performance of the financial sector

Active regulatory and supervisory activities conducted by the Central Bank of Kosovo, contributed to good results achieved by the financial sector, and in particular by the banking industry. Overall (based on preliminary November data), the banking sector grew in assets by 12 percent, outstanding loans by 16.5 percent, and deposits by 13.5 percent. Interest rates on loans (the average for the year) remained at the 2021 level of 5.99 percent, whereas deposit rates increased from 1.33 in 2021 to 1.60 percent in 2022. This increase in deposit rates may reflect a slight increase in competition for attracting more funds, given the actual increase in credit activity, and expected future demand. It should be noted that financing of the banking sector assets continues to be dominated by deposits and owners' capital (together about 90 percent of liabilities & equity) whereas borrowing from external markets is still insignificant. This is partially because: 1) the access to foreign markets is still limited, and 2) the cost of external sources is significantly higher than the cost of deposits.

The Central Bank's ability to provide liquidity has improved, and asset quality continues to be healthy, with non-performing loans standing at 2 percent, and the ratio of provisions for loan-losses at around 150 percent. The sector continues to be well-capitalized, with regulatory capital over risk-weighted assets being at around 16 percent (vs. 12 percent requirement). Also, liquidity and profitability indicators point to a positive outcome for the banking industry in 2022.
Looking forward, the Central Bank is committed to implement the FSSR recommendations and further strengthen the financial sector's regulatory and governance frameworks.

The authorities remain committed to design and implement structural reforms that are pivotal for future growth, employment, and social justice. The focus areas will be energy, formalization of economic activity, consolidation and targeting of social schemes, implementation of the law on public sector wages, improving the quality and execution of public sector investment projects, etc.

Reducing informality in the economy is high on the authorities' agenda, including through the introduction of additional e-services for taxpayers, enhancing transparency on tax collection and budget execution and ensuring a structured dialogue with businesses on both tax policy design and tax administration issues. On capital projects, based on the already identified issues and taking into account the recently approved law that provides guidance and offers solutions to issues caused by inflation, the Government expects a more efficient execution during 2023. Also, progress is expected to be made with secondary legislation to implement the law on salaries for public sector employees.

The Government has prepared and approved a comprehensive energy sector strategy, and once approved by the Assembly, efforts will shift to implementation. **In this context, the authorities have expressed their interest in an arrangement under the IMF's Resilience and Sustainability Facility.**