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Kosovo: Letter of Intent, and Technical Memorandum of Understanding

June 20, 2011

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LETTER OF INTENT – REPUBLIC OF KOSOVO

Mr. John Lipsky
Acting Managing Director
International Monetary Fund
Washington, DC, 20431
U.S.A.

Pristina, June 20, 2011

Dear Mr. Lipsky:

1. Kosovo's economy has performed strongly in 2010 and early 2011, supported by remittances and non-debt creating capital inflows. However, significant external imbalances persist. These reflect *inter alia* infrastructure bottlenecks, especially in the transport system and energy sector, that continue to stifle productivity and competitiveness.

2. We are making strong efforts to improve public infrastructure, while also addressing pressing social issues. These efforts exert pressure on the public finances, however, which, unless contained, would translate into a decline of the government's bank balances with the Central Bank of the Republic of Kosovo (CBK) below desirable levels. Adequate bank balances are needed not only to provide cash buffers for the Treasury, but also to safeguard financial stability: in our fully euroized economy, the ability of the CBK to provide emergency liquidity assistance requires a sufficient level of government deposits that is at the disposal of the CBK.

3. Against this background, the Ministry of Economy and Finance and the CBK developed a comprehensive policy strategy in 2010 aimed at restoring fiscal sustainability and safeguarding financial stability. Key pillars of this strategy are: (i) restraint on current spending and raising revenues to improve fiscal sustainability; (ii) securing financing for our large public investment program through expenditure reallocations, one-off revenues, and privatization proceeds; (iii) bolstering bank balances to provide scope for emergency liquidity assistance, if needed; and (iv) pursuing reforms to broaden the tax base, improve public financial management, enhance the CBK's independence, further strengthen and modernize the banking system, and shore up the financial position of the energy sector.

4. Based on our balance of payments needs, we requested that the IMF support our program through a Stand-By Arrangement (SBA) in the amount equivalent to SDR 92.656 million (157 percent of quota) for the period from July 1, 2010, through December 31, 2011. The IMF Executive Board approved this program on July 21, 2010. Performance was largely adequate in 2010, with all quantitative performance criteria met at end-August 2010 and all but one criterion met at end-December 2010. Not met was the

structural benchmark on the privatization of the post and telecommunications company (PTK) by end-December 2010.

5. No review of our program could be concluded. Political developments led to early elections at end-2010. Due to the timing of the formation of the new Government, the 2011 budget was approved in March 2011. Consultations with IMF staff regarding the new budget advanced but could not be finalized, one issue being the substantial increase in the wage bill inscribed into the budget. This increase was not in line with the program objectives under the SBA.

6. Importantly, we consider the wage increases one-off adjustments that are only temporary deviations from our policy strategy. As a result, we request a Staff-Monitored Program through the end of this year, with a view to paving the way to a program endorsed by the IMF Executive Board in 2012. We believe that the policies set forth in this Letter are sufficient to achieve the objectives of our economic program, but we will take any further measures that may become necessary. We will consult with IMF staff on the adoption of these measures, and in advance of revisions to the policies contained in here. Further, we will provide IMF staff with all information it requests on policy implementation and achievement of program objectives. The understandings between us and IMF staff regarding benchmarks and structural measures described in this letter are further specified in the attached Technical Memorandum of Understanding.

7. The government and the CBK authorize the IMF to publish this letter and the associated Article IV staff report.

I. Macroeconomic Outlook

8. The growth outlook for 2011 is positive. Domestic demand is expected to remain strong, fuelled by remittances, foreign direct investment—especially in construction—and an expansionary fiscal stance, notably the public sector wage increases and the large capital outlays for the highway R7. Credit growth is projected at 13 percent (y-o-y) for this year. Overall we expect real GDP to grow by more than 5 percent in 2011.

9. Inflation has increased due to the surge in imported food prices, but we expect it to decelerate in the second half of the 2011 as the base effect disappears from the inflation data. 12-month CPI inflation (end-of-period) increased to above 10 percent in both March and April. Prices for bread and edible oil prices have been the key drivers of this increase, while regulated prices for electricity—mostly generated with domestic coal—have been a mitigating factor. Going forward, inflation is projected to gradually return to single digits as food prices stabilize. There are no firm indications of domestically generated price pressures yet, but the evolution of private sector wages needs to be watched carefully. Possible tariff increases by the electricity regulator in the context of the privatization of electricity distribution could also trigger price pressures.

10. The current account deficit is projected to widen substantially this year. While high nickel prices are boosting exports, the export base is small, and buoyant domestic demand is fueling imports of consumption goods and intermediate goods, notably for the highway construction. The deficit is expected to be financed by FDI—in part relating to receipts from the privatization of PTK now expected for this year—and other private non-debt creating flows. In the medium term, the current account deficit is projected at about 15 percent of GDP, which, in our view, can be financed sustainably by non-debt creating inflows.

II. Fiscal Policy in 2011

11. The overarching objective fiscal policy in 2011 is to create space for large capital spending needs by exercising restraint on current expenditures and by increasing revenue collection. To this end, we are targeting a primary deficit of €226 million (4.8 percent of GDP, quantitative benchmark) that we can finance without bank balances falling to excessively low levels. To this end, measures of €35 million (0.7 percent of GDP) over and above our original plans are needed that partially compensate for the impact of the wage and transfer increases earlier this year.

12. Specifically, we are pursuing the following objectives:

- ***Revenue:*** tax revenues in 2011 are projected to increase by €164 million (18 percent) relative to 2010, reflecting inflation, progress in the reform of tax administration and customs, and additional measures on excises. Specifically, excise increases on gambling licenses and imports of used cars will take effect by end-June, 2011. We estimate these measures will yield additional revues of about €23 million (0.5 percent of GDP) in 2011.
- ***Expenditure:*** we will limit the annual increase in the wage bill to €74 million through restraint on hiring and stronger control of the Ministry of Finance over the execution of the wage bill for the rest of 2011. To this end, we will allocate a maximum of €386 million to this year's public sector wage bill (including MoUs), implying savings of €10 million (0.2 percent of GDP) relative to the budget. We will also contain non-highway capital spending at a maximum of €315 million, and limit transfers and subsidies to €295 million (implying savings of €2 million. Transfers and subsidies include capital transfers to state-owned enterprises). Further, we aim to keep energy-related subsidies to publicly owned enterprises and net lending to KEK—the publicly-owned energy company—at the budgeted levels of €27 million and €45 million, respectively. We will also refrain from introducing new spending initiatives in 2011. Overall, we will limit total primary expenditures to €1,487 million this year (quantitative benchmark).
- ***Financing:*** we will maintain a level of bank balances with the CBK of at least €305 million by end-December 2011 (quantitative benchmark). While this is some €50 million lower of what we targeted under the SBA, we believe that the level suffices to both satisfy the Treasury's short-term cash-flow requirements and to

enable the CBK to provide emergency liquidity assistance to the financial sector if needed. The timely privatization of PTK is a key pillar of our financing strategy (structural benchmark for end-December). We will refrain from issuing non-concessional debt.

- ***Contingencies.*** Should emergency financing needs arise during the course of the year, we will—consistent with the law on public financial management and accountability—seek offsetting cuts through further reductions in spending allocations. Moreover, as a safeguard for the unlikely case that the privatization of PTK falls behind schedule, we will leave €60 million in expenditures unallocated until the winner of the auction for PTK has been announced. This contingency should not be built against wages and salaries, however, nor against spending for the R7 highway, as under-execution on the highway project would likely give rise to costly penalties.

13. We are making several modifications to planned introductions or enhancements of benefits to ensure consistency with a sustainable medium-term fiscal framework.

- ***Pensions.*** We will continue to require proof of 15 years of contributions to the former pay-as-you-go pension system as a precondition for receiving the supplementary pension (currently €35 per month). We will also refrain from relaxing eligibility criteria for pensions for families, disabled, and early retirees.

- ***War related benefits.***
  (i) We will modify the draft law on war related benefits such that the introduction of a general war veterans' pension is relegated to a separate (follow-up) law. This follow-up law will clearly define eligibility criteria and the nature of benefits. Prior to consideration of the follow-up law by the cabinet an in-depth fiscal impact assessment will be conducted that evaluates the law's budgetary impact over a period of at least 5 years and includes a thorough evaluation of the number of eligible beneficiaries (structural benchmark for end-December). We will seek assistance from the World Bank for this endeavor. The results of this assessment will be shared with IMF staff.
  (ii) We have dissolved the committee reviewing eligibility for all current categories of war related benefits and fixed the number of beneficiaries at a maximum corresponding to the level at end-May 2011, with the exception of applications that have already been received at that date (prior action by June 15). Going forward, we will review the register of war invalids and civilian invalids of war, which we expect to result in a reduction in the number of beneficiaries.
  (iii) The final versions of both the law of war related benefits and the follow-up law on the war veteran pension will be shared with IMF staff prior to consideration by the cabinet.

- ***Benefits for former political prisoners.***
  (i) We have issued a sub-legal act on the "Law on the Rights of Formerly Politically

Convicted and Persecuted Persons" that determines that the benefits payable under this law shall only be paid from funds that have been specifically and explicitly appropriated for this purpose under the then applicable budget law (prior action).
(ii) A newly established working group will clearly define benefits and eligibility criteria related to former political prisoners, determine the number of eligible recipients, and evaluate the law's budgetary impact over a period of at least 5 years (structural benchmark for end-December).
(iii) No further sub-legal acts relating to this law will be issued and no funds will be appropriated to benefits related to this law before the budgetary impact assessment has been completed and discussed with IMF staff. The results of the assessment will serve as a basis for both further sub-legal acts related to the law and possible amendments of the law that may become necessary.

14. As a general principle, all new laws or amendments to laws that create benefits and other transfers will grant only cash benefits. Moreover, there will be no link between the level of these benefits and the level of the minimum wage. Further, all such laws will be preceded by a through fiscal impact assessment that evaluates the budgetary impact over a period of at least 5 years and, in case of new benefits, includes a thorough evaluation of the number of eligible beneficiaries.

15. To protect the integrity of the budget from unforeseen circumstances that may yield fiscal strains, we will include a paragraph into all new benefit-creating laws and amendments to benefit-creating laws that explicitly allows cutting benefits in case sufficient budgetary funds are unavailable (continuous structural benchmark).

16. We are moving to create a domestic market for government securities. A computerized system for electronic debt auctions is being installed at the central bank. A trial issuance will not take place before 2012. The system will allow banks to make bids on their own account or on behalf of their clients. To minimize financing costs, we intend to set clear rules in line with international best practices to prevent collusion among bidders.

III. Fiscal Policy in 2012 and Beyond

17. Over the medium term, our fiscal policy is guided by the objectives of enhancing the efficiency of public expenditures and achieving a sustainable fiscal stance consistent with stabilizing public debt as a share of GDP well below the 40-percent threshold enshrined in our public debt law. To this end, further structural fiscal adjustment will be required in the years ahead.

18. The budget passed by the Assembly for 2012 will contain additional fiscal tightening of at least ¾ of a percent of GDP, based on realistic macro-forecast and prudent budgeting (structural benchmark for end-December). As regards the composition of the budget and its financing, we are guided by the following objectives:

- ***Revenues:*** revenue measures will aim at reducing the size of the informal market and improving the environment for private sector while simultaneously aiming at a gradual shift away from border taxes to domestic taxes.
- ***Current expenditures*****:** To create space for the highway project in the budget, we will continue to exercise restraint on current spending, with a particular focus on the wage bill.
- ***Capital expenditures:*** The R7 highway project will absorb considerable budgetary resources in the years ahead. Swift completion is necessary to avoid the enactment of cost escalation clauses in the contract. To this end, we have started procurement procedures for an on-site consultant supervising highway works.
- ***Financing:*** we plan on starting commercial borrowing in 2012, in a gradual process of building a track record with investors. In this context, we are committed to ensuring that the pension and savings trust of Kosovo (KPST) is not subject to undue risk of exposure to a single borrower, including the government. With the successful implementation of this staff-monitored program, we are confident that budgetary grants and concessional loans from International Financial Institutions will resume in 2012 to help us close any remaining financing gap.

19. Over the medium-term, our expenditure priorities include a highway to Macedonia (R6), and the introduction of an employee/employer financed health care fund that may require up-front funding from the government. We will go forward with these projects only once we have identified and secured financing that is consistent with a sustainable fiscal stance, for example one-off revenues and/or concessional borrowing. We will consult with IMF and World Bank staff prior to moving ahead with these plans, and especially prior to entering into contractual agreements.

20. More generally, the scope of our envisaged expenditure projects combined with our limited revenue base may require a reorientation of both revenue and expenditure priorities and objectives.

- As regards revenues, we intend to further improve the efficiency of our tax system, especially in view of the low revenues generated from direct taxes. To this end, we have requested technical assistance (TA) from the IMF that is expected to be delivered in the third quarter of this year. We expect the TA mission to help us identify revenue measures that avoid hurting the business environment while reducing the size of the informal sector. Based on the findings of this mission, we will analyze options to modify the structure of our tax system. Until then we will not introduce changes in tax structure, notably as regards value-added tax rates.
- As regards expenditures, we will seek IMF technical assistance on expenditure rationalization, with a view to prioritizing projects, avoiding unfunded initiatives, and realizing savings on projects with lower priority.

IV. Structural Fiscal Reforms

Tax Administration

21. We will develop a taxpayer compliance strategy by end-September (structural benchmark) that is aligned with the concept recommended by the February 2011 TA mission on tax administration. The strategy will direct the Tax Administration of Kosovo's (TAK) efforts at mitigating compliance risks. Further, we will align operational plans for taxpayer services, audit, enforced collection, and tax fraud investigations with the taxpayer compliance strategy by end-December 2011.

22. We plan to further mitigate compliance risks related to large taxpayers. To this end, we will redesign the large taxpayer unit, in line with the recommendations of IMF TA.

23. We have made significant progress with regard to cleansing the taxpayer register, issuing fiscal numbers to taxpayers and solving document processing delays. We plan to address the backlog of unprocessed returns and resolve the high percentage of non-filers. The new tax fraud investigation unit will investigate and resolve serious tax fraud cases and organized fraudulent activities.

24. We plan to address the high outstanding tax arrears position. Total arrears excluding fines, fees, penalties, interest and non-tax revenue as a percentage of total tax revenue stood at 104 percent in 2010. We aim at bringing the level down to those typical in advanced economies, i.e., 5 to 10 percent of tax revenue. Steps will also be taken to identify and write off uncollectible debt through a transparent and accountable process.

25. We completed the first stage of the upgrade of our core IT system (SIGTAS) in October 2010. While this upgrade has mitigated some weaknesses in the system, a replacement option will be needed in the medium term to implement the 'fast track' methodology recommended by a February 2011 IMF TA mission. We are developing a plan by end-2011 to procure the replacement IT system.

Public Financial Management

26. To improve our ability to monitor and avoid arrears, we will introduce a new module in Free Balance, our accounting system, by September 2011 that records due payments, including receipts of invoices. We took steps to ensure that budget organizations enter expenditure commitments with accurate information about the due dates of payments to improve cash flow planning at the Treasury and prevent pressures from building that could result in arrears. Since end-April, the Treasury reports on a monthly basis unpaid invoices of budgetary organizations within a 30-day period.

27. We intend to strengthen the budgeting and execution of capital expenditures. A Public Investment Committee was established in August 2010 to monitor capital spending

execution. In the 2012 budget, the Ministry of Finance will lower capital expenditure allocations in case of significant under-execution compared to budgetary allocations in 2011.

28. Once the data of our new census have been released, we plan to revise the current grant system formula with the aim of reducing budgetary grants from the central government to municipalities. To compensate for the municipalities' revenue loss, we intend to increase significantly the minimum rate of the property tax from its current low level of 0.05 percent starting in 2012. We will also increase municipal charges on cars. Moreover, starting in 2012 we will introduce an annual inflation adjustment mechanism on motor vehicle taxes and other fixed fees, rents, and charges. In this context, we will discuss fiscal implications of the draft law of the City of Pristina with IMF staff prior to resubmitting it to the cabinet.

V. Monetary and Financial Sector Policies

29. The banking sector, which is mostly foreign-owned, has remained well-capitalized, liquid and profitable. Nonperforming loans have increased to 5.9 percent in March 2011 from 4.3 percent at end-2009, but are fully provisioned, and an aggregate capital adequacy ratio of 18 percent as of March 2011 suggests that banks have ample room to accommodate shocks to credit quality.

30. We are fully committed to the institutional and operational independence of the CBK, as enshrined in the constitution and specified in the central bank law. In this context, the appointment of a new central bank governor earlier this year was characterized by a clean implementation of the nomination rules under the law.

31. Financial supervision continues to strengthen. The superintendency of banks follows a based-risk supervision model under the framework of Basel I based on CAMELS indicators (capital, asset quality, management, earnings, liquidity, and risk sensitivity) that are updated annually, through a combination of on-site inspection and off-site analysis. For foreign banks, the assessment is conducted jointly with home supervisors. For each bank, the superintendency of banks conducts at least one comprehensive on-site inspection each year. Significant progress has also been made in the area of stress-testing. With technical assistance from the IMF, stress tests of credit, exchange rate and liquidity risk were conducted in November 2010. Currently, an in-house stress-testing model is being developed. In December 2010, the CBK published its first financial stability report. On a related matter, Kosovo joined the GDDS system of the IMF as the 87th member in April 2011.

32. Going forward, a priority is to make operational the CBK's ability to provide emergency liquidity assistance (ELA). At the conceptual level, ELA was introduced in 2010 with the approval of the new central bank law. By end-December 2011 a memorandum of understanding (MoU) will be finalized between the government and the central bank that establishes duties and responsibilities between competent authorities, based on the central bank law and the budget law for 2012. It will also establish a designated account of

government deposits with the central bank whose resources are earmarked for ELA. In 2012, the government intends to deposit an amount to be specified in this account. For the unlikely case an emergency need arises in 2011, the government will take measures to ensure that the CBK has adequate funding for ELA.

33. A new draft banking law, developed in consultation with IMF staff, is under discussion with stakeholders.

- The law will strengthen governance standards for banks, including with respect to fit and proper criteria for administrators and suitability requirements for significant shareholders; include tighter restrictions on lending to bank-related parties; and allow for consolidated supervision of banking groups. The law will also ensure that the authorities have the proper tools for bank resolution, including the ability to conduct purchase and assumption transactions.
- The draft law will be expanded to strengthen rules for the operations of microfinance institutions. Microfinance institutions hold only 5 percent of the assets of the banking system, but play an important role in providing financial services to segments of the population with limited access to banks. In recent months, problems have surfaced in the largest microfinance institution that point to inadequate corporate governance. The CBK has appointed an administrator, but a stronger legal framework for the sector is also needed. The expanded draft law aims at (i) enhancing the CBK's authority with regard to licensing, regulating and supervising microfinance institutions, (ii) requiring microfinance institutions to have a clearly defined ownership and governance structure, and (iii) banning microfinance institutions from taking deposits. We will request assistance from both the World Bank and the IMF for this endeavor.
- We intend to submit the banking law expanded by the provisions on microfinance institutions to the Assembly by end-September. We will request IMF TA to revise existing banking rules and regulations so as to bring them in line with the banking law.

34. A deposit insurance law (DIL) was adopted last November, with a view to speeding up depositors' access to their funds in case a bank is being resolved. To further strengthen the law, we will amend the DIL such that the funds of the Deposit Insurance Fund of Kosovo (DIFK) can be used for purchase and assumption transactions. Moreover, the DIFK is being set up as an institution independent from the CBK and will be governed by a five-member board and employ one full time employee.

VI. Competitiveness

35. Maintaining competitive wage levels requires *inter alia* wage restraint in the public sector and a level of the minimum wage that does not endanger job creation. As regards the latter, the government intends to approve the proposal by the Socio-Economic Council only to the extent that it includes an exemption to the minimum wage for younger workers. Specifically, we are ready to accept a minimum monthly wage of no more than €130 for workers below the age of35and of no more than €170 for the remaining workforce. Moreover, we will revisit the maternity leave provisions in our Labor Law to preserve the employability of women.

36. We aim at significantly improving our ranking in the Doing Business survey of the World Bank. To this end, a package of twelve laws to reduce the cost of setting up businesses, unify business registries, and simplify the licensing system will be approved by the Assembly before end-December.

VII. ENERGY SECTOR

37. Billings and collections of the state electricity company (KEK) have improved. Subsidies in 2010 amounted to only half of the 2009 level. KEK is committed to continue combating electricity theft and collecting unpaid bills. Going forward, we plan to move ahead with the privatization of the energy sector. Specifically:

- A new regulation with a revamped formula for electricity pricing will be published by end-June 2011. The government will determine the parameter values of this formula such that, in the event of electricity imports, a substantial share of the cost will be passed on to electricity tariffs and therefore consumers. This is critical to reduce subsidies and avoid blackouts while partially smoothing the volatility of tariffs.
- We intent to develop a plan to address overstaffing at KEK with a view to improving the company's cost structure.
- The winner of the privatization of the distributor is expected to be announced before end-October 2011, and ownership shares are expected to be transferred to the new owner by end-December 2011.
- We intend to issue the tender documents for privatization of KEK's mining and electricity generation operations before end-November 2011.

VIII. PROGRAM MONITORING

38. The Program Monitoring Committee (PMC)—composed of the Minister of Finance (head), the Director of the Treasury, the two Budget Directors, the two Deputy Governors of the CBK, the advisor to the Prime Minister, the head of the Macro Unit, a representative of the tax administration of Kosovo, and the Director of Finance of the Ministry of Labor and Social Welfare—will meet at least once a month to assess progress with implementation of the SMP and consistency of all relevant policy initiatives with the SMP's objectives (continuous structural benchmark). The IMF resident representative will attend the meetings as an observer. The MoF will prepare minutes of these meetings and send them to the IMF resident representative no later than 5 business days after the each meeting.

39. The staff-monitored program will run through end-2011. It will contain two test dates (end-September and end December) and include quantitative and structural benchmarks as defined in the attached Technical Memorandum of Understanding (TMU). Quantitative benchmarks for both test dates are set out in table 1. Structural benchmarks and prior actions are set out in table 2.

/s/

Hashim Thaçi

Prime Minister

/s/	/s/
Bedri Hamza	Gani Gërguri
Minister of Finance	Governor, Central Bank of the Republic of Kosovo

Table 1. Quantitative Benchmarks (QB) and Indicative Targets (IT), 2011
(Millions of euros, cumulative from beginning of the year)

	2011		
Test date	Jun.	Sep.	Dec.
Type of objective	IT	QB	QB
Objective to be observed			
Floor on the bank balance of the general government 1/	249	200	305
Floor on the primary fiscal balance of the general government 1/	27	-20	-226
Ceiling on primary expenditures of the general government 1/	537	912	1,487
Ceiling on contracting or guaranteeing nonconcessional debt by the general government	0	0	0
Ceiling on the accumulation of domestic payment arrears of the central government 2/	…	0	0
Ceiling on the accumulation of external payments arrears of the general government 3/	0	0	0
Memorandum items:			
Ceiling on the accumulation of domestic payment arrears of the general government	…	0	0
Program assumptions			
New privatization receipts	0	0	300
Non-project grants	5	5	5
Budget support loans	0	0	0
Project grants	0	0	2
Project loans	0	0	2

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

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

2/ A zero ceiling on the stock of domestic arrears of the central government is to be observed at end-June 2011; a zero ceiling on the accumulation of new domestic payment arrears by the central government is to be observed continuously beginning in July 1, 2011.

3/ To be observed continuously.

Table 2. Kosovo: Prior Actions and Structural Benchmarks, 2011—SMP

Actions	Type	Timing
Dissolve the committee reviewing eligibility for all current categories of war related benefits and freeze the number of beneficiaries at a maximum corresponding to the level at end-May 2011, with the exception of applications that have already been received by that date	Prior Action	June 15, 2011
Issue a sub-legal act on the "Law on the Rights of Formerly Politically Convicted and Persecuted Persons" that determines that the benefits payable under this law shall only be paid from funds that have been specifically and explicitly appropriated for this purpose under the then applicable budget law	Prior Action	June 15, 2011
Development of a taxpayer compliance strategy aligned with the concept recommended by the February 2011 IMF technical assistance mission on tax administration	Structural benchmark	End-September 2011
Passage of a budget for 2012 by the Assembly agreed with IMF staff that contains fiscal tightening of at least ¾ of a percent of GDP, based on realistic macro-forecast and prudent budgeting	Structural benchmark	End-December 2011
In-depth fiscal impact assessments that evaluate the budgetary impacts of the introduction of (i) a war veteran pension and (ii) benefits related to former political prisoners over a period of at least 5 years and include a thorough evaluation of the number of eligible beneficiaries	Structural benchmark	End-December 2011
Completion of the privatization of PTK	Structural benchmark	End-December 2011
Inclusion of a paragraph into all new benefit-creating laws and amendments to benefit-creating laws that explicitly allows cutting the level of benefits in case sufficient budgetary funds are unavailable	Structural benchmark	Continuous
Monthly meetings of the Program Monitoring Committee as defined in paragraph 38 of the Letter of Intent to assess progress with implementation of the SMP and consistency of all relevant policy initiatives with the SMP's objectives, and transmission of the meetings' minutes to the IMF Resident Representative within 5 business days	Structural benchmark	Continuous

Technical Memorandum of Understanding

REPUBLIC OF KOSOVO

Definitions and Data Reporting Requirements under the 2011 Staff-Monitored Program

1. This Technical Memorandum of Understanding sets out the understandings between the Kosovo authorities and the IMF staff regarding the definition of quantitative benchmarks and indicative targets, and reporting requirements for the Staff-Monitored Program ("SMP") requested in June 2011.

I. Quantitative Benchmarks and Indicative Targets

A. Coverage

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

3. **Quantitative Benchmarks and Indicative Targets.** The quantitative benchmarks, indicative targets, and their respective test dates are set in Table 1 of the Letter of Intent (LOI).

B. Bank Balances of the General Government

4. **Bank balances** are funds usable and readily available (i.e., liquid or marketable, and free of any pledges or encumbrances), held and controlled by the general government for the purposes of making payments and transfers. Bank balances include Undistributed Funds of the Government of Kosovo plus funds specifically reserved for policy purposes but do not include the balance of unspent Own Source Revenues (OSR) carried forward, or funds encumbered or pledged as Donor Designated Funds and funds relative to onlending operations. Bank balances do not include investments made and managed by an outside Investment Manager assigned by the Minister pursuant to Kosovo's Law on Public Financial Management Article 7.1.(iii). Bank balances may be held in the form of gold, holdings of foreign exchange and traveler's checks, demand and short-term deposits at foreign banks, domestic banks, and the Central Bank of the Republic of Kosovo (CBK), long-term deposits abroad that can be liquidated without penalty, and any holdings of investment-grade securities held directly by the general government. Bank balances at December 31, 2010, were € 244.112 million.

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

- the excess of budget grants and loans relative to program assumptions
- the repayment of loans extended to public enterprises.

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

C. Primary Expenditures of the General Government

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

➢ The ceiling on primary expenditures set in Table 1 will be raised by the excess of project grants and loans relative to program assumptions.

➢ The ceiling on primary expenditures set in Table 1 will be lowered by the shortfall of project grants and loans relative to program assumptions..

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

8. **Reporting requirements.** Data on the monthly 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 7 and

including domestically and budget support financed capital expenditure and externally project financed capital expenditure; (vi) the gross payment and gross accumulation of domestic payments arrears; (vii) external loan receipts and principal payments; (viii) external arrears payments and accumulation; (ix) bank and nonbank financing; (x) privatization and receipts of the sales of nonfinancial assets; and (xi) any other revenue, expenditure, or financing not included above.

D. Primary Fiscal Balance of the General Government

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

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

➢ The floor on the primary fiscal balance set in Table 1 will be raised by

- the shortfall in project loans relative to program assumptions
- the excess in budget loans relative to program assumptions.

E. Contracting or Guaranteeing Nonconcessional Debt by the General Government

10. **Nonconcessional debt** is defined as debt contracted or guaranteed by the general government with a grant element of less than 35 percent. The grant element of a debt is the difference between the present value (PV) of debt and its nominal value, expressed as a percentage of the nominal value of the debt. The PV of debt at the time of its contracting is calculated by discounting the future stream of payments of debt service due on this debt. The discount rates used for this purpose are the using currency-specific commercial interest reference rates (CIRRs) published by the Development Assistance Committee of the Organization for Economic Cooperation and Development (OECD). For debt with a maturity of at least 15 years, the ten-year-average CIRR will be used to calculate the PV of debt and, hence, its grant element. For debt with a maturity of less than 15 years, the six-month average CIRR will be used. To both the ten-year and six-month averages, the same margins for differing repayment periods as those used by the OECD need to be added (0.75 percent for repayment periods of less than 15 years, 1 percent for 15 to 19 years, 1.15 percent for 20 to 29 years, and 1.25 percent for 30 years or more). The ceilings exclude purchases from the IMF, the sale of the SDR holdings allocated to Kosovo, and the contracting of Partial Risk Guarantees with the World Bank for the privatization of the energy sector. Debt rescheduling and debt reorganization of debts contracted before the approval of the SMP are excluded from the limits on nonconcessional debt. The definition of short-term nonconcessional debt excludes normal short-term (less than one year) import-related financing. The quantitative benchmark applies not only to debt as defined below but also to commitments contracted or guaranteed

for which value has not been received. The contracting or guaranteeing nonconcessional debt by the general government will be assessed at each test date.

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

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

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

13. **Reporting requirements.** Details of all new debt taken or guaranteed, indicating terms of debt and creditors, will be provided on a quarterly basis within five weeks of the end of each quarter.

F. Domestic Payments Arrears

14. A domestic payment obligation to suppliers or creditors is deemed to be in **arrears** if: (a) goods and services have been received; (b) they have been certified to conform to the order of the contract; and (c) the due-for-payment date has passed and the obligation has remained unpaid for more than 60 days. The stock of arrears will be assessed at end-June 2011 and the accumulation of new domestic arrears will be assessed continuously. A payment obligation is defined to be domestic if the creditor is resident in Kosovo.

15. **Reporting requirements.** The Ministry of Finance will submit detailed tables of the stocks of domestic arrears and of domestic payment obligation to suppliers or creditors not in arrears as of end-September and end-December 2011. Moreover, it will submit a monthly table with the stock of domestic payments arrears, including the accumulation (if any), payment, rescheduling and write-off of domestic payments arrears during the month. The data are to be provided within five weeks after the end of the month.

G. External Payments Arrears

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

17. **Reporting requirements.** The Ministry of 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.

II. Other Data Requirements

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

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

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

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

22. 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.