April 2012
IMF Country Report No. 12/100

Republic of Kosovo: Request for Stand-By Arrangement—Staff Report; Press Release on the Executive Board Discussion.

In the context of the request for a Stand-By Arrangement, the following documents have been released and are included in this package:

- The staff report for the Request for Stand-By Arrangement, prepared by a staff team of the IMF, following discussions that ended on March 5, 2012, with the officials of the Republic of Kosovo on economic developments and policies. Based on information available at the time of these discussions, the staff report was completed on April 12, 2012. The views expressed in the staff report are those of the staff team and do not necessarily reflect the views of the Executive Board of the IMF.

- A Press Release summarizing the views of the Executive Board as expressed during its April 27, 2012 discussion of the staff report that completed the request and/or review.

The documents listed below have been or will be separately released.

Letter of Intent sent to the IMF by the authorities of Kosovo*
Technical Memorandum of Understanding*

*Also included in Staff Report

The policy of publication of staff reports and other documents allows for the deletion of market-sensitive information.

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Washington, D.C.

INTERNATIONAL MONETARY FUND

REPUBLIC OF KOSOVO

Request for Stand-By Arrangement

Prepared by the European Department
(in Consultation with other Departments)

Approved by Poul M. Thomsen and Jan Kees Martijn

April 12, 2012

Stand-By Arrangement: In the attached letter, the Kosovar authorities are requesting a 20-month Stand-By Arrangement for SDR 90.968 million (equivalent to €107 million or 154 percent of quota). An initial purchase of SDR 4.251 million becomes available on approval of this request. The request follows effective implementation of a Staff-Monitored Program during June-December 2011.

The letter outlines the economic program for which the authorities seek Fund financial support. Key objectives include: (i) the restoration of an adequate level of government bank balances by 2013, and of a sustainable fiscal stance by 2014; (ii) the anchoring of fiscal policy after the program period through the introduction of a legally binding fiscal rule; (iii) further progress with the design and costing of spending initiatives; (iv) reforms to enhance the efficacy of Kosovo's system of fiscal decentralization; (v) a stronger legal framework for financial regulation and supervision; and (vi) equipping the central bank with the necessary funds for emergency liquidity assistance. If fully implemented, the program would significantly enhance the institutional framework for the conduct of macroeconomic policy.

Mission**:** Pristina, February 21–March 5. The mission met with Prime Minister Hashim Thaçi, Minister of Finance Bedri Hamza, Central Bank Governor Gani Gërguri, other government officials, parliamentarians, private sector representatives, the International Civilian Office, and envoys representing the international community.

Team**:** Messrs. Wiegand (head), Castro, Druck (all EUR), Alper (FAD), Qu (SPR), and Parker (MCM). Messrs. Sulemane (Resident Representative) and Thaçi (Resident Representative's Office) assisted the mission. Mr. Kiekens (OED) joined during final days of the mission. The staff team cooperated closely with a World Bank mission that was in the field at the same time.

Publication**:** The authorities have agreed to publication of the staff report.

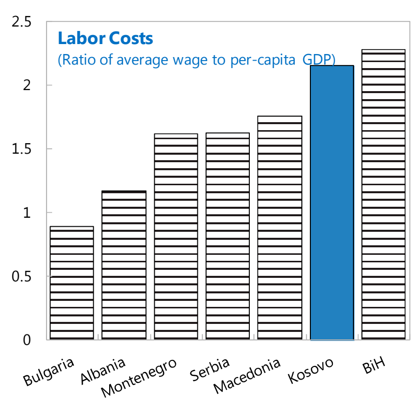
Contents Page

I. Background and Macroeconomic Challenges

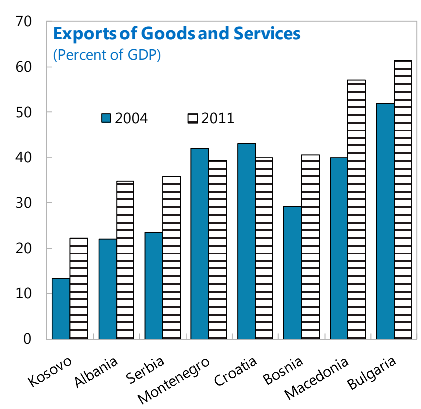
1. **Kosovo is in the final stages of transition to full self-governance in economic and financial affairs.** Until February 2008, Kosovo was under the administration of the United Nations (UNMIK). Multilateral institutions continued to play a key role also thereafter, notably the International Civilian Office (ICO) charged with overseeing Kosovo's "supervised independence,"[1] while donors like the World Bank, the European Commission, the US Treasury, USAID, and KfW of Germany assisted in building economic and social institutions and promoting economic governance. In the fifth year after Kosovo's declaration independence, however, the ICO is gradually reducing its involvement, and donor support is receding.

2. **Macroeconomic challenges are severe.**[2]

- ***External competitiveness is weak***. Reasons include a deficient public infrastructure—notably in energy supply and transportation—modest skill levels of large parts of the working force, and a challenging business environment (Kosovo ranks #117 in the World Bank's "Doing Business" survey). Large remittances and FDI from the Kosovar diaspora fund domestic absorption but also drive up wages, impeding the development of a tradable sector (Box 1, Figure 1). As a result, the bulk of Kosovo's growth in the past decade has come from domestic demand. Registered unemployment stands at more than 40 percent, but informal employment is widespread.



Sources: World Bank; national statistics offices and tax administration.



Sources: IMF WEO World Economic Outlook

- ***Kosovo's fiscal position was strong at declaration of independence, but has since deteriorated.*** Kosovo started off with almost no public debt, sustainable social security systems, primary surpluses, and sizeable cash buffers. From 2008, however,

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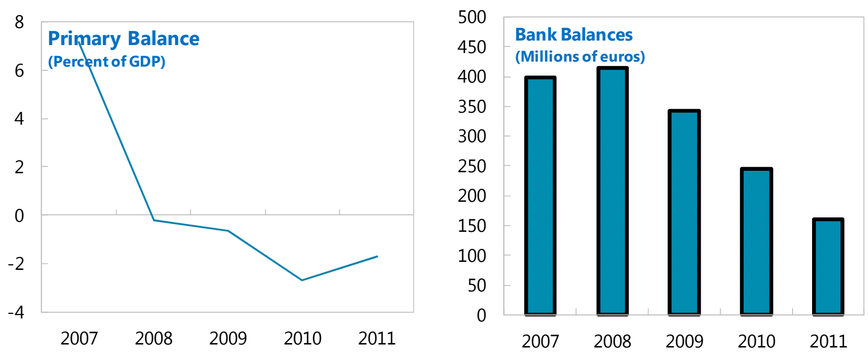
[1] The ICO enjoys veto power over government decisions in many policy areas—including economic and financial matters—although it has never made use of these powers.

[2] For more elaboration of these points see Kosovo's 2011 Article IV report, IMF Country Report No. 11/210.

- the government adopted an expansionary fiscal stance, reflecting inter alia an ambitious highway construction program and higher social spending. The resulting deficits were financed with donor support and by drawing down cash buffers. Structural fiscal challenges include: (i) a revenue structure that is tilted toward border taxes and provides a limited revenue base to address social and capital spending needs; (ii) inadequate design and costing of spending initiatives; (iii) a system of fiscal decentralization that—while granting municipalities adequate resources—provides insufficient incentives to raise own-source revenues; and (iv) difficulties in monitoring payment obligations and overdue bills.



Source: Country authorities; and IMF staff calculations.

- ***The central bank's (CBK's) toolkit to safeguard financial stability requires strengthening.*** Kosovo's banks have grown rapidly: at end-2011 they held assets of almost 60 percent of GDP, compared to 5 percent of GDP in 2000. Banks are mostly foreign-owned, but funded with domestic retail deposits. While the banking system has remained stable, the legal framework for supervision and regulation as well as the CBK's capacity to provide emergency liquidity assistance to banks are in need of an upgrade.

3. **Kosovo has been closely involved with the Fund since becoming its 186th member in 2009.**[3]

- ***In July 2010, the Executive Board approved an 18-month Stand-By Arrangement (SBA),*** to support policy credibility and arrest the decline in bank balances. The SBA went off track without completing a review, however, reflecting inter alia outsized public sector wage increases (by 30–50 percent) as part of the 2011 budget.

- ***In June 2011, the authorities requested a Staff-Monitored Program (SMP)*** until end-2011 to establish a track record of disciplined policy implementation that could lead to a new SBA in 2012. The SMP targeted inter alia: (i) structural fiscal adjustment of 1½ percentage points of GDP in the context of the 2011 and 2012

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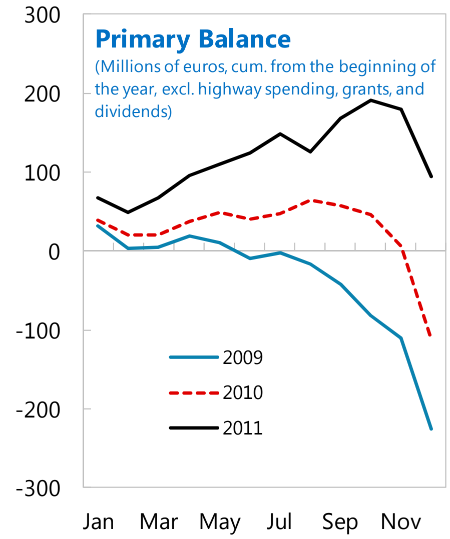
[3] Kosovo received IMF technical assistance even before joining the Fund.

budgets to gradually move toward a sustainable fiscal stance; (ii) improved budgetary planning and execution; and (iii) steps to strengthen the financial system's resilience, such as completing the legal and administrative framework for the provision of emergency liquidity assistance (ELA).



- ***Implementation of the SMP has been broadly satisfactory*** (Appendix I). Most quantitative and structural benchmarks for end-September and end-December 2011 were met. Significant overperformance was achieved relative to fiscal targets, with an overall fiscal deficit in 2011 of 1.9 percent of GDP, compared to a program target of 2.9 percent and a deficit of 5.0 percent originally inscribed into the 2011 budget (Figure 2). Most structural conditionality was also met, with important progress especially on financial sector reforms.

4. **Notwithstanding these efforts, the government's financial position has deteriorated further.** The principal reason is the failure to privatize the telecommunications company (PTK) in 2011 as planned, owing to the withdrawal of one out of two prequalified bidders. The process had to be restarted and is now unlikely to be completed before 2013. Privatization had been expected to generate receipts of at least €300 million (6 percent of GDP). As a result, the treasury's useable balances with the CBK stood at €160 million at end-2011—about half the level needed to insure adequately against fiscal and financial risks (Box 2)—and would fall further in 2012 in the absence of external support. In a unilaterally euroized economy, useable bank balances serve not only as a buffer against fiscal shocks, they also enable the central bank to act as a lender of last resort. Kosovo's balance of payments need results from this anticipated shortfall in useable bank balances, which is equivalent to a shortage in foreign currency reserves in an economy with an own currency.

5. **At the same time, Kosovo's economy has remained largely shielded from turbulence in the euro area, owing to limited integration into cross-border financial markets and a small export base** (Figure 3). Real GDP growth in 2011 is estimated at 5 percent, driven principally by domestic demand, in particular investment. Inflation moderated to 3.5 percent (y-o-y), after a spike to double-digit figures in early 2011 triggered by higher prices for imported food stuffs. The current account deficit is estimated to have widened to about 20 percent of GDP in 2011, from 17½ percent of GDP in 2010, reflecting mostly higher imports. Strong capital inflows, including FDI from the Kosovo diaspora, have continued to fund the deficit. The Kosovar economy has continued to display resilience also in early 2012, although there are some indications of a modest weakening in domestic demand, such as weaker tax revenues and deposit inflows into banks.

II. The Fund Supported Program

A. Overall Program Objectives

6. **The program's key policy objective is to make further decisive steps toward restoring fiscal sustainability and to anchor fiscal policy, complemented by appropriate structural fiscal and financial sector reforms.** With no monetary policy, fiscal policy is the main tool to safeguard macroeconomic stability. Policies to strengthen competitiveness are primarily being addressed by the World Bank in the context of its Sustainable Employment Development Policy Operation (SEDPO) (Box 3). In terms of financing, the purchases under the SBA allow maintaining an acceptable level of bank balances in 2012 and 2013, and therefore adequate resources to insure against fiscal and financial shocks. Bank balances are expected to recover during the course of 2013, when PTK privatization is expected to be finalized. The program is also expected to facilitate donor assistance.

B. Macroeconomic Framework

7. **The macroeconomic framework is based on the following assumptions** (LOI ¶6):

- ***Real GDP growth*** in 2012 is projected at 3.8 percent (Tables 1 and 2). The deceleration relative to 2011 reflects primarily weaker growth prospects for Germany and Switzerland and knock-on effects on domestic demand. In subsequent years, growth is expected to gradually recover, in line with developments in the euro area. The anticipated completion of highway R7 in 2013 would trigger a temporary deceleration in growth in 2014, however.
- ***Consumer price inflation*** is projected at 0.6 percent (y-o-y) for 2012, in line with expected developments for imported goods, even though possible tariff increases in the context of a revamped electricity regulation may partially offset cheaper imports. Deflationary pressures from import prices are projected to keep inflation low also in subsequent years.
- The ***current account*** deficit is expected to narrow somewhat in 2012/13, reflecting weaker domestic demand and higher metals exports (Table 3). FDI and other non debt-creating flows will remain major financing items. Over the medium term, the external balance is expected to gradually improve due to import substitution.

8. **The main risk to the outlook is a sharper-than-expected downturn with higher unemployment in Germany and Switzerland,** countries where most of the Kosovar diaspora resides. In such a scenario, remittances and FDI inflows would likely slow, with negative repercussions for growth (by curtailing domestic demand), the fiscal position (by reducing consumption taxes) and the financial system (as remittances both fund deposits and are used to service loans). The example of El Salvador during the 2009 financial crisis shows how deteriorating labor market conditions in the emigrants' host country can undermine growth prospects and budgetary outcomes (Box 4). By contrast, risks from direct financial

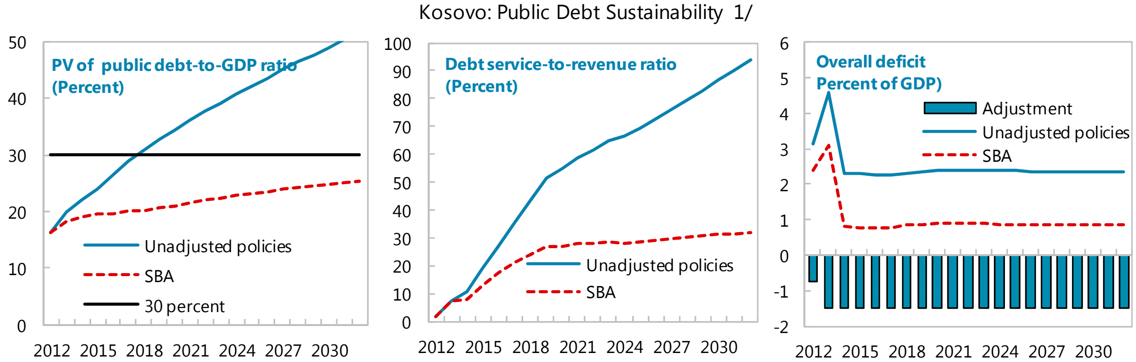
contagion appear limited: Kosovo's banking system does not depend on foreign funding, including from parent institutions, while CBK regulations limit asset-side exposure of Kosovar banking subsidiaries to their parents to a small fraction of their capital.

C. Fiscal Policy

9. **The authorities and staff agreed that anchoring fiscal policy would be an overarching program objective, with key components as follows** (LOI ¶¶7, 8, Tables 4 and 5):

- ***Structural fiscal adjustment.*** The SBA would continue the process of restoring a sustainable fiscal stance that started with the SMP, when 1½ percent of GDP in structural tightening was achieved in the context of the 2011 and 2012 budgets. The objective is to achieve a primary deficit of 0.9 percent of GDP by 2014, which would stabilize public debt in the long term at less than 30 percent of GDP—a level at the lower end of public debt ratios considered sustainable for emerging economies (Appendix II).[4] To this end, adjustment of another 1½ percent of GDP is needed relative to the 2012 budget.[5] About 0.4 percentage points in adjustment will be achieved through environmental taxes and fees that will be introduced during the second and third quarters of 2012 and that are in addition to the 2012 budget. The remainder would be achieved in the context of the 2013 and 2014 budgets.

Kosovo: Public Debt Sustainability 1/



1/ This DSA exercise assumes that a notional debt of 7.2 percent of GDP (in present value) inherited from before the conflict will start being serviced in 2017.

- ***Bank balances.*** The program aims at restoring an adequate level of bank balances in 2013 (i.e., of at least €325 million), when PTK is expected to be privatized. For end-2012, an interim level of €187 million is targeted. Achieving this requires—besides

[4] See for example "Public Debt in Emerging Markets—is it too High?," IMF, *World Economic Outlook*, September 2003, Chapter III. Kosovo's Law on Public Debt contains a ceiling for public debt of 40 percent of GDP. Thus, the targeted stance leaves 10 percentage points of fiscal space to react to adverse shocks.

[5] The 2010–13 budgets contain extraordinary expenditures for highway construction, thus the change in the headline deficit 2012–14 exceeds structural adjustment in the same period.

the additional revenue measures mentioned above—one-off spending cuts of €20 million (0.4 percent of GDP) and higher dividend payments from PTK as a result of cuts in labor cost of 10–20 percent enacted in early 2012 (LOI ¶¶10, 11).

- ***Fiscal rule.*** A legally binding fiscal rule would provide an operational framework for safeguarding fiscal sustainability even after the program has expired. The rule should take into account transient factors, such as large one-off privatization receipts, and Kosovo's fiscal decentralization framework. The authorities have requested technical assistance from the IMF to help develop a rule, aiming at incorporating the rule into legislation before the end of the program. With a framework in place that would permanently safeguard confidence in the sustainability of fiscal policy, the government should be able to cover its financing needs in a self-sustained manner—including to maintain an adequate level of cash balances—thus facilitating the graduation from official support.

10. **There was agreement that restraint on current spending and growth friendly revenue measures would remain key components of fiscal adjustment.** In particular, public sector wage restraint is vital, to partly compensate for the excessive wage increases in the context of the 2011 budget. Revenue measures would be oriented on the recommendations of an IMF tax policy technical assistance mission of October 2011 (Box 5). Moreover, no measures would be taken that undermine the integrity of the current tax system, especially as regards corporate income tax and Kosovo's highly effective VAT regime (LOI ¶13).

11. **Careful costing of spending initiatives will be at the core of the SBA** (LOI ¶15). Several ambitious projects are ongoing or in preparation whose integration into a sustainable budgetary framework requires meticulous design and preparation, and often implementation in a phased manner. These include:

- the ***highway R7 to Albania*** that is scheduled to be completed in 2013. Vigilant cost control will be needed as the project nears finalization, especially with respect to variation costs.
- another planned ***highway R6 to Macedonia***, for which the government is currently evaluating financing options. Staff and the authorities agreed that preconditions for moving forward with R6 include a transparent financing plan consistent with a sustainable medium-term budgetary framework, and a positive assessment by the World Bank of the project's economic viability.
- ***war veteran benefits***, a ***reform of the health care system***, a ***possible extension of pensioner benefits***, and ***civil service reform***, all of which require thorough preparation and costing, in cooperation with the World Bank.

Further, to contain fiscal risks the program specifies several requirements for laws that create or amend benefits (LOI ¶9). These include: (i) only cash benefits will be granted, with no link of benefit levels to the minimum wage; (ii) consideration of new benefits by the cabinet is preceded by fiscal impact assessments that cover a period of at least five years (continuous structural benchmark); and (iii) an article is to be included into any such law that explicitly allows cutting benefits in case of insufficient budgetary funds (continuous structural benchmark).

12. **The government has made a promising start in issuing debt to private investors, but further progress is needed before financing needs can be covered in a self-sustained manner** (LOI ¶12).

- ***T-bill issuance program.*** Earlier this year, the government conducted three auctions for three-month government T-bills—the first in Kosovo's history—and raised a total amount of €30 million, mostly from private banks, at effective interest rates of 3.5–4 percent (annualized). Looking ahead, the next step is to increase the maturity of government paper and establish a yield curve. To facilitate this step, the government aims at obtaining a rating from an international credit rating agency later this year.
- ***Pillar II pension fund.*** Part of the planned issuance of government paper in 2012 of €74 million (1.7 percent of GDP) is expected to be purchased by Kosovo's pillar II pension fund (KPST). To enable such purchases, the assembly passed in early April a revised pension fund law that loosens KPST's exposure limit to the government from 5 to 30 percent of total assets. At the same time, the law sets a ceiling on annual investments into government paper of 50 percent of previous-year premium inflows into KPST, to protect the integrity of KPST's investment strategy (prior action).

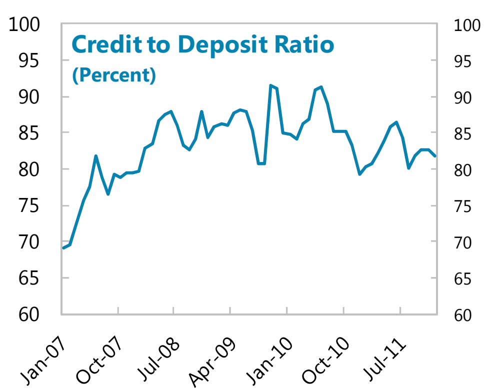
13. **While the authorities agreed with staff that Kosovo's system of fiscal decentralization requires an overhaul, they argued reforms should advance in a gradual manner** (LOI ¶16). The current system is based on a general grant from the central government to municipalities that equips municipalities with adequate resources, but provides little incentives to raise municipal own-source revenues. Further, rigid, centrally set ceilings on current spending provoke an inefficient allocation of resources, characterized by municipal over-investment and insufficient maintenance of the capital stock. An IMF technical assistance mission that visited Kosovo in December 2011 recommended lifting spending ceilings for all categories except wages, and modifying the formula for the general grant in various ways so as to warrant a more equitable allocation of resources across municipalities and provide better incentives to raise own-source revenues (Box 6). The authorities agreed to allow municipalities to allocate own-source revenues freely across spending categories except wages, starting with the 2012 budget (structural benchmark for end-May). They argued, however, that more consultation was needed with municipalities before further steps could be taken. Staff and the authorities agreed to return to this issue during future program reviews.

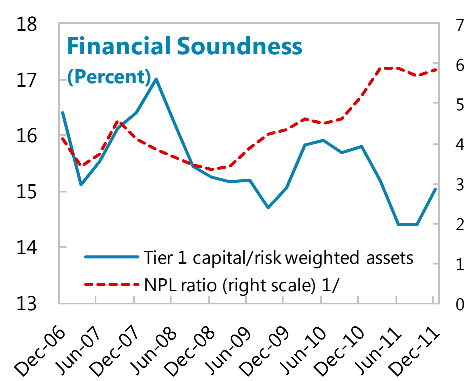
14. **Capacity building is needed to improve the government's ability to monitor payment obligations** (LOI ¶17). Under the SMP, both the central government and

decentralized entities repeatedly accumulated small amounts of domestic arrears, reflecting insufficient capacity to record and monitor bills payable. Further, there are deficiencies regarding the timely recording and reporting of payment obligations. The authorities have requested IMF technical assistance to assess capacity constraints. The recommendations of the technical assistance mission may translate into structural conditionality later in the program. By the end of the SBA, the Treasury should be able to monitor all invoices in real time.

D. Financial Sector Policies

15. **Kosovo's banking system has remained profitable, liquid, and well-capitalized, although financial strength varies across banks** (Tables 6, 7, Figure 4). Aggregate capital adequacy for the banking system stood at 17.5 percent at end-January 2012, well above regulatory requirements. 5.9 percent of loans were non-performing, down from 6.3 percent a year earlier. Banks also have conservative credit-to-deposit ratios of about 80 percent, and substantial excess liquidity. However, the capital adequacy ratio of a small domestic bank, accounting for 6 percent of the banking system's assets, dropped temporarily below the regulatory minimum of 12 percent at end-2011, reflecting additional provisions after an on-site audit identified misclassified loans. Since then, the bank's owners have injected additional capital, and an action plan is being implemented to address the causes underlying the misclassification. The central bank has also requested technical assistance from the IMF to analyze loan documentation and classification practices, as on-site audits have repeatedly encountered irregularities in this area. Further priorities may be identified by an IMF/World Bank mission under the Financial Sector Assessment Program (FSAP), scheduled for the fall of this year (LOI ¶22).





Sources: Central Bank of Kosovo; and IMF staff estimates.
1/ Liquid assets are cash, balances with CBK and commercial banks, and securities.

16. **The authorities and staff agreed that several steps are needed to complete Kosovo's framework for financial supervision and regulation, and that these steps should be taken early in the program.**

- ***Financial supervision.*** A Banking and Microfinance Law (BML) was adopted by the assembly in mid-April (prior action) that strengthens provisions for corporate governance within banks, limits banks' exposure to large borrowers and related parties, and provides a framework for the efficient resolution of troubled financial institutions, including by facilitating early intervention and creating a legal basis for purchase-and-assumption transactions (LOI ¶20). The next steps are harmonizing rules and regulations with the BML, and revising the Deposit Insurance Law (DIL) to allow using resources of the deposit insurance fund for purchase-and-assumption transactions (LOI ¶21). Submission of a revised DIL to the Assembly is a structural benchmark for end-May 2012.

- ***Emergency Liquidity Assistance*** (ELA). A framework for the provision of emergency liquidity assistance was established with the passage of a revised Central Bank Law in 2010 and the signing of a memorandum of understanding between the Ministry of Finance, the CBK, and the Budget and Finance Committee of the Assembly in 2011. However, to date no funds have been assigned to the special reserve fund (SRF) designated for ELA. Taking into account the overall resources available to the CBK, the CBK will have adequate funds after the second purchase under the SBA to fund the SRF in an amount of €46 million (1 percent of GDP), so as to render the provision of ELA fully operational. Prior to the purchase, the Law on Public Financial Management and Accountability would be amended to specify that only the CBK has access to the SRF (structural benchmark for June 15, 2012, LOI ¶19).

E. Competitiveness and Private Sector Development

17. **While competitiveness issues are primarily being addressed by the World Bank in the context of its SEDPO loan, the program assists these efforts by placing key infrastructure projects in a sustainable fiscal framework.** These include in particular the authorities' highway construction program, and plans to privatize and modernize Kosovo's system of energy generation and distribution that are advanced in close consultation with the World Bank (LOI ¶27). Further, staff welcomes the government's efforts to improve the business environment, including through a package of twelve laws aiming at enhancing Kosovo's ranking in the World Bank's "Doing Business" survey (LOI ¶25), as well as its preparedness to take legislative action as needed to safeguard labor market competitiveness and the employability of women (LOI ¶26).

III. Program Modalities

18. **Kosovo's balance of payments need is modest and concentrated in 2012** (Tables 8a, 8b). The external financing gap is estimated at SDR 90.968 million (equivalent to €107 million, 154 percent of quota) for 2012 and 2013, which would allow maintaining an acceptable interim level of government bank balances throughout the program period. SDR 78.216 million would be made available in 2012.

19. **Kosovo's capacity to meet its obligations to the Fund is adequate** (Table 9). Initial debt levels are low. Repurchases to the IMF are scheduled to peak in 2016 at less than 1 percent of GDP and less than 3 percent of fiscal revenue, reflecting the modest size of the program. Nevertheless, staff encourages the authorities to build up an extra cash buffer in 2013–15 in anticipation of the repurchases.

20. **Nevertheless, risks to the program are substantial.**

- ***Shocks and contingencies.*** A sharper than anticipated downturn in the euro area would curtail current and capital inflows, with negative repercussions for domestic demand and tax revenues. PTK privatization may be delayed further or yield less receipts than anticipated, while unanticipated cost overruns may materialize with respect to spending initiatives, especially highway R7 to Albania. All these events would translate into lower government bank balances than currently envisaged, and thus give rise to an additional financing need that may require further adjustment.
- ***Implementation risk.*** Political challenges may test the government's commitment to policy discipline, as was the case in 2010. Fiscal discipline may be especially difficult to maintain in the run-up to parliamentary and presidential elections expected for the second half of 2013.
- ***Upside risks.*** There are also upside risks to the program, especially the possibility that from 2013 the Kosovar Privatization Agency (PAK) may transfer receipts from the privatization of erstwhile socially-owned enterprises to the budget. The liquidation process for these companies has not yet advanced sufficiently to include such receipts in budgetary forecasts at this juncture.[6]

21. **The program's purchase and review schedule are designed to mitigate risks to the Fund** (Table 10). The SBA will be for 20 months starting in April 2012. Thus, the run-up to elections in 2013 would be covered by the program, supporting the authorities' efforts to maintain policy discipline in this period. The purchase and review schedule throughout 2012 is aligned with the authorities' funding needs and Kosovo's budgetary preparation schedule, with strong policy actions tied to each purchase:

- ***A first purchase*** of SDR 4.251 million is being made available upon program approval, following the completion of prior actions that: (i) ensure consistency of the 2012 budgetary framework with fiscal sustainability and an acceptable level of bank balances; (ii) enhance the central bank's ability to safeguard financial stability; and (iii) shield the pillar II pension fund from pressures to fund budget deficits.

[6] Once these receipts materialize, careful fiscal management will be needed to prevent that one-off receipts fund permanent spending commitments.

- ***A second purchase*** of SDR 39.108 million would be made available upon completion of the first review, with a test date of end-April 2012 and a review mission in June. The resources will be credited to an account under the central bank's full control (LOI ¶19). It is expected that after this purchase, the authorities will fund the central bank's special reserve fund for emergency liquidity assistance, as noted in paragraph 16. Prior to completion of the review, the Law on Public Financial Management and Accountability would be amended to restrict access to the special reserves fund to the CBK.
- ***A third purchase*** of SDR 34.857 million would be made available upon completion of the second review, with a test date of end-August 2012 and a review mission in October. This purchase would be made into a CBK account accessible for the treasury, to mitigate the expected drop in bank balances towards the end of the year associated with seasonality in capital spending. Prior to completion of the review, the authorities and staff would agree on the 2013 budget (structural benchmark for end-October 2012).
- ***In 2013*** the program is scheduled to move regular quarterly reviews, with purchases of SDR 3.188 million tied to each. Revisions to this schedule may be needed in view of Kosovo's budgetary and electoral calendar.

22. **High-level program monitoring on the authorities' side aims at supporting ownership and at facilitating coordination across government agencies** (LOI ¶27). A Program Monitoring Committee (PMC) headed by the Minister of Finance and involving high-level participation from the Prime Minister's office, the CBK, the Ministry of Labor and Social Welfare, and the Ministry of Economic Development, will meet at least once a month to assess progress with implementation of the Fund supported program and consistency of all relevant policy initiatives with the program's objectives (continuous structural benchmark).

23. **Program conditionality is oriented on the program's objectives to anchor fiscal policy and enhance the resilience of the financial sector.** Quantitative performance criteria are summarized in Table 1 of the Letter of Intent and include a floor on the general government's bank balance, a floor on the general government's primary balance, a ceiling on the general government's primary expenditures (in view of risks to spending discipline), a ceiling on the net contracting of the general government's non-concessional debt, a ceiling on general government guarantees, and a continuous ceiling on non-accumulation of external payments arrears by the general government. The indicative ceiling on central government arrears could be upgraded to a performance criterion once an effective monitoring mechanism is in place. Structural benchmarks through end-2012 are summarized in Table 2 of the Letter of Intent.

24. **An updated central bank safeguards assessment is expected to be completed before the first review.** The CBK underwent a safeguards assessment in the context of the Stand-By Arrangement approved on July 21, 2010. At the time, the assessment confirmed

that key safeguards were in place, including on external audits and financial reporting frameworks, notwithstanding a need to improve procedures in some areas, such as internal audit independence and IT audits. Revisions to the CBK Law in 2010 had addressed most safeguards concerns with the legal framework. Further, a Memorandum of Understanding has been signed that protects the Fund disbursements into government accounts at the CBK.

IV. Staff Appraisal

25. **In the past 10 months, the conduct of macroeconomic policy in Kosovo has improved significantly.** Following the deterioration in the fiscal stance after the declaration of independence and policy slippages that forced the 2010 Stand-By Arrangement off-track, fiscal adjustment of 1½ percentage points of GDP was achieved under the 2011 Staff-Monitored Program in the context of the 2011 and 2012 budgets. Progress has also been made with respect to the design and costing of spending initiatives, while important steps have been taken to strengthen the resilience of the financial sector.

26. **However, the return to sustainable policies is not yet complete.** To fully return to a sustainable fiscal stance, structural adjustment of another 1½ percent of GDP is required, to be implemented through a mix of restraint on current spending and growth-friendly revenue measures, while protecting priority capital and social spending. Further, the government's cash buffers need to be restored to a level sufficient to insure the economy against fiscal and financial shocks.

27. **Over the longer-term, the challenge is to establish a level of policy credibility that would generate sustained confidence in Kosovo's macroeconomic framework.** To this end, an extended period of disciplined policy implementation is needed, placed within a sound medium-term policy framework. A legally binding fiscal rule could be a particularly important component of the framework, in view of the lack of monetary policy instruments that owes to Kosovo's unilateral adoption of the euro. Policy credibility would facilitate the government's access to funding markets, and eventually allow self-sustained financing of sustainable budgetary balances. It would also contribute to a more attractive environment for private sector investments, including from the Kosovar diaspora.

28. **Careful prioritization, design, costing, and sequencing of spending initiatives are pivotal to strengthen fiscal management.** Kosovo is a young country whose capital and social spending needs are large. Policymakers are under considerable and often understandable pressure to address these needs rapidly. However, any spending initiative needs to fit into the available fiscal space and requires careful management of associated fiscal risks, lest unfunded expenditure commitments would jeopardize macroeconomic stability.

29. **The central bank needs the full toolkit of legal, regulatory, and financial instruments to safeguard financial stability, and be able to use these tools without interference.** The legal framework for banking supervision and regulation has been upgraded

with the passage of a revised Banking and Microfinance Law that greatly enhances the CBK's ability to resolve financial institutions. The next step is to grant the CBK the resources to provide emergency liquidity assistance if needed. A sound, state-of-the-art legal and regulatory framework needs to be matched by a practice of financial supervision that vigilantly monitors risks to financial stability, takes timely actions, and ensures high governance standards in Kosovo's financial sector.

30. **Kosovo's unilateral adoption of the euro places a premium not only on fiscal discipline, but also on labor market flexibility, wage restraint, and structural reforms that enhance the economy's competitiveness.** Recent measures to improve the business climate and improve Kosovo's rank in the World Bank's "Doing Business" survey are welcome steps in the right direction. However, Kosovo's legal and institutional framework will require significant further strengthening to attract domestic and international investors. Improvements in infrastructure are another priority, especially in the transport and energy sectors.

31. **The authorities' program is designed to address Kosovo's macroeconomic challenges in a comprehensive manner.** Restoring a sustainable fiscal stance and an adequate level of government cash buffers, anchoring fiscal policy in the medium term, and fostering financial stability are the key objectives of the proposed Stand-By Arrangement. If fully implemented, the program would significantly enhance Kosovo's framework for the conduct of macroeconomic policy.

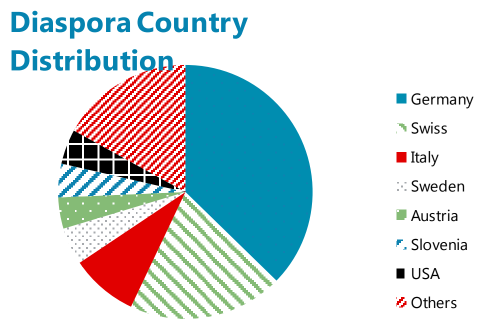
32. **While some risks to the program are mitigated by its design, success will ultimately depend on the formation of a broad political consensus that grants macro-financial stability priority over short-term considerations.** Most policies under the program are within the realm of the Ministry of Finance and the Central Bank, institutions that have shown strong commitment to macro-financial stability and policy discipline under the Staff-Monitored Program. However, the support, and sometimes patience, of the entire political class will be needed to extend this success to the SBA, and prevent a repetition of the unfavorable experience with Kosovo's first SBA of July 2010. A critical test will be the run-up to parliamentary and presidential elections currently expected for the second half of 2013.

33. **Staff supports the authorities' request for a 20-month Stand-By Arrangement.**

Box 1. The Role of Remittances in Kosovo's Economy

Kosovo's economy depends heavily on current and capital inflows, notably remittances. Between 2004–10, remittances—i.e., transfers from Kosovars living abroad—averaged 14 percent of GDP. A large part of FDI and "other capital flows" also originates with the Kosovar diaspora; taken all together current and capital inflows financed a trade deficit of 39 percent of GDP. Inflows are critical for growth, government revenue, and financial development. This box summarizes features of Kosovo's remittances based on data from the 2010 "Kosovo Remittances Study," collected by the UNDP with other agencies (including the IMF).

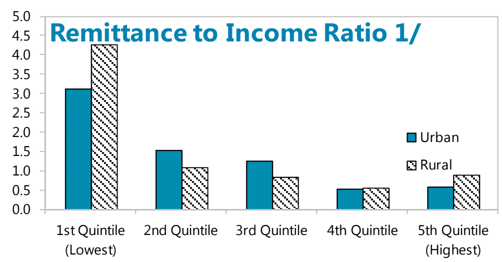
Geographic origin. More than half of Kosovo's emigrants live in Germany and Switzerland. During the recent financial turbulence this has been an advantage, as employment in these labor markets held up well. Were the German and Swiss economies to stall, however, Kosovo's concentrated exposure would become a risk.



Source: Kosovo Remittance Study 2010.

Income Distribution. Remittances support in particular poor households. In 2009, 31 percent of families in the lowest income quintile received remittances, compared to 18 percent for the average of the population.[1] Moreover, for the poorest quintile remittances exceeded wage income by a factor of almost 4. Remittances are mostly spent on consumption goods.

Employment. Econometric evidence suggests that remittances affect employment decisions by increasing reservation wages.[2] Remittances are therefore likely to contribute to Kosovo's high registered unemployment rate (about 45 percent).



Source: Kosovo Remittance Study 2010 and IMF Staff caculation.
1/ The denominator is using household income excluding remittances

Overall, remittances are a double-edged sword. On the one hand they provide a steady flow of income, especially for the most vulnerable households. On the other hand, they undermine competitiveness of Kosovo's economy and disproportionately fund consumption. The challenge is to channel a larger portion of remittances into investment, including by strengthening the business climate and upgrading public infrastructure.

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[1] Income quintiles are computed using the income per capita excluding remittances.

[2] The estimates control for factors such as household income, living standards, and region fixed effects. The key result is statistically significant and robust across different specifications.

Box 2. Assessing the Adequacy of Government Bank Balances

In a fully euroized economy like Kosovo, the government's balances at the central bank serve two purposes: (i) they serve as a buffer against fiscal risks; and (ii) they allow the central bank to insure against balance-of-payments (BOP) shocks. The latter function is akin to that of international reserves in a country with an own currency. A shortfall in bank balances corresponds therefore conceptually to a BOP financing need.

While there is no generally recognized formula for reserves adequacy in a euroized economy, rules-of-thumb for countries with a fixed exchange rate provide a useful starting point. A recent IMF Board paper[1] proposes the following rule:

$$Reserves_{peg} = 10\%\ exports + 10\%\ M2 + 30\% \binom{short\ term}{ext.debt} + 15\% \binom{other\ portf.}{liabilities}$$

Some of these components are relevant for euroized economies, while others are not.

- *Relevant* are buffers to insure against a bank run and to safeguard the government's ability to pay its debt. There is no need to cover base money, however; thus the term for M2 is replaced by bank deposits. Further, as all government debt is in "FX" –i.e., the currency to service debt cannot be created by the central bank—the buffer ought to cover obligations vis-à-vis both domestic and external creditors.
- *Not relevant* are buffers to cover FX needs of the non-financial private sector.

Accounting for these factors yields:

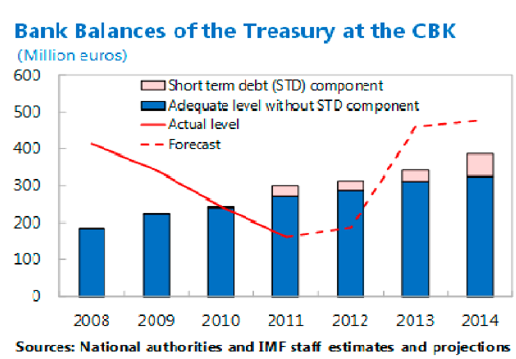
$$Reserves_{Kosovo} = 10\% \binom{bank}{deposits} + 30\% \binom{short\ term}{public\ debt}$$

To transform the reserves rule into one for bank balances, two modifications are necessary: (i) the *fiscal buffer* needs to be added—a standard yardstick is one month of government expenditures—and (ii) the *central bank's own freely available resources* need to be subtracted. These consist essentially of Kosovo's SDR allocation received in the context of the 2009 SDR increase.[2]

Overall, the rule-of-thumb for adequate bank balances is therefore:

$$Bank\ balances = 1\ month\ of\ exp. + 10\% \binom{bank}{deposits} + 30\% \binom{public\ short}{term\ debt} - SDR\ allocation$$

Until recently, the term on short term public debt played an insignificant role, as Kosovo had negligible debt payment obligations. It will acquire more prominence going forward, however, as the government started to issue debt this year. Temporary up- or downward deviations from the bank balance rule may be called for in case of: (i) large anticipated government payment obligations, for example on infrastructure projects; or (ii) large anticipated receipts, for example from privatizations.



[1] IMF Board Paper SM/11/31, 2011, "Assessing Reserve Adequacy".
[2] The central bank's balance sheet also contains funds administrated for the Kosovar Privatization Agency or for commercial banks (required reserves). However, these funds are considered earmarked for their respective depositors and therefore not freely available.

Box 3. Conditionality Under the World Bank Budget Support Grant in 2012

The World Bank provides budgetary support to Kosovo under its Sustainable Employment Development Policy Operation (SEDPO). A first grant of US$ 24.4 million was disbursed in December 2011. The remaining second and third installments, amounting to US$ 46.8 million, are planned to be disbursed in May 2012. Objectives under the SEDPO include supporting a stable macroeconomic framework through strengthened budgetary management, and laying the institutional and legislative foundations for sustainable employment and growth.

Conditions for the disbursement of the second and third installments include:

1. Submission of a monitoring report on ***capital budget execution*** to the Government and Assembly.
2. Approval of secondary legislation for the ***public procurement*** law and issuing the authorization for the central procurement agency to conduct consolidated procurement.
3. Adoption of regulation on ***job classification.***
4. Establishment of 22 one-stop-shops across Kosovo to ***ease new business registration*** outside Pristina.
5. Amendment by the CBK of ***regulation to improve credit data***, including access to individual credit histories.
6. Digitalization of the ***registry of the unemployed*** from the current paper-based system.
7. Fostering incentives to seek work by ***strengthening conditionality for the receipt of social assistance.***
8. Finalization of the ***management information system for social assistance*** to strengthen transparency and accountability.
9. Accreditation *of* ***vocational education training providers*** by the Ministry of Education, Science and Technology.

Box 4. A Downside Scenario: Lessons from the Recent Experience of El Salvador

El Salvador's economy has several characteristics resembling Kosovo. It is a small economy, uses a foreign currency as legal tender (the U.S. dollar), and remittances play a key role, including by funding a large trade deficit. The Salvadorian diaspora lives mostly in the United States, while the Kosovar diaspora lives mainly in Germany and Switzerland.

The experience of El Salvador during the 2008–09 crisis contains important lessons for Kosovo. El Salvador obtained approval of a precautionary Stand-By Arrangement in January 2009. The financial crises that hit the United States in late 2008 rapidly changed the economic outlook for 2009, with negative repercussions for remittances, trade, and tax collections. The economy, originally projected to growth by 2½ percent in 2009, contracted sharply; non-oil imports fell to 26.7 percent of GDP in 2009, from 32 percent a year earlier; and the fiscal deficit swelled to about 5¾ percent of GDP compared to 3 percent originally programmed, owing mainly to weaker revenue collection. El Salvador's authorities reacted by gradually reducing the fiscal deficit, including strong tax revenue (yielding about 1 percent of GDP), and strengthening the banking system's resiliency to external shocks. On the other hand, Kosovo came through the 2008/09 crisis relatively well, with growth moderating to 3 percent in 2009 compared to 6 percent originally forecast. Labor markets in Germany and Switzerland held up better than in the U.S., and activity was supported by a fiscal expansion funded with one-off dividends from the state telecommunications company PTK.

	El Salvador		Kosovo			
	2009		2009		2012	
	Program 1/	Outturn	2008	Outturn 2/	Proj.	Downside
Fiscal balance	-2.8	-5.7	-0.2	-0.7	-2.7	-4.9
Real GDP growth	2.5	-3.1	6.9	2.9	3.8	-1.7
Trade balance	-16.5	-13.5	-41.2	-39.7	-42.5	-40.6
Memorandum items:						
U.S. GDP growth 3/	0.9	-3.5				
US unemployment rate 3/	5.8	9.3				
Germany GDP growth			0.8	-5.1	0.3	
Germany unemployment rate			7.6	7.7	6.2	

Sources: WEO, Kosovo staff reports, IMF staff estimates.

1/ A precautionary SBA was approved by the Board on January 2009.
2/ Include dividends from PTK of 5.2 percent of GDP.
3/ Data on column pre-crisis corresponds to 2008 end-year.

An insight from El Salvador is that Kosovo's economy could rapidly deteriorate if the crisis reaches the labor markets where Kosovar diaspora is located, especially as, in contrast to 2009, Kosovo now lacks fiscal space to run countercyclical policies. According to staff estimates, a contraction in real GDP by 1.7 percent in 2012—5½ percentage points weaker than the current forecast of 3.8 percent growth—would create additional fiscal funding gap of about €100 million (2.2 percent of GDP).

Box 5. Key Recommendations of the 2011 Tax Policy Mission

A FAD Tax Policy mission visited Kosovo in October 2011, to advise the Kosovar authorities on a strategic reorientation of tax policies and to identify possible high-quality structural revenue measures in view of the need for structural fiscal adjustment in 2012 and beyond. Kosovo relies heavily on indirect taxes collected at the border, with only about 14 percent of tax revenues stemming from direct taxes. However, indirect taxes will continue to provide the revenue for required fiscal consolidation during the transition towards greater reliance on direct taxes. Key recommendations are as follows:

1. ***Preserve the integrity of the tax system.*** Given the low rate of Corporate Income Tax of 10 percent, tax holidays—that have been considered by the government—would have negligible incentive effects and cannot be afforded. Similarly, the authorities should refrain from introducing reduced VAT rates and/or exemptions for intermediary inputs from VAT. More generally, the VAT system is well-designed and efficient owing to the relatively low single rate, a high threshold, and few exemptions, advantages that should be preserved.

2. ***Increase fiscal disincentives for harmful activities.*** Options include:
    a) Excises: phase in increases in tobacco excises over three years.
    b) Introduce environmental taxes.

3. ***Increase the revenue collected from direct taxes*** annually by 0.5 percent of GDP, without reducing the overall tax-to-GDP ratio, with an emphasis on personal and corporate income tax, property taxes, and circulation taxes for motor vehicles.

4. ***Broaden the tax base and increase progressivity.*** Options are:
    a) *Corporate income tax*: include a thin capitalization rule in the tax law (i.e., limit deductibility of interest expenditures).
    b) *Capital incomes*: introduce a 10 percent withholding tax on all capital incomes for both individuals and corporations.
    c) *Personal income tax*: adjust the tax threshold upwards and introduce a more progressive PIT rate structure.
    d) *Property taxes*: introduce a minimum rate band to which all local governments must adhere. This should ideally begin with a rate band ranging from 0.25 to 1 percent, with the commitment that the minimum rate is increased annually by 0.05 percentage points until a minimum rate of about 0.8 percent has been reached.
    e) *Presumptive tax*: unify tax rate and increase minimum payment to provide incentives for formalization. Require professional service providers to file tax returns under the standard income tax regime.

Box 6. Reforming Fiscal Decentralization

A FAD Fiscal Decentralization mission visited Kosovo in December 2011, to advise the authorities on the design of the inter-governmental grants system and assess the implications of the recent population census. Transfers to municipalities have been contributing to growing fiscal imbalances in Kosovo. While municipalities have been unable to borrow, increases in central government transfers have fuelled rapid growth in local government outlays, with municipal spending rising as a share of general government spending from 20 to 25 percent between 2008 and 2011. In this context, the authorities have expressed concern that the general grant to municipalities may be excessive. Key recommendations are as follows:

1. ***The size of the general grant is too generous***. The general grant should be reduced gradually from 2.5 percent of GDP in 2010 to 1.8 percent of GDP in 2015. Revenue shortfalls could be compensated by increasing property taxes.

2. ***Municipalities should be allowed to freely shift expenditures between all categories except wages.*** Rules to constrain the growth of current spending, combined with the increase in grants, have led to a distorted allocation of expenditures characterized by high levels of capital spending and inadequate spending on goods and services. Efforts by municipalities to circumvent expenditure ceilings may also be diminishing transparency. Insufficient flexibility to spend own-source revenue has also weakened municipalities' incentives for tax collection. Restrictions on employment and the wage bill could be lifted following the implementation of the civil service reform and a fiscal rule.

3. ***Revenue capacity considerations should be incorporated into the general grant distribution formula.*** This would stimulate own-source revenue efforts.

4. ***The negative impact of the new census on the distribution of the grant formula should be incorporated in a gradual manner.*** The current law provides a one-year grace period to municipalities that will receive a lower general grant allocation with the new population data. This appears overly disruptive. A rule ensuring that no municipality will suffer a year-to-year loss greater than 10–15 percent would be preferable.

5. ***Consideration should also be given to replacing the formula variable for surface with a variable for population density***. Such an approach would recognize the impact of very low and very high population density on the cost of basic local services.

Table 1. Kosovo: Main Indicators, 2008–17

(Percent, unless otherwise indicated)

	2008	2009	2010	2011		2012	2013	2014	2015	2016	2017
				SMP (Initiation)	Est.	Projections					
Real growth rates											
GDP	6.9	2.9	3.9	5.3	5.0	3.8	4.1	3.2	5.0	5.0	4.6
GDP per capita	5.6	1.4	2.4	3.7	3.4	2.2	2.6	1.7	3.4	3.4	3.1
Consumption	4.3	1.0	2.9	2.7	2.9	2.3	2.9	3.3	3.4	3.3	3.0
Investment	18.1	11.7	8.8	13.3	7.6	6.6	8.4	1.7	10.4	9.3	9.4
Exports	4.7	7.8	24.2	7.2	13.6	6.4	5.4	6.7	7.3	9.2	6.6
Imports	5.9	5.3	11.9	5.5	5.6	3.7	5.0	3.8	6.4	6.6	6.0
Official unemployment (percent of workforce)	47.5	45.4	45.1	…	…	…	…	…	…	…	…
Price changes											
CPI, period average	9.4	-2.4	3.5	8.3	7.3	0.6	1.2	1.4	1.4	1.2	1.3
CPI, end of period	0.5	0.1	6.6	6.2	3.6	1.0	1.9	1.0	1.7	0.8	1.7
Import prices	11.8	-4.9	3.2	14.4	7.7	-2.1	-1.0	-1.4	-1.2	-0.8	-0.6
GDP deflator	6.2	-1.3	3.7	5.8	4.8	2.1	2.4	1.9	1.9	1.9	1.9
Real effective exch. rate (average; -=depreciation)	3.2	-1.0	-0.7	…	3.5	…	…	…	…	…	…
Real effective exch. rate (end of period; -=depreciation)	0.2	-1.0	0.8	…	0.7	…	…	…	…	…	…
General government budget (percent of GDP)											
Revenues, incl. interest income 1/	24.5	29.3	27.6	27.1	28.1	28.1	27.1	27.8	27.9	28.3	28.5
Primary expenditures	24.7	29.9	30.0	31.8	29.8	30.5	30.2	28.6	28.7	29.1	29.3
Of which											
Wages and salaries	5.9	6.8	7.4	8.3	8.3	4.9	8.3	8.2	0.0	8.3	8.2
Subsidies and transfers	7.1	7.3	6.4	6.3	5.8	3.5	6.1	6.1	0.0	6.2	6.2
Capital and net lending, incl. highway project	7.6	11.6	11.9	13.0	11.9	12.3	11.7	9.9	10.0	10.2	10.4
Capital expenditures on highway project 2/	…	…	2.9	5.3	5.6	6.0	5.6	0.0	0.0	0.0	0.0
Overall balance	-0.2	-0.7	-2.6	-5.0	-1.9	-2.7	-3.4	-1.1	-1.1	-1.1	-1.2
Debt financing, net	0.0	-0.2	0.3	0.2	-0.1	1.9	2.5	1.4	1.6	1.8	2.0
Privatization	0.0	0.0	0.0	6.4	0.0	0.0	5.9	0.2	0.2	0.2	0.3
Stock of government bank balances	10.8	8.7	5.8	6.5	3.5	3.8	8.8	8.7	8.4	7.8	7.8
Recommended minimum bank balances 3/	…	…	5.7	7.6	5.8	6.1	6.2	6.7	7.2	7.6	7.8
Financing gap	0.0	0.0	0.0	0.0	0.0	1.9	0.3	0.0	0.0	0.0	0.0
Savings-investment balances (percent of GDP) 4/											
Domestic savings	-12.6	-7.4	-6.7	-7.3	-7.9	-5.2	-2.7	-2.3	-0.3	2.1	4.2
Transfers excluding general government (net)	14.0	11.9	12.5	12.1	12.2	11.9	11.8	12.0	11.7	11.4	11.0
Net factor income	4.3	2.1	2.1	2.6	2.6	2.4	2.5	2.5	2.6	2.6	2.6
National savings	5.8	6.6	8.0	7.4	7.0	9.1	11.5	12.3	14.1	16.0	17.7
Investment	28.6	32.3	33.9	37.8	33.2	32.8	33.6	31.7	32.3	33.1	34.1
Current account, excl. official transfers	-22.8	-25.7	-25.9	-30.4	-26.2	-23.7	-22.0	-19.5	-18.3	-17.1	-16.4
Current account balance, incl. official transfers	-15.3	-15.4	-17.4	-25.0	-20.3	-18.3	-18.2	-15.9	-15.0	-14.0	-13.8
Of which : official transfers 5/	7.5	10.3	8.6	5.5	5.9	5.4	3.9	3.5	3.2	3.1	2.6
Net foreign direct investment	8.9	7.1	8.5	15.2	8.0	8.6	12.0	7.3	7.4	7.6	7.8
Portfolio investment, net	1.7	-1.4	-5.5	-3.0	-2.3	-3.4	-2.0	-2.8	-2.1	-1.9	-1.5
Bank credit to the private sector	32.7	8.9	12.6	12.9	14.7	7.4	…	…	…	…	…
Deposits of the private sector	25.8	22.2	23.1	12.0	11.4	8.6	…	…	…	…	…
Non-performing loans (percent of total loans)	3.3	4.3	5.2	5.9 6/	5.7 7/	…	…	…	…	…	…
GDP (millions of euros)	3,851	3,912	4,216	4,672	4,637	4,911	5,234	5,508	5,895	6,310	6,726
GDP per capita (euros)	2,323	2,325	2,468	2,070	2,674	2,790	2,930	3,038	3,203	3,378	3,548
GNDI per capita (euros)	2,749	2,650	2,829	2,376	3,071	3,189	3,348	3,480	3,662	3,848	4,029
Population (thousands) 8/	1,658	1,683	1,708	2,256	1,734	1,760	1,786	1,813	1,840	1,868	1,896

Sources: Kosovo authorities; and IMF staff estimates and projections.

1/ Projections assume a grant from IDA in 2012.
2/ Based on World Bank estimates.
3/ Temporary deviations from the recommendation may be warranted in case of (i) large anticipated payments, for example on infrastructure, or (ii) large receipts, for example from privatizations.
4/ Savings-investment balance of entire economy, including donor sector.
5/ Total foreign assistance excluding capital transfers.
6/ March 2011.
7/ December 2011.
8/ Series updated with the 2011 census.

Table 2. Kosovo: Real Growth, 2007–17
(Percent, unless otherwise indicated)

	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017
					Est.	Projections					
					(Real growth, percent)						
Consumption	5.3	4.3	1.0	2.9	2.9	2.3	2.9	3.3	3.4	3.3	3.0
Private	8.0	6.4	0.4	3.8	3.0	2.6	3.2	3.2	3.2	3.1	2.9
Public	-5.4	-5.9	3.9	-1.5	2.3	0.5	1.2	3.7	4.3	4.4	3.6
General government	-2.3	-0.2	15.9	7.1	8.5	5.4	7.1	4.8	6.4	6.6	5.3
Donor sector 1/	-8.7	-12.2	-11.4	-16.0	-10.9	-12.2	-17.1	-1.0	-5.0	-6.1	-5.9
Investment	15.2	18.1	11.7	8.8	7.6	6.6	8.4	1.7	10.4	9.3	9.4
Private	21.6	0.6	4.8	7.0	7.2	3.5	12.9	8.4	12.0	10.0	10.2
Public	-9.7	109.2	29.0	12.6	8.4	12.5	0.5	-11.5	6.8	7.6	7.5
General government	-8.7	153.6	35.1	13.8	9.4	13.2	0.7	-11.7	7.4	8.1	7.9
Donor sector 1/	-12.3	-18.6	-26.0	-7.3	-11.1	-5.1	-5.6	-5.8	-10.1	-9.9	-9.8
Exports 2/	13.4	4.7	7.8	24.2	13.6	6.4	5.4	6.7	7.3	9.2	6.6
Imports	11.0	5.9	5.3	11.9	5.6	3.7	5.0	3.8	6.4	6.6	6.0
GDP	6.3	6.9	2.9	3.9	5.0	3.8	4.1	3.2	5.0	5.0	4.6
Memorandum item:											
GDP (millions of euros)	3,394	3,851	3,912	4,216	4,637	4,911	5,234	5,508	5,895	6,310	6,726

Sources: Kosovo authorities; and IMF staff estimates and projections.

1/ Donor sector includes UNMIK, EULEX, KFOR, and other donor spending.
2/ Including service receipts comprising donor sector consumption.

Table 3. Kosovo: Balance of Payments, 2009-17
(Millions of euros, unless otherwise indicated)

	2009	2010	2011	2012	2013	2014	2015	2016	2017
			Projections						
Goods and services balance	-1,553	-1,710	-1,904	-1,866	-1,901	-1,875	-1,920	-1,958	-2,015
Goods	-1,673	-1,776	-2,090	-2,087	-2,161	-2,188	-2,294	-2,406	-2,517
Exports	177	305	322	355	391	438	481	539	599
Imports	-1,851	-2,081	-2,412	-2,442	-2,552	-2,626	-2,775	-2,946	-3,116
Services	121	66	186	221	260	314	374	448	502
Receipts	429	476	608	654	699	748	815	903	969
Payments	-308	-410	-422	-433	-439	-434	-441	-455	-467
Income	83	89	121	118	130	140	151	161	172
Compensation of employees (net)	169	172	178	186	193	201	209	217	226
Investment income	-86	-82	-57	-67	-63	-61	-58	-56	-54
Interest payments on public debt	-1	-9	-9	-13	-11	-11	-10	-10	-9
Transfers	866	889	839	848	819	857	884	911	918
Official transfers	401	361	273	265	202	194	191	194	178
Other transfers (net)	465	528	566	583	617	663	693	717	740
Of which: inflows of remittances	506	512	548	553	569	592	619	648	674
Current account	-604	-732	-943	-899	-952	-878	-886	-886	-925
Capital and financial account	543	553	743	608	737	678	686	686	725
Capital account	108	25	6	2	2	2	2	2	2
Of which: WB Trust Fund	89	0	5	0	0	0	0	0	0
Financial account, incl. CBK	435	527	737	605	735	676	684	684	723
Foreign direct investment, net	277	358	371	423	629	400	434	482	522
Commercial banks, excl. FDI	-98	-101	25	-86	-35	-53	-19	-6	19
General government	-132	21	-4	17	45	-22	-57	-113	-83
Disbursements, incl. past IMF purchases	0	22	8	29	59	0	0	0	0
Repayments	-132	-11	-12	-11	-14	-22	-38	-62	-47
Prepayment of debt	-132	-11	-12	-11	-14	-22	-38	-62	-47
Other repayments	0	0	0	0	0	0	0	0	0
Other	0	10	0	0	0	0	0	0	0
Other sectors, excl. FDI 1/	366	284	334	295	387	389	368	343	329
Central Bank of Kosovo	22	-35	11	-44	-292	-38	-41	-23	-64
Reserve assets	94	-47	60	-24	-292	-38	-41	-23	-64
Government balances (program definition)	-17	236	73	-27	-272	-19	-16	4	-36
Other reserve assets, incl. SDRs	111	-283	-14	3	-20	-19	-25	-27	-27
Non-reserves assets	-132	12	-46	-19	0	0	0	0	0
Liabilities 2/	60	0	-3	0	0	0	0	0	0
Net errors and omissions 3/	61	180	200	200	200	200	200	200	200
Financing gap	0	0	0	92	15	0	0	0	0
Memorandum items:									
Current account, excl. official transfers	-1,005	-1,093	-1,216	-1,164	-1,154	-1,072	-1,077	-1,080	-1,103
(in percent of GDP)	-25.7	-25.9	-26.2	-23.7	-22.0	-19.5	-18.3	-17.1	-16.4
Current account, incl. official transfers	-604	-732	-943	-899	-952	-878	-886	-886	-925
(in percent of GDP)	-15.4	-17.4	-20.3	-18.3	-18.2	-15.9	-15.0	-14.0	-13.8
Official transfers (percent of GDP)	10.3	8.6	5.9	5.4	3.9	3.5	3.2	3.1	2.6
Debt service to export ratio (percent)	21.9	2.6	2.2	2.4	2.3	2.8	3.7	5.0	3.6
Net foreign assets of commercial banks	444	545	519	607	641	694	714	743	748
Net foreign assets of CBK	1,088	1,108	1,097	1,141	1,433	1,471	1,512	1,535	1,599
Gross international reserves of the CBK	625	686	607	651	943	981	1,022	990	1,054

Sources: Kosovo authorities; and IMF staff estimates and projections.

1/ Including trading companies, insurance companies, and pension funds.
2/ Includes SDR allocations and IMF account at historical value.
3/ Projections of errors include unidentified private remittances and other capital based on average historical levels.

Table 4. Kosovo: Consolidated Government Budget, 2011-14

(Excluding donor designated grants; millions of euros; cumulative from the beginning of the year)

	2011			2012			2013	2014
	Year			Apr.	Aug.	Year	Year	
	SMP (Initiation)	SMP (1st Review)	Prel.	Projections			Projections	
Total primary revenue and grants	1,261	1,295	1,303	378	873	1,381	1,417	1,525
Total primary revenue	1,253	1,270	1,277	377	841	1,347	1,415	1,525
Taxes	1,057	1,048	1,072	322	735	1,145	1,249	1,348
Direct taxes	151	140	151	68	129	168	186	211
Indirect taxes	939	941	949	264	625	1,012	1,100	1,177
Tax refunds	-33	-34	-28	-11	-19	-35	-38	-40
Nontax revenues	196	222	205	56	106	202	166	177
Of which : dividends	45	60	60	0	0	45	0	0
Grants	8	26	26	1	33	34	3	0
Budget support	0	20	19	0	30	30	0	0
Trust fund at the World Bank	5	3	4	0	0	0	0	0
Project grants	3	3	3	1	3	4	3	0
Primary expenditure	1,487	1,426	1,382	400	914	1,499	1,582	1,574
Current expenditure	879	865	832	243	536	896	969	1,030
Wages and salaries	386	386	385	102	238	407	432	456
Goods and services	195	187	177	58	120	188	213	229
Subsidies and transfers	296	289	270	84	178	297	321	341
Pension and social assistance	188	179	178	64	130	197	214	225
Other transfers and subsidies 1/	109	111	92	20	48	100	107	116
Reserve	3	3	0	0	0	4	4	4
Capital expenditure and net lending	608	562	550	156	377	603	613	545
Capital expenditure	563	532	520	145	366	592	603	540
Highway project 2/	248	248	259	104	214	296	293	0
Other capital spending	315	284	261	42	152	296	310	540
Net lending	45	30	30	11	11	11	10	5
Primary balance	-226	-131	-79	-21	-41	-119	-165	-50
Interest income, net	-7	-5	-7	-6	-6	-12	-11	-12
Overall balance	-233	-136	-86	-27	-46	-130	-176	-62
Financing	233	136	86	22	-5	39	161	62
Foreign financing	16	21	2	3	10	17	45	-22
Drawings, incl. official financing	22	27	8	9	16	29	59	0
Amortization	-11	-13	-12	-6	-6	-11	-14	-22
Trust fund at the World Bank	6	6	5	0	0	0	0	0
Prospective repurchases	0	0	0	0	0	0	0	0
Domestic financing	217	115	85	19	-15	21	116	84
Domestic borrowing (net)	0	0	0	30	50	74	85	98
Privatization revenues	300	0	0	0	0	0	310	10
Other financial assets, net	-17	-17	0	-5	-10	-20	-3	0
Own-source revenue (– = increase)	-5	-5	0	0	0	-5	-5	-5
Bank balance (prog.; – = increase)	-61	137	84	-6	-55	-27	-272	-19
Financing gap	0	0	0	5	51	92	15	0
Memorandum items:								
Bank balance of the general government	305	107	160	166	215	187	459	478
Of which: ELA	0	0	0	0	46	46	46	46

Sources: Kosovo authorities; and IMF staff estimates and projections.

1/ Including capital transfers to public enterprises.
2/ Based on the WB estimates.

Table 5. Kosovo: Consolidated Government Budget, 2011–17

(Excluding donor designated grants; percent of GDP)

	2011			2012	2013	2014	2015	2016	2017
	SMP (Initiation)	SMP (1st Review)	Prelim.	Projections					
Total primary revenue and grants	27.0	27.9	28.1	28.1	27.1	27.7	27.8	28.2	28.4
Total primary revenue	26.8	27.3	27.5	27.4	27.0	27.7	27.8	28.2	28.4
Taxes	22.6	22.5	23.1	23.3	23.9	24.5	24.7	25.0	25.3
Direct taxes	3.2	3.0	3.3	3.4	3.6	3.8	4.1	4.5	4.8
Indirect taxes	20.1	20.2	20.5	20.6	21.0	21.4	21.2	21.3	21.2
Tax refunds	-0.7	-0.7	-0.6	-0.7	-0.7	-0.7	-0.7	-0.7	-0.7
Nontax revenues	4.2	4.8	4.4	4.1	3.2	3.2	3.2	3.1	3.1
Of which : dividends	1.0	1.3	1.3	0.9	0.0	0.0	0.0	0.0	0.0
Grants	0.2	0.5	0.6	0.7	0.1	0.0	0.0	0.0	0.0
Budget support	0.0	0.4	0.4	0.6	0.0	0.0	0.0	0.0	0.0
Trust fund at the World Bank	0.1	0.1	0.1	0.0	0.0	0.0	0.0	0.0	0.0
Project grants	0.1	0.1	0.1	0.1	0.1	0.0	0.0	0.0	0.0
Primary expenditure	31.8	30.7	29.8	30.5	30.2	28.6	28.7	29.1	29.3
Current expenditure	18.8	18.6	17.9	18.3	18.5	18.7	18.8	18.9	18.9
Wages and salaries	8.3	8.3	8.3	8.3	8.2	8.3	8.2	8.2	8.2
Goods and services	4.2	4.0	3.8	3.8	4.1	4.2	4.3	4.4	4.4
Subsidies and transfers	6.3	6.2	5.8	6.1	6.1	6.2	6.2	6.2	6.2
Pension and social assistance	4.0	3.8	3.8	4.0	4.1	4.1	4.1	4.1	4.1
Other transfers and subsidies 1/	2.3	2.4	2.0	2.0	2.0	2.1	2.1	2.1	2.1
Reserve	0.1	0.1	0.0	0.1	0.1	0.1	0.1	0.1	0.1
Capital expenditure and net lending	13.0	12.1	11.9	12.3	11.7	9.9	10.0	10.2	10.4
Capital expenditure	12.0	11.4	11.2	12.0	11.5	9.8	10.0	10.2	10.4
Highway project 2/	5.3	5.3	5.6	6.0	5.6	0.0	0.0	0.0	0.0
Other capital spending	6.7	6.1	5.6	6.0	5.9	9.8	10.0	10.2	10.4
Net lending	1.0	0.6	0.6	0.2	0.2	0.1	0.0	0.0	0.0
Primary balance	-4.8	-2.8	-1.7	-2.4	-3.2	-0.9	-0.9	-0.9	-0.9
Interest income, net	-0.2	-0.1	-0.2	-0.2	-0.2	-0.2	-0.2	-0.2	-0.3
Overall balance	-5.0	-2.9	-1.9	-2.7	-3.4	-1.1	-1.1	-1.1	-1.2
Financing	5.0	2.9	1.9	0.8	3.1	1.1	1.1	1.1	1.2
Foreign financing	0.3	0.4	0.0	0.4	0.9	-0.4	-0.7	-1.0	-0.7
Drawings, incl. official financing	0.5	0.6	0.2	0.6	1.1	0.0	0.0	0.0	0.0
Amortization	-0.2	-0.3	-0.3	-0.2	-0.3	-0.4	-0.3	-0.2	-0.2
Trust fund at the World Bank	0.1	0.1	0.1	0.0	0.0	0.0	0.0	0.0	0.0
Prospective repurchases	0.0	0.0	0.0	0.0	0.0	0.0	-0.3	-0.8	-0.5
Domestic financing	4.6	2.5	1.8	0.4	2.2	1.5	1.8	2.1	1.9
Domestic borrowing (net)	0.0	0.0	0.0	1.5	1.6	1.8	2.0	2.0	2.2
Privatization revenues	6.4	0.0	0.0	0.0	5.9	0.2	0.2	0.2	0.3
Other financial assets (net)	-0.4	-0.4	0.0	-0.4	-0.1	0.0	0.0	0.0	0.0
Own-source revenue (– = increase)	-0.1	-0.1	0.0	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1
Bank balance (prog.; – = increase)	-1.3	3.0	1.8	-0.6	-5.2	-0.3	-0.3	0.1	-0.6
Financing gap	0.0	0.0	0.0	1.9	0.3	0.0	0.0	0.0	0.0
Memorandum items:									
Bank balance of the general government	6.5	2.3	3.5	3.8	8.8	8.7	8.4	7.8	7.8
Of which: ELA	0.0	0.0	0.0	0.9	0.9	0.8	0.8	0.7	0.7
Nominal GDP (millions of euros)	4,672	4,649	4,637	4,911	5,234	5,508	5,895	6,310	6,726

Sources: Kosovo authorities; and IMF staff estimates and projections.

1/ Including capital transfers to public enterprises.

2/ Based on World Bank estimates.

Table 6. Kosovo: Central Bank and Commercial Bank Survey, 2008-14
(Millions of euros, unless otherwise indicated)

					Projections		
	2008	2009	2010	2011	2012	2013	2014
			Central Bank				
Net foreign assets	1,111	1,088	1,108	1,097	1,141	1,435	1,473
Foreign assets	1,111	1,198	1,247	1,233	1,277	1,569	1,607
Of which: Securities	541	529	199	25	45	65	85
Deposits	529	522	854	1,059	1,083	1,355	1,373
Foreign liabilities	0	110	139	136	136	136	136
Net domestic assets	-1,111	-1,088	-1,108	-1,097	-1,141	-1,435	-1,473
Net claims on the central government	-870	-681	-813	-797	-824	-1,096	-1,115
Liabilities	-870	-681	-813	-797	-824	-1,096	-1,115
Of which: Government balances (program definition)	-414	-178	-233	-160	-187	-459	-478
Commercial banks	-137	-233	-204	-210	-223	-239	-254
Other institutions	-64	-131	-46	-39	-39	-39	-39
Other items, net	-39	-43	-46	-51	-55	-61	-65
			Commercial banks				
Net foreign assets	325	444	545	519	607	641	694
Assets	401	584	710	676	777	827	895
Liabilites	76	140	165	156	170	185	200
Net domestic assets	815	949	1,169	1,389	1,466	1,583	1,665
Credit to private sector	1,183	1,289	1,451	1,664	1,787	1,930	2,034
Claims on the CBK	137	233	203	220	223	239	254
Net claims on the central government	-1	-165	-12	-1	25	25	25
Net claims on other public entities	-264	-123	-120	-127	-135	-145	-154
Other items, net	-240	-285	-354	-367	-433	-466	-494
Liabilities to the private sector	1,140	1,393	1,714	1,908	2,073	2,224	2,359
Demand deposits	384	441	545	598	659	716	768
Time deposits	756	951	1,169	1,311	1,413	1,508	1,591
Memorandum item:							
Gross international reserves	670	625	686	626	651	943	981
			(12-month percent change)				
Liabilities to private sector	25.8	22.2	23.1	11.4	8.6	7.3	6.1
Loans to the private sector	32.7	8.9	12.6	14.7	7.4	8.1	5.4
			(Percent of GDP)				
Total private sector deposits	29.6	35.6	40.7	41.2	42.2	42.5	42.8
Credit to the private sector	30.7	32.9	34.4	35.9	36.4	36.9	36.9

Sources: Central Bank of the Republic of Kosovo; and IMF staff estimates and projections.

Table 7. Kosovo: Selected Financial Soundness Indicators, 2007–12

(Percent)

	2007	2008	2009	2010	2011		2012
					Jan .	Dec.	Jan.
Capital adequacy							
Regulatory capital/risk weighted assets	17.4	16.5	17.9	18.8	18.8	17.6	17.5
Tier 1 capital/risk weighted assets	16.4	15.3	15.1	15.8	15.7	14.8	15.0
Asset quality							
NPL ratio 1/	4.1	3.3	4.3	5.2	6.3	5.7	5.9
NPL net of provisions/capital	2.6	2.8	2.3	3.7	5.6	4.6	3.5
Sectoral breakdown of loans							
Agriculture	3.2	3.2	3.0	2.6	2.6	2.4	2.3
Manufacturing	10.6	8.0	11.5	10.9	10.8	9.9	10.0
Trade	49.6	44.5	43.2	37.1	37.5	37.1	37.1
Other services	8.4	15.1	8.8	12.1	11.9	13.7	13.5
Construction	5.6	5.5	6.9	7.5	7.5	6.8	6.8
Households	22.5	23.7	26.7	29.8	29.7	30.1	30.3
Liquidity							
Liquid assets/total assets 2/	33.2	30.0	37.3	36.8	34.9	31.3	32.3
Deposits/loans	128.1	122.0	138.6	126.1	131.8	125.2	127.1
Liquid assets to short-term liabilities 2/	47.8	42.1	47.0	46.2	44.4	39.6	41.0
Profitability							
Return on assets	2.9	2.6	1.4	1.8	0.9	1.5	1.2
Return on equity	27.1	24.7	21.4	18.8	8.9	15.3	11.6
Interest margin to gross income 3/	58.4	60.3	55.3	55.6	56.7	57.0	58.6
Non-interest expense to gross income 4/	12.6	11.2	16.3	16.6	25.0	17.8	18.1
Market risk							
Net open currency position/tier 1 capital	17.8	8.9	18.8	-0.1	-	2.5	-

Source: Central Bank of the Republic of Kosovo.

1/ NPL ratio includes the loans which are classified as doubtful loans and bad loans.
2/ Liquid assets are cash, balances with CBK and commercial banks, and securities.
3/ Interest income minus interest expenditures. Gross income taken from income statement. Quarterly value.
4/ Includes fees, commissons, provisions for loan and other asset losses, and depreciation of fixed assets.

Table 8.a. Kosovo: Gross Financing Requirements, 2011–13
(Millions of euros)

	2011	2012	2013
Gross Financing Requirements	955	911	966
Current account deficit	943	899	952
Amortization of medium and long term public debt	12	11	14
Sources of Financing	955	819	951
Capital account (net)	6	2	2
Foreign direct investment (net)	371	423	629
Net bank financing	25	-86	-35
Government loans	8	29	59
Net Foreign assets of the Central Bank of Kosovo	11	-44	-292
Other financing inc. net erros and omissions	534	495	587
Official Financing		92	15
IMF		92	15
in percent of quota		133	22
Memorandum items:			
Kosovo IMF quota (SDR millions)	59	59	59
Kosovo IMF quota (Euro millions)	69	69	69

Source: IMF staff estimates and projections.

Table 8.b. Kosovo: Gross Financing Requirements, 2011–13
(Percent of GDP)

	2011	2012	2013
Gross Financing Requirements	20.6	18.5	18.5
Current account deficit	20.3	18.3	18.2
Amortization of medium and long term public debt	0.3	0.2	0.3
Sources of Financing	20.6	16.7	18.2
Capital account (net)	0.1	0.0	0.0
Foreign direct investment (net)	8.0	8.6	12.0
Net bank financing	0.5	-1.8	-0.7
Government loans	0.2	0.6	1.1
Net Foreign assets of the Central Bank of Kosovo	0.2	-0.9	-5.6
Other financing inc. net erros and omissions	11.5	10.1	11.2
Official Financing		1.9	0.3
IMF		1.9	0.3

Source: IMF staff estimates and projections.

Table 9. Kosovo: Indicators of Capacity to Repay the Fund, 2012–18 [1/]

	2012	2013	2014	2015	2016	2017	2018
Fund obligations based on prospective purchases (millions of SDR)							
Principal	0.0	0.0	0.0	10.8	41.5	34.6	4.0
Charges and interest	0.6	1.0	1.0	1.0	0.8	0.3	0.0
Fund obligations based on existing and prospective purchases (millions of SDR)							
Principal	0.0	2.4	9.4	17.9	41.5	34.6	4.0
Charges and interest	0.7	1.2	1.2	1.1	0.8	0.3	0.0
Total obligations based on existing and prospective purchases							
SDR millions	0.7	3.5	10.6	19.0	42.3	35.0	4.0
Euro millions	0.9	4.2	12.4	22.3	49.8	41.1	4.7
Percent of exports of goods and services	0.1	0.4	1.0	1.7	3.4	2.6	0.3
Percent of debt service	3.5	16.7	38.1	45.9	69.6	73.0	10.9
Percent of GDP	0.0	0.1	0.2	0.4	0.8	0.6	0.1
Percent of government revenue	0.1	0.3	0.8	1.4	2.8	2.1	0.2
Percent of quota	1.2	6.0	17.9	32.1	71.7	59.3	6.8
Outstanding Fund credit							
SDR millions	97.0	107.4	98.0	80.1	38.6	4.0	0.0
Euro millions	114.1	126.3	115.3	94.3	45.4	4.7	0.0
Percent of exports of goods and services	11.3	11.6	9.7	7.3	3.1	0.3	0.0
Percent of debt service	470.6	505.1	352.8	194.0	63.6	8.3	0.0
Percent of GDP	2.3	2.4	2.1	1.6	0.7	0.1	0.0
Percent of government revenue	8.5	8.9	7.5	5.7	2.5	0.2	0.0
Percent of quota	164.4	182.0	166.1	135.8	65.5	6.8	0.0
Net use of Fund credit (millions of SDR)	78.2	10.4	-9.4	-17.9	-41.5	-34.6	-4.0
Purchases	78.2	12.8	0.0	0.0	0.0	0.0	0.0
Repurchases	0.0	2.4	9.4	17.9	41.5	34.6	4.0
Memorandum items:							
Exports of goods and services (millions of euros)	1,009	1,089	1,185	1,297	1,443	1,568	1,704
External debt service (millions of euros) [2]	24.2	25.0	32.7	48.6	71.5	56.3	43.6
Nominal GDP (millions of euros)	4,911	5,234	5,508	5,895	6,310	6,726	7,169
Government revenue (millions of euros)	1,348	1,417	1,529	1,647	1,784	1,917	2,057
Quota (millions of SDR)	59.0	59.0	59.0	59.0	59.0	59.0	59.0

Sources: IMF staff estimates and projections.

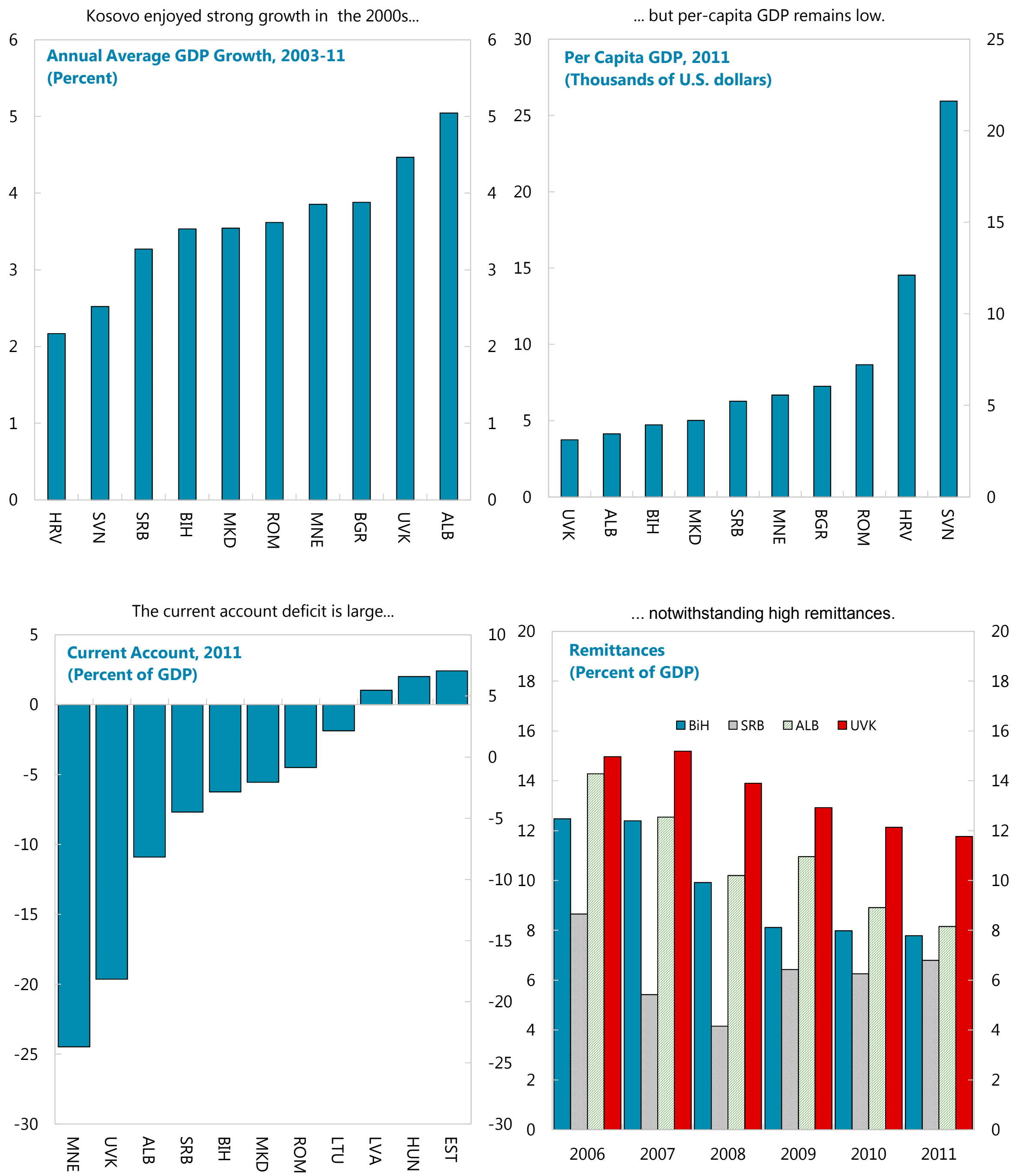
[1/] Assumes prospective SBA disbursements in 2012 and 2013.

[2/] Total debt service includes IMF repurchases and interest charges.

Table 10. Kosovo: Schedule of Purchases Under the Stand-By Arrangement, 2012–13

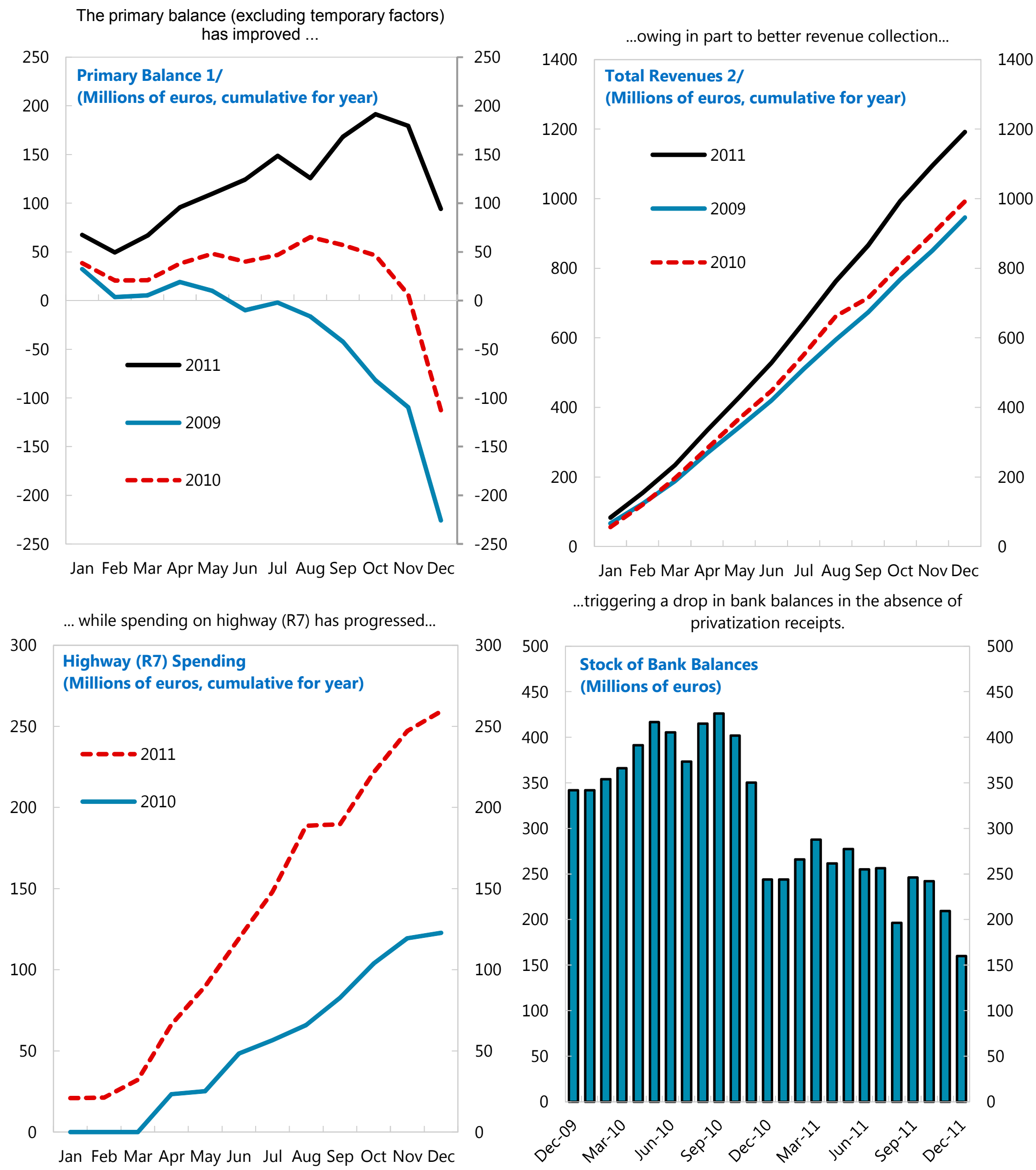
Amount	Percent of Quota	Date Available	Conditions Necessary for Purchase
SDR 4.251 million	7	April 27, 2012	Executive Board approval of the Stand-By Arrangement (SBA)
SDR 39.108 million	66	June 30, 2012	Observance of the continuous performance criteria and of the performance criteria for April 30, 2012; and completion of the first SBA review.
SDR 34.857 million	59	December 20, 2012	Observance of the continuous performance criteria and of the performance criteria for August 31, 2012; and completion of the second SBA review.
SDR 3.188 million	5	February 28, 2013	Observance of the continuous performance criteria and of the performance criteria for December 31, 2012; and completion of the third SBA review.
SDR 3.188 million	5	May 31, 2013	Observance of the continuous performance criteria and of the performance criteria for March 31, 2013; and completion of the fourth SBA review.
SDR 3.188 million	5	August 31, 2013	Observance of the continuous performance criteria and of the performance criteria for June 30, 2013; and completion of the fifth SBA review.
SDR 3.188 million	5	November 30, 2013	Observance of the continuous performance criteria and of the performance criteria for September 30, 2013; and completion of the sixth SBA review.
Total: SDR 90.968 million (154 percent of quota)			

Figure 1. Kosovo: Cross-Country Comparison of Selected Economic Indicators, 2003-11



Sources: IFS; WEO; World Bank; and IMF staff estimates.

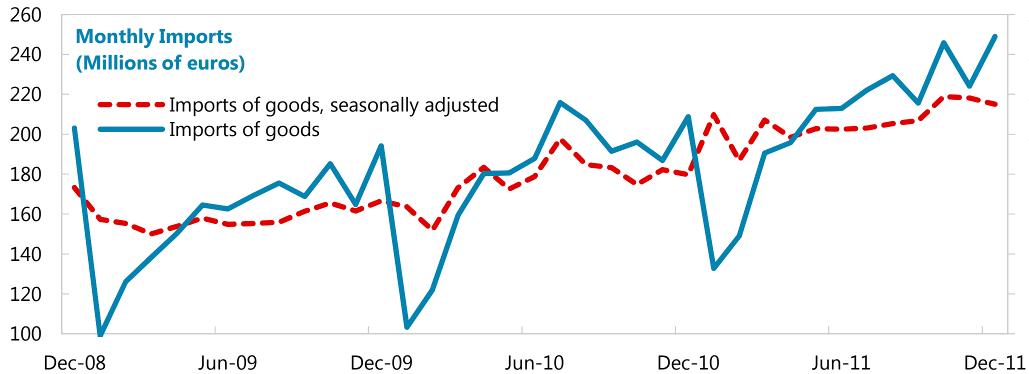
Figure 2. Kosovo: Recent Fiscal Developments



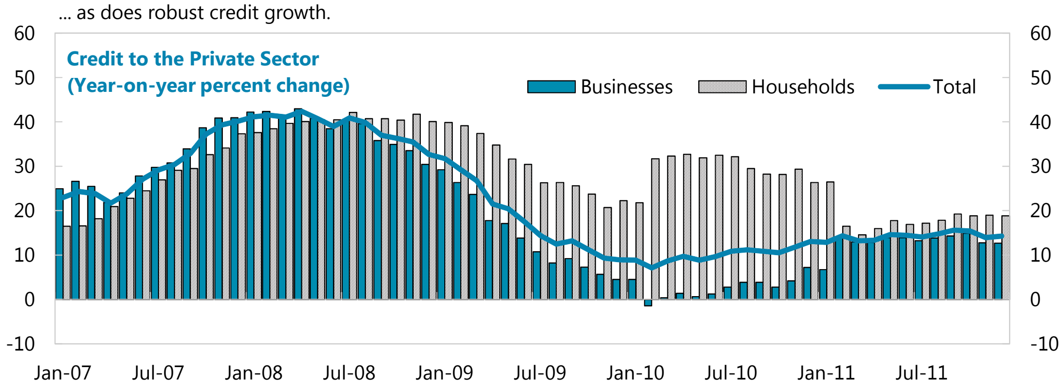
Source: Country authorities; and IMF staff calculations.
1/ Primary balance excluding highway (R7) expenditures, grants, and dividends.
2/ Total revenues excluding grants and dividends.

Figure 3. Kosovo: Recent Economic Developments

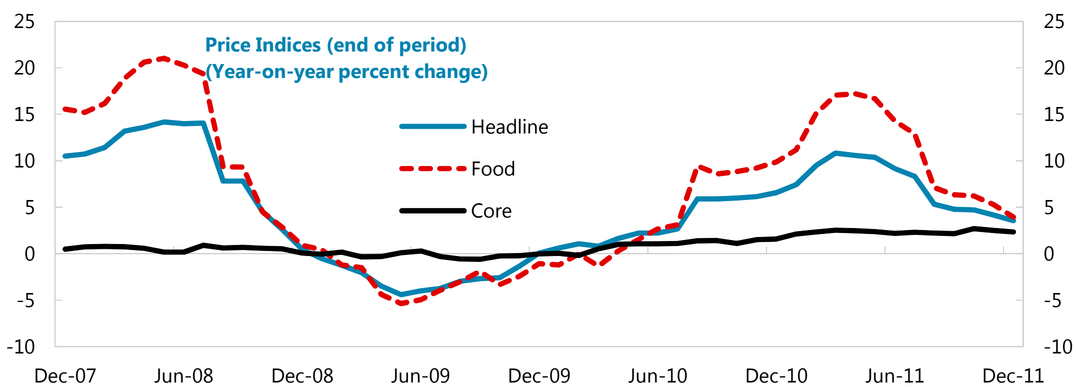
Strong imports point to solid domestic demand...



... as does robust credit growth.



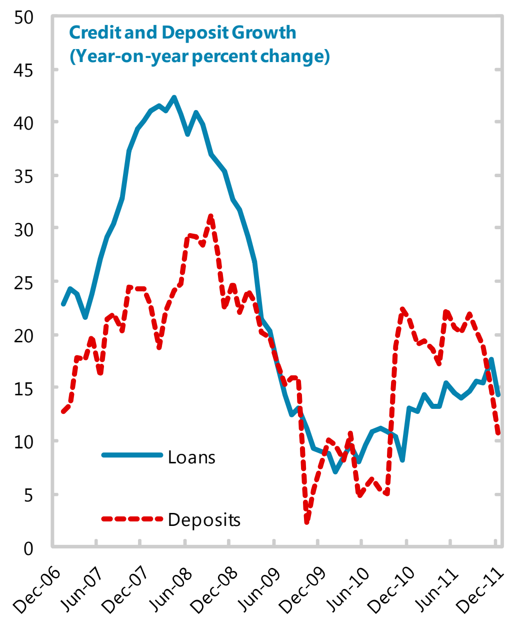
Headline inflation is driven by food prices while core inflation remains anchored.



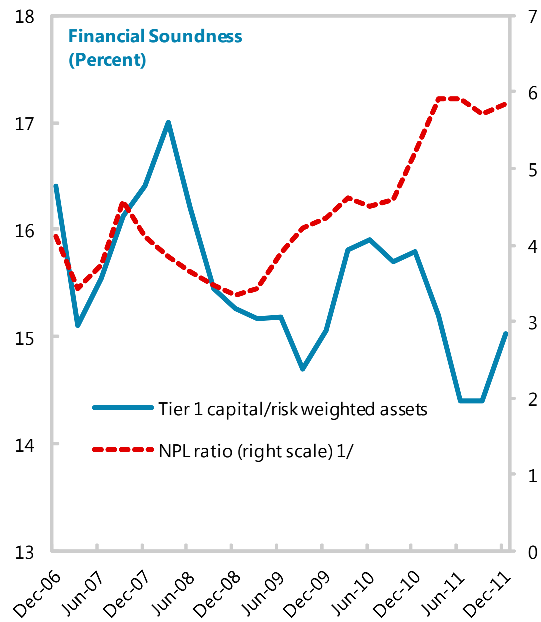
Source: National authorities; and IMF staff estimates and projections.

Figure 4. Kosovo: Selected Banking Sector Indicators

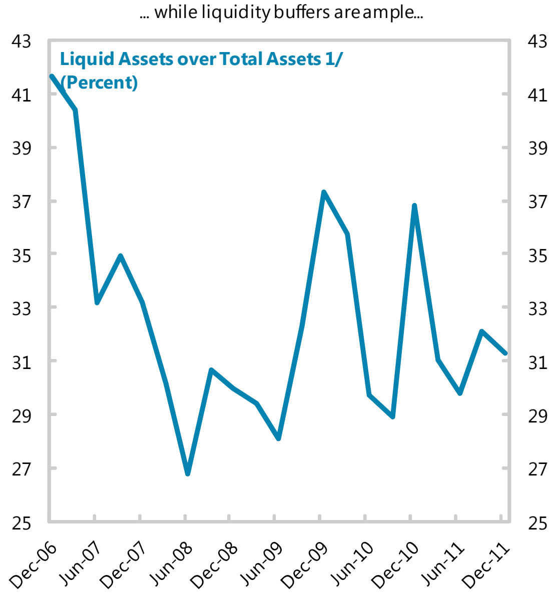
Credit and deposit growth are robust.



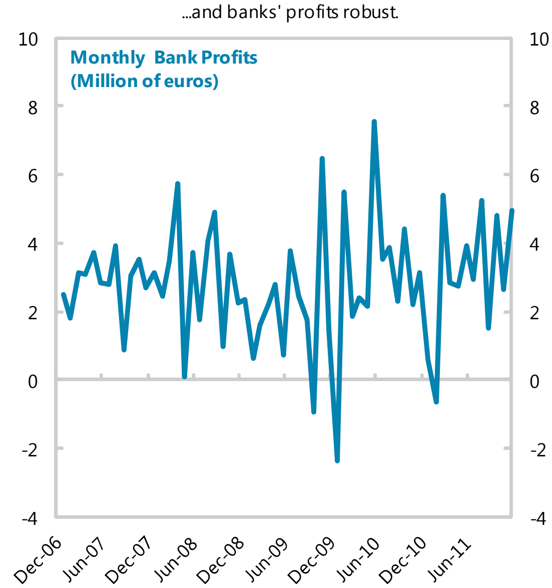
Capitalization remains high and NPLs modest...



... while liquidity buffers are ample...



...and banks' profits robust.



Sources: Cental Bank of Kosovo; IMF staff estimates.
1/ Liquid assets are cash, balances with CBK and commercial banks, and securities.

REPUBLIC OF KOSOVO

Attachment I. Letter of Intent

Ms. Christine Lagarde
Managing Director
International Monetary Fund
Washington, DC 20431
U.S.A.

Pristina, April 12, 2012

Dear Ms. Lagarde:

1. Kosovo's economy has continued to perform strongly, shielded from the financial crisis in the euro area by limited trade and financial linkages. However, large external imbalances persist, reflecting *inter alia* infrastructure bottlenecks that continue to stifle productivity and competitiveness. These shortcomings are tackled by the government's program to improve Kosovo's infrastructure, including the highway network, that we have pursued since Kosovo gained independence in 2008. The associated increase in government spending, in particular capital expenditures, caused the fiscal balance to record deficits in subsequent years. To contain and fund these deficits we adopted a strategy consisting of the following elements: (i) drawing down the government's bank balances, while maintaining a prudent minimum level, (ii) exercising restraint on current and non-infrastructure capital spending, and (iii) privatizing the state telecommunications company (PTK).

2. In 2010, we requested a Stand-By Arrangement (SBA) from the IMF in support of our program, with a view to helping anchor fiscal policy during the period of increased infrastructure spending and facilitating donor support. An 18-month SBA was approved by the IMF Executive Board in July 2010. While almost all quantitative performance criteria for 2010 were met, large public sector wage increases in the context of the 2011 budget prevented the completion of reviews under the SBA. Hence, in June 2011 we initiated a Staff Monitored Program (SMP) through end-2011, to establish a track record of disciplined policy implementation. The SMP targeted steps toward restoring fiscal sustainability, improved fiscal planning and budgetary execution, and measures to strengthen the financial system's resilience. Implementation of the SMP has been broadly satisfactory, with significant overperformance in particular regarding fiscal targets, resulting in an overall fiscal deficit in 2011 of 1.9 percent, compared to 5.0 percent originally inscribed into the 2011 budget. Important progress has also been made in the area of financial sector structural reforms.

3. Notwithstanding these efforts the government's cash buffers have fallen further, reflecting primarily the fact that we have not yet completed the privatization of PTK, after

the privatization process had to be abandoned following the withdrawal of one out of two prequalified bidders. As a result of this unexpected temporary drop in foreign direct investment, at end-2011 government useable bank balance stood at €160 million, about half the level needed to insure adequately against possible fiscal and financial risks. Provided the financial transaction related to PTK privatization will not be closed by end-2012, bank balances would remain well below prudent levels also in 2012. In a fully euroized economy like ours, bank balances serve not only as a budgetary buffer, they are also required to provide emergency liquidity assistance to banks if needed, and fulfill a similar role to international reserves in an economy with an own currency. The financing need resulting from the shortfall in bank balances therefore corresponds conceptually to a balance-of-payments need in a non-euroized economy.

4. Based on the resulting financing need and our performance under the SMP, we request that the Fund support our program through a new Stand-By Arrangement of 20 months in the amount of SDR 90.968 million (154 percent of quota). The program is outlined below. Its key objective is to continue on the path to fiscal sustainability that we embarked on in 2011 and anchor fiscal policy in the long-term, complemented by structural fiscal reforms and steps to further strengthen the financial system's stress resilience. We believe that the policies set forth in this letter are sufficient to achieve the objectives of our economic program, but we will take any further measures that may become necessary for this purpose as circumstances change. We will consult with the Fund on the adoption of these measures, and in advance of revisions to the policies contained here, in accordance with the Fund's policies on such consultation. Further, we will provide the Fund with such information as it requests on policy implementation and achievement of the program objectives. The understandings between us and IMF staff regarding performance criteria and structural measures described in this letter are further specified in the attached Technical Memorandum of Understanding.

5. The government and the Central Bank of Kosovo (CBK) authorize the IMF to publish this letter and the associated staff report.

I. Macroeconomic Outlook

6. The economy is expected to experience only minor spillovers from the crisis in the euro area, in view of limited financial linkages and a small export base. Moreover, we expect remittances, FDI, and other non debt-creating flows from Kosovars living in Germany and Switzerland to remain stable, reflecting the solid economic and labor market conditions in these economies. Such inflows have been an important source of growth in recent years. Nevertheless, the euro area crisis renders the outlook unusually uncertain. As a result, the macroeconomic framework underpinning the program is based on purposely cautious assumptions, with a view to minimizing the risk of downward revisions during the program period.

a. *Real GDP growth* is forecast at 3.8 percent in 2012. We believe there is a possibility of a better outcome, given that thus far there are no significant indications of a slowing in private sector demand. Moreover, in 2013 GDP growth is expected to recover, in line with developments in the euro area.

b. *Consumer price inflation* is expected to be subdued at around 1 percent this year, reflecting expected developments in global commodities markets, even though possible tariff increases in the context of a revamped electricity regulation may partially offset cheaper imports.

c. *The current account deficit* is expected to narrow somewhat in 2012/13 reflecting weaker domestic demand, falling below 20 percent of GDP. FDI and other non debt-creating flows will remain major financing items. Over the medium term the external balance is expected to gradually improve due to import substitution.

II. Fiscal Policy

7. The program's principal objective is to anchor fiscal policy by restoring a sustainable fiscal stance and maintaining an acceptable level of government bank balances. With no monetary policy, fiscal policy is the main tool to safeguard macroeconomic stability. Structural fiscal adjustment started under the SMP, we aim at completing the process by 2014. We estimate that further adjustment of 1½ percent of GDP in 2013/14 is needed to return to a sustainable underlying primary deficit that would stabilize public debt at a prudent level of at most 30 percent of GDP in the long term. As regards bank balances, buffers of about €300 million would be desirable to adequately insure against fiscal and financial risks—a reference value that will increase as the government enters debt markets and needs to ensure debt servicing capacity even in case of disruptions in market access. We aim at returning to a fully adequate level of bank balances during the course of 2013.

8. To ensure that fiscal policy remains on a sustainable track even after the program period, we plan to adopt a legally binding fiscal rule that would provide guidance to policy makers and the public about the sustainable budgetary balance. The rule should also take into account transient factors and Kosovo's fiscal decentralization framework. We requested technical assistance from the IMF to help us develop a rule, aiming at enacting the rule no later than mid-2013.

9. Further, fiscal management and planning will continue to abide by the following principles:

a. any new law, amendment to laws or regulations that create benefits will grant only cash benefits, with no link to the minimum wage;

b. any such law, amendment to a law or regulation will be preceded by a thorough fiscal impact assessment covering a period of at least 5 years (continuous structural benchmark);

c. any such law, amendment to a law or regulation will include an article that explicitly allows cutting benefits in case of insufficient budgetary funds (continuous structural benchmark).

A. Fiscal Policy in 2012

10. The 2012 budget law passed by the Assembly in December 2011 foresees an overall deficit of 3.3 percent of GDP and contains structural adjustment of ¾ percent of GDP, through a mix of wage restraint, revenue measures, and energy sector reforms reducing the need of budgetary support for the sector. The largest financing item in the budget law is the privatization of PTK. However, the privatization process has only recently been re-launched with the appointment of a new transaction advisor, and at this stage it cannot be pre-judged whether the transaction will be closed in 2012 or at a later stage.

11. To partly compensate for the shortfall in bank balances that would result in case of closure after 2012, the additional measures specified below are being implemented. We estimate their total yield at €40 million:

a. ***Revenues.*** At least €10 million will be raised from the introduction of environmental taxes and excise fees that will be phased in during the second and third quarters of 2012. These measures are structural and in line with the recommendations of the IMF technical assistance mission on tax policy from November 2011.

b. ***Expenditures.*** We decided not to allocate €20 million from the 2012 budget, and issued a government decision in March specifying the corresponding expenditure categories (€10.1 million in goods and services, €7.5 million in non-highway capital spending, and 2.4 million subsidies; prior action).

c. ***Dividend income.*** We have revised upward the expected dividend from PTK for 2012 by €10 million to €45 million, reflecting higher expected profits as a result of a reduction in wage and benefit cost in PTK enacted earlier this year.

12. In January of this year, we issued for the first time 3-month government T-bills at an effective interest rate of 3.5 percent (annualized). We plan to raise €74 million by selling securities in 2012, mainly to banks and to the pillar II pension fund (KPST). Going forward, we would like to gradually increase the maturity of government paper and establish a yield curve. To this end, a modification of our debt management strategy may be required, for which we are considering requesting technical assistance. Further, we have passed a revised pension fund law in April 2012 that loosens the exposure limit of KPST to the government to 30 percent of assets but introduces an investment limit of 50 percent of previous-year inflows into KPST, with a view to protecting the integrity of KPST's investment strategy (prior action).

B. Medium Term Spending Initiatives and Structural Fiscal Reforms

13. We will protect the integrity of our tax system, and share with the IMF staff any planned legislation or government directive that has implications for the current tax policy. Specifically, we will refrain from introducing tax holidays from corporate income tax, maintain the current VAT threshold level, and refrain from adding new exemptions or reduced rates to VAT. Further, we are planning a broad review of the mining industry's contribution to tax revenue and requested technical assistance for a review of Kosovo's mining tax regime from the IMF.

14. To continue strengthening domestic tax collection, we will develop a strategy to transform the large taxpayer unit into a center that offers the full range of tax administration functions, and design a taxpayer compliance management plan for 2013 that follows up on the plan developed in 2011, both with support of IMF technical assistance.

15. Several capital and social spending initiatives require careful preparation and execution to safeguard fiscal sustainability.

a. Working groups are currently preparing the methodologies for fiscal impact assessments for ***benefits for war veterans and erstwhile political prisoners***, in consultation with the World Bank. The impact assessments require, as a starting point, a thorough evaluation of the number of eligible beneficiaries, and a careful design of the type and level of benefits. Any draft legislation that may be produced by these working groups will be shared with the IMF staff prior to consideration by the government.

b. Eligibility criteria for ***pensions*** of families, disabled, and early retirees will remain unchanged. In particular, proof of 15 years of contributions to the former pay-as-you-go pension system will remain a precondition for receiving the supplementary pension (currently €35 per month).

c. We are in the process of preparing a reform of the ***health sector***. The objective is to ultimately transfer the provisions of health services from the government to a health fund that is partly funded by a government grant and partly by premia. Once we move to enacting relevant legislation this would occur in a phased manner and in close consultation with IMF and World Bank staff, with strong safeguards in place to ensure the financial viability of the health fund.

d. Efforts to advance ***civil service reform*** are ongoing. The required secondary legislation will be issued only once the fiscal implications of the reform are well understood. Prerequisites are a thorough evaluation of the number of civil servants, as well as introducing safeguards to address the risk of over-grading and overtime payments. As a first step, we plan to introduce a grading system and a unified salary structure, supported by technical assistance from the World Bank.

e. ***Highway R7*** to Albania requires careful financial management as the project nears completion in 2013, notably with regard to containing variation cost. We are evaluating various options for the design and financing of ***Highway R6*** to Macedonia, and will closely consult with IMF and World Bank staff prior to taking any decisions, including on how to integrate the project into a sustainable medium-term budgetary framework.

16. We are in the process of reforming the inter-governmental grants system, based on the recent technical assistance mission from the IMF. Starting with the first budget circular foreseen to be issued in May 2012, we will grant municipalities flexibility to shift own-source revenues among all economic categories except wages (structural benchmark for end-May), with the objective to eventually expand the flexibility to all budgetary allocations, including the general grant. Further, we are considering additional reforms, such as (i) amending the distribution formula for the general grant to municipalities by a factor for revenue capacity; (ii) incorporating the official census results (to be announced in September 2012) in a gradual manner; and (iii) reducing the general grant gradually while increasing minimum property tax rates, to provide stronger incentives for municipalities to collect own-source revenues.

17. We are upgrading our system to monitor payment obligations. The objective is to develop the capacity to monitor in real time all payments coming due, in order to assist planning of the Treasury's cash flow and prevent any accumulation of domestic payment arrears. We have requested technical assistance from the IMF to identify weaknesses in our system of recording and monitoring of payment obligations and make recommendations on how to improve the situation. We are currently training staff in the use of an upgraded software to monitor accounts payable, a process we expect to be complete by the end of 2012.

III. Financial Sector Policies

18. Kosovo's financial sector has remained stable and unaffected by turbulence in the euro area, reflecting solid economic activity and the fact that the banking system—while mostly foreign owned—is funded by retail deposits and therefore shielded from strains in funding conditions in the euro area. Further, most banks are liquid, profitable, and well capitalized, with modest rates of nonperforming loans (about 6 percent for the average of the banking system). Notwithstanding the soundness of the banking system, we are strengthening the central bank's ability to support and intervene in the banking system in case of need.

19. The central bank's capacity to provide emergency liquidity assistance (ELA) to banks is now near-complete, with a memorandum of understanding between the CBK, the Ministry of Finance, and the Assembly's Committee for Budget and Finance governing the provision of ELA taking effect last year. The second purchase under the SBA, amounting to €46 million, is foreseen to be deposited in the special reserve fund (SRF) designated for

ELA. Prior to this purchase, we will introduce an amendment into the Law on Public Financial Management and Accountability that specifies that only the CBK can dispose over the funds in the SRF for ELA (structural benchmark for June 15).

20. The new Banking and Microfinance Law (BML) was adopted in April (prior action). The BML significantly improves the central bank's ability to deal with problem banks while strengthening the regulatory framework in several areas, including bank governance and exposure to related parties and large borrowers. With the support of technical assistance from the IMF, we envisage completing the process of revising rules and regulations to fully implement the BML by end-July 2012.

21. The Deposit Insurance Law (DIL) will be revised to ensure consistency with the new BML. The revised DIL will allow purchase and assumption transactions and it will maintain the narrow mandate of the deposit insurance fund, which limits its involvement in bank resolution, given that the BML assigns this role largely to the CBK. Submission of the revised law to the Assembly is a structural benchmark for end-May 2012.

22. To further strengthen our supervision capacity, we will request IMF technical assistance on loan documentation and classification practices—an area where on-site audits have repeatedly encountered irregularities. We are also looking forward to Kosovo's first assessment under the IMF's Financial Sector Assessment Program (FSAP) to be conducted by the IMF's Monetary and Capital Markets Department and the World Bank in the second half of 2012. We expect the FSAP mission to take stock of all relevant reforms of recent years and propose further improvements to our financial architecture.

23. We are moving ahead with the reforms of the insurance sector, for which the CBK is the regulator. We conducted a full assessment of the insurance core principles (ICP) with World Bank assistance. A new resident advisor, financed by the U.S. Treasury, will work with the Insurance Supervision Department of the CBK on (i) reviewing the statement of duties for the CBK's insurance supervision department; (ii) reviewing prudential requirements (for current and future reports) as well as the legal framework; and (iii) implementing a new on-site supervision manual for life and non-life insurance, including implementation of key actions as recommended from a World Bank report.

24. In the context of the arrangement, the Central Bank of Kosovo will undergo an updated safeguards assessment in accordance with the IMF safeguards policy.

IV. Competitiveness and Structural Reforms

25. To further strengthen the business environment, raise competitiveness, and foster the development of a tradable sector, we have prepared a package of twelve laws aiming at reducing costs of setting up businesses, unifying business registries, and simplifying the licensing system. Nine laws have been passed (including on business organization, cadastre, reporting and auditing, establishment of immovable property right registers, external trade,

management and control of state borders). The remaining three laws have been drafted, and are expected to be approved by the Assembly by mid-year.

26. To safeguard the labor market competitiveness and employability of women, a report on the implementation of the Labor Law with the emphasis on maternity leave provisions is complete. We will analyze the report and take legislative action as necessary.

27. Our energy sector reforms are advancing. Billings and collections of the energy company (KEK) have improved substantially. We have finalized a functional and staffing audit of KEK, and in March the KEK's management and Board set a timeframe for the implementation of the audit's recommendations and right size the company. These steps are reducing the need for the Treasury to transfer resources to KEK. Further, after years of preparation, KEK intends to privatize its distribution and supply division. Bids are scheduled to be submitted by end-April. An auction for the New Kosova project for generation and mining is scheduled for September. The resulting investment in energy generation is expected to increase supply and reliability of electricity and reduce pollution.

V. Program Monitoring

28. The program will be monitored by quantitative performance criteria, indicative targets, and structural benchmarks as defined in the Technical Memorandum of Understanding (TMU). Monitoring will be on a quarterly basis, although in 2012 the review schedule will be slightly amended to bring it in line with Kosovo's budget preparation schedule. The quantitative performance criteria and indicative targets for end-April 2012, end-August 2012, and end-December 2012 are set out in Table 1. The prior actions and structural benchmarks of the program are set out in Table 2. The first review is expected to be completed after June 30, 2012, the second review to be completed after December 20, 2012, and the third review after February 28, 2013.

29. The Program Monitoring Committee (PMC)—composed of the Minister of Finance (head), the Director of the Treasury, the two Budget Directors, the two Deputy Governors of the CBK, the advisor to the Prime Minister, the head of the Macro Unit, a representative of the tax administration of Kosovo, the Director of Finance of the Ministry of Labor and Social Welfare, and a representative of the Ministry of Economic Development—will meet at least once a month to assess progress with implementation of the Fund supported program and consistency of all relevant policy initiatives with the program's objectives (continuous structural benchmark). The IMF resident representative will attend the meetings as an observer. The Ministry of Finance will prepare minutes of these meetings and send them to the IMF resident representative no later than 5 business days after the each meeting.

Sincerely yours,

/s/

Hashim Thaçi
Prime Minister

/s/	/s/
Bedri Hamza	Gani Gërguri
Minister of Finance	Governor of Central Bank of the Republic of Kosovo

Table 1. Kosovo: Quantitative Performance Criteria and Indicative Targets, SBA 2012–13
(Millions of euros; flows cumulative from beginning of the year)

	2012		
	Apr.	Aug.	Dec.
Performance Criteria 1/			
Floor on the bank balance of the general government	166	215	187
Floor on the primary fiscal balance of the general government	-21	-41	-119
Ceiling on primary expenditures of the general government	400	914	1,499
Ceiling on the net contracting of nonconcessional debt by the general government 2/	150	150	150
Ceiling on guaranteeing nonconcessional debt by the general government 2/	0	0	0
Ceiling on the accumulation of external payments arrears of the general government 3/	0	0	0
Indicative Targets			
Ceiling on the stock of domestic payment arrears of the central government	0	0	0
Ceiling on the stock of domestic payment arrears of the general government	0	0	0
Memorandum items:			
Program assumptions			
Repayment of policy loans extended to public corporations	…	…	4
Non-project grants	4	30	30
Budget support loans	0	0	0
Project grants	1	3	4
Project loans	0	6	7

Sources: Kosovo authorities; and IMF staff estimates and projections.

1/ The floors and ceilings are adjusted according to the Technical Memorandum of Understanding.

2/ Exemptions apply according to Technical Memorandum of Understanding.

3/ Continuous ceiling on the gross flow of new accumulation.

Table 2. Kosovo: Prior Actions and Structural Benchmarks, 2012—SBA

Actions	Type	Timing
Passage of the Pension Fund Law in a version that limits (i) exposure of the pillar II pension fund to the government to 30 percent of the fund's assets and (ii) annual investments of the fund in government paper to 50 percent of inflows into the fund in the previous calendar year	Prior Action	
Passage of the revised Banking and Microfinance Law in a version consistent with the recommendations of IMF technical assistance	Prior Action	
Issuance of a government decision that specifies spending cuts of €20 million across expenditure categories relative to the approved 2012 budget	Prior Action	
Publication of budget circulars for municipalities that contain no limits on spending allocations across non-wage categories	Structural benchmark	End-May 2012
Submission of a revised Deposit Insurance Fund Law to the assembly that is consistent with the new Banking and Microfinance Law	Structural benchmark	End-May 2012
Amendment of the Law on Public Financial Management and Accountability by a provision that specifies that only the CBK can dispose over the funds in the Special Reserves Fund designated for Emergency Liquidity Assistance	Structural benchmark	June 15, 2012
Submission of a 2013 budget consistent with the objectives of the program to the assembly	Structural benchmark	End-October 2012
Monthly meetings of the Program Monitoring Committee and transmission of the meetings' minutes to the IMF Resident Representative	Structural benchmark	Continuous
Inclusion of a paragraph into all new benefit creating laws, amendment to laws or regulations that allows cutting cut benefits if budgetary funds are unavailable	Structural benchmark	Continuous
Fiscal impact assessments evaluating the budgetary impact of all new benefit creating laws, amendments to such laws or regulations over a period of at least 5 years	Structural benchmark	Continuous

REPUBLIC OF KOSOVO

Attachment II. Technical Memorandum of Understanding

Definitions and Data Reporting Requirements under the 2012–13 Stand-By Arrangement

1. This Technical Memorandum of Understanding (TMU) sets out the understandings between the Kosovo authorities and the IMF staff regarding the definition of quantitative performance criteria and indicative targets, and reporting requirements for the Stand-By Arrangement ("SBA") requested in April 2012.

I. PERFORMANCE CRITERIA AND INDICATIVE TARGETS

A. Coverage

2. For the purpose of this memorandum, the **central government** is composed of the Executive, the Legislative, and Judiciary branches of the Government, and any other public authorities except municipalities that receive direct budgetary appropriations. The **general government** includes the central government and municipalities. Both the central and the general government exclude publicly owned enterprises and socially owned enterprises.

3. **Performance Criteria and Indicative Targets.** The performance criteria, indicative targets, and their respective test dates are set in Table 1 of the Letter of Intent (LOI).

B. Bank Balances of the General Government

4. **Bank balances** are funds usable and readily available (i.e., liquid or marketable, and free of any pledges or encumbrances), held and controlled by the general government for the purposes of making payments and transfers. Bank balances include Undistributed Funds of the Government of Kosovo plus funds specifically reserved for policy purposes including emergency liquidity assistance but do not include the balance of unspent Own Source Revenues (OSR) carried forward, or funds encumbered or pledged as Donor Designated Funds and funds relative to on lending operations. Bank balances do not include investments made and managed by an outside Investment Manager assigned by the Minister pursuant to Kosovo's Law on Public Financial Management Article 7.1.(iii). Bank balances may be held in the form of gold, holdings of foreign exchange and traveler's checks, demand and short-term deposits at the Central Bank of the Republic of Kosovo (CBK), long-term deposits abroad that can be liquidated without penalty, and any holdings of investment-grade securities held directly by the general government. Bank balances at December 31, 2011, were € 159.986 million.

- The floor on the bank balance set in Table 1 will be raised by

- the excess of budget grants and loans relative to program assumptions

5. **Reporting requirements.** A table on bank balances will be transmitted by the Treasury with a maximum delay of five weeks after the end of each month. In addition, the CBK will submit twice a month, with a delay of 1 day, the Report of Positions of Treasury Accounts. Within 45 days after each test date, the CBK will submit to the IMF the independent audit of the reconciliation of government accounts.

C. Primary Expenditures of the General Government

6. **Primary expenditures** are measured on a cash basis cumulatively from the beginning of the calendar year. Primary expenditures include current expenditures (wages and salaries, goods and services, subsidies and transfers, reserves), capital expenditures, and net lending. They do not include interest payments or receipts or expenditures designated by donors financed with grants ("donor designated grants"). Net lending comprises loans granted by the general government except that it does not include onlending such as funds borrowed from KfW, which is instead included as a domestic financing item ("below the line"). All expenditures and net lending financed with loans to be serviced by the general government are in the program's concept of expenditures and net lending, even if the cash did not transit through the Treasury.

➢ The ceiling on primary expenditures set in Table 1 will be raised by the excess of project grants and loans relative to program assumptions.

➢ The ceiling on primary expenditures set in Table 1 will be lowered by

- the shortfall of project grants and loans relative to program assumptions.
- the repayment of loans extended to public corporations in excess of program assumptions.

7. For the purposes of this memorandum, **proceeds of privatizations** will be understood to mean all monies received by the government from the sale of a publicly owned company, organization, or facility to a private company or companies, organization(s), or individual(s), as well as any proceeds generated from the sale of government nonfinancial assets and from the liquidation of the assets of the Privatization Agency of Kosovo (PAK). Proceeds of privatizations are not part of revenues. Instead, these are recorded as a domestic financing (Net acquisition of financial assets).

8. **Reporting requirements.** Data on the monthly execution, budget appropriations, and budget allocations of revenues and expenditures will be provided monthly no later than five weeks after the end of each month, including (i) government domestic revenue detailing by components direct taxes, indirect taxes, and nontax revenues; (ii) external budget support grants; (iii) primary recurrent expenditure, (iv) domestic and external interest payments and receipts, (v) capital expenditure detailing all those related to the construction of Route 7 and

including domestically and budget support financed capital expenditure and externally project financed capital expenditure; (vi) the gross payment and gross accumulation of domestic payments arrears; (vii) external loan receipts and principal payments; (viii) external arrears payments and accumulation; (ix) bank and nonbank financing; (x) privatization and receipts of the sales of nonfinancial assets; and (xi) any other revenue, expenditure, or financing not included above.

D. Primary Fiscal Balance of the General Government

9. **Primary fiscal balance** of the general government is defined as revenues and grants minus primary expenditures cumulatively since the beginning of the calendar year. Revenues do not include privatization receipts.

- The floor on the primary fiscal balance set in Table 1 will be lowered by the excess in project loans relative to program assumptions.

- The floor on the primary fiscal balance set in Table 1 will be raised by

- the shortfall in project loans relative to program assumptions

- the excess in budget grants relative to program assumptions.

E. Contracting and Guaranteeing Nonconcessional Debt by the General Government

10. **Nonconcessional debt** is defined as debt contracted or guaranteed by the general government with a grant element of less than 35 percent. The grant element of a debt is the difference between the present value (PV) of debt and its nominal value, expressed as a percentage of the nominal value of the debt. The PV of debt at the time of its contracting is calculated by discounting the future stream of payments of debt service due on this debt. The discount rates used for this purpose are the using currency-specific commercial interest reference rates (CIRRs) published by the Development Assistance Committee of the Organization for Economic Cooperation and Development (OECD). For debt with a maturity of at least 15 years, the ten-year-average CIRR will be used to calculate the PV of debt and, hence, its grant element. For debt with a maturity of less than 15 years, the six-month average CIRR will be used. To both the ten-year and six-month averages, the same margins for differing repayment periods as those used by the OECD need to be added (0.75 percent for repayment periods of less than 15 years, 1 percent for 15 to 19 years, 1.15 percent for 20 to 29 years, and 1.25 percent for 30 years or more).

11. The ceilings on contracting and on guaranteeing nonconcessional debt cover both domestic and external debt, but exclude purchases from the IMF and the sale of the SDR holdings allocated to Kosovo. Debt rescheduling and debt reorganization of debts contracted before the approval of the SBA are excluded from the limits on nonconcessional debt. The quantitative performance criteria apply not only to debt as defined below but also to

commitments contracted or guaranteed for which value has not been received. The contracting or guaranteeing nonconcessional debt by the general government will be assessed at each test date.

12. The government of Kosovo will consult with Fund staff before contracting or guaranteeing any new debts in circumstances where they are uncertain whether the instrument in question is covered under the quantitative performance criterion.

13. **Definition of debt.** The definition of debt is set out in Executive Board Decision No. 12274-(00/85), Paragraph 9, as amended on August 31, 2009 (Decision No. 14416-(09/91)):

> "(a) For the purpose of this guideline, the term **"debt"** will be understood to mean a current, i.e., not contingent, liability, created under a contractual arrangement through the provision of value in the form of assets (including currency) or services, and which requires the obligor to make one or more payments in the form of assets (including currency) or services, at some future point(s) in time; these payments will discharge the principal and/or interest liabilities incurred under the contract. Debts can take a number of forms, the primary ones being as follows:
>
>> "(i) loans, i.e., advances of money to the obligor by the lender made on the basis of an undertaking that the obligor will repay the funds in the future (including deposits, bonds, debentures, commercial loans and buyers' credits) and temporary exchanges of assets that are equivalent to fully collateralized loans under which the obligor is required to repay the funds, and usually pay interest, by repurchasing the collateral from the buyer in the future (such as repurchase agreements and official swap arrangements);
>>
>> "(ii) suppliers' credits, i.e., contracts where the supplier permits the obligor to defer payments until some time after the date on which the goods are delivered or services are provided; and
>>
>> "(iii) leases, i.e., arrangements under which property is provided which the lessee has the right to use for one or more specified period(s) of time that are usually shorter than the total expected service life of the property, while the lessor retains the title to the property. For the purpose of the guideline, the debt is the present value (at the inception of the lease) of all lease payments expected to be made during the period of the agreement excluding those payments that cover the operation, repair or maintenance of the property.
>
> "(b) Under the definition of debt set out in this paragraph, arrears, penalties, and judicially awarded damages arising from the failure to make payment under a contractual obligation that constitutes debt are debt. Failure to make payment on an obligation that is not considered debt under this definition (e.g., payment on delivery) will not give rise to debt."

14. **Reporting requirements.** Details of all new debt taken or guaranteed, indicating terms of debt and creditors, will be provided on a quarterly basis within five weeks of the end of each quarter.

F. Domestic Payments Arrears

15. A domestic payment obligation to suppliers or creditors is deemed to be in **arrears** if: (a) goods and services have been received; (b) they have been certified to conform to the order of the contract; and (c) the obligation has remained unpaid for more than 60 days after the invoice was received. A payment obligation is defined to be domestic if the creditor is resident in Kosovo.

16. **Reporting requirements.** The Ministry of Finance will submit a monthly table with the stock of domestic payments arrears and not in arrears. The data are to be provided within five weeks after the end of the month.

G. External Payments Arrears

17. **External arrears** are defined as total external debt service obligations of the government that have not been paid by the time they are due (after the expiration of the relevant grace period). External arrears exclude external debt service obligations subject to ongoing good faith negotiations of debt-rescheduling agreements. A debt service obligation is defined to be external if the creditor is not resident in Kosovo.

18. **Reporting requirements.** The Ministry of Finance will inform the Fund staff immediately of any accumulation of external arrears. Data on (i) debt-service payments; and (ii) external arrears accumulation and payments will be transmitted on a quarterly basis by the Ministry of Finance within five weeks of the end of each quarter.

II. Other Data Requirements

19. The monthly monetary statistics (including balance sheets and monetary surveys) of the CBK, the consolidated commercial banks and revisions to historical data (if any) will be transmitted on a monthly basis with a maximum delay of five weeks

20. Data on exports and imports, including volume and prices and compiled by the Statistical Office of Kosovo (SOK), will be transmitted on a quarterly basis within forty-five days after the end of each quarter.

21. A preliminary quarterly balance of payments, compiled by the CBK, will be forwarded within three months after the end of each quarter.

22. The table of Financial Soundness Indicators and the regulatory capital and liquidity ratios of individual banks will be transmitted by the CBK to the IMF on a monthly basis within six weeks after the end of each month.

23. A monthly report on the number of employees will be transmitted to the IMF by the Treasury Department of the Ministry of Finance within two weeks after the end of each month.

Appendix I. The 2011 Staff-Monitored Program

Kosovo's Staff-Monitored Program (SMP) was initiated in June 2011 after Kosovo's 2010 Stand-By-Arrangement went off track, in large part reflecting outsized public sector wage increases in the 2011 budget. Policies under Kosovo's SMP targeted decisive steps towards fiscal sustainability and stronger budget management and execution, with the expectations that a track record of strong performance under the SMP could pave the way for a return to an IMF-supported program in 2012.

A first assessment based on end-September data was successfully completed on December 15, 2011.[1] The second and final assessment was conducted during the SBA program negotiation mission. Quantitative outcomes were as follows:

- All but one end-December ***quantitative benchmarks*** were met. The primary balance is was €52 million stronger than the envisaged, owing mainly to €44 million (1 percent of GDP) under-execution of spending, distributed across capital expenditures (€12 million), subsidies and transfers (€19 million), goods and services (€10 million), and non-allocation of general reserves (€3 million). Revenues exceeded the program target by €8 million. As a result, the government's bank balance significantly exceeded the program target.
- the ***missed quantitative benchmark*** was, as in the first review, the non-accumulation of domestic payment arrears by the central government, where a minuscule amount had been accumulated.

Performance on structural conditionality was mixed:

- The ***2012 budget*** passed by the Assembly in December 2011 was in line with understandings with staff (structural benchmark), containing structural adjustment of ¾ of a percent of GDP through a mix of public sector wage restraint, revenue measures in line with the recommendations of the October 2011 Tax Policy TA mission, and structural reforms that reduce the need for subsidies to the energy sector. This followed another ¾ of a percent in structural fiscal adjustment measures taken upon initiation of the SMP.
- A ***revised pension fund law*** was submitted to the Assembly that contains an exposure limit of the Pillar II pension fund (KPST) to the government of 30 percent of KPST's assets and an annual investment limit into government paper of 50 percent of previous-year inflows.

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[1] IMF Country Report No. 11/374

- ***Continuous structural benchmarks*** were met on monthly meetings of the Program Monitoring Committee and the inclusion of a paragraph into all new benefit creating laws that allows cutting benefits in case of insufficient budgetary funds.
- On the downside, the ***privatization of the state telecommunications company (PTK)*** could not be completed, after one out of two pre-qualified bidders pulled out of the process, and the ***terms of reference for working groups*** charged with the preparation of possible war veteran benefits and benefits for erstwhile political prisoners were written only with a delay.

Overall, implementation of the SMP has been broadly satisfactory, with significant steps taken toward returning to a sustainable fiscal stance, better costing and design of spending initiatives, and structural reforms to enhance the financial sector's stress resilience.

Kosovo. SMP: Quantitative Benchmarks (QB) , 2011
(Millions of euros, cumulative from beginning of the year)

	2011					
Test date	Jun.		Sep.		Dec.	
Type of objective	IT	Act.	QB adjusted 1/	Act.	QB adjusted 1/ 2/	Est.
Objective to be observed						
Floor on the bank balance of the general government	249	255	200	246	89	160
Floor on the primary fiscal balance of the general government	27	55	-20	44	-144	-79
Ceiling on primary expenditures of the general government	537	528	913	893	1,429	1,382
Ceiling on contracting or guaranteeing nonconcessional debt by the general government	0	0	0	0	0	0
Ceiling on the accumulation of domestic payment arrears of the central government 3/	…	1.1	0.0	0.3	0.0	0.9
Ceiling on the accumulation of external payments arrears of the general government 4/	0.0	0.0	0.0	0.0	0.0	0.0
Memorandum items:						
Ceiling on the accumulation of domestic payment arrears of the general government	…	3.5	0.0	2.2	0.0	0.9
Program assumptions						
New privatization receipts from PTK	0	0	0	0	0	0
Spending cuts contingent on non-privatization of PTK		0	0	0	60	60
Non-project grants	5	4	5	4	23	23
Budget support loans	0	0	0	0	5	5
Project grants	0	1	0	1	3	3
Project loans	0	0	0	0	3	3

Sources: Kosovo authorities; and IMF staff estimates and projections.

1/ The floors and ceilings are adjusted according to the applicable Technical Memorandum of Understanding.

2/ Adjusted in line with expected application of adjustors by end-December 2011.

3/ A zero ceiling on the stock of domestic arrears of the central government is to be observed at end-une 2011; a zero ceiling on the accumulation of new domestic payment arrears by the central government is to be observed at the end of each test date beginning in July 2011.

4/ To be observed continuously.

Kosovo: Program Monitoring (SMP)

	Program approval	1st assessment	2nd assessment
Quantitative benchmarks			
Floor on the bank balance of the general government	…	Met	Met
Floor on the primary fiscal balance of the general government	…	Met	Met
Ceiling on primary expenditures of the general government	…	Met	Met
Ceiling on contracting or guaranteeing nonconcessional debt by the general government	…	Met	Met
Ceiling on the accumulation of domestic payment arrears of the central government	…	Missed	Missed
Ceiling on the accumulation of external payments arrears of the general government	…	Met	Met
Prior actions			
Dissolve the committee reviewing eligibility for all current categories of war related benefits and freeze the number of beneficiaries at a maximum corresponding to the level at end-May 2011, with the exception of applications that have already been received by that date	Met	…	…
Issue a sub-legal act on the “Law on the Rights of Formerly Politically Convicted and Persecuted Persons” that determines that the benefits payable under this law shall only be paid from funds that have been specifically and explicitly appropriated for this purpose under the then applicable budget law	Met	…	…
Passage of the law regulating benefits for war-related categories by the Assembly in a form that is consistent with the Letter of Intent of June 2011, or withdrawal of the law from the Assembly	…	Met	…
Structural benchmarks			
Development of a taxpayer compliance strategy aligned with the TA recommendation	…	Met	…
Passage of a budget for 2012 by the Assembly agreed with IMF staff that contains fiscal tightening of at least ¾ of a percent of GDP, based on realistic macro-forecast and prudent budgeting	…	…	Met
Completion of the privatization of PTK	…	…	Missed
Submission to the Assembly of a revised law on the Kosovo pension fund that limits both (i) exposure of the Pillar II pension fund (KPST) to the general government to 30 percent of its total portfolio and (ii) annual purchases of government paper by KPST to 50 percent of the new inflows into KPST in the previous calendar year	…	…	Met
Setting up working groups to prepare the methodology for fiscal impact assessments for (i) the planned war veteran pension and (ii) possible benefits for former political prisoners, and defining the groups’ terms of reference.	…	…	Met with delay
Continuous structural benchmarks			
Monthly meetings of the Program Monitoring Committee and transmission of meetings' minutes to the IMF	…	Met	Met
Inclusion of a paragraph into all new benefit-creating laws and amendments to laws allowing to cut benefits if budgetary funds are unavailable	…	Met	Met

Appendix II. Debt Sustainability Analysis

Table A1. Kosovo: External Debt Sustainability Framework, Baseline Scenario, 2009-2032 1/
(In percent of GDP, unless otherwise indicated)

	Actual			Historical Average 6/	Standard Deviation 6/	Projections									
	2009	2010	2011			2012	2013	2014	2015	2016	2017	2012-2017 Average	2022	2032	2018-2032 Average
External debt (nominal) 1/	**17.6**	**16.6**	**15.0**			**16.4**	**16.9**	**15.8**	**14.2**	**12.3**	**10.9**	**14.4**	**14.6**	**17.8**	**15.5**
o/w public and publicly guaranteed (PPG)	17.6	16.6	15.0			16.4	16.9	15.8	14.2	12.3	10.9		14.6	17.8	
Change in external debt	-3.7	-1.0	-1.6			1.4	0.5	-1.1	-1.6	-1.8	-1.4		0.6	0.2	
Identified net debt-creating flows	**8.5**	**8.4**	**11.9**			**10.2**	**6.5**	**9.1**	**7.8**	**6.5**	**6.2**		**5.3**	**8.9**	
Non-interest current account deficit	**15.3**	**17.2**	**20.2**	**11.3**	**5.1**	**18.0**	**17.9**	**15.6**	**14.8**	**13.8**	**13.6**	**15.6**	**12.4**	**16.2**	**13.7**
Deficit in balance of goods and services	39.7	40.6	41.1			38.0	36.3	34.0	32.6	31.0	30.0	33.7	27.5	27.0	27.4
Exports	15.5	18.5	20.0			20.6	20.8	21.5	22.0	22.9	23.3		20.5	20.0	
Imports	55.2	59.1	61.1			58.5	57.1	55.6	54.6	53.9	53.3		48.0	47.0	
Net current transfers (negative = inflow)	-22.1	-21.1	-18.1	-21.9	1.9	-17.3	-15.6	-15.6	-15.0	-14.4	-13.6	-15.3	-13.3	-11.0	-12.6
o/w official	-10.3	-8.6	-5.9			-5.4	-3.9	-3.5	-3.2	-3.1	-2.6		-1.7	-0.6	
Other current account flows (negative = net inflow)	-2.3	-2.3	-2.8			-2.7	-2.8	-2.8	-2.8	-2.8	-2.7		-1.8	0.2	
Net FDI (negative = inflow)	**-6.6**	**-7.7**	**-6.9**	**-4.9**	**3.3**	**-7.6**	**-11.1**	**-6.4**	**-6.5**	**-6.9**	**-7.0**	**-7.6**	**-7.0**	**-7.0**	**-7.0**
Endogenous debt dynamics 2/	**-0.2**	**-1.1**	**-1.3**			**-0.3**	**-0.3**	**-0.2**	**-0.5**	**-0.4**	**-0.4**	**-0.3**	**-0.1**	**-0.3**	**-0.2**
Contribution from nominal interest rate	0.2	0.2	0.2			0.3	0.3	0.3	0.3	0.2	0.2		0.5	0.5	
Contribution from real GDP growth	-0.6	-0.6	-0.7			-0.5	-0.6	-0.5	-0.7	-0.7	-0.5		-0.6	-0.8	
Contribution from price and exchange rate changes	0.3	-0.6	-0.8			…	…	…	…	…	…		…	…	
Residual, including assets, errors, and omissions (3-4) 3/	**-12.2**	**-9.4**	**-13.5**			**-8.8**	**-6.0**	**-10.2**	**-9.4**	**-8.4**	**-7.6**		**-4.8**	**-8.6**	
o/w exceptional financing	0.0	0.0	0.0			0.0	0.0	0.0	0.0	0.0	0.0		0.0	0.0	
PV of external debt 4/	...	...	13.4			14.9	15.3	14.5	13.3	11.8	10.6		12.7	14.6	
In percent of exports	...	...	66.8			72.5	73.5	67.4	60.5	51.6	45.6		61.7	73.1	
PV of PPG external debt	**...**	**...**	**13.4**			**14.9**	**15.3**	**14.5**	**13.3**	**11.8**	**10.6**		**12.7**	**14.6**	
In percent of exports	**...**	**...**	**66.8**			**72.5**	**73.5**	**67.4**	**60.5**	**51.6**	**45.6**		**61.7**	**73.1**	
In percent of government revenues	**...**	**...**	**48.5**			**54.3**	**56.5**	**52.3**	**47.6**	**41.7**	**37.3**		**45.0**	**52.1**	
Debt service-to-exports ratio (in percent)	**2.5**	**2.5**	**2.2**			**9.8**	**16.6**	**15.7**	**13.8**	**15.4**	**15.0**		**37.8**	**147.9**	
PPG debt service-to-exports ratio (in percent)	**2.5**	**2.5**	**2.2**			**2.4**	**2.7**	**3.2**	**2.7**	**5.1**	**4.6**		**9.5**	**10.4**	
PPG debt service-to-revenue ratio (in percent)	**1.3**	**1.8**	**1.6**			**1.8**	**2.1**	**2.5**	**2.1**	**4.1**	**3.8**		**7.0**	**7.4**	
Total gross financing need (Billions of euros)	0.4	0.4	0.6			0.6	0.5	0.7	0.7	0.7	0.7		1.2	6.8	
Non-interest current account deficit that stabilizes debt ratio	19.0	18.2	21.8			16.7	17.4	16.8	16.4	15.7	15.0		11.9	16.0	
Key macroeconomic assumptions															
Real GDP growth (in percent)	2.9	3.9	5.0	4.5	1.5	3.8	4.1	3.2	5.0	5.0	4.6	4.3	4.4	4.6	4.5
GDP deflator in euro terms (change in percent)	-1.3	3.7	4.8	1.1	3.4	2.1	2.4	1.9	1.9	1.9	1.9	2.0	2.0	2.0	2.0
Effective interest rate (percent) 5/	0.8	1.2	1.2	0.4	0.6	1.9	2.0	1.9	1.8	1.7	1.5	1.8	3.8	2.9	3.5
Growth of exports of G&S (euro terms, in percent)	6.4	28.8	19.1	21.7	31.3	8.6	7.9	8.8	9.4	11.3	8.7	9.1	5.3	6.7	5.5
Growth of imports of G&S (euro terms, in percent)	0.1	15.4	13.7	10.4	7.4	1.5	4.0	2.3	5.1	5.7	5.4	4.0	5.5	6.7	5.7
Grant element of new public sector borrowing (in percent)	...	...	...	...	...	10.0	26.9	11.5	11.5	11.5	11.5	13.8	11.5	11.5	12.0
Government revenues (excluding grants, in percent of GDP)	29.3	26.4	27.6			27.4	27.1	27.8	27.9	28.3	28.5		28.1	28.1	28.2
Aid flows (in Billions of euros) 7/	0.0	0.0	0.0			0.0	0.0	0.0	0.0	0.0	0.0		0.0	0.0	
o/w Grants	0.0	0.0	0.0			0.0	0.0	0.0	0.0	0.0	0.0		0.0	0.0	
o/w Concessional loans	0.0	0.0	0.0			0.0	0.0	0.0	0.0	0.0	0.0		0.0	0.0	
Grant-equivalent financing (in percent of GDP) 8/	...	...	...			0.9	0.5	0.0	0.0	0.0	0.0		0.3	0.3	0.3
Grant-equivalent financing (in percent of external financing) 8/	...	...	...			29.8	28.9	11.5	11.5	11.5	11.5		11.5	11.5	12.0
Memorandum items:															
Nominal GDP (Billions of euros)	3.9	4.2	4.6			4.9	5.2	5.5	5.9	6.3	6.7		9.1	17.5	
Nominal dollar GDP growth	1.6	7.8	10.0			5.9	6.6	5.2	7.0	7.0	6.6	6.4	6.5	6.7	6.6
PV of PPG external debt (in Billions of euros)			0.6			0.7	0.8	0.8	0.8	0.7	0.7		1.2	2.6	
(PVt-PVt-1)/GDPt-1 (in percent)						2.4	1.4	0.0	-0.3	-0.7	-0.5	0.4	1.1	1.1	1.1
PV of PPG external debt (in percent of GDP)	...	...	13.4			14.9	15.3	14.5	13.3	11.8	10.6		12.7	14.6	
PV of PPG external debt (in percent of exports)	...	...	66.8			72.5	73.5	67.4	60.5	51.6	45.6		61.7	73.1	
Debt service of PPG external debt (in percent of exports)	...	...	2.2			2.4	2.7	3.2	2.7	5.1	4.6		9.5	10.4	

Sources: Country authorities; and staff estimates and projections.

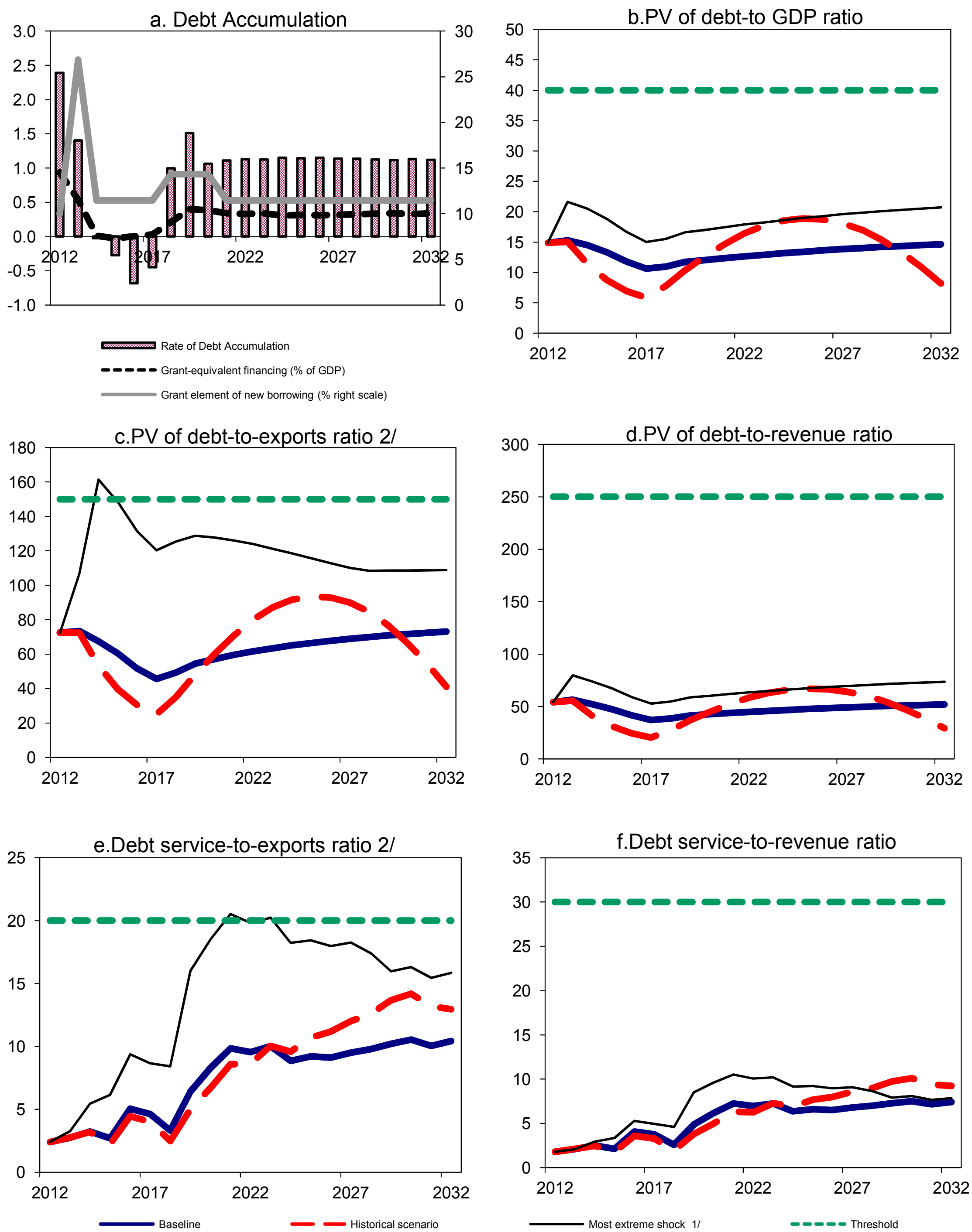
1/ Data on private external debt is unavailable.
2/ Derived as [r - g - ρ(1+g)]/(1+g+ρ+gρ) times previous period debt ratio, with r = nominal interest rate; g = real GDP growth rate, and ρ = growth rate of GDP deflator in euro terms.
3/ Includes exceptional financing; changes in gross foreign assets; errors and ommissions, and valuation adjustments. For projections also includes contribution from price and exchange rate changes.
4/ Assumes that PV of private sector debt is equivalent to its face value.
5/ Current-year interest payments divided by previous period debt stock.
6/ Historical averages and standard deviations are generally derived over the past 10 years, subject to data availability.
7/ Defined as grants, concessional loans, and debt relief.
8/ Grant-equivalent financing includes grants provided directly to the government and through new borrowing (difference between the face value and the PV of new debt).

Table A2. Kosovo: Public Sector Debt Sustainability Framework, Baseline Scenario, 2009-2032
(In percent of GDP, unless otherwise indicated)

	Actual						Estimate	Projections								
	2008	2009	2010	2011	Average 5/	Standard Deviation 5/	2012	2013	2014	2015	2016	2017	2012-17 Average	2022	2032	2018-32 Average
Public sector debt 1/	21.4	17.6	16.6	15.0			17.9	20.0	20.5	20.5	20.2	20.5		23.9	28.6	
o/w foreign-currency denominated	21.4	17.6	16.6	15.0			13.9	12.8	11.8	10.7	9.8	9.0		3.8	-0.1	
Change in public sector debt	-3.9	-3.7	-1.0	-1.6			2.9	2.1	0.5	0.1	-0.3	0.3		0.7	0.4	
Identified debt-creating flows	-13.6	0.5	1.6	0.3			1.8	-3.6	0.1	-0.3	-0.3	-0.3		0.3	-0.1	
Primary deficit	0.2	0.7	2.7	1.7	-0.2	3.6	2.4	3.1	0.8	0.8	0.8	0.8	1.4	0.9	0.9	0.9
Revenue, grants, and interest income	24.5	29.3	27.3	28.1			28.1	27.1	27.8	27.9	28.3	28.5	28.0	28.1	28.1	28.2
of which: grants	0.6	0.0	0.9	0.6			0.7	0.1	0.0	0.0	0.0	0.0		0.0	0.0	
Primary (noninterest) expenditure	24.7	29.9	30.0	29.8			30.5	30.2	28.6	28.7	29.1	29.3	29.4	29.0	29.0	29.0
Automatic debt dynamics	-3.0	-0.2	-1.1	-1.3			-0.6	-0.8	-0.6	-0.9	-0.9	-0.8	-0.8	-0.6	-1.0	-0.8
Contribution from interest rate/growth differential	-2.1	-0.7	-0.6	-0.8			-0.6	-0.7	-0.6	-0.9	-0.9	-0.8		-0.6	-1.0	
of which: contribution from average real interest rate	-0.5	-0.1	0.0	0.0			0.0	0.0	0.0	0.0	0.0	0.1		0.3	0.3	
of which: contribution from real GDP growth	-1.6	-0.6	-0.7	-0.8			-0.5	-0.7	-0.6	-1.0	-1.0	-0.9		-1.0	-1.3	
Contribution from real exchange rate depreciation	-0.9	0.5	-0.4	-0.5			0.0	-0.1	0.0	0.0	0.0	0.0		...	...	
Other identified debt-creating flows	-10.8	0.0	0.0	0.0			0.0	-5.9	-0.2	-0.2	-0.2	-0.3		0.0	0.0	
Privatization receipts (negative)	-10.8	0.0	0.0	0.0			0.0	-5.9	-0.2	-0.2	-0.2	-0.3		0.0	0.0	
Recognition of implicit or contingent liabilities	0.0	0.0	0.0	0.0			0.0	0.0	0.0	0.0	0.0	0.0		0.0	0.0	
Debt relief (HIPC and other)	0.0	0.0	0.0	0.0			0.0	0.0	0.0	0.0	0.0	0.0		0.0	0.0	
Other (specify, e.g. bank recapitalization)	0.0	0.0	0.0	0.0			0.0	0.0	0.0	0.0	0.0	0.0		0.0	0.0	
Residual, including asset changes	9.6	-4.2	-2.6	-1.9			1.1	5.6	0.4	0.4	0.0	0.6	1.4	0.5	0.5	0.4
Other Sustainability Indicators																
PV of public sector debt	...	...	...	13.4			16.4	18.3	19.2	19.6	19.7	20.2		22.0	25.5	
o/w foreign-currency denominated	...	...	...	13.4			14.9	15.3	14.5	13.3	11.8	10.6		12.7	14.6	
PV of contingent liabilities (not included in public sector debt)	...	...	...	...			...	...	...	...	...	...		...	...	
Gross financing need 2/	0.2	1.0	3.1	2.1			2.9	5.1	3.1	4.4	5.8	6.9		8.8	9.9	
PV of public sector debt-to-revenue and grants ratio (in percent)	…	…	…	48			58	68	69	70	70	71		78	91	
PV of public sector debt-to-revenue ratio (in percent)	…	…	…	49			60	68	69	70	70	71		78	91	
o/w external 3/	…	…	…	49			54	56	52	48	42	37		45	52	
Debt service-to-revenue and grants ratio (in percent) 4/	0.0	1.3	1.7	1.6			1.8	7.4	8.1	12.9	17.7	21.3		28.2	32.0	
Debt service-to-revenue ratio (in percent) 4/	0.0	1.3	1.8	1.6			1.8	7.5	8.1	12.9	17.7	21.3		28.2	32.0	
Primary deficit that stabilizes the debt-to-GDP ratio		4.4	3.7	3.3			-0.5	1.0	0.3	0.7	1.1	0.5		0.2	0.5	
Key macroeconomic and fiscal assumptions																
Nominal GDP (local currency)	3.9	3.9	4.2	4.6			4.9	5.2	5.5	5.9	6.3	6.7		9.1	17.5	
Real GDP growth (in percent)	6.9	2.9	3.9	5.0	4.5	1.5	3.8	4.1	3.2	5.0	5.0	4.6	4.3	4.4	4.6	4.5
Average nominal interest rate on forex debt (in percent)	0.0	0.8	1.2	1.2	0.4	0.6	1.9	2.0	1.9	1.8	1.7	1.5	1.8	3.8	2.9	3.5
Average nominal interest rate on domestic debt (in percent)	...	...	...	...	…	…	...	2.5	3.8	3.4	3.5	3.4	3.3	3.4	3.4	3.4
Average real interest rate (in percent)	-2.1	-0.4	0.3	-0.3	-1.8	1.3	-0.1	0.0	0.2	0.2	0.2	0.3	0.1	1.6	1.1	1.4
Average real interest rate on foreign-currency debt (in percent)	-2.1	-1.1	-0.9	-1.5	-2.2	0.8	2.0	2.0	2.0	2.0	2.0	2.0	2.0	2.0	2.0	2.0
Real exchange rate depreciation (in percent, + indicates depreciation)	-3.8	2.5	-2.6	-3.1	1.3	3.8	-0.1	...	...	...	...	...	...	...	...	...
Inflation rate (GDP deflator, in percent)	6.2	-1.3	3.7	4.8	1.1	3.4	2.1	2.4	1.9	1.9	1.9	1.9	2.0	2.0	2.0	2.0
Growth of real primary spending (deflated by GDP deflator, in percent)	0.4	24.8	4.1	4.3	3.8	8.1	6.2	3.1	-2.4	5.6	6.2	5.5	4.0	4.3	4.6	4.4
Grant element of new external borrowing (in percent)	...	...	...	...	…	…	10.0	26.9	11.5	11.5	11.5	11.5	13.8	11.5	11.5	12.0

Sources: Country authorities; and staff estimates and projections.
1/ Covers general government. Gross debt concept is used.
2/ Gross financing need is defined as the primary deficit plus debt service plus the stock of short-term debt at the end of the last period.
3/ Revenues excluding grants.
4/ Debt service is defined as the sum of interest and amortization of medium and long-term debt.
5/ Historical averages and standard deviations are generally derived over the past 10 years, subject to data availability.

Figure A1. Kosovo: Indicators of Public and Publicly Guaranteed External Debt
under Alternatives Scenarios, 2011-2031 1/

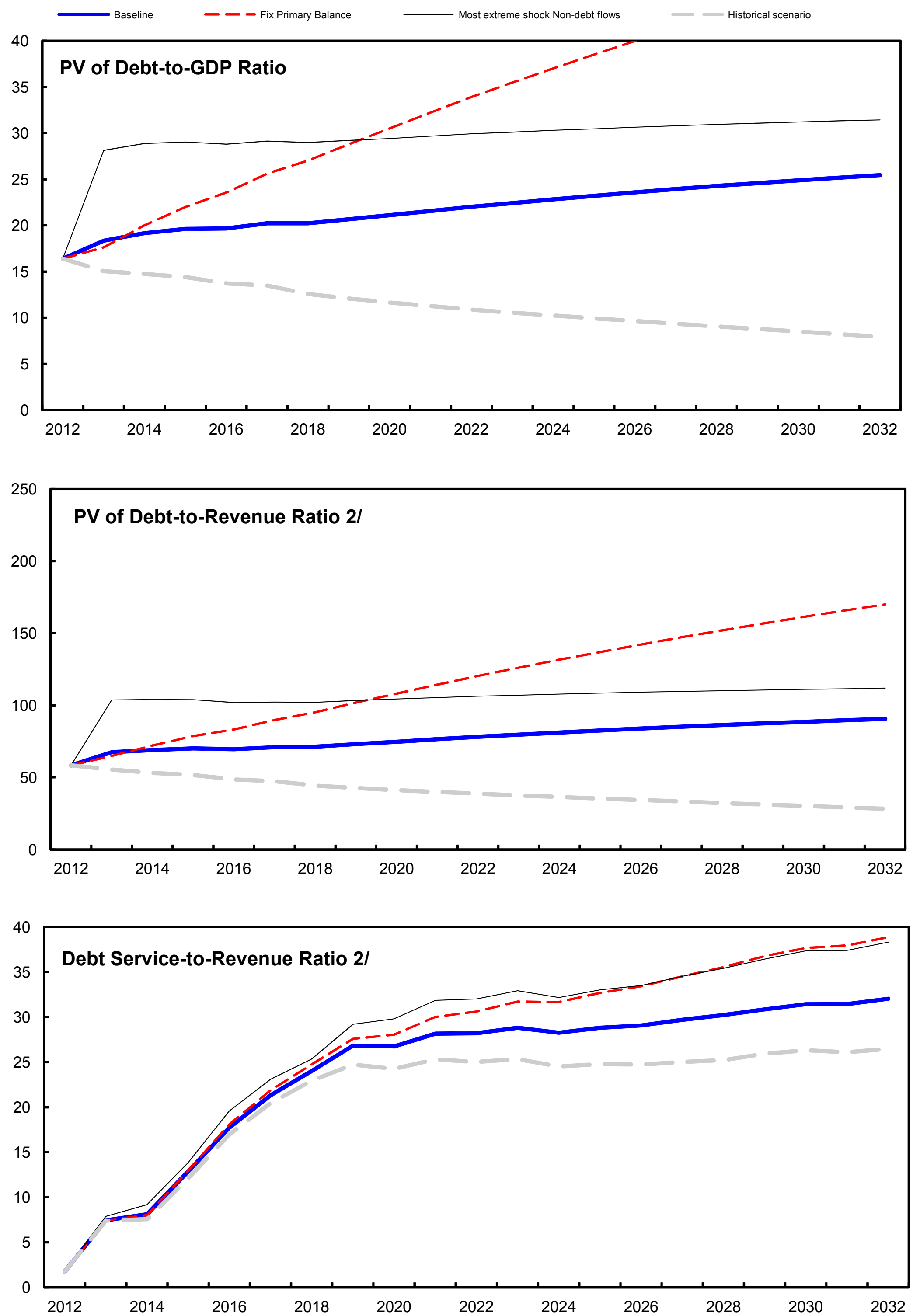


Sources: Country authorities; and staff estimates and projections.

1/ The most extreme stress test is the test that yields the highest ratio in 2022. In figure b. it corresponds to a One-time depreciation shock; in c. to a Exports shock; in d. to a One-time depreciation shock; in e. to a Exports shock and in figure f. to a Exports shock

2/ The magnitude of the export shock reflects the variability of prices of metals, which represented 76 percent of Kosovo's exports in 2010.

Figure A2. Kosovo: Indicators of Public Debt Under Alternative Scenarios, 2011-2031 1/



Sources: Country authorities; and staff estimates and projections.
1/ The most extreme stress test is the test that yields the highest ratio in 2022.
2/ Revenues are defined inclusive of grants.

INTERNATIONAL MONETARY FUND

REPUBLIC OF KOSOVO

Request for Stand-By Arrangement—Informational Annex

Prepared by the European Department
(in consultation with other departments)

April 12, 2012

Contents Page

I. KOSOVO—FUND RELATIONS

Financial Position in the Fund as of February 29, 2012

I. Membership Status: Joined: June 29, 2009; Article VIIII

II. General Resources Account:	**SDR Million**	**%Quota**
Quota	59.00	100.00
Fund holdings of currency	63.60	107.80
Reserve Tranche Position	14.17	24.01

III. SDR Department:	**SDR Million**	**%Allocation**
Net cumulative allocation	55.37	100.00
Holdings	54.86	99.08

IV. Outstanding Purchases and Loans:	**SDR Million**	**% Quota**
Stand-by Arrangements	18.76	31.80

V. Latest Financial Arrangements:

Type	Date of Arrangement	Expiration Date	Amount Approved (SDR Million)	Amount Drawn (SDR Million)
Stand-By	July 21, 2010	Jan 20, 2012	92.66	18.76

VI. Projected Payments to Fund [1/]
(SDR Million; based on existing use of resources and present holdings of SDRs):

	Forthcoming				
	2012	2013	2014	2015	2016
Principal		2.35	9.38	7.04	
Charges/Interest	0.16	0.22	0.16	0.05	0.00
Total	0.16	2.56	9.54	7.08	0.00

[1/] When a member has overdue financial obligations outstanding for more than three months, the amount of such arrears will be shown in this section.

VII. Implementation of HIPC Initiative: Not Applicable

VIII. Implementation of Multilateral Debt Relief Initiative (MDRI): Not Applicable

IX. Implementation of Post-Catastrophe Debt Relief (PCDR): Not Applicable

X. Safeguards Assessments

The Central Bank of the Republic of Kosovo (CBK) was subject to a safeguards assessment with respect to the Stand-By Arrangement approved on July 21, 2010. The assessment of the

CBK, completed on November 4, 2010, found that key safeguards, concerning external audit and financial reporting frameworks, were in place. Revisions to the CBK Law in 2010 had addressed most safeguards concerns with the legal framework. The assessment noted that internal audit independence required strengthening through the transfer of incompatible control responsibilities, and the expansion of IT audits. Operational controls had been established over areas of relevance to safeguards, including accounting, banking operations and reserves management. A memorandum of understanding had been signed to protect the Fund disbursements for budget support. However, additional procedures were needed regarding data reporting under the SBA. An update safeguards assessment is underway with respect to the new SBA and is expected to be completed before the first review.

XI. Exchange Arrangements

Kosovo does not issue a currency of its own, but uses the euro as legal means of payment. Kosovo is not part of the euro area and the Central Bank of the Republic of Kosovo is not part of the European System of Central Banks. Kosovo is an Article XIV member and has not yet accepted the obligations of Article VIII of the Articles of Agreement.

XII. Previous Article IV Consultation

The last Article IV Board discussion took place on June 21, 2011. The associated Executive Board assessment and staff report is IMF Country Report 11/210 available at http://www.imf.org/external/pubs/cat/longres.aspx?sk=25090.0 .

XIII. Technical Assistance

Since 1999, the Fund has provided technical assistance (TA) and policy advice to UNMIK under EBD/99/80 and, since September 2008, to Kosovo under EBD/08/95. Technical assistance has centered on the Fund’s core competencies, notably in the areas of fiscal policy, the banking and payments systems, and macroeconomic statistics. Assistance has also contributed to developing key aspects of the legal and institutional framework needed for a market economy. TA has been provided on the following issues:

Real Sector

- Multisector Statistics (Oct. 2003, Sep. 2005, Feb 2011)
- National Accounts Statistics (Feb. 2006, Nov. 2006, Mar. 2008, Jul 2008, Sep. 2009, April 2010, Sep. 2011)

Fiscal Sector

- IT systems and Taxpayer Compliance (missions from HQ: May 2008, November 2009, February 2011; expert visits: February 2010 and February 2011)

- Tax Policy and Administration (October 2006, April 2008, September 2008, October 2009, February 2010, September 2011, March 2011, May 2011, and March 2012)
- Fiscal Decentralization (September 2007, January 2010, March 2011, December 2011)
- Public Financial Management (May 2007, March 2008, March 2009, September 2011)
- Tax legislation (several missions October 2006–March 2008)
- Debt Management (October 2006)

Monetary and Financial Sectors

- Resident Advisor to the Governor (since January 2009)
- New Banking Law (November 2009, April 2010, December 2010)
- Stress tests (March 2008, November 2010)
- Financial Sector Emergency Planning (April 2010)
- Central Bank Legislation (May 2009, October 2009)
- Monetary and Financial Statistics (September 2003, January 2005, December 2008)
- Anti-Money Laundering and Combating the Financing of Terrorism (AML/CFT), (April 2006)
- Central bank accounting (October 2010)
- Reserve Management (March 2012)

External Sector

- Balance of Payments Statistics (March 2006, July 2006, July 2007, September 2009, March 2012)

Other

- Preparation for IMF membership (August 2008)

XIV. Resident Representative: Mr. Sulemane took up his post in October 2010.

II. Kosovo: Joint IMF–World Bank Management Action Plan April 2012–April 2013

Title	Products	Provisional Timing of Missions	Expected Delivery Date
1. Fund work program	First SBA review	June 2012	July 2012
	TA on cash and debt management	May 2012	June 2012
	Second SBA review	October 2012	December 2012
	TA on banks' loan classification	To be scheduled	To be scheduled
	FSAP	September 2013	December 2013
	TA on estimating GDP from supply side	To be scheduled	To be scheduled
	Third SBA review	February 2013	March 2013
	TA on tax administration	February 2013	February 2013
2. Bank work program	Public Sector Modernization Project (PSMP)	Project began in June 2011 and activities ongoing	Completion date is June 2013
	SEDPP	Negotiations scheduled on March 20–21 (via VC)	Board date is May 3, and disbursement expected in May/June 2012
	Business Environment TA (BETA)	March 28 – April 4, 2012	May 31, 2012
	TA on and financing of RTGS	March 21–23, 2012	June 2012
	TA and partial capitalization of DIFK	Amendments to the pensions law related to	Board approval expected in September

		the second pillar and the functioning of KPST	2012
	TA on social issues (war veterans, pensions, social assistance, health)	July 2012 – June 2013 (planned)	June 2013
	TA on Sustainable Energy Development and Diversification	March 2012	June 2016
	Real Estate Cadastre and Registration Project	26–30, March 2012	July 2015
	Agriculture and Rural Development Project	ongoing	July 2017

III. KOSOVO—STATISTICS ISSUES

1. **Data provision is adequate for surveillance and for program monitoring.** Performance criteria can be tested with accuracy. The official statistics have improved in the areas of government, monetary, and external statistics and Kosovo subscribed to the GDDS on April 1, 2011. However, the national accounts and labor statistics are still untimely, incomplete, and with low frequency.

2. **The authorities are strengthening official statistics.** Kosovo enacted a revised statistics law in December 2011 that establishes a legal framework and determines the fundamental principles for the organization, production, and publication of official statistics. The law states that official statistics should be reliable, impartial and, in due time, should cover the administrative, demographic, economic, social, health, education, and agricultural development.

3. **Improvements have been made to the national accounts, but significant weaknesses remain**. While the quality of GDP data based on the expenditure approach has improved, only annual data is available and with long lags. In addition, GDP data based on the production approach is not available.

4. **Labor market statistics are weak.** Data on the labor force and wages are particularly unreliable, given the large share of the informal economy. A population census was held in 2011. Considerable work remains to be done to improve the sample coverage of the labor force survey.

5. **Fiscal data on a cash basis are provided regularly**. Data on general, central, and municipal budgets with errors and omissions equal to zero are provided within five weeks. There are quarterly reconciliation reports of the independent audits of Treasury's deposits at the central bank. However, the accounting standards deviate from the *Government Finance Statistics Manual, 2001*, in that cash accounting is adopted instead of accrual. The Treasury does not monitor accounts payable on real time and relies on multiple untimely manual reports from individual budgetary units.

6. **Monetary and financial statistics have been improved substantially.** Data are broadly consistent with the IMF's *Monetary and Financial Statistics Manual, 2000* (*MFSM*). The data are available with a lag of six to eight weeks.

7. **External sector statistics have consistently improved in recent years.** The CBK now compiles quarterly balance of payments. With technical assistance from STA, the accuracy, periodicity, and timeliness of balance of payments statistics have continued to improve. However, as Kosovo uses the euro as legal tender, it remains difficult to capture transactions conducted outside the banking system, which causes persistent positive errors and omissions, perhaps overestimating the current account deficit. The external debt statistics and the International Investment Position have incomplete coverage.

Kosovo: Common Indicators Required for Surveillance
(As of March 20, 2012)

	Date of Latest Observation	Date Received	Frequency of Data[7]	Frequency of Reporting[7]	Frequency of Publication[7]
Exchange Rates	March 20, 2012	March 20, 2012	D	D	D
International Reserve Assets and Reserve Liabilities of the Monetary Authorities[1]	January 31, 2012	March 8, 2012	M	M	M
Reserve/Base Money	January 31, 2012	March 8, 2012	M	M	M
Broad Money	January 31, 2012	March 8, 2012	M	M	M
Central Bank Balance Sheet	January 31, 2012	March 8, 2012	M	M	M
Consolidated Balance Sheet of the Banking System	January 31, 2012	March 8, 2012	M	M	M
Interest Rates[2]	January, 2012	March 8, 2012	M	M	M
Consumer Price Index	February 2012	March 20, 2012	M	M	M
Revenue, Expenditure, Balance and Composition of Financing[3] – General Government[4]	January 2012	March 6, 2012	M	M	M
Revenue, Expenditure, Balance and Composition of Financing[3]– Central Government	January 2012	March 6, 2012	M	M	M
Stocks of Central Government and Central Government-Guaranteed Debt[5]	December 2011	January 31, 2012	Q	Q	Q
External Current Account Balance	Q3 2011	January 31, 2012	Q	Q	Q
Exports and Imports of Goods[8]	January 2012	March 20, 2012	M	M	M
GDP[9]	2010	October 31, 2011	A	A	A
Gross External Debt (public)	Dec 31, 2011	Jan. 31, 2012	Q	Q	Q
International Investment Position[6]	Not available	Not available	Not available	Not available	Not available

[1]Includes reserve assets pledged or otherwise encumbered as well as net derivative positions.
[2] Both market-based and officially-determined, including discount rates, money market rates, rates on treasury bills, notes and bonds.
[3] Foreign, domestic bank, and domestic nonbank financing.
[4] The general government consists of the central government (budgetary funds, extra budgetary funds, and social security funds) and state and local governments.
[5] Including currency and maturity composition.
[6] Includes external gross financial asset and liability positions vis-à-vis nonresidents.
[7] Daily (D), weekly (W), monthly (M), quarterly (Q), annually (A), irregular (I); and not available (NA).
[8] Services data available on quarterly basis.
[9] GNDI data estimated by IMF staff.

INTERNATIONAL MONETARY FUND
EXTERNAL RELATIONS DEPARTMENT

Press Release No. 12/154
FOR IMMEDIATE RELEASE
April 27, 2012

International Monetary Fund
Washington, D.C. 20431 USA

IMF Executive Board Approves € 106.6 Million Stand-By Arrangement for Kosovo

The Executive Board of the International Monetary Fund (IMF) today approved a 20-month Stand-By Arrangement (SBA) for Kosovo in a total amount equivalent to SDR 90.968 million (€ 106.6 million or US$140.8 million) in support of the government's economic program for 2012–13. The Board's decision immediately enables the initial disbursement of an amount equivalent to SDR 4.251 million (about € 5 million or US$6.6 million). The approval of the SBA follows the successful completion of a Staff-Monitored Program between June-December 2011.

Following the Executive Board discussion on Kosovo, Ms. Shafik, Deputy Managing Director and Acting Chair, said:

"The Fund-supported program comprehensively addresses Kosovo's macroeconomic challenges through policies and reforms to restore fiscal sustainability, re-build government cash buffers, strengthen the fiscal framework, and preserve financial stability. Determined program implementation, backed by broad political support, will be crucial to build confidence and credibility in the policy framework. In this regard, the strong track record of policy implementation under the staff-monitored program in 2011 is encouraging.

"Fiscal policy is the main instrument to safeguard macroeconomic stability. A sustainable fiscal stance should be restored by 2014, through restraint on current spending and growth-friendly revenue measures. However, priority capital and social spending should be protected. Careful prioritization, design, and costing of spending initiatives are pivotal to support this effort. Kosovo's policy framework could be usefully complemented by a legally-binding fiscal rule to anchor fiscal policy.

"To safeguard financial stability, the central bank needs the full toolkit of legal, regulatory, and financial instruments and the ability to use these instruments without interference. Important steps have been taken, including the upgrading of the legal framework for banking regulation and supervision.

"To strengthen external competitiveness and boost economic growth, further reforms are needed to enhance the business climate, preserve labor market flexibility, develop the traded sectors of the economy, and upgrade public infrastructure."

Background and Program Summary

In the past 10 months, the conduct of macroeconomic policy in Kosovo has improved significantly. Following the deterioration in the fiscal stance after independence and policy slippages, fiscal adjustment of 1½ percentage points of GDP was achieved under the 2011 Staff-Monitored Program. Progress has also been made with respect to the design and costing of spending initiatives, while important steps have been taken to strengthen the resilience of the financial sector.

However, the return to sustainable policies is not yet complete. To fully restore sustainability of the fiscal stance, structural adjustment of another 1½ percent of GDP is required that should be implemented through a mix of restraint on current spending and growth-friendly revenue measures, while protecting priority capital and social spending. Further, a level of government cash buffers needs to be reestablished that is sufficient to insure the economy against fiscal and financial shocks.

The program's key policy objective is to make further decisive steps toward restoring fiscal sustainability and to anchor fiscal policy. With no monetary policy, fiscal policy is the main tool to safeguard macroeconomic stability. A sound policy stance would be complemented with appropriate structural fiscal reforms, as well as steps to enhance the financial system's resilience. Bank balances are expected to recover during the course of 2013 when PTK privatization is expected to be finalized. The SBA-supported program is also expected to facilitate donor support.

Kosovo's unilateral adoption of the euro places a premium not only on fiscal discipline, but also on labor market flexibility, wage restraint, and structural reforms that enhance the economy's competitiveness. Recent measures to improve the business climate and improve Kosovo's rank in the World Bank's "doing business" survey are welcome steps in the right direction. However, Kosovo's legal and institutional framework will require significant further strengthening to attract domestic and international investors.

The authorities' program is designed to address Kosovo's macroeconomic challenges in a comprehensive manner. Restoring and anchoring fiscal sustainability while fostering financial stability are the key objectives of the Stand-By Arrangement.