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

July 6, 2015

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

July 6, 2015

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

Dear Ms. Lagarde:

1. In collaboration with the Fund, Kosovo has preserved macroeconomic stability, characterized by low public deficits and debt and a sound financial system. Over the last five years, the economy has performed well with an average GDP growth of around 3.5 percent, the highest in the Western Balkans. Nevertheless, this growth performance has been insufficient to substantially lift incomes and accelerate convergence towards the EU average. Unemployment has remained at a high level particularly among the younger generations while female labor participation is very low. Relatively high labor costs, a significant infrastructure gap and a weak business environment—notwithstanding recent improvements—are the main factors holding back our medium-term prospects.

2. The Government of Kosovo has recently formulated a comprehensive reform agenda in the National Economic Reform Program 2015–2018 (NERP) and the Medium-Term Expenditure Framework (2016–18), aimed at increasing Kosovo’s economic growth potential and creating new jobs. Sustainable growth will be achieved by ensuring a sound and credible fiscal policy, preserving financial stability, and accelerating the implementation of our ambitious structural reform agenda.

3. On the fiscal front, we remain committed to bringing the deficit down so as to preserve the credibility of the fiscal rule and ensure debt sustainability. However, adjustment will be focused on mobilizing revenue and reducing the relative weight of current spending to create space for development and education projects, together with well-targeted social assistance.

4. Part of our strategy is to accelerate the implementation of key infrastructure projects, including those that could be financed by multilateral and bilateral development agencies (donors). To this end, we are actively seeking resources from donors to expand and accelerate the implementation of key growth-enhancing investment projects. We believe that a Fund-supported program would further reassure our creditors about the credibility of our policies and thus facilitate the mobilization of donors’ funding and FDI more generally.

5. The financial sector has remained well capitalized, liquid and profitable. In the coming months, we will adopt a new legal framework for Emergency Liquidity Assistance (ELA) in line with best practices. We are making substantial progress on rolling out risk-based supervision to all banks operating in Kosovo, while developing our nascent macroprudential and crisis prevention frameworks. An important challenge remains to unlock bank liquidity to support increased lending
and, hence, support higher levels of economic growth. To this end, we will continue to work with Fund staff to identify any outstanding institutional bottlenecks to credit provision in the regulatory, legal, or judicial areas and to outline policy measures to address them in a timely and effective manner.

6. We are committed to fully implement our structural reform agenda, which we are confident will deliver higher growth and job creation. Our top priorities are to align wages closer to productivity, raise workforce skills through targeted training and better education, and enhance the business environment.

7. The enclosed Memorandum of Economic and Financial Policies (MEFP) and the Technical Memorandum of Understanding (TMU) provide comprehensive details of our reform agenda and program. In support of it, the Government of Kosovo hereby requests a 22-month Stand-by Arrangement (SBA) of SDR 147.5 million (250 percent of quota).

8. 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.

9. The Government of Kosovo authorizes the IMF to publish this letter, the attached MEFP and TMU, and the related staff report, including placement of these documents on the IMF website.

Sincerely yours,

/s/
Mr. Isa Mustafa
Prime Minister

/s/ Mr. Avdullah Hoti  
Minister of Finance

/s/ Mr. Bedri Hamza  
Governor

Ministry of Finance        Central Bank of the Republic of Kosovo

Economic and Financial Policies

I. Recent Developments

1. This memorandum reports on recent economic developments and outlines the economic and financial policy agenda of the Government of Kosovo, which could be supported by the IMF with a 22-month Stand-by Arrangement (SBA). The policy agenda is based upon the Government’s recent Program 2015–2018 and the Medium-Term Expenditure Framework (2016–18).

2. Kosovo’s economy has continued to perform well despite the slow recovery of the European economy. In the last few years, the economy has expanded at a steady rate of around 3.5 percent, which is higher than our neighbors. Going forward, the economy is projected to grow at a 3.8 percent rate this year, and slightly above in the following years. Continued growth in Germany and Switzerland will keep remittances steady, and thus stimulate consumption. Moreover, the recent signing of a significant investment project in the tourism sector will boost investment, employment and, in a few years, boost our export receipts. On the inflation front, low import prices (a key component of our CPI basket) will be reflected in very low domestic inflation.

3. The risks to our baseline remain balanced. While we are confident that the outlined medium-term macroeconomic outlook underpinning our program is based on reasonable assumptions, there are risks that we see as balanced. Stronger impact on private consumption from last year’s public wage increase is an upside risk. At the same time, a lower-than-expected growth in Diaspora countries, notably Germany and Switzerland, could affect, via remittances, the Kosovo economy. Nevertheless, past remittances have proven resilient to economic and financial turmoil in Europe.

4. We recognize that the current growth model, which largely hinges on remittance-fueled consumption, is insufficient to lift income per capita and to make a dent in the large unemployment rate. In recent years, remittances have been a key source of growth by supporting private consumption and housing investment, in turn fueling high imports in the face of limited domestic production. Remittances might have contributed to raising the reservation wage above levels that productivity can sustain, thus creating labor supply disincentives. Despite recent economic growth performance, unemployment has remained high, labor participation has not improved and the income gap with Europe and neighboring countries has shown limited improvement. Higher growth can be generated by improving competitiveness which requires deflating domestic costs, scaling up infrastructure spending, improving the skills of our labor force, and enhance the business environment to boost private sector development.
II. Fiscal Policy

5. A key principal objective of the program is to maintain a sustainable fiscal position and bring government bank balances back to a prudent level. To preserve the credibility of the fiscal rule, we are committed to parliamentary approval of a supplementary budget targeting a deficit, excluding PAK spending, of no more than €137 million for this year (prior action).

6. In 2015, a number of measures have already been adopted to contain deficits and improve the quality of the budget. The 2014 decision to increase public wages and other pension benefits led to a significant erosion of fiscal space for productive spending within the fiscal rule’s ceiling. Having fully acknowledged the impact of these measures on the quality of the budget, we decided in the 2015 budget to keep public sector wages at 2014 levels, and more recently introduced an increase in tobacco and alcohol excises. We are also working to increase tax compliance. However, because these measures are not enough to contain the deficit, we are committed to adopting the following additional measures, as part of the 2015 supplementary budget:

a. A further increase in excises yielding 0.3 percent of GDP in annualized gains.

b. A new VAT law to enter into force in July 2015 that will increase the standard rate from 16 to 18 percent while introducing a reduced 8 percent rate for a limited category of goods together with a number of exemptions. This new law will yield 0.4 percent of GDP in annualized gains.

c. A half percentage point of GDP reduction in the wage bill relative to the original 2015 budget, in part by not filling a number of vacancies. Lengthy technical and legal preparations are delaying the implementation of the health insurance law agreed in 2014 and will therefore yield additional savings.

d. Savings in transfers will yield 0.2 percent of GDP.

e. A 0.2 percentage point of GDP reduction in the goods and services allocation relative to the original budget.

f. The 2015 supplementary budget also commits us to sell mobile telecom licenses by end-2015.

g. Further gains in tax compliance will also help us to mobilize revenues.

7. We are also committed to using any revenue over-performance or under-execution in capital spending because of normal implementation delays towards a lower deficit or higher allocation for Route 6 payments to minimize any backloading of its payment schedule. Any revenue windfall or capital spending saving will not be used to finance higher wages and salaries, or subsidies and transfers. Revenue over-performance could be used to finance an additional goods and services allocation up to a maximum of €4 million.
8. Because the supplementary budget foresees €15 million owed to the government under the Memorandum of Understanding between the Privatization Agency of Kosovo (PAK) and Tax Administration of Kosovo (TAK), and because these funds are available but cannot be transferred without an acting Board in PAK, the Government will act as expeditiously as possible and no later than end-September 2015 to submit to parliament the list of recommended candidates to fill the PAK Board (structural benchmark for the first review).

9. We have also started discussions on the prospective 2016 budget, which will continue to reflect our ongoing commitment to responsible public financial management and sound fiscal policies. The 2016 budget will aim for a further reduction in the deficit by reducing the weight of current spending relative to 2015 levels, while preserving capital spending at the nominal level in the 2015 supplementary budget. As part of this effort, public sector wages will remain at 2015 levels in nominal terms. Any necessary revenue measures will be taken to meet an overall deficit target of €98 million, excluding new donor-financed capital projects under the revised investment clause. We are confident that, with this plan, our bank balances will end the year at the prudent level of 4.5 percent of GDP.

10. Looking ahead, we need to substantially scale up public investment to address our structural bottlenecks. The government is strongly committed to prudent budgetary policy and macroeconomic stability. At the same time, we are convinced that this objective would become meaningless in the absence of substantial gains in economic development and job creation. Therefore, a key objective is to increase spending for large growth-enhancing projects, including those financed by donors. However, the fiscal rule framework does not give us the space we need for this investment. In fact, even under the previously discussed fiscal adjustment, the rule would not allow any room for new capital projects in the next few years. This would severely constrain our development strategy and economic objectives, in a country that is currently servicing little more than 10 percent of GDP in public debt.

11. With the support of Fund staff, the investment clause in the fiscal rule will be modified to support capital spending with high economic returns. The current investment clause allows the government to use privatization proceeds to finance capital projects above the 2 percent deficit ceiling, with the excess not counting as excessive deficit, provided that the underlying deficit is at most 2 percent of GDP and cash balances are at least at 4.5 percent of GDP. This clause, while good in principle, is currently of limited use given the low amount of available privatization receipts and limited assets for future privatization. Therefore, we will expand the investment clause to enable capital spending financed through donors’ funding, in addition to resources from privatization (PAK) receipts, still provided the abovementioned safeguards are met. In addition, we will add a public debt limit of 30 percent of GDP and a sunset clause (10 years) for the use of this flexibility to ensure that donor-financed projects do not compromise in any way our strong and sustainable debt position. To enhance oversight of the process, we will submit to parliament for information semi-annual reports on these projects (economic rationale, projected cost, financing terms), starting in early 2016 (structural benchmark for the second review).
III. Financial Sector

12. **Progress has been made in strengthening the banking system.** The system is, overall, well capitalized, highly liquid, and profitable. All banks comfortably meet minimum capital requirement ratios. Liquidity positions are such that banks would have enough resources to withstand significant deposit shocks, a key consideration in a euroized economy; in addition, parent banks have provided letters of comfort regarding their subsidiaries and branches in Kosovo in a liquidity event. In addition, the central bank (CBK) has made substantial progress in strengthening the bank supervisory and regulatory framework. We have implemented most of the 2012 FSAP recommendations. The draft regulation for the use of Emergency Liquidity Assistance (ELA) is in line with international best practices and reflects in full all recommendations provided by Fund staff; its approval by the CBK Board is expected by end-September 2015 at the latest (structural benchmark for the first review). Following the adoption of the risk-based supervision framework (guided by Fund technical assistance), including the new manual and reporting system, the CBK will complete the full rollout of risk-based supervision to all banks operating in Kosovo. More precisely, following the risk-based manual prepared in junction with IMF technical assistance, we are committed to completing on-site examination of one bank by end-September 2015 (structural benchmark for the first review) and of the three remaining banks by end-February 2016, at the latest (structural benchmark for the second review), including completion of a report of examination for each bank.

13. **We are also taking steps to address systemic risk.** The CBK Executive Board has established a Macroprudential Advisory Committee (MAPC) and approved the Terms of Reference of its tasks and responsibilities. We have recently completed our Macroprudential Policy, strategy which will develop the CBK’s macroprudential toolkit and advise the CBK Board on systemic risk in the financial sector. As part of this effort, the CBK’s Board is expected to establish the MPAC by August 2015, with indicators to be selected and reporting to begin by the end of 2015. The MPAC will, as necessary, also inform the National Committee for Financial Stability and Crisis Management (NCFSCM), comprising the CBK, Ministry of Finance and Parliamentary Budget Committee, of systemic risk in the financial sector. We intend to take steps to more fully institutionalize the NCFSCM in order to further build up Kosovo’s financial safety net, in particular its contingency planning and crisis management capacity.

14. **A key challenge is to make the financial system more supportive of inclusive and broad-based growth.** Despite ample liquidity in the banking system, credit penetration remains low, with credit to GDP at 35 percent. Limited credit growth is partly due to supply-side factors. Impediments to stronger credit provision include high levels of informality, uncertain and slow court processes, and difficult debt collection procedures. These have influenced high collateral requirements and interest rate spreads at many banks. Addressing these structural impediments, which requires substantial changes across the legal system, is a central pillar of our overall growth strategy aimed at mobilizing bank liquidity for productive investment. Several initiatives are already underway, including draft legislation currently in parliament to establish a commercial section of the court system that would focus on commercial cases with appropriate staffing and expertise; work undertaken with USAID to reduce the current court backlog; a legislative amendment to improve the
recently introduced system of private bailiffs, which will help to improve debt collection processes; and the drafting of legislation for a bankruptcy law that will improve liquidation and administration processes. To support our goals in this area, we remain committed to working with Fund staff towards a comprehensive diagnostic of impediments—legal or structural—that is holding back credit growth. We would welcome an assessment of efforts currently underway as well as proposals for potential additional measures that could supplement those discussed above.

15. **We will continue our efforts to enhance collaboration with foreign supervisors.** Following the signing of Memoranda of Understanding (MoU) with all foreign banking supervisors of subsidiaries operating in Kosovo except Austria’s Financial Market Authority, our intention is to intensify negotiations with the latter. A delegation from the FMA is expected in Kosovo over the summer.

IV. **Structural Reforms**

16. **Faster implementation of structural reforms is essential to raise potential growth, reduce the trade deficit, and boost job creation.** The National Economic Reform Program (NERP), the 2015–2018 Government Program and the Medium-Term Expenditure Framework provide the blueprint for our reform agenda and the top priorities are ensure close alignment of wages to productivity, accelerate infrastructure implementation, reform education and the labor market, and foster a business-friendly environment. Remittances have helped support household income and smooth consumption, but as mentioned above they may have also pushed reservation wages well above productivity levels. Recent large increases in public sector wages have further deteriorated cost competitiveness given significant pass-through to private sector wages. Currently, the average public sector wage is above that of the private sector, making it very difficult for the latter to attract and retain talent.

17. **In a context of euroized economy, close monitoring of wage developments is a key tool to regain competitiveness.** To prevent large and discretionary jumps in public sector wages as have happened in recent years, we are committed to developing a rules-based mechanism in cooperation with Fund staff that will cap the growth of the public sector wage bill in accordance to a well-identified proxy for productivity. Our plan is to adopt this new mechanism by the end of 2015 (structural benchmark for the second review).

18. **A skilled labor force is essential to support job creation and foster foreign investments.** Despite significant flexibility, the labor market suffers from a lack of skilled supply of workers. Therefore, our objective is to better align labor force skills to market needs. With the support of the European Union and the World Bank, we are upgrading all curricula for pre-university education. We are also determined to modernizing the vocational school system in cooperation with our European partners, in particular for the IT and agricultural sectors. We are also adopting active labor market measures aimed at increasing labor participation particularly among women and the poor, including targeted wage subsidies and training.
19. **We will persevere in our efforts to make the business environment more attractive and tackle the informal sector.** While the World Bank’s Doing Business Indicators have recently improved and reached the Western Balkans’ average, we are fully aware that the *de-facto* implementation of legal reforms is still lagging. In particular, perceptions of weak governance continue to be a deterrent to domestic and foreign direct investment.

20. **In this context, we are committed to mainstreaming the use of centralized procurement and e-procurement so as to create a more level and transparent playing field for businesses dealing with the government.** A few months ago, the government approved for the first time a list of six categories of common goods and services that will be subject to centralized procurement for all central administrations. To operationalize this, we are committed to issuing, by end-September 2015, the tenders for contracts of centralized procurement for fuel, office supplies and plane tickets, covering the three-year needs of 43 central government administrations and agencies (*structural benchmark for the first review*). Implementation of the process will be led by the Central Procurement Agency. We also commit to awarding these bids in 2016 (*structural benchmark for the third review*). In addition, we will expand the list of goods and services eligible for centralized procurement in the next round of tenders, guided by the importance of the various goods and services in our procurement spending (*structural benchmark for the third review*). We will also gradually bring in publicly-owned enterprises and municipalities under centralized procurement. The government is also committed to adopt, by end-2015, draft legislation that would make the use of e-procurement mandatory for all central administrations (*structural benchmark for the second review*). We strongly believe the combined use of centralized and e-procurement will increase efficiency and transparency, ensure a level playing field for all agents dealing with the public sector, and substantially reduce costs.

21. **Ensuring energy security is a key goal of our government.** The two available power plants are old, inefficient, and one of them will soon need to be decommissioned. This creates doubts about our country’s energy supply, in turn deterring private sector development. The completion of the regional transmission line with Albania will definitely help increase energy trade in the region and mitigate any temporary shortage in energy supply. In addition, with the collaboration of the World Bank, we have been actively seeking international partners to build a more efficient and cleaner power plant with larger capacity, and are now moving closer to naming a preferred bidder.

22. **Upgrades to our physical infrastructure are moving forward, creating conditions for economic development.** Construction of Route 6, linking Pristina to Skopje, will continue as planned, and once completed the road will substantially reduce travel time and costs in a key trade route for our country. With the support of the EBRD and EIB, we will move ahead with the rehabilitation of the railway Line 10, which will facilitate interconnectivity with neighboring countries. Following recently signed loans with various development agencies, we plan to accelerate the expansion and upgrade of the road connecting Pristina to Mitrovica. As part of the expanded investment clause, we plan to move forward with infrastructure investments in key identified growth sectors, not least agriculture. We commit to adopting a detailed concept note of all these donor-
financed projects (structural benchmark for the second review) and to submitting a semi-annual report to parliament for information starting in January 2016 assessing these projects (structural benchmark for the second review).

23. **The development of the Brezovica resort is expected to have a significant impact on investment, job creation and revenues.** The total investment, led by a very reputable foreign consortium, is about 8 percent of GDP over three phases, with an estimated investment of around 3 percent of GDP for the first phase (2016–18). The plan calls for a world class, year-round tourism resort in the mountains of Brezovica. Given short travel time from Pristina International Airport, we expect the project to attract a significant volume of international tourists. Similarly, the rapid and smooth implementation of this large investment will send positive signals to other potential investors that Kosovo is a good place to do business.

24. **Regional trade agreement negotiations are advancing.** The Stabilization and Association Agreement (SAA) with the European Union (EU) has been endorsed by the EU Commission and is now awaiting the final adoption by the EU Council and parliament. Over the medium term, both the SAA and the trade agreement with Turkey will enhance economic efficiency by facilitating free trade.

25. **Program implementation will be monitored through prior actions, reviews, quantitative and continuous performance criteria, indicative targets, and structural benchmarks.** These are detailed in Tables 1 and 2, with definitions provided in the attached Technical Memorandum of Understanding (TMU). Quantitative performance criteria have been set for end-August and end-December 2015 and indicatives targets have been set through end-December 2016. The first review is scheduled to take place in November 2015 with the following reviews scheduled to be completed on a semi-annual basis.
Table 1. Kosovo: Quantitative Performance Criteria and Indicative Targets, 2015–16

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

<table>
<thead>
<tr>
<th>Performance Criteria 1/</th>
<th>2015</th>
<th>2016</th>
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<tr>
<td></td>
<td>Prog.</td>
<td>Prog.</td>
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<tr>
<td>Floor on the headline fiscal balance (ex PAK) of the general government 1/</td>
<td>-105</td>
<td>-137</td>
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<tr>
<td>Floor on the underlying fiscal balance (ex PAK and ex new donor-financed projects) of the general government 1/</td>
<td>-105</td>
<td>-137</td>
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<tr>
<td>Floor on the bank balance of the general government 1/</td>
<td>125</td>
<td>171</td>
</tr>
<tr>
<td>Ceiling on the accumulation of external payments arrears of the general government 2/</td>
<td>0</td>
<td>0</td>
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<tr>
<th>Indicative Targets</th>
<th>2015</th>
<th>2016</th>
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<tr>
<td>Ceiling on current expenditures of the general government 1/</td>
<td>873</td>
<td>1,187 4/</td>
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Memorandum items:

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<thead>
<tr>
<th></th>
<th>2015</th>
<th>2016</th>
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<tr>
<td>Program assumptions 3/</td>
<td>0</td>
<td>0</td>
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<tr>
<td>Sectoral budget support</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>Disbursements for new donor-financed projects contracted after the SBA approval.</td>
<td>0</td>
<td>45</td>
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<tr>
<td>Change in OSR Balances</td>
<td>0</td>
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<tr>
<th></th>
<th>2015</th>
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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.
Table 2. Kosovo: Structural Benchmarks for SBA 2015–17

<table>
<thead>
<tr>
<th>Measure</th>
<th>Review</th>
<th>Justification</th>
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<tr>
<td><strong>Prior actions</strong></td>
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<tr>
<td>Adoption by parliament of a supplementary budget for 2015 in line with program objectives as defined in paragraphs 5 and 6 of the MEFP.</td>
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<td><strong>Entrenching wage restraint</strong></td>
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<tr>
<td><strong>Improving governance</strong></td>
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<tr>
<td>Government submission to parliament of a list of recommended candidates to fill the Privatization Agency of Kosovo Board.</td>
<td>October 31, 2015</td>
<td>Improve governance and unlock available resources to be transferred to the Ministry of Finance.</td>
</tr>
<tr>
<td>Issuing the bids for contracts for centralized procurement covering 43 central government administrations and agencies for fuel, office supplies and plane tickets.</td>
<td>October 31, 2015</td>
<td>Improve oversight and control of public procurement, with potential budgetary savings and a more transparent and level playing field for bidding firms.</td>
</tr>
<tr>
<td>Awarding the contracts for centralized procurement, covering 43 central government administrations and agencies for fuel, office supplies and plane tickets.</td>
<td>October 31, 2016</td>
<td>Improve oversight and control of public procurement, with potential budgetary savings and a more transparent and level playing field for bidding firms.</td>
</tr>
<tr>
<td>Government adoption of the draft Law making e-procurement mandatory for all central government agencies.</td>
<td>March 15, 2016</td>
<td>Improve oversight and control of public procurement, with potential budgetary savings and a more transparent and level playing field for bidding firms.</td>
</tr>
<tr>
<td>Government adoption of an expanded list of goods and services eligible for centralized procurement in the next round of tenders.</td>
<td>October 31, 2016</td>
<td>Improve oversight and control of public procurement, with potential budgetary savings and a more transparent and level playing field for bidding firms.</td>
</tr>
<tr>
<td><strong>Building needed infrastructure</strong></td>
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<td>Government adoption of a detailed concept note of new capital projects to be financed by donors.</td>
<td>March 15, 2016</td>
<td>Facilitate implementation and monitor progress in capital spending associated with the government’s development strategy.</td>
</tr>
<tr>
<td>Semi-annual submission to parliament of reports for information assessing donor-financed projects under the investment clause.</td>
<td>March 15, 2016</td>
<td>Enhancing transparency and oversight of capital projects.</td>
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<th><strong>Developing the financial sector</strong></th>
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<tr>
<td>Approval of the ELA regulation by the CBK Board.</td>
<td>October 31, 2015</td>
<td>Strengthening the crisis-prevention framework.</td>
</tr>
<tr>
<td>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.</td>
<td>October 31, 2015</td>
<td>Enhancing banking sector supervision.</td>
</tr>
<tr>
<td>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.</td>
<td>March 15, 2016</td>
<td>Enhancing banking sector supervision.</td>
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Technical Memorandum of Understanding

I. 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.

II. Definitions and Performance Criteria and Indicative Targets

A. Coverage

2. For the purpose of this memorandum, **general government** is composed of the Executive, 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.(iii). Bank balances may be held in the form of gold, holdings of foreign exchange and traveler’s checks, demand and short-term deposits at the Central Bank of the Republic of Kosovo (CBK), long-term deposits abroad that can be liquidated without penalty, and any holdings of investment-grade securities held directly by the general government. Bank balances at end-December 2014 were €101 million.

B. 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 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 financed from OSR** carried forward are defined as budget appropriations of municipalities and central budget organizations financed by own-source revenues 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.

**C. 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.

11. **Underlying fiscal balance (ex PAK and ex new donor-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.

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.
D. 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.

III. 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 (€1503 million) by an equal amount.

IV. 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, compiled by the Statistical Agency of Kosovo (SAK), 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.