KOSOVO: Plans for territorial swap with Serbia likely to be thwarted

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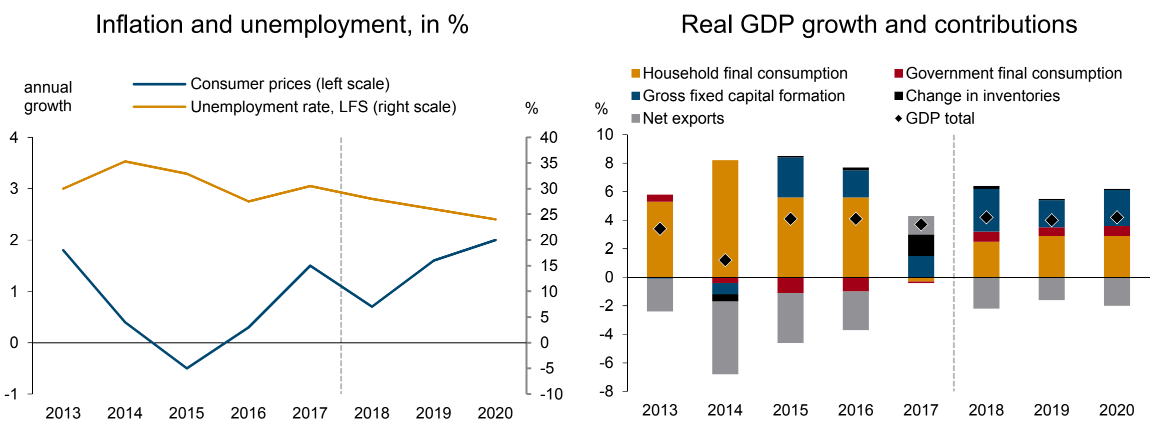
We forecast that growth will strengthen further to above 4%. Imminent risks due to political tensions surrounding the consultations about territorial swapping with Serbia remain high. Infrastructure investments will be a major driver of growth in the medium term boosted by private and public investments. The banking sector remains solid and well capitalised and credit growth is expected to continue on its upward trend. The fiscal stance and monetary policy remain supportive of growth.

Figure 45 / Kosovo: Main macroeconomic indicators



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

The consultations around a 'territorial correction' between Serbia and Kosovo cause strains for the entire region. In summer the presidents of both Kosovo and Serbia launched the idea of border corrections as a one-size-fits-all solution to the secular disputes between Serbia and Kosovo, the EU membership prospects for Serbia and the future of Kosovo with respect to the EU. Even though such an agreement might work on paper, it is very unrealistic on the ground. First, there is no political consensus at national, regional and international level. Second, the consultations, mediated by international partners, have been burdened by overwhelming nationalistic feelings and overreactions on both sides – e.g. the mobilisation of the Serbian army close to the Kosovo border or the attempt of the Kosovo government to amend the law on transforming the country's security forces into a regular army. Certainly, this is a very dangerous trail not only for the parties directly involved, but also for the entire region, and its implications are likely to be economic and political ones. Despite the tensions, the good news for Kosovo is the EU Parliament's approval of visa liberalisation. Emigration might gain momentum especially among younger age cohorts, e.g. those born after the 1990s, who have been isolated ever since despite being geographically very close to the EU.

Growth picked up to 4.7% in the second quarter of 2018, year on year. Growth has been backed by a double-digit rise (11%) in gross fixed capital formation and strong exports of services (up 20%) during the first half of 2018 as compared with the same period of the previous year. In production terms growth benefited from the strong performance of financial activities, services and construction. Both household and government consumption have been buoyant and grew by 3% and 5% respectively in the first half of 2018, year on year. Public investments surged as capital expenditures of the central government rose by 21% in January-July 2018 as against the first half of 2017. Household consumption recovered and strengthened on the back of rising wages and inflows of remittances, each at 7%, in the first half of 2018, year on year. Also demand for credit among households rose by 11% in the same period. The manufacturing sector, after a negative first quarter of 2018, recovered and is contributing to growth again.

FDI fell strongly during the first half of the year. The heightened uncertainly because of the political tensions may have been among the causes for the 40% decline in FDI in the first half of 2018, year on year. Given the current internal and external political discourse the downside risks might be protracted also in the medium term. Nevertheless, starting with 2019 we expect a strong recovery of FDI owing to the new coal-fired power plant 'Kosova e Re' worth EUR 1.3 billion. Apart from the strong impact on economic growth in the medium term, its construction is expected to generate more than 10,000 new jobs. The Kosovo government and the US company ContourGlobal are in the process of selecting the construction investing company and the construction works are expected to start in the first half of 2019. Meanwhile, the World Bank has announced that it will not support the project on the grounds of environmental and economic costs. Also, in June, the Energy Community based in Vienna – which regulates the energy market of the EU and its neighbouring countries – released a note which argued that the contractual framework for the power plant 'Kosova e Re' is quite in favour of the US company ContourGlobal – protected against market and commercial risks and coupled with guaranteed and risk-free profits.[29]

Infrastructure investments backed by public investments will also be one of the major drivers of growth in the medium term. This year the government will complete the construction of the 'Arber Xhaferi' highway connecting Kosovo and Macedonia – a 55 km long highway which has absorbed EUR 700 million of public funding. Meanwhile, the government announced the construction of the 'Dukagjini' highway, 91 km long, to be launched in the second half of 2019.

Jobless growth characterised the first half of 2018. Despite economic growth of above 4%, employment prospects, especially among the youth, remain gloomy. Unemployment has been hovering at 29.4% in the second quarter of 2018, but also employment has receded in the same period. Job growth is expected to gain momentum with the start of new infrastructure projects by 2019. Nevertheless, the emigration potential remains strong. Germany is absorbing a great number of young people, including graduates, not only from Kosovo, but also from other Western Balkan countries, through a number of employment agreements recently established with the governments in the region.

29 https://energy-community.org/news/Energy-Community-News/2018/06/14.html

Net exports contributed positively to growth thanks to rapidly rising services exports in the first half of 2018, up 20%. Nevertheless, the external balance deteriorated as merchandise exports shrank by 3% and consumer goods imports surged by 10%. Coupled with the 40% drop in FDI net flows, the current account deficit widened further over the first half of 2018. Exports of mineral products, base metals and related articles (accounting for more than half of goods exports) slowed down until August 2018. Imports of machinery expanded by 24%, hinting at an acceleration of private investments. In the medium term the current account deficit is expected to hover at 7%, slightly mitigated by a rise in FDI and remittances inflows but aligned with increasing consumer goods imports. Still, a current account deficit of this level is less risky than would normally be the case because it has a high share of concessional funding from international financial institutions, which tend to have low interest rates and long repayment terms.

The general government budget is in surplus and public debt is low. The fiscal stance in the first half of 2018 improved in the wake of rising revenues and expenditures, by 1% and 8% respectively. Still the former exceeded the latter by 8%. The rise in revenues was due to a better performance in VAT, personal and income tax collection. The marked increase in expenditures resulted from the surge in capital expenditures by 21%, social transfers by 14% and salaries by 10%. The public debt-to-GDP ratio stands at 16%, but is expected to widen because of the expansionary fiscal policy that the government is pursuing by raising further public wages, social transfers and capital investments.

Demand for credit was quite strong in the first half of 2018. The stock of loans to the non-financial private sector picked up by 11%, while among households the rise was at 12%. The sectors of the economy whose stock of loans expanded the most were agriculture, construction, trade and industry. The growth in wages and remittances was reflected in higher household deposits. The low level of non-performing loans, which dropped to 2.8% by June, compared to 3.9 % recorded at the end of 2017, signals a stable and well capitalised banking sector. As such the banking sector is expected to continue being supportive to growth.

In summary, we expect the economy to accelerate further, above 4.3% in the medium term. Growth strengthening will rest on steady growth of consumption and investments. With a number of big infrastructure projects ahead to start in 2019, private and foreign direct investments are expected to pick up and boost further growth. Nevertheless, there are downward risks to investment and growth due to the political instability in the country and the uncertainty surrounding the discourse of territorial swapping with Serbia.

Table 20 / Kosovo: Selected economic indicators

	2014	2015	2016	2017 1)	2017	2018	2018	2019	2020
					January-June			Forecast	
Population, th pers., average	1,813	1,788	1,778	1,794	.	.	1,813	1,832	1,848
Gross domestic product, EUR mn, nom.	5,567	5,807	6,070	6,282	2,838	2,974	6,600	7,000	7,400
annual change in % (real)	1.2	4.1	4.1	3.7	3.6	4.2	4.2	4.0	4.2
GDP/capita (EUR at PPP)	6800	7400	7700	7900	.	.	.	.	.
Consumption of households, EUR mn, nom.	4,802	4,943	5,194	5,271	2,564	2,645	.	.	.
annual change in % (real)	9.8	6.5	6.6	-0.4	-0.1	3.1	3.0	3.5	3.5
Gross fixed capital form., EUR mn, nom.	1,294	1,499	1,550	1,729	.	.	.	.	.
annual change in % (real)	-3.3	12.1	7.3	5.7	.	.	11.0	7.0	9.0
Gross industrial production 2)									
annual change in % (real)	7.3	3.7	-6.7	4.9	.	.	3.0	3.5	3.0
Gross agricultural production									
annual change in % (real)	-21.4	13.8	15.2	-8.6	.	.	.	.	.
Construction output 3)									
annual change in % (real)	-6.1	15.8	4.5	12.4	.	.	.	.	.
Employed persons, LFS, th, average 4)	323.5	296.9	331.8	357.1	352.9	342.0	360	370	380
annual change in %	-4.4	-8.2	11.7	7.6	12.1	-3.1	0.2	3.0	3.0
Unemployed persons, LFS, th, average 4)	176.7	145.8	126.1	156.6	155.3	133.0	140	130	120
Unemployment rate, LFS, in %, average 4)	35.3	32.9	27.5	30.5	30.6	28.0	28.0	26.0	24.0
Reg. unemployment rate, in %, eop	.	.	.	.	.	.	.	.	.
Average monthly net wages, EUR	430	451	457	450	448	484	480	510	530
annual change in % (real, net)	9.0	5.4	1.0	-3.0	-5.7	7.7	7.0	4.0	1.5
Consumer prices, % p.a.	0.4	-0.5	0.3	1.5	1.7	0.3	0.7	1.6	2.0
Producer prices, % p.a.	1.7	2.7	-0.1	3.4	0.2	0.9	2.7	3.0	2.5
General governm.budget, nat.def., % of GDP									
Revenues	24.2	29.4	29.3	30.6	32.0	29.2	30.0	30.0	30.0
Expenditures	27.2	27.8	29.1	29.2	28.4	28.8	30.0	30.5	31.0
Deficit (-) / surplus (+)	-2.9	1.6	0.2	1.4	3.5	0.5	0.0	-0.5	-1.0
General gov.gross debt, nat.def., % of GDP	10.5	12.9	14.0	15.9	15.5	16.3	16.0	16.0	17.0
Stock of loans of non-fin.private sector, % p.a.	6.2	7.2	10.5	9.7	10.2	11.4	.	.	.
Non-performing loans (NPL), in %, eop	8.3	6.2	4.9	3.1	3.9	2.8	.	.	.
Central bank policy rate, % p.a., eop 5)	9.29	7.69	7.22	6.83	6.8	6.5	7.00	7.30	7.50
Current account, EUR mn	-385	-497	-481	-383	-421	-424	-410	-440	-510
Current account, % of GDP	-6.9	-8.6	-7.9	-6.1	-14.8	-14.3	-6.2	-6.3	-6.9
Exports of goods, BOP, EUR mn	324	323	308	379	179	173	350	370	390
annual change in %	11.3	-0.5	-4.5	23.1	19.4	-3.3	-8.0	7.0	5.0
Imports of goods, BOP, EUR mn	2,383	2,432	2,599	2,843	1,303	1,436	3,010	3,220	3,490
annual change in %	4.2	2.1	6.9	9.4	7.6	10.2	6.0	7.0	8.5
Exports of services, BOP, EUR mn	929	952	1,131	1,330	361	433	1,460	1,580	1,720
annual change in %	6.1	2.5	18.8	17.6	11.0	20.1	10.0	8.5	9.0
Imports of services, BOP, EUR mn	469	494	492	536	217	265	590	630	690
annual change in %	32.0	5.5	-0.5	9.0	6.2	22.2	10.0	7.0	10.0
FDI liabilities, EUR mn	151	309	220	255	149	80	180	.	.
FDI assets, EUR mn	27	37	43	43	11.0	18.8	40	.	.
Gross reserves of NB excl. gold, EUR mn	645	734	830	850	.	.	.	.	.
Gross external debt, EUR mn	1,737	1,932	2,015	2,089	2114	2058	2,100	2,300	2,400
Gross external debt, % of GDP	31.2	33.3	33.2	33.2	33.6	31.2	32.0	32.5	32.0

1) Preliminary. - 2) Turnover in manufacturing industry (NACE C). - 3) Value added. - 4) Population 15-64. - 5) Average weighted effective lending interest rate of commercial banks (Kosovo uses the euro as national currency).

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