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Kosovo and the IMF

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July 15, 2013

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Kosovo: Letter of Intent, Memorandum of Economic and Financial Policies, and Technical Memorandum of Understanding

June 28, 2013

The following item is a Letter of Intent of the government of Kosovo, which describes the policies that Kosovo intends to implement in the context of its request for financial support from the IMF. The document, which is the property of Kosovo, is being made available on the IMF website by agreement with the member as a service to users of the IMF website.

Kosovo: Letter of Intent

Pristina, June 28, 2013

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

Dear Ms. Lagarde:

1. Following modest growth in 2012, Kosovo's economy developed unevenly in the early months of 2013, with stronger activity in the first quarter but signs of a renewed slowdown more recently, roughly in line with developments in the euro area. The banking system continues to be well-capitalized and liquid, with non-performing loans remaining the lowest in the region. We remain vigilant to risks, including from deteriorating economic conditions in the host countries of Kosovar Diaspora that could negatively affect both growth and the banking system. As such, we remain committed to disciplined fiscal management, rebuilding of an adequate level of government bank balances, further strengthening of the legal and regulatory framework for Kosovo's financial system, prudent financial supervision, and structural reforms to boost competitiveness.

2. Implementation of our economic program has remained broadly consistent with our commitments under the Stand-By Arrangement (SBA; Tables 1 and 2):

- All *quantitative performance criteria* for end-April and all *continuous performance criteria* were met. The primary fiscal balance was stronger than programmed by €45 million, as a shortfall in revenue collection was overcompensated by under-execution of spending, especially the capital expenditures. The floor on government bank balance was exceeded by €72 million. Both the general government's primary expenditures and the net contracting of non-concessional debt remained below program ceilings.

- All end-May *structural benchmarks* were met:

(i) On May 28, the Minister of Finance approved the amended financial rules of the Treasury to ensure the recording of all payment-related documents within 3 days in the IT system.

(ii) On May 24, the Executive Board of the CBK approved an instruction to pay ex-ante for legal representation when staff is sued for carrying out official duties in good faith.

(iii) On May 28, we completed a draft administrative instruction for a rule-based setting of minimum wage levels and sent it to IMF staff.

(iv) The *indicative (zero) targets* for domestic payment arrears of the central and general government were missed by modest amounts, but corrective action is being taken.

(v) We also met the continuous structural benchmark on monthly meetings of our Program Monitoring Committee. The continuous structural benchmark on fiscal impact assessments evaluating the budgetary impact of all new benefit creating laws and amendments to such laws over a period of at least 5 years was not fully met in the context of the mid-year budget review, but corrective action is being taken (¶9).

3. Based on this performance, we request completion of the fourth review under the Stand-By Arrangement. We intend to treat the Stand-By Arrangement as precautionary in 2013, and therefore intend not to draw the amount that we would be entitled to purchase with the completion of this review. Quantitative performance criteria and indicative targets through end-August 2013 are set out in Table 2 and in the Technical Memorandum of Understanding, both attached to this letter.

4. We believe that the policies set out in the letters of April 12, 2012, June 27, 2012, December 5, 2012, April 8, 2013 and in this letter are adequate for successful implementation of the program. However, the government stands ready to take additional measures as appropriate to ensure achievement of the program's objectives. As is standard under all IMF arrangements, we will consult with the IMF before modifying measures contained in this letter or before the adoption of new measures that would deviate from the goals of the program, in accordance with the Fund's policies on such consultations, and provide IMF staff with the necessary information for program monitoring. The fifth review is expected to be completed after October 28, 2013. The understandings between us and the IMF regarding program criteria and structural measures described in this letter are further specified in the Technical Memorandum of Understanding. We authorize the IMF to publish this letter and the associated staff report.

I. Macroeconomic Outlook

5. The macroeconomic framework underpinning our program is based on prudent assumptions, with a view to minimizing the risk of downward revisions during the program period.

- *Real GDP growth* is expected to strengthen somewhat but remain below potential, reflecting largely still subdued conditions in the host countries of the Diaspora. Still, we expect growth to be higher than in most Western Balkan economies. We also expect a modest contribution from a recovery in exports. The main risk to the outlook is a possible deterioration in economic conditions in Diaspora host countries.

- Annual average *consumer price inflation* is expected to moderate to around 2 percent, reflecting mostly lower global food and fuel prices.

- *The trade deficit* for 2013 is estimated to remain roughly stable, as recoveries in both imports and exports are expected to roughly balance one another out.

II. Fiscal Policy

A. 2013 Budget Execution

6. In the first four months of 2013, budget implementation has been broadly in line with our program.

a. *Revenue collection* was short of program projections by €14 million, owing to (i) a shortfall in border tax collection of €10 million, (ii) the non-receipt of a royalty from the electricity company KEK of €7.2 million that is likely to translate into an end-year shortfall of about €4 million (as a portion of the royalty accrued in 2013 may be paid only in early 2014), and (iii) the non-receipt of revenues from the sale of telecommunications licenses for which we expected to collect €20 million (now expected for the last quarter of 2013). On the upside, collection of domestic taxes and fees exceeded the program projection by €7 million, and the government received a dividend from the telecommunications company (PTK) of €15 million earlier than originally planned, but this did not suffice to compensate for the shortfall. Moreover, in May we observed a further shortfall in border tax revenue of about €10 million relative to plan, arguably reflecting a mix of weaker imports and a decline in import prices.

b. Execution of *budget expenditures* through end-April was lower than expected by about €60 million. While execution of the capital budget was €72 million below the original program projections, subsidies and transfers exceeded program projections by €12 million, due to subsidies for KEK's import of electricity and other publicly owned enterprises, where a significant part of the full-year budget allocation has already been exhausted.

7. In April, we announced a purchase agreement for PTK, with a gross sales price of €277 million. The transaction is expected to be settled in September or October—although the legal framework allows settlement until December—which would bring the level of usable bank balance above a fully adequate level.

8. We continue to target a primary deficit (excluding PAK-related expenditures) of no more than €155 million (3 percent of GDP) for 2013. To achieve this target despite the revenue shortfall accumulated to date, we are taking the following corrective actions, yielding budgetary savings of €24 million:

a. We have already secured an additional PTK dividend of €10 million (in addition to the €30 million in PTK dividends already foreseen in the 2013 budget). Further, we have secured a dividend of €3 million from the electricity transmission company KOSTT that will be transferred to the budget by end-July 2013.

b. On June 17, we issued a government decision to not allocate €11 million from the 2013 budget, with the following breakdown of savings across expenditure categories: €3.1 million in goods and services, €5.9 million in capital spending, and €2.0 million in subsidies and transfers (prior action).

c. We have received the first installment of €5.8 million of the KEK royalty payment in June, and will secure additional royalty payments of €4.2 million by end-September. KEK's management commits to transferring any royalty it collects promptly to the treasury.

In the event that additional revenue shortfalls would emerge later in the year, we stand ready to take further measures as needed to safeguard compliance with the end-2013 primary deficit target.

9. On June 18, we submitted the mid-year budget review to the assembly. Prior to submission, we committed to the review being in line with the following principles (prior action):

a. New spending initiatives would be limited to (i) new projects funded by World Bank loans, (ii) costs related to the creation of two new municipalities by end-year, and (iii) costs related to the implementation of the recent agreement with Serbia. The initiatives would be funded from internal budget savings.

b. Reallocations across spending categories (goods and services, transfers and subsidies, wages and salaries, and capital spending) would be limited to €10 million at the central government level. There might also be reallocations for municipalities from own-source revenues that were expected to not exceed €5 million.

c. We would not increase the budget allocation for wages and salaries excluding civil service reform, and neither the budget allocations for railway, telecommunication, energy, or subsidies to other publicly owned enterprises, in line with the legal framework.

The review submitted to the assembly was broadly consistent with these principles. However, it included the re-allocation of €2 million from energy subsidies to a thus far unspecified benefit for erstwhile political prisoners for which a fiscal impact assessment has not yet been conducted. The assembly committee for budget and finance will amend the mid-year budget review after the first reading in the assembly and no later than July 5, 2013, specifying that the spending allocation for erstwhile political prisoners will be executed only after completion of a fiscal impact assessment that covers a period of five years and includes a verification of beneficiaries. We will transmit the minutes documenting this decision to IMF staff no later than July 5. Further, we will execute the allocation on erstwhile political prisoners only after the impact assessment has been reviewed by IMF staff.

B. Rule-Based Fiscal Framework

10. Draft amendments to the Law on Public Financial Management and Accountability (LPFMA), were submitted to the Assembly on March 29, 2013. The amendments establish a rules-based fiscal framework, consistent with the parameters set in our Letter of Intent for the third review of April 8, 2013 (¶10). The Assembly proceeded without delay with the first reading. The second reading and

final parliamentary vote on the legislation is planned for early July 2013, to ensure that the framework is binding for the 2014 budget.

C. Highway R6

11. We reiterate our commitments with respect to the preparation of the planned highway R6 to Macedonia (LOI December 5, 2012, ¶10 and LOI April 8, 2013, ¶¶8, 9). While R6 is a priority project, serving to integrate Kosovo further into the network of regional highway in South-Eastern Europe, it needs to be managed carefully to limit risks to the public finances and safeguard economic viability. Commitments include:

a. Integrating R6 into a sustainable budgetary framework. This includes a level of the usable government bank balance of at least €300 million prior to entering into contractual commitments with respect to R6.

b. Ensuring economic viability. To this end, while we will tender R6 as one project, we will procure the mountainous section close to the Macedonian border as a design-and-build contract, while the northern section will be procured as a standard works contract.

c. Transparent and competitive bidding.

D. The 2014 Budget

12. Preparation of the 2014 budget will be guided by the rules-based fiscal framework. In addition, the 2014 budget submitted to the assembly will be in line with the following parameters (structural benchmark for end-October):

a. For end-2013, we expect a considerable excess bank balance relative to the floor set by the rules-based fiscal framework, owing in particular to the completion of PTK privatization. While the rules-based framework would allow us to draw down cash balances to 4½ percent of expected end-2014 GDP, we will preserve a substantial excess cash buffer, given that highway R6 to Macedonia will absorb substantial budgetary resources also in future years, and given upcoming IMF repurchases. Specifically, the end-2014 usable bank balances inscribed into the 2014 budget will be at least the average of (i) the minimum level allowed by the rules-based fiscal framework and (ii) the expected level of the usable bank balance at end-2013. In the unlikely case that, by October 2013, we expect the end-2013 bank balance to be less than 4½ percent of GDP, the 2014 budget will contain a plan to restore the bank balance.

b. Current spending (program definition) will not exceed €1050 million.

c. New issuance of T-bills in 2014 budget will not exceed €120 million.

E. Other Fiscal Issues

13. Careful planning of spending initiatives is at the core of our efforts to improve public financial management. To this end, the introduction of all new laws and regulations or amendments to laws or regulations with fiscal implications will continue to be preceded by a fiscal impact assessment covering a period of at least 5 years (continuous structural benchmark). This provision includes (i) the recently approved parliamentary resolution to count years during which teachers were forcibly removed from the workplace in the 1990s toward qualification for the supplementary pension, and (ii) the possible creation of additional beneficiary groups under the law for war-related categories. In both cases, no budgetary allocation will be made before a thorough fiscal impact assessment has been conducted.

14. We have made further progress with the implementation of our action plan to improve recording and monitoring of payment obligations. On May 28, we amended relevant internal financial rules of the Treasury to ensure the recording of all payment-related documents within 3 days in our IT system, in line with the end-May structural benchmark. From June, the Treasury will conduct a publicity campaign to inform all stakeholders, including the regulatory commission for public procurement (RCPP), about the amended rules and the consequences of noncompliance. To minimize risk to private companies involved with public procurement, the RCPP will, by end-August, issue an administrative instruction to amend all draft tender contracts. The draft tender contracts will then detail the key documents required by the budget organizations to ensure the contracts' validity. Planned upgrades to the IT system will support implementation of these rules by generating automatic reports—that would be accessible to the Auditor General (AG)—detailing the degree of budget organization's non-compliance. The Treasury will use these reports to actively monitor payment obligations, detect early non-compliance problems, request AG audits, and ensure timely execution of legitimate outstanding payment obligations.

III. Financial Sector Policies

15. Bank financial soundness indicators have remained stable since the third review. Non-performing loans decreased slightly to 7.7 percent at end-April (from 7.8 at end-January), while banks' profitability declined somewhat. The aggregate banking system's capital adequacy ratio (CAR) decreased slightly to 14.8 percent (from 14.9 at end-January) as risk-weighted assets grew faster than profits.

16. We remain vigilant of banks' risks and committed to ensuring compliance with prudential rules and strengthening supervision. In April, the CBK issued an amendment to the credit risk management regulation that grants banks more flexibility to prudently reschedule loans to borrowers with payment arrears (i.e., banks should *not* reschedule to avoid appropriate classification and provisioning, but should align loans with the payment capacity of the borrowers). We plan amending the advisory letter on credit risk management to give more guidance to banks on the expected standards. The CBK will enhance off-site monitoring and conduct focused on-site examinations of rescheduled loans. Further, we will conduct a focused examination of the adequacy

of provisions for assets other than loans, as these are not covered by specific provisioning requirements.

17. As of end-April, banks have mostly brought related lending within the new legal limit set by the Banking Law. The CBK will take measures as needed in order to bring end-June capital levels of these banks in compliance with capital requirements. The CBK will conduct focused on-site inspections of capital adequacy requirements of banks in August 2013.

18. We have continued to work on implementing key FSAP recommendations.

a. In line with our commitment in the April LOI, on May 24 the CBK Executive Board approved a By-Law on paying ex-ante for legal representation when staff, agents, or members of the decision-making bodies of the CBK are sued for carrying out official duties in good faith.

b. In May, the CBK, Ministry of Finance (MOF), and the Parliamentary Committee on Budget and Finance, amended the tri-partite Memorandum of Understanding (MOU) on Financial Stability Cooperation. The MOU clarifies that the CBK would make the emergency liquidity assistance (ELA) facility for solvent banks fully operational in case of need, but would refrain from granting ELA to insolvent banks without an explicit government guarantee.

c. The CBK has solicited the view of banks on a bank-financed premium for ELA, and requested TA from the IMF to strengthen the crisis management framework (including on instituting a bank premium as well as contingency planning). The Deposit Insurance Fund (DIFK) has discussed with the technical staff of the MOF the size and options for extraordinary funding arrangements.

d. The CBK has requested TA from the IMF to move to more risk-based supervision, as well as on macro modeling and enhancing stress testing, to support the development of a macroprudential policy framework. The CBK has also drafted the terms of reference for a macroprudential policy advisory committee.

19. Looking ahead, we will take the following next steps to further progress with implementing key FSAP recommendations—particularly to strengthen the crisis management framework and the institutional underpinning of financial soundness:

a. Upon receiving a renewed request from DIFK, and on the recommendation of the Central Bank, the Ministry of Finance will submit a request to financial institutions for providing a stand-by arrangement to DIFK—i.e., a credit line of €10 million—to the assembly by September 2013. Such a pre-arranged borrowing agreement is also foreseen under the facility with the donors that provided part of DIFK's seed capital.

b. The CBK will draft amendments to the ELA regulation and instructions on providing ELA to solvent banks in line with FSAP recommendations, to discuss them with the planned IMF TA mission on crisis management.

c. The CBK will review the overall bank liquidity risk framework and profile; e.g., level of required reserves, liquidity risk requirements, arrangements related to the special reserves fund (SRF) for ELA, in cooperation with planned IMF TA. On this basis, it will propose a target size for the SRF, in line with its duties outlined in the financial stability MOU. Options for operationalizing a bank premium or quota to ensure the sufficiency of the SRF will be developed jointly with IMF TA.

d. The CBK will discuss with the Ministry of Justice and Kosovo Judicial Council preparations to establish a special department in the basic courts to deal with banking issues. This should support more timely and effective resolution of NPLs, and thus banking system soundness.

20. Also in line with the MOU on financial stability cooperation, the CBK, MOF, and Parliamentary Committee on Budget and Finance will appoint deputies to the National Council on Financial Stability and Crisis Management. Starting with the third quarter of 2013, the Council will meet at least once every three months. The Council will establish an action plan and working groups to address the key FSAP recommendations on strengthening the crisis management framework. For the remainder of the year, these include drafting regulation to address technical shortcomings in the bank resolution framework, assessing the legal powers to establish a bank premium or quota for ELA, as well as incorporating contingency planning arrangements into the cooperation MOU. Where relevant, the DIFK will be involved in the arrangements.

IV. Competitiveness and Structural Reforms

21. We have prepared a draft proposal for a rules-based framework for setting minimum wages, in line with the corresponding end-May structural benchmark, and have discussed the draft with World Bank and IMF staff. By end-August, the government will issue a corresponding administrative instruction with the following elements (structural benchmark):

a. An annual review of monthly minimum wage levels will be conducted at end-December. Changes to minimum wage levels will be considered only if (i) CPI inflation published by the statistical agency of Kosovo (12-months average, October-over-October) exceeds two percent, and (ii) the appreciation of the real effective exchange rate published by the CBK does not exceed 0.5 percent (12-months average, October-over-October).

b. In case a change in the minimum wage level will be considered, the percentage change will be an average of (i) the percentage change in the CPI index excluding transport fuel and food prices, and (ii) the percentage change in average private sector wages as reported to the tax administration of Kosovo.

c. The percentage change will be applied to the average of the minimum levels for each age category.

d. The rule will be applied retroactively to 2012 and 2013. To ensure that the rule remains up-to-date, the minimum wage formula can be reviewed every three years based on a rigorous analysis of labor market conditions and discussions with relevant bodies.

22. We have continued to make progress with implementing our SME development strategy. There are two ongoing projects aiming at improving SMEs' access to finance and enhancing their international competitiveness:

a. The first project—supported by the Austrian Development Cooperation, the Swiss Development Cooperation, USAID, and other donor institutions—aids business support needs through a voucher counseling scheme, and their financing needs through a credit guarantee scheme. The latter is being negotiated with commercial banks and expected to be operational in March 2014.

b. The second project—with a budget of €4 million funded by the European Commission (€3 million) and by the Ministry of Trade and Industry (MTI) (€1 million)—provides grants for export-oriented SMEs to improve technology, increase production lines and export capacity, as well as to SMEs producing import substitution goods. Call for proposals will be launched in September, and the first set of grants is expected to be disbursed by end-year.

23. We continue with investment promotion through a recently launched IFC project that targets labor-intensive low- to medium-skilled sectors. Further, we are working on initiatives to (i) amend during the course of the summer the law on foreign investment to provide Kosovar investors (with double nationality) the same level of protection as foreign investors, thus encouraging Diaspora FDI, and (ii) finalize a law on licensing and permits with the objective of avoiding unnecessary bureaucratic requirements.

Sincerely yours,

/s/
Hashim Thaçi
Prime Minister

/s/
Besim Beqaj
Minister of Finance

/s/
Bedri Hamza
Governor, Central Bank of the Republic of Kosovo

Table 1. Kosovo: Quantitative Performance Criteria and Indicative Targets, 2012–13

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

	2012						2013			
	End-Apr.		End-Aug.		End-Dec.		End-Apr.			End-Aug.
	Prog.	Actual	Prog.	Actual	Prog.	Actual	Prog.	Adj. Prog.	Actual	Prog.
Performance Criteria 1/										
Floor on the bank balance of the general government 2/	166	180	237	281	205	216	160	160	232	171
Floor on the primary fiscal balance of the general government 2/, 3/	-21	4	-19	6	-112	-113	-36	-37	9	-94
Ceiling on primary expenditures of the general government 3/	399	353	911	842	1,490	1435	448	448	388	1005
Ceiling on the net contracting of nonconcessional debt by the general government 3/	150	30	150	49	150	73	150	150	20	150
Ceiling on guaranteeing nonconcessional debt by the general government 3/	0	0	0	0	0	0	0	0	0	0
Ceiling on the accumulation of external payments arrears of the general government 4/	0	0	0	0	0	0	0	0	0	0
Indicative Targets										
Ceiling on the stock of domestic payment arrears of the central government	0	2	0	0	0	3	0	0	1	0
Ceiling on the stock of domestic payment arrears of the general government	0	2	0	3	0	5	0	0	5	0
Memorandum items:										
Program assumptions										
Repayment of policy loans extended to public corporations	...	4	4	4	4	4	2	2	2	4
Non-project grants	4	1	37	37	37	37	0	0	0	0
Budget support loans	0	0	0	0	0	0	0	0	0	0
Project grants	1	0	3	0	0	0	1	0	0	2
Project loans	0	0	6	0	7	7	1	2	2	3
PAK-related spending	...	...	5	4	8	6	2	2	1	5

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

1/ Adjusted according to the Technical Memorandum of Understanding.

2/ The end-August and end-December, 2012, and end-April, 2013 PCs have been adjusted to reflect higher than expected budget grants relative to program assumptions, as specified in the TMU.

3/ Excluding PAK related spending from August 2012.

4/ Continuous ceiling on the gross flow of new accumulation.

Table 2. Kosovo: Program Monitoring

	Program Approval	First Review End-April 2012	Second Review End-August 2012	Third Review End-December 2012	Fourth Review End-April 2013
Performance criteria					
Floor on the bank balance of the general government	...	Met	Met	Met	Met
Floor on the primary fiscal balance of the general government	...	Met	Met	Missed	Met
Ceiling on primary expenditures of the general government	...	Met	Met	Met	Met
Ceiling on the net contracting of nonconcessional debt by the general government	...	Met	Met	Met	Met
Indicative targets					
Ceiling on the stock of domestic payment arrears of the central government	...	Missed	Missed	Missed	Missed
Ceiling on the stock of domestic payment arrears of the general government	...	Missed	Missed	Missed	Missed
Prior actions					
Passage of the Pension Fund Law in a version that limits (i) exposure of the pillar II pension fund to the government to 30 percent of the fund's assets and (ii) annual investments of the fund in government paper to 50 percent of inflows into the fund in the previous calendar year	Met	...	...	...	...
Passage of the revised Banking and Microfinance Law in a version consistent with the recommendations of IMF technical assistance	Met	...	...	...	...
Issuance of a government decision that specifies spending cuts of €20 million across expenditure categories relative to the approved 2012 budget	Met	...	...	...	...
Passage of the 2013 Budget Law by the Assembly, consistent with the objectives of the program.	...	...	Met	...	...
Issuance of a government decision that specify spending cuts of €11 million across spending categories relative the the approved 2013 budget (by June 25, 2013).	...	...	...	...	Met
Submission of the 2013 Mid-Year Budget Review to the Assembly consistent with ¶9 of the Letter of Intent (by June 25, 2013).	...	...	...	...	Missed 2/
Structural benchmarks					
Publication of budget circulars for municipalities that contain no limits on spending allocations across non-wage categories (by end-May, 2012)	...	Met	...	...	...
Submission of a revised Deposit Insurance Fund Law to the Assembly that is consistent with the new Banking and Microfinance Law (by end-May, 2012)	...	Met with delay	...	...	...
Amendment of the Law on Public Financial Management and Accountability by a provision that specifies that only the central bank can dispose over the funds in the Special Reserves Fund designated for Emergency Liquidity Assistance (by June 15, 2012)	...	Met	...	...	...
Launch of the tender offer for PTK (by end-August, 2012)	...	...	Met with delay	...	...
Submission of the 2013 Budget, consistent with the objectives of the program, to the Assembly (by end-October).	...	...	Met	...	...
Submission of an economic viability study for highway R6 to the World Bank and IMF staff (by end-January, 2013)	...	...	...	Missed 3/	...
Submission of legislation to the assembly on the Rules-Based Fiscal Framework that is consistent with ¶11 of the Letter of Intent as of Dec 5th, 2012 (by end-March 2013).	...	...	...	Met	...
Approval of the amended financial rules 02 and 04 of the Treasury to ensure the recording of all payment-related documents within 3 days in the IT system (by End-May 2013) 3/	...	...	...	...	Met 4/
Approval by CBK's Executive Board of an instruction to pay for legal representation of staff when they are sued for carrying out official duties in good faith (by End-May 2013)	...	...	...	...	Met
Drafting of secondary legislation to provide for a more rules-based treatment of setting minimum wage levels (by end-May 2013)	...	...	...	...	Met
Continuous structural benchmarks					
Monthly meetings of the Program Monitoring Committee and transmission of meetings' minutes to the IMF	...	Met	Met	Met	Met
Inclusion of a paragraph into all new benefit creating laws, amendment to laws or regulations that allows cutting benefits if budgetary funds are unavailable 1/	...	Missed	...	...	...
Fiscal impact assessments evaluating the budgetary impact of all new benefit creating laws, amendments to such laws or regulations over a period of at least 5 years	...	Met	Met	Met	Missed 2/

1/ Eliminated after the first review following a corresponding amendment of the Law on Public Financial Management and Accountability.
2/ The 2013 Mid-Year Budget Review contained a spending allocation for an unspecified benefit to erstwhile political prisoners without prior compilation of a fiscal impact assessment.
3 /The study was submitted on time, but did not contain all the elements defined in the LOI of December 2012.
4 /The amended financial rules have been renumbered rules 01 and 02.

Table 3. Kosovo: Structural Conditionality	
Actions	**Timing**
Structural benchmarks	
Issuance of an administrative instruction to provide for a rules-based setting of minimum wage levels consitent with ¶21 of the Letter of Intent.	End-August 2013
Submission of a 2014 budget to the Assembly consistent with ¶12 of the Letter of Intent.	End-October 2013
Monthly meetings of the Program Monitoring Committee and transmission of meetings' minutes to the IMF.	Continuous
Fiscal impact assessments evaluating the budgetary impact of all new benefit creating laws, amendments to such laws or regulations over a period of at least 5 years.	Continuous

Kosovo: Technical Memorandum of Understanding

Definitions and Data Reporting Requirements under the 2012–13 Stand-By Arrangement

1. This Technical Memorandum of Understanding (TMU) sets out the understandings between the Kosovo authorities and the IMF staff regarding the definition of quantitative performance criteria and indicative targets, and reporting requirements for the Stand-By Arrangement ("SBA") requested in April 2012.

I. Performance Criteria and Indicative Targets

A. Coverage

2. For the purpose of this memorandum, the central government is composed of the Executive, the Legislative, and Judiciary branches of the Government, and any other public authorities except municipalities that receive direct budgetary appropriations. The general government includes the central government and municipalities. Both the central and the general government exclude publicly-owned enterprises and socially-owned enterprises.

3. Performance Criteria and Indicative Targets. The performance criteria, indicative targets, and their respective test dates are set in Table 1 of the 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 including emergency liquidity assistance but do not include the balance of unspent Own Source Revenues (OSR) carried forward, or funds encumbered or pledged as Donor Designated 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 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 were € 159.986 million at December 31, 2011, and € 215.587 million at December 31, 2012.

- The floor on the bank balance set in Table 2 will be raised by
    - the excess of budget grants and loans relative to program assumptions
    - the excess of privatization proceeds, including from the telecommunication company (PTK) and the receipt of transfers from the Privatization Agency of Kosovo (PAK) relative to program assumptions

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. Expenditures of the Privatization Agency of Kosovo (PAK) are excluded. 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 2 will be raised by the excess of project grants and loans relative to program assumptions.

- The ceiling on primary expenditures set in Table 2 will be lowered by

    - the shortfall of project grants and loans relative to program assumptions.

    - the repayment of loans extended to public corporations in excess of 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 Root 6, and including domestically and budget support financed capital expenditure and externally project financed

capital expenditure; (vi) the gross payment and gross accumulation of domestic payments arrears; (vii) external loan receipts and principal payments; (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. Expenditures of the Privatization Agency of Kosovo (PAK) are excluded. Revenues do not include privatization receipts.

- The floor on the primary fiscal balance set in Table 2 will be lowered by the excess in project loans relative to program assumptions.

- The floor on the primary fiscal balance set in Table 2 will be raised by

    - the shortfall in project loans relative to program assumptions

    - the excess in budget grants relative to program assumptions.

E. Contracting and 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 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).

11. The ceilings on contracting and on guaranteeing nonconcessional debt cover both domestic and external debt, but exclude purchases from the IMF and the sale of the SDR holdings allocated to Kosovo. Debt rescheduling and debt reorganization of debts contracted before the approval of the SBA are excluded from the limits on nonconcessional debt. The quantitative performance criteria apply 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.

12. 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 performance criterion.

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

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

14. **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

15. 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 obligation has remained unpaid for more than 60 days after the invoice was received. A payment obligation is defined to be domestic if the creditor is resident in Kosovo.

16. **Reporting requirements.** The Ministry of Finance will submit a monthly table with the stock of domestic payments arrears. The data are to be provided within five weeks after the end of the month.

G. External Payments Arrears

17. **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.

18. **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

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

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

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

22. The table of Financial Soundness Indicators and the regulatory capital and liquidity ratios 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.

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