



KOSOVO

Highlights

- **EU-11 approximation has advanced.** In April 2015 the European Commission adopted the Stabilisation and Association Agreement (SAA) for Kosovo. This is the first comprehensive contractual relationship between the EU and Kosovo and represents an important milestone for the country.
- **A new IMF programme is in place.** The new Stand-by Arrangement, approved in July 2015, targets macroeconomic stability and the removal of key obstacles to investment and growth.
- **Progress on privatisation has stalled.** The failure of a flagship privatisation of the Post and Telecom of Kosovo in 2014 was a significant setback, and other sales of state-owned assets are also lagging behind.

Key priorities for 2016

- **Energy sector reforms are the top priority.** With a high frequency of power outages and the poor condition of existing plants, it is imperative that progress is made this year towards a comprehensive solution to Kosovo's long-term energy needs.
- **The privatisation process needs a boost.** Given the complete lack of progress in 2014 it is important that the authorities make new efforts to bring some sales to completion and attract fresh investment to the country.
- **Macroeconomic stability should be preserved.** Kosovo's adherence to prudent and conservative fiscal targets under the previous IMF programme has played an important role in stabilising the economy, and it will be important to stick to agreed targets under the new IMF programme.

Main macroeconomic indicators %

	2011	2012	2013	2014	2015 proj.
GDP growth	4.4	2.8	3.4	0.9	2.0
Inflation (average)	7.3	2.5	1.8	0.4	-0.5
Government balance/GDP	-1.1	-1.2	-2.5	-3.0	-2.6
Current account balance/GDP	-13.7	-7.5	-6.4	-8.2	-8.0
Net FDI/GDP [neg. sign = inflows]	-7.9	-4.2	-4.5	-2.3	-4.2
External debt/GDP	29.7	30.0	30.2	32.2	n.a.
Gross reserves/GDP	n.a.	n.a.	n.a.	n.a.	n.a.
Credit to private sector/GDP	36.4	35.9	34.9	n.a.	n.a.

Macroeconomic performance

Economic growth slowed markedly in 2014. Kosovo's economy was more resilient than its neighbours throughout the global and eurozone crises, growing by 3.5 per cent annually on average. However, there was a marked slow-down in economic growth in 2014 to just 1 per cent, representing the weakest year of growth relative to previous years. An explosion at the country's largest (thermal) power producer in June 2014 temporarily halted electricity output as well as the output of the sector's main supplier, the mining industry. The six-month political stalemate after the June general elections negatively affected economic sentiment last year, deferring private investment. Exports of goods, primarily scrap metal to China, rose sharply in the middle of 2014, but the effect was balanced by a similar increase in imports because of the disruption to the electricity supply. A further sharp increase in exports of metals was recorded in the first two months of 2015.

Kosovo has a new IMF programme. A new 22-month €185 million Stand-by Arrangement (SBA) was approved in July 2015. The programme has three broad objectives: (i) preserving low public deficits and debt by containing current spending, while creating fiscal space for growth-enhancing capital spending; (ii) removing key structural impediments to growth, including the creation of a more conducive environment for private activity and investment, and the upgrade of Kosovo's infrastructure and the strengthening of bank intermediation; and (iii) catalysing support from other multilateral and bilateral creditors. In order to lock in the adjustments achieved under the previous IMF programme, from 2014 fiscal policy has been anchored by a fiscal rule that sets a ceiling of 2 per cent of GDP on the general government deficit (with very limited exceptions allowed) and a cap of 40 per cent of GDP on public debt.

Growth is expected to pick up in 2015. After the slow-down in 2014, economic activity is forecast to speed up in 2015, as the political uncertainty that dominated most of last year has been resolved and the new government is in place, supported by remittance inflows and a pick-up in external demand. Kosovo is the poorest country in the region, and hence it possesses the greatest catch-up potential in the medium term. However, downside risks are substantial due to a range of internal problems, namely: weak institutional capacity, high levels of informality and limited investment appetite. A key challenge for Kosovo will be to raise the productive and export capacity of its economy. This will require addressing the problems of structural unemployment and related skills mismatches; ensuring energy security; and improving the business environment.

Major structural reform developments

EU approximation has advanced. In April 2015, the European Commission adopted the SAA for Kosovo. The agreement will enter into force once it is ratified by the European Council and the European Parliament. Once in force, the SAA will be the first comprehensive contractual relationship between the EU and Kosovo. The agreement provides an EU integration process framework for a potential candidate country. Kosovo and the EU initialled an SAA in July 2014. Kosovo has been allocated up to €645.5 million under the EU's new Instrument for Pre-Accession Assistance (IPA II) for 2014-2020. The assistance will support reforms in preparation for EU membership, socio-economic and regional development, social policies and rural development.

Further efforts have been made to improve the business environment. The government has taken steps to improve procurement policies by centralising and streamlining the process. In the first half of 2015, the government approved a list of six categories of goods and services that henceforth are subject to centralised procurement for central administrations, and has committed to further reforms within the context of the new IMF programme. Elsewhere, Kosovo's ranking on the World Bank's *Doing Business 2016* report has remained steady with respect to the previous year. The country is ranked 66th out of 189 economies.

Privatisation has made little progress in the past year. Investor appetite remains very limited and there were virtually no revenues from privatisation in 2014. In April 2015 the government decided to further postpone any efforts to sell the telecommunications company PTK, after a failed attempt more than a year previously. The future of the Trepca mining complex also remains unclear because of complications over the ownership structure and potential creditor claims from Serbia. The Supreme Court of Kosovo has set 1 November 2016 as a deadline for submission of the reorganisation plan for the complex.

The energy sector is a key weakness and needs substantial investment. Major challenges in the energy sector include: reducing the carbon intensity of generation, modernisation of the transmission grid and reducing non-technical losses in the distribution. The construction of the 400kV interconnection line between Albania and Kosovo, planned for completion by spring 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. In addition, Kosovo and Albania have announced the start of work on the establishment of a common energy market for the two countries. The first meeting of the relevant steering committee has already taken place, and committee members agreed to set up three working groups to handle legal and regulatory, technical and financial aspects of the market.

Plans for construction of a new power plant have advanced. The government is negotiating with the US company, ContourGlobal, for the construction of two 300 MW power plants Kosova e Re. ContourGlobal submitted its bid in January 2015. If negotiations succeed, the aim is to have the plant operational by 2020. 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.

The banking sector remains profitable. Banking sector profit more than doubled in 2014 on the back of falling interest costs and lower loan loss provisions. Banks are also well capitalised, with the overall capital adequacy ratio at 17.4 per cent in 2014 (regulatory capital to risk-weighted assets). Non-performing loans (NPLs, which, according to Kosovo's central bank, do not include sub-standard loans) are stable and fell slightly to 7.2 per cent of total loans as of June 2015, the lowest in the south-eastern Europe region. NPLs are also well provisioned at more than 100 per cent. But lending remains constrained, mainly because of the general weak economic environment, high levels of informality and the lack of institutional incapacity. The banking sector is largely foreign-owned, with parent banks coming primarily from eurozone countries.