July 2012
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Republic of Kosovo: First Review Under the Stand-By Arrangement, and Request for Modification of Performance Criteria—Staff Report; Press Release on the Executive Board Discussion.

In the context of the first review under the stand-by arrangement the following documents have been released and are included in this package:

- The staff report for the First Review Under the Stand-By Arrangement, and Request for Modification of Performance Criteria, prepared by a staff team of the IMF, following discussions that ended on June 11, 2012, with the officials of the Republic of Kosovo on economic developments and policies. Based on information available at the time of these discussions, the staff report was completed on June 28, 2012. The views expressed in the staff report are those of the staff team and do not necessarily reflect the views of the Executive Board of the IMF.

- A Press Release summarizing the views of the Executive Board as expressed during its July 16, 2012 discussion of the staff report that completed the request and/or review.

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

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INTERNATIONAL MONETARY FUND

REPUBLIC OF KOSOVO

First Review Under the Stand-By Arrangement, and Request for Modification of Performance Criteria

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

Approved by Poul M. Thomsen and Jan Kees Martijn

June 28, 2012

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

Program status. All end-April 2012 and continuous quantitative performance criteria were met. Four—out of six applicable—benchmarks were also met, the exceptions being: (i) a continuous structural benchmark on including a cost control clause into all benefit creating laws was not met on one occasion, but corrective action has been taken; and (ii) the end-May structural benchmark on submission of a revised deposit insurance law that was met with a slight delay.

Discussions. Discussions were held in Pristina, May 30–June 11. The mission met with Prime Minister Hashim Thaçi, Minister of Finance Bedri Hamza, Central Bank Governor Gani Gërguri, other senior officials, parliamentarians, private sector representatives, and envoys representing the international community. The staff team comprised Mr. Wiegand (head), Ms. Budina, Messrs. Castro, Druck (all EUR), Alper (FAD) and Qu (SPR). It cooperated closely with an overlapping MCM technical assistance mission (Mr. Parker). Messrs. Sulemane (Resident Representative) and Thaçi (Economist in the Resident Representative's Office) assisted the mission.

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

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I. INTRODUCTION AND SUMMARY

1. **Macroeconomic and financial policies are broadly on-track** (Letter of Intent, Table 1).

- All end-April and continuous ***quantitative performance criteria*** under the Stand-By Arrangement (SBA) were met with comfortable margins, as a modest shortfall in revenue collection was overcompensated by under-execution of spending.
- Most ***structural benchmarks*** through end-June were also met. The exceptions are: (i) the end-May structural benchmark on submitting a revised Deposit Insurance Law to the Assembly, which was met with a delay of three weeks, as consultations with stakeholders took longer than originally envisaged; and (ii) a continuous structural benchmark on including an agreed cost control clause into benefit creating laws, as the Assembly removed the clause from a draft law on one occasion (pensions of the Kosovo Security Force). Corrective action has been taken (LOI ¶14).
- The ***indicative targets*** on the nonaccumulation of domestic arrears by the central and the general government were missed by small margins, reflecting weaknesses in the monitoring of payments obligations. The authorities are developing measures, in close cooperation with an IMF technical assistance mission, to address these shortcomings.

2. **Kosovo's economy has remained largely shielded from the euro area crisis, but there are risks.** Growth appears to be slowing modestly but is still robust, as anticipated under the program baseline (¶4). Direct financial or trade linkages to crisis countries are small. The economy remains vulnerable, however, to a possible deterioration in labor markets conditions in host countries of the Kosovar diaspora, which could trigger a drop in remittances and capital inflows, with negative repercussions for growth, the fiscal position, and financial stability.

3. **Against this backdrop, the program's key objectives remain restoring a sustainable fiscal position and sufficient government cash buffers, anchoring fiscal policy through the introduction of a fiscal rule, and enhancing the resilience of the financial system.**

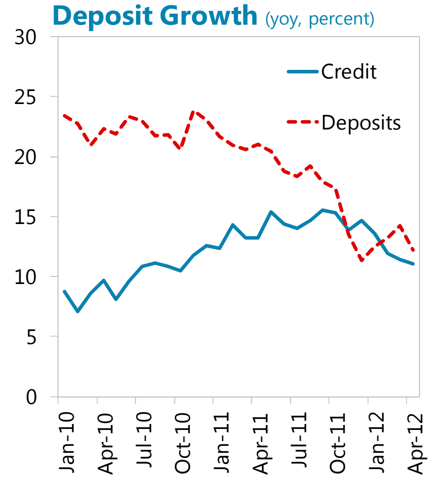
- ***Structural fiscal adjustment.*** Structural adjustment of 1.1 percent of GDP is being implemented in 2012 (¶8). The authorities and staff reached understandings on the broad parameters of the 2013 budget, including further structural adjustment of 0.6 percent of GDP, which would bring Kosovo's fiscal position close to a fully sustainable stance (¶10).
- ***Cash buffers.*** Preparations for the privatization of the telecommunications company PTK are advancing (¶11). The receipts from PTK privatization—expected to be transferred to the treasury in 2013—would help restore an adequate level of government bank balances, thus strengthening the authorities' capacity to absorb fiscal and financial shocks.
- ***Fiscal rule.*** An IMF technical assistance (TA) mission visited Pristina in late June to discuss options for a legally binding fiscal rule that would anchor fiscal policy in the medium term (¶12). Enactment of the fiscal rule is envisaged for the first half of 2013.

- ***Financial system.*** After the purchase that becomes available with the completion of this review, the authorities intend to fund the central bank's special reserve fund (SRF) for emergency liquidity assistance (¶16). An upgraded Banking and Microfinance Law (BML) strengthens the central bank's ability to resolve troubled financial institutions. A revised Deposit Insurance Law consistent with the BML was submitted to the Assembly in June (¶15).

II. Recent Developments

4. **Recent data point to a modest slowing in economic growth, as anticipated under the program baseline.** (Tables 1–3, Figure 1). While there are only limited high frequency activity indicators, private sector credit growth moderated to 11 percent (y-o-y) in April, some 4½ percentage points less than six months earlier. Deposit growth has slowed even more from the high pace of recent years, which reflected in part monetization of the economy. Imports dropped sharply in February due to unusually harsh weather conditions, but have normalized since. Consumer price inflation was marginally higher than expected in April at 1.2 percent (y-o-y), reflecting higher prices for imported fuel and an increase in tobacco excise rates.

Private Sector Credit and Deposit Growth (yoy, percent)



5. **The banking sector remains well-capitalized, liquid, and profitable** (Tables 4, 5, Figure 2). Average capital adequacy stood at 18 percent at end-April, compared to the regulatory minimum of 12 percent, while the share of nonperforming loans was 6 percent—both largely unchanged from end-2011. Prudent loan-to-deposit ratios averaging about 80 percent across the banking sector give rise to substantial excess liquidity. A small domestic bank was recapitalized by its owners in February after its capital adequacy ratio had dropped below the regulatory minimum in 2011, reflecting an increase in provisions needed to comply with central bank regulations.

III. Economic Outlook and Risks

6. **The economic outlook is unchanged from the time of the SBA's approval** (LOI ¶6)**.**

- ***Outlook.*** Staff projects real GDP growth of 3.8 percent in 2012, down from 5 percent in 2011. Robust domestic demand is funded by transfers and capital inflows that originate, to a large extent, with the Kosovar diaspora. These inflows finance a wide trade deficit, projected at almost 40 percent of GDP. Consumer price inflation is expected to average less than one percent in 2012, reflecting disinflation for imported commodities.

- ***Risks***. Direct contagion from turbulence in the euro area is likely to remain limited, owing to the small size of Kosovo's export sector and its low level of integration into cross-border financial markets. While most banks are foreign owned—with parent institutions in Germany, Austria, Slovenia, Turkey, and Albania—they are deposit funded and do not depend on financing from their parents. Moreover, stringent prudential regulations are in place that would prevent an excessive withdrawal of liquidity from Kosovar subsidiaries by their parents (¶15). However, an intensification of the euro area crisis could affect Kosovo if labor market conditions in host countries of the Kosovar diaspora deteriorate. This could depress remittances and FDI, with negative repercussions for growth—by depressing domestic demand—tax revenues—by reducing border taxes—and financial stability—as funds from the diaspora finance both deposits and the repayment of loans.

IV. Policy Discussions

A. Fiscal Policy

7. **Strengthening fiscal sustainability and restoring adequate government bank balances remain at the core of the SBA-supported program** (LOI ¶7).

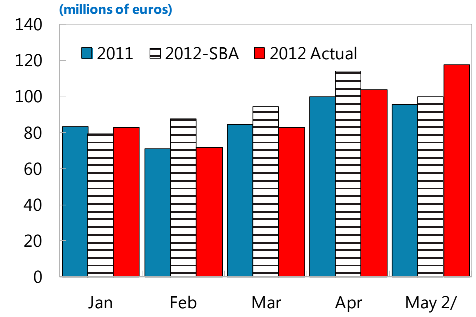
- ***Fiscal adjustment*** started in 2011 in the context of Kosovo's Staff-Monitored Program, when an adjustment need of 3 percent of GDP was identified. The SBA-supported program aims at restoring a sustainable fiscal stance by 2014 that would stabilize the ratio of public debt over GDP at less than 30 percent of GDP in the long run. The 2011 and 2012 budgets include 1.8 percent of GDP in structural fiscal adjustment. The remaining effort of 1.2 percent of GDP is envisaged for 2013 and 2014.
- Restoration of an adequate level of ***government bank balances*** is targeted for 2013. In view of Kosovo's unilateral euroization and limited access to debt markets, cash buffers are required both to satisfy the government's liquidity needs and to make resources available to the central bank for the provision of emergency liquidity assistance to banks if needed.

Fiscal Policy in 2012

8. **Budget implementation in the early months of 2012 was in line with the program** (Tables 6, 7, Figure 3, LOI ¶¶8, 10).

- The ***cumulative primary balance*** at end-April exceeded the program floor by €25 million (about ½ percent of annual GDP), as a modest shortfall in revenue collection (excluding dividends) was overcompensated by under-execution of spending—notably on capital projects—and the earlier-than-expected receipt of dividends from

Monthly Revenues 1/
(millions of euros)



Source: Country authorities; and IMF staff calculations.
1/ Revenues excluding grants and dividends.
2/ May 2012 values are preliminary

the telecommunications company PTK. The revenue shortfall owed in part to severe winter weather in February that temporarily depressed trade and receipts from taxes collected at the border. Preliminary data for May point to an improvement in revenue collection.

- ***Budgetary financing*** is also on target. The government issued—a first in Kosovo's history—three-month treasury bills, raising €30 million thus far at an annual yield of 3–4 percent. Auctions for six-month bills are planned for the second half of the year. In June, the government received a World Bank budget grant in the context of the Bank's Sustainable Employment Development Policy Program, as anticipated.

9. **The authorities and staff agreed that the 2012 fiscal targets remain achievable and appropriate.** Small changes in fiscal projections related to the government's Mid-Year Budget Review (MYBR) and the activities of the Kosovo Privatization Agency (PAK) have no material impact on program targets (LOI ¶9).

- In the ***MYBR***, scheduled to be passed by the Assembly in July, a small amount (€5 million, 0.1 percent of GDP) will be re-allocated from capital to current spending; mostly related to higher maintenance expenditures reflecting the severe weather early in the year.[1]

- ***PAK*** is charged with the privatization and liquidation of formerly socially owned enterprises (Box 1). Until last year, PAK's activities were funded mostly by donor grants, and its operations were overseen by the International Civilian Office. However, as part of Kosovo's transition from supervised to full independence, PAK has now been integrated into the general government budget. Staff and the authorities agreed to

Kosovo: Revisions in Fiscal Projections, 2012
(Excluding donor designated grants; millions of euros)

	Orig. Program	Source of Changes			Revised Program
		Reclassification of PAK funding	Mid-Year Budget Review		
			PAK related	Other	
Total revenue and grants	1381	-5	0	0	1376
of which: Nontax revenues	202	-5	0	0	197
Primary expenditure	1499	0	3	0	1503
Of which: PAK-related expenditures	5	0	3	0	8
Current expenditure	896	0	3	5	905
o/w wages and salaries	407	0	2	1	410
o/w goods and services	188	0	1	4	193
Capital expenditure and net lending	603	0	0	-5	598
Capital expenditure	592	0	0	-5	587
Highway	296	0	0	-2	294
Nonhighway	296	0	0	-3	293
Net lending	11	0	0	0	11
Primary balance	-119	-5	-3	0	-127
Primary balance net of PAK	-119	0	0	0	-119
Financing	44	5	3	0	52
Of which:					
Privatization revenues	0	5	26	0	31
Change in unspent own source revenues (– = increase)	-5	0	-22	0	-28
Memorandum item:					
Projected Bank balance	187	0	0	0	187

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

[1] Further, the municipal wage bill was raised by a minuscule amount (€1 million), reflecting staffing needs of newly established communities in Kosovo's North. The spending cuts affect, in roughly equal parts, expropriations for highway construction that have advanced less rapidly than anticipated, and non-highway capital spending.

exclude PAK-related spending from the program targets, as PAK is self-financed and determines its expenditures autonomously.[2] PAK's projected spending in 2012 was revised upward in the context of the MYBR (from €5 to €8 million).

Fiscal Policy in 2013

10. **The authorities and staff initiated discussions on the 2013 budget** (LOI ¶11). There was agreement that the primary deficit (excluding PAK) should not exceed €155 million (3.1 percent of GDP), requiring structural fiscal adjustment of at least €31 million (0.6 percent of GDP).[3] To this end, the government has already increased royalties on lignite, effective from January 2013, which is expected to raise an additional €22 million. Options for the remaining adjustment include wage restraint and further growth-friendly revenue measures, oriented on the recommendations of an IMF technical assistance mission from November 2011.[4] A forthcoming mining tax TA mission, scheduled for September, may identify further alternatives. The authorities and staff envisage reaching understandings on the 2013 budget prior to the completion of the second review under the SBA.

11. **Restoration of government bank balances in 2013 to a fully adequate level will depend on securing sizeable one-off financing, including from the privatization of PTK** (LOI ¶12).[5] Following extensive preparatory work—including stripping the postal service out of PTK—the launch of the tender offer is planned for end-August (structural benchmark). An upside risk to financing is the possibility that PAK would start transferring privatization and liquidation receipts to the budget in 2013.[6] To continue developing the nascent government securities market, the government aims at extending t-bill maturities to 12 months in 2013.

Structural Fiscal Reforms

12. **The introduction of a rules-based fiscal policy framework is in preparation** (LOI ¶13). An IMF TA mission to develop a fiscal rule visited Pristina in late June; its report is expected to be transmitted to the government in August. Staff and the authorities will discuss the TA mission's recommendations during the second review mission in October. The TA mission

[2] The authorities originally recorded PAK's financing from own-source revenues as nontax revenue. The recording has now been changed to financing, in line with the Technical Memorandum of Understanding.

[3] The primary deficit is projected to widen in 2013 due to a drop in dividend receipts (as PTK is expected to be privatized) and budget grants (as no further disbursements are foreseen from the World Bank). These factors overcompensate for the impact of structural fiscal adjustment on the headline deficit.

[4] See Box 5 of the Staff Report for the Request of the Stand-By Arrangement, IMF Country Report No. 12/100.

[5] For the computation of bank balance adequacy, see Box 2 of IMF Country Report No. 12/100.

[6] Due to uncertainty about the amount and timing of transfers from PAK, these are currently not included in the fiscal projections.

also analyzed shortcomings in the recording and monitoring of domestic payments obligations, with a view to preventing the accumulation of domestic payments arrears.

13. **Careful preparation, costing and phasing of spending initiatives remain at the core of the program,** to prevent that unfunded spending commitments would put fiscal sustainability at risk (LOI ¶15).

- As regards the government's ambitious ***highway construction program****,* it was agreed that the ongoing construction of highway R7 to Albania requires tight cost control as the project nears completion in 2013. There was also agreement that the government should enter into contractual obligations with respect to the planned highway R6 to Macedonia only once the privatization receipts for PTK had been received and the final costs for highway R7 were known, to be able to assess the space available for fitting R6 into a sustainable fiscal framework. Competitive bidding and a positive assessment by the World Bank of the project's viability are additional requirements.
- ***Health care reform, the expansion of pensioner and war veteran benefits, and civil service reform*** (Box 2) are further spending initiatives that require careful preparation and often phased implementation, in close consultation with the World Bank. In cases where these initiatives involve the extension of benefits to recipients whose number is unknown—such as war veterans, or retirees forcibly removed from their workplace in the 1990s—an assessment of the number of eligible beneficiaries is a prerequisite for a fiscal impact assessment, in line with the program's corresponding continuous structural benchmark.

14. **The authorities and staff discussed steps to advance fiscal decentralization** (LOI ¶16), oriented on the recommendations of a recent IMF TA mission. Objectives include (i) increasing the efficiency of spending allocations at the municipal level; and (ii) giving municipalities more incentives to raise own-source revenues. The circulars for the 2013 budget grant municipalities, for the first time, autonomy to allocate own-source revenues freely across spending categories except wages, in line with the corresponding end-May structural benchmark. The authorities consented that from 2014 this flexibility should be extended to *all* municipal spending, including expenditures financed with the general grant from the central government. In return, the general grant could gradually be reduced, thus contributing to fiscal adjustment.

B. Monetary and Financial Policies

15. **The upgrade of Kosovo's legal and regulatory framework for financial supervision is near-complete** (LOI ¶¶18, 19).

- A revised ***Deposit Insurance Law*** (DIL) was submitted to the Assembly on June 22, i.e. with a slight delay relative to the end-May structural benchmark. The additional time was needed to complete consultations with stakeholders, including KfW of Germany—that co-funds the seed capital of the Deposit Insurance Fund (DIF)—and IMF staff. The revised DIL permits the use of the DIF for purchase and assumption transactions, and clarifies the responsibilities of the central bank and the DIF in bank resolution. The DIF's mandate is limited to administrating payments of insured depositors.

- The DIL follows the passage of the revised ***Banking and Microfinance Law*** (BML) in April, and of an upgraded ***Central Bank Law*** in 2010. The BML enhances the central bank's ability to resolve troubled financial institutions, and introduces tighter prudential requirements, including on banks' exposures to their parent banks and to single borrowers. As the next step, the authorities are revising prudential regulations to bring them in line with the BML and with Basel core principles, including on liquidity and consolidated supervision.

16. **The central bank's capacity to provide emergency liquidity assistance (ELA) to banks will be fully established with the completion of this review** (LOI ¶¶3, 19). After the purchase of about €46 million upon completion of this review becomes available, the authorities intend to fund the central bank's special reserve fund (SRF) for ELA. The revised Law on Public Financial Management and Accountability (LPFMA) passed on June 14 includes a new article that grants the central bank exclusive control over the SRF, in line with the structural benchmark for mid-June.[7]

17. **A joint IMF/World Bank mission under the Financial Sector Assessment Program (FSAP) scheduled for September may identify further reform priorities.** The FSAP mission will, among other things, conduct a comprehensive review of the regulatory framework for both banks and insurance companies, discuss crisis preparedness, analyze the vulnerability of Kosovo's financial system to shocks, including through links between subsidiaries operating in Kosovo and their parent banks, and assess the appropriateness of the deposit insurance scheme.

C. Competitiveness and Private Sector Development

18. **The authorities are pursuing further initiatives to strengthen competitiveness and promote the development of a tradable sector.**

- Before the end of the year, enactment of a package of twelve laws is expected to streamline business registration and ***improve Kosovo's ranking in the Doing Business Survey*** of the World Bank (LOI ¶21).
- A joint project with Austrian Development Agency and Swiss Cooperation Office aims at ***improving access to financing for small and medium-sized enterprises***.
- To ***safeguard labor market flexibility and employability of women***, the government has prepared a preliminary report on implementation of the Labor Law, with an emphasis on the Law's maternity leave provisions that may induce discrimination against women in

[7] Technically the SRF is an account of the treasury with the central bank.

the labor market. The authorities plan to make amendments to the Labor Law as needed once the report is finalized (LOI ¶22).

- ***Energy sector reforms*** are advancing: the auction for the privatization of energy distribution has been completed and the winner has been announced, while the privatization of mining and energy generation is in preparation (LOI ¶23, Box 3).

V. Program Modalities

19. **The attached Letter of Intent describes the authorities' progress in implementing their economic program and sets out performance criteria and structural conditionality through December 2012.** The following modifications to program conditionality are proposed (Box 4, Tables 8–10, LOI ¶¶ 4, 12, 14, LOI Tables 2, 3, and TMU ¶¶ 6, 9):

- The performance criteria on the primary fiscal balance and the bank balance of the general government for end-August would be revised upward, reflecting the early receipt of dividends from PTK in April that had originally been expected for October.
- The program definitions of primary expenditures and the primary fiscal balance would be revised to exclude spending related to the activities of the Kosovo Privatization Agency (PAK). The ceiling for primary expenditures would be adjusted downward by the amount of PAK-related spending.
- The continuous structural benchmark on including a paragraph into all new benefit creating laws and amendment to such laws that allows for benefit cuts in case of insufficient budgetary funds would be dropped from program conditionality. The LPFMA, which has legal precedence over individual benefit creating laws, contains a similar, although somewhat more restrictively defined adjustment clause.[8] As a result, this benchmark becomes redundant.
- A structural benchmark would be introduced on the launch of the tender offer for the privatization of the telecommunications company PTK, with a target date of end-August.

20. **An updated safeguards assessment of the central bank has been completed.** Most recommendations made in the context of the safeguards assessment for the 2010 Stand-By Arrangement have been implemented. In particular, audit committee oversight has been strengthened, and the internal audit department has taken key steps toward full compliance with international standards. Going forward, the department should be subject to an external quality review. To safeguard IMF purchases used for budgetary financing, the authorities have

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[8] The LFMPA allows the government to cut expenditures in case of (i) a macroeconomic shock reducing fiscal revenue or financing, (ii) natural disasters, or (iii) the suspension or cancellation of a program or project to which the spending allocation relates. It does not, however, authorize the government to cut entitlements in other cases of budgetary shortfalls, for example structural underperformance in tax collection.

committed to continue (i) using the central bank as the sole investment manager; and (ii) holding all government accounts at the central bank (LOI ¶20).

VI. Staff Appraisal

21. **Macroeconomic and financial policies are broadly on-track.** All end-April and continuous quantitative performance criteria were met, as a revenue shortfall recorded early in the year owing mostly to temporary factors was overcompensated by under-execution of spending. Revenue collection has recovered subsequently. Four out of six applicable structural benchmarks were also met, one was met with a slight delay, and appropriate corrective action has been taken in the case of the missed structural benchmark.

22. **The economic outlook has remained stable, but there are downside risks.** While Kosovo has remained shielded from the euro area crisis due to limited financial and export linkages, a deterioration in labor market conditions in host countries of the Kosovar diaspora could depress growth and tax revenue, as well as affect financial stability. Against this backdrop, key objectives under the program remain to restore a fully sustainable fiscal stance and an appropriate level government bank balances, anchoring fiscal policy, and reinforcing the resilience of the financial system.

23. **Fiscal targets for 2012 remain achievable and appropriate, but require vigilant spending discipline and a sustained effort to meet revenue collection targets.** The government should stand ready to take additional savings measures as needed in case revenue collection shortfalls reappear, including by using another part of the contingency reserve inscribed into the 2012 budget law that allows the government to leave up to €60 million from the budget unallocated.

24. **The 2013 budget should continue the process of fiscal consolidation through restraint on current spending and growth-friendly revenue measures.** Restoring an adequate level of government bank balances in 2013 will depend on securing sizeable one-off financing, including from the privatization of PTK and the transfer of privatization and liquidation receipts from PAK. No major new spending initiatives should be advanced as long as bank balances are below the desired minimum targeted under the program (€325 million for 2013). As regards PTK, careful preparation of the privatization in line with the authorities' revised strategy is being called for to maximize the transaction's chances for success, and avoid a repeat of the last year's experience when the auction had to be called off for a lack of bidders. As for PAK, no funds—beyond those earmarked for covering PAK's operational expenditures—should be transferred to the government budget before clarity has been established that these funds are free of claims from creditors and other stakeholders. For the period after 2013, the envisaged fiscal rule will be critical to anchor fiscal policy.

25. **Thorough prioritization, preparation and costing of spending initiatives remain pivotal to avoid unfunded expenditure commitments that could put fiscal sustainability at risk.** This will require resisting temptations to address social spending pressures in an ad-hoc,

haphazard fashion. Kosovo's ambitious highway construction program needs especially careful management, in view of its high budgetary cost and corresponding fiscal risks that depend—as the experience with highway R7 to Albania has illustrated—in part on the design of the construction contract. To allow the integration of the planned highway R6 to Macedonia into a sustainable budgetary framework, the government should enter into contractual commitments only once the ongoing work on highway R7 is near completion, and the PTK privatization receipts have been received.

26. **Kosovo's upgraded legal and regulatory framework for financial supervision provides the central bank with a comprehensive toolkit to safeguard the resilience of the financial system.** A critical component is the central bank's capacity to provide ELA that will be fully established after the completion of this review. The framework needs to be complemented by a practice of financial supervision that continues to vigilantly enforce prudential rules and safeguard high standards of corporate governance in Kosovo's financial system.

27. **The policies under the program provide the best safeguard to steer Kosovo's economy through the period ahead, establish confidence in Kosovo's macroeconomic management, and lay the foundations for robust and balanced growth.** Steadfast commitment to policy discipline by all stakeholders, and strong support for the program's objectives across the political spectrum will be needed to render its implementation a success, and avoid a repeat of the unfavorable experience with Kosovo's first SBA of July 2010.

28. **Staff supports the authorities' request for completion of the first review.** Staff also supports the requested modifications of program conditionality that are fully consistent with the program's objectives.

Box 1. The Kosovo Privatization Agency (PAK)

PAK was established in 2008 as an independent public body to ensure proper administration, privatization and liquidation of formerly Socially Owned Enterprises (SOEs). By May 2012, PAK had privatized about 60 percent of 600 SOEs, raising €567 million in the process. However, not all creditor claims against that these companies have already been settled. The sale of assets of companies that could not be sold as a whole has been less successful, as only €53 million in proceeds have been raised to date. Further, Kosovo's transition from supervised to full sovereignty has resulted in a discontinuation of grants to fund PAK's activities as of 2012.

To address these challenges, a revised PAK law was passed by the Assembly in 2011, aiming at (i) speeding up liquidation and expediting the distribution of privatization and liquidation proceeds to SOE stakeholders; and (ii) establishing a new framework for the financing of PAK's activities.

i. PAK contracted Deloitte Central Europe to speed up the settlement of claims. The interim target is to settle all claims against 179 SOEs by mid-2013. The finalization of privatization and liquidation, and the dissolution of PAK, is envisaged for 2016.

ii. As for financing, 5 percent of PAK's total trust funds are scheduled to be transferred to the treasury, and are earmarked to finance PAK's operational and other expenses (for a period of up to 5 years). 20 percent of trust funds are set aside for SOE employees that are entitled to a share of sales proceeds on a priority basis. The remainder of the trust fund (75 percent) is used to satisfy creditor claims. Any residual funds would eventually also be transferred to the treasury.

As a result, the government expects to receive €30.5 million in PAK trust funds this year earmarked for PAK-related spending. PAK-related spending in 2012 is projected at €8.1 million and includes fees for Deloitte. The excess in transferred trust funds over 2012 PAK-related spending will be saved as own-source revenue and fund PAK's activities in future years.

Box 2. Reforming Kosovo's Civil Service

Kosovo continues to lack a professional civil service, which is an impediment to administrative capacity. The public administration was established gradually from 2003 with the transfer of functions from the temporary UNMIK administration to the Provisional Institutions of Self Government. Until 2010, the legal framework for Kosovo's civil service was based on UNMIK regulations, but had important flaws: (i) all public employees were defined as 'civil servants', with no distinction between administrative, professional and auxiliary staff; (ii) no transparent grading or pay structure existed; and (iii) there were no open-ended contracts nor transparent criteria for the renewal of public sector employment.

To address these deficits, two Laws on Civil Servants and on Salaries of Civil Servants were drafted with support from the World Bank, and passed by the Assembly in June 2010.[1] The laws define the rights and obligations of civil servants, and establish a uniform pay and grading structure. However, they have not yet been implemented, as the transition to the new structure requires substantial advance preparation, and out of concern about the reform's budgetary impact. A fiscal impact assessment in 2009 put the cost of civil service reform at €9.1 million in the first year. Several developments since then suggest that this estimate is now too low, and tightly written secondary legislation is critical to keep a lid on cost.

- The determination of the ***number of civil servants*** covered by the law needs to be re-established, as since 2009 the number of public employees has increased (notably support staff in schools, and staff for new ministries and municipalities).
- ***Over-grading*** and overly ***rapid promotions*** are upside risks to cost. Over-grading should be limited by adherence to the Law on Public Administration that requires a standard organic structure for ministries, agencies, and municipalities. As for promotions, annual progression to a higher salary grade should be limited to at most 10 percent of staff from the current limit of 50 percent, and the cost of progression could be contained by inscribing modest differentials between salary steps into secondary legislation.
- ***Over-staffing at the municipal level*** is another cost factor. As of December 2011, total public employment stood at 75,000, with 33,000 public employees working for the central government and 42,000 for municipalities. A recent World Bank analysis suggests that municipal staffing levels are 13 percent too high.
- Limits on **overtime pay** were part of the original draft Law on Civil Servants, but were removed during deliberations in the Assembly. Secondary legislation should introduce a limit for paid overtime to no more than 10 percent of the base salary.

[1] For more detail see World Bank's December 2009 Public Sector Modernization Project report, #51060-XK

Box 3. Reforming the Energy Sector

Kosovo's energy sector is not only a fiscal burden, but a detriment to the private sector development and an environmental hazard. The state-owned energy company (KEK) operates two coal-fired plants (Kosova A and B) and imports electricity. Key problems include:

1. *Commercial inefficiency.* In 2010, only 69 percent of the energy supplied was paid by customers, due to theft of electricity and payment delinquencies.
2. *Technical inefficiency.* About 17 percent of the energy in the network is lost, owing to years of under-investment and inadequacy of the voltage standard.
3. *Inadequate generation capacity*. Electricity supply is unstable. Power cuts result from insufficient generation capacity, notably in peak hours, and from technical failures of aging and poorly-maintained generators.
4. *Environmental inadequacy*. The power plants are highly polluting, especially the 35-year old Kosova A plant, which is among the largest single-point sources of pollution in the Balkans. EU Directives prescribe that Kosovo A be decommissioned by 2017. Kosovo B can operate until 2030 but must be refurbished.

In the 2000s, KEK absorbed substantial transfers from the budget to subsidize electricity imports and fund investments. The situation has improved recently, however. Revenue collection strengthened from 54 percent of the energy supplied in 2007 to an estimated 73 percent in 2011, reflecting managerial changes in KEK and support from the police in disconnecting illegal cables. These efforts have allowed cutting subsidies for KEK without raising tariffs, and thus contributed to fiscal adjustment.

Kosovo: Transfers to KEK, 2009-12

	2009	2010	2011	2012*
	(Percent of GDP)			
Total	3.7	2.1	1.2	0.6
Subsidies	1.6	0.7	0.6	0.4
Loans	2.0	1.4	0.6	0.2

* Projection

Going forward, upgrading technical and environmental standards to European levels requires investments at a scale surpassing the government's financial capacity. The authorities therefore intend to privatize energy distribution as well as mining and electricity generation.

- On *distribution*, the winning bid was announced in June 2012. The private distributor will be in charge of improving commercial efficiency.
- On *mining and generation*, a request for proposals was issued in March 2012. The winning company will rehabilitate Kosova B and is expected, with assistance of the World Bank, to build a new power plant that will eventually replace Kosova A and enhance generation capacity.

Box 4. 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) enhancing the efficacy of fiscal decentralization; (v) strengthening the legal framework for financial regulation and supervision; and (vi) equipping the central bank with the funds needed for emergency liquidity assistance.

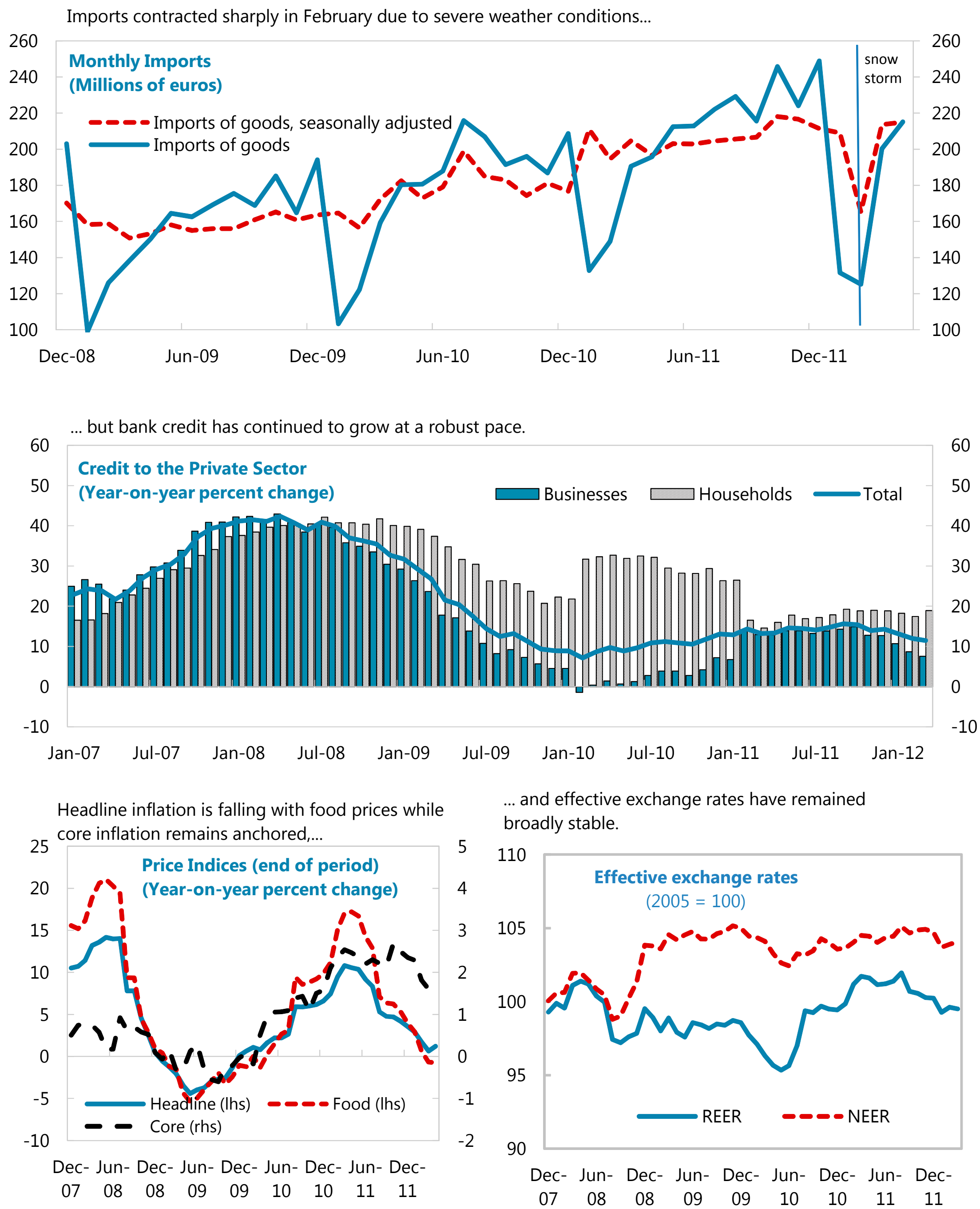
Program Modalities:

- ***Access:*** SDR 90.968 million (154 percent of quota)
- ***Length:*** 20 months (through December 26, 2013)
- ***Phasing:*** SDR 4.251 million was made available after Board approval on April 27, 2012. The second purchase, subject to completion of the first review, amounts to SDR 39.108 million. Subsequent purchases are contingent on the completion of further reviews.

Conditionality:

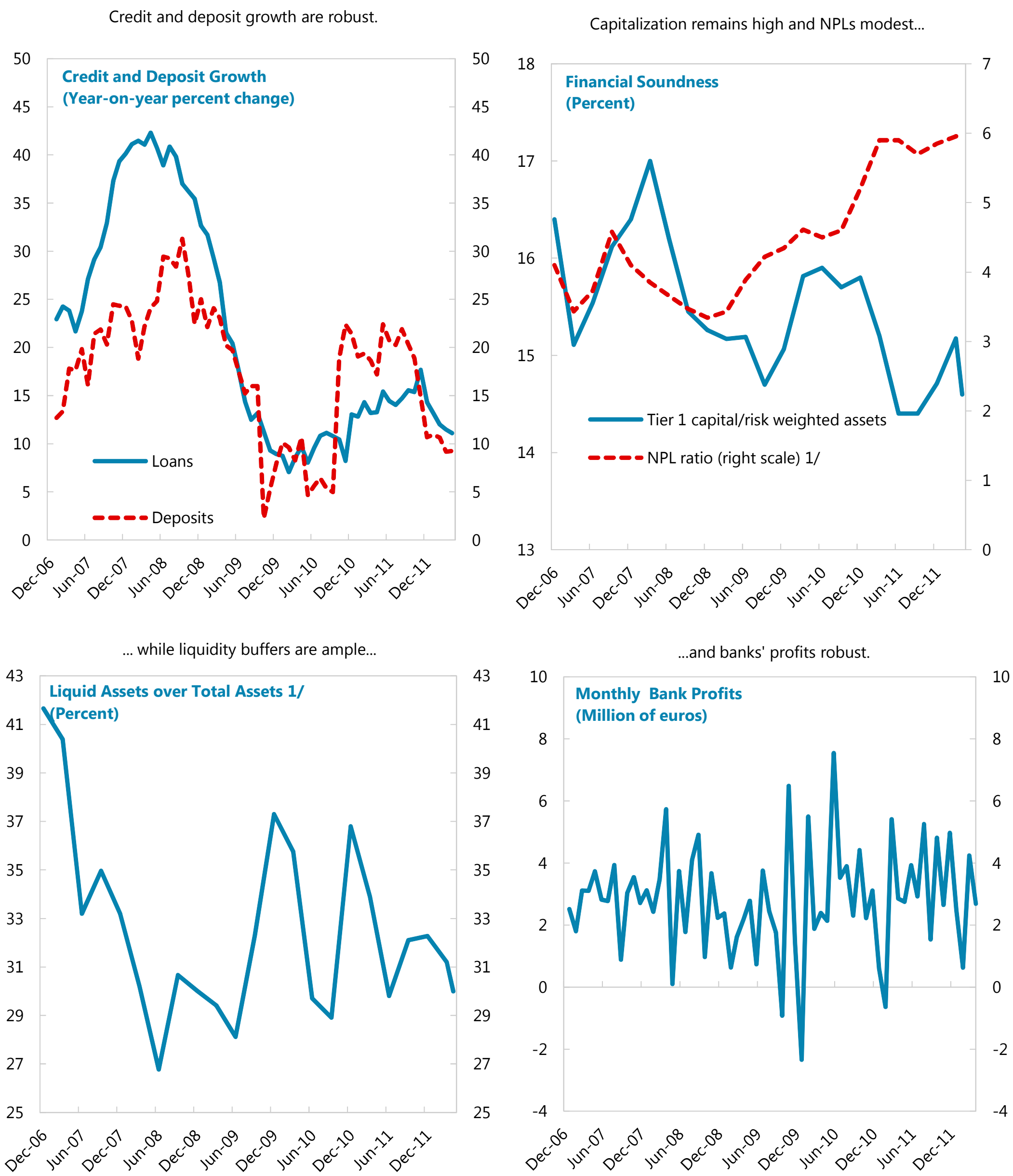
- ***Quantitative performance criteria***
  - Floor on the bank balance of the general government
  - Floor on the primary fiscal balance of the general government
  - Ceiling on primary expenditures of the general government
  - Ceiling on the net contracting of nonconcessional debt by the general government
  - 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***
  - Launch of the tender offer for PTK. *By end-August 2012*.
  - Submission of a 2013 budget to the Assembly that is consistent with the objectives of the program. *By end-October 2012.*
  - Monthly meetings of the Program Monitoring Committee and transmission of the meetings' minutes to the IMF Resident Representative. *Continuous.*
  - Fiscal impact assessments evaluating the budgetary impact of all new benefit creating laws, amendments to laws or regulations over a period of at least five years. *Continuous.*

Figure 1. Kosovo: Recent Economic Developments



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

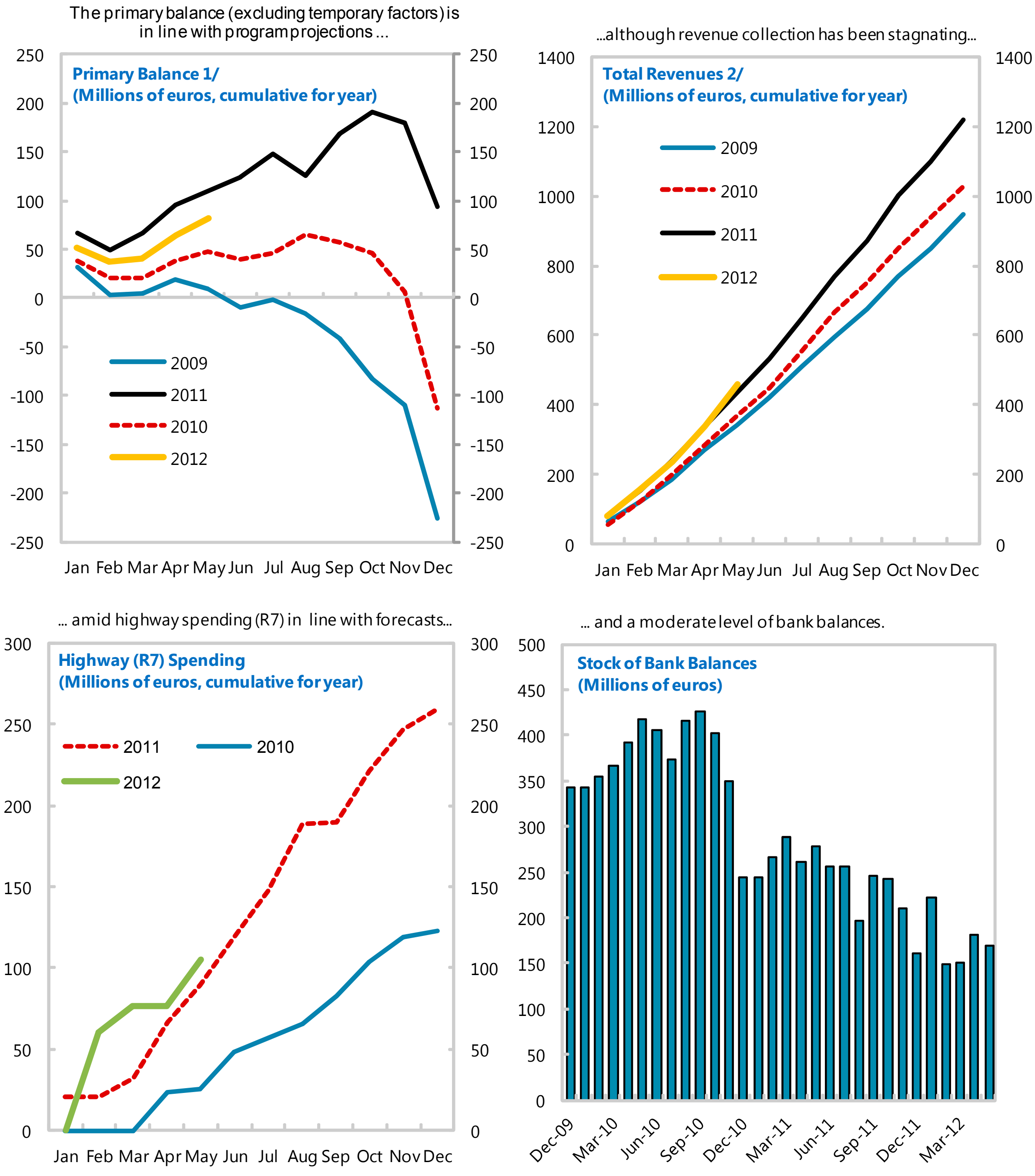
Figure 2. Kosovo: Selected Banking Sector Indicators



Sources: Cental Bank of Kosovo; IMF staff estimates.

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

Figure 3. Kosovo: Recent Fiscal Developments



Source: Country authorities; and IMF staff calculations.
1/ Primary balance excluding highway (R7) expenditures, grants, and dividends. The 2011 outcome exceeded the program target under the SMP by a large margin.
2/ Total revenues excluding grants and dividends.

Table 1. Kosovo: Main Indicators, 2008–17

(Percent, unless otherwise indicated)

	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017
				Est.	Projections					
Real growth rates										
GDP	6.9	2.9	3.9	5.0	3.8	4.1	3.2	5.0	5.0	4.6
GDP per capita	5.6	1.4	2.4	3.4	2.2	2.6	1.7	3.4	3.4	3.1
Consumption	4.3	1.0	2.9	2.9	2.5	2.7	3.4	3.3	3.3	3.0
Investment	18.1	11.7	8.8	7.6	6.0	9.1	1.4	10.6	9.3	9.4
Exports	4.7	7.8	24.2	13.6	6.4	5.4	6.7	7.3	9.2	6.6
Imports	5.9	5.3	11.9	5.6	3.7	5.0	3.8	6.4	6.6	6.0
Official unemployment (percent of workforce)	47.5	45.4	45.1	…	…	…	…	…	…	…
Price changes										
CPI, period average	9.4	-2.4	3.5	7.3	0.6	1.2	1.4	1.4	1.2	1.3
CPI, end of period	0.5	0.1	6.6	3.6	1.0	1.9	1.0	1.7	0.8	1.7
Import prices	11.8	-4.9	3.2	7.7	-2.1	-1.0	-1.4	-1.2	-0.8	-0.6
GDP deflator	6.2	-1.3	3.7	4.8	2.1	2.4	1.9	1.9	1.9	1.9
Real effective exch. rate (average; -=depreciation)	3.2	-1.0	-0.7	3.5	…	…	…	…	…	…
Real effective exch. rate (end of period; -=depreciation)	0.2	-1.0	0.8	0.7	…	…	…	…	…	…
General government budget (percent of GDP)										
Revenues, incl. interest income 1/	24.5	29.3	27.6	28.1	28.0	27.1	27.7	27.9	28.3	28.5
Primary expenditures	24.7	29.9	30.0	29.8	30.6	30.2	28.6	28.7	29.1	29.3
Of which										
Wages and salaries	5.9	6.8	7.4	8.3	8.4	8.3	8.3	8.2	8.2	8.2
Subsidies and transfers	7.1	7.3	6.4	5.8	6.1	6.1	6.2	6.2	6.2	6.2
Capital and net lending, incl. highway project	7.6	11.6	11.9	11.9	12.2	11.8	9.9	10.0	10.2	10.4
Capital expenditures on highway project 2/	…	…	2.9	5.6	6.0	5.6	0.0	0.0	0.0	0.0
Overall balance	-0.2	-0.7	-2.6	-1.9	-2.8	-3.4	-1.3	-1.2	-1.2	-1.3
Debt financing, net	0.0	-0.2	0.3	-0.1	2.0	2.5	1.4	1.8	1.9	2.0
Privatization	0.0	0.0	0.0	0.0	0.6	5.9	0.2	0.2	0.2	0.3
Stock of government bank balances	10.8	8.7	5.8	3.5	3.8	8.9	8.7	8.5	7.9	7.8
Recommended minimum bank balances 3/	…	…	5.7	5.8	6.1	6.2	6.7	7.2	7.6	7.8
Financing gap	0.0	0.0	0.0	0.0	1.8	0.3	0.0	0.0	0.0	0.0
Savings-investment balances (percent of GDP) 4/										
Domestic savings	-12.6	-7.4	-6.7	-7.9	-5.3	-2.7	-2.3	-0.3	2.1	4.2
Transfers excluding general government (net)	14.0	11.9	12.5	12.2	11.9	11.8	12.0	11.7	11.4	11.0
Net factor income	4.3	2.1	2.1	2.6	2.4	2.5	2.5	2.5	2.5	2.5
National savings	5.8	6.6	8.0	7.0	9.0	11.6	12.2	14.0	16.0	17.7
Investment	28.6	32.3	33.9	33.2	32.7	33.7	31.7	32.3	33.1	34.1
Current account, excl. official transfers	-22.8	-25.7	-25.9	-26.2	-23.7	-22.0	-19.5	-18.3	-17.1	-16.4
Current account balance, incl. official transfers	-15.3	-15.4	-17.4	-20.3	-18.3	-18.2	-16.0	-15.0	-14.1	-13.8
Of which: official transfers 5/	7.5	10.3	8.6	5.9	5.4	3.9	3.5	3.2	3.1	2.6
Net foreign direct investment	8.9	7.1	8.5	8.0	8.6	12.0	7.3	7.4	7.6	7.8
Portfolio investment, net	1.7	-1.4	-5.5	-2.3	-3.2	-1.5	-2.6	-1.6	-0.8	-0.1
Bank credit to the private sector	32.7	8.9	12.6	14.7	7.7	…	…	…	…	…
Deposits of the private sector	25.8	22.2	23.1	11.4	8.6	…	…	…	…	…
Non-performing loans (percent of total loans)	3.3	4.3	5.2	5.8	6.0 6/	…	…	…	…	…
GDP (millions of euros)	3,851	3,912	4,216	4,637	4,911	5,234	5,508	5,895	6,310	6,726
GDP per capita (euros)	2,323	2,325	2,468	2,674	2,790	2,930	3,038	3,203	3,378	3,548
GNDI per capita (euros)	2,749	2,650	2,829	3,071	3,189	3,348	3,480	3,661	3,848	4,027
Population (thousands) 7/	1,658	1,683	1,708	1,734	1,760	1,786	1,813	1,840	1,868	1,896

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

1/ Projections assume a grant from IDA in 2012.

2/ Based on World Bank estimates.

3/ Temporary deviations from the recommendation may be warranted in case of (i) large anticipated payments, for example on infrastructure, or (ii) large receipts, for example from privatizations.

4/ Savings-investment balance of entire economy, including donor sector.

5/ Total foreign assistance excluding capital transfers.

6/ April 2012.

7/ Series updated with the 2011 census.

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

	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017
					Est.	Projections					
	(Real growth, percent)										
Consumption	5.3	4.3	1.0	2.9	2.9	2.5	2.7	3.4	3.3	3.3	3.0
Private	8.0	6.4	0.4	3.8	3.0	2.6	3.2	3.2	3.2	3.1	2.9
Public	-5.4	-5.9	3.9	-1.5	2.3	1.5	-0.3	4.3	4.0	4.4	3.6
General government	-2.3	-0.2	15.9	7.1	8.5	6.9	5.0	5.7	6.1	6.6	5.3
Donor sector 1/	-8.7	-12.2	-11.4	-16.0	-10.9	-12.2	-17.1	-1.0	-5.0	-6.1	-5.9
Investment	15.2	18.1	11.7	8.8	7.6	6.0	9.1	1.4	10.6	9.3	9.4
Private	21.6	0.6	4.8	7.0	7.2	3.2	13.3	8.0	12.2	10.0	10.2
Public	-9.7	109.2	29.0	12.6	8.4	11.5	1.7	-11.6	6.5	7.6	7.5
General government	-8.7	153.6	35.1	13.8	9.4	12.2	2.0	-11.7	7.0	8.1	7.9
Donor sector 1/	-12.3	-18.6	-26.0	-7.3	-11.1	-5.1	-5.6	-5.8	-10.1	-9.9	-9.8
Exports 2/	13.4	4.7	7.8	24.2	13.6	6.4	5.4	6.7	7.3	9.2	6.6
Imports	11.0	5.9	5.3	11.9	5.6	3.7	5.0	3.8	6.4	6.6	6.0
GDP	6.3	6.9	2.9	3.9	5.0	3.8	4.1	3.2	5.0	5.0	4.6
Memorandum item:											
GDP (millions of euros)	3,394	3,851	3,912	4,216	4,637	4,911	5,234	5,508	5,895	6,310	6,726

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

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

Table 3. Kosovo: Balance of Payments, 2009–17 1/
(Millions of euros, unless otherwise indicated)

	2009	2010	2011	2012	2013	2014	2015	2016	2017
			Projections						
Goods and services balance	-1,553	-1,710	-1,904	-1,866	-1,901	-1,875	-1,920	-1,958	-2,015
Goods	-1,673	-1,776	-2,090	-2,087	-2,161	-2,188	-2,294	-2,406	-2,517
Exports	177	305	322	355	391	438	481	539	599
Imports	-1,851	-2,081	-2,412	-2,442	-2,552	-2,626	-2,775	-2,946	-3,116
Services	121	66	186	221	260	314	374	448	502
Receipts	429	476	608	654	699	748	815	903	969
Payments	-308	-410	-422	-433	-439	-434	-441	-455	-467
Income	83	89	121	118	130	139	150	160	170
Compensation of employees (net)	169	172	178	186	193	201	209	217	226
Investment income	-86	-82	-57	-67	-63	-62	-59	-57	-56
Interest payments on public debt	-1	-9	-9	-13	-11	-11	-10	-10	-9
Transfers	866	889	839	848	819	857	884	911	918
Official transfers	401	361	273	265	202	194	191	194	178
Other transfers (net)	465	528	566	583	617	663	693	717	740
Of which: inflows of remittances	506	512	548	553	569	592	619	648	674
Current account	-604	-732	-943	-899	-952	-879	-887	-888	-928
Capital and financial account	543	553	743	613	737	679	687	688	728
Capital account	108	25	6	2	2	2	2	2	2
Of which: WB Trust Fund	89	0	5	0	0	0	0	0	0
Financial account, incl. CBK	435	527	737	610	735	677	685	686	726
Foreign direct investment, net	277	358	371	423	629	400	434	482	522
Commercial banks, excl. FDI	-98	-101	25	-76	-8	-38	11	65	109
General government	-132	21	-4	22	45	-22	-57	-113	-83
Disbursements, incl. past IMF purchases	0	22	8	34	59	0	0	0	0
Repayments	-132	-11	-12	-11	-14	-22	-38	-62	-47
Prepayment of debt	-132	-11	-12	-11	-14	-22	-38	-62	-47
Other repayments	0	0	0	0	0	0	0	0	0
Other	0	10	0	0	0	0	0	0	0
Other sectors, excl. FDI 2/	366	284	334	285	367	372	345	273	232
Central Bank of Kosovo	22	-35	11	-44	-298	-36	-47	-23	-54
Reserve assets	94	-47	60	-44	-298	-36	-47	-23	-54
Government balances (program definition)	-17	236	73	-27	-278	-17	-22	4	-26
Other reserve assets, incl. SDRs	111	-283	-14	-17	-20	-19	-25	-27	-27
Non-reserves assets	-132	12	-46	0	0	0	0	0	0
Liabilities 3/	60	0	-3	0	0	0	0	0	0
Net errors and omissions 4/	61	180	200	200	200	200	200	200	200
Financing gap	0	0	0	87	15	0	0	0	0
Memorandum items:									
Current account, excl. official transfers	-1,005	-1,093	-1,216	-1,164	-1,154	-1,073	-1,078	-1,081	-1,106
(in percent of GDP)	-25.7	-25.9	-26.2	-23.7	-22.0	-19.5	-18.3	-17.1	-16.4
Current account, incl. official transfers	-604	-732	-943	-899	-952	-879	-887	-888	-928
(in percent of GDP)	-15.4	-17.4	-20.3	-18.3	-18.2	-16.0	-15.0	-14.1	-13.8
Trade Balance (percent of GDP)	-39.7	-40.6	-41.1	-38.0	-36.3	-34.0	-32.6	-31.0	-30.0
Debt service to export ratio (percent)	21.9	2.6	2.2	2.4	2.3	2.8	3.7	5.0	3.6
Net foreign assets of commercial banks	444	545	519	596	604	642	631	589	503
Net foreign assets of CBK	1,088	1,108	1,097	1,141	1,439	1,475	1,522	1,545	1,599
Gross international reserves of the CBK	625	686	626	670	968	1,004	1,052	981	1,035

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

1/ The authorities are in the process of revising the balance of payments statistics, based in part on recommedations by a recent STA TA mission.
2/ Including trading companies, insurance companies, and pension funds.
3/ Includes SDR allocations and IMF account at historical value.
4/ Projections of errors include unidentified private remittances and other capital flows based on average historical levels.

Table 4. Kosovo: Consolidated Government Budget, 2011–14 1/

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

	2011	2012						2013	2014
		Apr.		Aug.		Dec			
	Est.	Prog.	Est.	Prog.	Revised Prog.	Prog.	Revised Prog.	Proj.	Proj.
Total primary revenue and grants	1,303	378	357	873	886	1,381	1,376	1,417	1,520
Total primary revenue	1,277	377	356	841	853	1,347	1,342	1,415	1,520
Taxes	1,072	322	298	735	735	1,145	1,145	1,253	1,348
Direct taxes	151	68	60	129	129	168	168	186	211
Indirect taxes	949	264	248	625	625	1,012	1,012	1,105	1,177
Tax refunds	-28	-11	-11	-19	-19	-35	-35	-38	-40
Nontax revenues	205	56	58	106	118	202	197	161	172
Of which :									
Dividends	60	0	15	0	15	45	45	0	0
PAK-related receipts		0	0	3	0	5	0	0	0
Grants	26	1	1	33	33	34	34	3	0
Budget support	19	0	1	30	30	30	30	0	0
Trust fund at the World Bank	4	0	0	0	0	0	0	0	0
Project grants	3	1	0	3	3	4	4	3	0
Primary expenditure	1,382	400	353	914	916	1,499	1,503	1,581	1,578
Of which :									
PAK-related expenditures		1	1	3	5	5	8	8	8
Primary expenditure excluding PAK	…	352	352	911	911	1,494	1,494	1,573	1,569
Current expenditure	832	243	236	536	542	896	905	966	1,031
Wages and salaries	385	102	101	238	240	407	410	433	458
Goods and services	177	58	58	120	124	188	193	208	229
Subsidies and transfers	270	84	77	178	178	297	298	321	341
Pension and social assistance	178	64	59	130	130	196	196	216	226
Other transfers and subsidies 2/	92	20	18	48	48	101	102	105	114
Reserve	0	0	0	0	0	4	4	4	4
Capital expenditure and net lending	550	156	117	377	374	603	598	615	546
Capital expenditure	520	145	118	366	363	592	587	605	541
Highway project 3/	259	104	76	214	213	296	294	293	0
Other capital spending	261	42	41	152	150	296	293	312	541
Net lending	30	11	-1	11	11	11	11	10	5
Primary balance	-79	-21	4	-41	-30	-119	-127	-164	-58
Primary balance net of PAK		-20	5	-38	-26	-119	-119	-155	-50
Interest income, net	-7	-6	-5	-6	-6	-12	-12	-14	-14
Overall balance	-86	-27	-1	-46	-36	-130	-138	-178	-72
Financing	86	22	1	0	-10	44	52	171	81
Foreign financing	2	3	-1	15	15	22	22	45	-22
Drawings, incl. official financing	8	14	5	21	21	34	34	59	0
Amortization	-12	-6	-6	-6	-6	-11	-11	-14	-22
Trust fund at the World Bank	5	0	0	0	0	0	0	0	0
Prospective repurchases	0	0	0	0	0	0	0	0	0
Domestic financing	85	19	2	-15	-25	21	30	126	103
Domestic borrowing (net)	0	30	30	50	50	74	74	85	98
Privatization revenues	0	0	0	0	13	0	31	310	10
o/w PAK privatization				…	13	…	31	0	0
Quotas of international institutions	0	0	0	0	0	0	0	0	0
Other financial assets, net	0	-5	0	-10	-10	-20	-20	-3	0
Own-source revenue (– = increase)	0	0	-8	0	-8	-5	-28	3	3
o/w PAK related		…	…	…	-8	…	-22	8	8
Bank balance (prog.; – = increase)	84	-6	-20	-55	-70	-27	-27	-278	-17
Financing gap	0	0	0	46	46	87	87	15	0
Memorandum items:									
Bank balance of the general government	160	166	180	215	230	187	187	465	482
Of which: ELA	0	0	0	46	46	46	46	46	46

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.
3/ Based on the WB estimates.

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

(Excluding donor designated grants; percent of GDP)

	2011	2012	2013	2014	2015	2016	2017
	Est.	Revised Prog.	Projections				
Total primary revenue and grants	28.1	28.0	27.1	27.6	27.8	28.2	28.4
Total primary revenue	27.5	27.3	27.0	27.6	27.8	28.2	28.4
Taxes	23.1	23.3	23.9	24.5	24.7	25.0	25.3
Direct taxes	3.3	3.4	3.6	3.8	4.1	4.5	4.8
Indirect taxes	20.5	20.6	21.1	21.4	21.2	21.3	21.2
Tax refunds	-0.6	-0.7	-0.7	-0.7	-0.7	-0.7	-0.7
Nontax revenues	4.4	4.0	3.1	3.1	3.2	3.1	3.1
Interest income	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Fees and other charges	0.9	0.9	1.0	1.0	0.9	0.9	0.9
Municipal own revenues	0.8	0.8	0.8	0.8	0.8	0.8	0.8
Telecom licenses	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Other	1.4	1.4	1.4	1.4	1.4	1.4	1.4
Of which:							
Dividends	1.3	0.9	0.0	0.0	0.0	0.0	0.0
PAK-related receipts	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Grants	0.6	0.7	0.1	0.0	0.0	0.0	0.0
Budget support	0.4	0.6	0.0	0.0	0.0	0.0	0.0
Trust fund at the World Bank	0.1	0.0	0.0	0.0	0.0	0.0	0.0
Project grants	0.1	0.1	0.1	0.0	0.0	0.0	0.0
Primary expenditure	29.8	30.6	30.2	28.6	28.7	29.1	29.3
Of which:							
PAK-related expenditures	…	0.2	0.2	0.2	0.0	0.0	0.0
Primary expenditure excluding PAK	…	30.4	30.0	28.5	0.0	0.0	0.0
Current expenditure	17.9	18.4	18.5	18.7	18.8	18.9	18.9
Wages and salaries	8.3	8.4	8.3	8.3	8.2	8.2	8.2
Goods and services	3.8	3.9	4.0	4.2	4.3	4.4	4.4
Subsidies and transfers	5.8	6.1	6.1	6.2	6.2	6.2	6.2
Pension and social assistance	3.8	4.0	4.1	4.1	4.1	4.1	4.1
Other transfers and subsidies 1/	2.0	2.1	2.0	2.1	2.1	2.1	2.1
Reserve	0.0	0.1	0.1	0.1	0.1	0.1	0.1
Capital expenditure and net lending	11.9	12.2	11.8	9.9	10.0	10.2	10.4
Capital expenditure	11.2	11.9	11.6	9.8	10.0	10.2	10.4
Highway project 2/	5.6	6.0	5.6	0.0	0.0	0.0	0.0
Other capital spending	5.6	6.0	6.0	9.8	10.0	10.2	10.4
Net lending	0.6	0.2	0.2	0.1	0.0	0.0	0.0
Primary balance	-1.7	-2.6	-3.1	-1.1	-0.9	-0.9	-0.9
Primary balance net of PAK	0.0	-2.4	-3.0	-0.9	-0.9	-0.9	-0.9
Interest income, net	-0.2	-0.2	-0.3	-0.3	-0.3	-0.3	-0.4
Overall balance	-1.9	-2.8	-3.4	-1.3	-1.2	-1.2	-1.3
Financing	1.9	1.1	3.1	1.3	1.2	1.2	1.3
Foreign financing	0.0	0.5	0.9	-0.4	-0.7	-1.0	-0.7
Drawings, incl. official financing	0.2	0.7	1.1	0.0	0.0	0.0	0.0
Amortization	-0.3	-0.2	-0.3	-0.4	-0.3	-0.2	-0.2
Trust fund at the World Bank	0.1	0.0	0.0	0.0	0.0	0.0	0.0
Prospective repurchases	0.0	0.0	0.0	0.0	-0.3	-0.8	-0.5
Domestic financing	1.8	0.6	2.3	1.7	1.8	2.2	2.0
Domestic borrowing (net)	0.0	1.5	1.6	1.8	2.1	2.1	2.2
Drawings	0.0	3.3	7.4	4.7	4.3	6.1	6.9
Amortization	0.0	-1.8	-5.8	-2.9	-2.2	-4.0	-4.8
Privatization revenues	0.0	0.6	5.9	0.2	0.2	0.2	0.3
o/w PAK privatization	0.0	0.6	0.0	0.0	0.0	0.0	0.0
WB subscription	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Other financial assets (net)	0.0	-0.4	-0.1	0.0	0.0	0.0	0.0
Own-source revenue (– = increase)	0.0	-0.6	0.1	0.1	-0.1	-0.1	-0.1
o/w PAK related	0.0	-0.5	0.2	0.2	0.0	0.0	0.0
Bank balance (prog.; – = increase)	1.8	-0.6	-5.3	-0.3	-0.4	0.1	-0.4
Financing gap	0.0	1.8	0.3	0.0	0.0	0.0	0.0
Memorandum items:							
Bank balance of the general government	3.5	3.8	8.9	8.7	8.5	7.9	7.8
Of which: ELA	0.0	0.9	0.9	0.8	0.8	0.7	0.7
Nominal GDP (millions of euros)	4,637	4,911	5,234	5,508	5,895	6,310	6,726

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

1/ Including capital transfers to public enterprises.

2/ Based on World Bank estimates.

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

					Projections		
	2008	2009	2010	2011	2012	2013	2014
			Central Bank				
Net foreign assets	1,111	1,088	1,108	1,097	1,141	1,441	1,477
Foreign assets	1,111	1,198	1,247	1,233	1,277	1,575	1,611
Of which: Securities	541	529	199	25	45	65	85
Deposits	529	522	854	1,059	1,083	1,361	1,377
Foreign liabilities	0	110	139	136	136	136	136
Net domestic assets	-1,111	-1,088	-1,108	-1,097	-1,141	-1,441	-1,477
Net claims on the central government	-870	-681	-813	-797	-824	-1,102	-1,119
Liabilities	-870	-681	-813	-797	-824	-1,102	-1,119
Of which: Government balances (program definition)	-414	-178	-233	-160	-187	-465	-482
Commercial banks	-137	-233	-204	-210	-223	-239	-254
Other institutions	-64	-131	-46	-39	-39	-39	-39
Other items, net	-39	-43	-46	-51	-55	-61	-65
			Commercial banks				
Net foreign assets	325	444	545	519	596	604	642
Assets	401	584	710	676	766	789	842
Liabilites	76	140	165	156	170	185	200
Net domestic assets	815	949	1,169	1,389	1,477	1,620	1,717
Credit to private sector	1,183	1,289	1,451	1,664	1,793	1,944	2,048
Claims on the CBK	137	233	203	220	223	239	254
Net claims on the central government	-1	-165	-12	-1	30	50	65
Net claims on other public entities	-264	-123	-120	-127	-135	-145	-154
Other items, net	-240	-285	-354	-367	-433	-467	-495
Liabilities to the private sector	1,140	1,393	1,714	1,908	2,073	2,224	2,359
Demand deposits	384	441	545	598	659	716	768
Time deposits	756	951	1,169	1,311	1,413	1,508	1,591
Memorandum item:							
Gross international reserves	670	625	686	626	670	968	1,004
			(12-month percent change)				
Liabilities to private sector	25.8	22.2	23.1	11.4	8.6	7.3	6.1
Loans to the private sector	32.7	8.9	12.6	14.7	7.7	8.4	5.4
			(Percent of GDP)				
Total private sector deposits	29.6	35.6	40.7	41.2	42.2	42.5	42.8
Credit to the private sector	30.7	32.9	34.4	35.9	36.5	37.1	37.2

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

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

(Percent)

	2007	2008	2009	2010	2011		2012
					April	Dec.	April
Capital adequacy							
Regulatory capital/risk weighted assets	17.4	16.5	17.9	18.8	17.9	17.5	17.4
Tier 1 capital/risk weighted assets	16.4	15.3	15.1	15.8	15.0	14.7	14.6
Asset quality							
NPL ratio 1/	4.1	3.3	4.3	5.2	6.2	5.8	6.0
NPL net of provisions/capital	2.6	2.8	2.3	3.7	5.2	4.6	3.8
Sectoral breakdown of loans							
Agriculture	3.2	3.2	3.0	2.6	2.5	2.4	2.4
Manufacturing	10.6	8.0	11.5	10.9	9.7	9.9	9.7
Trade	49.6	44.5	43.2	37.1	38.6	37.1	37.3
Other services	8.4	15.1	8.8	12.1	12.2	13.7	13.0
Construction	5.6	5.5	6.9	7.5	7.5	6.8	7.4
Households	22.5	23.7	26.7	29.8	29.4	30.1	30.3
Liquidity							
Liquid assets/total assets 2/	33.2	30.0	37.3	36.8	34.0	32.3	30.0
Deposits/loans	128.1	122.0	138.6	126.1	125.2	125.2	120.9
Liquid assets to short-term liabilities 2/	47.8	42.1	47.0	46.2	43.2	39.6	37.9
Profitability							
Return on assets	2.9	2.6	1.4	1.8	1.1	1.5	1.2
Return on equity	27.1	24.7	21.4	18.8	10.5	14.9	11.6
Interest margin to gross income 3/	58.4	60.3	55.3	55.6	57.1	57.0	57.0
Non-interest expense to gross income 4/	12.6	11.2	16.3	16.6	23.7	18.0	20.7
Market risk							
Net open currency position/tier 1 capital	17.8	8.9	18.8	-0.1	-	2.5	-

Source: Central Bank of the Republic of Kosovo.

1/ NPL ratio includes the loans which are classified as doubtful loans and bad loans.

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

3/ Interest income minus interest expenditures. Gross income taken from income statement. Quarterly value.

4/ Includes fees, commissons, provisions for loan and other asset losses, and depreciation of fixed assets.

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

	2011	2012	2013
Gross Financing Requirements	955	910	966
Current account deficit	943	899	952
Amortization of medium and long term public debt	12	11	14
Sources of Financing	955	824	951
Capital account (net)	6	2	2
Foreign direct investment (net)	371	423	629
Net bank financing	25	-76	-8
Government loans	8	34	59
Net Foreign assets of the Central Bank of Kosovo	11	-44	-298
Other financing inc. net erros and omissions	534	485	567
Financing Need		87	15
IMF 1/		87	15
in percent of quota		125	22
Memorandum items:			
Kosovo IMF quota (SDR millions)	59	59	59
Kosovo IMF quota (Euro millions)	69	69	69

Source: IMF staff estimates and projections.

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

	2011	2012	2013
Gross Financing Requirements	20.6	18.5	18.5
Current account deficit	20.3	18.3	18.2
Amortization of medium and long term public debt	0.3	0.2	0.3
Sources of Financing	20.6	16.8	18.2
Capital account (net)	0.1	0.0	0.0
Foreign direct investment (net)	8.0	8.6	12.0
Net bank financing	0.5	-1.5	-0.2
Government loans	0.2	0.7	1.1
Net Foreign assets of the Central Bank of Kosovo	0.2	-0.9	-5.7
Other financing inc. net erros and omissions	11.5	9.9	10.8
Financing Need		1.8	0.3
IMF 1/		1.8	0.3

Source: IMF staff estimates and projections.

1/ The purchase of €5.02 million that became available upon program approval is included under government loans in "sources of financing".

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

	2012	2013	2014	2015	2016	2017	2018
Fund obligations based on prospective purchases (millions of SDR)							
Principal	0.0	0.0	0.0	9.8	39.4	33.6	4.0
Charges and interest	0.5	0.9	1.0	1.0	0.8	0.3	0.0
Fund obligations based on existing and prospective purchases (millions of SDR)							
Principal	0.0	2.4	9.4	17.9	41.5	34.6	4.0
Charges and interest	0.7	1.2	1.2	1.1	0.8	0.3	0.0
Total obligations based on existing and prospective purchases							
SDR millions	0.7	3.5	10.6	19.0	42.3	35.0	4.0
Euro millions	0.8	4.1	12.4	22.3	49.8	41.1	4.7
Percent of exports of goods and services	0.1	0.4	1.0	1.7	3.4	2.6	0.3
Percent of debt service	3.2	16.6	38.1	45.9	69.6	73.0	10.9
Percent of GDP	0.0	0.1	0.2	0.4	0.8	0.6	0.1
Percent of government revenue	0.1	0.3	0.8	1.4	2.8	2.1	0.2
Percent of quota	1.1	5.9	17.9	32.1	71.7	59.3	6.8
Outstanding Fund credit							
SDR millions	97.0	107.4	98.0	80.1	38.6	4.0	0.0
Euro millions	114.1	126.3	115.3	94.3	45.4	4.7	0.0
Percent of exports of goods and services	11.3	11.6	9.7	7.3	3.1	0.3	0.0
Percent of debt service	473.3	506.5	353.4	194.1	63.6	8.3	0.0
Percent of GDP	2.3	2.4	2.1	1.6	0.7	0.1	0.0
Percent of government revenue	8.5	8.9	7.6	5.7	2.5	0.2	0.0
Percent of quota	164.4	182.0	166.1	135.8	65.5	6.8	0.0
Net use of Fund credit (millions of SDR)	78.2	10.4	-9.4	-17.9	-41.5	-34.6	-4.0
Purchases	78.2	12.8	0.0	0.0	0.0	0.0	0.0
Repurchases	0.0	2.4	9.4	17.9	41.5	34.6	4.0
Memorandum items:							
Exports of goods and services (millions of euros)	1,009	1,089	1,185	1,297	1,443	1,568	1,704
External debt service (millions of euros) [2]	24.1	24.9	32.6	48.6	71.5	56.3	43.6
Nominal GDP (millions of euros)	4,911	5,234	5,508	5,895	6,310	6,726	7,169
Government revenue (millions of euros)	1,343	1,417	1,524	1,647	1,784	1,917	2,057
Quota (millions of SDR)	59.0	59.0	59.0	59.0	59.0	59.0	59.0

Sources: IMF staff estimates and projections.

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

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

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

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

Attachment I. Letter of Intent

REPUBLIC OF KOSOVO

Letter of Intent

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

Pristina, June 27, 2012

Dear Ms. Lagarde:

1. Kosovo's economy has continued to perform well in a difficult international environment. Robust current and capital inflows and solid lending by a well-capitalized and liquid banking system have supported growth, while contagion from the financial crisis in the euro area has remained subdued, owing to a small export base and limited financial linkages. However, downside risks remain, as foreign direct investment and remittances from the Kosovar diaspora could be affected in case of a deterioration of labor market conditions in host countries. Steadfast commitment to disciplined fiscal management, the restoration of a sufficient level of government bank balances, the further strengthening of the legal and regulatory framework of Kosovo's financial system, vigilant financial supervision, and progress with structural reforms to boost competitiveness provide the best safeguard to steer Kosovo's economy through the period ahead, and to establish the fundaments for robust and balanced growth.

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

- all *quantitative performance criteria* for end-April were met. The primary fiscal balance and government bank balances were stronger than programmed, despite a modest shortfall in revenue, as spending was under-executed and dividend payments from the state-owned telecommunications company (PTK) were advanced.
- most *structural benchmarks* were also met.

  (i) on May 10, we published the first 2013 budget circulars for municipalities. The circulars contain no limits on spending allocations from own-source revenues across nonwage categories, in line with the corresponding end-May structural benchmark;

  (ii) on June 14, the Assembly amended the Law on Public Financial Management and Accountability (LPFMA) with a provision specifying that only the central bank can authorize the withdrawal of funds from the special reserves fund (SRF) for emergency liquidity assistance (ELA), consistent with the corresponding structural benchmark;

(iii) also respected were the continuous structural benchmarks on monthly meetings of the Program Monitoring Committee, and on fiscal impact assessments evaluating the budgetary impact of all new benefit creating laws and amendments to such laws over a period of at least 5 years;

(iv) on June 22, we submitted a revised Deposit Insurance Fund Law to the Assembly in a form consistent with the new Banking and Microfinance Law. While the submission occurred somewhat later than originally specified under the structural benchmark (end-May), the delay was needed to complete discussions with stakeholders;

(v) on one occasion the continuous structural benchmark on including an article into all new benefit creating laws and amendment to such laws that allows for benefit cuts in case of insufficient budgetary funds was violated, as the law on pensions for the Kosovo Security Force was passed on May 3 without such a clause. The LPFMA contains a similar adjustment clause, however, for all budgetary allocations granted in the annual budget law. The amendment of the LPFMA passed on June 14 contains a provision emphasizing that the LPFMA's legal precedence over individual benefit creating laws extends to this adjustment clause (see also ¶14).

3. Based on this performance, we request completion of the first review under the Stand-By Arrangement. We also request a purchase of SDR 39.108 million following completion of the first review. We intend to deposit the purchase in the SRF designated for ELA.

4. We request two modifications of performance criteria:

- *increase the floors for the primary fiscal balance and the bank balance of the general government for end-August 2012* by €15 million, reflecting the early receipt of dividends from PTK in April that had originally been expected for October;
- *lower the ceiling on primary expenditures by the projected spending of the Kosovar Privatization Agency*, *and exclude PAK-related spending from the program definitions of primary expenditures and the primary balance.* Before 2012, PAK-related spending—both PAK's operational budget, and fees PAK pays to corporations charged with the liquidation of socially owned enterprises (SOEs)—were funded by donor grants. From this year, and in the context of Kosovo's transition from supervised to full independence, PAK pays for its expenditures from its own funds, consisting mostly of receipts from SOE privatization that will eventually be distributed among claimants, the residual claimant being the government. In the original 2012 budget, we recorded PAK's spending as primary expenditure and the use of PAK's funds as nontax revenue. We have now modified the recording and will register the use of PAK's funds as financing, in line with the definition in the Technical Memorandum of Understanding. The changes in program definitions avoid an unintended deterioration in the government's reported primary balance that would result otherwise from this recording change.

Quantitative performance criteria through end-2012 and indicative targets through end-June 2013 are set out in Table 2 and in the Technical Memorandum of Understanding, both attached to this letter.

5. We believe that the policies set forth in the letter of April 12, 2012 and in this letter are adequate for successful implementation of the program. However, the government stands ready to take additional measures as appropriate to ensure achievement of the program's objectives. As is standard under all IMF arrangements, we will consult with the IMF before modifying measures contained in this letter or before the adoption of new measures that would deviate from the goals of the program, in accordance with the Fund's policies on such consultations, and provide IMF staff with the necessary information for program monitoring. The second review is expected to be completed after December 20, 2012, the third review after February 28, 2013, and the program is expected to be monitored by quarterly reviews thereafter. The understandings between us and the IMF regarding performance criteria and structural measures described in this letter are further specified in the attached Technical Memorandum of Understanding. We authorize the IMF to publish this letter and the associated staff report.

I. Macroeconomic Outlook

6. The outlook remains broadly unchanged from the April Letter of Intent. The macroeconomic framework underpinning our program is based on purposely cautious assumptions, with a view to minimizing the risk of downward revisions during the program period.

a. We maintain a forecast for *real GDP growth* of 3.8 percent in 2012, driven primarily by robust private consumption and investment. The resilience of private sector demand is expected to continue in 2013.

b. Consumer price *inflation* is expected to remain subdued at around 1 percent, owing primarily to disinflation for import prices, notwithstanding prospective tariff increases in the context of a revamped electricity regulation.

c. The *external trade deficit* for goods and services is expected to narrow to 38 percent of GDP, from more than 40 percent in 2011. The deficit will continue to be financed by non debt-creating flows such as FDI, remittances, and other current transfers.

II. Fiscal Policy

A. Implementation of the 2012 budget

7. Fiscal policy remains anchored by the objectives of restoring a sustainable fiscal stance and maintaining an acceptable level of government bank balances. To this end, the 2012 budget contains structural adjustment measures of ¾ percent of GDP. In addition to these measures, we are in the process of introducing environmental taxes and fees that are expected to raise at least €10 million in 2012 (0.2 percent of GDP), with a full-year impact of 0.4 percent of GDP.

Further, we have also left €20 million in expenditures from the 2012 budget unallocated, and we have specified these across spending categories (€10.1 million in goods and services, €7.5 million in non-highway capital spending, and €2.4 million in subsidies).

8. In the first four months of 2012, budget implementation has been broadly in line with our program. Revenues excluding dividends were €36 million (0.7 percent of annual GDP) lower than expected, owing mostly to temporary factors such as unusually severe winter weather that depressed trade and border tax receipts. The shortfall in revenue collection was overcompensated by advancing dividend payments from PTK (€15 million, out of a total €45 million in PTK dividends for the year) and by exercising spending restraint—primary expenditure was €45 million below the program ceiling, owing in part to under-execution of capital spending by €27 million.

9. In the months ahead, we expect both revenue collection and expenditure execution to catch up with original program projections—we have already registered an improvement in revenue collection in May. As a result, we see no need to revise our projections for tax revenue or expenditures for end-August and end-December, and request to increase the program floor on the primary balance at end-August by €15 million, reflecting the PTK dividend received in April (instead of October as originally projected). Moreover, in the mid-year budget review we will keep the overall spending envelope for 2012 constant, notwithstanding a modest shift from capital spending to spending on goods and services that became necessary due to in part to higher maintenance needs caused by the severe weather in January and February. We stand ready, however, to take additional revenue or expenditure measures in case revenue collection fails to catch up with program projections going forward. We will decide on the need for such measures the latest on the basis of end-August data.

10. We have conducted five consecutive successful 3-month treasury-bill auctions this year, raising €30 million (net) at an average annual yield of between 3-4 percent. To lay the foundations for self-sustained budget financing we intend, as the next step, to issue bills with a maturity of 6 months in the second half of this year, and of 12 months in 2013, although variations to this schedule are possible depending on the absorptive capacity of the market.

B. Medium-Term Fiscal Issues and Structural Fiscal Reforms

11. For our 2013 budget, we will target a primary deficit of no more than €155 million (excluding possible budget support grants; structural benchmark for end-October). Structural fiscal adjustment of at least €31 million (0.6 percent of GDP) will be needed to achieve this objective. Part of the adjustment will come from an increase in lignite royalties that the Assembly approved in early June. The remaining adjustment measures will be specified in full during the budget preparation process; options include restraint on current spending, notably wages and salaries, and growth friendly revenue measures, consistent with the recommendations of the IMF technical assistance mission on tax policy from November 2011. A technical

assistance mission analyzing Kosovo's mining tax regime, scheduled for September of this year, may also identify options for adjustment.

12. Restoring an adequate level of bank balances in 2013 as envisaged will in part depend on the successful privatization of the telecommunications operator PTK. The privatization process has made significant progress in recent months. A new transaction advisor was hired in April, and road shows in London and Istanbul in May generated substantial investor interest. We began with the prequalification of bidders in June, and by July will present separate balance sheets for PTK and the postal service that has been split from PTK earlier this year. Thereafter we will launch the tender offer (new structural benchmark for end-August). The winner of the bidding process is expected to be announced toward the end of this year.

13. We are preparing the introduction of a legally binding, rules based fiscal framework. An IMF technical assistance mission is visiting Kosovo in late June. We will discuss the TA mission's recommendations changes with the IMF mission for the 2nd review under the SBA, scheduled for early October. We intend to enact the necessary legislation in early 2013, i.e., during the early stages of the 2014 budget preparations. The technical assistance mission in June will also develop proposals to improve the recording and monitoring of payment obligations, with a view to preventing the accumulation of domestic payments arrears.

14. We intend to maintain a flexible structure of our budget to preserve options for adjustment, should the need arise. To this end, the Assembly passed on June 14 an amendment to the Law on Public Financial Management and Accountability (LPFMA) that emphasizes that the LPFMA's legal precedence over individual benefit creating laws extends to an adjustment clause allowing the government to reduce budgetary allocations in case of (i) a macroeconomic shock reducing fiscal revenue or financing, (ii) natural disasters, or (iii) the suspension or cancellation of a program or project to which the allocation relates. This provision renders redundant the continuous structural benchmark of including a corresponding adjustment clause into any new benefit creating or amending law. We therefore request to drop that benchmark. Further, with a view to upholding principles of sound fiscal management and costing, we will maintain the requirements that (i) new laws, amendments to laws or regulations that create benefits will grant only cash benefits, with no link to the minimum wage; and (ii) any such law, amendment to a law or regulation will be preceded by a thorough fiscal impact assessment covering a period of at least 5 years (continuous structural benchmark).

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

a. *Highway R7 to Albania.* The ongoing construction of highway R7 to Albania requires close cost control as the project nears completion in 2013, especially with regard to variation cost.

b. *Highway R6 to Macedonia.* The analysis of design and financing options for R6 is ongoing. We will move beyond the preparation stage only once (i) R6 can be integrated into a sustainable budgetary framework, and (ii) World Bank staff confirms that the highway's design is economically viable. Bidding for the highway project will be competitive and transparent, and we will consult with IMF staff prior to entering into any contractual obligations. In case we were to decide to finance R6 fully out of the budget, prerequisites for entering into contractual obligations are the completion of the privatization of PTK and the near-completion of highway R7, to have sufficient clarity about the available budgetary space.

c. *Health care reform*. We submitted a proposal of a new Health Law to the Assembly that will allow the Ministry of Health to contract services from hospitals based on the services' quantity and quality. The contracting of services will only start after the costs have been assessed and budgeted.

d. *Civil Service Reform.* We are in the process of finalizing the terms of reference for the activities of a company that will assist the Ministry of Public Administration in establishing a grading system and a unified pay structure for civil servants. Thereafter we will, with assistance from the World Bank, re-assess the civil service reform's fiscal impact, and include cost control measures into secondary legislation as needed to keep the budgetary impact manageable. We will move forward with implementation of the reform only once its medium-term fiscal implications are fully understood.

e. *Pension reform*. A revised Pillar I Pension Law is in preparation. Legislation for the pensions for workers forcibly removed from their workplace in the 1990s will only be developed after a fiscal impact assessment has been conducted.

f. *War veteran pensions.* A working group under the supervision of the Prime Minister's Office is preparing a fiscal impact assessment for a possible war veteran pension, starting with an assessment of eligible beneficiaries. To move the work forward, we are considering hiring an international consultant to assist the working group.

16. We have enhanced the budgetary autonomy of municipalities by refraining from specifying municipal spending limits for all expenditure categories except wages from own-source revenues in the first budget circular for 2013, in line the end-May structural benchmark. In early 2013, we intend to revise the Law on Local Government Finance to (i) implement in a gradual manner the revised grant allocation in line with the 2011 census results (scheduled to be published in September); (ii) reduce gradually the size of the general grant. Going forward, we intend to allow municipalities to shift expenditures across all spending categories except wages for both own sources revenues and revenues from the general grant.

III. Financial Sector Policies

17. The financial system has remained well-capitalized, liquid, and profitable. Capital adequacy stood at 17.4 percent at end-April, while the share of nonperforming loans in total loans has continued to hover around 6 percent. Credit to private sector grew by about 11 percent in the 12 months to April. A domestic bank whose capital adequacy ratio fell below

the regulatory minimum of 12 percent last year has been recapitalized by its owners, and its board and senior management have been replaced.

18. We have submitted a revised Deposit Insurance Law (DIL) consistent with the new Banking and Microfinance Law (BML) to the Assembly on June 22, i.e., with a small delay compared to the corresponding structural benchmark of end-May. The extra time was needed to complete discussions with stakeholders, including KfW of Germany and the IMF. The revised DIL streamlines procedures to deal with troubled banks, including by allowing the use of resources from the deposit insurance fund for purchase and assumption transactions. Further, the revised law limits the deposit insurance fund's mandate to administrating payments of insured depositors, while issues related to bank resolution remain primarily the responsibility of the central bank.

19. The completion of the framework for deposit insurance is part of a larger effort to upgrade our prudential policies, with a view to safeguarding the stability and health of the banking sector in an uncertain external environment.

- The SRF for ELA establishes the central bank's capacity to combat liquidity strains in the banking sector if needed.
- The revised BML (passed in April) contains tight prudential requirements, such as limits on banks' exposures to their foreign controlling institutions of 20 percent of Tier 1 capital—containing the risk that liquidity strains in controlling institutions would spread to their Kosovar affiliates—and exposure limits to single borrowers of 15 percent of Tier 1 capital.
- Other rules and regulations, including on liquidity requirements and consolidated supervision, are currently being revised to bring them in line with the BML and Basel core principles, with an expected completion date of end-October.
- The central bank is committed to maintaining prudent loan-to-deposit ratios of around 80 percent, and to maintain high standards of corporate governance within the banking system.
- We cooperate closely with the home supervisors of Kosovar banking subsidiaries and have signed MoUs with all but one home supervisors (the remaining MoU is expected to be completed in due course).

We are confident that these measures provide strong support for our financial system to withstand strains, but are prepared to take additional measures as needed, such as requesting banks to temporarily suspend dividends payments to increase capital buffers. Further priorities may emerge from our discussions with the joint IMF/World Bank mission under the Financial Sector Assessment Program (FSAP), scheduled for September.

20. In line with the recommendation from the IMF's safeguard assessment, the CBK will continue to act as the sole investment manager for the government, and the government will continue holding all its deposits at the central bank.

IV. Competitiveness and Private Sector Development

21. To further strengthen the business climate and promote competitiveness of the economy, we have prepared a package of twelve laws to reduce costs of setting up business, unify business registries and simplify the licensing system. Eleven laws have been passed (including on business organization, cadastre, reporting and auditing, establishment of immovable property right registers, external trade, management and control of state borders, construction, and the customs code). The remaining law (on execution procedure) has been drafted and sent to the Assembly for approval, enactment is expected before end-year. To foster the development of telecommunication and mining sectors, we are preparing two additional laws that remove entry barriers and ensure equal treatment among investors. While the law regulating the mining sector is still being drafted, the law concerning the telecommunication sector is expected to be approved in the coming months. Further, we are planning to launch a joint project on promoting the development of SMEs with Austrian Development Agency and the Swiss Cooperation Office.

22. We are finalizing the analysis on the implementation of the Labor Law with an emphasis on maternity leave provisions, notably whether the length of maternity leave provokes employment discrimination against women. The final report will be ready by the end-June 2012. Thereafter we will initiate preparatory work for the amendment of the Labor Law if necessary.

23. The reform of the energy sector is advancing. In May, the bids for the privatization of the distribution and supply division of the electricity company (KEK) were received, and the winner was announced in June. This result comes on the back of important gains in KEK's revenue collection capacity and the revision of electricity price regulation, to enhance the sector's attractiveness for private investors.

Sincerely yours,

/sgd/

Hashim Thaçi
Prime Minister

/sgd/
Bedri Hamza
Minister of Finance

/sgd/
Gani Gërguri
Governor Central Bank of the Republic of Kosovo

Table 1. Kosovo: Program Monitoring

	April 2012
Performance criteria	
Floor on the bank balance of the general government	Met
Floor on the primary fiscal balance of the general government	Met
Ceiling on primary expenditures of the general government	Met
Ceiling on the net contracting of nonconcessional debt by the general government	Met
Indicative targets	
Ceiling on the stock of domestic payment arrears of the central government	Not met
Ceiling on the stock of domestic payment arrears of the general government	Not met
Prior actions for SBA approval	
Passage of the Pension Fund Law in a version that limits (i) exposure of the pillar II pension fund to the government to 30 percent of the fund's assets and (ii) annual investments of the fund in government paper to 50 percent of inflows into the fund in the previous calendar year	Met
Passage of the revised Banking and Microfinance Law in a version consistent with the recommendations of IMF technical assistance	Met
Issuance of a government decision that specifies spending cuts of €20 million across expenditure categories relative to the approved 2012 budget	Met
Structural benchmarks	
Publication of budget circulars for municipalities that contain no limits on spending allocations across non-wage categories (by end-May, 2012)	Met
Submission of a revised Deposit Insurance Fund Las 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
Continuous structural benchmarks	
Monthly meetings of the Program Monitoring Committee and transmission of meetings' minutes to the IMF	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	Not met
Fiscal impact assessments evaluating the budgetary impact of all new benefit creating laws, amendments to such laws or regulations over a period of at least 5 years	Met

Table 2. Kosovo: Quantitative Performance Criteria and Indicative Targets, SBA 2012-2013
(Millions of euros; flows cumulative from beginning of the year)

	2012						2013	
	End-Apr.		End-Aug.		End-Dec.		End-Mar.	End-Jun.
	Prog.	Actual	Prog.	Rev. Progr.	Prog.	Rev. Progr.	Proj.	Proj.
Performance Criteria 1/								
Floor on the bank balance of the general government	166	180	215	230	187	187	164	173
Floor on the primary fiscal balance of the general government 2/	-21	4	-41	-26	-119	-119	-7	-26
Ceiling on primary expenditures of the general government 2/	399	353	914	911	1,499	1,494	288	655
Ceiling on the net contracting of nonconcessional debt by the general government 2/	150	30	150	150	150	150	250	250
Ceiling on guaranteeing nonconcessional debt by the general government 2/	0	0	0	0	0	0	0	0
Ceiling on the accumulation of external payments arrears of the general government 3/	0	0	0	0	0	0	0	0
Indicative Targets								
Ceiling on the stock of domestic payment arrears of the central government	0	2	0	0	0	0	0	0
Ceiling on the stock of domestic payment arrears of the general government	0	2	0	0	0	0	0	0
Memorandum items:								
Program assumptions								
Repayment of policy loans extended to public corporations	…	4	…	4	4	4	0	0
Non-project grants	4	1	30	30	30	30	0	0
Budget support loans	0	0	0	0	0	0	0	0
Project grants	1	0	3	3	4	4	1	2
Project loans	0	0	6	6	7	7	1	3
PAK-related spending	…	…	3	5	5	8	1	4

Sources: Kosovo authorities; and IMF staff estimates and projections.
1/ Adjusted according to the Technical Memorandum of Understanding. Numbers are indicative targets for 2013.
2/ Excluding PAK related spending from August 2012.
3/ Continuous ceiling on the gross flow of new accumulation.

Table 3: Structural Conditionality

Actions	Type	Timing
Launch of the tender offer for PTK	Structural benchmark	End-August 2012
Submission of a 2013 budget consistent with the objectives of the program to the Assembly	Structural benchmark	End-October 2012
Monthly meetings of the Program Monitoring Committee and transmission of the meetings' minutes to the IMF Resident Representative	Structural benchmark	Continuous
Fiscal impact assessments evaluating the budgetary impact of all new benefit creating laws, amendments to such laws or regulations over a period of at least 5 years	Structural benchmark	Continuous

Attachment II. Technical Memorandum of Understanding

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

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

I. PERFORMANCE CRITERIA AND INDICATIVE TARGETS

A. Coverage

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

3. **Performance Criteria and Indicative Targets.** The performance criteria, indicative targets, and their respective test dates are set in Table 2 of the Letter of Intent (LOI).

B. Bank Balances of the General Government

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

- The floor on the bank balance set in Table 2 will be raised by
    - the excess of budget grants and loans relative to program assumptions

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 including domestically and budget support financed capital expenditure and externally project financed capital expenditure; (vi) the gross payment and gross accumulation of domestic payments arrears; (vii) external loan receipts and principal payments; (viii) external arrears payments and

accumulation; (ix) bank and nonbank financing; (x) privatization and receipts of the sales of nonfinancial assets; and (xi) any other revenue, expenditure, or financing not included above.

D. Primary Fiscal Balance of the General Government

9. **Primary fiscal balance** of the general government is defined as revenues and grants minus primary expenditures cumulatively since the beginning of the calendar year. Expenditures of the Privatization Agency of Kosovo (PAK) are excluded. Revenues do not include privatization receipts.

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

- The floor on the primary fiscal balance set in Table 2 will be raised by

- the shortfall in project loans relative to program assumptions

- the excess in budget grants relative to program assumptions.

E. Contracting and Guaranteeing Nonconcessional Debt by the General Government

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

11. The ceilings on contracting and on guaranteeing nonconcessional debt cover both domestic and external debt, but exclude purchases from the IMF and the sale of the SDR holdings allocated to Kosovo. Debt rescheduling and debt reorganization of debts contracted before the approval of the SBA are excluded from the limits on nonconcessional debt. The quantitative performance criteria apply not only to debt as defined below but also to commitments contracted or guaranteed for which value has not been received. The contracting or guaranteeing nonconcessional debt by the general government will be assessed at each test date.

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

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

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

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

F. Domestic Payments Arrears

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

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

G. External Payments Arrears

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

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

II. Other Data Requirements

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

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

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

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

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

Annex: Debt Sustainability Analysis

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

	Actual			Historical Average 6/	Standard Deviation 6/	Projections									
	2009	2010	2011			2012	2013	2014	2015	2016	2017	2012-2017 Average	2022	2032	2018-2032 Average
External debt (nominal) 1/	**17.6**	**16.6**	**15.0**			**16.4**	**16.9**	**15.8**	**14.2**	**12.3**	**10.9**	**14.4**	**15.4**	**19.7**	**16.7**
o/w public and publicly guaranteed (PPG)	17.6	16.6	15.0			16.4	16.9	15.8	14.2	12.3	10.9		15.4	19.7	
Change in external debt	-3.7	-1.0	-1.6			1.4	0.5	-1.1	-1.6	-1.8	-1.4		0.7	0.3	
Identified net debt-creating flows	**8.5**	**8.4**	**11.9**			**10.2**	**6.5**	**9.1**	**7.8**	**6.5**	**6.2**		**5.3**	**8.7**	
Non-interest current account deficit	**15.3**	**17.2**	**20.2**	**11.3**	**5.1**	**18.0**	**17.9**	**15.7**	**14.8**	**13.8**	**13.6**	**15.6**	**12.4**	**16.1**	**13.6**
Deficit in balance of goods and services	39.7	40.6	41.1			38.0	36.3	34.0	32.6	31.0	30.0	33.7	27.5	27.0	27.4
Exports	15.5	18.5	20.0			20.6	20.8	21.5	22.0	22.9	23.3		20.5	20.0	
Imports	55.2	59.1	61.1			58.5	57.1	55.6	54.6	53.9	53.3		48.0	47.0	
Net current transfers (negative = inflow)	-22.1	-21.1	-18.1	-21.9	1.9	-17.3	-15.6	-15.6	-15.0	-14.4	-13.6	-15.3	-13.3	-11.0	-12.6
o/w official	-10.3	-8.6	-5.9			-5.4	-3.9	-3.5	-3.2	-3.1	-2.6		-1.7	-0.6	
Other current account flows (negative = net inflow)	-2.3	-2.3	-2.8			-2.7	-2.8	-2.8	-2.8	-2.8	-2.7		-1.8	0.1	
Net FDI (negative = inflow)	**-6.6**	**-7.7**	**-6.9**	**-4.9**	**3.3**	**-7.6**	**-11.1**	**-6.4**	**-6.5**	**-6.9**	**-7.0**	**-7.6**	**-7.0**	**-7.0**	**-7.0**
Endogenous debt dynamics 2/	**-0.2**	**-1.1**	**-1.3**			**-0.3**	**-0.3**	**-0.2**	**-0.5**	**-0.4**	**-0.4**	**-0.3**	**-0.1**	**-0.3**	**-0.2**
Contribution from nominal interest rate	0.2	0.2	0.2			0.3	0.3	0.3	0.3	0.2	0.2		0.5	0.5	
Contribution from real GDP growth	-0.6	-0.6	-0.7			-0.5	-0.6	-0.5	-0.7	-0.7	-0.5		-0.6	-0.8	
Contribution from price and exchange rate changes	0.3	-0.6	-0.8			…	…	…	…	…	…		…	…	
Residual, including assets, errors, and omissions (3-4) 3/	**-12.2**	**-9.4**	**-13.5**			**-8.8**	**-6.0**	**-10.2**	**-9.4**	**-8.4**	**-7.7**	**-8.4**	**-4.6**	**-8.4**	**-5.8**
o/w exceptional financing	0.0	0.0	0.0			0.0	0.0	0.0	0.0	0.0	0.0		0.0	0.0	
PV of external debt 4/	...	...	13.4			14.9	15.3	14.5	13.3	11.8	10.6		13.4	16.2	
In percent of exports	...	...	66.8			72.5	73.4	67.3	60.4	51.5	45.6		65.1	81.2	
PV of PPG external debt	**...**	**...**	**13.4**			**14.9**	**15.3**	**14.5**	**13.3**	**11.8**	**10.6**		**13.4**	**16.2**	
In percent of exports	**...**	**...**	**66.8**			**72.5**	**73.4**	**67.3**	**60.4**	**51.5**	**45.6**		**65.1**	**81.2**	
In percent of government revenues	**...**	**...**	**48.5**			**54.5**	**56.4**	**52.4**	**47.5**	**41.6**	**37.2**		**47.5**	**57.8**	
Debt service-to-exports ratio (in percent)	**2.5**	**2.5**	**2.2**			**9.7**	**16.6**	**15.7**	**13.8**	**15.4**	**15.0**		**34.8**	**139.0**	
PPG debt service-to-exports ratio (in percent)	**2.5**	**2.5**	**2.2**			**2.4**	**2.7**	**3.2**	**2.7**	**5.1**	**4.6**		**10.0**	**11.5**	
PPG debt service-to-revenue ratio (in percent)	**1.3**	**1.8**	**1.6**			**1.8**	**2.1**	**2.5**	**2.1**	**4.1**	**3.8**		**7.3**	**8.2**	
Total gross financing need (billions of euros)	0.4	0.4	0.6			0.6	0.5	0.7	0.7	0.7	0.7		1.1	6.5	
Non-interest current account deficit that stabilizes debt ratio	19.0	18.2	21.8			16.7	17.4	16.8	16.4	15.7	15.0		11.7	15.8	
Key macroeconomic assumptions															
Real GDP growth (in percent)	2.9	3.9	5.0	4.5	1.5	3.8	4.1	3.2	5.0	5.0	4.6	4.3	4.4	4.6	4.5
GDP deflator in euro terms (change in percent)	-1.3	3.7	4.8	1.1	3.4	2.1	2.4	1.9	1.9	1.9	1.9	2.0	2.0	2.0	2.0
Effective interest rate (percent) 5/	0.8	1.2	1.2	0.4	0.6	1.9	2.0	1.8	1.8	1.7	1.5	1.8	3.8	2.9	3.5
Growth of exports of G&S (euro terms, in percent)	6.4	28.8	19.1	21.7	31.3	8.6	7.9	8.8	9.4	11.3	8.7	9.1	5.3	6.7	5.5
Growth of imports of G&S (euro terms, in percent)	0.1	15.4	13.7	10.4	7.4	1.5	4.0	2.3	5.1	5.7	5.4	4.0	5.5	6.7	5.7
Grant element of new public sector borrowing (in percent)	...	...	...	...	...	10.0	27.1	11.5	11.5	11.5	11.5	13.8	11.5	11.5	12.0
Government revenues (excluding grants, in percent of GDP)	29.3	26.4	27.6			27.3	27.1	27.7	27.9	28.3	28.5		28.1	28.1	28.2
Aid flows (in billions of euros) 7/	0.0	0.0	0.0			0.0	0.0	0.0	0.0	0.0	0.0		0.0	0.0	
o/w Grants	0.0	0.0	0.0			0.034	0.003	0.0	0.0	0.0	0.0		0.0	0.0	
o/w Concessional loans	0.0	0.0	0.0			0.0	0.0	0.0	0.0	0.0	0.0		0.0	0.0	
Grant-equivalent financing (in percent of GDP) 8/	...	...	...			0.9	0.5	0.0	0.0	0.0	0.0		0.4	0.4	0.4
Grant-equivalent financing (in percent of external financing) 8/	...	...	...			29.8	29.2	11.5	11.5	11.5	11.5		11.5	11.5	12.0
Memorandum items:															
Nominal GDP (billions of euros)	3.9	4.2	4.6			4.9	5.2	5.5	5.9	6.3	6.7		9.1	17.5	
Nominal dollar GDP growth	1.6	7.8	10.0			5.9	6.6	5.2	7.0	7.0	6.6	6.4	6.5	6.7	6.6
PV of PPG external debt (in billions of euros)			0.6			0.7	0.8	0.8	0.8	0.7	0.7		1.2	2.8	
(PVt-PVt-1)/GDPt-1 (in percent)						2.4	1.4	0.0	-0.3	-0.7	-0.5	0.4	1.3	1.3	1.3
PV of PPG external debt (in percent of GDP)	...	...	13.4			14.9	15.3	14.5	13.3	11.8	10.6		13.4	16.2	
PV of PPG external debt (in percent of exports)	...	...	66.8			72.5	73.4	67.3	60.4	51.5	45.6		65.1	81.2	
Debt service of PPG external debt (in percent of exports)	...	...	2.2			2.4	2.7	3.2	2.7	5.1	4.6		10.0	11.5	

Sources: Country authorities; and staff estimates and projections.

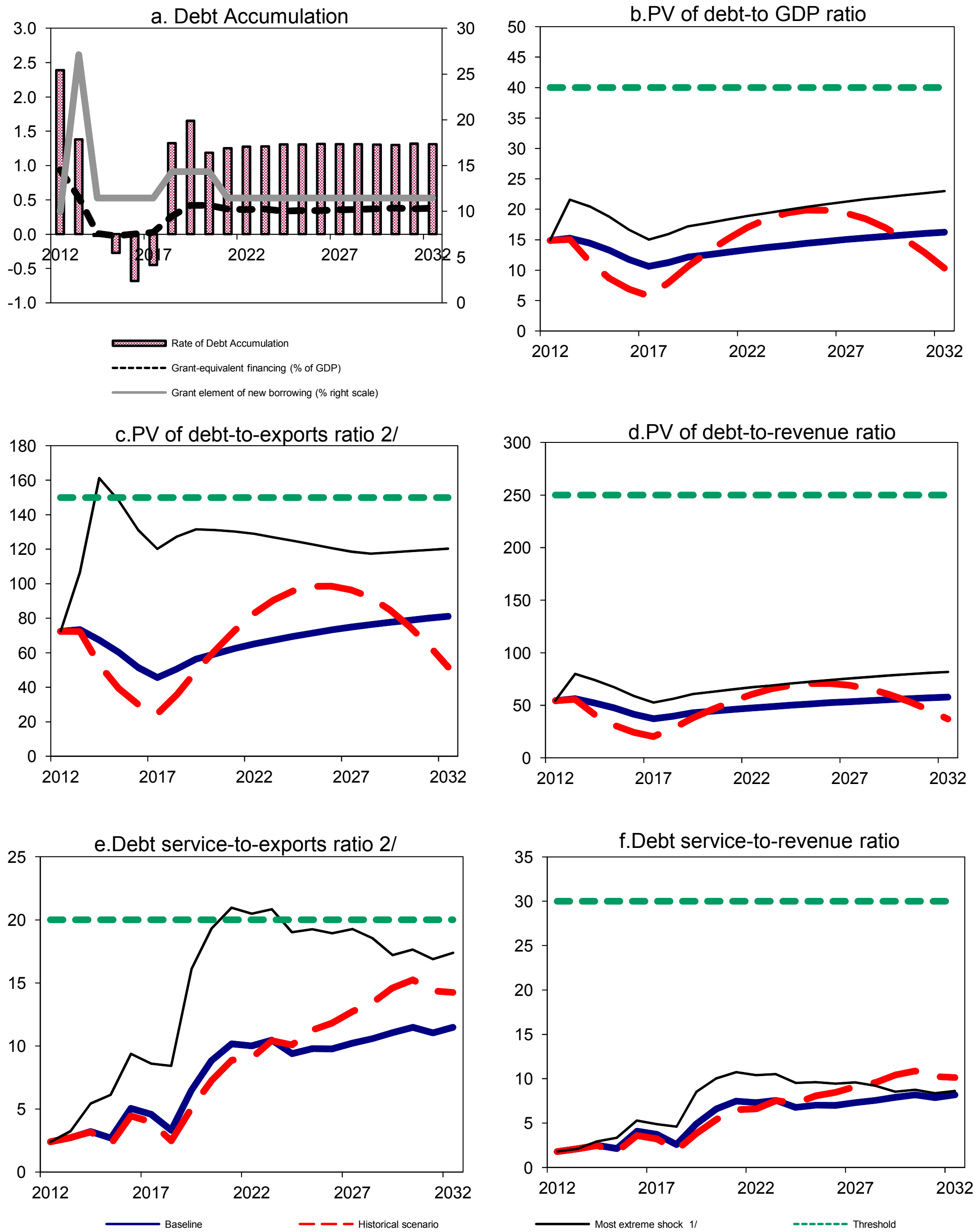
1/ Data on private external debt is unavailable.
2/ Derived as [r - g - ρ(1+g)]/(1+g+ρ+gρ) times previous period debt ratio, with r = nominal interest rate; g = real GDP growth rate, and ρ = growth rate of GDP deflator in euro terms.
3/ Includes exceptional financing; changes in gross foreign assets;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

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

	Actual					Estimate	Projections								
	2009	2010	2011	Average 5/	Standard Deviation 5/	2012	2013	2014	2015	2016	2017	2012-17 Average	2022	2032	2018-32 Average
Public sector debt 1/	17.6	16.6	15.0			17.9	19.9	20.4	20.7	20.5	20.7		24.8	30.6	
Change in public sector debt	-3.7	-1.0	-1.6			2.9	2.0	0.5	0.2	-0.2	0.3		0.8	0.5	
Identified debt-creating flows	0.5	1.6	0.3			1.4	-3.5	0.2	-0.2	-0.2	-0.2		0.4	0.0	
Primary deficit	0.7	2.7	1.7	-0.2	3.6	2.6	3.1	1.0	0.8	0.8	0.8	1.5	0.9	0.9	0.9
Revenue, grants, and interest income	29.3	27.3	28.1			28.0	27.1	27.7	27.9	28.3	28.5	27.9	28.1	28.1	28.2
of which: grants	0.0	0.9	0.6			0.7	0.1	0.0	0.0	0.0	0.0		0.0	0.0	
Primary (noninterest) expenditure	29.9	30.0	29.8			30.6	30.2	28.6	28.7	29.1	29.3	29.4	29.0	29.0	29.0
Automatic debt dynamics	-0.2	-1.1	-1.3			-0.6	-0.7	-0.6	-0.9	-0.8	-0.7	-0.7	-0.5	-0.9	-0.6
Contribution from interest rate/growth differential	-0.7	-0.6	-0.8			-0.6	-0.6	-0.6	-0.9	-0.8	-0.7		-0.5	-0.9	
of which: contribution from average real interest rate	-0.1	0.0	0.0			0.0	0.1	0.1	0.1	0.1	0.2		0.5	0.5	
of which: contribution from real GDP growth	-0.6	-0.7	-0.8			-0.5	-0.7	-0.6	-1.0	-1.0	-0.9		-1.0	-1.3	
Contribution from real exchange rate depreciation	0.5	-0.4	-0.5			0.0	-0.1	0.0	0.0	0.0	0.0		...	...	
Other identified debt-creating flows	0.0	0.0	0.0			-0.6	-5.9	-0.2	-0.2	-0.2	-0.3		0.0	0.0	
Privatization receipts (negative)	0.0	0.0	0.0			-0.6	-5.9	-0.2	-0.2	-0.2	-0.3		0.0	0.0	
Recognition of implicit or contingent liabilities	0.0	0.0	0.0			0.0	0.0	0.0	0.0	0.0	0.0		0.0	0.0	
Debt relief (HIPC and other)	0.0	0.0	0.0			0.0	0.0	0.0	0.0	0.0	0.0		0.0	0.0	
Other (specify, e.g. bank recapitalization)	0.0	0.0	0.0			0.0	0.0	0.0	0.0	0.0	0.0		0.0	0.0	
Residual, including asset changes	-4.2	-2.6	-1.9			1.5	5.6	0.2	0.5	0.0	0.5	1.4	0.5	0.5	0.4
Other Sustainability Indicators															
PV of public sector debt	...	...	13.4			16.4	18.3	19.1	19.8	19.9	20.4		22.7	27.1	
PV of contingent liabilities (not included in public sector debt)	...	...	...			...	...	...	...	...	...		...	...	
Gross financing need 2/	1.0	3.1	2.1			3.1	5.2	4.7	3.8	6.3	7.0		9.1	10.2	
PV of public sector debt-to-revenue and grants ratio (in percent)	…	…	48			58	68	69	71	70	72		81	96	
PV of public sector debt-to-revenue ratio (in percent)	…	…	49			60	68	69	71	70	72		81	96	
Debt service-to-revenue and grants ratio (in percent) 4/	1.3	1.7	1.6			1.8	7.7	13.5	10.7	19.5	21.8		29.1	33.4	
Debt service-to-revenue ratio (in percent) 4/	1.3	1.8	1.6			1.8	7.7	13.5	10.7	19.5	21.8		29.1	33.4	
Primary deficit that stabilizes the debt-to-GDP ratio	4.4	3.7	3.3			-0.3	1.0	0.5	0.6	1.0	0.5	0.5	0.0	0.4	0.2
Key macroeconomic and fiscal assumptions															
Nominal GDP (local currency)	3.9	4.2	4.6			4.9	5.2	5.5	5.9	6.3	6.7		9.1	17.5	
Real GDP growth (in percent)	2.9	3.9	5.0	4.5	1.5	3.8	4.1	3.2	5.0	5.0	4.6	4.3	4.4	4.6	4.5
Average nominal interest rate on forex debt (in percent)	0.8	1.2	1.2	0.4	0.6	1.9	2.0	1.8	1.8	1.7	1.5	1.8	3.8	2.9	3.5
Interest on domestic debt (percentage of previous year stock, in percent)	...	...	...	…	…	...	7.3	5.0	5.0	5.0	5.0	5.5	5.0	5.0	5.0
Average real interest rate (in percent)	-0.4	0.3	-0.3	-1.8	1.3	-0.1	0.4	0.4	0.6	0.7	0.9	0.5	2.2	1.6	2.0
Real exchange rate depreciation (in percent, + indicates depreciation)	2.5	-2.6	-3.1	1.3	3.8	-0.1	...	...	...	...	...	...	...	...	...
Inflation rate (GDP deflator, in percent)	-1.3	3.7	4.8	1.1	3.4	2.1	2.4	1.9	1.9	1.9	1.9	2.0	2.0	2.0	2.0
Growth of real primary spending (deflated by GDP deflator, in percent)	24.8	4.1	4.3	3.8	8.1	6.5	2.8	-2.1	5.3	6.2	5.5	4.0	4.3	4.6	4.4
Grant element of new external borrowing (in percent)	...	...	...	…	…	10.0	27.1	11.5	11.5	11.5	11.5	13.8	11.5	11.5	12.0

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

Figure A1. Kosovo: Indicators of Public and Publicly Guaranteed External Debt under Alternatives Scenarios, 2012-2032 1/

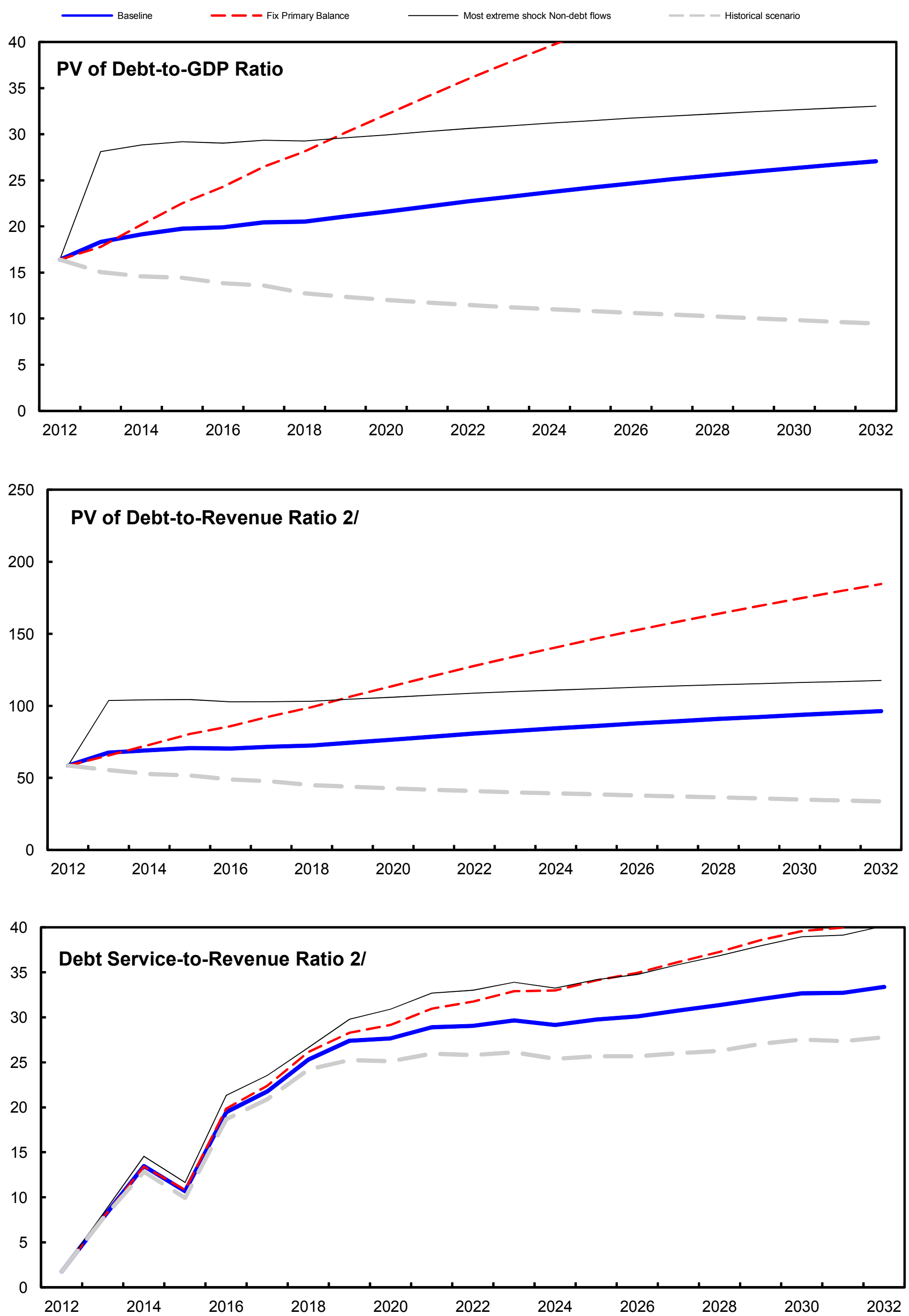


Sources: Country authorities; and staff estimates and projections.

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

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

Figure A2. Kosovo: Indicators of Public Debt Under Alternative Scenarios, 2012-2032 1/



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