



REPUBLIC OF KOSOVO

March 2017

SECOND AND THIRD REVIEWS UNDER THE STAND-BY ARRANGEMENT, AND REQUEST FOR PROGRAM EXTENSION—PRESS RELEASE; STAFF REPORT; AND STATEMENT BY THE EXECUTIVE DIRECTOR FOR THE REPUBLIC OF KOSOVO

In the context of the Second and Third Reviews under the Stand-By Arrangement, and Request for Program Extension, the following documents have been released and are included in this package:

- A **Press Release** including a statement by the Chair of the Executive Board.
- The **Staff Report** prepared by a staff team of the IMF for the Executive Board's consideration on March 13, 2017, following discussions that ended on November 18, 2016 with the officials of the Republic of Kosovo on economic developments and policies underpinning the IMF arrangement under the Stand-By Arrangement. Based on information available at the time of these discussions, the staff report was completed on February 24, 2017.
- A **Statement by the Executive Director** for Republic of Kosovo.

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

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

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

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IMF Executive Board Completes the Second and Third Reviews of Kosovo's Stand-By Arrangement

On March 13, 2017, the Executive Board of the International Monetary Fund (IMF) completed the second and third reviews of the Republic of Kosovo's economic performance under the Stand-By Arrangement (SBA). The completion of the reviews enables the disbursement of SDR 79.20 million (about €100 million), which would bring the total disbursements under the SBA to SDR 135.40 million (about €172 million).

In completing the review, the Board approved the authorities' request for an extension of the current SBA to August 4, 2017 to facilitate policy continuity and allow sufficient time for ongoing structural reforms to progress.

On July 29, 2015, the Executive Board approved a 22-month, SDR 147.50 million SBA for Kosovo (see Press Release No. 15/362). It supports the government's economic program, which aims at raising Kosovo's economic potential by creating fiscal space for growth-enhancing expenditure. Preserving low debt, upgrading key infrastructure by catalyzing donor resources, and boosting competitiveness – by realigning labor costs, removing structural obstacles to credit, and creating a more level and transparent business – environment are also program goals.

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

“Kosovo has performed strongly under the program. The economic recovery continues, led by robust domestic demand growth. Policy implementation has been laudable. Maintaining this momentum through the end of the program will help to lock in these gains in macroeconomic and financial stability.

“Stronger public finances have been key to the program's success. The authorities have remained well within their fiscal deficit limit while improving budget composition. They

have achieved the latter by shifting budget focus away from unproductive current spending and creating more space for much-needed, growth-enhancing capital investments. At the same time, they have significantly boosted their fiscal buffers, critical to macroeconomic stability in a unilaterally euroized country. The 2017 budget is in line with the program's objectives and will continue to support healthy public finances, a further shift toward capital investment projects, and other measures to support durable growth.

“The authorities have also taken important steps to strengthen Kosovo's financial safety net. Most recently, this has meant the adoption of a macroprudential policy framework, which the authorities are now operationalizing. The authorities are also working toward improving the contract enforcement system, which will allow for more efficient recovery of collateral and distressed assets and ultimately enable the bank lending that Kosovo needs to bolster stronger economic growth.

“Achieving higher and inclusive long-term growth also requires a more competitive business environment. The authorities have taken important steps in this area by intensifying efforts to mobilize donor financing for major infrastructure projects under the fiscal rule's revised investment clause and continuing to enhance the transparency and efficiency of the public procurement system,” Mr. Furusawa said.



REPUBLIC OF KOSOVO

February 24, 2017

SECOND AND THIRD REVIEWS UNDER THE STAND-BY ARRANGEMENT, AND REQUEST FOR PROGRAM EXTENSION

EXECUTIVE SUMMARY

Overview: Economic performance remains positive, with growth estimated at 3½ percent in 2016 and projected at similar levels this year. Fiscal deficits remain contained, with strong tax revenues limiting the impact from rising war veteran pensions. The banking system is healthy and credit growth robust. Political tensions related to opposition protests earlier in the year have subsided, but some disagreements have emerged inside the governing coalition.

Program performance. Performance has been satisfactory overall:

- All performance criteria and indicative targets (fiscal deficit, bank balance, current spending) for December 2015 and June 2016 (2nd and 3rd reviews, respectively) were met with comfortable margins. The 2016 deficit outturn (1.2 percent of GDP) was also lower than targeted. However, the authorities missed the December 2016 indicative target on current spending by 0.2 percent of GDP because of higher than expected spending on war veteran pensions, notwithstanding efforts to contain spending elsewhere. The December 2016 indicative target on the bank balance was also missed, on account of delays in disbursements associated with the 2nd and 3rd reviews.
- All structural benchmarks for the second and third reviews have been completed, several ahead of schedule and only one with a small delay.
- Parliament recently approved the 2017 budget in line with program objectives. In addition, the authorities submitted and parliament approved the reform of war veteran pension schemes (a prior action for the 2nd review) to ensure medium-term fiscal sustainability and improve labor market incentives. The time needed to gather the necessary public support explains the delay in the review. Parts of the new law are being reviewed by the constitutional court. The authorities are committed to taking any measures, if needed, to preserve the intended savings of the reform.

Given this progress, staff supports the authorities' request for the completion of the second and third reviews. Staff also supports the request for a two-month program extension from May 28 to August 4, 2017 to give the authorities' added time to complete some important reforms. Appendix I comprises the authorities' Letter of Intent, Supplementary Memorandum of Economic and Financial Policies, and the Technical Memorandum of Understanding.

Approved By
Thanos Arvanitis and
Andrea Richter Hume

The mission team included Messrs. Miniane (head), Cipollone and Weiss (all EUR), Mr. Misch (FAD), Mr. Peralta Alva (SPR), Ms. Morgan (SPR), and Messrs. Vermeulen and Thaci (Resident Representative Office). The discussions for the second and third reviews of the SBA arrangement took place in Pristina during March 23–April 5, June 16–24, and November 9–18, 2016. The mission met with President Hashim Thaci, Prime Minister Isa Mustafa, Speaker of Parliament Kadri Veseli, Minister of Finance Avdullah Hoti, Central Bank Governor Bedri Hamza, other senior officials, members of Parliament, as well as representatives of the private sector, development partners, and civil society.

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POLITICAL CONTEXT

1. Earlier political tensions with the opposition have eased but disagreements have emerged within the ruling coalition. Opposition disruption of parliamentary activity related to the Brussels agreement on normalization of relations with Serbia has largely faded since the spring. However, some disagreements have arisen between the two key coalition partners, compromising the ability of the coalition to pass key legislation (such as the border demarcation agreement with Montenegro, a precondition for EU visa liberalization). This is now compounded by the fact that a minority coalition partner has suspended its participation in parliament, leaving the coalition with a simple rather than a two-thirds majority. Municipal and general elections are scheduled for October 2017 and mid-2018, respectively, although early elections cannot be ruled out.

RECENT DEVELOPMENTS, OUTLOOK AND RISKS

2. The economic recovery continues (Figure 1). GDP grew by about 3½ percent in 2016, with robust domestic demand expanding by some 6 percent on the back of healthy remittance inflows, stronger credit growth, and an acceleration of the pace of construction of large projects such as Route 6. This was moderated by a higher than expected import drag, as well as weaker than expected exports due to the extended stoppage of work at a major nickel plant. High-frequency indicators suggest that this overall picture continues into 2017. The growth outlook for 2017 remains largely unchanged at 3.5 percent, still led by domestic demand.

3. Prices are slowly recovering. After averaging -0.5 percent over 2015 and remaining negative through most of 2016, inflation has started to recover (1.3 percent y/y in December 2016). The drivers of this turnaround have been external food and energy prices. Under the baseline, base effects should imply a modest but positive inflation for 2017 as a whole.

4. External deficits remain high, but also safely financed. Kosovo's trade deficits have been historically high, on account of the country's narrow export base and high import dependence. Data up to 2016Q3 suggest that the trade deficit did not increase relative to 2015's level (28.5 percent), as favorable terms of trade mitigated the impact of strong domestic demand and associated imports. The current account deficit was close to 10 percent. Following historical patterns, financing of external deficits remains steady and largely non-debt creating, mostly in the form of remittances, official transfers, and FDI (the latter often associated with the Kosovar Diaspora). Going forward, staff project some deterioration in external deficits in 2017–18, as the construction of large projects gathers steam. Gross international reserves remain above prudent levels.

5. The medium-term growth outlook remains positive but still not sufficient for Kosovo's needs. The acceleration of key infrastructure projects should boost investment and expand the production base. This, together with the ongoing removal of obstacles to bank lending and progress in realigning labor costs via public sector wage moderation, should help support medium-term growth in the range of 3.5 to 4 percent. Such a level is in line with the baseline outlined at the time

of the approval of the SBA-supported program. It is ahead of regional averages but still not enough to rapidly reduce Kosovo's high unemployment and close the income gap with the rest of Europe. Notably, staff have revised down GDP growth over 2017–19 relative to the first review because of failure to secure financing for the Brezovica ski resort (see below for detail), which is no longer in the baseline.

6. Risks to the baseline are tilted to the downside. Political tensions, both domestic and regional, could intensify in the coming months, weighing on confidence. In addition, the run up to local and general elections could see the return of populist measures that could compromise medium term stability. On the upside, medium-term growth could be higher than in the current baseline if the large Brezovica tourism resort and a planned new power plant materialize.

PROGRAM PERFORMANCE

7. Performance against 2nd and 3rd review quantitative performance criteria has been satisfactory (text table). The 2015 budget deficit was contained at 1.8 percent of GDP, 0.7 percentage points of GDP below the 2nd review target.¹ Budget over-performance, coupled with stronger-than-expected financing,² helped bank balances finish 0.5 percentage points of GDP above the program target, despite the fact that the purchases accompanying the first review of the program were disbursed in January 2016 and not December 2015 as originally expected. All end-June 2016 (3rd review) quantitative targets were also met by a comfortable margin. The end-June fiscal balance and government bank balance both outperformed performance criteria by 1.0 percent of GDP, while current expenditures were 1.6 percent of GDP below the indicative ceiling.³

¹ The program target called for a 2.4 percent of GDP deficit, but after adjusters per the Technical Memorandum of Understanding the adjusted target became 2.5 percent of GDP.

² In particular, the Privatization Agency of Kosovo transferred some 0.5 percentage points of GDP more in privatization funds than was expected in the budget.

³ Because this target is on the level of spending rather than the deficit, small changes in seasonality can have large effects on performance relative to a mid-year value.

Program Performance: Quantitative Performance Criteria and Indicative Targets for end-December 2015 and end-June 2016

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

	end-Dec. 2015 - II Review				end-June 2016 - III Review			
	Prog. Target	Adjusted Target 1/	Actual	Diff % GDP	Prog. Target	Adjusted Target 1/	Actual	Diff % GDP
Performance Criteria								
Floor on the headline fiscal balance of the general government (ex PAK), including new IFI-financed projects 1/	-137	-148	-105	0.7	-94	-94	13	1.8
Floor on the underlying fiscal balance of the general government (ex PAK), excluding new IFI-financed projects 1/	-137	-148	-105	0.7	-49	-49	13	1.0
Floor on the bank balance of the general government	171	171	201	0.5	220	220	282	1.0
Ceiling on the accumulation of external payments arrears of the general government 2/	0	0	0	0.0	0	0	0	0.0
Indicative Targets								
Ceiling on current expenditures of the general government 1/	1187	1187	1156	-0.5	670	670	573	-1.6

1/ Adjusted according to the TMU

2/ Continuous ceiling throughout the SBA period

8. The positive fiscal performance continued through the end of 2016, although there is still room to improve the execution of the capital budget (Tables 2 and 3). According to provisional data, the deficit reached €73 million (1.2 percent of GDP) in 2016, substantially below the indicative program target of €93 million.⁴ This performance was supported by various factors:

- *Strong revenue performance.* Tax revenues grew by more than 12 percent, on account of buoyant domestic demand coupled with tax measures taken as part of the program. Tax revenues ended almost a full percent of GDP higher than the targets in the original 2016 budget.⁵ This tax performance was partly offset by weak non-tax revenues, notably dividends and municipal own-source revenues (OSR), yet overall revenues exceeded original budget targets by 0.2 percent of GDP.
- *Containment of current spending.* As the number of certified war veterans surpassed expectations (see below), spending on their pensions exceeded original budget allocations by €25 million (0.4 percent of GDP). However, discipline in public sector hiring coupled with tighter (but, in the views of the authorities, fair) criteria to qualify for the basic pension limited total current spending to only €9 million (less than 0.2 percent of GDP) above the end-December indicative target agreed as part of the Fund program.
- *Under-execution of the capital budget,* which ended 0.3 percent of GDP below original budget targets but still above 2015 levels. Under-execution was in part driven by weak municipal own-source revenues (OSR); by law, some municipal capital projects can only proceed if the

⁴ This is the target as adjusted per the TMU. The unadjusted target was €98 million as in the budget.

⁵ Tables 2 and 3 show performance against the supplementary budget as well.

attached funding sources materialize. But it is also the case that absorption of IFI-financed projects has not scaled up as staff and the authorities had hoped, highlighting important absorption constraints (see below).

- Given the low deficit, the bank balance ended the year at 3.5 percent of GDP, below the 4.5 percent targeted in the program. But this was only because of delays in completing the 2nd and 3rd reviews. With Fund disbursements associated to these reviews (worth 1.6 percent of GDP), the bank balance would have been above the 4.5 percent target.

9. All structural benchmarks for the second and third reviews have been met, several ahead of schedule and one with some delay (Table 2, MEFP).

Second review:

- *A rules-based mechanism to govern the public sector wage bill was adopted by Parliament on December 14, 2015, well ahead of program schedule (March 15, 2016). The new rule will prevent the public sector wage bill from growing faster than nominal GDP, a sharp slowdown relative to historical practice (the public sector wage bill has grown three times faster than nominal GDP since independence).*
- *The sale of telecommunication licenses, which generated 0.25 percent of GDP in proceeds, was completed on December 28, 2015.*
- *Amendments to the law on public procurement were approved by Parliament on December 28, 2015, and again in February 2016. Separately, on March 15, 2016 the government issued a decision making e-procurement mandatory for the Centralized Procurement Agency (CPA), other central government procurement agencies, and all municipalities.*
- *Parliament appointed the vacant seats of the Procurement Review Board (PRB) on March 28, 2016, with some delay relative to the program schedule (February 28, 2016).*
- *In March and September 2016, the Government submitted to Parliament the first and second semi-annual reports (for information purposes only) on the implementation of donor-financed projects falling under the revised investment clause (see below).*
- *The on-site examinations of the three remaining banks using the new risk-based supervision manual prepared with IMF technical assistance were completed ahead of schedule and reports shared with staff.*

Third review:

- *Contracts for the centralized procurement of fuel, office supplies, and plane tickets, covering 43 central government administrations and agencies, were awarded in June 2016.*

- *The government adopted an expanded list of goods and services that are eligible for centralized procurement in the next round of tenders.*

PROGRAM AND POLICY DISCUSSIONS

A. Fiscal Policy

Discussions centered on a 2017 budget in line with program objectives, and a long-term reform of war-related social and pension schemes. Beyond the program timeframe, efforts will need to be maintained to contain underlying pressures on current spending.

10. The authorities remain committed to fiscal prudence. Parliament has adopted a 2017 budget which is in line with program objectives of keeping deficits within the fiscal rule's limits so as to preserve low debt, while creating space for priority spending. It targets a 1.5 percent of GDP deficit (ex. PAK and donor-financed new projects) on the basis of:

- A modest increase in revenues relative to 2016 (0.2 percent of GDP) as tobacco excises will be raised to comply with regional agreements on the harmonization of excise rates. Based on 2016 outturns, staff expect lower non-tax revenues than the authorities, but this should have little implication on the deficit as shortfalls in municipal OSR are mostly budget-neutral.
- Holding current expenditures constant as a share of GDP. This includes a modest wage increase of 0.5 percent as part of the collective agreement signed in 2014; no new growth in social schemes beyond the (delayed) introduction of two small schemes which are part of the 2014 Law on Pensions; ongoing savings (about 0.3 percent of GDP on an annual basis) from tightening documentation requirements to receive the basic pension⁶; and allocations for all war-related schemes combined in the amount of €75 million (1¼ percent of GDP), a level that staff judge sustainable and is supported by the recently launched reform of these schemes (see below). These efforts will make room for needed hiring in the justice and penal systems, new contributions owed by the State to its employees as part of the Health Insurance law, and higher goods and services spending tied to scaled up capital investment.
- Maintaining budget-financed capital spending at some 8 percent of GDP, similar to this year's budget. In addition, the authorities envisage a significant increase in donor-financed capital spending, as well as in capital spending financed by transfers from the privatization agency (PAK) equivalent to a combined 3 percent of GDP. These donor and PAK targets appear to be optimistic: (i) absorption capacity constraints make 1¾ percent of GDP in new donor projects unlikely; and (ii)

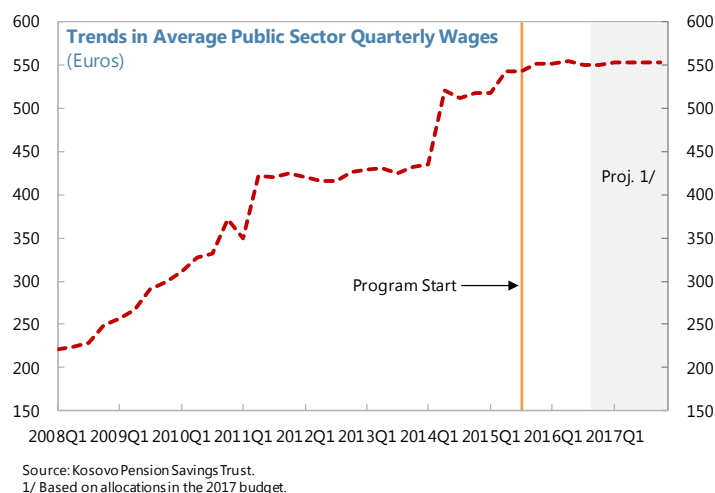
⁶ This is to avoid Diaspora Kosovars from flying into the country to collect the pension. According to the latest, pre-reform data, there were 20 percent more beneficiaries of the basic pension than there were people older than 65 in Kosovo.

given the needed due process to assess creditor claims on old SOEs, staff do not expect that PAK will release 1½ percent of GDP in privatization funds this year.⁷

- The expected low deficit, coupled with Fund disbursements, should bring the bank balance above the minimum prudent level of 4.5 percent of GDP targeted in the program.

11. Efforts under the program are helping deflate high labor costs, which have undermined the country's competitiveness.

In the three budgets passed as part of the Fund-supported program, nominal public sector wages have increased by about 1 percent cumulatively. This is in sharp contrast with historical experience, with nominal wages increasing by 13 percent per year on average since 2008. Since the State is the main employer in the country, public sector wage restraint is expected to help moderate labor costs in the private sector, aiding competitiveness.⁸ Going forward, the new public sector wage rule due to take effect in 2018 should help entrench these gains.



12. Beyond 2017, pressures from war-related social schemes could threaten future budgets while impairing labor market incentives.

In 2016, the commission in charge of certifying war veterans awarded upwards of 46,000 certificates, more than double what had been expected. As a result, there are at present close to 30,000 certified veterans receiving a pension, versus 13,000 allocated for in the original 2016 budget. Even assuming the pension level does not rise faster than GDP⁹, the scheme could end up costing 1.3 percent of GDP/year for close to three decades, compared with 0.4 percent originally anticipated. Spending on war disability pensions¹⁰ is also set to rise following the certification of an additional 3,000 war disabled (see below). In the absence of reform, spending on all war-related social schemes¹¹ combined could exceed 2 percent of GDP per year for decades. This would crowd out priority spending in other areas, and put the credibility of

⁷ The donor-financed projects would still be subject to the 30 percent debt limit in the revised investment clause but this limit is not expected to be reached within the projection period. Note that PAK-funded capital projects are excluded from the fiscal rule's deficit limit because they are not debt-creating.

⁸ Proper assessment of the pass-through from public to private sector wages is marred by unreliable data on the latter.

⁹ Since independence, benefits to categorical groups have clearly outpaced nominal GDP.

¹⁰ These are distinct from war veteran pensions. In fact, war disability pensions are significantly higher, at some €300 euro/month on average.

¹¹ In addition to war veteran and war disability pensions, this includes other smaller schemes such as pensions for war widows.

the fiscal rule at risk. In addition, because the war veteran pensions are relatively generous, have no minimum age requirement, and can only be earned by veterans with no income, they are incentivizing people to move into the sizeable informal sector, hide business income, or simply not work.

13. Recognizing these risks, parliament has recently reformed war veteran pensions. The key elements of the amendments are as follows:

- The amendments introduce explicit criteria tied to length of service during the war to divide veterans into three distinct categories. Pensions will be differentiated accordingly (€120, 170, and 250/month), compared with a uniform €170/month pre-reform.
- The amendments create the legal basis for the establishment of a reclassification commission and define which institutions should be represented in the commission.
- The amendments set an explicit cap on total spending on war veteran pensions, equal to 0.7 percent of GDP per year.¹² The amendments also mandate explicitly that all pensions be cut proportionately if needed to comply with this cap.
- The amendments remove the minimum wage floor on the pension that existed in the original law, thus removing a key obstacle to any needed cut.

14. Some elements of the reform have been challenged in the constitutional court.

Opposition members claim that it is unconstitutional to (i) separate veterans into different categories and different pension levels, and (ii) to grant access to the pension to veterans living abroad but in neighboring countries while denying it to veterans living in non-neighboring countries. The Court has sixty days to rule starting from January 10, but could extend this deadline further. Without prejudging how the constitutional court will rule, the authorities have committed to taking any needed measures to preserve the intended savings and the aggregate spending cap. Assuming the court's ruling upholds the amended law, the authorities are determined to complete the reclassification of war veterans per the criteria set in the law by May 15, 2017, including all administrative appeals.

15. In addition, the authorities are also determined to reform the war disability pension scheme. War disability pensions (€300/month on average) are significantly more generous than their civilian disability counterparts, and the disability threshold to qualify for the former is significantly lower as well. With 3,000–4,000 newly certified war disabled, spending on war disability pensions could go from 0.2–0.3 percent per year to 0.6–0.7 percent, pushing spending on all war-related schemes combined above 2 percent of GDP/year.¹³ Thus, bringing this spending under a

¹² Implementation bylaws will specify which measure of GDP (actual vs. budget forecast) will be used. Staff will argue in favor of the latest available annual outturn rather than a forecast, consistent with the approach taken in the wage bill law.

¹³ For the newly certified war disabled to receive the war disability pension, they would have to be formally assessed by the medical commission, which has not been re-opened yet.

sustainable envelope of 1¼ percent of GDP per year would require reform of war disability pensions in addition to war veteran pensions. To this end, the authorities plan to revise legislation to increase the threshold to qualify for a war disability pension, bringing it in line with civilian disability. This should help reduce spending on war disability pensions by about half; in addition, the authorities see it as socially fair. Parliamentary approval by May 1, 2017 of these amendments to war disability is a structural benchmark for the fourth review.

Potential savings from reform of war-related schemes		
	Spending (percent of GDP, per year) 1/	
	Pre-reform	Post-reform
War veteran pension	1.3	0.7
War disability pension	0.5–0.6	0.2–0.3
Other war-related schemes	0.3–0.4	0.3–0.4
Total	2.1–2.3	1.2–1.4

1/ This is assuming nominal benefits grow in line with nominal GDP. Historically benefits have outpaced GDP, in which case both spending and the gains from reform would be higher than shown.

16. Continued vigilance will be needed to keep current spending contained and reasonably well targeted. This has been an overarching goal of the program. Staff estimate that the measures taken so far under the SBA have put current spending some 2 percent of GDP below what it would have otherwise been, while improving some of the targeting (as in the increase in funding of the properly designed social assistance scheme). Still, government and parliament remain under pressure from various constituencies, and continued vigilance will be needed to lock in the gains made under the program.

- The government is seeking to institute early retirement in the police force in order to lower the average age among active officers—currently, officers cannot retire before the age of sixty-five, the standard retirement age. There may be valid reasons to contemplate early retirement in some professions like the police. At the same time, an overly generous, non-contributory scheme as had been initially proposed would create a permanent gap in the budget and entice other professions to seek similar benefits, undermining the retirement system. The authorities are now working with staff to ensure any early retirement scheme is in line with best practice.
- Despite the ongoing reform of war schemes, additional efforts will be needed to put social assistance on a more equitable and better-targeted footing. Excluding the basic pension for the elderly, social schemes under the Ministry of Labor and Social Welfare amount to some €240 million (4 percent of GDP). Of this, only €30 million are comprised of reasonably well

targeted social assistance for poor families. Much of the remaining €210 million go toward non means-tested schemes that provide generous transfers to occupational groups, some of whose members are poor but many of whom are not. Refocusing social assistance towards those truly in need on the basis of recommendations from recent Fund technical assistance will be a key priority in the coming years.

B. Financial Sector Policy

With the financial sector in good health, policy discussions focused on the development of the new macro-prudential framework, ongoing work to remove structural impediments to lending, and the need to address weaknesses in the insurance sector.

17. The banking sector remains in good health and has increased lending. Capital ratios are well above regulatory minima, with the system-wide capital adequacy ratio above 18 percent. Profitability remains high, as improvements in asset quality (the system's aggregate NPL ratio is 4.8 percent, from 6.2 percent at end 2015), together with cost-cutting among banks, have more than compensated for lower interest rate spreads. In turn, these lower spreads and stronger domestic demand are helping to spur credit growth, which has accelerated from 3 to 10 percent over the last two years, led by lending to the household sector. Liquid assets still cover some 40 percent of short-term liabilities, comfortably above prudential requirements. Ongoing inspections under the new risk-based model have uncovered no major weaknesses in the banks.

18. The authorities are making strong progress in establishing and implementing a macro-prudential policy framework. In a euroized economy with no independent monetary policy such as Kosovo, a well-established macro-prudential policy framework is of critical importance to identify and mitigate systemic financial risks as they arise. The CBK, with support from Fund technical assistance, crafted a new framework (none existed before) in line with best practice, which the CBK adopted in August 2016. The framework establishes roles and responsibilities, available tools, and communication policies to monitor and mitigate any systemic risk in the financial system. The CBK is now engaged in operationalizing this new framework, including refining the range of indicators to be monitored by the Monetary Policy Advisory Committee, as well as improving synergies with other already-existing lines of work at the CBK, such as the semiannual stress tests.

19. Staff also welcome progress to address structural impediments to banking lending. Despite stronger credit growth, credit penetration remains low in Kosovo, at 36 percent of GDP. A key problem has been weak contract enforcement, which pushes banks to lend at higher interest rates and to demand more collateral. The authorities have taken some key measures to improve contract enforcement:

- *The CBK has put in place a unique account registry.* This unique account registry now allows private enforcement agents (PEAs) to garnish debtor accounts automatically via this registry, increasing the speed and efficiency of asset recovery.

- *The authorities have introduced important amendments to the Law on Enforcement Procedures in line with Fund recommendations.* The amendments, which now stand between 1st and 2nd reading in parliament, close loopholes that in the past were abused by debtors to circumvent PEA orders and return their cases back into over-worked courts.
- *The authorities are in the process of increasing the number of PEAs and enhancing their oversight.* The government added 10 PEAs in September, bringing the total number of working PEAs to 35 (versus a target of 72.) Oversight of PEAs has until now been weak, hence the authorities plan to formally adopt the Manual on Supervision of the Work of the Private Enforcement Agents developed in coordination with international partners, to ensure proper and consistent inspection processes (*structural benchmark for the fourth review, March 31, 2017*).
- *Finally, the authorities are improving and publishing court-related statistics to better monitor performance of creditor claims in courts, although progress is slow.* Resource constraints are hindering the organization and publication of such data.

20. Steps are needed to shore up Kosovo’s weak insurance sector. Kosovo’s 15 insurance companies, largely focused on non-life motor insurance, had an aggregate loss ratio of 65 percent of total premiums collected over 2012–15, and four companies are undercapitalized. The poor performance has been a result of an excess number of insurance companies in a relatively small and undiversified market; a large number of unlawfully uninsured drivers that increases costs; and an overly burdensome taxation system out of line with EU norms. Kosovo’s insurance sector is small (accounting for only 3 percent of financial assets) and so does not pose a systemic risk to the financial sector or economy. Nonetheless, a stronger sector is needed to foster financial deepening in the country.

21. The first step will be to address under-provisioning and weak capitalization. The authorities approved a new insurance law in December 2015 in line with EU standards, and subsequently adopted secondary regulations in line with FSAP recommendations. With this, the European Solvency I framework effective from January 1, 2017 gives the central bank the right framework to assess provisioning levels and any related capital gaps. The CBK is committed to demanding credible and time bound recovery plans for any undercapitalized firms, together with more stringent fit and proper rules for insurance auditors, managers, and board directors. In this environment, the authorities and staff agreed that it is appropriate to delay the liberalization of insurance premiums until the industry is on a more stable footing.

22. The authorities should also reform the insurance sector’s skewed tax regime. Kosovo insurance companies are currently taxed at 5 percent of gross revenues in addition to an 18 percent VAT. This is an overly burdensome tax regime and out of line with EU directives, which exempt insurance companies from paying VAT. In this context, the authorities should consider replacing VAT for insurance companies with an indirect tax on premia paid by consumers as in other EU countries, and replacing the 5 percent tax on gross revenues with the standard corporate income tax (ie. tax on profits) paid by most businesses in Kosovo.

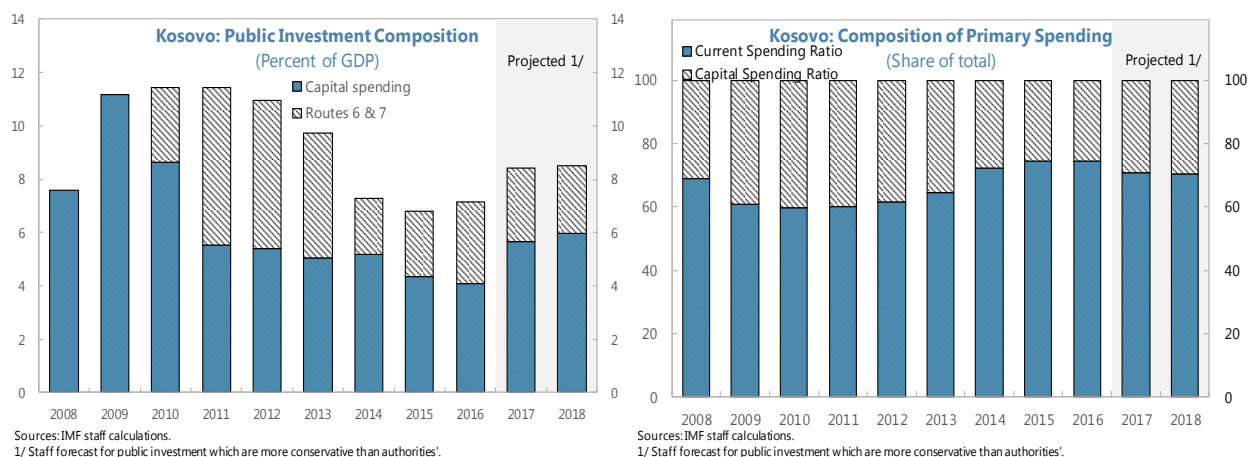
23. The authorities have taken steps to strengthen their AML/CFT regime. Earlier this year, parliament passed a new AML/CFT law that more clearly criminalizes money laundering and terrorist financing and brings the requirements (and related penalties) for banks to report money laundering and terrorist financing activities closer to international standard. The CBK, in turn, is now preparing to adopt secondary legislation to support the new law that covers, among other things, policies and procedures for customer due diligence and politically exposed persons. Further efforts to address remaining gaps in the AML/CFT legal framework and ensure an effective implementation of the regime will be key in addressing ML/TF risks, including underlying offences such as corruption and organized crime. This will also contribute to alleviate potential pressures on Kosovo banks' correspondent banking relationships.

24. Staff welcomes the deposit insurance fund's (DIFK's) efforts to bolster its contribution to Kosovo's financial safety net. DIFK recently concluded an agreement with the EBRD to increase and expand the duration of its existing credit line, which will help DIFK cover its target of 9 percent of insured deposits while it continues to build up its own funds.

C. Large Infrastructure Projects: Investing in Long-Term Growth

25. The capital budget in Kosovo is large, but so are the country's infrastructure needs.

Since independence in 2008, the annual capital budget has accounted for 9 percent of GDP on average. In addition, infrastructure spending has accounted for roughly 35 percent of total public spending, with a rate of implementation close to 90 percent. Yet these numbers may exaggerate the extent to which public infrastructure has been upgraded, because in small economies like Kosovo single projects can absorb a large share of GDP. For instance, construction of Route 7, linking Pristina with the Albanian border (at a total cost of about 20 percent of GDP), absorbed much of the capital budget between 2010 and 2013 while Route 6 (linking Pristina to the Macedonian border, at an expected cost of 11 percent of GDP) will take up much of the available space until 2018.¹⁴



¹⁴ The authorities are currently negotiating a one-year extension to the Route 6 contract (ending construction in December 2018 rather than 2017) so as to spread payments over one additional budget. Staff budget forecasts assume this extension.

26. In this context, the authorities are intensifying efforts to mobilize donor financing for key capital projects under the revised investment clause. The revised clause lays the groundwork for scaling up donor-funded capital spending while safeguarding debt sustainability. The authorities have created a priority project list and are proactively negotiating with donors, recently signing some important agreements such as the rehabilitation of a major railway.

	Priority Projects	Estimated Total Cost (Millions of euro)	Execution Period
1	Rehabilitation of Railway 10	195.3	2016-2021
2	Rehabilitation of regional roads	29	2017-2018
3	Modernisation of the railway Pristina-Fushe-Pristina Airport	40.2 1/	TBD
4	Water Security and Canal Protection Project	22	2017-2022
5	Construction of Road 9 Pristina-Peje	60.8	TBD
6	Rehabilitation of the Eastern-Sourthern Railway	158.5 1/	TBD
7	Extending irrigation system of Radoniqi - Stage II	31.5 1/	2017-2021
8	Construction of the new Highway Pristina-Gjilan-Dheu I Bardhe	250 1/	TBD
	1/ Preliminary estimation of total project costs.		

27. Despite progress, more is needed to accelerate implementation. Total donor disbursements for new projects was less than €15 million in 2016, and they are expected to accelerate to about €50 million in 2017. This is substantially less than the €90 million/year ceiling allocated under the program. Underperformance owes to clear bottlenecks:

- Limited capacity to formulate, evaluate, prioritize and plan projects, including the strict due diligence required by many donors to move forward with a project.
- Unrealistic costing and budgeting regarding both construction and recurrent costs, including maintenance costs. In this context, the Medium Term Expenditure Framework should better reflect future pressures from large scale capital projects.
- Limited scope for the auditor general to audit projects, which would provide timely and unbiased assessment of key investment projects.

The authorities recognize these issues, and have requested technical assistance from both the Fund and other donors to address them.

28. On the private investment side, the anticipated large foreign investment in the Brezovica ski resort project has not materialized. This project was expected to amount to 3 percent of GDP in the first three-year phase, and 8 percent of GDP over 15-20 years. However, foreign investors that had been in discussions on the project decided against the investment shortly before the May 2016 deadline. The authorities are hopeful that the recently-passed Law on Strategic Investments may help the project to go forward by enabling direct negotiations with new potential investors, although this is not likely to take place in the near term.

29. The authorities continue to work towards a new, badly-needed power plant. Kosovo's energy supply is currently reliant on outdated power plants that require replacement. Key stakeholders, notably government, donors, and the private consortium selected to build and operate the plant, are slowly converging towards an agreed size in terms of generation capacity. However, the plans being for a coal powered plant, donor financing is also contingent on a strict assessment of the social and environmental impact of the project. In a best-case scenario, work on the new plant would begin in early 2018, with the plant coming online in 2022–23.

D. Governance – Improving Public Procurement

Discussions focused on accelerating the roll-out of centralized procurement and e-procurement, aimed at improving transparency and reducing rent seeking in the large public procurement market.

30. The authorities have made important progress in strengthening the legal framework underpinning public procurement, which will make the overall process more transparent and public spending more efficient. On December 21, 2015, the new law on procurement was adopted by parliament with subsequent amendments in February 2016. The new law represents a significant improvement on many levels. In particular, it eliminates the preferential treatment for Kosovar companies, and strengthens fit and proper rules for members of the Procurement Review Board (PRB).

31. As part of the ongoing reform of public procurement, the authorities need to continue efforts to expand centralized procurement. Under the program, the authorities introduced a designated list of standardized goods and services that can only be procured centrally including for municipalities. Replacing multiple small procurement tenders with one larger central tender makes oversight of the system easier, reducing the scope for rent seeking. This list now incorporates nine goods and services, including key common goods such as vehicle fuel. The authorities are committed to further expanding this list, adding three to five goods and services whose estimated annual procured amounts exceed €1 million for each item (*structural benchmark for the fourth review, February 28, 2017*).

32. Similarly, ongoing progress in rolling out e-procurement needs to be deepened so as to further increase transparency in the system. Since September 1, e-procurement is mandatory for the central procurement agency (CPA) and all other central government procurement agencies. For municipalities, e-procurement is mandatory since January 1, 2017. Crucially, e-procurement will apply to essential medical supplies procured by the Ministry of Health, by far the single largest non-defense procurement item. For all this progress, implementation of e-procurement has lagged not least because of capacity constraints to set up and handle complex electronic systems. Continued technical support from donors, and renewed ownership on the authorities' side, will be crucial to translate *de jure* changes into tangible gains.

E. Other Issues

33. The authorities have moved closer to implementing the recommendations of the 2015 safeguards assessment. After significant delay, legal amendments to the CBK law to (a) remove the current requirement for parliamentary approval of the CBK external auditor; and (b) establish a due process for the removal of the CBK governor and board members have been approved in government and submitted to parliament. Parliamentary approval is expected in late February.

34. Following the EU Council's adoption of the Stabilization and Association Agreement (SAA), the phased adoption of the EU common external tariff has begun. The gradual adoption of the common external tariff started on April 1, 2016. The SAA will facilitate the economic integration with the EU by expanding trade opportunities. Expected revenue losses have already been factored in in budget and medium-term projections.

PROGRAM DESIGN AND RISKS

35. Staff supports the authorities' request for the following additions to program conditionality (Tables 1 and 2 of the MEFP). New performance criteria have been set for end-March 2017 on the deficit ex PAK, the deficit ex PAK and ex new donor financed projects, and the bank balance. An end-March 2017 indicative target has been set on current spending. In addition, structural benchmarks have been set for the fourth review, including adoption by parliament of legal amendments to align disability criteria for war and civilian disability pensions; the formal adoption by the Ministry of Justice of the manual on oversight of private enforcement agents; and the government addition of three to five additional goods and services under centralized procurement whose estimated annual procured amounts exceed €1 million each. Finally, staff support the authorities' request to extend the program from May 28 to August 4, 2017, as the time needed to pass the war veteran reform has delayed implementation of other structural reforms.

36. Kosovo's capacity to repay the Fund remains sound, with public debt is expected to remain quite low throughout the forecast period (DSA Tables). Kosovo's outstanding debt to the Fund will peak at 185.8 percent of the quota in 2017, and is expected to be almost fully repaid by 2022. Moreover, overall exposure to the Fund remains modest compared to key macroeconomic indicators such as GDP, exports plus remittances, and government revenues. More broadly, staff expect Kosovo's low public debt to increase to about 24.5 percent in 2018, and to stabilize thereafter. The debt sustainability analysis shows the importance of reforming war-related schemes: should reform (which is still in its initial phase) fail, debt would continue to increase and exceed 30 percent of GDP by the end of the projection period.

37. The constitutional challenge to the war veteran reform is an important risk to the program, although this risk is mitigated by the authorities' commitment to take contingent measures should parts of the new law be invalidated. In the current political climate, early elections and associated pressures that would compromise program objectives cannot be excluded. Confidence effects from domestic and regional political uncertainty could derail growth, although the risks on fiscal sustainability are contained on account of low deficits and low debt.

STAFF APPRAISAL

38. Staff welcomes progress on the implementation of the program. The economy continues to expand faster than others in the region, although still at a slower pace than needed for incomes to converge to regional standards and to create enough jobs for Europe's youngest population. Fiscal performance has been strong and government bank balances are moving back towards prudent levels. Credit growth is accelerating and the CBK continues to make progress in shoring up the safety and soundness of the banking sector. Important structural reforms are underway.

39. Staff recognizes the authorities' continued efforts to maintain fiscal stability. The fiscal outturn in 2016 outperformed targets thanks to strong tax revenue performance. However, current spending was modestly higher than originally expected because of unanticipated pressures from war veteran pensions, while the scaling up of capital spending was somewhat below expectations. The 2017 budget envisions a deficit well within the authorities' fiscal rule and is based on realistic tax revenue assumptions, together with continued containment of unproductive current spending provided reform of war schemes is followed through. This creates space for a significant ramp up in capital spending.

40. If left unattended, the rapid expansion of war-related social schemes would have represented a serious threat to the credibility of the fiscal rule and to fiscal sustainability. Reforming war veteran pensions proved politically sensitive; the need to garner social support explains the delay in completing the 2nd and 3rd reviews. Now that parliament has approved these reforms, steadfast and transparent implementation will be critical. Should the constitutional court invalidate some components of the law, the authorities are committed to taking corrective measures to preserve the sustainability of the system. Separately, aligning the war and civilian disability threshold will be needed for budgetary reasons, and staff concur with the authorities that it would be socially fair as well.

41. Reform of war-related schemes should be followed with a broader reform of social assistance. The current system needs to be refocused away from non means-tested transfers to specific occupational groups, and towards well targeted transfers that support those truly in need. This points to underlying pressures from various constituencies that will need to be kept in check beyond the program, so as to lock in and deepen recent gains.

42. Accelerating the implementation of infrastructure projects is an important priority. The recent pace of public-financed infrastructure development has not matched the need for raising growth potential. Despite some progress such as the establishment of the National Investment Council, the authorities' preparedness for a desired scale-up of public investment spending is not complete. Improved implementation capacity, including a concerted effort within the government, is required to bring to fruition all the key priority projects.

43. The banking sector remains sound and the CBK is advancing its reform agenda. Staff welcome the roll out of risk-based supervision to all banks in Kosovo, which strengthens the supervisory oversight of the CBK. The CBK's recent adoption and ongoing operationalization of a macro-prudential policy framework will also help to identify and mitigate financial sector risks, which appear contained at present.

44. Staff welcomes the authorities' efforts to address structural impediments to bank lending. Rapid adoption by parliament of amendments to the Law on Enforcement Procedures would address current loopholes, which have been abused by debtors to delay enforcement of commercial claims. This, along with a new, fully-automated account registry and a steadily increasing number of PEAs to enforce claims, should give banks more confidence in their ability to collect on due debts and thus encourage an expanded provision of credit. The authorities' plans to further develop their capacity to supervise PEAs is important to ensuring the effective and fair functioning of this system.

45. Developing the weak insurance sector is another financial sector priority. Now that the authorities have better regulatory tools at hand, they need to demand credible, time-bound recovery plans from weak firms and, failing those, force consolidation in the sector. Tighter fit and proper rules should be part of this effort. Reform of the current tax system, which is too punitive of insurance companies, should be the carrot to the abovementioned sticks.

46. The modernization of the public procurement system needs to continue. In particular, continued expansion of the list of centrally procured goods, and widespread implementation of e-procurement, should be the next goals, all the while bringing in municipalities and publicly owned enterprises to these higher standards.

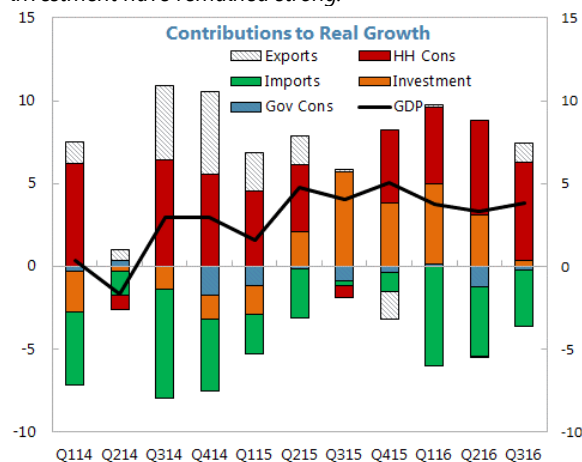
47. Staff welcome the recent progress made in improving Kosovo's AML/CFT regime and encourage the authorities to ensure its effective implementation. The AML/CFT law passed earlier this year and the subsequent regulations being prepared by the CBK are welcomed steps, which would contribute to mitigate risks of laundering of proceeds of crime, including corruption, and potential pressures on correspondent banking relationships.

48. Staff urges the authorities to finalize plans to implement recommendations of the safeguards assessment. Implementation of the recommendations has been significantly delayed, and parliament should approve these relatively uncontroversial amendments to the CBK law expeditiously.

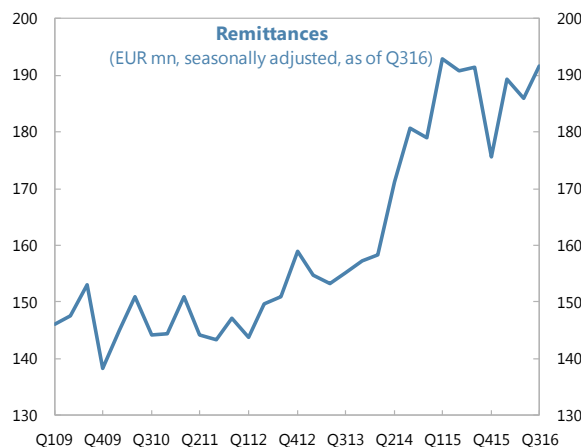
49. Staff supports the authorities' request for the completion of the second and third program review, taking into account the authorities' record of good progress in economic management in a volatile domestic political environment alongside significant efforts to compress unproductive spending, reform the social benefit schemes, and implement important financial sector and public procurement reforms. Staff also support the request for an extension to the Fund-supported program from May 28 to August 4, 2017 to give the authorities the needed time to complete the remaining reforms.

Figure 1. Kosovo: Recent Economic Developments

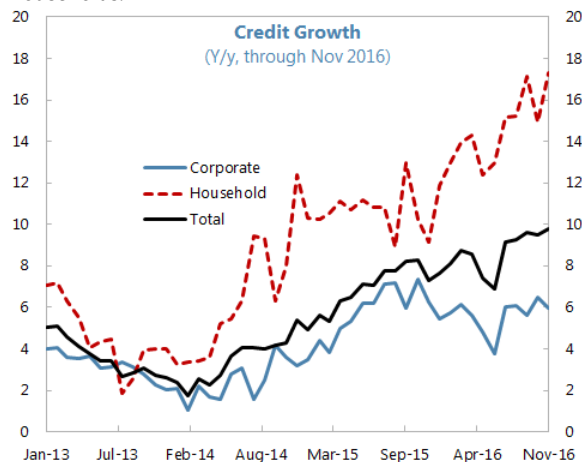
2016 growth has slowed a bit, but HH consumption and investment have remained strong.



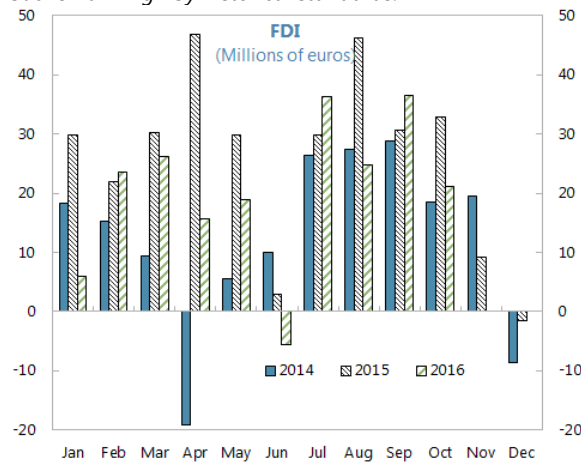
Remittances remain high by historical standards.



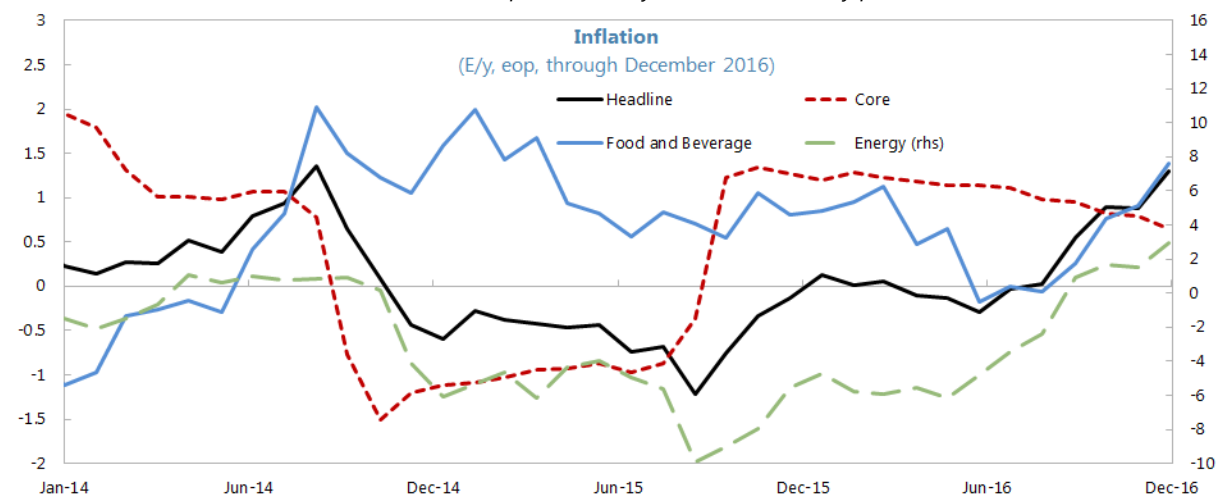
Credit growth accelerated in 2016, driven by lending to households.



FDI inflows have generally lagged behind those of 2015, but remain high by historical standards.



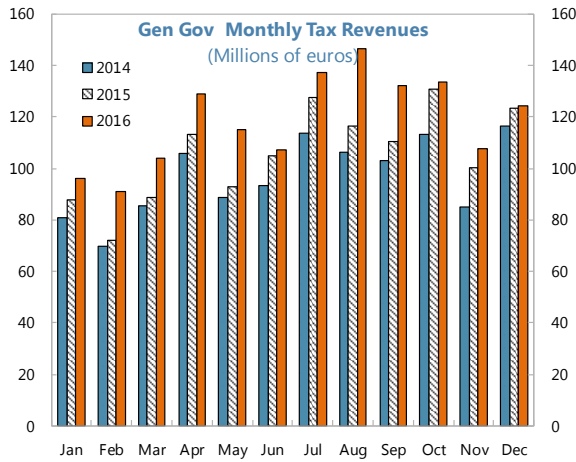
Inflation has turned positive, led by external commodity prices.



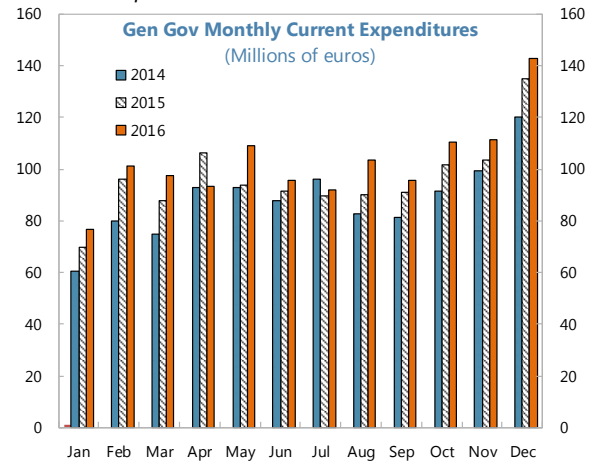
Sources: Kosovo Agency of Statistics; Central Bank of Kosovo; and IMF staff estimates.

Figure 2. Kosovo: Recent Fiscal Developments

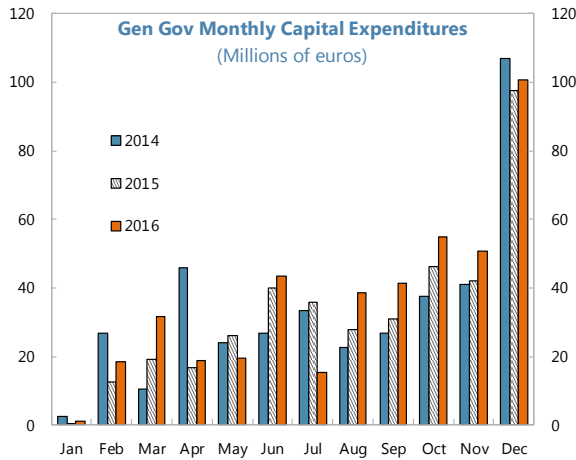
Tax revenues performed strongly throughout 2016...



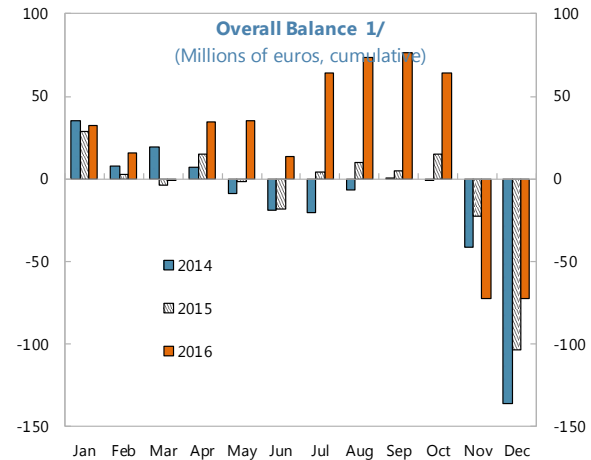
...while current spending increased, not least due to higher war veteran pensions.



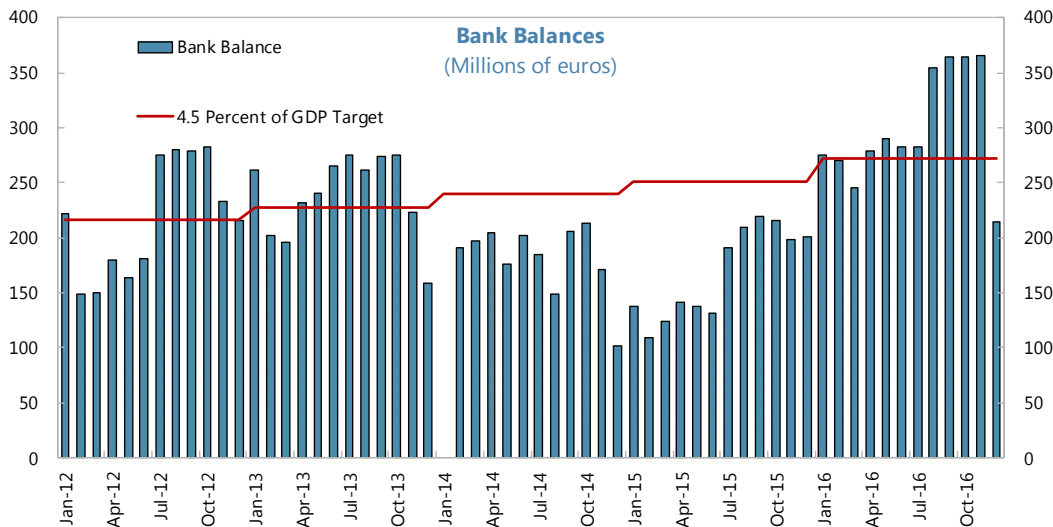
Capital expenditure execution improved over 2015.



Overall, this means that the 2016 balance was better than 2014 and 2015.



Government bank balances finished below target, but only due to a lack of IMF disbursements since January 2016.

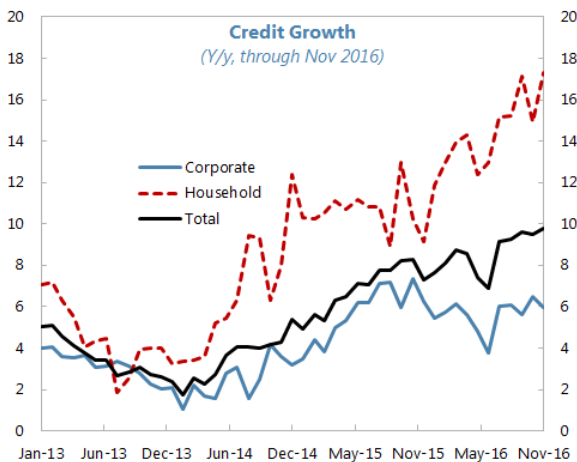


Sources: Kosovo Ministry of Finance; and IMF staff estimates.

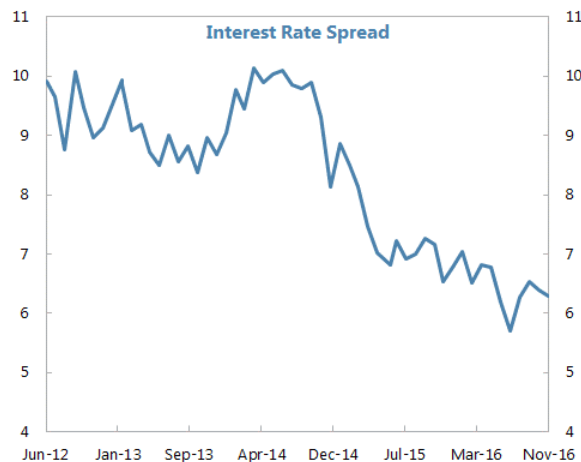
1/ Overall balance excludes PAK spending.

Figure 3. Kosovo: Banking Sector Overview

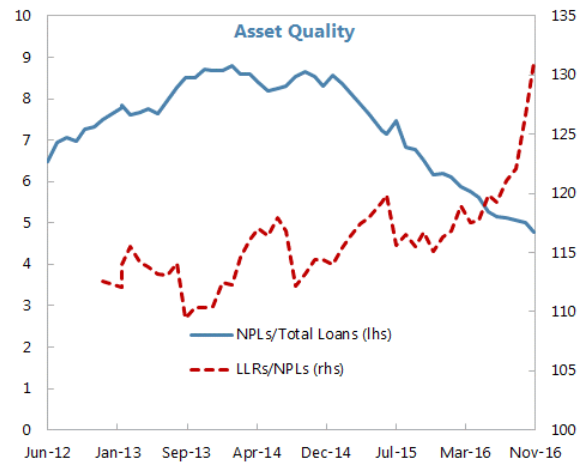
The acceleration in credit growth...



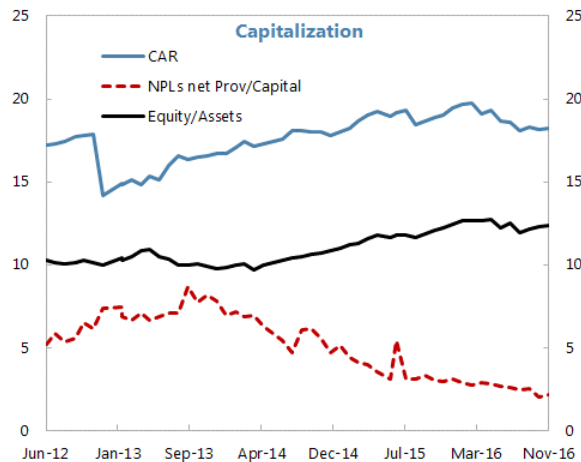
...has been aided by historically low interest rates.



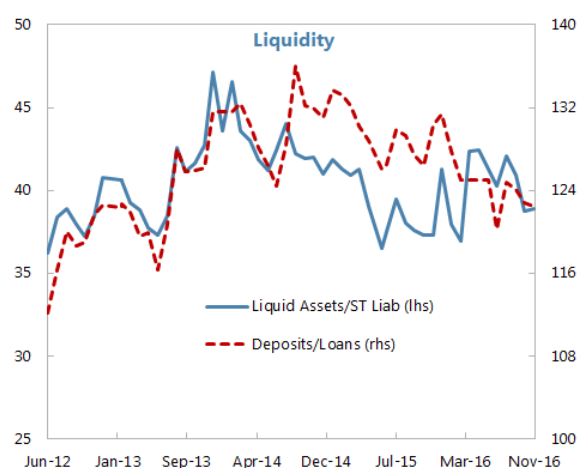
Asset quality continued to improve through 2016...



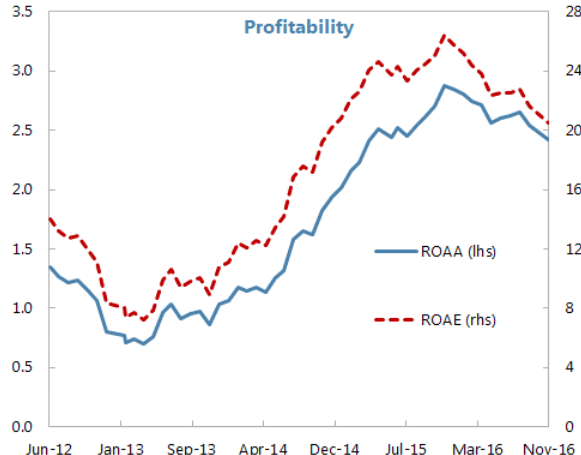
...while banks have remained well-capitalized...



...liquid, despite some recent shortening of deposit tenors...



...and highly profitable, despite profitability peaking in late 2015.



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

Table 1. Kosovo: Select Economic Indicators, 2013–22
(Percent, unless otherwise indicated)

	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022
	Projections									
Real growth rates										
GDP	3.4	1.2	4.1	3.6	3.5	3.6	3.6	3.8	4.0	4.0
Consumption	2.2	3.7	2.4	4.3	3.8	3.0	3.3	3.4	3.7	3.7
Private	2.0	4.8	3.8	5.5	3.7	3.4	3.7	3.7	3.9	3.9
Public	3.3	-2.5	-6.5	-2.6	4.7	0.4	0.8	1.6	2.3	2.7
Investment	-0.3	-5.0	11.3	6.2	7.3	3.9	3.0	2.0	4.6	4.5
Exports	2.5	16.7	2.5	1.7	3.7	4.2	6.6	4.4	4.3	4.9
Imports	-1.5	8.4	3.6	6.8	3.3	3.7	5.1	5.7	5.8	3.7
Official unemployment (percent of workforce)	30.0	35.3	32.9	...	...	...	...	...	...	...
Price changes										
CPI, period average	1.8	0.4	-0.5	0.3	0.9	1.8	1.9	2.1	2.2	2.0
CPI, end of period	0.5	-0.4	-0.1	1.3	1.0	1.8	2.0	2.2	2.2	1.8
Import prices	0.0	-0.4	-0.7	-1.9	3.8	1.3	-0.3	0.1	1.2	1.3
GDP deflator	1.8	3.3	0.2	0.6	1.0	1.8	1.7	1.9	2.1	1.9
Real effective exch. rate (average; -=depreciation)	0.4	1.3	-2.2	1.3	...	...	...	...	...	...
Real effective exch. rate (end of period; -=depreciation)	1.3	-1.1	-1.0	0.3	...	...	...	...	...	...
General government budget (percent of GDP)										
Primary revenues	24.6	24.0	25.1	26.4	26.6	26.4	26.4	26.4	26.4	26.4
Primary expenditures	27.6	26.3	26.7	27.5	28.7	28.8	28.0	27.4	27.7	27.7
Of which: Wages and salaries	7.8	8.7	9.0	9.0	9.0	9.0	9.0	9.0	9.0	9.0
Subsidies and transfers	6.0	6.6	7.4	8.0	7.6	7.6	7.6	7.6	7.6	7.6
Capital and net lending	9.7	7.3	6.8	7.2	8.4	8.5	7.7	7.1	7.5	7.4
Overall balance ex-PAK and ex-new donor projects	-3.0	-2.5	-1.8	-1.2	-1.5	-1.7	-0.7	-0.7	-0.7	-0.8
Overall balance excluding PAK 1/	-3.0	-2.5	-1.8	-1.4	-2.5	-2.7	-2.1	-1.6	-1.8	-1.9
Privatization	0.4	0.0	1.1	0.0	0.3	0.2	1.1	0.0	0.0	0.0
Stock of government bank balances	3.0	1.8	3.5	3.5	5.2	5.0	5.0	5.0	5.0	5.0
Balance of Payments (percent of GDP)										
Current account balance, incl. official transfers	-3.6	-7.0	-8.5	-9.7	-10.8	-11.1	-10.6	-10.3	-9.8	-9.7
Of which: official transfers 2/	6.9	5.2	3.5	3.3	2.9	2.4	2.5	2.8	3.7	3.3
Capital and financial account	-3.2	3.2	4.2	6.3	7.9	8.6	8.1	7.9	7.3	7.2
Of which: Net foreign direct investment	4.9	2.2	4.7	4.1	5.1	5.4	5.4	5.5	5.5	5.4
Portfolio investment, net	-2.6	-0.2	-0.8	-1.9	0.1	0.3	-1.0	-0.9	-1.0	-0.6
Errors and Omissions	6.7	3.9	4.3	3.4	3.0	2.5	2.5	2.5	2.5	2.5
Savings-investment balances (percent of GDP)										
National savings	17.1	13.5	15.4	15.2	15.4	15.7	15.9	15.2	14.8	15.3
Investment	27.6	25.8	27.6	28.2	29.2	29.2	29.0	28.3	28.3	28.3
Current account, excl. official transfers	-10.5	-12.3	-12.2	-13.0	-13.8	-13.5	-13.1	-13.1	-13.5	-13.0
Non-performing loans (percent of total loans)										
Bank credit to the private sector (percent change)	2.7	5.4	7.3	10.3	9.5	10.6	10.2	9.4	9.2	8.5
Deposits of the private sector (percent change)	8.0	4.0	7.3	8.7	6.6	7.6	7.4	7.9	8.3	8.2
Regulatory capital/risk weighted assets	16.8	17.8	19.0	...	...	...	...	...	...	...
Memorandum items:										
Total public debt (percent of GDP)	16.2	16.7	18.9	20.6	23.5	24.5	24.1	24.2	24.5	24.9
Of which: Debt of the former Yugoslavia 3/	7.0	6.3	5.8	5.2	4.6	4.1	3.5	2.9	2.4	1.9
GDP (millions of euros)	5327	5568	5807	6052	6329	6680	7038	7447	7909	8384
GDP per capita (euros)	2935	3023	3159	3244	3343	3476	3608	3761	3935	4110
GNDI per capita (euros)	3446	3525	3673	3743	3856	4014	4150	4324	4528	4732
Population (thousands)	1815	1842	1838	1866	1894	1922	1951	1980	2010	2040

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

1/ Includes capital spending by publicly-owned enterprises via onlending from the general government.

2/ Total foreign assistance excluding capital transfers.

3/ Kosovo neither recognizes nor services nor tracks this debt.

Table 2. Kosovo: Consolidated Government Budget, 2013–22 1/
(Excluding donor designated grants; millions of euros; cumulative from the beginning of the year)

	2013	2014	2015	2016			2017		2018	2019	2020	2021	2022
				Original Budget	Mid-year Budget	Prelim	Budget	Proj	Projections				
Total primary revenue and grants	1,313	1,334	1,457	1,584	1,606	1,595	1,713	1,682	1,766	1,860	1,967	2,087	2,214
Total primary revenue	1,313	1,333	1,457	1,583	1,605	1,595	1,713	1,682	1,766	1,860	1,967	2,087	2,214
Taxes	1,121	1,162	1,269	1,370	1,410	1,424	1,512	1,512	1,587	1,671	1,766	1,875	1,986
Direct taxes	174	188	196	245	216	234	264	241	246	260	275	292	309
Indirect taxes	985	1,007	1,107	1,168	1,233	1,229	1,292	1,312	1,383	1,456	1,540	1,634	1,731
Of which: VAT	560	560	611	651	683	694	748	738	778	820	868	922	977
Tax refunds	-37	-33	-34	-43	-39	-39	-44	-41	-43	-45	-48	-51	-54
Nontax revenues	192	171	188	213	195	171	201	170	180	189	200	213	228
Of which: Dividends	43	15	15	26	15	0	5	0	0	0	0	0	1
Grants	0	1	0	1	1	0	0	0	0	0	0	0	0
Budget support	0	0	0	0	0	0	0	0	0	0	0	0	0
Project grants	0	1	0	1	1	0	0	0	0	0	0	0	0
Primary expenditure	1,468	1,464	1,552	1,666	1,703	1,666	1,990	1,818	1,924	1,968	2,042	2,194	2,322
Of which:													
PAK-related expenditures	7	5	6	10	9	8	11	11	12	12	13	14	15
Current expenditure	950	1,059	1,156	1,220	1,230	1,229	1,284	1,284	1,355	1,428	1,510	1,604	1,700
Wages and salaries	417	485	525	548	549	544	572	572	604	636	673	715	758
Goods and services	216	206	204	209	205	202	225	225	237	250	264	281	298
Subsidies and transfers	318	368	427	459	474	484	482	482	509	536	568	603	639
Pension and social assistance	225	347	399	440	455	465		463	489	515	545	579	614
Other transfers and subsidies 2/	93	21	29	19	19	19		19	20	21	22	24	25
Current reserves	0	0	0	5	3	0	5	5	5	5	5	5	5
Capital expenditure and net lending	518	404	395	446	472	437	706	533	569	540	532	590	623
Capital expenditure	524	404	395	454	479	444	717	545	583	540	532	590	623
R6	0	56	115	110	148	160		170	143	32	0	0	1
Budget-financed	0	56	115	110	148	160		150	143	32	0	0	0
PAK-financed	0	0	0	0	0	0	87	20	0	0	0	0	1
Expropriation	0	21	27	30	28	28		25	25	0	0	0	0
Other capital spending	309	289	254	314	297	256		366	416	508	532	590	623
Donor-financed new projects 3/					15	10	105	51	62	87	56	84	86
Capital Reserves					6	0		4	4	0	0	0	0
Net lending	-6	0	0	-8	-7	-7	-11	-11	-14	0	0	0	0
Primary balance ex-PAK and ex-new donor-financed projects	-149	-124	-89	-73	-73	-53	-74	-74	-84	-8	-7	-9	-8
Primary balance ex-PAK 4/	-149	-124	-89	-73	-92	-67	-192	-138	-156	-106	-71	-93	-94
Interest income, net	-11	-13	-16	-26	-25	-20	-23	-23	-27	-42	-46	-50	-62
Overall balance ex-PAK and ex-new donor-financed projects	-160	-137	-105	-98	-98	-73	-97	-97	-111	-50	-54	-58	-71
Overall balance ex-PAK 4/	-160	-137	-105	-98	-117	-87	-207	-161	-183	-148	-117	-143	-157
Financing	166	136	96			74		161	183	148	117	143	156
Foreign financing	-8	-18	13			-9		151	67	72	-8	26	69
Drawings, incl. official financing	6	4	5			8		25	13	26	31	38	40
Amortization	-14	-22	-28			-66		-54	-19	-52	-102	-97	-57
Donor financing for new projects 5/			0			14		64	72	97	64	84	86
IMF financing			36			35		116	0	0	0	0	0
Domestic financing	116	97	183			96		126	120	94	145	140	111
Domestic borrowing (net)	78	104	111			101		106	105	14	145	140	110
Privatization revenues	19	0	61			0		20	15	80	0	0	1
Own-source revenue (- = increase)	19	-7	11			-5		0	0	0	0	0	0
Accumulation of Assets (- = increase)	57	57	-99			-14		-116	-3	-18	-20	-23	-24
Memorandum items:													
Bank balance of the general government	159	102	201			215		331	334	352	372	395	419
Of which: ELA	46	46	46			46		46	46	46	46	46	47
Total public debt	864	931	1,099			1,245		1,486	1,634	1,694	1,805	1,941	2,088
Of which: Debt of the former Yugoslavia 6/	371	351	337			316		294	271	246	219	189	158

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

1/ Does not yet reflect the GFSM 2001 methodology.

2/ Including capital transfers to public enterprises.

3/ Based on information on new donor projects up to this point. New projects may be identified in the future.

4/ Includes capital spending by publicly-owned enterprises via onlending from the general government.

5/ Including financing for projects for publicly-owned enterprises via onlending from the general government.

6/ Kosovo neither recognizes nor services nor tracks this debt.

Table 3. Kosovo: Consolidated Government Budget, 2013–22 1/
(Excluding donor designated grants; percent of GDP)

	2013	2014	2015	2016			2017		2018	2019	2020	2021	2022
				Original	Mid-year	Prelim	Budget	Proj	Projections				
				Budget 2/	Budget 2/								
Total primary revenue and grants	24.6	24.0	25.1	26.2	26.5	26.4	27.1	26.6	26.4	26.4	26.4	26.4	26.4
Total primary revenue	24.6	23.9	25.1	26.2	26.5	26.4	27.1	26.6	26.4	26.4	26.4	26.4	26.4
Taxes	21.0	20.9	21.8	22.6	23.3	23.5	23.9	23.9	23.8	23.7	23.7	23.7	23.7
Direct taxes	3.3	3.4	3.4	4.0	3.6	3.9	4.2	3.8	3.7	3.7	3.7	3.7	3.7
Indirect taxes	18.5	18.1	19.1	19.3	20.4	20.3	20.4	20.7	20.7	20.7	20.7	20.7	20.6
Tax refunds	-0.7	-0.6	-0.6	-0.7	-0.6	-0.6	-0.7	-0.6	-0.6	-0.6	-0.6	-0.6	-0.6
Nontax revenues	3.6	3.1	3.2	3.5	3.2	2.8	3.2	2.7	2.7	2.7	2.7	2.7	2.7
Of which:													
Dividends	0.8	0.3	0.3	0.4	0.2	0.0	0.1	0.0	0.0	0.0	0.0	0.0	0.0
Grants	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Budget support	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Project grants	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Primary expenditure	27.6	26.3	26.7	27.5	28.1	27.5	31.4	28.7	28.8	28.0	27.4	27.7	27.7
Of which:													
PAK-related expenditures	0.1	0.1	0.1	0.2	0.1	0.1	0.2	0.2	0.2	0.2	0.2	0.2	0.2
Primary expenditure excluding PAK	...	...	...	...	...	...	...	...	...	...	...	...	...
Current expenditure	17.8	19.0	19.9	20.2	20.3	20.3	20.3	20.3	20.3	20.3	20.3	20.3	20.3
Current expenditure excluding PAK	17.7	18.9	19.8	20.0	20.2	20.2	20.1	20.1	20.1	20.1	20.1	20.1	20.1
Wages and salaries	7.8	8.7	9.0	9.1	9.1	9.0	9.0	9.0	9.0	9.0	9.0	9.0	9.0
Goods and services	4.0	3.7	3.5	3.4	3.4	3.3	3.6	3.6	3.6	3.6	3.6	3.6	3.6
Subsidies and transfers	6.0	6.6	7.4	7.6	7.8	8.0	7.6	7.6	7.6	7.6	7.6	7.6	7.6
Pension and social assistance	4.2	6.2	6.9	7.3	7.5	7.7	7.3	7.3	7.3	7.3	7.3	7.3	7.3
Current reserves	0.0	0.0	0.0	0.3	0.3	0.0	0.1	0.1	0.1	0.1	0.1	0.1	0.1
Capital expenditure and net lending	9.7	7.3	6.8	7.4	7.8	7.2	11.1	8.4	8.5	7.7	7.1	7.5	7.4
Capital expenditure	9.8	7.3	6.8	7.5	7.9	7.3	11.3	8.6	8.7	7.7	7.1	7.5	7.4
R7	4.0	0.7	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
R6	0.0	1.0	2.0	1.8	2.4	2.6	2.7	2.1	0.5	0.0	0.0	0.0	0.0
Budget-financed	0.0	1.0	2.0	1.8	2.4	2.6	2.4	2.1	0.5	0.0	0.0	0.0	0.0
PAK-financed	0.0	0.0	0.0	0.0	0.0	0.0	1.4	0.3	0.0	0.0	0.0	0.0	0.0
Expropriations	0.0	0.4	0.5	0.5	0.5	0.5	0.4	0.4	0.0	0.0	0.0	0.0	0.0
Other capital spending	5.8	5.2	4.4	5.2	4.9	4.2	5.8	6.2	7.2	7.1	7.5	7.4	
Donor-financed new projects 3/				0.0	0.1	0.2	1.7	0.8	0.9	1.2	0.7	1.1	1.0
Capital Reserves				0.1	0.0	0.0	0.1	0.1	0.0	0.0	0.0	0.0	0.0
Net lending	-0.1	0.0	0.0	-0.1	-0.1	-0.1	-0.2	-0.2	-0.2	0.0	0.0	0.0	0.0
Primary balance ex-PAK and ex-new donor-financed projects	-2.8	-2.2	-1.5	-1.2	-1.2	-0.9	-1.2	-1.2	-1.3	-0.1	-0.1	-0.1	-0.1
Primary balance ex-PAK 4/	-2.8	-2.2	-1.5	-1.2	-1.5	-1.1	-3.0	-2.2	-2.3	-1.5	-0.9	-1.2	-1.1
Interest income, net	-0.2	-0.2	-0.3	-0.4	-0.4	-0.3	-0.4	-0.4	-0.4	-0.6	-0.6	-0.6	-0.7
Overall balance ex-PAK and ex-new donor-financed projects	-3.0	-2.5	-1.8	-1.6	-1.6	-1.2	-1.5	-1.5	-1.7	-0.7	-0.7	-0.7	-0.8
Overall balance ex-PAK 4/	-3.0	-2.5	-1.8	-1.6	-1.9	-1.4	-3.3	-2.5	-2.7	-2.1	-1.6	-1.8	-1.9
Financing	3.1	2.4	1.7			1.2		2.5	2.7	2.1	1.6	1.8	1.9
Foreign financing	-0.1	-0.3	0.2			-0.1		2.4	1.0	1.0	-0.1	0.3	0.8
Drawings, incl. official financing	0.1	0.1	0.1			0.1		0.4	0.2	0.4	0.4	0.5	0.5
Amortization	-0.3	-0.4	-0.5			-1.1		-0.8	-0.3	-0.7	-1.4	-1.2	-0.7
Donor financing for new projects 5/			0.0			0.2		1.0	1.1	1.4	0.9	1.1	1.0
IMF financing			0.6			0.6		1.8	0.0	0.0	0.0	0.0	0.0
Domestic financing	2.2	1.7	3.1			1.6		2.0	1.8	1.3	2.0	1.8	1.3
Domestic borrowing (net)	1.5	1.9	1.9			1.7		1.7	1.6	0.2	2.0	1.8	1.3
Privatization revenues	0.4	0.0	1.1			0.0		0.3	0.2	1.1	0.0	0.0	0.0
Own-source revenue (- = increase)	0.4	-0.1	0.2			-0.1		0.0	0.0	0.0	0.0	0.0	0.0
Accumulation of Assets (- = increase)	1.1	1.0	-1.7			-0.2		-1.8	0.0	-0.3	-0.3	-0.3	-0.3
Memorandum items:													
Bank balance of the general government	3.0	1.8	3.5			3.5		5.2	5.0	5.0	5.0	5.0	5.0
Of which: ELA	0.9	0.8	0.8			0.8		0.7	0.7	0.7	0.6	0.6	0.6
Total public debt	16.2	16.7	18.9			20.6		23.5	24.5	24.1	24.2	24.5	24.9
Of which: Debt of the former Yugoslavia 6/	7.0	6.3	5.8			5.2		4.6	4.1	3.5	2.9	2.4	1.9
Nominal GDP (millions of euros)	5,327	5,568	5,807			6,052		6,329	6,680	7,038	7,447	7,909	8,384

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

1/ Does not yet reflect the GFSM 2001 methodology.

2/ Nominal values per current GDP projections.

3/ Based on information on new donor projects up to this point. New projects may be identified in the future.

4/ Includes capital spending by publicly-owned enterprises via onlending from the general government.

5/ Including financing for projects for publicly-owned enterprises via onlending from the general government.

6/ Kosovo neither recognizes nor services nor tracks this debt.

Table 4. Kosovo: Balance of Payments, 2013–22
(Millions of euros, unless otherwise indicated)

	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022
				Projections						
Goods and services balance	-1,488	-1,610	-1,653	-1,719	-1,842	-1,936	-1,980	-2,093	-2,258	-2,359
Goods	-1,996	-2,059	-2,109	-2,240	-2,417	-2,567	-2,695	-2,874	-3,074	-3,148
Exports	291	324	322	331	357	368	392	406	437	475
Imports	-2,287	-2,383	-2,432	-2,571	-2,774	-2,934	-3,087	-3,280	-3,511	-3,623
Services	507	448	456	521	575	631	715	781	816	789
Receipts	852	904	950	1,015	1,084	1,146	1,241	1,323	1,396	1,474
Payments	-345	-456	-493	-494	-509	-515	-526	-542	-579	-685
Income	122	109	84	96	97	101	104	109	121	135
Compensation of employees (net)	219	200	206	208	212	216	220	222	224	226
Investment income	-97	-91	-109	-112	-114	-115	-116	-113	-103	-91
Interest payments on public debt	-9	-10	-11	-14	-18	-18	-20	-21	-19	-17
Transfers	1,175	1,109	1,062	1,036	1,059	1,095	1,131	1,214	1,364	1,414
Official transfers	370	292	203	201	185	161	177	209	294	279
Other transfers (net)	805	817	859	835	874	934	953	1,006	1,070	1,135
Workers' remittances (net)	498	553	608	585	606	640	647	685	725	777
Inflows of remittances	573	622	665	637	626	657	664	677	713	749
Other (net)	308	264	251	250	268	293	307	321	345	358
Current account	-191	-392	-494	-587	-686	-740	-745	-769	-773	-810
Capital and financial account	-168	176	245	379	498	571	573	587	579	603
Capital account	36	-2	-2	-2	-2	2	2	3	0	1
Financial account, incl. CBK	-204	178	247	381	500	569	571	584	579	602
Foreign direct investment, net	262	124	272	250	322	358	381	411	435	450
Commercial banks, excl. FDI	-47	75	4	-72	143	68	24	11	-9	-22
General government	14	-17	13	35	138	57	62	-16	-58	-16
Drawings	3	5	41	95	192	75	114	87	38	40
Repayments	11	-22	-28	-60	-54	-19	-52	-102	-97	-57
Other	0	0	0	0	0	0	0	0	0	1
Other sectors, excl. FDI 1/	-122	-485	-13	120	121	106	141	201	238	219
Central Bank of Kosovo	-311	481	-29	48	-223	-20	-37	-23	-27	-29
Reserve assets (- = accumulation)	36	57	-89	4	-222	-25	-42	-27	-31	0
Government balances (program definition)	57	57	-99	-14	-116	-3	-18	-20	-23	-24
Program financing (- = increase) 2/	0	0	-36	-35	-116	0	0	0	0	0
Other reserve assets, incl. SDRs	-22	0	10	17	-106	-22	-24	-7	-8	24
Non-reserves assets	-347	424	26	34	1	5	4	4	4	-29
Liabilities 3/	0	0	35	10	-2	0	0	0	0	0
Net errors and omissions 4/	359	216	248	208	187	168	173	183	195	207
Overall balance	0	0	0	0	0	0	0	0	0	0
	(In percent of GDP)									
Goods and services balance	-27.9	-28.9	-28.5	-28.4	-29.1	-29.0	-28.1	-28.1	-28.5	-28.1
Exports	21.5	22.1	21.9	22.2	22.8	22.7	23.2	23.2	23.2	23.2
Imports	-49.4	-51.0	-50.4	-50.6	-51.9	-51.6	-51.3	-51.3	-51.7	-51.4
Income (net)	2.3	2.0	1.4	1.6	1.5	1.5	1.5	1.5	1.5	1.6
Transfers (net)	22.1	19.9	18.3	17.1	16.7	16.4	16.1	16.3	17.2	16.9
Official	6.9	5.2	3.5	3.3	2.9	2.4	2.5	2.8	3.7	3.3
Other	15.1	14.7	14.8	13.8	13.8	14.0	13.5	13.5	13.5	13.5
Current account, excl. official transfers	-10.5	-12.3	-12.2	-13.0	-13.8	-13.5	-13.1	-13.1	-13.5	-13.0
Current account, incl. official transfers	-3.6	-7.0	-8.5	-9.7	-10.8	-11.1	-10.6	-10.3	-9.8	-9.7
Capital and financial account	-3.2	3.2	4.2	6.3	7.9	8.6	8.1	7.9	7.3	7.2
Foreign direct investment, net	4.9	2.2	4.7	4.1	5.1	5.4	5.4	5.5	5.5	5.4
Other sectors, excl. FDI 1/	-2.3	-8.7	-0.2	2.0	1.9	1.6	2.0	2.7	3.0	2.6
Net errors and omissions 4/	6.7	3.9	4.3	3.4	3.0	2.5	2.5	2.5	2.5	2.5
Overall balance	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Memorandum items:										
Debt service to export ratio (percent)	-0.2	2.6	3.0	5.5	4.9	2.4	4.4	7.1	6.3	3.8
Debt service to exports and remittances (percent)	-0.1	1.7	2.0	3.8	3.4	1.7	3.1	5.1	4.5	2.8
External debt (percent of GDP)	13.4	12.1	12.4	12.7	14.3	14.2	14.1	12.9	12.1	11.8
Of which: Debt of the former Yugoslavia 5/	7.0	6.3	5.8	5.2	4.6	4.1	3.5	2.9	2.4	1.9
Net foreign assets of CBK	1,286	1,045	1,073	1,025	1,248	1,268	1,305	1,328	1,355	1,384
Gross international reserves of the CBK 6/	695	645	735	731	953	979	1,020	1,048	1,079	1,133
Gross international reserves in months of imports 6/	3.2	2.7	3.0	2.9	3.5	3.4	3.4	3.3	3.2	3.2

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

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

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

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

4/ Errors and omissions are thought to be mostly comprised of unidentified private remittances and unidentified FDI.

5/ Kosovo neither recognizes nor services nor tracks this debt.

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

Table 5. Kosovo: Central Bank and Commercial Bank Survey, 2013–17
(Millions of euros, unless otherwise indicated)

	2013	2014	2015	2016	2017
					Proj.
Central Bank					
Net foreign assets	1,286	1,045	1,073	1,025	1,248
Foreign assets	1,504	1,266	1,329	1,291	1,513
<i>Of which:</i> Securities	561	121	127	568	588
Deposits	790	983	1,046	403	604
Foreign liabilities	218	222	256	266	264
Net domestic assets	-1,286	-1,045	-1,073	-1,025	-1,248
Net claims on commercial banks	-333	-316	-316	-296	-303
Claims on commercial banks	0	0	0	0	0
Liabilities to commercial banks	-333	-316	-316	-296	-303
Net claims on the central government	-668	-629	-626	-623	-847
Claims on central government	0	0	0	0	0
Liabilities to central government	-773	-730	-754	-737	-847
<i>Of which:</i> KTA (privatization) fund	-550	-558	-487	-461	-455
<i>Of which:</i> Government balances (program definition)	-159	-102	-201	-215	-331
Net Claims on other sectors	-238	-52	-82	-58	-51
Claims on other sectors	1	0	-30	-6	2
Liabilities to other sectors	-239	-52	-52	-52	-52
Other items, net 1/	-48	-48	-48	-47	-47
Commercial banks					
Net foreign assets	573	534	535	598	465
Assets	748	716	740	775	682
Liabilities	-175	-182	-204	-177	-217
Net domestic assets	2,145	2,320	2,524	2,709	2,984
Claims on the CBK	333	316	316	295	303
Net claims on the central government	99	187	221	234	292
Claims on central government	100	193	226	239	292
Liabilities to central government	-1	-5	-6	-6	0
Net claims on other public entities	-73	-65	-31	-46	-48
Claims on other public entities	0	1	1	3	3
Liabilities to other public entities	-73	-65	-32	-49	-52
Credit to private sector	1,786	1,881	2,019	2,227	2,438
Deposits of the private sector	2,286	2,378	2,552	2,773	2,957
Demand deposits	841	1,131	1,381	1,624	1,733
Time deposits	1,445	1,247	1,171	1,150	1,225
Other items, net 1/	432	476	507	534	492
Memorandum item:					
Gross international reserves 2/	695	645	735	731	953
Deposits of the private sector (12-month percent change)	8.0	4.0	7.3	8.7	6.6
Credit to the private sector (12-month percent change)	2.7	5.4	7.3	10.3	9.5
Deposits of the private sector (Percent of GDP)	42.9	42.7	43.9	45.8	46.7
Credit to the private sector (Percent of GDP)	33.5	33.8	34.8	36.8	38.5

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

1/ Includes shares and other equity.

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

Table 6. Kosovo: Selected Financial Soundness Indicators, 2010–16

	2010	2011	2012	2013	2014	2015	Nov-16
Capital adequacy							
Regulatory capital to risk weighted assets 1/	18.8	17.6	14.2	16.7	17.8	19.0	18.2
Tier 1 capital to risk weighted assets 1/	15.8	14.8	11.6	12.8	14.6	16.7	16.1
Capital to assets	10.1	10.2	10.0	9.7	10.8	12.2	12.4
Asset quality							
NPL to total loans 2/	5.2	5.7	7.5	8.7	8.3	6.2	4.8
NPL net of provisions to capital	3.7	4.6	7.4	7.8	4.7	3.0	2.2
Large exposures to capital	72.4	77.8	80.4	107.4	97.1	63.5	62.5
Sectoral breakdown of loans							
Agriculture	2.6	2.4	2.5	2.6	2.4	3.0	2.7
Manufacturing	11.0	10.1	9.5	9.7	10.0	10.0	9.7
Trade	37.1	37.8	37.8	36.9	35.8	34.9	32.8
Other services	12.0	11.7	11.6	12.4	12.8	13.3	13.3
Construction	7.5	7.0	7.2	6.6	6.0	4.9	4.7
Households	29.8	31.0	31.4	31.8	33.0	34.6	35.9
Liquidity							
Liquid assets to total assets 3/	37.5	32.6	34.3	37.8	38.3	37.8	34.5
Deposits to loans	126.1	117.6	122.6	130.8	129.4	130.4	122.5
Liquid assets to short-term liabilities 4/	46.2	39.6	40.8	47.1	41.0	37.3	38.9
Profitability							
Return on average assets 5/	1.6	1.6	0.8	1.0	1.9	2.9	2.4
Return on average equity 5/	16.9	16.9	8.3	10.8	20.2	26.4	20.5
Interest margin to total income	55.5	56.9	55.6	54.3	62.2	68.6	69.4
Non-interest expense to total income 6/	16.6	18.0	23.9	22.2	12.9	1.5	14.3
Interest margin to gross income 7/	74.4	75.2	74.7	73.1	76.1	76.2	76.1
Non-interest expense to gross income 6/ 7/	76.6	77.3	87.8	84.5	66.8	51.8	62.0
Market risk							
Net open currency position to tier 1 capital	-0.1	2.5	0.7	2.3	1.8	1.8	1.8

Source: Central Bank of the Republic of Kosovo.

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

2/ Loans classified as doubtful or loss.

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

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

5/ Profits are before taxes and extraordinary items.

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

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

Table 7. Kosovo: Indicators of Capacity to Repay the Fund, 2016–22

	2016	2017	2018	2019	2020	2021	2022
Fund obligations based on prospective purchases (millions of SDR) 1/							
Principal	0.0	0.0	0.0	0.0	32.7	45.7	12.9
Charges and interest	0.0	1.2	1.2	1.2	1.1	0.6	0.1
Fund obligations based on existing and prospective purchases (millions of SDR) 1/							
Principal	39.1	27.7	3.5	24.6	57.3	49.2	12.9
Charges and interest	0.5	3.3	3.4	3.1	2.4	1.1	0.2
Total obligations based on existing and prospective purchases 1/							
SDR millions	39.6	31.1	6.9	27.7	59.7	50.3	13.1
Euro millions	49.7	39.6	8.8	35.4	76.1	64.1	16.8
Percent of exports of goods and services	3.7	2.7	0.6	2.2	4.4	3.5	0.9
Percent of exports of goods and services and remittances	2.5	1.9	0.4	1.5	3.2	2.5	0.6
Percent of debt service	70.8	61.9	23.6	48.8	62.3	55.5	21.9
Percent of GDP	0.8	0.6	0.1	0.5	1.0	0.8	0.2
Percent of government revenue	3.1	2.4	0.5	1.9	3.9	3.1	0.8
Percent of quota	47.9	37.6	8.4	33.5	72.3	60.9	15.9
Outstanding Fund credit (based on existing and prospective drawings) 1/							
SDR millions	89.9	153.4	149.9	125.3	68.0	18.9	5.9
Euro millions	112.9	195.7	191.4	160.1	86.8	24.1	7.6
Percent of exports of goods and services	8.4	13.6	12.6	9.8	5.0	1.3	0.4
Percent of exports of goods and services and remittances	5.7	9.5	8.8	7.0	3.6	0.9	0.3
Percent of GDP	1.9	3.1	2.9	2.3	1.2	0.3	0.1
Percent of government revenue	7.1	11.6	10.8	8.6	4.4	1.2	0.3
Percent of quota	108.8	185.8	181.5	151.7	82.4	22.8	7.2
Net use of Fund credit (millions of SDR) 1/							
Purchases	-11.0	63.6	-3.5	-24.6	-57.3	-49.2	-12.9
Repurchases	28.1	91.3	0.0	0.0	0.0	0.0	0.0
	39.1	27.7	3.5	24.6	57.3	49.2	12.9
<i>Memorandum items:</i>							
Exports of goods and services (millions of euros)	1,346	1,441	1,514	1,633	1,729	1,833	1,949
Exports of goods and services and remittances (millions of euros)	1,983	2,067	2,171	2,297	2,407	2,545	2,699
External debt service (millions of euros)	70.2	63.9	37.3	72.5	122.2	115.6	76.3
Nominal GDP (millions of euros)	6,052	6,329	6,680	7,038	7,447	7,909	8,384
Government revenue (millions of euros)	1,595	1,682	1,766	1,860	1,967	2,087	2,216
Quota (millions of SDR) 2/	82.6	82.6	82.6	82.6	82.6	82.6	82.6

Sources: IMF staff estimates and projections.

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

2/ Kosovo's new quota is SDR 82.6 million. The old quota of SDR 59 million is used for the purpose of calculating surcharges and commitment fees as per Kosovo's request to be grandfathered.

Table 8. Kosovo: Gross Financing Requirements, 2016–17
(Millions of euros)

	2016	2017
Gross Financing Requirements	643	732
Current account deficit	583	685
Amortization of medium and long term public debt	61	47
Sources of Financing	644	732
Capital account (net)	-2	-2
Foreign direct investment (net)	250	322
Net bank financing	-72	143
Government loans	95	192
IMF financing	35	116
Net Foreign assets of the Central Bank of Kosovo	48	-223
Other financing inc. net errors and omissions	324	301
Financing gap	0	0
Memorandum items:		
Kosovo IMF quota (SDR millions)	83	83

Sources: IMF staff estimates and projections.

(Percent of GDP)

	2016	2017
Gross Financing Requirements	10.6	11.6
Current account deficit	9.6	10.8
Amortization of medium and long term public debt	1.0	0.7
Sources of Financing	9.8	15.1
Capital account (net)	0.0	0.0
Foreign direct investment (net)	4.1	5.1
Net bank financing	-1.2	2.3
Government loans	1.6	3.0
IMF financing	0.6	1.8
Net Foreign assets of the Central Bank of Kosovo	0.8	-3.5
Other financing inc. net errors and omissions	5.3	4.8
Financing gap	0.0	0.0

Sources: IMF staff estimates and projections.

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

Amount	Percent of Quota	Date Available	Conditions Necessary for Purchase
SDR 28.1 million	34	July 29, 2015	Purchase made
SDR 28.1 million	34	November 1, 2015	Purchase made
SDR 39.6 million	48	May 1, 2016	Observance of continuous and end-December 2015 performance criteria and completion of the second review.
SDR 39.6 million	48	November 1, 2016	Observance of continuous and end-June 2016 performance criteria and completion of the third review.
SDR 12.1 million	15	May 1, 2017	Observance of continuous and end-March 2017 performance criteria and completion of the fourth review.
Total: SDR 147.5 million (179 percent of Kosovo's new quota of SDR 82.6 million)			

Annex. Debt Sustainability Analysis

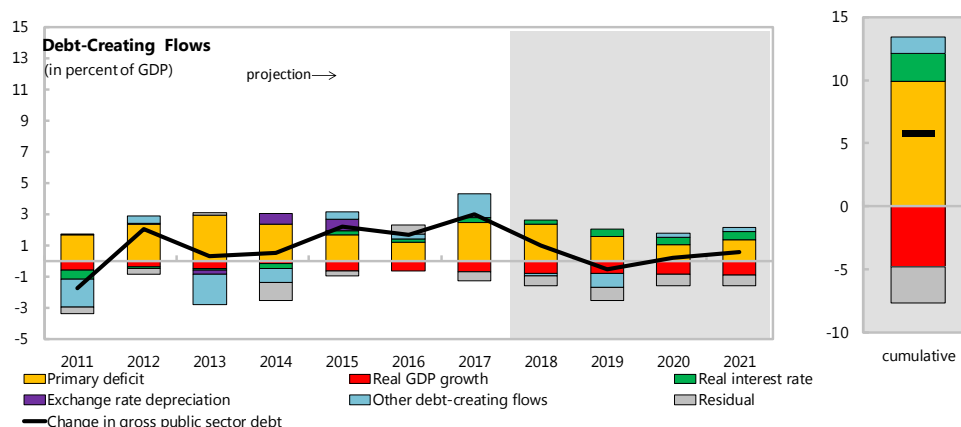
Kosovo Public Sector Debt Sustainability Analysis (DSA) – Baseline Scenario (In percent of GDP, unless otherwise indicated)

Debt, Economic and Market Indicators ^{1/}

	Actual			Projections						As of 10/21/2016		
	2011-2013 ^{2/}	2014	2015	2016	2017	2018	2019	2020	2021	Sovereign Spreads	Foreign	Local
Nominal gross public debt	15.3	16.7	18.9	20.6	23.6	24.5	24.0	24.2	24.7	EMBIG (bp) ^{3/}	n/a	n/a
Public gross financing needs	4.8	7.9	6.9	6.9	6.2	5.7	5.3	5.4	7.0	5Y CDS (bp)	n/a	n/a
Real GDP growth (in percent)	3.5	1.2	4.1	3.6	3.5	3.6	3.6	3.8	4.0	Ratings	Foreign	Local
Inflation (GDP deflator, in percent)	2.9	3.3	0.2	0.6	1.0	1.8	1.7	1.9	2.1	Moody's	n.a.	n.a.
Nominal GDP growth (in percent)	6.6	4.5	4.3	4.2	4.6	5.5	5.4	5.8	6.2	S&P's	n.a.	n.a.
Effective interest rate (in percent) ^{4/}	1.3	1.5	1.7	1.8	2.6	2.9	3.8	4.1	4.5	Fitch	n.a.	n.a.

Contribution to Changes in Public Debt

	Actual			Projections						cumulative	debt-stabilizing primary balance ^{9/}
	2011-2013	2014	2015	2016	2017	2018	2019	2020	2021		
Change in gross public sector debt	0.2	0.5	2.2	1.7	3.0	1.0	-0.5	0.2	0.5	5.8	primary
Identified debt-creating flows	0.4	1.7	2.5	1.0	3.6	1.6	0.3	0.9	1.2	8.7	balance ^{9/}
Primary deficit	2.3	2.3	1.7	1.2	2.5	2.4	1.5	1.0	1.3	9.9	-0.1
Primary (noninterest) revenue and grants	25.9	24.0	25.1	26.4	26.6	26.4	26.4	26.4	26.4	158.6	
Primary (noninterest) expenditure	28.2	26.3	26.7	27.5	29.0	28.8	28.0	27.4	27.7	168.5	
Automatic debt dynamics ^{5/}	-0.8	0.2	0.4	-0.4	-0.4	-0.6	-0.4	-0.4	-0.4	-2.5	
Interest rate/growth differential ^{6/}	-0.7	-0.5	-0.4	-0.4	-0.4	-0.6	-0.4	-0.4	-0.4	-2.5	
Of which: real interest rate	-0.2	-0.3	0.2	0.2	0.3	0.2	0.5	0.5	0.5	2.2	
Of which: real GDP growth	-0.5	-0.2	-0.7	-0.7	-0.7	-0.8	-0.8	-0.9	-0.9	-4.8	
Exchange rate depreciation ^{7/}	-0.1	0.7	0.8	...	...	...	...	...	...	...
Other identified debt-creating flows ^{10/}	-1.1	-0.9	0.5	0.3	1.5	-0.2	-0.9	0.3	0.3	1.3	
Privatization/Drawdown of Deposits	-1.1	-0.9	0.5	0.3	1.5	-0.2	-0.9	0.3	0.3	1.3	
Contingent liabilities	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Please specify (2) (e.g., ESM and Euro)	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Residual, including asset changes ^{8/}	-0.2	-1.2	-0.3	0.6	-0.6	-0.6	-0.8	-0.7	-0.7	-2.9	



Source: IMF staff.

1/ Public sector is defined as general government.

2/ Based on available data.

3/ Long-term bond spread over German bonds.

4/ Defined as interest payments divided by debt stock (excluding guarantees) at the end of previous year.

5/ Derived as $[(r - \pi(1+g) - g + ae(1+r))/(1+g+\pi+gr)]$ times previous period debt ratio, with r = interest rate; π = growth rate of GDP deflator; g = real GDP growth rate;

a = share of foreign-currency denominated debt; and e = nominal exchange rate depreciation (measured by increase in local currency value of U.S. dollar).

6/ The real interest rate contribution is derived from the numerator in footnote 5 as $r - \pi(1+g)$ and the real growth contribution as $-g$.

7/ The exchange rate contribution is derived from the numerator in footnote 5 as $ae(1+r)$.

8/ Includes asset changes and interest revenues (if any). For projections, includes exchange rate changes during the projection period.

9/ Assumes that key variables (real GDP growth, real interest rate, and other identified debt-creating flows) remain at the level of the last projection year.

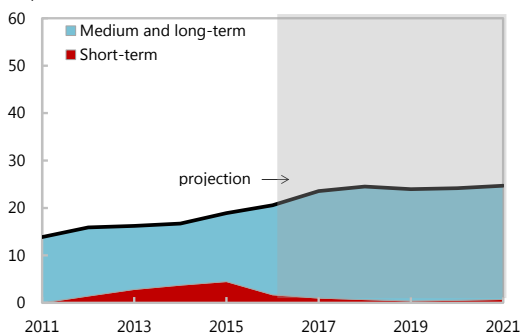
10/ Other identified debt-creating flows largely reflect fluctuations in government bank balances.

Kosovo Public DSA – Composition of Public Debt and Alternative Scenarios

Composition of Public Debt

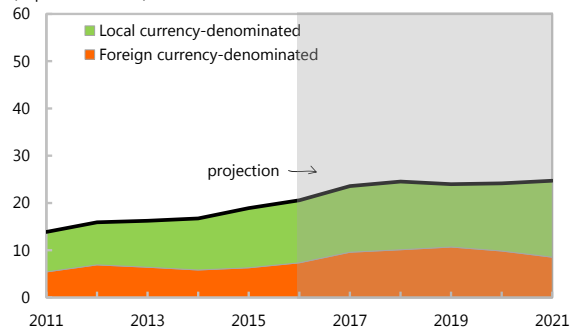
By Maturity

(in percent of GDP)



By Currency

(in percent of GDP)



Alternative Scenarios

— Baseline

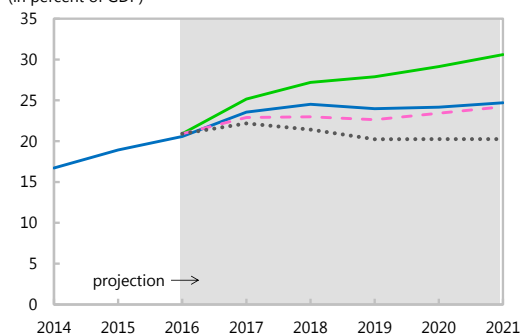
..... Historical

--- Constant Primary Balance

— No Reform of War Related Social Schemes

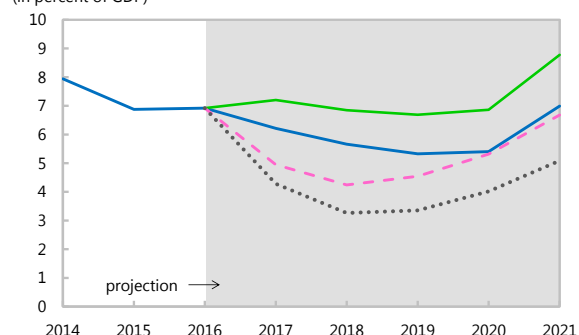
Gross Nominal Public Debt

(in percent of GDP)



Public Gross Financing Needs

(in percent of GDP)



Underlying Assumptions

(in percent)

Baseline Scenario

	2016	2017	2018	2019	2020	2021
Real GDP growth	3.6	3.5	3.6	3.6	3.8	4.0
Inflation	0.6	1.0	1.8	1.7	1.9	2.1
Primary Balance	-1.2	-2.5	-2.4	-1.5	-1.0	-1.3
Effective interest rate	1.8	2.6	2.9	3.8	4.1	4.5

Constant Primary Balance Scenario

Real GDP growth	3.6	3.5	3.6	3.6	3.8	4.0
Inflation	0.6	1.0	1.8	1.7	1.9	2.1
Primary Balance	-1.2	-1.2	-1.2	-1.2	-1.2	-1.2
Effective interest rate	1.8	2.6	2.9	3.9	4.2	4.5

No Reform of War Related Social Schemes

Real GDP growth	3.6	3.5	3.6	3.6	3.8	4.0
Inflation	0.6	1.0	1.8	1.7	1.9	2.1
Primary Balance	-1.2	-3.4	-3.2	-2.3	-1.8	-2.1
Effective interest rate	1.8	2.6	2.8	3.7	3.9	4.2

Historical Scenario

	2016	2017	2018	2019	2020	2021
Real GDP growth	3.6	3.9	3.9	3.9	3.9	3.9
Inflation	0.6	1.0	1.8	1.7	1.9	2.1
Primary Balance	-1.2	-0.5	-0.5	-0.5	-0.5	-0.5
Effective interest rate	1.8	2.6	2.2	3.2	3.4	3.5

Source: IMF staff.

Kosovo: External Debt Sustainability Framework, 2011–2021

(In percent of GDP, unless otherwise indicated)

	Actual					Projections						Debt-stabilizing non-interest current account 6/ -6.0		
	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021			
Baseline: External debt	13.9	14.5	13.4	12.1	12.4	12.7	14.3	14.2	14.1	12.9	12.1			
Change in external debt	-1.7	0.6	-1.1	-1.2	0.3	0.2	1.6	-0.1	-0.1	-1.2	-0.8	0.0		
Identified external debt-creating flows (4+8+9)	5.6	0.8	-1.6	3.3	1.9	4.5	4.8	4.7	4.2	4.3	3.8	0.0		
Current account deficit, excluding interest payments	12.6	5.6	3.4	6.9	8.3	9.5	10.6	10.8	10.3	10.0	9.5	6.0		
Deficit in balance of goods and services	34.3	30.7	27.9	28.9	28.5	28.4	29.1	29.0	28.1	28.1	28.5			
Exports	23.2	22.7	21.5	22.1	21.9	22.2	22.8	22.7	23.2	23.2	23.2			
Imports	57.5	53.4	49.4	51.0	50.4	50.6	51.9	51.6	51.3	51.3	51.7			
Net non-debt creating capital inflows (negative)	-6.5	-3.3	-4.9	-2.2	-4.7	-4.8	-5.6	-5.9	-5.9	-5.5	-5.5	-5.5		
Automatic debt dynamics 1/	-0.5	-1.5	-0.1	-1.3	-1.7	-0.2	-0.1	-0.2	-0.2	-0.2	-0.2	-0.5		
Contribution from nominal interest rate	0.2	0.2	0.2	0.2	0.1	0.2	0.3	0.3	0.3	0.3	0.3	0.2		
Contribution from real GDP growth	-0.7	-0.3	-0.5	-0.1	-0.4	-0.4	-0.4	-0.5	-0.5	-0.5	-0.5	-0.5		
Contribution from price and exchange rate changes 2/	0.0	-1.3	0.2	-1.4	-1.5	...	...	...	...	...	...	-0.3
Residual, incl. change in gross foreign assets (2-3) 3/	-7.4	-0.2	0.5	-4.5	-1.6	-4.3	-3.2	-4.8	-4.3	-5.6	-4.6	0.0		
External debt-to-exports ratio (in percent)	59.9	63.7	62.4	55.0	56.8	57.1	62.6	62.5	60.8	55.4	52.1			
Gross external financing need (in billions of US dollars) 4/	959.1	538.4	425.6	635.0	671.0	749.3	853.2	912.1	921.6	949.0	953.2			
in percent of GDP	15.1	8.1	5.8	9.2	10.6	10-Year	10-Year	11.0	12.0	12.1	11.7	11.3	10.7	
Scenario with key variables at their historical averages 5/						12.7	12.4	10.9	10.2	8.8	8.4	-5.3		
Key Macroeconomic Assumptions Underlying Baseline						Historical Average	Standard Deviation					For debt stabilization		
Nominal GDP (US dollars)	6345.2	6636.7	7299.7	6865.3	6316.3			6794.3	7117.1	7517.1	7905.4	8371.6	8914.4	9492.3
Real GDP growth (in percent)	4.4	2.8	3.4	1.2	4.1	3.2	1.1	3.6	3.5	3.6	3.6	3.8	4.0	4.0
Exchange rate appreciation (US dollar value of local currency, change in percent)	-4.6	8.2	-3.2	7.7	13.4	4.4	7.0	3.2	0.2	0.1	-0.2	0.1	0.3	0.3
GDP deflator (change in domestic currency)	4.8	2.2	1.8	3.3	0.2	2.8	1.8	0.6	1.0	1.8	1.7	1.9	2.1	2.1
GDP deflator in US dollars (change in percent)	-0.1	10.6	-1.5	11.2	13.6	7.3	6.4	3.8	1.2	1.9	1.5	2.0	2.4	2.4
Nominal external interest rate (in percent)	1.3	1.3	1.6	1.3	1.4	1.7	0.7	1.9	2.3	2.0	2.1	2.1	1.9	1.9
Growth of exports (US dollar terms, in percent)	29.0	2.6	4.0	-3.3	-8.7	25.3	52.1	2.5	6.9	5.0	8.1	5.8	5.7	
Growth of imports (US dollar terms, in percent)	13.9	-2.9	1.8	-3.0	-9.1	18.6	45.9	1.5	7.0	5.0	4.9	5.7	6.7	
Current account balance, excluding interest payments	-12.6	-5.6	-3.4	-6.9	-8.3	-8.0	3.5	-9.5	-10.6	-10.8	-10.3	-10.0	-9.5	
Net non-debt creating capital inflows	6.5	3.3	4.9	2.2	4.7	4.6	1.6	4.8	5.6	5.9	5.9	5.5	5.5	

1/ Derived as $[r - g - r(1+g) + ea(1+r)] / (1+g+r+gr)$ times previous period debt stock, with r = nominal effective interest rate on external debt; r = change in domestic GDP deflator in US dollar terms, g = real GDP growth rate, e = nominal appreciation (increase in dollar value of domestic currency), and a = share of domestic-currency denominated debt in total external debt.

2/ The contribution from price and exchange rate changes is defined as $[-r(1+g) + ea(1+r)] / (1+g+r+gr)$ times previous period debt stock. r increases with an appreciating domestic currency ($e > 0$) and rising inflation (based on GDP deflator).

3/ For projection, line includes the impact of price and exchange rate changes.

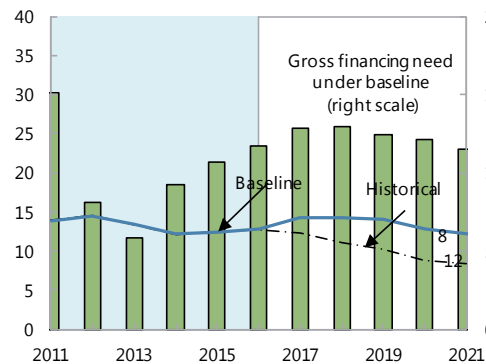
4/ Defined as current account deficit, plus amortization on medium- and long-term debt, plus short-term debt at end of previous period.

5/ The key variables include real GDP growth; nominal interest rate; dollar deflator growth; and both non-interest current account and non-debt inflows in percent of GDP.

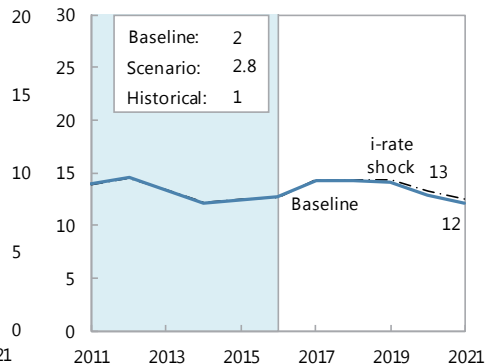
6/ Long-run, constant balance that stabilizes the debt ratio assuming that key variables (real GDP growth, nominal interest rate, dollar deflator growth, and non-debt inflows in percent of GDP) remain at their levels of the last projection year.

Kosovo: External Debt Sustainability: Bound Tests 1/ 2/

Baseline and historical scenarios

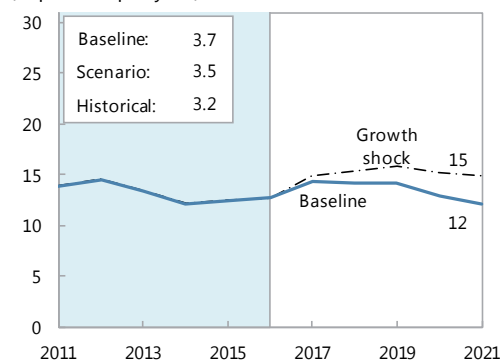


Interest rate shock (in percent)



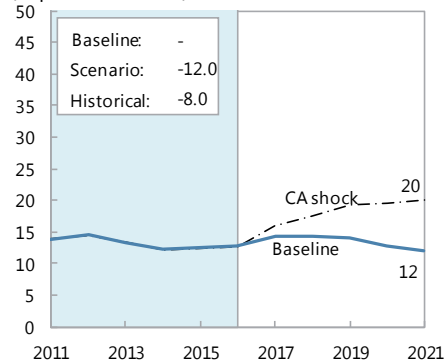
Growth shock

(in percent per year)

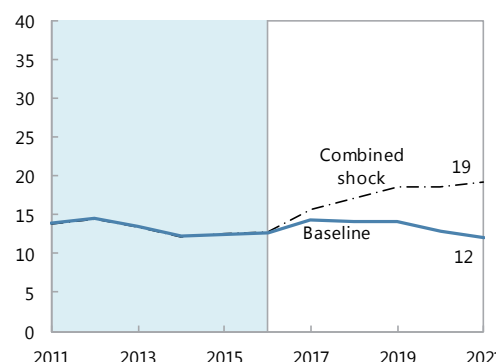


Non-interest current account shock

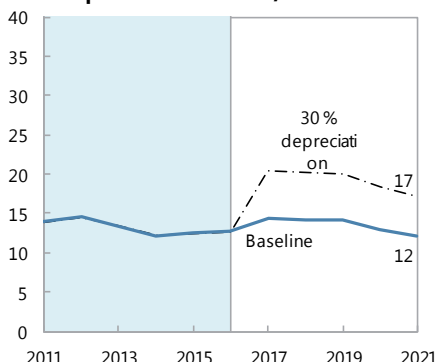
(in percent of GDP)



Combined shock 3/



Real depreciation shock 4/



Sources: International Monetary Fund, Country desk data, and staff estimates.

1/ Shaded areas represent actual data. Individual shocks are permanent one-half standard deviation shocks. Figures in the boxes represent average projections for the respective variables in the baseline and scenario being presented. Ten-year historical average for the variable is also shown.

2/ For historical scenarios, the historical averages are calculated over the ten-year period, and the information is used to project debt dynamics five years ahead.

3/ Permanent 1/4 standard deviation shocks applied to real interest rate, growth rate, and current account balance.

4/ One-time real depreciation of 30 percent occurs in 2016.

Appendix I. Letter of Intent

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

Pristina, February 24, 2017

Dear Ms. Lagarde:

1. The attached Supplementary Memorandum of Economic and Financial Policies (MEFP) summarizes the significant progress made in implementing the SBA-supported program through November 2016 and outlines our economic and structural policies for the remainder of 2016 and 2017. This MEFP complements and updates the MEFPs of July 6, 2015 and December 2, 2015, which set out the objectives and reported on the progress of our 22-month SBA-supported program.
2. Performance under the program has been very strong. We have met all quantitative performance criteria and indicative targets at end-December 2015 and end-June 2016 by a wide margin. We have also met all structural benchmarks for the second and third review (only one with some delay).
3. We remain committed to our reform agenda as confirmed by ongoing progress in our public finances, our financial regulatory and supervisory framework, and our work to enhance bank lending and to improve competitiveness by realigning labor costs and strengthening the public procurement process. Parliament has also adopted amendments to the Law on War Veterans that will ensure that spending on war-related schemes remains fiscally sustainable over the medium term. These achievements will provide us with the foundation necessary to reach stronger and more durable economic growth.
4. We believe that the policies set forth in the attached MEFP remain adequate to achieve the program objectives, but we will take any further measures that may become appropriate for this purpose.
5. The Kosovo authorities will consult with the IMF, at our own initiative or whenever the Managing Director of the IMF requests such a consultation, on the adoption of these measures and in advance of any revisions to the policies contained in our MEFP, in accordance with the IMF's policies on such consultations. We will provide IMF staff with data and information necessary for the purpose of monitoring the program.

6. On the basis of this performance, and on the strength of the policies set forth in the attached Memorandum, we request that the second and third reviews under the Stand-by arrangement be completed and that the third and fourth disbursements be approved in the amount of SDR 79.2 million. Separately, we kindly request that the program be extended by two months to August 4, 2017, to give us some additional time to complete reforms related to the fourth and final review of the program. In this context, we propose to set new performance criteria and indicative targets for end-March 2017, as per Table 1 of the MEFP.

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

Sincerely yours,

/s/

Mr. Isa Mustafa
Prime Minister

/s/

Mr. Avdullah Hoti
Minister of Finance
Ministry of Finance

/s/

Mr. Bedri Hamza
Governor
Central Bank of Kosovo

Attachments: Supplementary Memorandum of Economic and Financial Policies of the Government of Kosovo for 2015–2017

Technical Memorandum of Understanding

Attachment I. Supplementary Memorandum of Economic and Financial Policies of the Government of Kosovo for 2015–2017

A. Macroeconomic Context

1. **Kosovo's economy recovered in 2015 with GDP growth at 4.1 percent, and it is set to grow at a similar pace in 2016.** Through the third quarter of 2016, GDP was growing at around 3½ percent, largely led by strong private consumption and investment. Healthy tax revenues, remittances, and bank lending suggest that this positive trend will continue into 2017. In the medium term, we expect GDP growth to improve further to above 4 percent, largely led by private consumption and investment, public infrastructure projects, enhanced bank lending, and an expanded tradable sector base. This should help us to continue reducing high unemployment in Kosovo.
2. **Prices are slowly recovering** with inflation reaching 0.9 percent in October. This uptick is primarily driven by a recovery in international commodity prices. While we expect external prices to remain subdued, the recent modest increase in core prices should lead to a positive inflation for this year (0.2 percent) and an acceleration next year.
3. **The current account is expected to widen slightly.** The current account deficit, excluding official transfers, is expected to increase by some ½ percent of GDP in 2016 due to strong import growth, and stabilize at around 14 percent of GDP over the medium term. However, the current account deficit, including official transfers, is projected to remain slightly above 10 percent of GDP and fully financed largely via non debt-creating flows, such as FDI and non-recorded remittances.
4. **Risks to growth remain balanced. The momentum of private consumption supported by remittances might not last as long as we expect.** In the medium term, GDP growth could be substantially higher should the new power plant project and other high-scale infrastructure projects materialize.

B. Program Implementation

5. **Performance against the program's quantitative targets has been strong** (Table 1). All performance criteria and indicative targets at end-December 2015 and end-June 2016 were comfortably met.
 - The headline fiscal balance and bank balance as of end of December 2015 outperformed program targets by large margins (*€49 million and €30 million, respectively*).
 - The headline fiscal balance was *€107 million* below the target and the bank balance was *€62 million* above the target by end of June 2016.

- Current spending remained below the indicative target at both test dates.

6. With regard to 2015, the good fiscal outturn was driven by strong tax performance and current spending restraint. Tax revenues increased by €107 million or 9.2 percent compared to 2014, and current spending was €31 million below our program targets last year. While total capital spending was €53 million below our budget allocation, this underspending was largely due to lower municipal investments (tied by law to lower municipal revenues) and some delays for two donor-financed investment projects, rather than cuts needed to achieve deficit target (as in the past). In fact, we substantially increased allocations for Route 6 above the original budgeted amounts. Our strong performance on both revenues and expenditures, coupled with privatization receipts that were €31 million more than budgeted, was reflected in our substantially increased government bank balance compared to 2014. We have continued to serve our external obligations with no arrears accumulation.

7. Strong fiscal performance continued in 2016, though we acknowledge some underexecution in the capital budget. Our budget deficit ex PAK came in at 1.2 percent of (forecasted) GDP, below the 1.6 percent targeted in the budget and the program. This reflects several factors:

- *Strong revenue performance.* Tax revenues grew by more than 12 percent relative to 2015, on account of buoyant domestic demand coupled with tax measures taken as part of the program. With this, tax revenues ended almost a full percent of GDP higher than the targets in the original 2016 budget. This tax performance was partly marred by weak non-tax revenues, notably dividends and municipal own-source revenues (OSR), yet overall revenues exceeded original budget targets by 0.2 percent of GDP.
- *Containment of current spending.* We faced strong pressures from war veteran pensions, spending on which was more than €30 million higher than expected at the beginning of 2016 (see below). However, tight control over public sector employment and disciplined spending on other schemes meant that total current spending was only €9 million (0.2 percent of GDP) above the end-December indicative target agreed as part of the Fund program.
- *Under-execution of the capital budget,* which ended 0.3 percent of GDP below original budget targets but still above 2015 levels. Under-execution was in part driven by weak municipal OSR, as some small-scale capital projects can only proceed if the attached funding sources materialize. But it is also the case that absorption of IFI-financed projects has not scaled up as we had hoped for, though we are already tackling these bottlenecks (see below).
- *Given the low deficit, the bank balance (program definition) ended the year at some 3.5 percent of GDP,* below the 4.5 percent targeted in the program but only because

disbursements tied to the 2nd and 3rd reviews did not materialize as planned. With said disbursements, the bank balance will be above the program target.

8. We have also completed all structural reforms under our SBA-supported program, all ahead of schedule except one with a minor delay (Table 2). These reforms are critical to moving forward our broader policy agenda.

- *Parliament adopted the wage bill rule in December 2015.* Our new wage rule will govern increases in the public wage bill while bringing greater discipline and predictability to the public wage-setting process. This rules-based mechanism will also help to boost public finances, competitiveness, and job creation while allowing for some flexibility in the event of a recession (with a correction mechanism to avoid permanent increases in the wage bill-to-GDP ratio).
- *Government successfully completed the sale of telecommunications licenses in December 2015,* mobilizing needed non-tax revenue and helping to meet end-December 2015 fiscal targets.
- *In January 2016, the CBK completed on-site examinations of the three remaining major banks under its new risk-based supervision framework,* further minimizing risks and boosting stability in Kosovo's financial sector.
- *In March 2016, government issued a decision making e-procurement mandatory.* This will improve the oversight and control of public procurement and in turn increase transparency, level the playing field for bidding firms, and potentially deliver budgetary savings to the government.
- *Government also adopted a detailed concept note discussing new donor-financed capital projects and submitted two semi-annual reports (March and September 2016) to parliament.* The reports will enhance transparency and oversight of growth-enhancing capital projects, including related spending around such projects.
- *On March 28, 2016 Parliament nominated new members to fill the vacant seats of the Public Procurement Review Board (PRB).* While this was originally expected at end-February, the PRB is now staffed allowing for oversight and control of public procurement to improve.
- *The first three contracts issued by the Centralized Procurement Agency (CPA) covering 43 central government agencies have been awarded (June 2016).*
- *An expanded list of goods and services eligible for centralized procurement was adopted by the Government (January 2016).*

C. Program Objectives

9. The program's objectives remain unchanged: Our government remains committed to maintaining a stable macroeconomic environment and increasing Kosovo's potential growth and long-term employment prospects by (a) containing the fiscal deficit; (b) making the budget composition more growth-friendly by generating space for key infrastructure projects; (c) further enhancing the banking sector's regulatory and supervisory framework; (d) reducing remaining obstacles to bank lending to productive sector; and (e) improving Kosovo's business environment by enhancing the public procurement system.

Fiscal Policy

10. Our commitment to the successful implementation of the program is confirmed by the 2017 budget law recently approved by parliament. This budget will strengthen our fiscal position while creating room for growth-enhancing capital spending in line with program objectives. The overall deficit, excluding PAK spending and new donor-financed projects, is projected at 1.5 percent of GDP, fully in line with program objectives. The key features of the 2017 budget law are:

- a. A modest increase in revenues relative to this year (0.2 percent of GDP), as tobacco excises will be raised to comply with regional agreements on the harmonization of excise rates. Total tax revenues will reach 27.1 percent of GDP, 2.8 percentage points of GDP higher than in 2014, the last year before the SBA-supported program.
- b. Current expenditures will be kept constant as a share of GDP compared to 2016. This includes a modest wage increase (0.5 percent nominal), ongoing savings from tightened residency criteria on basic pensions, and maintaining social and pension benefits at 2016 nominal levels. These will make room for needed hiring in the justice and penal systems, as well as for higher goods and services spending tied to scaled-up capital investment. Spending on all war related schemes has been capped at 1¼ percent of GDP, which we consider a sustainable level.
- c. An explicit clause has been included in the budget law to cap the overall budget allocation for war veterans (€38 million) and war disabled (€12 million) at €50 million. This clause gives the government the legal right to adjust the individual benefits to safeguard these budgetary caps.
- d. The capital budget has been substantially increased relative to 2016 budget. While the budget-financed capital spending will be kept at around 8 percent of GDP as in previous years, donor-financed and PAK-financed capital spending, as part of the new investment clause, has been raised considerably to implement growth-

enhancing large infrastructure projects, with a total amount slightly above 3 percent of GDP.

11. We would like to confirm that the 2017 budget allocation for the full implementation of the Law on Pension Schemes Financed by the State (Law N.04/L-131) and the Law on Health Insurance (Law N.04/L-249) will not be used for any other purposes.

Therefore, any savings from postponement of these schemes after January 1, 2017 should only be used to reduce the deficit.

12. Like in the past, any revenue over-performance above the 2017 budget forecast will be used to either lower the deficit or allow for higher-than-budgeted payments for capital projects. Any under-execution in a specific capital project will only be reallocated toward a lower deficit or another capital project.

13. Despite some initial delays, we are making progress on the planning, monitoring, and execution of large capital spending, including IFI-funded infrastructure projects that qualify under the investment clause. In order to take full advantage of the additional space created for IFI-funded capital projects under the program and the modified investment clause, we have improved the process for the selection, implementation, and monitoring of projects. We established a high-level Strategic Planning Committee (SPC), chaired by the prime minister, and put in place a single project pipeline, which was a key recommendation of IMF technical assistance. With the support of the EBRD, EIB and EU, the rehabilitation of railway 10 is expected to begin soon. The project on rehabilitation and expansion of regional roads is at an advanced stage and the implementation phase will start by mid-2017. We are in the process of ratifying the recently approved loan by the World Bank to finance the rehabilitation and expansion of the Iber-Lepenc water supply project. Other priority projects are at an advanced stage of securing IFI financing. Despite recent progress, we are committed to further enhancing our absorptive capacity for large donor financed projects by addressing key planning and execution bottlenecks.

War Veteran/War Invalid Issues

14. Spending on war-related benefit schemes has grown unsustainably. The number of war veteran pension beneficiaries is expanding rapidly, absorbing a bigger-than-expected portion of the budget. The total number of certified war veterans exceeds 46,000 and, as of end of October, there were more than 28,000 pension beneficiaries, more than double the number expected at the time of the approval of the 2016 budget. Even though the number of new applicants has recently slowed down, the total cost of war veteran pensions could easily reach 1.3 percent of GDP per year, if no reform is enacted. Including other war-related schemes, such as war disabled and survivor pensions, the total cost of all war schemes could easily exceed 2 percent of GDP. This will crowd out priority expenditure related to education, health, development projects, and well-targeted social assistance. Moreover, giving a life-time pension to war veterans is creating strong disincentives to remain employed, search for a job, or properly declare income.

15. To tackle this problem, parliament has introduced major amendments to the 2014 Law on Kosovo Liberation War Veterans (Law n. 10/L-261). The key elements of the reform are:

- The amendments introduce explicit criteria tied to length of service during the war to divide veterans into three categories. Each category will receive a different pension (€120, 170, and 250/month, respectively) compared with the uniform €170/month in the previous system. Since we expect that more veterans will fall in the lower than in the higher category, the reclassification should deliver substantial savings. Savings are also expected from additional criteria that have been introduced to qualify for the pension, such as country of residency;
- The amendments create the legal basis for the reclassification commission according to the criteria set in the law, and define which institutions should be represented in the commission.
- The amendments introduce an explicit cap on total spending on war veteran pensions, equal to 0.7 percent of GDP on any given year. They also mandate that all pensions be cut proportionately if needed to comply with this cap.
- The amendments remove the minimum wage floor on the pension that existed in the original law, thus removing a key obstacle to any needed cut.

16. We are committed to dealing with any negative fallout that might arise from the constitutional challenge to the reform. In early January, the opposition challenged the constitutionality of some of the new amendments. In particular, it argues that it is unconstitutional to separate veterans into different categories, and to grant the pension to veterans living in neighboring countries while denying it to those living in non-neighboring countries. We cannot presume how the court might rule, but should it strike down important components of the new law we are committed to taking any needed measures to preserve the integrity of the reform, safeguarding its expected savings and the credibility of the 0.7 percent of GDP annual spending cap. Assuming the constitutional court upholds the amended law, we are firmly committed to completing the reclassification per the new criteria, including all administrative appeals, together with the circulation to government of the final list of war veteran fighters, by May 15, 2017.

17. The large number of war disabled, including those recently certified, poses a related fiscal challenge. To tackle this problem, we are committed to revise Law N. 04/L-054 to upward adjust the disability threshold to qualify for the war and civilian war invalidity pension and align it with the higher threshold that applies to the standard civilian disability pension. Aligning the two thresholds would not only deliver significant savings but would be socially fair as well. Once the war invalidity disability threshold is adjusted in the law, all war and civilian war

disabled will be recertified under the new threshold. Adoption by parliament by May 1, 2017 of the amendments to the Law N. 04/L-054 will be a *structural benchmark for the fourth review*.

Police Force Pension Scheme

18. We confirm our commitment to work closely with the IMF to establish a sustainable contributory early retirement scheme for the police force. We believe that an early retirement scheme for the police force will help to strengthen its effectiveness. At the same time, we fully appreciate that any early retirement scheme needs to be properly designed and calibrated to ensure that it is contributory and properly funded, and does not generate a permanent gap in the budget.

Financial Sector

19. The banking system remains healthy and lending, after picking up last year, has continued to accelerate this year. Capital ratios are well above regulatory minima, with the overall capital adequacy ratio at 18 percent. Profitability has remained high, thanks to improved asset quality and substantial cuts in operational costs, which have more than compensated for lower interest rate spreads. The ratio of liquid assets to short-term liabilities remains well above prudential requirements. Credit growth has averaged nearly 9 percent this year, up from 6 percent in 2015. Stronger lending has been spurred by lower interest rates, increased competition and a stronger macroeconomic environment, as well as steps to ease structural barriers to lending. The NPL ratio has fallen further, declining to 5.1 percent as of September 2016, down from 7.5 percent a year earlier.

20. In this context, we are making progress on several fronts toward implementing measures to reduce structural impediments to bank lending, a pillar of the SBA-supported program.

- *The CBK has put in place a unique account registry, which allows for garnishment.* Following the completion of the implementation stage (August 2016), the unique account registry will allow private enforcement agents (PEAs) to automatically garnish bank accounts. This will substantially improve and accelerate the asset recovery process for banks while reducing barriers to lending. We are committed to carefully monitoring the use of this system to ensure that the garnishment process does not result in permanently blocked bank accounts for a large number of debtors (which could have negative economic effects), and we are confident that we have sufficient data needed to carry out this monitoring.
- *Increasing the number of PEAs.* Last September, we added 10 PEAs bringing the total number of working PEAs to 35, and our plan is to continue offering targeted examinations in order to work towards the target of 69 set in the law.

- *Improving enforcement procedures.* We have submitted to parliament important amendments to the Law on Enforcement Procedures. These amendments, prepared in cooperation with the IMF, are aimed at addressing gaps in the law that allow for excessive appeals of enforcement orders of debtors. The draft law also includes provisions to improve the efficiency of the auction system, the supervision of PEAs, and the PEAs' fee structure. The amended Law on Enforcement Procedures will also enable the Ministry of Justice to establish a supervisory mechanism over PEAs. Formal adoption by the Ministry of Justice of the manual on supervision of the work of the Private Enforcement Agents, to complement Article 7 of the Administrative Instruction on Methods of Inspection and Control of the Private Enforcement Agents, will be a *structural benchmark for the fourth review* (March 31, 2017). We also commit to completing inspections of a least three PEAs by March 31, 2017.
- *Improving case statistics.* Working with the Kosovo Judicial Council, we are in the process of collecting data on the number, composition, and duration of commercial cases by category and, once fully compiled, will publish them. This will help us to more accurately assess the performance of the claims enforcement system and improve the system's accountability. The process is made difficult by IT and other capacity constraints in the KJC, but we are working with our European partners to addressing them.

21. The first macro-prudential policy framework was adopted last August. A robust macro-prudential policy toolkit will significantly improve our ability to identify and, if necessary, take steps to mitigate systemic risks in the financial system. A strong framework is particularly important for a country such as ours that does not have an exchange rate regime or a traditional monetary policy. The framework, developed jointly with the IMF, establishes the CBK's objectives in this area, the range of indicators to be monitored and instruments that could potentially be used, and the communication policy in this area. With the support of the IMF, the operationalization of the overall framework is well on track.

22. Weaknesses in the insurance sector are being tackled. Although the system is small (3 percent of total financial sector assets) and hence does not pose any systemic risk, its stabilization and further development are important for broader financial development in Kosovo. As such, we are focusing on five important areas, drawing extensively from IMF technical assistance in this area:

- *Proper provisioning and capital levels.* With the introduction of Solvency I in January 2017, we now have a proper framework to assess provisioning levels. Accordingly, firms will be asked to cover any provisioning gap, and any company facing a capital shortfall as a result will be asked to present time-bound recovery plans. At this stage, we believe this will only affect two small companies accounting for about 10 percent of the system.
- *Strengthen fit and proper rules.* We will amend our regulations, to ensure that senior managers and a qualified share of Directors possess several years of experience in the field of insurance or other financial institutions, with a reasonable phase-in period.

- *Strengthen rules on external auditors of insurance companies*, to (i) ensure external auditors possess experience auditing financial statements of insurance or other financial companies, including actuarial experience; (ii) ensure that external auditors are engaged for no less than three years, unless reasons for the change of external auditors during the term appointment are provided to the CBK. In case of low quality reports or incomplete/missing information, the CBK will exercise its power of withdrawal over the appointed external auditor.
- *Compliance with insurance laws*, notably to crack down on the high share (estimated at 20-30 percent) of uninsured vehicles that are in violation of the law. They impose a high cost on insured drivers and the system as a whole.
- In the medium term, once the sector is consolidated, we are committed to bringing the taxation of the sector in line with the EU best practices.

23. We have taken steps to strengthen our AML/CFT regime. Earlier this year, parliament passed a new AML/CFT law that is in compliance with EU standards and Council of Europe recommendations. This new law more clearly criminalizes money laundering and terrorist financing and brings the requirements (and related penalties) for banks to report money laundering and terrorist financing activities in line with the EU. It also clarifies the central bank's role in AML/CFT policy, allowing it to more effectively implement supporting regulations related to the law. The new regulation will also allow the CBK to sanction institutions in violation of AML/CFT laws.

Reform of Public Procurement

24. We are continuing to make progress on implementing the centralized public procurement system. Five centralized procurement tenders have been signed and four others have been recently issued. For the tenders launched last year related to the program, namely office supplies, travel tickets and fuel, the awarding contracts have been signed (June 2016). We also amended the Public Procurement Law in December 2015 and February 2016 to strengthen the procurement process by tightening governance criteria (particularly for the Board members of PRB), and to level the playing field for domestic and foreign bidders.

25. A new list of goods and services eligible to centralized procurement has been approved. Following last year's list of common goods and services subject to centralized procurement, we widened the pool of goods and services by adding IT equipment and other goods. However, this is not the end of the process and we plan to add to this list three to five goods and services whose estimated procured amounts, according to the consolidated procurement plans submitted by central procurement agencies in January 2017, exceed €1 million for each item (*structural benchmark for the fourth review*, February 28, 2017). We have also issued a government decision making mandatory for all municipalities by January 1, 2017

the use of centralized procurement for goods and services included in the 2015 list, including gasoline, travel tickets, tires, food, and hygienic products.

26. Despite some delays, the rollout of e-procurement has begun. Following the adoption of the new law on public procurement, the government adopted a decision to make e-procurement mandatory for all central agencies from September 1, 2016, and all municipalities from January 1, 2017. The pilot project, financed by the World Bank, which covered a few agencies from both central and local agencies, has been concluded successfully. With support from donors, we have been providing basic training to both central and local government procurement agents, with the goal to cover all of the roughly 700 public agents by early of 2017. We have also updated the secondary legislation on procurement and published the revised manuals for both economic operators and public procurement agents. Finally, we have issued a decision to terminate starting January 1, 2017 the submission of hard copy bids for all central level procurement agencies, including the Ministry of Health and the Central Procurement Agency (CPA).

Safeguards

27. In line with the IMF's recommendations on safeguards, government has approved important amendments to the CBK law in order to (i) remove the current requirement that the CBK's external auditor be approved by parliament; and (ii) ensure that the CBK governor and Board members cannot be dismissed without due process. These amendments are now in parliament, where we expect them to be approved in February.

Program Monitoring

28. Program implementation will continue to be monitored through prior actions, reviews, quantitative and continuous performance criteria, indicative targets, and structural benchmarks. These are detailed in Tables 1 and 2, with definitions provided in the attached Technical Memorandum of Understanding (TMU). Quantitative performance criteria have been set for end-March 2017. The fourth review is scheduled to take place in July 2017.

Table 1. Kosovo: Quantitative Performance Criteria and Indicative Targets, 2014–17
(Millions of euros; flows cumulative from beginning of the year)

	2014		2015				2016			2017		
	End-Dec.	End-Aug.	End-Dec.		End-Dec.		End-June		End-Dec.		End-March	
	Actual	Prog.	Actual	Prog.	Adjusted	Actual	Prog.	Actual	IT	Adjusted	Prel.	Prog.
Performance Criteria 1/												
Floor on the headline fiscal balance (ex PAK) of the general government 1/	-137	-105	10	-137	-148	-105	-94	13	-188	-183	-87	-50
Floor on the underlying fiscal balance (ex PAK and ex new donor-financed projects) of the general government 1/	-137	-105	10	-137	-148	-105	-49	13	-98	-93	-73	-25
Floor on the bank balance of the general government	102	125	210	171	171	201	220	282	269	269	215	290
Ceiling on the accumulation of external payments arrears of the general government 2/	0	0	0	0	0	0	0	0	0	0	0	0
Indicative Targets												
Ceiling on current expenditures of the general government 1/	1059	873	725	1187	1187	1156	670	573	1220	1220	1229	320
Memorandum items:												
Program assumptions \3												
Sectoral Budget support	0	0		0	0	0	1	0	1	0	0	0
Disbursements for new donor-financed projects contracted after the SBA approval.	0	0		0	0	0	45	0	90	90	9	25
Change in OSR Balances	0	0		0	-11	-11	0	0	0	5	5	0

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

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

2/ Continuous ceiling throughout the SBA period.

3/ For adjusters as indicated in the TMU.

Table 2. Kosovo: Structural Benchmarks for SBA

Measure	Review	Justification	Status
Prior Action			
Parliamentary approval of amendments to the Law on Kosovo Liberation Army War Veterans to ensure the medium-term sustainability of the war veteran pension scheme.			Met.
Entrenching wage restraint			
Government approval of a rules-based mechanism governing increases in the public sector wage bill.	March 15, 2016	Prevent large, discretionary jumps in wages that undermine budget composition and compromise fiscal credibility.	Met.
Increasing non-tax revenue mobilization			
Completion of the telecommunication licenses auction and transfer of any revenues from the sale to government.	December 31, 2015	Meet the non-tax revenue target in line with the 2015 supplementary budget.	Met.
Improving governance			
Government submission to parliament of a list of recommended candidates to fill the Privatization Agency of Kosovo Board.	October 31, 2015	Improve governance and unlock available resources to be transferred to the ministry of finance.	Met.
Issuing the bids for contracts for centralized procurement covering 43 central government administrations and agencies for fuel, office supplies and plane tickets.	October 31, 2015	Improve oversight and control of public procurement, with potential budgetary savings and a more transparent and level playing field for bidding firms.	Met.
Parliament nomination of the vacant seats of the public Procurement Review Board (PRB).	February 28, 2016	Improve oversight and control of public procurement, with potential budgetary savings and a more transparent and level playing field for bidding firms.	Met with delay (March 30, 2016).
Government adoption of the draft Law making e-procurement mandatory for all central government agencies.	March 15, 2016	Improve oversight and control of public procurement, with potential budgetary savings and a more transparent and level playing field for bidding firms.	Met.

Table 2. Kosovo: Structural Benchmarks for SBA (continued)

Awarding the contracts for centralized procurement, covering 43 central government administrations and agencies for fuel, office supplies, and plane tickets.	October 31, 2016	Improve oversight and control of public procurement, with potential budgetary savings and a more transparent and level playing field for bidding firms.	Met.
Government adoption of an expanded list of goods and services eligible for centralized procurement in the next round of tenders.	October 31, 2016	Improve oversight and control of public procurement, with potential budgetary savings and a more transparent and level playing field for bidding firms.	Met.
Building needed infrastructure			
Government adoption of a detailed concept note of new capital projects to be financed by donors. Semi-annual submission to parliament of reports for information assessing donor-financed projects under the investment clause.	March 15, 2016	Facilitate implementation and monitor progress in capital spending associated with the government's development strategy.	Met.
Submission to parliament of a report for information assessing donor-financed projects under the investment clause.	March 15, 2016	Enhancing transparency and oversight of capital projects.	Met.
Developing the financial sector			
Approval of the ELA regulation by the CBK Board.	October 31, 2015	Strengthening the crisis-prevention framework.	Met.
Completion of an on-site examination of one bank following the risk-based manual prepared in junction with IMF technical assistance, including completion of a report of examination.	October 31, 2015	Enhancing banking sector supervision.	Met.
Completion of an on-site examination of the remaining three banks following the risk-based manual prepared in junction with IMF technical assistance, including completion of a report of examination.	March 15, 2016	Enhancing banking sector supervision.	Met.
New Structural Benchmarks for the fourth review			
Government adoption of a decision adding to the list of centralized procured goods and services between three and five goods and services, whose estimated procured amounts, according to the consolidated procurement plans submitted by central procurement agencies in January 2017, exceed €1 million for each item.	February 28, 2017	Improve oversight and control of public procurement, with potential budgetary savings and a more transparent and level playing field for bidding firms.	

Table 2. Kosovo: Structural Benchmarks for SBA (concluded)

Formal adoption by the Ministry of Justice of the manual on supervision of the work of the Private Enforcement Agents, to complement Article 7 of the Administrative Instruction on Methods of Inspection and Control of the Private Enforcement Agents.	March 31, 2017	Enhance supervision of PEAs to ensure proper functioning of contract enforcement.	
Adoption by parliament of the legislative amendments to align the disability criteria for the war and civilian war disability pension with those for the standard civilian disability pension.	May 1, 2017	Preserve fiscal sustainability	

Attachment II. Technical Memorandum of Understanding

A. Introduction

1. This Technical Memorandum of Understanding (TMU) sets out the understandings between the Kosovo authorities and the IMF staff regarding the definition of quantitative performance criteria and indicative targets, and reporting requirements for the Stand-By Arrangement (“SBA”) requested in July 2015.

Definitions and Performance Criteria and Indicative Targets

Coverage

For the purpose of this memorandum, **general government** is composed of the executive, the legislative, and judiciary branches of the government, its municipalities, and any other public authorities that receive direct budgetary appropriations. It excludes publicly-owned enterprises and socially-owned enterprises.

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).

The Bank balances of the General Government are funds usable and readily available (i.e., liquid or marketable, and free of any pledges or encumbrances), held and controlled by the general government for the purposes of making payments and transfers. Bank balances include Undistributed Funds of the Government of Kosovo plus funds specifically reserved for policy purposes including emergency liquidity assistance but do not include the balance of unspent Own Source Revenues (OSR) carried forward, or funds encumbered or pledged as Donor-Designated Grants and funds relative to on lending operations. Bank balances do not include investments made and managed by an outside Investment Manager assigned by the minister pursuant to Kosovo’s Law on Public Financial Management Article 7.1. Bank balances may be held in the form of gold, holdings of foreign exchange and traveler’s checks, demand and short-term deposits at the Central Bank of the Republic of Kosovo (CBK), long-term deposits abroad that can be liquidated without penalty, and any holdings of investment-grade securities held directly by the general government. Bank balances at end-December 2014 were €101 million.

Expenditures of the General Government

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

serviced by the general government are in the program's concept of expenditures and net lending, even if the cash did not transit through the Treasury.

Total expenditures, calculated on a cash basis, include current expenditures, capital expenditures, and net lending. Net lending comprises loans granted by the general government except that it excludes on-lending, such as funds borrowed from official creditors, passed on to publicly-owned enterprises, which is included as a domestic financing item ("below the line"). All expenditures and net lending financed with loans to be serviced by the general government are in the program's concept of expenditures and net lending, even if the cash did not transit through the Treasury.

For the purposes of this memorandum, **proceeds of privatizations** will be understood to mean all monies received by the government from the sale of a publicly-owned company, organization, or facility to a private company or companies, organization(s), or individual(s), as well as any proceeds generated from the sale of government nonfinancial assets and from the liquidation of the assets of the Privatization Agency of Kosovo (PAK). Proceeds of privatizations are not part of revenues. Instead, these are recorded as a domestic financing (net acquisition of financial assets).

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

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

Fiscal Balance of the General Government

Headline fiscal balance (ex PAK) of the general government is defined as revenues and grants minus total expenditures cumulatively since the beginning of the calendar year. Expenditures of the Privatization Agency of Kosovo (PAK) are excluded. Revenues do not include privatization receipts (PAK). The headline fiscal balance includes capital spending related to the implementation of new donor-financed projects contracted after the approval of this SBA (as defined in paragraph 12 of this TMU).

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

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

External Payments Arrears

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.

Adjusters

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

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

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

*The floor on the **headline fiscal balance** set in Table 1 will be adjusted downward (lowered) by the excess in disbursed amounts of new donor-financed projects relative to program assumptions up to an additional €15 million.*

*The floor on the **headline fiscal balance** set in Table 1 will be adjusted upward (increased) by the full shortfall in disbursed amounts of new donor-financed projects relative to program assumptions.*

*The floor on the **headline and underlying fiscal balance** set in Table 1 will be adjusted upward (increased) by the excess in the change of OSR balances relative to program assumptions. These assumptions are always set to zero.*

*The floor on the **headline and underlying fiscal balance** set in Table 1 will be adjusted downward (lowered) by the shortfall in the change of OSR balances relative to program assumptions. These assumptions are always set to zero.*

*Only for the **end-December 2015 target**, current spending could be raised by up to €4 million, provided that revenues over-perform the forecast (€1,503 million) by an equal amount.*

*Only for the **end-December 2016 target**, current spending on goods and services could be raised by up to €7 million, provided that revenues over-perform the forecast (€1,624 million) by an equal amount.*

Data Requirements

The Bank balances data (table) will be transmitted by the Treasury with a maximum delay of five weeks after the end of each month. In addition, the CBK will submit every month, with a delay of one day, the Report of Positions of Treasury Accounts. Within 45 days after each test date, the CBK will submit to the IMF the independent audit of the reconciliation of government accounts.

Data on the monthly budget execution, budget appropriations, and budget allocations of revenues and expenditures will be provided monthly no later than five weeks after the end of each month, including: (i) government domestic revenue detailing by components direct taxes, indirect taxes, and nontax revenues; (ii) external budget support grants; (iii) primary recurrent expenditure; (iv) domestic and external interest payments and receipts; (v) capital expenditure detailing all those related to the construction of Route 6 and including domestically and budget-support financed capital expenditure and externally project financed capital expenditure; (vi) the gross payment and gross accumulation of domestic payments arrears; (vii) external loan receipts and principal payments, including new signed external guarantees and loans; (viii) external arrears payments and accumulation; (ix) bank and nonbank financing; (x) privatization and receipts of the sales of nonfinancial assets; and (xi) any other revenue, expenditure, or financing not included above.

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

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.

Data on exports and imports, including volume and prices and compiled by the Statistical Office of Kosovo, will be transmitted on a quarterly basis within 45 days after the end of each quarter.

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

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

A monthly report on the number of employees will be transmitted to the IMF by the Treasury Department of the Ministry of Finance within two weeks after the end of each month.

**Statement by Michaela Erbenova, Executive Director for the Republic of Kosovo and
Mentor Mehmedi, Advisor to the Executive Director
March 13, 2017**

On behalf of the Kosovo authorities, we would like to thank staff for the in-depth report on the second and third reviews under the Stand-by Arrangement (SBA), the productive discussions and valuable policy advice during the recent missions to Pristina, and for the continuous and helpful technical assistance. The authorities highly value the ongoing policy dialogue with the Fund staff and management, which has been pivotal in ensuring prudent macroeconomic policy management. They broadly concur with staff's assessment outlined in the report.

Macroeconomic developments and outlook

Kosovo's economy has been performing well and continues to enjoy the highest growth in the Western Balkans, notwithstanding the challenging environment. Initial estimates show that GDP grew by 3.8 percent in 2016 on the back of strong remittances, healthy private consumption and investment, accelerating bank credit, and ongoing large infrastructure projects. Weaker than expected exports, due to a temporary stoppage of work at the Ferronickel plant, weighed on growth. The authorities acknowledge that faster growth is needed to converge to regional and EU standards, and to reduce the high unemployment rate, especially among the youth.

The authorities are more optimistic than staff on the outlook. Expecting the materialization of IFI/donor financed projects and a higher release of privatization funds, they estimate GDP growth to reach 4.4 percent in 2017, and to stay above 4.5 percent over the medium term, largely driven by private consumption and investment, public infrastructure projects and an expanded tradable sector base. At the same time, they assess risks to the baseline as symmetric, rather than tilted to the downside. Political tensions have subsided and business and consumer confidence remain healthy. The planned construction of a new power plant and the re-launch of the large Brezovica tourism resort project, under the recently approved Law on Strategic Investment, are important upside risks to the baseline.

Low energy and import prices (a key component of the CPI basket) have kept inflation low (0.6 percent last year). Higher external food and energy prices are expected to push inflation to 0.9 percent this year, and to 1.9 percent in 2018. The current account deficit (CAD) reached 9.7 percent in 2016 but the financing sources are stable and non-debt creating, including remittances, official transfers, and foreign direct investment (FDI). Over the medium term, the authorities project that large donor-funded investment projects and structural reforms will help address infrastructure bottlenecks, expand and diversify the narrow export base, reduce the dependence on imports, and ultimately, lead to an improvement in the trade and current account deficits.

Performance under the program

The authorities continue to show strong commitment to meeting the program targets and the performance against the SBA's quantitative targets has been very strong. All performance criteria and indicative targets at end-December 2015 (2nd review) and end-June 2016 (3rd review) were met with comfortable margins. The 2015 budget deficit was reduced to 1.8 percent of GDP, 0.7 percentage of GDP below the 2nd review target of 2.5 percent. Bank balances as of end of December 2015 also outperformed the program target by a large margin (0.5 percent of GDP). At same time, the ceiling on current expenditures of the general government was below the program target (0.5 percent of GDP) due to the authorities' efforts to streamline current spending and the strict monitoring of budget execution and employment in the public sector. The end-June 2016 fiscal balance and government bank balance also exceeded performance criteria by 1 percent of GDP each, while current spending was kept in check and way below the ceiling.

The authorities also strictly adhered to the implementation of structural reforms. All structural benchmarks for the 2nd and 3rd reviews pertaining to the financial sector, public procurement, and other structural reforms were met, several of them ahead of schedule, and only one with a slight delay.

Despite the authorities' dedication to reforming war veteran pensions to avoid jeopardizing the credibility of the fiscal rule and long-term sustainability of public finances, moving ahead with this reform proved socially and politically sensitive and the need to garner broad support among all stakeholders delayed the completion of the 2nd and 3rd reviews. Nonetheless, cognizant of the importance of the credible reform of war veteran pensions for the sustainability of public finances, Parliament approved major amendments to the 2014 law on War Veterans in December 2016. This contentious reform showcases the authorities' strong commitment to the Fund program. Importantly, the amendments introduce three categories of war veterans (based on the length of service) and an explicit cap on the total spending on war veteran pensions, equal to 0.7 percent of GDP in any given year (a ceiling considered by staff as fiscally sustainable). Notable is the provision that all pensions be cut proportionally if necessary to comply with the newly introduced cap. In addition, the amendments remove the minimum wage floor on the war pensions, thereby eliminating labor market disincentives. The authorities remain optimistic about the outcome of the ongoing deliberation by the Constitutional Court regarding the challenge to these amendments, and remain committed to taking any necessary measures to preserve the reform and enforce the annual spending cap.

Fiscal policy

Progress in strengthening public finances has been key to the program's success. The authorities have stayed comfortably below the fiscal rule's deficit limit while taking crucial steps to improve the composition of the budget, contain current spending and create fiscal space for growth-enhancing capital investments.

Tax revenue performance has been exceptional. Tax proceeds increased by 9.2 percent in 2015 and more than 12 percent in 2016, on account of buoyant domestic demand coupled with tax measures taken as part of the program. To this end, tax revenues in 2016 were almost 1 percent of GDP higher than the targets in the original 2016 budget, driving the deficit down to 1.2 percent of GDP (0.4 percent of GDP below the program target), one of the lowest fiscal deficits in recent years. Since the start of the program, concerted efforts in mobilizing domestic revenue and broadening the tax base have boosted tax revenues by 2.4 percent of GDP. Notwithstanding the higher than expected number of certified war veterans (spending was 0.5 percent of GDP greater than anticipated at the beginning of 2016), the total current spending envelope increased only by 0.2 percent of GDP due to measures put in place to keep public sector hiring and social spending under control. At the same time, the capital spending increased to 7.5 percent of GDP.

The 2017 budget was approved in December and is fully in line with program objectives. The budget strikes a good balance between fiscal prudence and growth policies, with an expected deficit of 1.5 percent of GDP which preserves the very low level of debt (14.4 percent of GDP), while creating room for high-priority capital spending. The budget foresees a modest increase in revenue (0.2 percent of GDP) while keeping current expenditures constant as a share of GDP. Budget-financed capital expenditures will increase to 8.4 percent of GDP. In addition, the budget foresees a significant increase, by up to 3 percent of GDP in donor-financed capital spending and in investment spending, financed by (non-debt creating) transfers from the privatization agency.

In view of the ramp-up in public investment, targeted policy measures are being taken to enhance the public investment management framework and tackle absorption capacity constraints. To this end, the authorities are in the process of implementing recommendations from the Public Financial Management Assessment conducted by staff, including enhancing the government's investment implementation institutions and increasing the efficiency and execution of capital investments.

The authorities concur that social assistance schemes, including war-related schemes, need to be better targeted and means-tested in order to keep current spending contained and create more room for growth-enhancing capital spending. In addition to the already implemented reform of the war veterans scheme and the planned reform of war disability pensions, in line with the Fund's technical assistance, the authorities are in the process of amending the law on Pension Schemes Financed by the State. Among others, the law aims to expand the scope of means testing, including through introducing means testing against pensions, enforcing rigorous residency criteria, and reducing discretion. These reforms are critical for creating better market incentives while enhancing governance and social fairness.

With the aim of tackling unproductive spending, adding predictability to the wage-setting mechanism in the public sector, and ensuring that labor costs are aligned to productivity dynamics, a public wage rule (a structural benchmark for the second review) has also been

approved by Parliament (effective 2018). The rule will guide the wage-setting process, improve competitiveness and ensure that the wage bill-to-GDP ratio stays at a reasonable level.

Financial sector

Kosovo's banking sector remains well capitalized, liquid, and profitable. At the end of December, the system's capital adequacy ratio stood at 17.9 percent, way above the regulatory minimum of 12 percent, while non-performing loans (NPLs) declined to the historic low of 4.8 percent and are fully provisioned at 126.5 percent. The profitability of the banking sector is high, with returns on equity and assets at 18.5 and 2.2 percent respectively. The weighted interest rate on loans has dropped by more than 50 percent in the last three years. Lower spreads, strong domestic demand, a more conducive business environment and better enforcement of contracts have been the main driving forces of credit growth, which increased by 10.4 percent in 2016.

Progress has been achieved in strengthening the banking supervision. The Central Bank of Kosovo (CBK) has fully rolled out the risk-based supervision for all banks (structural benchmark for the 2nd review). At the same time, the macro-prudential framework was adopted in August, and is seen as a critical part of the policy toolkit to identify and mitigate systemic risks in the financial sector given that Kosovo lacks monetary policy tools. The framework, which was designed in close coordination with staff, establishes the CBK's responsibilities in this area, the range of indicators to be monitored, instruments that could be used, and the communication policy.

To sustain economic growth, better access to credit and financial deepening are important. Credit penetration in Kosovo is low at 36.8 percent of GDP. The authorities have taken measures by addressing structural impediments to bank lending, specifically in the area of contract enforcement, which is giving banks more confidence to lend at lower rates while demanding less collateral. The amendments to the Law on Enforcement Procedures, currently under consideration by Parliament, will shorten excessive appeals of enforcement orders of debts and further strengthen creditor rights. At the same time, the authorities plan to increase the number of public enforcement agents (PEAs) and enhance their supervision and oversight. Additionally, the CBK has operationalized a unique account registry, which will allow PEAs to automatically access and garnish bank accounts, and accelerate the asset recovery process.

At only three percent of financial sector assets, the insurance sector remains small. The CBK is implementing policies aimed at further stabilizing and developing the sector. In this vein, policy measures are being taken, in close coordination with staff, to ensure proper provisioning and capital levels, implementing the Solvency 1 framework from January 2017, strengthening fit and proper rules, enhancing compliance, and strengthening the rules for external auditors.

The recent approval of the new AML/CFT law, which is fully in line with EU standards and the Council of Europe recommendations, will help tackle corruption and organized crime. The law

sets strict rules on money laundering and terrorist financing, provides the CBK with the legal mandate to sanction institutions which violate the provisions of the law, and improves the statistics on financial crimes.

The legal amendments to the CBK law, which address all the recommendations of the 2015 safeguards assessment, have passed the first reading in the Parliament and the law is on track to be approved quickly.

Structural reforms

Important strides have been made in making the public procurement process more transparent and efficient. In this context, the latest amendment to the Public Procurement Law ensures a more level playing field for domestic and foreign bidders and enhances the governance criteria. At the same time, the Public Procurement Board (PPB) is now fully staffed, allowing for proper oversight and control of the public procurement process. Since January 2017, e-procurement is mandatory for agencies at both the central and local level, and the authorities are working closely with the World Bank, the European Union (EU), USAID, and other donors to ensure the smooth transition to the new system.

The centralized procurement has continued to expand. The list of centrally procured goods and services has been extended and its applicability broadened to a larger number of public agencies, including at the local level. Overall, these measures have improved the oversight and control of the public procurement process, enhanced transparency, created a more level playing fields for bidding firms, and have started generating budgetary savings. The authorities concur that more work is needed to fully meet the EU requirements in this area, improve transparency at all stages of public procurement, and address capacity limitations of the Centralized Procurement Agency.

Progress is being made in ensuring reliable energy supply. In collaboration with the World Bank, the tendering process for building a new thermo-power plant with capacity of 500MW is moving forward. The financial aspects of the project with the selected preferred bidder are to be finalized soon. The construction of the new plant aims to comply with the EU's Industrial Emissions Directive while fully addressing social and environmental concerns. In July 2016, the construction of a new 400 kV interconnection line between Kosovo and Albania was finalized, boosting the infrastructure for the regional energy trade.

Final remarks

The authorities are requesting an extension of the program by two months to gain more time to complete the reforms related to the fourth review, including the completion of the classification of war veterans based on the criteria in the newly approved law, and legislating changes to the

war disabled scheme, including to align the disability threshold for the war and civil war invalidity pensions.

The authorities remain committed to building on the recent achievements and successfully concluding the program which has served as an important anchor for transforming the economy. They stand ready to address potential risks to the program going forward and to maintain the reform pace.