Financial Sector Benchmarking System

Kosovo High Level Financial Sector Overview

October 2012

About the Financial Sector Benchmarking System (FSBS)

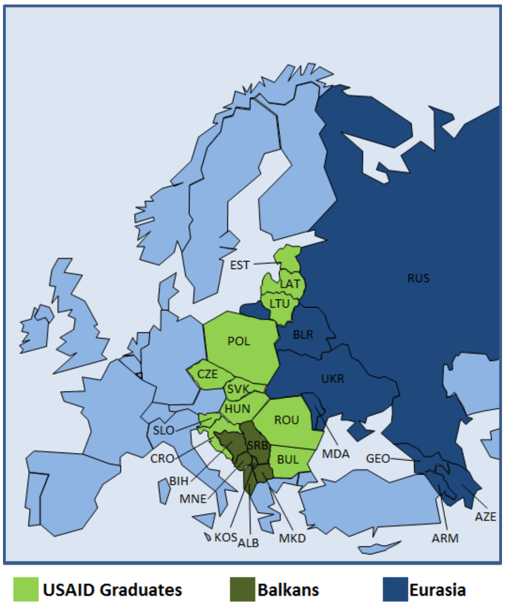
This High Level Financial Sector Overview is part of a series of benchmarking reports about financial sector challenges and USAID programming needs in the twelve countries in Southeast Europe and Eurasia that are beneficiaries of USAID's Partners for Financial Stability ("PFS") program. Interested persons can access this report, other financial sector benchmarking reports, a benchmarking methodology paper, and an interactive tool for generating customized reports from the benchmarking database at http://www.pfsprogram.org/fsbs-database

In this report, the subject country's financial sector is compared and contrasted against other emerging European countries in USAID's Europe and Eurasia (E&E) region and against a 'global benchmark' which is taken from one of these sources depending upon data availability and other considerations: the Eurozone countries' average; Korea (as a proxy for advanced developing countries); or a best-practices standard selected by PFS.

This report uses spider charts to very broadly summarize profiles. FSBS methodology is broadly consistent with the general scoring or ranking system utilized in USAID's Monitoring Country Progress reports based on a scale of "0" (worst) to "5" (best).

All of the data referenced in this document were obtained from public sources and the opinions expressed herein are based upon analysis by PFS.

Country groupings used in this report:

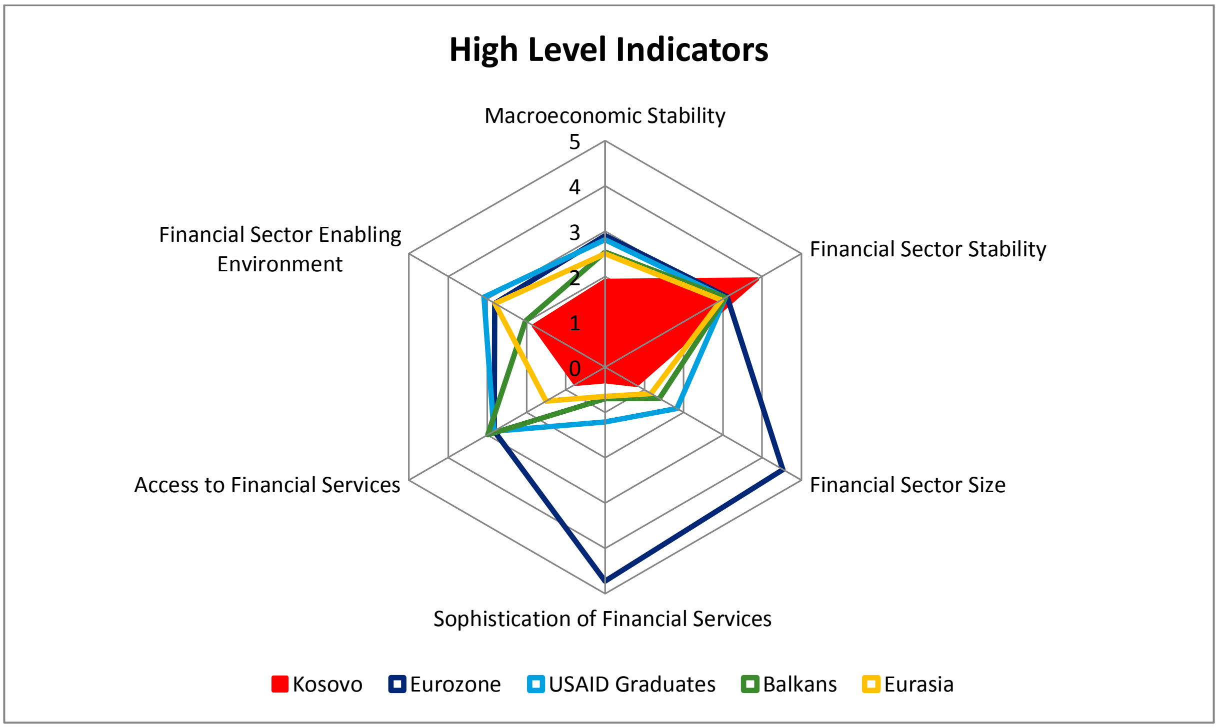


About PFS

The United States Agency for International Development Partners for Financial Stability Program is led by the Office of Economic Growth in the Europe and Eurasia Bureau. The project addresses the challenges facing the financial sector in 12 Partner Countries: Albania, Bosnia and Herzegovina, Kosovo, Macedonia, Montenegro and Serbia (Southeast Europe) as well as Armenia, Azerbaijan, Belarus, Georgia, Moldova, and Ukraine (Eurasia). Other countries in the E&E region that are considered USAID 'graduates' serve as Mentor Countries in the PFS Program.

The PFS Program is designed to complement the work of the bilateral USAID missions' Economic Growth programs in the region by bringing together regional players to address regional challenges. PFS Program activities include benchmarking studies, conferences, knowledge sharing, research and technical assistance. The PFS Program addresses the challenges of the financial systems in these regions, working in a broad range of subject areas including anti-money laundering, banking and non-bank financial regulation, supervision and institutional rehabilitation, corporate governance, financial literacy, access to finance and implementation of international standards in financial sector reporting.

Kosovo High Level Financial Sector Overview



The escalation of the Eurozone debt crisis during 2011-12 creates serious downside risks to economic growth and financial sector stability in the countries of Southeast Europe and, to a lesser extent, Eurasia. The SEE economies and financial sectors were among the hardest hit regions from the global financial crisis beginning in 2008. The fragile economic recovery and hard work to maintain financial stability in SEE from 2009-2011 are now at risk as the Eurozone economy is forecast to decline in 2012. This raises the possibility that several SEE countries will return to recession in 2012 as exports to their biggest trading partners dry up and remittances drop further.

On the financial side, many of the systemically important banks in the SEE countries are owned by banks from troubled Eurozone countries. Banks in SEE are operating under fairly tight local supervisory control and outward indications of public confidence in the banking systems appear sound. However, SEE banks could still face funding problems and credit growth generally remains tepid.

In this uncertain environment, policymakers must first focus on promoting financial sector stability and managing risks. However, there are still opportunities to undertake reforms that will over time result in deeper, more inclusive and diversified financial markets as economic uncertainties ease.

Kosovo ranks at or near the bottom of the Balkan countries in all of the benchmarking categories except Financial Sector Stability, where its banks appear to be some of the soundest in the region. Kosovo's macroeconomic vulnerabilities are the worst in the region, and it is the worst or second worst performing Balkan country in terms of Access to Finance, Financial Sector Size and Sophistication, and the Enabling Environment for the financial sector. Moreover, trends are deteriorating in the Macroeconomic Stability, Access to Finance, and Enabling Environment categories.

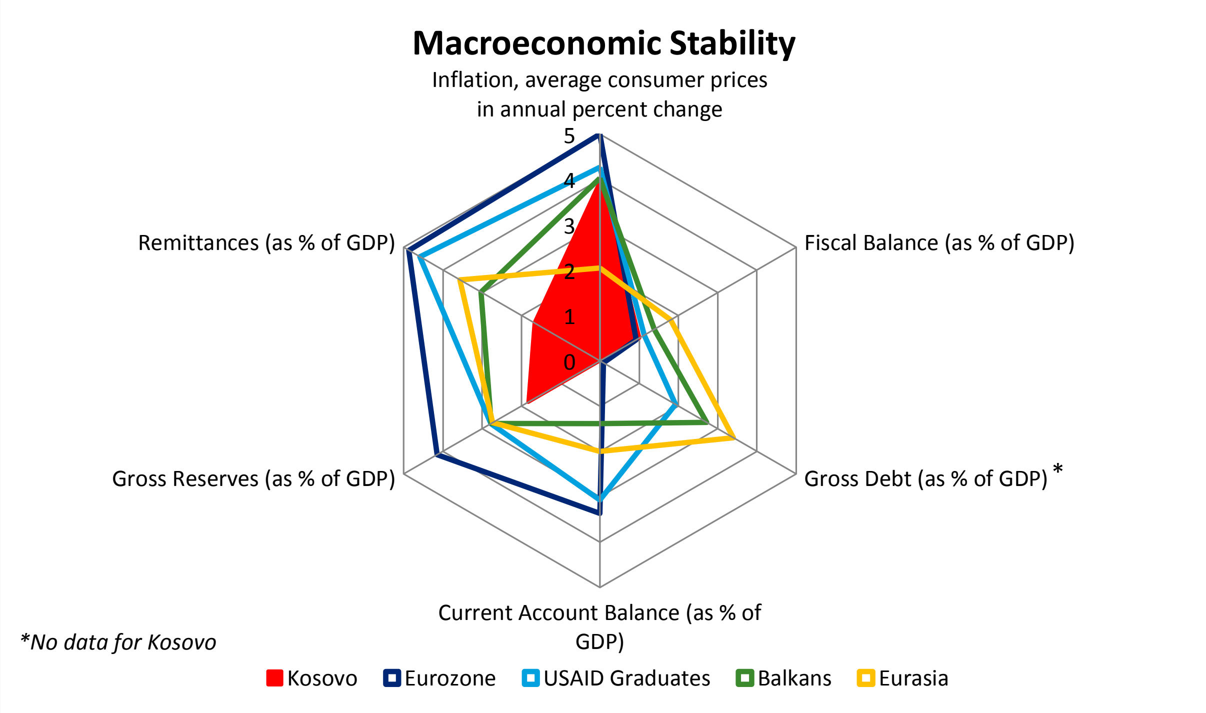
Kosovo's strong Financial Stability indicators may be a reflection of banks' conservative approach to lending given the macroeconomic vulnerabilities and other weaknesses which are holding back the country's progress. Given the myriad of issues facing this young country – which include continued very high unemployment (45 percent), the risk of political instability or conflict, exposure to fallout from an economic downturn in the EU that would reduce remittances, and empty government coffers – even the financial system cannot be considered immune from the impact of outside shocks.

With GDP per capita of just $1900, Kosovo remains by far the poorest country in Central-Eastern Europe.[1] A more vibrant financial sector would help support sustainable economic growth which is badly needed if Kosovo is to catch up with the standards of neighboring countries.

[1] Tajikistan and Uzbekistan in Central Asia have lower ratios of GDP per capita.

1. Macroeconomic and Financial Sector Stability

1.1. Macroeconomic Stability



Macro Stability Benchmarking Indicators – Kosovo					
	2007	2008	2009	2010	**2011**
Inflation, average consumer prices in annual percent	4.40%	9.40%	-2.40%	3.48%	**7.33%**
Fiscal Balance (as % of GDP)	0.83%	-1.98%	-6.56%	-5.37%	**1.9%**
Gross Debt (as % of GDP)	N/A	N/A	N/A	N/A	**N/A**
Current Account Balance (as % of GDP)	-8.80%	-15.34%	-15.42%	-17.36%	**-20.34%**
Gross Reserves (as % of GDP)	20.42%	15.84%	15.27%	15.54%	**11.49%**
Remittances (as % of GDP)	19.71%	18.53%	17.90%	16.78%	**14.44%**

Other Macro Stability Indicators – Kosovo					
	2007	2008	2009	2010	**2011**
Real GDP Growth Rate	6.26%	6.91%	2.90%	3.90%	**4.95%**
GDP per capita (USD)	N/A	$1,587	$1,672	$1,863	**$1,922**
Government Domestic Debt (as% of GDP)	N/A	N/A	N/A	N/A	**N/A**
External Debt (as % of GDP)	N/A	21.40%	17.60%	16.70%	**15.00%**
Net Foreign Direct Investment (as % of GDP)	12.66%	8.88%	7.23%	7.60%	**8.00%**
Unemployment rate (as % of total labour force)	46.30%	47.50%	45.40%	45.00%	**45.00%**

Notwithstanding GDP growth of nearly 5 percent in 2011 and a projected growth rate of 3.8 percent for 2012, Kosovo has the most vulnerable economy in the E&E region except for Tajikistan. Moreover, Kosovo's Macroeconomic Stability indicators generally moved in a negative direction in 2011. The already deep and unsustainable current account deficit widened to more than 20 percent, the government's meager official reserves declined dramatically, the inflation rate more than doubled to 7.3 percent, and the rate of unemployment remained stubbornly high at 45 percent. Balance of payments weaknesses largely relate to Kosovo's weak exporting capacity, a decline in remittances relative to GDP, and rising costs of food and fuel imports.

In fairness, inflation and balance of payments factors are partly out of Kosovo's control, as rising prices for food and fuel are major components of these measures. Likewise, with the euro declining against the dollar, many commodity imports (priced in dollars) adversely impact the balance of payments data. Moreover, remittances remain fairly high and are sourced primarily from Switzerland and Germany, both of which are doing better economically than the Eurozone as a whole. Therefore, remittance flows should remain fairly stable, even if declining a bit relative to GDP.

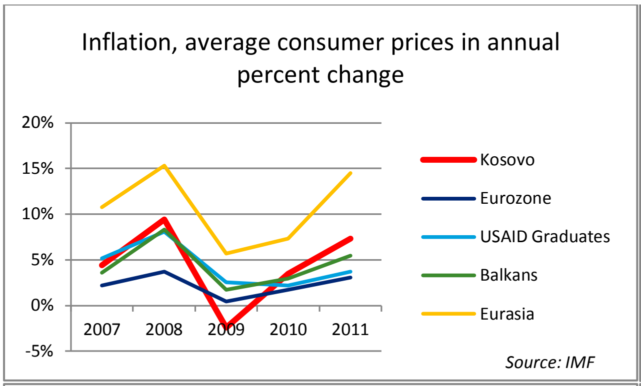
Kosovo has ceded monetary policy to the Eurozone by adopting the euro as its official currency, and the government has little capacity to use fiscal policies to improve economic performance or competitiveness. The low level of government indebtedness – the lowest in the region - is a reflection of the government being locked out of international debt markets. (Kosovo has no credit rating but aspires to borrow from abroad when the government's financial position improves). For now the international financial institutions are the only source of external financing. The government in 2012 arranged for a small $141 million Stand-by Agreement with the IMF in 2012.[2]

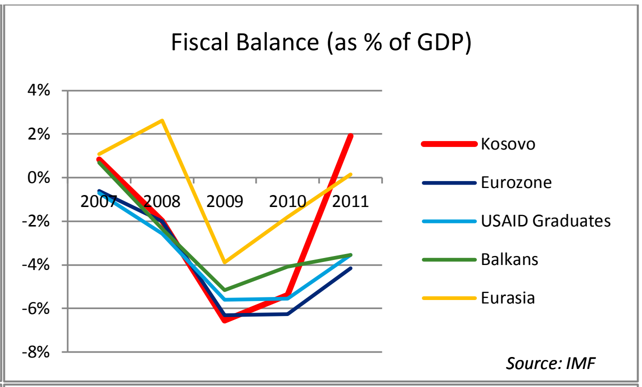
The fiscal deficit is projected to be fairly low at 2.7 percent of GDP in 2012 after narrowing in 2011 to 1.9 percent, but this is mainly a reflection of the government's limited capacity to borrow. A domestic government debt market is just getting off the ground and as it grows the government will be able to issue more debt instruments locally.

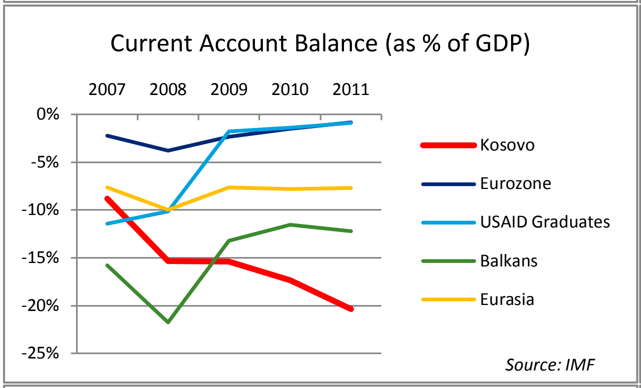
The government's weak revenues are a key structural weakness. The problem is partly due to high structural unemployment which translates into much of the economy operating in the informal (untaxed) sector. This makes it difficult to develop a broad enough fiscal base to provide normal public services and to invest in badly needed public infrastructure.

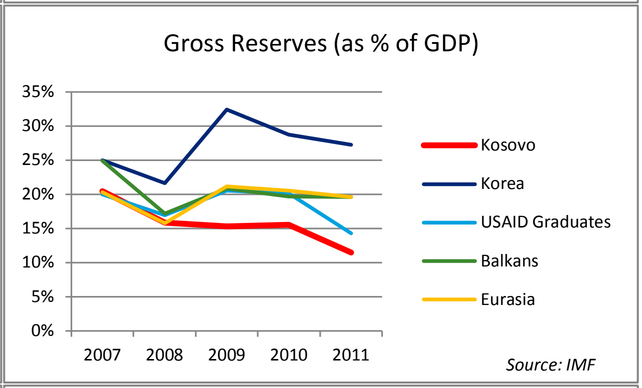
On the positive side, foreign direct investment (FDI) increased again in 2011, building on a positive trend after a decline in 2009. FDI remains the highest in the region when measured as a share of GDP. Additional FDI of €300 million is expected in 2012 if Kosovo is successful in privatizing its state-owned telecommunications company (PTK).

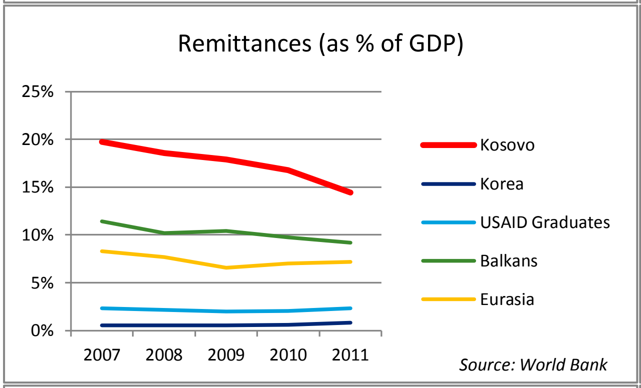
[2] See IMF Press Release 12/154, April 27, 2012.

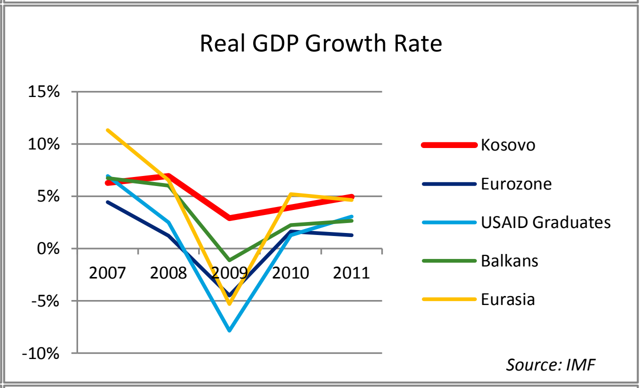

Inflation, average consumer prices in annual percent change
20%
15%
10%
5%
0%
-5%
2007 2008 2009 2010 2011
Kosovo
Eurozone
USAID Graduates
Balkans
Eurasia
Source: IMF

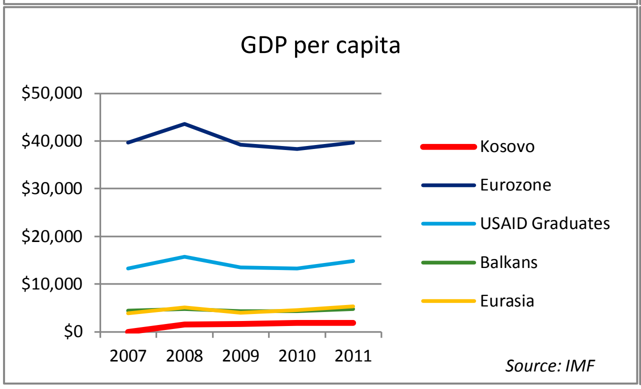

Fiscal Balance (as % of GDP)
4%
2%
0%
-2%
-4%
-6%
-8%
2007 2008 2009 2010 2011
Kosovo
Eurozone
USAID Graduates
Balkans
Eurasia
Source: IMF

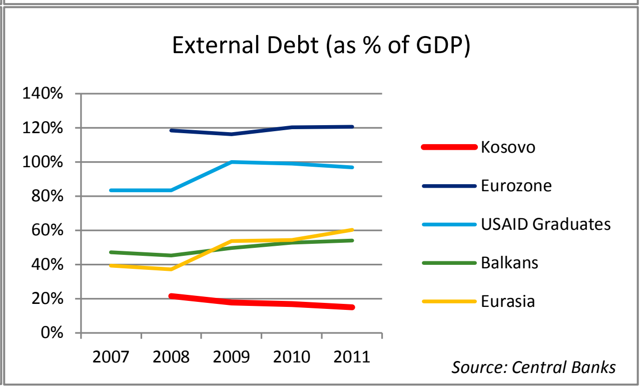

Current Account Balance (as % of GDP)
2007 2008 2009 2010 2011
0%
-5%
-10%
-15%
-20%
-25%
Kosovo
Eurozone
USAID Graduates
Balkans
Eurasia
Source: IMF

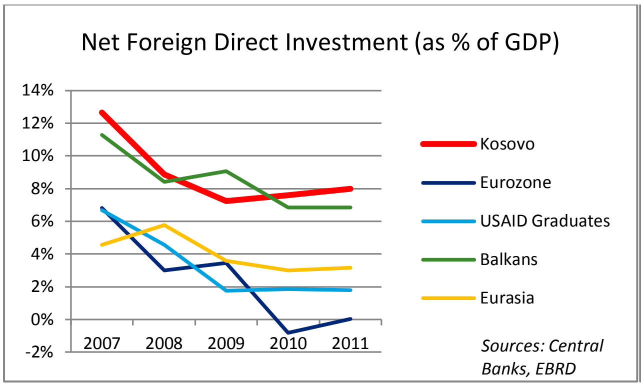

Gross Reserves (as % of GDP)
35%
30%
25%
20%
15%
10%
5%
0%
2007 2008 2009 2010 2011
Kosovo
Korea
USAID Graduates
Balkans
Eurasia
Source: IMF

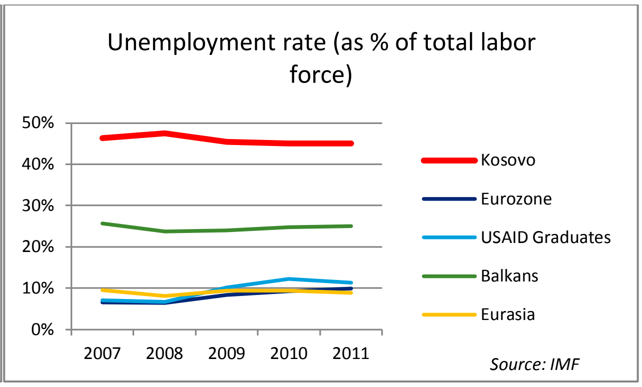

Remittances (as % of GDP)
25%
20%
15%
10%
5%
0%
2007 2008 2009 2010 2011
Kosovo
Korea
USAID Graduates
Balkans
Eurasia
Source: World Bank


Real GDP Growth Rate
15%
10%
5%
0%
-5%
-10%
2007 2008 2009 2010 2011
Kosovo
Eurozone
USAID Graduates
Balkans
Eurasia
Source: IMF

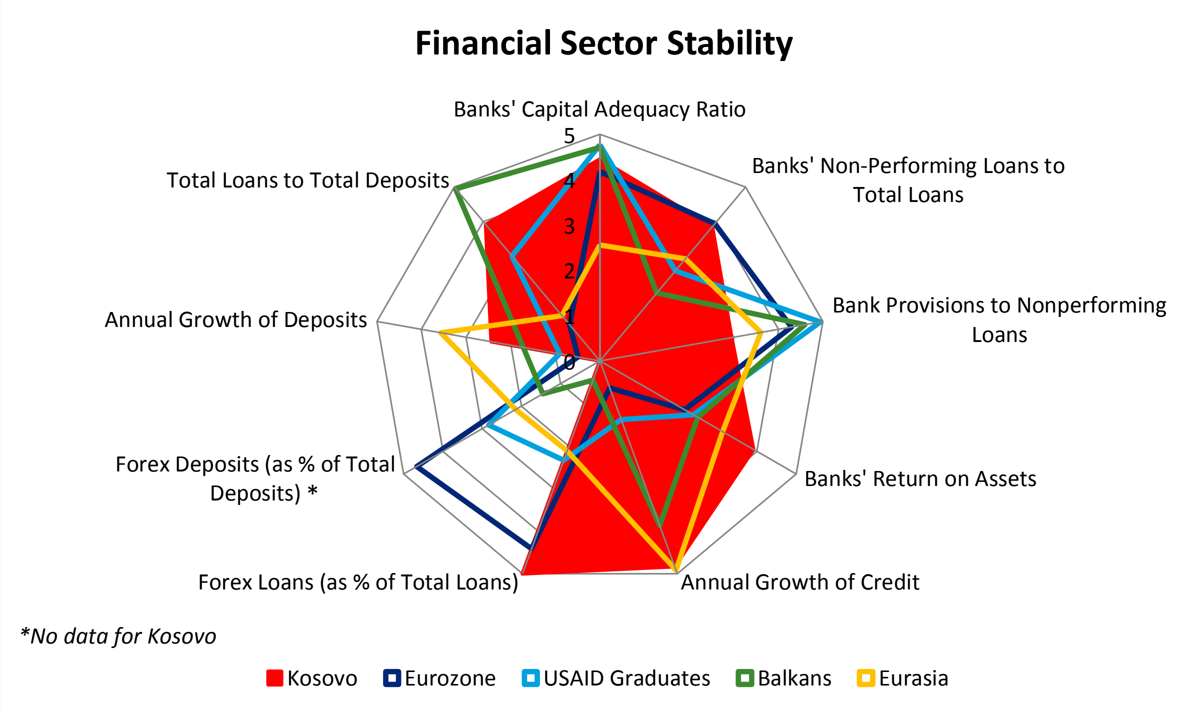

GDP per capita
$50,000
$40,000
$30,000
$20,000
$10,000
$0
2007 2008 2009 2010 2011
Kosovo
Eurozone
USAID Graduates
Balkans
Eurasia
Source: IMF


External Debt (as % of GDP)
140%
120%
100%
80%
60%
40%
20%
0%
2007 2008 2009 2010 2011
Kosovo
Eurozone
USAID Graduates
Balkans
Eurasia
Source: Central Banks


Net Foreign Direct Investment (as % of GDP)
14%
12%
10%
8%
6%
4%
2%
0%
-2%
2007
2008
2009
2010
2011
Kosovo
Eurozone
USAID Graduates
Balkans
Eurasia
Sources: Central Banks, EBRD


Unemployment rate (as % of total labor force)
50%
40%
30%
20%
10%
0%
2007
2008
2009
2010
2011
Kosovo
Eurozone
USAID Graduates
Balkans
Eurasia
Source: IMF

1.2. Financial Sector Stability



Financial Sector Stability Benchmarking Indicators – Kosovo					
	2007	2008	2009	2010	**2011**
Banks' Capital Adequacy Ratio	17.40%	16.50%	17.90%	18.80%	**17.60%**
Banks' Non-Performing Loans to Total Loans	4.10%	3.30%	4.30%	5.20%	**5.70%**
Bank Provisions to Nonperforming Loans	N/A	N/A	N/A	85.20%	**87.80%**
Banks' Return on Assets	2.90%	2.60%	1.40%	1.80%	**1.40%**
Annual Growth of Credit	40.13%	32.66%	8.92%	13.16%	**16.41%**
Forex Loans % of Total Loans	N/A	N/A	N/A	0.17%	**0.20%**
Forex Deposits % of Total Deposits	N/A	N/A	N/A	N/A	**N/A**
Annual Growth of Deposits	23.67%	26.33%	20.83%	11.00%	**8.54%**
Total Loans to Total Deposits	78.04%	81.95%	73.87%	75.31%	**80.77%**

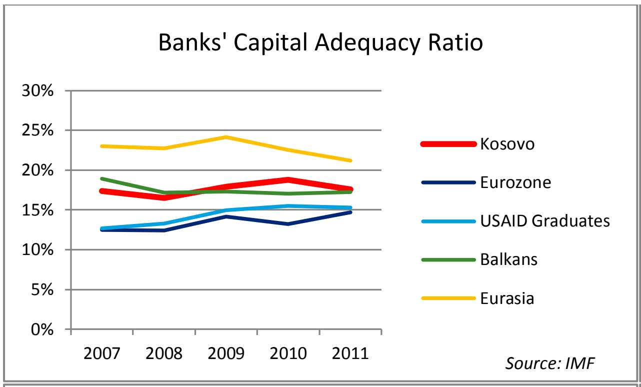
In terms of financial sector stability, Kosovo ranks highest in the E&E region. The banking sector appears to be sound and broadly outperforms regional norms. The main risks to financial stability center around contagion from the Eurozone, the risk of a loss of confidence in systemic banks, and the central bank's inadequate reserves for lending to systemic banks for short term liquidity needs if a crisis were to arise.

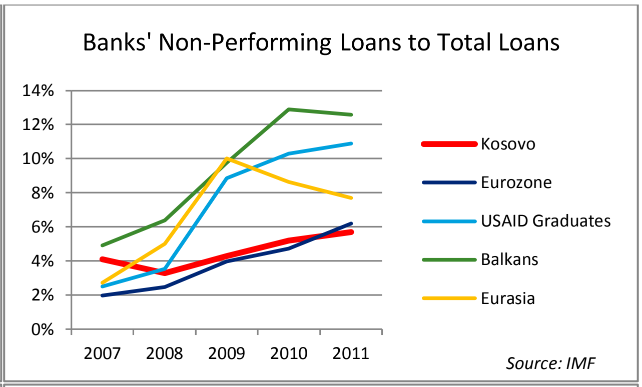
There was a modest deterioration in some of its key financial soundness indicators in 2011: capital adequacy declined, but remains fairly high at 17.6 percent; non-performing loans increased to 5.7 percent; and bank profits (measured by the Return on Assets ratio) declined from 1.8 percent to 1.4 percent.

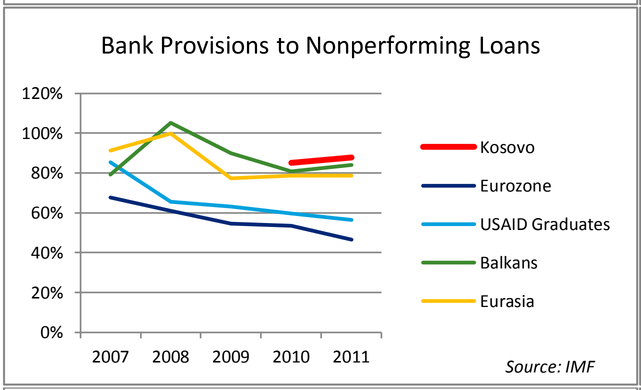
These negative trends are partly offset by steady and high reserves (provisions) for possible losses on non-performing loans and by banks' low levels of foreign exchange exposure. Banks remain quite liquid as shown by the ratio of loans to deposits which stands at 80.9 percent. Kosovo's banking system is the most liquid in the E&E region with the exception of Albania; this is positive with regard to financial stability but negative in terms of access to credit.

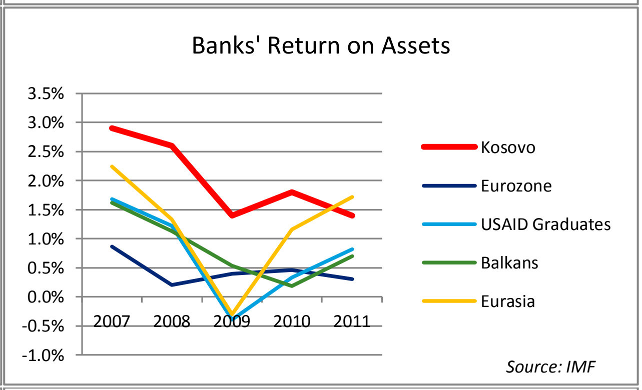
The rate of nominal credit growth bounced back to 16 percent in 2011 (9 percent when adjusted for inflation) after dropping to less than 9 percent per year in 2009 when the global crisis struck. These rates of growth are much more sustainable that the rapid growth rates seen prior to the crisis but may not be sufficient to play much of a role in stimulating the sustainable economic growth needed to catch up with neighboring countries' living standards. The IMF projects another decline in the rate of credit growth in 2012.

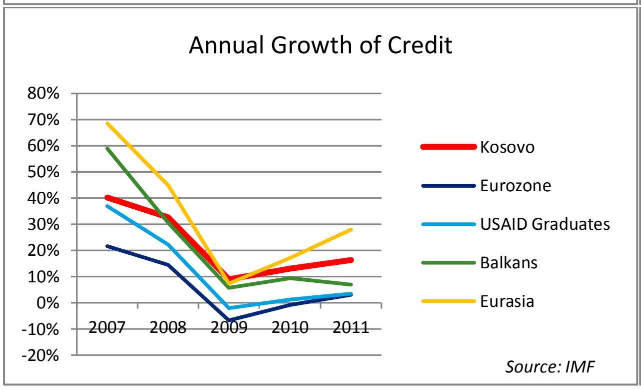
Deposit growth continued in 2011 at more than 11 percent following a 20 percent growth rate in 2010. This trend points to sustained confidence among depositors in the soundness of banks, the largest of which are foreign-owned. Confidence may have been strengthened by the introduction of deposit insurance in 2011. However, as with credit, deposit growth is projected to slow in 2012.

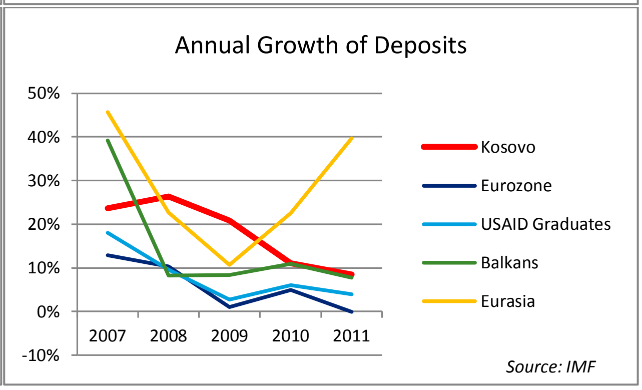


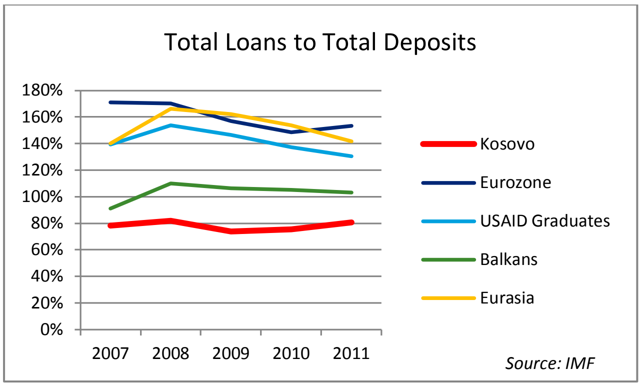




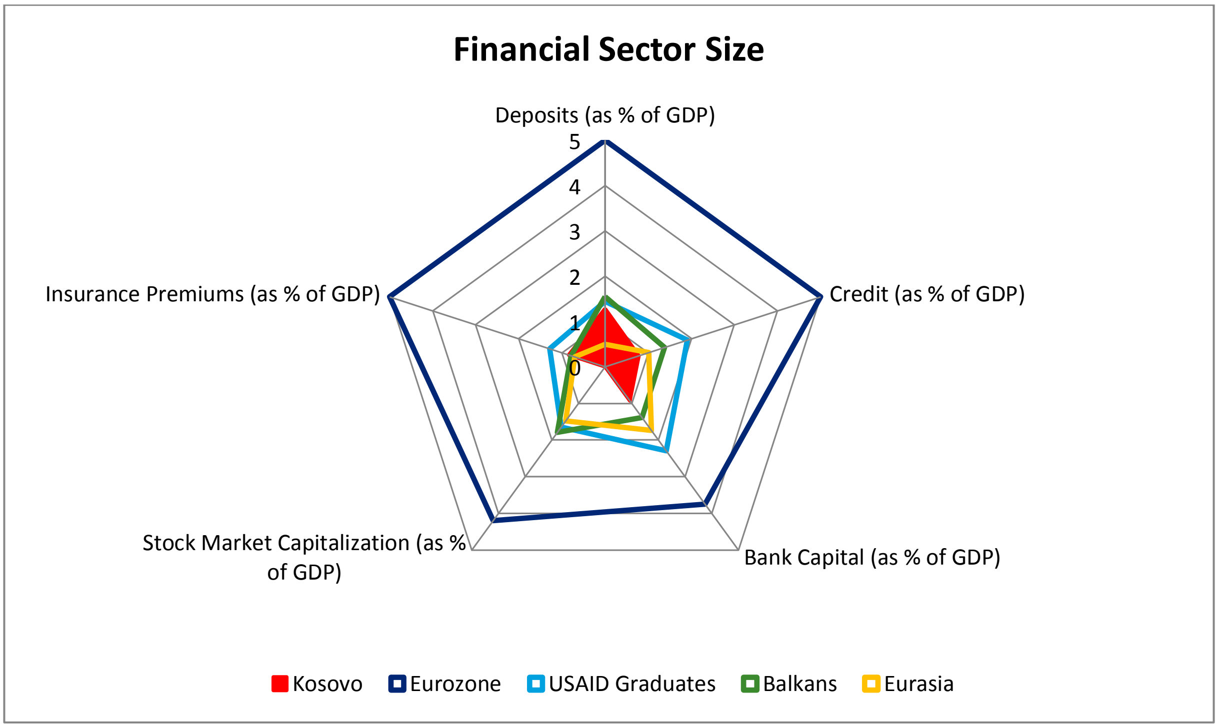







Total Loans to Total Deposits
180%
160%
140%
120%
100%
80%
60%
40%
20%
0%
2007
2008
2009
2010
2011
Kosovo
Eurozone
USAID Graduates
Balkans
Eurasia
Source: IMF

2. Financial Sector Size



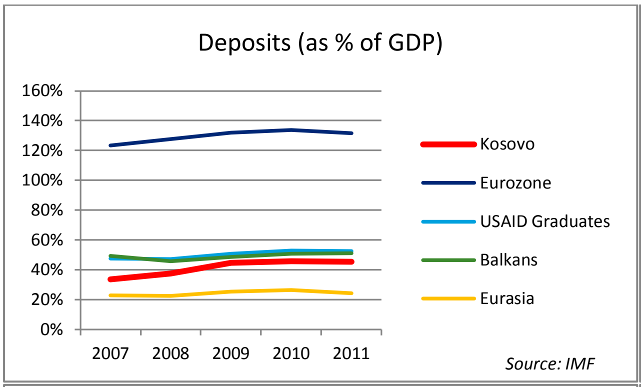
Size Benchmarking Indicators – Kosovo					
	2007	2008	2009	2010	**2011**
Deposits (as % of GDP)	33.68%	37.50%	44.60%	45.94%	**45.34%**
Credit (as % of GDP)	26.28%	30.73%	32.95%	34.60%	**36.62%**
Bank Capital (as % of GDP)	5.65%	6.26%	7.30%	8.59%	**N/A**
Stock Market Capitalization (as % of GDP)	0.00%	0.00%	0.00%	0.00%	**0.00%**
Insurance Premiums (as % of GDP)	1.49%	1.47%	1.73%	1.68%	**1.67%**

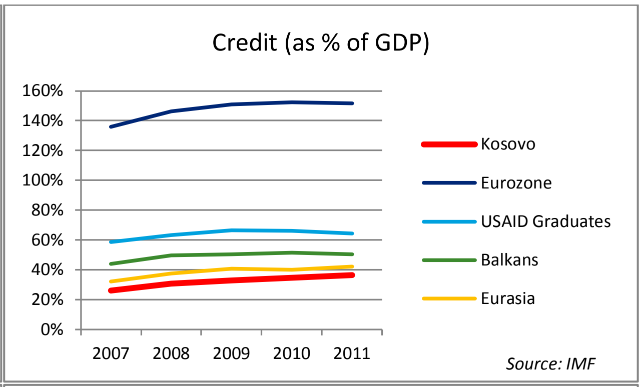
The financial sector in Kosovo remains small by regional norms and tiny by the standards of developed countries. More worryingly, the financial sector's growth (in relation to the overall economy) has stagnated at a time when the private sector badly needs the support of a healthy, vibrant financial sector. There is no capital markets activity in Kosovo and only a very small insurance sector.

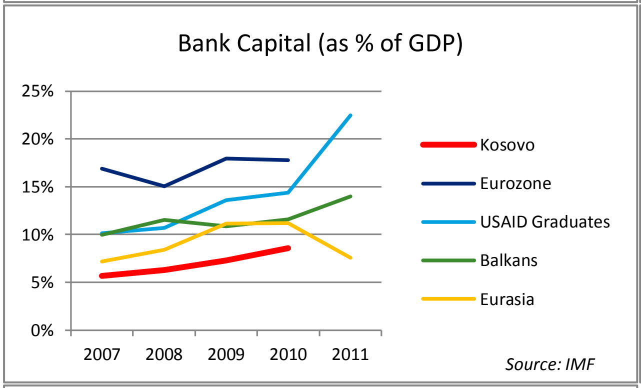
The authorities have taken first steps to expand non-bank financial activity. A review of Insurance Core Principles has been carried out, and steps may be taken to encourage development of this sector. Likewise, the government is considering the issuance of securities that will extend the yield curve, a prerequisite for further development of the debt market.

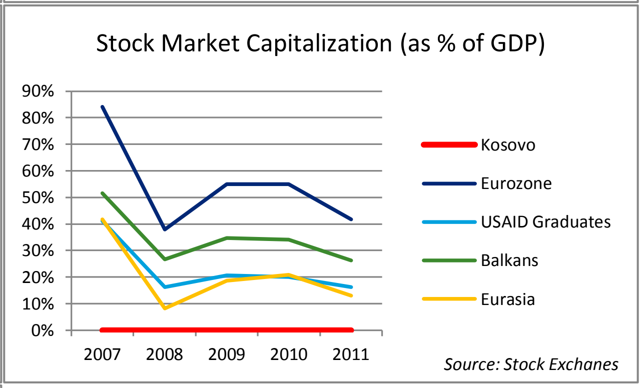
In addition to the banks, the other segment of the financial sector that is material in terms of relative assets (as a share of total financial sector assets) is the state pension fund. Efforts have been made to ensure that investment policy is prudent so that payments can be made as liabilities come due. However, this risk should be monitored.

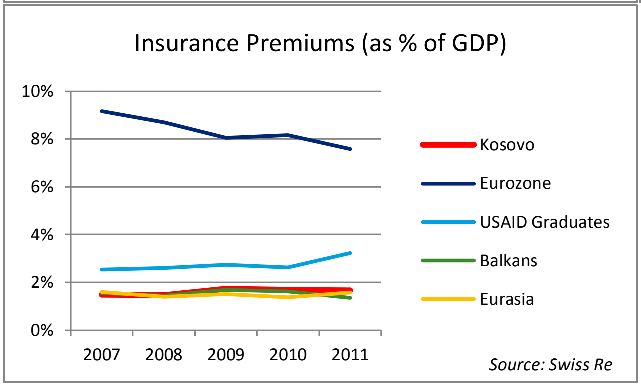
Microfinance institutions continue to play a small role in credit allocation to households and small businesses. A new Banking and Microfinance Law was adopted in 2012 that helps to ensure continued lending under regulated conditions.



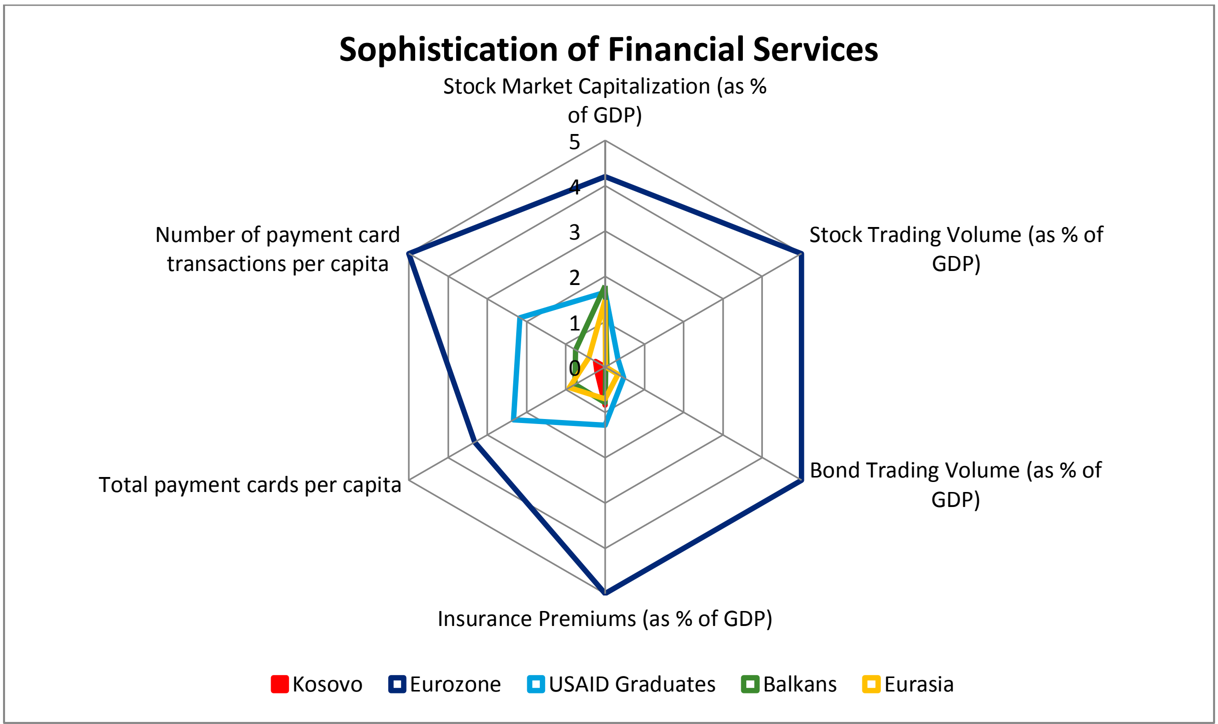








3. Financial Sector Sophistication



Sophistication Benchmarking Indicators – Kosovo					
	2007	2008	2009	2010	**2011**
Stock Market Capitalization (as % of GDP)	0.00%	0.00%	0.00%	0.00%	**0.00%**
Stock trading volume (as % of GDP)	0.00%	0.00%	0.00%	0.00%	**0.00%**
Bond Trading Volume (as % of GDP)	0.00%	0.00%	0.00%	0.00%	**0.00%**
Insurance Premiums (as % of GDP)	1.49%	1.47%	1.73%	1.68%	**1.67%**
Total payment cards per capita	N/A	N/A	N/A	0.29	**N/A**
Number of payment card transactions per capita	N/A	N/A	N/A	3.69	**N/A**

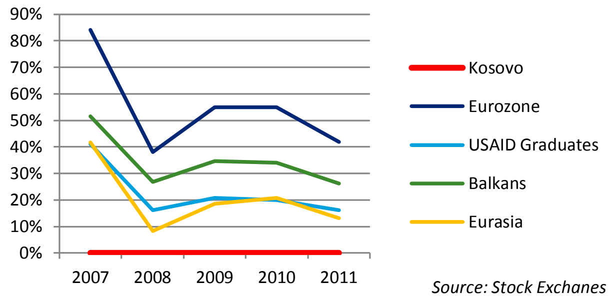
Other Sophistication Indicators – Kosovo					
	2007	2008	2009	2010	**2011**
Life Insurance Premiums (as % of GDP)	N/A	N/A	N/A	N/A	**N/A**
Non-Life Insurance Premiums (as % of GDP)	N/A	N/A	N/A	N/A	**N/A**
No. of Listed Companies	0	0	0	0	**0**

Kosovo's financial sector remains basic and unsophisticated, with no capital markets and a very small insurance sector. Most formal financial sector activity is through the banking sector, which appears to be sound but very fundamental in terms of the sophistication and range of services provided.

There is some use of credit and debit cards in the market, although activity is lower than average for the Balkan region.

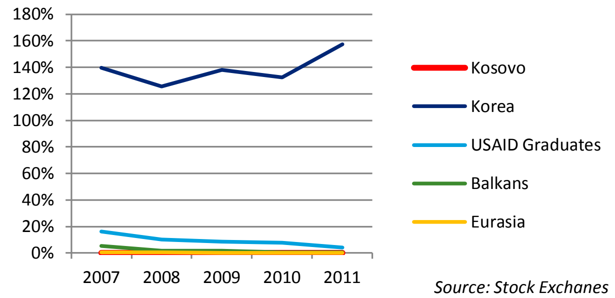
A wider penetration of financial services would help businesses and individuals gain access to debt and equity finance and would move more economic activity into the formal sector.

Stock Market Capitalization (as % of GDP)



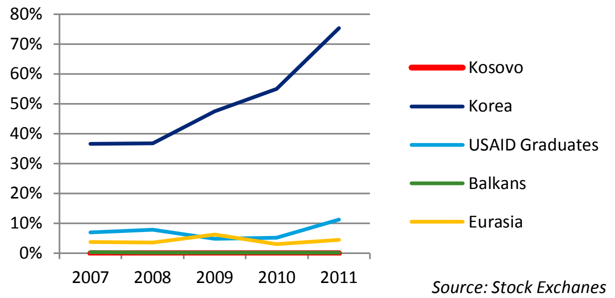
Source: Stock Exchanes

Stock Trading Volume (as % of GDP)



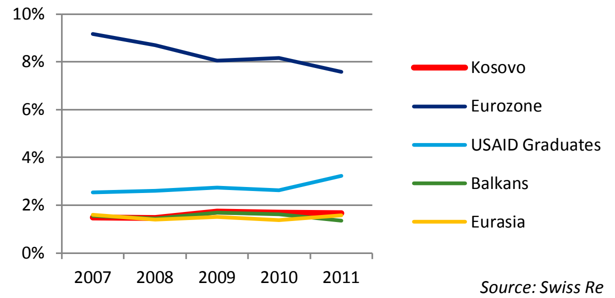
Source: Stock Exchanes

Bond Trading Volume (as % of GDP)



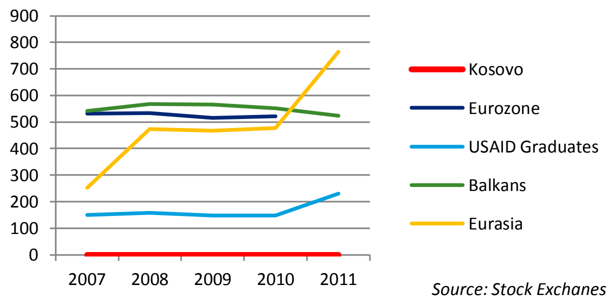
Source: Stock Exchanes

Insurance Premiums (as % of GDP)



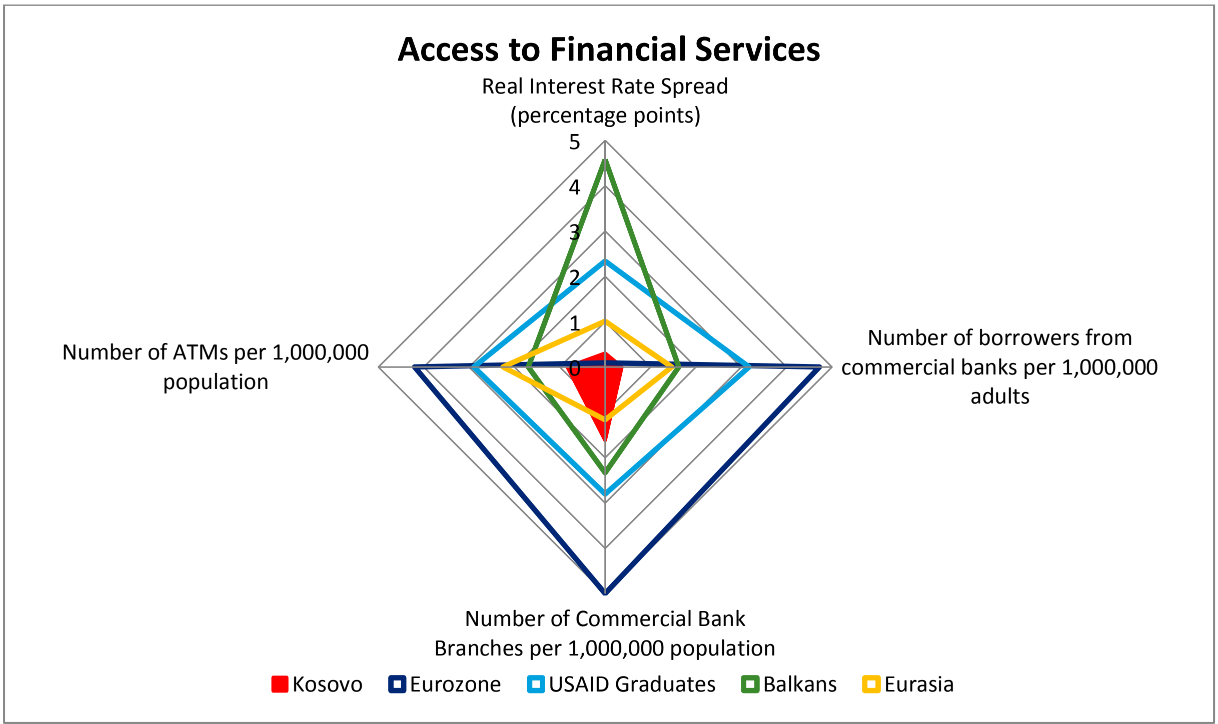
Source: Swiss Re

No. of Listed Companies



Source: Stock Exchanes

4. Access to Finance and Financial Services



Access Benchmarking Indicators – Kosovo					
	2007	2008	2009	2010	**2011**
Real Interest Rate Spread (percentage points)*	5.66	-0.04	12.51	7.45	**2.91**
Number of borrowers from commercial banks per 1,000,000 adults	51974	59965	55262	55649	**67072**
Number of Commercial Bank Branches per 1,000,000 population	179.42	177.98	176.56	175.14	**173.33**
Number of ATMs per 1,000,000 population	89.42	137.35	192.45	233.71	**256.37**

*Difference between real interest rates on loans and deposits in local currency.

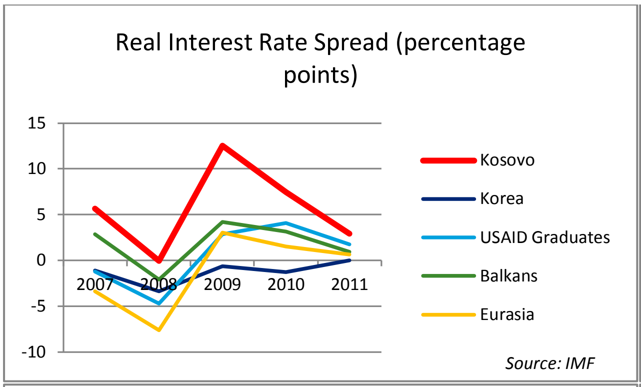
Other Access Indicators – Kosovo					
	2007	2008	2009	2010	**2011**
Nominal Interest Rate Spread (percentage points)*	10.06	9.36	10.11	10.93	**10.24**
Number of Commercial Bank Branches per 1,000 km²	28.57	28.57	28.57	28.57	**28.57**
Number of ATMs per 1,000 km²	14.24	22.04	31.14	38.12	**42.25**
Number of POS Machines per 1,000,000 population	N/A	N/A	N/A	3441.11	**N/A**

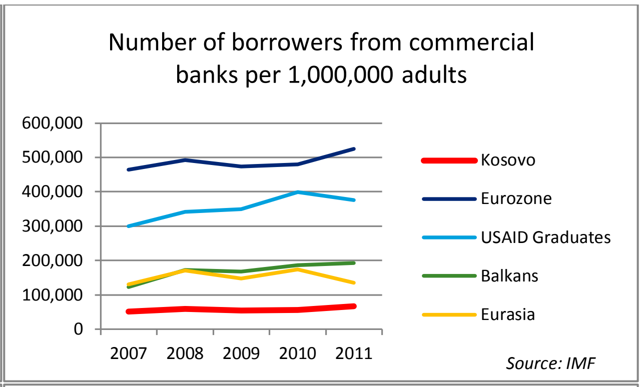
*Difference between nominal interest rates on loans and deposits in local currency.

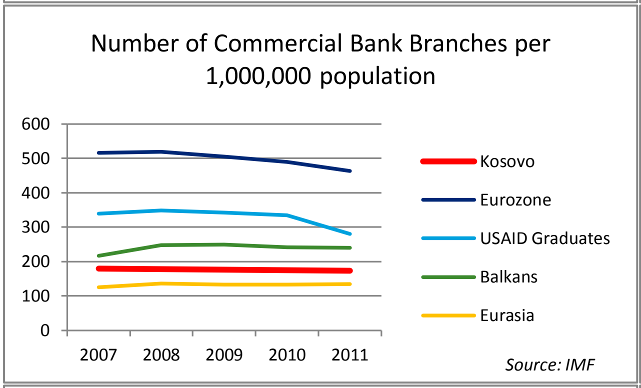
Access to credit and financial services is difficult in Kosovo, with Kosovo ranking near the bottom of the 29 countries surveyed. However, there are signs of slight improvement in most of the indicators.

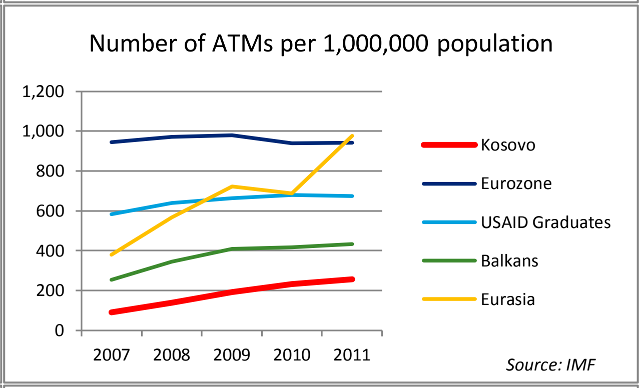
While nominal interest rate spreads remain high, the more important measure of real interest rate spreads declined considerably in 2011, from 7.45 percent to 2.9 percent. This indicates that the cost of borrowing from banks finally became more affordable in 2011, and it may be a hopeful sign of greater competition within the banking sector.

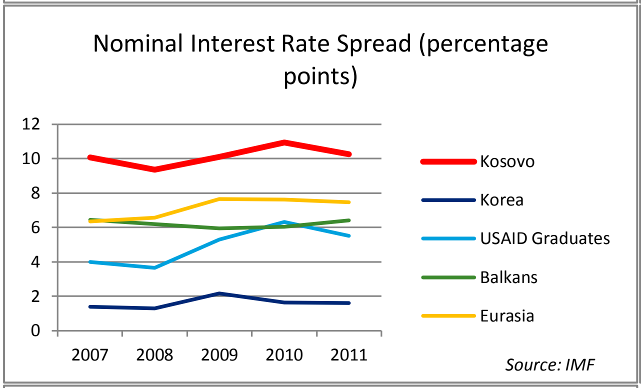
Some of these indicators may decline in 2012. The IMF is projecting slower growth of credit and deposits in 2012 (relative to GDP), and this may negatively impact access for some borrowers.

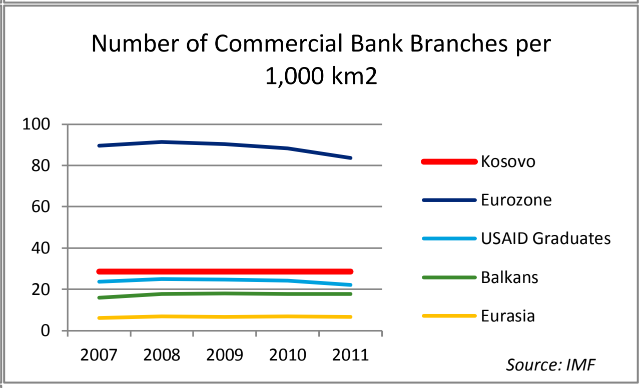


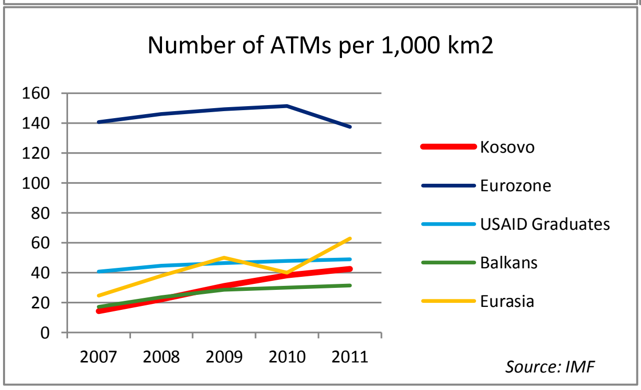




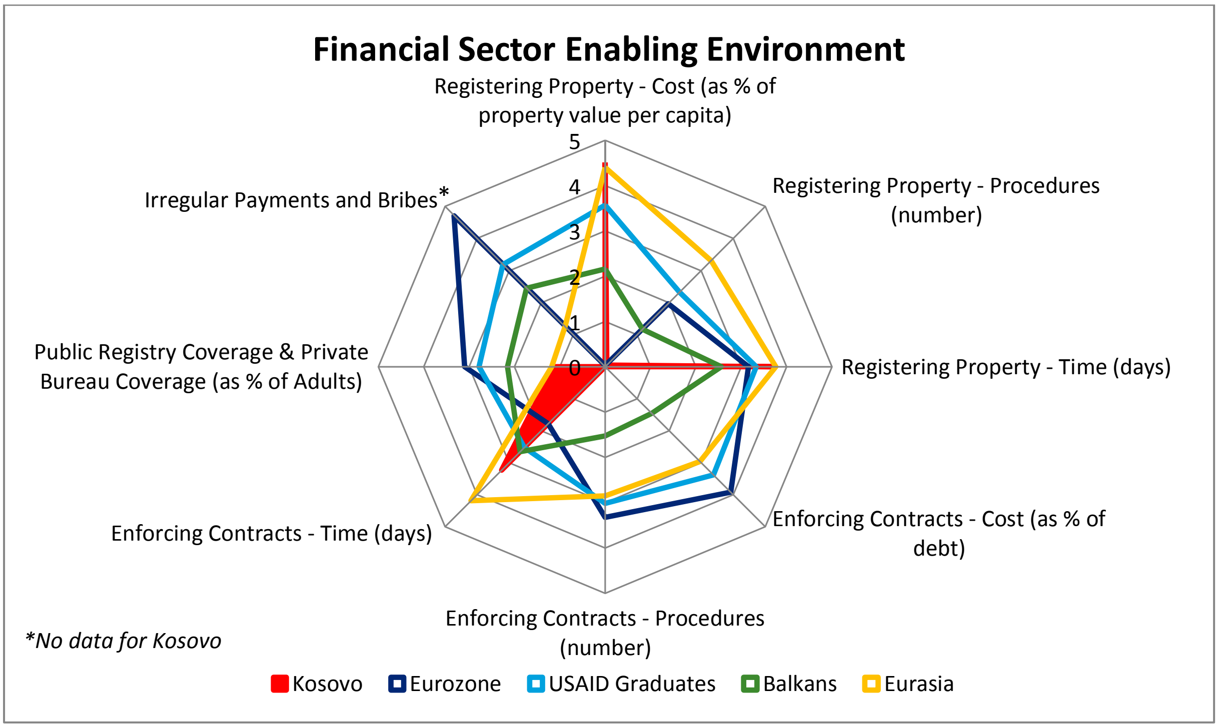








5. Financial Sector Enabling Environment and Transparency



Enabling Environment Benchmarking Indicators - Kosovo					
	2007	2008	2009	2010	**2011**
Registering Property: Cost (% of property value)	N/A	N/A	1.00%	0.60%	**0.60%**
Registering Property – Procedures (number)	N/A	N/A	8.00	8.00	**8.00**
Registering Property – Time (days)	N/A	N/A	33.00	33.00	**33.00**
Enforcing Contracts: Cost (as % of debt)	N/A	N/A	61.20%	61.20%	**61.20%**
Enforcing Contracts – Procedures (number)	N/A	N/A	53.00	53.00	**53.00**
Enforcing Contracts – Time (days)	N/A	N/A	420.00	420.00	**420.00**
Public Registry Coverage & Private Bureau Coverage (as % of Adults Covered)*	N/A	N/A	18.90%	16.90%	**20.50%**
Irregular Payments and Bribes (RANK/139)**	N/A	N/A	N/A	N/A	**N/A**

*Number of individuals and firms listed in credit registries as a percent of adult population)

* WEF Global Competitiveness Report (RANK: Best=1; Worst=139)

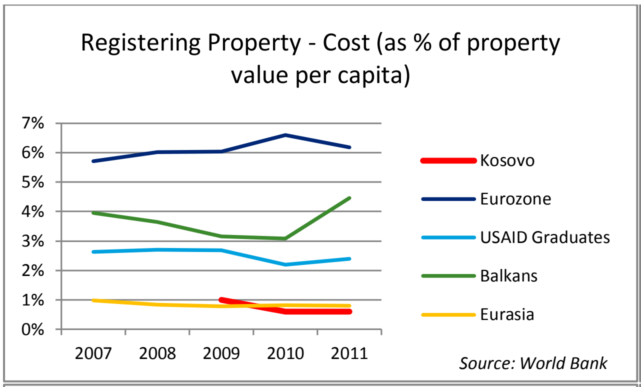
Other Enabling Environment Indicators – Kosovo					
	2007	2008	2009	2010	**2011**
Protecting Investors*	N/A	N/A	172.00	173.00	**174.00**
Strength of Auditing and Reporting Standards**	N/A	N/A	N/A	N/A	**N/A**
Diversion of Public Funds**	N/A	N/A	N/A	N/A	**N/A**
Public Trust of Politicians**	N/A	N/A	N/A	N/A	**N/A**
Judicial Independence**	N/A	N/A	N/A	N/A	**N/A**
Favouritism in Decisions of Government Officials**	N/A	N/A	N/A	N/A	**N/A**

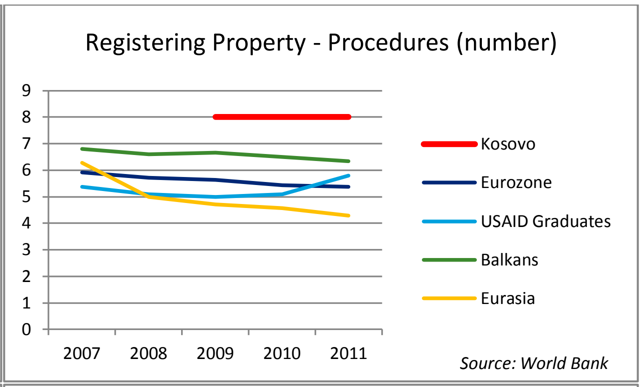
* World Bank Doing Business (RANK: Best=1; Worst 2007=178, 2008=181, 2009=183, 2010=183, 2011=183)

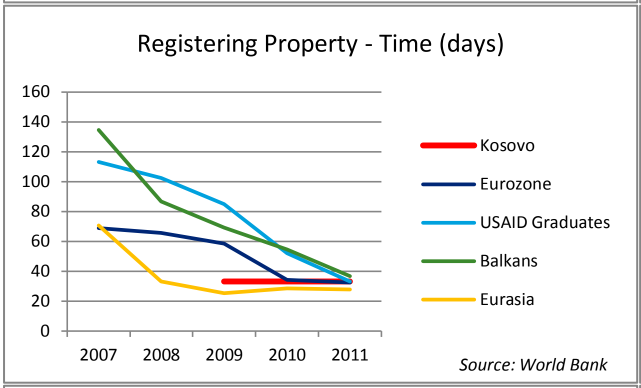
** WEF Global Competitiveness Report (RANK: Best=1; Worst 2008=134, 2009=133, 2010=139, 2011=142)

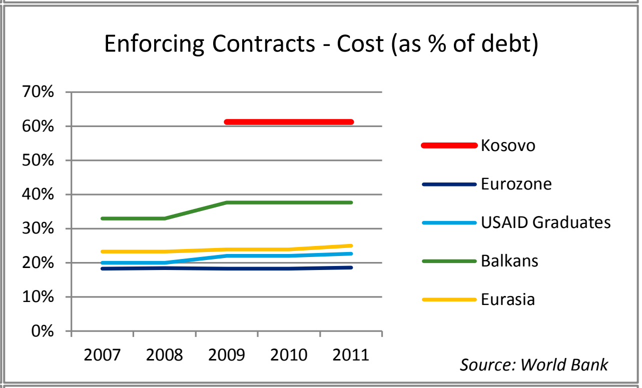
Kosovo's overall ranking for the Enabling Environment for the financial sector has declined steadily since 2009. Of the 29 countries surveyed only Ukraine, Albania, and Bosnia score worse than Kosovo in this category.

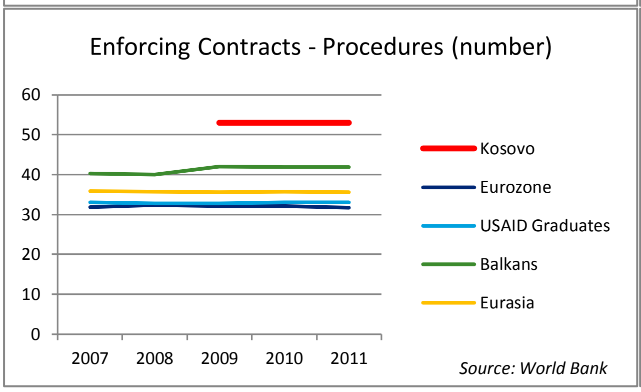
Legal reforms are underway to strengthen the collateral framework to allow speedier repossession and sale of foreclosed assets in cases of borrower default. This would reduce banks' costs and credit risks and contribute to greater access to credit. Altogether, 12 new pieces of legislation are expected to strengthen the overall business environment. However, there was little indication of improvements in 2011 with the exception of the expansion of the number of persons covered by the credit bureau.

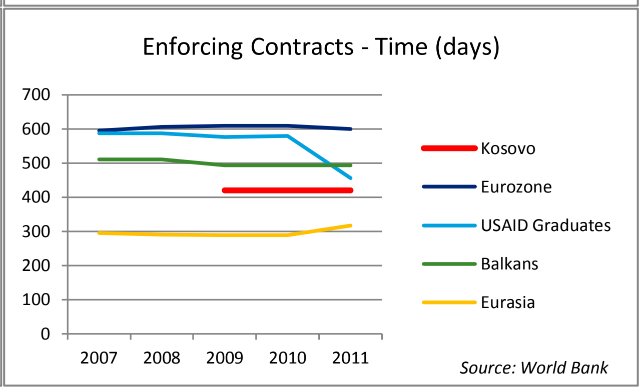


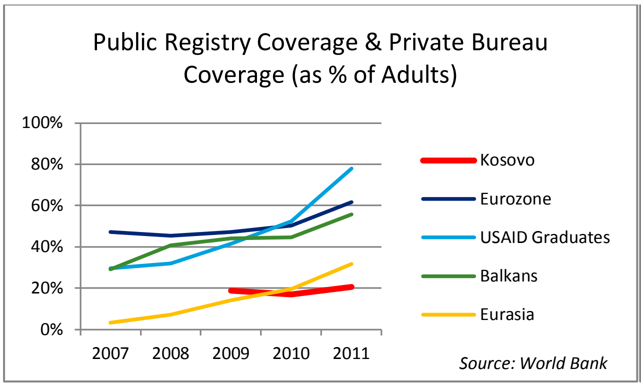


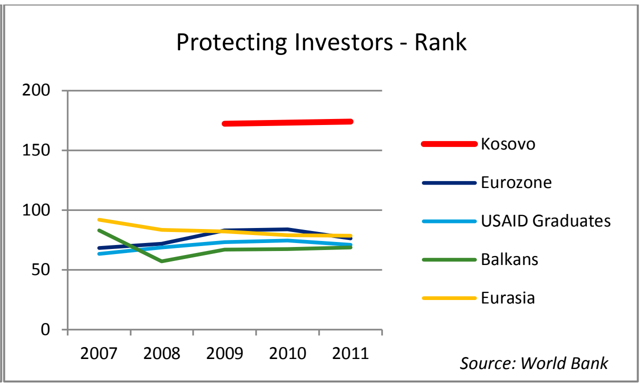









Public Registry Coverage & Private Bureau Coverage (as % of Adults)
100%
80%
60%
40%
20%
0%
2007
2008
2009
2010
2011
Kosovo
Eurozone
USAID Graduates
Balkans
Eurasia
Source: World Bank


Protecting Investors - Rank
200
150
100
50
0
2007
2008
2009
2010
2011
Kosovo
Eurozone
USAID Graduates
Balkans
Eurasia
Source: World Bank

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