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Republic of Kosovo: Letter of Intent, Memorandum of Economic and Financial Policies, and Technical Memorandum of Understanding

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The following item is a Letter of Intent of the government of Republic of Kosovo, which describes the policies that Republic of Kosovo intends to implement in the context of its request for financial support from the IMF. The document, which is the property of Republic of Kosovo, is being made available on the IMF website by agreement with the member as a service to users of the [IMF](#) website.

LETTER OF INTENT

REPUBLIC OF KOSOVO

Pristina, July 7, 2010

Mr. Dominique Strauss-Kahn
Managing Director
International Monetary Fund
Washington DC

Dear Mr. Strauss-Kahn:

Although Kosovo's economic performance has strengthened considerably over the past decade, large imbalances persist. The external imbalances reflect infrastructure bottlenecks, especially in the transport system and energy sector, that continue to stifle productivity and competitiveness. Our efforts to improve the public infrastructure, combined with the need to address pressing social issues, have led to a significant deterioration of our public finances. While still adequate, our bank balances held with the Central Bank of the Republic of Kosovo (CBK) have been declining since 2008. Although the financial sector has weathered the global financial crisis, the decline in these balances could undermine our efforts to continue to safeguard financial stability, given that the economy is euroized and that the scope for emergency liquidity assistance by the CBK largely depends on these balances.

Against this background, the Ministry of Economy and Finance (MoEF) and the CBK have developed a comprehensive policy strategy aimed at restoring fiscal sustainability and safeguarding financial stability, while advancing our goal for sustainable growth over the medium term. In support of these policies and based on our balance of payments needs, we initiated a policy program in June 2010 and request that the IMF support our program through a Stand-By Arrangement (SBA) in the amount equivalent to SDR 92.656 million (157 percent of quota).

To achieve the program's objectives, we intend to: (i) exercise restraint in our current spending and raise revenues to improve fiscal sustainability; (ii) secure financing for our large public investment program through expenditure reallocations, one-off revenues, and privatization proceeds to preserve debt sustainability; (iii) bolster our bank balances to provide scope for emergency liquidity assistance, if needed; and (iv) resolutely pursue reforms to broaden the tax base, improve public financial management, enhance the CBK's independence, further strengthen and modernize the banking system, and shore up the financial position of the energy sector.

We believe that the policies set forth in the attached Memorandum of Economic and Financial Policies (MEFP) are sufficient to achieve the objectives of our economic program, but we will take any further measures that may become necessary. Kosovo will consult with the Fund on the adoption of these measures, and in advance of revisions to the policies contained in the MEFP, in accordance with the Fund's policies on such consultation. Further,

we will provide the Fund with such information as it requests on policy implementation and achievement of the program objectives. The understandings between us and the IMF staff regarding performance criteria and structural measures described in this letter are further specified in the attached Technical Memorandum of Understanding.

The government and the CBK authorize the IMF to publish its staff report, this letter of intent, the MEFP, and the technical memorandum of understanding.

Sincerely yours,

/s/

Hashim Thaçi
Prime Minister

/s/

/s/

Ahmet Shala
Minister of Economy and Finance

Hashim Rexhepi
Governor Central Bank of the Republic of Kosovo

Attachments: Memorandum on Economic and Financial Policies
Technical Memorandum of Understanding

ATTACHMENT I

REPUBLIC OF KOSOVO

MEMORANDUM OF ECONOMIC AND FINANCIAL POLICIES

July 7, 2010

I. ECONOMIC AND POLICY DEVELOPMENTS

1. **The economy of Kosovo has exhibited strong growth this decade, but large macroeconomic imbalances persist.** After the end of the conflict in 1999, the immediate efforts aimed at the provision of essential public services and reconstruction. Following the initial donor-supported rapid growth, the private sector stepped up its activity and, more recently, the public sector intensified its efforts to address severe infrastructure bottlenecks. As a result, real GDP growth averaged about 6 percent during the last decade. The global financial crisis only had a moderate impact and real GDP growth decelerated to 4 percent in 2009. Inflation has closely mirrored developments in international markets, given high import dependence. Notwithstanding robust growth, structural bottlenecks and the resulting low productivity continue to hamper the economy's capacity to export. Addressing the resulting large external imbalances requires extensive infrastructure investments and bold structural reforms.

2. **More recently, our fiscal balance has weakened, mainly due to our efforts to address pressing social needs and upgrade the weak public infrastructure.** Two important areas of focus are inadequate and inconsistent supply of energy and severe transport bottlenecks, which pose serious challenges to private sector development. Our efforts to loosen these constraints necessitated large capital expenditures, especially for the transport infrastructure, and budgetary transfers to the energy sector. Besides much needed social measures, these expenditures contributed to a significant deterioration of our fiscal position. In addition to tax revenues, the financing of our expenditures mainly relied upon non-recurrent sources of income and a large drawdown of our bank balances held at Central Bank of the Republic of Kosovo (CBK).

3. **The financial sector has weathered the global financial crisis.** The CBK strengthened its supervisory capacity and took action to mitigate the risks from the global financial crisis. Like other countries in the region, Kosovo experienced rapid private sector credit growth prior to the crisis. However, loan growth was funded through a steady expansion in domestic deposits rather than foreign borrowing. As a safeguard against liquidity shortages, the CBK persuaded banks to curtail their leverage and adopt a ceiling on the ratio of loan to deposits. Moreover, a Crisis Preparedness Committee was formed,

involving the Minister of Finance and Economy, the CBK Governor, and the Chairperson of the Assembly's Budget and Finance Commission.

4. **Nevertheless, we recognize that the CBK lacks adequate resources to safeguard financial stability.** Kosovo's economy is euroised and, therefore, the international reserves of the CBK are relatively low. As a result, the scope for emergency liquidity assistance (ELA) by the CBK, if needed, largely hinges on the fiscal authorities' bank balances held at the central bank. However, a possible further decline of these balances could undermine the CBK's efforts to safeguard financial stability.

II. ECONOMIC OBJECTIVES AND OUTLOOK

5. **Our program aims to balance Kosovo's extensive development needs with our objectives of achieving fiscal sustainability and safeguarding financial sector stability.** To address large infrastructure needs and foster regional and trade integration we began construction of the Route 7 corridor, the country's first highway. The costs of this project are large (equivalent to 24.4 percent of the 2010 GDP) and, in order to safeguard fiscal and debt sustainability, our fiscal policy will target an average annual primary surplus—excluding capital expenditures for the Route 7 highway—of 0.6 percent of GDP during the construction period of 2010–14. Accordingly, we have taken measures to raise budget revenues and curtail current spending. Moreover, we are forging ahead with the privatization of PTK, the post and telecom operator, to secure substantial non-debt financing. Our policy stance will also replenish our bank balances and thus help safeguard financial sector stability.

6. **Our 2010 macroeconomic framework aims to bolster economic activity, stabilize the external deficit, and maintain moderate inflation:**

- **Real GDP growth** is projected to increase moderately to 4.6 percent in 2010, largely reflecting a rebound in global growth, remittances, and exports. We therefore expect a substantial improvement in private sector activity. However, our growth projections are subject to downside risks, considering the ongoing slowdown in private sector lending, possible delays with the execution of highway construction, and continued uncertainties about the external environment. While our direct exposure to the southern rim of the euro area is limited, we are immediately affected by potential adverse developments in the euro area.
- **Inflation**, as measured by the Consumer Price Index (CPI), is forecast to reach 1.7 percent on average in 2010. Amidst the global recovery, import prices are forecast to rise, thus ending a short-lived period of deflation. We expect the inflationary impact of our revenue measures to be muted, while the impact of the highway project on domestic prices should be limited, given the high import share of construction inputs.

- **The external deficit**, including official transfers, is projected to remain broadly unchanged at 18.5 percent of GDP in 2010. The positive impact of a rebound in exports and remittances is projected to be largely offset by rising imports, including of capital goods. Import substitution, combined with moderate but steady gains in competitiveness, is expected to improve external sustainability over the medium and to long run.

III. ECONOMIC POLICIES

7. **To achieve our program objectives, we will use all available fiscal, financial sector and structural policies:**

- **Fiscal adjustment will be the cornerstone of our stabilization program.** To fund the highway expenditures, we have taken revenue measures and decided to reallocate spending. The fiscal balance—excluding highway expenditures—will improve over the program period and reach a surplus of 0.6 percent of GDP in 2011. However, given rising highway expenditures, the overall balance is projected to widen to 5.5 percent of GDP in 2011 from 3.4 percent of GDP in 2010. Therefore, we recognize that, without jeopardizing the stability of our public finances, there is no scope to adopt initiatives in addition to our policy priorities outlined in this memorandum.
- **We will take further steps to maintain financial sector stability.** First, our fiscal stance is designed to bolster our bank balances and, therefore, the resources available to the CBK for the purpose of ELA, if needed. Second, we are intent on modernizing the CBK Law, and aim to establish a legal basis for ELA by the central bank, if necessary. Third, we are overhauling the banking law to improve corporate governance and broaden our legal framework for bank resolution.
- **We recognize that structural reforms are critical to boost the economy's low capacity to produce, save, and export.** Addressing this challenge requires a comprehensive policy strategy for the medium term. As initial steps, we are committed to (i) raising the productivity of the public sector; and (ii) reforming the energy sector—with support from the World Bank and other institutions.

A. The 2010 Budget

8. **As a prior action, the 2010 budget was revised.** The Assembly approved in July, 2010 the mid-year budget review (MYBR) reflecting all policy initiatives and adjustment measures included herein.

- **Revenues.** Effective July 1, 2010 select excises, including on alcohol, tobacco, and fuels, were increased. We estimate these measures will yield 1.0 percent of GDP

annually. Since last year's revenues were boosted by a tax amnesty, tax revenues are projected to rise by ½ percentage point of GDP to 21.6 percent of GDP in 2010. Including one-off receipts and donor grants (4.1 percent of GDP), revenues are projected to reach 28.9 percent of GDP.

- **Expenditures.** We decided to limit our 2010 primary expenditures at 32 percent of GDP. Excluding the outlays for the highway, expenditures are 1.7 percentage points of GDP lower than in 2009. These cuts underscore our commitment to provide funding for the highway project from expenditure reallocations. Moreover, we have decided to limit our current spending at 18.7 percent of GDP, only slightly higher than in 2009.
- **Contingencies.** Compared to 2009, transfers (subsidies and loans) to KEK, the publicly-owned energy company, are budgeted to decline by 0.8 percent of GDP in 2010. However, should KEK need any emergency financing, above the allocations included in the revised 2010 budget (in total of 2.4 percent of GDP), we will seek offsetting expenditure cuts through a further budget amendment by the Assembly. This measure ensures that adverse events in the energy sector will not widen the deficit.
- **Bank balance.** With budget support from the IMF, the bank balance will not fall below 5.9 percent of GDP, a level that we deem prudent and consistent with our responsibility for safeguarding financial stability.

B. Fiscal Policies for 2011

9. **We intend to contain current spending and raise revenues in 2011.** We are targeting a surplus of 0.6 percent of GDP in 2011 for the fiscal balance excluding highway-related expenditures. This improvement in large part reflects the full-year impact of the revenues measures that became effective in mid-2010. Nevertheless, the overall deficit will still widen to 5.5 percent of GDP in 2011, due to a doubling in highway-related expenditures. We are committed to lowering the share of current expenditures in GDP in 2011 to 18.5 percent. Expenditure restraint will limit the public sector wage bill (7.4 percent of GDP), goods and services (4.4 percent of GDP), and subsidies and transfers (6.6 percent of GDP).

10. **The risk of highway-related cost overruns calls for an increase in the bank balance for precautionary purposes.** The highway contract may not adequately protect the budget from cost overruns, while construction delays would trigger non-negligible penalties and cost increases. As a safeguard, we are prepared to raise the government's bank balance by 2 percentage points of GDP in 2011. Moreover, in case of unanticipated budget receipts (including from privatization of public enterprises, dividend income, repayment of budget loans, or any other one-off income), we are committed to maintaining our fiscal stance. In

this context, we will allocate a substantial share of these receipts to the bank balance, unless otherwise agreed in the context of program reviews.

11. **We recognize that the timely privatization of PTK (post and telecom operator) will be critical for raising non-debt-creating financing in 2011.** We have appointed a transaction advisor who has prepared a Privatization Strategy that is expected to be approved by the Assembly in July 2010. We will issue the request for proposals by end-August with the aim of completing the sale by year-end (structural benchmark). At the same time, we are mindful that the process needs to be transparent and competitive to help maximize sales revenues. In this context, the independent Telecommunications Regulatory Authority is considering the government's recommendation to place a five-year moratorium on the issuance of any further mobile telephony licenses.

12. **Given the policies outlined above, our budget will be fully financed without any commercial borrowing during 2010–11.** However, should a financing gap arise, including from a possible shortfall in privatization receipts or privatization delays, we will undertake further expenditure and revenue measures to maintain our program on track. In particular, at least 25 percent of the central government's capital expenditure budgeted for 2011 will remain unallocated until such time that the sale of PTK is completed. Moreover, should the sale receipts fall short of the expected minimum, the impact of this shortfall on the bank balance will be offset through a reduction in capital expenditures up to the maximum unallocated amounts. Should these expenditure cuts not be sufficient to meet our bank balance target in 2011, we will take revenue measures and avoid commercial borrowing.

C. Financial Sector Policies

13. **Maintaining financial sector stability is of paramount importance and we recognize the fiscal authorities' overarching responsibility for this objective.** Kosovo has emerged unscathed from the recent turmoil in international financial markets. Nonetheless, we are actively preparing a strategy to enhance financial sector stability in light of the limitations on the scope for emergency liquidity provision by the CBK that result from euroisation. Given that the CBK's liquid assets are in large part limited to the counterpart of the government's deposits held at the CBK, we are committed to aligning our fiscal stance with our responsibilities for financial sector stability. Therefore, the government intends to maintain its bank balances at 241 million euros by end-2010 and will increase these balances to 354 million euros by end-2011.

14. **We are preparing a policy on emergency liquidity assistance.** The government's bank balances will in part be held in a Special Reserve Fund of the Treasury at the CBK and be available for ELA, if needed. This emergency assistance would be extended on a temporary basis only. With IMF technical assistance, the government and the CBK will finalize a memorandum of understanding on cooperation to enhance crisis preparedness and

the CBK will issue a regulation that would govern any potential extension of ELA, by the first review.

15. **The CBK and the government will closely cooperate to ensure that a potential withdrawal of government deposits will not cause undue liquidity pressures in the banking sector.** Following a further dividend payment by PTK, government deposits with commercial banks rose to about 11.3 percent of total deposits (May 25, 2010). The MoEF and the commercial banks negotiated a maturity schedule in order to ensure that banks will not be subject to undue liquidity pressures at the time of withdrawal of the government's deposits. Nevertheless, prior to any withdrawal, the government will consult with the CBK and consider remedial action, if needed.

16. **We will bring the CBK Law in line with best international practice in order to underpin financial stability.** The existing central bank law does not provide a basis for ELA by the CBK and, therefore, severely undermines the scope for effective crisis management. As a prior action, the Assembly adopted in July a revised Law on the CBK, which establishes a basis for limited ELA by the CBK. Moreover, this law will enhance CBK independence and accountability in order to enhance the institution's ability to perform its functions. In this context, the position of the single representative of the MoEF on the CBK supervisory board will lapse after a transition period of five years, following adoption of the law. Moreover, the appointment and removal procedures for members of the CBK's executive board, including the Governor, are designed to prevent undue political interference and follow best international practice.

17. **The government intends to overhaul the Banking Law in order to safeguard financial stability.** The existing law is outdated and the government will submit to the Assembly for adoption by end-2010 a revised law, developed in consultation with IMF staff, that is consistent with best international practices. In particular, the draft law will strengthen governance standards for banks, including with respect to fit and proper criteria for administrators and suitability requirements for significant shareholders; provide for tighter restrictions on lending to bank-related parties; and enhance the coverage of the law to ensure consolidated supervision of banking groups and appropriate treatment of branches of foreign banks and nonbank deposit-taking entities. The draft law will also include an improved bank resolution regime that will ensure the authorities have the appropriate tools to liquidate banks and to place banks into official administration, including powers to approve purchase and assumption transactions. We will also send to the Assembly a law on the Deposit Insurance Fund (DIF) that is harmonized with the Banking Law to ensure depositors have speedy access to their deposits during bank resolution, including through use of DIF funds to facilitate a purchase and assumption transaction. The DIF will not have any responsibility for official administration or liquidation of banks and its permanent administration will employ no more than one full-time employee.

18. **We recognize that the CBK's reputation is closely linked to its continued success in supervision.** Improvements of insurance sector supervision need to keep pace with quality enhancements in banking sector supervision. The World Bank and the CBK have recently conducted a joint assessment of the insurance industry and the Financial Sector Reform and Strengthening (FIRST) Initiative is now providing a resident insurance advisor. The CBK, with the assistance of the World Bank, intends to conduct by October 2010 a full Assessment of the Insurance Core Principles (ICP) of supervision. In order to safeguard the protection of insurance policy holders—the CBK's key mandate as the insurance regulator—the CBK will adopt by end-2010 an action plan to address key vulnerabilities highlighted by the recently conducted sector assessment and the ICP assessment.

IV. FISCAL POLICY—ACHIEVING FISCAL SUSTAINABILITY

A. Improving Budget Processes and Expenditure Management

19. **We recognize that it is essential to strengthen the integrity of the budget process and avoid unfunded mandates.** A credible medium-term fiscal framework will be necessary to help secure fiscal sustainability.

- In support of our policy to contain current spending, the Cabinet made a commitment to ensure that no further spending initiatives are introduced this year.
- The Assembly adopted the Law on Wages of Civil Servants and the Law on Civil Service on May 13, 2010. These laws provide a rules-based framework for setting civil servants' wages. Therefore, starting January 1, 2011, all existing allowances hitherto paid to civil servants will be incorporated into the overall civil servants' wage bill consistent with the Law on Wages of Civil Servants. We are prepared to take expenditure measures needed to offset any unanticipated costs related to these reforms, including those that may result from grandfathering. We will ensure that the share of the public sector wage bill in GDP does not rise above 7.4 percent of GDP in 2011.
- As a prior action, the Law on Public and Financial Management and Accountability was amended to ensure that any spending initiatives introduced in MYBRs in 2011 and subsequent years will be fully financed by revenue measures or offsetting expenditure cuts. As a result of this amendment, unfunded expenditure commitments will no longer inflate expenditures and raise the deficit beyond the target set in the annual budget.
- We are committed to submitting, for approval by the Cabinet, only those draft laws for which the MoEF has undertaken a comprehensive assessment of their short- and long-term economic and fiscal impact.

20. **Strengthening the transparency and credibility of policies is vital to foster a social and political consensus on our prudent fiscal stance.** Therefore, starting immediately, we will include in the Medium Term Expenditure Framework (MTEF), the MYBR, and the annual budget the following information:

- A table comparing (i) the approved budget and related financing requirements; (ii) the projected/actual outcome; (iii) the MYBR (when relevant), and (iv) the MTEF.
- A table summarizing policy-induced changes in the fiscal framework, and their impact on expenditure, revenue, and/or financing requirements.
- Separate tables for (i) the central government, (ii) municipalities, (iii) inter-governmental transfers, and (iv) the consolidated government (i.e., the current Kosovo Consolidated Budget). An appendix in fiscal statements containing for each budget organization, including municipalities, a table on Own-Source Revenues (OSR) and their use by economic category of spending.

21. **Over the medium term, we intend to elaborate and implement a comprehensive strategy to rationalize public expenditure.** We request assistance from the IMF to help us prepare a strategy for expenditure rationalization. Such strategy would need to address several issues. First, public employment would need to be streamlined over the medium term. This will allow us to raise compensation for essential staff and avoid unnecessary turnover. Second, a comprehensive and fiscally sustainable strategy for health care, pension, and social spending remains to be adopted. This element would be essential to protect better the most vulnerable populations.

B. Improving Tax Administration

22. **We recognize the importance of broadening the domestic tax base to fund Kosovo's development and social needs in a sustainable manner.** Our main objective is to reduce Kosovo's tax gap by increasing the overall taxpayer compliance level within the current tax policy setting. A comprehensive upgrade of the Tax Administration of Kosovo's (TAK) outdated information technology (IT) system is urgently required to facilitate the implementation of an improved taxpayer compliance situation. The short-term agenda of TAK is therefore focused on the interrelated priorities of enhancing taxpayer compliance and strengthening the IT system.

23. **In the future, TAK's compliance efforts will be guided by a comprehensive annual compliance strategy.** A pilot strategy has been finalized by end-June 2010; it will direct TAK's compliance efforts for the remainder of 2010 and 2011 and will be supported by semi-annual reports on its implementation. Through the development and implementation of the compliance strategy, our objective is that TAK will take a strategic "top-down" view of all compliance risks and use a more structured and systematic process to identify, assess, and prioritize compliance risks, and determine appropriate treatment actions for the major risks identified. In line with IMF technical assistance (TA) recommendations, TAK has established a risk management unit that will be fully operational by end-2010.

24. **In parallel to developing the compliance strategy, TAK will take other actions to speed up compliance efforts.** As such, we will enhance our data quality substantially by updating the taxpayer register. We estimate that more than 90 percent of all existing businesses registered with TAK under a new tax identification number (TIN) by March 15, 2010. Based on the data received through the re-registration process, we are now working on cleansing the taxpayer register. These efforts will be completed by September 2010 and will enable us to effectively address our non-filer problems. Furthermore, TAK is implementing a risk-based approach when processing VAT refunds claims to reduce delays and unnecessary systematic checks.

25. **We will also make serious efforts to address tax losses related to the informal economy and sophisticated tax fraud schemes.** To this end, TAK created a tax fraud investigation unit which will be fully functional by end-2010. TAK will allocate sufficient capacity to investigate fraud cases, and the government will create external supporting mechanisms, such as specialized public prosecutors to improve enforcement. Moreover, the Law on Tax Administration and Procedures is expected to be amended by end-2010 to strengthen the scope for prosecution of tax offenses.

26. **A two-step approach has been adopted to improve the IT system.** The immediate needs to improve the IT system cannot wait for the roll-out of a new IT system. We therefore decided, in close coordination with the IMF and donors, to first improve the existing IT system while developing in parallel a comprehensive strategy for shifting to a new system.

- *An upgrade of our current core IT system (SIGTAS) commenced in November 2009 and will be completed by end-July 2010.* The upgrade will mitigate some of the major weaknesses in the system (e.g., modules related to audit, collections, appeals, and management information) until a new IT system can be implemented.
- *A tender for the procurement of a new IT system is expected to be issued by the European Commission (EC) by end-2010.* We will closely cooperate with the EC and the IMF in determining both the requirements to a new IT system and the subsequent need for redesigning TAK's business processes, which would be a substantial component of the IT contract.

C. Improving Public Financial Management

27. **Consistent with our PFM plan, we will strengthen the budgeting and execution of capital expenditures.** We will use the EC-supported Public Investment Program (PIP) framework as a decision-making tool to enhance planning, execution, and monitoring of capital spending. Starting in 2010, processing of central government capital projects above €1 million through the PIP framework became mandatory for allocation requests to be accepted by the budget department. We have established a Public Investment Committee (PIC) to enhance planning and monitoring of capital spending.

- The PIC will establish a quarterly monitoring mechanism of capital spending executions by August 2010. As part of this mechanism, quarterly execution benchmarks will be set. In future budget allocations, the MoEF retains the right to lower capital expenditure allocations in case of significant under-execution compared to the benchmark.
- Starting with the 2011 budget, we will publish a list of investment projects, ranked by their priority order. In case cuts have to be made, we will cut first projects with the lowest priority. A strict separation of preparation and execution phases of capital investments is necessary to prevent the commencement of capital projects without adequate costing or funding. Therefore, allocations for project execution will only be made upon completion of project preparation.
- We are taking steps to prepare for the introduction of mandatory cost-benefit analysis for all large scale projects. In order to prepare budget organizations for the introduction of cost-benefit analysis, we will undertake a feasibility study by June 2011. This study will draw on the lessons from cost benefit analysis that we plan to carry out for 10 large projects under consideration for inclusion in the 2012 budget.

28. **We are mindful of the importance of avoiding payment arrears.** There were temporary payment arrears to old age pensioners in 2009, notwithstanding the government's bank balances. These arrears arose due to diversion of funds for pension benefits to social assistance benefits. In order to reduce the possibility that arrears may arise in the future, we will introduce a new module in Free Balance, our accounting system, by September 2010 to record due payments, including receipt of invoices. Therefore, we will be able to avoid arrears and improve the cash flow plans of the Treasury. This is especially important given the difficulties in forecasting the payments resulting from the highway project, the uncertainties surrounding the timing of the privatization, and the fact that some of our bank balances are held with commercial banks.

29. **We are taking action to improve the current system of intergovernmental finance.** Recent technical assistance from the IMF has identified several areas where the intergovernmental finance system could be improved. We are preparing a comprehensive action plan to improve the system and, in the interim, we will address the most immediate shortcomings. To reduce the municipalities' reliance on transfers from the central budget, we will give serious consideration to: i) progressively increase the minimum rate of property tax from 0.05 percent to 0.5 percent of the market value of the property; ii) progressively increase municipal charges on cars; and iii) introduce an annual inflation adjustment mechanism for motor vehicle tax and other fixed fees, rents, and charges. In the area of capital spending, all municipal capital investment proposals should be channeled through PIP, using its cost-benefit functionality for projects above € 0.4 million. The Grants Commission should review and recommend capital projects for approval to the government.

V. ENERGY SECTOR AND OTHER STRUCTURAL POLICY INITIATIVES

30. **We assign a high priority to reforming the energy sector and restoring its financial viability.** Despite some progress in reducing losses in the electricity sector, its poor performance and conditions require significant budget resources and threaten Kosovo's energy security. KEK has dilapidated equipment, deep-rooted problems with billings and collections, and supplies energy at tariffs below cost recovery. As a result of these deficiencies, the budget transferred an estimated 3.8 percent of GDP to KEK in 2009. One of the beneficiaries of this policy is *Ferronikeli*, the privatized nickel producer, but we are committed to discontinue this implicit energy subsidy to Ferronikeli after its contractual expiration on March 17, 2011.

31. **In close consultation with the World Bank and the EU, we are devising a comprehensive strategy to shore up KEK's finances (structural benchmark).** This strategy will reduce the need for government subsidies and improve KEK's attractiveness to private investors. It will be completed by the time of the second review and, among other issues, it will consider the following:

- The need for a potentially substantial increase in tariffs in order to allow KEK cost recovery and facilitate the company's privatization.
- The feasibility of charging KEK royalty fees for its use of Kosovo's large lignite reserves, following a possible tariff increase.
- Adopting draft amendments to Kosovo's Criminal Code to address energy theft.
- Stepping up enforcement of debt judgments to curtail nonpayment problems by allowing the creation of a lien on a property or the use of private enforcement agencies that have been licensed.
- Setting out a timeline to address overstaffing at KEK to improve the company's cost structure.

32. **We recognize the importance of preserving labor market flexibility and low labor costs.** Given the high unemployment rate in Kosovo, the Assembly approved a labor law in May 2010 that will ensure that labor costs are consistent with our objective of improving competitiveness.

33. **We recognize that good governance of the Pension and Savings Trust of Kosovo (KPST) is essential to avoid any future fiscal liabilities.** Amendment to the Law on Pensions is under preparation with support from the World Bank. We intend to ensure that KPST will continue to exercise its fiduciary responsibilities towards its contributors, allow for maximizing returns for any given risk profile, and limit undue risks, including those that may arise from undue exposure to a single borrower.

VI. OTHER ISSUES

34. **We recognize the importance of improving the quality of statistics, particularly in the context of an IMF program.**

- To improve the accuracy of our fiscal accounts, there will be monthly audits of these data, in line with IMF safeguard advice. In particular, the data on bank balances from the Treasury and the CBK will be fully reconciled. For the purpose of program monitoring, the data on bank balances will be reported individually by the CBK and by the Treasury.
- To improve the institutional framework, we will submit to the Assembly by September 2010 the Law on Statistics, which will provide the Statistical Office of Kosovo (SOK) with independence. With greater flexibility on budget implementation, the quality and timeliness of statistics are expected to improve. Although technical assistance, including from the IMF, has been instrumental in improving the quality and timeliness of statistics, there remain considerable weaknesses, especially in the national income accounts. We therefore intend to make continued, substantial improvements to the quality of our statistics. With the objective to improve the quality of our economic statistics, we will join the General Data Dissemination System and have appointed the CBK as Country Coordinator.

VII. PROGRAM MONITORING

35. **The program will be monitored in general on a quarterly basis**, by quantitative performance criteria, indicative targets, and structural benchmarks as defined in the Technical Memorandum of Understanding (TMU). The quantitative performance criteria and indicative targets for end-August 2010, and end-December are set out in Table 1. The structural benchmarks of the program are set out in Table 2. To monitor program implementation, we have established a Program Monitoring Committee (PMC), composed of the Director of the Treasury, the two Budget Directors, the two Deputy Governors of the CBK, the advisor to the Prime Minister, the head of the Macro Unit, the two internal auditors, respectively one each from the CBK and the MoEF, and the IMF resident representative. The PMC will meet at least once monthly. The first and the second reviews are expected to be completed no later than November 30, 2010 and March 31, 2011, respectively.

Table 1. Kosovo: Quantitative Performance Criteria (PC) and Indicative Targets (IT), 2010—11
(Millions of euros, cumulative from beginning of the year)

Type of objective	Test date	2010		2011	
		Aug.	Dec.	Mar.	Jun.
		PC	PC	IT	IT
Objective to be observed					
Floor on the bank balance of the general government 1/		369	241	226	457
Floor on the primary fiscal balance of the general government 1/		21	-129	-37	-121
Ceiling on primary expenditures of the general government 1/		700	1,316	275	628
Ceiling on contracting or guaranteeing nonconcessional debt by the general government		0	0	0	0
Ceiling on the accumulation of domestic payment arrears of the general government 2/		0	0
Ceiling on the accumulation of external payments arrears of the general government 3/		0	0	0	0
Memorandum items:					
Indicative target for all test dates					
Ceiling on recurrent primary expenditures of the general government		459	770	183	387
Program assumptions					
Total revenue (excluding grants)		805	1,106	233	507
New privatization receipts		0	0	0	300
Non-project grants		0	80	5	60
Budget support loans		0	0	0	0
Project grants		0	1	0	0
Project loans		0	1	0	0

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

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

2/ A zero ceiling on the stock of domestic payment arrears is to be observed at end-December 2010; a zero ceiling on the accumulation of new domestic payment arrears is to be observed continuously beginning in January 1, 2011.

3/ To be observed continuously.

Table 2. Kosovo: Prior Actions and Structural Benchmarks, 2010—SBA

Actions	Type	Timing
Approval by the Assembly of the Central Bank Law consistent with IMF recommendations.	Prior Action	Approved at least five business days before Board program discussion.
Approval by the Assembly of the 2010 midyear budget review (MYBR) reflecting fiscal adjustment measures.	Prior Action	Approved at least five business days before Board program discussion.
Decision by the Cabinet not to introduce any spending initiatives of the central government in 2010 in addition to those included in the 2010 MYBR.	Prior Action	Approved at least five business days before Board program discussion.
Amendment to the Law on Public Financial Management and Accountability to ensure that any spending initiative introduced in MYBRs in 2011 and subsequent years will be fully compensated by credible new revenue measures, or offsetting expenditure cuts.	Prior Action	Approved at least five business days before Board program discussion.
Completion of the privatization of PTK by end-2010.	Structural benchmark	End-2010
Formulation of strategy to shore up KEK's finances	Structural benchmark	Second review

ATTACHMENT II**TECHNICAL MEMORANDUM OF UNDERSTANDING****REPUBLIC OF KOSOVO****Definitions and Data Reporting Requirements Under the 2010–11 SBA Arrangement**

1. This Technical Memorandum of Understanding sets out the understandings between the Kosovo authorities and the IMF staff regarding the definition of performance criteria and indicative targets, and reporting requirements for the Stand-by Arrangement (the “SBA”) requested for approval by the IMF Executive Board in July 2010.

I. QUANTITATIVE PERFORMANCE CRITERIA AND INDICATIVE TARGETS**A. Coverage**

2. For the purpose of this memorandum, **general government** is composed of the Executive, the Legislative, and Judiciary branches of the Government, its Municipalities, and any other public authorities that receive direct budgetary appropriations. It excludes enterprises owned by the state or by employees (publicly owned and socially owned enterprises, respectively).

3. **Performance Criteria and Indicative Targets.** The performance criteria, indicative targets, and their respective test dates are set in Table 1 of the Memorandum of Economic and Financial Policies (MEFP).

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 (e.g. undistributed KEK loan) but do not include the balance of unspent Own Source Revenues (OSR) carried forward, or funds encumbered or pledged as Donor Designated Funds and funds relative to onlending operations. Bank balances do not include investments made and managed by an outside Investment Manager assigned by the Minister pursuant to Kosovo’s Law on Public Financial Management Article 7.1.(iii). Bank balances may be held in the form of gold, holdings of foreign exchange and traveler’s checks, demand and short-term deposits at foreign banks, domestic banks, and 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, 2009 were € 341.930 million and at March 31, 2010, they were € 366.237 million.

- The floor on the bank balance set in Table 1 will be lowered by
 - the shortfall in the resources purchased from the IMF under this SBA relative to program assumptions.
- The floor on the bank balance set in Table 1 will be raised by
 - the excess in the euro value of the resources purchased from the IMF under this SBA relative to program assumptions;
 - the repayment of loans extended to public enterprises.

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

C. Primary Expenditures of the General Government

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

- The ceiling on primary expenditures set in Table 1 will be raised by
 - The excess of project grants and loans relative to program assumptions;
 - The excess of budget grants relative to program assumptions.
- The ceiling on primary expenditures set in Table 1 will be lowered by
 - The shortfall of project grants and loans relative to program assumptions;
 - The shortfall of budget grants relative to 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 Kosovo Privatization Authority. 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 of revenues and expenditures will be provided monthly no later than five weeks after the end of each month, including (i) government domestic revenue detailing by components direct taxes, indirect taxes, and nontax revenues; (ii) external budget support grants; (iii) primary recurrent expenditure, (iv) domestic and external interest payments and receipts, (v) capital expenditure detailing all those related to the construction of Route 7 and including domestically and budget support financed capital expenditure and externally project financed capital expenditure; (vi) the gross payment and gross accumulation of domestic payments arrears; (vii) external loan receipts and principal payments; (viii) external arrears payments and accumulation; (ix) bank and nonbank financing; (x) privatization and receipts of the sales of nonfinancial assets; and (xi) any other revenue, expenditure, or financing not included above.

D. Primary Fiscal Balance of the General Government

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

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

E. Contracting or 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). The ceilings 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 definition of short-term nonconcessional debt excludes normal short-term (less than one year) import-related financing. The performance criterion applies 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.

11. **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 performance criterion.**

12. **Reporting requirements.** Details of all new debt (including government guarantees), indicating terms of debt and creditors, will be provided on a quarterly basis within five weeks of the end of each quarter.

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.”

F. Domestic Payments Arrears

14. 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 due-for-payment date has passed and the obligation has remained unpaid beyond the normal or contractually agreed period of credit. The stock of arrears will be assessed at end-December 2010 and the accumulation of new domestic arrears will be assessed continuously beginning January 1, 2011 (when the monitoring system will be operational). A payment obligation is defined to be domestic if the creditor is resident in Kosovo.

15. **Reporting requirements.** The Ministry of Economy and Finance will submit a detailed table of the stock of domestic arrears due at end-December 2010. From that date onwards, a detailed table will be submitted quarterly with the stock of domestic payments arrears, including the accumulation (if any), payment, rescheduling and write-off of domestic payments arrears during the quarter. The data are to be provided within five weeks after the end of the quarter.

G. External Payments Arrears

16. **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.

17. **Reporting requirements.** The Ministry of Economy and 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 Economy and Finance within five weeks of the end of each quarter.

II. OTHER DATA REQUIREMENTS

18. 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

19. 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.

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

21. 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.

ANNEX I—REPUBLIC OF KOSOVO: SUMMARY OF POLITICAL EVENTS

1. **Kosovo became a member of the IMF on 29 June 2009.** The Executive Board had certified on May 8, 2009 the vote of IMF’s Board of Governors to offer membership to Kosovo.
2. **Kosovo’s constitution entered into force in June 2008, following the unilateral declaration of independence (UDI) in February.** In the aftermath of the conflict, UN Security Council Resolution No.1244 authorized the Secretary-General to establish an international civil presence in Kosovo. The United Nations Mission in Kosovo (UNMIK) was given executive responsibilities under four “pillars,” namely, police and justice, civil administration, institution building, and reconstruction. As local capacities increased, UNMIK’s powers were transferred to the Provisional Institutions of Self-Government (PISG) in a phased manner. UNMIK relinquished remaining powers upon entry into force of Kosovo’s constitution.
3. **The post-independence reconfiguration of UNMIK was accompanied by the deployment of a European Union “rule of law” mission (EULEX) and the establishment of an International Civilian Office (ICO).** The principal mission of EULEX is to assist the judicial authorities and law enforcement agencies to establish sustainable and accountable institutions and practices. The ICO’s mission is concentrated on ensuring implementation of those aspects of the Comprehensive Proposal for the Kosovo Status Settlement (viz., the Ahtisaari Proposal (AP)), aimed at building a multi-ethnic society through assistance in drafting legislation and regulations in the social and economic spheres. Although the AP was not brought to a vote in the UN Security Council, the Assembly of Kosovo formally adopted the proposal in February 2008 as the framework for Kosovo’s status resolution.
4. **Since 1999, Fund staff has provided technical assistance and policy advice to UNMIK under EBD/99/80 and, since September 2008, to Kosovo under EBD/08/95.** Technical assistance has been centered on the Fund’s core competencies, notably in the areas of fiscal policy, the banking and payments systems, and macroeconomic statistics. Assistance has also contributed to developing key aspects of the legal and institutional framework needed for a market economy. Fund policy advice was helpful in restoring macroeconomic stability after understandings on a policy package were reached with Fund staff in late 2005. Staff’s Letter of Assessment to the European Commission in July 2008 was instrumental in garnering donor support.¹ Following Staff’s Letter of Assessment to the

¹ <http://www.seerecon.org/kdc/loa.pdf>

European Commission of November 2009, ECFIN extended the December 2009 deadline to provide Macro-Financial Assistance to Kosovo.