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REPUBLIC OF KOSOVO

May 2013

THIRD REVIEW UNDER THE STAND-BY ARRANGEMENT, REQUEST FOR WAIVER OF NONOBSERVANCE OF PERFORMANCE CRITERION

In the context of the third review under the Stand-By Arrangement, request for waiver of nonobservance of performance criterion, the following documents have been released and are included in this package:

- **Staff Report** for the third review under the Stand-By Arrangement, and request for waiver of nonobservance of performance criterion, prepared by a staff team of the IMF, following discussions that ended on March 18, 2013, 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 April 10, 2013. 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.

Press Release summarizing the views of the Executive Board.

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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International Monetary Fund
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REPUBLIC OF KOSOVO

THIRD REVIEW UNDER THE STAND-BY ARRANGEMENT AND REQUEST FOR WAIVER OF NONOBSERVANCE OF PERFORMANCE CRITERION

April 10, 2013

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), and the third purchase of SDR 34.857 million was made available upon Board approval of the second review on December 21, 2012 (Country Report 12/345). The fourth purchase, subject to completion of this (third) review, amounts to SDR 4.251 million.

Program status. All but one end-December 2012 and all continuous performance criteria were met. The exception is the program floor on the primary balance of the general government, which was missed by a small amount (less than €1 million). The authorities are requesting a waiver as the nonobservance was minor. Most applicable structural benchmarks were also met. The end-January 2013 structural benchmark on submission of an updated feasibility study for the planned highway R6 was not fully met, however, as the study did not contain all elements specified in the Letter of Intent of December 5, 2012. Missed by small margins were the indicative targets on the nonaccumulation of domestic payments arrears by the central and general governments. Corrective action is being taken.

Purchase. The authorities have indicated they will not purchase the amount that would be made available upon completion of this review, in line with their intention to treat the SBA as precautionary in 2013.

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

Approved By
Poul M. Thomsen and Martin Mühleisen

Discussions were held in Pristina, March 5–18. The mission met with Prime Minister Hashim Thaçi, Acting Minister of Finance Ramadan Avdiu, Central Bank Governor Gani Gërguri, other ministers, senior officials, parliamentarians, private sector representatives, and envoys representing the international community.

The staff team comprised Mmes. Budina, Madrid (both EUR) and Fayad (SPR), and Messrs. Wiegand (EUR, head) and Crivelli (FAD). Messrs. Sulemane (Resident Representative) and Thaçi (Economist in the Resident Representative's Office) assisted the mission. Mr. Kollar (EOD) attended some final meetings. The mission cooperated closely with the World Bank's local staff in Pristina and a World Bank transport sector mission that was in the field at the same time. Outreach activities included a press conference and a television interview.

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INTRODUCTION AND SUMMARY

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

- Most ***quantitative performance criteria*** for end-December 2012 and all continuous performance criteria under the Stand-By Arrangement (SBA) were met. The exception is the floor on the general government's primary fiscal balance that was missed by a small amount (less than €1 million), as a shortfall in revenue collection was not fully compensated by under-execution of spending (¶7). The revenue shortfall reflects mostly slower growth and its detrimental impact on border tax receipts. Fiscal developments in early 2013 have been broadly on target.

Selected Performance Criteria, end-December 2012
(In millions of Euros; cum. from beginning of the year)

	Target	Outturn (prelim.)
Floor on the government bank balance	205	216
Floor on the primary fiscal balance	-112	-113
Ceiling on primary expenditures	1490	1435
Ceiling on the net contracting of nonconcessional debt	150	73

Sources: Kosovo authorities; and IMF staff estimates

- Most applicable ***structural benchmarks*** were also met, including the end-March benchmark on submitting a legally binding, rules-based fiscal framework to the assembly (¶11). The end-January benchmark on preparing an updated viability study for the planned highway R6 to Macedonia was not fully met, however, as the study did not contain all elements specified in the Letter of Intent of December 5, 2012. Corrective action is being taken (¶10).

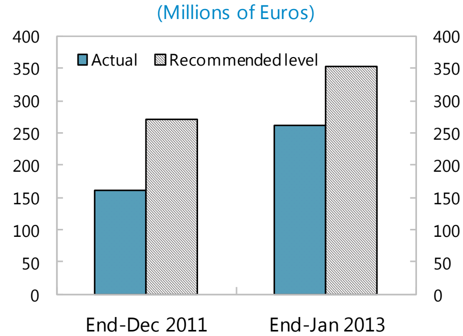
- The ***indicative targets*** on the nonaccumulation of domestic arrears by the central and the general governments were missed by small margins, reflecting continued weaknesses in the recording and monitoring of payment obligations. The authorities are implementing an action plan to address these shortcomings that is subject to structural conditionality (¶13).

2. **Good progress continues to be made toward 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 and fiscal rule.*** The fiscal stance inscribed into the 2013 budget is sustainable, following the implementation of a fiscal adjustment program that stretched over three years. The rules-based fiscal framework—which has been developed in close cooperation with IMF technical assistance—would safeguard fiscal sustainability from 2014.

- ***Cash buffers.*** The government's usable bank balance stood at €261 million at end-January 2013, or at 74

Government Bank Balance
(Millions of Euros)



Sources: Kosovo authorities; and IMF staff calculation.

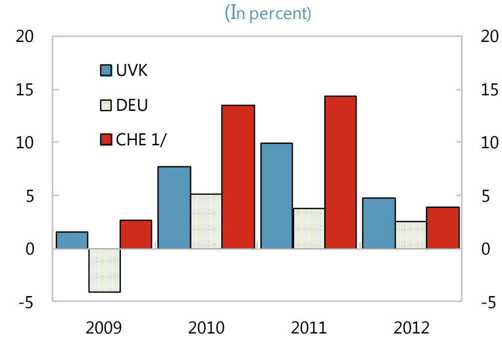
percent of a fully adequate level, compared to 60 percent at end-2011.[1] The more comfortable level of cash buffers strengthens the authorities' capacity to combat possible fiscal and financial shocks, and permits precautionary treatment of the SBA in 2013. Privatization of the telecommunications company PTK—expected for mid-April—would bring cash buffers to a fully adequate level.[2]

- ***Financial stability.*** The financial safety net has been strengthened further by increasing in the target size of Kosovo's Deposit Insurance Fund (¶15). The new banking law—which took effect in October 2012—and related new regulations tighten prudential requirements and strengthen banks' internal governance. The authorities have developed a plan to implement key recommendations from the recent IMF/World Bank mission under the Financial Sector Assessment Program (FSAP, ¶16)). These include a further strengthening of the Emergency Liquidity Assistance (ELA) facility for commercial banks, and improvements to the crisis management and resolution frameworks.

RECENT DEVELOPMENTS

3. The economy has continued to slow, in line with developments in Europe (Tables 1–3, Figure 1). Real GDP growth is estimated to have moderated to 2 percent in 2012, from 5 percent in 2011. More subdued economic conditions in the host countries of Kosovar Diaspora—notably Germany and Switzerland—dampened the growth of remittances and reduced other inflows, thus providing less support for domestic demand. Exports contracted, reflecting weaker global demand for mineral and metal products. Credit growth to the private sector stood at 5.1 percent (y-o-y) at end–January, down from close to 15 percent at end-2011. Nevertheless, Kosovo's economy has continued to avoid more severe contagion from the euro area, reflecting negligible export and financial linkages to crisis countries. Headline inflation was 2.6 percent (y-o-y) at end-February—somewhat above the long-term average—owing to elevated level reflecting mostly higher prices for imported foodstuffs, while core inflation remained contained at less than 2 percent.

Nominal GDP growth, 2009-2012
(In percent)



Source: WEO.
1/ Swiss nominal GDP converted into Euros.

[1] See Box 2 of IMF Country Report 12/100 for the computation of bank balance adequacy under the program.

[2] On April 3, two companies submitted bids to purchase 75 percent of PTK (out of five companies originally admitted to the auction). The government is currently analyzing the bids, and is expected to announce a decision during the course of April. In case PTK privatization would *not* go forward as envisaged, additional measures would be needed to preserve an acceptable level of government cash buffers. Some such measures have been inscribed into the 2013 budget as contingencies, such as not executing the budget allocation for highway R6 to Macedonia.

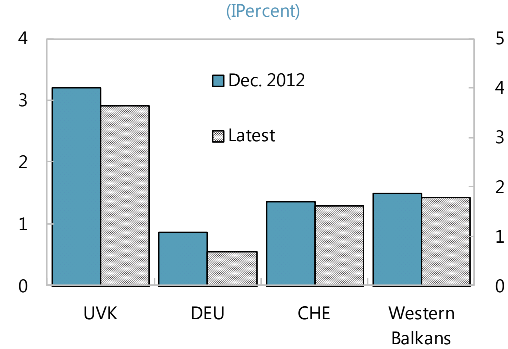
4. The financial system has remained stable, notwithstanding a further increase in nonperforming loans (NPLs). NPLs as a share of total loans rose to 7.8 percent at end-January 2013, from 5.8 percent at end-2011. The increase owes in part to slower credit growth (Box 1), but mostly to a deterioration in credit quality. NPLs remain adequately provisioned, however. Banks' capital adequacy has been affected by new legal and regulatory provisions that have tightened capital requirements (¶14). The banking system's average capital adequacy ratio stood at 14.9 percent at end-January, well above the regulatory minimum of 12 percent, although financial strength varies across banks. Conditions in the nascent government paper market have remained favorable, with 3-month and 6-months T-bills being rolled over at annual nominal yields of around 1 percent, reflecting both banks' excess liquidity and disciplined fiscal management.

ECONOMIC OUTLOOK AND RISKS

5. The economic outlook for 2013 is for subdued but resilient growth. Staff projects real GDP growth to recover somewhat to about 3 percent—a marginally lower growth rate than projected in the staff report for the second review, in view of similar downward revisions for Germany and Switzerland. Nevertheless, growth is projected to remain higher than in most neighboring countries. Resilient remittances and other inflows from the Kosovar Diaspora would support domestic demand, while exports would recover, in line with expected global demand for metals (Kosovo's main export commodity). These inflows would continue to finance a wide trade deficit, projected at about 40 percent of GDP. Consumer price inflation is expected to moderate, in line with lower prices for imported food stuffs. Core inflation would remain below 2 percent.

Real GDP Growth Projections, 2013

(IPercent)



Sources: World Economic Outlook and IMF staff projections.

6. Risks are modestly tilted to the downside. The main risk remains a possible deterioration in labor market conditions in the host countries of Kosovar's Diaspora. Deteriorating employment conditions for Kosovars living abroad could affect negatively remittances and other inflows, with negative implications for growth—by dampening domestic demand—tax revenues—by reducing border taxes—and financial stability—as remittances both fund deposits and are used to repay loans.[3] While there is no risk of repatriation of parent bank funding—the banking subsidiaries of euro area parent banks are fully deposit-funded, and tight regulations prevent a sizeable shifting of assets to parent banks—credit growth could be impacted in case parent banks attempt to preserve risk-weighted capital for the consolidated banking group.

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

POLICY DISCUSSIONS

A. Fiscal Policy

Fiscal Policy in 2012

7. In the final months of 2012, slower growth complicated the meeting of fiscal targets (Figure 2, Tables 4, 5).

Kosovo - Revenue Performance 2012

	1st Review	2nd Review	Est.
Total primary revenue and grants	1,376	1,359	1,322
Taxes	1,145	1,138	1,112
Border Taxes	875	869	845
Domestic Taxes	306	299	300
Refunds	-35	-31	-33
Nontax revenues	197	180	172
Grants	34	41	37

- ***Revenues*** fell short of end-2012 projections by €37 million (0.7 percent of annual GDP). The shortfall was concentrated in border taxes, as a result of weaker-than-expected imports.
- ***Spending restraint*** compensated for most of the revenue shortfall. The government executed €24 million in pre-identified current expenditure cuts—in line with program commitments—that were reinforced by under-execution of the capital budget.
- Nonetheless, the end-2012 ***cumulative primary balance*** still fell short of the program floor, although by a small amount of less than €1 million (0.02 percent of GDP). The authorities are requesting a waiver as the nonobservance was minor (LOI ¶3).[4]
- The ***government bank balance*** exceeded the end-2012 program target by €11 million, reflecting primarily unanticipated transfers from the privatization agency PAK earlier in the year.

Fiscal Policy in 2013

8. In the early months of 2013, budget implementation has been broadly in line with the program (LOI ¶6). While customs receipts remained behind plan in January and February, the weakness can be traced to a disruption in the tobacco imports triggered by new administrative registration requirements. Customs revenue collection normalized in March, a development that is expected to continue going forward. Other revenue components have evolved favorably, while spending has remained restrained.[5]

9. In view of these early trends, **the authorities and staff agreed that the 2013 fiscal targets remain achievable and appropriate.** However, the authorities committed to take measures as needed to safeguard achievement of the end-2013 fiscal targets in the context of the mid-year budget review, with savings measures amounting to at least the cumulative tax revenue shortfall

[4] Further, the authorities noted that Kosovo paid €1.05 million for a subscription to the EBRD's share capital upon joining the institution in December 2012. Without this payment, whose timing was beyond the authorities' control, the end-2012 deficit target would have been met.

[5] The 2013 budget is based on deliberately prudent revenue projections, see IMF Country Report 12/345.

through end-April (in case there is a shortfall, LOI ¶7). One possible candidate for eliminating spending—if needed—is civil service reform: the budget contains an allocation of €10 million for implementation of the reform from mid-year, but a delay in technical preparations renders this time table unrealistic (LOI ¶12). The authorities and staff agreed to resume this discussion during the next program review mission.

10. Preparations for highway R6 to Macedonia are advancing (LOI ¶¶8, 9). The 2013 budget contains an allocation of €28 million (0.5 percent of GDP) to start construction during the year's final months. Construction will stretch overall several years, however, and the total cost to the budget could amount to up to 15 percent of GDP. The authorities and staff followed up on the agreed pre-conditions for starting the project's implementation, notably economic viability and fiscal sustainability.

- ***Fiscal sustainability.*** The 2013 budget law specifies that the allocation for R6 would be executed only once the level of the usable government bank balance amounts to at least €300 million (close 6 percent of GDP). Whether this level can be reached in 2013 depends primarily on success with PTK privatization.

- **Economic viability.** The authorities submitted an updated feasibility study for R6 to World Bank and IMF staff in January, in line with the corresponding structural benchmark. World Bank staff confirmed that R6 passes minimum thresholds of viability, although only after incorporating additional cost savings, as was done in an updated version of the study in March. However, the study failed to analyze less expensive design options, in contrast to the authorities' commitment in the Letter of Intent of December 5, 2012. In particular, the design continues to include tunnels and other technically demanding elements in the southern section of R6 that—as experiences in neighboring countries suggest—hold the risk of potentially severe cost overruns. To limit risks to the public finances, it was agreed that the southern section would be procured as a "design and build", which requires the companies bidding for R6 to submit alternative designs. Further, a World Bank representative will join the Project Steering Committee for R6 as an observer.

Structural Fiscal Issues

11. On March 29, **the government submitted to the assembly legal amendments that establish a rules-based fiscal framework,** in line with the corresponding structural benchmark (LOI ¶10, Box 2). The amendments are to the Law on Public Financial Management and Accountability (LPFMA) and reflect extensive consultations of the authorities with both the program team and IMF technical assistance missions, stretching over almost a year. Parliamentary passage is envisaged for May or June, such that the framework will apply to the 2014 budget. The rules-based framework ensures that, under cautious assumptions, the net present value of public debt remains at or below 30 percent of GDP in the long term. It also provides some flexibility to react to business cycle dynamics.[6]

[6] The mission discussed the fiscal rule also with the main opposition parties, who signaled broad agreement.

12. Careful preparation, costing and phasing of social spending initiatives remain at the core of the program (LOI ¶13). Areas that require thorough budgetary planning include the government's pension and health reforms, as well as possible benefits to war veterans and former political prisoners.

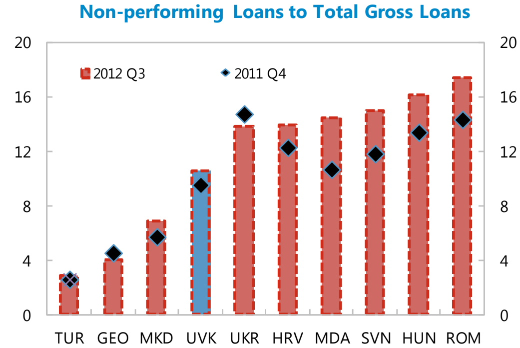
13. Progress is being made with recording and monitoring of payment obligations, to avoid the accumulation of domestic payments arrears (LOI ¶14). The Treasury has now established a specialized unit to monitor payment obligations across budget organizations, and has launched a publicity campaign to explain budget organizations' duties when entering into contractual obligations, in line with the commitments made in the December 5, 2012 Letter of Intent. Looking ahead, by end-May 2013 the Treasury will amend internal financial rules such that they enforce the timely recording of payments-related documents in the Treasury's IT system (structural benchmark). Together with upgrades of the IT system, these rules would ensure that failure to record payment-related documents results in an automatic disabling of payments. From August, the upgraded IT system is expected to also allow for the automatic generation of arrears reports, i.e., without relying on reports from individual budget organizations.

B. Financial Sector Policies

14. Both the economic slowdown and implementation of the new banking law have put some pressure on banks' soundness indicators, although the financial system remains stable overall (Tables 6, 7, Figure 3, LOI ¶15).

- ***Nonperforming loans*** (NPLs) have increased further to 7.8 percent of total loans in January 2013. Most of the increase is concentrated in real estate and construction, sectors that depend heavily on inflows from the Diaspora.[7] Some banks noted that weakness in the enforcement process also contribute to elevated NPLs. Nonetheless, NPLs remain adequately provisioned, and loan quality is monitored closely by the Central Bank of Kosovo (CBK). Further, the level of NPLs remains significantly below that of most neighboring countries.

Non-performing Loans to Total Gross Loans



Source: IMF Financial Soundness Indicators (FSI).

- Banks' ***capital adequacy*** has been affected by implementation of the new banking law and a related regulation. The new framework requires additional capital for operational risk and imposes more conservative risk-weights. It also requires deducting all related party loans from capital. Some new capital rules—notably on related lending—are significantly stricter than required under Basel rules, and were not anticipated by the banks. Overall, these changes triggered a drop in the aggregate CAR by about 3½ percentage points, and pushed some banks

[7] See the CBK Annual Report, 2011.

below the regulatory minimum of 12 percent. The CBK has requested recapitalization plans from the affected banks, and granted them until end-June to restore full capital adequacy. Related lending and large exposures are also required to be in line with the new, stricter limits by June.

15. Enhancements to Kosovo's deposit insurance framework further strengthen the financial safety net (LOI ¶16). The amended Deposit Insurance Law passed in December foresees a gradual increase of the size of insured deposits from currently €2,000 to €5,000 by 2018. Moreover, in January 2013 the Deposit Insurance Fund (DIFK) passed a resolution to increase the size of the target reserve fund from 5 percent to a range of 8–9 percent of total insured deposits over a period of 14 years.

16. The authorities and staff developed a plan to implement key FSAP recommendations that would further enhance the financial sector's resilience (Box 3, LOI ¶17). As an immediate priority—and with a view to strengthening supervisory independence—the CBK's Executive Board will approve by end-May an instruction to pay for legal representation of the CBK's staff when sued for carrying out official duties in good faith (structural benchmark). For other reforms more preparation is needed, such as strengthening the crisis management framework, instituting a bank premium to finance future enlargements of the ELA facility, moving to risk-based supervision, or introducing macro-prudential regulation. The CBK will request technical assistance from the IMF in several areas.

C. Competitiveness and Private Sector Development

17. The authorities are preparing draft secondary legislation that would provide for a more rules-based setting of minimum wages (Box 4, LOI ¶18). At present, the minimum wage is reviewed annually by a tripartite commission (comprising employer representatives, unions, and the government) that then makes a nonbinding proposal to the government. Experience suggests that this arrangement leaves much space for arbitrary or politically motivated minimum wage increases that could have negative repercussions for employment in the formal sector and labor market competitiveness. An inter-ministerial team will draft a regulation by end-May (structural benchmark) in cooperation with World Bank and IMF staff. The group will in particular explore options to tie future minimum wage increases to readily available indices such as the CPI (or components thereof). Staff and the authorities agreed to discuss the draft regulation during the next review mission, in close cooperation with the World Bank.

18. Initiatives to foster the development of small- and medium-sized enterprises (SMEs) are advancing (LOI ¶19). Almost all registered businesses in Kosovo are SMEs; enhancing their access to finance and strengthening their ability to compete are therefore critical for private sector development. Two projects are in preparation: (i) a voucher counseling and credit guarantee scheme that is being developed with the support from the Austrian Development Cooperation and the Swiss Cooperation Office—this project is close to being launched; and (ii) a scheme co-funded by the European Commission that would provide grants for some export-oriented SMEs to upgrade technology and increase production lines.

PROGRAM MODALITIES

19. 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 (Box 5, Figures 8–10, LOI ¶¶2, 14, 17, 18, LOI Table 3). Three new structural benchmarks would be introduced on: (i) approval of the amended financial rules 02 and 04 of the Treasury to ensure the recording of all payment-related documents within 3 days in the Treasury's IT system (by end-May 2013); (ii) approval by CBK's Executive Board of an instruction to pay for legal representation of staff when they are sued for carrying out official duties in good faith (by end-May 2013); and (iii) drafting of secondary legislation to provide for a more rules-based setting of minimum wage levels (also by end-May 2013).

20. The authorities plan not to draw the amount that they would be entitled to purchase with the completion of this review, in line with their intention to treat the Stand-By Arrangement as precautionary in 2013.

STAFF APPRAISAL

21. Macroeconomic and financial policies are broadly on-track. In the final months of 2012, implementation of the fiscal program was complicated by an unanticipated slowdown in growth and a corresponding drop in border tax receipts. The authorities proactively took compensating expenditure measures, however, and therefore missed the end-2012 deficit target by only a minimal amount. The 2013 budget is the first since Kosovo's declaration of independence in 2008 that is fully consistent with a sustainable fiscal stance. While budget implementation has been satisfactory in the year's early months, the government needs to vigilantly assess revenue trends and stand ready to take corrective measures as needed. Also required is expenditure discipline, building on the authorities' good track record in this area in recent years. The envisaged privatization of PTK would bring the government's bank balance to a fully adequate level.

22. Careful preparation of highway R6 to Macedonia is critical to limit risks to the public finances. While staff acknowledges that integrating Kosovo's roads into the regional network of highways in South-Eastern Europe is a policy priority, the sheer magnitude of R6 relative to Kosovo's fiscal capacity holds risks to the public finances. Utmost care is required to ensure that the highway's design is cost effective and provides a high economic return for the country. Procurement and tendering procedures as well as contractual arrangements should be designed to allow for the identification of additional savings, minimize the potential for cost overruns, and permit the government to preserve some budgetary flexibility. Staff encourages the authorities to work closely with the World Bank on these issues. Further, the government should enter into contractual obligations with respect to R6 only once its bank balance has recovered to a fully adequate level.

23. Careful preparation of social spending initiatives remains key. Social needs in Kosovo are large, and policymakers are under significant and often understandable pressure to address them rapidly. However, the authorities should refrain from introducing benefits without a careful analysis of their cost. The process established for possible benefits for war veterans—that started with registration, and now continues with a thorough assessment of eligibility—could, if carried through to the end, become a guiding example for the introduction of other benefits in the future.

24. Passage of the rules-based fiscal framework that is currently with the assembly would be an important step toward ensuring fiscal sustainability in the long term. Anchoring fiscal policy is especially critical in the context of Kosovo's unilaterally euroized economy, and against the backdrop of an unsettled political environment with still fragile institutions. Broad backing for the fiscal rule in the assembly would send a strong signal of support for macro-financial stability.

25. Important progress continues to be made in strengthening the financial safety net. In the past 12 months, an emergency liquidity facility (ELA) for banks has been established, the deposit insurance fund has been enhanced, and a revised banking law has been passed that strengthens the central bank's ability to resolve troubled financial institutions. Looking ahead, additional steps to enhance the financial system's resilience would include setting up a permanent funding mechanism for the ELA facility, strengthening the crisis management framework, and moving to risk-based supervision. Continued supervisory vigilance is needed to enforce the higher prudential standards set by the new banking law.

26. The authorities' efforts to foster competitiveness are commendable. However, these initiatives need to be part of a coherent overall policy strategy. Large and arbitrary increases in minimum wage rates, for example, could undermine the success of efforts to improve the business climate and enhance pubic infrastructure.

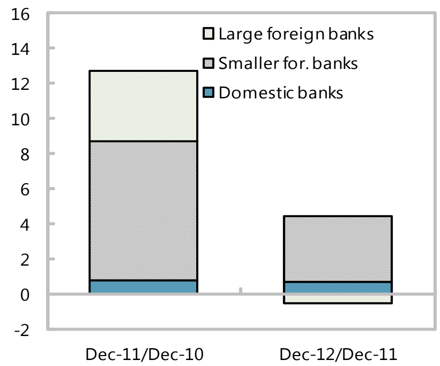
27. The fragile political environment remains the key risk to the program. Local elections are scheduled for late 2013, and national elections are likely in 2014. Previous experience suggests that populist pledges made during electoral campaigns can put hard-earned advances in macro-financial stability at risk, and can be very costly. Avoiding such setbacks is a common responsibility of all stakeholders. Also critical is policy continuity at the Ministry of Finance and the Central Bank. Both institutions—whose commitment to macro-financial stability has been critical to the success of the program thus far—have undergone leadership changes recently.

28. 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 third review. Staff also supports the request for a waiver for nonobservance of the end-2012 performance criterion for the general government's primary fiscal balance, as the nonobservance was minor.

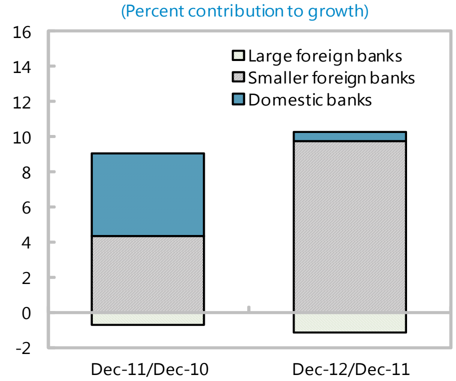
Box 1. Banking Sector Developments

After gaining momentum in 2011, credit growth moderated in 2012. This raises the issue of possible spillovers from the euro area (EA) crisis, given that the headquarters of the three largest banks—Procredit of Germany, Raiffeisen of Austria, and NLB of Slovenia—are located in the euro area. Although the Kosovar subsidiaries do not depend on parent funding, a crisis (or expectation thereof) and corresponding pressure on the parents' capital base could induce deleveraging through cutting lending.

Loans to Industry
(Percent contribution to growth)



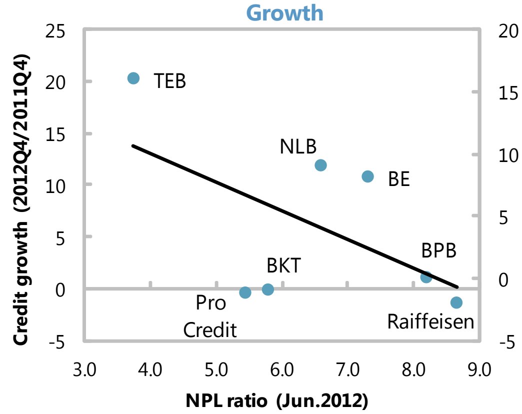
Deposits
(Percent contribution to growth)



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

ProCredit and Raiffeisen—that jointly hold more than half of the banking system's loan portfolio—reduced their credit portfolios in 2012, and appear to have discouraged deposits (they are marked as "large foreign banks" above). In contrast, other smaller foreign banks were the driving force behind credit growth in 2012, as many sought to increase their market share (e.g., TEB and NLB), while domestic banks (BE and BPB) maintained the same contribution to growth as in 2011. This difference in credit growth among banks may also be explained by local (bank-specific) conditions, in particular the increase in their nonperforming loans (NPLs) and moderating profitability.

Non-Performing Loans and Credit Growth



Source: Central Bank of the Republic Kosovo.

Box 2. Key Elements of the Rules-Based Fiscal Framework

The key elements of the rules-based fiscal framework submitted to the assembly at end-March are as follows:

- an **overall ceiling** on the general government deficit of 2 percent of GDP. The deficit ceiling will be allocated between the central government and municipalities entitled to accumulate debt according to their respective shares in general government spending. . The deficit ceiling complements the existing ceiling on public debt of 40 percent of GDP (Law 03-L-175 on Public Debt).

- **carry-over rules** for budgetary over- and underperformance. These allow for an increase of the deficit above the ceiling by up to 0.5 percent of GDP. Any excess deficit must be compensated within three fiscal years. The carry-over rules provide some flexibility to react to business cycle developments and let automatic stabilizers work.

- an **exemption for pre-specified capital projects** from the deficit ceiling, as long as the projects are (i) financed from privatization proceeds, hence there is no increase in government debt; and (ii) the government's usable bank balance amounts to at least 4.5 percent of GDP, to safeguard maintenance of acceptable minimum level of cash buffers.

- an **escape clause** that allows the assembly to temporarily suspend the deficit ceiling in case of four well-defined events with major financial and economic consequences. These are

  a) a **severe recession**, defined as nominal tax revenue remaining below the level of the previous fiscal year for any period of six months, excluding the effects of policy measures and one-off tax revenues;

  b) declaration of a **state of emergency** (including a natural disaster), in line with the definition in Article 131.1 of the Constitution

  c) declaration of a **systemic banking crisis** by the Central Bank Governor; and

  d) the drawing of a **state guarantee** that triggers an increase in total government expenditures by more than 1.5 percent of GDP within a fiscal year. A State Guarantee is defined by Law No. 03/L-175 on Public Debt.

Box 3. Plan to Implement Key FSAP Recommendations

- The authorities' plan focuses on the recommendations most critical for safeguarding stability. It is in line with the prioritization specified by the FSAP mission.

- ***Ensuring that costs associated with the legal defense of CBK staff are covered ex-ante.*** Given the importance of legal protection for the willingness of supervisors to act, the CBK is working on instructions to pay for legal representation when staff is sued for carrying out official duties in good faith. The instruction is expected to be ready by end-May.

- ***Subjecting Emergency Liquidity Assistance (ELA) granted to potentially insolvent systemically important institutions to very strict conditions.*** The authorities agree that the CBK should preferably not provide such assistance, and if so only with an explicit government guarantee and in case of a systemic crisis. Steps will be taken to operationalize this understanding, including by modifying the tripartite MOU on financial stability cooperation to clarify the responsibilities of the CBK and MOF in ELA.

- ***Instituting a bank premium to fund ELA needs.*** This would help the special reserve fund for ELA to grow in line with banks' liquidity risks and provide an incentive for banks to internalize the impact of their funding strategies. However, further work by the CBK and MoF is needed to establish the framework and to confirm the legal basis for such a premium (legislation or regulation).

Addressing shortcomings in the resolution framework and enhancing the crisis management framework. The shortcomings in the resolution framework are of a technical or procedural nature. Where possible the CBK will issue regulations to clarify terms and conditions (e.g., on the definition of purchase and assumption transactions), and formalize procedures in a manual. The CBK will also work to develop a contingency plan and crisis simulation exercise, for which it will request TA. Further, it will coordinate with other safety net providers (notably the DIFK) as necessary. The DIFK and MOF will evaluate further options for extraordinary funding arrangements for the DIFK.

- ***Introducing risk-based supervision.*** While the CBK's monitoring of credit risk is sound, the FSAP noted that further work is needed to assess operational and interest rate risks, as well as to develop consolidated supervision. This is another area where the CBK will request TA.

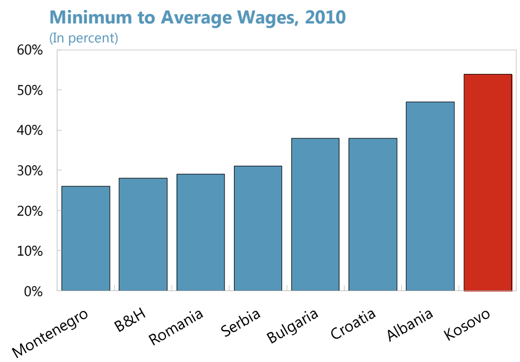
Establishing a macroprudential framework. The CBK plans to establish its own macroprudential committee that would be responsible for systemic risk identification, monitoring, and mitigation. Furthermore, the CBK would like to develop a macro model and is requesting TA for this.

Box 4. The Minimum Wage in Kosovo

Legal Framework

A legally binding minimum wage was first introduced in 2011. At the time, a standard monthly minimum wage of €170 was established, with a reduced minimum wage of €130 for employees under 35.

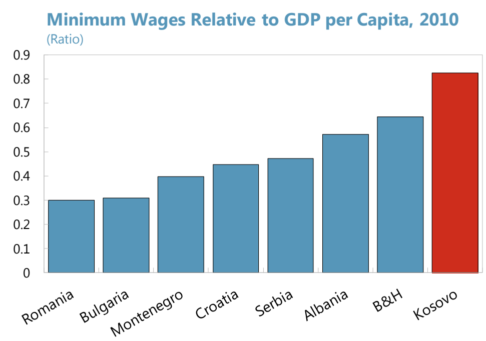
The Labor Law establishes that revisions to minimum wage levels can be made following an annual review by the Economic and Social Council. The council comprises representatives from employers' organizations, labor unions, and the government. The criteria on which the council's recommendations should be based are only loosely defined, however; they include the cost of living and labor market conditions. The lack of more concise guidance has triggered several calls for large and arbitrary increases in the minimum wage. The World Bank has therefore called for a more rules-based treatment.



Sources: Eurostat and Koettl and Santos (2011).

Regional comparison

Kosovo's standard minimum wage is among the highest in the region when measured in nominal terms, and is the highest when measured as a ratio of per capita GDP (or productivity), or in percent of average wages. Further, Kosovo has the highest registered unemployment rate in the region and the lowest labor force participation rate—although much of this arguably reflects the prevalence of informal employment.



Sources: Eurostat, Koettl and Santos (2011), and IMF staff calculations.

While there is no one-size-fits all policy for determining minimum wage rates, the existing data suggest that the minimum wage is already high, and further increases could push workers, especially low-skilled employees, out of the formal labor market. This would trigger a further deterioration in labor market outcomes and could undermine external competitiveness. It could also undermine fiscal sustainability by reducing the tax base.

Box 5. Stand-By Arrangement

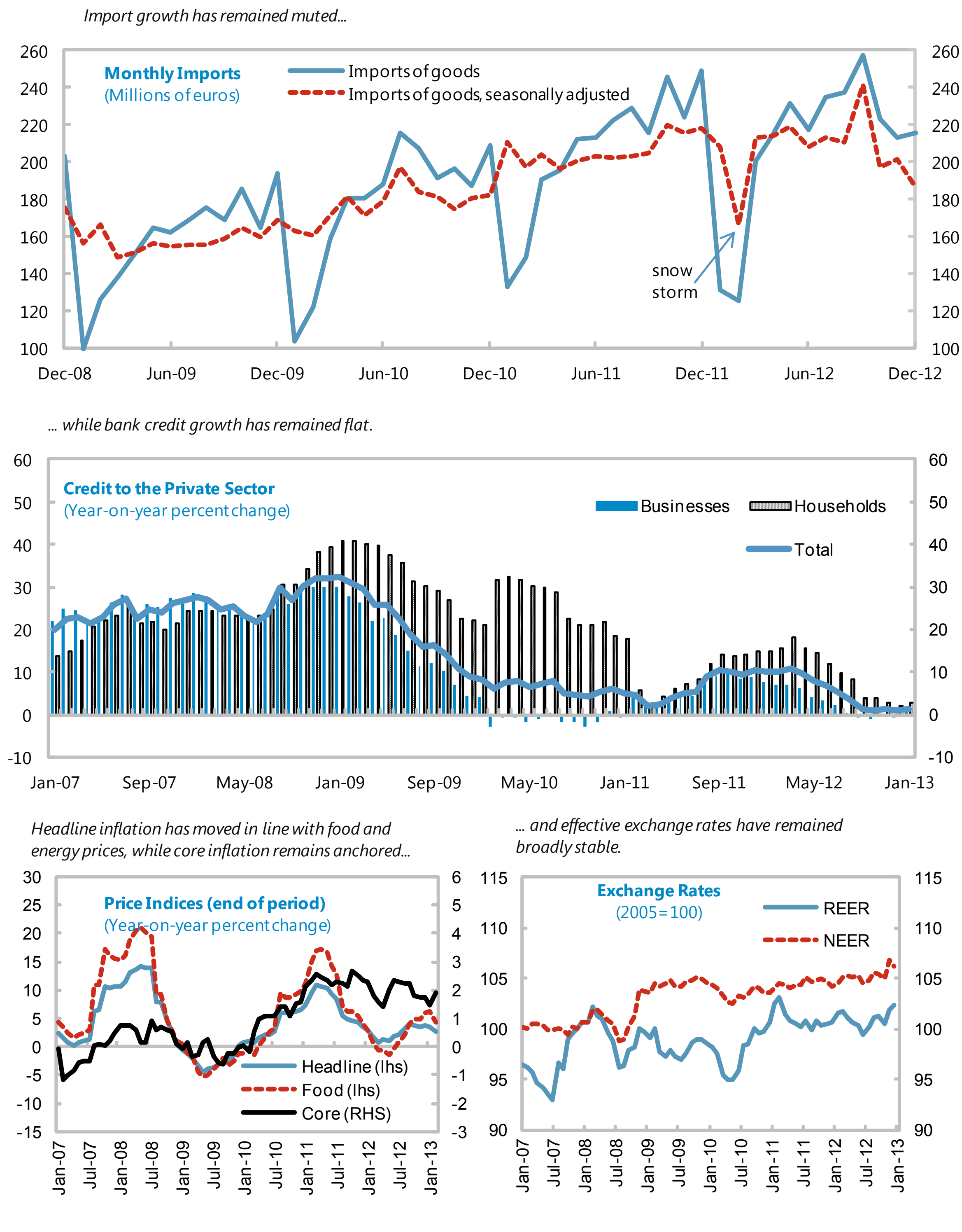
Key objectives: (i) restoring a sustainable fiscal stance and an adequate level of government cash buffers; (ii) establishing a legally binding fiscal rule; (iii) better design and costing of spending initiatives; (iv) strengthening the legal framework for financial regulation and supervision; and (v) 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 December 26, 2013)
- ***Phasing:*** SDR 4.251 million was made available after Board approval on April 27, 2012, SDR 39.108 after completion of the first review on July 16, 2012, and SDR 34.857 million after completion of the second review on December 21, 2012. SDR 4.251 million would become available upon completion of this (third) review; however, the authorities have indicated that they would not draw the amount that would become available, in line with their intention to treat the SBA as precautionary in 2013. Subsequent purchases are contingent on the completion of further reviews.

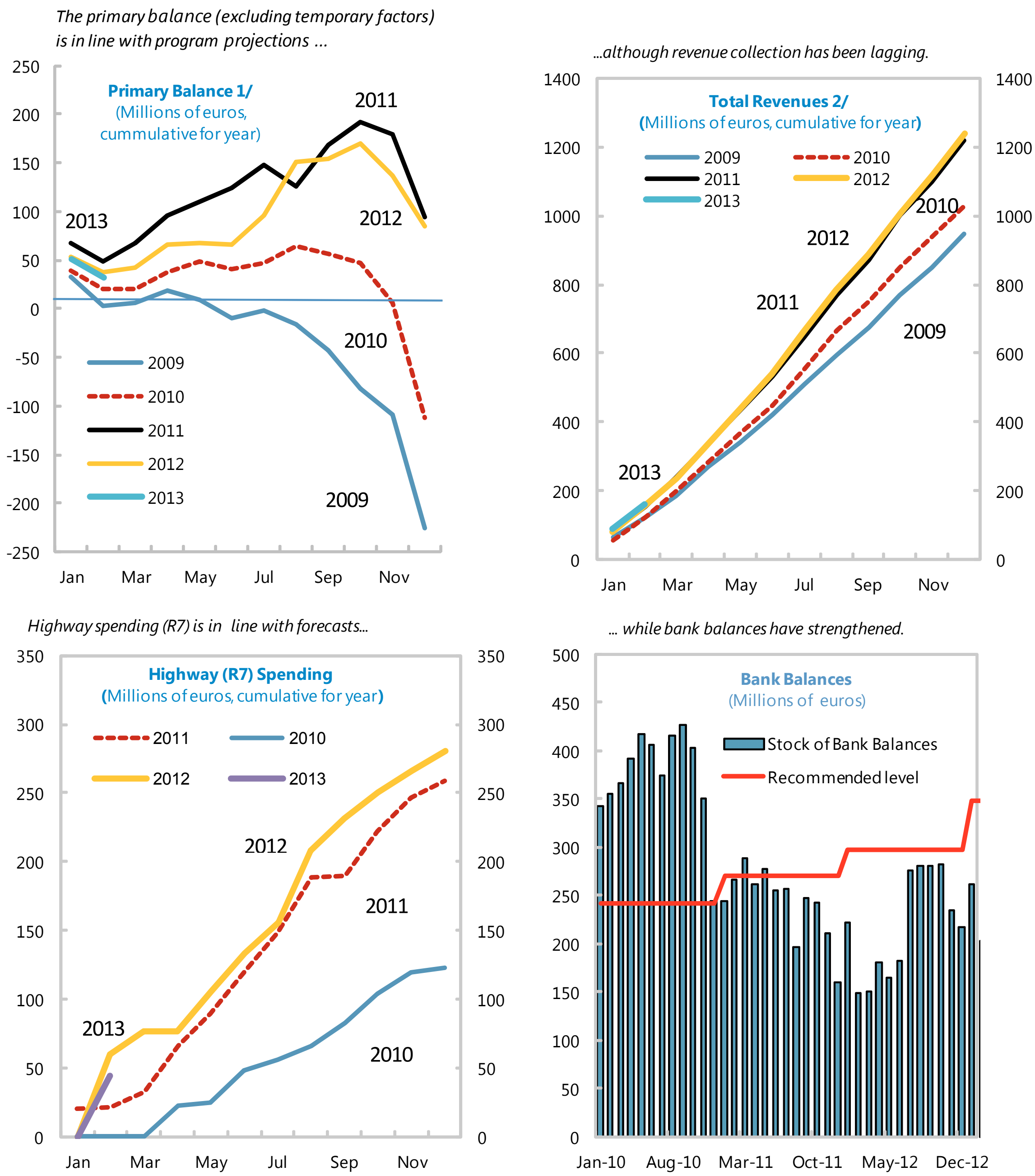
- **Conditionality** (going forward):
  - Quantitative performance criteria
    - Floor on the bank balance of the general government.
    - Floor on the primary fiscal balance of the general government.
    - Ceiling on primary expenditures of the general government.
    - Ceiling on the net contracting 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
    - Approval of the amended financial rules 02 and 04 of the Treasury to ensure the recording of all payment-related documents within 3 days in the free balance system. *By end-May 2013*
    - Approval by the Executive Board of the CBK of an instruction to pay for legal representation when staff is sued for carrying out official duties in good faith. *By end-May 2013*
    - Drafting secondary legislation to provide for a more rules-based setting of minimum wage levels (across age categories). *By end-May 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
(2007-2013)



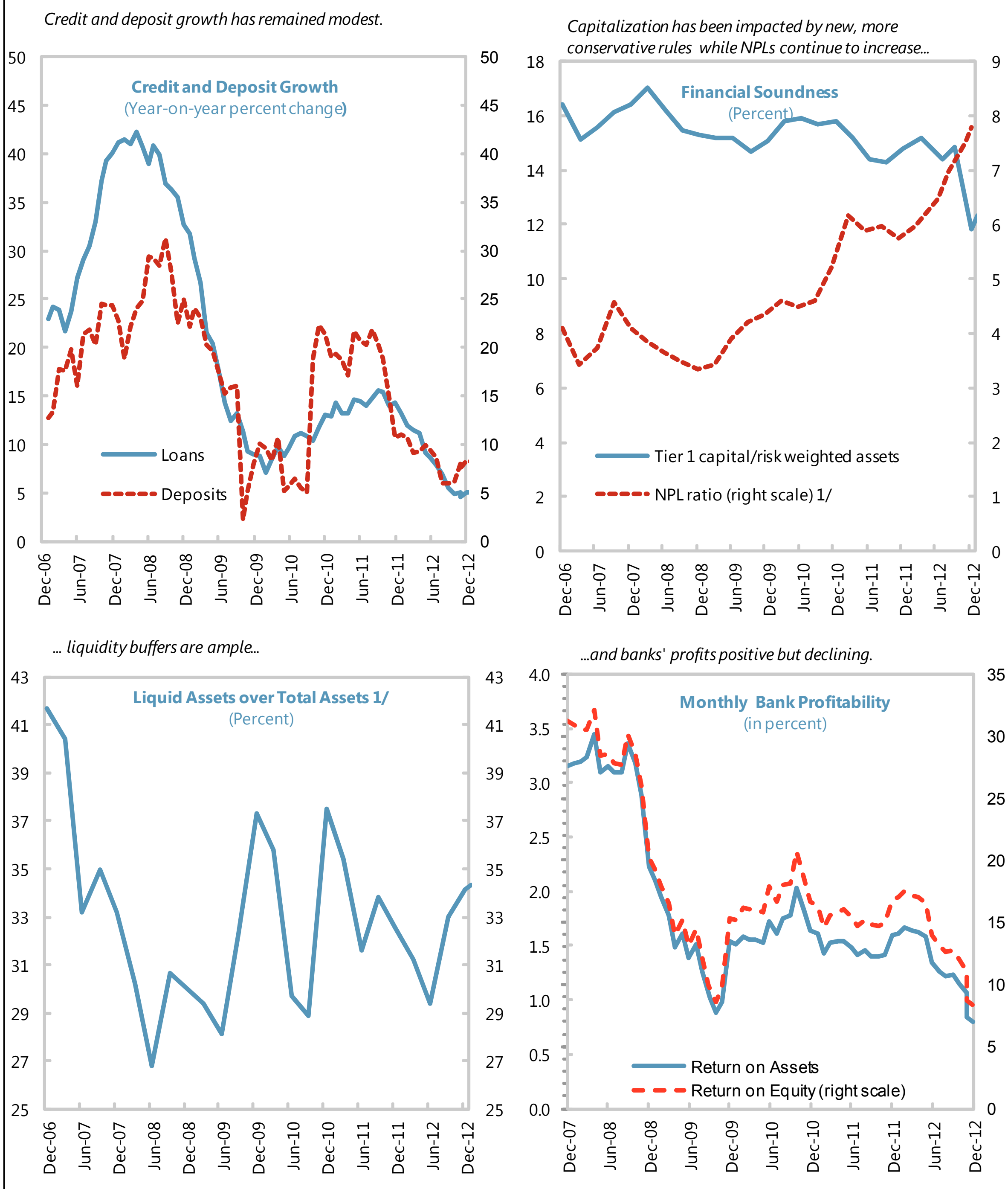
Sources: Central Bank of the Republic of Kosovo; and IMF staff estimates and projections.

Figure 2. Kosovo: Recent Fiscal Developments



Sources 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.

Figure 3. Kosovo: Selected Banking Sector Indicators



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

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

Table 1. Kosovo: Main Indicators, 2010–18

(Percent, unless otherwise indicated)

	2010	2011	2012	2013	2014	2015	2016	2017	2018
			Est.			Projections			
Real growth rates									
GDP	3.9	5.0	2.1	2.9	4.3	4.9	5.0	4.6	4.6
GDP per capita	2.4	3.4	0.6	1.4	2.8	3.4	3.4	3.1	3.1
Consumption	2.9	2.9	2.1	2.6	3.0	3.3	3.2	3.0	3.2
Investment	8.8	7.6	-0.3	5.3	3.5	7.6	7.0	6.3	5.3
Exports	24.2	13.6	-4.7	4.8	12.6	11.6	11.6	9.6	9.3
Imports	11.9	5.6	-2.4	4.4	4.4	6.2	5.8	5.0	4.7
Official unemployment (percent of workforce)	45.1	...	...	...	...	...	...	...	...
Price changes									
CPI, period average	3.5	7.3	2.5	2.4	1.5	1.5	1.5	1.5	1.5
CPI, end of period	6.6	3.6	3.7	1.5	1.7	1.4	1.5	1.5	1.5
Import prices	3.2	7.7	2.1	-2.6	-0.9	-0.4	-0.2	0.3	-0.3
GDP deflator	3.7	4.8	2.5	2.4	2.0	2.0	2.0	2.0	2.0
Real effective exch. rate (average; -=depreciation)	-0.7	3.5	...	...	...	...	...	...	...
Real effective exch. rate (end of period; -=depreciation)	0.8	0.7	...	...	...	...	...	...	...
General government budget (percent of GDP)									
Revenues, incl. interest income	27.6	28.1	27.2	27.8	27.8	27.9	28.2	28.4	28.8
Primary expenditures	30.0	29.8	29.7	31.0	29.2	29.4	29.7	29.8	29.9
Of which									
Wages and salaries	7.4	8.3	8.4	8.6	8.4	8.4	8.4	8.4	8.4
Subsidies and transfers	6.4	5.8	6.0	6.1	6.1	6.1	6.1	6.1	6.1
Capital and net lending, incl. highways	11.9	11.9	11.4	11.8	10.2	10.4	10.7	10.8	10.9
Capital expenditures on highways	2.9	5.6	5.8	5.3	4.4	4.1	3.6	0.0	0.0
Overall balance	-2.6	-1.9	-2.7	-3.5	-1.8	-1.9	-2.0	-2.0	-2.0
Debt financing, net	0.3	-0.1	3.2	1.5	2.0	2.1	1.7	1.9	2.4
Privatization	0.0	0.0	0.9	6.4	0.2	0.2	0.2	0.3	0.3
Stock of government bank balances	5.8	3.5	4.5	8.5	8.4	8.3	7.6	7.3	7.5
Recommended minimum bank balances 1/	5.7	5.8	6.1	6.9	7.0	7.3	7.4	7.3	7.4
Financing gap	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Savings-investment balances (percent of GDP)									
Domestic savings	-6.7	-7.9	-8.1	-8.0	-6.1	-3.9	-1.6	0.4	2.4
Transfers excluding general government (net)	12.5	12.2	12.1	12.0	12.0	11.7	11.2	10.9	10.5
Net factor income	2.1	2.6	2.5	2.4	2.5	2.5	2.5	2.4	2.2
National savings	8.0	7.0	6.4	6.4	8.4	10.2	12.1	13.7	15.1
Investment	33.9	33.2	32.4	30.3	29.5	30.0	30.5	31.0	31.1
Current account, excl. official transfers	-25.9	-26.2	-26.0	-24.0	-21.1	-19.8	-18.4	-17.3	-16.0
Current account balance, incl. official transfers	-17.4	-20.4	-20.3	-20.0	-17.6	-16.7	-16.0	-15.2	-13.6
Of which: official transfers 2/	8.6	5.9	5.6	3.9	3.6	3.1	2.4	2.1	2.4
Net foreign direct investment	8.5	8.0	6.6	12.2	7.4	6.7	6.5	6.3	6.2
Portfolio investment, net	-5.5	-2.3	-1.6	-3.5	-2.3	-1.1	-0.1	0.3	-0.5
Bank credit to the private sector	12.6	14.7	4.5	...	...	...	...	...	...
Deposits of the private sector	23.1	11.4	10.9	...	...	...	...	...	...
Non-performing loans (percent of total loans)	5.2	5.7	7.5	7.8 3/	...	...	...	...	...
Regulatory capital/risk weighted assets	18.8	17.6	14.4	14.9 3/	...	...	...	...	...
GDP (millions of euros)	4,216	4,637	4,857	5,121	5,452	5,838	6,251	6,667	7,114
GDP per capita (euros)	2,468	2,674	2,760	2,867	3,007	3,172	3,347	3,517	3,697
GNDI per capita (euros)	2,829	3,070	3,162	3,280	3,443	3,621	3,805	3,985	4,167
Population (thousands) 4/	1,708	1,734	1,760	1,786	1,813	1,840	1,868	1,896	1,924

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/ January 2013.
4/ Series updated with the 2011 census.

Table 2. Kosovo: Real Growth, 2010–18

(Percent, unless otherwise indicated)

	2010	2011	2012	2013	2014	2015	2016	2017	2018
			Est.			Projections			
					(Real growth, percent)				
Consumption	2.9	2.9	2.1	2.6	3.0	3.3	3.2	3.0	3.2
Private	3.8	3.0	2.6	2.6	3.2	3.2	3.1	2.9	3.0
Public	-1.5	2.3	-1.0	2.5	1.8	3.6	3.7	3.4	4.1
General government	7.1	8.5	3.9	9.0	2.6	5.7	5.5	5.3	5.8
Donor sector 1/	-16.0	-10.9	-13.9	-18.0	-1.2	-5.1	-4.8	-6.8	-6.0
Investment	8.8	7.6	-0.3	5.3	3.5	7.6	7.0	6.3	5.3
Private	7.0	7.2	-1.2	3.2	10.5	7.7	6.6	6.8	5.6
Public	12.6	8.4	1.4	9.0	-8.8	7.3	7.9	5.4	4.6
General government	13.8	9.4	1.8	9.6	-8.9	7.8	8.3	5.7	4.9
Donor sector 1/	-7.3	-11.1	-6.8	-6.7	-5.9	-10.3	-10.1	-10.0	-9.9
Exports	24.2	13.6	-4.7	4.8	12.6	11.6	11.6	9.6	9.3
Imports	11.9	5.6	-2.4	4.4	4.4	6.2	5.8	5.0	4.7
GDP	3.9	5.0	2.1	2.9	4.3	4.9	5.0	4.6	4.6
Memorandum item:									
GDP (millions of euros)	4216	4637	4857	5121	5452	5838	6251	6667	7114

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, 2010–18 1/

(Millions of euros, unless otherwise indicated)

	2010	2011	2012	2013	2014	2015	2016	2017	2018
			Est.			Projections			
Goods and services balance	-1,710	-1,904	-1,969	-1,965	-1,942	-1,981	-2,006	-2,042	-2,044
Goods	-1,776	-2,090	-2,144	-2,173	-2,210	-2,323	-2,447	-2,562	-2,640
Exports	305	322	277	295	348	394	445	503	568
Imports	-2,081	-2,412	-2,421	-2,469	-2,558	-2,717	-2,892	-3,065	-3,208
Services	66	186	175	208	268	342	441	520	596
Receipts	476	608	579	612	683	769	869	952	1,037
Payments	-410	-422	-404	-404	-415	-427	-428	-431	-440
Income	89	120	119	123	135	144	154	163	156
Compensation of employees (net)	172	178	186	193	201	209	217	226	239
Investment income	-82	-58	-66	-70	-66	-65	-64	-63	-84
Interest payments on public debt	-9	-9	-10	-14	-11	-10	-10	-9	-30
Transfers	889	839	861	817	849	865	850	863	920
Official transfers	361	273	272	202	194	184	147	139	172
Other transfers (net)	528	566	589	615	655	681	702	725	748
Of which: inflows of remittances	512	548	559	567	584	608	633	659	685
Current account	-732	-944	-988	-1,025	-958	-972	-1,003	-1,015	-968
Capital and financial account	552	744	788	825	758	772	803	815	768
Capital account	25	6	2	2	2	2	2	2	2
Of which: WB Trust Fund	0	5	0	0	0	0	0	0	0
Financial account, incl. CBK	527	738	786	823	756	770	801	813	766
Foreign direct investment, net	358	371	321	627	404	390	405	421	438
Commercial banks, excl. FDI	-101	-2	14	-98	-19	47	58	75	21
General government	21	-4	83	-5	-22	-27	-58	-51	-12
Disbursements, incl. past IMF purchases	22	8	94	9	0	0	0	0	0
Repayments	-11	-12	-11	-14	-22	-27	-58	-51	-12
Prepayment of debt	-11	-12	-11	-14	-22	-27	-58	-51	-12
Other repayments	0	0	0	0	0	0	0	0	0
Other	10	0	0	0	0	0	0	0	0
Other sectors, excl. FDI 2/	284	359	511	446	435	404	407	404	388
Central Bank of Kosovo	-35	14	-144	-147	-43	-45	-12	-36	-69
Reserve assets	-47	60	-266	-153	-43	-45	-12	-36	-69
Government balances (program definition)	236	73	-56	-220	-24	-23	10	-13	-45
Other reserve assets, incl. SDRs	-283	-13	-210	67	-19	-22	-22	-23	-24
Non-reserves assets	12	-47	31	7	0	0	0	0	0
Liabilities 3/	0	1	90	0	0	0	0	0	0
Net errors and omissions 4/	180	200	200	200	200	200	200	200	200
Overall balance	0	0	0	0	0	0	0	0	0
Financing gap	0	0	0	0	0	0	0	0	0
Memorandum items:									
Current account, excl. official transfers	-1,093	-1,217	-1,261	-1,227	-1,152	-1,156	-1,150	-1,154	-1,140
(in percent of GDP)	-25.9	-26.2	-26.0	-24.0	-21.1	-19.8	-18.4	-17.3	-16.0
Current account, incl. official transfers	-732	-944	-988	-1,025	-958	-972	-1,003	-1,015	-968
(in percent of GDP)	-17.4	-20.4	-20.3	-20.0	-17.6	-16.7	-16.0	-15.2	-13.6
Trade Balance (percent of GDP)	-40.6	-41.1	-40.5	-38.4	-35.6	-33.9	-32.1	-30.6	-28.7
Debt service to export ratio (percent)	2.6	2.2	2.5	3.1	3.2	3.2	5.1	4.1	2.6
Net foreign assets of commercial banks	508	509	491	594	613	566	474	356	293
Net foreign assets of CBK	1,108	1,095	1,239	1,385	1,428	1,473	1,485	1,521	1,590
Gross international reserves of the CBK	686	626	899	1,045	1,088	1,133	1,055	1,091	1,159

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.		Apr.	Aug.	Dec.
		Prog.	Actual	Prog.	Actual	Prog.	Actual	Prog.	Prog.	Proj.
Total primary revenue and grants	1,303	378	357	886	848	1,359	1,322	412	911	1,423
Total primary revenue	1,277	377	356	853	811	1,317	1,284	412	909	1,420
Taxes	1,072	322	298	735	700	1,138	1,112	321	744	1,200
Direct taxes	151	68	60	129	108	170	170	61	107	184
Indirect taxes	949	264	248	625	612	998	975	271	656	1,051
Tax refunds	-28	-11	-11	-19	-20	-31	-33	-11	-19	-35
Nontax revenues	205	56	58	118	111	180	172	91	166	220
Of which:										
Dividends	60	0	15	15	25	45	45	15	30	30
Grants	26	1	1	33	37	41	37	1	2	3
Budget support	19	0	1	30	37	37	37	0	0	0
Project grants	3	1	0	3	0	4	0	1	2	3
Primary expenditure	1,382	400	353	916	845	1,479	1,441	450	1,010	1,586
Of which:										
PAK-related expenditures		1	1	5	4	8	6	2	5	8
Primary expenditure excluding PAK	...	352	352	911	842	1,470	1,435	448	1,005	1,578
Current expenditure	832	243	236	542	522	896	888	265	598	984
Wages and salaries	385	102	101	240	237	408	408	110	256	439
Goods and services	177	58	58	124	116	188	191	58	132	229
Subsidies and transfers	270	84	77	178	168	296	289	98	208	312
Pension and social assistance	178	64	59	130	120	181	198	74	153	234
Other transfers and subsidies 2/	92	20	18	48	49	115	91	23	55	78
Reserve	0	0	0	0	0	4	0	0	2	4
Capital expenditure and net lending	550	156	117	374	323	583	553	185	412	602
Capital expenditure	520	145	118	363	317	572	541	187	416	608
Highways	259	104	76	213	208	294	281	94	189	271
R7	...	...	...	...	176	...	239	...	...	215
R6	...	...	...	...	0	...	0	...	...	28
Expropriation	...	...	...	...	31	...	42	...	...	28
Other capital spending	261	42	41	150	110	278	260	93	228	337
Net lending	30	11	-1	11	6	11	12	-2	-4	-6
Primary balance	-79	-21	4	-30	3	-120	-119	-38	-99	-163
Primary balance net of PAK		-20	5	-26	6	-112	-113	-36	-94	-155
Interest income, net	-7	-6	-4	-6	-6	-13	-10	-7	-10	-18
Overall balance	-86	-27	-1	-36	-3	-132	-129	-45	-109	-181
Financing	86	22	1	-10	3	89	129	45	109	181
Foreign financing	2	3	-1	15	48	70	83	-4	-2	-5
Drawings, incl. official financing	8	14	5	21	53	82	94	2	4	9
Amortization	-12	-6	-6	-6	-6	-11	-11	-6	-6	-14
Domestic financing	85	19	2	-25	-45	18	46	49	111	186
Domestic borrowing (net)	0	30	30	50	50	74	73	20	60	80
Privatization revenues	0	0	0	37	37	59	45	0	26	326
Other financial assets, net	0	-5	0	-10	0	-20	0	-1	-2	-3
Own-source revenue (– = increase)	0	0	-8	-32	-11	-28	-15	-38	-30	3
o/w PAK related		...	...	-32		-22		...	...	8
Bank balance (prog.; – = increase)	84	-6	-20	-70	-121	-67	-56	67	57	-220
Financing gap	0	0	0	46	0	43	0	0	0	0
Memorandum items:										
Bank balance of the general government	160	166	180	230	281	227	216	160	160	436
Of which: ELA	0	0	0	46	46	46	0	0	0	46
Recommended minimum level of bank balance	271	...	...	...	...	297	297	...	...	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, 2011–18 1/

(Excluding donor designated grants; percent of GDP)

	2011	2012		2013	2014	2015	2016	2017	2018
		Prog.	Est.	Proj.		Projections			
Total primary revenue and grants	28.1	28.0	27.2	27.8	27.7	27.8	28.1	28.3	28.6
Total primary revenue	27.5	27.1	26.4	27.7	27.7	27.8	28.1	28.3	28.6
Taxes	23.1	23.4	22.9	23.4	23.8	23.9	24.2	24.4	24.6
Direct taxes	3.3	3.5	3.5	3.6	3.8	4.1	4.2	4.2	4.4
Indirect taxes	20.5	20.6	20.1	20.5	20.6	20.5	20.7	20.8	20.9
Tax refunds	-0.6	-0.7	-0.7	-0.7	-0.7	-0.7	-0.7	-0.7	-0.7
Nontax revenues	4.4	3.7	3.6	4.3	3.9	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	0.0
Grants	0.6	0.9	0.8	0.1	0.0	0.0	0.0	0.0	0.0
Budget support	0.4	0.8	0.8	0.0	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	0.0
Project grants	0.1	0.1	0.0	0.1	0.0	0.0	0.0	0.0	0.0
Primary expenditure	29.8	30.4	29.7	31.0	29.2	29.4	29.7	29.8	29.9
Of which:									
PAK-related expenditures	...	0.2	0.1	0.2	0.2	...	...	...	...
Primary expenditure excluding PAK	...	30.3	29.5	30.8	29.0	...	...	...	...
Current expenditure	17.9	18.4	18.3	19.2	19.0	19.0	19.0	19.0	19.0
Wages and salaries	8.3	8.4	8.4	8.6	8.4	8.4	8.4	8.4	8.4
Goods and services	3.8	3.9	3.9	4.5	4.4	4.4	4.4	4.4	4.4
Subsidies and transfers	5.8	6.1	6.0	6.1	6.1	6.1	6.1	6.1	6.1
Pension and social assistance	3.8	3.7	4.1	4.6	4.8	4.7	4.7	4.7	4.7
Other transfers and subsidies 2/	2.0	2.4	1.9	1.5	1.4	1.4	1.4	1.4	1.4
Reserve	0.0	0.1	0.0	0.1	0.1	0.1	0.1	0.1	0.1
Capital expenditure and net lending	11.9	12.0	11.4	11.8	10.2	10.4	10.7	10.8	10.9
Capital expenditure	11.2	11.8	11.1	11.9	10.3	10.6	10.8	10.9	10.9
Highways	5.6	6.0	5.8	5.3	4.4	4.1	3.6	0.0	0.0
R7	...	...	4.9	4.2	0.0	0.0	0.0	0.0	0.0
R6	...	...		0.5	3.9	3.6	3.1	0.0	0.0
Expropriations	...	...	0.9	0.5	0.6	0.5	0.5	0.0	0.0
Other capital spending	5.6	5.7	5.4	6.6	5.9	6.4	7.3	10.9	10.9
Net lending	0.6	0.2	0.2	-0.1	-0.1	-0.1	-0.1	-0.1	0.0
Primary balance	-1.7	-2.5	-2.5	-3.2	-1.5	-1.6	-1.6	-1.5	-1.3
Primary balance net of PAK	0.0	-2.3	-2.3	-3.0	-1.4	-1.6	-1.6	-1.5	-1.3
Interest income, net	-0.2	-0.3	-0.2	-0.4	-0.3	-0.3	-0.4	-0.5	-0.7
Overall balance	-1.9	-2.7	-2.7	-3.5	-1.8	-1.9	-2.0	-2.0	-2.0
Financing	1.9	1.8	2.7	3.5	1.8	1.9	2.0	2.0	2.0
Foreign financing	0.0	1.4	1.7	-0.1	-0.4	-0.5	-0.9	-0.8	-0.2
Drawings, incl. official financing	0.2	1.7	1.9	0.2	0.0	0.0	0.0	0.0	0.0
Amortization	-0.3	-0.2	-0.2	-0.3	-0.4	-0.5	-0.9	-0.8	-0.2
Domestic financing	1.8	0.4	1.0	3.6	2.2	2.4	2.9	2.7	2.2
Domestic borrowing (net)	0.0	1.5	1.5	1.6	2.4	2.6	2.6	2.6	2.6
Privatization revenues	0.0	1.2	0.9	6.4	0.2	0.2	0.2	0.3	0.3
o/w PAK privatization	0.0			0.0	0.0	0.0	0.0	0.0	0.0
WB subscription	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Other financial assets (net)	0.0	-0.4	0.0	-0.1	0.0	0.0	0.0	0.0	0.0
Own-source revenue (– = increase)	0.0	-0.6	-0.3	0.1	0.1	0.0	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	0.0
Bank balance (prog.; – = increase)	1.8	-1.4	-1.2	-4.3	-0.4	-0.4	0.2	-0.2	-0.6
Financing gap	0.0	0.9	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Memorandum items:									
Bank balance of the general government	3.5	4.7	4.5	8.5	8.4	8.3	7.6	7.3	7.4
Of which: ELA	0.0	0.9	0.9	0.9	0.8	0.8	0.7	0.7	0.6
Recommended minimum level of bank balance	5.8	6.1	6.1	6.9	7.0	7.3	7.4	7.3	7.4
Nominal GDP (millions of euros)	4,637	4,857	4,857	5,121	5,452	5,838	6,251	6,667	7,114

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 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	1,095	1,239	1,385	1,428
Foreign assets	1,111	1,198	1,247	1,235	1,469	1,616	1,658
Of which: Securities	541	530	199	25	286	306	326
Deposits	529	522	854	1,059	1,034	1,161	1,183
Foreign liabilities	0	110	139	140	230	230	230
Net domestic assets	-1,111	-1,088	-1,108	-1,095	-1,239	-1,385	-1,428
Net claims on the central government	-870	-681	-813	-797	-838	-1,058	-1,081
Liabilities	-870	-681	-813	-797	-838	-1,058	-1,081
Of which: KTA (privatization) fund	406	-451	-522	-265	-549	-549	-549
Of which: Government balances (program definition)	-414	-178	-233	-160	-216	-436	-459
Commercial banks	-137	-233	-204	-210	-302	-227	-244
Other institutions	-64	-131	-46	-39	-51	-51	-51
Other items, net	-39	-43	-46	-48	-47	-49	-51
				Commercial banks			
Net foreign assets	325	444	508	509	491	594	613
Assets	401	584	710	666	634	746	780
Liabilites	76	140	202	156	142	152	167
Net domestic assets	815	949	1,206	1,399	1,625	1,608	1,753
Credit to private sector	1,183	1,289	1,451	1,664	1,740	1,880	2,003
Claims on the CBK	137	233	203	220	294	227	244
Net claims on the central government	-1	-165	-12	-1	59	40	85
Net claims on other public entities	-264	-123	-120	-128	-74	-79	-86
Other items, net	-240	-286	-317	-355	-394	-460	-494
Liabilities to the private sector	1,140	1,393	1,714	1,908	2,116	2,202	2,366
Demand deposits	384	441	545	598	694	702	765
Time deposits	756	951	1,169	1,311	1,422	1,500	1,601
Memorandum item:							
Gross international reserves	670	625	686	626	892	1,045	1,088
				(12-month percent change)			
Liabilities to private sector	25.8	22.2	23.1	11.4	10.9	4.1	7.4
Loans to the private sector	32.7	8.9	12.6	14.7	4.5	8.1	6.5
				(Percent of GDP)			
Total private sector deposits	29.6	35.6	40.7	41.2	43.6	43.0	43.4
Credit to the private sector	30.7	32.9	34.4	35.9	35.8	36.7	36.7

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

Table 7. Kosovo: Selected Financial Soundness Indicators, 2007–13

	2007	2008	2009	2010	2011	2012	2013 Jan.
Capital adequacy 1/							
Regulatory capital/risk weighted assets	17.5	16.5	18.1	18.8	17.6	14.4	14.9
Tier 1 capital/risk weighted assets	16.2	15.3	15.2	15.8	14.8	11.8	12.3
Asset quality							
NPL ratio 2/	4.1	3.3	4.3	5.2	5.7	7.5	7.8
NPL net of provisions/capital	2.8	3.0	2.9	3.7	4.6	7.3	7.5
Sectoral breakdown of loans							
Agriculture	3.2	3.2	3.0	2.6	2.4	2.5	2.5
Manufacturing	10.6	8.0	11.7	9.9	10.3	9.2	9.2
Trade	41.6	38.8	37.4	37.1	37.8	37.8	37.8
Other services	16.5	20.7	14.6	12.0	11.7	11.6	11.5
Construction	5.6	5.5	6.9	7.5	7.0	7.2	7.3
Households	22.5	23.7	26.7	29.8	30.7	31.2	31.3
Liquidity							
Liquid assets/total assets 3/	33.2	30.0	37.4	37.5	32.6	34.1	34.3
Deposits/loans	124.3	117.1	129.7	126.1	119.4	123.7	123.4
Liquid assets to short-term liabilities 4/	33.0	35.0	47.0	46.2	39.6	40.8	40.6
Profitability							
Return on average assets 5/	3.2	2.2	1.5	1.6	1.6	0.8	1.0
Return on average equity 5/	31.2	20.2	15.4	16.7	16.8	8.7	10.8
Interest margin to total income	58.4	57.8	55.3	55.5	56.9	56.1	56.0
Non-interest expense to total income 6/	12.6	14.2	16.4	16.6	18.0	23.8	23.2
Interest margin to gross income	69.9	74.1	74.4	74.5	75.2	74.2	72.5
Non-interest expense to gross income 7/	68.2	75.0	79.2	74.3	76.8	87.3	85.0
Market risk							
Net open currency position/tier 1 capital	NA	13.1	12.4	-0.1	2.5	0.7	NA

Source: Central Bank of the Republic of Kosovo.

1/ As of Dec. 2012, new capital adequacy rules include an additional capital requirement for operational risk, higher risk-weights for assets rated B- or less, and a deduction for related party loans.
2/ Loans classified as doubtful or loss.
3/ Liquid Assets are cash and balances with the CBK, as well as balances with commercial banks and securities.
4/ Short-term liabilities are deposits, and short-term borrowing and other liabilities (i.e., up to 1 year maturity).
5/ Profits are before taxes and extraordinary items.
6/ Non-interest expenditure from fees, commissions, provisions, and depreciation (i.e., excluding general and administrative expenses).
7/ Non-interest expense including general and administrative costs.

Table 8a. Kosovo: Gross Financing Requirements, 2011–13

(Millions of euros)

	2011	2012	2013
			Proj.
Gross Financing Requirements	956	1,000	1,039
Current account deficit	944	988	1,025
Amortization of medium and long term public debt	12	11	14
Sources of Financing	956	1,000	1,039
Capital account (net)	6	2	2
Foreign direct investment (net)	371	321	627
Net bank financing	-2	14	-98
Government loans	8	94	9
Net Foreign assets of the Central Bank of Kosovo	14	-144	-147
Other financing inc. net erros and omissions	559	711	646
Financing Need	0	0	0
IMF 1/	0	0	0
in percent of quota	0	0	0
Memorandum items:			
Kosovo IMF quota (SDR millions)	59	59	59
Kosovo IMF quota (Euro millions)	67	70	68

Source: IMF staff estimates and projections.

Table 8b. Kosovo: Gross Financing Requirements, 2011–13

(Percent of GDP)

	2011	2012	2013
			Proj.
Gross Financing Requirements	20.6	20.6	20.3
Current account deficit	20.4	20.3	20.0
Amortization of medium and long term public debt	0.3	0.2	0.3
Sources of Financing	20.6	20.6	20.3
Capital account (net)	0.1	0.0	0.0
Foreign direct investment (net)	8.0	6.6	12.2
Net bank financing	0.0	0.3	-1.9
Government loans	0.2	1.9	0.2
Net Foreign assets of the Central Bank of Kosovo	0.3	-3.0	-2.9
Other financing inc. net erros and omissions	12.1	14.6	12.6
Financing Need		0.0	0.0
IMF 1/		0.0	0.0

Source: IMF staff estimates and projections.

1/ Program is assumed to be 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, 2013–18

	2013	2014	2015	2016	2017	2018
A. Precautionary Treatment in 2013 (Baseline)						
Fund obligations based on existing and prospective purchases (millions of SDR)						
Principal	2.4	9.4	13.0	39.1	33.2	0.0
Charges and interest	1.0	0.9	0.8	0.6	0.2	0.0
Total obligations based on existing and prospective purchases						
SDR millions	3.3	10.3	13.8	39.7	33.4	0.0
Euro millions	3.8	12.0	16.2	46.7	39.4	0.0
Percent of exports of goods and services	0.4	1.2	1.4	3.6	2.7	0.0
Percent of debt service	13.5	36.1	43.6	69.4	66.4	0.0
Percent of GDP	0.1	0.2	0.3	0.7	0.6	0.0
Percent of government revenue	0.3	0.8	1.0	2.6	2.1	0.0
Percent of quota	5.6	17.5	23.4	67.3	56.6	0.0
Outstanding Fund credit						
SDR millions	94.6	94.6	85.3	72.3	33.2	0.0
Euro millions	109.7	110.1	99.7	84.9	39.2	0.0
Percent of exports of goods and services	12.1	10.7	8.6	6.5	2.7	0.0
Percent of debt service	388.5	331.3	269.0	126.3	66.0	0.0
Percent of GDP	2.1	2.0	1.7	1.4	0.6	0.0
Percent of government revenue	7.7	7.3	6.1	4.8	2.1	0.0
Percent of quota	160.4	160.4	144.5	122.5	56.2	0.0
Net use of Fund credit (millions of SDR)	10.4	-9.4	-13.0	-39.1	-33.2	0.0
Purchases	12.8	0.0	0.0	0.0	0.0	0.0
Repurchases	2.4	9.4	13.0	39.1	33.2	0.0
B. Full Purchases						
Fund obligations based on prospective purchases (millions of SDR)						
Principal	0.0	0.0	0.0	2.7	6.4	3.7
Charges and interest	0.1	0.1	0.1	0.1	0.1	0.0
Fund obligations based on existing and prospective purchases (millions of SDR)						
Principal	2.4	9.4	13.0	41.8	39.5	3.7
Charges and interest	0.9	1.1	1.0	0.8	0.3	0.0
Total obligations based on existing and prospective purchases						
SDR millions	3.3	10.5	14.0	42.5	39.8	3.8
Euro millions	3.8	12.2	16.4	50.0	47.1	4.5
Percent of GDP	0.1	0.2	0.3	0.8	0.7	0.1
Percent of government revenue	0.3	0.8	1.0	2.8	2.5	0.2
Outstanding Fund credit						
SDR millions	107.4	98.0	85.0	43.3	3.7	0.0
Euro millions	124.5	114.1	99.4	50.8	4.4	0.0
Net use of Fund credit (millions of SDR)	10.4	-9.4	-13.0	-41.8	-39.5	-3.7
Purchases	12.8	0.0	0.0	0.0	0.0	0.0
Repurchases	2.4	9.4	13.0	41.8	39.5	3.7
Memorandum items:						
Exports of goods and services (millions of euros)	907	1,031	1,163	1,314	1,455	1,605
External debt service (millions of euros) [1]	28.2	33.2	37.1	67.2	59.4	41.7
Nominal GDP (millions of euros)	5,121	5,452	5,838	6,251	6,667	7,114
Government revenue (millions of euros)	1,422	1,513	1,632	1,765	1,894	2,052
Quota (millions of SDR)	59.0	59.0	59.0	59.0	59.0	59.0
SDR/EUR	0.86	0.86	0.86	0.85	0.85	0.84

Sources: IMF staff estimates and projections.

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

Table 10. Kosovo: 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	Purchase made
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)			

Appendix I. Letter of Intent

Pristina, April 8, 2013

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

Dear Ms. Lagarde:

1. Kosovo's economy has continued to grow at healthy rates, notwithstanding an economic slowdown during the second half of 2012 related to developments in Europe. In particular, exports have been weaker and reduced capital inflows as well as constrained credit have provided less support for domestic demand. Nevertheless, the banking system continues to be well-capitalized and liquid, despite slower credit growth and an increase in nonperforming loans. In this difficult external environment, we remain committed to disciplined fiscal management, safeguarding an adequate level of government bank balances, strengthening 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):

- most *quantitative performance criteria* for end-December were met.
  - (i) The floor on government bank balance was exceeded by €11 million.
  - (ii) Both the general government's primary expenditures and the net contracting of nonconcessional debt remained below program ceilings.
  - (iii) However, the primary fiscal deficit exceeded the program target by a miniscule amount—€1 million—as a shortfall in revenue collection—concentrated in border taxes—was not fully compensated by under-execution of spending. Moreover, an originally unforeseen payment of €1 million was made for the subscription to the EBRD's share capital in the context of Kosovo's joining of the institution (in the absence of this spending item, the primary balance criterion would have been met).
- Most applicable *structural benchmarks* were met:

(i) On January 30, 2013, we submitted an updated economic viability study for highway R6 to the World Bank and IMF staff, in line with the end-January structural benchmark. However, not all elements specified in our December 5, 2012, Letter of Intent were reflected in that study.

(ii) We submitted the legislation on a rules-based fiscal framework consistent with ¶11 of the Letter of Intent from December 5, 2012 to the assembly on March 29.

(iii) We also met 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.

- The *indicative (zero) targets* for domestic payment arrears of the central and general government were missed by modest amounts.

3. Based on this performance, we request completion of the third review under the Stand-By Arrangement. We request a waiver for nonobservance of the primary balance performance criterion at end-December on the basis that the nonobservance was minor. We intend to treat the Stand-By Arrangement as precautionary in 2013, and therefore intend not to draw the amount that we would be entitled to purchase with the completion of this review. 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.

4. We believe that the policies set out in the letters of April 12, 2012, June 27, 2012, December 5, 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 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 program 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

5. We expect subdued but resilient growth in 2013, driven by a modest contribution of investment, a recovery in exports, as well as strengthened consumption supported by remittances and other inflows from the Kosovar Diaspora. The macroeconomic framework underpinning our program is based on prudent assumptions, given a continued fragile external environment, and with a view to minimizing the risk of downward revisions during the program period.

a. We expect *real GDP growth* in 2013 to recover by about a percentage point relative to 2012, which implies a downward revision of 2013 growth relative to our forecast at the time of the 2nd review. The revision reflects subdued growth dynamics early in 2013 and projected developments in the euro area. Nevertheless, we expect growth to be higher than in most neighboring countries.

b. Consumer price *inflation* is expected to moderate in 2012, reflecting lower projected global food and fuel prices. Core inflation is projected to remain below 2 percent.

c. We also expect the *trade deficit* for 2013 to narrow slightly, in line with subdued domestic demand and a recovery of exports, driven by higher global demand for metals.

II. Fiscal Policy

A. Implementation of the 2013 Budget

6. We continue to target a primary deficit (excluding PAK-related expenditures) of no more than €155 million (3 percent of GDP). Our budget is based on cautious revenue projections and contains sizeable contingency reserves.

a. Tax revenue collection through end-February was €7 million behind projections, reflecting in part a temporary disruption in imports of tobacco products caused by the adoption of a new regulation by the Ministry of Agriculture requiring registration of tobacco importers. The situation has normalized and we expect revenues to align with program targets in the coming weeks.

b. We expect that one-off revenues of €20 million from the sale of telecommunication licenses will be received in the month of May instead of March as originally projected, as the tender process is taking longer than originally expected.

c. However, execution of budget expenditures has been lower by €30 million than projected through end-February. Moreover, an additional PTK dividend of €10 million has already been approved (in addition to the €30 million in PTK dividends foreseen in the 2013 budget). At least €20 million out of the total dividend would be disbursed before end-April. As a result, we do not anticipate difficulties in meeting the quantitative performance criteria for end-April, and neither in staying within the targeted annual deficit for 2013.

7. In the event that revenues continue to fall behind program targets going forward, we will take compensatory expenditure or revenue measures in the context of the mid-year budget review to safeguard compliance of the end-2013 target for the primary deficit. These measures will amount at least to the cumulative tax revenue shortfall through end-April. We also stand ready to take measures as needed to safeguard an adequate level of government bank balances, in particular for the case that the privatization of the telecommunications company (PTK) does not advance as planned. Moreover, we remain committed to preserving the integrity of the tax system, notably the value-added tax.

B. Highway R6

8. Expanding our network of highways and integrating Kosovo into the regional Trans-European Transport (TEN-T) Networks remains a policy priority. We remain committed, however, to entering in contractual obligations with respect to R6 only after several preconditions have been met (LOI December 5, 2012, ¶10), notably: (i) integration into a sustainable budgetary framework—including a level of the usable government bank balance of at least €300 million—(ii) economic viability, and (iii) transparency and competitiveness of the bidding process.

9. To assess economic viability, an Inter-Ministerial Committee prepared an updated feasibility study and submitted it to World Bank and IMF staff in January. In the World Bank's assessment, the study is of good quality, but reasonable modifications to some assumptions used therein would have the economic return of R6 fall close to or below thresholds for economic viability considered acceptable by the Bank. The study did also not analyze alternative design option, such as replacing a tunnel with overland roads and reducing the number of traffic lanes, as analyzing such changes turned out technically demanding and was not feasible within the time frame. We have modified the economic viability study by including additional cost savings in some identified areas amounting to €13.4 million that will be specified in the bill of quantities. The World Bank has assessed these modifications and confirmed that they bring the project’s expected rate of return above minimum acceptable viability thresholds. Moreover:

a. Standard works contract procurement will be used for the northernmost 40 kilometers. Design-and-build contract procurement will be used for the remaining section from Kaçanik to the Macedonian border. The highway will be tendered as one project.

b. The government will maintain a Project Steering Committee tasked with regularly reviewing and deciding on the independent Procurement/Transaction Advisors’ recommendations. A World Bank representative will attend the Project Steering Committee as an observer.

c. The government will continue to consider other options for including possible design revisions that would reduce the cost of the southern section and ensure the highest possible economic return to public investment. To this end, tendering of the civil works for this section will be initiated only after the Transaction/Procurement Advisor has identified options for packaging the works in ways that increase competition and reduce costs.

C. Rule-Based Fiscal Framework

10. We have prepared amendments to the Law on Public Financial Management and Accountability (LPFMA) to establish a rules-based fiscal framework, in line with the parameters set in our Letter of Intent for the second review of December 5, 2012 (¶11). We submitted the legislation to the assembly on March 29, 2013, in line with the end-March structural benchmark. In preparing the legislation, we have cooperated closely with an IMF technical assistance (TA) mission that visited Pristina in February. The draft submitted to the assembly reflects the understandings reached at the time. Two issues were left open during our discussions with the TA mission, however. We regulate them as follows:

- The rules-based framework includes an escape clause with four specific quantitative triggers that would allow temporarily suspending the deficit ceiling. With respect to shortfalls in fiscal revenues and expenditures related to state guarantees, the legislation allows the escape clause to be triggered if:

  a) for any period of six months within a fiscal year nominal tax revenue collection is equal or below tax revenues collected during the same period in the previous fiscal year, excluding the effects of policy measures and one-off tax revenues;

  b) total expenditures increase by more than 1.5 percent of GDP within a fiscal year as a result of a state guarantee within the meaning of Law No. 03/L-175 on Public Debt having to be paid by the government.

- Expenditures financed from privatization proceeds shall be disregarded for purposes of compliance with the deficit ceiling if (i) the proceeds are used for capital spending, and (ii) the level of the usable government bank balance amounts to at least 4.5 percent of GDP.

D. Other Fiscal Issues

11. *Fiscal decentralization.* Starting in 2014, we will use the new population data from the 2011 census to the formula for the general grant allocation to municipalities. In line with the provisions in the Law on Local Government Finance (LLGF), the year 2014 will still be a transition year, in which no municipality will receive a lower nominal general grant as a result of the 2011 census. The objective is to give the municipalities suffering a revenue loss time to seek alternative own-source revenues. In addition, we have established a working group that will prepare an amendment of the LLGF, oriented on recommendations from a 2012 IMF technical assistance report. In particular, the working group will review the size of the general grant with a view to gradually reducing it, and add a fiscal capacity variable to the grant formula. Draft legislation will be submitted to the government by end-September 2013, with a view to passing the legislation before end-year.

12. *Civil Service Reform.* Preparations for civil service reform are advancing. The reform aims at providing for a more rational form of wage setting in the public sector. However, it seems unlikely that implementation could start by July 1, 2013, as originally envisaged, reflecting in part delays in establishing a new job grading system. As a result, the corresponding budget allocation of €10 million is not likely to be fully executed.

13. *Spending initiatives.* Careful planning, costing and phasing of spending initiatives remains at the core of our efforts to improve public financial management. To this end, the introduction of all laws and regulations or amendments to laws or regulations with fiscal implications will be preceded by a fiscal impact assessment covering a period of at least 5 years (continuous structural benchmark).

a. The revised *Pension Law* (Pillar I) is in preparation for its second reading in the assembly. We will make sure that only provisions that are fully costed are included in the law.

b. As regards possible *benefits for war veterans*, we have completed the application process for the status of "war veteran". The next steps are (i) a thorough verification process in order to eliminate nonqualifying applicants and avoid double-dipping, and (ii) designing and costing of the benefit. We have opened a similar application process for the status of "former political prisoner".

c. As regards *health reform*, the Health Law was approved on Dec 13, 2012. We have started the preparation of a Health Insurance Law, including the preparation of a basic health care package, price lists for services, contracts with hospitals, and the development of an IT system. However, more time is needed to carefully prepare this reform, in close collaboration with the World Bank. We will ensure that the law would not pose incalculable risks to the budget.

14. We have made progress with the implementation of our action plan to improve the recording and monitoring of payment obligations. In particular, we have established a specialized unit within Treasury that monitors payment obligations across budget organizations, and have launched a publicity campaign to explain the definition of payment arrears, the responsibilities of budget organizations when entering into contractual obligations, and the sanctions for noncompliance foreseen in the LPFMA. Going forward, we will by end-May 2013 amend financial rules 02 and 04 of the Treasury to ensure the recording of all payment-related documents (contracts, invoices and reports on receiving the goods or services) within 3 days in our free balance system (structural benchmark). Failure to comply with this deadline will result in an automatic disabling of payments. We will upgrade our IT system to accomplish this. Further, we will, from August, generate arrears reports directly from the IT system, i.e. without relying on reports from individual budget organizations.

E. Financial Sector Policies

15. Higher nonperforming loans (NPLs), slower credit growth and tighter regulatory requirements have put some pressure on banks' soundness indicators. Tighter requirements include in particular the treatment of related party loans in the new banking law, which requires their deduction from regulatory capital and is more stringent than Basel rules.. As a result, the capital adequacy ratio of the system dropped to 14.4 percent as of December 2012 (compared to 17.9 percent under the previous requirements). For banks whose capital adequacy has fallen below the regulatory minimum, we will require capital plans and guarantees to restore capital adequacy as soon as possible, but no later than end-June. Further, we are requiring banks to bring down their related lending and large exposures in line with legal and regulatory limits by end-June, and will monitor progress closely. In this context, we will issue a regulation on enforcement of administrative penalties by end-April.

16. We have taken further measures to strengthen the deposit insurance scheme. In particular, Article 27 of the amended Deposit Insurance Law (DIL) requires the Deposit Insurance Fund (DIFK) to continue collecting premiums once the reserve fund reaches 5 percent of insured deposits. In January, the Management Board of the Deposit Insurance Fund of Kosovo (DIFK) passed a resolution to increase the size of the target reserve fund to a range of 8-9 percent of total insured deposits. Finally, by June, €6.4 million in remaining contributions is expected to be disbursed by the government (including €3 million already paid-in) and another contributor, strengthening the DIFK's capital ahead of the increase in coverage scheduled for January 2014.

17. We have set up a plan to implement key recommendations from the recent Financial Sector Stability Assessment, with a view to further strengthen the resilience of our financial system. The CBK has incorporated the FSAP recommendations relevant to central banking and supervision into its strategic plan. Recommendations requiring inter-institution collaboration are being discussed with the relevant counterparts. Furthermore, the measures in ¶16 are in line with the key short-term recommendations on deposit insurance. Based on this, we have established as key priorities and steps:

a. *Ensuring that costs associated with the legal defense of CBK staff are covered ex-ante.* The CBK has established a working group to draft an instruction providing for the CBK to pay for legal representation when staff is sued for carrying out official duties in good faith. The instruction will be approved by the Executive Board of the CBK by end-May (structural benchmark).

b. *Subjecting Emergency Liquidity Assistance (ELA) granted to potentially insolvent systemically important institutions to very strict conditions.* The CBK, the Ministry of Finance (MoF) and the Assembly Committee on Budget and Finance will review the existing tripartite Memorandum of Understanding (MoU) to clarify roles and responsibilities for liquidity assistance. In particular, the MoU will clarify the CBK's responsibilities for designing appropriate procedures for liquidity assistance for solvent banks, and that the CBK would refrain from granting liquidity assistance in to insolvent banks without an explicit government guarantee.

c. *Instituting a bank premium to fund ELA needs.* The CBK will request technical assistance on the appropriate design of a bank financed liquidity fund, and will also seek the views of the banking industry. The CBK and the MOF will assess the legal and regulatory requirements for establishing such a fund.

d. *Addressing shortcomings in the resolution framework and enhancing the crisis management framework.* The CBK will draft regulations to address technical shortcomings in the bank resolution framework (e.g., clarifying the definitions of purchase and assumption transactions). Further, the CBK will request technical assistance to develop resolution procedures and a contingency plan. As regards extraordinary funding arrangements for deposit insurance, the DIFK will, in cooperation with the Ministry of Finance, review possible options for the size and funding a stand-by credit line. We will get back to this issue at the time of the next review of the SBA.

e. *Introducing risk-based supervision.* We will seek technical assistance in order to update our supervisory manual, to reflect the more risk-based aspects of the new banking law and regulations, including the new capital adequacy requirements as well as consolidated supervision.

f. *Taking initial steps to establish a framework for macroprudential monitoring.* We are developing terms of reference for a macroprudential committee within the CBK that will focus on systemic risk issues, including by reviewing existing laws and regulations to ensure the CBK has sufficient tools to adequately address risks and independently monitor developments that may have systemic risk implications. We will request TA from the IMF to develop a macro model and methodologies for the identification and monitoring of systemic risks.

III. Competitiveness and Structural Reforms

18. We are aiming at establishing a more predictable way to set minimum wage levels (across age categories), with a view to avoiding large discrete changes in minimum wage rates that could negatively affect employability and labor market competitiveness. At present, the Labor Law stipulates that relevant factors for setting minimum wage rates are CPI inflation and labor market conditions. This provision leaves much room for frequent and arbitrary minimum wage changes, and we therefore plan to introduce a regulation that would provide for a more rules-based treatment. To this end, we will draft secondary legislation by end-May (structural benchmark)} with involvement of the Ministries of Labor and Social Welfare, Finance, Economic Development, and Trade and Industry; and in consultation with World Bank and IMF staff. In view of Kosovo's already elevated minimum wage levels, the CPI index—excluding possibly some strongly fluctuating components for imported goods—will be a key yardstick for minimum wage changes. Until enactment of the regulation, we will not modify the current levels of the minimum wage.

19. We have made progress on projects to support SMEs' access to finance as well as to improve their international competitiveness:

a. The first project supports Kosovo's SME Agency (KOSME), and is receiving technical assistance from the Austrian Development Cooperation and the Swiss Development Cooperation, as well as funding from USAID and other donor institutions. In addition to building capacity for KOSME staff, the project focuses on catering for SMEs' business support needs with the help of local experts through a voucher counseling scheme (VCS), as well as for their financing needs through a planned credit guarantee scheme (CGS) with commercial banks.

b. The second project, with a budget of €4 million funded by the European Commission (€3 million) and by the Ministry of Trade and Industry (MTI) (€1 million), provides grants for export-oriented SMEs to improve technology, increase production lines and export capacity, as well as to SMEs producing import substitution goods. We will announce the call for proposals in June.

c. The MTI is also in the early stages of cooperation with the Ministry of Diaspora to promote the channeling of emigrants' remittances into investments in small businesses.

d. We will continue to work on revising maternity leave provisions of the Labor Law to preserve the employability of women, in consultation with the private sector and the World Bank.

Sincerely yours,

/s/

Hashim Thaçi
Prime Minister

/s/	/s/
Ramadan Avdiu	Bedri Hamza
Acting Minister of Finance	Governor, Central Bank of the Republic of Kosovo

Table 1. Kosovo: Program Monitoring

	Program Approval	End-April 2012	End-August 2012	End-December 2012
Performance criteria				
Floor on the bank balance of the general government	…	Met	Met	Met
Floor on the primary fiscal balance of the general government	…	Met	Met	Missed
Ceiling on primary expenditures of the general government	…	Met	Met	Met
Ceiling on the net contracting of nonconcessional debt by the general government	…	Met	Met	Met
Indicative targets				
Ceiling on the stock of domestic payment arrears of the central government	…	Missed	Missed	Missed
Ceiling on the stock of domestic payment arrears of the general government	…	Missed	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	…	…	…
Passage of the 2013 Budget Law by the Assembly, consistent with the objectives of the program.	…	…	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 the 2013 Budget, consistent with the objectives of the program, to the Assembly (by end-October).	…	…	Met	…
Submission of an economic viability study for highway R6 to the World Bank and IMF staff (by end-January, 2013)	…	…	…	Missed 2/
Submission of legislation to the assembly on the Rules-Based Fiscal Framework that is consistent with ¶11 of the Letter of Intent as of Dec 5th, 2012 (by end-March 2013).				Met
Continuous structural benchmarks				
Monthly meetings of the Program Monitoring Committee and transmission of meetings' minutes to the IMF	…	Met	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	Met

1/ Eliminated after the first review following a corresponding amendment of the Law on Public Financial Management and Accountability.
2 /The study was submitted on time, but did not contain all the elements defined in the LOI of December 2012.

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.	Actual	Prog.	Adj. Prog.	Actual	Prog.	Prog.
Performance Criteria 1/									
Floor on the bank balance of the general government 2/	166	180	237	281	205	205	216	160	171
Floor on the primary fiscal balance of the general government 2/, 3/	-21	4	-19	6	-112	-112	-113	-36	-94
Ceiling on primary expenditures of the general government 3/	399	353	911	842	1,494	1,490	1435	448	1005
Ceiling on the net contracting of nonconcessional debt by the general government 3/	150	30	150	49	150	150	73	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	0	3	0	0
Ceiling on the stock of domestic payment arrears of the general government	0	2	0	3	0	0	5	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	37	37	37	37	37	0	0
Budget support loans	0	0	0	0	0	0	0	0	0
Project grants	1	0	3	0	4	0	0	1	2
Project loans	0	0	6	0	7	7	7	1	3
PAK-related spending	…	…	5	4	8	8	6	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
Structural benchmarks	
Approval of the amended financial rules 02 and 04 of the Treasury to ensure the recording of all payment-related documents within 3 days in the IT system.	End-May 2013
Approval by CBK’s Executive Board of an instruction to pay for legal representation of staff when they are sued for carrying out official duties in good faith.	End-May 2013
Drafting of secondary legislation to provide for a more rules-based treatment of setting minimum wage levels (by end-May 2013)	End-May 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

Attachment I. 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 were €159.986 million at December 31, 2011 and €215.587 million at December 31, 2012.

- 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.

Appendix II. Debt Sustainability Analysis

Table A1. Kosovo: External Debt Sustainability Framework, Baseline Scenario, 2009-2032 1/

(In percent of GDP, unless otherwise indicated)

	Actual			Historical 6/	Standard 6/	Est.	Projections								
				Average	Deviation							2012-2017			2018-2032
	2009	2010	2011			2012	2013	2014	2015	2016	2017	Average	2022	2032	Average
External debt (nominal) 1/	**17.6**	**16.6**	**15.0**			**16.0**	**13.2**	**11.9**	**10.7**	**9.1**	**7.7**	**11.4**	**9.4**	**13.5**	**10.7**
o/w public and publicly guaranteed (PPG)	17.6	16.6	15.0			16.0	13.2	11.9	10.7	9.1	7.7		9.4	13.5	
Change in external debt	-3.7	-1.0	-1.6			0.9	-2.8	-1.2	-1.2	-1.6	-1.3		0.6	0.3	
Identified net debt-creating flows	**8.5**	**8.4**	**11.9**			**14.4**	**8.3**	**10.5**	**10.3**	**9.8**	**9.3**		**7.3**	**11.0**	
Non-interest current account deficit	**15.3**	**17.2**	**20.2**	**11.6**	**4.9**	**20.1**	**19.8**	**17.4**	**16.5**	**15.9**	**15.1**	**17.5**	**12.8**	**16.7**	**14.1**
Deficit in balance of goods and services	39.7	40.6	41.1			40.5	38.4	35.6	33.9	32.1	30.6	35.2	27.6	27.0	27.5
Exports	15.5	18.5	20.0			17.6	17.7	18.9	19.9	21.0	21.8		20.3	20.0	
Imports	55.2	59.1	61.1			58.2	56.1	54.5	53.9	53.1	52.4		47.9	47.0	
Net current transfers (negative = inflow)	-22.1	-21.1	-18.1	-22.0	1.9	-17.7	-15.9	-15.6	-14.8	-13.6	-12.9	-15.1	-13.3	-11.0	-12.6
o/w official	-10.3	-8.6	-5.9			-5.6	-3.9	-3.6	-3.1	-2.4	-2.1		-1.7	-0.6	
Other current account flows (negative = net inflow)	-2.3	-2.3	-2.8			-2.7	-2.6	-2.7	-2.6	-2.6	-2.6		-1.5	0.8	
Net FDI (negative = inflow)	**-6.6**	**-7.7**	**-6.9**	**-4.9**	**3.3**	**-5.6**	**-11.3**	**-6.5**	**-5.8**	**-5.7**	**-5.6**	**-6.7**	**-5.6**	**-5.6**	**-5.6**
Endogenous debt dynamics 2/	**-0.2**	**-1.1**	**-1.3**			**-0.1**	**-0.2**	**-0.3**	**-0.4**	**-0.3**	**-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			-0.3	-0.4	-0.5	-0.6	-0.5	-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**			**-13.5**	**-11.1**	**-11.7**	**-11.5**	**-11.5**	**-10.6**	**-11.7**	**-6.7**	**-10.7**	**-8.1**
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/	...	...	15.1			14.7	14.0	13.1	12.1	10.7	9.5		9.4	11.7	
In percent of exports	...	...	75.3			83.3	79.2	69.3	60.7	50.8	43.6		46.6	58.6	
PV of PPG external debt	**...**	**...**	**15.1**			**14.7**	**14.0**	**13.1**	**12.1**	**10.7**	**9.5**		**9.4**	**11.7**	
In percent of exports	**...**	**...**	**75.3**			**83.3**	**79.2**	**69.3**	**60.7**	**50.8**	**43.6**		**46.6**	**58.6**	
In percent of government revenues	**...**	**...**	**54.7**			**55.5**	**50.6**	**47.2**	**43.3**	**37.8**	**33.5**		**33.3**	**41.3**	
Debt service-to-exports ratio (in percent)	**2.5**	**2.5**	**2.2**			**9.1**	**15.6**	**15.8**	**15.4**	**16.3**	**13.2**		**55.3**	**195.1**	
PPG debt service-to-exports ratio (in percent)	**2.5**	**2.5**	**2.2**			**2.6**	**2.8**	**3.2**	**3.2**	**5.1**	**4.1**		**8.0**	**8.0**	
PPG debt service-to-revenue ratio (in percent)	**1.3**	**1.8**	**1.6**			**1.7**	**1.8**	**2.2**	**2.3**	**3.8**	**3.1**		**5.7**	**5.6**	
Total gross financing need (billions of euros)	0.4	0.4	0.6			0.8	0.6	0.8	0.8	0.9	0.8		1.7	8.8	
Non-interest current account deficit that stabilizes debt ratio	19.0	18.2	21.8			19.2	22.6	18.6	17.7	17.5	16.4		12.3	16.5	
Key macroeconomic assumptions															
Real GDP growth (in percent)	2.9	3.9	5.0	4.6	1.3	2.1	2.9	4.3	5.0	5.0	4.6	4.0	4.5	4.5	4.5
GDP deflator in euro terms (change in percent)	-1.3	3.7	4.8	1.1	3.4	2.5	2.4	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	1.4	1.6	1.6	1.6	1.5	1.6	4.7	3.1	4.2
Growth of exports of G&S (euro terms, in percent)	6.4	28.8	19.1	27.1	49.5	-7.9	6.0	13.6	12.9	13.0	10.7	8.0	5.9	6.6	6.0
Growth of imports of G&S (euro terms, in percent)	0.1	15.4	13.7	10.4	7.4	-0.3	1.7	3.5	5.8	5.6	5.3	3.6	5.8	6.6	5.9
Grant element of new public sector borrowing (in percent)	...	...	...	...	...	301.0	52.3	11.5	11.5	11.5	11.5	66.5	11.5	11.5	12.0
Government revenues (excluding grants, in percent of GDP)	29.3	26.4	27.6			26.4	27.8	27.8	27.9	28.2	28.4		28.4	28.4	28.4
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/	...	...	...			0.6	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/	...	...	...			79.3	68.4	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	5.1	5.5	5.8	6.3	6.7		9.2	17.5	
Nominal dollar GDP growth	1.6	7.8	10.0			4.7	5.4	6.5	7.1	7.1	6.7	6.2	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)						0.3	0.1	-0.1	-0.2	-0.7	-0.5	-0.2	0.8	0.9	0.8
PV of PPG external debt (in percent of GDP)	...	...	15.1			14.7	14.0	13.1	12.1	10.7	9.5		9.4	11.7	
PV of PPG external debt (in percent of exports)	...	...	75.3			83.3	79.2	69.3	60.7	50.8	43.6		46.6	58.6	
Debt service of PPG external debt (in percent of exports)	...	...	2.2			2.6	2.8	3.2	3.2	5.1	4.1		8.0	8.0	

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.

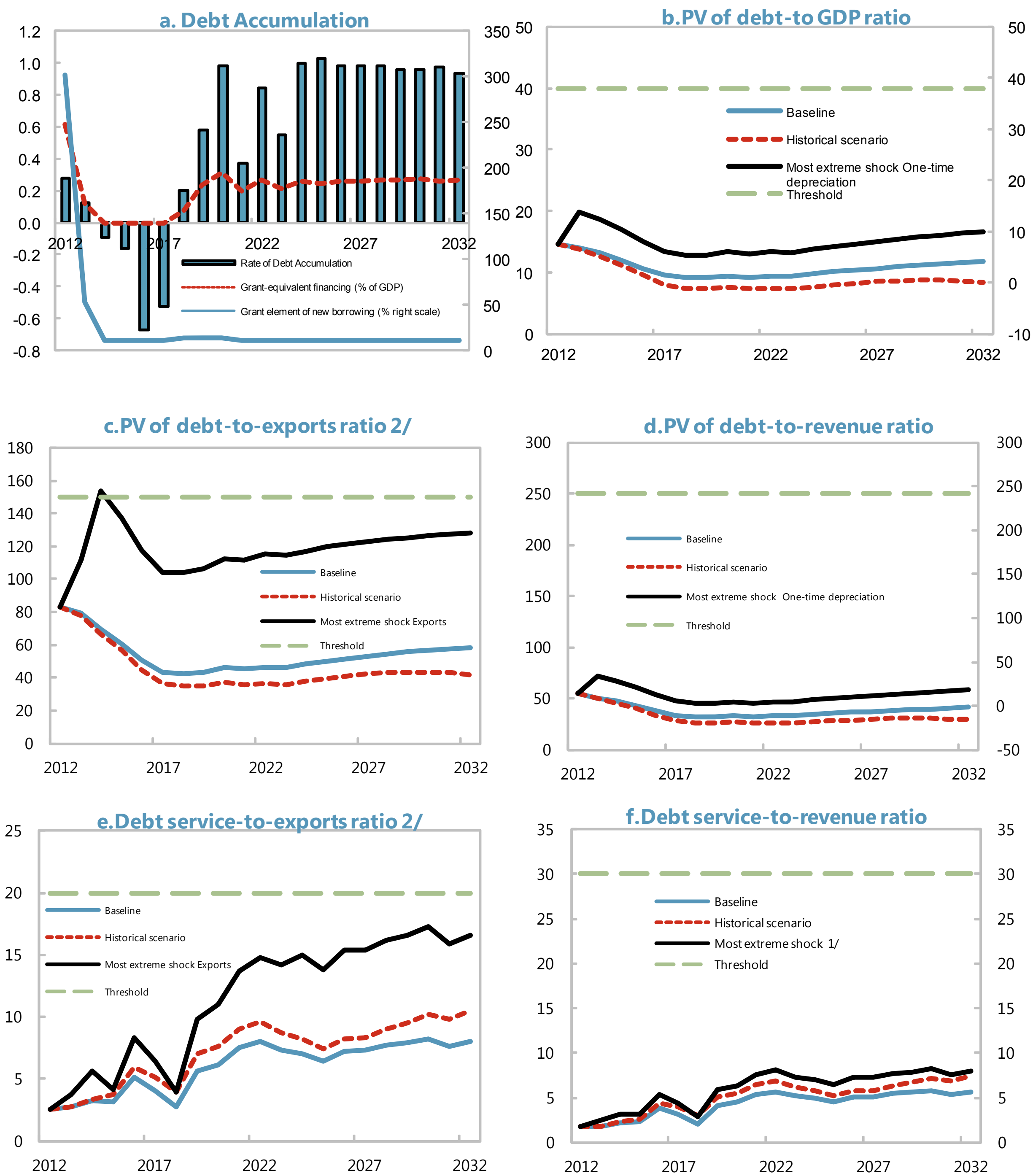
5/ Current-year interest payments divided by previous period debt stock.

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).

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.

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			17.5	16.1	17.1	18.1	18.6	19.3		24.9	32.1	
Change in public sector debt	-3.7	-1.0	-1.6			2.4	-1.3	1.0	1.0	0.5	0.7		1.0	0.5	
Identified debt-creating flows	0.5	1.6	0.3			1.0	-3.8	0.6	0.6	0.6	0.5		0.6	0.1	
Primary deficit	0.7	2.7	1.7	-0.2	3.6	2.4	3.2	1.4	1.5	1.5	1.4	1.9	0.9	0.8	0.9
Revenue, grants, and interest income	29.3	27.3	28.1			27.3	27.8	27.8	27.9	28.2	28.4	27.9	28.4	28.4	28.4
of which: grants	0.0	0.9	0.6			0.9	0.1	0.0	0.0	0.0	0.0		0.0	0.0	
Primary (noninterest) expenditure	29.9	30.0	29.8			29.7	31.0	29.2	29.4	29.7	29.8	29.8	29.3	29.2	29.3
Automatic debt dynamics	-0.2	-1.1	-1.3			-0.5	-0.6	-0.6	-0.7	-0.7	-0.6	-0.6	-0.4	-0.7	-0.5
Contribution from interest rate/growth differential	-0.7	-0.6	-0.8			-0.4	-0.5	-0.6	-0.7	-0.7	-0.6		-0.4	-0.7	
of which: contribution from average real interest rate	-0.1	0.0	0.0			-0.1	0.0	0.0	0.1	0.2	0.2		0.7	0.7	
of which: contribution from real GDP growth	-0.6	-0.7	-0.8			-0.3	-0.5	-0.7	-0.8	-0.9	-0.8		-1.0	-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			-0.9	-6.4	-0.2	-0.2	-0.2	-0.3		0.0	0.0	
Privatization receipts (negative)	0.0	0.0	0.0			-0.9	-6.4	-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			1.5	2.4	0.4	0.4	-0.2	0.2	0.8	0.5	0.5	0.5
Other Sustainability Indicators															
PV of public sector debt	...	...	15.1			16.2	17.0	18.3	19.5	20.2	21.1		24.9	30.3	
PV of contingent liabilities (not included in public sector debt)	...	...	...			...	...	...	...	...	...		...	...	
Gross financing need 2/	1.0	3.1	2.1			2.8	5.2	5.0	5.3	6.3	5.8		8.3	9.2	
PV of public sector debt-to-revenue and grants ratio (in percent)	...	...	54			59	61	66	70	71	74		88	107	
PV of public sector debt-to-revenue ratio (in percent)	...	...	55			61	61	66	70	71	74		88	107	
Debt service-to-revenue and grants ratio (in percent) 4/	1.3	1.7	1.6			1.7	7.2	12.8	13.8	17.2	15.4		25.8	29.8	
Debt service-to-revenue ratio (in percent) 4/	1.3	1.8	1.6			1.7	7.3	12.8	13.8	17.2	15.4		25.8	29.8	
Primary deficit that stabilizes the debt-to-GDP ratio	4.4	3.7	3.3			-0.1	4.5	0.5	0.5	1.0	0.7	1.2	-0.1	0.3	0.0
Key macroeconomic and fiscal assumptions															
Nominal GDP (local currency)	3.9	4.2	4.6			4.9	5.1	5.5	5.8	6.3	6.7		9.2	17.5	
Real GDP growth (in percent)	2.9	3.9	5.0	4.6	1.3	2.1	2.9	4.3	5.0	5.0	4.6	4.0	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	2.0	2.2	2.6	3.0	3.3	2.4	4.9	4.2	4.7
Average nominal interest rate on forex debt (in percent)	0.8	1.2	1.2	0.4	0.6	1.6	1.4	1.6	1.6	1.6	1.5	1.6	4.7	3.1	4.2
Interest on domestic debt (percentage of previous year stock, in percent)	...	...	...	...	...	...	7.4	5.0	5.0	5.0	5.0	5.5	5.0	5.0	5.0
Average real interest rate (in percent)	-0.4	0.3	-0.3	-1.8	1.3	-0.4	-0.1	0.3	0.6	1.0	1.3	0.5	2.8	2.2	2.6
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	2.5	2.4	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	1.7	7.5	-1.7	5.8	6.0	4.9	4.0	4.6	4.4	4.4
Grant element of new external borrowing (in percent)	...	...	...	...	...	301.0	52.3	11.5	11.5	11.5	11.5	66.5	11.5	11.5	12.0

Sources: Country authorities; and staff estimates and projections.

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

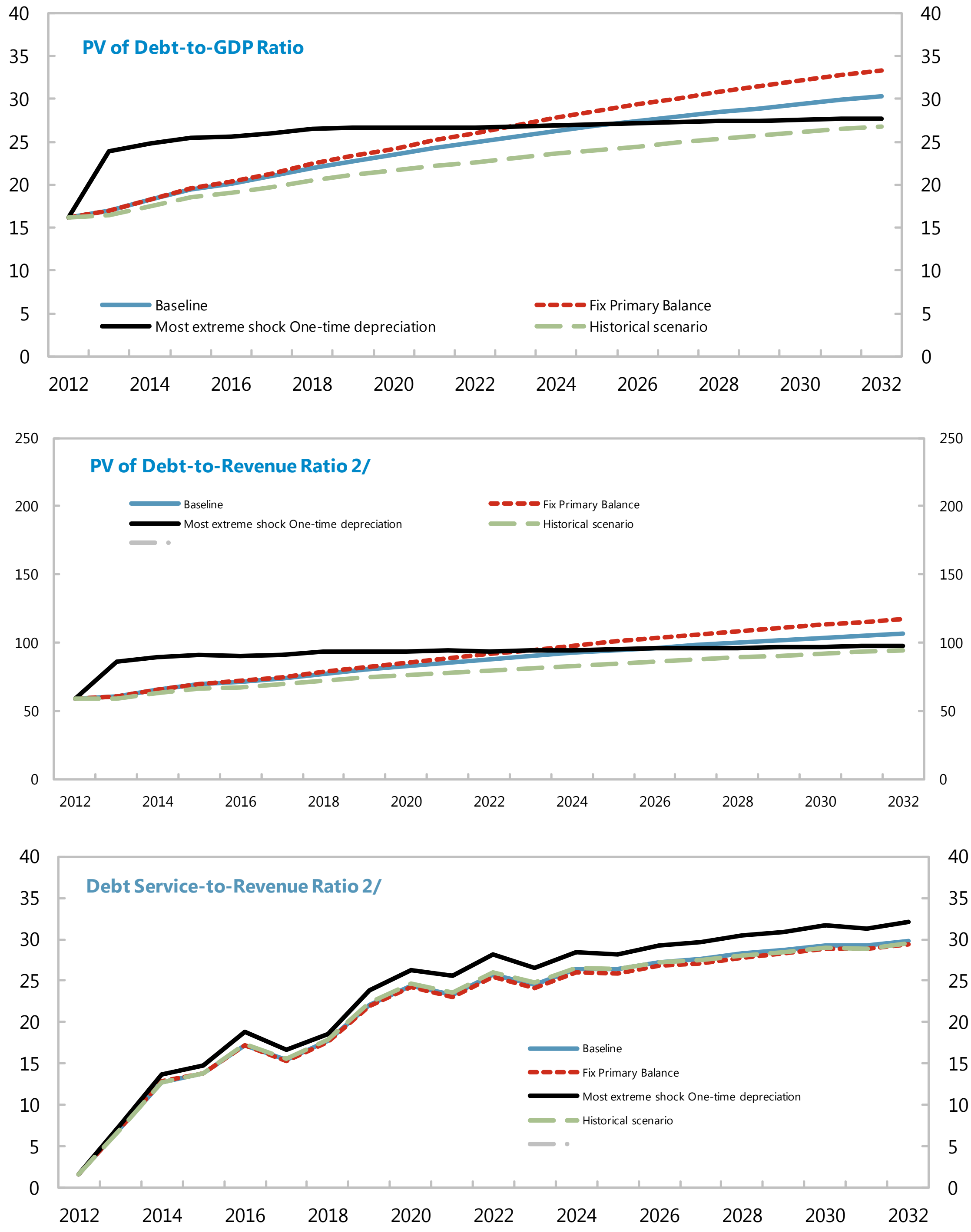
2/ Gross financing need is defined as the primary deficit plus debt service plus the stock of short-term debt at the end of the last period.

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 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.

Press Release No. 13/140
FOR IMMEDIATE RELEASE
April 24, 2013

International Monetary Fund
Washington, D.C. 20431 USA

IMF Executive Board Completes Third Review Under the Stand-By Arrangement with Kosovo; Approves €4.9 Million Disbursement

The Executive Board of the International Monetary Fund (IMF) today completed the third review of the Republic of Kosovo's economic performance under a program supported by a Stand-By Arrangement (SBA). The decision, which was taken on a lapse of time basis[1], enables the authorities to draw an additional amount equivalent to SDR 4.251 million (about €4.9 million), bringing the total resources available to the Republic of Kosovo under the arrangement to SDR 82.467 million (about €95.3 million). The authorities have indicated they will not purchase the amount made available by the completion of this review, in line with their intention to treat the SBA as precautionary in 2013.

All but one end-December 2012 and all continuous performance criteria were met. In completing the review, the Executive Board approved a waiver for the nonobservance of the performance criterion on the primary balance of the general government, which was missed by a small amount (less than €1 million), on the basis the non-observance was minor.

The Executive Board approved a 20-month SBA for the Republic of Kosovo on April 27, 2012 (see Press Release No. 12/154) in an amount equivalent to SDR 90.968 million (about €105.1 million or about US$136.6 million). Total disbursements so far amount to SDR 78.216 million (about €90.4 million).

[1] The Executive Board takes decisions under its lapse-of-time procedure when it is agreed by the Board that a proposal can be considered without convening formal discussions.