International Monetary Fund

Republic of Kosovo
and the IMF

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April 24, 2013

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Republic of Kosovo: Letter of Intent, and Technical Memorandum of Understanding

April 8, 2013

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Republic of Kosovo: Letter of Intent

Pristina, April 8, 2013

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

Dear Ms. Lagarde:

Kosovo's economy has continued to grow at healthy rates, notwithstanding an economic slowdown during the second half of 2012 related to developments in Europe. In particular, exports have been weaker and reduced capital inflows as well as constrained credit have provided less support for domestic demand. Nevertheless, the banking system continues to be well-capitalized and liquid, despite slower credit growth and an increase in nonperforming loans. In this difficult external environment, we remain committed to disciplined fiscal management, safeguarding an adequate level of government bank balances, strengthening the legal and regulatory framework for Kosovo's financial system, prudent financial supervision, and structural reforms to boost competitiveness.

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

- most *quantitative performance criteria* for end-December were met.
    - (i) The floor on government bank balance was exceeded by €11 million.
    - (ii) Both the general government's primary expenditures and the net contracting of nonconcessional debt remained below program ceilings.
    - (iii) However, the primary fiscal deficit exceeded the program target by a miniscule amount—€1 million—as a shortfall in revenue collection—concentrated in border taxes—was not fully compensated by under-execution of spending. Moreover, an originally unforeseen payment of €1 million was made for the subscription to the EBRD's share capital in the context of Kosovo's joining of the institution (in the absence of this spending item, the primary balance criterion would have been met).
- Most applicable *structural benchmarks* were met:

(i) On January 30, 2013, we submitted an updated economic viability study for highway R6 to the World Bank and IMF staff, in line with the end-January structural benchmark. However, not all elements specified in our December 5, 2012, Letter of Intent were reflected in that study.

(ii) We submitted the legislation on a rules-based fiscal framework consistent with ¶11 of the Letter of Intent from December 5, 2012 to the assembly on March 29.

(iii) We also met the continuous structural benchmarks on monthly meetings of our Program Monitoring Committee and 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 five years.

- The *indicative (zero) targets* for domestic payment arrears of the central and general government were missed by modest amounts.

2. Based on this performance, we request completion of the third review under the Stand-By Arrangement. We request a waiver for nonobservance of the primary balance performance criterion at end-December on the basis that the nonobservance was minor. 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.

3. We believe that the policies set out in the letters of April 12, 2012, June 27, 2012, December 5, 2012 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 fourth review is expected to be completed after June 28, 2013, and 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

4. We expect subdued but resilient growth in 2013, driven by a modest contribution of investment, a recovery in exports, as well as strengthened consumption supported by remittances and other inflows from the Kosovar Diaspora. The macroeconomic framework underpinning our program is based on prudent assumptions, given a continued fragile external environment, and with a view to minimizing the risk of downward revisions during the program period.

1. We expect *real GDP growth* in 2013 to recover by about a percentage point relative to 2012, which implies a downward revision of 2013 growth relative to our forecast at the time of the 2nd review. The revision reflects subdued growth dynamics early in 2013 and projected developments in the euro area. Nevertheless, we expect growth to be higher than in most neighboring countries.
2. Consumer price *inflation* is expected to moderate in 2012, reflecting lower projected global food and fuel prices. Core inflation is projected to remain below 2 percent.
3. We also expect the *trade deficit* for 2013 to narrow slightly, in line with subdued domestic demand and a recovery of exports, driven by higher global demand for metals.

II. Fiscal Policy

A. Implementation of the 2013 Budget

5. We continue to target a primary deficit (excluding PAK-related expenditures) of no more than €155 million (3 percent of GDP). Our budget is based on cautious revenue projections and contains sizeable contingency reserves.

4. Tax revenue collection through end-February was €7 million behind projections, reflecting in part a temporary disruption in imports of tobacco products caused by the adoption of a new regulation by the Ministry of Agriculture requiring registration of tobacco importers. The situation has normalized and we expect revenues to align with program targets in the coming weeks.
5. We expect that one-off revenues of €20 million from the sale of telecommunication licenses will be received in the month of May instead of March as originally projected, as the tender process is taking longer than originally expected.
6. However, execution of budget expenditures has been lower by €30 million than projected through end-February. Moreover, an additional PTK dividend of €10 million has already been approved (in addition to the €30 million in PTK dividends foreseen in the 2013 budget). At least €20 million out of the total dividend would be disbursed before end-April. As a result, we do not anticipate difficulties in meeting the quantitative performance criteria for end-April, and neither in staying within the targeted annual deficit for 2013.

6. In the event that revenues continue to fall behind program targets going forward, we will take compensatory expenditure or revenue measures in the context of the mid-year budget review to safeguard compliance of the end-2013 target for the primary deficit. These measures will amount at least to the cumulative tax revenue shortfall through end-April. We also stand ready to take measures as needed to safeguard an adequate level of government bank balances, in particular for the case that the privatization of the telecommunications company (PTK) does not advance as planned. Moreover, we remain committed to preserving the integrity of the tax system, notably the value-added tax.

B. Highway R6

7. Expanding our network of highways and integrating Kosovo into the regional Trans-European Transport (TEN-T) Networks remains a policy priority. We remain committed, however, to entering in contractual obligations with respect to R6 only after several preconditions have been met (LOI December 5, 2012, ¶10), notably: (i) integration into a sustainable budgetary framework—including a level of the usable government bank balance of at least €300 million—(ii) economic viability, and (iii) transparency and competitiveness of the bidding process.

8. To assess economic viability, an Inter-Ministerial Committee prepared an updated feasibility study and submitted it to World Bank and IMF staff in January. In the World Bank's assessment, the study is of good quality, but reasonable modifications to some assumptions used therein would have the economic return of R6 fall close to or below thresholds for economic viability considered acceptable by the Bank. The study did also not analyze alternative design option, such as replacing a tunnel with overland roads and reducing the number of traffic lanes, as analyzing such changes turned out technically demanding and was not feasible within the time frame. We have modified the economic viability study by including additional cost savings in some identified areas amounting to €13.4 million that will be specified in the bill of quantities. The World Bank has assessed these modifications and confirmed that they bring the project's expected rate of return above minimum acceptable viability thresholds. Moreover:

a. Standard works contract procurement will be used for the northernmost 40 kilometers. Design-and-build contract procurement will be used for the remaining section from Kaçanik to the Macedonian border. The highway will be tendered as one project.

b. The government will maintain a Project Steering Committee tasked with regularly reviewing and deciding on the independent Procurement/Transaction Advisors' recommendations. A World Bank representative will attend the Project Steering Committee as an observer.

c. The government will continue to consider other options for including possible design revisions that would reduce the cost of the southern section and ensure the highest possible economic return to public investment. To this end, tendering of the civil works for this section will be initiated only after the Transaction/Procurement Advisor has identified options for packaging the works in ways that increase competition and reduce costs.

C. Rule-Based Fiscal Framework

9. We have prepared amendments to the Law on Public Financial Management and Accountability (LPFMA) to establish a rules-based fiscal framework, in line with the parameters set in our Letter of Intent for the second review of December 5, 2012 (¶11). We submitted the legislation to the assembly on March 29, 2013, in line with the end-March structural benchmark.

In preparing the legislation, we have cooperated closely with an IMF technical assistance (TA) mission that visited Pristina in February. The draft submitted to the assembly reflects the understandings reached at the time. Two issues were left open during our discussions with the TA mission, however. We regulate them as follows:

- The rules-based framework includes an escape clause with four specific quantitative triggers that would allow temporarily suspending the deficit ceiling. With respect to shortfalls in fiscal revenues and expenditures related to state guarantees, the legislation allows the escape clause to be triggered if:

  a) for any period of six months within a fiscal year nominal tax revenue collection is equal or below tax revenues collected during the same period in the previous fiscal year, excluding the effects of policy measures and one-off tax revenues;

  b) total expenditures increase by more than 1.5 percent of GDP within a fiscal year as a result of a state guarantee within the meaning of Law No. 03/L-175 on Public Debt having to be paid by the government.

- Expenditures financed from privatization proceeds shall be disregarded for purposes of compliance with the deficit ceiling if (i) the proceeds are used for capital spending, and (ii) the level of the usable government bank balance amounts to at least 4.5 percent of GDP.

D. Other Fiscal Issues

10. *Fiscal decentralization.* Starting in 2014, we will use the new population data from the 2011 census to the formula for the general grant allocation to municipalities. In line with the provisions in the Law on Local Government Finance (LLGF), the year 2014 will still be a transition year, in which no municipality will receive a lower nominal general grant as a result of the 2011 census. The objective is to give the municipalities suffering a revenue loss time to seek alternative own-source revenues. In addition, we have established a working group that will prepare an amendment of the LLGF, oriented on recommendations from a 2012 IMF technical assistance report. In particular, the working group will review the size of the general grant with a view to gradually reducing it, and add a fiscal capacity variable to the grant formula. Draft legislation will be submitted to the government by end-September 2013, with a view to passing the legislation before end-year.

11. *Civil Service Reform.* Preparations for civil service reform are advancing. The reform aims at providing for a more rational form of wage setting in the public sector. However, it seems unlikely that implementation could start by July 1, 2013, as originally envisaged, reflecting in part delays in establishing a new job grading system. As a result, the corresponding budget allocation of
€10 million is not likely to be fully executed.

12. *Spending initiatives.* Careful planning, costing and phasing of spending initiatives remains at the core of our efforts to improve public financial management. To this end, the introduction of all laws and regulations or amendments to laws or regulations with fiscal implications will be preceded by a fiscal impact assessment covering a period of at least 5 years (continuous structural benchmark).

7. The revised *Pension Law* (Pillar I) is in preparation for its second reading in the assembly. We will make sure that only provisions that are fully costed are included in the law.
8. As regards possible *benefits for war veterans*, we have completed the application process for the status of "war veteran". The next steps are (i) a thorough verification process in order to eliminate nonqualifying applicants and avoid double-dipping, and (ii) designing and costing of the benefit. We have opened a similar application process for the status of "former political prisoner".
9. As regards *health reform*, the Health Law was approved on Dec 13, 2012. We have started the preparation of a Health Insurance Law, including the preparation of a basic health care package, price lists for services, contracts with hospitals, and the development of an IT system. However, more time is needed to carefully prepare this reform, in close collaboration with the World Bank. We will ensure that the law would not pose incalculable risks to the budget.

13. We have made progress with the implementation of our action plan to improve the recording and monitoring of payment obligations. In particular, we have established a specialized unit within Treasury that monitors payment obligations across budget organizations, and have launched a publicity campaign to explain the definition of payment arrears, the responsibilities of budget organizations when entering into contractual obligations, and the sanctions for noncompliance foreseen in the LPFMA. Going forward, we will by end-May 2013 amend financial rules 02 and 04 of the Treasury to ensure the recording of all payment-related documents (contracts, invoices and reports on receiving the goods or services) within 3 days in our free balance system (structural benchmark). Failure to comply with this deadline will result in an automatic disabling of payments. We will upgrade our IT system to accomplish this. Further, we will, from August, generate arrears reports directly from the IT system, i.e. without relying on reports from individual budget organizations.

E. Financial Sector Policies

14. Higher nonperforming loans (NPLs), slower credit growth and tighter regulatory requirements have put some pressure on banks' soundness indicators. Tighter requirements include in particular the treatment of related party loans in the new banking law, which requires their deduction from regulatory capital and is more stringent than Basel rules.. As a result, the capital adequacy ratio of the system dropped to 14.4 percent as of December 2012 (compared to

17.9 percent under the previous requirements). For banks whose capital adequacy has fallen below the regulatory minimum, we will require capital plans and guarantees to restore capital adequacy as soon as possible, but no later than end-June. Further, we are requiring banks to bring down their related lending and large exposures in line with legal and regulatory limits by end-June, and will monitor progress closely. In this context, we will issue a regulation on enforcement of administrative penalties by end-April.

15. We have taken further measures to strengthen the deposit insurance scheme. In particular, Article 27 of the amended Deposit Insurance Law (DIL) requires the Deposit Insurance Fund (DIFK) to continue collecting premiums once the reserve fund reaches 5 percent of insured deposits. In January, the Management Board of the Deposit Insurance Fund of Kosovo (DIFK) passed a resolution to increase the size of the target reserve fund to a range of 8-9 percent of total insured deposits. Finally, by June, €6.4 million in remaining contributions is expected to be disbursed by the government (including €3 million already paid-in) and another contributor, strengthening the DIFK's capital ahead of the increase in coverage scheduled for January 2014.

16. We have set up a plan to implement key recommendations from the recent Financial Sector Stability Assessment, with a view to further strengthen the resilience of our financial system. The CBK has incorporated the FSAP recommendations relevant to central banking and supervision into its strategic plan. Recommendations requiring inter-institution collaboration are being discussed with the relevant counterparts. Furthermore, the measures in ¶16 are in line with the key short-term recommendations on deposit insurance. Based on this, we have established as key priorities and steps:

10. *Ensuring that costs associated with the legal defense of CBK staff are covered ex-ante.* The CBK has established a working group to draft an instruction providing for the CBK to pay for legal representation when staff is sued for carrying out official duties in good faith. The instruction will be approved by the Executive Board of the CBK by end-May (structural benchmark).
11. *Subjecting Emergency Liquidity Assistance (ELA) granted to potentially insolvent systemically important institutions to very strict conditions.* The CBK, the Ministry of Finance (MoF) and the Assembly Committee on Budget and Finance will review the existing tripartite Memorandum of Understanding (MoU) to clarify roles and responsibilities for liquidity assistance. In particular, the MoU will clarify the CBK's responsibilities for designing appropriate procedures for liquidity assistance for solvent banks, and that the CBK would refrain from granting liquidity assistance in to insolvent banks without an explicit government guarantee.
12. *Instituting a bank premium to fund ELA needs.* The CBK will request technical assistance on the appropriate design of a bank financed liquidity fund, and will also seek the views

of the banking industry. The CBK and the MOF will assess the legal and regulatory requirements for establishing such a fund.

13. *Addressing shortcomings in the resolution framework and enhancing the crisis management framework.* The CBK will draft regulations to address technical shortcomings in the bank resolution framework (e.g., clarifying the definitions of purchase and assumption transactions). Further, the CBK will request technical assistance to develop resolution procedures and a contingency plan. As regards extraordinary funding arrangements for deposit insurance, the DIFK will, in cooperation with the Ministry of Finance, review possible options for the size and funding a stand-by credit line. We will get back to this issue at the time of the next review of the SBA.

14. *Introducing risk-based supervision.* We will seek technical assistance in order to update our supervisory manual, to reflect the more risk-based aspects of the new banking law and regulations, including the new capital adequacy requirements as well as consolidated supervision.

15. *Taking initial steps to establish a framework for macroprudential monitoring.* We are developing terms of reference for a macroprudential committee within the CBK that will focus on systemic risk issues, including by reviewing existing laws and regulations to ensure the CBK has sufficient tools to adequately address risks and independently monitor developments that may have systemic risk implications. We will request TA from the IMF to develop a macro model and methodologies for the identification and monitoring of systemic risks.

III. Competitiveness and Structural Reforms

17. We are aiming at establishing a more predictable way to set minimum wage levels (across age categories), with a view to avoiding large discrete changes in minimum wage rates that could negatively affect employability and labor market competitiveness. At present, the Labor Law stipulates that relevant factors for setting minimum wage rates are CPI inflation and labor market conditions. This provision leaves much room for frequent and arbitrary minimum wage changes, and we therefore plan to introduce a regulation that would provide for a more rules-based treatment. To this end, we will draft secondary legislation by end-May (structural benchmark)} with involvement of the Ministries of Labor and Social Welfare, Finance, Economic Development, and Trade and Industry; and in consultation with World Bank and IMF staff. In view of Kosovo's already elevated minimum wage levels, the CPI index—excluding possibly some strongly fluctuating components for imported goods—will be a key yardstick for minimum wage changes. Until enactment of the regulation, we will not modify the current levels of the minimum wage.

18. We have made progress on projects to support SMEs' access to finance as well as to improve their international competitiveness:

a. The first project supports Kosovo's SME Agency (KOSME), and is receiving technical assistance from the Austrian Development Cooperation and the Swiss Development Cooperation, as well as funding from USAID and other donor institutions. In addition to building capacity for KOSME staff, the project focuses on catering for SMEs' business support needs with the help of local experts through a voucher counseling scheme (VCS), as well as for their financing needs through a planned credit guarantee scheme (CGS) with commercial banks.

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. We will announce the call for proposals in June.

c. The MTI is also in the early stages of cooperation with the Ministry of Diaspora to promote the channeling of emigrants' remittances into investments in small businesses.

d. We will continue to work on revising maternity leave provisions of the Labor Law to preserve the employability of women, in consultation with the private sector and the World Bank.

Sincerely yours,

/s/

Hashim Thaçi
Prime Minister

/s/	/s/
Ramadan Avdiu	Bedri Hamza
Acting Minister of Finance	Governor, Central Bank of the Republic of Kosovo

Table 1. Kosovo: Program Monitoring

	Program Approval	End-April 2012	End-August 2012	End-December 2012
Performance criteria				
Floor on the bank balance of the general government	...	Met	Met	Met
Floor on the primary fiscal balance of the general government	...	Met	Met	Missed
Ceiling on primary expenditures of the general government	...	Met	Met	Met
Ceiling on the net contracting of nonconcessional debt by the general government	...	Met	Met	Met
Indicative targets				
Ceiling on the stock of domestic payment arrears of the central government	...	Missed	Missed	Missed
Ceiling on the stock of domestic payment arrears of the general government	...	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	...
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 2/
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
Continuous structural benchmarks				
Monthly meetings of the Program Monitoring Committee and transmission of meetings' minutes to the IMF	...	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/	...	Not met	...	...
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

1/ Eliminated after the first review following a corresponding amendment of the Law on Public Financial Management and Accountability.
2 /The study was submitted on time, but did not contain all the elements defined in the LOI of December 2012.

Table 2. 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.	Adj. Prog.	Actual	Prog.	Prog.
Performance Criteria 1/									
Floor on the bank balance of the general government 2/	166	180	237	281	205	205	216	160	171
Floor on the primary fiscal balance of the general government 2/, 3/	-21	4	-19	6	-112	-112	-113	-36	-94
Ceiling on primary expenditures of the general government 3/	399	353	911	842	1,494	1,490	1435	448	1005
Ceiling on the net contracting of nonconcessional debt by the general government 3/	150	30	150	49	150	150	73	150	150
Ceiling on guaranteeing nonconcessional debt by the general government 3/	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
Indicative Targets									
Ceiling on the stock of domestic payment arrears of the central government	0	2	0	0	0	0	3	0	0
Ceiling on the stock of domestic payment arrears of the general government	0	2	0	3	0	0	5	0	0
Memorandum items:									
Program assumptions									
Repayment of policy loans extended to public corporations	...	4	4	4	4	4	4	2	4
Non-project grants	4	1	37	37	37	37	37	0	0
Budget support loans	0	0	0	0	0	0	0	0	0
Project grants	1	0	3	0	4	0	0	1	2
Project loans	0	0	6	0	7	7	7	1	3
PAK-related spending	...	...	5	4	8	8	6	2	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 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 3. Kosovo: Structural Conditionality

Actions	Timing
Structural benchmarks	
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.	End-May 2013
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.	End-May 2013
Drafting of secondary legislation to provide for a more rules-based treatment of setting minimum wage levels (by end-May 2013)	End-May 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

Technical Memorandum of Understanding

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

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

19. 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.

20. **Performance Criteria and Indicative Targets.** The performance criteria, indicative targets, and their respective test dates are set in Table 2 of the Letter of Intent (LOI).

B. Bank Balances of the General Government

21. **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 on lending operations. Bank balances do not include investments made and managed by an outside Investment Manager assigned by the Minister pursuant to Kosovo's Law on Public Financial Management Article 7.1.(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

22. **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

23. **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.

24. 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).

25. **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 Route 6, and including domestically and budget support financed capital expenditure and externally project financed capital expenditure; (vi) the gross payment and gross accumulation of domestic payments arrears; (vii) external loan receipts and principal payments; (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

26. **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

27. **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).

28. 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.

29. 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.

30. **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.”

31. **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

32. 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.

33. **Reporting requirements.** The Ministry of Finance will submit a monthly table with the stock of domestic payments arrears and not in arrears. The data are to be provided within five weeks after the end of the month.

G. External Payments Arrears

34. **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.

35. **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

36. 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

37. 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.

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

39. 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.

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.