July 2010
IMF Country Report No. 10/245

Republic of Kosovo: Request for Stand-By Arrangement

The following documents have been released and are included in this package:

- The staff report, prepared by a staff team of the IMF, following discussions that ended on **May 28, 2010**, with the officials of the Republic of Kosovo on economic developments and policies. Based on information available at the time of these discussions, the staff report was completed **on July 7, 2010**. The views expressed in the staff report are those of the staff team and do not necessarily reflect the views of the Executive Board of the IMF.
- A staff statement by the IMF Representative on the Republic of Kosovo
- A Press Release summarizing the views of the Executive Board as expressed during its July 21, 2010 discussion of the staff report for the Republic of Kosovo
- A statement by the Executive Director for the Republic of Kosovo

The document(s) listed below 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*
Technical Memorandum of Understanding*
*Also included in Staff Report

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

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International Monetary Fund
Washington, D.C.

INTERNATIONAL MONETARY FUND

REPUBLIC OF KOSOVO

Request for Stand-By Arrangement

Prepared by the European Department
(In consultation with other departments)

Approved by Adam Bennett and Jan Kees Martijn

July 7, 2010

Stand-By Arrangement. In the attached letter, the Kosovar authorities request an 18-month Stand-By Arrangement (SBA) for SDR 92.656 million (157 percent of quota). An initial purchase of SDR 18.760 million (32 percent of quota) would become available on approval of this request, and the remainder would be available subject to quarterly reviews. The key objective of the authorities' economic program is to lay the foundation for restoring fiscal sustainability and to safeguard financial stability. To achieve these objectives, the authorities intend to:

- Exercise restraint in current spending and raise revenues to contain the impact of their large capital investment program on the overall fiscal deficit;
- Secure substantial budget financing from privatization to preserve debt sustainability;
- Pursue reforms to broaden the tax base and strengthen public financial management;
- Bolster the government's bank balances with the Central Bank of the Republic of Kosovo (CBK) to provide scope for emergency liquidity assistance (ELA), if needed;
- Provide the CBK with a mandate for ELA, enhance its independence, and further strengthen the banking system; and
- Improve the financial position of the energy sector.

Discussions. During May 19–27, discussions were held with President Sejdiu, Prime Minister Thaçi, Minister of Economy and Finance Shala, CBK Governor Rexhepi, other cabinet members and senior officials, representatives of the World Bank, and the European Union.

Mission team. Messrs. Odenius (head), Castro, Munteanu (all EUR), Alper (FAD), and Tharkur (SPR). The mission was assisted by the resident representative, Mr. Ruggiero. The mission closely coordinated with World Bank staff on structural policy issues.

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Annexes

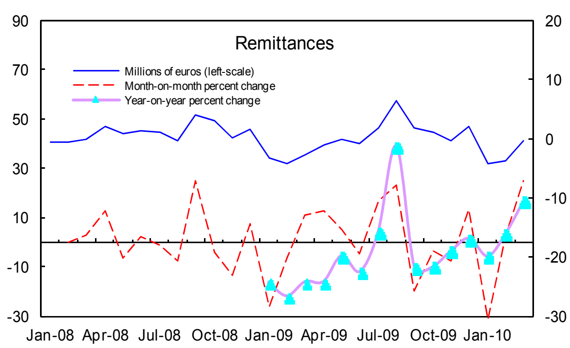
I. Background

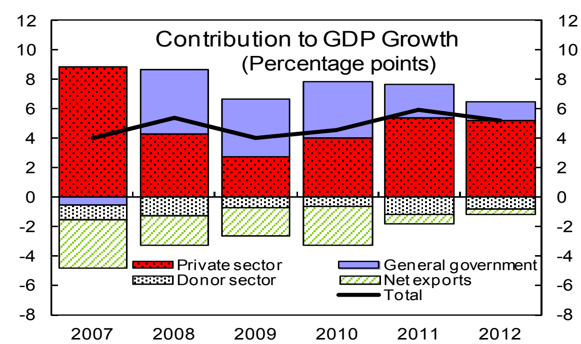
1. **Kosovo became the 186th member country of the IMF on June 29, 2009.** However, since 1999, the Fund has provided technical assistance and policy advice to the United Nations Mission in Kosovo, and since September 2008, to the Republic of Kosovo (Annex I). Fund policy advice was helpful in underpinning macroeconomic stability, and staff's Letter of Assessment to the European Commission in November 2009 was instrumental in facilitating donor support for the government's policy program.

2. **Structural deficiencies undermine export sector development and prospects for sustainable growth.** A decade after the end of the conflict that led to Kosovo's unilateral declaration of independence in February 2008, growth prospects continue to be hampered by profound structural impediments. These include poor public and private infrastructure, unreliable electricity supply, and inadequate regional connectivity of transportation routes. The economy remains undiversified and dominated by the trade and services sectors that are boosted by the large foreign presence and remittances. The export base is narrow and dominated by low-value added products, and a sector that could drive sustainable growth has yet to emerge.

A. Recent Economic and Policy Developments

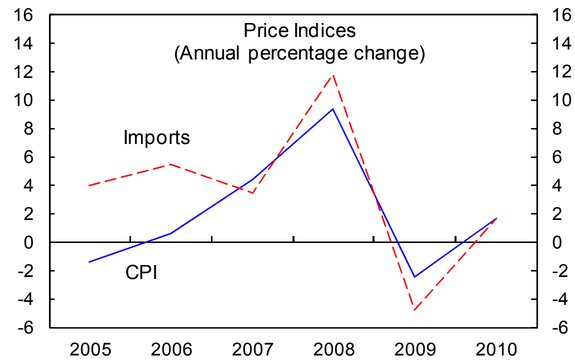
3. **Nevertheless, economic activity appears to be strengthening and last year's recession in Europe had only a modest impact on the economy.** Following a contraction last year, exports have been rebounding this year (Table 1). Remittances, an essential source of funding of private sector activity, have also been recovering (Figure 1).



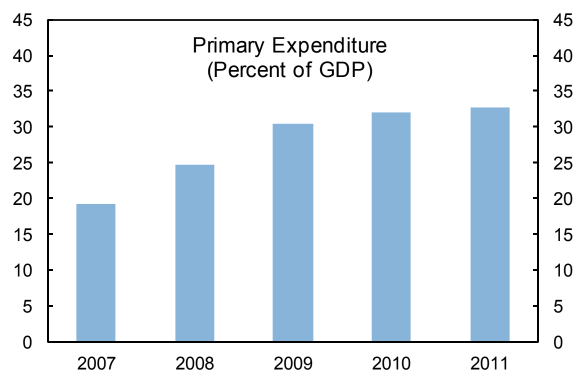


However, private sector credit growth continues to decelerate. Public spending, especially for capital investments, supported economic activity. Real growth therefore declined last year only moderately to 4 percent from 5.4 in 2008 (Table 2). Public investment spending is expected to increase in 2010, mainly due to the beginning of the construction of the Route 7 corridor, Kosovo's first highway. The World Bank estimates the project costs at about 24 percent of 2010 GDP over a four-year period, and cost overruns cannot be ruled out.

4. **Inflation in the euroized economy closely mirrors import price developments.** Import dependence is high—the import share in GDP is estimated to have reached 54 percent in 2009—and the euro area is Kosovo's largest trading partner. As a result, inflation closely mirrors international developments and tends to be volatile. Amidst the ongoing global recovery, a short-lived period of deflation has come to an end, and consumer price inflation (CPI) rose to 2.2 percent year-on-year in May.



5. **Rapid expenditure growth has undermined fiscal sustainability.** Real expenditures surged during 2008–09, albeit from low levels (Tables 3 and 4). These increases were in large part due to capital expenditures, as the authorities began to address extensive infrastructure needs, amid weaknesses in project preparation and execution. However, rising subsidies and net lending to KEK, the publicly-owned and loss-making electricity company, also contributed significantly to expenditures, in addition to appreciable public sector wage hikes. Revenues were boosted in 2009 by a large one-off dividend payment from PTK (5.2 percent of GDP), the publicly-owned telecom company. Excluding this one-off revenue, the underlying 2009 deficit reached 6 percent of GDP, following a balanced budget in 2008 and a substantial surplus in 2007.

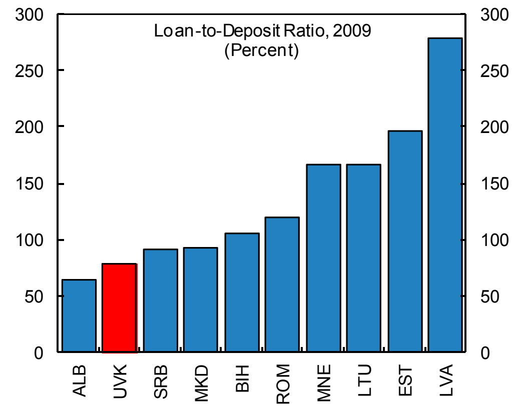


6. **The energy sector remains mired in financial difficulties and continues to absorb significant fiscal resources.** KEK remains under severe financial strain, given widespread difficulties with billings and collections, and a tariff structure that does not ensure cost recovery. Supply shortages persist and tend to result in expensive electricity imports. Budget subsidies and lending reached 3.8 percent of GDP last year. A long-awaited privatization and reform strategy—devised with the assistance of the World Bank and USAID—did not trigger sufficient private sector interest. A revised strategy appears to be attracting investor interest.

7. **Significant external imbalances persist, given deep-rooted structural deficiencies and the recent fiscal loosening.** Amid the surge in public capital expenditures, the current account deficit is estimated to have reached 25 percent of GDP

in 2009, excluding official transfers. Official transfers, although on a declining trend, remained high at the equivalent of 6.4 percent of GDP in 2009 (Table 5).

8. **The largely foreign-owned financial sector thus far has been comparatively unscathed by the global financial crisis.** Foreign subsidiaries dominate the banking sector, holding about 90 percent of deposits (March 2010). Not unlike other countries in the region, Kosovo experienced rapid private sector credit growth prior to the financial crisis. However, loan growth was funded by means of a steady expansion in the deposit base rather than foreign borrowing (Table 6). To shield against the risk of a sudden liquidity shortage, the CBK exercised moral suasion for banks to lower the ratio of loan to deposits to a prudent level, enhanced its daily monitoring of the banking sector, and stepped up its stress testing.



9. **Intrinsic weaknesses in the financial architecture nevertheless pose risks to financial stability.** While overall banking sector liquidity appears to be adequate (Table 7), euroization limits the scope for emergency liquidity assistance (ELA), if needed. The funds available for ELA are mostly confined to the counterpart of the government's balances held with the CBK. Moreover, the existing legal framework does not explicitly authorize the CBK to provide ELA, although the program addresses this issue. Departures of the banking law from best international practice pose additional risks to financial stability.

II. THE SBA-SUPPORTED PROGRAM

A. Program Objectives

10. **The authorities' program is focused on achieving fiscal stabilization, while accommodating large infrastructure investments, and safeguarding financial sector stability.** The authorities recognize that across-the-board policy strengthening is needed, especially expenditure restraint, to lay the foundation for restoring fiscal sustainability. Specifically, the program aims to: (i) restrain current spending and raise revenues to contain the impact of their large capital investment program—especially for the Route 7 highway project—on the overall fiscal deficit; (ii) secure substantial one-off budget financing from privatization to help meet the costs of the highway project and to preserve debt sustainability; (iii) pursue reforms to broaden the tax base and strengthen public financial management; (iv) bolster the government's bank balances held with the CBK to provide scope for ELA, if needed; (v) provide the CBK with a mandate for ELA, enhance its independence, and further strengthen the banking system; and (vi) improve the

financial position of the energy sector to limit its costs to the budget. If fully implemented, the program would improve overall macro stability and lay a foundation to enhance Kosovo's long-term growth potential.

B. Macroeconomic Framework

11. **The program is based on cautious macroeconomic projections:**

- *Real GDP growth* is projected to increase moderately to 4.6 percent in 2010, in large part owing to a recovery in exports and rising private activity. In particular, public investments, notably into the Route 7 highway, are expected to catalyze private investments.

- *Inflation* is expected to turn positive in 2010, mainly reflecting higher import prices and excise tax increases. At the same time, the boost in investment activity is expected to have only a negligible impact on domestic prices, given the high share of imports in construction supplies and considerable unemployment. Nevertheless, as a result of the combined effects, the CPI is forecast to rise above that of the euro area this year (Kosovo's main trading partner region).

- The *current account deficit*, excluding official transfers, is projected to widen marginally this year. Imports are increasing, mainly owing to large public investments. These increases are expected to outweigh the recovery in remittances and exports.

Kosovo: Main Indicators, 2009–12

	2009	2010	2011	2012
	Est.	Proj.	Proj.	Proj.
Real GDP growth rate (percent)	4.0	4.6	5.9	5.2
Average CPI growth rate (percent)	-2.4	1.7	3.2	2.2
Primary expenditures (percent of GDP)	30.3	32.0	32.8	31.7
Overall fiscal balance (percent of GDP)	-0.8	-3.4	-5.5	-4.0
Current account, excl. official transfer (percent of GDP)	-25.0	-26.2	-24.4	-22.3

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

12. **Beyond the program period, a strengthened policy framework would underpin fiscal sustainability and enhance long-term growth prospects.** Durable fiscal consolidation assumes implementation of reforms in tax administration and public financial management. At the same time, these reforms would provide scope for maintaining Kosovo's ambitious infrastructure development and, thereby, enhance its long-term growth prospects.

13. **There are important downside risks to the macroeconomic projections underlying the program.** In the near term, output growth could fall short of projections,

especially if an unexpected slowdown in euro area growth were to lead to a decline in remittances or foreign direct investments. The recent deceleration in private sector lending may become more protracted than expected, thereby limiting private sector investments. A substantial decline in energy production would also raise energy imports and curtail GDP growth, besides adding to pressures on public expenditures.

C. Fiscal Policy

14. **The authorities' fiscal stance aims at limiting the impact on the deficit of their large infrastructure projects.** With their decision to start building the Route 7 highway, the authorities assumed a considerable liability that is expected be discharged over a period of four years. To limit the impact on the deficit, the authorities have adopted an adjustment strategy that targets a steady improvement in the fiscal balance, excluding highway-related spending (Figure 2, MEFP ¶7).

Kosovo: Selected Fiscal Indicators, 2009–12
(Percent of GDP)

	2009 Est.	2010 Proj.	2011 Proj.	2012 Proj.
Revenues	29.7	28.9	27.5	27.9
Of which				
Taxes	21.1	21.6	22.3	22.8
Dividends	5.2	2.1	…	…
Primary expenditures	30.3	32.0	32.8	31.7
Recurrent	18.6	18.7	18.5	18.5
Capital and net lending	11.7	13.3	14.3	13.2
Highway	0.0	3.2	6.1	6.2
Non-highway	9.7	8.6	7.1	7.0
Net lending	2.0	1.5	1.0	0.0
Overall balance	-0.8	-3.4	-5.5	-4.0
Overall balance, excluding the highway	-0.8	-0.2	0.6	2.2
Privatization proceeds	0.0	0.0	6.7	0.2
Stock of government bank balances	8.8	5.9	7.9	6.4

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

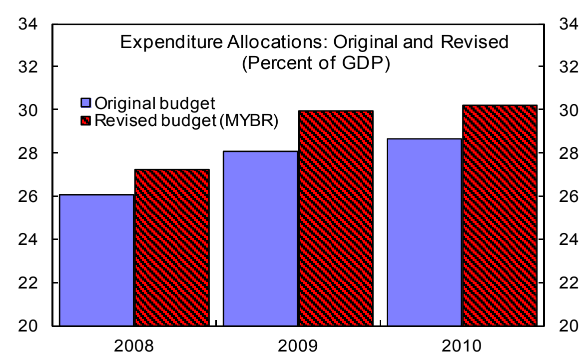
15. **Expenditure restraint and revenue measures are projected to facilitate a tightening of the fiscal deficit, excluding the highway, by 0.6 percent of GDP in 2010 (MEFP ¶8).** While adjustment ideally would have relied mainly on spending restraint, the authorities suggested that existing commitments made deep capital expenditure cuts difficult. Therefore, it was agreed to lower capital expenditures other than for the highway by 1.1 percentage points of GDP in 2010 (compared to 2009) and to supplement these cuts with permanent revenue measures. Increases in excise taxes were viewed as less regressive than VAT increases. In response to staff's concerns about potential revenue losses from smuggling, the increases in excise tax rates were limited to ensure that

domestic prices remain broadly aligned with regional averages. Moreover, the authorities committed to restrain current spending and to refrain from any commercial borrowing, given that budget grants remain a significant revenue source and that capital expenditures are large. As a result, the overall fiscal deficit excluding highway spending is expected to narrow to 0.2 percent of GDP in 2010 from 0.8 percent of GDP in 2009. The overall fiscal deficit is projected to widen to 3.4 percent of GDP this year.

16. **Fiscal policies will be anchored in 2011 through continued restraint on spending, excluding the highway (MEFP ¶9).** The authorities intend to marginally lower the share of current spending in GDP in 2011 compared to 2010, and to exercise further restraint of non-highway capital expenditures. Therefore, excluding highway spending, an underlying fiscal surplus of 0.6 percent of GDP is expected, although the overall balance is projected to widen to 5.5 percent of GDP in 2011, given the anticipated doubling of highway expenditures.

17. **Privatization receipts will be the primary source of deficit financing and bolster the government's bank balances in 2011.** The authorities intend to complete the sale of PTK by end-2010 (structural benchmark, MEFP ¶11). They stand ready to take fiscal contingencies measures in order to avoid commercial borrowing (MEFP ¶12). Moreover, to shield against the risk of potential cost overruns from the highway, the authorities are committed to increasing their bank balances by 2 percentage points of GDP in 2011 (MEFP ¶10). They agree that adequate bank balances are needed to provide the Treasury with liquidity and to generate scope for ELA (section D).

18. **The authorities are taking steps to improve the credibility of the budget process to avoid unfunded spending commitments.** Unfunded spending initiatives led to a significant increase in expenditures at the 2007–08 midyear budget reviews (MYBRs). The authorities concurred that a more effective policy commitment is needed to ensure that the annual deficit target will be realized. Therefore, they agreed to ensure that spending initiatives at future MYBRs will be deficit neutral (MEFP ¶19) and to amend the Law on Public Financial Management and Accountability (prior action), although they were concerned about social spending pressures. Moreover, from now on, any draft law will be submitted to the Cabinet only upon a comprehensive assessment by the Ministry of Economy and Finance (MoEF) of their economic and fiscal impact.



19. **A substantial broadening of the domestic tax base is necessary to finance Kosovo's development needs in a sustainable manner.** The authorities' main objective

is to reduce the tax gap by increasing overall taxpayer compliance (MEFP ¶22–26). Achieving this objective requires modernizing the IT system and a strategy to improve taxpayer compliance. These efforts will be supported by an annual compliance strategy and semi-annual reports on its implementation. In parallel, efforts will be made to address tax losses related to the informal economy and sophisticated tax fraud schemes. In this context, a tax fraud unit is expected to become fully functional by end-2010.

20. **Improvements in public financial management are needed in order to enhance expenditure efficiency.** Given Kosovo's vast infrastructure needs, capital expenditures account for about one third of government spending. The quality of these expenditures, however, tends to be low, given continued difficulties with budgeting and execution. To address these difficulties, the government is taking several steps, including setting up a monitoring mechanism that would allow cancellation of allocations, in case of significant under-execution (MEFP ¶27–29).

D. Financial Sector Policies

21. **Safeguarding financial sector stability requires a prudent fiscal policy stance.** On an aggregate basis, the banking sector appears well capitalized and liquid, although the financial strength of individual banks varies from bank to bank (Figures 3 and 4). Despite a recent increase in nonperforming loans (NPLs), the incidence of NPLs remains relatively moderate, and provisioning appears adequate at the moment. Staff stressed the importance of sound banking practices, including risk and liquidity management, effective supervision, and an appropriate bank resolution framework to mitigate risks. There was agreement that euroization places the burden of safeguarding financial stability largely on the fiscal authorities. It is therefore important that the government maintains its bank balances at an adequate level to facilitate limited ELA, if needed.

22. **The determination of an adequate pool of liquidity for ELA is fraught with difficulties (Box 1)**. Staff emphasized that the costs of maintaining a prudent level of bank balances, especially at the presently low interest rates, are relatively low compared to the risks from insufficient crisis preparedness. In line with IMF TA recommendations, there was agreement that carefully timed and steady increases in reserve requirements would help limit the resources that would need to be set aside for ELA. Moreover, staff suggested that supervisors should encourage bank subsidiaries to seek commitments from their parents to provide support, if needed.

23. **The authorities are preparing a policy on ELA and intend to take steps to safeguard financial sector liquidity, if needed.** With IMF TA, this policy is intended to clearly define the scope and responsibilities for ELA, while minimizing moral hazard. To enhance crisis preparedness, the MoEF and the CBK will finalize a memorandum of understanding by the first review of the program (MEFP ¶13–14). Separately, to avoid undue liquidity pressures that could result from the withdrawal of Treasury deposits with

the commercial banking system, the fiscal authorities intend to closely consult with the CBK prior to any withdrawal and take corrective action, if needed (MEFP ¶15). The CBK is closely monitoring those banks that may be affected.

24. **Important financial sector legislation is being brought in line with best international practice.** An overhaul of the Law on the Central Bank of the Republic of Kosovo, among other factors, is designed to establish the CBK's legal authority to provide ELA and buttress its independence (prior action, MEFP ¶16). In particular, the representation of the MoEF in the CBK board will expire after a transition period of five years. Moreover, revisions to the banking law aim at strengthening governance standards and broadening the tools for bank resolution, including official administration and liquidation (MEFP ¶17).

25. **Given the dominance of foreign-owned banks, the authorities are enhancing their cooperation with home supervisors.** In addition to the existing memoranda of understanding that facilitate cooperation with Albania, Slovenia and Turkey, the authorities are seeking cooperation with supervisors in Austria and Germany.[1]

E. Energy Sector and Other Issues

26. **The authorities intend to prepare a strategy to limit the drain of the energy sector on the public finances and improve prospects for attracting private investments** (Box 2). The strategy will be prepared in close consultation with the World Bank and its completion will be a structural benchmark for the second review. It would focus on assessing the need for a substantial tariff hikes to cost recovering levels, resolving KEK's, the electricity company, billing and collections problems, as well as curtailing the company's high operating costs (MEFP ¶31).

27. **Good governance of the Pension and Savings Trust of Kosovo (KPST) is essential to avoid any future fiscal liabilities.** Amendments to the Law on Pensions are under preparation with support from the World Bank. The authorities intend to ensure that KPST will continue to exercise its fiduciary responsibilities towards its contributors and limit undue risks, including those that may arise from undue exposure to a single borrower.

28. **Substantial changes to the Law on Statistics are expected to foster improvements in the data quality.** The law would grant independence to the Statistical Office of Kosovo. With greater flexibility on budget matters, the quality and timeliness of statistics are expected to improve (MEFP ¶34).

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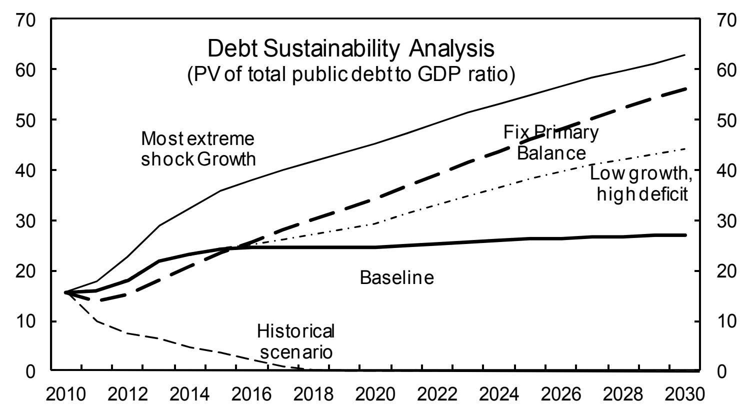
[1] The German parent company of Pro Credit, the largest subsidiary, remains a non-bank institution and thus is not subject to formal supervision by BaFin.

III. Program Modalities

29. **Kosovo faces moderate balance of payments needs over the program period.** The program aims to bolster foreign exchange reserves by placing a floor under the government's bank balances. Given underdeveloped domestic debt markets and a prohibition on lending by the CBK to the government under the revised central bank law, Fund resources would support the budget directly under the proposed program. The external financing gap for the fiscal program is €106 million (157 percent of quota) during 2010–11 (Table 8).

30. **Access under the 18–month arrangement is proposed at 157 percent of quota.** Access is within annual access limits and is back loaded to support the 2010 and 2011 budgetary targets (Table 9, Box 3).

31. **Kosovo's capacity to repay the Fund is expected to be satisfactory.** The public sector debt stock is low. The limits on commercial borrowing (MEFP ¶12) should help to safeguard Kosovo's moderate risk rating according to staff's DSA update (Annex II). The risk rating should remain moderate, even if the financing gaps after 2012 are covered with external borrowing, as assumed in the DSA. However, the narrow and volatile export base limits Kosovo's borrowing space as an export contraction could raise debt-to-export ratios above debt burden thresholds. A careful borrowing strategy after 2012 will be key to minimize rollover risks, especially given that the debt service ratios are projected to rise when the bulk of the obligations to the Fund come due in 2014–16. The authorities' commitment to a prudent fiscal stance and the low ratio of debt service to tax revenues provide adequate assurances that Kosovo will be able to discharge its obligations to the Fund in a timely manner. By the end of the SBA, Fund credit outstanding is projected to be 2.2 percent of GDP (Table 10).



32. **Notwithstanding the strength of the authorities' commitment, this program entails significant risks.** If adjustment is incomplete, higher fiscal and balance-of-payments disequilibria could lead to capital outflows and undermine Kosovo's ability to repay the Fund. The authorities recognize these risks and stand ready to adjust their policies, as warranted.

- *Unfunded spending commitments.* The government's resolve to curtail spending and refrain from unfunded spending commitments could be tested in the run up to the general elections expected in the second half of 2011.

- *Privatization.* Potential delays or substantial shortfalls of privatization receipts could require considerable further adjustment (MEFP ¶15).

- *Energy sector.* Continued reform difficulties combined with the risk of limited investor interest could result in the need for prolonged budget transfers.

- *Highway cost overruns.* The program is predicated on prudent cost estimates for the Route 7 highway, but planning and execution difficulties could generate considerable expenditure pressures.

- *Banking sector.* The sector is adequately capitalized and liquid, but financial strength varies across individual banks. Although none of the foreign banks present in Kosovo have ownership ties to Europe's southern rim, regional contagion risks remain.

33. **The program's design aims to mitigate some of the above risks to the Fund.** The prior actions frontload key policy decisions and should ensure that the 2010 budget will be amended in line with the program and that expenditure pressures will not undermine annual budget targets in future MYBRs. Moreover, early actions to improve tax administration, a strategy to limit the drain of budget resources by the energy sector (structural benchmark), and the timely and transparent privatization of PTK (structural benchmark) should all help to bolster government's bank balances at the CBK and, therefore, underpin Kosovo's ability to repay the Fund. Moreover, the program floors on the bank balance are also set to provide adequate scope for ELA, if needed.

34. **The SBA will be for 18 months starting in July 2010.** The size and timing of the disbursements should ensure that the Kosovar policy program through end-2011 is fully supported at the given access level. This is Kosovo's first IMF-supported program, and the authorities will consult with staff on evolving risks and agree on policy adjustments that may be needed to achieve the program's goals.

35. **The program will be monitored on a quarterly basis.** The first review of the program will be based on end-August 2010 targets and the second review on end-December 2010 targets. The program's conditionality is consistent with the program's focus on restoring fiscal sustainability and safeguarding financial stability.

36. **Key safeguards are in place.** The safeguard assessment mission concluded that relevant operational controls have been established at the CBK, including accounting, banking operations and reserves management. Although data reporting needs to be improved, effective procedures to protect Fund disbursements under the proposed SBA are being finalized, including a memorandum of understanding (MoU) to ensure that all

Fund resources are disbursed into a government account at the CBK (before use) and will not be placed in other accounts elsewhere. The MoU also establishes procedures for establishing obligations to the Fund.

IV. Staff Appraisal

37. **Kosovo's economic performance has strengthened considerably over the past decade, but large imbalances persist.** The external imbalances largely reflect infrastructure bottlenecks, especially in the transport system and energy sector, that continue to stifle the export sector and output growth. The authorities' efforts to improve public sector infrastructure, combined with their efforts to address social needs, led to a significant deterioration of the fiscal position during 2008-09. These pressures triggered a considerable decline in the government's bank balances and, therefore, the official foreign exchange reserves. These pressures have been exacerbated by the authorities' recent decision to build Kosovo's first highway and, without adjustment, reserves would fall to dangerously low levels.

38. **Against this background, the authorities' program—supported by the proposed SBA—seeks to restore fiscal sustainability and safeguard financial sector stability.** Adjustment relies on expenditure restraint and revenue measures in order to mitigate the impact of large public investment projects on the fiscal deficit. Combined with privatization efforts, such a fiscal stance is expected to shore up the government's bank balances. Besides providing a fiscal reserve, adequate bank balances will be important to allow scope for ELA (if needed), given that the economy is euroized. In this context, the revised Law of the Central Bank of the Republic of Kosovo establishes a legal basis for ELA, while revisions to the banking law are also aimed at improving financial sector stability.

39. **The 2010 budget limits the impact of the highway project on the fiscal deficit.** The amended 2010 budget aims to hold current spending broadly unchanged as a share in GDP compared to 2009, while capital expenditures (other than for the highway) are targeted to decline. Combined with selected excise tax increases, these measures are projected to limit the overall fiscal deficit to 3.4 percent of GDP this year. However, fiscal discipline and an unwavering commitment to refrain from unfunded spending initiatives will be essential, if this target is to be met.

40. **Effective policy priorities are vital to curtail fiscal pressures.** The program calls for continued restraint of current and capital spending (other than for the highway). Nevertheless, the overall fiscal balance is projected to widen to 5.5 percent of GDP in 2011, in large part owing to a doubling in highway-related investments, and fiscal pressures persist over the medium term. These pressures—combined with the risk of potential cost overruns for the highway project—underscore the importance of continuing expenditure restraint and setting effective spending priorities over the medium term.

41. **Restoring fiscal sustainability will require strengthening the credibility of the budget process and improving tax administration.** To discontinue the practice of unfunded spending commitments, amendments to the Law on Public Financial Management and Accountability will ensure that any intra-year spending initiatives will need to be financed either through offsetting expenditure cuts or additional revenue measures. Moreover, improvements in tax administration are needed to create fiscal space for pressing social and developments needs.

42. **Decisive action is necessary to improve energy sector finances and halt the drain of fiscal resources.** While some progress has been made in improving the sector's finances, fundamental changes are required to halt the drain of budget resources and achieve financial viability. The program calls for a comprehensive strategy to be drawn up—in close consultation with the World Bank and other international partners—to effectively improve the sector's financial performance and eliminate the need for budgetary transfers.

43. **Good governance of the Pension and Savings Trust of Kosovo (KPST) will be essential to avoid any future fiscal liabilities.** Amendments to the relevant legal framework are under preparation with support from the World Bank. To avoid the risk of future fiscal liabilities, it will be critical that KPST continue to exercise its fiduciary responsibilities towards its contributors and limit undue risks, including those that may arise from unwarranted exposure to a single borrower.

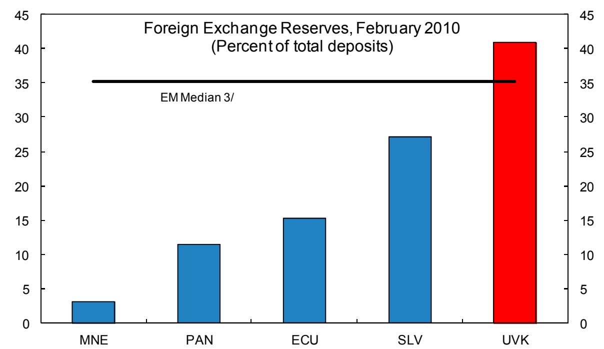
44. **The fiscal policy stance recognizes the authorities' responsibility for financial sector stability.** The program aims to provide scope for ELA by maintaining the government's bank balances at an adequate level. However, besides a prudent fiscal stance, timely privatization progress is necessary to achieve this objective. Therefore, it is critical that the authorities stand ready to adjust their policies to keep the program on track, especially in case of privatization delays or shortfalls in receipts.

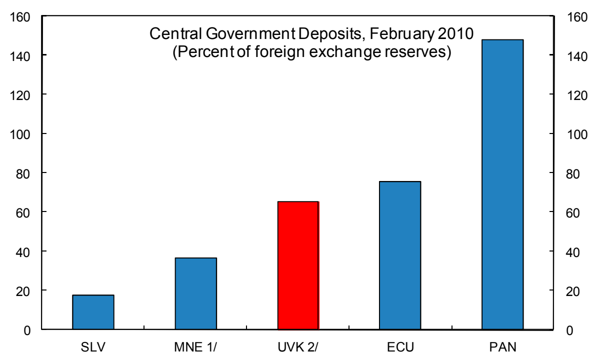
45. **Although the financial strength of the banking sector is adequate, crisis preparedness needs to be enhanced.** The program calls for a comprehensive policy to clearly delineate the responsibilities of the CBK and the Ministry of Economy and Finance in case of a potential crisis. Moreover, it is important that such a policy facilitates decisive action and limits moral hazard risks.

46. **Nevertheless, appreciable risks remain.** Importantly, the government's resolve for exercising expenditure restraint could be tested in the run-up to the 2011 general elections, while potential highway-related cost overruns could add to fiscal pressures. Shortfalls in privatization receipts could require a substantial recalibration of the program, as would events that could undermine financial stability. To minimize these risks, the SBA includes strong safeguards, namely the approval of key fiscal and legal measures prior to Board consideration of the request for the program. In view of Kosovo's balance of payments need and the authorities' policy commitment, staff support the authorities' request for an 18-month Stand-By Arrangement.

Box 1. Emergency Liquidity Assistance in Euroized Countries

The scope for emergency liquidity assistance (ELA) is largely limited to the liquid external reserves of central banks in eurorized (or dollarized) economies, such as Kosovo and Montenegro. This is because the money supply in circulation is not issued by the central bank and, therefore, not under its control.1/ The scope for liquidity provision depends on the stability of the counterparts to foreign exchange reserves. In most such economies, the main counterparts to external reserves are government deposits held with the central bank. The ability to use these external reserves would therefore depend on the counterpart deposit not being simultaneously drawn down by the government. Central bank reserve holdings can also be boosted by foreign credit lines and the application of reserve requirements on domestic banks, but the latter can only be a fraction of the banks' deposit base.2/





Sources: IFS; and IMF staff estimates.
ECU: Ecuador, MNE: Montenegro, PAN: Panama, SLV: El Salvador, UVK: Kosovo
1/ Latest data as of end-November 2009.
2/ Latest data as of end-May 2010.
3/ Median ratio of reserves to broad money in selected emerging market countries.

There is no widely accepted rule for an adequate level of international reserves for euroized or dollarized economies. Such reserves are not needed to protect the exchange rate or to guarantee the central bank's monetary liabilities, because neither exist. The usual metrics (months of imports, reserve money) therefore do not apply.

Scaling to broad money, on the other hand, remains relevant for an institution seeking to be able to provide liquidity to the banking system in the event it is needed. The ratio of reserves to total deposits for Kosovo (41 percent in February 2010) is relatively high by the standards of comparator countries, and is projected to decline towards the average observed in select emerging markets countries. This level could be justified by the uncertain circumstances of a country, like Kosovo, about to embark on an ambitious program of transition and reform in the context of an ongoing global financial crisis.

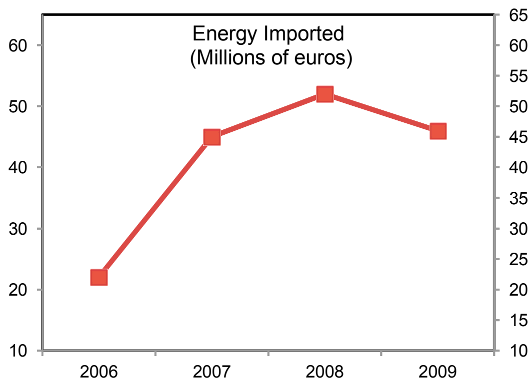
1/ Similar constraints apply to currency board arrangements (CBAs), where central banks do issue base money, but have no control over its supply. Most CBAs operate with at least 100 percent cover of base money, with the excess over 100 percent being available for liquidity assistance. However, no clear rules on the desirable level of excess balances have been established. In general, the excess (if there is one) depends on central banks' initial foreign exchange endowment compared with its initial level of monetary liabilities.

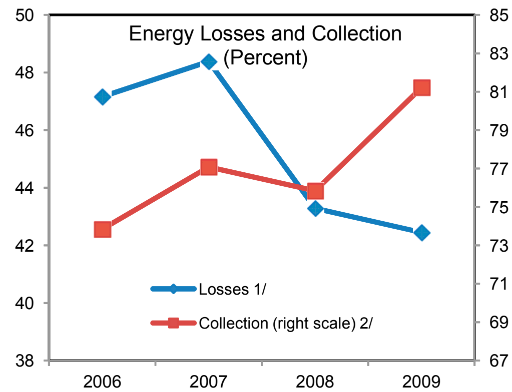
2/ Members of the euro area can usually avail themselves of credit lines from the ECB in the event of domestic liquidity problems. However, this option is not available to euroized countries outside the euro area.

Box 2. Energy Sector—Reform Challenges

Effective energy sector reform is central to restoring fiscal sustainability and enhancing the economy's growth potential. Frequent energy outages resulted in considerable production losses over the past decade, notwithstanding large-scale technical and financial support for the sector. The World Bank estimates that KEK, the publicly-owned energy company, received about € 1.1 billion in transfers (27 percent of 2010 GDP) over the past decade from the budget (€ 0.5 billion) and donors (€ 0.6 billion).[1] Last year alone, the Kosovo budget transferred 3.8 percent of GDP to KEK.

The scale of these transfers in part reflects the dilapidated state of the equipment in the two power plants. Despite considerable investments, KEK's two large power stations are still poorly maintained, highly-polluting and technically unreliable. As a result, about 10 percent of Kosovo's energy demand was imported last year at a cost to the budget of over 1 percent of GDP. The authorities decided to decommission the older power plant (Kosovo A) no later than in 2017.





Sources: KEK; IMF staff estimates.
1/ Percent of invoiced amounts.
2/ Percent of energy supply.

Tariffs are a major contributing factor to KEK's operating losses, since they do not allow for cost recovery. Moreover, the World Bank estimates that the company's staffing is excessive, and, therefore, inflates its cost structure. However, most damaging to KEK's finances, are commercial and technical losses, notwithstanding recent improvements. Last year, 42 percent of the energy entering the network was lost, stolen or otherwise not paid for. These losses in part reflect widespread illegal connections, meter tampering and low collection rates.

There is an increasing recognition that all of these issues need to be addressed to improve the prospects for private investments into the energy sector. The government recently expressed a willingness to consider supporting an increase in tariffs, although the decision ultimately needs to be by taken by the independent Energy Regulatory Office. Addressing the commercial losses, as a first step, requires amending Kosovo's criminal code to ensure that energy theft becomes a criminal offense. However, timely enforcement may prove difficult given the overloaded court system. Moreover, continued improvements in billings and collections are essential to improve KEK's cash flow.

In order to attract private capital to the energy sector, with support from the World Bank and the European Union, the authorities have devised the New Kosova project. This strategy aims at (i) bundling a concession for lignite mining with the construction of a new generation plant; and (ii) privatizing the electricity distribution network.

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[1] World Bank, Country Economic Memorandum (2010).

Box 3. Stand-By Arrangement

Access: SDR 92.656 million, 157 percent of quota.

Length: 18 months.

Phasing: SDR 18.760 million will be made available upon the Board's approval of the arrangement to address fiscal and balance of payment needs. The five subsequent quarterly tranches, starting from November 2010 and will equal SDR 73.896 million.

Conditionality

Prior Actions for Board consideration of the program request

- Approval by the Assembly of the Central Bank Law consistent with IMF recommendations.
- Approval by the Assembly of the 2010 mid-year budget review (MYBR) reflecting fiscal adjustment measures, including increases in selected excise tax rates.
- Decision by the Cabinet not to introduce any spending initiatives in 2010 in addition to those included in the 2010 MYBR.
- Amendment to the Law on Public Financial Management and Accountability to ensure that any spending initiative introduced in MYBRs in 2011 and subsequent years will be deficit neutral.

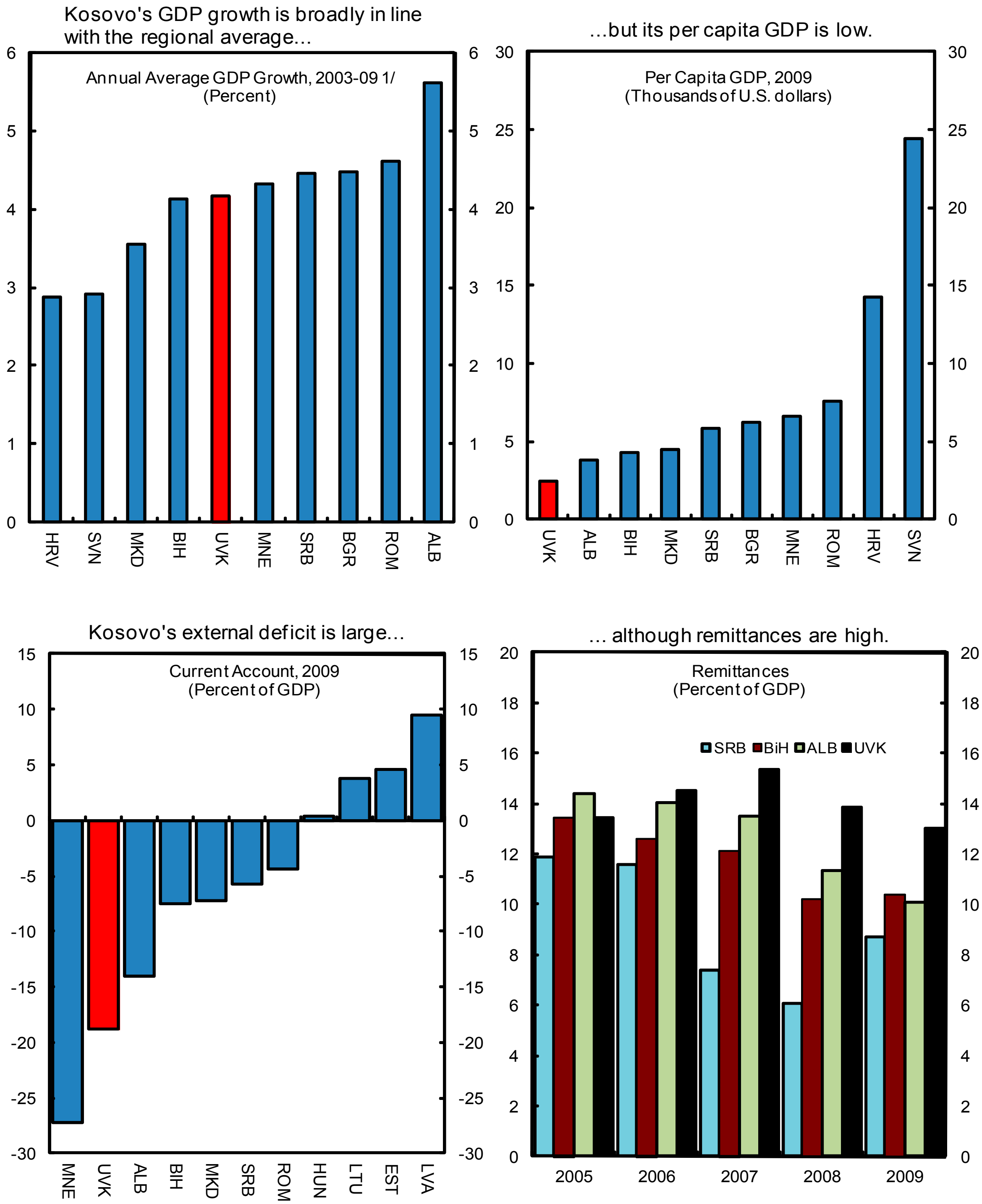
Quantitative Performance Criteria

- Floor on the bank balance of the general government.
- Floor on the primary fiscal balance of the general government.
- Ceiling on primary expenditures.
- Ceiling on contracting or guaranteeing nonconcessional debt.
- Ceiling on the accumulation of domestic arrears.
- Ceiling on the accumulation of external payment arrears.

Structural Benchmarks

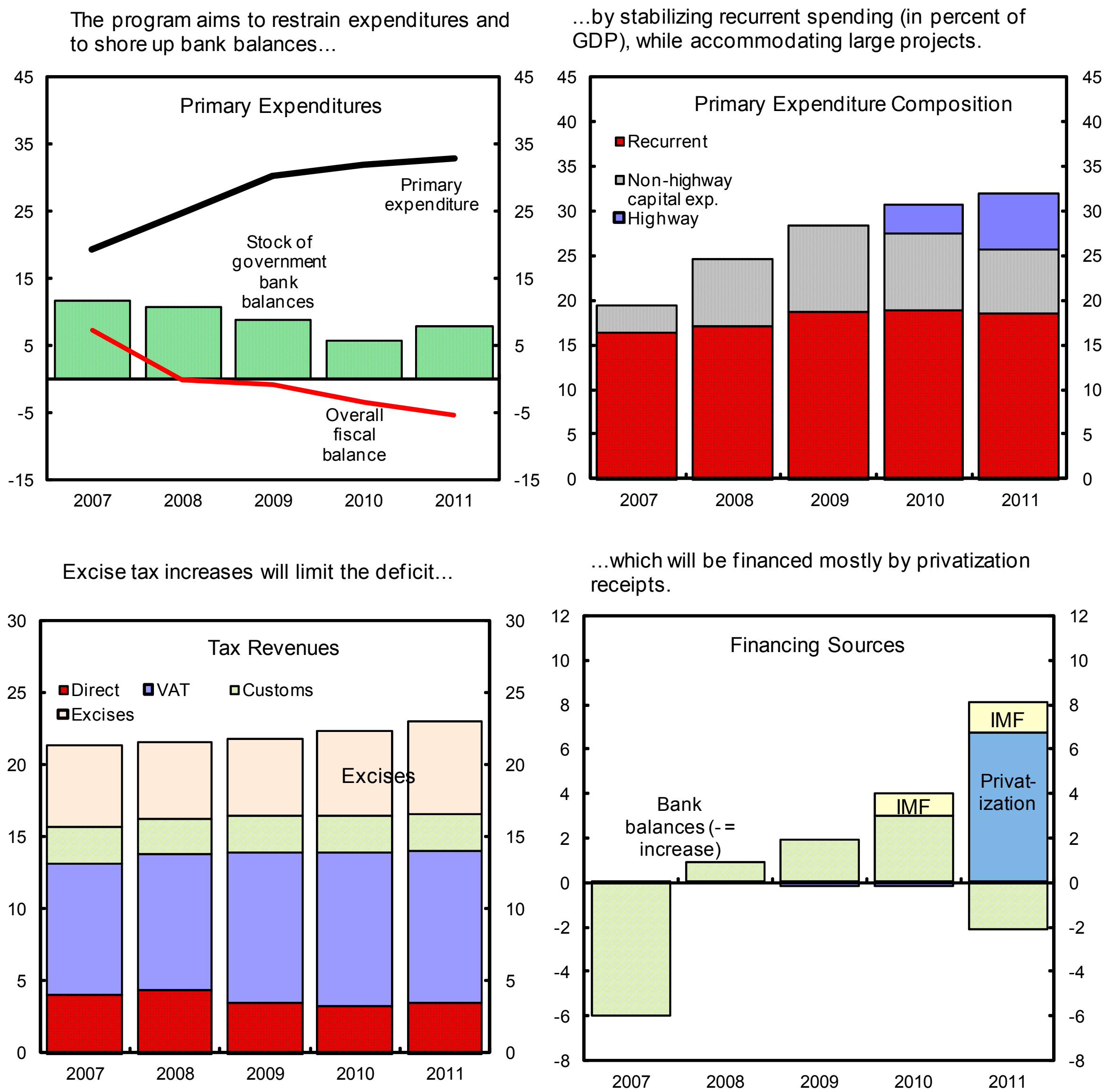
- By the second review, formulation of strategy to shore up KEK's finances.
- PTK privatization completed by end-2010.

Figure 1. Kosovo: Cross-Country Comparison of Selected Economic Indicators, 2003-09



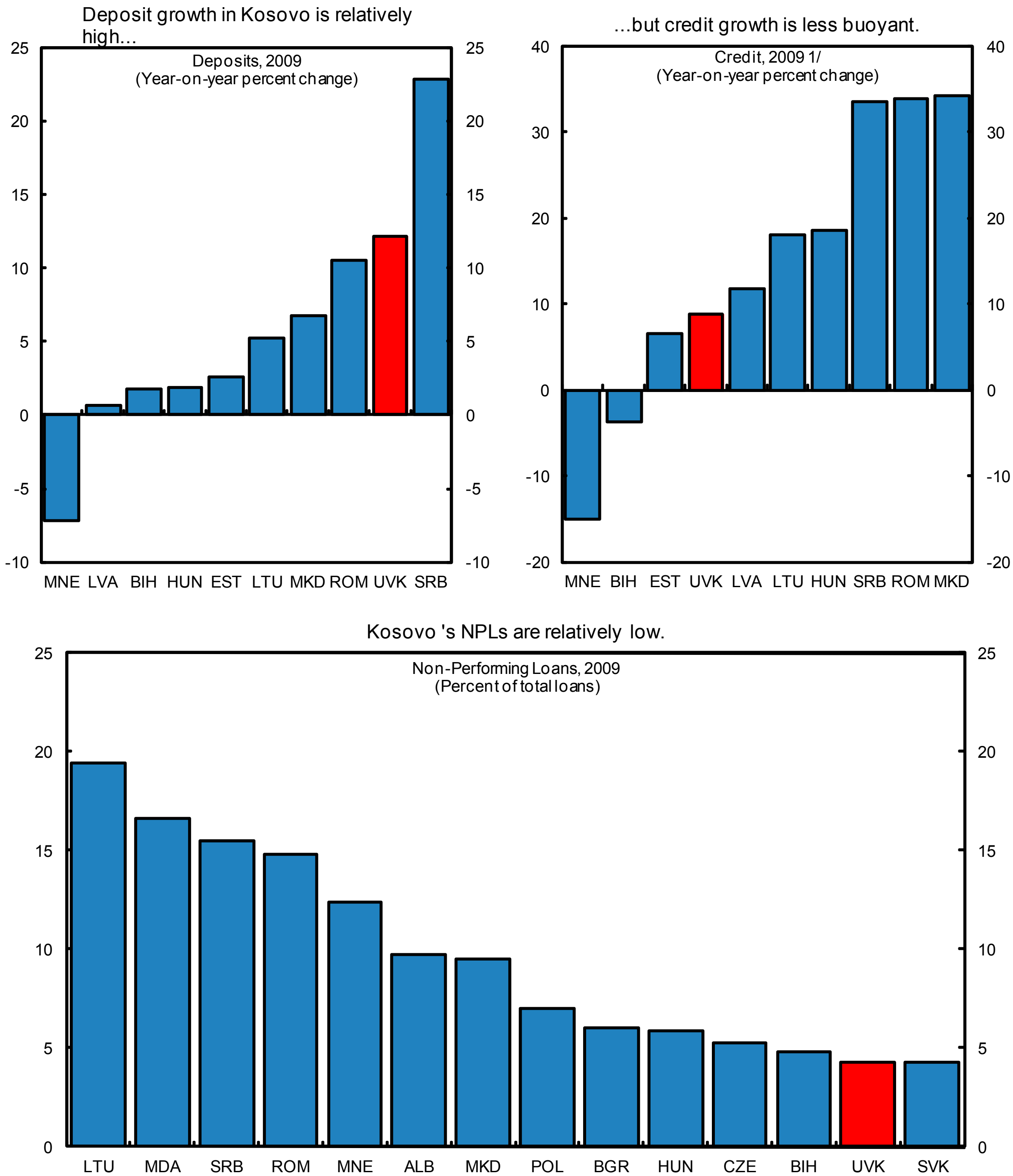
Sources: IFS; WEO; World Bank; and IMF staff estimates.
1/ ALB, BGR, HRV, MKD, ROM, SRB calculated as of 2008.

Figure 2. Kosovo: Fiscal Indicators, 2007–11
(Percent of GDP)



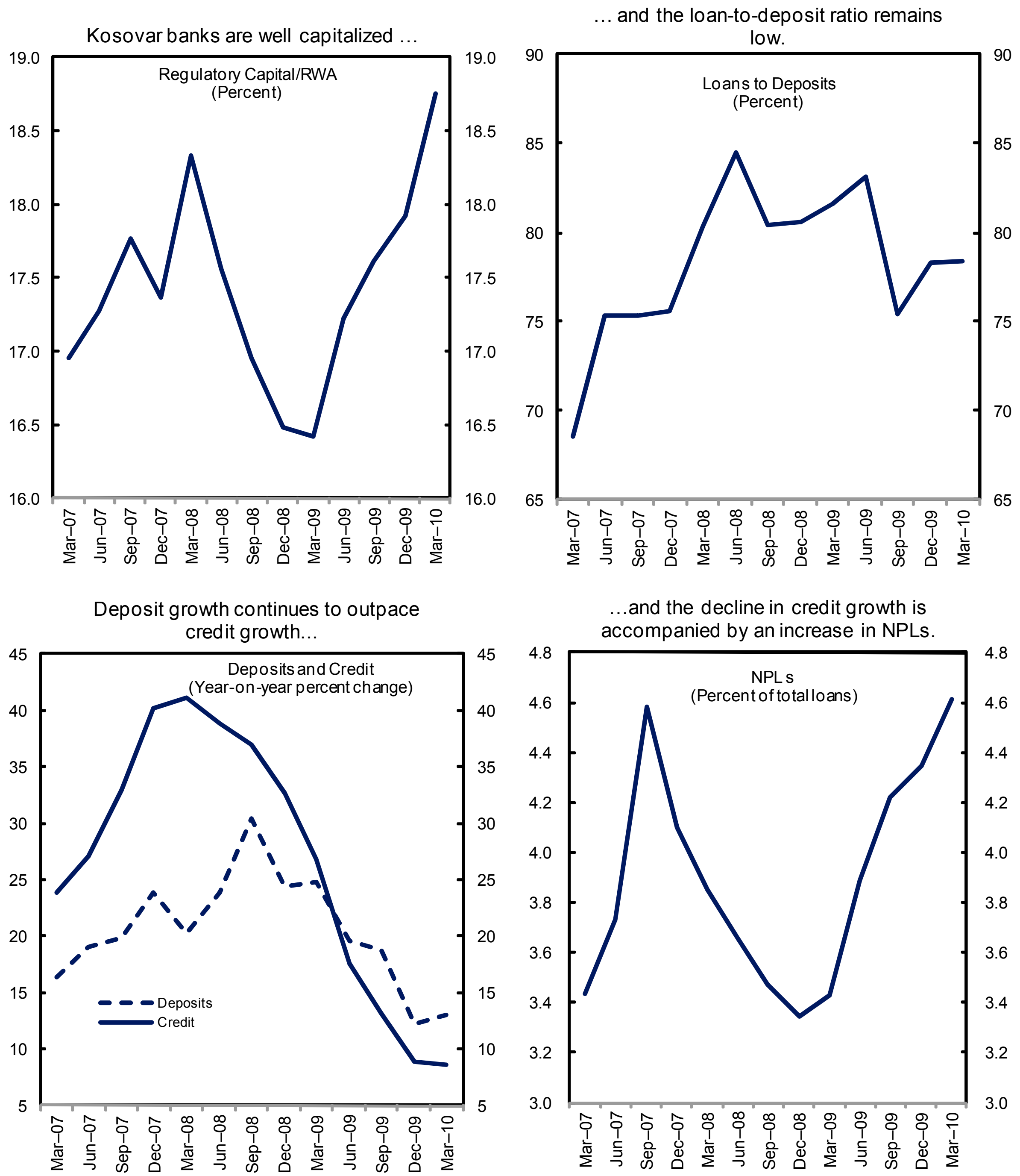
Sources: Kosovo authorities; and IMF staff estimates and projections.

Figure 3. Kosovo: Cross-Country Financial Sector Indicators, 2009



Sources: IFS; WEO; and IMF staff estimates.
1/ SRB, ROM, HUN, LVA, EST, MKD, LTU calculated as of 2008.

Figure 4. Kosovo: Banking Sector Indicators, 2007-10



Source: Central Bank of the Republic of Kosovo.

Table 1. Kosovo: Main Indicators, 2007–15
(Percent, unless otherwise indicated)

	2007	2008	2009	2010	2011	2012	2013	2014	2015
		Est.	Est.	Proj.	Proj.	Proj.	Proj.	Proj.	Proj.
Real growth rates									
GDP	4.0	5.4	4.0	4.6	5.9	5.2	4.9	3.7	4.4
GDP per capita	2.7	3.8	2.5	3.0	4.3	3.7	3.3	2.2	2.9
Consumption	6.1	3.7	2.5	3.1	2.7	2.9	3.0	3.0	2.5
Investment	3.9	15.5	13.1	14.9	12.7	8.9	5.2	0.8	6.6
Exports	11.7	4.2	-1.8	16.0	11.6	11.3	12.1	14.1	13.0
Imports	11.8	6.0	3.5	10.8	5.1	4.8	3.8	4.4	5.8
Price changes									
CPI, period average	4.4	9.4	-2.4	1.7	3.2	2.2	1.9	1.7	1.7
CPI, end of period	10.5	0.5	0.1	3.1	2.4	2.1	1.8	1.7	1.7
GDP deflator	5.2	7.0	-3.4	1.7	2.9	1.9	1.4	1.1	1.1
General government budget (percent of GDP)									
Revenues 1/	26.3	24.5	29.7	28.9	27.5	27.9	26.5	26.8	27.1
Primary expenditures	19.2	24.7	30.3	32.0	32.8	31.7	30.8	28.7	28.6
Of which									
Capital and net lending (including the highway)	2.8	7.6	11.7	13.3	14.3	13.2	12.2	9.8	9.5
Capital expenditures on the highway 2/	…	…	…	3.2	6.1	6.2	5.3	0.6	0.0
Overall balance	7.1	-0.2	-0.8	-3.4	-5.5	-4.0	-4.6	-2.4	-2.0
Overall balance, excluding the highway	7.1	-0.2	-0.8	-0.2	0.6	2.2	0.8	-1.8	-2.0
Debt financing, net	…	0.0	-0.2	-0.2	-0.1	2.0	3.4	1.1	1.1
Privatization	0.0	0.0	0.0	0.0	6.7	0.2	0.2	0.4	0.4
Stock of government bank balances 3/	11.6	10.8	8.8	5.9	7.9	6.4	6.7	7.0	7.4
Financing gap	0.0	0.0	0.0	1.0	1.4	1.0	1.6	1.5	1.4
Savings-investment balances (percent of GDP) 4/									
Domestic savings	-12.6	-12.6	-10.5	-9.5	-7.0	-5.9	-4.5	-4.5	-3.3
Transfers excluding general government (net)	14.6	13.9	12.8	13.0	13.1	13.2	13.3	13.2	13.2
Net factor income	6.4	4.1	2.4	2.8	2.9	3.4	3.8	3.8	3.9
National savings	8.4	5.4	4.8	6.3	8.9	10.6	12.5	12.5	13.9
Investment	26.0	28.9	29.8	32.5	33.3	32.9	32.0	29.8	29.4
Current account	-17.6	-23.4	-25.0	-26.2	-24.4	-22.3	-19.5	-17.3	-15.6
Current account balance (incl. official transfers)	-8.8	-16.0	-18.6	-18.5	-18.2	-17.1	-15.8	-13.4	-11.5
Of which: official transfers 1/5/	8.7	7.5	6.4	7.7	6.2	5.2	3.6	3.9	4.0
Net foreign direct investment	12.6	8.9	7.8	8.5	15.6	8.3	8.8	10.3	10.9
Portfolio investment (net)	-1.2	1.7	-1.0	-0.6	-1.4	-1.5	-1.5	-1.5	-1.5
Memorandum items:									
GDP (million of euros)	3,411	3,849	3,868	4,113	4,480	4,803	5,110	5,356	5,652
GDP per capita (euros)	1,605	1,784	1,766	1,850	1,985	2,097	2,198	2,270	2,360
GNDI per capita (euros)	1,942	2,105	2,036	2,143	2,303	2,445	2,574	2,657	2,764
Population (thousands)	2,126	2,158	2,190	2,223	2,256	2,290	2,325	2,360	2,395

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

1/ Assumes budget grants of €75 million per year in 2010–12.
2/ World Bank estimates.
3/ Starting in 2010, minimum bank balance recommended by staff.
4/ Savings-investment balance of entire economy, including donor sector.
5/ Total foreign assistance excluding capital transfers.

Table 2. Kosovo: Real Growth, 2007-15
(Percent, unless otherwise indicated)

	2007	2008	2009	2010	2011	2012	2013	2014	2015
		Est.	Est.	Proj.	Proj.	Proj.	Proj.	Proj.	Proj.
Consumption	6.1	3.7	2.5	3.1	2.7	2.9	3.0	3.0	2.5
Private	8.9	5.8	2.1	2.8	4.3	3.4	3.4	3.0	2.5
Public	-5.4	-5.9	4.9	4.4	-5.2	0.1	0.6	3.1	2.5
General government	-2.3	-0.2	16.4	12.8	2.2	7.0	5.1	5.1	5.2
Donor sector 1/	-8.7	-12.2	-9.8	-9.4	-20.3	-18.3	-14.9	-5.6	-10.3
Investment	3.9	15.5	13.1	14.9	12.7	8.9	5.2	0.8	6.6
Private	7.3	-4.5	5.0	9.3	9.9	12.9	11.0	10.7	9.4
Public	-9.7	109.2	30.4	24.7	16.9	3.0	-3.9	-17.0	0.0
General government	-8.7	153.6	34.6	27.4	18.7	3.9	-3.4	-17.0	0.4
Donor sector 1/	-12.3	-18.6	-7.1	-10.8	-16.6	-20.0	-19.4	-18.8	-18.2
Exports 2/	11.7	4.2	-1.8	16.0	11.6	11.3	12.1	14.1	13.0
Imports	11.8	6.0	3.5	10.8	5.1	4.8	3.8	4.4	5.8
GDP	4.0	5.4	4.0	4.6	5.9	5.2	4.9	3.7	4.4
Memorandum item:									
GDP (millions of euros)	3,411	3,849	3,868	4,113	4,480	4,803	5,110	5,356	5,652

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

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

Table 3. Kosovo: Consolidated Government Budget, 2009–15

(Excluding donor designated grants; millions of euros)

	2009	2010	2011	2012	2013	2014	2015
	Act.	Program		Projections			
Total revenue and grants	1,149	1,187	1,232	1,340	1,356	1,436	1,530
Total revenue	1,146	1,106	1,150	1,263	1,356	1,436	1,530
Taxes	816	890	998	1,097	1,177	1,244	1,324
Direct taxes	131	132	150	172	189	204	223
Personal Income Tax	60	72	84	96	107	118	132
Corporate Income Tax	55	52	60	69	74	78	82
Monopoly Surcharge	0	0	0	0	0	0	0
Profit tax	11	5	3	4	4	4	4
Other	5	3	3	4	4	4	4
Indirect taxes	711	786	878	957	1,023	1,076	1,139
VAT	403	437	473	504	542	572	603
Excise	207	242	291	331	352	369	393
Customs	101	107	115	122	129	135	143
Tax refunds	-26	-28	-30	-32	-34	-36	-38
Nontax revenues	330	216	152	165	179	193	206
Of which : dividends	200	85	…	…	…	…	…
Grants	3	81	82	77	0	0	0
Budget support	3	75	75	75	0	0	0
Trust fund for the 2010 debt service to the World Bank	0	5	5	0	0	0	0
Project grants	0	1	2	2	0	0	0
Primary expenditure	1,173	1,316	1,468	1,521	1,572	1,535	1,616
Current expenditure	720	770	828	889	950	1,010	1,079
Wages and salaries	264	313	331	367	394	422	453
Goods and services	173	188	198	211	225	240	256
Subsidies and transfers	282	257	297	307	327	344	366
Pension and social assistance	149	165	187	201	217	236	252
Other transfers and subsidies 1/	134	92	110	106	110	108	114
Reserve	0	12	3	4	4	4	4
Capital expenditure and net lending	454	546	640	632	622	525	537
Capital expenditure	375	486	595	632	622	525	537
Highway project	0	130	275	297	272	30	0
Other capital spending	375	355	320	335	350	496	537
Net lending	79	60	45	0	0	0	0
Disbursement	79	60	45	0	0	0	0
Repayment	0	0	0	0	0	0	0
Primary balance	-24	-129	-236	-181	-216	-99	-86
Interest payments	7	10	10	11	18	28	29
Overall balance	-31	-139	-246	-192	-233	-127	-115
Overall balance (excluding highway expenditures)	-31	-8	29	105	39	-97	-115
Errors and ommissions	0	…	…	…	…	…	…
Financing	31	96	183	145	150	46	38
Foreign financing	-52	-1	3	-3	9	9	9
Drawings	0	4	8	8	20	20	20
Amortization	-8	-11	-11	-11	-11	-11	-11
Trust fund for the 2010 debt service to the World Bank	0	6	6	0	0	0	0
World Bank loan prepayment	-125	0	0	0	0	0	0
Use of the trust fund for the loan prepayment	82	0	0	0	0	0	0
Domestic financing	82	97	181	148	142	38	29
Domestic borrowing (net)	0	0	0	100	166	48	56
Drawings	0	0	0	100	173	91	146
Amortization	0	0	0	0	7	43	91
Privatization revenues 2/	0	0	300	10	10	20	20
Other financial assets (net)	0	-3	-7	-7	0	0	0
Change in the stock of unspent own source revenues (– = increase)	11	0	0	0	0	0	0
Change in bank balance of the general government (– = increase)	72	101	-113	45	-34	-31	-46
Of which : change in balance at the CBK (– = increase)	236	-42	-134	45	-34	-31	-46
Financing gap to cover the recommended level of bank balance	0	43	63	47	83	80	77
Actual bank balance of the general government 2/	342	241	354	309	343	374	420
Recommended minimum level of bank balance	…	241	354	309	343	374	420
Memorandum items:							
Total public debt	690	729	789	929	1,190	1,334	1,485
External debt 3/	690	729	789	829	924	1,020	1,115
Domestic debt	0	0	0	100	266	314	370

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

1/ Including capital transfers to public enterprises.

2/ Includes balances at the CBK and in commercial banks.

3/ Assumes that financing gap is covered with external debt.

Table 4. Kosovo: Consolidated Government Budget, 2009–15

(Excluding donor designated grants; percent of GDP)

	2009	2010	2011	2012	2013	2014	2015
	Act.	Program			Projections		
Total revenue and grants	29.7	28.9	27.5	27.9	26.5	26.8	27.1
Total revenue	29.6	26.9	25.7	26.3	26.5	26.8	27.1
Taxes	21.1	21.6	22.3	22.8	23.0	23.2	23.4
Direct taxes	3.4	3.2	3.4	3.6	3.7	3.8	3.9
Personal Income Tax	1.5	1.8	1.9	2.0	2.1	2.2	2.3
Corporate Income Tax	1.4	1.3	1.3	1.4	1.5	1.5	1.5
Monopoly Surcharge	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Profit tax	0.3	0.1	0.1	0.1	0.1	0.1	0.1
Other	0.1	0.1	0.1	0.1	0.1	0.1	0.1
Indirect taxes	18.4	19.1	19.6	19.9	20.0	20.1	20.2
VAT	10.4	10.6	10.5	10.5	10.6	10.7	10.7
Excise	5.3	5.9	6.5	6.9	6.9	6.9	6.9
Customs	2.6	2.6	2.6	2.5	2.5	2.5	2.5
Tax refunds	-0.7	-0.7	-0.7	-0.7	-0.7	-0.7	-0.7
Nontax revenues	8.5	5.2	3.4	3.4	3.5	3.6	3.6
Of which : dividends	5.2	2.1	…	…	…	…	…
Grants	0.1	2.0	1.8	1.6	0.0	0.0	0.0
Budget support	0.1	1.8	1.7	1.6	0.0	0.0	0.0
Trust fund: interest payment to the World Bank	0.0	0.1	0.1	0.0	0.0	0.0	0.0
Project grants	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Primary expenditure	30.3	32.0	32.8	31.7	30.8	28.7	28.6
Current expenditure	18.6	18.7	18.5	18.5	18.6	18.9	19.1
Wages and salaries	6.8	7.6	7.4	7.6	7.7	7.9	8.0
Goods and services	4.5	4.6	4.4	4.4	4.4	4.5	4.5
Subsidies and transfers	7.3	6.2	6.6	6.4	6.4	6.4	6.5
Pension and social assistance	3.8	4.0	4.2	4.2	4.2	4.4	4.5
Other transfers and subsidies 1/	3.5	2.2	2.4	2.2	2.2	2.0	2.0
Reserve	0.0	0.3	0.1	0.1	0.1	0.1	0.1
Capital expenditure and net lending	11.7	13.3	14.3	13.2	12.2	9.8	9.5
Capital expenditure	9.7	11.8	13.3	13.2	12.2	9.8	9.5
Highway project	0.0	3.2	6.1	6.2	5.3	0.6	0.0
Other capital spending	9.7	8.6	7.1	7.0	6.8	9.3	9.5
Net lending	2.0	1.5	1.0	0.0	0.0	0.0	0.0
Disbursement	2.0	1.5	1.0	0.0	0.0	0.0	0.0
Repayment	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Primary balance	-0.6	-3.1	-5.3	-3.8	-4.2	-1.9	-1.5
Interest payments	0.2	0.2	0.2	0.2	0.3	0.5	0.5
Overall balance	-0.8	-3.4	-5.5	-4.0	-4.6	-2.4	-2.0
Overall balance (excluding highway expenditures)	-0.8	-0.2	0.6	2.2	0.8	-1.8	-2.0
Errors and omissions	0.0	…	…	…	…	…	…
Financing	0.8	2.3	4.1	3.0	2.9	0.9	0.7
Foreign financing	-1.3	0.0	0.1	-0.1	0.2	0.2	0.2
Drawings	0.0	0.1	0.2	0.2	0.4	0.4	0.4
Amortization	-0.2	-0.3	-0.3	-0.2	-0.2	-0.2	-0.2
Trust fund: principal payment to the World Bank	0.0	0.1	0.1	0.0	0.0	0.0	0.0
World Bank loan prepayment	-3.2	0.0	0.0	0.0	0.0	0.0	0.0
Use of the trust fund for the loan prepayment	2.1	0.0	0.0	0.0	0.0	0.0	0.0
Domestic financing	2.1	2.4	4.0	3.1	2.8	0.7	0.5
Domestic borrowing (net)	0.0	0.0	0.0	2.1	3.2	0.9	1.0
Privatization revenues	0.0	0.0	6.7	0.2	0.2	0.4	0.4
Other financial assets (net)	0.0	-0.1	-0.2	-0.1	0.0	0.0	0.0
Change in the stock of unspent own source revenues (– = increase)	0.3	0.0	0.0	0.0	0.0	0.0	0.0
Change in bank balance of the general government (– = increase)	1.9	2.4	-2.5	0.9	-0.7	-0.6	-0.8
Of which : change in balance at the CBK (– = increase)	6.1	-1.0	-3.0	0.9	-0.7	-0.6	-0.8
Financing gap to cover the recommended level of bank balance	…	1.0	1.4	1.0	1.6	1.5	1.4
Recommended minimum level of bank balance	…	5.9	7.9	6.4	6.7	7.0	7.4
Actual bank balance of the general government 2/	8.8	5.9	7.9	6.4	6.7	7.0	7.4
Memorandum items:							
Total public debt	17.8	17.7	17.6	19.3	23.3	24.9	26.3
External debt 3/	17.8	17.7	17.6	17.2	18.1	19.0	19.7
Domestic debt	0.0	0.0	0.0	2.1	5.2	5.9	6.5
GDP (millions of euros)	3,868	4,113	4,480	4,803	5,110	5,356	5,652

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

1/ Including capital transfers to public enterprises.

2/ Includes balances at the CBK and in commercial banks.

3/ Assumes that financing gap is covered with external debt.

Table 5. Kosovo: Balance of Payments, 2007-15
(Millions of euros, unless otherwise indicated)

	2007	2008	2009	2010	2011	2012	2013	2014	2015
			Est.	Proj.	Proj.	Proj.	Proj.	Proj.	Proj.
Goods and services balance	-1,317	-1,596	-1,558	-1,727	-1,809	-1,867	-1,867	-1,838	-1,849
Trade balance	-1,368	-1,668	-1,644	-1,832	-1,917	-2,014	-2,083	-2,083	-2,117
Exports	177	218	163	220	280	326	393	502	622
Imports	-1,545	-1,886	-1,807	-2,052	-2,197	-2,341	-2,476	-2,586	-2,740
Services	51	72	86	105	108	147	216	245	269
Receipts	338	357	382	422	458	510	558	595	630
Payments	-286	-285	-296	-317	-349	-363	-342	-349	-361
Income	219	158	95	116	129	163	195	205	219
Compensation of employees (net)	154	167	161	171	181	192	203	213	224
Investment income	64	-9	-66	-54	-51	-29	-8	-9	-5
Interest payments on public debt	0	0	-7	-10	-10	-11	-11	-10	-10
Transfers	796	823	744	850	865	884	863	916	977
Official transfers	297	287	247	316	278	250	185	208	228
Other transfers (net)	499	536	496	534	586	634	678	708	749
Inflows of workers' remittances	516	535	498	522	564	598	634	672	712
Current account	-302	-615	-720	-760	-815	-821	-809	-717	-653
Capital and financial account	69	494	455	499	534	556	508	419	358
Capital account	1	-2	87	16	5	5	5	5	5
Debt forgiveness from WB Trust Fund	0	0	82	11	0	0	0	0	0
Financial account	69	495	368	483	529	551	503	414	353
Foreign direct investment (net)	431	341	301	351	701	401	452	553	617
Commercial banks, excl. FDI	14	-6	-118	-12	-14	-70	20	2	-58
General government	0	0	-133	-7	-3	-3	9	9	9
Disbursements (excl. IMF)	0	0	0	4	8	8	20	20	20
Repayments	0	0	-133	-11	-11	-11	-11	-11	-11
Prepayment of debt	0	0	-125	0	0	0	0	0	0
Other repayments	0	0	-8	-11	-11	-11	-11	-11	-11
Other	0	0	0	0	0	0	0	0	0
Other sectors, excl. FDI 1/	40	213	296	167	29	239	53	-116	-165
Central Bank of Kosovo, net foreign assets (- = increase)	-417	-53	23	-16	-184	-15	-30	-33	-50
Reserve assets	-288	-77	75	79	-84	87	4	3	-12
Government balances at the CBK	-221	-17	236	-42	-134	45	-34	-31	-46
Other reserve assets (incl. SDR holdings and IMF quota)	-67	-60	-161	121	50	42	38	34	34
Non-reserves assets	-128	24	-163	-98	-100	-102	-35	-36	-38
Liabilities 2/	0	0	110	2	0	0	0	0	0
Net errors and omissions 3/	232	121	265	218	218	218	218	218	218
Financing gap	0	0	0	43	63	47	83	80	77
Memorandum items:									
Current account (excl. official transfers)	-599	-903	-967	-1,077	-1,093	-1,071	-994	-925	-881
Percent of GDP	-17.6	-23.4	-25.0	-26.2	-24.4	-22.3	-19.5	-17.3	-15.6
Current account (incl. official transfers)	-302	-615	-720	-760	-815	-821	-809	-717	-653
Percent of GDP	-8.8	-16.0	-18.6	-18.5	-18.2	-17.1	-15.8	-13.4	-11.5
Official transfers (percent of GDP)	8.7	7.5	6.4	7.7	6.2	5.2	3.6	3.9	4.0
Debt service to export ratio (percent)	0.0	0.0	25.7	3.3	2.9	2.6	2.3	2.0	1.7
Net foreign assets of commercial banks	320	325	444	456	469	540	519	518	575
Net foreign assets of CBK	1,058	1,111	1,088	1,104	1,288	1,303	1,334	1,367	1,417
Gross international reserves of the CBK	661	739	663	584	668	581	577	574	586

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

1/ Including trading companies, insurance companies, and pension funds.
2/ Includes SDR allocations and IMF account.
3/ Projections of errors include unidentified private remittances and other capital based on average historical levels.

Table 6. Kosovo: Monetary Survey, 2007-11
(Millions of euros, unless otherwise indicated)

	2007	2008	2009	2010	2011
				Proj.	Proj.
Net foreign assets	1,378	1,436	1,532	1,560	1,758
CBK	1,058	1,111	1,088	1,104	1,288
Assets	1,058	1,111	1,198	1,217	1,401
Liabilities 1/	0	0	-110	-113	-113
Commercial banks	320	325	444	456	469
Assets	369	401	584	567	539
Liabilities	-49	-76	-140	-112	-70
Net domestic assets	-197	32	115	197	192
Net claims on the central government	-853	-872	-846	-819	-998
Liabilities 2/	-853	-872	-846	-819	-998
Of which: KTA (privatization) fund	-398	-406	-451	-521	-591
Loans to the private sector	892	1,183	1,289	1,367	1,560
Other items net	-236	-280	-327	-351	-370
Broad money	1,180	1,468	1,647	1,756	1,950
Demand deposits	414	455	621	663	736
Time deposits	767	1,013	1,025	1,094	1,214
Memorandum item:					
Gross international reserves	647	670	576	552	697
	(12-month change in relation to broad money at the beginning of the period)				
Net foreign assets	42.2	5.0	6.5	1.7	11.3
Net domestic assets	-18.4	19.4	5.7	4.9	-0.3
Net claims on the central government	-39.7	-1.6	1.7	1.7	-10.2
	(12-month percent change, unless otherwise indicated)				
Broad money	23.8	24.4	12.2	6.7	11.0
Loans to the private sector	40.1	32.7	8.9	6.0	14.1
	(Percent of GDP)				
Total deposits	34.6	38.1	42.6	42.7	43.5
Loans to the private sector	26.2	30.7	33.3	33.2	34.8

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

1/ 2009 SDR allocation and liability relative to the IMF quota.

2/ Includes government balances and other official deposits.

Table 7. Kosovo: Selected Financial Soundness Indicators, 2006–10

(Percent)

	2006	2007	2008	2009	2010
	Q4	Q4	Q4	Q4	Q1
Capital adequacy					
Regulatory capital/risk weighted assets	16.8	17.4	16.5	17.9	18.8
Tier 1 capital/risk weighted assets	14.7	16.4	15.3	15.1	15.8
Asset quality					
NPL ratio 1/	4.1	4.1	3.3	4.3	4.6
NPL net of provisions/capital	…	2.6	2.8	2.3	3.3
Sectoral breakdown of loans					
Agriculture	2.0	3.2	3.2	3.0	0.5
Manufacturing	7.5	9.9	7.8	9.4	8.3
Trade	47.3	46.6	42.6	41.4	35.2
Other services	7.7	11.4	16.9	9.8	7.9
Construction	4.0	5.6	5.5	6.9	7.8
Households	22.9	22.5	23.7	26.6	31.1
Liquidity					
Liquid assets/total assets 2/	41.7	33.2	30.0	37.3	35.8
Deposits/loans	145.2	128.1	122.0	138.6	134.6
Liquid assets to short-term liabilities 2/	59.8	47.8	42.1	47.0	46.6
Profitability					
Return on assets 3/	2.3	2.9	2.6	1.4	0.3
Return on equity 3/	25.7	27.1	24.7	21.4	3.3
Interest margin to gross income 4/	60.4	58.4	60.3	55.3	53.6
Non-interest expense to gross income 5/	12.0	12.6	11.2	16.3	14.7

Source: Central Bank of the Republic of Kosovo.

1/ NPL ratio includes the loans which are classified as doubtful loans and bad loans.
2/ Liquid assets are cash, balances with CBK and commercial banks, and securities.
3/ Not annualized.
4/ Interest income minus interest expenditures. Gross income taken from income statement.
5/ Includes fees, commissions, provisions for loan and other asset losses, and depreciation of fixed assets.

Table 8.a. Kosovo: Gross Financing Requirements, 2009–11
(Millions of euros)

	2009	2010	2011
Financing requirements	-853	-846	-901
Current account deficit, excl. IDA and EC	-720	-835	-890
Amortization of medium and long term public debt	-133	-11	-11
Available financing	853	803	838
Official current transfers from IDA and EC	0	75	75
Capital transfers	87	16	5
FDI net	301	351	701
Net bank financing	-118	-12	-14
Government loans	0	4	8
Other financing incl. net errors and omissions	561	385	247
Net foreign assets of the Central Bank of Kosovo	23	-16	-184
Financing gap	0	43	63
Financing:			
IMF	…	43	63
Percent of quota	…	64	93

Source: IMF staff estimates and projections.

Table 8.b. Kosovo: Gross Financing Requirements, 2009–11
(Percent of GDP)

	2009	2010	2011
Financing requirements	-22.1	-20.6	-20.1
Current account deficit, excl. IDA and EC	-18.6	-20.3	-19.9
Amortization of medium and long term public debt	-3.4	-0.3	-0.3
Available financing	22.1	19.5	18.7
Official current transfers from IDA and EC	0.0	1.8	1.7
Capital transfers	2.2	0.4	0.1
FDI net	7.8	8.5	15.6
Net bank financing	-3.1	-0.3	-0.3
Government loans	0.0	0.1	0.2
Other financing incl. net errors and omissions	14.5	9.4	5.5
Net foreign assets of the Central Bank of Kosovo	0.6	-0.4	-4.1
Financing gap	0.0	1.0	1.4
Financing:			
IMF	…	1.0	1.4

Source: IMF staff estimates and projections.

Table 9. Kosovo: Schedule of Disbursements Under the SBA Arrangement, 2010–11[1/]

Amount	Date Available	Conditions Necessary for Disbursement
SDR 18.760 million	July 21, 2010	Following Executive Board approval of the 18 month SBA arrangement
SDR 18.760 million	November 30, 2010	Observance of the performance criteria for August 31, 2010, and completion of the first review under the arrangement
SDR 13.784 million	March 31, 2011	Observance of the performance criteria for December 31, 2010, and completion of the second review under the arrangement
SDR 13.784 million	June 30, 2011	Observance of the performance criteria for March 31, 2011, and completion of the third review under the arrangement
SDR 13.784 million	September 30, 2011	Observance of the performance criteria for June 30, 2011, and completion of the fourth review under the arrangement
SDR 13.784 million	December 15, 2011	Observance of the performance criteria for September 30, 2011, and completion of the fifth review under the arrangement
Total: SDR 92.656 million (157 percent of quota)		

Source: IMF

1/ Assumes Board approval on July 21, 2010.

Table 10. Kosovo: Indicators of Capacity to Repay the Fund, 2010–16 [1/]

	2010	2011	2012	2013	2014	2015	2016
Fund obligations based on existing and prospective credit (millions of SDR)							
Principal	0.0	0.0	0.0	2.4	29.1	44.0	17.2
Charges and interest	0.3	0.9	1.1	1.1	1.0	0.6	0.2
Total obligations based on existing and prospective credit							
SDR millions	0.3	0.9	1.1	3.5	30.1	44.6	17.4
Euro millions	0.3	1.0	1.2	3.8	32.7	48.5	18.9
Percent of exports of goods and services	0.0	0.1	0.1	0.4	3.0	3.9	1.4
Percent of debt service	1.3	4.3	5.2	14.8	63.1	73.4	32.9
Percent of GDP	0.0	0.0	0.0	0.1	0.6	0.9	0.3
Percent of domestic revenue	0.0	0.1	0.1	0.3	2.3	3.2	1.2
Percent of quota	0.4	1.5	1.9	5.9	51.0	75.5	29.5
Outstanding Fund credit							
SDR millions	37.5	92.7	92.7	90.3	61.2	17.2	0.0
Euro millions	40.8	100.7	100.7	98.2	66.5	18.7	0.0
Percent of exports of goods and services	6.4	13.7	12.0	10.3	6.1	1.5	0.0
Percent of debt service	190.8	449.6	434.6	384.6	128.3	28.4	0.0
Percent of GDP	1.0	2.2	2.1	1.9	1.2	0.3	0.0
Percent of domestic revenue	3.7	8.8	8.0	7.2	4.6	1.2	0.0
Percent of quota	63.6	157.1	157.1	153.1	103.7	29.2	0.0
Net use of Fund credit (millions of SDR)	37.5	55.1	0.0	-2.4	-29.1	-44.0	-17.2
Disbursements	37.5	55.1	0.0	0.0	0.0	0.0	0.0
Repayments and Repurchases	0.0	0.0	0.0	2.4	29.1	44.0	17.2
Memorandum items:							
Exports of goods and services (millions of euros)	642	737	837	951	1,097	1,253	1,328
External debt service (millions of euros) [2]	21.4	22.4	23.2	25.5	51.9	66.0	57.5
Nominal GDP (millions of euros)	4,113	4,480	4,803	5,110	5,356	5,652	6,022
Domestic revenue (millions of euros) [3]	1,106	1,150	1,263	1,356	1,436	1,530	1,619
Quota (millions of SDR)	59.0	59.0	59.0	59.0	59.0	59.0	59.0

Sources: IMF staff estimates and projections.

[1/] Assumes prospective SBA disbursements in 2010 and 2011.

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

[3/] Domestic revenues correspond to total revenues and excludes grants.

APPENDIX I—LETTER OF INTENT

REPUBLIC OF KOSOVO

Pristina, July 7, 2010

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

Dear Mr. Strauss-Kahn:

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

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

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

We believe that the policies set forth in the attached Memorandum of Economic and Financial Policies (MEFP) are sufficient to achieve the objectives of our economic program, but we will take any further measures that may become necessary. Kosovo will consult with the Fund on the adoption of these measures, and in advance of revisions to the policies contained in the MEFP, in accordance with the Fund's policies on such consultation. Further, we will provide the Fund with such information as it requests on policy implementation and achievement of the program objectives. The understandings between us and the IMF staff regarding performance criteria and structural measures described in this letter are further specified in the attached Technical Memorandum of Understanding.

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

Sincerely yours,

/s/

Hashim Thaçi
Prime Minister

/s/	/s/
Ahmet Shala Minister of Economy and Finance	Hashim Rexhepi Governor Central Bank of the Republic of Kosovo

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

ATTACHMENT I

REPUBLIC OF KOSOVO

MEMORANDUM OF ECONOMIC AND FINANCIAL POLICIES

July 7, 2010

I. ECONOMIC AND POLICY DEVELOPMENTS

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

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

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

4. **Nevertheless, we recognize that the CBK lacks adequate resources to safeguard financial stability.** Kosovo's economy is euroised and, therefore, the international reserves of the CBK are relatively low. As a result, the scope for emergency liquidity assistance (ELA) by the

CBK, if needed, largely hinges on the fiscal authorities' bank balances held at the central bank. However, a possible further decline of these balances could undermine the CBK's efforts to safeguard financial stability.

II. ECONOMIC OBJECTIVES AND OUTLOOK

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

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

- **Real GDP growth** is projected to increase moderately to 4.6 percent in 2010, largely reflecting a rebound in global growth, remittances, and exports. We therefore expect a substantial improvement in private sector activity. However, our growth projections are subject to downside risks, considering the ongoing slowdown in private sector lending, possible delays with the execution of highway construction, and continued uncertainties about the external environment. While our direct exposure to the southern rim of the euro area is limited, we are immediately affected by potential adverse developments in the euro area.

- **Inflation**, as measured by the Consumer Price Index (CPI), is forecast to reach 1.7 percent on average in 2010. Amidst the global recovery, import prices are forecast to rise, thus ending a short-lived period of deflation. We expect the inflationary impact of our revenue measures to be muted, while the impact of the highway project on domestic prices should be limited, given the high import share of construction inputs.

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

III. ECONOMIC POLICIES

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

- **Fiscal adjustment will be the cornerstone of our stabilization program.** To fund the highway expenditures, we have taken revenue measures and decided to reallocate spending. The fiscal balance—excluding highway expenditures —will improve over the program period and reach a surplus of 0.6 percent of GDP in 2011. However, given rising highway expenditures, the overall balance is projected to widen to 5.5 percent of GDP in 2011 from 3.4 percent of GDP in 2010. Therefore, we recognize that, without jeopardizing the stability of our public finances, there is no scope to adopt initiatives in addition to our policy priorities outlined in this memorandum.

- **We will take further steps to maintain financial sector stability.** First, our fiscal stance is designed to bolster our bank balances and, therefore, the resources available to the CBK for the purpose of ELA, if needed. Second, we are intent on modernizing the CBK Law, and aim to establish a legal basis for ELA by the central bank, if necessary. Third, we are overhauling the banking law to improve corporate governance and broaden our legal framework for bank resolution.

- **We recognize that structural reforms are critical to boost the economy's low capacity to produce, save, and export.** Addressing this challenge requires a comprehensive policy strategy for the medium term. As initial steps, we are committed to (i) raising the productivity of the public sector; and (ii) reforming the energy sector—with support from the World Bank and other institutions.

A. The 2010 Budget

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

- **Revenues.** Effective July 1, 2010 select excises, including on alcohol, tobacco, and fuels, were increased. We estimate these measures will yield 1.0 percent of GDP annually. Since last year's revenues were boosted by a tax amnesty, tax revenues are projected to rise by ½ percentage point of GDP to 21.6 percent of GDP in 2010. Including one-off receipts and donor grants (4.1 percent of GDP), revenues are projected to reach 28.9 percent of GDP.

- **Expenditures.** We decided to limit our 2010 primary expenditures at 32 percent of GDP. Excluding the outlays for the highway, expenditures are 1.7 percentage points of GDP lower than in 2009. These cuts underscore our commitment to provide funding for the highway project from expenditure reallocations. Moreover, we have decided to limit our current spending at 18.7 percent of GDP, only slightly higher than in 2009.

- **Contingencies.** Compared to 2009, transfers (subsidies and loans) to KEK, the publicly-owned energy company, are budgeted to decline by 0.8 percent of GDP in 2010. However, should KEK need any emergency financing, above the allocations included in the revised 2010 budget (in total of 2.4 percent of GDP), we will seek offsetting expenditure cuts through a further budget amendment by the Assembly. This measure ensures that adverse events in the energy sector will not widen the deficit.

- **Bank balance.** With budget support from the IMF, the bank balance will not fall below 5.9 percent of GDP, a level that we deem prudent and consistent with our responsibility for safeguarding financial stability.

B. Fiscal Policies for 2011

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

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

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

12. **Given the policies outlined above, our budget will be fully financed without any commercial borrowing during 2010–11.** However, should a financing gap arise, including from a possible shortfall in privatization receipts or privatization delays, we will undertake further

expenditure and revenue measures to maintain our program on track. In particular, at least 25 percent of the central government's capital expenditure budgeted for 2011 will remain unallocated until such time that the sale of PTK is completed. Moreover, should the sale receipts fall short of the expected minimum, the impact of this shortfall on the bank balance will be offset through a reduction in capital expenditures up to the maximum unallocated amounts. Should these expenditure cuts not be sufficient to meet our bank balance target in 2011, we will take revenue measures and avoid commercial borrowing.

C. Financial Sector Policies

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

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

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

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

procedures for members of the CBK's executive board, including the Governor, are designed to prevent undue political interference and follow best international practice.

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

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

IV. Fiscal Policy—Achieving Fiscal Sustainability

A. Improving Budget Processes and Expenditure Management

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

- In support of our policy to contain current spending, the Cabinet made a commitment to ensure that no further spending initiatives are introduced this year.

- The Assembly adopted the Law on Wages of Civil Servants and the Law on Civil Service on May 13, 2010. These laws provide a rules-based framework for setting civil servants' wages.

Therefore, starting January 1, 2011, all existing allowances hitherto paid to civil servants will be incorporated into the overall civil servants' wage bill consistent with the Law on Wages of Civil Servants. We are prepared to take expenditure measures needed to offset any unanticipated costs related to these reforms, including those that may result from grandfathering. We will ensure that the share of the public sector wage bill in GDP does not rise above 7.4 percent of GDP in 2011.

- As a prior action, the Law on Public and Financial Management and Accountability was amended to ensure that any spending initiatives introduced in MYBRs in 2011 and subsequent years will be fully financed by revenue measures or offsetting expenditure cuts. As a result of this amendment, unfunded expenditure commitments will no longer inflate expenditures and raise the deficit beyond the target set in the annual budget.

- We are committed to submitting, for approval by the Cabinet, only those draft laws for which the MoEF has undertaken a comprehensive assessment of their short- and long-term economic and fiscal impact.

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

- A table comparing (i) the approved budget and related financing requirements; (ii) the projected/actual outcome; (iii) the MYBR (when relevant), and (iv) the MTEF.

- A table summarizing policy-induced changes in the fiscal framework, and their impact on expenditure, revenue, and/or financing requirements.

- Separate tables for (i) the central government, (ii) municipalities, (iii) inter-governmental transfers, and (iv) the consolidated government (i.e., the current Kosovo Consolidated Budget). An appendix in fiscal statements containing for each budget organization, including municipalities, a table on Own-Source Revenues (OSR) and their use by economic category of spending.

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

B. Improving Tax Administration

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

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

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

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

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

- *An upgrade of our current core IT system (SIGTAS) commenced in November 2009 and will be completed by end-July 2010.* The upgrade will mitigate some of the major weaknesses in the system (e.g., modules related to audit, collections, appeals, and management information) until a new IT system can be implemented.

- *A tender for the procurement of a new IT system is expected to be issued by the European Commission (EC) by end-2010*. We will closely cooperate with the EC and the IMF in determining both the requirements to a new IT system and the subsequent need for redesigning TAK's business processes, which would be a substantial component of the IT contract.

C. Improving Public Financial Management

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

- The PIC will establish a quarterly monitoring mechanism of capital spending executions by August 2010. As part of this mechanism, quarterly execution benchmarks will be set. In future budget allocations, the MoEF retains the right to lower capital expenditure allocations in case of significant under-execution compared to the benchmark.

- Starting with the 2011 budget, we will publish a list of investment projects, ranked by their priority order. In case cuts have to be made, we will cut first projects with the lowest priority. A strict separation of preparation and execution phases of capital investments is necessary to prevent the commencement of capital projects without adequate costing or funding. Therefore, allocations for project execution will only be made upon completion of project preparation.

- We are taking steps to prepare for the introduction of mandatory cost-benefit analysis for all large scale projects. In order to prepare budget organizations for the introduction of cost-benefit analysis, we will undertake a feasibility study by June 2011. This study will draw on the lessons from cost benefit analysis that we plan to carry out for 10 large projects under consideration for inclusion in the 2012 budget.

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

resulting from the highway project, the uncertainties surrounding the timing of the privatization, and the fact that some of our bank balances are held with commercial banks.

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

V. Energy Sector and Other Structural Policy Initiatives

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

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

- The need for a potentially substantial increase in tariffs in order to allow KEK cost recovery and facilitate the company's privatization.

- The feasibility of charging KEK royalty fees for its use of Kosovo's large lignite reserves, following a possible tariff increase.

- Adopting draft amendments to Kosovo's Criminal Code to address energy theft.

- Stepping up enforcement of debt judgments to curtail nonpayment problems by allowing the creation of a lien on a property or the use of private enforcement agencies that have been licensed.

- Setting out a timeline to address overstaffing at KEK to improve the company's cost structure.

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

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

VI. Other Issues

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

- To improve the accuracy of our fiscal accounts, there will be monthly audits of these data, in line with IMF safeguard advice. In particular, the data on bank balances from the Treasury and the CBK will be fully reconciled. For the purpose of program monitoring, the data on bank balances will be reported individually by the CBK and by the Treasury.

- To improve the institutional framework, we will submit to the Assembly by September 2010 the Law on Statistics, which will provide the Statistical Office of Kosovo (SOK) with independence. With greater flexibility on budget implementation, the quality and timeliness of statistics are expected to improve. Although technical assistance, including from the IMF, has been instrumental in improving the quality and timeliness of statistics, there remain considerable weaknesses, especially in the national income accounts. We therefore intend to make continued, substantial improvements to the quality of our statistics. With the objective to improve the quality of our economic statistics, we will join the General Data Dissemination System and have appointed the CBK as Country Coordinator.

VII. Program Monitoring

35. **The program will be monitored in general on a quarterly basis**, by quantitative performance criteria, indicative targets, and structural benchmarks as defined in the Technical Memorandum of Understanding (TMU). The quantitative performance criteria and indicative targets for end-August 2010, and end-December are set out in Table 1. The structural benchmarks of the program are set out in Table 2. To monitor program implementation, we have established a Program Monitoring Committee (PMC), composed of the Director of the Treasury, the two

Budget Directors, the two Deputy Governors of the CBK, the advisor to the Prime Minister, the head of the Macro Unit, the two internal auditors, respectively one each from the CBK and the MoEF, and the IMF resident representative. The PMC will meet at least once monthly. The first and the second reviews are expected to be completed no later than November 30, 2010 and March 31, 2011, respectively.

Table 1. Kosovo: Quantitative Performance Criteria (PC) and Indicative Targets (IT), 2010—11

(Millions of euros, cumulative from beginning of the year)

	2010		2011	
Test date	Aug.	Dec.	Mar.	Jun.
Type of objective	PC	PC	IT	IT
Objective to be observed				
Floor on the bank balance of the general government 1/	369	241	226	457
Floor on the primary fiscal balance of the general government 1/	21	-129	-37	-121
Ceiling on primary expenditures of the general government1/	700	1,316	275	628
Ceiling on contracting or guaranteeing nonconcessional debt by the general government	0	0	0	0
Ceiling on the accumulation of domestic payment arrears of the general government 2/	…	…	0	0
Ceiling on the accumulation of external payments arrears of the general government 3/	0	0	0	0
Memorandum items:				
Indicative target for all test dates				
Ceiling on recurrent primary expenditures of the general government	459	770	183	387
Program assumptions				
Total revenue (excluding grants)	805	1,106	233	507
New privatization receipts	0	0	0	300
Non-project grants	0	80	5	60
Budget support loans	0	0	0	0
Project grants	0	1	0	0
Project loans	0	1	0	0

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

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

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

3/ To be observed continuously.

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

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

ATTACHMENT II

TECHNICAL MEMORANDUM OF UNDERSTANDING

REPUBLIC OF KOSOVO

Definitions and Data Reporting Requirements Under the 2010–11 SBA Arrangement

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

I. QUANTITATIVE PERFORMANCE CRITERIA AND INDICATIVE TARGETS

A. Coverage

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

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

B. Bank Balances of the General Government

4. **Bank balances** are funds usable and readily available (i.e., liquid or marketable, and free of any pledges or encumbrances), held and controlled by the general government for the purposes of making payments and transfers. Bank balances include Undistributed Funds of the Government of Kosovo plus funds specifically reserved for policy purposes (e.g. undistributed KEK loan) but do not include the balance of unspent Own Source Revenues (OSR) carried forward, or funds encumbered or pledged as Donor Designated Funds and funds relative to onlending operations. Bank balances do not include investments made and managed by an outside Investment Manager assigned by the Minister pursuant to Kosovo's Law on Public Financial Management Article 7.1.(iii). Bank balances may be held in the form of gold, holdings of foreign exchange and traveler's checks, demand and short-term deposits at foreign banks, domestic banks, and the Central Bank of the Republic of Kosovo (CBK), long-term deposits abroad that can be liquidated without penalty, and any holdings of investment-grade securities held directly by the general government. Bank balances at December 31, 2009 were € 341.930 million and at March 31, 2010, they were € 366.237 million.

- The floor on the bank balance set in Table 1 will be lowered by

    - the shortfall in the resources purchased from the IMF under this SBA relative to program assumptions.

- The floor on the bank balance set in Table 1 will be raised by

    - the excess in the euro value of the resources purchased from the IMF under this SBA relative to program assumptions;
    - the repayment of loans extended to public enterprises.

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

C. Primary Expenditures of the General Government

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

- The ceiling on primary expenditures set in Table 1 will be raised by

    - The excess of project grants and loans relative to program assumptions;
    - The excess of budget grants relative to program assumptions.

- The ceiling on primary expenditures set in Table 1 will be lowered by

    - The shortfall of project grants and loans relative to program assumptions;
    - The shortfall of budget grants relative to program assumptions.

7. For the purposes of this memorandum, **proceeds of privatizations** will be understood to mean all monies received by the government from the sale of a publicly owned company, organization, or facility to a private company or companies, organization(s), or individual(s), as well as any proceeds generated from the sale of government nonfinancial assets and from the liquidation of the assets of the Kosovo Privatization Authority. Proceeds of privatizations are not

part of revenues. Instead, these are recorded as a domestic financing (Net acquisition of financial assets).

8. **Reporting requirements.** Data on the monthly execution of revenues and expenditures will be provided monthly no later than five weeks after the end of each month, including (i) government domestic revenue detailing by components direct taxes, indirect taxes, and nontax revenues; (ii) external budget support grants; (iii) primary recurrent expenditure, (iv) domestic and external interest payments and receipts, (v) capital expenditure detailing all those related to the construction of Route 7 and including domestically and budget support financed capital expenditure and externally project financed capital expenditure; (vi) the gross payment and gross accumulation of domestic payments arrears; (vii) external loan receipts and principal payments; (viii) external arrears payments and accumulation; (ix) bank and nonbank financing; (x) privatization and receipts of the sales of nonfinancial assets; and (xi) any other revenue, expenditure, or financing not included above.

D. Primary Fiscal Balance of the General Government

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

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

E. Contracting or Guaranteeing Nonconcessional Debt by the General Government

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

the sale of the SDR holdings allocated to Kosovo. Debt rescheduling and debt reorganization of debts contracted before the approval of the SBA are excluded from the limits on nonconcessional debt. The definition of short-term nonconcessional debt excludes normal short-term (less than one year) import-related financing. The performance criterion applies not only to debt as defined below but also to commitments contracted or guaranteed for which value has not been received. The contracting or guaranteeing nonconcessional debt by the general government will be assessed at each test date.

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

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

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

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

during the period of the agreement excluding those payments that cover the operation, repair or maintenance of the property.

"(b) Under the definition of debt set out in this paragraph, arrears, penalties, and judicially awarded damages arising from the failure to make payment under a contractual obligation that constitutes debt are debt. Failure to make payment on an obligation that is not considered debt under this definition (e.g., payment on delivery) will not give rise to debt."

F. Domestic Payments Arrears

14. A domestic payment obligation to suppliers or creditors is deemed to be in **arrears** if: (a) goods and services have been received; (b) they have been certified to conform to the order of the contract; and (c) the due-for-payment date has passed and the obligation has remained unpaid beyond the normal or contractually agreed period of credit. The stock of arrears will be assessed at end-December 2010 and the accumulation of new domestic arrears will be assessed continuously beginning January 1, 2011 (when the monitoring system will be operational). A payment obligation is defined to be domestic if the creditor is resident in Kosovo.

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

G. External Payments Arrears

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

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

II. Other Data Requirements

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

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

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

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

ANNEX I—REPUBLIC OF KOSOVO: SUMMARY OF POLITICAL EVENTS

1. **Kosovo became a member of the IMF on 29 June 2009.** The Executive Board had certified on May 8, 2009 the vote of IMF's Board of Governors to offer membership to Kosovo.

2. **Kosovo's constitution entered into force in June 2008, following the unilateral declaration of independence (UDI) in February.** In the aftermath of the conflict, UN Security Council Resolution No.1244 authorized the Secretary-General to establish an international civil presence in Kosovo. The United Nations Mission in Kosovo (UNMIK) was given executive responsibilities under four "pillars," namely, police and justice, civil administration, institution building, and reconstruction. As local capacities increased, UNMIK's powers were transferred to the Provisional Institutions of Self-Government (PISG) in a phased manner. UNMIK relinquished remaining powers upon entry into force of Kosovo's constitution.

3. **The post-independence reconfiguration of UNMIK was accompanied by the deployment of a European Union "rule of law" mission (EULEX) and the establishment of an International Civilian Office (ICO).** The principal mission of EULEX is to assist the judicial authorities and law enforcement agencies to establish sustainable and accountable institutions and practices. The ICO's mission is concentrated on ensuring implementation of those aspects of the Comprehensive Proposal for the Kosovo Status Settlement (viz., the Ahtisaari Proposal (AP)), aimed at building a multi-ethnic society through assistance in drafting legislation and regulations in the social and economic spheres. Although the AP was not brought to a vote in the UN Security Council, the Assembly of Kosovo formally adopted the proposal in February 2008 as the framework for Kosovo's status resolution.

4. **Since 1999, Fund staff has provided technical assistance and policy advice to UNMIK under EBD/99/80 and, since September 2008, to Kosovo under EBD/08/95.** Technical assistance has been centered on the Fund's core competencies, notably in the areas of fiscal policy, the banking and payments systems, and macroeconomic statistics. Assistance has also contributed to developing key aspects of the legal and institutional framework needed for a market economy. Fund policy advice was helpful in restoring macroeconomic stability after understandings on a policy package were reached with Fund staff in late 2005. Staff's Letter of Assessment to the European Commission in July 2008 was instrumental in garnering donor support.[2] Following Staff's Letter of Assessment to the European Commission of November 2009, ECFIN extended the December 2009 deadline to provide Macro-Financial Assistance to Kosovo.

[2] http://www.seerecon.org/kdc/loa.pdf

ANNEX II

REPUBLIC OF KOSOVO

DEBT SUSTAINABILITY ANALYSIS (DSA)

The risk of debt distress in Kosovo is moderate. Although Kosovo's debt is low, its external borrowing space is constrained, mainly by its lackluster and volatile exports. Risks to debt sustainability arise primarily from possible expenditure pressure resulting from cost overruns of large infrastructure projects, shortfalls in privatization proceeds, and the duration of future debt.

I. BACKGROUND

1. **This DSA assesses Kosovo's debt distress risk in light of the policy program that is proposed to be supported by a Stand-By Arrangement (SBA).** Given that Kosovo is eligible to IDA resources, the determination of distress risk uses the World Bank-IMF Debt Sustainability Framework for low-income countries. The determination is made by comparing the debt indicators to the debt burden thresholds under the baseline and alternative scenarios and stress tests for the horizon 2010–30. The thresholds for Kosovo are those for medium-performer under the World Bank's Country Policy and Institutional Assessment (CPIA) rating of 3.4 (compared to 3.3 for the average IDA borrower).

2. **Kosovo's public debt stock is low and the maturities are long.** The present value (PV) of the public external debt at end-2009 was 15 percent of GDP.[3] This includes debt to the World Bank that was assumed when Kosovo became its member. The timing and terms of any future agreement to assume debt issued by the former Yugoslavia are highly uncertain. The PV of these potential liabilities is estimated at 8 percent of GDP. This DSA assumes that, beginning in 2015, these liabilities will be discharged. Because the SDR allocated to Kosovo has not been utilized, its PV is zero. The maturity profile of the existing debt averages 11 years. The general government does not have domestic debt, and private debt is not covered in this DSA.

[3] This DSA includes public debt of the central government, municipalities and the central bank. It does not include state-owned enterprises.

II. The Baseline Scenario: Macroeconomic Assumptions

3. **The baseline scenario is consistent with the policies of the proposed SBA.**

- **During 2010-15, fiscal deficits will be relatively high, but they are projected to decline to the debt-stabilizing level in the outer years (Table 3).** The Route 7 highway project is estimated to cost the equivalent of 25 percent of 2010 GDP and, therefore, will result in considerable fiscal pressure over the near term. Upon completion of this project, primary spending is projected to decline from a high 32 percent of GDP to below 30 percent in the outer years. It is assumed that progress in public financial management will improve the quality of expenditures, thereby widening the fiscal space for new policy initiatives, including social spending.

- **Although the proposed SBA does not foresee important public sector borrowing, this DSA assumes moderate borrowing thereafter.** The government's bank balances and privatization receipts are projected to be the major sources of financing during 2010-11, besides IMF budget financing. Domestic borrowing—at an assumed interest rate of 7 percent and duration of 2.5 years—is projected to begin in 2012 as agreed with the authorities under the proposed SBA. In the outer years, external borrowing is assumed to finance ⅔ of the net borrowing needs.

- **The current account deficit is projected to narrow gradually, notably after the deceleration of public investments in 2013–14 (Table 1).** While the economic viability of certain infrastructure investments is difficult to assess, it is assumed that public investments will contribute to overall productivity and spur economic diversification. As a result, private sector and export sector performance are expected to strengthen. Combined with continued foreign direct investments, these developments would result in steady improvements in the goods and services balance. The reduction of official transfers and remittances, as Kosovo climbs the income ladder, will prevent a further reduction in the current account deficit.

- **Growth is expected to rise steadily, in part reflecting the gains in potential output resulting from public investments.** Staff and the authorities agreed that infrastructure investments and structural reforms are assumed to bolster potential growth permanently and help narrow the income gap with other countries in the region. The authorities expect the impact of reforms on potential output to be larger than staff expects. Prices will be stable as a consequence of the use of euro in the country.

III. Analysis of the Sustainability of the External Public Debt

A. Baseline Scenario

4. **External sustainability indicators remain below the debt burden thresholds through the forecast horizon, but liquidity indicators are projected to increase markedly around 2015 (Figure 1).** Domestic borrowing will limit the need for foreign borrowing and keep the solvency ratios (debt stock in PV terms relative to GDP, exports and revenues) below the debt burden threshold. This favorable trajectory hinges critically on the assumption that fiscal policies will be tightened and that growth will strengthen. On the other hand, the liquidity indicators (debt service to exports and revenues) will rise from 2015 onwards as a result of repayments to the IMF and the assumed servicing of liabilities assumed from the former Yugoslavia. Despite the rise in rollover needs, the external debt service should remain well below the debt burden thresholds in the baseline scenario.

Kosovo: Debt Sustainability, Assumptions 2009−30

	2009	2010−14 1/	2020	2030
		(Percent)		
Real Sector				
Real GDP growth	4.0	4.9	5.2	5.5
GDP deflator inflation rate	-3.4	1.8	2.0	2.0
		(Percent of GDP)		
General government budget				
Total revenue (excl. grants)	29.6	26.4	28.4	28.9
Primary expenditure	30.3	31.2	29.8	30.0
Primary balance	-0.7	-4.7	-1.4	-1.1
Interest payments	0.2	0.4	1.0	1.1
Overall balance	-0.9	-5.1	-2.4	-2.1
Financial statement (stocks)				
Public debt (nominal)	17.8	21.6	28.9	28.8
Public debt (PV)	14.6	19.0	24.5	27.1
Bank balance	8.8	6.8	7.4	7.4
Balance of payments				
Exports of goods and services	14.1	17.7	20.3	20.0
Imports of goods and services	54.4	56.1	48.2	47.0
Current transfers	19.2	18.5	14.5	12.0
of wich: budget support	0.0	1.1	0.6	0.6
Current account deficit	18.6	16.6	10.8	13.8
Net foreign investment 2/	14.7	14.3	9.3	12.3
Loans, net	2.0	1.9	1.5	1.5
Gross reserves (flows)	1.9	0.4	0.0	0.0

Sources: Authorities; and IMF staff estimates and projections.
1/ Period average.
2/ Excluding debt-creating liabilities.

5. **Following the end of the SBA in 2011, the concessionality of external borrowing will improve, but these improvements are only temporary (Figure 1, Chart a).** Given

Kosovo's development stage, the country may be able to raise concessional or soft concessional loans with multilateral and bilateral development partners, provided there is credible commitment to sound policies. In the outer years, as the country climbs the income ladder, soft loans should become rarer and the average grant element of new borrowing is projected to decline to zero in the early 2020's.

B. Alternative Scenarios and Stress Tests[4]

6. **The alternative scenario of low growth and high fiscal deficits implies a continuous rise of the risk of distress.** In this scenario (Table 2, scenario A3), the PV of external debt would keep growing without bounds. This alternative scenario assumes average growth in 2016–30 equal to historical growth of 3.6 percent and primary fiscal deficits of 2 percent of GDP, instead of 5.3 and 0.7 percent, respectively, as in the baseline scenario (Table 3). In this scenario, the debt stock ratio relative to exports would breach the threshold at the end of the period, while the ratio relative to GDP would come close to the threshold. The policy implication of this exercise is that continuous monitoring of deficit levels and GDP is needed to adjust fiscal policy in the event that GDP growth disappoints expectations. The authorities consider such event unlikely.

7. **The narrow and volatile export base is the main factor limiting Kosovo's borrowing space**:

a. **For the debt ratios relative to exports (Figure 1, panels c and e):** the worst case scenario simulates a situation where exports of goods and services decline by 24 percent in two consecutive years (Table 2, shock B2), thus from 16 percent of GDP to less than 10 percent of GDP. This magnitude is equal to the historical average growth rate (19 percent) minus one standard deviation (43 percent) calculated for the period 2002–09. As a result, the solvency and liquidity indicators relative to exports breach the debt burden threshold permanently by a wide margin, which justifies the moderate risk rating.

b. **For the debt ratios relative to revenues and GDP (Figure 1, panels b, d, and f):** the worst case scenario is a shock on non-debt creating flows (B4). Such shock would substantially raise the debt indicators. However, the debt trajectory edges the threshold only for the debt-to-GDP ratio. The test confirms the view that exports pose the main constraint to the country's capacity to borrow.

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[4] In the DSA model, the public debt rises with an external shock to the balance-of-payments because of the assumption that the public sector will borrow externally to cover the gap opened by the shock.

IV. Analysis of the Sustainability of the Total Public Debt

A. Baseline Scenario

8. **The total public debt will rise quickly during the construction of the Route 7 highway while the debt service will rise sharply thereafter.** Total debt will rise by 6 percentage points of GDP during 2012–15, notably to finance the Route 7 project. Indeed, the average deficit excluding the Route 7 expenditures is close to zero during this period. Provided that this level will be maintained upon completion of the project, the debt level will stabilize, as assumed in this DSA. The debt service will rise sharply because of (i) amortization of the domestic loans to be raised in 2012–13 to finance the Route 7 project; (ii) debt service obligations due to the IMF; and (iii) the assumption that service of debts assumed from the former Yugoslavia would begin in 2015. The implication is that a careful debt strategy is needed to minimize rollover risks.

B. Alternative Scenarios and Stress Tests

9. **The alternative scenarios show that debt sustainability hinges on the assumption that the increase in public investment expenditures and their adverse impact on fiscal deficits are temporary, while the resulting output gains are permanent.** This mirrors the result described in paragraph 6. All alternative scenarios with higher deficits and lower growth result in an increased risk of debt distress (scenarios A2-4 in Table 4). The historical scenario shows a debt decline only because the historical budget balance 2001–09 is a surplus of 1 percent of GDP.

10. **The stress tests also show that, if growth falls short of expectations, a policy adjustment would be needed to preserve debt sustainability.** In the extreme scenario deemed improbable by the authorities, GDP growth during 2011–12 is 1.6 percent, equivalent to about ¼ of the baseline growth rate (scenario B1, Table 4). In this case, primary expenditures as a percent of GDP will be about 2 percentage points higher than in the baseline scenario throughout the forecast horizon. Under such extreme circumstances, solvency and liquidity debt ratios would rise without bounds, even if fiscal policy is tightened following the completion of the Route 7 highway. A significant adjustment beyond that assumed in the baseline scenario would be needed.

V. Conclusions

11. **The main conclusions and policy implications of the analysis are:**

   a. Narrow and volatile export base limits Kosovo's borrowing space. Therefore, far reaching structural reforms are needed to fuel private investment in the export sector.

b. There is a need to quickly revert to normal deficit levels after the completion of the Route 7 highway. Maintaining the fiscal deficits at the levels projected for the near term will not prove sustainable.

c. A debt strategy is needed to minimize liquidity risks. Debt service will be rising by 2015 and amortizations will be due to the IMF, domestic and other international creditors.

d. A shortfall in growth from expectations calls for a faster reduction of the fiscal deficit to preserve sustainability. The authorities, therefore, should consider preparing a DSA on a regular basis in order to detect deviations from a sustainable policy path and adjust accordingly.

Table 1. Kosovo: External Debt Sustainability Framework, Baseline Scenario, 2007−30 1/
(percent of GDP, unless otherwise indicated)

	Actual			Historical 0 Average	0 Standard Deviation	Projections									
	2007	2008	2009			2010	2011	2012	2013	2014	2015	2010-2015 Average	2020	2030	2016-2030 Average
External debt (nominal) 1/	28.2	24.7	22.6			20.9	18.9	18.0	20.5	21.7	21.3		21.5	21.2	
of which: public and publicly guaranteed (PPG)	25.2	21.4	17.8			18.6	18.6	18.3	19.2	20.2	20.9		21.0	20.8	
Change in external debt	-3.3	-3.5	-2.1			-1.7	-2.0	-0.9	2.5	1.3	-0.4		0.1	0.0	
Identified net debt-creating flows	-11.3	-4.3	5.2			2.6	-1.7	1.4	2.6	2.0	0.6		0.5	0.5	
Non-interest current account deficit	8.8	15.9	18.3	9.5	4.5	18.1	17.9	16.8	15.6	13.0	11.2	15.4	10.2	13.2	11.4
Deficit in balance of goods and services	38.6	41.5	40.3			42.0	40.4	38.9	36.5	34.3	32.7	37.5	27.9	27.0	27.8
Exports	15.1	14.9	14.1			15.6	16.5	17.4	18.6	20.5	22.2	18.5	20.3	20.0	20.3
Imports	53.7	56.4	54.4			57.6	56.8	56.3	55.2	54.8	54.9	55.9	48.2	47.0	48.2
Net current transfers (negative = inflow)	-23.3	-21.4	-19.2	-22.3	1.8	-20.7	-19.3	-18.4	-16.9	-17.1	-17.3		-14.5	-12.0	-13.7
of which: official	-8.7	-7.5	-6.4			-7.7	-6.2	-5.2	-3.6	-3.9	-4.0		-2.7	-1.3	
Other current account flows (negative = net inflow)	-6.5	-4.2	-2.7			-3.2	-3.2	-3.7	-4.1	-4.2	-4.3		-3.1	-1.9	
Net FDI (negative = inflow)	-15.0	-15.4	-14.7	-9.1	5.7	-14.9	-18.7	-14.7	-12.5	-10.7	-10.1	-13.6	-9.3	-12.3	-10.5
Endogenous debt dynamics 2/	-5.1	-4.8	1.6			-0.6	-0.8	-0.6	-0.6	-0.4	-0.5		-0.5	-0.4	
Contribution from nominal interest rate	0.1	0.1	0.3			0.4	0.3	0.3	0.3	0.4	0.4		0.6	0.7	
Contribution from real GDP growth	-1.1	-1.3	-1.0			-1.0	-1.1	-0.9	-0.8	-0.7	-0.9		-1.0	-1.1	
Contribution from price and exchange rate changes	-4.1	-3.7	2.3			…	…	…	…	…	…		…	…	
Residual (3-4) 3/	8.0	0.9	-7.4			-4.3	-0.3	-2.4	-0.1	-0.7	-0.9		-0.4	-0.4	
of which: exceptional financing	0.0	0.0	0.0			0.0	0.0	0.0	0.0	0.0	0.0		0.0	0.0	
PV of external debt 4/	...	...	19.4			17.9	16.3	15.8	18.0	18.9	18.3		17.1	19.5	
percent of exports	...	...	137.6			114.8	99.3	90.7	96.7	92.2	82.5		83.9	97.6	
PV of PPG external debt	...	...	14.6			15.7	16.0	16.1	16.7	17.3	17.9		16.5	19.1	
percent of exports	...	...	103.8			100.3	97.2	92.3	89.8	84.7	80.7		81.1	95.7	
percent of government revenues	...	...	49.3			58.3	62.3	61.1	62.9	64.7	66.0		58.2	66.2	
Debt service-to-exports ratio (percent)	12.9	10.7	20.0			21.9	14.0	4.8	2.0	7.7	12.0		9.3	8.9	
PPG debt service-to-exports ratio (percent)	0.0	0.0	2.8			3.4	3.0	2.9	2.7	4.7	7.1		7.6	7.6	
PPG debt service-to-revenue ratio (percent)	0.0	0.0	1.3			2.0	2.0	1.9	1.9	3.6	5.8		5.4	5.3	
Total gross financing need (Billions of U.S. dollars)	-0.2	0.1	0.3			0.4	0.1	0.2	0.2	0.3	0.3		0.3	0.6	
Non-interest current account deficit that stabilizes debt ratio	12.1	19.3	20.5			19.8	19.8	17.7	13.1	11.8	11.5		10.2	13.1	
Key macroeconomic assumptions															
Real GDP growth (percent)	4.0	5.4	4.0	3.6	1.9	4.6	5.9	5.2	4.9	3.7	4.4	4.8	5.2	5.5	5.3
GDP deflator in US dollar terms (change percent)	14.8	14.9	-8.5	6.5	9.1	1.7	1.8	1.3	0.8	0.4	0.4	1.1	2.0	2.0	2.0
Effective interest rate (percent) 5/	0.3	0.4	1.2	1.0	1.3	1.8	1.6	1.6	1.7	1.9	1.8	1.7	2.8	3.3	3.1
Growth of exports of G&S (US dollar terms, percent)	28.2	19.7	-10.2	19.4	43.5	17.9	13.6	12.8	13.0	14.6	13.5	14.2	6.6	7.6	6.6
Growth of imports of G&S (US dollar terms, percent)	26.3	27.2	-8.3	13.1	13.5	12.6	6.4	5.5	3.6	3.5	5.0	6.1	6.2	7.6	6.3
Grant element of new public sector borrowing (percent)	...	...	...	...	...	9.8	10.0	9.2	33.0	33.0	23.3	19.7	23.3	0.5	8.1
Government revenues (excluding grants, percent of GDP)	26.3	23.8	29.6			26.9	25.7	26.3	26.5	26.8	27.1		28.4	28.9	28.5
Aid flows (in Billions of US dollars) 7/	0.0	0.0	0.0			0.1	0.1	0.1	0.1	0.1	0.1		0.2	0.1	
of which: Grants	0.0	0.0	0.0			0.1	0.1	0.1	0.0	0.0	0.0		0.1	0.1	
of which: Concessional loans	0.0	0.0	0.0			0.0	0.0	0.0	0.1	0.1	0.1		0.1	0.0	
Grant-equivalent financing (percent of GDP) 8/	...	...	...			2.1	2.0	1.7	0.7	0.8	0.7		1.2	0.6	0.8
Grant-equivalent financing (percent of external financing) 8/	...	...	...			65.4	58.1	63.9	33.0	33.0	23.3		38.6	20.4	26.5
Memorandum items:															
Nominal GDP (Billions of US dollars)	4.7	5.7	5.4			5.7	6.2	6.6	7.0	7.2	7.6		10.7	22.0	
Nominal dollar GDP growth	19.4	21.1	-4.9			6.3	7.8	6.6	5.7	4.2	4.9	5.9	7.3	7.6	7.4
PV of PPG external debt (in Billions of US dollars)			0.8			0.9	1.0	1.1	1.2	1.3	1.4		1.8	4.2	
(PVt-PVt-1)/GDPt-1 (percent)						1.2	1.6	1.1	1.6	1.4	1.4	1.4	1.1	1.7	1.4

Sources: Kosovo authorities; and staff estimates and projections.

1/ Includes both public and private sector external debt.

2/ Derived as [r - g - ρ(1+g)]/(1+g+ρ+gρ) times previous period debt ratio, with r = nominal interest rate; g = real GDP growth rate, and ρ = growth rate of GDP deflator in U.S. dollar terms.

3/ Includes exceptional financing (i.e., changes in arrears and debt relief); changes in gross foreign assets; and valuation adjustments. For projections also includes contribution from price and exchange rate changes.

4/ Assumes that PV of private sector debt is equivalent to its face value.

5/ Current-year interest payments divided by previous period debt stock.

6/ Historical averages and standard deviations are generally derived over the past 10 years, subject to data availability.

7/ Defined as grants, concessional loans, and debt relief.

8/ Grant-equivalent financing includes grants provided directly to the government and through new borrowing (difference between the face value and the PV of new debt).

Table 2. Kosovo: Sensitivity Analysis for Key Indicators of Public and Publicly Guaranteed External Debt, 2010−30
(percent)

	Projections							
	2010	2011	2012	2013	2014	2015	**2020**	2030
PV of debt-to GDP ratio								
Baseline	16	16	16	17	17	18	**17**	19
A. Alternative Scenarios								
A1. Key variables at their historical averages in 2010-2030 1/	16	17	15	12	10	10	**7**	8
A2. New public sector loans on less favorable terms in 2010-2030 /2	16	16	16	18	19	21	**23**	28
A3. Alternative Scenario : low growth, high deficit 7/	16	16	16	17	17	18	**21**	36
B. Bound Tests								
B1. Real GDP growth at historical average minus one standard deviation in 2011-2012	16	17	17	18	19	19	**18**	21
B2. Export value growth at historical average minus one standard deviation in 2011-2012 3/	16	21	30	30	31	31	**26**	22
B3. US dollar GDP deflator at historical average minus one standard deviation in 2011-2012	16	17	17	18	19	19	**18**	21
B4. Net non-debt creating flows at historical average minus one standard deviation in 2011-2012 4/	16	29	37	38	38	38	**31**	23
B5. Combination of B1-B4 using one-half standard deviation shocks	16	28	36	36	37	37	**30**	23
B6. One-time 30 percent nominal depreciation relative to the baseline in 2011 5/	16	23	23	24	25	25	**23**	27
PV of debt-to-exports ratio								
Baseline	100	97	92	90	85	81	**81**	96
A. Alternative Scenarios								
A1. Key variables at their historical averages in 2010-2030 1/	100	101	83	66	51	44	**35**	40
A2. New public sector loans on less favorable terms in 2010-2030 /2	100	98	93	96	94	93	**111**	140
A3. Alternative Scenario : low growth, high deficit 7/	100	97	92	90	85	81	**104**	181
B. Bound Tests								
B1. Real GDP growth at historical average minus one standard deviation in 2011-2012	100	97	92	89	84	80	**81**	95
B2. Export value growth at historical average minus one standard deviation in 2011-2012 3/	100	191	382	362	335	314	**289**	242
B3. US dollar GDP deflator at historical average minus one standard deviation in 2011-2012	100	97	92	89	84	80	**81**	95
B4. Net non-debt creating flows at historical average minus one standard deviation in 2011-2012 4/	100	177	214	202	186	173	**155**	115
B5. Combination of B1-B4 using one-half standard deviation shocks	100	196	280	264	244	227	**204**	154
B6. One-time 30 percent nominal depreciation relative to the baseline in 2011 5/	100	97	92	89	84	80	**81**	95
PV of debt-to-revenue ratio								
Baseline	58	62	61	63	65	66	**58**	66
A. Alternative Scenarios								
A1. Key variables at their historical averages in 2010-2030 1/	58	65	55	46	39	36	**25**	28
A2. New public sector loans on less favorable terms in 2010-2030 /2	58	63	62	67	72	76	**79**	97
A3. Alternative Scenario : low growth, high deficit 7/	58	62	61	63	65	66	**75**	125
B. Bound Tests								
B1. Real GDP growth at historical average minus one standard deviation in 2011-2012	58	65	66	68	70	71	**63**	71
B2. Export value growth at historical average minus one standard deviation in 2011-2012 3/	58	82	114	114	115	115	**93**	75
B3. US dollar GDP deflator at historical average minus one standard deviation in 2011-2012	58	65	66	68	70	72	**63**	72
B4. Net non-debt creating flows at historical average minus one standard deviation in 2011-2012 4/	58	113	142	142	142	142	**111**	80
B5. Combination of B1-B4 using one-half standard deviation shocks	58	108	136	136	137	136	**107**	78
B6. One-time 30 percent nominal depreciation relative to the baseline in 2011 5/	58	88	86	89	91	93	**82**	93

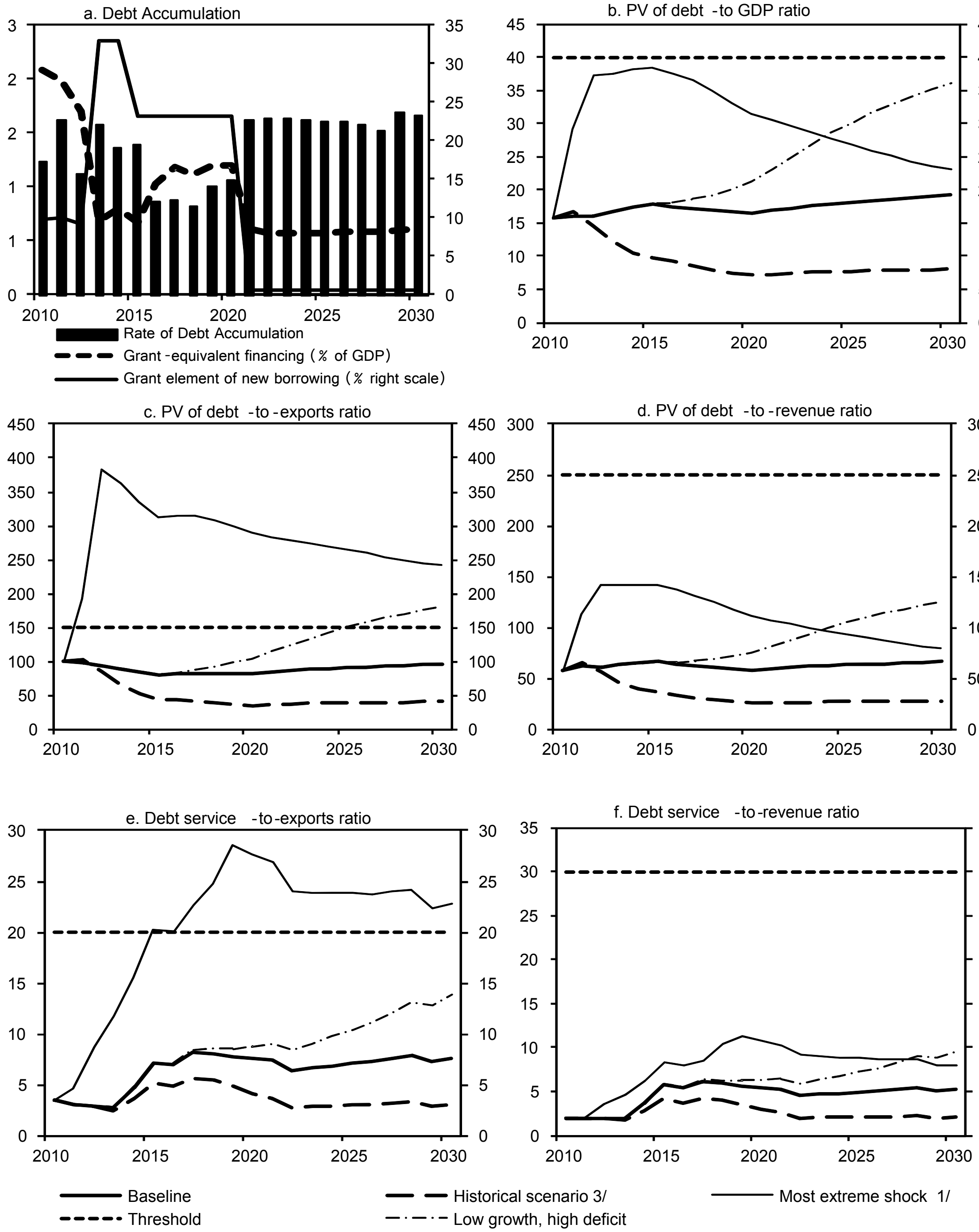
Table 2. Kosovo: Sensitivity Analysis for Key Indicators of Public and Publicly Guaranteed External Debt, 2010−30 (continued)
(percent)

				Debt service-to-exports ratio				
Baseline	3	3	3	3	5	7	**8**	8
A. Alternative Scenarios								
A1. Key variables at their historical averages in 2010-2030 1/	3	3	3	2	4	5	**4**	3
A2. New public sector loans on less favorable terms in 2010-2030 /2	3	3	3	3	5	5	**8**	12
A3. Alternative Scenario : low growth, high deficit 7/	3	3	3	3	5	7	**9**	14
B. Bound Tests								
B1. Real GDP growth at historical average minus one standard deviation in 2011-2012	3	3	3	3	5	7	**8**	8
B2. Export value growth at historical average minus one standard deviation in 2011-2012 3/	3	5	9	12	16	20	**28**	23
B3. US dollar GDP deflator at historical average minus one standard deviation in 2011-2012	3	3	3	3	5	7	**8**	8
B4. Net non-debt creating flows at historical average minus one standard deviation in 2011-2012 4/	3	3	5	7	8	10	**15**	12
B5. Combination of B1-B4 using one-half standard deviation shocks	3	4	7	9	11	14	**20**	15
B6. One-time 30 percent nominal depreciation relative to the baseline in 2011 5/	3	3	3	3	5	7	**8**	8
				Debt service-to-revenue ratio				
Baseline	2	2	2	2	4	6	**5**	5
A. Alternative Scenarios								
A1. Key variables at their historical averages in 2010-2030 1/	2	2	2	2	3	4	**3**	2
A2. New public sector loans on less favorable terms in 2010-2030 /2	2	2	2	2	4	4	**6**	8
A3. Alternative Scenario : low growth, high deficit 7/	2	2	2	2	4	6	**6**	10
B. Bound Tests								
B1. Real GDP growth at historical average minus one standard deviation in 2011-2012	2	2	2	2	4	6	**6**	6
B2. Export value growth at historical average minus one standard deviation in 2011-2012 3/	2	2	3	4	5	7	**9**	7
B3. US dollar GDP deflator at historical average minus one standard deviation in 2011-2012	2	2	2	2	4	6	**6**	6
B4. Net non-debt creating flows at historical average minus one standard deviation in 2011-2012 4/	2	2	4	5	6	8	**11**	8
B5. Combination of B1-B4 using one-half standard deviation shocks	2	2	3	4	6	8	**10**	8
B6. One-time 30 percent nominal depreciation relative to the baseline in 2011 5/	2	3	3	3	5	8	**8**	7
Memorandum item:								
Grant element assumed on residual financing (i.e., financing required above baseline) 6/	7	7	7	7	7	7	**7**	7

Sources: Kosovo authorities; and staff estimates and projections.

1/ Variables include real GDP growth, growth of GDP deflator (in U.S. dollar terms), non-interest current account percent of GDP, and non-debt creating flows.
2/ Assumes that the interest rate on new borrowing is by 2 percentage points higher than in the baseline, while grace and maturity periods are the same as in the baseline.
3/ Exports values are assumed to remain permanently at the lower level, but the current account as a share of GDP is assumed to return to its baseline level after the shock (implicitly assuming an offsetting adjustment in import levels).
4/ Includes official and private transfers and FDI.
5/ Depreciation is defined as percentage decline in dollar/local currency rate, such that it never exceeds 100 percent.
6/ Applies to all stress scenarios except for A2 (less favorable financing) in which the terms on all new financing are as specified in footnote 2.
7/ Assumes historical growth of 3.6 percent and primary deficit of 2 percent on average in 2015–30 (instead of 5.3 and 0.7, respectively).

Figure 1. Kosovo: Indicators of Public and Publicly Guaranteed External Debt under Alternatives Scenarios, 2010–30 1/



Sources: Kosovo authorities; and staff estimates and projections.

1/ The most extreme stress test is the test that yields the highest ratio in 2020. In figure b. it corresponds to a Non-debt flows shock; in c. to a Exports shock; in d. to a Non-debt flows shock; in e. to a Exports shock and in figure f. to a Non-debt flows shock.

Table 3. Kosovo: Public Sector Debt Sustainability Framework, Baseline Scenario, 2007−30
(percent of GDP, unless otherwise indicated)

	Actual			Average	Standard Deviation	Estimate	Projections								
	2007	2008	2009			2010	2011	2012	2013	2014	2015	2010-15 Average	2020	2030	2016-30 Average
Public sector debt 1/	25.2	21.4	17.8			18.6	18.6	20.3	24.4	26.0	27.5		28.9	28.8	
of which: foreign-currency denominated	25.2	21.4	17.8			18.6	18.6	18.3	19.2	20.2	20.9		21.0	20.8	
Change in public sector debt	-3.5	-3.8	-3.6			0.8	-0.1	1.8	4.0	1.7	1.4		0.1	0.0	
Identified debt-creating flows	-14.3	-1.1	-0.7			3.2	-2.6	2.7	3.3	1.1	0.6	1.4	-0.5	-0.5	-0.4
Primary deficit	-7.1	0.2	0.7	-1.0	3.6	3.1	5.3	3.8	4.2	1.9	1.5	3.3	0.8	0.5	0.7
Revenue and grants	26.3	24.5	29.6			28.9	27.5	27.9	26.5	26.8	27.1		29.0	29.5	
of which: grants	0.0	0.6	0.0			2.0	1.8	1.6	0.0	0.0	0.0		0.6	0.6	
Primary (noninterest) expenditure	19.2	24.7	30.3			32.0	32.8	31.7	30.8	28.7	28.6	30.7	29.8	30.0	29.9
Automatic debt dynamics	-4.9	-1.3	-1.4			0.1	-1.1	-0.9	-0.7	-0.4	-0.6		-1.0	-1.0	
Contribution from interest rate/growth differential	-1.9	-1.8	-0.9			-0.7	-1.1	-1.0	-0.9	-0.7	-0.9		-1.0	-1.0	
of which: contribution from average real interest rate	-0.8	-0.5	-0.1			0.1	0.0	-0.1	0.1	0.2	0.2		0.4	0.5	
of which: contribution from real GDP growth	-1.1	-1.3	-0.8			-0.8	-1.0	-0.9	-1.0	-0.9	-1.1		-1.4	-1.5	
Contribution from real exchange rate depreciation	-3.1	0.5	-0.5			0.8	-0.1	0.1	0.2	0.3	0.3		...	...	
Other identified debt-creating flows	-2.2	0.0	0.0			0.0	-6.7	-0.2	-0.2	-0.4	-0.4		-0.3	0.0	
Privatization receipts (negative)	-2.2	0.0	0.0			0.0	-6.7	-0.2	-0.2	-0.4	-0.4	-1.3	-0.3	0.0	-0.2
Recognition of implicit or contingent liabilities	0.0	0.0	0.0			0.0	0.0	0.0	0.0	0.0	0.0		0.0	0.0	
Debt relief (HIPC and other)	0.0	0.0	0.0			0.0	0.0	0.0	0.0	0.0	0.0		0.0	0.0	
Other (specify, e.g. bank recapitalization)	0.0	0.0	0.0			0.0	0.0	0.0	0.0	0.0	0.0		0.0	0.0	
Residual, including asset changes	10.7	-2.7	-2.9			-2.4	2.5	-0.9	0.7	0.6	0.8	0.2	0.5	0.5	0.5
of which: change in bank balance (− = decrease)	6.5	0.4	-2.1			-2.4	2.5	-0.9	0.7	0.6	0.8		0.5	0.5	
Other Sustainability Indicators															
PV of public sector debt	0.0	0.0	14.6			15.7	16.0	18.2	21.9	23.2	24.4		24.5	27.1	
of which: foreign-currency denominated	0.0	0.0	14.6			15.7	16.0	16.1	16.7	17.3	17.9		16.5	19.1	
of which: external	...	...	14.6			15.7	16.0	16.1	16.7	17.3	17.9		16.5	19.1	
PV of contingent liabilities (not included in public sector debt)	...	...	...			...	...	...	...	...	...		...	...	
Gross financing need 2/	-7.1	0.2	1.1			3.7	5.8	4.3	5.0	3.9	5.0		5.2	4.9	
PV of public sector debt-to-revenue and grants ratio (percent)	0.0	0.0	49.3			54.3	58.2	65.1	82.5	86.6	90.2		84.5	91.8	
PV of public sector debt-to-revenue ratio (percent)	0.0	0.0	49.3			58.3	62.3	69.1	82.5	86.6	90.2		86.4	93.7	
of which: external 3/	…	…	49.3			58.3	62.3	61.1	62.9	64.7	66.0		58.2	66.2	
Debt service-to-revenue and grants ratio (percent) 4/	0.0	0.0	1.3			1.9	1.8	1.8	2.9	7.8	12.9		15.3	14.9	
Debt service-to-revenue ratio (percent) 4/	0.0	0.0	1.3			2.0	2.0	1.9	2.9	7.8	12.9		15.7	15.2	
Primary deficit that stabilizes the debt-to-GDP ratio	-3.6	4.0	4.3			2.3	5.3	2.0	0.2	0.2	0.1	1.7	0.7	0.4	0.7
Key macroeconomic and fiscal assumptions															
Real GDP growth (percent)	4.0	5.4	4.0	3.6	1.9	4.6	5.9	5.2	4.9	3.7	4.4	4.8	5.2	5.5	5.3
Average nominal interest rate on forex debt (percent)	0.0	0.0	0.8	0.1	0.3	1.5	1.5	1.6	1.7	1.7	1.7	1.6	2.8	3.3	3.1
Average real interest rate on domestic debt (percent)	...	...	...	…	…	...	...	...	5.3	5.3	4.9	5.2	3.8	3.8	3.8
Real exchange rate depreciation (percent, + indicates depreciation)	-11.4	2.1	-2.3	-3.6	10.5	4.7	...	...	...	...	...	...	...	...	...
Inflation rate (GDP deflator, percent)	5.2	7.0	-3.4	0.5	3.9	1.7	2.9	1.9	1.4	1.1	1.1	1.7	2.0	2.0	2.0
Growth of real primary spending (deflated by GDP deflator, percent)	0.0	0.4	0.3	0.2	0.3	0.1	0.1	0.0	0.0	0.0	0.0	0.0	0.1	0.1	0.1
Grant element of new external borrowing (percent)	...	...	...	…	…	9.8	10.0	9.2	33.0	33.0	23.3	19.7	23.3	0.5	...

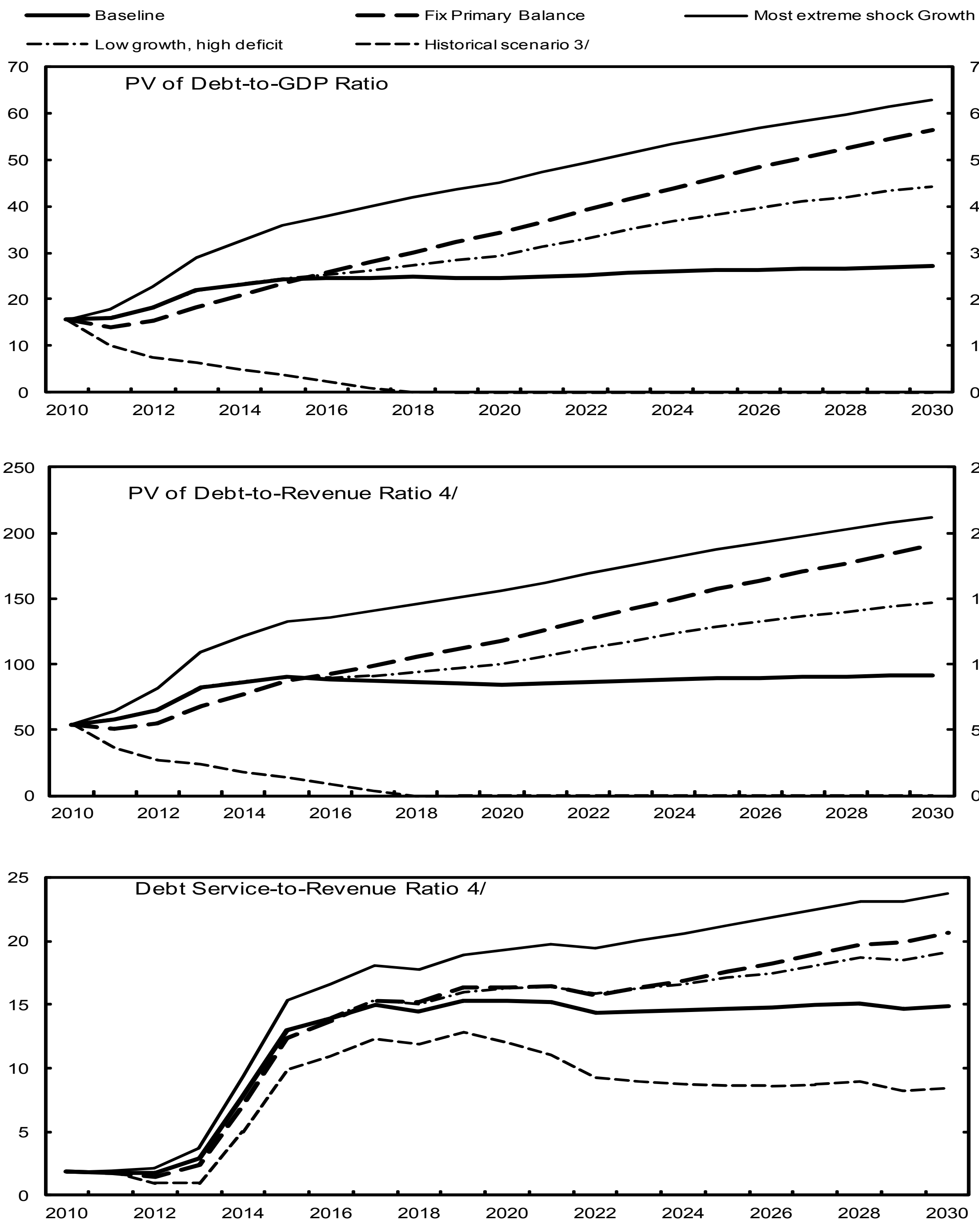
Sources: Kosovo authorities; and staff estimates and projections.
1/ Net general government debt.
2/ Gross financing need is defined as the primary deficit plus debt service plus the stock of short-term debt at the end of the last period.
3/ Revenues excluding grants.
4/ Debt service is defined as the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

Table 4. Kosovo: Sensitivity Analysis for Key Indicators of Public Debt 2010−30

	Projections							
	2010	2011	2012	2013	2014	2015	2020	2030
PV of Debt-to-GDP Ratio								
Baseline	16	16	18	22	23	24	24	27
A. Alternative scenarios								
A1. Real GDP growth and primary balance are at historical averages 1/	16	10	8	6	5	4	0	0
A2. Primary balance is unchanged from 2010	16	14	15	18	21	24	34	56
A3. Permanently lower GDP growth 2/	16	16	19	23	25	27	31	51
A4. Alternative Scenario : Low growth, high deficit 3/	16	16	18	22	23	24	29	44
B. Bound tests								
B1. Real GDP growth is at historical average minus one standard deviations in 2011-2012	16	18	23	29	32	36	45	63
B2. Primary balance is at historical average minus one standard deviations in 2011-2012	16	13	14	18	19	21	21	25
B3. Combination of B1-B2 using one half standard deviation shocks	16	12	11	17	20	23	31	47
B4. One-time 30 percent real depreciation in 2011	16	23	25	28	29	30	29	33
B5. 10 percent of GDP increase in other debt-creating flows in 2011	16	26	28	32	33	34	33	33
PV of Debt-to-Revenue Ratio 4/								
Baseline	54	58	65	83	87	90	85	92
A. Alternative scenarios								
A1. Real GDP growth and primary balance are at historical averages 1/	54	36	27	24	18	14	0	0
A2. Primary balance is unchanged from 2010	54	50	55	68	77	87	118	191
A3. Permanently lower GDP growth 2/	54	59	67	86	92	98	108	171
A4. Alternative Scenario : Low growth, high deficit 3/	54	58	65	83	87	90	100	147
B. Bound tests								
B1. Real GDP growth is at historical average minus one standard deviations in 2011-2012	54	64	81	109	121	132	156	212
B2. Primary balance is at historical average minus one standard deviations in 2011-2012	54	49	52	69	73	77	73	84
B3. Combination of B1-B2 using one half standard deviation shocks	54	43	41	64	75	85	108	160
B4. One-time 30 percent real depreciation in 2011	54	82	88	105	108	111	100	113
B5. 10 percent of GDP increase in other debt-creating flows in 2011	54	95	100	119	123	126	113	112
Debt Service-to-Revenue Ratio 4/								
Baseline	2	2	2	3	8	13	15	15
A. Alternative scenarios								
A1. Real GDP growth and primary balance are at historical averages 1/	2	2	1	1	5	10	12	8
A2. Primary balance is unchanged from 2010	2	2	2	2	7	12	16	21
A3. Permanently lower GDP growth 2/	2	2	2	3	8	13	17	20
A4. Alternative Scenario : Low growth, high deficit 3/	2	2	2	3	8	13	16	19
B. Bound tests								
B1. Real GDP growth is at historical average minus one standard deviations in 2011-2012	2	2	2	4	9	15	19	24
B2. Primary balance is at historical average minus one standard deviations in 2011-2012	2	2	1	2	7	12	14	14
B3. Combination of B1-B2 using one half standard deviation shocks	2	2	1	2	7	13	16	19
B4. One-time 30 percent real depreciation in 2011	2	2	3	4	9	16	18	19
B5. 10 percent of GDP increase in other debt-creating flows in 2011	2	2	3	5	10	15	18	17

Sources: Kosovo authorities; and staff estimates and projections.
1/ Debt stock drops to zero in scenario A1 because of historical surpluses in 2001-09.
2/ Assumes that real GDP growth is at baseline minus one standard deviation divided by the square root of the length of the projection period.
3/ Assumes growth of 3.6 percent and deficit of 2 percent in 2016-30 (instead of 5 percent and zero in the baseline).
4/ Revenues are defined inclusive of grants.

Figure 2.Kosovo: Indicators of Public Debt Under Alternative Scenarios, 2010–30 1/



Sources: Kosovo authorities; and staff estimates and projections.
1/ The most extreme stress test is the test that yields the highest ratio in 2020.
2/ Assumes that real GDP growth is at baseline minus one standard deviation divided by the square root of the length of the projection period.
3/ Debt stock reaches zero in the historical scenario because of historical surpluses in 2001-09.

INTERNATIONAL MONETARY FUND

REPUBLIC OF KOSOVO

Request for Stand-By Arrangement—Informational Annex

Prepared by the European Department
(In consultation with other departments)

July 7, 2010

Contents | Page

I. KOSOVO—FUND RELATIONS

Financial Position in the Fund as of May 31, 2010

I. Membership Status: Joined: June 29, 2009; Article VIII

II. General Resources Account:	**SDR Million**	**%Quota**
Quota	59.00	100.00
Fund holdings of currency	44.84	76.00
Reserve Tranche Position	14.17	24.01
Lending to the Fund		
Notes Issuance		
Holdings Exchange Rate		

III. SDR Department:	**SDR Million**	**%Allocation**
Net cumulative allocation	55.37	100.00
Holdings	55.38	100.02

IV. Outstanding Purchases and Loans: None

V. Latest Financial Arrangements: None

VI. Projected Payments to Fund [1/]
(SDR Million; based on existing use of resources and present holdings of SDRs):

	Forthcoming				
	2010	2011	2012	2013	2014
Principal					
Charges/Interest	0.00	0.00	0.00	0.00	0.00
Total	0.00	0.00	0.00	0.00	0.00

[1/] When a member has overdue financial obligations outstanding for more than three months, the amount of such arrears will be shown in this section.

VII. Implementation of HIPC Initiative: Not Applicable

VIII. Implementation of Multilateral Debt Relief Initiative (MDRI): Not Applicable

IX. Safeguards Assessments

In the context of the request for a Stand-By Arrangement, a Safeguards Assessment was performed in May 2010 and the report is forthcoming.

X. Exchange Arrangements

Kosovo does not issue a currency of its own, but uses the euro as legal means of payment. Kosovo is not part of the euro area and the Central Bank of the Republic of Kosovo is not part of the European System of Central Banks. Kosovo is an Article XIV member and has not yet accepted the obligations of Article VIII of the Articles of Agreement. Staff is currently in the process of assessing whether Kosovo imposes exchange restrictions and/or multiple currency practice subject to Fund jurisdiction.

XI. Previous Article IV Consultation

The first Article IV Consultation with Kosovo is expected to take place in 2010.

XII. Technical Assistance

Since 1999, the Fund has provided technical assistance and policy advice to UNMIK under EBD/99/80 and, since September 2008, to Kosovo under EBD/08/95. Technical assistance has centered on the Fund's core competencies, notably in the areas of fiscal policy, the banking and payments systems, and macroeconomic statistics. Assistance has also contributed to developing key aspects of the legal and institutional framework needed for a market economy. More recently, TA has been provided on the following issues:

Real Sector

- National Accounts Statistics (Feb. 2006, Nov. 2006, Mar. 2008, Jul 2008, Sep. 2009, April 2010)
- Multisector Statistics (Oct. 2003, Sep. 2005)

Fiscal Sector

- Fiscal Decentralization (Sep. 2007, Jan. 2010)
- IT systems and Taxpayer Compliance (Nov. 2009)
- Tax legislation (several missions Oct. 2006–Mar. 2008).
- Tax Policy and Administration (Oct. 2006, Apr. 2008, Sep. 2008, Oct. 2009, Feb. 2010)
- Public Financial Management (May 2007, Mar. 2008, Mar. 2009)
- Debt Management (Oct. 2006)

Monetary and Financial Sectors

- Monetary and Financial Statistics (Sep. 2003, Jan. 2005, Dec. 2008)
- New Banking Law (Nov. 2009, Apr. 2010)
- Modernizing Central Bank Legislation (May. 2009, Oct. 2009)
- Anti-Money Laundering and Combating the Financing of Terrorism (AML/CFT), (Apr. 2006)
- Planning for Financial Sector Emergency (Apr. 2010)
- Stress tests (Mar. 2008)

External Sector

- Balance of Payments Statistics (Mar. 2006, Jul. 2006, Jul. 2007, Sep. 2009)

Other

- Preparation for IMF membership (Aug. 2008)

XIII. Resident Representative: Edgardo Ruggiero.

II. Kosovo: Joint IMF–World Bank Management Action Plan, July 2010–June 2011

Title	Products	Provisional Timing of Missions	Expected Delivery Date
1. Fund work program	Quarterly reviews under the SBA during 2010–11	First review scheduled for October 2010	
	Debt Sustainability Analysis	Completed	June 2010
	TA on new CBK law	TA delivered	Law to be approved by the Assembly as a prior action under the SBA
	TA on banking law	First phase of TA delivered in April 2010	Submission to the Assembly scheduled by end-2010
	TA on emergency liquidity assistance (ELA)	TA delivered in April-May 2010	Regulation on ELA to be issued by first review
	TA on tax administration reform	Ongoing–next TA mission scheduled for August 2010	
	TA to statistical agency on national income accounts	Ongoing–provided by IMF resident expert in Montenegro	
	TA to the CBK on BoP estimates	TA delivered in September 2009	Quarterly BoP estimates by end-September 2010
2. Bank work program	Country Economic Memorandum	Report published, thematic follow ups planned for the next six months	July–December 2010

	Public Sector Modernization Project (PSMP)	Assembly approval expected in July 2010	Start implementation in September 2010.
	SEDPP	Negotiations planned for July/August; Board approval expected in September 2010	September 2010
	Debt Relief Trust Fund (additional $25.75 million donor funds for debt relief)		August 2010
	Business Environment TA (BETA)	Ongoing–supervision mission tentatively planned for September	Closing date– June 30, 2011
	TA on financial sector– payment system upgrade	Identification mission for additional financing scheduled for June–July 2010	
	TA on pension law	Amendments to the pensions law related to the second pillar and the functioning of KPST	Ongoing–expected to be completed in the next few months
	FIRST project: technical advisory service to CBK	Banking supervision mission scheduled for June – July 2010	First semester 2011
	FIRST project: technical advisory service to strengthen insurance regulation and supervision	Supervision mission scheduled for June–July 2010	Expected no later than by January 2011

III. KOSOVO—STATISTICS ISSUES

1. **Data provision is adequate for surveillance and for program monitoring.** Performance criteria can be tested with accuracy. However, the statistical system still suffers from considerable shortages of financial and human resources.

2. **The authorities are strengthening official statistics.** Kosovo is in the final stages of enacting a revised statistics law that will establish a legal framework and determine the fundamental principles for the organization, production and publication of official statistics. The law states that official statistics should be reliable, impartial and, in due time, should cover the administrative, demographic, economic, social, health, education, agriculture development. Kosovo is considering subscribing to the GDDS.

3. **Improvements have been made to the national accounts, but significant weaknesses remain**. While the quality and timeliness of nominal GDP data based on the expenditure approach has been improved, constant price GDP data remain to be published. GDP data based on the production approach are available, but publication lags are long.

4. **Labor market statistics are weak.** Data on the labor force and wages are particularly unreliable, given the large share of the informal economy. A population census will be held in 2011. Considerable work remains to be done to improve the sample coverage of the labor force survey.

5. **Data on fiscal flows are reliable and are provided regularly**. Monthly reports on cash basis budget executions are provided about two weeks after the end of each month. Exhaustive data on general, central, and municipal budgets are provided in fivve weeks. However, difficulties to verify donor-executed operations are preventing their integration in the fiscal accounts. Moreover, budget classification is not consistent with GFSM 2001. The main deviations from GFSM2001 are: data on cash basis, not accrual; classification of grants below the line; classification of lending for policy purposes (similar to subsidies) below primary balance. Capital transfers should be included in current expenditure instead of capital expenditure, as is current practice. Annual budget documents should also specify both current and capital spending related to individual projects. Looking forward, data on budget execution for municipalities, including grants received from the central government as well as data on social assistance and subsidies to publicly owned enterprises, should be provided on a monthly basis. Debt statistics need to be strengthened without delay. Monitoring of domestic arrears, if any, will be possible from September 2010.

6. **Monetary and financial statistics have been improved substantially.** Data are broadly consistent with the IMF's *Monetary and Financial Statistics Manual, 2000* (*MFSM*). The data are available with a lag of six to eight weeks. However, given the relatively high turnover of CBK staff, continued monitoring, training, and Fund technical assistance are needed.

7. **External sector statistics have consistently improved in recent years.** The CBK provides financial sector information to IFS and will soon provide quarterly balance of payments data. With technical assistance from STA, the accuracy, periodicity, and timeliness of balance of payments statistics have continued to improve. Preparations are underway to begin publishing quarterly balance of payments statistics in 2010. Nevertheless, external debt statistics and the International Investment Position have incomplete coverage and are released with delays.

Kosovo: Common Indicators Required for Surveillance

(As of June 21, 2010)

	Date of Latest Observation	Date Received	Frequency of Data[7]	Frequency of Reporting[7]	Frequency of Publication[7]
Exchange Rates	June 30, 2010	June 30, 2010	D	D	D
International Reserve Assets and Reserve Liabilities of the Monetary Authorities[1]	Mar 31, 2010	May 25, 2010	M	M	M
Reserve/Base Money	N/A	N/A	N/A	N/A	N/A
Broad Money	Mar 31, 2010	May 25, 2010	M	M	Q
Central Bank Balance Sheet	Mar 31, 2010	May 25, 2010	M	M	Q
Consolidated Balance Sheet of the Banking System	Mar 31, 2010	May 25, 2010	M	M	Q
Interest Rates[2]	Mar 31, 2010	May 25, 2010	M	M	Q
Consumer Price Index	May 31, 2010	June 10, 2010	M	M	M
Revenue, Expenditure, Balance and Composition of Financing[3] – General Government[4]	April 30, 2010	June 10, 2010	M	M	M
Revenue, Expenditure, Balance and Composition of Financing[3]– Central Government	April 30, 2010	June 10, 2010	M	M	M
Stocks of Central Government and Central Government-Guaranteed Debt[5]	December 31, 2009	January 31, 2010	Q	Q	Q
External Current Account Balance	Dec 31, 2009	May 24, 2009	A	A	A
Exports and Imports of Goods[8]	March 31, 2010	May 20, 2010	M	M	M
GDP[9]	Dec 31, 2008	Dec. 31, 2009	A	A	A
Gross External Debt	December 31, 2009	January 31, 2010	Q	Q	Q

International Investment Position[6]	N/A	N/A	N/A	N/A	N/A

[1]Includes reserve assets pledged or otherwise encumbered as well as net derivative positions.
[2] Both market-based and officially-determined, including discount rates, money market rates, rates on treasury bills, notes and bonds.
[3] Foreign, domestic bank, and domestic nonbank financing.
[4] The general government consists of the central government (budgetary funds, extra budgetary funds, and social security funds) and state and local governments.
[5] Including currency and maturity composition.
[6] Includes external gross financial asset and liability positions vis-à-vis nonresidents.
[7] Daily (D), weekly (W), monthly (M), quarterly (Q), annually (A), irregular (I); and not available (NA).
[8] Services data available on annual basis.
[9] GNDI data not available.

Statement by the IMF Staff Representative on the Republic of Kosovo
July 21, 2010

This statement provides information that has become available since the issuance of the staff report (EBS/10/140). The new information does not alter the thrust of the staff appraisal.

1. **All prior actions for the program have been completed.** The Assembly adopted on July 12, 2010 three decisions that are prior actions for the program. Specifically, the Assembly adopted (i) the Law of the Central Bank of the Republic of Kosovo that affirms the institution's independence and provides a basis for emergency liquidity assistance; (ii) the midyear budget review (MYBR), thus revising the 2010 budget in line with the agreed program parameters; and (iii) amendments to the Law on Public Financial Management and Accountability to ensure that any spending initiative introduced in future MYBRs will be fully funded by revenue measures or expenditure cuts. In addition, the cabinet took a decision on July 2, 2010 confirming that the central government will not introduce any spending initiatives this year that are without allocations in the revised 2010 budget (also a prior action).

2. **A new legal initiative may affect the budget framework for 2011.** On July 15 the Assembly discussed in a first reading the Law on the City of Pristina. According to staff's preliminary understanding, this law, if adopted, could (i) result in a modest increase in transfers from the central government budget to the city of Pristina, and (ii) devolve some spending responsibilities, including for secondary health care, to this municipality. The revised 2010 budget does not include any allocations for additional budget transfers from the central government to the city of Pristina, and the authorities have assured staff that the implementation of this law will begin only in 2011. Staff will review the implications of this law (if enacted) in the context of the first review of the program.

Press Release No. 10/300
FOR IMMEDIATE RELEASE
July 21, 2010

International Monetary Fund
Washington, D.C. 20431 USA

IMF Executive Board Approves € 108.9 Million 18-Month Stand-By Arrangement for the Republic of Kosovo

The Executive Board of the International Monetary Fund (IMF) today approved an 18-month Stand-By Arrangement (SBA) for the Republic of Kosovo in a sum equivalent to SDR 92.656 million (about €108.9 million, or US$ 139.6 million), or 157 percent of its quota in the Fund. An initial disbursement equivalent to SDR 18.760 million (about € 22.1 million, or US$ 28.3 million) is available immediately, with subsequent disbursements subject to quarterly reviews.

Kosovo became the 186th member of the IMF on June 29, 2009. Prior to that, Fund staff had provided technical assistance and policy advice to the United Nations Mission in Kosovo, and, since 2008, to the Republic of Kosovo.

Following the Executive Board's discussion of Kosovo, Mr. Murilo Portugal, Deputy Managing Director and Acting Chair, made the following statement:

"Kosovo's economic performance has strengthened in recent years, although large fiscal and external imbalances persist, which could be exacerbated by considerable capital spending, including for the country's first major highway. Against this background, the authorities' commitment to a comprehensive policy program that aims to lay the foundation for restoring fiscal sustainability and to safeguard financial sector stability is, therefore, most welcome.

"The program seeks to raise revenues and restrain current expenditures in order to limit the impact of large capital spending on the fiscal deficit and on the government's bank balances. To this end, the Assembly recently revised the 2010 budget and raised excise rates.

"The authorities are committed to improving tax administration, refraining from unfunded spending initiatives, and ensuring the credibility of the budget process by revising future budgets exclusively in a deficit-neutral fashion. Disciplined implementation of these policies will help ensure sound public finances over the medium term.

"An important objective of the Fund-supported program is to shore up the government's bank balances to a prudent level in order to provide an adequate fiscal reserve and funds for emergency liquidity assistance to the banking system, if this is needed. The timely privatization of PTK, the post and telecom operator, will help replenish bank balances and ensure that deficit financing will not rely on short-term commercial borrowing.

"To effectively address quasi-fiscal risks, the authorities intend to devise a strategy to improve energy sector finances in order to phase out the need for continued budget transfers. To further protect against contingent fiscal liabilities, the authorities recognize the importance of safeguarding the fiduciary responsibilities of the pension fund and of avoiding undue exposure by this fund to a single borrower.

"Kosovo's financial system has weathered the global financial crisis relatively well, and will be further strengthened by improving crisis preparedness. In this context, the revised central bank law allows for the extension of emergency liquidity assistance, if needed, and the authorities intend to draw up regulations that will operationalize the provision of such assistance, while limiting moral hazard."

Recent Economic Developments

A decade after the end of the conflict that led to Kosovo's unilateral declaration of independence in February 2008, growth prospects continue to be hampered by profound structural impediments. These include poor public and private infrastructure, unreliable electricity supply, and inadequate regional connectivity of transportation routes.

The economy remains undiversified and dominated by the trade and services sectors that are boosted by the large foreign presence and remittances. The export base is narrow and dominated by low value-added products, and a sector that could drive sustainable growth has yet to emerge. Public expenditure has increased due in part to rising subsidies and net lending to the publicly-owned loss-making electricity company KEK, which remains under severe financial strain as a result of widespread difficulties with billings and collections, and a tariff structure that does not ensure cost recovery.

Nevertheless, economic activity appears to be strengthening and the recession in Europe in 2009 had only a modest impact on Kosovo's economy. Following a contraction last year, exports have been rebounding so far in 2010 and remittances—an essential source of funding for private sector activity—have also been recovering.

However, private sector credit growth continues to decelerate. Public spending, especially for capital investments, has supported economic activity. Real growth therefore declined only moderately to 4 percent in 2009, from 5.4 in 2008. Public investment spending is expected to increase in 2010, mainly due to the beginning of the construction of the Route 7 corridor, Kosovo's first highway.

Program Summary

The key objective of the authorities' economic program is to lay the foundation for restoring fiscal sustainability and to safeguard financial stability by:

- Exercising restraint in current spending and raise revenues to contain the impact of their large capital investment program on the overall fiscal deficit;
- Securing substantial budget financing from privatization to preserve debt sustainability;
- Pursuing reforms to broaden the tax base and strengthen public financial management;
- Bolstering the government's bank balances with the Central Bank of the Republic of Kosovo (CBK) to provide scope for emergency liquidity assistance (ELA), if needed;
- Providing the CBK with a mandate for ELA, affirm its independence, and further strengthen the banking system; and
- Improving the financial position of the energy sector.

Selected Financial Indicators

Kosovo: Main Indicators, 2007–15

(Percent, unless otherwise indicated)

	2007	2008	2009	2010	2011	2012	2013	2014	2015
		Est.	Est.	Proj.	Proj.	Proj.	Proj.	Proj.	Proj.
Real growth rates									
GDP	4.0	5.4	4.0	4.6	5.9	5.2	4.9	3.7	4.4
GDP per capita	2.7	3.8	2.5	3.0	4.3	3.7	3.3	2.2	2.9
Consumption	6.1	3.7	2.5	3.1	2.7	2.9	3.0	3.0	2.5
Investment	3.9	15.5	13.1	14.9	12.7	8.9	5.2	0.8	6.6
Exports	11.7	4.2	-1.8	16.0	11.6	11.3	12.1	14.1	13.0
Imports	11.8	6.0	3.5	10.8	5.1	4.8	3.8	4.4	5.8
Price changes									
CPI, period average	4.4	9.4	-2.4	1.7	3.2	2.2	1.9	1.7	1.7
CPI, end of period	10.5	0.5	0.1	3.1	2.4	2.1	1.8	1.7	1.7
GDP deflator	5.2	7.0	-3.4	1.7	2.9	1.9	1.4	1.1	1.1
General government budget (percent of GDP)									
Revenues 1/	26.3	24.5	29.7	28.9	27.5	27.9	26.5	26.8	27.1
Primary expenditures	19.2	24.7	30.3	32.0	32.8	31.7	30.8	28.7	28.6
Of which									
Capital and net lending (including the highway)	2.8	7.6	11.7	13.3	14.3	13.2	12.2	9.8	9.5
Capital expenditures on the highway 2/	…	…	…	3.2	6.1	6.2	5.3	0.6	0.0
Overall balance	7.1	-0.2	-0.8	-3.4	-5.5	-4.0	-4.6	-2.4	-2.0
Overall balance, excluding the highway	7.1	-0.2	-0.8	-0.2	0.6	2.2	0.8	-1.8	-2.0
Debt financing, net	…	0.0	-0.2	-0.2	-0.1	2.0	3.4	1.1	1.1
Privatization	0.0	0.0	0.0	0.0	6.7	0.2	0.2	0.4	0.4
Stock of government bank balances 3/	11.6	10.8	8.8	5.9	7.9	6.4	6.7	7.0	7.4
Financing gap	0.0	0.0	0.0	1.0	1.4	1.0	1.6	1.5	1.4
Savings-investment balances (percent of GDP) 4/									
Domestic savings	-12.6	-12.6	-10.5	-9.5	-7.0	-5.9	-4.5	-4.5	-3.3
Transfers excluding general government (net)	14.6	13.9	12.8	13.0	13.1	13.2	13.3	13.2	13.2

Net factor income	6.4	4.1	2.4	2.8	2.9	3.4	3.8	3.8	3.9
National savings	8.4	5.4	4.8	6.3	8.9	10.6	12.5	12.5	13.9
Investment	26.0	28.9	29.8	32.5	33.3	32.9	32.0	29.8	29.4
Current account	-17.6	-23.4	-25.0	-26.2	-24.4	-22.3	-19.5	-17.3	-15.6
Current account balance (incl. official transfers)	-8.8	-16.0	-18.6	-18.5	-18.2	-17.1	-15.8	-13.4	-11.5
Of which: official transfers 1/5/	8.7	7.5	6.4	7.7	6.2	5.2	3.6	3.9	4.0
Net foreign direct investment	12.6	8.9	7.8	8.5	15.6	8.3	8.8	10.3	10.9
Portfolio investment (net)	-1.2	1.7	-1.0	-0.6	-1.4	-1.5	-1.5	-1.5	-1.5
Memorandum items:									
GDP (millions of euros)	3,411	3,849	3,868	4,113	4,480	4,803	5,110	5,356	5,652
GDP per capita (euros)	1,605	1,784	1,766	1,850	1,985	2,097	2,198	2,270	2,360
GNDI per capita (euros)	1,942	2,105	2,036	2,143	2,303	2,445	2,574	2,657	2,764
Population (thousands)	2,126	2,158	2,190	2,223	2,256	2,290	2,325	2,360	2,395

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

1/ Assumes budget grants of € 75 million per year in 2010–12.
2/ World Bank estimates.
3/ Starting in 2010, minimum bank balance recommended by staff.
4/ Savings-investment balance of entire economy, including donor sector.
5/ Total foreign assistance excluding capital transfers.

Statement by Mr. Bakker and Ms. Barendregt on Republic of Kosovo
July 21, 2010

Kosovo is a young country. It declared independence on 17 February 2008. In June of the same year, the Constitution entered into force. Towards and since Kosovo's independence, the authorities have taken great efforts to build the country's institutions and to secure the basis for sustained growth of the economy, for the welfare of the Kosovan people. Kosovo has also strived for a place in the international community. Becoming a member of the IMF on 29 June 2009 was an important step towards both objectives.

In building the institutions, the authorities are not alone and did not have to start from scratch. Ever since its presence in Kosovo in the aftermath of the conflict, the United Nations Mission in Kosovo (UNMIK) has helped the population to develop public functions such as police and justice, and civil administration. The EU's EULEX mission, the International Civilian Office, the World Bank, USAID and others provide much-needed support in the build-up of the country. The European Union is expected to provide budget support in 2010, 2011 and 2012. The IMF has played a crucial role ever since 1999 in providing technical assistance in areas such as fiscal policy, banking and payment systems and macroeconomic statistics.

The Kosovans are proud of what they have achieved in the short time of their independence: political stability in a democratic system, a high degree of security, sound public services, economic growth and price-stability, and a stable financial sector and private initiative as preconditions for economic growth. However, great challenges remain ahead and to offer its young and ambitious population a brighter future, Kosovo must enhance its legal infrastructure for the growth potential of the economy. In this regard, Government strategic priorities have been designed to create preconditions for sustainable economic growth. Within this context, the Government is keen to improve the market environment by tackling the informal economy in order to enable private sector development in a way that would bring the Kosovan economy in line with the economies in the region. There is no doubt that reaching the above-mentioned objectives contributes to improvement of the citizens' welfare, which is one of the preconditions for integration into the European Union. Therefore, for these objectives to be met, further reforms and hard work are needed towards elimination of barriers and factors that may hinder economic development.

In this regard, the authorities are also strongly committed to investing in the country's physical infrastructure, as shown by the high capital to current expenditure ratio in the budget. The fact that Kosovo is a landlocked country in a precarious international environment adds to the infrastructural challenges. At the same time, there is a need to maintain the minimum level of social benefits which are currently offered to protect the vulnerable groups within the population.

The authorities realize that sound public financial management is a precondition for the development of the economy, as it will ensure that scarce public resources are deployed effectively and efficiently. They also feel that they should take precautionary measures and set aside resources to ensure that financial stability can be maintained if the need arises. The financial and developmental needs mentioned above, and the wish to make full use of the advice which the Fund can offer, have led the government to request a Fund-supported program.

Kosovo's economic starting position at the beginning of the Fund-supported program is one of moderate real GDP growth (4.6 percent), low inflation (1.7 percent) and a high external deficit (18.5 percent including official transfers).

Monetary policy

Kosovo is a fully euroized economy. This policy has provided an anchor for inflation and thereby strongly contributed to macroeconomic stability. At the same time, it puts the bar high for the quality of fiscal policies, as monetary instruments are lacking. In particular, the lender of last resort function of the central bank is limited to its reserves and the fiscal resources at its disposal for this purpose. Although the financial sector is stable, the authorities do believe that they must make available a prudent level of resources to the Central Bank to be able to provide temporary liquidity, in case the need might arise. Therefore, the program foresees the establishment of an Emergency Liquidity Assistance (ELA) Fund. Setting aside a considerable amount of resources in terms of GDP for a tail risk was not an easy decision in view of the limited budget and large development needs. The Stand-By Arrangement temporarily provides resources for this purpose and thus is essential in making this necessary arrangement.

Fiscal policy

The core medium-term strategy for the fiscal policy is to make room for Kosovo's immediate investment needs, while safeguarding fiscal sustainability. Kosovo's top priority in physical infrastructure is the construction of the Route 7 highway. Route 7 will be the country's main link to the regional transport network in South-Eastern Europe, including to Albania's port of Durres on the Adriatic Sea.

The capital expenditures for Route 7 in the years 2010–2013 of on average 5.2 percent of GDP (6.1 percent in 2011) are mainly financed as follows:

- by limiting other capital expenditures (a reduction of about 2.6 percent of GDP in 2011 and maintained through 2013 as compared to 2009, before the start of the project);
- by reserving privatization proceeds for this purpose (a one-off 6.7 percent in 2011); and
- by raising specific excise taxes (yielding 1.0 percent of GDP per year).

During this period, current expenditures are broadly kept the same at a level of 18.5 percent of GDP or 56 percent of primary expenditures in 2011 (was 18.6 percent of GDP in 2009). Wages and salaries will be slightly reduced next year by 0.2 percent of GDP and will make up a modest 23 percent of primary expenditures and 40 percent of total current expenditures in 2011. While the fiscal balance excluding highway-related spending will improve steadily, the budget will see a temporary increase in the overall deficit topping at 5.5 percent in 2011 and gradually receding in the years thereafter to 2 percent in 2015.

Financial contingencies and safeguards are in place to cover possible risks related to the highway project. The total budgeted costs for Route 7 include a significant contingency estimate in line with international standards. Nevertheless, the authorities acknowledge that large infrastructure investments are internationally associated with risks of cost overruns. Therefore, even though they have made great efforts to address such risks in the contract with the consortium of road-builders, the authorities have agreed to raise the bank balance by 2 percent of GDP in 2011 as compared to 2010 as a special contingency. On the revenue side, the authorities feel that risks to the budget are balanced. Direct and indirect taxes provide a steady source of revenues. Moreover, growth projections are cautious. However, the exact revenue to be generated by the privatization of PTK, the profit-making public Telecom firm, is uncertain. Based on valuation of the company, the authorities believe that the budgeted amount for PTK's privatization is cautious. The authorities are committed to taking extra measures on the (capital) expenditure side and on the revenue side if necessary to reach their fiscal targets. The responsible budgeting and precautionary measures mentioned above will ensure that Kosovo can avoid commercial borrowing during the period of the Fund-supported program.

Public financial management

Strengthening budget processes and public financial management are key pillars of Kosovo’s Fund-supported program. While the institutional base is generally adequate, capacities need strengthening and processes and practices need further development. Main elements of the strategy are to strengthen the medium-term budget cycle including through enhanced transparency and ensuring budget-neutral midyear budget reviews. The authorities’ commitment to results is demonstrated by the fulfillment of the prior actions in this field.

Other objectives during the program period are improving tax administration and rationalizing public expenditure. Regarding the latter, unfortunately, due to capacity constraints the IMF could not grant requested TA assistance before the preparation of the 2011 budget. Nevertheless, the authorities remain committed to elaborating a medium-term rationalization strategy.

Energy sector

The poor quality of the energy sector remains one of the biggest constraints to doing business in Kosovo. The unreliable supply of electricity continues to have major consequences for Kosovo's economy. The energy sector in Kosovo is dominated by the electricity sector and associated lignite mines. The Kosovo Energy Corporation (KEK) is the sole producer of electric power in Kosovo. KEK's two large power plants, Kosovo A and B, are about 40 and 25 years old and poorly maintained. While nominal capacities are 800 MW and 680 MW respectively, only about 60 percent or about 900 MW of the aggregate capacities are available, well below the peak demand during the cold season. The current state of the publicly-owned energy company, both technically and financially, poses risks to Kosovo's economic development and presents too high costs to the budget. The main causes for KEK's negative fiscal impact are technical and commercial losses, difficulties in billing and collection, and power import subsidies- a subsidy that will increase in the future as demand for energy and power import prices increase. As a result the fiscal burden of the energy sector on the Kosovo's budget has been running about €70 million per year or about 11 percent of the budget expenditures over the previous years, representing a continuous drain on the budget. Therefore, as a structural benchmark under the program, the authorities have committed to developing a comprehensive strategy to address KEK's financial challenges.

Financial sector supervision

The financial sector in Kosovo is licensed, supervised and regulated by the Central Bank of the Republic of Kosovo. During 2009, the financial sector in Kosovo continued to grow and remained stable despite the unfavorable conditions that characterized global financial markets in the past 2 years. Regarding the structure of the financial sector, the banking sector continues to represent the majority of assets (78.6 percent), followed by pension funds (13.6 percent) and the remaining part is constituted by micro-financial institution and insurance companies.

Currently in Kosovo eight commercial banks continue to develop their activities from which two are domestically owned and the remaining six are owned by foreign institutions. Moreover, the banking sector continues to be dominated by foreign owners that manage

91.5 percent of total assets. Deposits in the banking sector continue to increase, amounting to € 1.7 billion by the end of 2009, while loans amounted to around € 1.3 billion.

The Parliament has approved a revised Law on the Central Bank of the Republic of Kosovo. While the strength of the financial sector is adequate, the Banking Law is being revised with IMF TA in order to bring it in line with international best practice. The revised law will strengthen governance standards for banks, provide for tighter restrictions on lending to bank-related parties, and enhance supervision of banking groups and branches of foreign financial institutions. It will also include an improved bank resolution regime. The authorities are furthermore working on improvements of insurance sector supervision.