INTERNATIONAL MONETARY FUND

IMF Country Report No. 13/224

REPUBLIC OF KOSOVO

FOURTH REVIEW UNDER THE STAND-BY ARRANGEMENT

July 2013

In the context of the Fourth Review Under the Stand-By Arrangment, the following documents have been released and are included in this package:

- **Staff Report** for the Fourth Review Under the Stand By Arrangment, prepared by a staff team of the IMF, following discussions that ended on June 10, 2013, with the officials of Republic of Kosovo on economic developments and policies. Based on information available at the time of these discussions, the staff report was completed on June 28, 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 as expressed during its July 15, 2013 discussion of the staff report that concluded the review.
- **A Statement from the Executive Director for Republic of Kosovo**

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

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

*Also included in Staff Report

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

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June 28, 2013

EXECUTIVE SUMMARY

Stand-By Arrangement. A 20-month SBA in an amount of SDR 90.968 million (154.2 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 completion 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 completion of the second review on December 21, 2012 (Country Report 12/345). The fourth purchase of SDR 4.251 million was made available upon Board completion of the third review on April 24, 2013 (Country Report 13/113), but has not been drawn.

Program status. All end-April 2013 quantitative performance criteria were met, as a shortfall in revenue collection was overcompensated by under-execution of spending. All continuous performance criteria and most applicable structural benchmarks were also met. Missed by small margins were the indicative targets on the non-accumulation 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 Dhaneshwar Ghura

Discussions were held in Pristina, May 28-June 10. The mission met with Prime Minister Hashim Thaçi, Minister of Finance Besim Beqaj, Central Bank Governor Bedri Hamza, other ministers, senior officials, parliamentarians, private sector representatives, and envoys representing the international community.

The staff team comprised Mr. Wiegand (head), Mdms. Budina and Madrid (all EUR) and Fayad (SPR), and Mr. Crivelli (FAD). Messrs. Sulemane (Resident Representative) and Thaçi (Economist in the Resident Representative's Office) assisted the mission. Ms. Le and Mr. Scott (both EUR) assisted with the preparation of the document.

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APPENDICES

INTRODUCTION AND SUMMARY

1. **Macroeconomic and financial policies have remained broadly on-track** (Letter of Intent, Tables 1, 2).

- All ***quantitative performance criteria*** for end-April and all continuous performance criteria under the Stand-By Arrangement (SBA) were met with comfortable margins, as a shortfall in revenue collection was overcompensated by under-execution of spending, notably on the capital budget. Shortfalls materialized especially at customs.

Selected Performance Criteria, end-April 2013

(In millions of Euros; cum. from beginning of the year)

	Target	Outturn
Floor on the government bank balance	160	232
Floor on the primary fiscal balance	-37	9
Ceiling on primary expenditures	448	388
Ceiling on the net contracting of nonconcessional debt	150	20

Sources: Kosovo authorities; and IMF staff estimates

- A ***prior action*** on issuance of a government decision to reduce expenditure allocations by €11 million—aimed at compensating for part of the early-year revenue shortfall—was met (¶7). Not fully met was a prior action on submission of the mid-year budget review to the assembly, as the review included an expenditure allocation not foreseen under the prior action. Corrective action is being taken to safeguard compliance of the mid-year review with program objectives (¶8).

- All end-May ***structural benchmarks*** were met: the treasury department amended internal financial rules to enforce the timely recording of payments-related documents in the IT system; the ministries of finance, labor, economic development and trade prepared draft secondary legislation on a rules-based framework for setting minimum wage levels; and the Central Bank of Kosovo (CBK) issued an instruction to indemnify staff ex-ante in case they are sued for carrying out their official duties. Missed was the continuous structural benchmark on fiscal impact assessments, relating again to the additional expenditure allocation in the mid-year budget review.

- Missed by small margins were the ***indicative targets*** on the non-accumulation of domestic payments arrears, but corrective action is being taken (¶13).

2. **Good progress continues to be made toward achieving the program's key objectives** (Box 1).

- ***Fiscal adjustment.*** The fiscal stance inscribed into the 2013 budget is sustainable. Measures are being taken to compensate for the customs revenue shortfall early in the year.

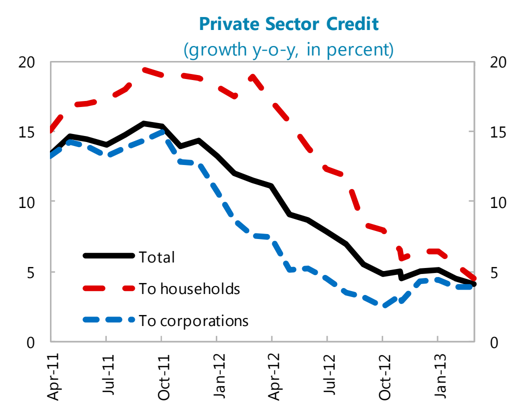
- A **rules-based fiscal framework,** designed in close cooperation with IMF staff, is expected to be enacted by the assembly in early July. It would anchor fiscal policy from 2014 (¶10).

- ***Cash buffers.*** An auction for the telecommunications company PTK was successfully completed in late April, with a net purchase price of €242 million.[1] The authorities expect that the transaction would be settled by late September or early October, although the legal framework allows completion as late as December. With the transfer of the PTK sales receipts to the treasury, adequacy of the government bank balance would be restored.

- ***Financial stability.*** Progress is being made with implementing key recommendations from the 2012 Financial Sector Assessment Program (FSAP, ¶15). Besides the issuance of the instruction to protect CBK staff, the CBK, Ministry of Finance, and Parliamentary Committee for Budget and Finance amended a tri-partite Memorandum of Understanding (MOU) to ensure that emergency liquidity assistance (ELA) would be granted to potentially insolvent banks only with an explicit government guarantee. Work is in preparation to finance future increases of the CBK's special reserves fund for ELA with a bank premium.

RECENT DEVELOPMENTS, OUTLOOK, AND RISKS

3. **The economy strengthened in the first quarter of 2013, following a weak final quarter of 2012, but appears to have hit another rough patch in April and May** (Figure 1). While there are few reliable high-frequency activity indicators, credit growth to businesses, tax collection, and imports all point to better growth in Q1 but a slowdown from April.[2] Headline inflation decelerated to 2.2 at end-May (y-o-y), owing to lower imported food and energy prices. Core inflation remained contained at slightly above 2 percent.



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

4. **Banking sector soundness indicators have remained largely unchanged** (Figure 2). Non-performing loans stood at 7.7 percent at end-April, compared to 7.8 percent at end-January, while banks' cumulative 12-monthly return on assets remained solid at 1.0 percent at end-April (y-o-y). The aggregate capital adequacy ratio (CAR) for the banking system remained close to 15 percent—significantly above the regulatory minimum of 12 percent—although financial strength varies between banks.

5. **Staff has marked down real GDP growth in 2013 to around 2½ percent, from close to 3 percent at the time of the 3rd review.** The revision reflects both weaker incoming data and a similar downward revision for Germany, one of the principal host countries of the Diaspora. The key downside risk to the short-term outlook is that the recent weakening in activity would turn into a

[1] The gross price is €277 million, but PTK will be sold with a net cash balance of at least €35 million.

[2] The national statistical office has published revisions to GDP for 2007-11 that, however, do not alter the growth pattern significantly (Box 2).

prolonged trend, driven by less favorable conditions in the Diaspora host countries, and, correspondingly, more muted remittances and FDI inflows (see also Boxes 2 and 3 of the 2013 Article IV report).

POLICY DISCUSSIONS

A. Fiscal Policy

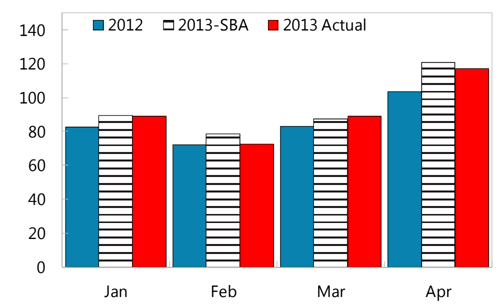
Fiscal Policy in 2013

6. **Budget implementation in the early months of 2013 was broadly in line with the program** (Table 1, Figure 3).

- The cumulative **primary balance** at end-April exceeded the program floor by €45 million (about 0.8 percent of GDP), as a shortfall in revenue collection of €14 million was overcompensated by under-execution of spending, notably on capital projects.

- The **revenue shortfall** owed to a mix of lower-than-programmed customs receipts (€10 million), and delays in receiving transfers from the sales of telecommunication licenses (€20 million) and lignite royalties (€7 million). The shortfall was only partially compensated by higher domestic tax collection (€7 million) and the earlier-than-expected receipt in dividends from PTK (€15 million). Preliminary data indicate that the customs revenue shortfall intensified in May and early June, arguably reflecting a mix of lower import quantities and a decline in import prices, notably for food.

Monthly Revenues 1/
(millions of euros)



Source: Country authorities; and IMF staff calculations.
1/ Revenues excluding grants and dividends.

- The government **bank balance** exceeded the end-April target by €72 million, reflecting primarily over-performance on the primary balance.

- As for **budgetary financing,** in April the government issued—a first in Kosovo's history—one-year treasury bills, raising €20 million (net) at an annual yield of 2¼ percent. Total new issuance of T-bills was €40 million (net) through end-May, half of total planned issuance for the year.

7. **The authorities and staff agreed on measures to compensate for the early-year revenue shortfall,** in an amount totaling €24 million (0.5 percent of GDP), split roughly equally between securing additional dividends from publicly-owned companies (€13 million) and spending cuts (€11 million; LOI ¶8; prior action). There was agreement that with these measures taken, both the end-August program targets and the end-2013 targets inscribed in the budget remain feasible and appropriate. However, an effort will be needed to achieve revenue collection targets in the

second half of the year. The government indicated it would take measures as needed should further revenue shortfalls materialize.

8. **The mid-year budget review (MYBR)—scheduled to be passed by the Assembly in the second half of July—will accommodate modest shifts across spending categories but contain no further changes to the spending envelope**.

- The draft MYBR submitted by the government to the assembly in mid-June re-allocates €3.7 million (0.4 percent of GDP) from capital to current spending, related mostly to projects co-funded by World Bank project loans.

- The draft MYBR also contains re-allocations within expenditure categories, including €2 million from energy subsidies to an unspecified benefit for erstwhile political prisoners. This reallocation was originally not foreseen, and is inconsistent both with a corresponding prior action (LOI ¶9a-c) and the continuous structural benchmark on conducting fiscal impact assessments prior to the introduction of laws with fiscal implications (LOI ¶13) that aims at avoiding unfunded spending obligations. To preserve consistency of the MYBR with program objectives, the government proposed that the assembly committee for budget and finance would amend the MYBR by a clause rendering execution of that allocation contingent on a fiscal impact assessment. Further, the authorities commit to executing the allocation only after the fiscal impact assessment has been reviewed by IMF staff (LOI ¶9).

9. **Preparations for highway R6 to Macedonia are advancing as planned** (LOI ¶11). The authorities reaffirmed their commitments to safeguarding the project's economic viability and integrating it into a sustainable budgetary framework. In particular, the government's usable bank balance would amount to at least €300 million before the government would engage into contractual commitments with respect to R6. In practice, this level will be reached with the completion of PTK privatization.

Fiscal Policy in 2014 and Beyond

10. **The assembly is scheduled to vote in early July on amendments to the Law on Public Financial Management and Accountability (LPFMA) that establish a rules-based fiscal framework** (Box 3, LOI, ¶10). The framework reflects extensive consultations between the authorities and IMF staff, stretching over almost a year. The rule's key component is a deficit ceiling of 2 percent of GDP that can be exceeded, however, if (i) the government has additional financing from privatization, (ii) the excess resources finance capital spending, and (iii) the government's bank balance exceeds a minimum threshold (4½ percent of GDP). These parameters ensure that, under cautious assumptions, the net present value of public debt would remain at or below 30 percent of GDP in the long term.

11. **The authorities and staff reached understandings on the broad parameters of the 2014 budget** (LOI ¶12). While the budget will be guided by the rules-based fiscal framework, there was agreement that additional constraints are appropriate. In particular:

- Only one-half of the ***excess government's balance***—that would result from the privatization of PTK—relative to the minimum set by the fiscal rule will be drawn down in 2014. The remaining excess balance will be kept as a reserve for the years beyond 2014, given that highway R6 is expected to be a significant budgetary burden for several years, and in view of upcoming IMF repurchase obligations.

  While agreeing with the principle, the authorities noted that that preserving a substantial extra government cash buffer would be difficult in case structural revenue shortfalls were to emerge in the second half of 2013 that would translate into lower-than-currently-expected revenue forecasts for 2014. Staff argued that taking additional revenue measures or scaling back spending ambitions would be more appropriate in this case than exhausting precautionary cash buffers.

- Staff and the authorities also agreed on a ***ceiling on current spending***—to ensure that the resources from PTK privatization will indeed fund capital expenditures, notably highway R6—and on a ***limit for domestic debt issuance***.

Submission of a budget to the Assembly consistent with the agreed parameters is a structural benchmark for end-October. On current projections about the financing envelope—that at this stage are highly uncertain—the parameters imply an overall deficit of around 3 percent of GDP for 2014. The authorities and staff will seek to work out a detailed 2014 budget during the discussions for the fifth review under the SBA in the fall.

12. **There was concurrence that several social spending initiatives require more preparation before a corresponding budget allocation could be made** (LOI ¶13). These include in particular: (i) the introduction of benefits for war veterans, for which a fiscal impact assessment is expected to be finalized in early 2014, (ii) the introduction of general health insurance—an area where the Ministry of Health is cooperating closely with the World Bank, (iii) modifications to the eligibility criteria for the supplementary pension, and (iv) the introduction of new war-related categories.

13. **Further steps are being taken as regards the recording and monitoring of payment obligations, with a view to avoiding the accumulation of domestic payment arrears** (LOI ¶14). Following the amendment of internal treasury rules to enforce the timely recording of payments-related documents, the next steps include (i) a publicity campaign to inform all stakeholders about these changes and their implications; (ii) upgrades to the IT system, and (iii) the monitoring of payment obligations by the Treasury, and the application of the sanction mechanisms to ensure compliance.

B. Financial Sector Policies

14. **Progress is being made in bringing all banks in compliance with prudential rules that were tightened with the application of the new Banking Law from December 2012** (LOI ¶16, 17). Banks are on-track to bring exposures to related parties to within the new legal limit. For a

couple of small banks whose CAR had fallen below the regulatory minimum of 12 percent—reflecting the tighter capitalization rules of the Banking Law—recapitalization plans are on-track, with full capital adequacy expected to be restored by end-June. The Central Bank of Kosovo (CBK) will conduct on-site inspections thereafter to verify compliance. Since May, changes to credit risk management regulation allow banks to reschedule delinquent interest to better align past-due loans with the payment capacity of borrowers. The CBK will conduct targeted on-site examinations of rescheduled loans. It plans to also verify the adequate provisioning of assets other than loans.

15. **Several important steps have been taken to implement key recommendations from the FSAP mission of September 2012** (LOI ¶18). Besides issuing the by-law to protect central bank staff from legal costs, the central bank has—jointly with the Ministry of Finance and the Parliamentary Committee on the Budget and Finance—amended the tri-partite Memorandum of Understanding on Financial Stability Cooperation to shield the CBK from solvency risk when providing emergency liquidity assistance (ELA). The CBK has also solicited the views of banks on a bank-financed premium for ELA, and has requested TA from the IMF to strengthen the crisis management framework, move to more risk-based supervision, and develop a macro-prudential policy framework. In this context, the CBK has drafted the terms of reference for a macro-prudential policy advisory committee.

16. **Looking ahead, the authorities and staff agreed on the next steps in implementing the FSAP recommendations and strengthening the institutional framework** (LOI ¶¶19, 20). These include (i) organizing a back-up facility for the deposit insurance fund, (ii) reviewing the bank liquidity risk framework, (iii) proposing a target size for the central bank's special reserves fund for ELA, and (iv) taking further steps to strengthen the judicial system's ability to deal with banking issues, to support the timely and effective resolution of problem loans. Further progress in many of these areas is expected upon the delivery of IMF technical assistance that is scheduled to begin in the second half of 2013.

C. Competitiveness and Private Sector Development

17. **A rules-based framework for setting minimum wage levels is about to be implemented** (Box 4, LOI ¶21). An inter-ministerial committee prepared a draft instruction in May, in line with the corresponding structural benchmark. The key element is a provision tying minimum wage increases to the development of core inflation and average wages. Following minor revisions done in consultation with World Bank and IMF staff, the instruction has been finalized, and is expected to be issued by end-August (structural benchmark). The instruction is expected to be applied retroactively from 2012 (there has been no minimum wage change since 2011). Progress is also being made with schemes to support small- and medium-sized enterprises, in cooperation with foreign donors (LOI ¶22).

PROGRAM MODALITIES

18. **The attached Letter of Intent describes the authorities' progress in implementing their economic program, and sets out performance criteria and structural conditionality through the end of the program, i.e. December 26, 2013** (Box 1, Tables 2-4, LOI ¶¶8, 9, 12, 21, LOI Tables 1-3). The following modifications to program conditionality are proposed:

- Two ***prior actions*** for completion of this review would be introduced on: (i) issuance of a government decision that specifies spending cuts of €11 million across spending categories relative to the approved 2013 budget, and (ii) submission of the 2013 mid-year budget review to the assembly consistent with ¶9 of the Letter of Intent.

- Two new ***structural benchmarks*** would be introduced on: (i) issuance of an administrative instruction to provide for a rules-based setting of minimum wage levels consistent with ¶21 of the Letter of Intent by end-August, and (ii) submission of a 2014 budget to the Assembly consistent with the parameters specified in ¶12 of the Letter of Intent by end-October.

19. **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

20. **Macroeconomic and financial policies have remained broadly on-track.** All continuous and quantitative performance criteria for end-April and most applicable structural benchmarks have been met. The end-August program targets and the end-year parameters inscribed into the 2013 budget remain appropriate, provided an effort is made to achieve the revised targets for tax and non-tax revenues, and the government maintains expenditure discipline. In case of further adverse revenue developments, the government should stand ready to take corrective actions as needed. Settlement of the PTK transaction would bring the government's bank balance to a fully adequate level.

21. **Passage of the rules-based fiscal framework, envisaged for July, would be a key step toward ensuring fiscal sustainability in the longer term.** Anchoring fiscal policy is especially important in the context of Kosovo's unilaterally euroized economy, and against the backdrop of an unsettled political environment with still fragile institutions. The agreed parameters for the 2014 budget—notably maintenance of a sizeable excess government bank balance relative to the minimum specified by the fiscal rule—preserve fiscal space also for the years beyond 2014, when resources will be needed for completing highway R6. The extra cash buffer also provides a reserve to service upcoming IMF repurchase obligations.

22. **It is critical that the government sticks to the agreed process for preparing highway R6 to Macedonia,** to limit fiscal risks and ensure viability of the project. In particular, in case the PTK privatization receipts are transferred later than currently anticipated, the government should delay

entering into contractual obligations with respect to R6 accordingly, even if this would mean the allocation for R6 in the 2013 budget would not be fully executed.

23. **Careful preparation of social spending initiatives and avoiding unfunded spending obligations remains crucial for ensuring sound public finances.** Budgetary allocations should be made only once the fiscal implications are fully understood. Avoiding the introduction of spending initiatives without prior costing is a common responsibility of all stakeholders.

24. **Good progress is being made toward strengthening financial stability.** Following the tightening of prudential rules in line with the new Banking Law, the CBK has ordered two banks to restore capital adequacy by end-June, and banks' plans are on-track. The amended MOU on emergency liquidity assistance protects the integrity of the central bank's balance sheet—and therefore its financial independence—in case of solvency risks. Steps forward are being made with implementing other key FSAP recommendations, although progress with several initiatives requires first the delivery of technical assistance.

25. **The draft secondary legislation on specifying rules for setting minimum wage levels is a commendable step toward safeguarding employment and labor market competitiveness.** If implemented as foreseen, this will enhance the chances for success of ongoing efforts to improve the business climate, promote private sector development through SME development, and enhance pubic infrastructure.

26. **The main risk to the program continues to stem from fragile political environment and corresponding risk of populist policies.** Local elections are scheduled for late 2013, and national elections for 2014. While policy implementation has been impressive in the past two years, Kosovo's experience with the first SBA of July 2010 shows that political setbacks can put the hard-won macro stability at risk and can be very costly. In the run-up to the elections, persistent willingness to sustain prudent macroeconomic management and take corrective action as needed will be required to preserve the progress made.

27. **The policies under the program provide the best safeguard to steer Kosovo's economy through the period ahead,** foster confidence in macroeconomic management, and lay the foundations for robust and balanced growth. Staff supports the authorities' request for completion of the fourth review.

Box 1. Stand-By Arrangement

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

Program Modalities:

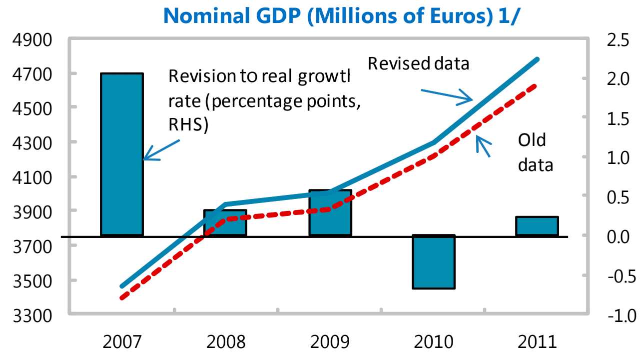
- ***Access:*** SDR 90.968 million (154.2 percent of quota)
- ***Length:*** 20 months (through December 26, 2013)
- ***Phasing:*** SDR 4.251 million was made available after Board approval on April 27, 2012, SDR 39.108 after completion of the first review on July 16, 2012, and SDR 34.857 million after the completion of the second review on December 20, 2012. SDR 4.251 million was made available after completion of the third review on April 24, 2013, but the authorities did not purchase the amount, in line with their intent to treat the SBA as precautionary in 2013.Another SDR 4.251 million would be made available after completion of this fourth review.

Conditionality:

- ***Prior actions***
  - ➢ Issuance of a government decision specifying spending cuts of €11 million across spending categories relative to the approved 2013 budget
  - ➢ Submission of the 2013 Mid-Year Budget Review to the Assembly consistent with ¶9a-c of the Letter of Intent
- ***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***
  - ➢ Issuance of an administrative instruction to provide for a rules-based setting of minimum wage levels consistent with ¶21 of the Letter of Intent (*by end-August 2013*).
  - ➢ Submission of a 2014 budget to the assembly consistent with the parameters specified in ¶12 of the Letter of Intent (*by end-October 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*.

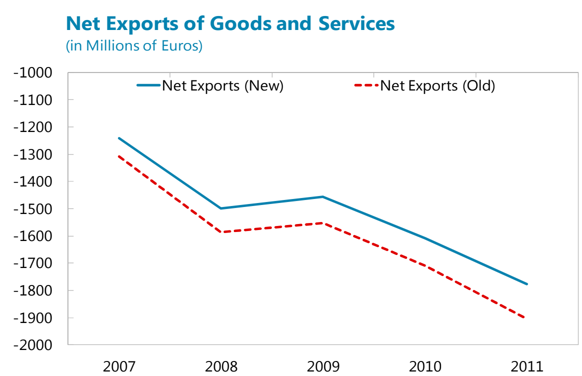
Box 2. The Revision of Kosovo's National Accounts for 2007–11

Kosovo's Agency of Statistics has released revised national accounts data for the period 2007 to 2011.[1/] The revision, produced with the support of IMF technical assistance, incorporates revised balance of payments data by the Central Bank of Kosovo and a revision in gross fixed capital formation for 2010.



Sources: Kosovo Agency of Statistics; and IMF staff

The BOP revisions result in an increase in net exports of between €67 and €125 million 2007-2011. About half of this increase is due to an upward revision of export of services, while the remainder is a result of a downward revision in imports of goods and services, reflecting better data on imported goods transported by Kosovo residents and information from banks on non-residents visiting Kosovo.



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

These changes, along with upward revisions to remittances and donation transfers, lower the current account deficit. Revisions to FDI data, trade credit, and a new methodology for estimating currency in circulation reduce the financial account surplus and net errors and omissions in the BOP. The increase in net exports raises nominal GDP by between 2 and 3 percent.

The new data also suggest slightly different growth dynamics: the real growth rate is revised up for 2007-09, and down for 2010 and 2011. Average growth over the period 2007-2011 increases by 0.3 percentage points, from 5.0 percent to 5.3 percent per year.

1/ See Kosovo Agency of Statistics (2012), Gross Domestic Product by expenditure approach (2004-2011), Series 3: Economic Statistics, Pristina, Kosovo.

Box 3. 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 is consistent with keeping gross public debt at or below 30 percent of GDP. It leaves a buffer of 10 percent of GDP relative to 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 and an automatic correction mechanism***. 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 4. A Framework for Setting Minimum Wage Levels

A legally binding minimum wage was instituted in 2011, with a floor of €170 per month for workers of 35 years or older, and of €130 for younger workers. These levels are comparable to Kosovo's peers in nominal terms, but appear elevated when measured in percent of per capita GDP (a measure for productivity), or of average wages. The provision in the Labor Law on setting minimum levels is fairly vague, leaving room for calls for large and arbitrary increases in minimum wage levels. If implemented, such increases could affect negatively labor market opportunities especially for low-skilled and younger workers, and provoke a further shift from the formal to the informal sector (for details see Box 4, IMF Country Report No. 13/113).

To address these challenges, an inter-ministerial committee consisting of the Ministries of Finance, Labor, Trade, and Economic Development has drafted an administrative instruction to complement the Labor Law that is scheduled to be issued by end-August (structural benchmark). The instruction lays out the conditions under which a change in minimum wage levels is deemed necessary, and links the resulting adjustment to a measure of core inflation and productivity changes. Specifically, for each annual (end-December) review of monthly minimum wage levels:

a. A change will be made if (i) CPI inflation (12-months average, October-over-October) exceeds two percent, and (ii) the appreciation of the real effective exchange rate does not exceed 0.5 percent (12-months average, October-over-October).

b. In case minimum wage levels are being changed, the percentage change will be an average of (i) the percentage change in the CPI index excluding volatile components for transport fuel and food prices, and (ii) the percentage change in average private sector wages.

c. The percentage change will be applied to the average of the minimum levels for the two age categories.

The rule will be applied retroactively to 2012 and 2013, as minimum wage levels have not been reviewed since introduced in 2011. Furthermore, to ensure that the rule remains up-to-date, the minimum wage formula can be reviewed every three years based on an analysis of labor market conditions and discussions with relevant bodies.

Table 1. Kosovo: Consolidated Government Budget, 2011–14 1/

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

	2011	2012	2013					2014
			Apr.		Aug.		Dec.	
			Prog.	Actual	Prog.	Rev. Proj.	Proj.	Proj.
Total primary revenue and grants	1,303	1,322	412	398	911	881	1,412	1,448
Total primary revenue	1,277	1,284	412	398	909	879	1,409	1,448
Taxes	1,072	1,112	321	322	744	734	1,180	1,264
Direct taxes	151	170	61	69	107	107	184	196
Indirect taxes	949	975	271	265	656	646	1,031	1,104
Tax refunds	-28	-33	-11	-12	-19	-19	-35	-37
Nontax revenues	205	172	91	76	166	146	229	184
Of which:								
Dividends	60	45	15	30	30	30	43	0
Grants	26	37	1	0	2	2	3	0
Budget support	19	37	0	0	0	0	0	0
Project grants	3	0	1	0	2	2	3	0
Primary expenditure	1,382	1,441	450	390	1,010	980	1,575	1,604
Of which:								
PAK-related expenditures		6	2	1	5	5	8	9
Primary expenditure excluding PAK	...	1,435	448	388	1,005	975	1,567	1,595
Current expenditure	832	888	265	276	598	598	983	1,035
Wages and salaries	385	408	110	104	256	256	439	462
Goods and services	177	191	58	62	132	132	227	237
Subsidies and transfers	270	289	98	110	208	208	314	332
Pension and social assistance	178	198	74	75	153	153	236	253
Other transfers and subsidies 2/	92	91	23	35	55	55	78	80
Reserve	0	0	0	0	2	2	3	5
Capital expenditure and net lending	550	553	185	114	412	382	592	569
Capital expenditure	520	541	187	116	416	386	598	575
Highways	259	281	94	63	189	189	271	270
R7	...	239	...	44	...	...	215	0
R6	...	0	...	0	...	...	28	240
Expropriation	...	42	...	19	...	...	28	30
Other capital spending	261	260	93	53	228	198	327	305
Net lending	30	12	-2	-2	-4	-4	-6	-6
Primary balance	-79	-119	-38	8	-99	-99	-163	-156
Primary balance net of PAK		-113	-36	9	-94	-94	-155	-147
Interest income, net	-7	-10	-7	-5	-10	-10	-18	-14
Overall balance	-86	-129	-45	2	-109	-109	-181	-170
Financing	86	129	45	-2	109	109	181	170
Foreign financing	2	83	-4	-4	-1	-1	-5	-22
Drawings, incl. official financing	8	94	2	2	4	4	9	0
Amortization	-12	-11	-6	-6	-6	-6	-14	-22
Domestic financing	85	46	49	2	110	110	186	192
Domestic borrowing (net)	0	73	20	20	60	60	80	117
Privatization revenues	0	45	0	0	26	26	303	0
Other financial assets, net	0	0	-1	0	-2	-2	-3	0
Own-source revenue (– = increase)	0	-15	-38	-2	-30	-30	3	3
o/w PAK related			...	...	...	...	8	9
Bank balance (prog.; – = increase)	84	-56	67	-16	56	56	-197	73
Financing gap	0	0	0	0	0	0	0	0
Memorandum items:								
Bank balance of the general government	160	216	160	232	171	171	413	341
Of which: ELA	0	0	0	0	0	0	46	46
Minimum bank balance (fiscal rule)	...	...	...		...	...	...	251
Recommended bank balance (SBA)	271	297	...	...	...	...	351	383

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 2a. Kosovo: Gross Financing Requirements, 2011–13

(Millions of euros)

	2011	2012	2013
Gross Financing Requirements	671	391	567
Current account deficit	659	380	553
Amortization of medium and long term public debt	11	11	14
Sources of Financing	671	391	567
Capital account (net)	42	13	2
Foreign direct investment (net)	379	213	542
Net bank financing	7	102	-98
Government loans	5	94	9
Net Foreign assets of the Central Bank of Kosovo	15	-237	-44
Other financing inc. net erros and omissions	223	206	156
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)	69	69	69

Sources: IMF staff estimates and projections.

Table 2b. Kosovo: Gross Financing Requirements, 2011–13

(Percent of GDP)

	2011	2012	2013
Gross Financing Requirements	14.0	7.8	10.8
Current account deficit	13.8	7.6	10.5
Amortization of medium and long term public debt	0.2	0.2	0.3
Sources of Financing	14.0	7.8	10.8
Capital account (net)	0.9	0.3	0.0
Foreign direct investment (net)	7.9	4.3	10.3
Net bank financing	0.1	2.0	-1.9
Government loans	0.1	1.9	0.2
Net Foreign assets of the Central Bank of Kosovo	0.3	-4.7	-0.8
Other financing inc. net erros and omissions	4.7	4.1	3.0
Financing need	...	0.0	0.0
IMF	...	0.0	0.0

Sources: 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 3. Kosovo: Indicators of Capacity to Repay the Fund, 2013–18

	2013	2014	2015	2016	2017	2018
Fund obligations based on existing and prospective purchases (millions of SDR) 1/						
Principal	2.4	9.4	13.0	41.2	39.5	4.3
Charges and interest	1.1	1.1	1.0	0.8	0.3	0.0
Total obligations based on existing and prospective purchases						
SDR millions	3.4	10.5	14.0	42.0	39.8	4.3
Euro millions	4.0	12.2	16.4	49.3	47.1	5.1
Percent of exports of goods and services	0.4	1.1	1.3	3.5	3.0	0.3
Percent of debt service	14.2	35.9	43.2	70.0	69.6	12.7
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	2.9	2.6	0.3
Percent of quota	5.8	17.8	23.7	71.2	67.5	7.3
Outstanding Fund credit						
SDR millions	107.4	98.0	85.0	43.8	4.3	0.0
Euro millions	124.5	114.1	99.4	51.4	5.0	0.0
Percent of exports of goods and services	12.7	10.3	7.9	3.6	0.3	0.0
Percent of debt service	444.8	335.1	262.7	73.0	7.4	0.0
Percent of GDP	2.4	2.0	1.7	0.8	0.1	0.0
Percent of government revenue	8.8	7.8	6.3	3.0	0.3	0.0
Percent of quota	182.0	166.1	144.1	74.2	7.2	0.0
Net use of Fund credit (millions of SDR)	10.4	-9.4	-13.0	-41.2	-39.5	-4.3
Purchases	12.8	0.0	0.0	0.0	0.0	0.0
Repurchases	2.4	9.4	13.0	41.2	39.5	4.3

Sources: IMF staff estimates and projections.
1/ Assumes full drawings under the SBA.

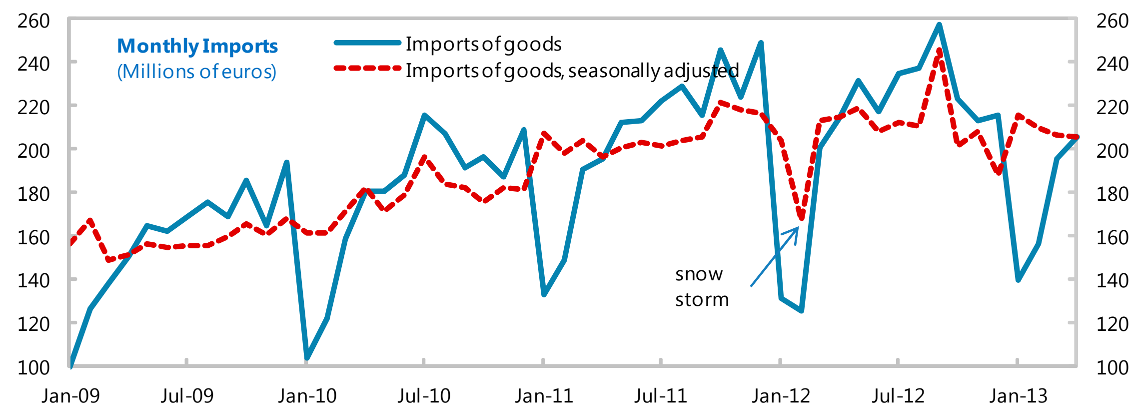
Table 4. Kosovo: Schedule of Purchases Under the Stand-By Arrangement, 2012–13

Amount	Percent of Quota	Date Available	Conditions Necessary for Purchase
SDR 4.251 million	7	April 27, 2012	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	Purchase not made (authorities treating arrangement as precautionary)
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.

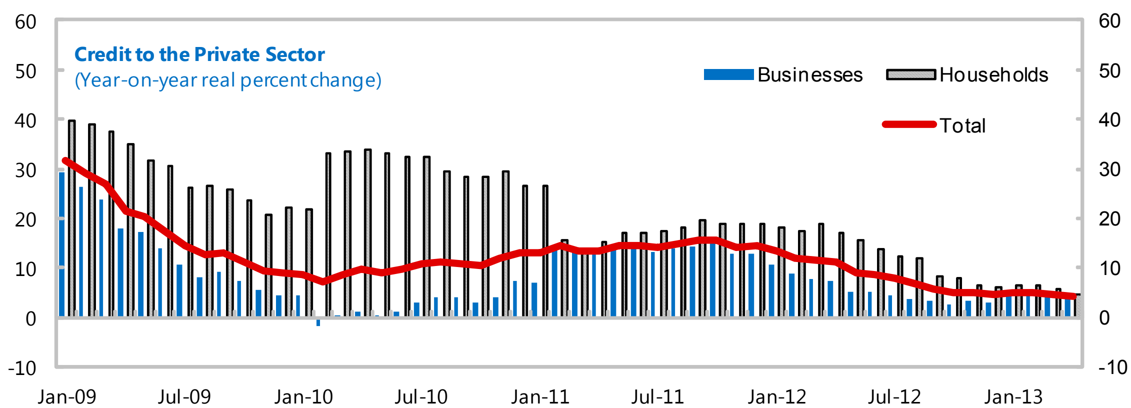
Total: SDR 90.968 million (154 percent of quota)

Figure 1. Kosovo: Recent Economic Developments
(2009-2013)

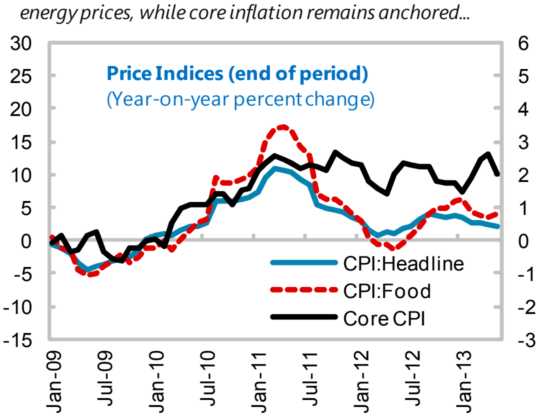
Import growth is beginning to recover, following the last year's stagnation...



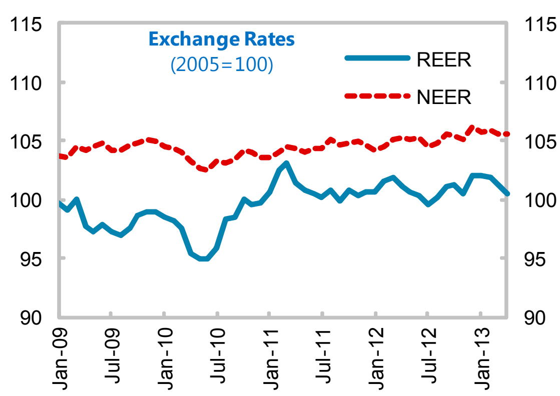
... while bank credit growth has flattened after picking in the early part of the year.



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

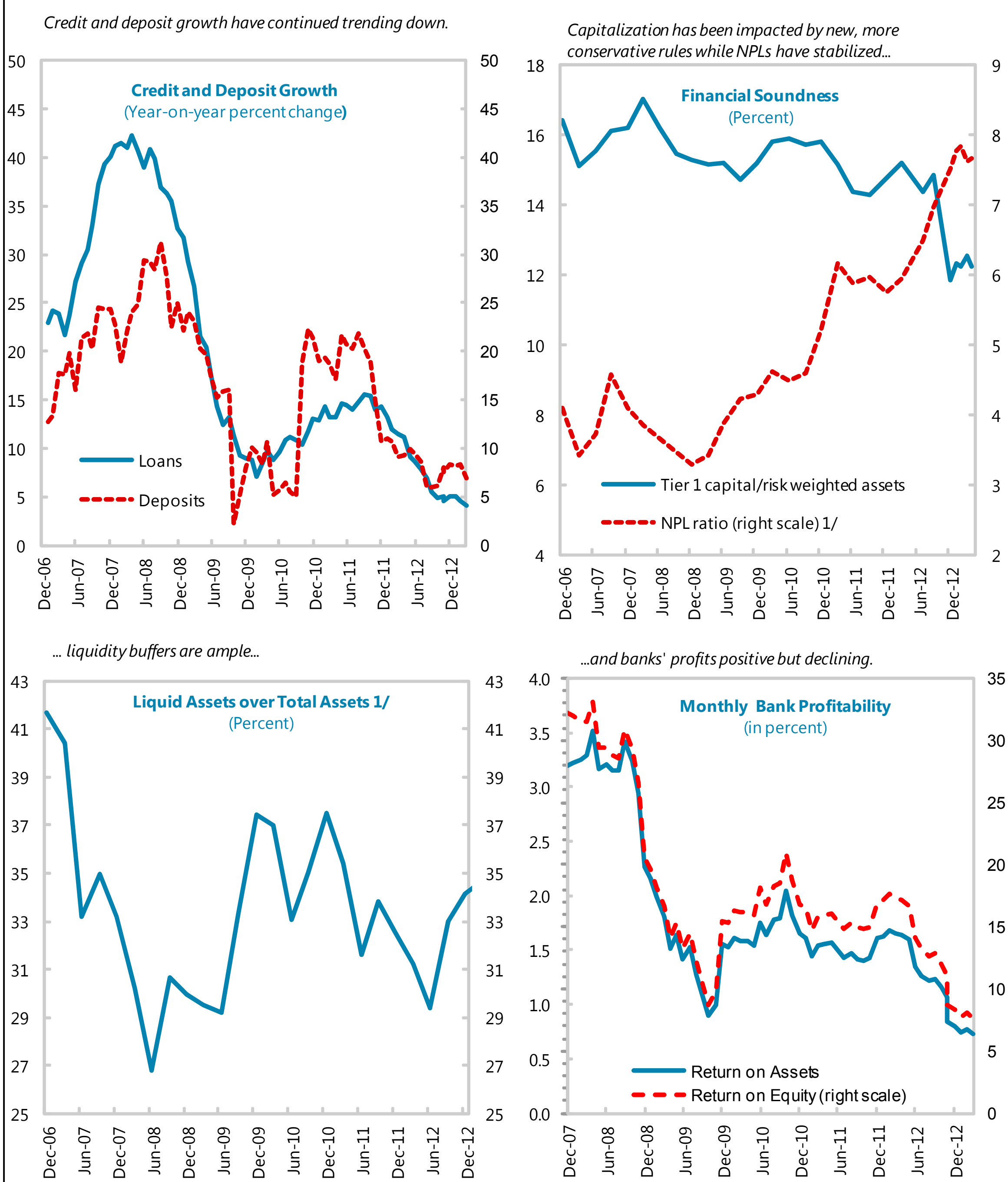


... and effective exchange rates have remained broadly stable.



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

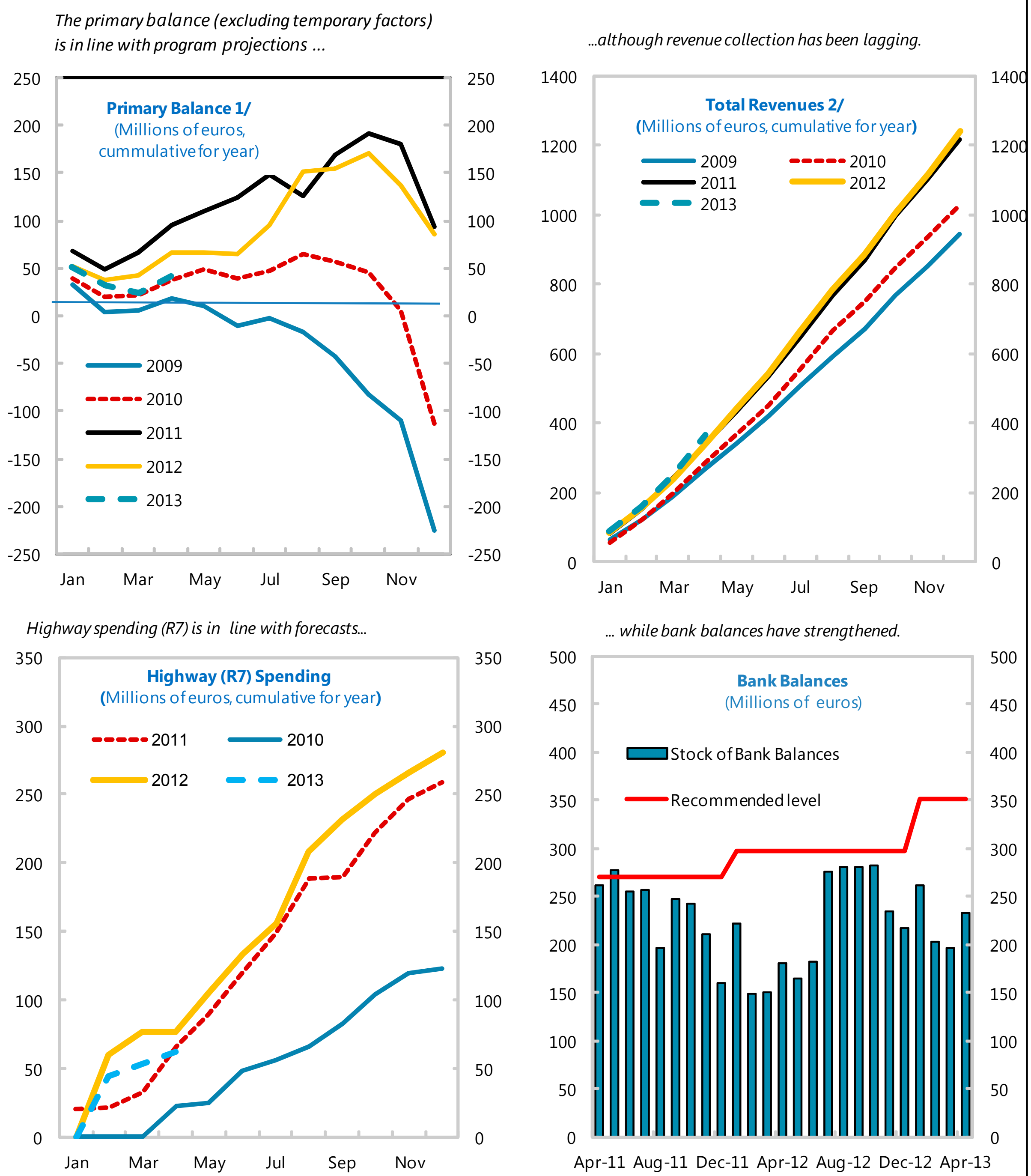
Figure2. Kosovo: Selected Banking Sector Indicators



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

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

Figure 3. 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.

Appendix I. Letter of Intent

Pristina, June 28, 2013

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

Dear Ms. Lagarde:

1. Following modest growth in 2012, Kosovo's economy developed unevenly in the early months of 2013, with stronger activity in the first quarter but signs of a renewed slowdown more recently, roughly in line with developments in the euro area. The banking system continues to be well-capitalized and liquid, with non-performing loans remaining the lowest in the region. We remain vigilant to risks, including from deteriorating economic conditions in the host countries of Kosovar Diaspora that could negatively affect both growth and the banking system. As such, we remain committed to disciplined fiscal management, rebuilding of an adequate level of government bank balances, further strengthening of the legal and regulatory framework for Kosovo's financial system, prudent financial supervision, and structural reforms to boost competitiveness.

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

- All *quantitative performance criteria* for end-April and all *continuous performance criteria* were met. The primary fiscal balance was stronger than programmed by €45 million, as a shortfall in revenue collection was overcompensated by under-execution of spending, especially the capital expenditures. The floor on government bank balance was exceeded by €72 million. Both the general government's primary expenditures and the net contracting of non-concessional debt remained below program ceilings.

- All end-May *structural benchmarks* were met:

(i) On May 28, the Minister of Finance approved the amended financial rules of the Treasury to ensure the recording of all payment-related documents within 3 days in the IT system.

(ii) On May 24, the Executive Board of the CBK approved an instruction to pay ex-ante for legal representation when staff is sued for carrying out official duties in good faith.

(iii) On May 28, we completed a draft administrative instruction for a rule-based setting of minimum wage levels and sent it to IMF staff.

(iv) The *indicative (zero) targets* for domestic payment arrears of the central and general government were missed by modest amounts, but corrective action is being taken.

(v) We also met the continuous structural benchmark on monthly meetings of our Program Monitoring Committee. The continuous structural benchmark 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 5 years was not fully met in the context of the mid-year budget review, but corrective action is being taken (¶9).

3. Based on this performance, we request completion of the fourth review under the Stand-By Arrangement. 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, April 8, 2013 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 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. The macroeconomic framework underpinning our program is based on prudent assumptions, with a view to minimizing the risk of downward revisions during the program period.

- *Real GDP growth* is expected to strengthen somewhat but remain below potential, reflecting largely still subdued conditions in the host countries of the Diaspora. Still, we expect growth to be higher than in most Western Balkan economies. We also expect a modest contribution from a recovery in exports. The main risk to the outlook is a possible deterioration in economic conditions in Diaspora host countries.

- Annual average *consumer price inflation* is expected to moderate to around 2 percent, reflecting mostly lower global food and fuel prices.

- *The trade deficit* for 2013 is estimated to remain roughly stable, as recoveries in both imports and exports are expected to roughly balance one another out.

II. Fiscal Policy

A. 2013 Budget Execution

6. In the first four months of 2013, budget implementation has been broadly in line with our program.

a. *Revenue collection* was short of program projections by €14 million, owing to (i) a shortfall in border tax collection of €10 million, (ii) the non-receipt of a royalty from the electricity company KEK of €7.2 million that is likely to translate into an end-year shortfall of about €4 million (as a portion of the royalty accrued in 2013 may be paid only in early 2014), and (iii) the non-receipt of revenues from the sale of telecommunications licenses for which we expected to collect €20 million (now expected for the last quarter of 2013). On the upside, collection of domestic taxes and fees exceeded the program projection by €7 million, and the government received a dividend from the telecommunications company (PTK) of €15 million earlier than originally planned, but this did not suffice to compensate for the shortfall. Moreover, in May we observed a further shortfall in border tax revenue of about €10 million relative to plan, arguably reflecting a mix of weaker imports and a decline in import prices.

b. Execution of *budget expenditures* through end-April was lower than expected by about €60 million. While execution of the capital budget was €72 million below the original program projections, subsidies and transfers exceeded program projections by €12 million, due to subsidies for KEK's import of electricity and other publicly owned enterprises, where a significant part of the full-year budget allocation has already been exhausted.

7. In April, we announced a purchase agreement for PTK, with a gross sales price of €277 million. The transaction is expected to be settled in September or October—although the legal framework allows settlement until December—which would bring the level of usable bank balance above a fully adequate level.

8. We continue to target a primary deficit (excluding PAK-related expenditures) of no more than €155 million (3 percent of GDP) for 2013. To achieve this target despite the revenue shortfall accumulated to date, we are taking the following corrective actions, yielding budgetary savings of €24 million:

a. We have already secured an additional PTK dividend of €10 million (in addition to the €30 million in PTK dividends already foreseen in the 2013 budget). Further, we have secured a dividend of €3 million from the electricity transmission company KOSTT that will be transferred to the budget by end-July 2013.

b. On June 17, we issued a government decision to not allocate €11 million from the 2013 budget, with the following breakdown of savings across expenditure categories: €3.1 million in goods and services, €5.9 million in capital spending, and €2.0 million in subsidies and transfers (prior action).

c. We have received the first installment of €5.8 million of the KEK royalty payment in June, and will secure additional royalty payments of €4.2 million by end-September. KEK's management commits to transferring any royalty it collects promptly to the treasury.

In the event that additional revenue shortfalls would emerge later in the year, we stand ready to take further measures as needed to safeguard compliance with the end-2013 primary deficit target.

9. On June 18, we submitted the mid-year budget review to the assembly. Prior to submission, we committed to the review being in line with the following principles (prior action):

a. New spending initiatives would be limited to (i) new projects funded by World Bank loans, (ii) costs related to the creation of two new municipalities by end-year, and (iii) costs related to the implementation of the recent agreement with Serbia. The initiatives would be funded from internal budget savings.

b. Reallocations across spending categories (goods and services, transfers and subsidies, wages and salaries, and capital spending) would be limited to €10 million at the central government level. There might also be reallocations for municipalities from own-source revenues that were expected to not exceed €5 million.

c. We would not increase the budget allocation for wages and salaries excluding civil service reform, and neither the budget allocations for railway, telecommunication, energy, or subsidies to other publicly owned enterprises, in line with the legal framework.

The review submitted to the assembly was broadly consistent with these principles. However, it included the re-allocation of €2 million from energy subsidies to a thus far unspecified benefit for erstwhile political prisoners for which a fiscal impact assessment has not yet been conducted. The assembly committee for budget and finance will amend the mid-year budget review after the first reading in the assembly and no later than July 5, 2013, specifying that the spending allocation for erstwhile political prisoners will be executed only after completion of a fiscal impact assessment that covers a period of five years and includes a verification of beneficiaries. We will transmit the minutes documenting this decision to IMF staff no later than July 5. Further, we will execute the allocation on erstwhile political prisoners only after the impact assessment has been reviewed by IMF staff.

B. Rule-Based Fiscal Framework

10. Draft amendments to the Law on Public Financial Management and Accountability (LPFMA), were submitted to the Assembly on March 29, 2013. The amendments establish a rules-based fiscal framework, consistent with the parameters set in our Letter of Intent for the third review of April 8, 2013 (¶10). The Assembly proceeded without delay with the first reading. The second reading and

final parliamentary vote on the legislation is planned for early July 2013, to ensure that the framework is binding for the 2014 budget.

C. Highway R6

11. We reiterate our commitments with respect to the preparation of the planned highway R6 to Macedonia (LOI December 5, 2012, ¶10 and LOI April 8, 2013, ¶¶8, 9). While R6 is a priority project, serving to integrate Kosovo further into the network of regional highway in South-Eastern Europe, it needs to be managed carefully to limit risks to the public finances and safeguard economic viability. Commitments include:

a. Integrating R6 into a sustainable budgetary framework. This includes a level of the usable government bank balance of at least €300 million prior to entering into contractual commitments with respect to R6.

b. Ensuring economic viability. To this end, while we will tender R6 as one project, we will procure the mountainous section close to the Macedonian border as a design-and-build contract, while the northern section will be procured as a standard works contract.

c. Transparent and competitive bidding.

D. The 2014 Budget

12. Preparation of the 2014 budget will be guided by the rules-based fiscal framework. In addition, the 2014 budget submitted to the assembly will be in line with the following parameters (structural benchmark for end-October):

a. For end-2013, we expect a considerable excess bank balance relative to the floor set by the rules-based fiscal framework, owing in particular to the completion of PTK privatization. While the rules-based framework would allow us to draw down cash balances to 4½ percent of expected end-2014 GDP, we will preserve a substantial excess cash buffer, given that highway R6 to Macedonia will absorb substantial budgetary resources also in future years, and given upcoming IMF repurchases. Specifically, the end-2014 usable bank balances inscribed into the 2014 budget will be at least the average of (i) the minimum level allowed by the rules-based fiscal framework and (ii) the expected level of the usable bank balance at end-2013. In the unlikely case that, by October 2013, we expect the end-2013 bank balance to be less than 4½ percent of GDP, the 2014 budget will contain a plan to restore the bank balance.

b. Current spending (program definition) will not exceed €1050 million.

c. New issuance of T-bills in 2014 budget will not exceed €120 million.

E. Other Fiscal Issues

13. Careful planning of spending initiatives is at the core of our efforts to improve public financial management. To this end, the introduction of all new laws and regulations or amendments to laws or regulations with fiscal implications will continue to be preceded by a fiscal impact assessment covering a period of at least 5 years (continuous structural benchmark). This provision includes (i) the recently approved parliamentary resolution to count years during which teachers were forcibly removed from the workplace in the 1990s toward qualification for the supplementary pension, and (ii) the possible creation of additional beneficiary groups under the law for war-related categories. In both cases, no budgetary allocation will be made before a thorough fiscal impact assessment has been conducted.

14. We have made further progress with the implementation of our action plan to improve recording and monitoring of payment obligations. On May 28, we amended relevant internal financial rules of the Treasury to ensure the recording of all payment-related documents within 3 days in our IT system, in line with the end-May structural benchmark. From June, the Treasury will conduct a publicity campaign to inform all stakeholders, including the regulatory commission for public procurement (RCPP), about the amended rules and the consequences of noncompliance. To minimize risk to private companies involved with public procurement, the RCPP will, by end-August, issue an administrative instruction to amend all draft tender contracts. The draft tender contracts will then detail the key documents required by the budget organizations to ensure the contracts' validity. Planned upgrades to the IT system will support implementation of these rules by generating automatic reports—that would be accessible to the Auditor General (AG)—detailing the degree of budget organization's non-compliance. The Treasury will use these reports to actively monitor payment obligations, detect early non-compliance problems, request AG audits, and ensure timely execution of legitimate outstanding payment obligations.

III. Financial Sector Policies

15. Bank financial soundness indicators have remained stable since the third review. Non-performing loans decreased slightly to 7.7 percent at end-April (from 7.8 at end-January), while banks' profitability declined somewhat. The aggregate banking system's capital adequacy ratio (CAR) decreased slightly to 14.8 percent (from 14.9 at end-January) as risk-weighted assets grew faster than profits.

16. We remain vigilant of banks' risks and committed to ensuring compliance with prudential rules and strengthening supervision. In April, the CBK issued an amendment to the credit risk management regulation that grants banks more flexibility to prudently reschedule loans to borrowers with payment arrears (i.e., banks should *not* reschedule to avoid appropriate classification and provisioning, but should align loans with the payment capacity of the borrowers). We plan amending the advisory letter on credit risk management to give more guidance to banks on the expected standards. The CBK will enhance off-site monitoring and conduct focused on-site examinations of rescheduled loans. Further, we will conduct a focused examination of the adequacy

of provisions for assets other than loans, as these are not covered by specific provisioning requirements.

17. As of end-April, banks have mostly brought related lending within the new legal limit set by the Banking Law. The CBK will take measures as needed in order to bring end-June capital levels of these banks in compliance with capital requirements. The CBK will conduct focused on-site inspections of capital adequacy requirements of banks in August 2013.

18. We have continued to work on implementing key FSAP recommendations.

a. In line with our commitment in the April LOI, on May 24 the CBK Executive Board approved a By-Law on paying ex-ante for legal representation when staff, agents, or members of the decision-making bodies of the CBK are sued for carrying out official duties in good faith.

b. In May, the CBK, Ministry of Finance (MOF), and the Parliamentary Committee on Budget and Finance, amended the tri-partite Memorandum of Understanding (MOU) on Financial Stability Cooperation. The MOU clarifies that the CBK would make the emergency liquidity assistance (ELA) facility for solvent banks fully operational in case of need, but would refrain from granting ELA to insolvent banks without an explicit government guarantee.

c. The CBK has solicited the view of banks on a bank-financed premium for ELA, and requested TA from the IMF to strengthen the crisis management framework (including on instituting a bank premium as well as contingency planning). The Deposit Insurance Fund (DIFK) has discussed with the technical staff of the MOF the size and options for extraordinary funding arrangements.

d. The CBK has requested TA from the IMF to move to more risk-based supervision, as well as on macro modeling and enhancing stress testing, to support the development of a macroprudential policy framework. The CBK has also drafted the terms of reference for a macroprudential policy advisory committee.

19. Looking ahead, we will take the following next steps to further progress with implementing key FSAP recommendations—particularly to strengthen the crisis management framework and the institutional underpinning of financial soundness:

a. Upon receiving a renewed request from DIFK, and on the recommendation of the Central Bank, the Ministry of Finance will submit a request to financial institutions for providing a stand-by arrangement to DIFK—i.e., a credit line of €10 million—to the assembly by September 2013. Such a pre-arranged borrowing agreement is also foreseen under the facility with the donors that provided part of DIFK's seed capital.

b. The CBK will draft amendments to the ELA regulation and instructions on providing ELA to solvent banks in line with FSAP recommendations, to discuss them with the planned IMF TA mission on crisis management.

c. The CBK will review the overall bank liquidity risk framework and profile; e.g., level of required reserves, liquidity risk requirements, arrangements related to the special reserves fund (SRF) for ELA, in cooperation with planned IMF TA. On this basis, it will propose a target size for the SRF, in line with its duties outlined in the financial stability MOU. Options for operationalizing a bank premium or quota to ensure the sufficiency of the SRF will be developed jointly with IMF TA.

d. The CBK will discuss with the Ministry of Justice and Kosovo Judicial Council preparations to establish a special department in the basic courts to deal with banking issues. This should support more timely and effective resolution of NPLs, and thus banking system soundness.

20. Also in line with the MOU on financial stability cooperation, the CBK, MOF, and Parliamentary Committee on Budget and Finance will appoint deputies to the National Council on Financial Stability and Crisis Management. Starting with the third quarter of 2013, the Council will meet at least once every three months. The Council will establish an action plan and working groups to address the key FSAP recommendations on strengthening the crisis management framework. For the remainder of the year, these include drafting regulation to address technical shortcomings in the bank resolution framework, assessing the legal powers to establish a bank premium or quota for ELA, as well as incorporating contingency planning arrangements into the cooperation MOU. Where relevant, the DIFK will be involved in the arrangements.

IV. Competitiveness and Structural Reforms

21. We have prepared a draft proposal for a rules-based framework for setting minimum wages, in line with the corresponding end-May structural benchmark, and have discussed the draft with World Bank and IMF staff. By end-August, the government will issue a corresponding administrative instruction with the following elements (structural benchmark):

a. An annual review of monthly minimum wage levels will be conducted at end-December. Changes to minimum wage levels will be considered only if (i) CPI inflation published by the statistical agency of Kosovo (12-months average, October-over-October) exceeds two percent, and (ii) the appreciation of the real effective exchange rate published by the CBK does not exceed 0.5 percent (12-months average, October-over-October).

b. In case a change in the minimum wage level will be considered, the percentage change will be an average of (i) the percentage change in the CPI index excluding transport fuel and food prices, and (ii) the percentage change in average private sector wages as reported to the tax administration of Kosovo.

c. The percentage change will be applied to the average of the minimum levels for each age category.

d. The rule will be applied retroactively to 2012 and 2013. To ensure that the rule remains up-to-date, the minimum wage formula can be reviewed every three years based on a rigorous analysis of labor market conditions and discussions with relevant bodies.

22. We have continued to make progress with implementing our SME development strategy. There are two ongoing projects aiming at improving SMEs' access to finance and enhancing their international competitiveness:

a. The first project—supported by the Austrian Development Cooperation, the Swiss Development Cooperation, USAID, and other donor institutions—aids business support needs through a voucher counseling scheme, and their financing needs through a credit guarantee scheme. The latter is being negotiated with commercial banks and expected to be operational in March 2014.

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. Call for proposals will be launched in September, and the first set of grants is expected to be disbursed by end-year.

23. We continue with investment promotion through a recently launched IFC project that targets labor-intensive low- to medium-skilled sectors. Further, we are working on initiatives to (i) amend during the course of the summer the law on foreign investment to provide Kosovar investors (with double nationality) the same level of protection as foreign investors, thus encouraging Diaspora FDI, and (ii) finalize a law on licensing and permits with the objective of avoiding unnecessary bureaucratic requirements.

Sincerely yours,

/s/
Hashim Thaçi
Prime Minister

/s/
Besim Beqaj
Minister of Finance

/s/
Bedri Hamza
Governor, Central Bank of the Republic of Kosovo

Table 1. 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.	Actual	Prog.	Adj. Prog.	Actual	Prog.
Performance Criteria 1/										
Floor on the bank balance of the general government 2/	166	180	237	281	205	216	160	160	232	171
Floor on the primary fiscal balance of the general government 2/, 3/	-21	4	-19	6	-112	-113	-36	-37	9	-94
Ceiling on primary expenditures of the general government 3/	399	353	911	842	1,490	1435	448	448	388	1005
Ceiling on the net contracting of nonconcessional debt by the general government 3/	150	30	150	49	150	73	150	150	20	150
Ceiling on guaranteeing nonconcessional debt by the general government 3/	0	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	0
Indicative Targets										
Ceiling on the stock of domestic payment arrears of the central government	0	2	0	0	0	3	0	0	1	0
Ceiling on the stock of domestic payment arrears of the general government	0	2	0	3	0	5	0	0	5	0
Memorandum items:										
Program assumptions										
Repayment of policy loans extended to public corporations	…	4	4	4	4	4	2	2	2	4
Non-project grants	4	1	37	37	37	37	0	0	0	0
Budget support loans	0	0	0	0	0	0	0	0	0	0
Project grants	1	0	3	0	0	0	1	0	0	2
Project loans	0	0	6	0	7	7	1	2	2	3
PAK-related spending	…	…	5	4	8	6	2	2	1	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, and end-April, 2013 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 2. Kosovo: Program Monitoring

	Program Approval	First Review End-April 2012	Second Review End-August 2012	Third Review End-December 2012	Fourth Review End-April 2013
Performance criteria					
Floor on the bank balance of the general government	…	Met	Met	Met	Met
Floor on the primary fiscal balance of the general government	…	Met	Met	Missed	Met
Ceiling on primary expenditures of the general government	…	Met	Met	Met	Met
Ceiling on the net contracting of nonconcessional debt by the general government	…	Met	Met	Met	Met
Indicative targets					
Ceiling on the stock of domestic payment arrears of the central government	…	Missed	Missed	Missed	Missed
Ceiling on the stock of domestic payment arrears of the general government	…	Missed	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	…	…
Issuance of a government decision that specify spending cuts of €11 million across spending categories relative the the approved 2013 budget (by June 25, 2013).	…	…	…	…	Met
Submission of the 2013 Mid-Year Budget Review to the Assembly consistent with ¶9 of the Letter of Intent (by June 25, 2013).	…	…	…	…	Missed 2/
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 3/	…
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	…
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 (by End-May 2013) 3/	…	…	…	…	Met 4/
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)	…	…	…	…	Met
Drafting of secondary legislation to provide for a more rules-based treatment of setting minimum wage levels (by end-May 2013)	…	…	…	…	Met
Continuous structural benchmarks					
Monthly meetings of the Program Monitoring Committee and transmission of meetings' minutes to the IMF	…	Met	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/	…	Missed	…	…	…
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	Missed 2/

1/ Eliminated after the first review following a corresponding amendment of the Law on Public Financial Management and Accountability.
2/ The 2013 Mid-Year Budget Review contained a spending allocation for an unspecified benefit to erstwhile political prisoners without prior compilation of a fiscal impact assessment.
3 /The study was submitted on time, but did not contain all the elements defined in the LOI of December 2012.
4 /The amended financial rules have been renumbered rules 01 and 02.

Table 3. Kosovo: Structural Conditionality

Actions	Timing
Structural benchmarks	
Issuance of an administrative instruction to provide for a rules-based setting of minimum wage levels consitent with ¶21 of the Letter of Intent.	End-August 2013
Submission of a 2014 budget to the Assembly consistent with ¶12 of the Letter of Intent.	End-October 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 1 of the Letter of Intent (LOI).

B. Bank Balances of the General Government

4. Bank balances are funds usable and readily available (i.e., liquid or marketable, and free of any pledges or encumbrances), held and controlled by the general government for the purposes of making payments and transfers. Bank balances include Undistributed Funds of the Government of Kosovo plus funds specifically reserved for policy purposes including emergency liquidity assistance but do not include the balance of unspent Own Source Revenues (OSR) carried forward, or funds encumbered or pledged as Donor Designated Funds and funds relative to onlending 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 Root 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 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. 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.

INTERNATIONAL MONETARY FUND
COM COMMUNICATIONS DEPARTMENT

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FOR IMMEDIATE RELEASE
July 15, 2013

International Monetary Fund
Washington, D.C. 20431 USA

IMF Executive Board Completes Fourth Review Under Stand-By Arrangement for Kosovo; Approves €4.9 Million Disbursement

The Executive Board of the International Monetary Fund (IMF) today completed the fourth review of the Republic of Kosovo's economic performance under a program supported by a Stand-By Arrangement (SBA). The decision enables the authorities to draw an additional amount equivalent to SDR 4.251 million (about €4.9 million, or US$6.4 million), bringing the total resources available to Kosovo under the arrangement to SDR 86.718 million (about €99.9 million, or US$130 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.

The Executive Board approved a 20-month SBA for Kosovo on April 27, 2012 (see Press Release No. 12/154) in an amount equivalent to SDR 90.968 million (about €104.8 million or US$136.3 million). Total disbursements so far amount to SDR 78.216 million (about €90.1 million or US$117.2 million).

Following the Executive Board's discussion on Kosovo, Ms. Nemat Shafik, Deputy Managing Director and Acting Chair, stated:

"Kosovo's economy has displayed resilience despite headwinds from the global financial crisis, owing to sound policies under the Fund-supported program and robust remittances and foreign direct investment from the Diaspora. Looking ahead, it will be important to reduce the dependence on such flows and develop a tradable sector that will support self-sustained growth.

"Important steps have been taken to build a more competitive economy. Continued decisive efforts to further strengthen the business climate, investments in public infrastructure, and steps to normalize cross-country relations in the region will be essential to enhance competitiveness and support growth. This strategy would also benefit from stronger education and training policies.

“The authorities have restored a sustainable fiscal stance in the past two years. A rules-based fiscal framework will anchor fiscal policy from 2014. The framework needs to be complemented by sound fiscal practices, especially the careful preparation and costing of spending initiatives. Kosovo’s reliance on indirect taxes is appropriate given the transfer-dependent structure of the economy. The revenue structure will need to adjust, however, as trade integration advances and as the growth model shifts from dependence on transfers to domestic production. The government’s bank balance with the central bank is a critical prudential buffer and needs to be guarded carefully.

“The banking system has grown rapidly in the past decade, but further progress will require the strengthening of institutions, in particular faster contract enforcement by the judicial system. At the same time, the banking system has remained stable, with adequate capital buffers, modest non-performing loans, and high liquid reserves. Vulnerabilities could be reduced further by comprehensive risk-based supervision, the development of a macro-prudential policy framework, and a permanent funding mechanism for the special reserve fund for emergency liquidity assistance,” she stated.

Statement by Mr. Johann Prader and Mr. Omer Yalvac on Republic of Kosovo

July 15, 2013

On behalf of our Kosovar authorities, we thank staff and Management for the fruitful policy discussions and support during the 2013 Article IV consultations and the fourth review under the Stand-by Arrangement. These exchanges of views are very helpful for the authorities when designing their policies.

Since the last review in April, there have been very positive developments in terms of relations with the European Union (EU). On April 19, 2013, the governments of Kosovo and Serbia completed an agreement that would allow both countries to apply for EU membership, a significant improvement towards normalizing relations. Following this major step, there were rounds of talks between delegations from both countries. On June 28, 2013, the European Council announced the decision to begin negotiations for a Stabilization and Association Agreement (SAA) between the Republic of Kosovo and the EU. The SAA is the first contractual agreement between the Republic of Kosovo and the EU which provides a perspective for Kosovo's full membership. The start of negotiations for an SAA with the EU bodes well for the country's economic prospect.

The Article IV report's findings illustrate that the economy has performed strongly, despite headwinds from the global financial crisis and turbulence in the euro area. Growth has continued to stay over 2 percent since 2007 and average growth has been the highest among peer countries. Macroeconomic fundamentals have been strengthened with the support of the Stand-by Arrangement. Very limited financial and export linkages to countries most affected by the euro area crisis and strong remittances from Germany and Switzerland have positively contributed to Kosovo's growth prospects.

Growth Outlook

The economy is expected to gradually accelerate throughout 2013 and continue along the path to 4.5 percent growth over the next few years. In the coming period, favorable demographics, the strong banking sector, remittances, and foreign direct investment will be important pillars for strong growth performance. There are encouraging signs in terms of an increase in domestic production, which substitutes imports for domestic consumption. Improvements in competitiveness and continued support from the Diaspora are expected to boost the economy's medium-term growth prospects.

The authorities are mindful of the need to increase the economy's productive capacity for sustainable growth. To this end, the authorities have committed to strengthening infrastructure, improving the business climate, and increasing regional integration. In order to improve infrastructure, budget spending has focused mainly on capital expenditures. With regard to the business climate, the authorities continue to develop the business environment beyond achieving a significant improvement in the World Bank's 2013 Doing Business survey. As an important step, the Kosovar authorities have initiated a development strategy for small and medium enterprises (SMEs) which could improve their access to finance and enhance competitiveness. For more regional integration, the authorities are gearing their efforts towards entering into negotiations for a Stabilization and Association Agreement with the EU.

Fiscal Policy

The authorities have been cognizant of the importance of strong fiscal balances in a highly uncertain global environment. Fiscal adjustment was implemented through a mix of revenue and expenditure measures. The authorities are keen on maintaining the sustainable fiscal stance with the help of prudent policies in capital spending. To this end, a rules-based fiscal rule will be in place starting from July 2014. The rule has been designed to keep the general government deficit as well as gross public debt under control. In order to support the economy's growth potential, capital projects are exempt from the ceiling; depending on the privatization receipts and the level of the government bank balance. The authorities attach utmost importance to the level of the government bank balance, which is critical to safeguarding an adequate level of reserves that would insure both the public and financial system against liquidity shocks. Taking Kosovo's development needs and prudent fiscal policies into consideration, 4.5 percent of GDP seems to be feasible for the adequate level of government bank balance. Nevertheless, the authorities are aware of the need for targeting higher levels due to multi-year investment projects or debt servicing obligations.

Financial Sector

The 2012 FSAP findings revealed that the banking sector has remained liquid, profitable, and well-capitalized. Although there is an increase in non-performing loans (NPLs), they are comparably low and almost fully provisioned. The banking authority is monitoring the risks stemming from weaker economic activity. The return on assets is one of the highest in the region. The capital adequacy ratio of the system is around 15 percent, the effect of tighter capital rules under the new banking law. The banking subsidiaries of euro area banks are largely deposit-funded and there is limited risk of deleveraging. Lending activity is also expected to be supported by new banks in the system.

The authorities are closely following the 2012 FSAP recommendations to strengthen the oversight of the financial sector. In this regard, the authorities have started numerous initiatives in supervision and in the legal and institutional framework. Recently, they began a study on an emergency liquidity assistance facility for banks through a bank premium. They are also working with other international organizations and donors on improving the property registry and NPL resolution, the court process for contract enforcement, and establishing a mortgage market. Once completed, these initiatives will positively contribute to the growth performance and the banking sector.

Structural Reforms

The authorities are keen on strengthening the competitiveness of the economy. Despite improvements in many areas, public infrastructure – notably energy and transport – are the main challenges to a better investment environment. The high level of capital spending is expected to close the gap and improve public infrastructure. Additionally, the authorities have learned the lesson of the huge public sector wage increases related to the 2010 election campaign and therefore pay due regard to the importance of cautious public sector wage policies and a rules-based framework for setting wage levels to improving competitiveness.

Program Performance and Next Steps

The authorities have shown strong commitment to the program targets. All end-April quantitative performance criteria were met. All continuous performance criteria and most applicable structural benchmarks were also met. Although indicative targets on the nonaccumulation of domestic payments arrears by the central and general governments were not met, they were missed only by small margins and corrective actions were taken. The authorities are ready to take further measures, as needed, to safeguard compliance with the program targets.

The authorities are keen on maintaining sound fiscal policies. The 2013 budget execution has been in line with program targets. In order to keep up with the targets, the authorities have submitted the mid-year budget to the assembly, in line with prior actions and supporting measures. The fiscal rule, which is a critical pillar for the program, is planned to be finalized by parliament in early July 2013 to be in place for the 2014 budget. Under the guidance of the rules-based fiscal framework, the 2014 budget will be submitted to the assembly in line with program targets.

The authorities continue to further strengthen financial sector surveillance in parallel with FSAP recommendations. The authorities will improve the crisis management framework and institutional capacity. The establishment of the National Council on Financial Stability and Crisis Management will be instrumental in following up and working on key FSAP recommendations.

The authorities are attaching utmost importance to competitiveness and structural reforms. With regard to improving infrastructure, they are committed to the preparation of the planned highway R6 to Macedonia by limiting risks to public finances and safeguarding economic viability. In order to limit risks stemming from wages, the authorities will issue an administrative instruction in coordination with the Fund and World Bank staff. The Kosovar authorities will continue projects with international organizations and donor institutions to improve access to finance for SMEs.