Summer 8-2007

THE ROLE OF THE INTERNATIONAL MONETARY FUND (IMF) IN KOSOVA

Agron Reçica
University for Business and Technology - UBT

University for Business and Technology

BA Thesis:

THE ROLE OF THE INTERNATIONAL MONETARY FUND (IMF) IN KOSOVA

Prepared for the degree “Bachelor of Management, Business, and Economics”

Under the supervision
of

Prof. Dr. Robert Muharremi

Submitted to

University for Business and Technology – UBT
In cooperation with
Vienna University and Oakland University

By
Agron Reçica
(20040034/B)

August 2007, Prishtina

Table of Contents

Tables

Figures

Acknowledgments

This thesis represents the crown of my long tour in obtaining my Bachelor Degree in Management, Business and Economics Faculty from the University for Business and Technology in Prishtina. There are people who made this tour easier with their words of encouragement and more intellectually satisfying through offering different viewpoints, helping expand my ideas and strengthen my problem-solving skills.

First, very special thanks to UBT President, Mr. Edmond Hajrizi, who gave me the opportunity to be part of the first generation of UBT in which I take pride. Thank you very much Mr. Hajrizi.

No words can describe the pleasant common journey with my precious colleagues. We became a family, stood always together in workshops, projects, business plans and hot debates. Teamwork and spirit of cooperation always prevailed. Thanks to all of you.

Exceptional thanks go to Prof. Robert Muharremi, who was always there to help and encourage students in their endeavors to further their future plans. I learned from him the most important thing in being successful, and that is confidence in yourself and courage. It was a pleasure to be your student and discussions on International Relations were particularly exciting. Professor Robert boosted my confidence to begin my thesis. Even though I had to do the bulk of my research within a relatively short period of time, the prompt support and feedback from Dr. Robert was crucial for me and challenged me to set my benchmark even higher. I learned to believe in myself, my work, and my future;
Thank you Professor.

Many thanks for the IMF's Resident Representative in Kosova, Mr. Agim Demukaj, and to the Ministry of Finance & Economy, to the Macroeconomic Department, especially to Mr. Hajdar Korbi. This work would have been much harder without their valuable support and contribution.

My thanks extend to all those who are not mentioned here and who have provided material for this thesis and who allowed me to use their statements and data.

ACRONYMS AND ABBREVIATIONS

BPK Banking and Payments Authority of Kosova
EU European Union
FRY Federal Republic of Yugoslavia
HBS Household Budget Survey
HIPC Heavily Indebted Poor Countries
KCB Kosova Consolidated Budget
KTA Kosova Trust Agency
LOI Letter of Intent
LFS Labor Force Survey
MDRI Multilateral Debt Relief Initiative
MFE Ministry of Finance and Economy
PIP Public Investment Program (Donor funded)
PISG Provisional Institutions of Self-Government
POE Publicly Owned Enterprise
PRGF Poverty Reduction and Growth Facility
SDR Special Drawing Right
SOE Socially Owned Enterprises
SOK Statistical Office of Kosova
SRSG Special Representative of the Secretary-General
UNMIK United Nations Interim Administration Mission in Kosova

A. INTRODUCTION

I. ARTICLES OF AGREEMENT OF THE IMF

Governments on whose behalf the Agreement is signed agreed as follows:

The International Monetary Fund is established and shall operate in accordance with the provisions of the Agreement signed as originally adopted and subsequently amended.[1]

To enable the Fund to conduct its operations and transactions, the Fund shall maintain a General Department and a Special Drawing Rights Department. Membership in the Fund shall give the right to participation in the Special Drawing Rights Department.[2]

Operations and transactions authorized by this Agreement shall be conducted through the General Department, consisting in accordance with the provisions of this Agreement of the General Resources Account, the Special Disbursement Account, and the Investment Account; except that operations and transactions involving special drawing rights shall be conducted through the Special Drawing Rights Department.[3]

[1] Articles of Agreement of the IMF; http://www.imf.org/pubs/ft/aa/aa.pdf .
[2] Ibid.
[3] Ibid.

II. THE IMF'S OBJECTIVES

The objectives of the International Monetary Fund are:

To promote international monetary cooperation through a permanent institution, which institution provides the machinery for consultation and collaboration on international monetary problems.[4]

To facilitate the expansion and balanced growth of international trade, and to contribute thereby to the promotion and maintenance of high levels of employment and real income and to the development of the productive resources of all members as primary objectives of economic policy.[5]

To promote exchange stability, to maintain orderly exchange arrangements among members, and to avoid competitive exchange depreciation.

To assist in the establishment of a multilateral system of payments in respect of current transactions between members and in the elimination of foreign exchange restrictions which hamper the growth of world trade.[6]

To give confidence to members by making the general resources of the Fund temporarily available to them under adequate safeguards, thus providing them with opportunity to correct maladjustments in their balance of payments without resorting to measures destructive of national or international prosperity.[7]

In accordance with the above objectives, to shorten the duration and lessen the degree of disequilibrium in the international balances of payments of member states.[8]

[4] Articles of Agreement of the IMF; http://www.imf.org/pubs/ft/aa/aa01.htm.
[5] Ibid.
[6] Andreas F. Lowenfeld, International Economic Law, Oxford 2003, p. 503.
[7] Ibid.
[8] Ibid.

In addition, the objectives of the International Monetary Fund are also explained as follows:

The International Monetary Fund was established to promote international monetary cooperation, exchange rate stability and to provide temporary financial assistance to countries in order to help easing the balance of payments adjustment.

The IMF would also loan foreign currency to the states that had problems with their Balance of Payments. Each member state was required to contribute a designated amount of quota i.e. one quarter of gold and three quarters of national currency to the Fund. The amounts of loans were based on the amount that each respective state had contributed to the Fund. The more a state contributed, the more it could borrow. The USA was the dominant power with the highest amount of quotas.

Today the IMF maintains the same quota system and member countries enjoy the same privilege to borrow even though many are no longer maintaining a fixed exchange rate. Instead, many countries borrow from the IMF when they become unable to maintain payments on international debts. The IMF plays a major role in the global monetary system. The Fund surveys and monitors economic and financial developments, lends funds to countries with balance-of-payment difficulties, and provides technical assistance by training members states' government officials in macroeconomic management, reforming tax systems, developing central banking and financing systems.

The IMF goals are to facilitate the expansion and balanced growth of international trade, to assist in the elimination of foreign exchange restrictions which hamper the growth of international trade, and to shorten the duration and lessen the disequilibrium in the international balances of payments of members.

The mitigation of wide currency fluctuations is achieved through a complex lending system which permits a country to borrow money from other Fund members or from the Fund itself (by way of “SDR” Special Drawing Right)[9] for the purpose of stabilizing the relationship of its currency to other world currencies.

Based on the IMF’s objectives and its operations we can notice that they fit mostly. As we go about our daily lives, it is easy to overlook the importance of international trade. For example, America ships enormous volumes of food, airplanes, machinery and computers to other countries, while in return it gets other goods and services.

That’s why the IMF's primary purpose is to ensure the stability of the international monetary system—the system of exchange rates and international payments that enables countries (and their citizens) to buy goods and services from each other. This is essential for sustainable economic growth and rising living standards and that’s why monetary stability was to be considered important. To maintain stability and prevent crises in the international monetary system, the IMF reviews national, regional, and global economic and financial developments. It provides advice to its 184 member countries, encouraging them to adopt policies that foster economic stability, reduce their vulnerability to economic and financial crises, and raise living standards, and serves as a forum where they can discuss the national, regional, and global consequences of their policies.[10]

The IMF also makes financing temporarily available to member countries to help them address balance of payments problems—that is, when they find

[9] The SDR, or Special Drawing Right, is an international reserve asset that member countries (states) can add to their foreign currency and gold reserves and use for payments requiring foreign exchange. Its value is set daily using a basket of four major currencies: the Euro, Japanese yen, pound sterling, and US dollar. The IMF introduced the SDR in 1969 because of concern that the stock and prospective growth of international reserves might not be sufficient to support the expansion of world trade. The SDR was introduced as a supplementary reserve asset, which the IMF could “allocate” periodically to members when the need arose, and cancel, as necessary.

[10] IMF’s purposes; http://www.imf.org/external/pubs/ft/exrp/what.htm#do.

themselves short of foreign exchange because their payments to other countries exceed their foreign exchange earnings.[11]

III. HISTORICAL BACKGROUND

The Bretton Woods conference in 1944 represented a response to the international financial "anarchy" that had existed in the 1930's as countries pursued beggar-my-neighbor policies in the form of competitive devaluations and protectionist commercial policy. Against a backdrop of global recession and shrinking world trade there was a belief that an international monetary order could be established that would facilitate global expansion and "full" employment without having to revert to the rigidities imposed by the gold standard.[12]

IV. GREAT DEPRESSION

The Great Depression was an economic slump in North America, Europe, and other industrialized areas of the world that began in 1929 and lasted until about 1939. It was the longest and most severe depression ever experienced by the industrialized Western world. The Great Depression began in the United States but quickly turned into a worldwide economic slump owing to the special and intimate relationships that had been forged between the United States and European economies after World War I. The United States had emerged from the war as the major creditor and financier of postwar Europe, whose national economies had been greatly weakened by the war itself, by war debts, and, in the case of Germany and other defeated nations, by the need to pay war reparations. So once the American economy slumped and the flow of American investment credits to Europe dried up, prosperity tended to collapse there as well. The Depression hit hardest those nations that were most deeply indebted to the United

[11] Ibid.
[12] Historical Background; http://books.google.com/books?id=dTw6oS_XXCUC&pg=RA1-PA2&ots=1ctDDwGBCR&dq=historical+background+of+IMF&sig=MjnkR7RK83mqYvDrwGgas_Nb-N4#PRA1-PA2,M1.

States, i.e., Germany and Great Britain. In Germany, unemployment rose sharply beginning in late 1929 and by early 1932 it had reached 6 million workers, or 25 percent of the work force. Britain was less severely affected, but its industrial and export sectors remained seriously depressed until World War II. Many other countries had been affected by the slump by 1931.[13]

Almost all nations sought to protect their domestic production by imposing tariffs, raising existing ones, and setting quotas on foreign imports. The effect of these restrictive measures was to greatly reduce the volume of international trade: by 1932 the total value of world trade had fallen by more than half as country after country took measures against the importation of foreign goods.[14]

After the Great Depression, government action, whether in the form of taxation, industrial regulation, public works, social insurance, social-welfare services, or deficit spending, came to assume a principal role in ensuring economic stability in most industrial nations with market economies.

V. BRETTON WOODS SYSTEM

One thing was evident: the huge need for a new stabilized monetary system, and there were plans made to monitor all actions by supervising institutions. In 1944 during the international conference, the International Monetary Fund and the International Bank for Reconstruction and Development were “created”. They agreed on implementing a system of fixed exchange rates with the US dollar as the main currency.

The plans for the Bretton Woods System were developed by two very important economists, the US financial secretary Harry Dexter White and the British economist John Keynes who stated: “We the delegates of this conference have been trying to accomplish something very difficult. It has been our task to find a common measure, a common standard, a common rule acceptable for all”.

[13] Great Depression; http://www.english.uiuc.edu/maps/depression/about.htm.
[14] Ibid.

This statement outlines the difficulty of creating a system that every nation could accept.[15]

Within the context of Bretton Woods's system, the IMF fulfilled four key functions. First, it was an adjustment institution offering advice and some degree of compulsion in terms of appropriate domestic macroeconomic policy. Second, it was a financing institution providing short to medium term financial assistance in support of approved policy, designed to eliminate balance of payments deficits. Third, it helped to co-ordinate macroeconomic policy internationally by encouraging countries to design policies in ways that supported pegged exchange rates, in effect supervising a rule-based system of macroeconomic co-ordination. Finally, it acted as a forum for the debate of international monetary reform. Although never completely free from contemporary criticism, during the golden age of the 1950's and 1960's criticisms of the Fund were muted. As known, the Fund had been set up to run a system designed to encourage global economic growth, full employment and expanding world trade and on all counts the world economy seemed to be performing quite satisfactorily.

The end of the Bretton Woods System is a subject of debate. However, most economists agree that the System broke down due to the excessive expansion of the reserve currency upon which the System was based, the US dollar. The US went from being a surplus nation after the Second World War to running an enormous trade deficit primarily due to spending heavily on the Vietnam War and the President Johnson's great society initiatives. The closing of the "gold window" on August 15, 1971 by President Nixon ended the convertibility of the US dollar into gold and triggered the collapse of the Bretton Woods international monetary regime. The crisis was caused by a persistent US balance of payments deficit, which was the result of inflationary US fiscal and monetary policies. Moreover, rather than increasing taxes to finance these expenses, the US resorted

[15] Ralph H. Folsom, Michael W. Gordon, John A. Spanogle, International Trade and Economic Relations, USA 2004.

to an expansionary monetary policy, effectively printing more money to finance the growing budget deficit.[16]

B. SOME SPECIFIC POLICIES AND ACTIVITIES OF THE INTERNATIONAL MONETARY FUND (IMF)

I. Exchange rate stability through fixed exchange rates

Seeking to restore order to international monetary relations, the IMF's founders charged the new institution with overseeing the international monetary system to ensure exchange rate stability and encouraging member countries to eliminate exchange restrictions that hindered trade. Under the Bretton Woods system, exchange rates were supposed to be "fixed but adjustable" with adjustment limited to cases of fundamental disequilibrium. Countries could, with the Fund's agreement, adjust their par values to reflect their changing economic circumstances relative to other countries. The organizing idea was that the many changes in exchange rates in the inter-war period had produced instability, introduced extra risk to international trade, encouraged manipulation and generally contributed to the depression and war that were on the minds of all those who planned the post-war world[17]. The aim was to prevent unilateral adjustments of the kind seen in the 1930's and over the years, many exchange rate values were altered. Although increasing strains in the system became evident during the 1960's, the Bretton Woods exchange rate regime, combined with trade liberalization, and had enabled the industrial countries in particular to grow rapidly in the postwar period. But the Bretton Woods system hinged on the continued willingness of the US authorities to maintain the so-called gold window- the right of anyone to convert their dollars into gold at the fixed rate of 35$ per ounce. For much of the postwar period, large US capital account deficits

[16] Bretton Woods System; http://html.rincondelvago.com/bretton-woods_1.html
http://www.reference.com/browse/wiki/Bretton_Woods_system
http://www.answers.com/topic/bretton-woods-system .

[17] Andreas F. Lowenfeld, International Economic Law, Oxford 2003, p.524.

had been offset by current account surpluses. As the US economy came under pressure from the struggle to finance rapid rises in domestic spending programs and the cost of the war in Vietnam, the US government decided it could no longer underpin the international financial system. In august 1971, President Nixon announced that the gold window would be closed and by 1973 the system of fixed exchange rates had been abandoned.

II. Breakdown of the fixed exchange rate system

This breakdown of the fixed exchange rate system ended each country's obligation to maintain a fixed price for its currency against gold and other currencies.[18]

For the first three decades after World War II, under the Breton Woods arrangements, the US dollar was the main currency, where most of transactions in international trade and finance were carried out in dollars and even payments were made in US dollars. Based on this, the world was on a dollar standard. But on the other side, recovery contained the seeds of its own destruction. US trade deficits were fueled by an overvalued currency, budget deficits to finance the Vietnam War, and growing overseas investment by American firms.[19]

By 1971, the stock of liquid dollar balances had become so large that governments had difficulty defending the official parities and the lower barriers to financial flows meant that billions of dollars could cross the Atlantic in minutes and threaten to overwhelm existing parities.[20]

These are some of the main reasons why this system was demised, while as the United States abandoned the Bretton Woods system, the world moved into the modern financial system. Financial systems within developed economies are essentially similar in their structure and operation. Generically, institutions,

[18] Breakdown of the fixed exchange rate system; http://www.britannica.com/eb/article-247600/money.
[19] Paul A. Samuelson & William D. Nordhaus, ECONOMICS, Seventeenth Edition 2001, page 628.
[20] Ibid.

markets and instruments are fundamentally alike, but may often be differentiated by size, terminology, and the level of government regulation and prudential supervision. While each nation-state is responsible for the structure and operation of its own financial system, today, each financial system is a part of the global financial system. Internationalization of financial markets, supported by the adoption of sophisticated technology-based information and product delivery systems, has resulted in the development of new products and markets, and an enormous increase in the volume and speed of the flow of funds through the international money and capital markets.[21]

III. Macroeconomic and financial policies

1. IMF Borrowing

Technically, countries do not receive loans from the IMF- they “purchase” foreign exchange from the IMF’s reserve assets, paying with their own currency. The loan is considered repaid when the borrower “repurchases” its currency from the IMF in exchange for reserve assets. While talking about borrowing, it’s worth of mentioning stand-by-arrangements and conditionality.

Stand-by-arrangements form the core of the IMF’s lending policies. It provides assurance to a member country that it can draw up to a specified amount, usually over 12-18 months, to deal with a short-term balance of payments problem.

When a country borrows from the IMF, its government makes commitments on economic and financial policies- a requirement known as conditionality. Conditionality is a way for the IMF to monitor that its loan is being used effectively in resolving the borrower’s economic difficulties, so that the country will be able to repay promptly, and make the funds available to other members in need. In recent years, the IMF has worked to focus and streamline conditionality, in order to promote national ownership of strong and effective policies.

[21] Modern financial system; http://www.designpoint.com.au/pdf/books/fininst-text.pdf.

2. Surveillance

The IMF is responsible for overseeing the international monetary system and for monitoring the economic and financial policies of its 185 member countries. This process is known as surveillance. It involves tracking economic developments, both globally and in individual countries, and letting policymakers know if adjustments are warranted.

In its oversight of member states, the IMF focuses on the following:

- Macroeconomic policies relating to the government's budget, the management of money and credit, and the exchange rate;
- Macroeconomic performance- government and consumer spending, business investment, exports and imports, output (GDP), employment and inflation
- Balance of payments- that is, the balance of a country's transactions with the rest of the world
- Financial sector policies, including the regulation and supervision of banks and other financial institutions, and
- Structural policies that affect macroeconomic performance, such as those governing labor markets, the energy sector and trade.

The IMF advises members on how they might improve their policies in these areas so as to achieve higher rates of employment, lower inflation, and sustainable economic growth.[22]

[22] Macroeconomic and financial policies; http://www.imf.org/external/pubs/ft/exrp/what.htm#box5.

C. THE IMF'S ROLE TODAY

I. IMF and assistance to developing countries

As its systematic role evaporated with the collapse of the Bretton Woods system, so the International Monetary system (IMF) became drawn into a much more specific role in the context of the balance of payments (BOP) problems that developing countries were encountering. At its inception, the IMF had been seen as having no specific role in developing countries, but now it became exclusively these countries that formed its clientele. While during the 1970s, the IMF had continued to make a few relatively large loans to a limited member of industrial countries (e.g. Italy and the United Kingdom), beyond the mid-1970s industrial countries ceased to draw any resources from it.

In the early 1990's, the emergence of the Central and East European economies (countries in transition) presented the IMF with a new challenge as well as a new opportunity, but developing countries continued to dominate the pattern of its lending. The IMF has extended substantial amounts of credit to member countries and has allocated special drawing rights to them. Developing countries have especially benefited from the IMF's basic financing and from certain facilities designed mainly for them. More specifically, except promoting exchange stability and assist in eliminating foreign exchange restrictions, IMF is expected to make its resources temporarily available to members under adequate safeguards, thus providing them with opportunity to correct maladjustments in their balance of payments without resorting to measures destructive of national or international prosperity.

Consultations with members have become a major function, and the IMF has been enjoined to exercise surveillance over exchange rate policies of members and international liquidity. After early disagreements, IMF lending policies have been worked out and adapted over the years. Initially, financial assistance was provided in only one way; charges were uniform for members but were graduated according to complex schedules. In time, special needs of groups of members, particularly developing countries, were recognized by the establishment of several special policies or facilities for the use of the Fund's financial resources. Larger drawings in relation to quotas were permitted. Charges were simplified and, to a limited extent, subsidized for low-income countries. All these developments were approved by the executive board and, in some cases, by votes of the governors and member governments, but they were disturbing to some, while others thought they did not go far enough. The subject of additional economic assistance to the developing countries is timely because of the adverse impact on them of the recent world-wide recession, the prospect that some of the poorest countries will not participate fully in the recovery, the unfavorable terms of trade of the non-oil developing countries, the persistent external debt problem, and the expectations that per capita income will continue to stagnate or decline in some countries. External assistance can encourage and complement policies that will help developing countries strengthen their balance of payments and domestic economies, resulting in beneficial effects on world trade and finance[23].

The provision of additional economic assistance through the IMF would be an extension of past practices rather than a new departure. All users of the Fund's financial resources have been assisted. Developing countries have received especially significant amounts of economic assistance because they have drawn on the Fund's basic financing and special facilitates to a much greater extent than have the industrial countries. In addition, part of the Fund's gold has been used for the benefit of the developing countries.

[23] Book, Economic Assistance to Developing Countries through the IMF, Richard Goode, Washington DC, Publisher:: The Brookings Institution.

II. Resolution of financial crisis

In the early 1980s, Mexico, then Brazil and then a number of other states, principally in Latin America, became unable to pay their external debts, and even interest in their debts, as the came due. Even the Eastern Europe and the former Soviet Union states, as they turned away from communism, found themselves without the resources needed to join the international economy and the international monetary system that had grown up largely without their participation.

The details of the origin of the crisis of developing country debt are beyond the scope of this volume, and indeed vary from state to state. However, in 1970s, following the first sharp rise in oil prices, many developing countries, particularly in Latin America, undertook massive borrowing from commercial banks in the US, Western Europe and Japan. The banks, which were bidding, through high rates, for deposits from the newly super rich oil-producing states and sheikdoms of the Middle East, were more than willing to re-lend the funds thus acquired to developing countries as long as the interest was high enough[24].

On the other side, the developing countries, uncomfortable with conditionality administered by IMF and to some extent by the World Bank, found that commercial banks had neither the will nor the political legitimacy to enforce conditions on sovereign decision-making by the borrowers.

In some crisis, coordinated debt restructuring by private creditors may be needed. To facilitate debt restructuring the IMF has promoted the inclusion of Collective Action Clauses in international bond issues. The use of these clauses, which is the norm under U.K law and has become the market standard for bonds issued under New York law, and which is designed to prevent a small minority of creditors from blocking a restructuring deal to which the majority of creditors agree. The IMF also supports the Principles for Stable Capital Flows and fair debt

[24] Andreas F. Lowenfeld, International Economic Law, Oxford 2003, p. 567.

restructuring drafted by the Institute for International Finance in 2004, and the Paris Club's Evian Approach to debt relief for countries that have unsustainable debt but that do not qualify for assistance under the HIPC Initiative.[25]

III. Technical assistance

Technical assistance means that IMF supports the development of the productive resources of member countries by helping them to effectively manage their economic policy and financial affairs. The IMF helps these countries to strengthen their capacity in both human and institutional resources, and to design appropriate macroeconomic, financial, and structural policies. It is normally provided free of charge to any requesting member country, within IMF resource constraints. About 90% of IMF technical assistance goes to low and lower-middle income countries, particularly in sub-Saharan Africa and Asia. Post conflict countries are also major beneficiaries. Apart from the immediate benefit to recipient countries, by helping individual countries reduce weaknesses and vulnerabilities, technical assistance also contributes to a more robust and stable global economy.

The IMF provides technical assistance mainly in its areas of core expertise: macroeconomic policy, tax policy and revenue administration, expenditure management, monetary policy, exchange rate system, financial sector sustainability. Since demand for technical assistance consistently exceeds supply, priority is given to providing assistance that complements and enhances the IMF's other key areas of operations, surveillance and lending. Efforts in recent years to strengthen the international financial system have triggered additional demands for IMF technical assistance.

At the same time, there is a continuing demand for technical assistance to help low-income countries build capacity to design and implement poverty reducing and growth programs, and to help heavily indebted poor countries undertake debt

[25] Resolution of financial crisis; http://www.imf.org/external/pubs/ft/exrp/what.htm#box4.

sustainability analyses and manage debt reduction programs. The IMF also contributes actively to the integrated framework for trade-related technical assistance, which aims to assist the low income countries expand their participation in the global economy.[26]

The IMF provides technical assistance while the recipient country is fully involved in the entire process, from identification of need, to implementation, monitoring and evaluation. Depending on the nature of assignment, support is often provided through staff missions of limited duration sent from headquarters. Assistance might also be provided in the form of technical and diagnostic studies, training courses, seminars, workshops, and online advice and support. The IMF has increasingly adopted a regional approach to the delivery of technical assistance and training. It operates six regional technical assistance centers: in the Pacific, the Caribbean, East, West and Central Africa and the Middle East. IMF technical assistance is financed from both internal and external sources. The IMF finances directly technical assistance delivery, supervision, administrative and other overhead costs, and these accounts for about one-fourth of its total net administrative budget. The IMF also administers funding provided by bilateral and multilateral donors. Such cooperation and resource sharing has two benefits: it leverages the resources available for technical assistance, and it helps avoid duplication of advice by different donors.[27]

IV. Financial assistance

Financial assistance is available to give member countries the breathing room they need to correct balance of payments problems. A policy program supported by IMF financing is designed by the national authorities in close cooperation with the IMF, and continued financial support is conditional on effective

[26] Book, Economic Assistance to Developing Countries through the IMF, Richard Goode, Washington DC, Publisher:: The Brookings Institution.
[27]Technical assistance; http://www.imf.org/external/np/exr/facts/tech.htm.

implementation of this program. The International Monetary Fund offers assistance in several areas, including: fiscal policy, monetary and exchange rate policies, banking and financial system supervision and regulation. As an example, the collapse of the Soviet Union the Fund stepped in to help the Baltic States, Russia, and other former soviet countries by setting up treasury systems for their central banks as part of the transition from centrally planned to market-based economic systems.[28]

The financial assistance is provided through different types of lending policies: stand-by arrangements and medium term extended arrangements. While medium term arrangements are intended for countries with balance of payments difficulties related to structural problems which may take longer to correct than macroeconomic weaknesses, stand-by arrangements are designed to deal mainly with short term balance of payments. Typically when a member applies for a stand-by, negotiations are initiated between the staff of the Fund and financial officials of the member state. The process is dispatched from Fund headquarters, to gather information and discuss the steps that the Fund is going to take by making the line of credit available to the state for six months, a year or under so called Extended Arrangements, which means longer periods. The final step or end- product is a Letter of Intent to the Managing Director of the Fund signed by the Minister of Finance or Governor of the Central Bank of the applicant state, in consideration of which the Executive Board approves the stand-by[29].

The IMF also provides loan to help its poorest member countries achieve external viability, sustainable economic growth and improved living standards. The International Monetary Fund also provides the type of loans that help its member states succeed with balance of payments problems caused by different events such as natural disasters, the aftermath of military conflicts and temporary shortfalls in export earnings. However, like the World Bank, the IMF makes loans also conditional on the borrowing country adopting sound policies that promise to

[28]Financial assistance; http://www.imf.org/external/ns/search.aspx?NewQuery=financial+assistance&col=SITENG&collection=&year=&filter_val=N&lan=eng.
[29] Andreas F. Lowenfeld, International Economic Law, Oxford 2003 , p. 517.

correct its balance of payments problem. Although such conditions have come under criticism from certain quarters, they are supposed to help ensure that by borrowing from the IMF, a country does not just postpone hard choices and accumulate more debt, but is able to strengthen its economy and repay the loan. In the face of mounting criticism of its intrusive conditionality policy the Fund sought to streamline its conditionality in 2000-2001 by making it more sharply focused on macroeconomic and financial sector policies and less intrusive into countries' policy choices. Unlike the lending by other development agencies such as the World Bank, IMF lending is temporary, ranging from about 3-10 years.

V. Poverty Reduction and Growth Facility

The Poverty Reduction and Growth Facility was established by the IMF in September 1999, in order to make the objectives of poverty reduction and facility growth more central to lending operations in its poorest member countries. Based on some of the IMF's staff reviews in 2002 and by the Independent Evaluation Office of the IMF in 2004 the designs of the programs supported by Poverty Reduction and Growth Facility (PRGF) lending has become more accommodating to higher public expenditure, in particular pro-poor spending.[30]

Another review of PRGF program design by the Executive Board in September 2005 found that while macroeconomic outcomes in low-income countries had improved markedly in recent years, per capita income remains low. This review is focused in the importance of broad economic institutions for sustained growth and stability, and the need to manage carefully increased aid flows.[31]

These supported programs are framed around country owned Poverty Reduction Strategy Papers, which are prepared by government with the active participation of civil society and other development partners and which then considered by the Executive Boards of the IMF and World Bank as the basis for

[30] Poverty Reduction and Growth Facility; http://www.imf.org/external/np/exr/facts/prgf.htm.
[31] Ibid.

concession lending from each institution and debt relief under the joint Heavily Indebted Poor Countries Initiative.[32]

VI. Heavily Indebted Poor Countries Initiative

With the aim of ensuring that no poor country faces a debt burden that can not manage, in 1996 the IMF launched the Initiative for Heavily Indebted Countries. In order to reduce to sustainable levels the external debt burdens of the most heavily indebted poor countries, the Initiative entails coordinated action by the international financial community, including multilateral organizations and governments.[33]

Based on the Review of 1999, a number of modifications were approved to provide faster, deeper and broader debt relief and to strengthen the links between debt relief, poverty reduction and social policies. However, even supplemented by the Multilateral Debt Relief Initiative, the Heavily Indebted Poor Countries Initiative is not a panacea (disapproving something that will solve all problems).Even if all of the external debts of these countries were forgiven, most would still depend on significant levels of concession external assistance, since their receipts of such assistance have been much larger than their debt-service payments for many years.[34]

VII. Multilateral Debt Relief Initiative

The Multilateral Debt Relief Initiative provides for hundred percent reliefs on eligible debt from three multilateral institutions to a group of low income countries. In June 2005, the group of eight major industrial countries (G8) proposed that the three multilateral institutions: the International Monetary Fund (IMF), the International Development Association (IDA) of the World Bank, and the African Development Fund (AfDF) – cancel hundred percent of their debt

[32] Ibid.
[33] Heavily Indebted Poor Countries Initiative; http://www.imf.org/external/np/exr/facts/hipc.htm.
[34] Ibid.

claims on countries that have reached the completion point under the joint IMF-World Bank enhanced HIPC Initiative.[35]

In comparison with HIPC, the MDRI goes further by providing full debt relief so as to free up additional resources to help these countries reach the MDGs. It's worth of mentioning that in deciding to implement the MDRI, the IMF Executive Board modified the original G-8 proposal to fit the requirement, specific to the IMF, that the use of the IMF's resources be consistent with the principle of uniformity of treatment.[36]

The IMF and the World Bank are cooperating closely in the implementation and monitoring of the MDRI. The first progress report on the IMF's implementation of the MDRI was presented to the IMF Board in April 2006.

D. SHORT DESCRIPTION OF KOSOVA'S DEVELOPMENT SINCE 1999

Kosova's population is roughly 2.4 million, with a working population of 1.1 million and an area of about 11 thousand square kilometers. Following the end of the war of March–June 1999, the United Nations (UN) Security Council Resolution 1244 (UNSCR1244) of June 10, 1999, placed Kosova under temporary UN administration, while reaffirming the sovereignty of the Federal Republic of Yugoslavia (FRY) over the territory.

According to a new constitutional framework, adopted on May 15, 2001 responsibility for administering the territory is now shared between the UN Interim Administration Mission in Kosova (UNMIK), and Kosova's self-government, the Provisional Institutions of Self Government (PISG), which took office in April 2002. [37]

Kosova has entered a decisive face in its current development. The maintenance of stability, both economical and political, will be of central importance in supporting the forthcoming discussions on the final status of Kosova, which is yet to be determined. The UN Security Council has indicated its support for a set of standards, whose achievement

[35] Multilateral Debt Relief Initiative; http://www.imf.org/external/np/exr/facts/mdri.htm .
[36] Ibid.
[37] Rakia Moalla-Fetini, Heikki Hatanpää and Shehadah Hussein (EUR)
and Natalia Koliadina (PDR) Approved by Alessandro Leipold and Donal Donovan (November 18, 2004).

paved the way toward discussions on the future of Kosova's final status, and as well as on its future development. [38]

At the request of UNMIK, and later the PISG, and together with the rest of the international community, the IMF has been assisting institution building and the formulation and implementation of economic policy in Kosova. With its assistance Kosova have nevertheless, developed a realistic medium-term macroeconomic framework based upon prudent fiscal policy. This work has been closely coordinated with the World Bank and other multilateral and bilateral donors. Apart from technical assistance provided by the Fund's Fiscal Affairs Department, Monetary and Financial Systems Department, and Statistics Department, the European Department has provided macroeconomic policy advice on an ongoing basis.[39]

I hope that the analysis of the Letter of Intent, comparisons and the analyses of IMF recommendations from 2002 till 2006 - 2007 will contribute to informing the debate about economic policies, in particular, and about the broader issues that will shape Kosova's future.

E. AN OVERVIEW OF THE IMF'S ESTIMATION OF KOSOVA'S ECONOMY

While Kosova has a unique history which reflects its current uncertain status, it is one of the last countries to start the road of transition to a market economy with labor market and unemployment problems.[40]

Assuming a population growth of 2 percent per annum for Albanian and 1.2 percent for other ethnic groups living in Kosova, the IMF estimates population in Kosova of 2.4 million.

Table 1 Macroeconomic indicators

	2002	2003	2004	2005 *
GDP in mil € 1	1,735	1,797	1,895	1,999
GDP growth (annual), % 1	1.2	3.1	3.2	1.7
CPI 1	3.6	1.0	1.5	2.0
GDP per capita, in € 1	913	930	964	1,000
Gov. revenues (% of GDP)	28.8	32.8	31.9	30.8
Bank deposits, mil.€ 2	413	501	677 (Nov)	-

[38] Letter of Intent to the International donor community (2 November 2005).
[39] Rakia Moalla-Fetini, Heikki Hatanpää and Shehadah Hussein (EUR)
and Natalia Koliadina (PDR) Approved by Alessandro Leipold and Donal Donovan (November 18, 2004).

[40] IMF estimates, 2 – Banking and Payment Authority of Kosova, * IMF projection.

Registered job-seekers	257,505 (Dec)	280,923 (Nov)	298,036 (Jul)	-

The IMF estimates that 750,000 - 800,000 people are currently working in services (55%), manufacturing (20%), and agro-food (15%). Therefore the unemployment rate of Kosova is 45-50%.[41]

Total production (GDP) in Kosova is € 2.5 billion. GDP is measured by combining total consumption and investment (€ 2.5 billion = € 1.9 billion + € 0.5 billion). The GDP per capita is approximately € 1040 and is measured by dividing total GDP of €2.5 billion by total population of 2.4 million people.[42]

The total income is € 850 million; Income = GDP - consumption + investment + government deficit + trade balance (exports – imports).

In 1999, of €1, 40% was subsidized, 30% from abroad, 30% taxed
In 2006, of € 1, 10% is from grants from the international community, 15% from abroad, 75% taxed (25% from GDP and 50% from the products sector).[43]
The private investment of € 500 million is financed primarily by banks. Currently there is € 900 million in deposits available for lending in the banks. 72% is currently being lent, whereas the maximum that may be lent is 75%.

25% of GDP, €630 million, is collected in taxes: customs and VAT. This has been a stable source of income for Kosova as the customs officials have been quite diligent on collecting the taxes at the border.[44]

Total spending in Kosova is € 700 million: € 140 million for public investment; € 210 million for subsidies; € 200 million for civil service; € 150 million for general expenses, such as cars, gas, etc. € 30,000 million is spent on education and only € 18,000 on teachers. There is a need to reform the educational sector; however the government is hesitant to do so because of their fear of unions. However, it is recommended that Kosova should strengthen their human infrastructure through allocating more money to the education sector. It is advised that there may be a role for UNICEF to advocate for more effective spending on education.[45]

[41] Marc Auboin (20 June 2006), IMF's Resident Representative to Kosova briefed the office on Kosova's economic situation.
[42] Ibid.
[43] Ibid.
[44] Ibid.
[45] Ibid.

There are 77,000 people working in the public sector; 30 c of €1 pays their wages. 64,000 people were hired by UNMIK before the transfer. Starting next year there will be public service reform where 10% of the workers will be reduced, however there will not be a reduction in the police, tax and education sectors.

Fiscal sustainability is when the right resources are in the right place, which leads to competitiveness. Kosova is not really competitive because there are high salaries compared to other regions.

Kosova has a debt of €550 million owed to the World Bank for projects related to infrastructure prior to 1999. The World Bank is not negotiable on the debt and insists that Kosova pay the annual interest of € 50 million every year. Marc insists that it is essential that Kosova does not default on the loan; therefore the government must factor in the debt in its total budget.[46]

The Medium Term Expenditure Framework (MTEF) is the projected amount the government may spend. The total spending is €700 million- €50 million owed to the World Bank which allows for € 650 million expenditure.

There will be an estimated 2% growth per year. Unfortunately with the amount of young people coming onto the labor market, Kosova needs 5% growth to be sustainable. Additionally, there is a prevailing issue of employment availability abroad as the migrant workers from the new EU member states will have priority in the EU labor market. Migrant workers from Kosova will have fewer employment opportunities.[47]

It's worth of mentioning the fact that the labor market in Kosova has some distinctive characteristics compared to other countries, because its young population annual net inflows in the labor force is 5%-6% of current employment, which means that employment has to grow by more than 6% per year for unemployment to fall. On the other hand, there is a large scale of emigration (both temporary and permanent emigration).

The effects of emigration on the labor market are of particular interest given its scale and the level of remittances. This is because it is mainly young and other working age individuals that emigrate, which affects the labor force and therefore the unemployment rate in Kosova. When estimating the remittances, there are different estimations. Data from Statistical Office of Kosova estimates that the average monthly income per

[46] Ibid.
[47] Ibid.

household from remittances is 48.9 €. The International Monetary Fund (2004) argues that this is an underestimation of remittances because of the following reasons:

- Households do not want to draw attention to their total income, and
- Do not report remittances from the family members working abroad illegally

The IMF estimates annual remittances of 241 Mio €, which is 13.4 percent of the GDP estimated in 2003.

It would be of great interest to explore the impact of the informal employment and in general of the informal economy. It is true that informal economy creates unfair competition and therefore damages other private businesses that pay taxes. Now, such a research would identify causes that businesses keep unregistered employed people or in the extreme case they stay informal altogether.

This research would help the government to address these problems as it is beneficial for all parties: increase taxes, improve competition etc. However, due to a lack of a proper social security, informal economy provides the only source of income for many households.

F. FIRST IMF'S MISSIONS IN KOSOVA

I. Kosova's economic landscape has changed significantly during the last three years.

Reconstruction of public and private buildings is now well advanced, agriculture is being revitalized, there is a vibrant private service sector, and an emerging banking system is transforming the cash-based economy. Although comprehensive and reliable statistics are not available, real growth has almost certainly been in the double digits in 2000 and 2001. There are still, of course, major problems: unemployment remains very high, the economy is heavily aid-dependent and still dominated by public and socially-owned enterprises, poverty is widespread, the legal framework for a market economy is not yet complete, gray activities are pervasive, and the quality of public infrastructure is low. But despite these handicaps and distortions, Kosova's economy today has a recognizable face.[48]

II. The IMF has been active in Kosova since it came under temporary UN administration.

The Fund has advised UNMIK and—more recently—the Kosovar self-government on macroeconomic policies through frequent missions and ongoing dialogue, coordinating

[48] Statement by the IMF Staff Representative at the Donor Coordination Meeting for Kosova November 5, 2002.

with donors through the Working Level Steering Group, as well as bilaterally. The Fund has provided technical assistance to the Central Fiscal Authority (CFA) in the areas of tax policy, tax administration, and setting up the treasury; and to the Banking and Payments Authority of Kosova (BPK) in introducing a payments system, modern prudential standards and bank supervision, as well as in its internal reorganization. The Fund also appoints the BPK's Managing Director. The Fund has published two reports (Kosova: Macroeconomic Issues and Fiscal Sustainability in 2001 and Kosova: Institutions and Policies for Reconstruction and Growth in 2002), providing the only publicly available source at that time of macroeconomic statistics and analysis for Kosova. Finally, in September 2002 the Fund opened a Liaison Office in Pristina, with financial support by Luxembourg.[49]

This is a good time for both Kosovars and donors to take stock of the situation and medium-term prospects, and draw conclusions that would guide policies in the coming years.[50]

The end of the post war situation means that the future of Kosova's economy, political and social development is in the hands of decision making institutions or policy makers in Prishtina, such as UNMIK or the self-government. Their policy decisions today will shape the future of Kosova's economy. At the same time, since continuing uncertainty about Kosova's final status impedes access to foreign direct investment and financing, Kosova still needs support in the form of donor grants in order to build a sustainable economy.

III. The dearth of economic statistics makes it difficult to assess the state of the economy

Preliminary estimates suggest that GDP in 2001 reached € 1.7 billion or about US$900-950 per capita (Table 1). Consumption and investment together were more than twice as high, owing to large official and private transfers. Imports were about 120 percent of GDP and, given the extremely low level of exports, were financed almost entirely by transfers from donors and Kosovars abroad. As a result of the latter, GNP exceeded GDP by about 40 percent. There are indications that in 2002, the pace of economic growth has slowed to 7 percent from two-digit figures in 2000-01, reflecting the easing of the post-conflict reconstruction and a small decline in the presence of expatriates in Kosova.

[49] Ibid.
[50] Ibid.

Consumer price inflation is also estimated to have slowed to about 6½ percent from over 10 percent in 2001.[51]

IV. The economy is heavily dependent on official transfers.

Between July 1999 and end-2001, a total of € 2.1 billion of grants were committed and € 1.6 billion disbursed, which annualized corresponds to about 45 percent of GDP over the same period. As a first approximation, official transfers and the local spending of expatriates together generate currently about one-fourth of total value added in the economy. This not only creates distortions—mainly an expansion of the government at the expense of the private sector and of services at the expense of traded goods—but also makes the economy especially sensitive to cutbacks in donor support.[52]

G. AID AND ECONOMIC ACTIVITY IN KOSOVA

Aid has had strong positive effects, both on the supply and on the demand side: it has been instrumental in repairing the physical infrastructure, establishing the legal framework and institutions for a market economy, generating demand for private service activities, providing employment, and building skills. However, it has also created distortions: in particular, it has distorted relative wages and raised the relative price of non-traded goods—including labor—thus inhibiting the development of the traded goods sector. [53]

In the past three years, Kosova received substantial aid to address immediate humanitarian and reconstruction needs, well above levels observed in most post-conflict economies. If services provided directly by donors, such as the services of expatriate advisers, security (provided by KFOR), police, etc. are added, the amount of aid is almost equal to Kosova's GDP in the early post-conflict years.[54]

Aid dependence—the concept commonly used in economic literature—is defined as the ratio of aid (in all forms) to domestically available resources (C+I+G), and is estimated at close to 30 percent in 2002. The share of aid to GDP consists of aid (in all its forms) plus local spending of expatriates minus the import content of these expenditures. This measure amounted to about one-fourth of Kosova's GDP and one-third of total aid flows in 2002. It should be stressed that the estimates of the value of services provided directly

---

[51] Statement by the IMF Staff Representative at the Donor Coordination Meeting for Kosova November 5, 2002.
[52] Ibid.
[53] World Bank estimates of disbursements of donor grants and MoFE and staff calculations.
[54] Ibid.

by donors, as well as the domestic spending by expatriates, are very tentative and subject to a large margin of error.[55]

A substantial decline in aid will have a major negative impact on growth. Based on the calculations above, a € 100 million decline in total aid would directly lower GDP by about € 33 million. Over time, of course, the impact of a reduction in aid on GDP would also depend on a host of other factors, such as the areas in which the cutbacks would take place and their phasing. But most importantly, the impact on growth would depend on the domestic supply response to the economic policies in place.[56]

The two major sources of growth in Kosova today are aid-related activities (primarily government and other services) and other domestic activities (notably agriculture, construction, light industry, and trade). By 2007, these activities will dominate the economy, sustaining an annual growth rate of 5-6 percent, in line with the experience of other post-conflict economies in the region. In the near term, however, the contribution of domestic activities will not be sufficient to offset the impact of the decline in aid, as official transfers are projected to fall from over 50 percent of GDP in 2002 to 23 percent by 2004. This is expected to cause a slowdown in growth to 4-4½ percent in 2003-04 (Table 1). Performance in later years would depend crucially on the success of structural reforms, namely setting up effective economic institutions, repairing the infrastructure, and creating an environment conducive to productive private investment. As regards the balance of payments, the tapering off of reconstruction activity and fall in aid flows will depress imports. Growing exports and some pick up of remittances are expected to keep the external current account in broad balance. Since Kosova is using the Euro, inflation is projected to remain low. At an average of 3 percent per annum, however, it is expected to exceed the Euro area level of inflation.

Share of the government in Kosova's economy (in percent of GDP) [57]

Table 2	**2000**	**2001**	**2002 Est.**
Kosova Consolidated Budget (KCB) expenditures (incl. municipalities)	15.7	16.0	27.0
KCB + public investment program (PIP)	60.1	49.6	47.6

[55] Ibid.
[56] Ibid.
[57] Ministry of Economy &Finance ; Macroeconomic Department, 13th floor of Government Building.

KCB + PIP + government services provided by donors	100.4	87.4	77.9

In this table measures, it is not included the public investment program (PIP), which has so far been financed entirely by donor grants. Once this is added, the share of the government reaches about 50 percent of GDP.

As already mentioned the depth and duration of the slowdown in growth in the near term will depend on the donor grants. Secondly, the extent and sustainability of the rebound over the medium term will depend on the success of macroeconomic and structural policies, as well as on modalities of the resolution of Kosova's final status.

On the basis of the assumptions about the target level of public investment outlined above, donor grants for investment are projected to fall from just over € 400 million this year to about € 200 million in 2005, and continue declining thereafter. This would lower the share of total government spending to GDP (excluding services provided directly by donors) from almost 50 percent this year to 31 percent by 2005 and below 30 percent thereafter. Even for this declining path of grants to materialize, new donor commitments will be required. In the absence of new commitments, public investment would fall short of the targeted level that has been incorporated in this macroeconomic framework[58].

The main medium-term challenge for the public finances is to manage a reduction of the size of the government while ensuring the provision of an adequate level of public services.

Public expenses that the government is handling can be justified and reasonably understandable by the urgent reconstruction and institution-building needs. As these are now declining, donor grants will naturally fall. (Preliminary estimates of grant disbursements have been made by the World Bank on the basis of a target level of public investment of 10-15 percent of GDP during 2003-05, declining to 6–10 percent thereafter. The sum of domestic revenues and donor grants is the resource envelope likely to be available to the Kosova authorities to finance government current and capital spending). At the same time, although domestically-generated tax revenues will continue to increase. This will require careful policy choices and effective prioritization of expenditure needs in a medium-term context.[59]

[58] IMF office in Prishtina, BPK Building, IMF's recommendation of Staff Representatives at the Donor Coordination Meeting for Kosova, November 5, 2002.
[59] Ibid.

It has been assumed that, at least for the period of the projections, the Kosova budget will not undertake domestic or external borrowing.

Self government institutions, UNMIK as well as IMF agreed that borrowing is an uncertain action. The IMF advises are not to borrow without mechanisms to ensure that projects financed by debt are chosen transparently and have an adequate rate of return; Secondly, the settlement of past debt issues; and finally, a strong domestic revenue base that could cover future debt servicing needs. Moreover, having access to financing it would be a critical issue for Kosova's future long-term development.[60]

Domestic revenue collection will continue improving, but at a slower pace then in 2000-02.

Revenues of the Kosova Consolidated Budget (KCB) are reaching 20½ percent of GDP, as similarly happened during two previous years. Although the domestic tax is likely to slightly rise above the 20½-21½ percent range, at least in the near term, because the pace of economic growth is likely to slow as donors withdraw.

The Fund staff's detailed domestic revenue estimates are based on the following assumptions:

- Estimates of *domestic VAT* collection were based on the growth of private consumption, which is expected to decline in 2004-05 and then increase for the remainder of the period. The VAT rate is assumed to remain at 15 percent for the period.
- Estimates for *excises* were based on the growth in domestic consumption as well as the demand for petroleum products are linked to growth in economic activity.
- Estimates of *individual* and *profit taxes* were based on projected wage increases and real GDP growth, respectively. Furthermore, the estimates incorporate the impact of the planned extension of the current wage tax to all incomes in 2003.
- *Customs duties* were based on dutiable import growth assumptions and a gradual reduction of the average tariff rate during 2003-05, in line with the authorities' current intentions.

If no access to borrowings, total expenditures of the KCB (which excludes the PIP) would have to be approximately equal to domestic revenues during 2003-05. The level of total KCB expenditures is thus projected at 21-22 percent of GDP during 2003-07, compared with 15-16 percent in previous years. This should be sufficient to finance current spending at the level of 17-18 percent of GDP and a small amount of capital

[60] Ibid.

spending. Given that the KCB is not at present burdened with any debt service payments and the cost of the social safety net in Kosova is relatively low by international standards, this current expenditure envelope is broadly in line with that in other comparable economies, and should provide sufficient room for financing the provision of basic public services. [61]

Tax policy should remain oriented toward a simple and efficient system, and tax collection should be enforced

UNMIK and the self-government should reconsider the current intention to lower import tariff rates. At this stage, this could result in a potentially significant loss of revenue from a well-established tax source. In later years, once domestic revenue collection improves, tariff reduction could be compensated by a modest VAT rate increase. Investments in tax administration and the training of tax inspectors take years to bear fruit and should continue to remain a government priority.

The key to medium-term fiscal sustainability is current expenditure discipline

Budget Spending jumped from € 220 million in 2000 to € 380 million in 2002, partly on account of the energy sector emergency. Demands for large wage hikes, in particular, are out of line with economic fundamentals: the total government wage bills in Kosova, as well as the average government wages, are already at or above the level in comparable economies.

[61] Ibid.

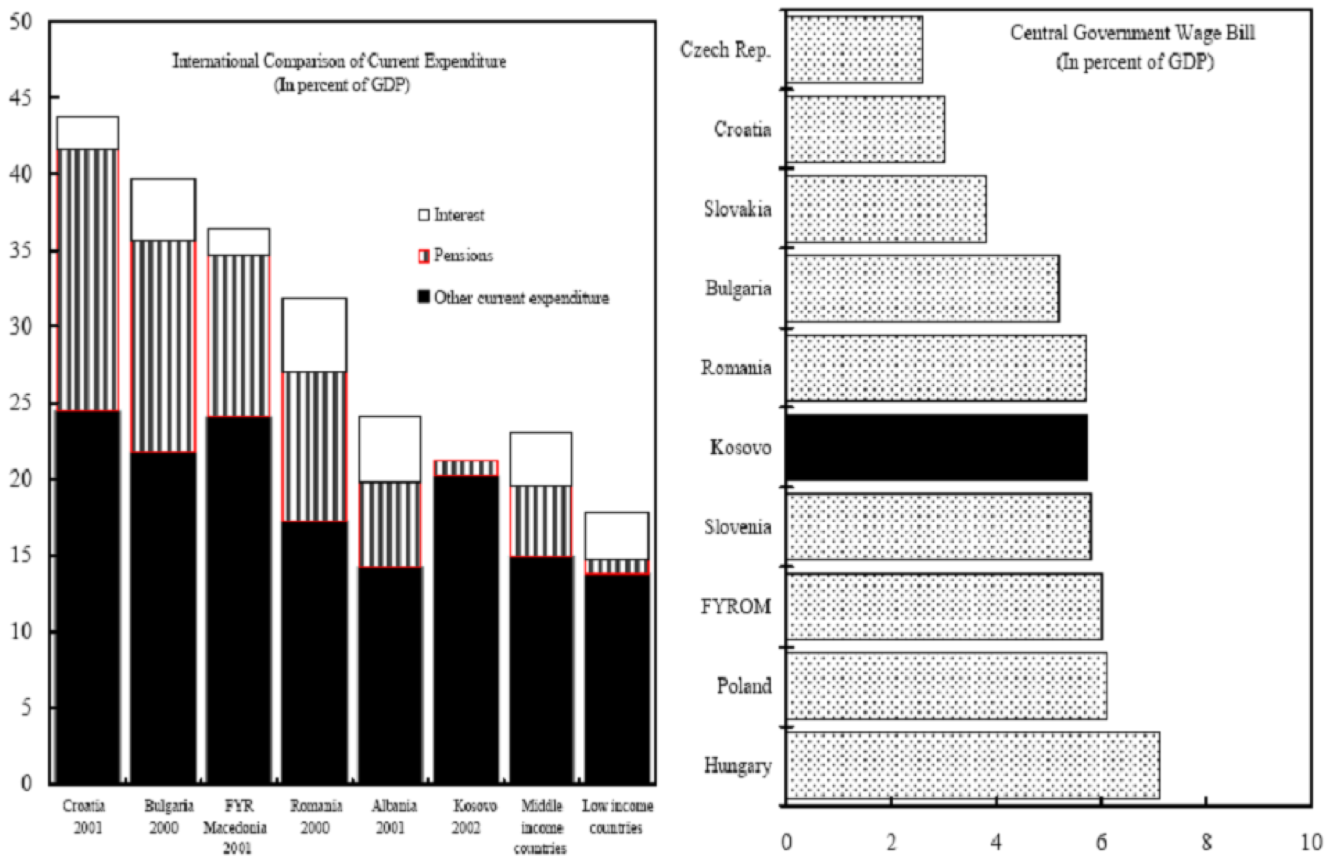

Figure1. International comparison of current expenditure & Central Government wage bill (In percent of GDP)

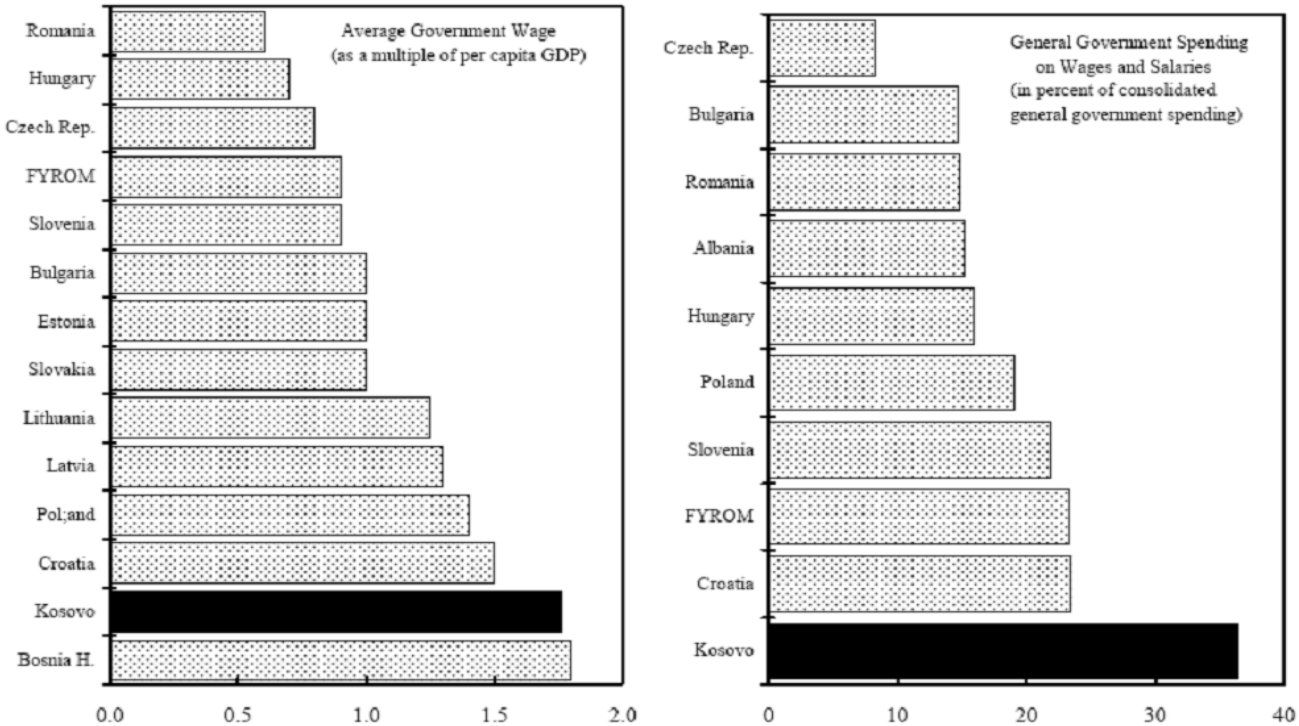

Figure2. Average Government Wages as a multiple of per capita GDP) & General Government Spending on Wages and Salaries (in percent of consolidated general government spending)

Therefore, during the coming years, average public wage increases should be limited to about the rate of inflation, and measures should be taken to reduce overstaffing in the civil service, thus:

- allowing greater wage differentiation within the same wage bill envelope;
- pension increases should be kept strictly in line with the cost of the basic food basket, as provided for in the legislation;
- maintenance expenditures should be kept up, but savings in spending on goods & services should be generated through better public expenditure management,
- appropriate procurement procedures, and stronger internal audit;
- subsidies to public enterprises should be rapidly reduced by accelerating their restructuring and improving collection rates.[62]

[62] Ministry of Finance and Economy, World Bank, and IMF staff calculations.

I. Recommendations in private sector

Progressive steps forward have already been undertaken in this area since 1999.UNMIK and the self-government should now accelerate the legislative agenda, putting particular emphasis on the laws on bankruptcy, foreign trade, public procurement,
competition, and land use; ensure that laws are applied equally to all, including notably the tax laws; establish a pledge registry and land cadastre; improve the functioning of the judiciary; and address concerns about judges' bias in dealing with disputes between banks and their customers. These steps would not encourage only the private sector to get better organized in its legal field, but also to turn the informal activities to a legal and formal economy.[63]

II. Financial sector development requires enforceable property rights and strong supervision.

Financial intermediaries have an important role to play in evaluating and pricing risk, financing investment, and enforcing good accounting and management practices. Kosova's nascent financial sector (for instance banking sector) has already started transforming the traditionally cash-based economy. But despite very rapid credit growth in recent months, financial intermediation remains very shallow compared to other economies in the region.[64]

III. Privatization of socially-owned enterprises is a key component of the transition to a market economy

Over certain period of time privatization will generate considerable gains for the economy as a whole by unlocking the potential of assets—especially real estate—that many of these enterprises hold, eliminating a source of budgetary costs, leveling the playing field for all enterprises, and sending a signal about the kind of economy Kosova wants to build. It is now urgent to:

- impose hard budget constraints on these enterprises by enforcing payment of taxes;
- finalize and promulgate the land use rights law as soon as possible;
- approve the KTA regulations, including rules governing the claim registration
- process;
- prepare the tenders for the first and second wave of privatizations by year-end.[65]

---

[63] IMF office in Prishtina, BPK Building, IMF's recommendation of Staff Representatives at the Donor Coordination Meeting for Kosova, November 5, 2002.
[64] Ibid.
[65] Ibid.

H. COMMITMENTS OF THE KOSOVA'S GOVERNMENT EXPRESSED IN THE LETTER OF INTENT FOR THE INTERNATIONAL DONOR COMMUNITY[66]

I. Economic policy strategy expressed in LOI

Our modern and efficient tax system, with low uniform rates and few exemptions, in combination with the liberal trade and tariff regime has allowed us to raise the revenues required to operate government with a minimum of distortions. Since 1999, an increasingly self-sustained private sector led economic development, which has been instrumental in overcoming the drag on economic activity associated with a shrinking donor sector. As a result, GNP per capita has grown by an average $1^{3/4}$ per year since 2001.

Still more need to be done. Importantly, Kosova's competitiveness must be improved further. In the first instance, this requires reduction in the economy's costs, including by allowing wages, which are in some sectors still distorted by the large premia paid by donors, to adjust the line with underling productivity. It will be essential to raise productivity through competition and investment in the private sector, wich will be supported by Governments ongoing priority efforts to improve physical infrastructure through public investment and to raise human capital through better health services and education.[67]

II. Fiscal Policy

Our fiscal policy management has greatly improved in line with changing challenges. Our capacity to spend was lagging behind the growth of revenue, the year 2004 marked a sharp turnaround and the Kosova Consolidated Budget swung into a large deficit of 138 million € (some 5 and a half percent of GDP). The new Government quickly implemented corrective measures to cut the deficit to 95 million € in the current year (3.9 percent of GDP).

In the first place, ongoing deflation will curtail the growth of revenues. Thus in order to continuo the consolidation process, both the growth and structure of public expenditure must be tightly controlled. Controlled and management of the budget is a central factor in the need to lower costs and hence foster private sector job creation.

[66] Letter of Intent to the internal donor community (2 November 2005).
[67] Ibid.

The budget is in line with these requirements. We target a deficit not to exceed 77 million €, which will arrest the growth of the share of public expenditure in GDP. At the same time, the Government will implement the required transfer of powers to the PISG.

We have also abrogated those parts of the collective labor agreement, which necessitated additional outlays for civil servants (including meal allowances and a thirteenth wage). These measures will save some 56 million € form the wage bill.
To avoid undue stress on the Kosova Civil Service and to encourage professional growth, vacancies will be offered in the first instance to qualify individuals in the current workforce.

We are committed not to introduce any new benefits, including those, the implementation of which has been postponed. Finally, we will abrogate the section in the collective labor agreement requiring the budget to copay maternity leave benefits pay in the private sector including the POEs.

We will not proceed with rehabilitation of Kosova A power plant through public funds and have postponed plans to set up an independent transmission systems operator in the electricity sector. This will save costs, but also not prejudge ongoing work in energy sector reform. In order to ensure that budget organizations implement their generally tighter allocations, we are also implementing a commitments monitoring system.

III. Macroeconomic Objectives

A wide gap between labor costs and productivity is present in comparison with countries in the region and elsewhere, and these needs to be narrowed to generate more employment. This process has started already as witnessed by observed sustained deflation since June 2004. In shorter term, ongoing donor withdrawal, as well as the sharp deterioration in Kosova's terms of trade associated with the recent sharp raise in commodity prices, is working in the opposite direction. We estimate that the increase in oil prices alone is lowering GDP growth by some $1^{1/2}$ percent in 2005.

IV. Medium-Term policy Framework

We will have to manage the further disengagement of donors, which may require additional obligations for the budget. Indeed, there is some scope for saving as well particularly with respect to public sector wage bill and the potential to redeploy our sizable civil servants. With regard to the latter, we also intend to initiate public service reform program during 2006, with the aim of reducing our civil service mainly through attrition, by some 10 percent in 2008.

Accordingly and in line with medium term macroeconomic framework, we plan to keep the growth of real spending to below ½ percent. We expect that this transparent approach will also help us in securing multi year pledges of budget support for international donors. In addition, we will continue our work to improve the effectiveness of public investment program (PIP). This requires us o improve information on donor coordination statistics with a view toward eventual full integration of the PIP into the budget.

V. Socially and Publicly Owned Enterprises

KTA is seeking to privatize 90 percent of its value by mid 2006. The liquidation process has also started for nine pilot enterprises as a result of spin-off privatization. We will continue to improve governance of POE. The PTK and Prishtina Airport were incorporated in June 2005, and the incorporation of the POE’s is under way.

Turning to KEK, we intend to raise our payment ratio from 37 percent in October 2005 to 45 percent by the end of 2006 in line with KEK’s financial recovery plan for 2004-2010. These targets will be reached notably through a. the improvement of meter reading in billing, b. effective disconnection, and c. reduction of illegal consumption. A joined task force will be established to facilitate coordination of the institutional support to KEK’s implementing its financial recovery plan. The task force will be composed of UNMIK and PISG senior officials and will also be associated by the Head of Police and Justice.

VI. Financial sector

Over the last months bank landing has rapidly grown, and competition has held in extending the majority available loans. In order to secure this welcome success, we are keen to strengthen our regulatory and supervisory abilities in line with this rapid growth.
Expected changes in this macroeconomic environment such as deflation and donors’ withdrawal will also be incorporated in the analyses.

VII. Labor Market

A flexible labor market is of primary importance in creating urgently needed employment. We regret initiatives undertaken by the previous government in the context of the three partite agreements (Government, Kosova Chamber of Commerce, Syndicates) that are now limiting the required flexibility.

We will allow for a new employment contract that is not subject to minimum wages (but to taxation). For the future, we will not interfere in the workings of the bargaining process between employers and workers.

VIII. Technical assistance and statistics

Technical assistance from donors will continue to be essential in several areas. The recently finalized national accounts statistics will need to be carried forward and local compilation capacity strengthened, while financial statistics will need to become more comprehensive. There are also needs in further capacity building in the fiscal area including tax administration and expenditure management.

I. IMF REPORT AND RECOMMENDATIONS FOR KOSOVA IN MAY 2006

Facing strong headwinds, the economy has nevertheless recorded considerable progress.[68]

Since 2003, GDP has grown by some 1⅔ percent on average, and is projected at three percent for 2006. This rapid expansion is thought to be as a result of an active performance of the private sector. However, there is a gap between productivity and wages causing Kosova’s huge trade deficit of 40 percent of its GDP. This gap should be lowered through labor intensive growth in outward oriented production—in both import-competing and exporting sectors.

I. Economic adjustment will be a challenge for all.[69]

In 2003, prices have declined by some 5 percent, providing a better position for the private sector. In this environment, corporate profits and margins have been squeezed; this is a welcome sign, and must not be an argument for extending protection. Similarly,

[68] AIDE MEMOIRE of the IMF Staff Mission in Kosova, May 22 - 31, 2006.
[69] Ibid.

pressures for lower wages, reinforced by falling donors, must not be counteracted by policies that then impede the creation of the demand for new jobs opportunities.

II. Status presents opportunities but also new demands on policy makers.[70]

Beside the fact that the resolution of status will lead to a clearance of the property rights, improve the domestic investment climate, facilitate access to international capital flows improving dramatically the prospects for growth, on the other hand it basically will:

- Place heavy demands on the budget due to the fact that remaining UNMIK functions will be transferred,
- Call for additional budget outlays on capital, education, and health,
- Draw the attention to the fact that donor flows tend to be rapidly scaled back,
- Call for servicing external debt (the amount of which is currently being determined in talks with the Serbian authorities).

III. Recent decisions raise concerns as to whether policies are up to the task.[71]

In late 2005 authorities adopted a Letter of Intent that sets out a comprehensive policy package to support economic development. It rests on prudent fiscal policy, structural reforms, and a social safety net targeted. However, there is a significant deviation of the policies set out in the Letter of Intent, concerning the fact that no progress was made in preparing the civil service reform, while social transfer schemes (which already cover 10 percent of the population and absorb almost one fifth of revenues) are set to continue growing. Apart from the risks to the budget, these trends impede private sector growth in two ways:

- The gap between productivity and wage bill and ill targeted due to generous transfers may increase
- Financing the above mentioned policies stated in the Letter of Intent will require higher taxes in the future, which will only add new costs to businesses.

IV. A deeper public debate on economic policy choices and constraints may help secure stronger support for sound policies.[72]

A unique economic situation has brought Kosova to a complex issue which is not faced elsewhere. The combination of use of the Euro currency, which has drastically scaled back the donor support, and tremendous unemployment have brought a lid on income and

[70] Ibid.
[71] Ibid.
[72] Ibid.

wage growth for years to come. On the other hand, the economy has in the past benefited from a strong private sector that has proven itself able to adapt quickly and find niches. This should help those who call for less public employment and less extension of social transfers. At the same time, wide-spread poverty is undeniable, and a well-informed public debate may be beneficial in realigning social transfers to the most needy, and, more generally, in prioritizing public spending.

J. CURRENT SITUATION

I. Fields in which Kosova has made progress

Concerning macroeconomic and structural policies, a recognizable progress has been made. The economy is regionally participating, with a growth of 3 percent of GDP, and with a stable price level.

The system, based on a wide base with low and uniform rates, is kept unchanged, except for obligations under international agreements. In particular, no new exemptions from taxes or import duties—formal or informal—are granted, no new differential rates introduced, or existing differential rates extended. The recently adopted strategic reform is in compliance with IMF recommendations.

Noticeable progress is made also in fiscal management, for instance, revenue collection by 13 percent to €713 million was possible due to a special dividend scheme on the telecommunication monopoly. Secondly, in spring of 2006, banking system has renewed its investor interest, mobile-phone license was successfully re-tendered for the second time, and finally, the work on comprehensive civil reform strategy is initiated, and a rapid expansion of the private sector is faced.

Indeed, since 2003 prices have declined by some 5 percent, a key factor underpinning private sector growth, in such environments, corporate profits and margins are squeezed; this is a welcome sign.

II. Fields in which Kosova need improvements

Kosova needs a reduction in costs of production in order to ensure a successfully competition in domestic and international markets. Even though, in LOI it is stated the aim to improve physical and human capital through public investment, this is yet an immediate need.

The statistical base continues to lag considerably behind the developments in, and requirements of, the economy while several donors have offered assistance, the limited staying power of such assistance in the past suggests that better donor coordination is necessary. It is also essential to safeguard the banking sector through proper supervision and vigilance in addressing any evolving problems, in addition to working toward raising competition through market forces. Past experience has also shown that the framework dealing with loan recovery needs to be beefed up.

In regard to social transfer spending there are some remaining difficulties especially the miners' early retirement benefit continues to be paid at higher levels than provided for in the relevant regulation, while a new benefit to compensate war martyrs has cost implications that cannot be borne in the budget. Better targeted benefits are essential to redress severe poverty within scarce budgetary means, while also limiting the negative incentive effects for employment creation. Past spot audits have documented weak benefit administration, as many ineligible claimants receive benefits. The joint task force was not effective, as poor billing and collections continue and remain at the core of KEK's failure to improve electricity supply, and no longer require KEK to grant forgiveness of electricity bills to "social cases". KEK needs to complement budget support by much improved billing and collections.

Importantly enough is the fact that we have yet recommendations to limit government employment to what is strictly needed to provide functions, thus effectively achieve its target to cut the civil service by 10 percent by 2008, and support plans to rationalize expenditure on goods and services. Limiting the civil service wage bill and improving the targeting of social benefits will strengthen incentives for private sector employment creation. However, legislative proposals for the pension system, early retirement benefits, and wage-tax funded unemployment and health insurance run counter these requirements and are likely to result in even higher unemployment. The fact that there are expenditures from a large underspending on public investment of €52 million, this is already putting an urgent need for a new investment into lignite mines into question.

Expeditious privatization of utilities after status should be targeted as a priority matter, including by designing appropriate corporate governance set up. In addition, the privatization or liquidation of remaining SOEs should not be allowed to slow, given the contribution of privatized entities to export growth and higher foreign direct investment.

The Kosova C energy and mining project should be structured in line with international best practice. A framework for Public Private Partnership should not result in any contingencies for the budget and only burden the government with the risk it can control.

K. CONCLUSION

While the Fund's mandate is as relevant today as it was in 1945, the first thing that is worth of mentioning is that the world economy has undergone enormous change since the IMF was established at the end of the WW II. In fact, in todays rapidly integrating global economy, the maintenance of international financial stability is even more important than it was in those early days. I'm saying this based on the fact that today IMF has more than five times as many members as when it started out.

As the world economy has evolved, so did the International Monetary Fund. All member states have learned a great deal about how economies function and about how best to achieve sustained rapid growth, raise living standards, and reduce poverty. If we carefully notice the period after 1990's, IMF has attached greater importance to sound fiscal policies and sustainable debt levels, by appreciating the central role that financial sector plays in fostering growth, and by knowing that flexible exchange rate regimes enable economies more easily to adjust the shocks. But, in many low income countries (e.g. Kosova) policies discourage businesses and enterprises. Property rights are often difficult to enforce and in many cases weak judicial systems make contract enforcement virtually impossible. In recent years IMF realized that such issues need to be addressed if a macroeconomic framework is to be sustainable.

Of course that macroeconomic stability is important for the low income members while it has become increasingly apparent over these years. Most of the poorer countries that have put in place policies to reduce inflation and crate the conditions for growth have experienced higher growth rates (always with the IMF's advices and encouragements).

Unfortunately, except the "advantages" of the IMF mentioned in the above paragraphs, the International Monetary Fund has problems and difficulties. The problems that exist in the IMF are only the most extreme version of a problem that exists in all international organizations. The IMF is suffering from serious structural distortions that have slowly developed since the Second Amendment to the Articles of Agreement. These problems create a substantial barrier to the effective functioning by the IMF.

They can only be corrected through a broad ranging reform program that will overhaul the structure and operating principles of the IMF. Without undertaking this reform program, it is unclear if the IMF will ever be able to effectively make any useful contributions to solving the complex problems of poverty, inequality and inadequate governance which plague developing countries today.

Despite the fact that the path of Kosova's transition was and continues to be not an easy one, Kosova has experienced a higher growth as well. In a complex and unique political situation in which Kosova finds itself, it is a general impression that a lot has been achieved as far as creating institutions and policies. However, there is still a long way to go.

Based on IMF' recommendations, Government objectives and current necessities, the study concluded that there is an immediate need to:

- reduce the unacceptably high level of unemployment,
- focus on reconstruction, private investment, import-competing, export sectors, privatizing socially owned enterprises, and support the overall improvement in competitiveness,
- adjust economy costs in line with its underlying productivity, limit the growth of budgetary wage bill, redeploy the size of civil service with the aim of reducing it, improve physical infrastructure, and to rise human capital,
- improve fiscal policy management, cut the deficit of KCB (not to exceed 3% of GDP), maintain low rate of tax regime, provide more effectively the administration of social transfers in line with initial intention of providing a safety net for those most in need (disability pensions, the war invalid benefit, and the early retirement benefit for minors),
- implement monitoring system ensuring tighter allocation of budget, to enhance non-tax revenue,
- improve the effectiveness of the public investment program (PIP), and information in donor coordination statistics,
- privatize all the total assets of SOE by KTA (mainly based on the client plan for the future development of the social enterprise to be privatized) , and to improve the governance of public enterprises (such as: PTK and Prishtina International Airport).
- Moreover, pending the assignment of an international dialing code(second mobile operator), so the tendency to avoid possibilities for monopolistic behavior must be high.

- strengthen the regulatory and supervisory abilities, introduce more foreword-looking approach in assessing the risks facing the banking system, and to create a more comprehensive financial statistics.

The above mentioned points show also the IMF’s role in Kosova, which is to be appreciated with respect to the fact that it has strengthen the capacity in both human and institutional resources, designed appropriate macroeconomic policy, tax policy, revenue administration, expenditure management, financial sector sustainability, more specifically it has assisted in policies relating to the government’s budget, the management of money and credit, government and consumer spending, business investment, exports and imports, output (GDP), employment and inflation, financial sector policies, including the regulation and supervision of banks and other financial institutions, and structural policies that affect macroeconomic performance, such as those governing labor markets, the energy sector and trade, which all reflects to a possible better balance of payments.
I can conclude that the Fund’s unique thing is the cross- country perspective that has significant advantages when helping countries address their economic policy needs.

Finally, we also have the possibility to notice the changing role of the IMF, especially in its PRGF, HIPC and MDRI programs when thinking in the context of what initially IMF was supposed to do.

References

Andreas F. Lowenfeld, International Economic Law, Oxford 2003, p. 517, 521, 522, 524, and 567.

Paul A. Samuelson & William D. Nordhaus, ECONOMICS, Seventeenth Edition 2001, p. 628.

Andreas F. Lowenfeld, International Economic Law, Oxford 2003, p. 503.

Richard Goode, Economic Assistance to Developing Countries through the IMF, Washington DC, Publisher: The Brookings Institution.

Ralph H. Folsom, Michael W. Gordon, John A. Spanogle, International Trade and Economic Relations, USA 2004.

Rakia Moalla-Fetini, Heikki Hatanpää and Shehadah Hussein (EUR) and Natalia Koliadina (PDR) Approved by Alessandro Leipold and Donal Donovan (November 18, 2004).

Letter of Intent to the International Donor Community (2 November 2005).

IMF estimates, 2 – Banking and Payment Authority of Kosova, * IMF projection.

Marc Auboin (20 June 2006), IMF's Resident Representative to Kosova briefed the office on Kosova's economic situation.

Statement by the IMF Staff Representative at the Donor Coordination Meeting for Kosova, November 5, 2002.

World Bank estimates of disbursements of donor grants and MoFE and staff calculations.

Ministry of Economy &Finance; Macroeconomic Department, 13th floor of Government Building.

Ministry of Finance and Economy, World Bank, and IMF staff calculations.

AIDE MEMOIRE of the IMF Staff Mission in Kosova, May 22 - 31, 2006.

http://www.imf.org/pubs/ft/aa/aa01.htm

http://www.imf.org/external/pubs/ft/exrp/what.htm#do

http://books.google.com/books?id=dTw6oS_XXCUC&pg=RA1-PA2&ots=1ctDDwGBCR&dq=historical+background+of+IMF&sig=MjnkR7RK83mqYvDrwGgas_Nb-N4#PRA1-PA2,M1

http://www.english.uiuc.edu/maps/depression/about.htm

http://www.imf.org/external/np/exr/facts/tech.htm

http://html.rincondelvago.com/bretton-woods_1.html

http://www.imf.org/external/pubs/ft/exrp/what.htm#box5

http://www.reference.com/browse/wiki/Bretton_Woods_system

http://www.answers.com/topic/bretton-woods-system

http://www.imf.org/external/pubs/ft/exrp/what.htm#box4

http://www.britannica.com/eb/article-247600/money

http://www.imf.org/external/np/exr/facts/prgf.htm

http://www.imf.org/external/np/exr/facts/hipc.htm

http://www.imf.org/external/np/exr/facts/mdri.htm

http://www.imf.org/external/ns/search.aspx?NewQuery=financial+assistance&col=SITENG&collection=&year=&filter_val=N&lan=eng