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

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January 15, 2016

December 3, 2015

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Kosovo: Letter of Intent

December 2, 2015

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

Dear Ms. Lagarde:

1. The attached Supplementary Memorandum of Economic and Financial Policies (MEFP) summarizes the substantial progress made in implementing the SBA-supported program through October 2015 and outlines our economic and structural policies for the whole of 2016. This MEFP complements and updates the MEFP of July 6, 2015, which set out the objectives of our 22-month SBA-supported program.
2. Performance under the program has been strong. We have met all quantitative performance criteria at end-August 2015 by a wide margin. We have also met all structural benchmarks for the first review and one structural benchmark originally planned for the second review.
3. We remain committed to our reform agenda as confirmed by ongoing improvements in our public finances, our financial regulatory and supervisory framework, our work to remove credit obstacles, address competitiveness gaps by realigning labor costs and strengthen public procurement process. This will provide us with the foundation necessary to achieve stronger and durable economic growth.
4. We believe that the policies set forth in the attached MEFP remain adequate to achieve the objectives of the program, but we will take any further measures that may become appropriate for this purpose.
5. We request a modification of the performance criterion on the headline fiscal balance ex-PAK of the general government, to include capital spending by publicly-owned enterprises via on-lending from the general government. This modification makes the performance criterion tighter.
6. The Kosovo authorities will consult with the IMF, at our own initiative or whenever the Managing Director of the IMF requests such a consultation, on the adoption of these measures and in advance of any revisions to the policies contained in our MEFP, in accordance with the IMF's policies on such consultations. We will provide IMF staff with data and information necessary for the purpose of monitoring the program.
7. On the basis of this performance, and on the strength of the policies set forth in the attached Memorandum, we request that the first review under the Stand-By Arrangement be completed and that the second disbursement be approved in the amount of SDR 28.1 million.

8. Continuing with our policy of transparency, we consent to the publication of this letter, the attached MEFP, and the accompanying Executive Board documents on the IMF's website.

Sincerely yours,

/s/

Mr. Isa Mustafa

Prime Minister

/s/

Mr. Avdullah Hoti

Minister of Finance

Ministry of Finance

/s/

Mr. Bedri Hamza

Governor

Central Bank of the Republic of Kosovo

Kosovo: Supplementary Memorandum of Economic and Financial Policies of the Government for 2015–17

A. Macroeconomic Context

1. **The recovery of the Kosovo economy is continuing with GDP growth estimated at 3.8 percent for 2015**, in line with projections at the time of the program request. This projection is underpinned by strong remittances, high credit growth and increased FDI inflows. For the medium term, we still expect a further expansion of economic activity with a GDP growth of around 4 percent from 2016 onwards. However, we aim for higher GDP growth rate to reduce high unemployment, particularly among women and the youth.
2. **The pass-through from low prices in the euro area and the decline in global food and energy prices explain falling prices in Kosovo.** At the same time, reduced imported food and energy prices are reflected in a somewhat improved current account balance (from 8 percent of GDP in 2014 to 6.6 percent projected for end-2015). The recent uptick in FDI, reversing last year's negative trend, will strengthen our external accounts.
3. **Risks remain tilted to the downside.** Securing financing and starting the implementation of the Brezovica ski resort is vital, and any substantial delay would have a substantial impact on investment and growth in 2016. Separately, political efforts are being made in resolving issues in parliament to avoid delays in the legislative agenda and a negative impact on confidence.
4. **The ongoing refugee crisis in Europe has bypassed Kosovo so far**, as we do not share borders with the EU; however, we will remain vigilant and will continue to monitor the situation very closely.

B. Program Implementation

5. **The SBA-supported program is on track and performance against the quantitative targets has been strong** (Table 1). All performance criteria and indicative targets at end-August 2015 were comfortably met.
 - *The headline fiscal balance and the bank balance as of end-August outperformed program targets by a large margin (€115 million and €85 million, respectively). Tax performance has been strong, and we are further rationalizing current expenditures relative to the revised mid-year budget thanks to strict monitoring of execution. Separately, there have been normal execution delays in the capital budget. Any savings from this will be used either to reduce the deficit or accelerate the implementation of Route 6, which will help us to minimize the current significantly back-loaded payment path, in line with our commitments in the July 6, 2015 MEFP (paragraph 7).*
 - *Our projections for current spending over the course of 2015 remain valid, since we are currently estimating an under-execution in the range of 0.2–0.3 percent of GDP compared to*

end-December 2015 target. The current spending indicative target (IT) was well below the end-August ceiling (by €148 million). Current spending is a large aggregate and therefore a few weeks' delay in executing some items explain this large but temporary end-August over-performance. We have continued to serve our external obligations and no new arrears were accumulated.

6. We registered good progress in implementing structural reforms under our economic program (Table 2). This confirms our strong commitment to move expeditiously in implementing the ambitious policy agenda underpinning the SBA-supported program.

- *Government has submitted to parliament amendments to the investment clause of the fiscal rule in line with the program objectives.* The revised investment clause will allow for new donor-financed capital projects, in addition to privatization-financed projects, not to count as an excessive deficit against the fiscal rule as long as: (i) cash balances are at least 4.5 percent of GDP; and (ii) the underlying fiscal deficit is consistent with the fiscal rule. The amendment also includes a debt limit of 30 percent of GDP, and a 10-year sunset clause.
- *On September 30, the CBK Board adopted a new regulation on emergency liquidity assistance (ELA).* The new regulation is the result of a constructive and extensive dialogue with the Fund and it is in line with international best practices. Among other things, the new regulation better clarifies how ELA applicants would be assessed and the conditions to which their borrowing would be subject. This will help to bolster Kosovo's financial safety net while helping to safeguard CBK resources (structural benchmark, October 31, 2015).
- *We have made progress towards full rollout of risk-based supervision,* another key component of guarding against potential risks in the financial system. We completed the risk-based supervision manual and finalized the first on-site examination report of a domestic bank (structural benchmark, October 31, 2015). The risk-based supervision of the remaining banks is proceeding on schedule (structural benchmark, March 15, 2016).
- *We successfully issued the tender bids for centralized procurement of oil, air tickets and office supplies* (structural benchmark, October 31, 2015). The award of the fuel and office supplies bids are expected to be finalized in coming weeks. While the awarding of air plane tickets bid has been challenged, we are confident we will complete its awarding ahead of schedule (structural benchmark, October 31, 2016).
- *With the support of Fund staff, the government adopted a public sector wage bill rule, well ahead of the original schedule* (structural benchmark, March 15, 2016). The new rule will: (i) not come into effect until the 2018 budget, allowing program targets to govern fiscal objectives for 2016 and 2017; (ii) have a nominal GDP growth cap on the overall wage bill of the central and local governments, with no exemptions; and (iii) provide some flexibility in case of a recession, but with a correction mechanism to avoid permanent increases in the wage bill/GDP ratio.

7. **We have, however, encountered some delays in mobilizing non-tax revenues,** incorporated in the 2015 budget, namely the transfer of revenues and privatization funds by the Privatization Agency of Kosovo (PAK), and revenues from the sale of new telecommunication licenses. Given the crucial role of these resources for the execution of the 2015 budget and bringing the bank balance back to a prudent level without curtailing capital spending beyond normal execution delays, we have undertaken important steps to ensure that these revenues materialize as originally planned. In particular:

- *On October 30, 2015, the government submitted the list of recommended candidates to fill the PAK Board. After the parliament nomination of the PAK Board, the Board will transfer to the government a minimum €5 million in tax obligations and €30 million in privatization funds (prior action).*
- *We are also making substantial progress in finalizing the sale for new telecommunication licenses. On October 20, 2015, the telecommunication authority has announced the price for new telecommunication license. While the nature of the process does not allow us to gauge with certainty the proceeds from the sale, we are confident we will receive any revenues stemming from the sale by end-December 2015 (structural benchmark, December 31, 2015).*

Against this background, we remain confident that end-December 2015 targets, agreed at the time of program approval, will be safely met.

C. Program Objectives for 2016

8. **The core economic objectives of the program remain unchanged:** maintaining a broadly stable macroeconomic environment and boosting potential growth by: (a) containing a fiscal deficit; (b) improving the budget composition and generating more room for critical infrastructure projects; (c) further strengthening the regulatory and supervisory framework of the banking sector; (d) further removing obstacles to credit expansion; and (e) improving the business environment, transparency and governance by enhancing the public procurement system.

Fiscal Policy

9. **We remain committed to strengthening our fiscal position while creating room for high priority capital spending.** We are confident that parliament will approve a 2016 budget, including supportive legislative measures, which target a deficit, excluding PAK spending and new donor-financed projects, of no more than €98 million (prior action). Assuming a ceiling of €90 million disbursements for new donor-financed projects, the fiscal deficit, excluding PAK spending, will not be higher than €188 million.

10. **We are confident that tax revenues will continue to increase at a steady pace.** Last April and July's increases in excises in alcohol and tobacco, as well as the new VAT law and other measures adopted in the context of the 2015 supplementary budget are delivering revenues in line with our projections.

11. In addition, we will continue to contain current expenditures in line with our program objectives.

- *Wage and salary levels will remain unchanged at 2015 nominal levels, as agreed at the time of program approval. However, there will be a marginal increase in the wage bill to accommodate the 2014 collective agreement, as agreed at the time of program approval, and to absorb additional costs from the implementation of the "Brussels" agreement (€5 million).*
- *The budget allocation for social subsidies and transfers, excluding the cost of the implementation of the Law on Pension Schemes Financed by the State (Law N.04/L-131) will remain as agreed at the time of program approval, which de facto represents keeping allocations at the 2015 levels. The only social scheme whose funding will be increased is our well-designed social assistance scheme. This scheme is the only properly means-tested scheme in Kosovo, and it is well targeted to the most vulnerable. Moreover, entitlements under this scheme have not been raised since 2003, except for a €5 increase in 2009, while remaining very low in absolute value or relative to cost of living. All in all, the net budgetary cost of this additional funding in social assistance will not exceed €4.5 million.*

12. Despite these efforts, we are aware that more is needed to meet the 2016 fiscal deficit target (ex-PAK and new donor-financed projects) of €98 million. To fill this gap, the following measures will be adopted, to support the 2016 budget:

- *A further increase in excises, yielding €10 million per year.*
- *Cuts in the goods and services allocation for €5 million. Our recent experience with centralized procurement has been very positive; further mainstreaming of centralized procurement will generate significant savings relative to the old decentralized procurement system.*
- *In addition, we commit to ensuring that the full implementation of the revised Law on Pension Schemes Financed by the State (Law N.04/L-131) will generate €23 million in new obligations on a full-year basis. The Kosovo's law gives government the right to set the qualification criteria and the amounts pertaining to the application of this law. Hence, any legal obligations to the State pertaining to the application of this law, including retroactive obligations, will not exceed this new budget allocation of €23 million. We will share with Fund staff the secondary legislation for the implementation of this law, including the amounts of these obligations. In addition, we will request technical assistance from the Fund to review our social security schemes with the aim to streamline and better target them to the most vulnerable.*
- *All in all, we commit to not spending more than €548 million in wages and salaries, €209 million in goods and services, and €459 million in subsidies and transfers over the course of 2016.*

13. We would also like to reiterate our commitment to using any revenue over-performance above €1,584 million towards a lower deficit, towards higher-than-budgeted payments for Route 6, or towards an increase in the goods and services allocation

related to better maintenance of our capital stock by up to a maximum of €7 million. Any under-execution in capital spending (relative to the €454 million budgeted) will be reallocated towards a lower deficit or higher allocation for Route 6 payment to minimize any back-loading of its payment schedule.

14. **We are advancing in the implementation of key infrastructure projects.** After having secured a long-term and low-cost loan (€39.9 million) from the EBRD, we are currently negotiating with the EIB a loan of similar amount and conditions, as well as a grant with the EU, to finance the first rehabilitation phase of the railway Line 10. We are moving ahead with other critical capital projects, including one on the education sector, possibly to be supported by the World Bank, as well as various road-upgrading projects, which are part of the EBRD regional connectivity strategy.

15. **We have recently established a National Investment Committee (NIC).** It is co-chaired by the minister of finance and minister of European Integration with the objective to prioritize our infrastructure projects and prepare a “single project pipeline.” The NIC is responsible for preparing detailed financial plans needed to seek financial support from multilateral and bilateral institutions and donors. In this context, we remain committed to adopt a detailed concept note for new capital projects to be financed by donors (structural benchmark, March 15, 2016) and submit semi-annual reports to parliament (starting from March 2016), which assess the progress made in implementing the single project pipeline and identifying new priority projects (structural benchmark, March 15, 2015).

Financial Sector

16. **The banking system remains healthy and credit growth has accelerated.** By the end of August, credit growth reached 7.8 percent y/y, while asset quality has improved this year with an NPL ratio at 7.5 percent. Falling lending rates—interest spreads declined by 190 basis points over the year—and improvements in structural constraints to lending, as well as recovery demand, are supporting credit growth well balanced between the corporate and household sectors. The improved system of private bailiffs, which has been helping to improve debt collection and address large backlog of court cases, is paying off both in terms of lower interest spreads and credit growth. At the same time, while credit continues to grow at a healthy rate, there is scope for credit penetration to increase further. To this end, more efforts are needed to tackle structural obstacles to lending.

17. **We are continuing to make progress in developing the macro-prudential policy framework.** A robust macro-prudential policy toolkit is critical to identifying and containing systemic risk in any financial sector, but particularly in a euroized economy without an independent monetary policy such as Kosovo’s. We have drafted an initial macro-prudential policy document outlining our objectives for macro-prudential policy, how the Macro-Prudential Advisory Committee (MPAC) will assess systemic risk, which instruments will be considered for use and the MPAC’s governance structure. We are working with Fund staff to refine this document in order to assure a sound basis for these policies. We also remain committed to further institutionalizing the National Committee for Financial Stability and Crisis Management, a cross-institutional body that is a key

component of Kosovo's contingency planning and crisis management capacity, in line with Fund recommendations.

18. **We appreciate the analysis of the Fund mission identifying obstacles to more effective enforcement of civil and commercial claims.** The recommendations of the Fund mission reflect the government's concerns and build upon initiatives that the government already has underway. In other areas, we will consult with the Fund staff on developing an action plan to address the issues identified.

19. **We concur that case statistics could be improved** to more accurately assess the performance of the claims enforcement system. To that end, the government will work with the Kosovo Judicial Council to build on current data strengthening initiatives in the courts and publish 2015 data on the number of cases and duration of court process of mortgage enforcement, insolvency, and tax cases, by end-March 2016.

20. **We recognize that there are existing gaps in the Law on Enforcement Procedures** that hamper its effectiveness. Accordingly, we are proceeding with current plans to approve the concept paper on the Law on Enforcement Procedures (LEP) by end-December 2015, which among other things, limits the possibilities to object to enforcement orders and sets strict deadlines for review of objections.

21. **We appreciate that Fund staff recognizes the advances we have made with the Central Bank of Kosovo's Unique Account Holder registry** that is used for garnishment of bank accounts. With help from donors, we have prepared the legal infrastructure and are advancing on the IT system to automatize and make this registry operational. Thus, subject to timely resolution of the possible conflict of access to the registry and Kosovo's privacy laws, we aim to have the Central Bank of Kosovo's Unique Account Holder Registry automatized and operational by end-September 2016.

22. **In addition, we appreciate that the Fund TA mission has identified certain areas where the system for implementation and monitoring of the private enforcement agent system could be strengthened.** Accordingly, also, by end-March 2016 the government will develop an action plan including our proposed measures on how to strengthen the operation of the enforcement process, focusing on the following issues: ensuring that the number of enforcement agents moves towards the number required by law; ensuring that the supervision over enforcement agents is effected according to the law, including on financial disclosure; ensuring that the implementation of the enforcement agent's fees is in accordance with the objective of the law and administrative regulations, and incentivizes recovery; ensuring that enforcement agents respond to creditor requests for enforcement within a clear deadline; ensuring the auction system is made more effective by modifying the reserve price system, with the aim to maximize recovery.

23. **We are developing a revised regulation that will help to promote residential mortgage lending by banks.** This new regulation will adjust risk weightings on residential mortgage loans, in line with Basle II standards. Because our current risk weightings are more stringent than those

mandated by Basle II, we expect this new regulation to spur lending in this area and, in turn, financial deepening in Kosovo, without compromising financial stability.

Reform of Public Procurement

24. **We will continue to press ahead with the implementation of the centralized public procurement system.** The centralized procurement process has commenced with the issuing of centralized bids for three common goods (fuel, air plane tickets, and office supplies). For fuel and office supplies, we remain confident that we will award this tender bid ahead of schedule (structural benchmark, October 31, 2016). Separately, we have recently awarded two centralized tender bids (wood and coal), which were issued after the abovementioned tenders. Centralized tender bids for heavy fuel and tires have been also launched with the aim to complete the process in coming weeks. To further mainstream the use of centralized procurement, we are committed to issuing a second list of common goods eligible to centralized tender bids by end-March 2016, ahead of the original schedule agreed at the time of program request (structural benchmark, October 31, 2016).

25. **We are committed to fill the vacant Board seats of the PPR Board by end-February 2016.** The under-filled PPR Board is creating delays and backlogs in processing complaints. In addition, a full Board is legally required for reviewing complaints related to large and/or complex tender bids. Any further delays in filling the vacant Board seats would seriously affect the credibility of the overall public procurement system. Therefore, the government will act expeditiously to submit to parliament a list of recommended candidates for the remaining vacant seats with parliament nomination to be completed no later than February 28, 2016 (structural benchmark for the second review).

26. **We remain committed to moving forward on e-procurement.** The government recently adopted a new procurement law, which is in line with EU directives and best international practice. Following parliament adoption of this new law, the government will issue a decision making e-procurement mandatory for all central level agencies. An e-procurement pilot project covering six selected agencies, which requires parliamentary adoption of the law on procurement, is planned for the beginning of January 2016. Conditional on the success of the pilot project, all new centralized tender bids from the Centralized Procurement Agency (CPA) will be handled under e-procurement.

Safeguards Assessment

27. **We welcomed the key findings of the recent Fund mission on the updated safeguards assessment.** According to the recent Fund mission on safeguards assessment, the CBK has an effective system of controls in place in its reserves management and vault operations remain appropriate. The governance and audit oversight mechanisms are also appropriate. We have requested technical assistance from the Fund that would help us address remaining recommendations, and more generally, enhance our central bank risk management.

Table 1. Kosovo: Quantitative Performance Criteria and Indicative Targets, 2015–16

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

	2014		2015		2016	
	End-Dec.	End-Aug.	End-Dec.	End-Dec.	End-June	End-Dec.
	Actual	Prog.	Actual	Prog.	Prog.	Ind. Targets
Performance Criteria 1/						
Floor on the headline fiscal balance (ex PAK) of the general government 1/	-137	-105	10	-137	-94	-188
Floor on the underlying fiscal balance (ex PAK and ex new donor-financed projects) of the general government 1/	-137	-105	10	-137	-49	-98
Floor on the bank balance of the general government 1/	101	125	210	171	220	269
Ceiling on the accumulation of external payments arrears of the general government 2/	0	0	0	0	0	0
Indicative Targets						
Ceiling on current expenditures of the general government 1/	1059	873	725	1187 4/	670	1220 5/
Memorandum items:						
Program assumptions 3/						
Sectoral budget support	0	0	0	0	1	1
Disbursements for new donor-financed projects contracted after the SBA approval.	0	0	0	0	45	90
Change in OSR Balances	0	0	0	0	0	0

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

1/ Adjusted according to the Technical Memorandum of Understanding (TMU).

2/ Continuous ceiling throughout the SBA period.

3/ For adjusters as indicated in the TMU.

4/ Only for end-December 2015 target, current spending could be raised by up to €4 million provided that revenues overperform the forecast (€1503 million) by an equal amount.

5/ Only for end-December 2016 target, spending on goods and services could be raised by up to €7 million provided that revenues overperform the forecast (€1584) by an equal amount.

Table 2. Kosovo: Prior Actions and Structural Benchmarks for SBA, 2015–17

Measure	Review	Justification	Status
Prior actions			
1. Adoption by parliament of a 2016 budget in line with program targets as defined in paragraph 9 of this MEFP. 2. Transfer to the government by the Privatization Agency of Kosovo (PAK) of a minimum of €5 million in tax obligations and a minimum of €30 million in privatization funds to government as described in paragraph 7 of this MEFP.			
Entrenching wage restraint			
Government approval of a rules-based mechanism governing increases in the public sector wage bill.	March 15, 2016	Prevent large, discretionary jumps in wages that undermine budget composition and compromise fiscal credibility.	Met. The draft amendments have been approved by government and have been submitted to parliament.
Increasing non-tax revenue mobilization			
Completion of the telecommunication licenses auction and transfer of any revenues from the sale to government.	December 31, 2015	Meet the non-tax revenue target in line with the 2015 supplementary budget.	New.
Improving governance			
Government submission to parliament of a list of recommended candidates to fill the Privatization Agency of Kosovo Board.	October 31, 2015	Improve governance and unlock available resources to be transferred to the Ministry of Finance.	Met. The authorities submitted the list of candidates to parliament.
Issuing the bids for contracts for centralized procurement covering 43 central government administrations and agencies for fuel, office supplies, and plane tickets.	October 31, 2015	Improve oversight and control of public procurement, with potential budgetary savings and a more transparent and level-playing field for bidding firms.	Met. The centralized procurement agency has issued tender bids for these three categories of common goods and services.
Awarding the contracts for centralized procurement, covering 43 central government administrations and agencies for fuel, office supplies, and plane tickets.	October 31, 2016	Improve oversight and control of public procurement, with potential budgetary savings and a more transparent and level-playing field for bidding firms.	
Government adoption of the draft Law making e-procurement mandatory for all central government agencies.	March 15, 2016	Improve oversight and control of public procurement, with potential budgetary savings and a more transparent and level-playing field for bidding firms.	Ongoing. The government has adopted the draft law on procurement. Once the law is passed by parliament, the government will issue a decision to make e-procurement mandatory for all central level agencies.

Table 2. Kosovo: Prior Actions and Structural Benchmarks for SBA, 2015–17 (concluded)

Measure	Review	Justification	Status
Improving governance			
Parliament nomination of the vacant seats of the Public Procurement Review Board (PPRB).	February 28, 2016	Improve oversight and control of public procurement, with potential budgetary savings and a more transparent and level-playing field for bidding firms.	New.
Government adoption of an expanded list of goods and services eligible for centralized procurement in the next round of tenders.	October 31, 2016	Improve oversight and control of public procurement, with potential budgetary savings and a more transparent and level-playing field for bidding firms.	
Building needed infrastructure			
Government adoption of a detailed concept note of new capital projects to be financed by donors.	March 15, 2016	Facilitate implementation and monitor progress in capital spending associated with the government's development strategy.	
Semi-annual submission to parliament of reports for information assessing donor-financed projects under the investment clause.	March 15, 2016	Enhancing transparency and oversight of capital projects.	
Developing the financial sector			
Approval of the ELA regulation by the CBK Board.	October 31, 2015	Strengthening the financial stability framework.	Met. The draft regulation was adopted by the CBK Board on September 30.
Completion of an on-site examination of one bank following the risk-based manual prepared in junction with IMF technical assistance, including completion of a report of examination.	October 31, 2015	Enhancing banking sector supervision.	Met. The on-site examination was completed, and the report submitted to Fund staff in October.
Completion of an on-site examination of the remaining three banks following the risk-based manual prepared in junction with IMF technical assistance, including completion of a report of examination.	March 15, 2016	Enhancing banking sector supervision.	

Kosovo: Technical Memorandum of Understanding

A. Introduction

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 July 2015.

B. Definitions and Performance Criteria and Indicative Targets

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 publicly-owned enterprises and socially-owned enterprises.

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

4. **The Bank balances of the General Government** 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 Grants 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. 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 end-December 2014 were €101 million.

Expenditures of the General Government

5. **Current expenditures are measured on a cash basis cumulatively from the beginning of the calendar year.** Current expenditures include wages and salaries, goods and services, subsidies and transfers including capital transfers to publicly-owned enterprises, and reserves. Current expenditures of the Privatization Agency of Kosovo (PAK) are included. They do not include expenditures financed by donor-designated grants. Current expenditures 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.

6. **Total expenditures**, calculated on a cash basis, include current expenditures, capital expenditures, and net lending. Net lending comprises loans granted by the general government except that it excludes on-lending, such as funds borrowed from official creditors, passed on to publicly-owned enterprises, which is 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.

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. **Expenditures from OSR** carried forward are defined as budget appropriations of municipalities and central budget organizations financed by OSR of previous years, which had not been used in the prevailing year, but spent in the following years.

9. **The balances of OSR** are defined as the accumulated stock of unused and unexpired budget appropriations financed by OSR from previous years.

Fiscal Balance of the General Government

10. **Headline fiscal balance (ex PAK)** of the general government is defined as revenues and grants minus total 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 (PAK). The headline fiscal balance includes capital spending related to the implementation of new donor-financed projects contracted after the approval of this SBA (as defined in paragraph 12 of this TMU).

11. **Underlying fiscal balance (ex PAK and ex new IFI-financed projects)** of the general government is defined as the headline fiscal balance (ex PAK) excluding capital spending related to the implementation of donor-financed projects contracted after the approval of this SBA (as defined in paragraph 12 of this TMU).

12. **New donor-financed projects are all projects** contracted with multilateral and bilateral development agencies (donors) by the general government after the approval of this SBA, including when executed by publicly-owned enterprises via on-lending from the general government.

External Payments Arrears

13. **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.

C. Adjusters

14. **The quantitative target on the current spending of the general government specified under the program is subject to the following adjusters:**

- *The ceiling on current expenditures set in Table 1 will be raised by the excess of disbursed amounts in sectoral budget support grants to be used for current spending relative to program assumptions.*

15. **The quantitative target on the headline and underlying fiscal balance of the general government specified under the program is subject to the following adjusters:**

- *The floor on the **headline fiscal balance** set in Table 1 will be adjusted downward (lowered) by the excess in disbursed amounts of new donor-financed projects relative to program assumptions up to an additional €15 million.*
- *The floor on the **headline fiscal balance** set in Table 1 will be adjusted upward (increased) by the full shortfall in disbursed amounts of new donor-financed projects relative to program assumptions.*
- *The floor on the **headline and underlying fiscal balance** set in Table 1 will be adjusted upward (increased) by the excess in the change of OSR balances relative to program assumptions. These assumptions are always set to zero.*
- *The floor on the **headline and underlying fiscal balance** set in Table 1 will be adjusted downward (lowered) by the shortfall in the change of OSR balances relative to program assumptions. These assumptions are always set to zero.*
- *Only for the **end-December 2015 target**, current spending could be raised by up to €4 million, provided that revenues over-perform the forecast (€1,503 million) by an equal amount.*
- *Only for the **end-December 2016 target**, current spending on goods and services could be raised by up to €7 million, provided that revenues over-perform the forecast (€1,584 million) by an equal amount.*

D. Data Requirements

16. **The Bank balances data (table) 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 every month, with a delay of one 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.
17. **Data on the monthly budget 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 6 and including domestically and budget-support financed capital expenditure and externally project financed capital expenditure; (vi) the gross payment and gross accumulation of domestic payments arrears; (vii) external loan receipts and principal payments, including new signed external guarantees and loans; (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.
18. **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.
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, will be transmitted on a quarterly basis within 45 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 and asset quality of individual banks will be transmitted by the CBK to the IMF on a monthly basis within four 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.**

Kosovo: Supplementary Letter of Intent

January 11, 2016

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

Dear Ms. Lagarde:

Further to our letter of December 2, 2015, which reiterates our commitment to the economic program supported by the Stand-By Agreement (SBA) with the Fund, we hereby request a waiver of applicability for the end-December 2015 quantitative performance criteria, which have become controlling in view of the January 15, 2016 Board consideration of the first review under the SBA. While preliminary data on the end-December 2015 quantitative performance criteria are available (and they show that we have met the targets), final data used for program verification purposes will not be available until February 5, 2016 per the requirements in the Technical Memorandum of Understanding. The continuous quantitative performance criterion on a zero accumulation of external arrears of the general government has been observed, and there are no changes to the data contained in our December 2, 2015 letter pertaining to the end-August 2015 quantitative performance criteria.

Sincerely yours,

_____/s/____

Mr. Isa Mustafa

Prime Minister

_____/s/____

Mr. Avdullah Hoti

Minister of Finance

Ministry of Finance

_____/s/____

Mr. Bedri Hamza

Governor

Central Bank of the Republic of Kosovo