July 2011
IMF Country Report No. 11/210

Republic of Kosovo: 2011 Article IV Consultation and the Initiation of a Staff-Monitored Program—Staff Report; Public Information Notice on the Executive Board Discussion

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

- The staff report, prepared by a staff team of the IMF, following discussions that ended on **May 30, 2011**, with the officials of the Republic of Kosovo on economic developments and policies. Based on information available at the time of these discussions, the staff report was completed on **June 21, 2011**. The views expressed in the staff report are those of the staff team and do not necessarily reflect the views of the Executive Board of the IMF.

- A Public Information Notice (PIN) summarizing the views of the Executive Board as expressed during its **July 6, 2011** discussion of the staff report that concluded the Article IV Consultation and the Initiation of a Staff-Monitored Program.

The document(s) listed below will be separately released

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

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

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INTERNATIONAL MONETARY FUND

REPUBLIC OF KOSOVO

Staff Report for the 2011 Article IV Consultation and the Initiation of a Staff-Monitored Program

Prepared by Staff Representatives for the 2011 Consultation with the Republic of Kosovo

Approved by Juha Kähkönen and Jan Kees Martijn

June 21, 2011

KEY ISSUES

Setting. Kosovo is a young country still in the process of building key social and economic institutions. Assets include a young population, cost-effective social security systems, and low public debt. Growth in the past decade has been robust but tilted towards domestic demand, funded by remittances and foreign direct investment from Kosovars living abroad. Social challenges loom large, with about 40 percent of the workforce unemployed. Fiscal policy is increasingly under strain as it addresses rising capital and social spending needs from a limited revenue base. The financial system has evolved rapidly but maintained a sound funding structure.

Article IV topics. Discussions focused on policies to (i) *enhance competitiveness* to support the emergence of a tradable sector and promote self-sustained growth, through administrative and legal reforms, better infrastructure, and wage restraint, (ii) *restore fiscal sustainability* by exercising restraint on current spending and raising more permanent revenue, including from direct taxes, and (iii*) safeguard financial stability* and foster the development of the financial sector. The authorities and staff largely agreed on the key themes.

Staff-monitored program (SMP). An 18-month Stand-By Arrangement approved by the Executive Board in July 2010 went off track in 2011, reflecting inter alia large increases in public sector wages. On this mission, the authorities and staff reached understandings on a SMP until end-2011. It includes important steps towards restoring fiscal sustainability and strengthening budget planning and execution. Successful implementation would create a track record of sound fiscal management that could pave the way to a program endorsed by the IMF Executive Board in 2012.

Mission team: Messrs. Wiegand (head), Castro, Druck (all EUR), Alper (FAD), and Lanau (SPR) visited Pristina May 17–30. The mission met with Prime Minister Hashim Thaçi, Minister of Finance Bedri Hamza, Central Bank Governor Gani Gerguri, other government officials, parliamentarians, private sector representatives, the head of the International Civilian Office Pieter Feith, and other envoys representing the international community. Messrs. Sulemane (Resident Representative) and Domi (Economist in the Resident Representative's Office) assisted the mission. Mr. Kiekens (OED) attended the concluding meeting.

Publication: The authorities have agreed to publication of the staff report.

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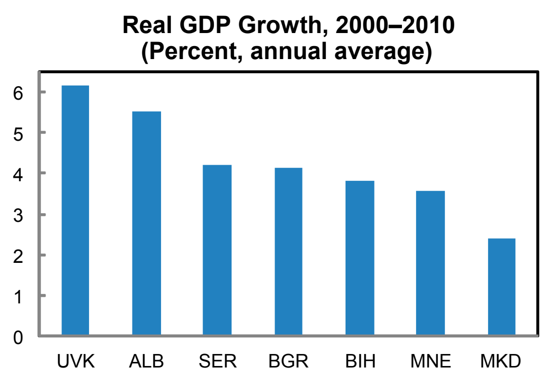
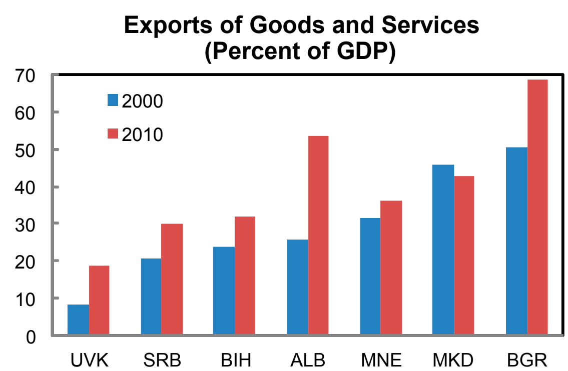
I. Context and Recent Developments

A. The Setting

1. **Kosovo is a young country still in the process of building key social and economic institutions.** For much of the 2000s Kosovo was under the administration of the United Nations. In 2008 it declared independence, and in June 2009 Kosovo became the 186th member of the IMF. While international institutions, notably the International Civilian Office (ICO) and the rule of law mission of the European Union (EULEX), still play some role, Kosovo is today mostly self-governed (Box 1). Efforts to build core functions of a public administration and strengthen governance have over the years benefitted from considerable external assistance, including from the World Bank, the European Union, the United States, and the IMF (Box 2).

2. **Kosovo's economic performance over the past decade has been robust, even though growth has been heavily tilted towards domestic demand, fuelled by transfers and non-debt creating capital inflows** (Figure 1). Large remittances from Kosovars living abroad boosted consumption, while foreign direct investment fuelled activity in particular in the services sector and in construction. By contrast, Kosovo's (labeled "UVK" below) export sector has remained small, even by regional standards, and produces mostly low-valued-added products, especially base metals. Per-capita GDP remains at one of the lowest levels in Europe. Social challenges loom large, with unemployment estimated at more than 40 percent of the workforce, although much of this arguably reflects informal employment.



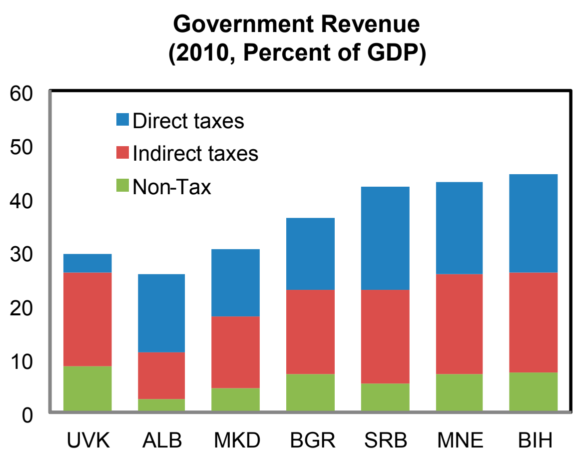


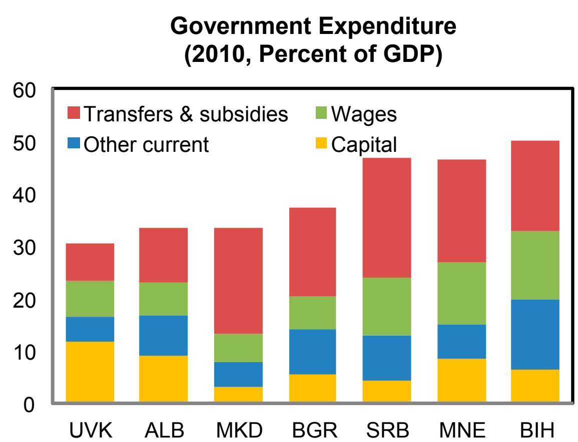
Source: WEO, and staff computatios.

3. **Kosovo has unilaterally adopted the euro as its legal tender**. While this supports stability by providing a strong monetary anchor and has generally served the economy well, it places a premium on disciplined macroeconomic policies, the maintenance of competitive wage levels, and flexibility to react to external shocks through internal adjustment. The absence of an independent monetary policy also implies that fiscal policy is the main instrument for domestic demand management.

4. **Kosovo's financial system has expanded rapidly in the 2000s, but—in contrast to other countries in the region—has avoided the build-up of large funding imbalances** (Figure 2). Financial assets as a share of GDP more than doubled from 33 percent in 2003 to 73 percent in 2010 (Box 3). The financial system is dominated by banks, most of them foreign owned, and is largely deposit funded, in part from remittances. As a result, the Kosovar banking system enjoys one of the most conservative loan-to-deposit ratios in the region. Supported by technical assistance, the central bank has gradually taken over the responsibility for financial supervision, and it is building the capacity to provide emergency liquidity assistance (ELA) to banks if needed. In a fully euroized economy such as Kosovo's, the funds for ELA stem mostly from deposits of the government at the central bank.

5. **During most of the 2000s, Kosovo pursued a conservative fiscal policy.** The potential for fiscal expansion was constrained by limited administrative capacity, the narrow coverage of domestic tax instruments—especially direct taxes—and the government's inability to issue debt. As a result, Kosovo enjoys not only low levels of public debt,[1] but the government also holds cash buffers in the form of deposits with the central bank. Government spending as a share of GDP is modest compared to Kosovo's neighbors, owing in part to a low level of transfers. This reflects on the one hand Kosovo's young population[2] and on the other the fact that many social security systems schemes were rebuilt after 1999, notably the pension system. More generally, Kosovo does not bear a burden of large long-term obligations—to pensioners, veterans, or creditors—that threaten the finances of any neighboring countries.





Source: Country authorities and staff computations

[1] Kosovo owes 5 percent of GDP to the World Bank, and another 0.8 percent of GDP to the IMF and Germany's KfW. A final determination of Kosovo's share in the debt of former Yugoslavia is still outstanding.

[2] The median age of Kosovo's population is estimated at 26 years, compared to 30 years in Albania, 35 years in Macedonia, 37 years in Montenegro, 40 years in Bosnia and Herzegovina, and 41 years in Serbia and Croatia (source: CIA, World Factbook)

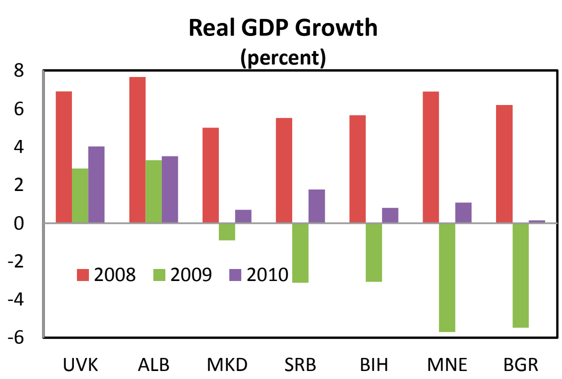
B. Recent Developments

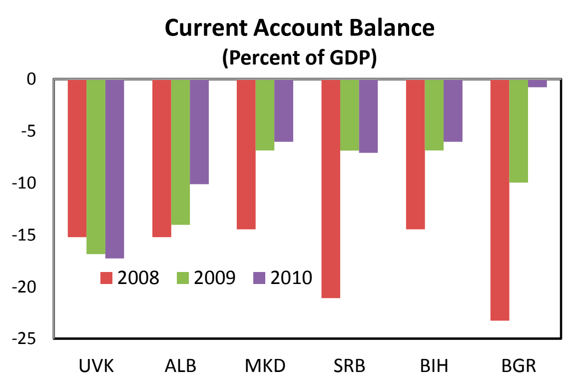
6. **The global financial crisis had only a modest impact on Kosovo, owing in part to limited integration into international financial and goods markets.**

- ***Real GDP growth*** slowed from close to 7 percent in 2008 to about 3 percent in 2009, before recovering to 4 percent in 2010 (Tables 1 and 2, Figure 3). This contrasts with many countries in the region where activity contracted. The solid growth performance owed much to robust domestic demand, which was buttressed by higher government spending as well as remittances and non-debt creating capital inflows from the diaspora (Table 3). Many Kosovars live in Germany and Switzerland, countries in which growth and employment held up relatively well. By contrast, in many neighboring countries sharp capital flow reversals forced disruptive current account adjustments through a compression of domestic demand. At the same time, Kosovo's small export base limited the impact of weak demand in trading partner countries.

- ***Inflation*** fell into negative territory in 2009, reflecting lower import prices for food and gasoline, but has since recovered. Core inflation remained well behaved throughout the crisis.

- ***Growth in credit to the private sector*** slowed from more than 30 percent in 2007–08 to about 13 percent in 2009–10 (Table 4, Figure 4). The quality of bank assets deteriorated only modestly. Nonperforming loans (NPLs) increased to 5.9 percent in March 2011 from 3.3 percent at end-2008 (Table 5). High coverage of NPLs through provisions and an aggregate capital adequacy ratio of 18 percent suggest that banks continue to have large shock-absorbing capacity. They have also remained liquid and profitable.





Source: WEO, and staff computations

7. **Since 2008, growth in government expenditures accelerated, with the resulting deficits financed from accumulated savings, the sale of assets, and donor support** (Figure 5). As a result, the general government balance shifted from a surplus of more than 7 percent of GDP in 2007 to a deficit of 2.6 percent in 2010. Capital spending has been the

main driver of this expansion. Last year, construction started on a highway connecting Pristina with Albania's border, with total costs estimated at more than 20 percent of annual GDP spread over a period of 4 years. The central government would be subject to large penalties in case of rephasing if, for example, the necessary land expropriations proceed less rapidly than planned, which adds considerable risks to the fiscal outlook. In 2011, the government increased public sector wages and benefits for war invalids and their families between 30 and 50 percent; additional, potentially costly spending initiatives are in preparation (see below).

8. **An 18-month Stand-By Arrangement (SBA) was approved by the IMF Executive Board on July 21, 2010, but went off track in 2011.** The program supported by the SBA was built around (i) restraint on current spending, higher revenues and privatization receipts to contain the impact on the investment program on the overall deficit, and (ii) bolstering the government's deposits with the Central Bank to build buffers for fiscal and financial contingencies (Box 4). The 2011 budget adopted by the newly constituted Assembly deviated from the budget agreed in the context of the SBA, notably the large public sector wage increases. Unfunded social spending initiatives with unclear budgetary impacts posed additional risks to fiscal sustainability. As a result, no review under the program could be completed.

II. Economic Outlook and Risks

9. **The short-term economic outlook is benign, even though high food prices put upward pressure on inflation.**

- ***Growth.*** Continued robust remittances inflows, solid credit growth, especially to households, and the increase in public sector wages are projected to support consumption, while public investment and FDI are expected to remain fervent. Anecdotal evidence suggests especially strong construction activity. Exports are growing fast, although from a low base. Staff projects real growth at 5.3 percent in 2011 and 5 percent in 2012.

- ***Inflation.*** Consumer price inflation is projected to rise temporarily to more than 8 percent (annual average), boosted by rising prices for imported food and gasoline, but would return to levels consistent with euroization once commodities prices stabilize. While thus far there are few indications of a pass-through to core inflation, developments have to be watched carefully, in particular as the increase in public sector salaries may affect private sector wage dynamics.

- ***External balance.*** The current account deficit is projected to increase to 25 percent of GDP in 2011, reflecting higher import prices and highway-related imports. It is expected to be financed mostly by FDI and other non-debt creating inflows.[3]

10. **For the medium term, staff projects real GDP growth to converge to 4½ percent.** The GDP deflator would increase at a rate of slightly below 2 percent, in line with euro area inflation, while consumer price inflation would fluctuate around the deflator in line with import prices. The long-term sustainable current account deficit is estimated at about 15 percent of GDP, financed to a large extent with non-debt creating inflows.

11. **The economic outlook is subject to large downside risks, from both domestic and external sources.**

- ***Domestic risks*** include the potential for political turbulences that could trigger higher government spending pressures, putting confidence in fiscal management at risk. A marked slowdown in construction activity is another risk.
- ***External risks*** relate in particular to weaker growth in Europe, which could be triggered, for example, by an intensification of the euro area debt crisis. This could depress incomes of Kosovars living abroad, thus reducing transfers and FDI inflows, which, in turn, would force a contraction in domestic demand. Lower inflows and remittances could also have a negative impact on the public finances, by decreasing the yield from consumption taxes, and on the banking system, by reducing both deposits and the capacity of debtors to service their debts. A small-probability risk is that of liquidity strains for Western European parent banks of Kosovar subsidiaries triggering liquidity outflows from Kosovo's banking system. If large enough, such outflows could constrain credit growth.
- In case of a marked slowdown, the ***scope for countercyclical policies would be limited***, given Kosovo's already stretched fiscal position.

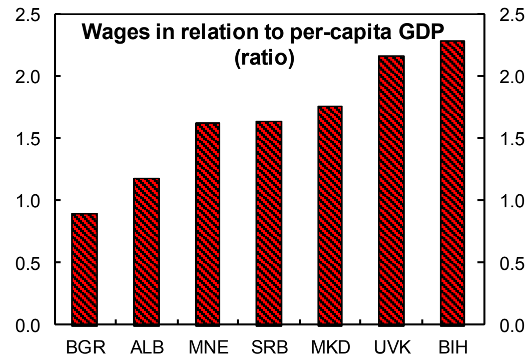
III. Policy Discussions

A. Strengthening External Competitiveness and Fostering Self-Sustained Growth

12. **Staff emphasized—and the authorities concurred—that Kosovo's growth model needs reorientation.** To date growth has relied mostly on exceptionally high remittances and FDI, but the authorities acknowledged that the longer-term prospects for these flows were subdued as diaspora Kosovars integrate more closely into their host countries. There was consensus that going forward, the key challenge was the emergence of a tradable sector that would drive economic development and growth.

[3] Kosovo's current account deficit may be overestimated due to underreporting of cash transfers.

13. **Staff and the authorities agreed that numerous constraints were impeding the development of a tradable sector** (Figure 6). Public infrastructure is lacking, notably in transport and energy. The business climate is hampered by limited administrative and judiciary capacity. Education and skill levels of large parts of the population are low, reflecting *inter alia* severe disruptions in the public provision of education prior to independence. Severe data limitations preclude a full assessment of Kosovo's real exchange rate, notably the absence of a unit labor cost real effective exchange rate measure (Box 5). A cross-country comparison of private sector wage levels, however, suggests that wages are not particularly competitive when scaled with a measure of productivity, such as per capita GDP. Remittances may well contribute to elevated wage levels by increasing workers' reservation wages.



14. **The government's recently adopted economic development strategy contains important steps in the right direction.** Key pillars are administrative and legal reforms to improve Kosovo's ranking in the World Bank's "Doing Business" survey; support for the agricultural sector; and the government's ambitious highway construction program, although the fiscal burdens arising from these projects need to be managed carefully (see below). Staff commended the authorities' intention to privatize energy distribution and generation in 2011–12, with technical assistance from the World Bank. Progress in this area is critical to improve the quality and reliability of energy supply, and to limit costs to the budget.

15. **Staff emphasized that the impact of government policies on labor costs needed to be watched carefully.** It noted that the sharp increase in public sector salaries this year may trigger undesired spillovers to private sector wages. Moreover, staff underscored that the minimum wage level suggested by the Socio-Economic Committee commission of €170 per month was high relative to both minimum wages in neighboring countries and Kosovo's average wage level. As a result, an even larger share of the labor force could be pushed out of formal employment, especially younger workers—a concern shared by World Bank staff. The authorities replied that they saw scope for a lower minimum wage for younger workers.

B. Restoring Fiscal Sustainability

16. **The authorities and staff agreed that fiscal policy should be anchored by two complementary objectives: adequate liquidity management and sustainability of public debt.**

- ***Liquidity management.*** There was agreement that in a euroized economy, bank balances of the government with the Central Bank of Kosovo (CBK) were needed not only to satisfy the government's liquidity needs, but also to make resources available to the central bank to provide emergency liquidity assistance if needed. Staff suggested that an adequate yardstick was one month of government expenditure plus one-tenth of banks' non-equity liabilities, resulting in targeted cash buffers of about €300 million (about 6 percent of GDP).[4]

- ***Debt sustainability.*** Staff suggested targeting a very gradual increase of public debt that would allow public debt to stabilize at ratio of about 30 percent of GDP in the long-term. The authorities noted that Kosovo's public debt law prescribes a maximum public debt ratio of 40 percent of GDP, thus, the targeted long-term level leaves the government room to react to external or growth shocks. To achieve this objective, staff advised to target a medium-term primary deficit of about ½ percent of GDP.

17. **Staff pointed out that Kosovo's current fiscal stance was inconsistent with either objective** (Tables 6, 7). Liquidity management was complicated by the large outlays on the highway—about €300 million (6 percent of GDP) per year until 2013—that give rise to large albeit temporary deficits. One option in principle was to issue domestic debt, but the amounts that can be placed would likely be limited, given that Kosovo has not yet built an adequate macroeconomic track record. As regards sustainability, staff estimates the underlying primary deficit at 3½ percent of GDP, although any such estimate is dependent on uncertain assumptions about long-term capital spending.[5] Thus, the implied fiscal adjustment need is close to 3 percent of GDP.

18. **Specifically, while in 2011 fiscal challenges appeared manageable, in 2012 bank balances would likely fall below desired levels in the absence of disbursements from IFIs and/or fiscal adjustment**.

- ***Revenue.*** Tax revenues have evolved well thus far in 2011Q1, growing by about one-quarter compared to Q1 2010. The authorities emphasized, that while some of this improvement owed to inflation, structural factors such as improved revenue collection and better tax payer compliance also played a part, measures often taken in response to IMF technical assistance.

- ***Spending.*** The public sector wage hike (that took effect in March) is projected to raise current expenditures permanently by about 1 percent of GDP. In this year's budget, the increase is partly compensated by lower capital spending.

- Staff projects the ***overall deficit for 2011*** corresponding to these policies at 5.7 percent of GDP, with receipts from the privatization of the post and telecom operator (PTK) being the main source of deficit financing. The authorities stated that

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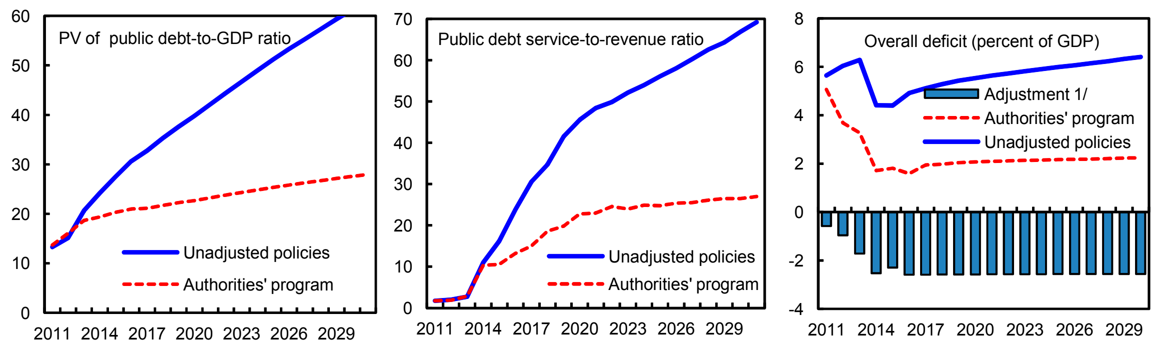
[4] The central bank has also some own resources for ELA, notably central bank capital and reserves. Overall, available resources add up to 15–20 percent of total bank deposits.

[5] The underlying deficit excludes (temporary) highway expenditures. 3½ percent of GDP is the medium-term primary deficit that would result without fiscal adjustment.

the sale is on schedule to be finalized by the end of the year. Bank balances would remain close to adequate levels in 2011, but staff emphasized that, on unchanged policies, the government's cash buffers were likely to be depleted by end-2012.

19. **Against this background, the authorities and staff agreed that fiscal adjustment was needed of about ¾ of a percent of GDP annually over a period of four years.** This would safeguard both adequate liquidity buffers and a sustainable fiscal stance, provided international assistance would resume in 2012. Specifically, bank balances could be maintained at levels around €300 million, and by 2014 the fiscal stance would be close to debt-stabilizing levels. Adjustment should come primarily from higher revenues and restraint on current spending.

Kosovo: Public Debt Sustainability



1/ Excluding grants.

20. **Several policy initiatives in the pipeline would create additional but difficult-to-assess fiscal costs.** The authorities and staff agreed that fiscal burdens from these initiatives would need to be compensated by potentially substantial additional adjustment elsewhere.

- As regards ***capital spending***, the government is considering a second highway from Pristina to Skopje/Macedonia. Staff cautioned that this would require careful evaluation. In particular, a thorough cost-benefit analysis and a sound and transparent financing plan consistent with fiscal sustainability were indispensible prerequisites; especially in view of the fiscal risks created by the ongoing highway construction project to Albania.

- As for ***social policy initiatives***, the government's priorities include a pension for war veterans and benefits for former political prisoners. Staff argued—and the authorities agreed—that more work was needed to identify eligible beneficiaries before such benefits could be adequately designed and costed, with staff pointing to the negative experiences of the Federal Republic of Bosnia with war related benefits (Box 6).

- An employer-employee financed ***health care fund*** could—depending on the design—also have fiscal implications, although the authorities insisted that the only spending item would be relatively limited employer contributions for public sector employees.

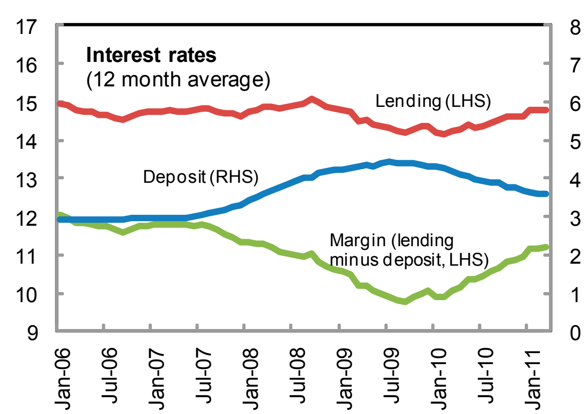
21. **More generally, staff argued that the ambitiousness of the government's spending plans required a strategic reorientation of fiscal priorities.** The current model of funding additional expenditures mostly with one-off revenues was unsustainable to the extent that spending pressures were permanent. In this case, a higher level of permanent revenues was needed. One option would be to increase the low yield from direct taxes. In this context, the authorities expressed interest in close cooperation with an upcoming IMF technical assistance mission on tax policy.

22. **The authorities and staff agreed that Kosovo's system of fiscal decentralization needs amendments.** A well-designed system of budgetary grants leaves adequate funds for municipalities, but there are little incentives for municipalities to raise own-source revenue, which results in exceptionally low municipal tax rates (Box 7). Staff recommended raising the minimum rate on the property tax that is collected by municipalities, and reducing central government grants accordingly. The authorities agreed in principle, but noted that such a reform required careful preparation—notably a revision of the grants system.

23. **Staff warned against using unorthodox funding measures to fill financing gaps.** In particular, the existing stock of assets held by the Kosovar pillar II pension fund should not be used to fund the fiscal deficit, although going forward a part of *new* inflows into the fund could be used to purchase government paper, in line with existing legislation. Staff also warned against accumulating large amounts of nonconcessional debt. While such actions could alleviate short-term financing constraints, they would make financing of the budget over the medium term more difficult.

C. Safeguarding Financial Stability

24. **The authorities and staff agreed that while Kosovo's financial system had evolved rapidly, further progress was impeded by high risk costs, limited legal capacity, and limited availability of collateral for lending operations.** These constraints keep interest rates high and prevent financial intermediation from spreading to wider parts of the population. The authorities noted that market concentration may also contribute to elevated lending rates. However, the uneven distribution of profits across banks, relatively low fee income, aggressive attempts by new entrants to gain market share (notably subsidiaries of Turkish banks), and substantial increases in deposit rates during the financial crisis suggest insufficient competition may not be the most important factor.



Source: Central Bank of Kosovo.

25. **The authorities underscored that they are improving a property cadastre with support from the World Bank, especially in rural areas.** One objective of this initiative is to increase the use of collateral. Staff noted that reforms to speed up contract enforcement by the courts were also needed, especially with respect to seizing collateral in case of loan defaults.

26. **Staff emphasized that full institutional and operational independence of the central bank is critical for preserving financial stability.** In this context staff noted that the appointment of a new central bank governor earlier this year was characterized by a clean implementation of the nomination rules under the law.

27. **The authorities pointed to progress made in the area of financial supervision.** The superintendency of banks follows a risk-based supervision model under the framework of Basel I, assessing banks according to CAMELS indicators (capital, asset quality, management, earnings, liquidity, and risk sensitivity). For subsidiaries of foreign banks this assessment is carried out jointly with home country supervisors.[6] It contains at least one comprehensive on-site inspection per bank each year as well as permanent off-site surveillance. Significant advances are also being made in the area of stress-testing, with an in-house stress-testing model being developed.

28. **Passage of the new banking law, envisaged for September, is expected to strengthen the institutional framework for banks and microfinance institutions.** The draft law enhances governance standards, introduces tighter restrictions for lending to bank-related parties, and allows for consolidated supervision of banking groups. It will also ensure that the authorities have adequate tools for bank resolution. Staff recommended enhancing the deposit insurance law such that funds of the Deposit Insurance Fund of Kosovo can be used for purchase and assumption transactions. As regards microfinance institutions, the authorities and staff agreed that the law should assign the CBK the responsibility for licensing and require microfinance institutions to have a clearly defined ownership structure. Microfinance institutions hold less than 5 percent of the financial system's assets, but play an important role in reaching parts of the population with limited access to banking services.

29. **The authorities and staff agreed that a priority was to build the capacity to provide emergency liquidity assistance to the banking system.** At the conceptual level, ELA was introduced in 2010 with the approval of the new central bank law. Going forward, a memorandum of understanding between the government and the central bank is required to establish a designated account of government deposits at the central bank whose resources are earmarked for ELA.

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[6] The parent of the largest bank, ProCredit Kosovo, is in the process of applying for a bank license. Once this has been granted it will be subject to supervision by BaFin.

IV. THE STAFF-MONITORED PROGRAM

30. **The authorities and staff reached understandings on a staff-monitored program (SMP) until end-2011.** The SMP is an informal agreement with staff to monitor the implementation of the authorities' economic program, and aims at establishing a track record of strong performance that could lead to an IMF-supported program in 2012. It does not entail endorsement by the IMF Executive Board and does not involve financial assistance by the IMF. The SMP is guided by quantitative and structural benchmarks as described in the attached Letter of Intent (LOI) and has two test dates, end-September and end-December 2011.

31. **The SMP's primary objective is to take decisive steps towards restoring fiscal sustainability and improving budget execution and monitoring.** Key elements include:

- Fiscal adjustment of ¾ percent of GDP in 2011, through a mix of excise increases and restraint on current spending, notably the wage bill, which allows for bank balances of above €300 million by the end of the year (LOI ¶¶11, 12);
- A contingency reserve in case the privatization of PTK is delayed, by not-allocating capital expenditures and transfers until a winner of the privatization bid is announced (LOI ¶12);
- In-depth fiscal impact assessments of the war veterans pension and benefits for political prisoners prior to designing these benefits and fitting them into a sustainable medium-term framework (LOI ¶13);
- Introduction of an automatic adjustment clause into all new laws and amendments to laws that create new benefit that explicitly allows cutting benefits in case there are insufficient budgetary funds (LOI ¶15);
- Commitment to a budget for 2012 that contains another ¾ of a percent in GDP of fiscal adjustment, partly from the wage bill, and is agreed with IMF staff (LOI ¶15);
- Enhanced program monitoring that is upgraded to the ministerial level (LOI ¶38).

The authorities' fiscal program is complemented by structural reforms to strengthen tax administration (LOI ¶¶21–25), public financial management (LOI ¶¶26–28), financial sector policies (LOI ¶¶30–34), competitiveness (LOI ¶¶35, 36) and energy sector policies (LOI ¶37).

32. **Risks to the SMP are considerable.** As regards *implementation risk*, the government's determination to curtail spending and refrain from unfunded spending commitments could again be tested by domestic political pressures. A key short-term *financing risk* is a possible delay of the privatization of PTK, although the contingency reserve built into the SMP should warrant that the government has sufficient liquid funds to finance its operations.

V. Staff Appraisal

33. **Kosovo has made major inroads in the past decade in building key social and economic institutions, but progress is incomplete.** Significant additional efforts are needed to enhance competitiveness of the economy, strengthen fiscal sustainability and safeguard financial stability.

34. **The short-term macroeconomic outlook is benign, even though there are significant downside risks.** Kosovo enjoyed robust economic growth in the 2000s and has weathered the global financial crisis well, owing to limited integration into global financial and goods markets. Going forward, domestic demand continues to be supported by remittances and non-debt creating inflows, much of it financing construction activity. Risks include both domestic policy missteps and a slowdown in advanced Europe, which could curtail remittances and therefore domestic demand.

35. **Kosovo's growth model needs reorientation.** To date growth has relied on exceptionally high transfers from abroad and FDI, fuelling construction and activity in the services sector, but longer-term prospects for these flows are subdued as diaspora Kosovars integrate more closely into their host countries. Going forward, the key challenge is fostering the emergence of a tradable sector that could drive economic development and growth and help reduce unemployment. Reforms are needed to upgrade public infrastructure, improve the business climate, and maintain competitive wage levels.

36. **The unilateral adoption of the euro provides a strong monetary anchor and has served the economy well, but it increases the demands on macroeconomic management.** In particular, the currency regime places a premium on disciplined fiscal policies, competitive wage levels, and flexibility of the economy to adjust to external shocks. Moreover, full-scale euroization implies that the government—rather than the central bank—needs to provide a large part of the resources for emergency liquidity assistance to the financial system.

37. **Kosovo benefits from low public debt and sizeable government cash buffers, owing to a conservative fiscal policy for most of 2000s.** Moreover, government expenditure as a share of GDP is modest, owing in part to low spending on transfers. More generally, Kosovo does not bear large burdens of long-term obligations to pensioners, veterans, or creditors, in contrast to many countries in the region, an advantage that should be maintained.

38. **The switch to an expansionary fiscal stance since the late 2000s is unsustainable and risks encountering financing constraints in the absence of fiscal adjustment.** Ambitious capital and social spending projects are increasingly financed from one-off revenues or by drawing down cash buffers, as Kosovo's revenue base has not kept pace with the expansion in expenditure. In the short term, disciplined budget execution and financial management is pivotal to safeguard sound public finances. Any future capital or social spending initiatives should be carefully designed and costed, and accompanied by

compensating revenue and/or expenditure measures as needed to ensure the fiscal position remains compatible with sustainability. The accumulation of large amounts of commercial debt should be avoided. In the medium term a reorientation of fiscal priorities is needed, which includes raising more revenue from direct taxes.

39. **While Kosovo's banking system has developed in a sound manner, further progress is impeded by limited legal capacity and incompletely defined property rights.** The central bank has made important advances in the area of financial supervision. Going forward, a priority is to build the capacity to provide emergency liquidity assistance to the banking system.

40. **The Staff-Monitored Program until end-2011 agreed between the authorities and IMF staff is an opportunity to take decisive steps towards restoring fiscal sustainability** and reversing policies that caused the 2010 Stand-By Arrangement to go off track Key components of the SMP are fiscal adjustment of ¾ of a percent of GDP, and strengthened budgetary planning and execution. Steadfast and successful implementation is vital to pave the way for a program endorsed by the IMF Executive Board in 2012.

41. **It is recommended that the next Article IV consultation with Kosovo be held on the standard 12-month cycle.**

Box 1. The Constitutional and Political Setting

In 1999 UN Security Council authorized the Secretary-General to establish an international civil presence in Kosovo. The United Nations Mission in Kosovo (UNMIK) was given executive responsibilities under four "pillars:" police and justice, civil administration, institution building, and reconstruction. As local capacities increased, UNMIK's powers were gradually transferred to the Provisional Institutions of Self-Government. UNMIK relinquished remaining powers upon the entry into force of Kosovo's constitution.

Following independence in 2008, a European Union rule of law mission (EULEX) was deployed to Kosovo and an International Civilian Office (ICO) established. The principal task of EULEX is to assist the judicial authorities and law enforcement agencies to establish sustainable and accountable institutions and practices. The ICO assists in drafting legislation and regulations on social and economic matters.

In 2010 the International Court of Justice issued an advisory opinion that Kosovo's declaration of independence did not violate international law. More than 70 countries have recognized Kosovo thus far, among them all of Kosovo's immediate neighbors except Serbia. In 2009 Kosovo joined the World Bank and the IMF, but it is not yet a member of the United Nations.

Hashim Thaçi, head of the Democratic Party of Kosovo (PDK) and a former political leader of the Kosovo Liberation Army, has been Prime Minister since 2007. Until 2010 he led a coalition government consisting mainly of the PDK and the Democratic League of Kosovo (LDK). In October 2010, the LDK left the coalition, which triggered early elections in December. These confirmed Thaçi as Prime Minister, with his parliamentary majority depending on the support of several delegates representing ethnic minorities.

Box 2. Structural Reforms and International Technical Assistance

Kosovo has received far-reaching technical assistance (TA) from the international community. In recent years, key areas and objectives have been (with lead TA providers in parentheses):

Public sector

- *Tax administration*: improvements in tax collection by broadening the tax base and enhancing collection efforts (IMF and USAID).
- *Public financial management*: a debt law prescribes binding limits for public debt. Amendments to the law on budgeting procedures enhance budget preparation and execution (IMF and U.S. Treasury).
- *Fiscal decentralization*: greater financial autonomy for municipalities (IMF and USAID).
- *Civil service:* a law on civil servants provides common rules and standards for public employment (WB).

Financial sector

- *Central bank:* strengthening financial supervision and regulation through a central bank law, the implementation of emergency liquidity assistance and deposit insurance. The central bank is also developing a stress testing model and is upgrading the payment system (all IMF).
- *Financial system:* a draft banking law is under preparation to enhance risk management in banks (IMF). Revision of regulations for the insurance sector and pensions (WB).
- *Cash and Debt Management:* establishment of a framework for domestic borrowing (IMF, US Treasury).
- *National Statistics System:* Kosovo started participating in the Fund's GDDS this year (IMF).

Business environment

- *Infrastructure*: construction of a highway connecting Pristina with Albania's border (WB)
- *Privatization:* the airport is now run by a private company. Privatization of the post and telecom operator and electricity distribution and generation are under preparation (WB, USAID).
- *Labor law:* the law sets rules to protect workers and employees (WB).
- *Cadastre* for real estate, notably in rural areas (WB).

Going forward, priorities for IMF-supported technical assistance include:

Fiscal: tax policy; reassessment of the grants system for municipalities; the development of a taxpayer compliance strategy.

Financial sector: drafting the law on banks and microfinance institutions; adapting the rules and regulations governing activities of banks and microfinance institutions to this law; banknote management.

Statistics: capacity building for balance of payments and national accounts data collection.

Box 3. The Structure of Kosovo's Financial System

Kosovo's financial system has grown rapidly over the past decade. Financial sector assets reached about 73 percent of GDP by end-2010, from 33 percent in 2003. The system is dominated by banks. Only two smaller banks are domestically owned, while the three largest foreign subsidiaries hold about three quarters of banking sector assets. Two of these foreign-owned banks belong to banking groups based in Austria and Slovenia, the third (Kosovo's largest) has as majority shareholder a financial holding based in Germany.

Financial Sector Structure

		2010		
	Number of	Total Assets		
	Institutions	Mil Euros	Share	% of GDP
Banks		**2,325**	**76.0**	**55.5**
Commercial banks	**8**	**2,325**	**76.0**	**55.5**
Foreign banks	6	2,090	**68.3**	**49.8**
Domestic banks	2	235	**7.7**	**5.6**
Non-banks	**18**	**144**	**4.7**	**3.4**
Microfinances institutions	17	138	4.5	3.3
Others	1	5	0.2	0.1
Insurance companies	**11**	**97**	**3.2**	**2.3**
Life insurance companies	1	4	0.1	0.1
Non-life insurance companies	10	94	3.1	2.2
Pension	**2**	**494**	**16.1**	**11.8**
KPST	1	489	16.0	11.7
Other	1	5	0.2	0.1
Total		**3,059**	**100.0**	**73.0**

Source: Central Bank of Kosovo, only data on banks and KPST are audited.

In spite of rapid growth, banks have managed to maintain a prudent funding structure. By end 2010, deposits, mostly from households, accounted for about 87 percent of banks' non-equity liabilities. Half of the deposits are long-term.

Private sector credit stood at 35 percent of GDP in 2010. Reflecting the nascent state of the industrial sector, about 80 percent of loans were allocated to retail trade, other services, and households. The international financial crisis had only limited effects on the banking system, given banks' low foreign exposures.

Total Deposits
(as percent of total)

Household	67.1
Private Companies	15.6
Public Sector	7.1
Nonresidents	4.4
Others	5.8

Box 4. The 2010 Stand-By Arrangement

The Stand-By Arrangement (SBA) approved by the IMF Executive Board on July 21, 2010, aimed at halting the deterioration in the government's bank balances with the central bank that had resulted from the shift to an expansionary fiscal stance, reflecting *inter alia* an increase in public investments, especially the Highway 7 to Albania. The decline in bank balances put at risk the central bank's ability to provide emergency liquidity assistance to banks if needed.

The fiscal strategy supported by the SBA was built around restraint on current spending and efforts to raise more revenues, so as to create space for capital spending while keeping bank balances at prudent levels. Specifically, current expenditures were targeted to grow in line with nominal GDP, while substantial receipts were meant to be secured from privatization and budgetary grants from the World Bank and the European Commission. The program also contained structural measures to support these objectives, such as improvements in tax administration and budgeting procedures, reforms of the energy sector to reduce the need for state subsidies, and an overhaul of the laws regulating activities of the central bank and commercial banks.

The execution of the 2010 budget was broadly in line with the program, with quantitative performance criteria met for end-August 2010, and all but one met for end-2010. The slippage—accumulation of arrears to domestic suppliers—was short-lived and minor (0.4 percent of GDP).[7] Donor assistance did not materialize as planned, owing to the interruption of the program in the wake of the political crisis in October 2010 (see below), but the targets on the primary fiscal balance and the bank balances were still met due to under-execution of the capital budget.

Performance in the SBA, December 2010
(Millions of euros, cumulative from beginning of the year)

	PC 1/	Actual
Performance criteria		
Floor on bank balances	241	244
Floor on the primary fiscal balance	-129	-113
Ceiling on primary expenditures	1,316	1,265
Indicative target		
Ceiling on recurrent primary expenditures	770	762
Memorandum: IMF financing	43	22

Sources: Kosovo authorities; and IMF staff estimates and projections.
1/ Unadjusted.

Progress on structural reforms was uneven. Efforts to privatize the telecom company (PTK) stalled, and steps to reform the energy sector were also delayed by political events.

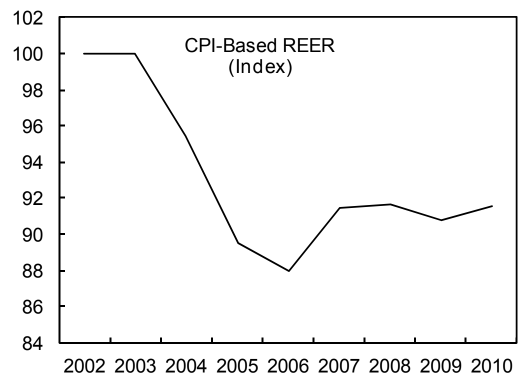
The coalition crisis in October 2010 and subsequent parliamentary elections in December prevented the completion of a review in 2010. Following the elections, the newly constituted Assembly passed a 2011 budget that deviated in critical components from the strategy agreed in the context of the SBA, casting the budget's medium-term sustainability in doubt.

[7] However, without the accumulation of arrears the end-December performance criteria on bank balances and the primary fiscal balance would not have been met.

Box 5. External Competitiveness

While severe data limitations preclude a full quantitative assessment of Kosovo's real exchange rate, the large and persistent current account deficit—averaging 16 percent of GDP over the last three years—and small export sector beg the question whether Kosovo's real exchange rate is overvalued.

Kosovo's CPI-based real effective exchange rate has depreciated by about 8 percent since 2002. While this development seems to suggest a moderate improvement in competitiveness, it is largely exogenous as Kosovo's CPI closely traces import price developments.



While a unit-labor-cost real effective exchange rate is not available, average nominal wages are relatively low by regional standards. This said, in the last two years, agricultural and manufacturing wages have increased by 30 and 25 percent respectively, although it is unclear whether this reflects real wage dynamics or a statistical artifact—stricter controls by the tax administration may have reduced under-reporting of wages. Moreover, scaling wages with a measure of productivity—such as per-capita GDP—results in fairly unfavorable ratios compared to neighboring countries. Thus, low wages arguably just reflect low productivity.

Structural weaknesses further affect Kosovo's competitiveness negatively, including bottlenecks in the transport and energy sectors and a difficult business environment. The World Bank's Doing Business Survey ranks Kosovo 119th out of 183 countries participating in the survey, the lowest in the region. Particular low are rankings for investor protection, ease of dealing with construction permits, and ease of starting a business. This said, Kosovo ranks in the upper quartile of countries as regards ease of obtaining credit, taxes, and ease of closing a business.

Ease of Doing Business Sub-indicators 1/

	Start a business	Pay taxes	Trade across borders	Enforce contracts	Close a business
Albania	45	149	75	89	183
BiH	160	127	71	124	73
Bulgaria	43	85	108	87	83
Kosovo	163	41	130	155	31
Macedonia, FYR	5	33	66	65	116
Montenegro	51	139	34	135	47
Serbia	83	138	74	94	86

Source: World Bank Doing Business Survey 2011

1/ Country ranks. 1 = highest rank

Box 6. War-Related Benefits

Like in other countries in the region, parts of Kosovo's population suffered from the consequences of armed conflict. The resulting social burden was addressed by legislation adopted in 2000 and 2006 that provides for disability pensions to veterans, civilian victims of war, their families, and surviving families. It also includes subsidies, including for health care, education, and housing. The latest draft legislation regulating war-related benefits expands both benefits and eligibility.

The 2009 fiscal crisis in FBH—one of the two autonomous entities in Bosnia and Herzegovina—provides a cautionary lesson for Kosovo. In FBH, war-related benefits doubled from 2006 to 2008, and were a major contributor to the country's fiscal crisis in 2009. War-related payments averaged 3 percent of GDP between 2002 and 2009 and made up about a third of total budget in 2009. Much of the spending pressure stemmed from poorly targeted benefits.

While Kosovo's conflict (1998–1999) involved far less casualties than the Bosnian war, ill-defined eligibility criteria and increases of already generous benefits would be causes for concern for medium term fiscal sustainability also in Kosovo.

War-Related Cash Benefits in Federation of Bosnia-Herzegovina (FBH) and Kosovo
(in percent of monthly average gross wage)

	FBH [1]	Kosovo [1]	
		Current System	Draft Legislation
Civilian invalids with 60% disability[2]	8	28	31
Disabled war veterans with 21% disability	3	55	60
60% disability	12	92	100
100% disability	66	110	143
Families of veterans killed (1 member)[3]	28	110	143
4 or more	43	157	287
Memorandum items			
Average gross Wage (euros/month)	€ 569	€ 327	
Number of Beneficiaries (thousand)	109	13	-
Population (mil.)	2.5	1.8-2.1	

Sources: Popic, L. and B. Panjeta (2010) "Compensation, Transitional Justice and conditional international credit in Bosnia and Herzegovina" for Bosnia and Herzegovina; Authorities and World Bank and IMF Staff calculations for Kosovo.

[1] As of June 2009 for FBH and May 2011 for Kosovo.

[2] Minimum invalidity to qualify is 60 and 40 percent in FBH and Kosovo, respectively.

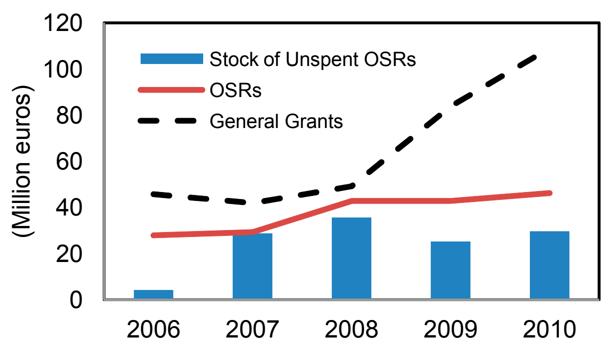
[3] In FBH, families with income and without children receive 19% of average wage.

Box 7. Fiscal Decentralization

Fiscal decentralization was shaped by the Ahtisaari proposal of 2007.[8] Among other elements, it included measures to decentralize government by creating new municipal competencies in secondary health care and higher education, as well as financial matters, by devolving more freedom to enact measures over revenue, expenditure, and issuing debt to municipalities.

In this context, the Law on Local Government Finance (drafted with IMF TA) has been instrumental. The legislation established that the central government has to transfer 10 percent of total central budget revenues (excluding dividends) to municipalities, in addition to specific grants for health, education, and other issues. This annual general grant is allocated across municipalities based on a formula that assigns weights to characteristics like the size of the population, its ethnic composition (to protect minorities), or its location. In addition to grants and revenue received from the central government municipalities have own source revenues (OSRs) from property taxes, construction permits, licenses, and fees.

Although the current system has served municipalities well, adjustments are needed. Central government transfers doubled in nominal terms from 2008–2010, while municipalities' own source revenues stagnated, with a large stock of unspent own source revenues carried forward to future years. This situation increases pressures on the central government budget and implies a shift from direct taxes (collected by municipalities) to indirect taxes, such as VAT or excises. Factors contributing to the situation include (i) the large increase in central grants provided incentives to municipalities to reduce own collection efforts, (ii) cuts in property taxes prior to municipal elections, to enhance reelection prospects of incumbent mayors; and (iii) insufficient flexibility of municipalities to spend out of their own source revenues as the central government determines staffing limits.



Source: Kosovar authorities, and staff computations.

[8] Name after the Special Envoy of the United Nations' Security Council, Marti Ahtisaari.

Table 1. Kosovo: Main Indicators, 2008–16

(Percent, unless otherwise indicated)

	2008	2009	2010	2011	2012	2013	2014	2015	2016
			Est.		Projections				
Real growth rates									
GDP	6.9	2.9	4.0	5.3	5.0	4.7	3.4	4.4	4.5
GDP per capita	5.3	1.4	2.5	3.7	3.4	3.2	1.9	2.9	3.0
Consumption	4.3	1.0	2.7	2.7	2.9	3.3	3.7	2.7	3.1
Investment	18.1	10.1	5.2	13.3	6.6	9.0	0.5	8.5	8.1
Exports	4.7	8.9	30.1	7.2	6.9	7.4	7.2	9.2	8.7
Imports	5.9	4.7	11.0	5.5	2.6	5.8	3.6	6.0	6.3
Price changes									
CPI, period average	9.4	-2.4	3.5	8.3	2.6	1.2	0.7	1.1	1.7
CPI, end of period	0.5	0.1	6.6	6.2	1.9	0.7	0.8	1.4	1.9
GDP deflator	6.2	-1.3	3.0	5.8	3.3	2.2	1.5	1.8	1.8
Real effective exch. rate (average; -=depreciation)	3.2	-1.0	-0.7	…	…	…	…	…	…
Real effective exch. rate (end of period; -=depreciation)	0.2	-1.0	0.9	…	…	…	…	…	…
General government budget (percent of GDP)									
Revenues, incl. interest income 1/	24.5	29.3	27.8	27.1	27.5	27.9	27.1	27.5	28.2
Primary expenditures	24.7	29.9	30.2	31.8	30.8	30.6	28.0	28.5	28.9
Of which									
Wages and salaries	5.9	6.8	7.4	8.3	7.9	7.9	7.9	7.9	7.9
Subsidies and transfers	7.1	7.3	6.4	6.3	6.4	6.4	6.4	6.4	6.4
Capital and net lending, incl. the highway	7.6	11.6	12.0	13.0	12.3	12.2	9.5	9.8	10.1
Capital expenditures on the highway 2/	…	…	2.9	5.3	5.8	5.4	1.2	0.0	0.0
Overall balance	-0.2	-0.7	-2.6	-5.0	-3.5	-3.0	-1.4	-1.5	-1.2
Debt financing, net	0.0	-0.2	0.3	0.2	1.5	1.7	1.1	1.2	1.4
Privatization	0.0	0.0	0.0	6.4	0.0	0.2	0.2	0.2	0.2
Stock of government bank balances	10.8	8.7	5.8	6.5	5.8	5.8	5.7	5.8	5.9
Recommended minimum bank balances	…	…	5.8	7.6	5.8	5.8	5.7	5.8	5.9
Financing gap	0.0	0.0	0.0	0.0	1.8	1.7	0.3	0.5	0.1
Savings-investment balances (percent of GDP) 3/									
Domestic savings	-12.6	-7.4	-7.1	-7.3	-5.0	-2.5	-2.0	0.2	2.2
Transfers excluding general government (net)	14.0	11.9	12.6	12.1	12.1	12.1	12.5	12.4	12.0
Net factor income	4.3	2.3	3.0	2.6	2.9	3.1	3.0	3.0	2.9
National savings	5.8	6.8	8.5	7.4	10.0	12.7	13.5	15.6	17.1
Investment	28.6	31.8	33.5	37.8	36.6	36.8	34.8	35.6	36.2
Current account, excl. official transfers	-22.8	-25.0	-24.9	-30.4	-26.6	-24.1	-21.3	-20.0	-19.1
Current account balance, incl. official transfers	-15.2	-17.2	-16.3	-25.0	-20.5	-18.9	-17.6	-16.5	-15.8
Of which : official transfers 4/	7.6	7.8	8.6	5.5	6.0	5.1	3.7	3.5	3.3
Net foreign direct investment	8.9	7.0	7.4	15.2	7.2	7.2	7.7	7.7	7.8
Portfolio investment, net	1.7	-1.4	-5.5	-3.0	-1.6	0.7	-0.7	-0.1	0.1
Bank credit to the private sector	32.7	8.9	12.6	12.9	11.0	…	…	…	…
Deposits of the private sector	25.8	22.2	23.1	12.0	11.3	…	…	…	…
Non-performing loans (percent of total loans)	3.3	4.3	5.2	5.9 5/	…	…	…	…	…
GDP (millions of euros)	3,851	3,912	4,192	4,672	5,066	5,424	5,695	6,052	6,472
GDP per capita (euros)	1,785	1,786	1,886	2,070	2,212	2,333	2,414	2,527	2,662
GNDI per capita (euros)	2,113	2,040	2,179	2,376	2,544	2,688	2,788	2,915	3,060
Population (thousands) 6/	2,158	2,190	2,223	2,256	2,290	2,325	2,360	2,395	2,431

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

1/ Projections assume that grants from the EC and IDA will be received.

2/ Based on World Bank estimates.

3/ Savings-investment balance of entire economy, including donor sector.

4/ Total foreign assistance excluding capital transfers.

5/ March 2011.

6/ The recent census indicates that a revision to previous estimates will be needed.

Table 2. Kosovo: Real Growth, 2007–16
(Percent, unless otherwise indicated)

	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016
				Est.			Proj.			
				(Real growth, percent)						
Consumption	5.3	4.3	1.0	2.7	2.7	2.9	3.3	3.7	2.7	3.1
Private	8.0	6.4	0.4	3.2	2.9	3.9	3.9	3.6	2.5	2.9
Public	-5.4	-5.9	3.9	0.0	2.2	-2.3	-0.6	4.4	4.1	4.4
General government	-2.3	-0.2	15.9	9.6	8.5	2.1	4.6	5.6	6.9	6.3
Donor sector 1/	-8.7	-12.2	-11.4	-16.0	-11.7	-13.9	-17.1	-0.4	-7.7	-5.1
Investment	15.2	18.1	10.1	5.2	13.3	6.6	9.0	0.5	8.5	8.1
Private	21.6	0.6	2.6	1.4	11.8	8.1	11.1	10.9	8.5	8.1
Public	-9.7	109.2	29.0	12.6	15.9	4.2	5.1	-19.3	8.5	8.2
General government	-8.7	153.6	35.1	13.8	17.3	4.6	5.4	-19.7	9.1	8.8
Donor sector 1/	-12.3	-18.6	-26.0	-7.3	-11.9	-6.9	-5.7	-5.2	-9.9	-10.3
Exports 2/	13.4	4.7	8.9	30.1	7.2	6.9	7.4	7.2	9.2	8.7
Imports	11.0	5.9	4.7	11.0	5.5	2.6	5.8	3.6	6.0	6.3
GDP	6.3	6.9	2.9	4.0	5.3	5.0	4.7	3.4	4.4	4.5
Memorandum item:										
GDP (millions of euros)	3,394	3,851	3,912	4,192	4,672	5,066	5,424	5,695	6,052	6,472

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

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

Table 3. Kosovo: Balance of Payments, 2009-16
(Millions of euros, unless otherwise indicated)

	2009	2010	2011	2012	2013	2014	2015	2016
			Projections					
Goods and services balance	-1,534	-1,698	-2,111	-2,107	-2,131	-2,098	-2,137	-2,200
Trade balance	-1,673	-1,735	-2,176	-2,241	-2,333	-2,379	-2,488	-2,623
Exports	177	305	345	393	440	493	553	619
Imports	-1,851	2,041	2,521	2,634	2,773	2,872	3,040	3,241
Services	139	37	65	134	202	281	350	422
Receipts	435	515	586	634	688	735	813	900
Payments	-295	-478	-521	-500	-486	-454	-463	-478
Income	90	125	122	149	166	171	180	187
Compensation of employees (net)	169	172	178	186	193	201	209	217
Investment income	-78	-46	-57	-36	-27	-30	-28	-30
Interest payments on public debt	-1	-4	-10	-11	-11	-11	-10	-10
Transfers	770	889	822	918	937	924	961	991
Official transfers	305	361	255	306	279	211	211	211
Other transfers (net)	465	528	567	611	659	713	749	780
Inflows of workers' remittances	506	512	549	581	611	642	676	711
Current account	-674	-684	-1,167	-1,040	-1,027	-1,003	-996	-1,022
Capital and financial account	458	453	967	748	736	788	763	814
Capital account	108	27	7	2	2	2	2	2
Of which: WB Trust Fund	89	0	6	0	0	0	0	0
Financial account, incl. CBK	350	426	960	746	734	786	761	812
Foreign direct investment, net	271	311	708	364	391	436	466	504
Commercial banks, excl. FDI	-102	-101	-68	-13	104	64	96	28
General government	-132	5	11	2	-5	-22	-19	-11
Disbursements, incl. IMF	0	22	22	13	8	0	0	0
Repayments	-132	-17	-11	-11	-14	-22	-19	-11
Prepayment of debt	-132	-6	0	0	0	0	0	0
Other repayments	0	-11	-11	-11	-14	-22	-19	-11
Other sectors, excl. FDI 1/	366	231	393	406	291	336	269	347
Central Bank of Kosovo	-53	-20	-85	-14	-47	-29	-50	-56
Reserve assets	-23	-61	130	-28	-22	-19	-23	-27
Government balances (program definit	-17	-55	-72	14	-25	-10	-27	-29
Other reserve assets, incl. SDRs	-6	-6	202	-41	3	-9	3	2
Non-reserves assets	-30	12	-214	14	-25	-10	-27	-29
Liabilities 2/	0	29	-1	0	0	0	0	0
Net errors and omissions 3/	215	231	200	200	200	200	200	200
Financing gap	0	0	0	92	91	15	33	8
Memorandum items:								
Current account, excl. official transfers	-979	-1,045	-1,422	-1,346	-1,306	-1,214	-1,208	-1,233
(in percent of GDP)	-25.0	-24.9	-30.4	-26.6	-24.1	-21.3	-20.0	-19.1
Current account, incl. official transfers	-674	-684	-1,167	-1,040	-1,027	-1,003	-996	-1,022
(in percent of GDP)	-17.2	-16.3	-25.0	-20.5	-18.9	-17.6	-16.5	-15.8
Official transfers (percent of GDP)	8.0	8.6	5.5	6.0	5.1	3.7	3.5	3.3
Debt service to export ratio (percent)	21.7	2.6	2.3	2.2	2.2	2.7	2.2	1.4
Net foreign assets of commercial banks	444	545	613	626	521	457	361	266
Net foreign assets of CBK	1,088	1,108	1,193	1,207	1,255	1,283	1,333	1,390
Gross international reserves of the CBK	625	686	556	584	606	625	649	623

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

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

Table 4. Kosovo: Central Bank and Commercial Bank Survey, 2008-12
(Millions of euros, unless otherwise indicated)

				Proj.	
	2008	2009	2010	2011	2012
			Central Bank		
Net foreign assets	1,111	1,088	1,108	1,193	1,207
Foreign assets	1,111	1,198	1,247	1,331	1,345
Of which: Securities	541	529	199	279	299
Deposits	529	522	854	858	853
Foreign liabilities	0	110	139	138	138
Net domestic assets	-1,111	-1,088	-1,108	-1,193	-1,207
Net claims on the central government	-870	-681	-813	-885	-872
Liabilities	-870	-681	-813	-885	-872
Of which: Government balances (program definition)	-414	-178	-233	-305	-292
Commercial banks	-137	-233	-204	-210	-233
Other institutions	-64	-131	-46	-46	-46
Other items, net	-39	-43	-46	-52	-56
			Commercial banks		
Net foreign assets	325	444	545	613	626
Assets	401	584	710	778	806
Liabilites	76	140	165	165	180
Net domestic assets	815	949	1,169	1,307	1,511
Credit to private sector	1,183	1,289	1,451	1,637	1,818
Claims on the CBK	137	233	203	210	233
Net claims on the central government	-1	-165	-12	0	74
Net claims on other public entities	-264	-123	-120	-133	-146
Other items, net	-240	-285	-354	-406	-468
Liabilities to the private sector	1,140	1,393	1,714	1,920	2,137
Demand deposits	384	441	545	614	695
Time deposits	756	951	1,169	1,306	1,442
Memorandum item:					
Gross international reserves	670	625	686	556	584
			(12-month percent change)		
Liabilities to private sector	25.8	22.2	23.1	12.0	11.3
Loans to the private sector	32.7	8.9	12.6	12.9	11.0
			(Percent of GDP)		
Total private sector deposits	29.6	35.6	40.9	41.1	42.2
Credit to the private sector	30.7	32.9	34.6	35.0	35.9

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

Table 5. Kosovo: Selected Financial Soundness Indicators, 2006–10

(Percent)

	2006	2007	2008	2009	2010		2011
	Q4	Q4	Q4	Q4	Q1	Q4	Q1
Capital adequacy							
Regulatory capital/risk weighted assets	16.8	17.4	16.5	17.9	18.8	18.8	18.2
Tier 1 capital/risk weighted assets	14.7	16.4	15.3	15.1	15.8	15.8	15.2
Asset quality							
NPL ratio 1/	4.1	4.1	3.3	4.3	4.6	5.2	5.9
NPL net of provisions/capital	NA	2.6	2.8	2.3	3.3	3.7	5.0
Sectoral breakdown of loans							
Agriculture	2.0	3.2	3.2	3.0	0.5	2.6	2.6
Manufacturing	7.5	9.9	7.8	9.4	8.3	10.9	9.8
Trade	47.3	46.6	42.6	41.4	35.2	37.1	38.5
Other services	7.7	11.4	16.9	9.8	7.9	12.3	12.4
Construction	4.0	5.6	5.5	6.9	7.8	7.5	7.7
Households	22.9	22.5	23.7	26.6	31.1	29.5	29.0
Liquidity							
Liquid assets/total assets 2/	41.7	33.2	30.0	37.3	35.8	36.8	35.2
Deposits/loans	145.2	128.1	122.0	138.6	134.6	126.1	122.8
Liquid assets to short-term liabilities 2/	59.8	47.8	42.1	47.0	46.6	46.2	44.7
Profitability							
Return on assets 3/	2.3	2.9	2.6	1.4	0.3	1.8	0.1
Return on equity 3/	25.7	27.1	24.7	21.4	3.3	18.8	1.5
Interest margin to gross income 4/	60.4	58.4	60.3	55.3	53.6	55.5	57.6
Non-interest expense to gross income 5/	12.0	12.6	11.2	16.3	14.7	16.6	25.0
Market risk							
Net open currency position/tier 1 capital	NA	17.8	8.9	18.8	8.9	-0.1	…

Source: Central Bank of the Republic of Kosovo.

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

Table 6. Kosovo: Consolidated Government Budget, 2010–16

(Excluding donor designated grants; millions of euros)

	2010	2011		2012	2013	2014	2015	2016
	Act.	Proj.	Unadjusted policies	Projections				
Total primary revenue and grants	1,152	1,261	1,238	1,387	1,505	1,533	1,656	1,814
Total primary revenue	1,115	1,253	1,231	1,312	1,430	1,533	1,656	1,814
Taxes	894	1,057	1,034	1,147	1,252	1,345	1,458	1,603
Direct taxes	126	151	153	170	190	207	230	259
Indirect taxes	796	939	913	1,013	1,101	1,178	1,271	1,391
Tax refunds	-28	-33	-32	-36	-39	-41	-43	-47
Nontax revenues	221	196	197	165	177	188	198	210
Of which : dividends	85	45	45	0	0	0	0	0
Grants	38	8	8	75	76	0	0	0
Budget support	30	0	0	71	71	0	0	0
Trust fund for the 2010 debt service to the World Bank	4	5	5	0	0	0	0	0
Project grants	3	3	3	3	4	0	0	0
Primary expenditure	1,265	1,487	1,500	1,559	1,658	1,595	1,725	1,871
Current expenditure	762	879	891	935	994	1,054	1,130	1,214
Wages and salaries	311	386	396	403	429	450	478	514
Goods and services	182	195	195	205	214	234	261	285
Subsidies and transfers	268	296	298	324	348	367	387	412
Pension and social assistance	166	188	180	224	251	276	298	319
Other transfers and subsidies 1/	102	109	118	100	97	91	89	93
Reserve	0	3	3	4	4	4	4	4
Capital expenditure and net lending	503	608	609	624	664	541	595	656
Capital expenditure	443	563	564	604	644	521	575	636
Highway project 2/	123	248	248	296	293	67	0	0
Other capital spending	320	315	316	308	351	454	575	636
Net lending	60	45	45	20	20	20	20	20
Primary balance	-113	-226	-261	-172	-153	-62	-69	-57
Interest income, net	3	-7	-7	-6	-10	-17	-19	-24
Overall balance	-110	-233	-268	-178	-163	-79	-89	-80
Overall balance (excluding highway expenditures)	13	15	-20	117	130	-12	-89	-80
Financing	110	233	268	87	72	63	56	72
Foreign financing	16	16	16	2	-5	-22	-19	-11
Drawings, incl. official financing	22	22	22	13	8	0	0	0
Amortization	-11	-11	-11	-11	-14	-22	-19	-11
Trust fund at the World Bank	6	6	6	0	0	0	0	0
Domestic financing	93	217	252	85	77	85	75	83
Domestic borrowing (net)	0	0	0	74	95	85	91	103
Privatization revenues	0	300	300	0	10	10	10	10
Other financial assets, net	0	-17	-17	-3	-3	0	0	0
Change in the stock of own source revenues (– = increase)	-5	-5	-5	0	0	0	0	0
Change in bank balance (program definition; – = increase)	98	-61	-26	14	-25	-10	-27	-29
Of which : change in balance at the CBK (– = increase)	-55	-72	-37	14	-25	-10	-27	-29
Financing gap	0	0	0	92	91	15	33	8
Memorandum items:								
Bank balance of the general government 3/	244	305	270	292	317	326	353	382
Recommended minimum level of bank balance 4/	241	354	354	292	317	326	353	382
Total public debt	700	714	…	890	1,083	1,170	1,288	1,410

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

1/ Including capital transfers to public enterprises.

2/ Based on World Bank estimates.

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

4/ The increase of the recommended minimum in 2011 reflects carryover from the privatization of PTK.

Table 7. Kosovo: Consolidated Government Budget, 2010–16

(Excluding donor designated grants; percent of GDP)

	2010	2011		2012	2013	2014	2015	2016
	Act.	Proj.	Unadjusted policies	Projections				
Total primary revenue and grants	27.5	27.0	26.5	27.4	27.8	26.9	27.4	28.0
Total primary revenue	26.6	26.8	26.3	25.9	26.4	26.9	27.4	28.0
Taxes	21.3	22.6	22.1	22.6	23.1	23.6	24.1	24.8
Direct taxes	3.0	3.2	3.3	3.4	3.5	3.6	3.8	4.0
Indirect taxes	19.0	20.1	19.6	20.0	20.3	20.7	21.0	21.5
Tax refunds	-0.7	-0.7	-0.7	-0.7	-0.7	-0.7	-0.7	-0.7
Nontax revenues	5.3	4.2	4.2	3.3	3.3	3.3	3.3	3.2
Of which : dividends	2.0	1.0	1.0	0.0	0.0	0.0	0.0	0.0
Grants	0.9	0.2	0.2	1.5	1.4	0.0	0.0	0.0
Budget support	0.7	0.0	0.0	1.4	1.3	0.0	0.0	0.0
Trust fund for the 2010 debt service to the World Bank	0.1	0.1	0.1	0.0	0.0	0.0	0.0	0.0
Project grants	0.1	0.1	0.1	0.1	0.1	0.0	0.0	0.0
Primary expenditure	30.2	31.8	32.1	30.8	30.6	28.0	28.5	28.9
Current expenditure	18.2	18.8	19.1	18.5	18.3	18.5	18.7	18.8
Wages and salaries	7.4	8.3	8.5	7.9	7.9	7.9	7.9	7.9
Goods and services	4.3	4.2	4.2	4.0	4.0	4.1	4.3	4.4
Subsidies and transfers	6.4	6.3	6.4	6.4	6.4	6.4	6.4	6.4
Pension and social assistance	4.0	4.0	3.9	4.4	4.6	4.8	4.9	4.9
Other transfers and subsidies 1/	2.4	2.3	2.5	2.0	1.8	1.6	1.5	1.4
Reserve	0.0	0.1	0.1	0.1	0.1	0.1	0.1	0.1
Capital expenditure and net lending	12.0	13.0	13.0	12.3	12.2	9.5	9.8	10.1
Capital expenditure	10.6	12.0	12.1	11.9	11.9	9.2	9.5	9.8
Highway project 2/	2.9	5.3	5.3	5.8	5.4	1.2	0.0	0.0
Other capital spending	7.6	6.7	6.8	6.1	6.5	8.0	9.5	9.8
Net lending	1.4	1.0	1.0	0.4	0.4	0.4	0.3	0.3
Disbursement	1.4	1.0	1.0	0.4	0.4	0.4	0.3	0.3
Repayment	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Primary balance	-2.7	-4.8	-5.6	-3.4	-2.8	-1.1	-1.1	-0.9
Interest income, net	0.1	-0.2	-0.2	-0.1	-0.2	-0.3	-0.3	-0.4
Overall balance	-2.6	-5.0	-5.7	-3.5	-3.0	-1.4	-1.5	-1.2
Overall balance (excluding highway expenditures)	0.3	0.3	-0.4	2.3	2.4	-0.2	-1.5	-1.2
Financing	2.6	5.0	5.7	1.7	1.3	1.1	0.9	1.1
Foreign financing	0.4	0.3	0.3	0.0	-0.1	-0.4	-0.3	-0.2
Drawings, incl. official financing	0.5	0.5	0.5	0.3	0.2	0.0	0.0	0.0
Amortization	-0.3	-0.2	-0.2	-0.2	-0.3	-0.4	-0.3	-0.2
Trust fund at the World Bank	0.1	0.1	0.1	0.0	0.0	0.0	0.0	0.0
Domestic financing	2.2	4.6	5.4	1.7	1.4	1.5	1.2	1.3
Domestic borrowing (net)	0.0	0.0	0.0	1.5	1.8	1.5	1.5	1.6
Privatization revenues	0.0	6.4	6.4	0.0	0.2	0.2	0.2	0.2
Other financial assets (net)	0.0	-0.4	-0.4	-0.1	-0.1	0.0	0.0	0.0
Change in the stock of own source rev. (– = increase)	-0.1	-0.1	-0.1	0.0	0.0	0.0	0.0	0.0
Change in bank balance (– = increase)	2.3	-1.3	-0.5	0.3	-0.5	-0.2	-0.4	-0.5
Of which : change in balance at the CBK (– = increase)	-1.3	-1.5	-0.8	0.3	-0.5	-0.2	-0.4	-0.5
Financing gap	0.0	0.0	0.0	1.8	1.7	0.3	0.5	0.1
Memorandum items:								
Bank balance of the general government 3/	5.8	6.5	5.8	5.8	5.8	5.7	5.8	5.9
Recommended minimum level of bank balance 4/	5.8	7.6	7.6	5.8	5.8	5.7	5.8	5.9
Total public debt	16.7	15.3	…	17.6	20.0	20.5	21.3	21.8
Nominal GDP (millions of euros)	4,192	4,672	4,672	5,066	5,424	5,695	6,052	6,472

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

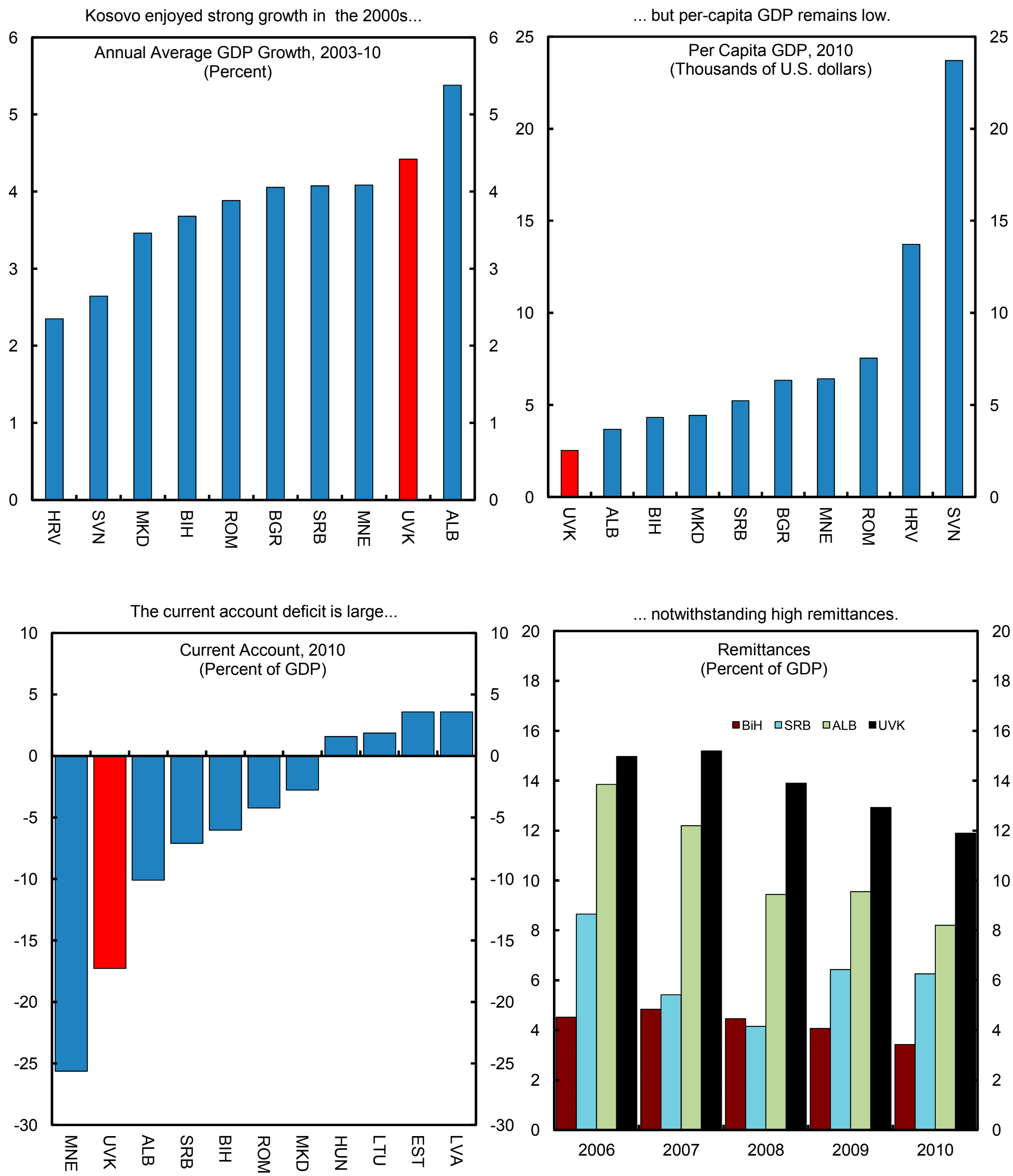
1/ Including capital transfers to public enterprises.

2/ Based on World Bank estimates.

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

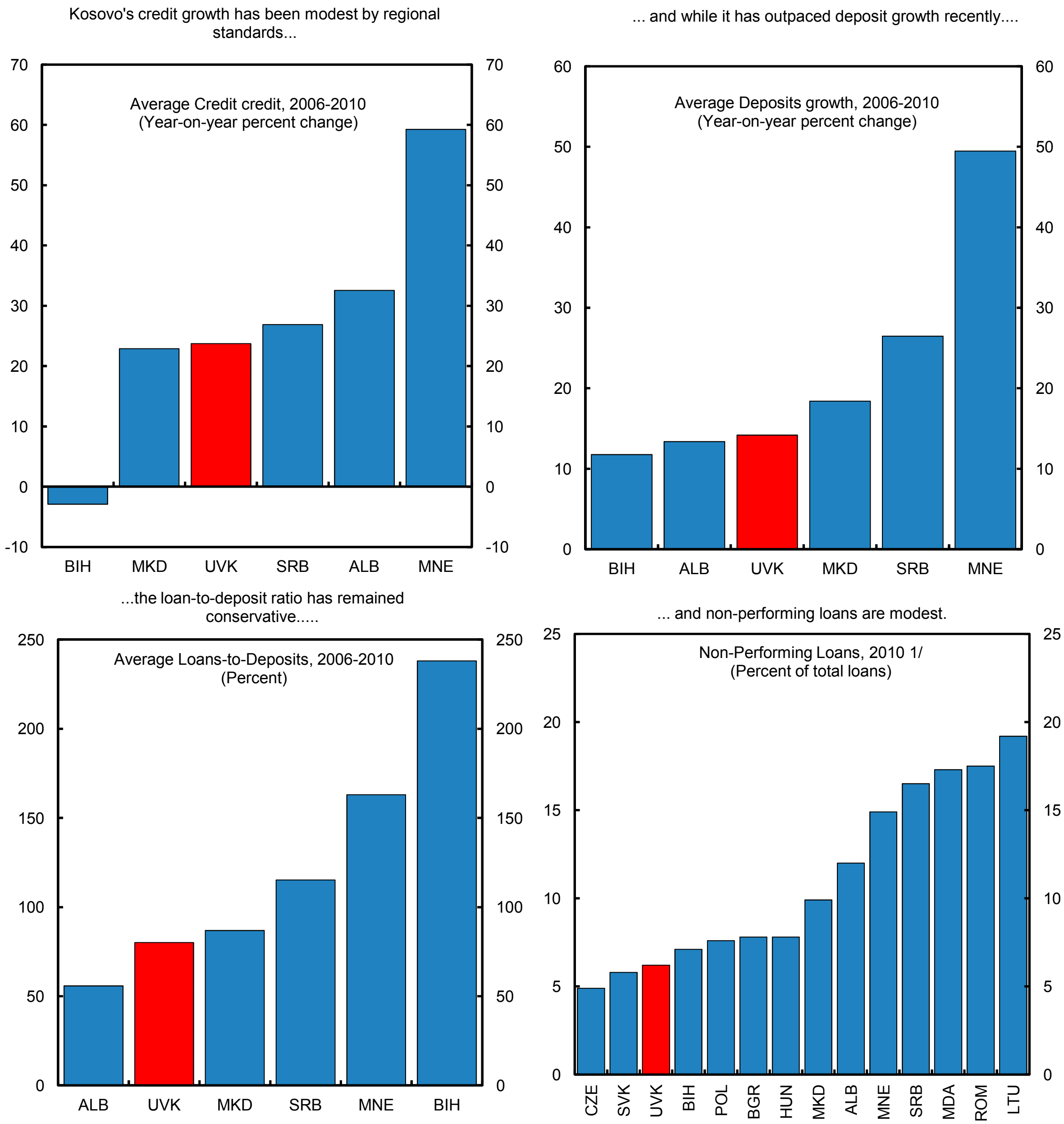
4/ The increase of the recommended minimum in 2011 reflects carryover from the privatization of PTK.

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



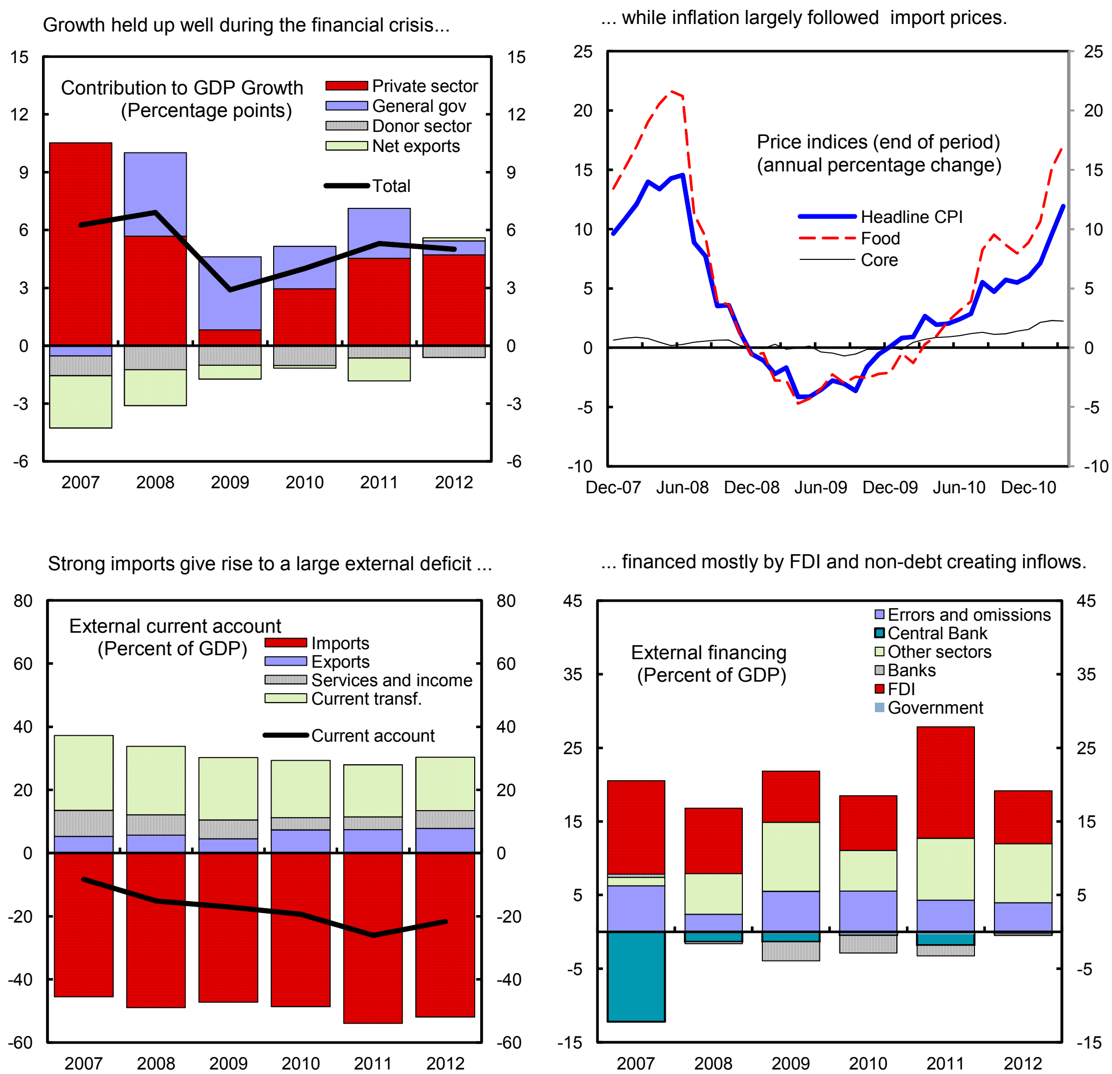
Sources: IFS; WEO; World Bank; and IMF staff estimates.

Figure 2. Kosovo: Cross-Country Financial Sector Indicators, 2006-2010



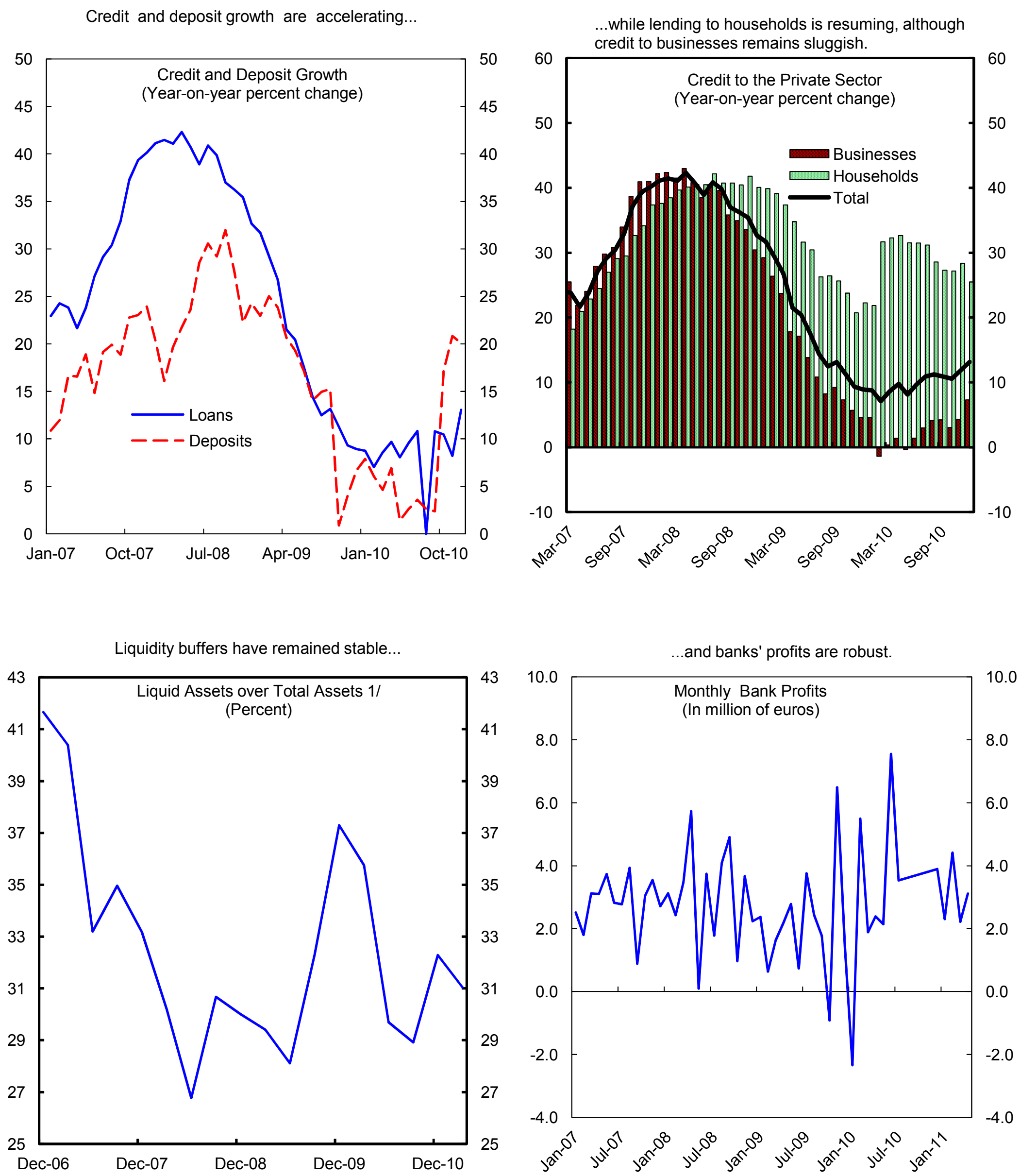
Sources: IFS; WEO; GFSR, and IMF staff estimates.
1/ Non-performing loan data the latest avaialble from GFSR.

Figure 3. Kosovo: Real and External Sectors Indicators, 2007–12



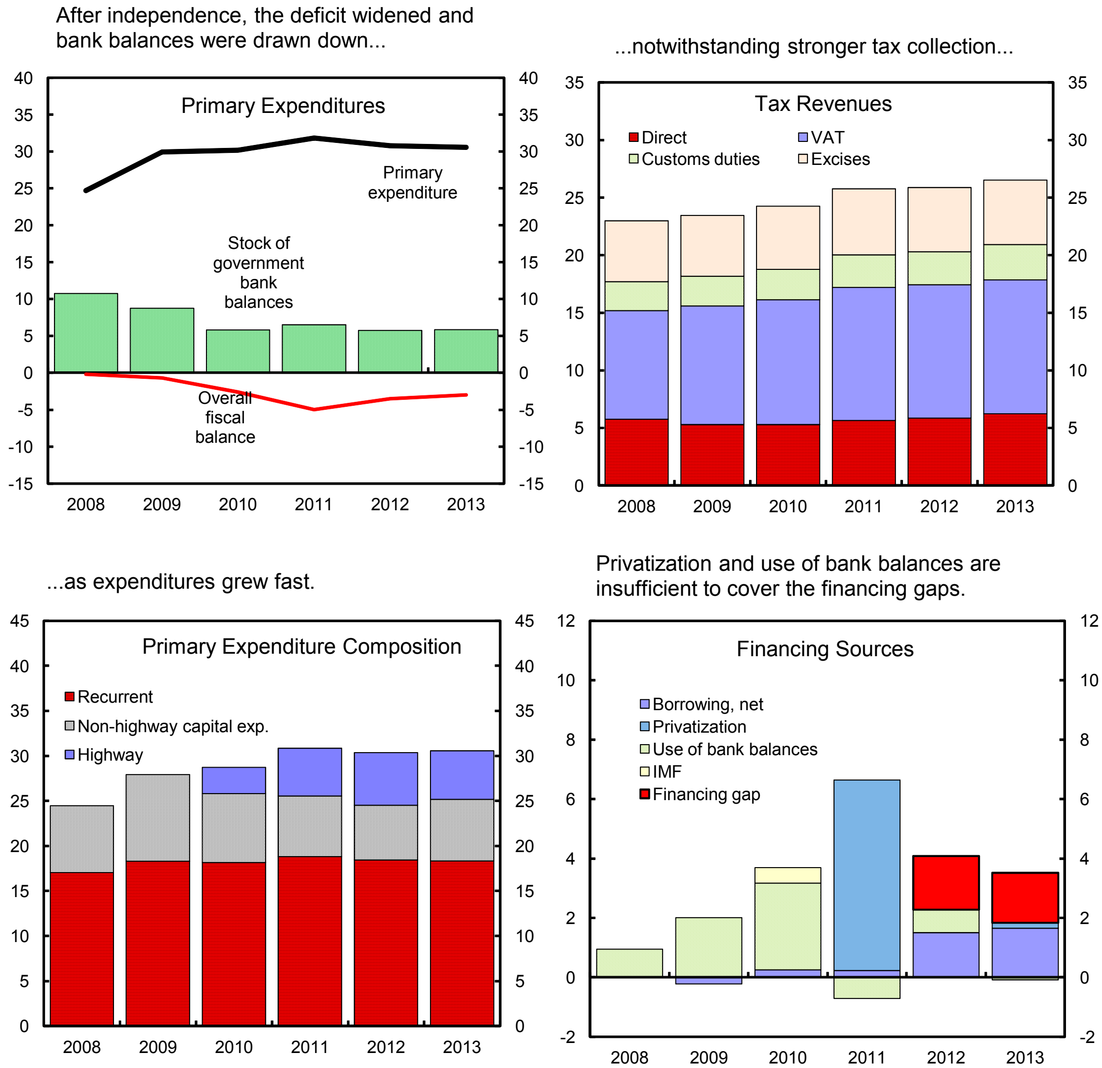
Source: National authorities and IMF staff estimates and projections.

Figure 4. Kosovo: Selected Banking Sector Indicators, 2006-10



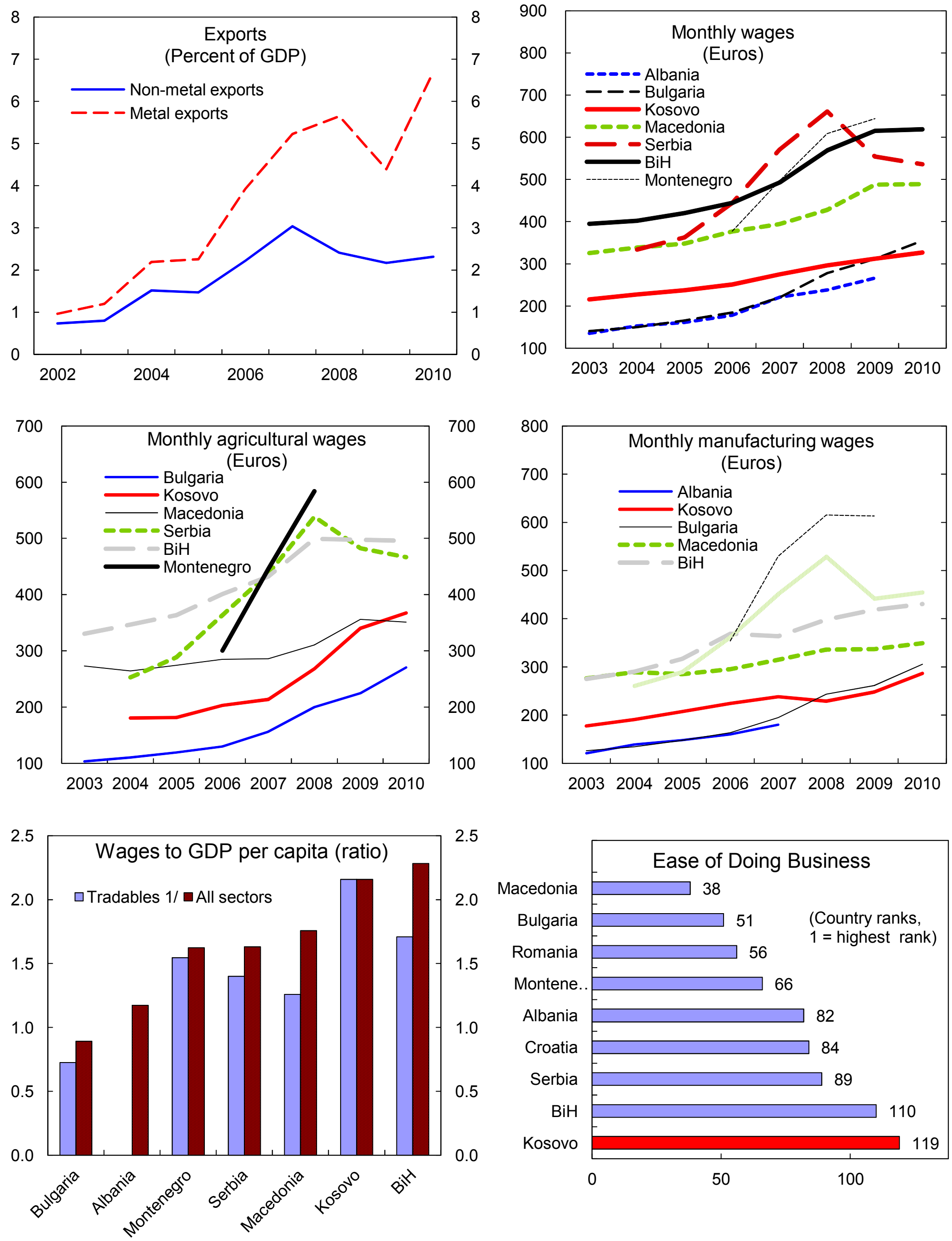
Sources: Cental Bank of Kosovo; IMF staff estimates.
1/ Liquid assets are cash, balances with CBK and commercial banks, and securities.

Figure 5. Kosovo: Fiscal Indicators, 2008–13
(Percent of GDP)



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

Figure 6. Kosovo: Indicators of External Competitiveness



Sources: Statistical Office of Kosovo, World Bank, WEO.
1/ Agriculture and manufacturing.

APPENDIX. DEBT SUSTAINABILITY ANALYSIS

Table A1. Kosovo: External Debt Sustainability Framework, Baseline Scenario, 2008-2031 1/
(In percent of GDP, unless otherwise indicated)

	Actual			Historical 6/ Average	Standard 6/ Deviation	Projections									
	2008	2009	2010			2011	2012	2013	2014	2015	2016	2011-2016 Average	2021	2031	2017-2031 Average
External debt (nominal) 1/	**21.4**	**17.6**	**16.7**			**15.3**	**16.1**	**15.9**	**15.2**	**14.6**	**13.9**		**17.8**	**23.6**	
o/w public and publicly guaranteed (PPG)	21.4	17.6	16.7			15.3	16.1	15.9	15.2	14.6	13.9		17.8	23.6	
Change in external debt	-3.9	-3.7	-0.9			-1.4	0.8	-0.2	-0.7	-0.6	-0.7		0.8	0.4	
Identified net debt-creating flows	-1.0	-0.8	-5.3			2.9	0.7	0.3	0.6	0.3	-0.7		1.2	0.9	
Non-interest current account deficit	**15.2**	**17.0**	**16.1**	**10.0**	**4.3**	**25.8**	**21.4**	**19.7**	**18.3**	**17.1**	**16.4**	19.8	**12.1**	**14.4**	13.1
Deficit in balance of goods and services	41.2	39.2	40.5			45.2	41.6	39.3	36.8	35.3	34.0		28.1	27.0	
Exports	14.8	15.6	19.6			19.9	20.3	20.8	21.6	22.6	23.5		20.5	20.0	
Imports	56.0	54.8	60.1			65.1	61.9	60.1	58.4	57.9	57.5		48.6	47.0	
Net current transfers (negative = inflow)	-21.7	-19.7	-21.2	-22.3	1.7	-16.5	-16.9	-16.2	-15.2	-14.9	-14.4		-13.6	-11.2	-12.9
o/w official	-7.6	-7.8	-8.6			-4.4	-4.9	-4.0	-2.7	-2.5	-2.3		-1.9	-0.7	
Other current account flows (negative = net inflow)	-4.3	-2.5	-3.2			-2.8	-3.2	-3.4	-3.3	-3.3	-3.2		-2.4	-1.4	
Net FDI (negative = inflow)	**-13.2**	**-17.6**	**-20.4**	**-10.3**	**6.5**	**-22.3**	**-20.3**	**-19.0**	**-17.5**	**-16.5**	**-16.8**	-18.7	**-11.0**	**-13.3**	-11.9
Endogenous debt dynamics 2/	**-3.0**	**-0.2**	**-0.9**			**-0.6**	**-0.4**	**-0.4**	**-0.2**	**-0.3**	**-0.3**	-0.4	**0.1**	**-0.2**	
Contribution from nominal interest rate	0.0	0.2	0.2			0.2	0.3	0.3	0.3	0.3	0.3		0.8	0.8	
Contribution from real GDP growth	-1.5	-0.6	-0.7			-0.8	-0.7	-0.7	-0.5	-0.6	-0.6		-0.7	-1.0	
Contribution from price and exchange rate changes	-1.5	0.3	-0.5			...	...	...	...	...	...		...	...	
Residual (3-4) 3/	**-2.9**	**-3.0**	**4.3**			**-4.3**	**0.1**	**-0.5**	**-1.3**	**-0.9**	**0.0**		**-0.4**	**-0.5**	
o/w exceptional financing	0.0	0.0	0.0			0.0	0.0	0.0	0.0	0.0	0.0		0.0	0.0	
PV of external debt 4/	...	...	14.8			13.7	14.6	14.6	14.0	13.6	13.1		14.9	18.3	
In percent of exports	...	...	75.7			68.8	72.1	70.2	65.1	60.2	55.6		72.7	91.6	
PV of PPG external debt	**...**	**...**	**14.8**			**13.7**	**14.6**	**14.6**	**14.0**	**13.6**	**13.1**		**14.9**	**18.3**	
In percent of exports	**...**	**...**	**75.7**			**68.8**	**72.1**	**70.2**	**65.1**	**60.2**	**55.6**		**72.7**	**91.6**	
In percent of government revenues	**...**	**...**	**55.7**			**51.1**	**56.5**	**55.4**	**52.1**	**49.7**	**46.6**		**53.2**	**65.3**	
Debt service-to-exports ratio (in percent)	**0.0**	**2.5**	**4.9**			**3.1**	**0.7**	**-2.5**	**2.6**	**3.4**	**5.1**		**19.3**	**23.5**	
PPG debt service-to-exports ratio (in percent)	**0.0**	**2.5**	**2.4**			**2.4**	**2.5**	**3.0**	**9.0**	**5.8**	**6.4**		**16.9**	**20.7**	
PPG debt service-to-revenue ratio (in percent)	**0.0**	**1.3**	**1.8**			**1.7**	**2.0**	**2.4**	**7.2**	**4.8**	**5.4**		**12.4**	**14.8**	
Total gross financing need (Billions of euros)	0.1	0.0	-0.1			0.2	0.1	0.0	0.1	0.1	0.1		0.4	1.0	
Non-interest current account deficit that stabilizes debt ratio	19.1	20.8	17.0			27.2	20.6	19.9	19.1	17.7	17.1		11.3	14.0	
Key macroeconomic assumptions															
Real GDP growth (in percent)	6.9	2.9	4.0	3.9	2.3	5.3	5.0	4.7	3.4	4.4	4.5	4.6	4.4	4.6	4.5
GDP deflator in euro terms (change in percent)	6.2	-1.3	3.0	0.6	3.1	5.8	3.3	2.2	1.5	1.8	2.3	2.8	2.0	2.0	2.0
Effective interest rate (percent) 5/	0.0	0.8	1.4	0.3	0.5	1.5	1.9	1.9	2.1	2.4	2.4	2.0	4.8	3.8	4.4
Growth of exports of G&S (euro terms, in percent)	11.1	7.5	34.0	16.4	36.9	13.5	10.4	9.8	8.8	11.2	11.2	10.8	5.3	6.7	5.4
Growth of imports of G&S (euro terms, in percent)	18.4	-0.5	17.4	8.2	9.7	20.8	3.0	4.0	2.1	5.3	6.2	6.9	5.0	6.7	5.2
Grant element of new public sector borrowing (in percent)	...	...	...	...	...	34.5	11.0	10.4	5.4	5.4	5.4	12.0	6.9	6.9	7.7
Government revenues (excluding grants, in percent of GDP)	23.8	29.3	26.6			26.8	25.9	26.4	26.9	27.4	28.0		28.1	28.1	28.1
Aid flows (in Billions of euros) 7/	0.0	0.0	0.0			0.0	0.1	0.1	0.0	0.0	0.0		0.0	0.0	
o/w Grants	0.0	0.0	0.0			0.0	0.1	0.1	0.0	0.0	0.0		0.0	0.0	
o/w Concessional loans	0.0	0.0	0.0			0.0	0.0	0.0	0.0	0.0	0.0		0.0	0.0	
Grant-equivalent financing (in percent of GDP) 8/	...	...	...			0.4	1.7	1.5	0.1	0.1	0.1		0.3	0.4	0.3
Grant-equivalent financing (in percent of external financing) 8/	...	...	...			49.6	46.3	59.6	5.4	5.4	5.4		6.9	6.9	7.7
Memorandum items:															
Nominal GDP (Billions of euros)	3.9	3.9	4.2			4.7	5.1	5.4	5.7	6.1	6.5		8.8	16.8	
Nominal dollar GDP growth	13.5	1.6	7.1			11.4	8.4	7.1	5.0	6.3	6.9	7.5	6.5	6.7	6.5
PV of PPG external debt (in Billions of euros)			0.6			0.6	0.7	0.8	0.8	0.8	0.8		1.3	3.1	
(PVt-PVt-1)/GDPt-1 (in percent)						0.5	2.2	1.0	0.1	0.4	0.4	0.8	1.4	1.5	1.4
PV of PPG external debt (in percent of GDP)	...	...	14.8			13.7	14.6	14.6	14.0	13.6	13.1		14.9	18.3	
PV of PPG external debt (in percent of exports)	...	...	75.7			68.8	72.1	70.2	65.1	60.2	55.6		72.7	91.6	
Debt service of PPG external debt (in percent of exports)	...	...	2.4			2.4	2.5	3.0	9.0	5.8	6.4		16.9	20.7	

Sources: Country authorities; and staff estimates and projections.

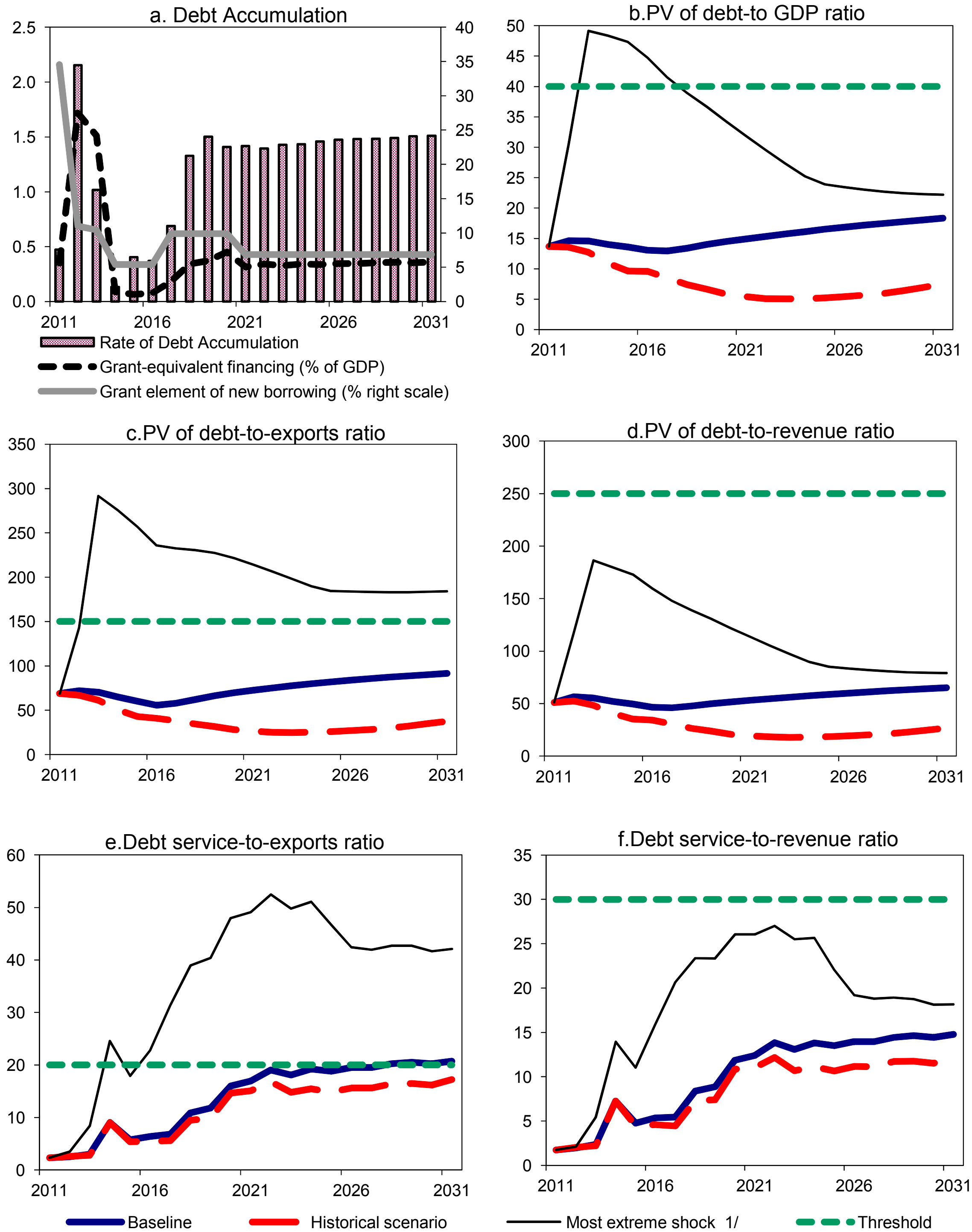
1/ Data on private external debt unavailable.
2/ Derived as [r - g - ρ(1+g)]/(1+g+ρ+gρ) times previous period debt ratio, with r = nominal interest rate; g = real GDP growth rate, and ρ = growth rate of GDP deflator in euro terms.
3/ Includes exceptional financing (i.e., changes in arrears and debt relief); changes in gross foreign assets; and valuation adjustments. For projections also includes contribution from price and exchange rate changes.
4/ Assumes that PV of private sector debt is equivalent to its face value.
5/ Current-year interest payments divided by previous period debt stock.
6/ Historical averages and standard deviations are generally derived over the past 10 years, subject to data availability.
7/ Defined as grants, concessional loans, and debt relief.
8/ Grant-equivalent financing includes grants provided directly to the government and through new borrowing (difference between the face value and the PV of new debt).

Table A2. Kosovo: Public Sector Debt Sustainability Framework, Baseline Scenario, 2008-2031
(In percent of GDP, unless otherwise indicated)

	Actual				Average 5/	Standard Deviation 5/	Estimate	Projections								
	2007	2008	2009	2010			2011	2012	2013	2014	2015	2016	2011-16 Average	2021	2031	2017-31 Average
Public sector debt 1/	25.3	21.4	17.6	16.7			15.3	17.6	20.0	20.5	21.3	21.8		26.1	33.2	
o/w foreign-currency denominated	25.3	21.4	17.6	16.7			14.7	13.4	12.2	11.3	10.3	9.4		4.1	0.0	
Change in public sector debt	-3.4	-3.9	-3.7	-0.9			-1.4	2.3	2.4	0.6	0.7	0.5		0.9	0.6	
Identified debt-creating flows	-21.2	-13.6	0.5	1.7			-3.1	2.5	1.9	0.6	0.4	0.1		0.6	0.2	
Primary deficit	-7.2	0.2	0.7	2.7	-0.6	3.6	4.8	3.4	2.8	1.1	1.1	0.9	2.4	0.9	0.9	0.9
Revenue and grants	26.5	24.5	29.3	27.5			27.0	27.4	27.8	26.9	27.4	28.0	27.4	28.1	28.1	28.1
of which: grants	0.0	0.6	0.0	0.9			0.2	1.5	1.4	0.0	0.0	0.0		0.0	0.0	
Primary (noninterest) expenditure	19.3	24.7	29.9	30.2			31.8	30.8	30.6	28.0	28.5	28.9	29.8	29.0	29.0	29.0
Automatic debt dynamics	-2.3	-3.0	-0.2	-1.0			-1.5	-0.9	-0.7	-0.3	-0.6	-0.7	-0.8	-0.3	-0.7	-0.5
Contribution from interest rate/growth differential	-2.4	-2.1	-0.7	-0.6			-0.8	-0.7	-0.7	-0.4	-0.6	-0.6		-0.3	-0.7	
of which: contribution from average real interest rate	-0.8	-0.5	-0.1	0.0			0.0	0.0	0.1	0.3	0.3	0.3		0.7	0.7	
of which: contribution from real GDP growth	-1.7	-1.6	-0.6	-0.7			-0.8	-0.7	-0.8	-0.7	-0.9	-0.9		-1.1	-1.4	
Contribution from real exchange rate depreciation	0.1	-0.9	0.5	-0.3			-0.6	-0.2	0.0	0.1	0.0	0.0		...	...	
Other identified debt-creating flows	-11.7	-10.8	0.0	0.0			-6.4	0.0	-0.2	-0.2	-0.2	-0.2		0.0	0.0	
Privatization receipts (negative)	-11.7	-10.8	0.0	0.0			-6.4	0.0	-0.2	-0.2	-0.2	-0.2		0.0	0.0	
Recognition of implicit or contingent liabilities	0.0	0.0	0.0	0.0			0.0	0.0	0.0	0.0	0.0	0.0		0.0	0.0	
Debt relief (HIPC and other)	0.0	0.0	0.0	0.0			0.0	0.0	0.0	0.0	0.0	0.0		0.0	0.0	
Other (specify, e.g. bank recapitalization)	0.0	0.0	0.0	0.0			0.0	0.0	0.0	0.0	0.0	0.0		0.0	0.0	
Residual, including asset changes	17.8	9.6	-4.2	-2.6			1.7	-0.2	0.5	0.0	0.3	0.5	0.4	0.4	0.4	0.3
Other Sustainability Indicators																
PV of public sector debt	...	...	...	14.8			13.7	16.1	18.6	19.4	20.3	21.0		23.3	28.0	
o/w foreign-currency denominated	...	...	...	14.8			13.7	14.6	14.6	14.0	13.6	13.1		14.9	18.3	
PV of contingent liabilities (not included in public sector debt)	...	...	...	...			...	...	...	...	...	...		...	...	
Gross financing need 2/	-7.2	0.2	1.0	3.2			5.3	3.9	3.6	3.9	4.0	4.6		7.4	8.5	
PV of public sector debt-to-revenue and grants ratio (in percent)	…	…	…	54			51	59	67	72	74	75		83	100	
PV of public sector debt-to-revenue ratio (in percent)	…	…	…	56			51	62	71	72	74	75		83	100	
o/w external 3/	…	…	…	56			51	56	55	52	50	47		53	65	
Debt service-to-revenue and grants ratio (in percent) 4/	0.0	0.0	1.3	1.7			1.7	1.9	2.9	10.3	10.6	13.2		23.0	27.0	
Debt service-to-revenue ratio (in percent) 4/	0.0	0.0	1.3	1.8			1.7	2.0	3.1	10.3	10.6	13.2		23.0	27.0	
Primary deficit that stabilizes the debt-to-GDP ratio		4.1	4.4	3.6			6.3	1.1	0.4	0.5	0.4	0.4		0.0	0.4	
Key macroeconomic and fiscal assumptions																
Nominal GDP (local currency)	3.4	3.9	3.9	4.2			4.7	5.1	5.4	5.7	6.1	6.5		8.8	16.8	
Real GDP growth (in percent)	6.3	6.9	2.9	4.0	3.9	2.3	5.3	5.0	4.7	3.4	4.4	4.5	4.6	4.4	4.6	4.5
Average nominal interest rate on forex debt (in percent)	0.0	0.0	0.8	1.2	0.3	0.5	1.5	2.1	2.4	2.5	2.5	2.5	2.2	4.6	3.7	4.2
Average nominal interest rate on domestic debt (in percent)	...	...	...	...	…	…	...	...	6.8	6.5	6.1	6.0	6.3	5.8	5.9	5.9
Average real interest rate (in percent)	-2.8	-2.1	-0.4	0.3	-2.0	1.3	-0.1	0.1	0.8	1.4	1.5	1.4	0.8	3.0	2.3	2.7
Average real interest rate on foreign-currency debt (in percent)	-2.7	-2.1	-1.1	-0.9	-2.2	0.8	2.4	2.0	2.0	2.0	2.0	2.0	2.1	2.0	2.0	2.0
Real exchange rate depreciation (in percent, + indicates depreciation)	0.5	-3.8	2.5	-2.0	1.7	3.4	-4.0	...	...	...	...	...	...	...	...	...
Inflation rate (GDP deflator, in percent)	2.3	6.2	-1.3	3.0	0.6	3.1	5.8	3.3	2.2	1.5	1.8	2.3	2.8	2.0	2.0	2.0
Growth of real primary spending (deflated by GDP deflator, in percent)	0.0	36.8	24.8	4.8	7.5	13.6	11.1	1.5	4.1	-5.2	6.2	6.0	3.9	4.5	4.7	4.5
Grant element of new external borrowing (in percent)	...	...	...	...	…	…	34.5	11.0	10.4	5.4	5.4	5.4	12.0	6.9	6.9	7.7

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

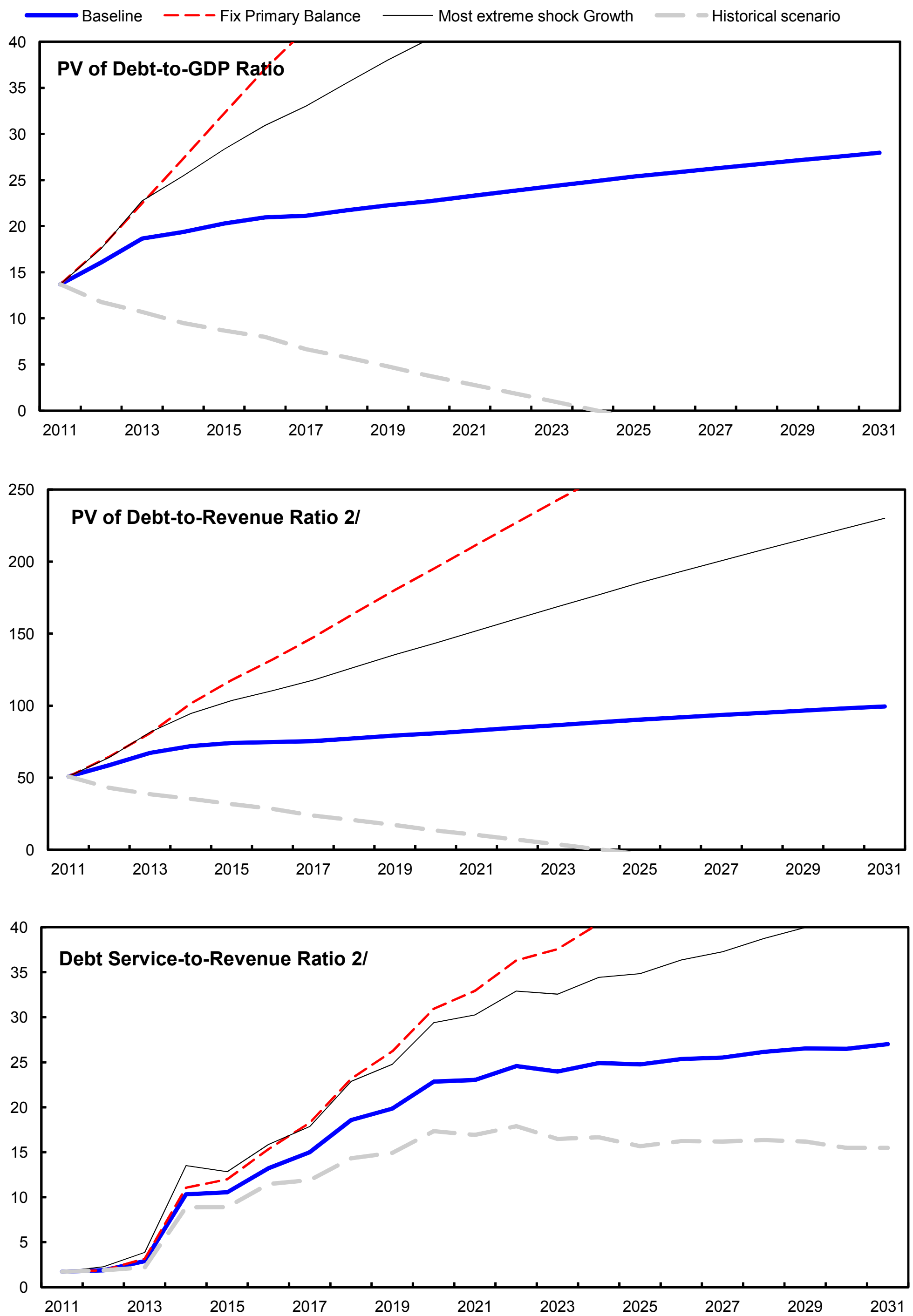
Figure A1. Kosovo: Indicators of Public and Publicly Guaranteed External Debt under Alternatives Scenarios, 2011-2031 1/



Sources: Country authorities; and staff estimates and projections.

1/ The most extreme stress test is the test that yields the highest ratio in 2021. In figure b. it corresponds to a Combination shock; in c. to a Exports shock; in d. to a Combination shock; in e. to a Exports shock and in figure f. to a Combination shock

Figure A2. Kosovo: Indicators of Public Debt Under Alternative Scenarios, 2011-2031 1/



Sources: Country authorities; and staff estimates and projections.
1/ The most extreme stress test is the test that yields the highest ratio in 2021.
2/ Revenues are defined inclusive of grants.

ATTACHMENT I. 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

ATTACHMENT II. 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.

INTERNATIONAL MONETARY FUND

REPUBLIC OF KOSOVO

Staff Report for the 2011 Article IV Consultation and Initiation of a Staff-Monitored Program—Informational Annex

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

June 21, 2011

Contents Page

I. KOSOVO—FUND RELATIONS

Financial Position in the Fund as of May 31, 2011

I. Membership Status: Joined: June 29, 2009.

II. General Resources Account:	**SDR Million**	**%Quota**
Quota	59.00	100.00
Fund holdings of currency	63.60	107.80
Reserve Tranche Position	14.17	24.01
Lending to the Fund		
Notes Issuance		
Holdings Exchange Rate		

III. SDR Department:	**SDR Million**	**%Allocation**
Net cumulative allocation	55.37	100.00
Holdings	55.07	99.47

IV. Outstanding Purchases and Loans:	**SDR Million**	**% Quota**
Stand-by Arrangements	18.76	31.80

V. Latest Financial Arrangements: None

Type	Date of Arrangement	Expiration Date	Amount Approved (SDR Million)	Amount Drawn (SDR Million)
Stand-By	July 21, 2010	Jan 20, 2012	92.66	18.76

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

	Forthcoming				
	2011	2012	2013	2014	2015
Principal			2.35	9.38	7.04
Charges/Interest	0.14	0.29	0.29	0.21	0.06
Total	0.14	0.29	2.63	9.59	7.10

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

VII. Implementation of HIPC Initiative: Not Applicable

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

IX. Safeguards Assessments

The Central Bank of the Republic of Kosovo (CBK) was subject to a safeguard assessment with respect to the Stand-By Arrangement approved on July 21, 2010. The assessment of the

CBK, completed on November 4, 2010, found that key safeguards, concerning external audit and financial reporting frameworks, are in place. Recent revisions to the CBK Law addressed most safeguards concerns with the legal framework. Going forward, internal audit independence requires strengthening through the transfer of incompatible control responsibilities, and the expansion of IT audits. Operational controls have been established over areas of relevance to safeguards, including accounting, banking operations and reserves management. An MOU has been signed to protect the Fund disbursements for budget support.

X. Exchange Arrangements

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

XI. Previous Article IV Consultation

This is the first Article IV Consultation with Kosovo.

XII. Technical Assistance

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

Real Sector

- Multisector Statistics (Oct. 2003, Sep. 2005, Feb 2011)
- National Accounts Statistics (Feb. 2006, Nov. 2006, Mar. 2008, Jul 2008, Sep. 2009, April 2010)

Fiscal Sector

- IT systems and Taxpayer Compliance (HQ Missions: May 2008, Nov. 2009, Feb 2011; expert visits: Feb. 2010 and Feb. 2011)
- Tax Policy and Administration (Oct. 2006, Apr. 2008, Sep. 2008, Oct. 2009, Feb. 2010)
- Fiscal Decentralization (Sep. 2007, Jan. 2010)
- Public Financial Management (May 2007, Mar. 2008, Mar. 2009)
- Tax legislation (several missions Oct. 2006–Mar. 2008).
- Debt Management (Oct. 2006)

Monetary and Financial Sectors

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

External Sector

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

Other

- Preparation for IMF membership (Aug. 2008)

XIII. Resident Representative: Mr. Sulemane took up his post in October 2010.

II. Kosovo: Joint IMF–World Bank Management Action Plan, June 2011–May 2012

Title	Products	Provisional Timing of Missions	Expected Delivery Date
1. Fund work program	First Review SMP	November 2011	November 2011
	Second review SMP	February 2012	February 2012
	TA on tax administration reform	Scheduled for February 2011	Delivered on February 2011
	TA on banknote management	TA schedule for June 2011	July 2011
	TA on stress testing	Follow-up previous TA	[August 2011]
	TA on new banking and microfinance institutions law	Scheduled for [July 2011]	Submission to the Assembly by [September 2011]
	TA to the CBK on BoP estimates	TA scheduled for [September 2011]	[October 2011]
	TA on national accounts	TA scheduled for [October 2011]	[November 2011]
	TA on implementation of new Banking Law	To be scheduled	[To be scheduled]
	TA on Fiscal decentralization	Scheduled for November 2011	November 2011
	TA on public	Ongoing–next two	February and May

Title	Products	Provisional Timing of Missions	Expected Delivery Date
	financial management	TA mission scheduled February and May 2012.	2012
	Revenue administration	One TA mission in February 2012, and four short-term expert visits in June 2011, September 2011, January 2012, and April 2012	One TA mission in February 2012, and four short-term expert visits in June 2011, September 2011, January 2012, and April 2012
	FSAP	January 2012	March 2012
2. Bank work program	Public Sector Modernization Project (PSMP)	Assembly approval on May 6, 2011; effectiveness due by June 20, 2011; project launch workshop and mission in June 2011	Start implementation in June-July 201
	SEDPP	Preparation of SEDPP 2	Board approval expected in September 2012
	Business Environment TA (BETA)	Ongoing	
	TA on and financing of RTGS	Funding for RTGS expected to be available in Q3 2011 and TA to be provided from Q3 2011	Closing date – June 30, 2012
	TA and partial capitalization of DIFK	Funding for capitalization of DIFK expected to be	Ongoing– expected to be completed in 2014

Title	Products	Provisional Timing of Missions	Expected Delivery Date
		available in Q3 2011 and TA to be provided from Q3 2011	
	TA on pension law	Amendments to the pensions law related to the second pillar and the functioning of KPST	Ongoing– expected to be completed in 2012
	FIRST project: technical advisory service to CBK	Ongoing	
	FIRST project: technical advisory service to strengthen insurance regulation and supervision	Ongoing	

III. KOSOVO—STATISTICAL ISSUES

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

2. **The authorities are strengthening official statistics.** A draft of the statistics law is being considered by the Ministry of Public Administration. This will establish a legal framework and determine fundamental principles for the organization, production and publication of official statistics. The law states that official statistics should be reliable, impartial and, in due time, should cover the administrative, demographic, economic, social, health, education, agriculture development. Also, Kosovo joined the GDDS system of the IMF as the 87th member in April 2011.

3. **Improvements have been made to the national accounts, but significant weaknesses remain**. The quality and timeliness of nominal and real GDP data based on the expenditure approach has been improved. GDP data based on the production approach are available, but publication lags are long. Kosovo should also seek to publish GDP on quarterly basis.

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

5. **Data on fiscal flows are reliable and are provided regularly**. Monthly reports on cash basis budget executions of central government and municipalities are provided five weeks after the end of each month. However, budget classification is not consistent with GFSM 2001 because: (i) data is on cash basis, not accrual; (ii) grants are classified as a financing, instead of revenue; (iii) lending for policy purposes (similar to subsidies) is included after calculating the primary balance; (iv) capital transfers should be included in current expenditure instead of capital expenditure; (v) memoranda of understanding (MOU) should be properly classified depending on their final purpose; (vi) annual budget documents should specify both current and capital spending related to individual projects. Looking forward, data on budget execution for municipalities, including grants received from the central government as well as data on social assistance should be provided on a monthly basis. Monitoring of domestic arrears should be strengthened.

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

7. **External sector statistics have improved in recent years.** The CBK provides financial sector information to IFS and also provides quarterly balance of payments data. With technical assistance from STA, the accuracy, periodicity, and timeliness of balance of payments statistics have continued to improve. Nevertheless, external debt statistics have incomplete coverage and are released with delays.

Kosovo: Common Indicators Required for Surveillance

(As of June, 2011)

	Date of Latest Observation	Date Received	Frequency of Data[7]	Frequency of Reporting[7]	Frequency of Publication[7]
Exchange Rates	June 30, 2011	June 30, 2011	D	D	D
International Reserve Assets and Reserve Liabilities of the Monetary Authorities[1]	April 30, 2011	May 26, 2011	M	M	M
Reserve/Base Money	N/A	N/A	N/A	N/A	N/A
Broad Money	April 30, 2011	May 26, 2011	M	M	Q
Central Bank Balance Sheet	April 30, 2011	May 26, 2011	M	M	Q
Consolidated Balance Sheet of the Banking System	April 30, 2011	May 26, 2011	M	M	Q
Interest Rates[2]	April 30, 2011	May 26, 2011	M	M	Q
Consumer Price Index	April 30, 2011	May 19, 2011	M	M	M
Revenue, Expenditure, Balance and Composition of Financing[3] – General Government[4]	April 30, 2011	May 19, 2011	M	M	M
Revenue, Expenditure, Balance and Composition of Financing[3]– Central Government	April 30, 2011	May 19, 2011	M	M	M
Stocks of Central Government and Central Government-Guaranteed Debt[5]	December 31, 2010	May 19, 2011	Q	Q	Q
External Current Account Balance	Dec 31, 2010	March 7, 2011	A	A	A
Exports and Imports of Goods[8]	March 31, 2011	May 24, 2011	M	M	M
GDP[9]	Dec 31, 2008	Nov. 20, 2010	A	A	A
Gross External Debt	December 31, 2010	May 19, 2011	Q	Q	Q
International Investment Position[6]	N/A	N/A	N/A	N/A	N/A

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

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IMF Executive Board Concludes 2011 Article IV Consultation with the Republic of Kosovo

On July 6, 2011, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with Kosovo.[1]

Background

Kosovo enjoyed robust economic growth in the 2000s and weathered the global financial crisis well, owing to limited integration into global financial and goods markets. The economy is expected to grow by more than 5 percent in 2011, up from 4 percent in 2010, supported by continued large remittances inflows from the Kosovar diaspora, robust credit growth, especially to households, and higher public spending, including on infrastructure projects. Inflation follows closely price developments for imported food and gasoline, triggering deflation in 2009 and double-digit inflation in early 2011, but core inflation has remained well-behaved. While credit growth has moderated, banks' portfolio quality has deteriorated only modestly and profits have remained high. Large capital buffers suggest banks—which are mostly foreign owned—have ample shock-absorbing capacity.

While Kosovo pursued a conservative fiscal policy during most of the 2000s, since 2008 the government has moved to an increasingly expansionary stance, financing the resulting deficits from accumulated savings, the sale of assets, and donor support. As a

[1] Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. A staff team visits the country, collects economic and financial information, and discusses with officials the country's economic developments and policies. On return to headquarters, the staff prepares a report, which forms the basis for discussion by the Executive Board. At the conclusion of the discussion, the Managing Director, as Chairman of the Board, summarizes the views of Executive Directors, and this summary is transmitted to the country's authorities. An explanation of any qualifiers used in summings up can be found here: http://www.imf.org/external/np/sec/misc/qualifiers.htm.

result, the general government balance shifted from a surplus of more than 7 percent of GDP in 2007 to a deficit of 2.6 percent in 2010. Capital spending has been the main driver of this expansion. Last year, construction started on a highway connecting Pristina with Albania's border, with total costs estimated at more than 20 percent of annual GDP spread over a period of 4 years. In 2011, the government increased public sector wages and benefits for war invalids and their families by 30 to 50 percent.

An 18-month Stand-By Arrangement (SBA) was approved by the IMF Executive Board on July 21, 2010. The program supported by the SBA was built around (i) restraint on current spending, higher revenues and privatization receipts to contain the impact on the investment program on the overall deficit, and (ii) bolstering the government's deposits with the Central Bank to build buffers for fiscal and financial contingencies. The 2011 budget adopted by the newly constituted Assembly deviated from the budget agreed in the context of the SBA, notably the large public sector wage increases. As a result, no review under the program could be completed.

Executive Board Assessment

Executive Directors welcomed the progress made by the Kosovar authorities in building key social and economic institutions. Nevertheless, further efforts are necessary to enhance competitiveness, ensure fiscal sustainability and safeguard financial stability.

Directors highlighted the need to reorient Kosovo's growth model, especially to address the uncertain prospects of remittances and Foreign Direct Investment (FDI), which have so far supported growth. Going forward, policies should focus on enhancing competitiveness to foster the emergence of a tradable sector that can drive economic development and self-sustained growth, and help reduce unemployment. To this end, it will be critical to upgrade public infrastructure and education, improve the business climate, and maintain competitive wage levels.

Directors noted that while the unilateral adoption of the euro provides a strong monetary anchor, it also increases demands on macroeconomic management. A premium should be placed on disciplined fiscal policies and flexibility to adjust to external shocks.

Directors noted that Kosovo's shift to an expansionary fiscal stance since 2008 was unsustainable. They stressed that improving fiscal management is essential to maintain fiscal sustainability. For the near term, Directors urged disciplined budget execution and public financial management. This should include prudent wage policies, and a careful design and sequencing of social and capital spending initiatives, with thorough assessments of the resulting fiscal costs and compensating savings measures as needed. Over the medium term, it will be critical to reorient fiscal priorities, including by raising more revenue from direct taxes.

Directors welcomed the progress on developing Kosovo's financial system. They noted that a strong institutional framework, especially improved legal capacity and defined property rights, will be crucial to safeguard financial stability. Passage of the new banking law will be an important step in this direction. Building the capacity to provide emergency liquidity assistance to the banking system is also a priority and the authorities should undertake measures to make this operational.

Directors welcomed the agreement reached on the staff-monitored program (SMP). They underscored that steadfast implementation of policies under the SMP would allow Kosovo to take decisive steps towards ensuring fiscal sustainability and pave the way for a future Fund-supported program.

Kosovo: Main Indicators, 2008-12

	2008	2009	2010	2011	2012
			Est.	Projections	
Real growth rates					
GDP	6.9	2.9	4.0	5.3	5.0
GDP per capita	5.3	1.4	2.5	3.7	3.4
Consumption	4.3	1.0	2.7	2.7	2.9
Investment	18.1	10.1	5.2	13.3	6.6
Exports	4.7	8.9	30.1	7.2	6.9
Imports	5.9	4.7	11.0	5.5	2.6
Price changes					
CPI, period average	9.4	-2.4	3.5	8.3	2.6
CPI, end of period	0.5	0.1	6.6	6.2	1.9
GDP deflator	6.2	-1.3	3.0	5.8	3.3
Real effective exch. rate (average; -=depreciation)	3.2	-1.0	-0.7	…	…
Real effective exch. rate (end of period; -=depreciation)	0.2	-1.0	0.9	…	…
General government operations (percent of GDP)					
Revenues, incl. interest income 1/	24.5	29.3	27.8	27.1	27.5
Primary expenditures	24.7	29.9	30.2	31.8	30.8
Of which					
Wages and salaries	5.9	6.8	7.4	8.3	7.9
Subsidies and transfers	7.1	7.3	6.4	6.3	6.4
Capital and net lending, incl. the highway	7.6	11.6	12.0	13.0	12.3
Capital expenditures on the highway 2/	…	…	2.9	5.3	5.8
Overall balance	-0.2	-0.7	-2.6	-5.0	-3.5
Debt financing, net	0.0	-0.2	0.3	0.2	1.5
Privatization	0.0	0.0	0.0	6.4	0.0
Stock of government bank balances	10.8	8.7	5.8	6.5	5.8
Recommended minimum bank balances	…	…	5.8	7.6	5.8
Financing gap	0.0	0.0	0.0	0.0	1.8
Savings-investment balances (percent of GDP) 3/					
Domestic savings	-12.6	-7.4	-7.1	-7.3	-5.0
Transfers excluding general government (net)	14.0	11.9	12.6	12.1	12.1
Net factor income	4.3	2.3	3.0	2.6	2.9
National savings	5.8	6.8	8.5	7.4	10.0
Investment	28.6	31.8	33.5	37.8	36.6
Current account, excl. official transfers	-22.8	-25.0	-24.9	-30.4	-26.6
Balance of payments (percent of GDP)					
Current account balance, incl. official transfers	-15.2	-17.2	-16.3	-25.0	-20.5
Of which: official transfers 4/	7.6	7.8	8.6	5.5	6.0
Net foreign direct investment	8.9	7.0	7.4	15.2	7.2
Portfolio investment, net	1.7	-1.4	-5.5	-3.0	-1.6
Banking sector (percentage change)					
Bank credit to the private sector	32.7	8.9	12.6	12.9	11.0
Deposits of the private sector	25.8	22.2	23.1	12.0	11.3
Non-performing loans (percent of total loans)	3.3	4.3	5.2	5.9 5/	…
GDP (millions of euros)	3,851	3,912	4,192	4,672	5,066
GDP per capita (euros)	1,785	1,786	1,886	2,070	2,212

1/ Projections assume grants of EC and IDA.
2/ Based on World Bank estimates.
3/ Savings-investment of the economy including donor sector
4/ Excluding capital transfers
5/ March 2011.