

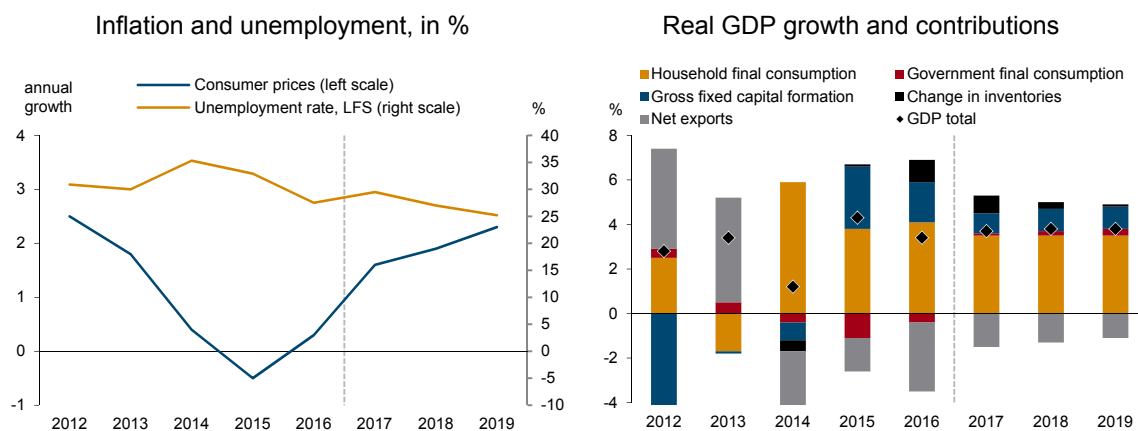


## KOSOVO: New government facing challenges, but growth will remain strong

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The new government has a tiny majority and is made up of a diverse set of parties, meaning that significant reform will be difficult. However, the economy is growing strongly, driven in particular by supportive external factors, and this is likely to remain the case over the forecast period. Exports are growing rapidly, but from a very low base, and a significant change in Kosovo's remittance-dependent growth model is unlikely in the medium term.

Figure 39 / Kosovo: Main macroeconomic indicators



Source: wiiw Annual Database incorporating national and Eurostat statistics, own calculation. Forecasts by wiiw.

**A new government was approved by parliament in September 2017, with Ramush Haradinaj of the Alliance for the Future of Kosovo (AAK) as prime minister.** Mr Haradinaj heads the PAN coalition, which received 61 votes in parliament out of 120, meaning that his majority is wafer thin. Important support came from Srpska Lista, the main Serbian party in Kosovo, which in return will have three ministries in the administration. The Bosnian and Turkish minorities are also represented in the government. The tiny majority and large number of parties in the coalition create particularly significant risks to political stability and policy formation.

**Mr Haradinaj has stated that he intends to focus on continued dialogue with Serbia, and tackling corruption.** Broadly, we expect few radical changes compared with the previous government's policy stance. The challenges facing the government remain daunting. Aside from those emphasised by

Mr Haradinaj, they include EU visa liberalisation, a border demarcation agreement with Montenegro, and changing the Kosovo Security Force into a regular army.

**In the near term, a government led by Mr Haradinaj is probably positive for regional stability.**

Albin Kurti, the Vetevendosje candidate for PM, would likely have taken a much more antagonistic approach towards Serbia. Vetevendosje is a relatively new party which opposes continued dialogue with Serbia on the current terms and came second in the recent election. Mr Kurti previously said that EU-mediated Serbia-Kosovo talks have 'failed' and should not continue. However, whoever is in power, relations with Serbia will remain difficult. This will continue to be a major structural impediment to Kosovo's economy, and particularly the development of the external sector.

**Kosovo's public debt is low, and the fiscal deficit is not a source of risk at present.** However, fiscal reforms initiated by the ex-finance minister Avdullah Hoti could now be abandoned. The new government is also pushing forward with a plan to increase wages in the public sector. Pressure from social groups for increased transfers could create fiscal pressures over the medium term.

**The economy is currently growing strongly, driven in particular by supportive external developments.** Real GDP rose by 3.7% year on year in Q1, and growth strengthened to 4.4% in Q2. Growth in Q2 was driven primarily by gross capital formation and exports, which rose by 8.4% and 20.7%, respectively. Household consumption fell by 3.1% and imports by 1.7%. On the production side, the fastest growth in Q2 came from mining and quarrying (+23.5%), electricity (+6%), construction (+18.8%), transportation and storage (+9.8%) and accommodation and food services (+8%).

**We expect growth to remain robust during the forecast period, with Kosovo set to be among the fastest growing economies in the Western Balkans in 2018-19.** Growth is forecast to average 3.8% in the next two years, driven primarily by private consumption and investment. The latter should benefit from a continued steady increase in net foreign direct investment (FDI) inflows. Remittance inflows will also remain strong, with growth in key source countries such as Switzerland and Germany likely to remain robust.

**The labour market remains a major source of weakness for the economy, and this will remain the case during the forecast period.** Remittances from much wealthier countries such as Switzerland and Germany are partly behind this; domestic wages are at a level where many locals are unwilling to work. Remittances accounted for 11.5% of GDP in 2016. However, a bigger reason is the lack of productive capacity in the economy. As of 2016, Kosovo had the lowest employment rate and the highest unemployment rate of the CESEE countries for which we provide data. Youth unemployment is also particularly high.

**Monetary conditions have continued to loosen, tracking developments in the eurozone.** The effective interest rate on new loans has continued to fall, for both corporates and households. Inflation has tailed off from its April peak of 2.2% year on year (as the very low oil prices of early 2016 dropped out of the base for year-on-year comparison) but is still relatively high (at 1.7% in both July and August). Nevertheless, it appears that Kosovo's brief flirtation with deflation is over. Credit growth will provide some support for growth during the forecast period.

**The external deficit is large, and will remain so during the forecast period.** Kosovo posted a current account deficit equivalent to 9.2% of GDP in 2016, and the shortfall widened by 13% year on year in January-July 2017. We expect a full-year deficit equivalent to 10% of GDP this year, and further widening thereafter. The expansion of the deficit is being driven by a wider goods shortfall; this widened by 7% year on year in January-July. The merchandise trade deficit was offset partly by higher surpluses on the services, primary income and secondary income accounts. The latter remains by far the most significant of the three, and largely reflects inflows of remittances from Kosovans abroad. Net secondary income inflows covered 46% of the goods deficit in January-July, a slight decrease from 49% in the same period of 2016. Separate quarterly data for remittances showed year-on-year growth of 13.2% in Q1 and 10.6% in Q2.

**Merchandise exports are growing rapidly, albeit from a very low base.** Nominal merchandise exports grew by an average 30.9% year on year on average in March-August. Imports were up by 9.6% over the same period, but with exports only equivalent to a little more than 10% of imports, the trade deficit still widened. Exports primarily go to other members of the Central European Free Trade Agreement (CEFTA); 47% went to other CEFTA countries in 2016, with a further 23% going to the EU. Manufactured goods (including machinery and transport equipment) accounted for 48% of total exports in 2016, with crude materials excluding fuels responsible for a further 22%. However, Kosovo has a very long way to go; merchandise exports represented just 5% of nominal GDP in 2016, well below regional peers such as Croatia (27%), Bosnia (31%), Serbia (39%) and Macedonia (44%).

**External debt is rising quite quickly, although remains the lowest in the region relative to GDP.** Gross external debt increased by 8.9% year on year in H1, driven by increases in both public and private credit. Banks are deleveraging on a net basis, while non-bank private sector borrowing is growing rapidly, in part because of a ramping up of short-term debt. Over one third of external debt is still made up of inter-company lending, although the share has fallen as non-bank private debt has increased (26.5% of the total in Q2).

**In summary, we expect the economy to grow by 3.7% this year, and 3.8% in 2018-19.** Growth will primarily be driven by external factors, particularly (but not only) remittances. This growth rate will ensure continued convergence with wealthier states, albeit from a low base. Inflation developments will largely track those of the eurozone, meaning that price growth will remain relatively subdued in the historical context. Significant reform is highly unlikely, given the broad coalition and its tiny majority. Further strong export growth is likely, although the export base will remain small, and major structural challenges – particularly tensions with Serbia – will keep Kosovo's export sector among the smallest in the region during the forecast period. As a result, the merchandise trade deficit will remain huge, although inflows of remittances, loans and other investment will help to offset this.

**Table 14 / Kosovo: Selected economic indicators**

	2013	2014	2015	2016 <sup>1)</sup>	2016 January-June	2017	2017 Forecast	2018 Forecast	2019
Population, th pers., average	1,818	1,813	1,788	1,778	.	.	1,770	1,760	1,750
Gross domestic product, EUR mn, nom.	5,327	5,568	5,807	5,985	2,729	2,831	6,300	6,700	7,100
annual change in % (real)	3.4	1.2	4.3	3.4	3.4	4.3	3.7	3.8	3.8
GDP/capita (EUR at PPP)	6500	6700	7400	7800	.	.	.	.	.
Consumption of households, EUR mn, nom. <sup>2)</sup>	4,468	4,821	4,964	5,176	2,492	2,529	.	.	.
annual change in % (real)	-1.9	7.0	4.3	4.8	0.9	1.8	4.0	4.1	4.0
Gross fixed capital form., EUR mn, nom.	1,323	1,294	1,499	1,545	.	.	.	.	.
annual change in % (real)	-0.2	-3.3	12.1	7.1	.	.	3.5	4.0	4.0
Gross industrial production <sup>3)</sup>	.	.	.	.	.	.	.	.	.
annual change in % (real)	6.5	-1.3	5.0	-1.1	.	.	4.0	5.0	5.0
Gross agricultural production <sup>3)</sup>	.	.	.	.	.	.	.	.	.
annual change in % (real)	1.4	0.8	-3.0	7.6	.	.	.	.	.
Construction output <sup>3)</sup>	.	.	.	.	.	.	.	.	.
annual change in % (real)	2.6	-6.1	4.0	1.2	.	.	.	.	.
Employed persons, LFS, th, average <sup>4)</sup>	338.4	323.5	296.9	331.8	314.7	353.0	370	390	400
annual change in %	11.7	-4.4	-8.2	11.7	.	12.2	12.0	4.3	3.1
Unemployed persons, LFS, th, average <sup>4)</sup>	144.8	176.7	145.8	126.1	116.0	155.0	150	140	130
Unemployment rate, LFS, in %, average <sup>4)</sup>	30.0	35.3	32.9	27.5	27.0	30.6	29.5	27.0	25.2
Reg. unemployment rate, in %, end of period	.	.	.	.	.	.	.	.	.
Average monthly net wages, EUR <sup>5)</sup>	364	429	458	453	.	.	450	470	490
annual change in % (real, net)	-3.9	17.4	7.3	-1.4	.	.	-1.5	1.5	1.5
Consumer prices, % p.a.	1.8	0.4	-0.5	0.3	-0.02	1.7	1.6	1.9	2.3
Producer prices, % p.a.	2.3	1.6	2.7	-0.1	-0.1	0.2	1.9	2.2	2.5
General government budget, nat.def., % of GDP	.	.	.	.	.	.	.	.	.
Revenues	25.5	24.2	29.4	29.7	.	.	28.9	29.8	29.8
Expenditures	28.0	27.2	27.8	29.5	.	.	31.0	32.0	32.0
Deficit (-) / surplus (+)	-2.5	-2.9	1.6	0.2	.	.	-2.1	-2.2	-2.2
Public debt, nat.def., % of GDP	8.9	10.5	12.9	14.2	13.8	14.5	15.6	16.9	18.1
Stock of loans of non-fin.private sector, % p.a	2.6	6.2	7.2	10.5	.	.	.	.	.
Non-performing loans (NPL), in %, eop	8.7	8.3	6.2	4.9	.	.	.	.	.
Central bank policy rate, % p.a., eop <sup>6)</sup>	10.90	9.29	7.69	7.22	7.2	6.8	6.80	7.00	7.30
Current account, EUR mn	-179	-385	-497	-549	-382	-366	-633	-709	-790
Current account, % of GDP	-3.4	-6.9	-8.6	-9.2	-14.0	-12.9	-10.0	-10.6	-11.1
Exports of goods, BOP, EUR mn	291	324	322	308	150	179	340	364	389
annual change in %	3.4	11.3	-0.6	-4.5	-5.4	19.4	10.4	7.1	6.9
Imports of goods, BOP, EUR mn	2,287	2,383	2,432	2,599	1,210	1,303	2,790	2,970	3,175
annual change in %	-1.9	4.2	2.1	6.9	10.1	7.6	7.4	6.5	6.9
Exports of services, BOP, EUR mn	875	929	952	1,038	325	351	1,070	1,133	1,209
annual change in %	-2.2	6.1	2.5	9.1	8.3	8.0	3.0	5.9	6.7
Imports of services, BOP, EUR mn	355	469	494	473	205	186	465	485	500
annual change in %	-10.1	32.0	5.5	-4.3	-13.5	-9.3	-1.8	4.3	3.1
FDI liabilities, EUR mn	280	151	309	216	85	139	450	.	.
FDI assets, EUR mn	30	27	37	40	1	9	40	.	.
Gross reserves of NB excl. gold, EUR mn	694	645	734	830	.	.	.	.	.
Gross external debt, EUR mn	1,608	1,737	1,932	2,045	2,003	2,174	2,200	2,300	2,500
Gross external debt, % of GDP	30.19	31.20	33.26	34.17	33.47	34.50	35.0	35.0	35.0

1) Preliminary. - 2) Including expenditures of NPISHs. - 3) According to gross value added (manufacturing industry for industrial production). - 4) Population 15-64. - 5) Net wages in state administration. - 6) Average weighted effective lending interest rate (Kosovo uses the euro as national currency).

Source: wiiw Databases incorporating national statistics. Forecasts by wiiw.