INTERNATIONAL MONETARY FUND

IMF Country Report No. 16/22

# REPUBLIC OF KOSOVO

January 2016

## FIRST REVIEW UNDER THE STAND-BY ARRANGEMENT AND REQUESTS FOR MODIFICATION AND WAIVERS OF APPLICABILITY OF PERFORMANCE CRITERIA—PRESS RELEASE; STAFF REPORT; AND STATEMENT BY THE EXECUTIVE DIRECTOR FOR THE REPUBLIC OF KOSOVO

In the context of the First Review Under the Stand-By Arrangement and Requests for Modification and Waivers of Applicability of Performance Criteria, the following documents have been released and are included in this package:

- A **Press Release** including a statement by the Chair of the Executive Board.
- The **Staff Report** prepared by a staff team of the IMF for the Executive Board's consideration on January 15, 2016, following discussions that ended on October 23, 2015, with the officials of the Republic of Kosovo on economic developments and policies underpinning the IMF arrangement under the Stand-By Arrangement. Based on information available at the time of these discussions, the staff report was completed on December 3, 2015.
- A **Staff Supplement** updating information on recent developments.
- A **Statement by the Executive Director** for the Republic of Kosovo.

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

Letter of Intent sent to the IMF by the authorities of the Republic of Kosovo*
Memorandum of Economic and Financial Policies by the authorities of the Republic of Kosovo*
Technical Memorandum of Understanding*
*Also included in Staff Report

The IMF's transparency policy allows for the deletion of market-sensitive information and premature disclosure of the authorities' policy intentions in published staff reports and other documents.

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January 15, 2016

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**IMF Executive Board Completes the First Review under the Stand-By Arrangement for Republic of Kosovo**

On January 15, 2016, the Executive Board of the International Monetary Fund (IMF) completed the first review of Republic of Kosovo's economic performance under the Stand-By Arrangement (SBA). The completion of the review enables the disbursement of SDR 28.1 million (about €35.6 million), which would bring the total disbursements under the SBA arrangement to SDR 56.2 million (about €71.2 million).

On July 29, 2015, the Executive Board approved a 22-month SBA for Kosovo (see Press Release No. 15/362), in the amount of SDR 147.5 million (about €184 million at the time of approval). The SBA supports the government's economic program, which aims at raising Kosovo's economic potential by creating fiscal space for growth-enhancing expenditure and preserving low debt, upgrading key infrastructure by catalyzing donor resources, and boosting competitiveness by realigning labor costs, removing structural obstacles to credit, and creating a more level and transparent business environment.

Following the Executive Board's decision, Mr. Min Zhu, Deputy Managing Director and Acting Chair, issued the following statement:

"Kosovo has performed strongly under the program and the economy is recovering from a slowdown. Maintaining the momentum of program implementation in the period ahead will help deepen macroeconomic and financial stability and support robust growth.

"Progress in strengthening public finances has been key to the program's success. The authorities have stayed within the fiscal rule's deficit limit while taking steps to improve the composition of the budget by reducing unproductive current spending, and building space for growth-enhancing capital investments. The 2016 budget is in line with the program and will continue to strengthen public finances while supporting growth.

"The authorities are taking key steps to make Kosovo's financial safety net stronger and its banks safer, including through adoption of an emergency liquidity assistance framework, progress toward risk-based supervision for all banks, and a new macroprudential policy framework. The authorities are also taking steps to promote banks' ability to extend credit by improving the central bank's holder account registry, closing legal loopholes in the enforcement system, and reviewing the system of private enforcement agents.

"Improving competitiveness is a necessary condition for Kosovo to achieve higher, inclusive long-run growth. To this end, the authorities have taken several significant measures, including: modification of the investment clause under the fiscal rule to create space for additional productive, donor-financed capital investment; adoption of a public wage bill that will move away from a pattern of excessive wage increases and make it easier for the private sector to hire and retain talent; and establishment of a centralized public procurement system that will generate savings and lead to a more transparent and level playing field."

INTERNATIONAL MONETARY FUND

# REPUBLIC OF KOSOVO

December 3, 2015

## FIRST REVIEW UNDER THE STAND-BY ARRANGEMENT AND REQUEST FOR MODIFICATION OF PERFORMANCE CRITERION

## EXECUTIVE SUMMARY

**SBA**. In July 2015, the Executive Board approved Kosovo's 22-month Stand-By Arrangement with access of SDR 147.5 million (250 percent of quota). One purchase of SDR 28.1 million was made upon approval. The program seeks to preserve Kosovo's low debt and financial stability, rebuild government bank balances, and create conditions for more dynamic and better-balanced growth.

**Recent Developments**. Economic growth is recovering after a slowdown in 2014 that coincided with an extended political stalemate. The recovery is being driven by accelerating remittance and FDI inflows, stronger bank credit, and solid exports. Tax revenues are performing well, and the authorities are containing current spending within the tighter envelopes set in the program. Bank asset quality is improving, and profitability is at record highs.

**Program performance and risks**. The program is on track. All end-August 2015 performance criteria and indicative targets were met by comfortable margins. All structural benchmarks for the first review have been met. More broadly, there is strong ownership of structural reforms in the financial sector and in public procurement. The authorities reaffirmed the targets for the fiscal deficit and bank balances for next year and identified measures to achieve these. Prior actions for the completion of this review include parliamentary adoption of a 2016 budget in line with program objectives, as well as the transfer of funds from the privatization agency to the government. The main risk for the timely implementation of the program is the ongoing blockage of parliamentary activity by the opposition, which objects to recent agreements aimed at normalizing relations with Serbia.

**Staff support the authorities' request for completion of the first review**.

Approved By
**Thanos Arvanitis and Mary Goodman**

A staff team comprising Messrs. Miniane (head), Cipollone, Weiss (all EUR), Misch (FAD), and Ms. Zdzienicka (SPR) visited Pristina during October 12–23, 2015, joined by Messrs. Vermeulen and Thaci (Resident Representative Office). Mr. Mehmedi (OED) joined policy meetings. The team met with Prime Minister Isa Mustafa, Finance Minister Avdullah Hoti, Central Bank Governor Bedri Hamza, other government officials, parliamentarians, private sector representatives, trade unions, multilateral agencies, and diplomatic envoys.

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# CONTEXT

**1. Political tensions have increased**. The opposition has mounted strong protests against the government following the signing of agreements on the normalization of relations with Serbia under EU sponsorship in October. While the ruling coalition enjoys a strong majority, the opposition has managed to stall parliamentary activity. This risks delaying important legislation, including amendments to the Law on Public Financial Management and the 2016 budget—critical to the government's reform program and Stand-By Arrangement (SBA). The situation in parliament also risks damaging investor confidence at a time when a foreign consortium is seeking financing for Brezovica, a major tourism investment project.

**2. The European refugee crisis has had a limited impact on Kosovo so far**. Most refugees have bypassed it in favor of other routes toward Western Europe. With Germany, which hosts a large part of the Kosovo Diaspora, facing a wave of refugees from the Middle East, fewer Kosovo migrants may be accepted there in the future and many of the recent, not-yet-accepted migrants may have to return to Kosovo. However, staff do not expect this to materially impact critical remittance flows from the Kosovar community already established in Western Europe.

# RECENT DEVELOPMENTS

**3. Growth appears to be recovering after last year's slowdown**. 2014 growth has been marked down to 1.2 percent based on revised national accounts data, well below staff's estimate of 2.7 percent at the time of program approval but higher than the authorities' initial 0.9 percent estimate.[1] The 2014 growth slowdown was driven by a sharper-than-expected contraction in public consumption and total investment (-2.5 and -5.0 percent, respectively), the latter most likely hampered by the long political stalemate following the June elections. At the same time, private consumption grew strongly (4.8 percent) on the back of last year's public sector wage increase, as did exports (+16.7 percent). It should also be noted that 2014 growth in nominal GDP, a key base for fiscal performance, was *stronger* than staff had estimated at the time of program approval (4.5 versus 3.3 percent).[2] As regards current developments, high-frequency indicators including tax revenues, credit to the private sector, exports, imports, and remittances, suggest a noticeable increase in activity during the first half of this year (Figure 1). Staff have revised their 2015 growth projection up to 3.5 percent from 3.2 percent previously.

**4. Despite robust domestic demand, inflation remains very low in line with other countries in the region**. Prices fell 0.4 percent m/m in September, mostly driven by weak energy and food prices, which comprise the majority of Kosovo's consumption basket. Core inflation has

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[1] National accounts data are released with a very long lag in Kosovo and are subject to significant revisions. Final annual data for 2014 was released in November 2015.

[2] All in all, staff believe the revised national accounts understate real GDP growth while overstating the GDP deflator—the latter grew much faster than CPI in the final national accounts data.

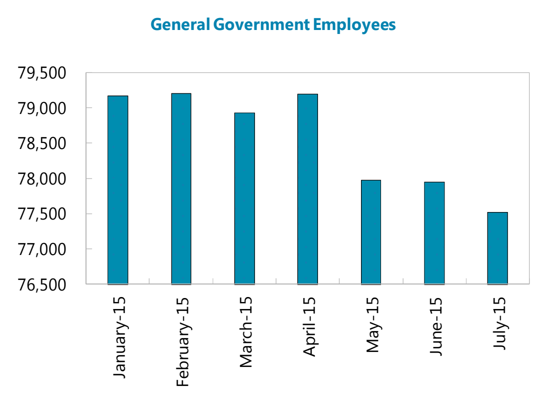
remained modestly positive at about 0.5 percent for most of the year, slightly below the euro area. Going forward, the recent VAT increase should boost prices in the remainder of the year, but staff still expect deflation in consumer prices for the year as a whole.

**5. Continued remittance inflows and stronger-than-expected export performance have helped to narrow the current account deficit (including official transfers)**. Staff expect the deficit to fall from 7.9 to 7.2 percent of GDP this year. Remittances were particularly strong in the first and third quarters, and export growth has remained robust despite a drop in global metals prices (Kosovo's primary export) due to resilient demand in most of its trading partners. Trends were also positive on the financing side, with FDI inflows about double from last year.

**6. Financial indicators are also encouraging**. Interest rate spreads have continued to fall (they were down 183 bps in the year through September), driven by developments in the euro area, increased competition among banks, and some measures to improve the contract enforcement process such as the introduction of private bailiffs. Credit to the private sector is up, from about 5 percent y/y in early 2015 to about 8 percent in September. The improvement has been driven by the corporate sector, which comprises roughly two-thirds of the system's loan book, with the bulk of corporate lending extended to trade and financial services companies. Overall, the banking sector remains well capitalized, liquid, and profitable, with an aggregate capital adequacy ratio of 18.5 percent and with liquid assets equivalent to 37 percent of short-term liabilities as of September. Asset quality has broadly continued to improve this year: the system's NPL ratio has fallen 1.5 percentage points since January to 6.8 percent and NPLs are fully provisioned. Profitability is also very strong, with return on equity bordering 25 percent.

# PROGRAM PERFORMANCE

**7. The program is on track**. All end-August performance criteria and indicative target were met with comfortable margins. In particular, the fiscal balance and government bank balance at end-August outperformed performance criteria by 2 percent of GDP and 1.5 percent of GDP, respectively. Tax performance has been strong, with revenues up 7.9 percent in the year to September (including a noticeable acceleration in July and August, benefiting from the seasonal influx of Diaspora visitors). The increase in the general VAT rate from 16 to 18 percent in September is expected to yield about 0.2 percent of GDP (non-annualized) in the remainder of the year. On the spending side, the authorities have made efforts to streamline current spending via strict monitoring of budgetary execution and efforts to control public sector employment; staff now expect current spending for the year to be 0.3 percent of GDP lower than at the time of program approval, and about 1 percent of GDP lower than at the time of the May 2015 Article IV staff report. Finally, capital expenditure is



Sources: Kosovo Ministry of Finance.

advancing but with some normal delays (part of the reason for the strong August over-performance); associated savings will be used to either reduce the deficit or accelerate the implementation of the Route 6 highway project.[3]

**8. All structural benchmarks for the first review have been completed**.

- *The authorities submitted to parliament amendments to the investment clause of the fiscal rule*. The agreed amendments will allow for new donor-financed capital projects not to count against the fiscal rule's deficit limit if: (i) the government's bank balance is at least 4.5 percent of GDP; and (ii) the underlying fiscal deficit is consistent with the fiscal rule. To ensure fiscal sustainability, the amendments contain a debt limit of 30 percent of GDP (a project cannot be considered under the clause if it would put Kosovo's debt-to-GDP ratio over 30 percent) and a 10-year sunset clause.

- *The authorities submitted to parliament legislation on a public wage bill rule (Box 1), a key objective of the program to bring predictability in the wage-setting process and boost competitiveness (structural benchmark for the second review)*. The new rule, which was developed with the assistance of staff, will come into effect with the 2018 budget; in the meantime, program targets will continue to drive fiscal objectives for 2016 and 2017. Once it becomes effective, the rule will cap increases in the overall wage bill of the central and local governments at nominal GDP growth, with no exemptions. It will provide some flexibility in the event of a recession, but with a corrective mechanism to avoid permanent increases in the wage bill to GDP ratio.

- *A new regulation on emergency liquidity assistance was adopted by the CBK's Board in September (structural benchmark for the first review)*. This new regulation is in line with international best practice.[4] This improved framework is important to ensuring financial stability in Kosovo, although given the healthy state of the banking sector staff do not expect it to be called upon in the near future.

- *The on-site examination of a bank under new risk-based supervision guidelines has been completed (structural benchmark for the first review)*. The new framework, developed with the assistance of Fund TA, will help the authorities to better identify risks and vulnerabilities in the banking system.

[3] This would minimize the significant backloading of the current Route 6 payment path and is in line with commitments in the July 2015 MEFP.

[4] See below for more details.

## Box 1. Kosovo's Public Wage Rule

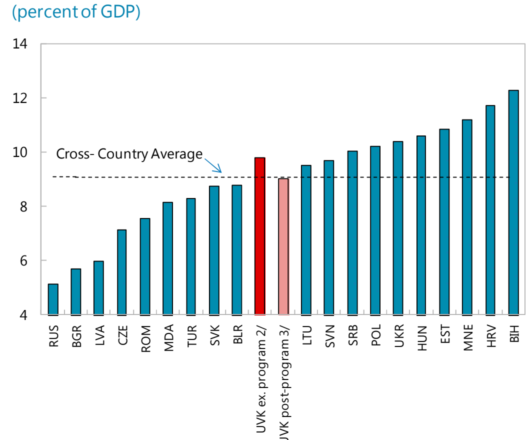
**Historically, the rapid growth in the public wage bill has compounded the problem of high labor costs and has thus been a significant factor in holding back competitiveness**. This is reflected by the widening of the gap between public and private sector wages over the last few years. The average public sector wage now exceeds the average private wage by over 30 percent which makes it difficult for the private sector to attract and retain competitive talent and which potentially exerts significant upward pressure on private sector wages.

**The recently agreed public wage bill rule will significantly decelerate this negative trend by linking the public wage bill to economic developments**. The rule will not go into effect until 2018, as the public wage bill for 2016 and 2017 will be governed by fiscal targets under the SBA. Specifically, the rule allows the public wage bill to grow by up to nominal GDP growth. By covering the total wage bill of central and local governments, the rule encompasses the aggregate that matters for fiscal sustainability, without "micromanaging" individual categories of wages, the trade-off between wages and employment, or between wage and non-wage compensation. To provide some flexibility in the event of a cyclical recession, the rule allows for the wage bill to increase by up to 0.5 percent even if nominal GDP grows by less than 0.5 percent. However, in such circumstances, the wage rule also requires the ratio of the wage bill to nominal GDP to revert back to its pre-increase level within three years starting in the fiscal year in which nominal GDP growth exceeds 0.5 percent; this is to avoid permanent increases in the ratio of the wage bill to nominal GDP.

**The wage bill rule will use the annual growth rate of nominal GDP of the latest calendar year for which data are available by the time of budget preparation**. While this implies that changes in nominal GDP translate into caps of the public sector wage bill with a considerable lag, nominal GDP growth forecasts (a possible alternative) are subject to larger revisions, and they might introduce a stronger degree of pro-cyclicality in the public wage bill. In addition, using such forecasts as part of the wage rule could potentially politicize the forecasts. Finally, note that there is no data on public sector productivity, and using inflation or real growth instead of nominal GDP growth as a cap would imply that public wage bill continuously falls as share of nominal GDP which is politically unrealistic. Hence, past nominal GDP is the best among a range of imperfect indicators.

**The wage rule will entail a sharp deceleration in public sector wage dynamics relative to the past, and ensure Kosovo's wage bill/GDP stays within reasonable norms**. The wage bill has grown by an average of 13 percent per year since 2008, while nominal GDP is expected to grow by much less in the future. It should also be noted that, following two years of consecutive nominal wage freezes in the program, the wage bill/GDP ratio will fall to around 9 percent in 2017. This is close to the average of comparator countries, suggesting that the rule will entrench a wage bill/GDP level that is not out of line.

**General Government Wage Bill in Eastern Europe 1/**
(percent of GDP)




Sources: WEO (live), IMF staff calculations.
1/ All countries are as of 2014. Albania and Macedonia not included as only central government data are available.
2/ 2015 value expected at the time of the May 2015 Article IV consultation.
3/ Currently expected value for 2017.

- *The tender bids for centralized procurement for oil, air tickets, and office supplies, covering the three-year needs of 43 government agencies, have been issued (structural benchmark for the first review)*. The award contracts for the fuel and office supplies bids are expected to be finalized soon, well ahead of the authorities' original plan. The award contract for the air ticket bid has been challenged but staff expect this to still be completed ahead of schedule.
- *The government submitted to parliament in October the list of candidates for the Privatization Agency of Kosovo (PAK) Board (structural benchmark for the first review)*. This step is necessary (although not sufficient, see below) to enable the transfer of €5 million (0.1 percent of GDP) in tax revenues owed by PAK to the Tax Administration of Kosovo (TAK) and €30 million (0.5 percent of GDP) in privatization funds to the government. Both of these have been incorporated into the revenue and financing forecasts of the mid-year budget.

# POLICY DISCUSSIONS

## A. Outlook and Risks

**9. Staff expect growth to pickup to 3.8 percent in 2016 and 4.1 percent in the medium term, aided by large new investments and competitiveness-enhancing reforms**.[5] This outlook is supported by: (i) the large Brezovica tourism investment project, which will have a significant direct impact (the first phase amounts to 3 percent of GDP in new investment over three years) and also improve broader investor sentiment for Kosovo; (ii) new donor-financed capital projects worth about 1 to 2 percent of GDP each year, catalyzed by additional space allowed under the fiscal rule's modified investment clause; (iii) a sustained pickup in bank lending to the private sector as institutional reforms, including improvements to the private contract enforcement system (see below), take hold; and (iv) steps to reduce corruption and improve the business environment, notably in the key public procurement market, boost sentiment, competitiveness, and efficiency. The authorities see a stronger upside potential, and view a medium-term growth of 4.5–5 percent to be within reach.

**10. The current account deficit is expected to increase next year before steadily declining through the forecast period**. Staff anticipate a temporary widening of the current account deficit (including official transfers) to 8.9 percent of GDP next year as imports increase in line with the large Brezovica tourism investment project. Over the medium term, payoff from this large investment in the form of greater exports should lead to some improvement in the trade and current account deficits. While these deficits are expected to remain large throughout the forecast period, staff still foresee a significant contribution from stable sources of funding, such as remittances, official transfers, and FDI. All in all, overall external reserves should remain above three months of imports of goods and services, and external debt service will account for a manageable fraction of exports or exports plus remittances.

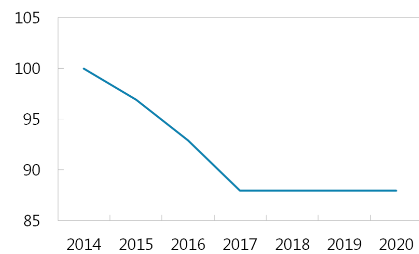
[5] Note that the pre-reform estimate of medium-term growth, made at the time of the 2015 Article IV consultation, was 3.5 percent; the new estimates are thus based on relatively conservative views on the "boost" to potential growth brought about by reforms.

## Box 2. Kosovo's External Competitiveness

**In the staff report for the 2015 Article IV consultation (Country Report No. 15/131), staff provided an assessment of overall competitiveness in Kosovo using both qualitative and quantitative methods**. In particular, staff estimated a real exchange rate overvaluation in the range of 15–20 percent, based on CGER methodologies. This overvaluation is driven by underlying fiscal dominance in the context of unsustainably large public sector wage increases, together with the economy's dependence on remittances that, in the case of Kosovo, have tended to stimulate consumption and investment in non-tradeable sectors (see Figure 4).

**As part of the SBA-supported program adopted last July, the authorities have taken serious commitments to contain current spending and in particular to compress the public wage bill over time**. The authorities have frozen nominal public sector wage levels in 2015 and are committed to continue doing so in 2016 (MEFP ¶11). In addition, they have also submitted to parliament a wage bill rule, which has a nominal GDP growth cap on the overall wage bill of central and local governments, and which is planned to come into effect in the 2018 budget (MEFP ¶6). In the context of a growing economy and rising productivity, nominal wage freezes should help deflate wage costs, gains which the subsequent wage rule is expected to entrench.

**Projected Public Sector Wage Deflation**
(public wages per GDP per capita; 2014 = 100)



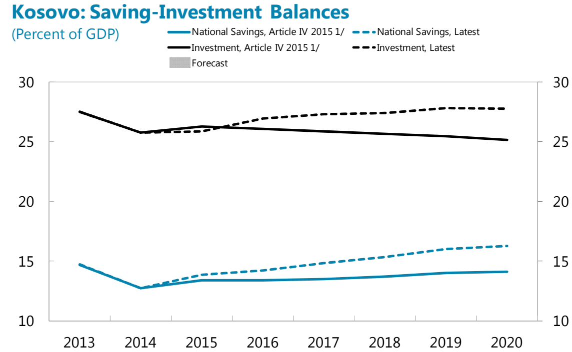

Sources: IMF staff calculations.

**In addition, the SBA-supported program aims to boost non-wage competitiveness via three channels**:

- *Improving infrastructure*. Amendments to the "investment clause" of the fiscal rule will make it easier for Kosovo to attract and accommodate large scale infrastructure projects financed by donors.
- *Removing obstacles to bank intermediation*. New measures in the latest Memorandum of Economic and Financial Policies are aimed at addressing problems in contract enforcement to allow banks to lend against lower collateral and lower interest rates.
- *Improving the business environment and reducing corruption*. The focus here is on the key public procurement market, where wider use of centralized procurement and e-procurement, together with some governance measures, are expected to make the system more transparent and verifiable.

**The end result of all these measures is an expected improvement in Kosovo's external position**. While the end-period current account deficit is now expected to be a bit higher than at the time of the Article IV consultation, this is because of a close to 3 percentage points of GDP higher investment rate, driven by the large Brezovica resort. In other words, measures outlined above are expected to generate a 2 percentage points of GDP gain in national savings over the medium term relative to the passive Article IV baseline. This is a good start, but certainly not enough to turn Kosovo into a competitive economy with a wide production and export base. Doing so will require multi-year efforts to redirect remittances to more productive ends (perhaps via a wider use of Diaspora bonds), as well as broader and deeper improvements to the business environment and the rule of law.

**Kosovo: Saving-Investment Balances**
(Percent of GDP)




Sources: IMF staff calculations.
1/ Article IV values have been normalized to match recently released 2014 data.

**11. The balance of risks is tilted to the downside**. Continued political gridlock could delay adoption of key economic legislation, including changes to the investment clause of the fiscal rule as well as the 2016 budget. More importantly, it risks undermining investor and consumer confidence at a critical time for the country, and could negatively affect financing for the key Brezovica resort. Kosovo will also remain highly vulnerable to a disruption in its electricity supply, until new investment comes on stream to replace the two aging power plants, or interconnectivity to the regional grid improves. In the medium term, the risk of a low-growth environment in Europe would negatively affect Kosovo via lower export demand and lower remittances from the Diaspora.

## B. Fiscal Policy

**12. While welcoming the strong tax performance and streamlined current spending, staff called for progress in collecting one-off revenues and privatization funds**. In addition to the government nominating candidates to the PAK board, parliamentary approval of these candidates is required before PAK funds can be transferred to the government (the actual transfer of these funds to the government is now a prior action for this review). Separately, the authorities are finally advancing on the sale of new telecommunications licenses, and announced the price for the new licenses on October 20. The authorities are confident that proceeds from the sale will be received by end-December, and will match or exceed the amounts budgeted (0.3 percent of GDP). Completion of the sale and transfer of any proceeds to the government by December 31 is now a structural benchmark for the second review.

**13. Provided these one-off revenues are received by year-end, 2015 fiscal outturns could be better than program targets**. With tax revenues in line with forecasts, and current spending below mid-year budget envelopes, the end-year deficit could come below 2 percent of GDP, versus 2.4 percent of GDP at the time of program approval.[6] In line with improved fiscal performance, the government's bank balances—critical in a unilaterally euroized economy—are expected to increase to €184 million by year-end, equivalent to 3.2 percent of GDP. This represents a significant improvement in Kosovo's fiscal buffers compared with levels at end-2014 (1.8 percent). Still, continued fiscal restraint—together with planned Fund disbursements—is needed to bring the bank balance back to its prudent level of 4.5 percent of GDP over 2016.

**14. The authorities remain committed to a €98 million (1.6 percent of GDP) fiscal deficit, excluding PAK and donor-financed IFI projects, for 2016, to allow the necessary fiscal consolidation to proceed**. This is the same quantitative target that had been preliminarily agreed to at the time of SBA approval. Passage of a 2016 budget consistent with this objective will be a prior action for this review.[7]

[6] At this stage, staff assume a 0.4 percent of GDP under-execution of the annual capital budget. Should under-execution be greater, the deficit would be correspondingly smaller.

[7] Per ¶9 in the Memorandum of Economic and Financial Policies, adoption of revenue measures needed to support the revenue projections in the 2016 budget are part of this prior action.

**15. Revenues in 2016 should benefit from the full-year effect of several measures taken this year**. This includes new excises introduced in April (on tobacco, alcohol, and heavy oils) and July (on tobacco, gambling, and fireworks), and the September VAT increase. All in all, the full-year effect of these measures should bring about a 0.3–0.4 percent of GDP increase in tax revenues relative to 2015.

**16. There will be modest increases in a few specific current spending items relative to the preliminary agreement reached at the time of the SBA approval**. These will be comprised of: (i) a new €5 million (0.1 percent of GDP) allocation for wages and salaries related to the new diplomatic agreement on the normalization of relations with Serbia; and (ii) a net €4 million increase in funding for a well-targeted, means-tested social assistance scheme whose benefits are very low in absolute terms and have not been increased since 2009. Given the relatively small size of these spending measures and the authorities' ability to find compensating measures elsewhere (see below), staff support these increases.[8]

**17. All in all, the authorities and staff believe a ½ percentage point of GDP in new measures is needed to reach the €98 million deficit target for next year**. In this regard, the authorities are considering the following measures:

- *A new increase in tobacco excises, to yield €10 million (0.2 percent of GDP) per year*.

- *Cuts in the goods and services allocation of €5 million (0.1 percent of GDP) relative to the previously envisaged envelope*. Further mainstreaming of centralized procurement should generate additional savings in this area, relative to the previous decentralized system.

- *€10 million (0.2 percent of GDP) in savings related to new, ill-targeted pension schemes*. The Law on Pension Schemes Financed by the State, which was passed before the 2014 elections, establishes new, non means tested, and poorly-targeted pension schemes. The authorities have now agreed to lower the benefit levels as well as the number of beneficiaries associated with these schemes by a third relative to what was envisaged at the time of program approval, so that the total cost of this revised law will now be €23 million (0.4 percent of GDP) per year, instead of €33 million.

- *As a result of these measures, the total indicative target ceiling for current spending for 2016 will fall from €1,226 million at the time of the SBA request to €1,220 million*.

**18. The program envisions the authorities' continued pursuit of a substantial increase in donor-financed capital spending over the next several years**. Following through on these plans will be critical to achieving the growth-enhancing investment that is important for Kosovo's program. So far, the authorities have secured a €40 million loan from the EBRD for a project that will

[8] In addition to these new commitments, current spending will increase next year due to the full implementation of the 2014 collective agreement, or of the 2014 Law on Pension Schemes, as agreed at the time of program approval.

establish a rail link with Macedonia for both freight and passengers. The authorities are currently negotiating with the EIB and EU for loans and grants for the same project. The authorities are exploring additional capital projects with the World Bank and EBRD, including a large-scale irrigation project for agriculture. At this stage, staff expect total donor disbursements for new projects to total about €50 million in 2016, below the €90 million cap established under the program.[9] The authorities' recently established National Investment Committee, whose goal is to prioritize infrastructure projects and proactively seek financing from donors, should help in this regard. The authorities have also developed a preliminary draft of a detailed concept note outlining new projects, the finalization of which is a structural benchmark for the second review.

## C. Financial Sector

**19. The CBK's newly adopted emergency liquidity assistance (ELA) regulation represents a major improvement in Kosovo's financial safety net**. It provides more detail and rigor than the previous regulation on the criteria by which ELA applicants will be assessed and the conditions to which they will be subject; it also better defines the types of collateral banks may use to receive ELA. The CBK is now working with Fund staff on supplementary guidance to further clarify how bank collateral would be assessed in the event of an ELA request and how ELA reserves would be used, if needed.

**20. The authorities remain fully committed to rolling out risk-based supervision to the rest of Kosovo's banking sector**. On-site examinations of Kosovo's three remaining banks for which risk-based supervision has not yet taken place (structural benchmark for the second review) are proceeding ahead of schedule. (The process is scheduled to be completed in early 2016 but may be completed earlier.) Commercial banks in Kosovo that have already moved to the new risk-based system told Fund staff that the transition has been smooth, and that they feel the new system will lead to a more timely and accurate identification of any emerging risks.

**21. The authorities are proactively engaging with staff to develop a macroprudential policy framework, which will further strengthen systemic financial stability**. This new framework, and the policy tools that will come with it, will enable the CBK to better identify and contain systemic risks. It is important that the final framework contain sufficient detail on the institutional setup of the CBK's Macroprudential Advisory Committee; the policy toolkit available to the CBK and how these tools will be applied to its objectives; and the identification of systemic risks. Staff plan to work closely with the CBK in developing its macroprudential policy framework, as it did on the CBK's recently adopted ELA regulation.

**22. The CBK has taken further steps to strengthen its contingency planning and crisis management capacities**. Relevant Kosovo agencies—including the CBK, Ministry of Finance, and Deposit Insurance Fund of Kosovo—recently participated in a crisis simulation exercise under the

[9] This figure includes disbursements to publicly-owned enterprises via on-lending from the general government.

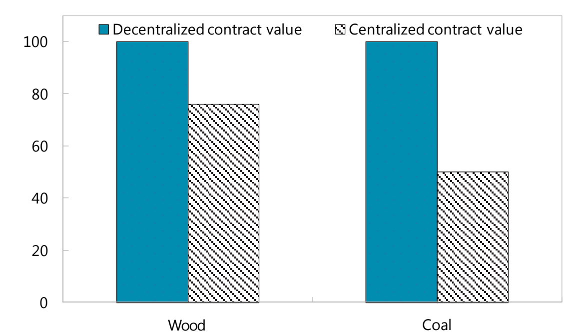
auspices of the World Bank to help improve crisis preparedness internally within agencies and coordination across agencies. Staff encouraged the CBK to fold this work into the broader context of the cross-agency National Committee for Financial Stability and Crisis Management, which in turn should continue to become fully operationalized by holding regular, formal meetings and progressing on contingency planning.

**23. Regarding structural impediments to credit provision, the authorities agreed with staff that further reforms to the contract enforcement process in Kosovo could help to unlock more—and more productive—bank lending**. The inability of creditors to enforce judgments against debtors has meant higher collateral requirements, higher lending rates, and, ultimately, less lending by banks. A system of private enforcement agents introduced in 2014 has helped to make the collections process more efficient, and in turn has been a factor in this year's uptick in lending, but several gaps remain before Kosovo's contract enforcement system is up to best standards. The authorities are committed to reforming various aspects of the system, very much in line with staff recommendations: (i) work with the Kosovo Judicial Council to improve the system of case statistics, critical to assessing the enforcement system's performance; (ii) adopt amendments to the Law on Enforcement Procedures, which would close significant loopholes that allow debtors to escape the private bailiffs' system and throw their case back into the overloaded courts; and (iii) automatize and operationalize the CBK's Unique Account Holder registry, which will facilitate the garnishment of bank accounts.[10] The authorities also recognized remaining issues related to the private enforcement agent system, including the number of agents, their supervision, and fee structures, and plan to provide in the coming months their own set of recommendations to address these issues.[11]

## D. Improving the Business Environment and Reducing Corruption

**24. The authorities are making strong progress in developing a centralized procurement system, which will help to make public expenditure more efficient and will improve governance**. In addition to the centralized bids for fuel, air tickets, and office supplies mentioned previously, staff welcomed: (i) the recent awarding of two centralized tender bids for wood and coal; (ii) the launching of additional centralized tender bids for other products; and (iii) the authorities' plans to issue a second list of common goods eligible to centralized tender bids by

**Purchasing 3-year Agreement Contract Values**
(Decentralized = 100)




Sources: Kosovo CPA; and staff estimates.

[10] The CBK is working to address concerns raised that access to the registry by private bailiffs may be inconsistent with Kosovo's privacy laws.

[11] Specifically, there is a need to review the enforcement agents' system, with the goal of increasing their number, ensuring fees are back loaded to incentivize enforcement and strengthening oversight of enforcement agents. Separately, the mortgage market continues to be hampered by deeper structural challenges, including the absence of a dependable register of land rights and cultural resistance to foreclosure.

March 2016, ahead of schedule under the program. The gains from widening centralized procurement are not just pro-forma: preliminary data indicate significant savings brought about by the new centralized procurement bids relative to the old, decentralized system.

**25. The government's recent adoption of a new procurement law is a positive step in this area**. The new law, which is now under discussion in parliament, is in line with EU directives and international best practice. Among other things, the revised law will tighten eligibility criteria for high-level officials working in the procurement system. Once the law is approved, the government intends to issue secondary legislation making e-procurement mandatory for all central procurement bids (government adoption of a draft law to this effect is a <u>structural benchmark for the second review</u>). In anticipation, the authorities will soon launch an e-procurement pilot project to ensure systems are functioning as expected. Roll-out of e-procurement will be another major step toward improving the efficiency and governance of the procurement process.

**26. Still, some challenges remain**. The vacant seats at the Public Procurement Review Board have yet to be filled, despite legal requirements to do so. This creates delays, harms credibility, and represents a significant gap in the governance of the procurement process, potentially threatening the gains made so far. In this context, the authorities and staff agreed it was imperative to have a proper Board approved by parliament and in place by end-February 2016 (<u>structural benchmark for the second review</u>).

**27. Outside of the procurement process, staff and the authorities discussed measures to strengthen enforcement of the anticorruption regime**. Staff encouraged the authorities to implement anticorruption safeguards in the judiciary, in line with the recommendations of the Project Against Economic Crime (April 2015), as well as complementary measures to enhance Kosovo's AML/CFT framework.

## E. Other Issues

**28. Data issues**. Staff discussed several issues related to national accounts data with the authorities, including long lags in the publication of annual data, the poor quality of quarterly data, and the lack of higher-frequency indicators of economic activity, such as retail sales. The authorities recognized these issues, and are considering the possibility of a committee of end users that would do quality control on the national accounts data prior to release, with proper safeguards to ensure there is no intended manipulation of the data by the committee.

**29. Parliament has withdrawn a draft law governing its own functioning following concerns raised by staff and other international partners**. Specifically, the draft law would have given parliament full independence in setting its own budget (forcing government to transfer any resources parliament deemed necessary) as well as its own procurement procedures, with no oversight. This would have undermined the general budget process and weakened efforts to enhance the transparency of public procurement. Going forward, parliament expressed a commitment to ensuring that any draft law achieves a better balance between parliamentary independence and accountability.

# PROGRAM DESIGN AND RISKS

**30. Staff reached understanding with the authorities on the following modifications to conditionality**:

- *Two prior actions have been added:* one on parliamentary approval of a 2016 budget in line with program objectives, together with any needed supportive measures; and one on the PAK transfer of funds (a minimum €5 million in above-the-line funds and €30 million in below-the-line funds) to the government.[12]

- *New structural benchmarks*. A structural benchmark requiring the completion of the telecommunications license auction and the transfer of any revenues from the sale to the government by December 31, 2015 has been added for the second review.[13] A structural benchmark on parliamentary nomination of the vacant seats on the Public Procurement Review Board by February 28, 2016 has also been added for the second review.

- *The indicative target for the ceiling on current expenditure of the central government for end-December 2016 will be lowered by €6 million to €1,220 million, based on savings identified by the authorities discussed above*. Performance criteria for June 2016 have now been set.

- *An adjustor for the indicative target on current spending for end-2016 has been added, very similar to the adjustor for current spending for end-2015*. The adjustor, which staff support, gives the authorities space to allocate additional funds for the maintenance of the public capital stock up to a €7 million (0.1 percent of GDP) limit, but only under the proviso that revenues over-perform the targets by an equal or higher amount.

- *The TMU has been modified to capture capital spending related to new donor projects executed by publicly-owned corporations via on-lending from the general government*.[14] As a result, the definition of the headline fiscal balance ex PAK of the general government (a performance criterion) changes accordingly.

**31. Kosovo's capacity to repay the Fund remains good, whether obligations are measured as a share of GDP, exports and remittances, or tax revenues** (Table 7). Public debt is low and expected to remain stable (well below 30 percent of GDP through the forecast period). Based on the

[12] Note, the prior action on PAK funds and the structural benchmark on telecom licenses do not bring about *new* commitments, but simply aim at ensuring that commitments made at the time of program approval and incorporated into the 2015 supplementary budget are met. These one-off revenues and financing items are important for the authorities to reach end-year program targets.

[13] As footnote 12.

[14] Spending via on-lending does not have any implications for debt sustainability because it is already captured by government debt statistics. However, spending financed via on-lending is not part of the budget, hence amending the TMU would ensure that spending financed via on-lending is captured within the €90 million annual cap on donor-financed projects under the program.

latest data submitted by the National Bank of Serbia, staff have revised down the estimate of the value of the Kosovo portion of ex-Yugoslavia debt as computed by Serbia (from €442 million to €351 million—or 6.3 percent of GDP—as of December 2014). Kosovo neither recognizes nor services nor tracks this debt.[15]

**32. Safeguards Assessment**. A recent update of the 2012 safeguards assessment was positive. It found that the CBK has an effective system of controls in place in its reserves management and vault operations. The assessment found that the CBK's governance practices are appropriate; noted the recent adoption of the new ELA regulation and the pending supplementary internal guidance, as well as the CBK's MoU with the finance ministry on the use and replenishment of ELA reserves; and it found that the CBK's financial reporting system is adequate. The assessment noted, however, the importance of ensuring the CBK's financial autonomy given its lack of seniorage capacity and the currently low return on its assets; it also pointed out continued challenges related to the completion of the annual audit plan and the internal audit function only partially conforming to international standards. On the latter, CBK expressed its commitment to working with Fund staff to address the issue.

**33. Possible delays in parliamentary approval of key legislation are the main risk to the program**. The authorities remain fully committed to the program and maintain a healthy majority in parliament. However, continued domestic political tensions related to the government's normalizing relations with Serbia could hinder legislation related to program conditionality. Weaker revenue outturns, should current political issues or other shocks affect growth, would affect the authorities' capacity to meet fiscal targets. This being said, current tax revenue forecasts for 2016 are conservative, as they assume €30 million (0.5 percent of GDP) in losses related to the implementation of the Stabilization and Association Agreement with the EU and FTA with Turkey. With these agreements unlikely to be implemented from January 1, 2016 as assumed, the losses could be correspondingly smaller. Should this buffer prove insufficient, there is little room to cut current spending, but capital spending typically cannot be fully executed and so some additional buffer would be available.

# STAFF APPRAISAL

**34. Growth is recovering after last year's slowdown but the economy remains below potential**. Kosovo enjoys low debt, and a sound financial system. However, Kosovo needs stronger- and higher-quality growth to raise incomes and employment. This means moving away from its current remittance- and consumption-driven growth model to one driven by the productive and tradeables sectors. This in turn requires strong steps to improve competitiveness and develop a more dynamic private sector.

**35. Early performance under Kosovo's program, which is designed to help achieve such a rebalancing while maintaining macro-financial stability, is strong**. The authorities have demonstrated a commitment to fiscal rectitude and debt sustainability through their actions this

[15] Serbia has been servicing this debt.

demonstrated a commitment to fiscal rectitude and debt sustainability through their actions this year and their plans for next year. A large fiscal adjustment is on track to be achieved in 2015 to keep Kosovo within the fiscal rule, although the authorities need to follow through on the outstanding PAK transfers and the sale of telecommunications licenses to complete this. In particular, the authorities have taken the politically difficult step of arresting the growth of current spending following large and unsustainable increases last year. The 2016 budget delivers a needed additional adjustment. The government's new public wage bill rule, once adopted by parliament, will anchor public wages to economic developments, gearing public spending toward more productive uses.

**36. The authorities have also taken meaningful steps to further strengthen Kosovo's banking sector**. The adoption of a new ELA framework in line with international best practices, critical in a euroized economy, as well as the continued rollout of risk-based supervision, will help to preserve that stability. The authorities' commitment to develop a strong macroprudential framework and policy toolkit will further support these efforts.

**37. The authorities should also persevere in their efforts to reduce structural impediments to bank lending**. Credit growth has increased substantially this year, but credit penetration remains low relative to Kosovo's development needs and lending remains focused on just a few sectors. The authorities should focus efforts on the contract enforcement system, which has improved but requires further refinements, in order to increase banks' appetite for lending.

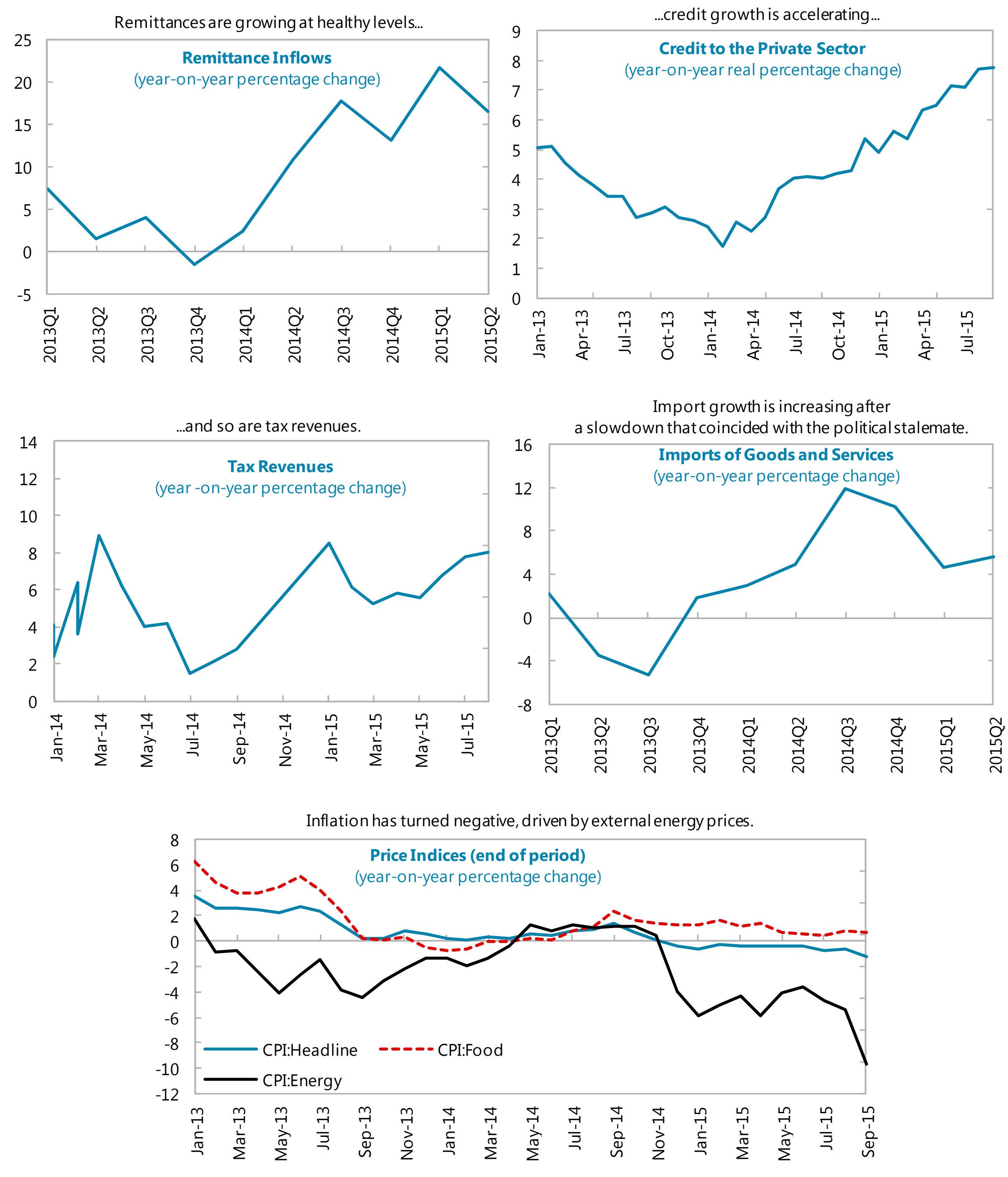
**38. The expansion of the investment clause under the fiscal rule is an important step in upgrading infrastructure and boosting competitiveness**. Kosovo has low debt and large investment needs. Additional investment under the amended fiscal rule will help Kosovo to bring in additional, high-quality, growth-enhancing capital projects. However, translating this amendment into successful investments will require strong and proactive planning by the authorities.

**39. Improving the business environment and reducing perceptions of corruption also requires the authorities to maintain the positive momentum exhibited so far in reforming the public procurement process**. The faster and deeper-than-anticipated expansion of centralized procurement is highly commendable; next steps include filling the vacant seats on the Public Procurement Review Board and issuing a decision, once parliament approves the new law on public procurement, to make e-procurement mandatory for all government agencies.

**40. Current delays in parliament put many of the above policy measures at risk**. In addition, they risk undermining investor and consumer confidence more generally, putting at risk some large projects. Staff welcome a quick and peaceful resolution to the blockages in parliament to allow the legislative process to proceed.

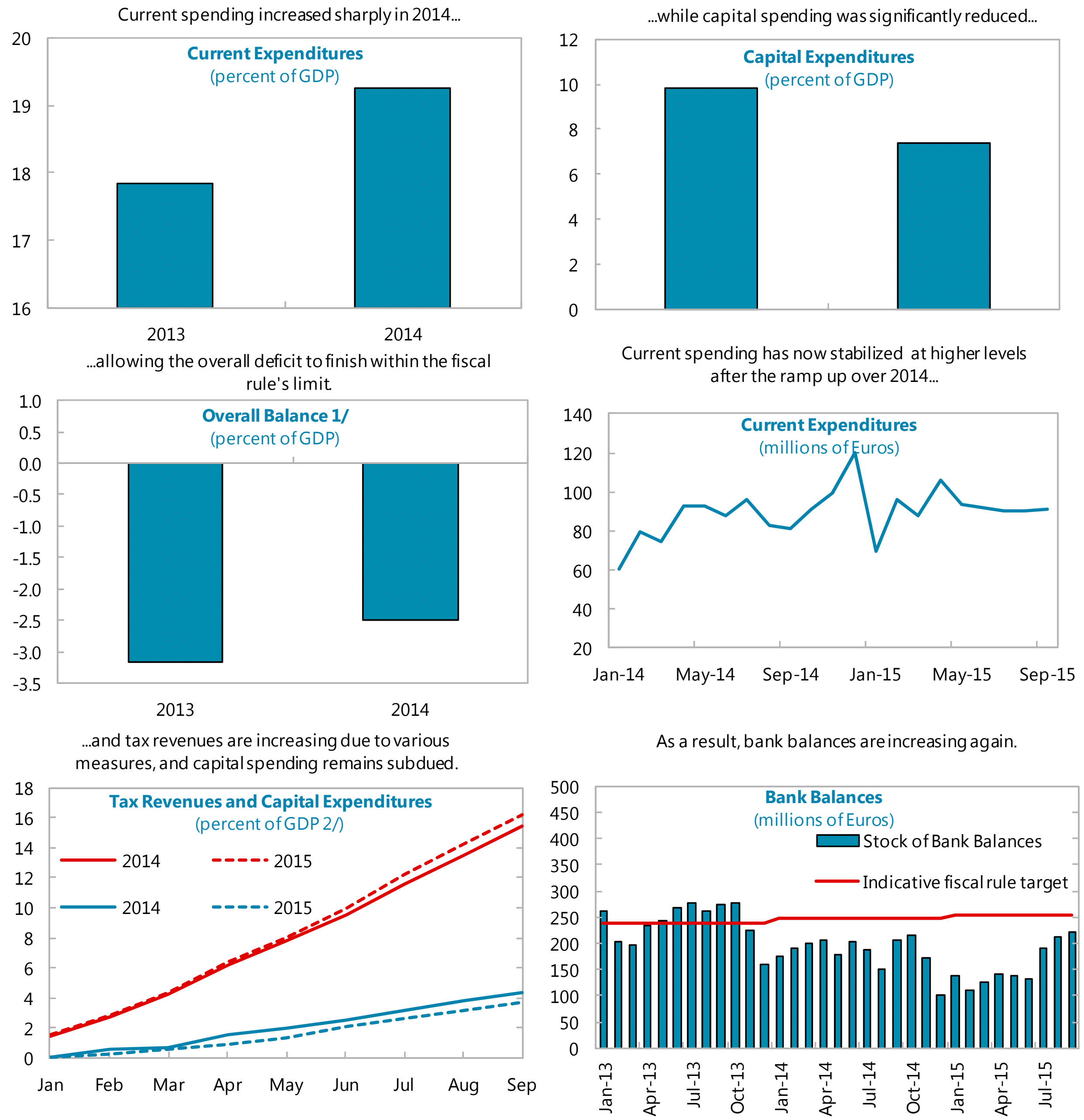
**41. Staff support the modification of the performance criterion on the headline fiscal balance ex-PAK of the general government to include on-lending. More generally, staff support completion of the First Review under the Stand-By Arrangement**.

## Figure 1. Kosovo: Recent Economic Developments, 2013–2015



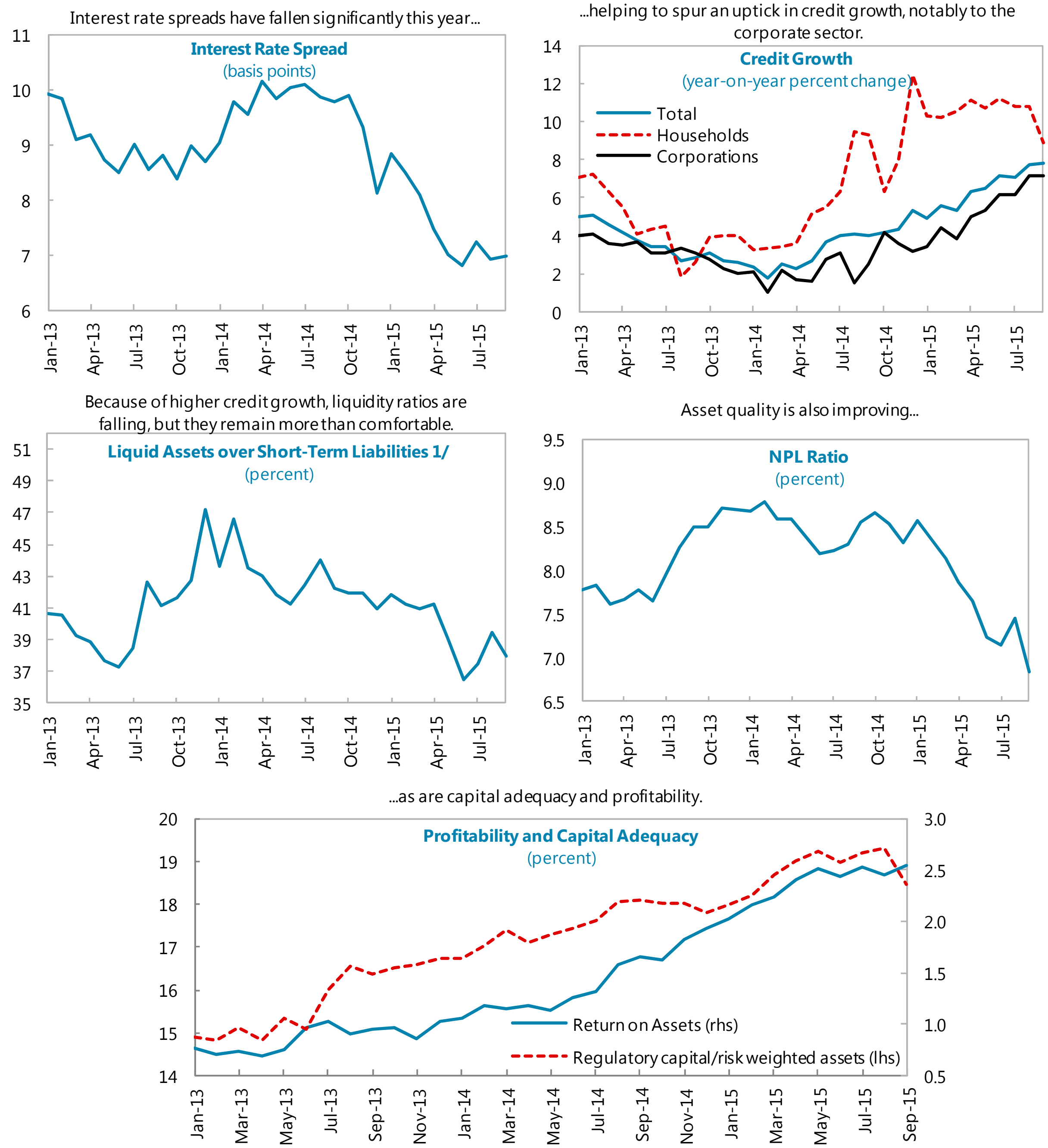

Sources: Central Bank of the Republic of Kosovo; and IMF staff estimates and projections.

**Figure 2. Kosovo: Recent Fiscal Developments, 2013–2015**




Sources: Country authorities; and IMF staff calculations.
1/ Overall balance excludes PAK spending.
2/ 2015 GDP is staff's forecast.

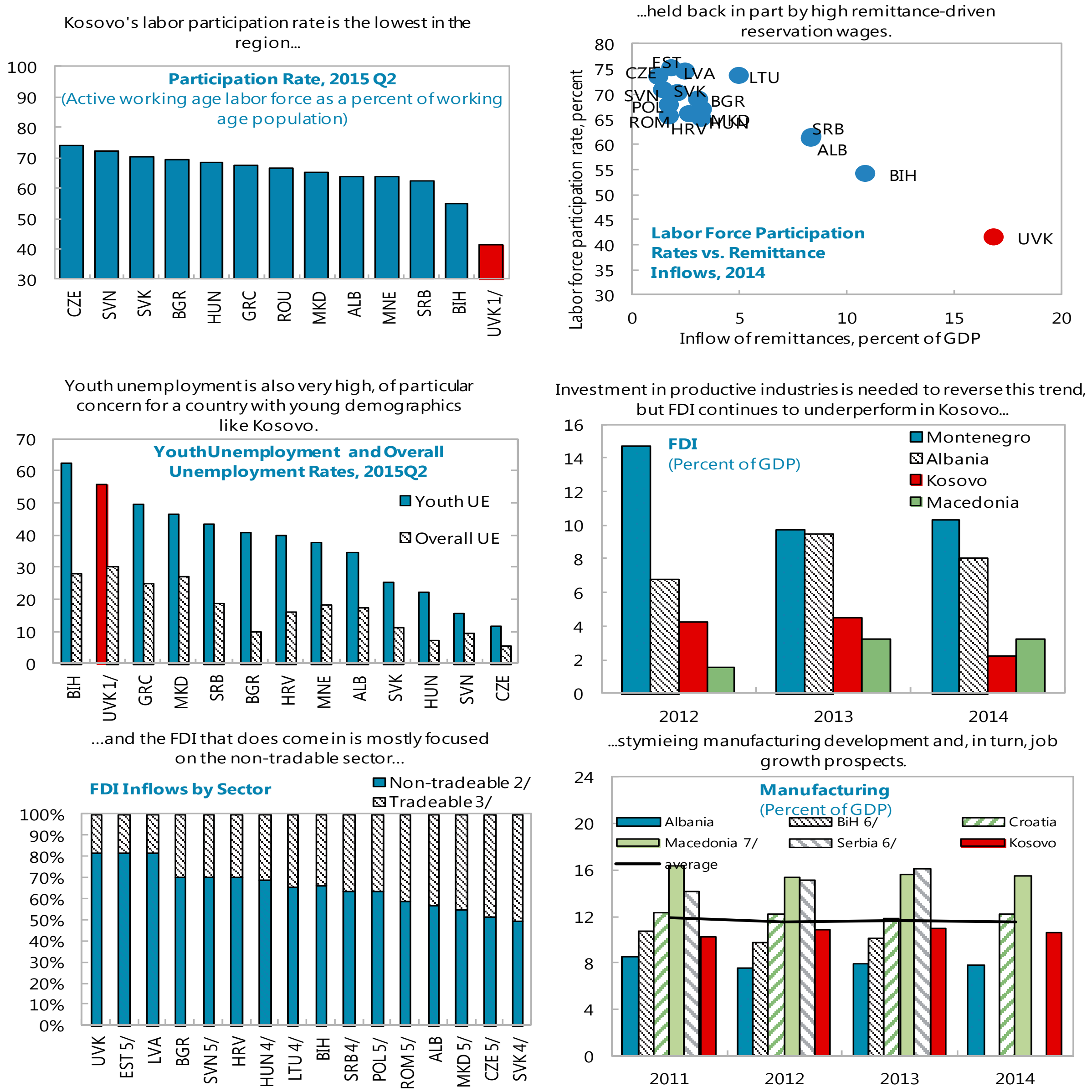
## Figure 3. Kosovo: Selected Banking Sector Indicators, 2013–15




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

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

## Figure 4. Kosovo: Selected Labor Market Outcomes




Source: Country authorities; Haver; World Economic Outlook; World Development Indicators World Bank; WIIW; and IMF staff calculations.

1/ 2014 annual data is used.

2/ Construction, wholesale, retail trade, repair of motor vehicles etc., hotels and restaurants, transport, storage and communication, financial intermediation, real estate, renting and business activities, public administration, defence, compuls. soc. security, education, health and social work, other.

3/ Agriculture, hunting and forestry, fishing, mining and quarrying, manufacturing, electricity and water supply.

4/ Data as of 2010.

5/ Data as of 2007.

6/ 2014 data not available for Serbia and BiH.

7/ Industry excluding construction.

## Table 1. Kosovo: Select Economic Indicators, 2012–20

(Percent unless otherwise indicated)

| | 2012 | 2013 | 2014 | 2015 | 2016 | 2017 | 2018 | 2019 | 2020 |
|---|---|---|---|---|---|---|---|---|---|
| | | | | Projections | | | | | |
| Real growth rates | | | | | | | | | |
| GDP | 2.8 | 3.4 | 1.2 | 3.5 | 3.8 | 4.1 | 4.1 | 4.1 | 4.1 |
| Consumption | 2.6 | 2.2 | 3.7 | 3.5 | 3.6 | 3.6 | 3.9 | 3.8 | 3.8 |
| Private | 2.7 | 2.0 | 4.8 | 3.7 | 4.1 | 4.2 | 4.0 | 4.0 | 4.0 |
| Public | 2.2 | 3.3 | -2.5 | 2.6 | 0.9 | 0.4 | 3.1 | 2.8 | 2.7 |
| Investment | -12.9 | -0.3 | -5.0 | 4.1 | 11.6 | 5.3 | 5.4 | 4.3 | 4.0 |
| Exports | 0.5 | 2.5 | 16.7 | 10.2 | 4.5 | 6.8 | 8.1 | 7.0 | 7.3 |
| Imports | -7.7 | -1.5 | 8.4 | 5.1 | 6.4 | 6.1 | 6.0 | 6.2 | 5.5 |
| Official unemployment (percent of workforce) | 30.9 | 30.0 | 35.3 | … | … | … | … | … | … |
| Price changes | | | | | | | | | |
| CPI, period average | 2.5 | 1.8 | 0.4 | -0.4 | 0.4 | 1.4 | 1.8 | 1.9 | 2.1 |
| CPI, end of period | 3.7 | 0.5 | -0.4 | 0.2 | 0.9 | 1.7 | 1.8 | 2.0 | 2.2 |
| Import prices | 4.9 | 0.0 | -0.4 | -0.6 | 0.4 | 0.7 | 0.5 | 0.7 | 1.0 |
| GDP deflator | 2.2 | 1.8 | 3.3 | -0.3 | 0.5 | 1.5 | 2.0 | 2.2 | 2.0 |
| Real effective exch. rate (average; -=depreciation) 1/ | -0.7 | 1.1 | 0.7 | -2.4 | … | … | … | … | … |
| Real effective exch. rate (end of period; -=depreciation) 1/ | 0.6 | 2.2 | -1.7 | -0.9 | … | … | … | … | … |
| General government budget (percent of GDP) | | | | | | | | | |
| Primary revenues | 26.1 | 24.6 | 24.0 | 26.0 | 26.4 | 26.1 | 26.1 | 26.1 | 26.1 |
| Primary expenditures | 28.5 | 27.6 | 26.3 | 27.7 | 28.5 | 28.0 | 28.1 | 28.0 | 27.8 |
| Of which: Wages and salaries | 8.1 | 7.8 | 8.7 | 9.2 | 9.1 | 9.0 | 9.0 | 9.0 | 9.0 |
| Subsidies and transfers 2/ | 5.7 | 6.0 | 6.6 | 7.5 | 7.7 | 7.5 | 7.5 | 7.5 | 7.5 |
| Capital and net lending | 10.7 | 9.7 | 7.3 | 7.3 | 8.1 | 8.1 | 8.1 | 8.0 | 7.9 |
| Overall balance ex-PAK and new donor projects | -2.4 | -3.0 | -2.5 | -1.8 | -1.6 | -1.5 | -1.6 | -1.8 | -1.9 |
| Overall balance excluding PAK 3/ | -2.4 | -3.0 | -2.5 | -1.8 | -2.5 | -2.2 | -2.4 | -2.4 | -2.2 |
| Privatization | 0.9 | 0.5 | 0.0 | 0.5 | 0.0 | 0.0 | 3.0 | 0.0 | 0.0 |
| Stock of government bank balances | 4.3 | 3.0 | 1.8 | 3.2 | 4.7 | 4.7 | 4.7 | 4.7 | 4.5 |
| Balance of Payments (percent of GDP) | | | | | | | | | |
| Current account balance, incl. official transfers | -7.5 | -6.4 | -7.9 | -7.2 | -8.9 | -8.7 | -8.6 | -8.6 | -8.3 |
| Of which: Official transfers 4/ | 7.9 | 6.4 | 5.2 | 4.8 | 3.9 | 3.8 | 3.5 | 3.2 | 3.2 |
| Capital and financial account | 2.8 | 3.1 | 3.0 | 2.8 | 5.6 | 6.3 | 6.6 | 6.9 | 6.7 |
| Of which: Net foreign direct investment | 4.2 | 4.5 | 2.2 | 4.2 | 5.7 | 5.6 | 5.6 | 5.5 | 5.5 |
| Portfolio investment, net | -3.7 | -2.5 | -4.1 | -1.6 | -0.9 | 0.8 | -0.2 | -0.9 | -1.2 |
| Errors and Omissions | 4.7 | 3.2 | 4.9 | 4.4 | 3.3 | 2.4 | 2.0 | 1.8 | 1.6 |
| Savings-investment balances (percent of GDP) | | | | | | | | | |
| National savings | 13.7 | 14.7 | 12.7 | 13.9 | 14.2 | 14.8 | 15.3 | 16.0 | 16.3 |
| Investment | 29.2 | 27.5 | 25.8 | 25.9 | 27.0 | 27.3 | 27.4 | 27.8 | 27.8 |
| Current account, excl. official transfers | -15.4 | -12.8 | -13.0 | -12.0 | -12.8 | -12.5 | -12.1 | -11.8 | -11.5 |
| Non-performing loans (percent of total loans) 5/ | 7.5 | 8.7 | 8.3 | 6.8 | … | … | … | … | … |
| Bank credit to the private sector (percent change) | 4.5 | 2.7 | 5.4 | 8.0 | 8.7 | 9.3 | 11.1 | 11.4 | 11.9 |
| Deposits of the private sector (percent change) | 10.9 | 8.0 | 4.0 | 5.5 | 5.9 | 7.7 | 8.3 | 8.5 | 8.3 |
| Regulatory capital/risk weighted assets 5/ | 14.4 | 16.8 | 17.8 | 18.5 | … | … | … | … | … |
| *Memorandum items* | | | | | | | | | |
| Total public debt (percent of GDP) | 15.9 | 16.2 | 16.7 | 19.6 | 23.0 | 24.0 | 22.0 | 22.9 | 23.5 |
| Of which: Debt of the former Yugoslavia 6/ | 7.6 | 7.0 | 6.3 | 5.9 | 5.3 | 4.6 | 4.0 | 3.4 | 2.9 |
| GDP (millions of euros) | 5059 | 5327 | 5568 | 5745 | 5994 | 6330 | 6722 | 7149 | 7590 |
| GDP per capita (euros) | 2799 | 2935 | 3023 | 3126 | 3213 | 3343 | 3497 | 3665 | 3833 |
| GNDI per capita (euros) | 3323 | 3488 | 3559 | 3704 | 3809 | 3970 | 4153 | 4356 | 4556 |
| Population (thousands) 7/ | 1807 | 1815 | 1842 | 1838 | 1866 | 1894 | 1922 | 1951 | 1980 |

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

1/ 2015 as of September.

2/ Due to a reclassification of the data, the relative shares of 'Pensions and social assistance' and 'Other transfers and subsidies' changed from 2014 onwards. This reclassification did not impact the total amount of 'Subsidies and transfers'.

3/ Based on information on new donor projects up to this point. New projects may be identified in the future. Includes capital spending related to these new donor projects by publicly-owned corporations via on-lending from the general government.

4/ Total foreign assistance excluding capital transfers.

5/ As of September 2015.

6/ Based on the latest data submitted by the National Bank of Serbia, staff have revised down the estimate of the value of the Kosovo portion of ex-Yugoslavia debt as computed by Serbia. Kosovo neither recognizes nor services nor tracks this debt.

7/ Series updated according to Kosovo Agency of Statistics (2013), Pristina, Kosovo.

## Table 2. Kosovo: Consolidated Government Budget, 2012–20 1/

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

| | 2012 | 2013 | 2014 | 2015 | | 2016 | | 2017 | 2018 | 2019 | 2020 |
|---|---|---|---|---|---|---|---|---|---|---|---|
| | | | | Projections | | | | | | | |
| | | | | Program Approval | First Review | Program Approval | First Review | | | | |
| Total primary revenue and grants | 1,322 | 1,313 | 1,334 | 1,503 | 1,491 | 1,581 | 1,584 | 1,654 | 1,758 | 1,866 | 1,977 |
| Total primary revenue | 1,284 | 1,313 | 1,333 | 1,503 | 1,491 | 1,581 | 1,583 | 1,654 | 1,758 | 1,866 | 1,977 |
| Taxes | 1,112 | 1,121 | 1,162 | 1,280 | 1,277 | 1,367 | 1,370 | 1,432 | 1,518 | 1,613 | 1,710 |
| Direct taxes | 170 | 174 | 188 | 222 | 219 | 234 | 245 | 242 | 257 | 274 | 290 |
| Indirect taxes | 975 | 985 | 1,007 | 1,098 | 1,098 | 1,175 | 1,168 | 1,233 | 1,308 | 1,390 | 1,474 |
| Of which: VAT | 549 | 560 | 560 | 606 | 606 | 667 | 651 | 687 | 730 | 776 | 824 |
| Tax refunds | -33 | -37 | -33 | -39 | -39 | -41 | -43 | -44 | -48 | -51 | -54 |
| Nontax revenues | 172 | 192 | 171 | 223 | 213 | 214 | 213 | 222 | 240 | 253 | 267 |
| Of which: Dividends | 45 | 43 | 15 | 30 | 21 | 30 | 26 | 30 | 30 | 30 | 30 |
| Grants | 37 | 0 | 1 | 0 | 0 | 0 | 1 | 0 | 0 | 0 | 0 |
| Budget support | 37 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 |
| Project grants | 0 | 0 | 1 | 0 | 0 | 0 | 1 | 0 | 0 | 0 | 0 |
| Primary expenditure | 1,441 | 1,468 | 1,464 | 1,634 | 1,591 | 1,757 | 1,709 | 1,773 | 1,888 | 2,002 | 2,113 |
| *Of which*: | | | | | | | | | | | |
| PAK-related expenditures | 6 | 7 | 5 | 10 | 10 | 11 | 10 | 11 | 12 | 13 | 14 |
| Current expenditure | 888 | 950 | 1,059 | 1,187 | 1,169 | 1,226 | 1,220 | 1,263 | 1,344 | 1,429 | 1,517 |
| Wages and salaries | 408 | 417 | 485 | 535 | 529 | 541 | 548 | 567 | 602 | 641 | 680 |
| Goods and services | 191 | 216 | 206 | 211 | 209 | 212 | 209 | 214 | 231 | 245 | 260 |
| Subsidies and transfers 2/ | 289 | 318 | 368 | 436 | 428 | 468 | 459 | 477 | 506 | 538 | 571 |
| Pension and social assistance | 198 | 225 | 347 | 305 | 400 | 328 | 440 | 457 | 485 | 516 | 548 |
| Other transfers and subsidies 3/ | 91 | 93 | 21 | 131 | 29 | 140 | 19 | 20 | 21 | 22 | 24 |
| Reserve | 0 | 0 | 0 | 5 | 3 | 5 | 5 | 5 | 5 | 5 | 5 |
| Capital expenditure and net lending | 553 | 518 | 404 | 447 | 422 | 530 | 488 | 510 | 544 | 573 | 596 |
| Capital expenditure | 541 | 524 | 404 | 448 | 423 | 538 | 496 | 521 | 559 | 573 | 596 |
| R7 | 281 | 215 | 38 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 |
| R6 | 0 | 0 | 56 | 110 | 110 | 110 | 110 | 165 | 219 | 0 | 0 |
| Expropriation | 0 | 0 | 21 | 30 | 30 | 30 | 30 | 30 | 27 | 0 | 0 |
| Other capital spending | 260 | 309 | 289 | 308 | 283 | 398 | 356 | 326 | 313 | 573 | 596 |
| Donor-financed new projects 4/ | | | | 0 | 0 | 90 | 42 | 40 | 49 | 30 | 20 |
| Net lending | 12 | -6 | 0 | -2 | -2 | -8 | -8 | -10 | -14 | 0 | 0 |
| Primary balance | -119 | -156 | -129 | -130 | -100 | -175 | -125 | -119 | -131 | -136 | -135 |
| Primary balance net of PAK | -113 | -149 | -124 | -120 | -90 | -164 | -115 | -108 | -119 | -123 | -122 |
| Interest income, net | -10 | -11 | -13 | -17 | -16 | -24 | -26 | -28 | -36 | -36 | -44 |
| Overall balance ex-PAK and ex-new donor-financed projects | -123 | -160 | -137 | -137 | -106 | -98 | -98 | -95 | -106 | -129 | -146 |
| Overall balance excluding PAK 4/ | -123 | -160 | -137 | -137 | -106 | -188 | -150 | -142 | -164 | -169 | -170 |
| of which new donor-financed projects via onlending | 0 | 0 | 0 | 0 | 0 | 0 | 9 | 6 | 10 | 10 | 5 |
| Financing | 186 | 168 | 136 | 137 | 106 | 188 | 150 | 142 | 164 | 169 | 170 |
| Foreign financing | 83 | -8 | -18 | 56 | 46 | 173 | 141 | 34 | 73 | 58 | 25 |
| Drawings, incl. official financing | 94 | 6 | 4 | 12 | 5 | 44 | 51 | 25 | 33 | 83 | 105 |
| Amortization | -11 | -14 | -22 | -25 | -28 | -60 | -61 | -53 | -19 | -66 | -105 |
| Donor financing for new projects 5/ | | | | 0 | 0 | 90 | 51 | 47 | 59 | 40 | 25 |
| IMF financing | | | | 69 | 69 | 99 | 99 | 16 | 0 | 0 | 0 |
| Domestic financing | 103 | 118 | 97 | 150 | 142 | 114 | 108 | 124 | 108 | 130 | 151 |
| Domestic borrowing (net) | 73 | 78 | 104 | 120 | 112 | 114 | 108 | 124 | -92 | 130 | 151 |
| Privatization revenues | 45 | 26 | 0 | 30 | 30 | 0 | 0 | 0 | 200 | 0 | 0 |
| Own-source revenue (- = increase) | -15 | 14 | -7 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 |
| Accumulation of Assets (- = increase) | -56 | 57 | 58 | -69 | -83 | -99 | -99 | -16 | -17 | -19 | -5 |
| Memorandum items: | | | | | | | | | | | |
| Bank balance of the general government | 216 | 159 | 101 | 171 | 184 | 269 | 283 | 299 | 316 | 335 | 340 |
| *Of which:* ELA | 0 | 46 | 46 | 46 | 46 | 46 | 46 | 46 | 46 | 46 | 46 |
| Total public debt | 805 | 864 | 931 | 1,240 | 1,124 | 1,555 | 1,377 | 1,521 | 1,477 | 1,638 | 1,785 |
| *Of which:* Debt of the former Yugoslavia 6/ | 384 | 371 | 351 | 442 | 337 | 442 | 316 | 294 | 271 | 246 | 219 |

1/ Does not yet reflect the GFSM 2001 methodology.

2/ Due to a reclassification of the data, the relative shares of 'Pensions and social assistance' and 'Other transfers and subsidies' changed from 2014 onwards. This reclassification did not impact the total amount of 'Subsidies and transfers'. This reclassification also explains large differences between program approval and first review figures.

3/ Including capital transfers to public enterprises.

4/ Based on information on new donor projects up to this point. New projects may be identified in the future. Includes capital spending related to these new donor projects by publicly-owned corporations via on-lending from the general government.

5/ Including by publicly-owned enterprises via on-lending from the general government.

6/ Based on the latest data submitted by the National Bank of Serbia, staff have revised down the estimate of the value of the Kosovo portion of ex-Yugoslavia debt as computed by Serbia. Kosovo neither recognizes nor services nor tracks this debt.

## Table 3. Kosovo: Consolidated Government Budget, 2012–20 1/

(Excluding donor-designated grants; percent of GDP)

| | 2012 | 2013 | 2014 | 2015 | | 2016 | | 2017 | 2018 | 2019 | 2020 |
|---|---|---|---|---|---|---|---|---|---|---|---|
| | | | | Projections | | | | | | | |
| | | | | Program Approval | First Review | Program Approval | First Review | | | | |
| Total primary revenue and grants | 26.1 | 24.6 | 24.0 | 26.4 | 26.0 | 26.4 | 26.4 | 26.1 | 26.1 | 26.1 | 26.1 |
| Total primary revenue | 25.4 | 24.6 | 23.9 | 26.4 | 25.9 | 26.4 | 26.4 | 26.1 | 26.1 | 26.1 | 26.1 |
| Taxes | 22.0 | 21.0 | 20.9 | 22.5 | 22.2 | 22.8 | 22.9 | 22.6 | 22.6 | 22.6 | 22.5 |
| Direct taxes | 3.4 | 3.3 | 3.4 | 3.9 | 3.8 | 3.9 | 4.1 | 3.8 | 3.8 | 3.8 | 3.8 |
| Indirect taxes | 19.3 | 18.5 | 18.1 | 19.3 | 19.1 | 19.6 | 19.5 | 19.5 | 19.5 | 19.4 | 19.4 |
| Tax refunds | -0.7 | -0.7 | -0.6 | -0.7 | -0.7 | -0.7 | -0.7 | -0.7 | -0.7 | -0.7 | -0.7 |
| Nontax revenues | 3.4 | 3.6 | 3.1 | 3.9 | 3.7 | 3.6 | 3.6 | 3.5 | 3.6 | 3.5 | 3.5 |
| *Of which*: | | | | | | | | | | | |
| Dividends | 0.9 | 0.8 | 0.3 | 0.5 | 0.4 | 0.5 | 0.4 | 0.5 | 0.4 | 0.4 | 0.4 |
| Grants | 0.7 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 |
| Budget support | 0.7 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 |
| Project grants | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 |
| Primary expenditure | 28.5 | 27.6 | 26.3 | 28.7 | 27.7 | 29.3 | 28.5 | 28.0 | 28.1 | 28.0 | 27.8 |
| *Of which*: | | | | | | | | | | | |
| PAK-related expenditures | 0.1 | 0.1 | 0.1 | 0.2 | 0.2 | 0.2 | 0.2 | 0.2 | 0.2 | 0.2 | 0.2 |
| Primary expenditure excluding PAK | ... | ... | ... | ... | ... | ... | ... | ... | ... | ... | ... |
| Current expenditure | 17.5 | 17.8 | 19.0 | 20.8 | 20.4 | 20.5 | 20.4 | 20.0 | 20.0 | 20.0 | 20.0 |
| Current expenditure excluding PAK | 17.4 | 17.7 | 18.9 | 20.7 | 20.2 | 20.3 | 20.2 | 19.8 | 19.8 | 19.8 | 19.8 |
| Wages and salaries | 8.1 | 7.8 | 8.7 | 9.4 | 9.2 | 9.0 | 9.1 | 9.0 | 9.0 | 9.0 | 9.0 |
| Goods and services | 3.8 | 4.0 | 3.7 | 3.7 | 3.6 | 3.5 | 3.5 | 3.4 | 3.4 | 3.4 | 3.4 |
| Subsidies and transfers 2/ | 5.7 | 6.0 | 6.6 | 7.7 | 7.5 | 7.8 | 7.7 | 7.5 | 7.5 | 7.5 | 7.5 |
| Pension and social assistance | 3.9 | 4.2 | 6.2 | 5.4 | 7.0 | 5.5 | 7.3 | 7.2 | 7.2 | 7.2 | 7.2 |
| Reserve | 10.7 | 0.0 | 0.0 | 0.1 | 0.1 | 0.1 | 0.1 | 0.1 | 0.1 | 0.1 | 0.1 |
| Capital expenditure and net lending | 10.7 | 9.7 | 7.3 | 7.8 | 7.3 | 8.9 | 8.1 | 8.1 | 8.1 | 8.0 | 7.9 |
| Capital expenditure | 10.7 | 9.8 | 7.3 | 7.9 | 7.4 | 9.0 | 8.3 | 8.2 | 8.3 | 8.0 | 7.9 |
| R7 | 5.6 | 4.0 | 0.7 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 |
| R6 | 0.0 | 0.0 | 1.0 | 1.9 | 1.9 | 1.8 | 1.8 | 2.6 | 3.3 | 0.0 | 0.0 |
| Expropriations | 0.0 | 0.0 | 0.4 | 0.5 | 0.5 | 0.5 | 0.5 | 0.5 | 0.4 | 0.0 | 0.0 |
| Other capital spending | 5.1 | 5.8 | 5.2 | 5.4 | 4.9 | 6.6 | 5.9 | 5.1 | 4.7 | 8.0 | 7.9 |
| Donor-financed new projects 3/ | | | | 0.0 | 0.0 | 1.5 | 0.7 | 0.6 | 0.7 | 0.4 | 0.3 |
| Net lending | 0.2 | -0.1 | 0.0 | 0.0 | 0.0 | -0.1 | -0.1 | -0.2 | -0.2 | 0.0 | 0.0 |
| Primary balance | -2.4 | -2.9 | -2.3 | -2.3 | -1.7 | -2.9 | -2.1 | -1.9 | -1.9 | -1.9 | -1.8 |
| Primary balance net of PAK | -2.2 | -2.8 | -2.2 | -2.1 | -1.6 | -2.7 | -1.9 | -1.7 | -1.8 | -1.7 | -1.6 |
| Interest income, net | -0.2 | -0.2 | -0.2 | -0.3 | -0.3 | -0.4 | -0.4 | -0.4 | -0.5 | -0.5 | -0.6 |
| Overall balance ex-PAK and ex-new donor-financed projects | -2.4 | -3.0 | -2.5 | -2.4 | -1.8 | -1.6 | -1.6 | -1.5 | -1.6 | -1.8 | -1.9 |
| Overall balance excluding PAK 3/ | -2.4 | -3.0 | -2.5 | -2.4 | -1.8 | -3.1 | -2.5 | -2.2 | -2.4 | -2.4 | -2.2 |
| of which new donor-financed projects via onlending | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.2 | 0.1 | 0.1 | 0.0 | 0.1 |
| Financing | 3.7 | 3.2 | 2.4 | 2.4 | 1.8 | 3.1 | 2.5 | 2.2 | 2.4 | 2.4 | 2.2 |
| Foreign financing | 1.6 | -0.1 | -0.3 | 1.0 | 0.8 | 2.9 | 2.3 | 0.5 | 1.1 | 0.8 | 0.3 |
| Drawings, incl. official financing | 1.9 | 0.1 | 0.1 | 0.2 | 0.1 | 0.7 | 0.8 | 0.4 | 0.5 | 1.2 | 1.4 |
| Amortization | -0.2 | -0.3 | -0.4 | -0.4 | -0.5 | -1.0 | -1.0 | -0.8 | -0.3 | -0.9 | -1.4 |
| Donor financing for new projects 4/ | | | | 0.0 | 0.0 | 1.5 | 0.9 | 0.7 | 0.9 | 1.8 | 0.3 |
| IMF financing | | | | 1.2 | 1.2 | 1.6 | 1.7 | 0.2 | 0.0 | 0.0 | 0.0 |
| Domestic financing | 2.0 | 2.2 | 1.7 | 2.6 | 2.5 | 1.9 | 1.8 | 2.0 | 1.6 | 1.8 | 2.0 |
| Domestic borrowing (net) | 1.4 | 1.5 | 1.9 | 2.1 | 1.9 | 1.9 | 1.8 | 2.0 | -1.4 | 1.8 | 2.0 |
| Privatization revenues | 0.9 | 0.5 | 0.0 | 0.5 | 0.5 | 0.0 | 0.0 | 0.0 | 3.0 | 0.0 | 0.0 |
| Own-source revenue (- = increase) | -0.3 | 0.3 | -0.1 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 |
| Accumulation of Assets (- = increase) | -1.1 | 1.1 | 1.0 | -1.2 | -1.4 | -1.6 | -1.7 | -0.2 | -0.2 | -0.3 | -0.1 |
| Memorandum items: | | | | | | | | | | | |
| Bank balance of the general government | 4.3 | 3.0 | 1.8 | 3.0 | 3.2 | 4.5 | 4.7 | 4.7 | 4.7 | 4.7 | 4.5 |
| *Of which:* ELA | 0.0 | 0.9 | 0.8 | 0.8 | 0.8 | 0.8 | 0.8 | 0.7 | 0.7 | 0.6 | 0.6 |
| Total public debt | 15.9 | 16.2 | 16.7 | 21.8 | 19.6 | 26.0 | 23.0 | 24.0 | 22.0 | 22.9 | 23.5 |
| *Of which:* Debt of the former Yugoslavia 5/ | 7.6 | 7.0 | 6.3 | 7.8 | 5.9 | 7.4 | 5.3 | 4.6 | 4.0 | 3.4 | 2.9 |
| Nominal GDP (millions of euros) | 5,059 | 5,327 | 5,568 | 5,693 | 5,745 | 5,988 | 5,994 | 6,330 | 6,722 | 7,149 | 7,590 |

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

1/ Does not yet reflect the GFSM 2001 methodology.

2/ Due to a reclassification of the data, the relative shares of 'Pensions and social assistance' and 'Other transfers and subsidies' changed from 2014 onwards. This reclassification did not impact the total amount of 'Subsidies and transfers'. This reclassification also explains large differences between program approval and first review figures.

3/ Based on information on new donor projects up to this point. New projects may be identified in the future. Includes capital spending related to these new donor projects by publicly-owned corporations via on-lending from the general government.

4/ Including by publicly-owned enterprises via on-lending from the general government.

5/ Based on the latest data submitted by the National Bank of Serbia, staff have revised down the estimate of the value of the Kosovo portion of ex-Yugoslavia debt as computed by Serbia. Kosovo neither recognizes nor services nor tracks this debt.

## Table 4. Kosovo: Balance of Payments, 2012–20

(Millions of euros, unless otherwise indicated)

| | 2012 | 2013 | 2014 | 2015 | | 2016 | | 2017 | 2018 | 2019 | 2020 |
|---|---|---|---|---|---|---|---|---|---|---|---|
| | | | | Projections | | | | | | | |
| | | | | Program Approval | First Review | Program Approval | First Review | | | | |
| Goods and services balance | -1,728 | -1,684 | -1,714 | -1,787 | -1,752 | -1,970 | -1,877 | -1,976 | -2,074 | -2,191 | -2,304 |
| Goods | -2,073 | -1,992 | -2,052 | -2,167 | -2,169 | -2,380 | -2,323 | -2,483 | -2,646 | -2,832 | -3,004 |
| Exports | 287 | 305 | 321 | 327 | 350 | 361 | 381 | 418 | 457 | 502 | 568 |
| Imports | -2,360 | -2,297 | -2,372 | -2,494 | -2,519 | -2,741 | -2,704 | -2,902 | -3,103 | -3,333 | -3,572 |
| Services | 345 | 308 | 337 | 380 | 416 | 410 | 446 | 508 | 572 | 641 | 700 |
| Receipts | 637 | 622 | 756 | 792 | 831 | 843 | 875 | 953 | 1,033 | 1,119 | 1,189 |
| Payments | -292 | -314 | -419 | -412 | -414 | -432 | -429 | -445 | -461 | -479 | -489 |
| Income | 154 | 122 | 108 | 120 | 123 | 127 | 123 | 128 | 131 | 135 | 138 |
| Compensation of employees (net) | 214 | 219 | 200 | 208 | 208 | 217 | 213 | 217 | 221 | 226 | 226 |
| Investment income | -60 | -97 | -92 | -88 | -85 | -89 | -89 | -88 | -90 | -90 | -87 |
| Interest payments on public debt | -8 | -9 | -10 | -16 | -11 | -17 | -17 | -16 | -17 | -19 | -21 |
| Transfers | 1,194 | 1,222 | 1,168 | 1,215 | 1,216 | 1,227 | 1,220 | 1,297 | 1,362 | 1,438 | 1,536 |
| Official transfers | 402 | 342 | 288 | 277 | 277 | 231 | 231 | 239 | 233 | 225 | 243 |
| Other transfers (net) | 793 | 880 | 880 | 938 | 939 | 995 | 989 | 1,058 | 1,130 | 1,213 | 1,293 |
| Workers' remittances (net) | 519 | 552 | 625 | 655 | 657 | 692 | 694 | 751 | 799 | 850 | 907 |
| Inflows of remittances | 605 | 621 | 694 | 717 | 718 | 753 | 754 | 784 | 840 | 889 | 939 |
| Other (net) | 274 | 328 | 255 | 282 | 282 | 303 | 295 | 308 | 331 | 362 | 387 |
| Current account | -380 | -339 | -438 | -452 | -412 | -616 | -534 | -550 | -580 | -618 | -630 |
| Capital and financial account | 140 | 167 | 164 | 180 | 159 | 397 | 333 | 397 | 446 | 492 | 511 |
| Capital account | 13 | 35 | 21 | 2 | 2 | 2 | 2 | 2 | 2 | 2 | 3 |
| Financial account, incl. CBK | 127 | 133 | 143 | 178 | 157 | 395 | 331 | 395 | 444 | 490 | 508 |
| Foreign direct investment, net | 213 | 241 | 124 | 240 | 241 | 340 | 340 | 355 | 373 | 393 | 417 |
| Commercial banks, excl. FDI | 102 | -47 | 75 | -3 | -3 | 26 | 26 | 124 | 58 | 82 | 60 |
| General government | 83 | -9 | -17 | 56 | 47 | 173 | 131 | 28 | 63 | 48 | 21 |
| Drawings | 94 | 3 | 5 | 81 | 74 | 233 | 192 | 81 | 82 | 113 | 125 |
| Repayments | -11 | -11 | -22 | -25 | -28 | -60 | -61 | -53 | -19 | -66 | -105 |
| Other | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 |
| Other sectors, excl. FDI 1/ | -33 | 90 | -281 | -69 | -71 | -82 | -106 | -50 | 28 | 67 | 90 |
| Central Bank of Kosovo | -237 | -142 | 242 | -45 | -58 | -62 | -60 | -62 | -78 | -100 | -80 |
| Reserve assets (- = accumulation) | -267 | 21 | 57 | -20 | -32 | -68 | -66 | -67 | -82 | -105 | -85 |
| Government balances (program definition) | -56 | 57 | 58 | -69 | -83 | -99 | -99 | -16 | -17 | -17 | -5 |
| Program financing (- = increase) 2/ | 0 | 0 | 0 | -69 | -69 | -99 | -99 | -16 | 0 | 0 | 0 |
| Other reserve assets, incl. SDRs | -211 | -36 | -1 | 49 | 50 | 31 | 34 | -52 | -65 | -88 | -80 |
| Non-reserves assets | 30 | -163 | 185 | -25 | -25 | 5 | 6 | 5 | 4 | 5 | 5 |
| Liabilities 3/ | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 |
| Net errors and omissions 4/ | 239 | 171 | 274 | 272 | 254 | 219 | 201 | 153 | 134 | 125 | 119 |
| Overall balance | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 |
| | | | | | (In percent of GDP) | | | | | | |
| Goods and services balance | -34.2 | -31.6 | -30.8 | -31.4 | -30.5 | -32.9 | -31.3 | -31.2 | -30.8 | -30.6 | -30.4 |
| Exports | 18.3 | 17.4 | 19.3 | 19.7 | 20.6 | 20.1 | 20.9 | 21.7 | 22.2 | 22.7 | 23.1 |
| Imports | -52.4 | -49.0 | -50.1 | -51.0 | -51.1 | -53.0 | -52.3 | -52.9 | -53.0 | -53.3 | -53.5 |
| Workers' remittances (net) | 10.3 | 10.4 | 11.2 | 11.5 | 11.4 | 11.6 | 11.6 | 11.9 | 11.9 | 11.9 | 11.9 |
| Current account, excl. official transfers | -15.4 | -12.8 | -13.0 | -12.8 | -12.0 | -14.1 | -12.8 | -12.5 | -12.1 | -11.8 | -11.5 |
| Current account, incl. official transfers | -7.5 | -6.4 | -7.9 | -7.9 | -7.2 | -10.3 | -8.9 | -8.7 | -8.6 | -8.6 | -8.3 |
| Capital and financial account | 2.8 | 3.1 | 3.0 | 3.2 | 2.8 | 6.6 | 5.6 | 6.3 | 6.6 | 6.9 | 6.7 |
| Foreign direct investment, net | 4.2 | 4.5 | 2.2 | 4.2 | 4.2 | 5.7 | 5.7 | 5.6 | 5.6 | 5.5 | 5.5 |
| Other sectors, excl. FDI 1/ | -0.7 | 1.7 | -5.1 | -1.2 | -1.2 | -1.4 | -1.8 | -0.8 | 0.4 | 0.9 | 1.2 |
| Net errors and omissions 4/ | 4.7 | 3.2 | 4.9 | 4.8 | 4.4 | 3.7 | 3.3 | 2.4 | 2.0 | 1.8 | 1.6 |
| Overall balance | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 |
| **Memorandum items:** | | | | | | | | | | | |
| Debt service to export ratio (percent) | 2.1 | 2.2 | 3.0 | 3.6 | 3.3 | 6.4 | 6.1 | 5.0 | 2.4 | 5.3 | 7.2 |
| Debt service to exports and remittances (percent) | 1.3 | 1.3 | 1.8 | 2.2 | 2.0 | 3.9 | 3.8 | 3.2 | 1.6 | 3.4 | 4.7 |
| External debt (percent of GDP) | 14.5 | 13.4 | 12.1 | 15.2 | 13.2 | 17.8 | 15.1 | 14.6 | 14.4 | 14.0 | 13.1 |
| *Of which:* Debt of the former Yugoslavia 5/ | 7.6 | 7.0 | 6.3 | 7.8 | 5.9 | 7.4 | 5.3 | 4.6 | 4.0 | 3.4 | 2.9 |
| Net foreign assets of CBK | 1,239 | 1,392 | 1,146 | 1,192 | 1,204 | 1,254 | 1,264 | 1,326 | 1,404 | 1,504 | 1,584 |
| Gross international reserves of the CBK 6/ | 841 | 800 | 747 | 820 | 780 | 888 | 845 | 913 | 994 | 1,099 | 1,184 |
| Gross international reserves in months of imports 6/ | 3.8 | 3.7 | 3.2 | 3.4 | 3.2 | 3.4 | 3.2 | 3.3 | 3.3 | 3.5 | 3.5 |

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

1/ Including trading companies, insurance companies, and pension funds.

2/ Includes only program financing under the 2015–17 SBA.

3/ Includes SDR allocations and IMF account at historical value.

4/ Projections of errors include unidentified private remittances and other capital based on average historical levels.

5/ Based on the latest data submitted by the National Bank of Serbia, staff have revised down the estimate of the value of the Kosovo portion of ex-Yugoslavia debt as computed by Serbia. Kosovo neither recognizes nor services nor tracks this debt.

6/ Includes only 25 percent of Kosovo's position at the Fund, rather than 100 percent assumed at the time of program approval.

## Table 5. Kosovo: Central Bank and Commercial Bank Survey, 2012–15

(Millions of euros, unless otherwise indicated)

| | 2012 | 2013 | 2014 | 2015 |
|---|---|---|---|---|
| | | | | Proj. |
| Central Bank | | | | |
| Net foreign assets | 1,239 | 1,392 | 1,146 | 1,204 |
| Foreign assets | 1,469 | 1,610 | 1,368 | 1,426 |
| *Of which:* Securities | 286 | 561 | 121 | 141 |
| Deposits | 1,034 | 896 | 1,085 | 1,123 |
| Foreign liabilities | 230 | 218 | 222 | 222 |
| Net domestic assets | -1,239 | -1,392 | -1,146 | -1,170 |
| Net claims on commercial banks | -302 | -333 | -316 | -260 |
| Claims on commercial banks | 0 | 0 | 0 | 0 |
| Liabilities to commercial banks | -302 | -333 | -316 | -260 |
| Net claims on the central government | -838 | -773 | -730 | -821 |
| Claims on central government | 0 | 0 | 0 | 0 |
| Liabilities to central government | -838 | -773 | -730 | -821 |
| *Of which:* KTA (privatization) fund | -549 | -550 | -558 | -572 |
| *Of which*: Government balances (program definition) | -216 | -159 | -101 | -184 |
| Net claims on other sectors | -51 | -238 | -52 | -41 |
| Claims on other sectors | 1 | 1 | 0 | 11 |
| Liabilities to other sectors | -51 | -239 | -52 | -52 |
| Other items, net 1/ | -48 | -48 | -48 | -48 |
| Commercial banks | | | | |
| Net foreign assets | 491 | 573 | 534 | 538 |
| Assets | 634 | 748 | 716 | 716 |
| Liabilites | -143 | -175 | -182 | -178 |
| Net domestic assets | 2,025 | 2,145 | 2,320 | 2,505 |
| Claims on the CBK | 301 | 333 | 316 | 260 |
| Net claims on the central government | 59 | 99 | 187 | 280 |
| Claims on central government | 60 | 100 | 193 | 280 |
| Liabilities to central government | -1 | -1 | -5 | 0 |
| Net claims on other public entities | -74 | -73 | -65 | -67 |
| Claims on other public entities | 1 | 0 | 1 | 1 |
| Liabilities to other public entities | -76 | -73 | -65 | -67 |
| Credit to private sector | 1,740 | 1,786 | 1,881 | 2,032 |
| Deposits of the private sector | 2,116 | 2,286 | 2,378 | 2,508 |
| Demand deposits | 694 | 841 | 1,131 | 1,193 |
| Time deposits | 1,422 | 1,445 | 1,247 | 1,316 |
| Other items, net 1/ | 401 | 432 | 476 | 491 |
| Memorandum item: | | | | |
| Gross international reserves 2/ | 841 | 800 | 747 | 780 |
| Deposits of the private sector (12-month percent change) | 10.9 | 8.0 | 4.0 | 5.5 |
| Credit to the private sector (12-month percent change) | 4.5 | 2.7 | 5.4 | 8.0 |
| Deposits of the private sector (Percent of GDP) | 41.8 | 42.9 | 42.7 | 43.7 |
| Credit to the private sector (Percent of GDP) | 34.4 | 33.5 | 33.8 | 35.4 |

1/ Includes shares and other equity.

2/ Includes only 25 percent of Kosovo's position at the Fund, rather than 100 percent assumed at the time of program approval.

## Table 6. Kosovo: Selected Financial Soundness Indicators, 2010–15

| | 2010 | 2011 | 2012 | 2013 | 2014 | Sep-15 |
|---|---|---|---|---|---|---|
| Capital adequacy | | | | | | |
| Regulatory capital to risk-weighted assets 1/ | 18.8 | 17.6 | 14.2 | 16.7 | 17.8 | 18.5 |
| Tier 1 capital to risk-weighted assets 1/ | 15.8 | 14.8 | 11.6 | 12.8 | 14.6 | 16.0 |
| Capital to assets | 10.1 | 10.2 | 10.0 | 9.7 | 10.8 | 11.7 |
| Asset quality | | | | | | |
| NPL to total loans 2/ | 5.2 | 5.7 | 7.5 | 8.7 | 8.3 | 6.8 |
| NPL net of provisions to capital | 3.7 | 4.6 | 7.4 | 7.8 | 4.7 | 3.1 |
| Large exposures to capital | 72.4 | 77.8 | 80.4 | 107.4 | 97.1 | 67.7 |
| Sectoral breakdown of loans | | | | | | |
| Agriculture | 2.6 | 2.4 | 2.5 | 2.6 | 2.4 | 2.7 |
| Manufacturing | 11.0 | 10.1 | 9.5 | 9.7 | 10.0 | 10.6 |
| Trade | 37.1 | 37.8 | 37.8 | 36.9 | 35.8 | 35.9 |
| Other services | 12.0 | 11.7 | 11.6 | 12.4 | 12.8 | 12.4 |
| Construction | 7.5 | 7.0 | 7.2 | 6.6 | 6.0 | 4.9 |
| Households | 29.8 | 31.0 | 31.4 | 31.8 | 33.0 | 33.5 |
| Liquidity | | | | | | |
| Liquid assets to total assets 3/ | 37.5 | 32.6 | 34.3 | 37.8 | 38.3 | 37.3 |
| Deposits to loans | 126.1 | 117.6 | 122.6 | 130.8 | 129.4 | 129.3 |
| Liquid assets to short-term liabilities 4/ | 46.2 | 39.6 | 40.8 | 47.1 | 41.0 | 38.0 |
| Profitability | | | | | | |
| Return on average assets 5/ | 1.6 | 1.6 | 0.8 | 1.0 | 1.9 | 2.5 |
| Return on average equity 5/ | 16.9 | 16.9 | 8.3 | 10.8 | 20.2 | 24.1 |
| Interest margin to total income | 55.5 | 56.9 | 55.6 | 54.3 | 62.2 | 68.7 |
| Non-interest expense to total income 6/ | 16.6 | 18.0 | 23.9 | 22.2 | 12.9 | 4.9 |
| Interest margin to gross income 7/ | 74.4 | 75.2 | 74.7 | 73.1 | 76.1 | 76.6 |
| Non-interest expense to gross income 6/ 7/ | 76.6 | 77.3 | 87.8 | 84.5 | 66.8 | 53.0 |
| Market risk | | | | | | |
| Net open currency position to tier 1 capital | -0.1 | 2.5 | 0.7 | 2.3 | 1.8 | 0.9 |

Source: Central Bank of the Republic of Kosovo.

1/ As of December 2012, new capital adequacy rules include an additional requirement for operational risk, higher risk-weights for assets rated B- or less, and a deduction for related party loans.

2/ Loans classified as doubtful or loss.

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

4/ Short-term liabilities are deposits, short-term borrowing, and other liabilities (up to 1 year maturity).

5/ Profits are before taxes and extraordinary items.

6/ Non-interest expense including general and administrative costs.

7/ Gross income is net interest income plus non-interest income.

## Table 7. Kosovo: Indicators of Capacity to Repay the Fund, 2015–20

| | 2015 | 2016 | 2017 | 2018 | 2019 | 2020 |
|---|---|---|---|---|---|---|
| **Fund obligations based on prospective purchases (millions of SDR) 1/** | | | | | | |
| Principal | 0.0 | 0.0 | 0.0 | 0.0 | 24.0 | 56.7 |
| Charges and interest | 0.1 | 0.9 | 1.3 | 1.3 | 1.2 | 0.8 |
| **Fund obligations based on existing and prospective purchases (millions of SDR) 1/** | | | | | | |
| Principal | 0.0 | 39.1 | 33.2 | 3.5 | 38.0 | 67.2 |
| Charges and interest | 0.1 | 1.8 | 1.8 | 1.6 | 1.4 | 0.9 |
| **Total obligations based on existing and prospective purchases 1/** | | | | | | |
| SDR millions | 0.1 | 40.9 | 34.9 | 5.1 | 39.4 | 68.1 |
| Euro millions | 0.2 | 51.5 | 43.8 | 6.3 | 49.2 | 84.5 |
| Percent of exports of goods and services | 0.0 | 4.1 | 3.2 | 0.4 | 3.0 | 4.8 |
| Percent of exports of goods and services and remittances | 0.0 | 2.6 | 2.0 | 0.3 | 2.0 | 3.1 |
| Percent of debt service | 0.5 | 66.9 | 63.8 | 17.5 | 57.7 | 67.1 |
| Percent of GDP | 0.0 | 0.9 | 0.7 | 0.1 | 0.7 | 1.1 |
| Percent of government revenue | 0.0 | 3.3 | 2.7 | 0.4 | 2.6 | 4.3 |
| Percent of quota | 0.2 | 69.3 | 59.2 | 8.6 | 66.8 | 115.4 |
| **Outstanding Fund credit (based on existing and prospective drawings) 1/** | | | | | | |
| SDR millions | 128.5 | 168.5 | 147.5 | 144.0 | 106.0 | 38.8 |
| Euro millions | 161.8 | 212.3 | 185.2 | 180.1 | 132.3 | 48.1 |
| Percent of exports of goods and services | 13.7 | 16.9 | 13.5 | 12.1 | 8.2 | 2.7 |
| Percent of exports of goods and services and remittances | 8.5 | 10.6 | 8.6 | 7.7 | 5.3 | 1.8 |
| Percent of GDP | 2.8 | 3.5 | 2.9 | 2.7 | 1.9 | 0.6 |
| Percent of government revenue | 10.9 | 13.4 | 11.2 | 10.2 | 7.1 | 2.4 |
| Percent of quota | 217.7 | 285.7 | 250.0 | 244.0 | 179.6 | 65.7 |
| **Net use of Fund credit (millions of SDR) 1/** | 43.2 | 40.1 | -21.1 | -3.5 | -38.0 | -67.2 |
| Purchases | 56.2 | 79.2 | 12.1 | 0.0 | 0.0 | 0.0 |
| Repurchases | 13.0 | 39.1 | 33.2 | 3.5 | 38.0 | 67.2 |
| **Memorandum items:** | | | | | | |
| Exports of goods and services (millions of euros) | 1,181 | 1,255 | 1,371 | 1,490 | 1,621 | 1,756 |
| Exports of goods and services and remittances (millions of euros) | 1,899 | 2,010 | 2,155 | 2,330 | 2,511 | 2,695 |
| External debt service (millions of euros) | 38.7 | 77.0 | 68.7 | 36.3 | 85.2 | 125.8 |
| Nominal GDP (millions of euros) | 5,745 | 5,994 | 6,330 | 6,722 | 7,149 | 7,590 |
| Government revenue (millions of euros) | 1,491 | 1,583 | 1,652 | 1,758 | 1,866 | 1,977 |
| Quota (millions of SDR) | 59.0 | 59.0 | 59.0 | 59.0 | 59.0 | 59.0 |

Sources: IMF staff estimates and projections.

1/ Assumes prospective SBA disbursements in 2015–2017 (baseline scenario).

**Table 8a. Kosovo: Gross Financing Requirements, 2015–17**

(Millions of euros)

| | 2015 | 2016 | 2017 |
|---|---|---|---|
| Gross financing requirements | 440 | 594 | 603 |
| Current account deficit | 412 | 534 | 550 |
| Amortization of medium and long-term public debt | 28 | 61 | 53 |
| Sources of financing | 440 | 594 | 603 |
| Capital account (net) | 2 | 2 | 2 |
| Foreign direct investment (net) | 241 | 340 | 355 |
| Net bank financing | -3 | 26 | 124 |
| Government loans | 74 | 192 | 81 |
| IMF financing | 69 | 99 | 16 |
| Net foreign assets of the Central Bank of Kosovo | -58 | -60 | -62 |
| Other financing inc. net erros and omissions | 183 | 95 | 104 |
| Financing gap | 0 | 0 | 0 |
| *Memo items:* | | | |
| IMF financing in percent of quota | 139 | 134 | 21 |

Sources: IMF staff estimates and projections.

**Table 8b. Kosovo: Gross Financing Requirements, 2015–17**

(Percent of GDP)

| | 2015 | 2016 | 2017 |
|---|---|---|---|
| Gross financing requirements | 7.7 | 9.9 | 9.5 |
| Current account deficit | 7.2 | 8.9 | 8.7 |
| Amortization of medium and long-term public debt | 0.5 | 1.0 | 0.8 |
| Sources of financing | 8.7 | 10.9 | 10.5 |
| Capital account (net) | 0.0 | 0.0 | 0.0 |
| Foreign direct investment (net) | 4.2 | 5.7 | 5.6 |
| Net bank financing | -0.1 | 0.4 | 2.0 |
| Government loans | 1.3 | 3.2 | 1.3 |
| IMF financing | 1.8 | 1.7 | 0.2 |
| Net foreign assets of the Central Bank of Kosovo | -1.0 | -1.0 | -1.0 |
| Other financing inc. net erros and omissions | 3.2 | 1.6 | 1.6 |
| Financing gap | 0.0 | 0.0 | 0.0 |

Sources: IMF staff estimates and projections.

**Table 9. Kosovo: Schedule of Purchases Under the Stand-By Arrangement, 2015–17**

| Amount | Percent of Quota | Date Available | Conditions Necessary for Purchase |
|---|---|---|---|
| SDR 28.1 million | 48 | July 29, 2015 | Purchase made |
| SDR 28.1 million | 48 | November 1, 2015 | Observance of continuous and end-August 2015 performance criteria and completion of the first review |
| SDR 39.6 million | 67 | May 1, 2016 | Observance of continuous and end-December 2015 performance criteria and completion of the second review |
| SDR 39.6 million | 67 | November 1, 2016 | Observance of continuous and end-June 2016 performance criteria and completion of the third review |
| SDR 12.1 million | 21 | May 1, 2017 | Observance of continuous and end-December 2016 performance criteria and completion of the fourth review |

Total: SDR 147.5 million (250 percent of quota)

# Appendix I. 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/ | /s/ |
| **Mr. Avdullah Hoti** | **Mr. Bedri Hamza** |
| Minister of Finance | Governor |
| Ministry of Finance | Central Bank of the Republic of Kosovo |

# Attachment I. 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 (<u>structural benchmark, October 31, 2015</u>).

- *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 (<u>structural benchmark, October 31, 2015</u>).The risk-based supervision of the remaining banks is proceeding on schedule (<u>structural benchmark, March 15, 2016</u>).

- *We successfully issued the tender bids for centralized procurement of oil, air tickets and office supplies* (<u>structural benchmark, October 31, 2015</u>). 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 (<u>structural benchmark, October 31, 2016</u>).

- *With the support of Fund staff, the government adopted a public sector wage bill rule, well ahead of the original schedule* (<u>structural benchmark, March 15, 2016</u>). 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 (<u>structural benchmark, October 31, 2016</u>). 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 (<u>structural benchmark, October 31, 2016</u>).

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 (<u>structural benchmark for the second review</u>).

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-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**<br>1. Adoption by parliament of a 2016 budget in line with program targets as defined in paragraph 9 of this MEFP.<br>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 restrain** | | | |
| 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. | |

# Attachment II. 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**.

# REPUBLIC OF KOSOVO

January 12, 2016

## FIRST REVIEW UNDER THE STAND-BY ARRANGEMENT AND REQUESTS FOR MODIFICATION AND WAIVERS OF APPLICABILITY OF PERFORMANCE CRITERIA—SUPPLEMENTARY INFORMATION AND SUPPLEMENTARY LETTER OF INTENT

Approved By
**Thanos Arvanitis and Mary Goodman**

Prepared by the European Department

1. **This supplement provides information on the status of the prior actions for the review as well as on the authorities' request for a waiver of applicability for the end-December 2015 quantitative performance criteria (QPC)**. The thrust of the staff appraisal remains unchanged.

2. **Parliament has approved a 2016 budget in line with commitments under the program (one of the two prior actions for this review)**. The deficit target of €98 million (about 1.6 percent of GDP) excluding PAK is supported by an increase in excise taxes and appropriations for current spending, including for wages and salaries and subsidies and transfers, that are all consistent with commitments in the December 2, 2015 Letter of Intent.

3. **However, the second prior action related to the transfer by the Privatization Agency of Kosovo (PAK) to the government of a minimum of €5 million in tax obligations and a minimum of €30 million in privatization funds has not been met in full**.[1] In December, parliament appointed a board for PAK, which subsequently approved the transfer of €61 million in privatization funds to the government, more than double the amount required under the prior action. However, PAK now argues that it cannot transfer €5 million (0.1 percent of GDP) related to tax debts of companies in its portfolio. As the tax administration did not register the tax liens in the cadastre, PAK argues that it cannot be considered a secured (and hence

[1] The €30 million and the €5 million were specified separately in the prior action as both would count towards the bank balance target under the program, but only the latter would count towards the deficit target.

preferred) creditor. Therefore, the transfer will only be possible once the Special Chamber asserts that the funds are not subject to other creditor claims. Despite the authorities' considerable efforts to find a solution, resolution of this issue will require the liquidation process to take its course in the Special Chamber, which could take weeks or months.

**4. Despite this setback, staff support completion of the first review**. In particular: (i) the authorities have demonstrated genuine efforts to implement the prior action; (ii) program implementation has been strong and the end-December 2015 QPC appear to have been comfortably met (based on preliminary data) without the €5 million; and (iii) PAK has transferred almost double the amounts required under the prior action, albeit under a different composition.

**5. Separately, staff supports the authorities' request in their January 11, 2016 Supplementary Letter of Intent for a waiver of applicability for the end-December 2015 QPC**. Although preliminary December data are already available (and they show the QPC have been observed), the final data used for program verification purposes will not be available until February 5, 2016.

# 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

**Statement by Ibrahim Halil Canakci, Executive Director for Kosovo and Mentor Mehmedi, Advisor to the Executive Director January 15, 2016**

On behalf of the Kosovo authorities, we would like to thank staff for the excellent report on the first review under the Stand-By Arrangement (SBA) and for the constructive dialogue and valuable advice during the recent missions to Pristina. The authorities appreciate the quality of engagement with Fund staff, which has been tremendously beneficial, and express their appreciation to Fund management and the Executive Board for their continued support. The authorities broadly agree with staff's assessment outlined in the report.

In recent weeks, the opposition parties have managed to stall parliamentary activity to protest against two recently agreed international accords and have organized several demonstrations demanding the annulment of these two agreements. The government and the opposition parties are continuing their dialogue and the authorities are confident that the current political tensions will subside and an agreement on resolving the dispute in the parliament will be reached. With the current coalition enjoying a strong majority in the parliament, the authorities remain committed to address any potential risks to the program.

**Macroeconomic developments and outlook**

Kosovo's economy is performing well thanks to prudent macroeconomic policies. The authorities' cautious stance is reflected in the medium-term projections. Although 2014 GDP growth was revised down to 1.2 percent, largely reflecting the sharper-than-expected slowdown in public consumption and total investment, which were both driven by the long political stalemate following the 2014 June elections, economic growth for 2015 and 2016 is projected to be higher compared to the estimates at the time of the program approval.

The latest high-frequency indicators and data signal an accelerated pace of economic growth for 2015. Foreign direct investments (FDIs) increased by 114.2 percent y/y at the end of September, reversing the previous year's negative trend. During the same period, exports also surged by 5.6 percent y/y, remittances were strong and robust (increased by 12 percent), while credit growth to the private sector accelerated by 8.3 percent y/y at the end of October. While staff has revised upward their 2015 growth projection to 3.5 percent (from 3.2 percent previously), the authorities are more upbeat and expect GDP growth for 2015 to reach 3.8 percent. Supported by continued remittances, an increase in consumption, and a surge in public investment as a result of the ramping up of the construction of the highway which links Pristina to Skopje, and the new donor-financed capital projects which will commence this year, GDP growth in 2016 is projected to reach 4.2 percent.

Low energy and import prices (a key component of the CPI basket) have kept inflation low but the recent VAT increase should boost prices in the medium term. The authorities expect a deflation of 0.5 percent for 2015, and an inflation of 0.4 percent this year. The current account deficit (CAD) is expected to increase to around 9 percent of GDP in 2016, as the Brezovica resort project and new donor-financed investments will trigger an increase in imports. Nevertheless, the non-debt creating financing sources for the CAD, such as remittances, official transfers, and FDI, are stable. Over the medium term, the authorities expect that large investment projects and the implementation of structural reforms will lead to a surge in exports and an improvement in the trade and current account deficits.

**Program implementation**

The authorities are showing strong commitment to meet the program targets under the Fund-supported program and have achieved an over-performance on all the quantitative performance criteria (PCs). To this end, all end-August PCs and indicative targets were met with comfortable margins. The fiscal balance turnout at end-August was 2 percent of GDP higher than the PC, driven by a very strong tax performance, while the floor on the government bank balance was 1.5 percent of GDP higher than the program target. At the same time, the ceiling on current expenditures of the general government was met comfortably due to the authorities' efforts to streamline current spending and the strict monitoring of budgetary execution and employment in the public sector.

Strong ownership of the structural reforms is evident. All structural benchmarks (SBs) for the first review pertaining to the financial sector and public procurement were met. In addition, with the support of Fund staff, the parliament adopted a public sector wage bill rule, well ahead of the original schedule (structural benchmark, March 15, 2016).

The 2016 budget, a prior action, was adopted by the parliament in line with program targets and the objectives as defined in the Memorandum of Economic and Financial Policies. The parliament also approved the candidates for the Privatization Agency of Kosovo (PAK) whose Board subsequently approved the transfer of privatization funds from the PAK to the government (€61.3 million or around 1.1 percent of GDP), double the amount foreseen in the program (second prior action).

Regardless of the authorities' concerted efforts, the PAK was not able to transfer 0.1 percent of GDP in tax obligations to the government due to legal constraints and challenges. Although the PAK is an independent agency reporting to the parliament, the government is committed to find a quick resolution to this issue so that the transfer of the tax obligations from the PAK to the Tax Administration of Kosovo takes place.

We would like to reiterate that while the non transfer of the tax obligations is unfortunate, the authorities' genuine efforts in solving this issue and the fact that this amount, based on the preliminary data, is not expected to be needed to meet any fiscal targets (for end-December) should not obscure the otherwise strong program performance and implementation. We thank staff and management for their understanding on this issue and for subsequently moving forward with the review.

**Fiscal policy**

The authorities have met their fiscal objectives for 2015 and the fiscal adjustment envisioned under the program is proceeding better than planned. The increases in excise taxes on alcohol and tobacco in April and July and the new VAT law, which came into effect in September (which also incorporates a rate increase from 16 percent to 18 percent), coupled with other measures adopted in the context of the 2015 supplementary budget, have delivered revenues in line with the authorities' projections. Based on the preliminary data (final data for program purposes will be available at the beginning of February), at the end of December, tax revenues were over 9 percent higher compared to the same period of last year. At the same time, the authorities have mobilized non-tax revenues. The sale of new telecommunication licenses has been finalized and generated 0.3 percent in revenue proceeds while the PAK Board has transferred to the government 1.1 percent of GDP in privatization funds. Additionally, in light of the strict monitoring of execution, great progress has been achieved in rationalizing current spending which we expect to be lower at end-December relative to the revised mid-year budget review and staff report.

Against the backdrop of a strong-fiscal consolidation path, underpinned by measures on both the revenue and expenditure side, fiscal adjustment for 2015 should turn out better than programmed. Based on the preliminary data, the 2015 year-end fiscal deficit was below 2 percent of GDP, much lower than the 2.4 percent of GDP target at the time of program approval, and in line with the fiscal rule in place. Importantly, the fiscal buffers have also improved considerably and the government bank balances at the central bank, based on preliminary data, are expected to have reached over 3.5 percent of GDP by the end of 2015 (from 1.8 percent of GDP level in July), even without the IMF disbursement which was planned for end-December. The authorities are fully committed to attain the 1.6 percent of GDP deficit target in 2016. The 2016 budget, which is a prior action for the completion of the first review, was approved on December 21, entails fiscal consolidation measures in the amount of 0.5 percent of GDP, in addition to keeping public sector wages constant in nominal terms. In this context, the excise tax on tobacco has been increased while cuts in current spending and savings in pension schemes have been approved and legislated.

With the aim of tackling unproductive current spending, improving the budget structure, containing increases in the wage bill, and creating more space for growth-enhancing capital expenditures, the parliament has approved a public wage rule (a structural benchmark for the second review) which will guide the wage-setting process and link wage growth in the public sector to the overall productivity dynamics. The wage rule, which was developed in coordination with staff, will come into effect in 2018 and will cap increases in the overall wage bill (of both central and local governments) at nominal GDP growth with no exceptions. The rule-setting mechanism will improve competitiveness and ensure that Kosovo's wage bill to GDP ratio stays at reasonable levels.

In line with the program objectives and with the aim of providing financing for growth-enhancing capital projects, the authorities have modified the investment clause of the fiscal rule which allows for new donor-financed capital projects, in addition to privatization-financed projects, not to count as an excessive deficit against the fiscal rule. The amendment to the rule includes safeguards regarding the approval of the projects, vetting procedures, and debt sustainability. Given Kosovo's low level of public debt and high infrastructure needs, the new donor-financed projects, expected to be worth about 1 to 2 percent of GDP each year, will go towards high growth dividend projects in sectors such as infrastructure, agriculture and irrigation, information technology, and education.

The authorities have recently created the National Investment Committee in charge of preparing and prioritizing infrastructure projects and seeking financing from multilateral and bilateral institutions. At the same time, they remain committed to improving the quality of investment and ensuring that only projects with the highest economic and social benefits are implemented. In this context, Fund technical assistance has been requested on conducting a comprehensive assessment of Kosovo's public investment management institutions and practices.

**Financial sector**

Banks in Kosovo are well capitalized, liquid, and profitable. The system's capital adequacy ratio stands at 18.6 percent (end of October), among the highest in the region, while non-performing loans (NPLs) have been declining and are now at 6.8 percent (the lowest level since 2011), and are fully provisioned. Profitability is also very strong, with return on equity at 25.7 percent. The weighted interest rate on loans has dropped by around 50 percent in the last three years to 8.2 percent. Consequently, the interest rate spread has declined by 2 percentage points y/y to 7.3 percent.

Enhancing the financial safety net, further strengthening the banking system supervision and increasing access to finance remain at the core of financial sector policies. In this vein, the Central Bank of the Republic of Kosovo (CBK) has adopted a new regulation on emergency liquidity assistance (ELA). The new regulation on ELA (structural benchmark), which is the product of a fruitful collaboration with staff, is in line with international standards and governs the conditions, processes, and modalities of any emergency liquidity assistance provided to banks. The ELA regulation will not only bolster Kosovo's financial safety net but will also safeguard CBK resources.

At the same time, the CBK has made considerable progress towards a full rollout of risk-based supervision. The risk-based supervision manual for banks has been completed and approved by the CBK while the on-site examination of one bank has been finalized (structural benchmark). The CBK will fully adopt the risk-based supervision for all banks by mid-March.

While credit to households and nonfinancial corporations surged by 8.2 percent y/y at the end of October and interest rate spreads have decreased, the authorities acknowledge that credit penetration in the country remains at only around 35 percent of GDP and more efforts are required to leverage the high liquidity in the banking sector. Lengthy court proceedings, weak enforcement of contracts, and high collateral requirements are some of the binding constraints. The authorities appreciate the analysis of the recent Fund TA mission in Pristina which has identified the obstacles to more effective enforcement of civil and commercial courts claims. Going forward, the authorities' focus will be on improving the performance of the enforcement system, addressing the existing gaps in the Law on Enforcement Procedures, strengthening the private bailiffs system, and in promoting residential mortgage lending by banks.

The Kosovo authorities remain committed to working with staff to further develop the macroprudential policy framework, especially by supporting the CBK's Macroprudential Advisory Committee to enhance the policy toolkit available, and further strengthen the contingency planning and crisis management capacities.

We are glad to note that the recent Fund mission on safeguards assessment finds that the CBK has in place an effective system of controls and its vault operations are appropriate. The report also acknowledges that the CBK has implemented almost all the recommendations from the 2012 assessment. The CBK is working with staff to enhance the CBK's risk management system.

**Structural Reforms**

The implementation of the structural reform agenda is off to a very good start. The centralized procurement process has been launched with the issuing of centralized bids for three common goods (fuel, air plane tickets, and office supplies). Two other centralized tender bids (wood and coal) have been awarded and two others on heavy fuel and tires have been launched. The new law on procurement has been adopted by parliament, and the government will soon issue a decree making e-procurement mandatory for all central level agencies. In this context, a pilot project covering six agencies has been launched this month. All in all, these measures should enhance the oversight and control of the public procurement process, improve governance, ensure a level-playing field, and generate efficiency gains.

On the energy sector, the authorities are continuing with their efforts to address the long-standing issues such as consistent energy shortages, which are a byproduct of the existing old and unreliable power plants, and low production capacity. In collaboration with the World Bank, the tendering process for building a new thermo-power plant (500MW) is under way and an international consortium has been selected as a preferred bidder. The authorities expect the tendering process to be successfully completed by mid-this year and the construction to commence by the end of 2016. The construction of the new power plant, which will comply with the EU's Industrial Emissions Directive, could potentially create up to 10,000 temporary jobs during the construction phase and 500 permanent positions once the power plant begins operations.

Kosovo's business environment rates relatively well in the regional context and the recently published World Bank's Doing Business Report ranks Kosovo 66$^{th}$. While improvements have been made in facilitating starting a business and dealing with construction permits, the authorities acknowledge that further reforms are required in tackling the constraints in getting electricity, enforcing contracts, and resolving insolvency to attract FDI and boost investment.