KOSOVO

Highlights

- **Relatively strong growth continues.** Gross domestic product (GDP) grew by 3.8 per cent in 2018 and 4.2 per cent year-on-year in the first half of 2019, driven by robust domestic demand.
- **Inflation has accelerated.** Average inflation has increased from below 1.0 per cent in the period of January to October 2018 to above 3.0 per cent thereafter, driven primarily by rising food prices.
- **The country has stepped up the fight against informality.** In May 2019, Kosovo adopted a revised strategy and action plan for fighting informality for the period 2019 to 2023.

Key priorities for 2020

- **Business climate reforms are needed to accelerate the growth of the private sector.** The Kosovo authorities should step up the fight against informality and tax evasion, as well as facilitate access to finance for small and medium-sized enterprises (SMEs) by addressing the underlying legal and institutional constraints that discourage formal activities. The competitiveness of SMEs should be supported as well since businesses often lack skills and expertise.
- **Problems in state-owned enterprises (SOEs) should be addressed.** Financial oversight, corporate governance, accountability and efficiency of SOEs are areas that need improvement. In addition, the privatisation of non-strategic SOEs should be stepped up.
- **Diversification away from coal is warranted.** The country should urgently take measures to decrease its (almost exclusive) reliance on lignite as a source of electricity and increase the share of renewables in power generation. Also, a broader green agenda is needed, including steps to improve energy efficiency at the residential, private sector and municipal level, and the construction of new wastewater treatment plants.

Main macroeconomic indicators %

	2015	2016	2017	2018	2019 proj.
GDP growth	4.1	4.1	4.2	3.8	4.0
Inflation (average)	-0.5	0.3	1.5	1.1	3.0
Government balance/GDP	-1.9	-1.5	-1.4	-2.9	-3.5
Current account balance/GDP	-8.6	-7.9	-6.0	-8.0	-7.5
Net FDI/GDP [neg. sign = inflows]	-4.7	-2.9	-3.3	-2.5	-3.0
External debt/GDP	33.3	33.2	33.2	30.3	n.a.
Gross reserves/GDP	12.2	10.0	10.7	11.4	n.a.
Credit to private sector/GDP	34.5	36.5	38.6	40.8	n.a.

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Macroeconomic performance

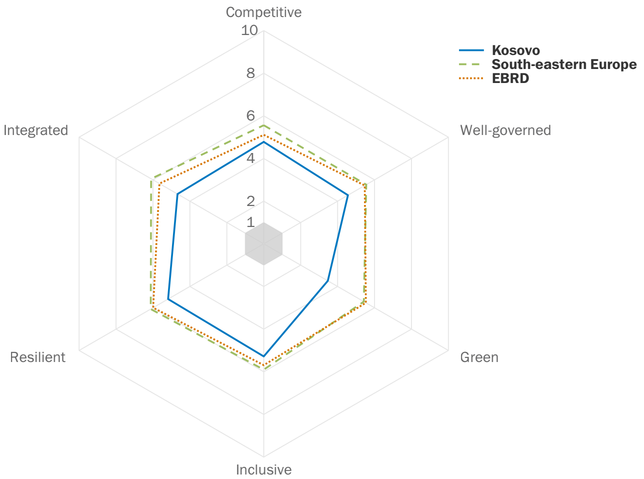
Relatively strong economic growth has continued for the fifth year in a row. After 4.2 per cent growth in 2017, GDP grew by 3.8 per cent in 2018, driven by investment and consumption. However, greater domestic demand contributed to an increase in imports and a widening of the current account deficit to over 8.0 per cent of GDP. Higher growth has not yet translated into more jobs, as the employment rate fell in 2018 by one percentage point, to 28.8 per cent. Similarly, the unemployment rate fell only slightly, staying close to 30.0 per cent, and at 55.4 per cent for young people. Despite high unemployment, businesses often struggle to find a skilled labour force. A salient feature of Kosovo's labour market is the very limited presence of women, with the female employment rate at only 12.3 per cent in 2018. Strong, domestic demand-driven growth continued in the first half of 2019, at 4.2 per cent year-on-year. Nevertheless, growth has been hindered by political instability and is still low for a meaningful catch-up.

Inflation has picked up. Inflation in 2018 remained subdued for the year as a whole, at around 1.0 per cent, but it has risen since the second half of the year, averaging 3.0 per cent year-on-year in the first nine months of 2019. The surge in inflation has been mainly driven by food prices (increasing on average 6.9 per cent year-on-year in the first nine months of 2019) and possibly also related to the imposition in November 2018 of 100.0 per cent taxes on goods imported from Serbia and Bosnia and Herzegovina.

Public debt remains low, but the government expenditure structure is unfavourable. While the budget deficit as defined by the fiscal rule (that is, the deficit excluding investments financed by international financial institutions, donors and privatisation proceeds) stayed well within the fiscal rule ceiling of 2.0 per cent, the overall deficit increased to 2.9 per cent of GDP in 2018 (from 1.4 per cent in 2017). Still, the public debt remains exceptionally low by regional standards. At the end of June 2019, it reached 16.5 per cent of GDP. However, transfers and subsidies have risen rapidly in recent years, accounting for a significant share of government current expenditures (around 40.0 per cent). The reform of the war veteran pension schemes, which would reduce pension costs, has still not been implemented. High social spending is not only adversely affecting the fiscal balance but is also having a negative impact on labour market participation. A government plan to build a new lignite-based power station and renovate an old one would not only conserve a highly polluting power generation structure with excessive carbon emissions, but also create additional fiscal risks, potentially leading to a breach of the fiscal rule.

Further catch-up is likely in the short term. GDP growth in 2019 and 2020 is expected to be 4.0 per cent annually, with domestic demand continuing to be the main growth driver. The risks to the projection are balanced. While upside risks relate to the possible start of the construction of a major new power plant and faster reform progress, weaknesses in public investment management, the economic slowdown in the European Union (EU), domestic political uncertainty and deteriorating relations with neighbours represent the main downside risks.

Assessment of transition qualities (1-10)



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Major structural reform developments

There has been little progress in EU approximation over the past year. Kosovo signed the Stabilisation and Association Agreement (SAA) with the EU in October 2015. It formally entered into force on 1 April 2016. While the European Commission has repeatedly stressed that Kosovo shares the European perspective of the Western Balkans, the question of its integration into the EU remains contentious due to the fact that five Member States do not recognise Kosovo bilaterally. The decision by the Kosovo government, on 20 November 2018, to impose 100 per cent tariffs on goods from Serbia has further complicated relations with the EU as it has been perceived by Brussels as a violation of the SAA and Central European Free Trade Agreement (CEFTA).

The business environment remains problematic. Widespread informality and corruption, an inefficient judiciary and weak rule of law and institutions are the key obstacles to doing business. Although business registration is simple and fast, with "one-stop shops" in place, businesses are burdened with a large number of licences and permits, cumbersome administrative procedures and frequent, uncoordinated and costly inspections. A general inspections reform is ongoing, with a plan to decrease the number of (overlapping and parallel) inspections from 36 to 15. However, the new Law on Inspections has not been adopted yet. According to the World Bank, Kosovo ranked 57th out of 190 in the *Doing Business 2020* report, dropping 13 places from the year before. Despite some improvements over the past year, the most problematic areas remain the same – dealing with construction permits (160th), protecting minority investors (128th) and getting electricity (90th).

A strategy against informality has been adopted. The informal economy, estimated by international institutions at close to one-third of GDP, is one of the main barriers for doing business in Kosovo. In May 2019, Kosovo adopted a revised strategy and action plan for fighting informality for the period 2019 to 2023. The measures include improving information exchange between relevant government institutions, reducing the cost of transactions for electronic payments in order to reduce cash payments and provision of bank loans based on financial statements submitted to the Tax Administration. The strategy also includes qualitative and quantitative indicators to enhance the monitoring process.

Public administration reform has advanced somewhat. A process of rationalisation of agencies has started, based on an action plan adopted in June 2018. In February 2019, the Law on Public Officials, defining different categories of public officials, and the Law on Salaries were adopted. The latter sets up a coherent and transparent salary system, although it risks having an adverse medium-term impact on the budget. A large increase in wages as part of the public administration reform, combined with an increase in employment, might entail a large fiscal cost and put the fiscal rule at risk. Also, political influence on senior appointments is still present and a comprehensive monitoring system of the public administration reform has not yet been established. The reform monitoring reports are neither actively discussed nor followed up at the political level. In addition, the reform relies predominantly on external donors, whose support often has not been secured, while annual budgetary expenditures are usually lower than planned. This raises concerns about the financial sustainability of the reform.

Resolution of state-owned enterprises (SOEs) is progressing slowly. According to the IMF, there are 16 non-financial central level and 44 local level publicly owned companies in the sectors of energy, telecommunications, railway and bus transport, water supply, sewerage and waste. The financial oversight, accountability and efficiency of SOEs are often inadequate. The privatisation process has lagged behind after the authorities' decision in November 2017 to freeze privatisation of socially owned land. In the second half of 2018, there were just six asset sales by the Privatization Agency from a total of 400 in the tender process. In January 2019, the government decided to re-launch the procedure for the privatisation of Kosovo Telecom (the third attempt since 2011), with the assistance of the EBRD. The company is overstaffed and has been a loss-maker since 2015. In March 2019, the socially owned Trepça mining complex, which holds Europe's largest lead-zinc and silver ore mine, was officially transformed into a joint stock company. The government has kept control of 80 per cent of the shares, while the remaining 20 per cent is owned by the employees. However, the ownership of the company has been disputed by Serbia.

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Modernisation of the country's transport infrastructure has progressed. Infrastructure development is key to the country's continued integration with the region. In May 2019, a second motorway was completed – the 60-kilometre highway linking the capital Pristina to the border with North Macedonia – but the project was criticised for its lack of transparency. In July 2019, the country started to upgrade its only operational international rail link, the 148-kilometre line connecting the Serbian border and Pristina with the capital of North Macedonia, Skopje. The project should improve the connection between Kosovo's railway network and the wider European network through European transport Corridor VIII and Corridor X.

Progress has been made to unlock investments in renewables. Kosovo is characterised by high energy intensity and over-reliance on coal, with less than 5 per cent of electricity produced from renewable sources in 2017. Following extensive policy dialogue, improvements to the power offtake structure were adopted in June 2019 and the EBRD financed the country's first major investment in wind power later that month. In line with the country's obligations as a member of the Energy Community, the next step is to establish an open and transparent auction system for further renewable energy projects. Limited progress has also been made to improve energy efficiency in the residential, public and private sectors, and adjustment of energy tariffs and incentives are required.