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Financial Buffers in a Euroized Economy

Republic of Kosovo

Javier Kapsoli and Ezgi Ozturk

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Financial Buffers in a Euroized Economy, Republic of Kosovo
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ABSTRACT: This paper analyzes reserve adequacy measurement in Kosovo, where euro serves as the legal tender. The study adapts the IMF's Assessing Reserve Adequacy framework to Kosovo's unique monetary context, focusing on precautionary motives for holding reserves. The analysis reveals limited readily available reserves at the Central Bank of Kosovo and recommends additional government deposits of 1.75-5.75 percent of GDP. Given the significant opportunity costs of maintaining such deposits, the paper suggests alternative solutions, including exploring a private lender of last resort model and maintaining ECB repo lines.

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FINANCIAL BUFFERS IN A EUROIZED ECONOMY[1]

A. Introduction

1. **Since its inception, Kosovo has not issued its own currency.** Immediately after the 1998–99 war, a UN Mission in Kosovo (UNMIK) was installed in Kosovo per the mandate of Security Council Resolution #1244. In September 1999, the UNMIK announced the adoption of the German mark as the official currency. Following the official circulation of the euro in the EU in January 2002, Kosovo unilaterally adopted it as its legal tender.[2]

2. **The adoption of the euro as the legal tender involves significant economic advantages and structural limitations.**[3] Unilateral euroization helps strengthen macroeconomic stability by "importing" the monetary policy credibility of the ECB and eliminating the possibility of fiscal dominance, since deficits cannot be monetized. It also reduces sovereign risk by eliminating exchange rate risk and transaction costs, resulting in lower financing costs for private firms and the Treasury. However, adopting another country's currency as a tender also has disadvantages, such as the inability to use monetary policy for macroeconomic stabilization, the loss of seigniorage revenue, and, importantly, the absence of a central bank that can act as a lender of last resort (LOLR).

3. **The LOLR function is somewhat needed in euroized economies as well.** In fractional-reserve banking, where banks are required to keep only a part of their deposit liabilities as reserves and use the remainder to make new loans, the central bank is the ultimate guarantor of system stability. LOLR functions by providing short-term loans to banks facing sudden periods of high demand for liquid assets, thereby preventing an individual problem from worsening, or turning into a systemic panic. Although high liquidity in the banking system and strong bank supervision may reduce the need for LOLR support, it does not eliminate it entirely. In Kosovo, banks have ample liquidity, and the Central Bank of Kosovo (CBK) has been enhancing its bank supervision function. However, as financial deepening continues and the financial sector expands rapidly, potential liquidity risks may emerge in the future. While the CBK cannot act as a full LOLR, it can still address bank liquidity pressures using domestic banks' excess, and required reserves, as well as government deposits.

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[1] Prepared by Javier Kapsoli and Ezgi Ozturk.

[2] The term unilateral euroization refers to the adoption of the euro as legal tender without membership in the Economic and Monetary Union (EMU) of the European Union (EU). Conversely, the formal or contractual euroization implies membership in EMU and the ability to issue euro banknotes. Montenegro and San Marino are the other two unilaterally euroized countries. Please see Lindquist (2018) and Laurens and Flamini (2010) for reserve adequacy discussions in Montenegro and San Marino, respectively.

[3] This paragraph highlights the elements that are more relevant for the purposes of this note. For a detailed assessment of the benefits/disadvantages of euroization, see Levasseur (2004), Wójcik and Backé (2004), and Laurens and Flamini (2010).

B. Measuring Reserve Adequacy in a Euroized Economy

4. Euroization affects the concept of foreign currency reserves. In Kosovo, euro is not only the domestic legal tender but also the foreign exchange reserves. The IMF Balance of Payments Manual (IMF 2009) defines reserves as "external assets that are readily available to and controlled by monetary authorities for meeting balance of payments financing needs, for intervention in exchange markets to affect the currency exchange rate, and for other related purposes (such as maintaining confidence in the currency and the economy and serving as a basis for foreign borrowing). Reserve assets must be foreign currency assets and assets that actually exist." This definition emphasizes two conditions for an asset to be considered as part of reserves: (i) it must be denominated in a foreign currency that is widely accepted in transactions worldwide, and (ii) it must be readily available. In a euroized economy where the euro is adopted as the legal tender, every asset held by the monetary authority is denominated in euros; therefore, the first condition is always fulfilled.

5. In a euroized economy, reserves are primarily held for precautionary motives. Countries hold reserves for various reasons, including to operationalize monetary or exchange rate policies, financing transactions in foreign currency for international trade or debt obligations, hedging against emergencies, and investing to obtain financial gains. Most of these reasons do not apply to a euroized economy, which does not have monetary or exchange rate policies and can conduct external transactions seamlessly with every asset circulating in the economy, as they will always be denominated in a foreign currency that conducted directly or easily exchanged. Moreover, holding reserves for investment purposes is limited to countries with large external surpluses, often coming from natural resource exports. Consequently, the principal motive for holding reserves in a unilaterally euroized economy is precautionary—hedging against emergencies.

6. The Fund has worked extensively on indicators to measure reserve adequacy. In addition to several traditional metrics of reserve adequacy in the literature (e.g., months of imports), an IMF policy paper on Assessing Reserve Adequacy (ARA) (IMF 2015) proposed a metric to assess reserve adequacy for emerging market economies based on four possible drains from the balance of payments: (i) export income, to account for terms of trade or external demand shocks; (ii) short-term debt, to cover for short-term external liability shocks; (iii) other external portfolio liabilities, to cover for equity and debt shocks; and (iv) broad money, to cover for a deposit run. Each of these components is multiplied by a relative risk weight based on the 10th percentile of observed outflows for emerging market economies. As the sample for euroized/dollarized economies is small, there is no separate formal metric proposed for countries with no separate legal tender.[4] However, euroized economies can be approached as an extreme case of hard peg, for which the IMF has proposed the following formula (IMF 2016):

$$RA = 0.1\ M2 + 0.2\ OPL + 0.3\ STD + 0.1\ X$$

[4] According to the latest AREAER report, in 2022, 14 countries do not have separate legal tender. They are Andorra, Ecuador, El Salvador, Kiribati, Kosovo, the Marshall Islands, the Federated States of Micronesia, Montenegro, Nauru, Palau, Panamá, San Marino, Timor Leste, and Tuvalu.

where RA is the adequate level of reserves, M2 is broad money, OPL is other external portfolio liabilities, STD is short-term external debt, and X is exports. In this formula, M2 captures potential residents' capital flight through the liquidation of their highly liquid domestic assets, STD reflects debt rollover risk, and X reflects the potential loss from a drop in external demand or a terms of trade shock. The coefficients reflected in this formula reflect the regression results from the IMF policy paper on ARA (IMF 2016) for economies with fixed exchange rate regimes, not including the dollarized/euroized economies.

7. In a euroized economy, the policy capacity of the central bank is limited. The central bank balance sheet, in a dollarized/euroized country, does not have assets denominated in local currency or cash in circulation on the liabilities side (Table 1). In Kosovo, raising reserves can be through either accumulation of government deposits or increasing bank required and excess reserves. Banks in Kosovo are required to hold 10 percent of total deposits at the CBK as required reserves. Historically, most of them used to hold even more than that, so there have always been some excess reserves. During a liquidity shock, such as a bank run, bank reserves would provide help to meet immediate demand for withdrawals, but recourse to government funds may also be needed. Therefore, accumulation of government deposits has a stronger role as a source of raising reserves.

Table 1. Kosovo: Stylized Balance Sheet of a Central Bank

Standard Central Bank		Dollarized/Euroized Central Bank	
Assets	**Liabilities**	**Assets**	**Liabilities**
FX assets	Currency	FX assets	
	Reserves		Reserves
LC assets	Capital		Capital

8. Readily available reserves at the CBK are limited. Being readily available is the second condition for a foreign-denominated asset to be considered as reserves. From the CBK balance sheet, at end-2023, most of the €1,362 million transferable deposits are reserve requirements from depositary corporations (ODC) and government deposits which are €511 million. However, not all of them are readily available reserves. For example, €165 million are deposits of the Privatization Agency of Kosovo (PAK) and €38 million are IMF RSF lending funds earmarked for the purposes of

Liabilities at the Central Bank of Kosovo
(In million of euros)

	2022	2023	2024 [1/]
Total deposits	1,331	1,362	1,485
Transferable deposits	1,331	1,362	1,185
ODC and others	745	852	651
Central government	586	511	534
o/w PAK	*166*	*165*	*172*
o/w ELA	*46*	*46*	*46*
o/w RSF	*0*	*38*	*47*
Term deposits	0	0	300
Other liabilities	375	275	281
Total liabilities	**1,706**	**1,637**	**1,766**
[1/] As of September.			
Memo			
Stock of usable government deposits	347	240	247

Sources: Kosovo authorities and IMF staff estimates.

the RSF arrangement. The remaining €286 million transferrable deposits, which include €46 million deposited in the CBK specifically for emergency liquidity assistance (ELA), are readily usable resources. Treasury cash management operations, which were reactivated in April 2024 to be intermediated by the CBK by placing €300 million in term deposits at the CBK, should not be considered as available for emergency purposes. Even for the readily available resources, it is important to have a clear institutional framework, backed by the corresponding legal instruments, for their use in case of a liquidity emergency.

9. Government deposits are also needed to fund the Treasury in cases of emergencies. In addition to being needed to support a liquidity emergency in the financial system, government deposits could be needed to hedge the Treasury against adverse shocks to revenues or expenditures. However, there is no consensus about how big a buffer this should be. Hürcan, Koç, and Balibek (2020) reviewed the experiences of different countries and listed different options, most of which are related to the amount of spending and debt services over different periods of time.

Table 2. Kosovo: Recommended Liquidity Buffer
(In percent of GDP)

	Non-EU based banks			All-banks		
10 percent of banks' deposits	3.1	3.1	3.1	6.4	6.4	6.4
One month current spending	1.6			1.6		
One month total spending		1.9			1.9	
One month total spending plus external debt service			2.4			2.4
Recommended liquidity buffer	4.6	4.9	5.4	7.9	8.2	8.7
Stock of free disposal deposits including ELA (end-2023)	3.0	3.0	3.0	3.0	3.0	3.0
Deposits required to reach recommended level	1.7	2.0	2.5	5.0	5.3	5.8

Source: IMF staff estimates

10. The ARA metric can be adapted to capture the peculiarities of the Kosovo's monetary regime.[5] We simplified the ARA equation to focus only on broad money, which can be replaced with bank deposits. Importantly, of the 12 banks that were operating in Kosovo as of 2023, the three largest ones had EU-based parent companies, holding half of banking sector deposits (see text table)[6]. We can consider a scenario where these banks are supported by their parent companies that have access to the ECB lending facilities. Additionally, as discussed above, we need to add a precautionary buffer for the Treasury. As there is no consensus about the size of

Banking System 2023

Bank	Deposits (mill. euro)	Parent Company
1 Raiffeisen Bank Kosovo	1,219	
2 NLB Banka	1,008	
3 Banka Tregtare Kombëtare	956	
4 ProCredit Bank	954	
5 Türk Ekonomi Bankası	723	
6 Economic Bank	537	
7 Bank for Business	417	
8 Turkiye Is Bankasi	84	
9 Komercijalna Banka AD Beograd	79	
10 Ziraat Bank	74	
11 PRIBANK SH.A.	57	
12 Credins Kosovë SH.A	48	
Total	**6,155**	

Sources: Central Bank of Kosovo and IMF staff estimates.

[5] This paragraph follows the findings of Wiegand (2013).

[6] One of the banks (Komercijalna Banka AD Beograd) voluntarily withdraw from the market in 2024, bringing the total number of banks to 11.

this component, we can consider three different metrics following IMF (2016): (i) one month of the central government's current spending, (ii) one month of total spending, and (iii) one month of spending plus external debt service. Adding all the components and deducting the available stock of ELA funds, we find the *additional* government deposits ranges between 1¾–5¾ percent of GDP or €160–560 million. Given that these resources are held with the purpose of primarily addressing liquidity emergencies, they need to be maintained in the form of transferable deposits or money market assets.

C. Conclusions

11. Maintaining such a level of government freely available deposits can be costly. At end-2023, the Treasury had 2½ percent of GDP in freely available deposits. To reach the minimum proposed in this note, it would need to accumulate an additional 1¾ percent of GDP (about €175 million). As discussed in the 2024 Article IV staff report, Kosovo has large development needs, particularly in infrastructure, that would make it politically challenging to justify a large accumulation of resources at the CBK. Furthermore, holding a high level of liquid deposits implies a large cost of carry. Against this backdrop, the authorities can explore other options to reduce the need to accumulate large government deposits. For instance, a private lender of last resort that can be modeled based on the Ecuadorian Financial Liquidity Fund.[7] Other option, that the authorities are using, is a REPO line with the ECB (€100 million) which expires on January 31, 2025 but can be renewed.[8] In any case, the need for liquidity buffers and how they are constituted should be an essential part of a more ambitious and comprehensive strategy for effectively managing assets and liabilities in Kosovo.

[7] The Ecuadorian Fund was created by law in 2009 with the specific mandate to act as lender of last resort for the financial system. It is funded by 3 percent of private banks deposits.

[8] The ECB offers the Eurosystem's repo facility for central banks (EUREP) to non-euro area central banks.

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