INTERNATIONAL MONETARY FUND

IMF Country Report No. 345

REPUBLIC OF KOSOVO

December 2012

SECOND REVIEW UNDER THE STAND-BY ARRANGEMENT, REQUEST FOR REPHASING OF PURCHASES AND MODIFICATION OF PERFORMANCE CRITERION

In the context of the Second Review Under the Stand-By Arrangement, Request for Rephasing of Purchases and Modification of a Performance Criterion, the following documents have been released and are included in this package:

- **Staff Report** for the Second Review, Request for Rephasing of Purchases and Modification of a Performance Criterion, prepared by a staff team of the IMF, following discussions that ended on October 29, 2012, with the officials of Kosovo on economic developments and policies. Based on information available at the time of these discussions, the staff report was completed on December 5, 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.
- **Staff Statement** of December 20, 2012.
- **Press Release** summarizing the views of the Executive Board as expressed during its December 20, 2012, discussion of the staff report that concluded the review.
- **Statement by the Executive Director** for the Republic of Kosovo.

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

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

*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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SECOND REVIEW UNDER THE STAND-BY ARRANGEMENT, REQUEST FOR REPHASING OF PURCHASES AND MODIFICATION OF PERFORMANCE CRITERION

December 5, 2012

EXECUTIVE SUMMARY

Stand-By Arrangement. A 20-month SBA in an amount of SDR 90.968 million (154 percent of quota) was approved by the Executive Board on April 27, 2012, and the first purchase of SDR 4.251 million was made available following the Board meeting (Country Report 12/100). The second purchase of SDR 39.108 million was made available upon Board approval of the first review on July 16, 2012 (Country Report 12/180). The third purchase, subject to completion of this (second) review, amounts to SDR 34.857 million.

Program status. All end-August 2012 and continuous performance criteria were met, as a modest shortfall in revenue collection was overcompensated by under-execution of spending. All applicable structural benchmarks were also met, although in one case with a slight delay (launching the tender offer for the telecommunications company PTK by end-August). The passage of a 2013 budget consistent with the objectives of the program is a prior action for completion of this review. The authorities have indicated that they intend to treat the SBA as precautionary in 2013.

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

Approved By
Poul M. Thomsen and Dhaneshwar Ghura

Discussions were held in Pristina, October 16–29. The mission met with Prime Minister Hashim Thaçi, Minister of Finance Bedri Hamza, Central Bank Governor Gani Gërguri, other senior officials, parliamentarians, private sector representatives, and envoys representing the international community. The staff team comprised Mr. Wiegand (head), Ms. Budina, Messrs. Druck (all EUR), Crivelli (FAD), Parker (MCM), and Qu (SPR). Messrs. Sulemane (Resident Representative) and Thaçi (Economist in the Resident Representative's Office) assisted the mission.

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INTRODUCTION AND SUMMARY

1. **Macroeconomic and financial policies have remained on-track, notwithstanding slower growth that complicates the meeting of fiscal targets** (Letter of Intent, Table 1).

- All ***quantitative performance criteria*** for end-August 2012 under the Stand-By Arrangement (SBA) were met, as a shortfall in revenue collection was overcompensated by under-execution of spending (¶8). The revenue shortage reflects in part slower growth (¶4).
- All applicable ***structural benchmarks*** were also met. However, the end-August benchmark on launching the tender offer for the telecommunications company PTK was met with a slight delay only, as more time than originally anticipated was needed to evaluate the large number of applying companies (¶12).
- Missed by small margins were the ***indicative targets*** on the non-accumulation of domestic arrears by the central and the general government, reflecting weaknesses in the monitoring of payment obligations. The authorities are developing an action plan to address these shortcomings (¶15).

2. **Good progress is being made toward achieving the program's key objectives, i.e., restoring a sustainable fiscal position and sufficient government cash buffers, anchoring fiscal policy, and enhancing the resilience of the financial system.**

- ***Fiscal adjustment.*** Structural adjustment of 1.1 percent of GDP is being implemented in 2012. The 2013 budget submitted to the assembly at end-October (structural benchmark) contains additional structural adjustment of 0.6 percent of GDP, which would bring Kosovo's fiscal position close to a fully sustainable stance (¶10). The budget is scheduled to be passed in mid-December (prior action).
- ***Cash buffers.*** The government's bank balance is projected to exceed the original end-2012 program target by some €40 million (¶8). Looking ahead, the receipts from PTK privatization—expected to be transferred to the treasury during the first half of 2013—would restore a fully adequate level of the government's bank balance, and therefore strengthen the authorities' capacity to combat possible fiscal and financial shocks (¶12).
- ***Fiscal rule.*** The authorities and the mission agreed on the basic parameters of a rules-based fiscal framework, based on the recommendations of a technical assistance (TA) mission from June 2012 (¶13). The framework aims at anchoring fiscal policy from 2014. Submission of the legislation to the assembly is a structural benchmark for end-March 2013.
- ***Financial stability.*** The financial safety net is being strengthened by: (i) a transfer of €46 million in August from the treasury to fund the central bank's (CBK's) special reserves fund for emergency liquidity assistance; and (ii) passage of a revised Deposit Insurance Law

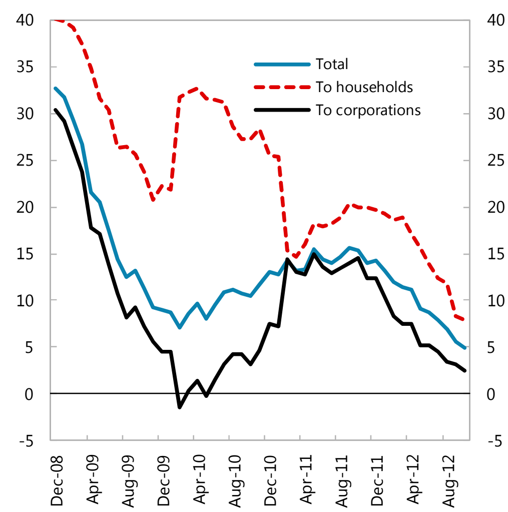
(DIL) that is expected for December. The revised DIL is consistent with the upgraded Banking and Microfinance Law enacted in April (¶16).

3. **The authorities intend to treat the SBA as precautionary in 2013.** With the anticipated privatization of PTK, the government's bank balance would return to a fully adequate level, thus eliminating the need for continued balance-of-payments support.

RECENT DEVELOPMENTS

4. **The economy is slowing, although it continues to display resilience overall** (Tables 1–3, Figure 1). Through mid-2012, Kosovo had remained largely shielded from turbulence in the euro area, owing to limited financial and trade links to crisis countries and robust current and capital inflows from the Kosovar diaspora. In recent months, however, signs of a slowdown have intensified: exports have contracted, reflecting less foreign demand for mineral and metal products; growth of remittances and imports have moderated; and the collection of tax revenues—most of which stems from consumption taxes—has remained below program projections. Moreover, growth of credit to the private sector decelerated to 4.9 percent (y-o-y) in October, from more than 14 percent at end-2011, reflecting both weaker demand and deleveraging by subsidiaries of foreign banks aiming at preserving capital for the consolidated banking group. Headline inflation increased to 3.8 percent at end-October (y-o-y) owing to increases in prices for imported food and energy, but core inflation has remained contained at around 2 percent.

Private Sector Credit
(growth y-o-y, in percent)



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

5. **The banking sector remains well-capitalized, liquid, and profitable, notwithstanding a recent increase in nonperforming loans that arguably relates to the economic slowdown** (Figure 2). Average capital adequacy stood at 17.7 percent at end-September, well above the regulatory minimum of 12 percent, even though there are significant differences in financial strength across banks. Banks continue to hold considerable excess liquidity. The share of nonperforming loans increased to 7.0 percent at end-September from 5.8 percent at end-2011. The increase is concentrated in the trade sector that accounts for about one-third of banks' loan portfolios.

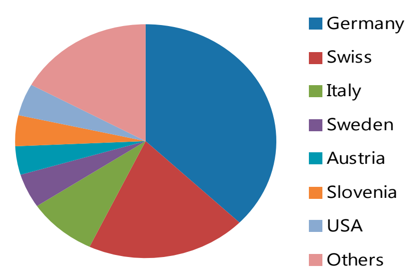
ECONOMIC OUTLOOK AND RISKS

6. **Staff has marked real GDP growth down to 2.7 percent in 2012 and to 3.2 percent in 2013,** from 3.8 percent/4.1 percent respectively at the time of the first review. The revisions reflect both weaker incoming data and downward revisions in growth forecasts for Kosovo's main partner

economies. Nevertheless, growth is projected to remain higher than in most neighboring countries, owing to still solid inflows from the Kosovar diaspora—two-thirds of which resides in Germany and Switzerland—that are expected to continue to support activity. These inflows would finance a wide trade deficit, projected at around 40 percent of GDP for both 2012 and 2013. Consumer price inflation has been revised upward to 2.5 percent (annual average) for 2012, but is expected to fall to around 2 percent in 2013.

7. **The main downside risk to the outlook remains a possible deterioration in labor market conditions in the host countries of Kosovar's diaspora** that could, for example, be triggered by a further intensification of the euro area crisis. Such an event would likely depress remittances and other inflows, with negative repercussions for growth—by depressing domestic demand—tax revenues—by reducing border taxes—and financial stability—as remittances both fund deposits and are used to repay loans.[1] Another risk is additional deleveraging by euro area parent banks with subsidiaries in Kosovo. While parent banks would not withdraw funding—local banks are deposit funded and do not depend on resources from their parents—efforts to preserve risk-weighted capital could curtail credit supply by some banks. The risk of direct contagion from turbulence in the euro area is limited, owing to the small size of Kosovo's export sector and the low level of integration into cross-border financial markets.

Diaspora Country Distribution



Source: Kosovo Remittance Study 2010.

POLICY DISCUSSIONS

A. Fiscal Policy

Fiscal Policy in 2012

8. **Budget implementation to date has been in line with the program** (Figure 3, Tables 4, 5).

- ***Revenue collection*** was below program projections through end-August, reflecting a mix of unfavorable weather conditions early in the year, administrative changes at customs triggering a more back-loaded annual pattern for the collection of border taxes,[2] and slowing economic growth. Preliminary information suggests that collection remained behind expectations also in September-November. On current trends, staff projects a revenue shortfall of about €20–30 million by end-year (0.4–0.6 percent of GDP).

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[1] See Box 4 of IMF Report 12/100 for a quantification of macroeconomic and fiscal risks from a negative shock to remittances.

[2] Border taxes are now paid when goods leave rather than enter the warehouse. Warehouses have to be cleared by end-year.

- The revenue shortfall notwithstanding, the ***primary fiscal balance*** exceeded the end-August program floor by €25 million, owing to under-execution of spending, notably on non-highway capital expenditures.
- The ***government bank balance*** was boosted by the earlier-than-expected receipt of €29 million in transfers from the privatization agency PAK, and stood at 90 percent of a fully adequate level at end-October (up from 60 percent at end-2011).[3]
- Sound fiscal management has helped ease conditions in the nascent ***government paper market***, with three-month t-bills being rolled over at an annual nominal yield of 2–3 percent in August.

9. **To safeguard meeting the primary fiscal balance target by end-year, the authorities have pre-identified spending cuts of €24 million.** Most cuts are on non-highway capital expenditure. The pattern of previous years suggests that under-execution of the budget will likely yield additional savings.

Fiscal Policy in 2013

10. **On October 31, the government submitted a 2013 budget law to the assembly consistent with the objectives of the program** (Box 1, LOI ¶9). Passage is a prior action for completion of this review. The budget contains structural adjustment measures equivalent to 0.6 percent of GDP, and limits the primary fiscal deficit to 3 percent of GDP, in line with the adjustment path targeted under the program.[4] Revenue projections are deliberately cautious and should be achievable even if growth falls a percentage point short of the program baseline. A contingency reserve of €20 million (0.4 percent of GDP) provides an additional buffer against unforeseen shocks. A the same time, the budget allows for the financing of upfront cost for key structural reforms, notably a health reform that will enable the government to contract services directly with hospitals, and a civil service reform that will establish a grading structure for public employees (from mid-2013), developed in cooperation with the World Bank. It also accommodates a modest increase in pensions.

11. **The investment budget includes an allocation of €30 million (0.6 percent of GDP) to start construction of a new highway R6 to Macedonia,** in the context of the government's long-standing policy priority to improve Kosovo's road network (Box 2, LOI ¶10).

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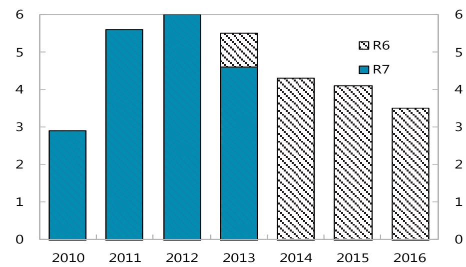
[3] See Box 2, IMF Staff Report 12/53, for the computation of bank balance adequacy.

[4] The program definition of the primary deficit excludes expenditures by the Kosovar Privatization Agency (PAK), as PAK is self-financed and determines its expenditures autonomously. The widening in the headline deficit relative to 2012 reflects mostly a drop in grant and dividend income.

- ***Total costs for R6*** are not yet known but could significantly exceed 10 percent of GDP. Provided construction is stretched until 2016, however, costs of this magnitude can be integrated into a sustainable budgetary framework without putting undue pressure on the deficit or other priority spending.[5]

Highway Construction Cost 1/
(in percent of GDP)



Source: Kosovo authorities; and IMF staff estimates.
1/ Including expropriations. Projections for 2012–16.

- ***Preconditions.*** The authorities and staff agreed that several conditions would need to be in place before the budget allocation for R6 could be executed. These include: (i) the government's bank balance is close to a fully adequate level;[6] (ii) an updated feasibility study is produced (structural benchmark for end-January 2013), and the World Bank confirms that the study identifies an economically viable design for R6; and (iii) bidding for R6 is transparent and competitive.

The budget also contains an allocation of €220 million to complete highway R7 to Albania, in line with the original construction schedule.

12. **Restoring an adequate level of the government bank balance in 2013 requires sizeable one-off financing, notably from the privatization of PTK.**

- The tender offer for ***PTK privatization*** was launched in September. Five international companies pre-qualified for the auction.[7] The winning bid is expected to be announced in early 2013, and the transaction is anticipated to be settled by mid-year. The government expects to raise about €300 million (6 percent of GDP) from the sale, which would bring the government's bank balance well above the minimum adequate level.[8]

- ***T-bill issuance.*** The 2013 budget envisages €80 million (net) in treasury bills. The maturity is expected to rise to 12 months—from three to six months in 2012—but deviations from this schedule are possible, depending on the market's absorptive capacity.

Medium-term Fiscal Issues

13. **The authorities and staff agreed on the basic parameters of a rules-based fiscal framework that would anchor fiscal policy from 2014** (Box 2, LOI ¶¶11, 12). The parameters are

[5] Annual costs for highway construction in 2014–16 would still be more than a percentage point of GDP lower than in 2011–13.

[6] This condition is inscribed into the budget law.

[7] This is a remarkable contrast to 2011, when the PTK auction had to be called off due to a lack of bidders.

[8] Additional financing could become available in case PAK privatization and liquidation receipts are transferred to the budget in 2013. These transfers are not included in the baseline projections, given substantial uncertainty about their magnitude and timing.

oriented on the recommendations of an FAD TA mission from June of this year. They include a ceiling of 2 percent of GDP for the overall fiscal balance, with an exemption for capital spending financed from non-debt creating sources, and carry-over rules for budgetary over- and underperformance. These parameters would, under cautious assumptions, ensure that the net present value of public debt converges to around 30 percent of GDP in the long-term. A follow-up TA mission scheduled for early 2013 will assist the authorities with drafting the necessary legislation. Submission of the legislation to the assembly is a structural benchmark for end-March.

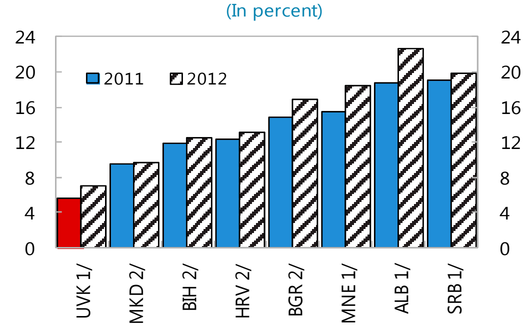
14. **Careful preparation, costing and phasing of spending initiatives remain at the core of the program, to prevent that unfunded spending commitments put fiscal sustainability at risk** (LOI ¶13). The completion of fiscal impact assessments for possible benefits to war veterans and former political prisoners is expected for the first half of 2013. Another area were preparatory work is needed are possible modifications of the pension framework, such as the introduction of pensions for workers forcibly removed from their workplace in the 1990s, or differentiated pensions by profession and qualifications.

15. **The treasury is developing an action plan to address shortcomings in the recording and monitoring of payment obligations** (LOI ¶14). A recent TA mission found that the volume of reported arrears is small and the expenditure control process in principle well designed, but urged further progress, especially in view of advancing fiscal decentralization. Elements of the action plan are: (i) establishing a unit within the treasury to monitor the reporting and level of arrears across budget organizations; (ii) launching a publicity campaign to explain the responsibilities of budget organizations when entering into contractual obligations; and (iii) enforcing sanctions on officials violating expenditure control regulations. The authorities and staff agreed to take stock of progress made in this area during the next review mission, and discuss further corrective policies if needed.

B. Financial Sector Policies

16. **The authorities and staff discussed the reasons behind the recent surge in nonperforming loans (NPLs), as well as possible corrective measures** (Figures 6, 7, LOI ¶15). The CBK noted that NPLs were concentrated in the trade sector, and attributed the increase to the slowdown in economic growth. The CBK also noted that the level of NPLs was still low compared to neighboring countries and were adequately provisioned, and underscored that banks' profitability and capital buffers remained high. Nonetheless, the CBK is taking measures to enhance oversight, including: (i) stepping up data collection to identify early misclassified bad loans and request corrective action if necessary; (ii) reassessing risks from banks' external assets, including with parent institutions;

Bank Nonperforming Loans to Total Loans
(In percent)



Sources: GFSR October 2012 and authorities.
1/ Latest data from September 2012.
2/ Latest data from June 2012.

and (iii) ensuring that banks are in compliance with provisions in the new Law on Banking and Microfinance Institutions, particularly with respect to exposure limits to bank-related parties. The CBK has also enforced the timely implementation of corrective actions requested from several commercial banks earlier this year (LOI ¶16).

17. **An amended Deposit Insurance Law (DIL) is] expected to be passed by the assembly in mid-December** (LOI ¶17). The amendments allow for a gradual increase in the maximum size of insured deposits from currently €2,000 to €5,000 in 2018, in parallel with the anticipated growth of the deposit insurance fund. The revised DIL also reduces the timeframe for repayment of insured depositors, and enhances information sharing and collaboration between the deposit insurance fund and the CBK.

18. **A joint IMF/World Bank mission under the Financial Sector Stability Assessment (FSAP) program has completed an evaluation of Kosovo's financial system** (Box 4). The FSAP mission commended the authorities for progress in promoting the growth and stability of the banking sector, and for the development of a comprehensive financial safety net. It also underscored the need to preserve the high degree of integrity and professionalism at the CBK. At the same time, the FSAP mission advised to enhance banking supervision from a relatively narrow focus on credit risk to a comprehensive risk-based approach, develop a macro-prudential policy framework, and overhaul the regulatory framework for the insurance sector. The authorities and staff will follow up on these recommendations during future program reviews.

C. Competitiveness and Private Sector Development

19. **Efforts to improve the business climate have been reflected in an improvement in the 2013 World Bank's *Doing Business* report** to #98 from #117 in 2012, reflecting the enactment of laws and regulations that aim at streamlining business registration and protecting investors (Box 5, LOI¶18).

20. **The authorities are pursuing further initiatives to strengthen competitiveness, attract investment from abroad, and promote the development of a tradable sector** (LOI ¶¶19, 20). These include:

- ***Small- and medium-sized enterprises (SMEs).*** A joint project with Austrian Development Agency and Swiss Cooperation Office aiming at facilitating access to credit for SMEs will be launched before the end of the year.
- ***Agriculture.*** An agricultural loan program supported by guarantees from USAID is being expanded to assist the sector with obtaining long-term capital.
- ***Labor markets.*** The authorities intend to modify maternity leave provisions to enhance the functioning of the labor market and safeguard the employability of women.

PROGRAM MODALITIES

21. **The attached Letter of Intent describes the authorities' progress in implementing their economic program and sets out performance criteria and structural conditionality through August 2013.** The following modifications to program conditionality are proposed (Box 6, Tables 8–10, LOI ¶¶3, 4,10–12, LOI Tables 2, 3, and TMU ¶¶4, 8):

- A ***prior action*** for completion of this review would be introduced on passage of a 2013 budget by the assembly that is consistent with the objectives of the program.
- Two new ***structural benchmarks*** would be introduced on: (i) the submission of an economic viability study for highway R6 to IMF and World Bank staff by end-January 2013; and (ii) the submission of legislation to the assembly establishing a rules-based fiscal framework by end-March 2013.
- The ***performance criteria*** on the bank balance of the general government for end-December 2012 would be revised upward to lock in overperformance from the unforeseen receipt of transfers from PAK.
- An ***adjustor*** to the performance criterion on the government's bank balance for privatization proceeds would be introduced.

22. **The authorities intend to treat the Stand-By Arrangement as precautionary in 2013, provided PTK privatization advances as expected**. They also request to re-phase the remaining access under the SBA (SDR 12.753 million) into three purchases with test dates of end-December 2012, end-April 2013, and end-August 2013. This schedule—which has been tried and tested in 2012—aligns program reviews with the authorities' budgetary calendar, and therefore allows the authorities and staff to discuss both the 2013 mid-year budget review and the 2014 budget in a timely manner.

STAFF APPRAISAL

23. **Macroeconomic and financial policies are on-track.** All end-August quantitative performance criteria were met. Spending cuts have been pre-identified to ensure meeting end-December fiscal targets. All applicable structural benchmarks were also met, although in one case—launching the tender for PTK privatization—with a slight delay.

24. **Short-term growth prospects have weakened, reflecting mostly a difficult external environment.** Against this backdrop, the key objectives under the program remain restoring a sustainable fiscal stance and an appropriate level of government cash buffers, anchoring fiscal policy, and reinforcing the stability of the financial system.

25. **The 2013 budget further advances fiscal consolidation**. Structural adjustment measures of 0.6 percent of GDP would bring Kosovo close to a fully sustainable fiscal stance, while revenue

forecasts are cautious to reflect the uncertain economic outlook. Execution of the allocation for the planned highway R6 to Macedonia—an ambitious project whose implementation will stretch over several years—is subject to stringent conditions. These conditions need to be fully respected, and preparation of R6 should not be rushed, in order to safeguard that R6 is a viable investment that poses no undue risks to the public finances. Careful preparation is also needed for other spending initiatives, such as possible war veteran benefits or modifications to the pension framework.

26. **Restoring an adequate level of government bank balances in 2013 will depend on securing sizeable one-off financing, in particular from the privatization of PTK.** While prospects for privatization look encouraging, the budget contains sizeable contingency measures (including non-execution of the R6 allocation) should these resources not be forthcoming. However, in such a case the program's fiscal and financial strategy would need to be reconsidered, including precautionary treatment of the arrangement in 2013.

27. **Swift progress is needed to put in place a rules-based fiscal framework that would anchor fiscal policy from 2014**. A strong and legally binding framework is critical to foster confidence in macroeconomic management, especially in the context of a unilaterally euroized economy without an independent monetary policy, and against the background of an unsettled political environment with still fragile institutions

28. **While important steps have been taken to establish a financial safety net, continued supervisory vigilance is required to enforce prudential rules and high standards of corporate governments in Kosovo's financial system.** To this end, it is critical that the CBK pursues its mandate free of political interference and preserves the high degree of professionalism and integrity of its staff. The selection of a central bank governor scheduled for March of next year needs to be guided by these principles.

29. **The progress made in strengthening the business environment is encouraging,** but should be seen as only a first step in an enduring effort to improve the investment climate, foster the emergence of a tradable sector, and promote self-sustained growth, with a view to reducing the excessive dependence of Kosovo's economy on transfers from the diaspora.

30. **The main risk to the program is the potential for political setbacks.** In the past two years, a relatively calm political environment has supported the implementation of stability-oriented policies. The unfavorable experience with Kosovo's first SBA of July 2010 suggests, however, that political turbulence could well put these achievements at risk, especially in the context of electoral campaigns. With parliamentary elections likely in 2013 or early 2014, strong and broad-based political support for macroeconomic stability is needed to preserve the gains made under the program. The upcoming parliamentary discussion of the rules-based fiscal framework will provide an important test in this regard.

31. **The policies under the program provide the best safeguard to steer Kosovo's economy through the period ahead, establish confidence in macroeconomic management, and lay the foundations for robust and balanced growth.** Staff supports the authorities' request for completion of the second review, as well as the rephasing of purchases and the modification of program conditionality, which are consistent with the program's objectives.

Box 1. Key Parameters of the 2013 Budget

The ***primary deficit*** is limited to €155 million (3 percent of GDP), consistent with the program's strategy to gradually restore a sustainable fiscal stance.

The ***tax revenue projections*** inscribed into the budget are conservative and would be achievable with real growth rates significantly below the program's baseline projection, to leave a safety buffer in case the economy slows more than currently anticipated (LOI ¶9a). To preserve the authorities' ability to meet the deficit target, additional one-off revenues are planned, notably from the sale of telecommunications licenses.

The budget contains ***structural fiscal adjustment*** measures—i.e., permanent spending reductions or revenue increases—of €32 million (0.6 percent of GDP). Adjustment measures consist primarily of higher royalty rates for lignite and the elimination of on-lending to the energy company KEK, a development made possible by structural energy sector reforms in previous years.[9]

Structural adjustment in the 2013 budget
(in millions of euros)

Structural tightening	
Lignite royalties	22
Increase in airport licensing fee	4
Elimination of net lending to KEK	17
Structural losening	
Reduction in customs tariffs	-2
Structural increase in recurrent spending*	-9
Net structural tightening	**32**

* reflects health reform, pension increases, and other reforms

There is a ***shift from capital to current spending*** of about ½ percent of GDP, reflecting: (i) upfront costs for the implementation of the government's health and civil service legislation—both reforms that should allow for a more rational management of public spending going forward; (ii) modest increases in pensions; and (iii) a shift in expenditures to current spending by municipalities, reflecting increased flexibility to allocate their non-wage expenditures across spending categories, as had been recommended by FAD TA mission from 2011.[10] Apart from these factors, current spending will remain restrained, including through another round of zero wage increases for public servants (following large increases in the context of the 2011 budget).

As an additional buffer against unforeseen fiscal risks, the 2013 budget law includes ***contingency reserve*** of €20 million in unallocated spending.

[9] Instead, KEK will start repaying the government from 2013 (on a net basis).

[10] See Box 6 of IMF Country Report No. 12/53.

Box 2. Kosovo's Highway Construction Program

Improving Kosovo's roads and integrating Kosovo into the network of highways in Southeastern Europe has been a long-standing policy priority of the government.

Construction of ***highway R7 to Albania*** was started in 2010 and is scheduled to be finalized in 2013. Once completed, R7 will cut the travel time from Pristina to the Albanian border by half to little more than one hour. On the Albanian side, the highway continues to Tirana and ultimately to the Adriatic port of Durres. Dubbed the "patriotic highway" for linking ethnic Albanians in Albania and Kosovo, R7 is considered important primarily for political and security reasons. It is constructed by the American-Turkish consortium Bechtel-Enka.

In November, the idea was floated to extend R7 to Nis in Serbia during discussions between the Serbian and Kosovar Prime Ministers in the context of EU-sponsored normalization talks, but no specific plans have yet been developed.

The total costs of R7 amount to more than 20 percent of 2010 GDP, which has exerted considerable pressure on Kosovo's budget. R7 has been financed in part through running higher deficits financed by drawing down cash buffers, and in part by curtailing other capital expenditures.

The planned ***highway R6 to Macedonia*** would enhance the overland route to Kosovo's main trade port (Thessaloniki in Greece). With a length of 55 km, R6 is only about half as long as R7, but the southernmost section close to the Macedonian border crosses mountainous terrain, which increases construction cost. Still, the annual costs to the budget as a share of GDP are anticipated to be considerably less compared to highway R7.

Box 3. The Rules-Based Fiscal Framework

The basic parameters of the rules-based fiscal framework are as follows:

(a) **an *overall deficit ceiling of 2 percent of GDP***—which, under cautious assumptions, is consistent with stabilizing the net present value of public debt at around 30 percent of GDP in the long term (Table A1).[11] The space to run deficits would be allocated between the central government and municipalities entitled to accumulate debt according to their respective shares in general government spending.

(b) ***full carryover of budgetary under- and over-performance*** to future budgets, and

(c) **an *exemption of pre-specified capital projects from the deficit ceiling***, as long as the projects are financed from non debt-creating sources (such as privatization receipts) and the government's bank balance is at an adequate level.

The design seeks to ensure: (i) long-term sustainability; and (ii) fairness both between current and future governments as well as between the central government and municipalities. Temporary exemptions would apply in narrowly defined case of large negative shocks to economic activity. The parameters of the fiscal rule should be reviewed every five years, taking into account developments on potential growth, interest rates, etc.. Corrective measures—including deficits tighter than 2 percent—will be needed if the government's bank balances are at inadequate levels.

[11] The fiscal rule is based on the overall rather than primary balance, as an overall deficit ceiling was considered easier to communicate to the public.

Box 4. Key Findings of the Financial Sector Stability Assessment

Stress tests. The banking system is generally resilient to a wide range of shocks, including a possible further deterioration in the euro area. However, there are pockets of vulnerability among small and medium-sized banks and in one large foreign subsidiary. These vulnerabilities stem primarily from loan and deposit concentration, and from possible risks to banks' external assets.

Banking supervision. The CBK has made commendable progress in promoting the growth and stability of the banking sector, and has exercised its authority under sometimes challenging circumstances. However, to date the CBK's focus has been almost exclusively on credit risk—the key risk in a nascent market. Looking ahead, the focus should shift to a comprehensive risk-based approach that includes the monitoring of operational and interest rate risks, and—in case of subsidiaries—risks stemming from relations with foreign parents. Legal protection for banking supervisors and other CBK employees needs to be strengthened.

Macro-prudential framework. In the absence of monetary and exchange rate policies, macro-prudential policy measures would be especially useful in countering cyclical risks and external shocks. Instruments could include time-varying reserve requirements, restrictions on loan-to-income or revenue ratios, and a counter-cyclical component to capital requirements.

Financial safety net. The Special Reserves Fund (SRF) for emergency liquidity assistance (ELA) and the deposit insurance fund provide a comprehensive financial safety net. Looking ahead, measures should be taken to ensure that the size of the SRF remains adequate, such as instituting a bank premium to fund future ELA-needs. The deposit insurance fund also needs a back-up funding arrangement.

Insurance sector. The regulatory framework for the sector needs to be overhauled to ensure solvency of the sector and remove obstacles to its development. Specifically, the CBK should reinstate the EU Solvency I framework as the main basis for monitoring, supervising and enforcing minimum solvency requirements.

Anti-money laundering (AML). The new anti-money laundering law has several technical deficiencies, including a lack of specific provisions giving authority to the CBK to carry out compliance inspections of financial institutions. The World Bank is scheduled to perform a comprehensive assessment of Kosovo's AML regime in 2013.

Box 5. Doing Business

Kosovo's improvement in the World Bank's 2013 "Doing Business"—both in absolute terms and relative to the region—owes to a number of recent reforms and government initiatives to improve the investment climate. These include:

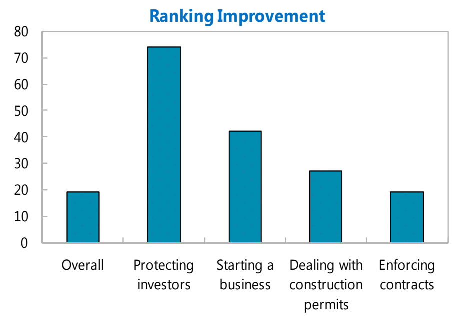
- ***Starting a business*** has been facilitated by reducing minimum capital requirements, unifying business registries, and simplifying business licensing.

	2009-11 Average	2012
Kosovo	116	98
Macedonia	31	23
Albania	82	85
Serbia	90	86
Montenegro	64	51
Bulgaria	51	66
Bosnia and Herzegovina	117	126
Romania	61	72

- Amendments to the ***Law on Business Organizations*** require shareholder-approval of related-party transactions, increase disclosure requirements, and make it easier for shareholders to take legal action against directors when transactions deem prejudicial. These changes have sharply improved Kosovo's score for investor protection.

- A ***minimum wage*** for the private sector has been introduced, which strengthens the score on hiring rules.

The authorities expect that additional reforms taken in 2012 would further improve Kosovo's ranking in the "Doing Business" survey, including through the establishment of one-stop-shops for business registration and laws that remove entry barriers and aim at equal treatment among investors in the telecommunication and mining sectors.



Source: Doing Business Report 2012, 2013.

Box 6. Stand-By Arrangement

Key objectives: (i) restoration of a sustainable fiscal stance and an adequate level of government cash buffers; (ii) introduction of a legally binding fiscal rule; (iii) better design and costing of spending initiatives; (iv) strengthening the legal framework for financial regulation and supervision; and (v) equipping the central bank with funds for emergency liquidity assistance.

Program Modalities:

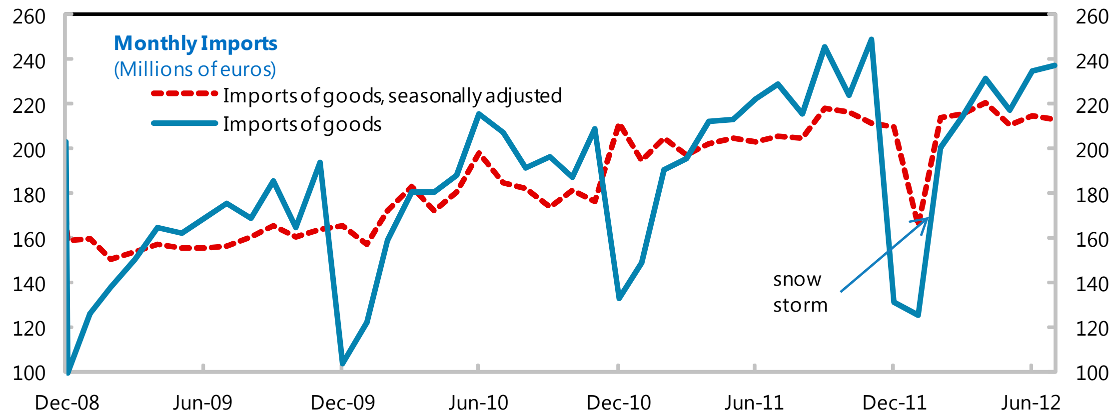
- ***Access:*** SDR 90.968 million (154 percent of quota)
- ***Length:*** 20 months (through end-December 2013)
- ***Phasing:*** SDR 4.251 million was made available after Board approval on April 27, 2012, and SDR 39.108 after completion of the first review on July 11, 2012. The third purchase, subject to completion of this second review, amounts to SDR 34.857 million. Subsequent purchases are contingent on the completion of further reviews.

Conditionality (going forward):

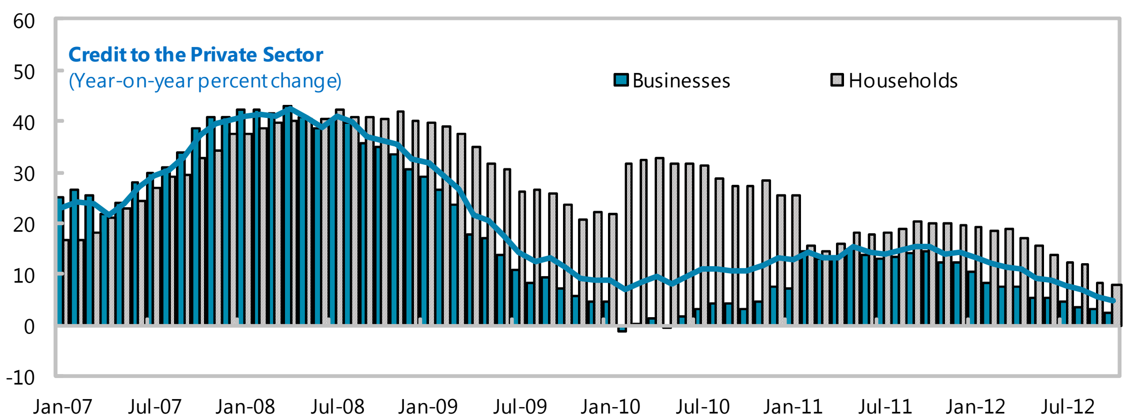
- ***Prior action***
  - Passage of a 2013 budget by the Assembly that is consistent with the objectives of the program.
- ***Quantitative performance criteria***
  - Floor on the bank balance of the general government.
  - Floor on the primary fiscal balance of the general government.
  - Ceiling on primary expenditures of the general government.
  - Ceiling on the net contracting of nonconcessional debt by the general government.
  - Ceiling on guaranteeing nonconcessional debt by the general government.
  - Ceiling on the accumulation of external payment arrears of the general government.
- ***Quantitative indicative targets***
  - Ceiling on the stock of domestic payment arrears of the central government.
  - Ceiling on the stock of domestic payments arrears of the general government.
- ***Structural benchmarks***
  - Submission of an economic viability study for highway R6 to World Bank and IMF staff. *By end-January, 2013.*
  - Submission of legislation to the assembly on a rules-based fiscal framework consistent with paragraph 11 of the letter of intent from December 5, 2012. *By end-March, 2013.*
  - Monthly meetings of the Program Monitoring Committee and transmission of the meetings' minutes to the IMF Resident Representative. *Continuous.*
  - Fiscal impact assessments evaluating the budgetary impact of all new benefit creating laws, amendments to laws or regulations over a period of at least five years. *Continuous.*

Figure 1. Kosovo: Recent Economic Developments

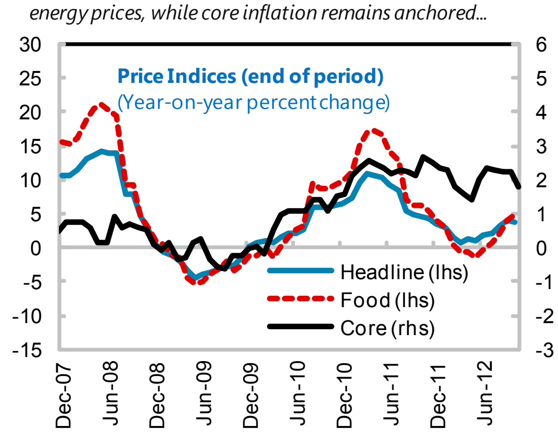
Import growth remained muted, following the sharp contraction in February due to severe weather conditions...



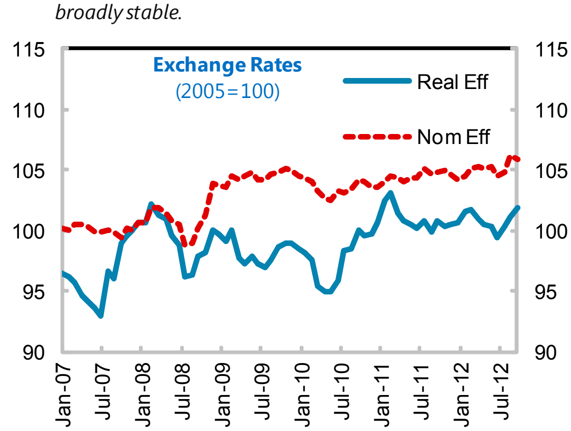
... while bank credit growth has moderated further.



Headline inflation has picked up, in line with food and energy prices, while core inflation remains anchored...

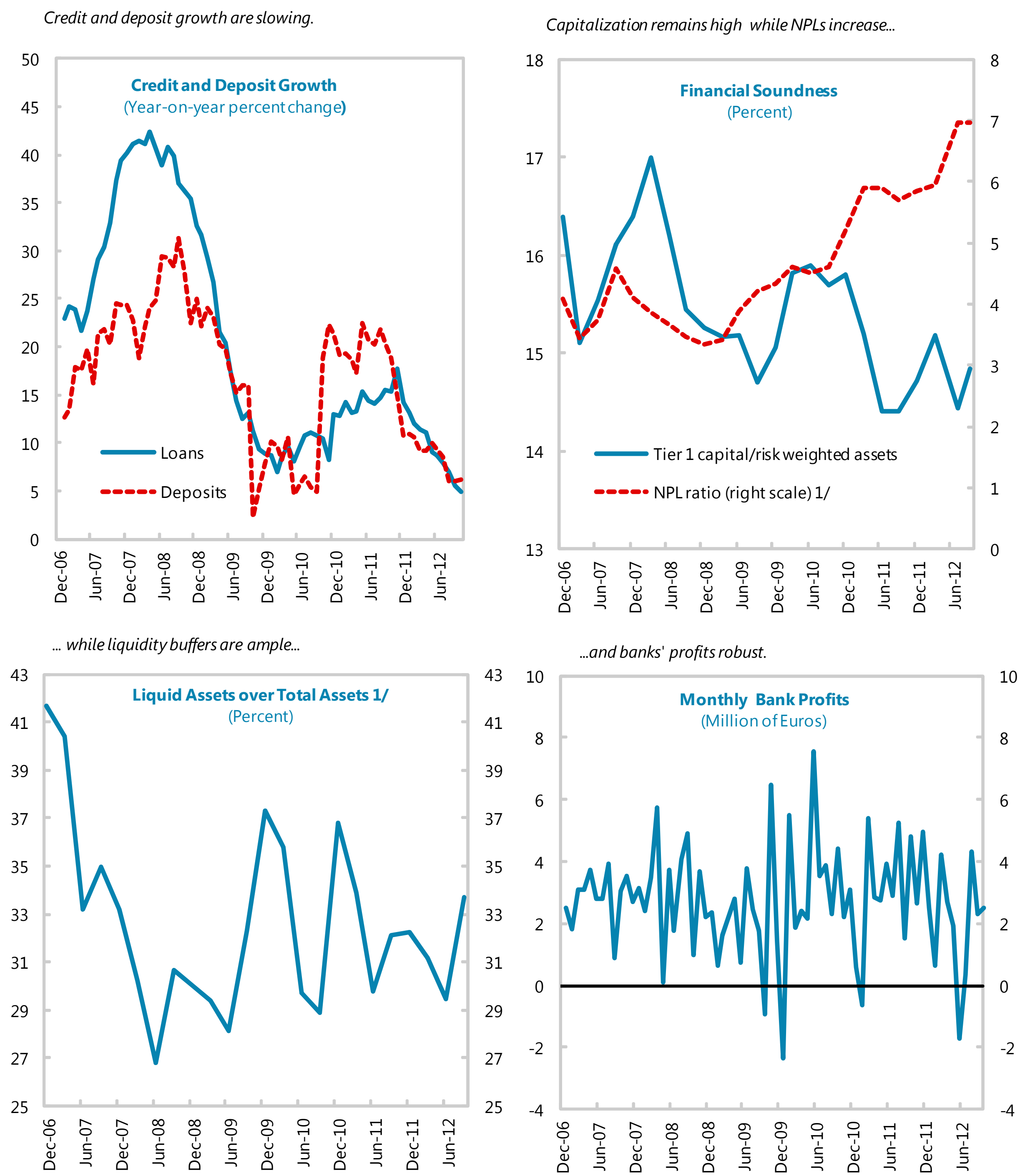


... and effective exchange rates have remained broadly stable.



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

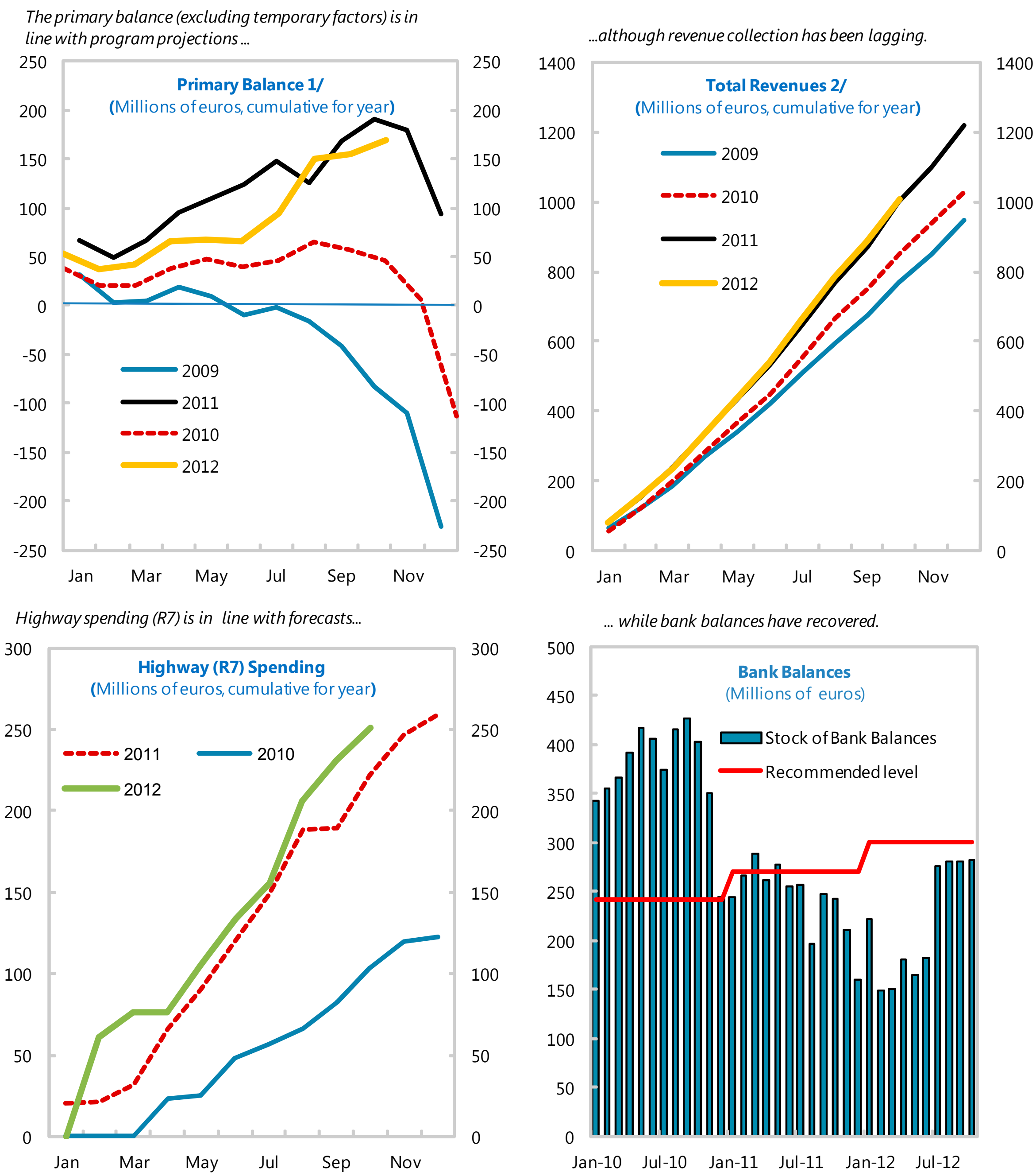
Figure 2. Kosovo: Selected Banking Sector Indicators



Sources: Cental Bank of Kosovo; IMF staff estimates.

1/ Liquid assets are cash, balances with CBK and commercial banks, and securities.

Figure 3. Kosovo: Recent Fiscal Developments



Source:s Country authorities; and IMF staff calculations.

1/ Primary balance excluding highway (R7) expenditures, grants, and dividends. The 2011 outcome exceeded the program target under the SMP by a large margin.

2/ Total revenues excluding grants and dividends.

Table 1. Kosovo: Main Indicators, 2008–17
(Percent, unless otherwise indicated)

	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017
							Projections			
Real growth rates										
GDP	6.9	2.9	3.9	5.0	2.7	3.2	4.3	5.0	5.0	4.6
GDP per capita	5.6	1.4	2.4	3.4	1.1	1.7	2.8	3.4	3.4	3.1
Consumption	4.3	1.0	2.9	2.9	2.0	2.6	3.1	3.3	3.1	3.0
Investment	18.1	11.7	8.8	7.6	4.4	4.3	1.5	8.3	7.1	7.0
Exports	4.7	7.8	24.2	13.6	-1.4	4.5	12.8	10.8	11.5	9.2
Imports	5.9	5.3	11.9	5.6	0.8	3.3	3.5	6.3	5.8	5.4
Official unemployment (percent of workforce)	47.5	45.4	45.1	...	...	...	...	...	...	...
Price changes										
CPI, period average	9.4	-2.4	3.5	7.3	2.5	2.2	1.6	1.5	1.5	1.5
CPI, end of period	0.5	0.1	6.6	3.6	3.8	1.7	1.4	1.6	1.4	1.5
Import prices	11.8	-4.9	3.2	7.7	1.8	-0.1	0.0	-0.8	-0.3	-0.1
GDP deflator	6.2	-1.3	3.7	4.8	2.6	2.5	2.0	2.0	2.0	2.0
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	24.5	29.3	27.6	28.1	27.8	27.6	27.7	28.0	28.2	28.5
Primary expenditures	24.7	29.9	30.0	29.8	30.3	30.7	29.1	29.4	29.7	29.8
Of which										
Wages and salaries	5.9	6.8	7.4	8.3	8.4	8.4	8.4	8.4	8.4	8.4
Subsidies and transfers	7.1	7.3	6.4	5.8	6.1	6.1	6.1	6.1	6.1	6.1
Capital and net lending, incl. highways	7.6	11.6	11.9	11.9	11.9	11.6	10.2	10.4	10.7	10.9
Capital expenditures on highways	...	...	2.9	5.6	6.0	5.5	4.4	4.1	3.5	0.0
Overall balance	-0.2	-0.7	-2.6	-1.9	-2.7	-3.5	-1.8	-1.9	-2.0	-2.0
Debt financing, net	0.0	-0.2	0.3	-0.1	3.0	1.4	1.9	2.1	2.0	2.1
Privatization	0.0	0.0	0.0	0.0	1.2	6.3	0.2	0.2	0.2	0.3
Stock of government bank balances	10.8	8.7	5.8	3.5	4.7	8.6	8.4	8.3	7.5	7.2
Recommended minimum bank balances 1/	...	...	5.7	5.8	6.2	6.8	7.0	7.3	7.3	7.2
Financing gap	0.0	0.0	0.0	0.0	0.9	0.0	0.0	0.0	0.0	0.0
Savings-investment balances (percent of GDP)										
Domestic savings	-12.6	-7.4	-6.7	-7.9	-7.5	-6.9	-5.2	-2.9	-0.6	1.5
Transfers excluding general government (net)	14.0	11.9	12.5	12.2	12.0	11.9	11.9	11.6	11.2	10.8
Net factor income	4.3	2.1	2.1	2.6	2.4	2.3	2.4	2.4	2.4	2.4
National savings	5.8	6.6	8.0	7.0	6.9	7.4	9.1	11.0	12.9	14.6
Investment	28.6	32.3	33.9	33.2	33.1	32.4	31.2	31.7	32.0	32.6
Current account, excl. official transfers	-22.8	-25.7	-25.9	-26.2	-26.3	-25.0	-22.1	-20.7	-19.1	-17.9
Current account balance, incl. official transfers	-15.3	-15.4	-17.4	-20.3	-20.7	-21.1	-18.6	-17.5	-16.5	-15.6
Of which : official transfers 2/	7.5	10.3	8.6	5.9	5.6	3.9	3.5	3.1	2.6	2.4
Net foreign direct investment	8.9	7.1	8.5	8.0	6.6	13.0	8.6	7.8	7.6	7.4
Portfolio investment, net	1.7	-1.4	-5.5	-2.3	-2.7	-1.5	-2.2	-1.0	-0.3	0.0
Bank credit to the private sector	32.7	8.9	12.6	14.7	4.6	...	...	...	...	...
Deposits of the private sector	25.8	22.2	23.1	11.4	5.0	...	...	...	...	...
Non-performing loans (percent of total loans)	3.3	4.3	5.2	5.8	7.0 3/	...	...	...	...	...
GDP (millions of euros)	3,851	3,912	4,216	4,637	4,885	5,169	5,501	5,892	6,312	6,736
GDP per capita (euros)	2,323	2,325	2,468	2,674	2,776	2,894	3,034	3,202	3,379	3,553
GNDI per capita (euros)	2,749	2,650	2,829	3,071	3,175	3,306	3,469	3,649	3,836	4,020
Population (thousands) 4/	1,658	1,683	1,708	1,734	1,760	1,786	1,813	1,840	1,868	1,896

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

1/ See Box 2 in the IMF Country Report No. 12/100, April 2012, International Monetary Fund, Washington DC.

2/ Total foreign assistance excluding capital transfers.

3/ September 2012.

4/ 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
						Projections					
						(Real growth, percent)					
Consumption	5.3	4.3	1.0	2.9	2.9	2.0	2.6	3.1	3.3	3.1	3.0
Private	8.0	6.4	0.4	3.8	3.0	2.6	2.6	3.2	3.2	3.1	2.9
Public	-5.4	-5.9	3.9	-1.5	2.3	-1.3	2.9	2.7	3.6	3.4	3.5
General government	-2.3	-0.2	15.9	7.1	8.5	3.6	9.5	3.7	5.6	5.4	5.3
Donor sector 1/	-8.7	-12.2	-11.4	-16.0	-10.9	-13.9	-17.9	-1.2	-5.1	-6.4	-6.1
Investment	15.2	18.1	11.7	8.8	7.6	4.4	4.3	1.5	8.3	7.1	7.0
Private	21.6	0.6	4.8	7.0	7.2	3.2	4.7	6.7	8.7	6.6	7.4
Public	-9.7	109.2	29.0	12.6	8.4	6.7	3.6	-8.1	7.4	8.1	6.1
General government	-8.7	153.6	35.1	13.8	9.4	7.2	4.0	-8.2	8.0	8.6	6.4
Donor sector 1/	-12.3	-18.6	-26.0	-7.3	-11.1	-6.9	-6.5	-5.9	-10.3	-10.1	-10.0
Exports	13.4	4.7	7.8	24.2	13.6	-1.4	4.5	12.8	10.8	11.5	9.2
Imports	11.0	5.9	5.3	11.9	5.6	0.8	3.3	3.5	6.3	5.8	5.4
GDP	6.3	6.9	2.9	3.9	5.0	2.7	3.2	4.3	5.0	5.0	4.6
Memorandum item:											
GDP (millions of euros)	3,394	3,851	3912	4216	4637	4885	5169	5501	5892	6312	6736

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

1/ Donor sector includes UNMIK, EULEX, KFOR, and other donor spending.

Table 3. Kosovo: Balance of Payments, 2009–17 1/

(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	-1,986	-2,030	-2,003	-2,040	-2,060	-2,093
Goods	-1,673	-1,776	-2,090	-2,185	-2,259	-2,298	-2,410	-2,536	-2,653
Exports	177	305	322	289	307	362	406	458	517
Imports	-1,851	-2,081	-2,412	-2,474	-2,566	-2,660	-2,816	-2,994	-3,170
Services	121	66	186	199	229	295	370	477	561
Receipts	429	476	608	631	664	742	830	937	1,026
Payments	-308	-410	-422	-432	-435	-447	-460	-461	-465
Income	83	89	121	116	121	131	140	150	159
Compensation of employees (net)	169	172	178	186	193	201	209	217	226
Investment income	-86	-82	-57	-69	-72	-69	-68	-68	-67
Interest payments on public debt	-1	-9	-9	-13	-14	-12	-12	-11	-10
Transfers	866	889	839	860	818	850	866	871	885
Official transfers	401	361	273	273	201	193	183	167	159
Other transfers (net)	465	528	566	587	616	657	683	704	727
Of which: inflows of remittances	506	512	548	557	568	586	609	636	661
Current account	-604	-732	-943	-1,010	-1,091	-1,022	-1,034	-1,039	-1,048
Capital and financial account	543	553	743	767	891	822	834	839	848
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	764	889	820	832	837	846
Foreign direct investment, net	277	358	371	321	674	470	460	479	498
Commercial banks, excl. FDI	-98	-101	25	-52	-3	-19	43	95	116
General government	-132	21	-4	70	-6	-23	-28	-60	-52
Disbursements, incl. past IMF purchases	0	22	8	82	9	0	0	0	0
Repayments	-132	-11	-12	-11	-15	-23	-28	-60	-52
Prepayment of debt	-132	-11	-12	-11	-15	-23	-28	-60	-52
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 2/	366	284	334	501	462	431	404	337	318
Central Bank of Kosovo	22	-35	11	-76	-238	-40	-47	-14	-33
Reserve assets	94	-47	60	-76	-238	-40	-47	-14	-33
Government balances (program definition)	-17	236	73	-67	-220	-18	-23	12	-6
Other reserve assets, incl. SDRs	111	-283	-14	-9	-18	-21	-25	-26	-27
Non-reserves assets	-132	12	-46	0	0	0	0	0	0
Liabilities 3/	60	0	-3	0	0	0	0	0	0
Net errors and omissions 4/	61	180	200	200	200	200	200	200	200
Financing gap	0	0	0	43	0	0	0	0	0
Memorandum items:									
Current account, excl. official transfers	-1,005	-1,093	-1,216	-1,283	-1,293	-1,215	-1,217	-1,206	-1,207
(in percent of GDP)	-25.7	-25.9	-26.2	-26.3	-25.0	-22.1	-20.7	-19.1	-17.9
Current account, incl. official transfers	-604	-732	-943	-1,010	-1,091	-1,022	-1,034	-1,039	-1,048
(in percent of GDP)	-15.4	-17.4	-20.3	-20.7	-21.1	-18.6	-17.5	-16.5	-15.6
Trade Balance (percent of GDP)	-39.7	-40.6	-41.1	-40.7	-39.3	-36.4	-34.6	-32.6	-31.1
Debt service to export ratio (percent)	21.9	2.6	2.2	2.7	3.0	3.2	3.2	5.1	4.0
Net foreign assets of commercial banks	444	545	519	573	575	595	552	480	388
Net foreign assets of CBK	1,088	1,108	1,097	1,173	1,411	1,450	1,498	1,512	1,545
Gross international reserves of the CBK	625	686	626	702	940	980	1,027	947	981

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

1/ The authorities are in the process of revising the balance of payments statistics, based in part on recommedations by a recent STA TA mission.

2/ Includes unrecorded remittances.

3/ Includes SDR allocations and IMF account at historical value.

4/ Projections of errors include unidentified private remittances and other capital flows based on average historical levels.

Table 4. Kosovo: Consolidated Government Budget, 2011–13 1/

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

	2011	2012						2013
		Apr.		Aug.		Dec		
		Prog.	Actual	Prog	Actual	Prog.	Rev. Prog.	Prog.
Total primary revenue and grants	1,303	378	357	886	848	1,376	1,359	1,423
Total primary revenue	1,277	377	356	853	811	1,342	1,317	1,420
Taxes	1,072	322	298	735	700	1,145	1,138	1,200
Direct taxes	151	68	60	129	108	168	170	184
Indirect taxes	949	264	248	625	612	1,012	998	1,051
Tax refunds	-28	-11	-11	-19	-20	-35	-31	-35
Nontax revenues	205	56	58	118	111	197	180	220
Of which :								
Dividends	60	0	15	15	25	45	45	30
Grants	26	1	1	33	38	34	41	3
Budget support	19	0	1	30	37	30	37	0
Project grants	3	1	0	3	0	4	4	3
Primary expenditure	1,382	400	353	916	845	1,503	1,479	1,586
Of which :								
PAK-related expenditures		1	1	5	4	8	8	8
Primary expenditure excluding PAK	…	352	352	911	842	1,494	1,470	1,578
Current expenditure	832	243	236	542	522	905	896	985
Wages and salaries	385	102	101	240	237	410	408	439
Goods and services	177	58	58	124	116	193	188	229
Subsidies and transfers	270	84	77	178	168	298	296	313
Pension and social assistance	178	64	59	130	120	196	181	204
Other transfers and subsidies 2/	92	20	18	48	49	102	115	109
Reserve	0	0	0	0	0	4	4	4
Capital expenditure and net lending	550	156	117	374	323	598	583	601
Capital expenditure	520	145	118	363	317	587	572	607
Highways	259	104	76	213	208	294	294	283
R7	…			…	176	…	…	220
R6	…			…	0	…	…	30
Expropriation	…			…	31	…	…	33
Other capital spending	261	42	41	150	110	293	278	324
Net lending	30	11	-1	11	6	11	11	-6
Primary balance	-79	-21	4	-30	3	-127	-120	-163
Primary balance net of PAK		-20	5	-26	6	-119	-112	-155
Interest income, net	-7	-6	-4	-6	-6	-12	-13	-18
Overall balance	-86	-27	-1	-36	-3	-138	-132	-181
Financing	86	22	1	-10	3	52	89	181
Foreign financing	2	3	-1	15	48	22	70	-5
Drawings, incl. official financing	8	14	5	21	53	34	82	9
Amortization	-12	-6	-6	-6	-6	-11	-11	-14
of which: IMF							0	-3
Trust fund at the World Bank	5	0	0	0	0	0	0	0
Prospective repurchases	0	0	0	0	0	0	0	0
Domestic financing	85	19	2	-25	-45	30	18	186
Domestic borrowing (net)	0	30	30	50	50	74	74	80
Privatization revenues	0	0	0	37	37	31	59	326
Other financial assets, net	0	-5	0	-10	0	-20	-20	-3
Own-source revenue (– = increase)	0	0	-8	-32	-11	-28	-28	3
o/w PAK related		…	…	-32		-22	-22	8
Bank balance (prog.; – = increase)	84	-6	-20	-70	-121	-27	-67	-220
Financing gap	0	0	0	46	0	87	43	0
Memorandum items:								
Bank balance of the general government	160	166	180	230	281	187	227	447
Of which: ELA	0	0	0	46	46	46	46	46
Recommended minimum level of bank balance	271	…	…	…	…	…	301	352

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

1/ Does not yet reflect the GFSM 2001 methodology to ensure consistency within a program context.
2/ Including capital transfers to public enterprises.

Table 5. Kosovo: Consolidated Government Budget, 2011–13 1/

(Excluding donor designated grants; percent of GDP)

	2011	2012		2013	2014	2015	2016	2017
	Year	Year						
	Est.	Prog.	Rev. Prog.	Prog.	Projections			
Total primary revenue and grants	28.1	28.0	27.8	27.5	27.6	27.9	28.1	28.3
Total primary revenue	27.5	27.3	27.0	27.5	27.6	27.9	28.1	28.3
Taxes	23.1	23.3	23.3	23.2	23.7	23.9	24.2	24.4
Direct taxes	3.3	3.4	3.5	3.6	3.8	4.1	4.2	4.3
Indirect taxes	20.5	20.6	20.4	20.3	20.5	20.6	20.7	20.8
Tax refunds	-0.6	-0.7	-0.7	-0.7	-0.7	-0.7	-0.7	-0.7
Nontax revenues	4.4	4.0	3.7	4.3	3.9	3.9	3.9	3.9
Of which :								
Dividends	1.3	0.9	0.9	0.6	0.0	0.0	0.0	0.0
Grants	0.6	0.7	0.8	0.1	0.0	0.0	0.0	0.0
Budget support	0.4	0.6	0.8	0.0	0.0	0.0	0.0	0.0
Trust fund at the World Bank	0.1	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Project grants	0.1	0.1	0.1	0.1	0.0	0.0	0.0	0.0
Primary expenditure	29.8	30.6	30.3	30.7	29.1	29.4	29.7	29.8
Of which :								
PAK-related expenditures	...	0.2	...	0.2	0.2	...	...	...
Primary expenditure excluding PAK	...	30.4	...	30.5	29.0	...	...	...
Current expenditure	17.9	18.4	18.3	19.0	19.0	19.0	19.0	19.0
Wages and salaries	8.3	8.4	8.4	8.4	8.4	8.4	8.4	8.4
Goods and services	3.8	3.9	3.9	4.4	4.4	4.4	4.4	4.4
Subsidies and transfers	5.8	6.1	6.1	6.1	6.1	6.1	6.1	6.1
Pension and social assistance	3.8	4.0	3.7	3.9	3.9	3.9	3.9	3.9
Other transfers and subsidies 2/	2.0	2.1	2.4	2.1	2.2	2.2	2.2	2.2
Reserve	0.0	0.1	0.1	0.1	0.1	0.1	0.1	0.1
Capital expenditure and net lending	11.9	12.2	11.9	11.6	10.2	10.4	10.7	10.9
Capital expenditure	11.2	11.9	11.7	11.8	10.3	10.5	10.8	11.0
Highways	5.6	6.0	6.0	5.5	4.4	4.1	3.5	0.0
R7	...	...	...	4.3	0.0	0.0	0.0	0.0
R6	...	...	...	0.6	3.8	3.6	3.1	0.0
Expropriations	...	...	...	0.6	0.5	0.5	0.5	0.0
Other capital spending	5.6	6.0	5.7	6.3	5.9	6.5	7.3	11.0
Net lending	0.6	0.2	0.2	-0.1	-0.1	-0.1	-0.1	-0.1
Primary balance	-1.7	-2.6	-2.5	-3.2	-1.5	-1.5	-1.6	-1.5
Primary balance net of PAK	0.0	-2.4	-2.3	-3.0	-1.4	-1.5	-1.6	-1.5
Interest income, net	-0.2	-0.2	-0.3	-0.3	-0.3	-0.3	-0.4	-0.5
Overall balance	-1.9	-2.8	-2.7	-3.5	-1.8	-1.9	-2.0	-2.0
Financing	1.9	1.1	1.8	3.5	1.8	1.9	2.0	2.0
Foreign financing	0.0	0.5	1.4	-0.1	-0.4	-0.5	-0.9	-0.8
Drawings, incl. official financing	0.2	0.7	1.7	0.2	0.0	0.0	0.0	0.0
Amortization	-0.3	-0.2	-0.2	-0.3	-0.4	-0.5	-0.6	-0.5
of which: IMF				-0.1	-0.2	-0.3	-0.4	-0.3
Trust fund at the World Bank	0.1	0.0	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	-0.3
Domestic financing	1.8	0.6	0.3	3.6	2.2	2.3	2.9	2.7
Domestic borrowing (net)	0.0	1.5	1.5	1.5	2.3	2.6	2.6	2.6
Privatization revenues	0.0	0.6	1.2	6.3	0.2	0.2	0.2	0.3
o/w PAK privatization	0.0	0.6		0.0	0.0	0.0	0.0	0.0
WB subscription	0.0	0.0	-0.6	0.0	0.0	0.0	0.0	0.0
Other financial assets (net)	0.0	-0.4	-0.5	-0.1	0.0	0.0	0.0	0.0
Own-source revenue (– = increase)	0.0	-0.6	-1.4	0.1	0.1	0.0	0.0	0.0
o/w PAK related	0.0	-0.5	0.0	0.2	0.2	0.0	0.0	0.0
Bank balance (prog.; – = increase)	1.8	-0.6	0.0	-4.2	-0.3	-0.4	0.2	-0.1
Financing gap	0.0	1.8	0.9	0.0	0.0	0.0	0.0	0.0
Memorandum items:								
Bank balance of the general government	3.5	3.8	4.7	8.6	8.4	8.3	7.5	7.2
Of which: ELA	0.0	0.9	0.9	0.9	0.8	0.8	0.7	0.7
Recommended minimum level of bank balance	5.8	6.1	6.2	6.8	7.0	7.3	7.3	7.2
Nominal GDP (millions of euros)	4,637	4,911	4,885	5,169	5,501	5,892	6,312	6,736

Sources: Kosovo authorities; and IMF staff estimates and projection

1/ Does not yet reflect the GFSM 2001 methodology to ensure consistency within a program context.

2/ Including capital transfers to public enterprises.

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	1,173	1,413	1,453
Foreign assets	1,111	1,198	1,247	1,233	1,309	1,547	1,586
Of which: Securities	541	529	199	25	45	65	85
Deposits	529	522	854	1,059	1,115	1,333	1,353
Foreign liabilities	0	110	139	136	136	136	136
Net domestic assets	-1,111	-1,088	-1,108	-1,097	-1,173	-1,413	-1,453
Net claims on the central government	-870	-681	-813	-797	-864	-1,084	-1,102
Liabilities	-870	-681	-813	-797	-864	-1,084	-1,102
Of which: Government balances (program definition)	-414	-178	-233	-160	-227	-447	-465
Commercial banks	-137	-233	-204	-210	-215	-229	-246
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	573	575	595
Assets	401	584	710	676	743	761	795
Liabilites	76	140	165	156	170	185	200
Net domestic assets	815	949	1,169	1,389	1,430	1,558	1,694
Credit to private sector	1,183	1,289	1,451	1,664	1,740	1,873	1,996
Claims on the CBK	137	233	203	220	215	229	246
Net claims on the central government	-1	-165	-12	-1	30	50	88
Net claims on other public entities	-264	-123	-120	-127	-134	-142	-153
Other items, net	-240	-285	-354	-367	-421	-451	-483
Liabilities to the private sector	1,140	1,393	1,714	1,908	2,003	2,134	2,289
Demand deposits	384	441	545	598	630	679	737
Time deposits	756	951	1,169	1,311	1,373	1,455	1,552
Memorandum item:							
Gross international reserves	670	625	686	626	702	940	980
				(12-month percent change)			
Liabilities to private sector	25.8	22.2	23.1	11.4	5.0	6.5	7.3
Loans to the private sector	32.7	8.9	12.6	14.7	4.6	7.6	6.6
				(Percent of GDP)			
Total private sector deposits	29.6	35.6	40.7	41.2	41.0	41.3	41.6
Credit to the private sector	30.7	32.9	34.4	35.9	35.6	36.2	36.3

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
					Sep.	Dec.	Sep.
Capital adequacy							
Regulatory capital/risk weighted assets	17.4	16.5	17.9	18.8	17.1	17.5	17.7
Tier 1 capital/risk weighted assets	16.4	15.3	15.1	15.8	14.3	14.7	14.8
Asset quality							
NPL ratio 1/	4.1	3.3	4.3	5.2	6.0	5.8	7.0
NPL net of provisions/capital	2.6	2.8	2.3	3.7	4.4	4.6	4.5
Sectoral breakdown of loans							
Agriculture	3.2	3.2	3.0	2.6	...	2.4	2.4
Manufacturing	10.6	8.0	11.5	10.9	...	9.9	9.4
Trade	49.6	44.5	43.2	37.1	...	37.1	36.5
Other services	8.4	15.1	8.8	12.1	...	13.7	13.6
Construction	5.6	5.5	6.9	7.5	...	6.8	7.2
Households	22.5	23.7	26.7	29.8	...	30.1	30.8
Liquidity							
Liquid assets/total assets 2/	33.2	30.0	37.3	36.8	33.4	32.3	33.7
Deposits/loans	128.1	122.0	138.6	126.1	128.4	125.2	127.0
Liquid assets to short-term liabilities 2/	47.8	42.1	47.0	46.2	43.5	39.6	43.7
Profitability							
Return on assets	2.9	2.6	1.4	1.8	1.4	1.5	0.9
Return on equity	27.1	24.7	21.4	18.8	13.7	14.9	8.9
Interest margin to gross income 3/	58.4	60.3	55.3	55.6	57.3	57.0	56.3
Non-interest expense to gross income 4/	12.6	11.2	16.3	16.6	19.9	18.0	23.3
Market risk							
Net open currency position/tier 1 capital	17.8	8.9	18.8	-0.1	2.8	2.5	4.8

Source: Central Bank of the Republic of Kosovo.

1/ Loans classified as doubtful or bad.

2/ Cash balances with the CBK and commercial banks, and securities.

3/ Interest income minus interest expenditures.

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	1,022	1,106
Current account deficit	943	1,010	1,091
Amortization of medium and long term public debt	12	11	15
Sources of Financing	955	978	1,106
Capital account (net)	6	2	2
Foreign direct investment (net)	371	321	674
Net bank financing	25	-52	-3
Government loans	8	82	9
Net Foreign assets of the Central Bank of Kosovo	11	-76	-238
Other financing inc. net erros and omissions	534	701	662
Financing Need	0	43	0
IMF 1/	0	43	0
in percent of quota	0	61	0
Memorandum items:			
Kosovo IMF quota (SDR millions)	59	59	59
Kosovo IMF quota (Euro millions)	67	71	72

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	20.9	21.4
Current account deficit	20.3	20.7	21.1
Amortization of medium and long term public debt	0.3	0.2	0.3
Sources of Financing	20.6	20.0	21.4
Capital account (net)	0.1	0.0	0.0
Foreign direct investment (net)	8.0	6.6	13.0
Net bank financing	0.5	-1.1	-0.1
Government loans	0.2	1.7	0.2
Net Foreign assets of the Central Bank of Kosovo	0.2	-1.6	-4.6
Other financing inc. net erros and omissions	11.5	14.4	12.8
Financing Need		0.9	0.0
IMF 1/		0.9	0.0

Source: IMF staff estimates and projections.

1/ Program is asssumed to go precautionary in 2013. The remaining purchases amount to 12.753 million SDR, 22 percent of quota.

Table 9. Kosovo: Indicators of Capacity to Repay the Fund, 2012–17

	2012	2013	2014	2015	2016	2017
A. With Precautionary Arrangement in 2013 (Baseline)						
Fund obligations based on prospective purchases (millions of SDR)						
Principal	0.0	0.0	0.0	0.0	17.4	17.4
Charges and interest	0.2	0.3	0.4	0.4	0.3	0.1
Fund obligations based on existing and prospective purchases (millions of SDR)						
Principal	0.0	2.4	9.4	13.0	39.1	33.2
Charges and interest	0.4	1.0	1.0	0.9	0.6	0.2
Total obligations based on existing and prospective purchases						
SDR millions	0.4	3.4	10.4	13.9	39.8	33.4
Euro millions	0.5	4.1	12.7	17.0	48.9	41.2
Percent of exports of goods and services	0.1	0.4	1.1	1.4	3.5	2.7
Percent of debt service	2.1	14.2	35.9	43.3	69.1	66.0
Percent of GDP	0.0	0.1	0.2	0.3	0.8	0.6
Percent of government revenue	0.0	0.3	0.8	1.0	2.7	2.1
Percent of quota	0.7	5.7	17.6	23.5	67.4	56.6
Outstanding Fund credit						
SDR millions	97.0	94.6	85.3	72.3	33.2	0.0
Euro millions	116.6	115.4	104.2	88.6	40.8	0.0
Percent of exports of goods and services	12.7	11.9	9.4	7.2	2.9	0.0
Percent of debt service	468.8	398.0	294.7	225.4	57.6	0.0
Percent of GDP	2.4	2.2	1.9	1.5	0.6	0.0
Percent of government revenue	8.8	8.1	6.8	5.4	2.3	0.0
Percent of quota	164.4	160.4	144.5	122.5	56.2	0.0
Net use of Fund credit (millions of SDR)	78.2	-2.4	-9.4	-13.0	-39.1	-33.2
Purchases	78.2	0.0	0.0	0.0	0.0	0.0
Repurchases	0.0	2.4	9.4	13.0	39.1	33.2
B. With Full Purchases in 2013						
Fund obligations based on prospective purchases (millions of SDR)						
Principal	0.0	0.0	0.0	0.0	19.6	23.8
Charges and interest	0.2	0.4	0.5	0.5	0.5	0.2
Fund obligations based on existing and prospective purchases (millions of SDR)						
Principal	0.0	2.4	9.4	13.0	41.2	39.5
Charges and interest	0.2	1.1	1.1	1.0	0.8	0.3
Total obligations based on existing and prospective purchases						
SDR millions	0.2	3.4	10.5	14.0	42.0	39.8
Euro millions	0.2	4.2	12.8	17.2	51.6	49.2
Percent of GDP	0.0	0.1	0.2	0.3	0.8	0.7
Percent of government revenue	0.0	0.3	0.8	1.0	2.9	2.6
Outstanding Fund credit						
SDR millions	97.0	107.4	98.0	85.0	43.8	4.3
Euro millions	116.6	131.0	119.8	104.3	53.9	5.2
Net use of Fund credit (millions of SDR)	78.2	10.4	-9.4	-13.0	-41.2	-39.5
Purchases	78.2	12.8	0.0	0.0	0.0	0.0
Repurchases	0.0	2.4	9.4	13.0	41.2	39.5
C. Memorandum items						
Exports of goods and services (millions of euros)	920	971	1,104	1,236	1,395	1,542
External debt service (millions of euros) [1]	24.9	29.0	35.4	39.3	70.8	62.4
Nominal GDP (millions of euros)	4,885	5,169	5,501	5,892	6,312	6,736
Government revenue (millions of euros)	1,319	1,422	1,522	1,649	1,783	1,917
Quota (millions of SDR)	59.0	59.0	59.0	59.0	59.0	59.0

Sources: IMF staff estimates and projections.

1/ Total debt service includes IMF repurchases and interest charges.

Table 10. Kosovo: Proposed Schedule of Purchases Under the Stand-By Arrangement, 2012–13 1/

Amount	Percent of Quota	Date Available	Conditions Necessary for Purchase
SDR 4.251 million	7	April 27, 2012	Purchase made
SDR 39.108 million	66	July 16, 2012	Purchase made
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 4.251 million	7	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 4.251 million	7	June 28, 2013	Observance of the continuous performance criteria and of the performance criteria for April 30, 2013; and completion of the fourth SBA review.
SDR 4.250 million	7	October 28, 2013	Observance of the continuous performance criteria and of the performance criteria for August 31st, 2013; and completion of the fifth SBA review.
Total: SDR 90.968 million (154 percent of quota)			

1/ Revised to reflect the new proposed purchase schedule.

Appendix I. Letter of Intent

Pristina, December 5, 2012

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

Dear Ms. Lagarde:

1. Kosovo's economy has continued to display considerable resilience in the face of financial turbulence in the euro area. Limited export and financial linkages have constrained contagion, while current and capital inflows, notably from the Kosovar diaspora, have continued to support demand. Advances have been made in enhancing the business climate, acknowledged by the World Bank through an improvement in Kosovo's ranking in the "Doing Business" report (see ¶18). The banking system has remained well-capitalized and liquid, despite a recent increase in non-performing loans (NPLs). Nevertheless, we remain vigilant to downside risks, including a possible deterioration in labor market conditions in the diaspora's host countries that could, for example, be caused by a further intensification of the euro area crisis. In this challenging environment, we remain committed to disciplined fiscal management, the rebuilding of an adequate level of government bank balances, the strengthening of the legal and regulatory framework for Kosovo's financial system, prudent financial supervision, and structural reforms to boost competitiveness.

2. Implementation of our economic program has remained broadly consistent with our commitments under the Stand-By Arrangement (SBA; Tables 1 and 2):

a. We have met all *quantitative performance criteria* for end-August. The primary fiscal balance and government bank balance were stronger than programmed, despite a modest shortfall in revenue relative to plan, owing to restraint on spending, higher-than-anticipated grant disbursements from the World Bank, the advancement of dividend payments from the telecommunications company (PTK), and the receipt of unconstrained transfers from the Kosovar Privatization Agency (PAK).

b. We have also met all *structural benchmarks*, although in one case with a slight delay.

(i) The end-August structural benchmark on launching the tender offer for PTK was met with a delay of 10 days, as more time was needed to evaluate the large number of companies that showed interest in the privatization. Five companies were admitted to the final bidding.

The winning bid for PTK is expected to be announced in January, and the transaction is anticipated to be settled in the first half of 2013.

(ii) On October 31, we submitted a 2013 budget to the assembly that contains a primary deficit of €155 million (excluding PAK-related expenditures) and structural adjustment measures of €32 million, consistent with the corresponding structural benchmark. The assembly is expected to pass the budget in December (prior action).

(iii) Also respected were the continuous structural benchmarks on monthly meetings of our Program Monitoring Committee, and on fiscal impact assessments evaluating the budgetary impact of all new benefit creating laws and amendments to such laws over a period of at least five years.

3. Based on this performance, we request completion of the second review under the Stand-By Arrangement, and a purchase of SDR 34.857 million following completion of the review. As we expect the government bank balance to return to or even exceed a fully adequate level with the anticipated completion of PTK privatization, and in view of the significant strengthening in policies under this SBA and the preceding Staff-Monitored Program, we intend to treat the Stand-By Arrangement as precautionary in 2013. Further, to better align subsequent program reviews with our budgetary calendar, we request the remaining access under the SBA (SDR 12.753 million) be re-phased in three purchases over the remainder of the program, with test dates of end-December 2012, end-April 2013, and end-August 2013.

4. We request that the performance criterion on the government bank balance be modified to reflect the unforeseen receipt of transfers from PAK in July, while leaving a buffer in the target to insure against unforeseen events. Quantitative performance criteria and indicative targets through end-August 2013 are set out in Table 2 and in the Technical Memorandum of Understanding, both attached to this letter.

5. We believe that the policies set forth in the letters of April 12, 2012, June 27, 2012 and in this letter are adequate for successful implementation of the program. However, the government stands ready to take additional measures as appropriate to ensure achievement of the program's objectives. As is standard under all IMF arrangements, we will consult with the IMF before modifying measures contained in this letter or before the adoption of new measures that would deviate from the goals of the program, in accordance with the Fund's policies on such consultations, and provide IMF staff with the necessary information for program monitoring. The third review is expected to be completed after February 28, 2013, the fourth review is expected to be completed after June 28, 2013, and the fifth review is expected to be completed after October 28, 2013. The understandings between us and the IMF regarding performance criteria and structural measures described in this letter are further specified in the Technical Memorandum of Understanding. We authorize the IMF to publish this letter and the associated staff report.

I. MACROECONOMIC OUTLOOK

6. We have revised our macro-forecasts in response to continuing turmoil in the euro area and its impact on both external demand and current and capital inflows. However, growth is expected to remain stronger than in most neighboring countries. The macroeconomic framework underpinning our program is based on cautious assumptions to reflect unusually uncertain external conditions and to minimize the risk of downward revisions during the program period.

a. We have marked down *real GDP growth* by about ½ of a percentage point for both 2012 and 2013 compared to our initial projections. We expect growth to recover to around potential growth from 2014, in line with projected developments in the euro area.

b. *Consumer price inflation* is projected to be slightly above 2 percent this year (annual average), mostly reflecting developments of prices for imported food, but is expected to fall below 2 percent in 2013. We expect core inflation to remain subdued.

c. We have revised upward the *trade deficit* to almost 40 percent both this year and next, reflecting weaker external demand and higher import prices, notably for food. We expect the deficit to be financed by current transfers, FDI, and other inflows, including from the Kosovar diaspora.

II. FISCAL POLICY

A. Budget Execution in 2012

7. Fiscal policy remains guided by the objectives of fully achieving a sustainable fiscal stance and an adequate level of government bank balances. Execution of the 2012 budget has thus far been broadly in line with our program.

a. *Revenue collection* was somewhat behind program targets at end-August, reflecting in part a different seasonality in collected revenues due to (i) unusually severe weather early in the year and (ii) an administrative change at the customs' administration (receipts are now collected when they leave rather than enter the warehouse). We have seen improvements in revenue collection in September and October.

b. The shortfall has been compensated by *under-execution of spending*, notably on non-highway capital projects.

c. On current trends, we expect higher budget receipts (composed of revenue and financing) than at the time of the first review. However, within this envelope we anticipate a *revenue shortfall of about €20 million by end-year*. To ensure meeting of end-year performance criterion for the primary fiscal balance, we have pre-identified spending cuts of €24 million distributed across expenditure categories as follows: capital spending (€15 million), subsidies and transfers (€2 million), goods and services (€5 million), and wages and salaries (€2 million, the latter reflecting unfilled vacancies).

8. We have conducted ten successful three-month treasury-bill auctions and two 6-month treasury-bill auctions this year, raising €74 million (net) at annualized yields of between 2 and 3 percent. We intend to issue bills with a maturity of 12 months in 2013, in an effort to lay the foundations for self-sustained budget financing, although variations to this schedule are possible depending on the absorptive capacity of the market.

B. The 2013 Budget

9. Consistent with our objective to gradually restore a sustainable fiscal stance, our 2013 budget targets a primary deficit (excluding PAK-related expenditures) of €155 million (3 percent of GDP). The budget law includes structural fiscal adjustment measures of €32 million (0.6 percent of GDP). Specifically, the 2013 budget contains the following parameters:

a. *Revenue projections* are cautious and should be achievable even if nominal GDP growth would be as low as 5 percent, to ensure that revenue collection will remain on target even in case of negative shocks to growth. We also plan to raise one-off revenues of €50 million, composed of €30 million from another PTK dividend, and €20 million from the sale of telecommunication licenses.

b. *Structural revenue measures* include an increase in lignite royalties (expected to raise €22 million) and an increase in airport licensing receipts (€4 million). The impact is partially offset by eliminating customs duties on some intermediate goods during the course of the year (€2 million), in an effort to strengthen the competitiveness of Kosovar producers of final goods.

c. We will exercise *spending restraint across current spending categories*. At the same time, the budget accommodates the short-term costs of two important structural reforms: (i) health reform, which allows the government to contract services directly from hospitals, and (ii) civil service reform, which will establish a grading structure for public employees and has been developed in consultation with the World Bank. There is also a shift from capital to current spending triggered by municipalities making use of the greater flexibility granted in the 2013 budget to allocate non-wage current spending across spending categories.

d. *The energy company KEK will start repaying the government in 2013 (in net terms)* in an amount of €6 million, which compares to sizeable positive net borrowing in previous years. We do not anticipate providing any further loans to KEK going forward. The ability of KEK to reduce its debt reflects structural improvements in revenue collection and tariff increases.

e. *Highway R7* to Albania will be completed in 2013. Further, the budget includes an allocation of €30 million (0.6 percent of GDP) to initiate highway R6 to Macedonia. The budget law will contain a clause that the allocation for the construction of R6 will be executed only once the government bank balance is at a level of at least €300 million.

f. As a *general contingency* for fiscal risks, the budget leaves €20 million unallocated, given the unusually uncertain economic outlook.

g. With this budget, the *government bank balance* is expected to exceed €400 million by end-2013, which is well above the adequate minimum level and provides a buffer to finance infrastructure projects in subsequent years, notably highway R6 to Macedonia.

C. Highway R6 to Macedonia

10. We intend to start the construction of highway R6 to Macedonia in 2013, in the context of our long-standing policy priority to improve Kosovo's road network and integrate it into the regional network of highways in Southeastern Europe. However, several preconditions have to be in place before we would enter into contractual obligations with respect to R6. These include:

a. *Integration into a sustainable budgetary framework*. We will start construction of highway R6 only once the government bank balance is close to a fully adequate level (see ¶9e above). To start construction in 2013, additional one-off revenues are needed to create fiscal space for R6 (¶9b above), reflecting the fact that in 2013 we will also be completing highway R7, which absorbs significant budgetary resources. From 2014, investments in R6 can be financed out of the regular budget envelope without putting undue pressure on the deficit, the government bank balance or on other priority spending, provided total costs for R6 remain within 15 percent of GDP and the realization of the project is stretched until 2016.

b. *Economic viability*. An earlier feasibility study from 2011 suggested that the northern section of R6 of about 42 kilometers is economically viable, while the southern section of about 13 kilometers linking R6 to Macedonia is not, owing primarily to high construction cost in a mountainous terrain. We are preparing alternative, less expensive design options for the southern section that include replacing a tunnel with overland roads and a reduction in the number of traffic lanes. We will update the feasibility study with these design options and new traffic volume estimates, and send the feasibility study to IMF and World Bank staff by end-January 2013 (structural benchmark). The World Bank will thereafter seek to confirm in a timely manner that: (i) the feasibility study is in line with sound international practices, and (ii) the results show economic viability of R6. A positive assessment by the World Bank is a precondition for us to proceed with the tender for construction of R6. If the study fails to show economic viability, we may analyze additional design options.

c. *Openness and transparency of the bidding process*. We will ensure open and transparent bidding, including by (i) the use of FIDIC contracts, (ii) the timely engagement of supervision engineers, and (iii) the publication of contract documents consistent with legal requirements.

We will take stock in early 2013 as regards preparations for highway R6, and may discuss alternative financing arrangements with the IMF, should the need arise.

D. Rules-Based Fiscal Framework

11. We are preparing the introduction of a legally binding fiscal rule to anchor fiscal policy in the medium-to-long term. The rule will contain the following elements:

a. *a ceiling on the overall deficit of the general government of 2 percent of GDP*, which is consistent with stabilizing the ratio of public debt over GDP at about 30 percent in the medium- to long-term. The space for deficits will be allocated between the central government and those municipalities entitled to accumulate debt according to their respective shares in general government spending.

b. *full carryover* of budgetary under- and over-performance to future budgets (under-performance has to be compensated within three years).

c. *an exemption of well- specified capital projects from the deficit ceiling*, as long as the projects are financed from non debt-creating sources (such as privatization receipts) and the government bank balance is at an adequate level.

The parameters of the fiscal rule would be revised every five years to take into account developments on potential growth, interest rates, etc. In case the government bank balance is at an inadequate level, and/or a 2 percent deficit cannot be financed without putting undue strains on the government paper market, deficits lower than 2 percent of GDP will be required.

12. In the coming months, we will draft the necessary legal changes to prepare the introduction of the rules-based fiscal framework. These could take the form either of amendments to the Law on Public Financial Management and Accountability (LPFMA), or of a new law. We will request technical assistance (TA) from the IMF to assist with the drafting of the legislation, following up on the TA mission that visited Pristina in June 2012 and developed a first set of proposals for a fiscal rule. We intend to submit legislation to the assembly by end-March 2013 (structural benchmark), such that it will be binding for the 2014 budget.

E. Other Fiscal Issues

13. Careful planning of spending initiatives remains at the core of our efforts to improve public financial management.

a. A revised Pillar I Pension Law is expected to be approved by the assembly in the coming months that includes increases of 33 percent for the basic pension and of 40 percent for the pension for contribute payers (retirees with a record of paying 15 years of contributions). These increases are included in the 2012 and 2013 budgets and are consistent with sustainability of the medium-term budgetary framework. Legislation on pensions for workers that were forcibly removed from their workplace in the 1990s, and/or differentiated pensions by profession and qualification, would only be introduced once fiscal impact assessments have been conducted.

b. Progress has been made as regards the preparation of possible benefits for war veterans and erstwhile political prisoners. Fiscal impact assessments covering a period of at least five years are expected to be completed in the first half of 2013.

14. We are developing an action plan to improve the recording and monitoring of payment obligations, with a view to avoiding domestic payments arrears.

a. We have set up a special unit within the treasury that is charged with monitoring arrears reporting and the level of arrears across all budgetary organizations.

b. We will engage in a publicity campaign that explains (i) the responsibilities of budgetary organizations when entering into contractual obligations, (ii) the definition of payment arrears, and (iii) enforcement sanctions for non-compliance as they are foreseen in the LPFMA.

c. We will enforce sanctions on officials contravening treasury expenditure control regulations after an infraction has been confirmed by the General Audit Office (GAO), and in line with the sanctions foreseen in the LPFMA. Further, the treasury will monitor the number cases submitted to the GAO for review, and the number of cases for which sanctions have been enforced.

We will analyze the need for further action in this area in the coming months, and will return to the issue during the next IMF review mission.

III. FINANCIAL SECTOR POLICIES

15. Kosovo's financial system remains well-capitalized, profitable, and liquid. The banking system's aggregate capital adequacy ratio stood at 17.7 percent at end-September, well above the regulatory minimum of 12 percent. Non-performing loans (NPLs) have continued to increase, however, reaching 7.0 percent in September, compared to 5.8 percent at end-2011, with the increase being concentrated in the corporate sector. Corrective actions include:

a. the central bank has stepped up data collection on loans' terms and conditions, to improve its ability to discover misreported problem loans and request corrective action at an early stage;

b. the central bank is reassessing risks to banks' external assets, including deposits held with other entities of a banks' consolidated financial group. The exercise is expected to be completed by end-December. Based on the results of this exercise, the central bank will request prudential measures as needed. These may include raising provisions or risk weights for external exposures, higher required minimum capital adequacy requirements, and/or requesting advance notification for transfers with related external parties.

16. Corrective measures imposed on several commercial banks earlier this year have been almost fully implemented. The measures included—depending on the specific situation of each

bank—republishing financial statements, injections of fresh capital, and the strengthening of governance, including by replacing members of some banks' senior management and supervisory boards. Further, we will take action as needed to ensure that banks are in compliance with rules set by the new Law on Banks and Microfinance Institutions, including with respect to exposure limits to bank-related parties.

17. We are in the process of introducing amendments to the draft deposit insurance law (DIL) prior to its passage by the assembly. The amendments aim at providing greater clarity on some legal definitions, reducing the timeframe for repayment of insured depositors, and enhancing information sharing and collaboration between the deposit insurance fund and the central bank. The amendments also raise the maximum size of insured deposits. Specifically,

a. the DIL will specify that the maximum size of insured deposits will gradually raise from a starting level of €2000 to (i) €3000 by January 1, 2014; (ii) €4000 by January 1, 2016; and (iii) €5000 by January 1, 2018. However, these increases will be implemented only after the deposit insurance fund has received €6.4 million in funds committed but not yet disbursed by the government and other contributors. It is expected that coverage could increase further in the years after 2018—in line with Kosovo's economic development and convergence of per-capita-GDP—which would bring the deposit insurance scheme closer in line with those of other countries in the region and in the European Union.

b. Article 27 of the DIL will specify that the deposit insurance fund will neither stop collecting bank premia nor reduce these premia except to reflect improvements in a bank's risk profile, in line with Deposit Insurance Core Principles. It will also be formulated in a way that allows expanding the size of the target reserve fund to more than 5 percent of insured deposits. The deposit insurance fund will issue a regulation to establish a working size of the fund equivalent to 8 to 9 percent of insured deposits.

IV. COMPETITIVENESS AND STRUCTURAL REFORMS

18. Our efforts to strengthen the business environment and investment climate have yielded an improvement of Kosovo's ranking in the World Bank's Doing Business report from #117 in 2011 to #98 in 2012. In this context, eleven laws have been passed out of a package of twelve laws that aim at reducing the costs of setting up business, unifying business registries, and simplifying the licensing system. The remaining law on execution procedure has been drafted and submitted to the assembly for approval.

19. Two additional laws on telecommunication and mining sectors have been drafted, and the law on telecommunications has already been passed by the assembly. Their objective is to remove entry barriers and ensure equal treatment among investors. Furthermore, we are finishing preparatory work for a project on promoting the development of SMEs, jointly with the Austrian Development Agency and the Swiss Office for Cooperation. To foster the development of the

agriculture sector, we have expanded an agricultural loan program to €20 million, supported by guarantees from USAID, to improve the sector's access to long-term capital.

20. The report on the implementation of the Labor Law with an emphasis on maternity leave provisions has been finalized. Based on the report's findings, we intend to reduce the maternity leave period from 12 months to 6-9 months, to prevent discrimination against women in the labor market.

Sincerely yours,

/s/

Hashim Thaçi
Prime Minister

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

Table 1. Kosovo: Program Monitoring

	Program Approval	End-April 2012	End-August 2012
Performance criteria			
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 the net contracting of nonconcessional debt by the general government	...	Met	Met
Indicative targets			
Ceiling on the stock of domestic payment arrears of the central government	...	Missed	Missed
Ceiling on the stock of domestic payment arrears of the general government	...	Missed	Missed
Prior actions			
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	Met	...	...
Passage of the revised Banking and Microfinance Law in a version consistent with the recommendations of IMF technical assistance	Met	...	...
Issuance of a government decision that specifies spending cuts of €20 million across expenditure categories relative to the approved 2012 budget	Met	...	...
Structural benchmarks			
Publication of budget circulars for municipalities that contain no limits on spending allocations across non-wage categories (by end-May, 2012)	...	Met	...
Submission of a revised Deposit Insurance Fund Law to the Assembly that is consistent with the new Banking and Microfinance Law (by end-May, 2012)	...	Met with delay	...
Amendment of the Law on Public Financial Management and Accountability by a provision that specifies that only the central bank can dispose over the funds in the Special Reserves Fund designated for Emergency Liquidity Assistance (by June 15, 2012)	...	Met	...
Launch of the tender offer for PTK (by end-August, 2012)	...	...	Met with delay
Submission of a 2013 budget consistent with the objectives of the program to the Assembly (by end-October, 2012).	...	...	Met
Continuous structural benchmarks			
Monthly meetings of the Program Monitoring Committee and transmission of meetings' minutes to the IMF Resident Representative	...	Met	Met
Inclusion of a paragraph into all new benefit creating laws, amendment to laws or regulations that allows cutting benefits if budgetary funds are unavailable 1/	...	Not met	...
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	...	Met	Met

1/ Eliminated after the first review following a corresponding amendment of the Law on Public Financial Management and Accountability.

Table 2. Kosovo: Quantitative Performance Criteria and Indicative Targets, 2012–13

(Millions of euros; flows cumulative from beginning of the year)

	2012							2013	
	End-Apr.		End-Aug.			End-Dec.		End-Apr.	End-Aug
	Prog.	Actual	Prog.	Adj. Prog.	Actual	Prog.	Rev. Prog.	Prog.	Prog.
Performance Criteria 1/									
Floor on the bank balance of the general government 2/	166	180	230	237	281	187	205	160	171
Floor on the primary fiscal balance of the general government 2/, 3/	-21	4	-26	-19	6	-119	-112	-36	-94
Ceiling on primary expenditures of the general government 3/	399	353	911	911	842	1,494	1494	448	1005
Ceiling on the net contracting of nonconcessional debt by the general government 3/	150	30	150	150	49	150	150	150	150
Ceiling on guaranteeing nonconcessional debt by the general government 3/	0	0	0	0	0	0	0	0	0
Ceiling on the accumulation of external payments arrears of the general government 4/	0	0	0	0	0	0	0	0	0
Indicative Targets									
Ceiling on the stock of domestic payment arrears of the central government	0	2	0	0	0.3	0	0	0	0
Ceiling on the stock of domestic payment arrears of the general government	0	2	0	0	3	0	0	0	0
Memorandum items:									
Program assumptions									
Repayment of policy loans extended to public corporations	...	4	4	4	4	4	4	2	4
Non-project grants	4	1	30	37	37	30	37	0	0
Budget support loans	0	0	0	0	0	0	0	0	0
Project grants	1	0	3	3	0	4	4	1	2
Project loans	0	0	6	6	0	7	7	1	3
PAK-related spending	...	...	5	5	4	8	8	2	5

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

1/ Adjusted according to the Technical Memorandum of Understanding.

2/ The end-August and end-December, 2012 PCs have been adjusted to reflect higher than expected budget grants relative to program assumptions, as specified in the TMU.

3/ Excluding PAK related spending from August 2012.

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

Table 3. Kosovo: Structural Conditionality

Actions	Timing
Prior action	
Passage of the 2013 Budget Law by the Assembly, consistent with the objectives of the program.	...
Structural benchmarks	
Submision of an economic viability study for highway R6 to the World Bank and IMF staff.	End-January 2013
Submission of legislation to the assembly on the Rules-Based Fiscal Framework that is consistent with para 11 of this Letter of Intent..	End-March 2013
Monthly meetings of the Program Monitoring Committee and transmission of meetings' minutes to the IMF.	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.	Continuous

Appendix 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 2 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 2 will be raised by:

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

- the excess of privatization proceeds, including from the telecommunication company (PTK) and the receipt of transfers from the Privatization Agency of Kosovo (PAK) 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. Expenditures of the Privatization Agency of Kosovo (PAK) are excluded. 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 2 will be raised by the excess of project grants and loans relative to program assumptions.

- The ceiling on primary expenditures set in Table 2 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 Route 6, 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. Expenditures of the Privatization Agency of Kosovo (PAK) are excluded. Revenues do not include privatization receipts.

- The floor on the primary fiscal balance set in Table 2 will be lowered by the excess in project loans relative to program assumptions.
- The floor on the primary fiscal balance set in Table 2 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.

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

	Actual			Historical 6/ Average	Standard 6/ Deviation	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**			**15.5**	**14.5**	**13.2**	**11.8**	**10.1**	**8.7**	**12.3**	**9.8**	**13.3**	**11.0**
o/w public and publicly guaranteed (PPG)	17.6	16.6	15.0			15.5	14.5	13.2	11.8	10.1	8.7		9.8	13.3	
Change in external debt	-3.7	-1.0	-1.6			0.4	-1.0	-1.3	-1.3	-1.7	-1.4		0.5	0.2	
Identified net debt-creating flows	**8.5**	**8.4**	**11.9**			**14.7**	**8.6**	**10.3**	**10.0**	**9.1**	**8.5**		**6.2**	**9.6**	
Non-interest current account deficit	**15.3**	**17.2**	**20.2**	**11.6**	**4.9**	**20.4**	**20.9**	**18.3**	**17.4**	**16.3**	**15.4**	**18.1**	**12.9**	**16.4**	**14.1**
Deficit in balance of goods and services	39.7	40.6	41.1			40.7	39.3	36.4	34.6	32.6	31.1	35.8	27.6	27.0	27.6
Exports	15.5	18.5	20.0			18.8	18.8	20.1	21.0	22.1	22.9		20.5	20.0	
Imports	55.2	59.1	61.1			59.5	58.1	56.5	55.6	54.7	54.0		48.1	47.0	
Net current transfers (negative = inflow)	-22.1	-21.1	-18.1	-22.0	1.9	-17.6	-15.8	-15.5	-14.7	-13.8	-13.1	-15.1	-13.3	-11.0	-12.6
o/w official	-10.3	-8.6	-5.9			-5.6	-3.9	-3.5	-3.1	-2.6	-2.4		-1.7	-0.6	
Other current account flows (negative = net inflow)	-2.3	-2.3	-2.8			-2.6	-2.6	-2.6	-2.6	-2.5	-2.5		-1.5	0.5	
Net FDI (negative = inflow)	**-6.6**	**-7.7**	**-6.9**	**-4.9**	**3.3**	**-5.6**	**-12.1**	**-7.7**	**-7.0**	**-6.8**	**-6.7**	**-7.6**	**-6.7**	**-6.7**	**-6.7**
Endogenous debt dynamics 2/	**-0.2**	**-1.1**	**-1.3**			**-0.1**	**-0.2**	**-0.4**	**-0.4**	**-0.4**	**-0.3**	**-0.3**	**0.0**	**-0.2**	**-0.1**
Contribution from nominal interest rate	0.2	0.2	0.2			0.2	0.2	0.2	0.2	0.2	0.1		0.4	0.4	
Contribution from real GDP growth	-0.6	-0.6	-0.7			-0.4	-0.5	-0.6	-0.6	-0.6	-0.4		-0.4	-0.6	
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**			**-14.3**	**-9.6**	**-11.6**	**-11.3**	**-10.8**	**-9.9**	**-11.3**	**-5.8**	**-9.4**	**-7.0**
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/	...	...	14.4			15.0	14.3	13.3	12.2	10.8	9.5		9.3	11.3	
In percent of exports	...	...	71.8			79.4	75.9	66.2	58.4	48.7	41.7		45.5	56.3	
PV of PPG external debt	**...**	**...**	**14.4**			**15.0**	**14.3**	**13.3**	**12.2**	**10.8**	**9.5**		**9.3**	**11.3**	
In percent of exports	**...**	**...**	**71.8**			**79.4**	**75.9**	**66.2**	**58.4**	**48.7**	**41.7**		**45.5**	**56.3**	
In percent of government revenues	**...**	**...**	**52.2**			**55.4**	**51.8**	**48.0**	**43.7**	**38.1**	**33.5**		**32.7**	**39.6**	
Debt service-to-exports ratio (in percent)	**2.5**	**2.5**	**2.2**			**10.5**	**18.4**	**16.6**	**14.8**	**16.1**	**15.0**		**49.8**	**164.0**	
PPG debt service-to-exports ratio (in percent)	**2.5**	**2.5**	**2.2**			**2.5**	**2.7**	**3.2**	**3.1**	**5.4**	**4.3**		**8.0**	**7.9**	
PPG debt service-to-revenue ratio (in percent)	**1.3**	**1.8**	**1.6**			**1.7**	**1.9**	**2.3**	**2.4**	**4.2**	**3.5**		**5.8**	**5.6**	
Total gross financing need (billions of euros)	0.4	0.4	0.6			0.8	0.6	0.8	0.8	0.8	0.8		1.5	7.5	
Non-interest current account deficit that stabilizes debt ratio	19.0	18.2	21.7			20.0	21.9	19.6	18.7	18.0	16.8		12.4	16.2	
Key macroeconomic assumptions															
Real GDP growth (in percent)	2.9	3.9	5.0	4.6	1.3	2.7	3.2	4.3	5.0	5.0	4.6	4.1	4.5	4.5	4.5
GDP deflator in euro terms (change in percent)	-1.3	3.7	4.8	1.1	3.4	2.6	2.5	2.0	2.0	2.0	2.0	2.2	2.0	2.0	2.0
Effective interest rate (percent) 5/	0.8	1.2	1.2	0.4	0.6	1.6	1.6	1.6	1.6	1.6	1.6	1.6	4.3	3.0	3.8
Growth of exports of G&S (euro terms, in percent)	6.4	28.8	19.1	27.1	49.5	-1.0	5.5	13.8	11.9	12.9	10.6	8.9	5.6	6.6	5.7
Growth of imports of G&S (euro terms, in percent)	0.1	15.4	13.7	10.4	7.4	2.6	3.3	3.5	5.4	5.5	5.2	4.2	5.6	6.6	5.7
Grant element of new public sector borrowing (in percent)	...	...	...	...	...	15.3	50.4	11.5	11.5	11.5	11.5	18.6	11.5	11.5	12.0
Government revenues (excluding grants, in percent of GDP)	29.3	26.4	27.6			27.0	27.5	27.7	28.0	28.2	28.5		28.5	28.5	28.5
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			0.041	0.003	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/	...	...	...			1.1	0.1	0.0	0.0	0.0	0.0		0.3	0.3	0.2
Grant-equivalent financing (in percent of external financing) 8/	...	...	...			46.9	66.0	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		9.3	17.6	
Nominal dollar GDP growth	1.6	7.8	10.0			5.3	5.8	6.4	7.1	7.1	6.7	6.4	6.6	6.6	6.6
PV of PPG external debt (in billions of euros)			0.7			0.7	0.7	0.7	0.7	0.7	0.6		0.9	2.0	
(PVt-PVt-1)/GDPt-1 (in percent)						1.4	0.1	-0.1	-0.2	-0.7	-0.6	0.0	0.8	0.9	0.8
PV of PPG external debt (in percent of GDP)	...	...	14.4			15.0	14.3	13.3	12.2	10.8	9.5		9.3	11.3	
PV of PPG external debt (in percent of exports)	...	...	71.8			79.4	75.9	66.2	58.4	48.7	41.7		45.5	56.3	
Debt service of PPG external debt (in percent of exports)	...	...	2.2			2.5	2.7	3.2	3.1	5.4	4.3		8.0	7.9	

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 omissions, 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								
	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/	17.6	16.6	15.0			17.0	17.4	18.3	19.2	19.5	20.0		25.3	31.9	
Change in public sector debt	-3.7	-1.0	-1.6			1.9	0.5	0.8	0.9	0.3	0.6		0.9	0.5	
Identified debt-creating flows	0.5	1.6	0.3			0.7	-3.8	0.6	0.5	0.5	0.4		0.5	0.0	
Primary deficit	0.7	2.7	1.7	-0.2	3.6	2.4	3.1	1.5	1.4	1.5	1.4	1.9	0.9	0.7	0.9
Revenue, grants, and interest income	29.3	27.3	28.1			27.8	27.6	27.7	28.0	28.2	28.5	28.0	28.5	28.5	28.5
of which: grants	0.0	0.9	0.6			0.8	0.1	0.0	0.0	0.0	0.0		0.0	0.0	
Primary (noninterest) expenditure	29.9	30.0	29.8			30.3	30.7	29.1	29.4	29.7	29.8	29.8	29.4	29.2	29.3
Automatic debt dynamics	-0.2	-1.1	-1.3			-0.5	-0.6	-0.7	-0.8	-0.8	-0.6	-0.7	-0.4	-0.7	-0.5
Contribution from interest rate/growth differential	-0.7	-0.6	-0.8			-0.4	-0.5	-0.7	-0.8	-0.8	-0.6		-0.4	-0.7	
of which: contribution from average real interest rate	-0.1	0.0	0.0			0.0	0.0	0.0	0.1	0.2	0.2		0.6	0.6	
of which: contribution from real GDP growth	-0.6	-0.7	-0.8			-0.4	-0.5	-0.7	-0.9	-0.9	-0.9		-1.1	-1.4	
Contribution from real exchange rate depreciation	0.5	-0.4	-0.5			-0.1	-0.1	0.0	0.0	0.0	0.0		...	...	
Other identified debt-creating flows	0.0	0.0	0.0			-1.2	-6.3	-0.2	-0.2	-0.2	-0.3		0.0	0.0	
Privatization receipts (negative)	0.0	0.0	0.0			-1.2	-6.3	-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	
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	
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	
Residual, including asset changes	-4.2	-2.6	-1.9			1.3	4.2	0.3	0.4	-0.2	0.1	1.0	0.5	0.5	0.5
Other Sustainability Indicators															
PV of public sector debt	...	...	14.4			16.5	17.2	18.4	19.6	20.2	20.9		24.8	29.8	
PV of contingent liabilities (not included in public sector debt)	...	...	...			...	...	...	...	...	...		...	...	
Gross financing need 2/	1.0	3.1	2.1			2.9	5.2	5.0	5.3	6.4	5.8		8.2	9.2	
PV of public sector debt-to-revenue and grants ratio (in percent)	...	...	51			59	63	67	70	71	74		87	105	
PV of public sector debt-to-revenue ratio (in percent)	...	...	52			61	63	67	70	71	74		87	105	
Debt service-to-revenue and grants ratio (in percent) 4/	1.3	1.7	1.6			1.7	7.4	12.9	13.8	17.5	15.6		25.8	29.7	
Debt service-to-revenue ratio (in percent) 4/	1.3	1.8	1.6			1.7	7.5	12.9	13.8	17.5	15.6		25.8	29.7	
Primary deficit that stabilizes the debt-to-GDP ratio	4.4	3.7	3.3			0.5	2.6	0.6	0.6	1.1	0.8	1.0	0.0	0.3	0.1
Key macroeconomic and fiscal assumptions															
Nominal GDP (local currency)	3.9	4.2	4.6			4.9	5.2	5.5	5.9	6.3	6.7		9.3	17.6	
Real GDP growth (in percent)	2.9	3.9	5.0	4.6	1.3	2.7	3.2	4.3	5.0	5.0	4.6	4.1	4.5	4.5	4.5
Average nominal interest rate on public debt (in percent)	0.8	1.2	1.2	0.4	0.6	1.6	2.1	2.2	2.6	2.9	3.2	2.4	4.7	4.2	4.5
Average nominal interest rate on forex debt (in percent)	0.8	1.2	1.2	0.4	0.6	1.6	1.6	1.6	1.6	1.6	1.6	1.6	4.3	3.0	3.8
Interest on domestic debt (percentage of previous year stock, in percent)	...	...	...	...	...	...	7.3	5.0	5.0	5.0	5.0	5.4	5.0	5.0	5.0
Average real interest rate (in percent)	-0.4	0.3	-0.3	-1.8	1.3	-0.3	0.1	0.2	0.6	0.9	1.2	0.4	2.7	2.1	2.5
Real exchange rate depreciation (in percent, + indicates depreciation)	2.5	-2.6	-3.1	1.3	3.8	-0.6	...	...	...	...	...	...	...	...	...
Inflation rate (GDP deflator, in percent)	-1.3	3.7	4.8	1.1	3.4	2.6	2.5	2.0	2.0	2.0	2.0	2.2	2.0	2.0	2.0
Growth of real primary spending (deflated by GDP deflator, in percent)	24.8	4.1	4.3	3.8	8.1	4.2	4.6	-0.9	6.0	6.0	5.1	4.2	4.6	4.4	4.4
Grant element of new external borrowing (in percent)	...	...	...	...	...	15.3	50.4	11.5	11.5	11.5	11.5	18.6	11.5	11.5	12.0

Sources: Country authorities; and staff estimates and projections.

1/ Covers general government. Gross debt concept is used.

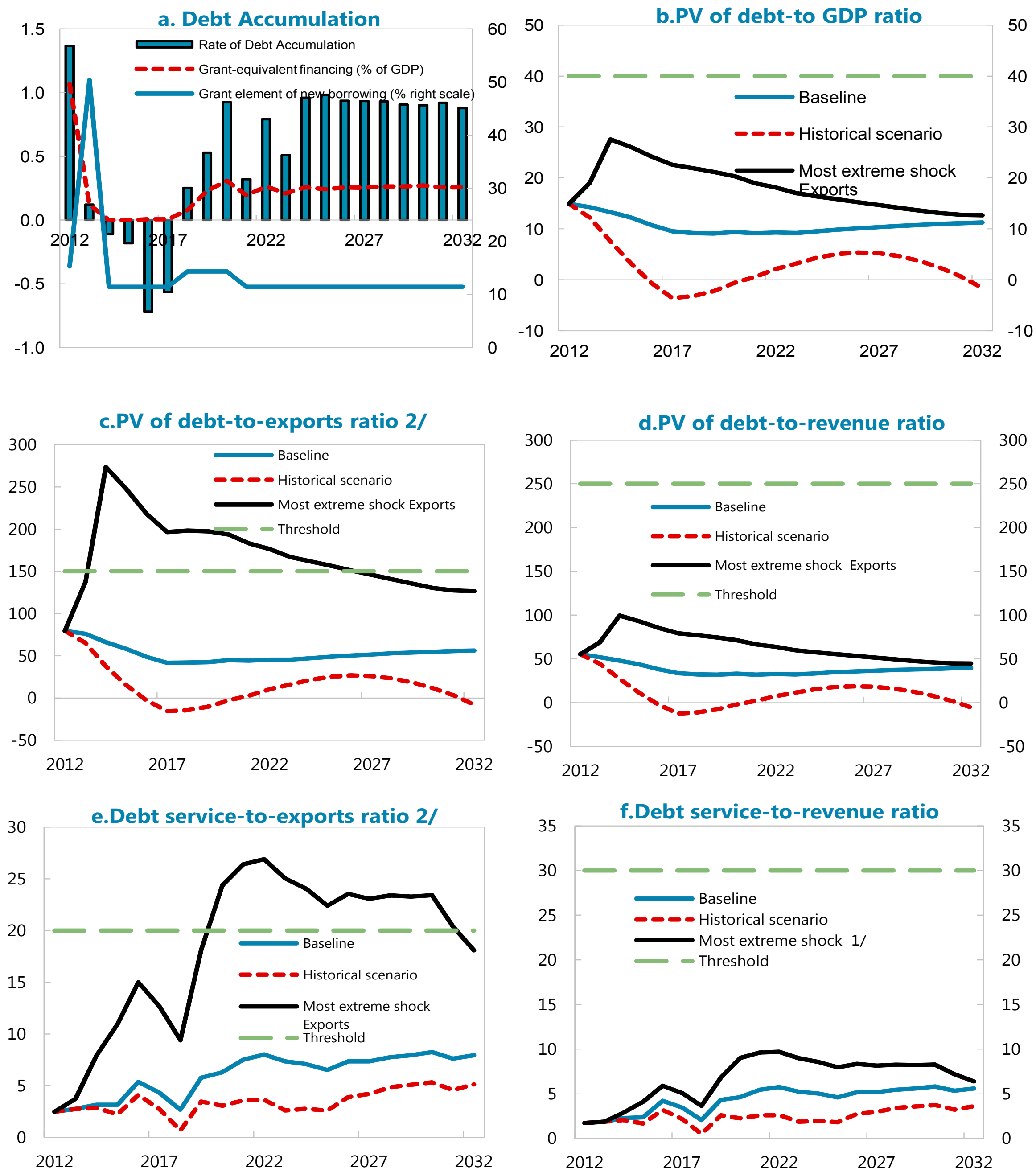
2/ Gross financing need is defined as the primary deficit plus debt service plus the stock of short-term debt at the end of the last period.

3/ Revenues excluding grants.

4/ Debt service is defined as the sum of interest and amortization of medium and long-term debt.

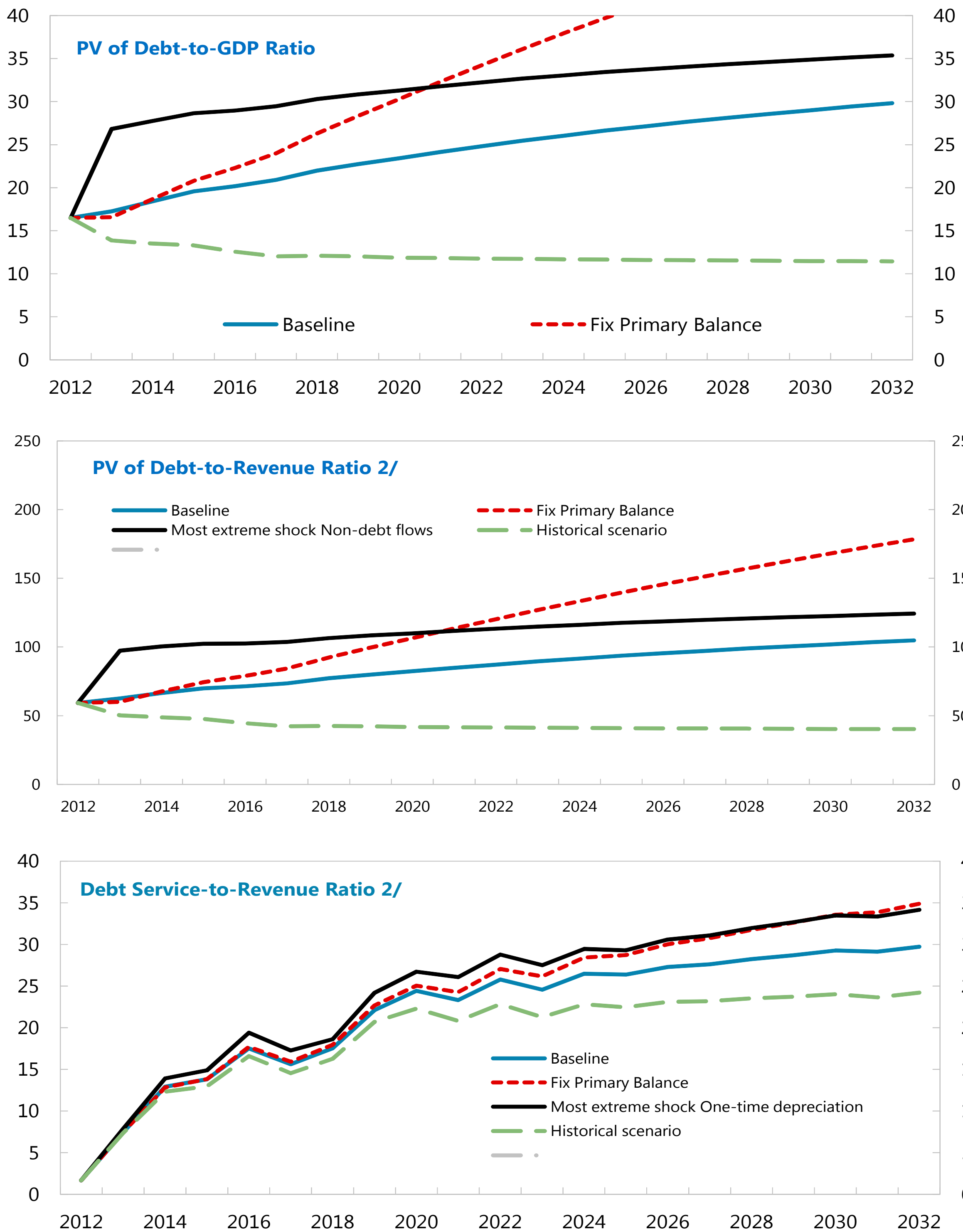
5/ Historical averages and standard deviations are generally derived over the past 10 years, subject to data availability.

Figure A1. Kosovo: Indicators of Public and Publicly Guaranteed External Debt under Alternatives Scenarios, 2012-2032 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 Exports shock; in c. to a Exports shock; in d. to a Exports 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, 2012-2032 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.

Statement by the IMF Staff Representative on the Republic of Kosovo
Executive Board Meeting
December 20, 2012

The information below has become available following the issuance of the staff report (EBS/12/160). It does not alter the thrust of the staff appraisal.

1. **On December 13, 2012, the Assembly passed the Law on the Budget of the Republic of Kosovo for 2013.** Compared to the version the government submitted to the Assembly at end-October, there is a minimal shift from current to capital spending, and within capital expenditures a somewhat larger shift (0.25 percent of GDP) from highway to non-highway projects. The budget law is consistent with the government's commitments in the Letter of Intent (LOI ¶9) and, more generally, the objectives of the program. The prior action for completion of this review has therefore been met.

Consolidated Government Budget, 2013
(Excluding donor designated grants; millions of euros)

	Staff Report	Approved Budget Law
Total primary revenue and grants	1,423	1,423
Total primary revenue	1,420	1,420
Taxes	1,200	1,200
Nontax revenues	220	220
Grants	3	3
Primary expenditure	1,586	1,586
Of which :		
PAK-related expenditures	8	8
Primary expenditure excluding PAK	1,578	1,578
Current expenditure	985	984
Wages and salaries	439	439
Goods and services	229	229
Subsidies and transfers	313	312
Reserve	4	4
Capital expenditure and net lending	601	602
Capital expenditure	607	608
Highways	283	271
R7	220	215
R6	30	28
Expropriation	33	28
Other capital spending	324	337
Net lending	-6	-6
Primary balance	-163	-163
Primary balance net of PAK	-155	-155
Interest income, net	-18	-18
Overall balance	-181	-181
Financing	181	181
Foreign financing	-5	7
Domestic financing	186	174
Bank balance (prog.; – = increase)	-220	-222
Financing gap	0	0

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

2. **In the same session, the Assembly also approved the following laws:**

(i) The amended ***Deposit Insurance Law*** (DIL), in line with recommendations of the Financial Sector Stability Assessment and the authorities' corresponding commitments in the Letter of Intent (LOI ¶17);

(ii) the ***Health Law*** (LOI ¶9c), and

(iii) the ***Law on Membership in the European Bank for Reconstruction and Development*** (EBRD), following the decision of the EBRD's Board of Governors on November 19 to admit Kosovo as its 66th member (effective December 17).

Press Release No. 12 /501
FOR IMMEDIATE RELEASE
December 20, 2012

International Monetary Fund
Washington, D.C. 20431 USA

IMF Completes Second Review under Stand-By Arrangement with Kosovo and Approves €40.66 Million Disbursement

The Executive Board of the International Monetary Fund (IMF) today completed the second review of Kosovo's economic performance under a program supported by a 20-month Stand-By Arrangement (SBA). The completion of the review enables the disbursement of SDR 34.857 million (about €40.66 million, or US$53.86 million), bringing total disbursements under the arrangement to SDR 78.216 million (about €91.24 million, or US$120.86 million). In completing the review, the Executive Board approved the rephasing of the remaining disbursements under the SBA to align program reviews with the authorities' budgetary calendar. The Board also approved the authorities' request for the modification of the performance criterion on the end-December 2012 bank balance of the general government.

The SBA with Kosovo was approved on April 27, 2012 (see Press Release No. 12/154) in a total amount of SDR 90.968 million (about €106.12 million, or US$140.57 million).

Following the Executive Board's discussion, Ms. Minouche Shafik, Deputy Managing Director and Acting Chair, said:

"Macroeconomic and financial policies are on track, notwithstanding a slowdown in economic growth that has complicated the meeting of fiscal targets. The authorities' intend to treat the arrangement as precautionary in 2013, provided the return of the government's bank balance to a fully adequate level is ensured.

"The 2013 budget brings Kosovo close to a fully sustainable fiscal stance. An allocation for starting construction for a new highway R6 to Macedonia will be executed only once the government bank balance is close to a fully adequate level, and a feasibility study confirming viability of the project has been completed. Careful preparation and costing of spending initiatives remain critical to avoid that unfunded expenditure commitments put fiscal sustainability at risk. Legislation is in preparation for a rules-based fiscal framework that would anchor fiscal policy from 2014.

"Important steps have been taken to establish a comprehensive financial safety net. Continued supervisory vigilance is needed to enforce prudential rules and safeguard high standards of corporate governments in the financial system. In this regard, it is critical to preserve the independence of the central bank and the high degree of professionalism and integrity of its staff.

"Continued strong ownership of policies under the Fund-supported program, especially in light of possible upcoming elections, will be necessary to preserve the gains thus far, address the challenges ahead, strengthen macroeconomic management, and foster robust and balanced growth."

Statement by Mr. Johann Prader, Executive Director for the Republic of Kosovo, and Mr. Omer Yalvac, Advisor to the Executive Director
December 20, 2012

The Kosovar authorities are grateful for the constructive dialogue and cooperation with the Fund staff. Technical assistance by the Fund, the World Bank and donors has been very helpful to design policies for improving institutional capacity and the resilience of the economy. Three years after becoming an IMF and World Bank member, the EBRD Board agreed to give Kosovo membership, an important step towards participating even more in regional integration and meeting its development goals.

Despite the crisis in Europe, Kosovo's economy is performing well due to prudent policies. The authorities' cautious stance is reflected in the medium-term projections. Although growth is revised down to 4 percent for 2013, it is still one of the highest in the region. Taking into consideration major infrastructure projects such as the new highway to Macedonia as well as in the tourism sector, these growth projections are realistic.

Program Performance

The authorities have shown a strong commitment to meet the program targets under the Fund-supported program despite lower-than-expected growth and external uncertainties. All quantitative performance criteria for end-August 2012 and all applicable structural benchmarks were met and only one with a slight delay. The indicative targets on the non-accumulation of domestic arrears were missed by small margins due to weaknesses in the monitoring of payment obligations. However, the authorities have taken corrective measures to prevent a recurrence of this issue.

Reflecting their increasing confidence and in light of the expected plans and revenues from the privatization of the telecommunication company PTK, the authorities intend to treat the Stand-By Arrangement as precautionary in 2013.

Fiscal Policy

The 2013 budget, which was a prior action for the completion of the second review, was approved on December 13 by the assembly in line with program targets. After a structural adjustment of 1.1 percent of GDP in 2012, the additional structural adjustment of 0.6 percent of GDP contained in the 2013 budget should meet the criterion of fiscal sustainability.

The authorities attach utmost importance to achieving a sustainable fiscal stance and an adequate level of government bank balances. Although revenue collection had been lower than program targets at end August due to severe weather conditions and a change in the customs administration, the shortfall has been compensated by cautious spending. As a sign of their strong commitment to program targets, the authorities had already identified spending cuts.

There have been remarkable improvements in public financial management; new treasury auctions, restructuring of the Energy Company, and further efforts on the rules-based fiscal framework. An IMF mission visited Pristina in June 2012 and developed the first set of proposals for a fiscal rule. The necessary legislation will be submitted to the assembly by end-March 2013. Despite the challenging environment, the authorities have successfully managed to conduct Treasury bill auctions and gradually increased the maturity structure of government debt. Furthermore, the financial position of the energy company KEK has improved due to structural measures.

In order to increase the productive capacity and competitiveness of the economy, the budget has been designed to maintain infrastructure investments. In this vein, the highway to Albania is expected to be completed in 2013, and the construction of a new highway to Macedonia will begin in 2013. The authorities are aware of the importance of fiscal stability. Therefore, the construction of the new highway will only be started after having met some pre-conditions such as a sustainable budgetary framework, economic viability as well as an open and transparent bidding process.

Monetary Policy and Financial Sector Policies

A joint IMF-World Bank Financial Sector Assessment Program mission was completed in October 2012. The findings of the FSAP reveal that the banking sector remains well-capitalized, liquid, and profitable, despite a recent increase in the level of nonperforming loans.

In the absence of an independent currency and monetary policy, the Central Bank of the Republic of Kosovo (CBK) has been pro-active to prevent risks which may result in macroeconomic instability. Since the level of nonperforming loans has increased in the wake of slower growth of the economy, the authorities have requested corrective measures from affected banks such as injecting fresh capital and strengthening governance including by replacing members of some banks' senior management and supervisory boards. Further efforts will be taken to ensure banks' compliance with the new law on banks and micro-finance institutions as well as revising the deposit insurance law.

Structural Reforms

The reforms in the business environment and investment climate have yielded an improvement of Kosovo's ranking in the World Bank's Doing Business Report. Building on the improvement, the authorities are keen on continuing further reforms. Two additional laws on telecommunication and mining sectors have been submitted to the assembly. Once implemented, these will be important for removing entry barriers and ensuring equal treatment among investors. With these reforms and investments in infrastructure we can expect the productive capacity and competitiveness of the economy to increase.