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# KOSOVO AND THE EURO:

## The Ins and Outs

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Article I

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Catalonia Working Group on Central Banks (CACEB)

CACEB is a research group focused on central banking, viewed through the lens of Catalan national interests. Our objective is to collect and generate knowledge about central banking that can support the cause of Catalonia's independence. We believe it is crucial to evaluate the extensive literature on this subject, as well as existing institutions, from a Catalan perspective.

The members of CACEB hail from diverse backgrounds and hold a variety of political opinions. What binds us together is our shared interest in central banking and our dedication to the national liberation of our country.

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# Index

# KOSOVO AND THE EURO: THE INS AND OUTS

The country has established a functional banking and financial system using a currency over which it has no power or control.

## 1. Outline

*This article explains how Kosovo uses the euro as its official currency without being part of the Eurozone. The use of a foreign currency, the euro, ever since its inception, makes the role of the Central Bank of Kosovo (CBK) quite different from that of an ordinary central bank. Although most financial institutions in the Balkan country are foreign, the financial market is underdeveloped and there is no capital market. However, the CBK can still implement an effective monetary policy. Despite the limitations of not having its own currency and of monetary rigidity and exchange rate, the euro has brought important gains due to macroeconomic stability - as the dangers of a weak currency disappear - and due to the reduction of costs for trade. Therefore, the adoption of a strong foreign currency, in this case, the euro, can be positive, at least temporarily, for countries that are still on the way to political and economic stabilisation and with a still developing monetary system.*

## 2. Introduction

After the traumatic conflicts in the latter part of the last century and the beginning of this one, most of the Balkan countries are yearning for social and economic development, which often involves integration into European institutions. Many of them, however, still do not meet the necessary conditions to join the European Union (EU). This is the case for Kosovo.

The international community has not unequivocally recognised this young country. Despite being recognized by most Western countries, it is still not accepted by some European states such as Spain, which, due to its own interests, prefers to support Serbia. Even though not part of the EU, Kosovo unilaterally has adopted one of its most important elements, the euro. Since the euro is an EU institution, Kosovo does not have the right to be part of the eurozone or to use the full legal infrastructure enjoyed by its members. The same applies to other countries that have decided to use the euro but are not EU members, such as Andorra, Montenegro, and San Marino.

In this article, we analyse why and how Kosovo uses the euro and draw conclusions that can be applied to other similar possible cases.

## 3. Why does Kosovo use the Euro?

Kosovo, as part of former Yugoslavia, used the dinar until 1999. Since the Balkan wars, new currencies came into use in the region that decade; the currency of a broken state did not generate enough confidence even among its citizens. That is why the franc, the mark, the dollar, and the lek (the Albanian currency) gained popularity to the point that, in 1999, the UN authority in the region accepted them as valid. Of these currencies, the mark became the strongest, due to remittances from many Kosovars who had emigrated to Germany. The available quantity of marks generated sufficient monetary supply in Kosovo with no need for the intervention of the German monetary authority, the Bundesbank.

The coexistence of these four currencies, as well as the prominence of the German mark, lasted until 2002 when the latter was legally replaced by the euro, which became the official currency of the Kosovo state. Despite the Bundesbank not having any role in the Kosovo financial system in the preceding years, the European Central Bank cooperated by providing around 100 million euros in cash to the Banking and Payments Authority of Kosovo in 2001.[I] Therefore, Kosovo has used the euro as its domestic currency since the euro's inception, despite not being part of the eurozone.

## 3.1. The financial system

The country has twelve commercial banks, and ten of them are foreign.[II] These ten foreign banks control 84.9% of overall assets, which indicates Kosovar financial system's low development level. The Central Bank of Kosovo (CBK) is defined as a public and independent agency responsible for authorizing, supervising, and regulating financial institutions and insurance companies in Kosovo. In addition, the CBK has ratified and adheres to financial regulations included in the Basel Accords and EU directives.

## 3.2. What is a central bank?

Before a detailed explanation of the Kosovar monetary system and the role of its central bank, it is convenient to briefly describe what a central bank is and how it operates from a traditional perspective.

When a bank lends money, it adds the corresponding amount to the customer's bank account. Although it is only an accounting entry, the bank must provide an asset if the owner of this account decides to withdraw cash or make a transfer to another bank. In the first case, the bank must provide banknotes to the customer in cash, and in the second case, the bank must transfer the money to the other financial entity through the central bank's interbank payment system. The management of this system, the supply of banknotes, and the management of the interbank payment system fall under the central bank's jurisdiction. The central bank is responsible for balancing, daily, the various imbalances that arise from the multiple transactions between commercial banks, including cross-border transfers and multiple deposits and withdrawals of money. Therefore, the central bank acts as a clearinghouse, where the balances of different commercial banks within the same system are settled after multiple back-to-back transactions.

Central banks provide liquidity (or cash) to commercial banks by lending at a linked interest rate that ultimately determines the financing cost for the country's banks. The amount they decide to lend and, therefore, the interest rate, is a very useful tool of monetary policy, as it will significantly influence the amount of money that commercial banks lend and hence circulate.

### 3.2.1. The Kosovar monetary system and *euroeuros*

As Kosovo is not part of the eurozone, it is not a member of the European interbank payment system, known as TARGET2. Moreover, commercial banks do not have access to the ECB's liquidity facility, and they must find alternative ways to reconcile imbalances and to have the minimum liquidity for the cash withdrawals and transfers to other banks requested by their clients. One of the formulas used is to rely on another bank that has access to the ECB, which performs a role akin to that of a central bank. In other words, Kosovar banks have deposits in eurozone banks, as if they were reserves in a central bank, and hence, they can obtain liquidity in euros. One of the main differences with respect to the conventional system is that, instead of financing deposits at the interest rate set by the ECB, commercial banks do so at the market interest rate.

This mechanism is not an isolated case. Most major European banks have been doing the same with American banks for decades to have access to dollars, known as eurodollars, allowing clients of European entities worldwide to transact in dollar without the need for American banks. To avoid dependence on third parties, instead of using American commercial banks, European banks usually operate through branches in the U.S. that provide them access to the Federal Reserve. This system is known as correspondent banking. Therefore, an English or French bank can obtain dollars by creating a deposit at its branch in the U.S.; the branch can indeed have a deposit (or, more precisely, reserves) at the Federal Reserve as a counterpart to the deposit that the European branch has there.[III]

In the case of Kosovo, a similar situation may arise, but instead of dollars, commercial banks demand euros. We therefore refer to the market for obtaining these assets as "euroeuros." Since most banks in Kosovo are foreign (and European), the situation is simpler, as these banks provide the necessary liquidity to their branches in the Balkan country. Consequently, thanks to this instrument, there is essentially no need for a central bank for this state, since through an intermediary (correspondent bank), one can always access to liquidity in euros (or dollars).

On the other hand, the existence of a central bank has some notorious advantages, such as certain logistical facilitation. This is the actual case in Kosovo, where the CBK acts as a clearinghouse and manages the infrastructure that allows interbank payments through the IPS (Interbank Payment System), which allows Kosovar banks to transfer money to each other much more easily and requires fewer intermediaries.

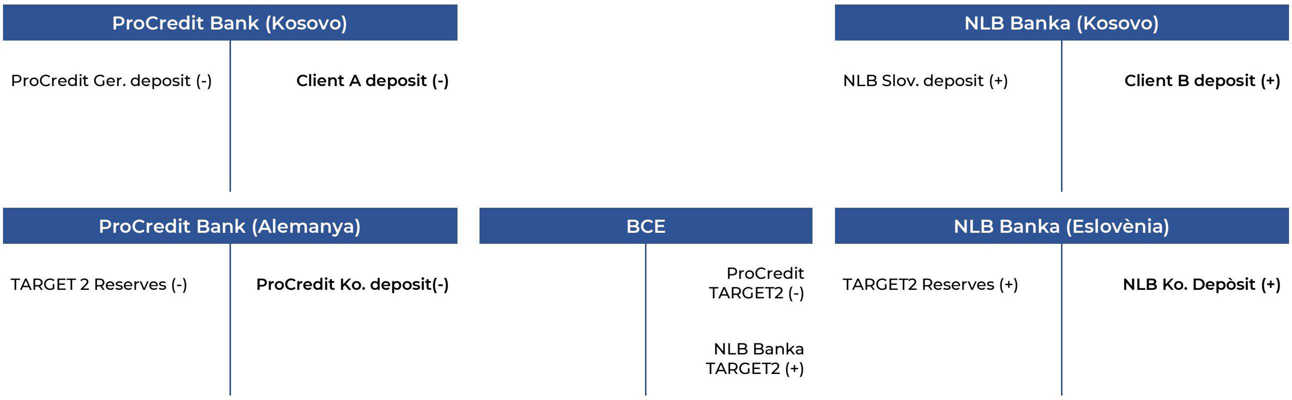
We see that there are two possible monetary systems in the absence of a national currency. The first one, which does not require a central bank and uses correspondent banking to make payments between different banking institutions; and the second, which has a central bank that manages a direct clearing system.

For example, imagine that a ProCredit Bank customer wants to transfer €1,000 to an NLB Banka customer. Both banks have their headquarters in eurozone countries. Using the IPS system, ProCredit Bank will deduct €1,000 from the customer's deposit, and its reserves at the CBK will also decrease by the same amount. The opposite will happen with NLB Banka. Since the IPS system is used in this case, we refer to it as IPS reserves.

| ProCredit Bank (Kosovo) | | CBK | | NLB Banka (Kosovo) | |
|---|---|---|---|---|---|
| IPS Reserves (-) | **Customer A deposit (-)** | | ProCredit IPS Reserves (-) | IPS Reserves (+) | **Customer B deposit (+)** |
| | | | NLB IPS Reserves (+) | | |

In the absence of a Kosovar payment system, banks would have to rely on correspondent banking and the ECB to perform this transaction. In this case, the deposit from ProCredit Bank Kosovo to ProCredit

Bank Germany decreases, as well as the reserves of the ProCredit Bank Germany at the ECB. In the case of NLB Banka, the procedure is the opposite; hence, we refer the reserves as TARGET2 Reserves because the ECB payment system is used to transfer funds from one bank to another."




It is important to consider that TARGET2 euros (or reserves) are not of the same "nature" as IPS euros, as the latter do not have the backing of the ECB and cannot be used for payments to other EU countries. Therefore, IPS euros need TARGET2 as a collateral to have value.

The IPS is the only payment system in existence in Kosovo, meaning that it handles the settlement of all payments made in the country, including high-value, individual, group, financial instruments, debt, etc. Currently, there are fifteen direct participants. In addition to the central bank and commercial banks, the pension fund and the Ministry of Finance are also members. The government, as well as other state institutions, holds its accounts at the CBK. This system, which uses the same technology as the payment systems of the eurozone or the USA, was designed with guidance from the IMF.

The existence of its own central bank also helps Kosovo to improve oversight of the financial system and ensure its smooth operation. Regarding this issue, it is important to mention that all banks are obliged to maintain 10% of their deposit base in reserves, of which at least 5% must be deposited with the CBK.[IV] If there is a lower balance, the bank must provide enough liquidity to restore minimum reserve level. In September 2022, most banks had more reserves than those required by the central bank, specifically 2.8 times more,[V] ensuring stability for possible unforeseen events.

### 3.2.2. Monetary policy and the financial market

Since Kosovo does not have its own currency, the Central Bank of Kosovo (CBK) cannot implement an independent monetary policy. In other words, it cannot set the base interest rate for the entire economy. Nevertheless, it can refinance commercial banks by supplying liquidity through what are known as repo operations. In this case, the CBK, lends to commercial banks, using government debt securities (treasury bonds) as collateral. Banks provide government debt securities to the CBK in exchange for euros (issued by the CBK, not the European Central Bank) that will become part of their reserves. Once the loan due date arrives, the banks repay the CBK with added interest, and the CBK will return the original government debt securities. It is important to note that, as of 2020, these

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transactions could only be carried out within the same day. Kosovar authorities are currently working to extend the due dates of these transactions.

In this way, the Central Bank of Kosovo (CBK) has a small margin to expand or reduce its balance sheet and thus meet the monetary needs of the country's economy. Since Kosovo does not have a capital market, the CBK cannot have an unconventional monetary policy involving the purchase of assets beyond government debt. It is one of the largest countries without a stock exchange. As outlined in the International Monetary Fund's (IMF) Financial Stability Report on Kosovo (2020),[VI] *"there is no stock exchange. The financial sector is dominated by banks, which focus on plain vanilla banking activity. The only securities in issuance are government bonds, for which there is no active secondary market. Neither banks nor insurance companies offer investment products. Corporates rely on bank loans for their funding needs. Aggregate credit growth is high but households' ability and willingness to consider capital markets as an alternative to banks is questionable."*

Some of the main objectives of Kosovo's monetary authorities are developing a capital market, the establishment of investment funds, and a secondary market for products such as government bonds. Additionally, despite having the required legal instruments, the CBK has not yet implemented conventional macroprudential measures focused on increasing solvency and mitigating potential financial risks, a step that will have to be taken at some point given Kosovo's significant credit growth. To sum up, the authorities in the Balkan country must change the institutional framework, including providing the BCK more power and resources, to develop the economy and ensure financial stability.

## 3.3. Central Bank of Kosovo: balance sheet

| *Milions of €* | 30-Nov-22 | 31-Dec-21 |
|---|---|---|
| **Assets** | **1,878** | **1,668** |
| Cash on hand | 534 | 538 |
| Current accounts with non-resident banks | 252 | 152 |
| Placements in monetary market | 100 | 14 |
| Securities | 667 | 633 |
| Assets related with IMF | 318 | 324 |
| Property, equipment and intangible assets | 5 | 6 |
| Other assets | 2 | 2 |
| | | |
| **Liabilities** | **1,807** | **1,605** |
| Due to domestic commercial banks | 603 | 589 |
| Due to IMF related accounts | 321 | 326 |
| Due to Governmental Institutions | 720 | 608 |
| Due to public and commercial entities | 158 | 77 |
| From borrowing | 2 | 2 |
| Other domestic liabilities | 2 | 2 |

| *Milions of €* | 30-Nov-22 | 31-Dec-21 |
|---|---|---|
| **Capital and reserves** | **71** | **63** |
| Authorized capital | 30 | 30 |
| Reserve fund | 33 | 27 |
| Net result of the financial year | 8 | 6 |

*Table 1. Balance sheet from CBK Financial Statement - November 2022* [VII]

In this table, we can observe the balance sheet of the Central Bank of Kosovo (CBK). The reserves of domestic commercial banks are represented as a liability on the CBK's balance sheet (Due to domestic commercial banks). As mentioned, the number of reserves in the CBK is higher than legally required. The centralization of liquidity in this institution allows it to address potential unforeseen events. It is important to note that the euros held in reserves are euros minted by the KCB and circulate among commercial banks through the IPS system; therefore, we can refer to them as euros (IPS). On the other hand, the euros that the CBK has in cash (on the asset side) are euros minted by the European Central Bank (ECB) and, hence, they will be accepted by the ECB and other international financial institutions. Since the system through which these funds move across Europe is TARGET2, we refer to these euros as Target 2 euros. As explained above, the CBK expands (or contracts) the money supply through repo transactions with government debt securities as collateral. Therefore, an expansionary monetary policy will be reflected in this balance sheet with an increase in securities and other assets on the asset side and an increase in reserves (due to domestic commercial banks) on the liability side.

| **CBK** | | **Commercial banks** | |
|---|---|---|---|
| Securities *(+)* | **Due to domestic commercial banks *(+)*** | Government debt bonds (-) | |
| | | Reserves (+) | |

Since, in the face of an expansionary policy, bank reserves and thus euros (IPS) increase, but not the cash held by the CBK, euros (TARGET2), the CBK cannot significantly expand credibly its balance sheet. The fact that the euros used in Kosovo (IPS) must be convertible into euros (TARGET2) for any international transaction imposes a higher level of discipline compared to Eurozone countries. In addition to domestic commercial bank reserves, the CBK also holds government cash and the rest of government institutions' assets. A significant portion of these assets is eventually invested in secure assets that offer guaranteed returns, especially government bonds from Western states.

Both the make-up and overall figures on this balance sheet show that the CBK is a small central bank, very different from the ECB or the Fed, and with notable larger limitations on monetary policy.

## 3.4. Risks and limitations of using the Euro

The phenomenon of using a foreign currency instead of the domestic one is known as dollarization. The term originates in Latin America, where some countries use the dollar due to the lack of credibility and trust in their respective currencies. When not only citizens but also authorities officially abandon the use of their currency and decide to adopt a foreign one (over which they have no control), official dollarization occurs. This is the case for Kosovo, although instead of the dollar, the adopted currency is the euro.

Only a small number of countries officially use a foreign currency. Besides the loss of a significant national symbol of any state, this process also carries economic and political costs, such as the loss of independent monetary policy and exchange rate policy, or not having a lender of last resort.[VIII]

Since most countries have a central bank that has the power to mint their currency, they can always rely on it as a lender in times of extreme need. This helps to generate sufficient credibility for international creditors. Kosovo, like all countries using a currency that is not its own, does not have this resource. In place of this mechanism, the Central Bank of Kosovo (CBK) created the Emergency Liquidity Assistance. However, this instrument would not be sufficient to cover the entire liquidity demand of the Kosovar financial system, according to a 2020 IMF report. Additionally, the trade deficit creates an increased level of risk due to a potential shortage of foreign currency.

Even though the CBK can ensure the financial system functions properly and can facilitate the circulation of money, the limited monetary flexibility due to euroization and the underdeveloped financial system results in higher demands for reserves and liquidity from commercial and central banks compared to a conventional financial system. Another significant limitation for Kosovo is that its central bank cannot set the base interest rate for its economy, and therefore, interest rates end up depending on foreign banks. Since most of these banks are European, it is the European Central Bank (ECB) that indirectly decides the cost of credit in the country."

The lack of an independent monetary policy influences the trade and fiscal policy of the country. On the one hand, since it is not possible to mitigate trade imbalances using the exchange rate, the trade deficit becomes more problematic, especially considering that the Central Bank of Kosovo (CBK) cannot create new euros to finance this deficit. Therefore, the CBK seeks to influence the economic development of the country by facilitating credit to exporting companies to reduce the current significant trade deficit.[IX] On the other hand, the government cannot excessively stimulate demand through an expansive fiscal policy, as it could lead to an excess of credit and an increase in the trade deficit.

Finally, the use of foreign currency increases the risk of economic collapse in the country in a hypothetical scenario where the country faces sanctions from hegemonic economic powers. Controlling one's currency helps to be more resilient against international community boycotts, as we can observe in the case of Russia since the beginning of the Ukraine war. However, a boycott or a sanction package by major financial powers is not a plausible scenario in Kosovo.

## 3.5. Advantages of the Euro

Despite the limitations mentioned above, there exists a consensus in Kosovo in favour of using the euro as the official currency.

The use of a strong currency facilitates access to foreign capital markets and significantly limits the risk of experiencing uncontrolled inflationary cycles, which are often generated from a vicious circle between exchange rate volatility and domestic prices.

Furthermore, it contributes to monetary and financial stability, it also brings trade benefits. According to the economic theory suggesting that a depreciated currency could undermine the balance of payments, some may argue that the euro leads to higher prices and fewer exports. However, Kosovo's export market is too small to benefit from a weak currency.[X] The gains in reducing uncertainty and transaction costs, especially when trading with other European countries, outweigh any potential costs.[XI]

From 2008 (the first year for which data is available) to the present, the GDP of the Balkan country has increased from 5.18 billion euros to 9.41 billion euros, representing a significantly higher relative growth than most European countries. Furthermore, foreign trade has remained above 70% of GDP throughout these years. [XII]Therefore, the euro has created a stable economic framework that has enabled the development of the Kosovar economy.

## 4. Conclusions

The case of Kosovo shows us that a young country, whose international recognition is still disputed, has successfully been able to adopt a foreign currency without being part of its legal and political structure. The euro has brought economic progress and protection against financial uncertainties. Most failures in the Kosovar system are due to the lack of financial infrastructure and a low level of development in capital markets. However, this is a characteristic of the country itself and not necessarily a consequence of adopting the euro; moreover, the adoption of a strong foreign currency may be, in part, a consequence of these shortcomings. Therefore, although there is still a long way to go, Kosovo serves as an example of a young and small country that is still stabilizing its political situation and establishing its institutions.

There are significant limitations in adopting a foreign currency, starting by a loss of sovereignty for a state that does not have its own currency and monetary policy. This loss is even more relevant if the state cannot participate in community decisions, as Eurozone countries do. However, the main attraction of adopting a foreign currency is the stability it brings, avoiding the threat of financial isolation and allowing the use of the existing banking structure. Therefore, for a newly created country where uncertainty still prevails and there are significant unresolved conflicts, this formula is especially useful. Even when creating its currency is on the long-term agenda, temporarily using the euro to build a more comprehensive monetary system can be particularly beneficial for the economic development of a country. For all these reasons, Catalonia needs to study the Kosovar case to learn from it and continue advancing.

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