

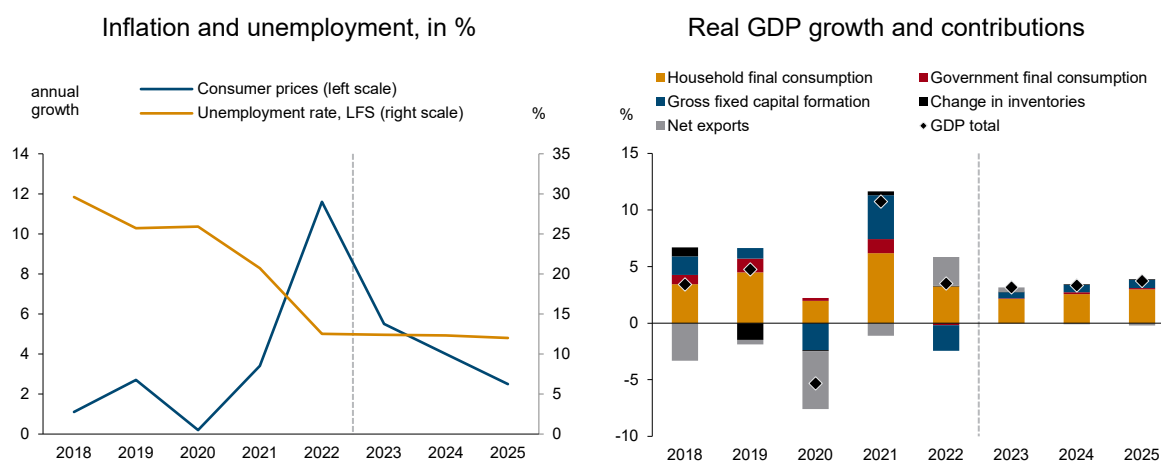


KOSOVO: Renewed tensions with Serbia jeopardising economic prospects

ISILDA MARA

Economic growth for 2023 will be around 3.2% and will be driven by domestic demand. Consumer price inflation has fallen substantially, though there is still upward pressure from food prices and energy costs. The uneasy dialogue with Serbia and the sanctions imposed by the EU are having repercussions for the economy, with a slowing of trade relations and EU investment.

Figure 6.10 / Kosovo: Main macroeconomic indicators



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

Economic growth in the first half of the year was 3%, with the main driver being domestic demand. However, this growth is showing signs of losing its vigour, and will be weaker than projected in our previous forecast. Both government and household consumption rose by less than 3% in H1 2023, while gross fixed capital formation remained subdued and did not exceed 2% of growth. Exports of goods lost steam, contracting by 6% in January-July 2023, year on year, in a reversal of the positive trend witnessed over the past three years. By contrast, exports of services maintained their positive trajectory. Overall, however, net exports have been a drag on economic growth and are expected to be so for the remainder of the year. The main sectors of the economy that supported growth were the information and communication sector, wholesale and retail trade, and scientific activities. On the flip side, other sectors such as manufacturing, the extraction industry and public administration made a negative contribution to economic activity, especially in Q2 2023.

Inflationary pressure has eased considerably this year. In August, annual consumer price inflation was 3.2%, and on average for January-August 2023 it still stood at 6%. For 2023 as a whole, the figure is expected to decline to 5.5%. Nevertheless, the upward pressure on inflation from food prices and energy costs continues: in the case of foodstuffs, inflation remained high – at above 10% – in the period

January-August. The expectation is that inflation will pick up again at the start of 2024 and will be driven by food and energy costs. Turning to energy, in real terms imports of electricity have risen further this year – up 8% in H1 2023 – due to higher demand from business and industry (though less so from households). At the same time, exports declined by 18%, resulting in the country again being a net importer of electricity.

The public finances have been doing well: revenues have been rising faster than government spending (at least up until July 2023). Public investment (mainly on the road network) grew strongly – by 80% for the period January-July 2023. That said, such investment has absorbed only 10% of public spending and is far below the budgetary plan. Government support for more vulnerable groups of the population has proved rather a failure: social transfers and subsidies – planned to expand by 5% for the year as a whole – actually contracted by 2% in the period January-July. All this will help keep the public debt relatively low, at 20% of GDP (one of the lowest figures in the region), but it will do nothing to assist the economy.

The signals from the banking sector are more positive. It has remained resilient, and demand for credit has been rising. Especially enterprises continued to seek loans in Q2, though at a slower pace than in Q1. Non-performing loans stood at a record low of 2% in Q2. However, the banks have recently tightened up on their conditions for loans and – together with the raising of interest rates – this could contribute to reduced credit demand from the corporate sector. With respect to households, however, the credit conditions have been tightened only marginally, and the expectation is that demand for credit from households will rise further, mainly to cover consumer spending.

After a relatively calm summer, political tensions in northern Kosovo flared up again recently, and there is deadlock in the dialogue with Serbia. In May 2023, the situation almost escalated after Albanian mayors took office in the wake of the April local elections in northern Kosovo. The elections had been held on the advice of the country's international partners; however, they were boycotted by ethnic Serbs, who then refused to accept the election results. Protests followed and emotions ran high, although the tension was relieved somewhat over the summer, thanks to the intervention of international partners and the protection and presence of the NATO-led international peace-keeping force KFOR. The Kurti government has agreed to fresh elections being held, and the formation of Association of Serb-majority Municipalities should undergo in line with the Kosovo constitution. The meeting of Kosovo's Prime Minister Albin Kurti and Serbia's President Alexander Vučić on 14 September, under the auspices of the EU and the US, was the latest in a round of meetings, but produced no tangible outcome. Ten days after the meeting, tensions flared again. Four people were killed – a Kosovar policeman and three ethnic Serb gunmen – and six other ethnic Serb gunmen were injured after a shootout in Banjska (northern Kosovo). It is difficult to see how the situation will resolve itself, given that the dialogue with Serbia is frozen and it is only with the assistance of the international community that further dangerous escalations can be avoided.

The uneasy dialogue with Serbia and the EU sanctions are already having a deleterious effect on the economy. The EU seems to blame mainly Kosovo for the stalemate in its dialogue with Serbia, and has announced a raft of sanctions against Kosovo, depriving the country of at least EUR 500m in EU funding. Trade relations and EU investment seem to have suffered somewhat. Although the inflows of foreign direct investment (FDI) rose by 14% in H1 2023, this was driven largely by Turkish investment. Kosovo's other major partners – such as the EU and the US – cut their FDI inflows. In particular, the

main investing partners – Germany and Switzerland – have reduced their FDI inflows to Kosovo by 7% and 4%, respectively, while FDI from the US almost halved. Turning to exports, those to the EU, Kosovo's main trading partner, recorded a decline of 7% in January-July – although (exceptionally) exports to Germany continued to expand by 12%. Trading relations have also mutated: Kosovo's exports to the countries covered by the Central European Free Trade Agreement (CEFTA) rose 6% in January-July – apart from to Serbia, where exports dropped by 15% (imports from that country shrank by almost 30% over the same period).

That economic activity is running at below its potential is shown by the meagre growth in employment. High-frequency data suggest that employment in manufacturing has remained almost unchanged, whereas it has contracted in retail trade. What new jobs there are have mainly been created in the service sector. Overall, the labour market situation remains dire, with an unemployment rate that remains among the highest in the region (12.5% as of 2022) and persistently high youth unemployment (age 15-24) of 19%. On top of that, a third of young people aged 15-24 are not in education, employment or training (NEET). The labour market mismatch and the low wages (average nominal wages of EUR 521, as of 2022) are a source of frustration on both the supply and the demand side of the labour market: employers struggle to find workers with the proper skills, and so turn their attention to workers from abroad; meanwhile, job seekers fail to find a decent job. Potential emigration from Kosovo is one of the highest in the region: according to the Balkan Barometer, 57% of Kosovars would consider moving and working abroad (against an average of 44% for the Western Balkan region as a whole). It is no coincidence that remittances have continued to rise and constitute an important source of income for many Kosovo households, helping to smooth their consumption: remittances soared by 12% in the period January-July 2023 and will most likely exceed 10% of GDP again this year.

Overall, we expect real growth this year to be 3.2% and to be driven by domestic demand, mainly household consumption. In the medium term, we expect weaker external demand as a consequence of the EU sanctions against Kosovo and other side effects of the uneasy dialogue with Serbia. Accordingly, growth will be around 3.3% in 2024 and 3.7% in 2025, 0.4 percentage points down on our previous forecast.

Table 6.10 / Kosovo: Selected economic indicators

	2020	2021	2022 ¹⁾	2022 January-June	2023	2023 Forecast	2024 Forecast	2025
Population, th pers., average	1,790	1,786	1,782	.	.	1,778	1,774	1,770
Gross domestic product, EUR m, nom.	6,772	7,958	8,955	3,955	4,266	9,700	10,500	11,300
annual change in % (real)	-5.3	10.7	3.5	3.7	2.9	3.2	3.3	3.7
GDP/capita (EUR at PPP)	7400	8660	9170	.	.	.	.	.
Consumption of households, EUR m, nom.	5,718	6,572	7,656	3,648	3,836	.	.	.
annual change in % (real)	2.5	7.3	3.9	6.1	2.3	2.5	3.0	3.5
Gross fixed capital form., EUR m, nom.	2,012	2,617	2,848	.	.	.	.	.
annual change in % (real)	-7.6	13.0	-6.8	.	.	1.7	2.0	2.3
Gross industrial production ²⁾								
annual change in % (real)	0.8	0.3	0.2	0.2	-0.1	0.5	2.0	3.0
Gross agricultural production								
annual change in % (real)	2.7	-2.0	4.5	.	.	.	.	.
Construction output ³⁾								
annual change in % (real)	-9.0	8.8	-3.0	.	.	.	.	.
Employed persons, LFS, th, average ⁴⁾	347.1	383.3	403.8	.	.	410	420	430
annual change in %	-4.4	10.4	5.4	.	.	1.0	2.0	2.0
Unemployed persons, LFS, th, average ⁴⁾	121.4	100.2	58.1	.	.	60	60	60
Unemployment rate, LFS, in %, average ⁴⁾	25.9	20.7	12.5	.	.	12.4	12.3	12.0
Reg. unemployment rate, in %, eop	.	.	.	.	.	.	.	.
Average monthly gross wages, EUR	466	484	521	608.0	693.3	620	680	720
annual change in % (real, gross)	-2.5	0.4	-3.5	-12.1	6.6	12.0	6.0	4.0
Average monthly net wages, EUR	416	432	446	538.7	612.8	480	510	530
annual change in % (real, net)	-3.4	0.4	-7.5	-12.0	6.4	1.0	2.0	2.0
Consumer prices (HICP), % p.a.	0.2	3.4	11.6	7.0	7.0	5.5	4.0	2.5
Producer prices, % p.a.	-0.6	4.9	9.3	9.8	-0.5	-0.5	1.0	2.5
General governm. budget, nat. def., % of GDP								
Revenues	25.4	27.4	27.7	28.6	31.5	28.0	28.2	28.5
Expenditures	33.0	28.8	28.3	24.6	26.5	28.5	29.6	30.5
Deficit (-) / surplus (+)	-7.6	-1.3	-0.5	3.9	4.9	-0.5	-1.4	-2.0
General gov. gross debt, nat. def., % of GDP	22.0	21.1	19.6	20.8	17.3	20.0	20.5	21.0
Stock of loans of non-fin. private sector, % p.a.	7.1	15.4	16.0	17.3	14.3	.	.	.
Non-performing loans (NPL), in %, eop	2.7	2.3	2.0	2.1	2.0	.	.	.
Central bank policy rate, % p.a., eop ⁵⁾	6.01	5.80	6.29	6.0	6.5	6.5	6.5	6.0
Current account, EUR m	-472	-695	-940	-639	-554	-860	-830	-860
Current account, % of GDP	-7.0	-8.7	-10.5	-16.2	-13.0	-8.9	-7.9	-7.6
Exports of goods, BOP, EUR m	475	753	932	451	427	860	890	910
annual change in %	20.8	58.4	23.8	31.0	-5.4	-8.0	3.0	2.5
Imports of goods, BOP, EUR m	3,048	4,320	5,219	2,436	2,528	5,380	5,570	5,680
annual change in %	-5.7	41.7	20.8	27.4	3.8	3.0	3.5	2.0
Exports of services, BOP, EUR m	995	1,906	2,503	867	1,089	2,850	3,020	3,140
annual change in %	-40.6	91.6	31.3	50.7	25.7	14.0	6.0	4.0
Imports of services, BOP, EUR m	603	871	1,127	459	536	1,260	1,300	1,400
annual change in %	-19.5	44.4	29.4	36.3	16.8	12.0	3.0	8.0
FDI liabilities, EUR mn	346	421	778	327	374	790	.	.
FDI assets, EUR mn	59	100	176	82	102	130	.	.
Gross reserves of CB excl. gold, EUR m	901	1,100	1,176	1,280	1,266	.	.	.
Gross external debt, EUR m	2,502	2,956	3,424	.	.	3,500	3,700	3,800
Gross external debt, % of GDP	37.0	37.1	38.2	.	.	36.0	35.0	34.0

1) Preliminary. - 2) Turnover in manufacturing industry (NACE C), covering 95% of enterprises. - 3) Based on gross value added data. -

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.