KOSOVO: Remittances to continue driving growth

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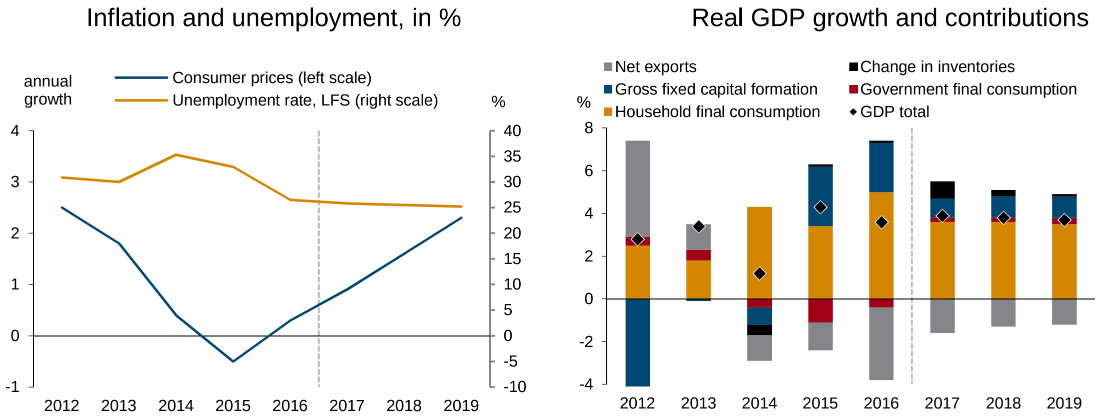
The economy will remain one of the fastest growing in Europe during the 2017-2019 forecast period, driven by remittances and investment. Domestic demand-driven growth and limited export capacity will mean that the large external deficit will widen further. The IMF programme will be key to maintaining fiscal discipline. Political risks have risen, but should remain contained and are unlikely to significantly derail the economy's momentum.

Figure 42 / Kosovo: Main macroeconomic indicators



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

Political tensions between Kosovo and Serbia have increased. Since the Brussels agreement in 2013, there have been increasing signs of cooperation between the two countries. However, in January 2017, a train left Belgrade to travel to Mitrovica in Kosovo, where the majority of remaining ethnic Serbs in Kosovo live. The train had been painted in Serbian national colours and had 'Kosovo is Serbia' written on it in 21 different languages, including Albanian. The train was stopped before it reached Kosovo. The two sides accused one another of stoking tensions. Serbian President Tomislav Nikolić said that Serbia was ready to enter northern Kosovo militarily to protect Serbs living there. Kosovo President Hashim Thaçi accused Serbia of attempting to replicate a 'Crimea model' to take control of northern Kosovo. The tensions currently look unlikely to go further than heated verbal exchanges. Both sides have a strong incentive not to escalate the situation. However, political risk has clearly risen, in line with a broader rise in tensions across much of the region.

The economy gained momentum in the second half of 2016, and looks quite strong heading into 2017. Real GDP growth reached 3.8% year on year in July-September, up from 2.4% in the second quarter. On the expenditure side, growth was driven exclusively by household consumption in the third quarter, while net exports contributed negatively. After five consecutive quarters of very strong growth, gross capital formation was largely flat. Using a production approach, growth in the third quarter was underpinned by a combination of mining and quarrying, and wholesale and retail trade. We estimate full-year growth of 3.9% in 2016 – lower than 2015 (4.3%), but otherwise the fastest for several years. This is an upward revision from our previous forecast round, reflecting stronger-than-expected consumption.

Private consumption will remain the main driver of growth during the forecast period. Remittances – a key driver of growth – rose by a relatively meagre 2% year on year in the first three quarters of 2016 (compared with an average 9.1% in 2013-2015). However, in general the outlook for remittance inflows appears positive. Around 60% of remittance inflows come from Germany and Switzerland, both of which have strong labour markets. Real disposable incomes are being boosted by low inflation, although the effects of this will wear off gradually during 2017 as price growth picks up. Household lending has risen particularly strongly (see below). The effective interest rate on new loans has continued to fall in line with loose European Central Bank policy, averaging 7.5% in 2016, compared with 8.3% in the previous year.

Investment will also contribute positively to growth, at least in the early part of the forecast period. This will be helped by public infrastructure investment programmes, supported by the IMF, in an attempt to increase the economy's productive potential. However, some large investment projects that have recently been driving growth (including public investment in roads and various private sector projects) will wind down by the end of the forecast period. As detailed in our autumn 2016 report, the failure to agree terms on a major ski resort investment has dealt a blow to the outlook for fixed capital formation growth. Net trade meanwhile should continue to make negative contributions to growth, reflecting the impact of strong remittance- and credit-driven consumption on imports in the context of limited domestic productive capacity.

We think that growth of a little below 4% is achievable during the forecast period. This will be driven in particular by remittances, credit and construction. Although the inflows of remittances look likely to be quite secure (the German and Swiss labour markets should continue to perform well), this remittance- and credit-driven consumption will widen the current account deficit, increasing Kosovo's external vulnerabilities. It may also push up inflation ahead of productivity, preventing the development of a stronger tradable sector and making the economy ever more unbalanced.

Inflation recovered towards the end of 2016, and will rise again this year. The harmonised index of consumer prices rose by 1.3% year on year in December, from 0.9% the previous month. This was the highest rate of inflation since September 2014. Prices were driven higher in December by the transport component (+3.7%), reflecting the rise in global energy prices. Strong growth (+6.1%) was also recorded in the prices of alcoholic beverages and tobacco. Global energy developments will continue to push up inflation this year, although the headline level will drop after the first quarter, as energy base effects become less supportive. We forecast consumer price growth of 0.9% on average in 2017, rising to 1.6% in 2018 and 2.3% in 2019.

The budget deficit will be around 2% of GDP during the forecast period. According to the IMF, the budget performed in line with targets up to the third quarter of 2016. Stronger economic growth benefited tax revenue. We estimate a full-year deficit equivalent to 1.9% of GDP for last year. The 2017 budget targets a rise in capital spending. However, the IMF has warned of the potential for current spending to rise too high. We think that in 2017-2019 the deficit will not rise much over 2%, thanks to the discipline of the IMF stand-by arrangement (SBA). Fiscal reforms (to social payments and pensions) are being undertaken as part of the SBA. Public debt is very low. Total debt reached 14.3% of GDP in the third quarter of 2016. Almost all of the debt is in euros, and almost half is concessional. The average weighted interest rate on public debt was 2.16% in the third quarter of 2016, while the average time to maturity was almost five years.

Credit growth has been rapid, with gross domestic loans rising by 10.4% in 2016, according to the central bank. This was driven primarily by loans to households, which rose by 14.7% last year, while credit to non-financial corporations increased by 8.5%. The level of non-performing loans is currently low, at around 5%. There has been some improvement in legislation around collateral recovery, and the sector overall is well capitalised and profitable. However, such a high level of credit growth creates some potential risks. The authorities are currently working on an improvement in the macro-prudential framework as part of the IMF SBA.

Kosovo runs big external deficits, reflecting a lack of domestic production of physical goods. The external shortfall reflects a huge goods deficit (equivalent to 36% of GDP in 2015, the last year for which full-year data are available). This is partly offset by secondary income inflows (largely remittances). Net secondary income inflows totalled 18% of GDP in 2015. The goods shortfall is otherwise financed by a combination of other income (loans), a surplus on the services account, an unobserved component and relatively small net foreign direct investment (FDI) inflows. The current account deficit reached an estimated 9.9% of GDP in 2016. In the first three quarters of 2016, the external shortfall widened by EUR 105 million to EUR 315 million, driven by a EUR 163 million widening of the goods deficit, reflecting strong domestic demand and a consequent rise in imports. This was partly offset by the EUR 88 million year-on-year increase in the services surplus. Net FDI inflows fell to EUR 158 million, down EUR 90 million compared with the same period of the previous year. The most important sources were China, Turkey, the UK and Albania (around two-thirds of FDI in this period went into real estate, with a further 20% into construction). Meanwhile net inflows of other investment (loans) rose to EUR 204 million, more than double the level of the previous year.

With consumption set to remain the main driver of growth, and domestic production unlikely to rise enough to meet this demand, the current account deficit will widen further during the forecast period. We expect the shortfall to reach 11.8% of GDP by 2019. This will continue to be primarily financed by a combination of remittances, lending and (to a lesser extent) net FDI inflows. There are signs that prolonged regional political instability, plus a lack of progress on sensitive topics (such as the demarcation line with Montenegro), is discouraging FDI. The part reliance on debt-creating inflows to finance the consumption-driven deficit is a potential source of risk. External debt has risen, reaching over EUR 2 billion in the third quarter of 2016. We estimate a full-year external debt level equivalent to 40% of GDP. Over 40% of external debt is inter-company lending, which reduces the risks associated with it. However, both banks and corporates have quite high levels of short-term external debt (representing around 30% of the total external debt level between them).

In summary, the economy should be able to maintain its healthy growth momentum during the forecast period. We forecast growth of 3.9% this year, and 3.8% and 3.7% in 2018 and 2019, respectively. The lack of significant domestic productive capacity is unlikely to change significantly in the coming years, and as a result remittance-financed private consumption, and investment, will be the primary drivers of growth.

Table 13 / Kosovo: Selected economic indicators

	2012	2013	2014	2015	2016 1)	2017	2018 Forecast	20119
Population, th pers., average	1,807	1,818	1,813	1,788	1,780	1,780	1,790	1,800
Gross domestic product, EUR mn, nom.	5,059	5,327	5,568	5,807	6,000	6,300	6,600	7,000
annual change in % (real)	2.8	3.4	1.2	4.3	3.6	3.9	3.8	3.7
GDP/capita (EUR at PPP)	6500	6500	6700	7400	7800	.	.	.
Consumption of households, EUR mn, nom.	4,458	4,652	4,926	5,045	5,338	.	.	.
annual change in % (real)	2.9	2.0	4.9	3.8	5.8	4.2	4.1	4.0
Gross fixed capital form., EUR mn, nom.	1,317	1,323	1,294	1,499	1,634	.	.	.
annual change in % (real)	-13.6	-0.2	-3.3	12.1	9.0	3.5	4.0	4.0
Gross industrial production 2)								
annual change in % (real)	14.9	6.5	-1.3	5.0	3.5	4.0	5.0	5.0
Gross agricultural production 2)								
annual change in % (real)	-8.5	1.4	0.8	-3.0	-2.8	.	.	.
Construction output 2)								
annual change in % (real)	-8.5	2.6	-6.1	4.0	5.0	.	.	.
Employed persons, LFS, th, average 3)	303	338	324	297	316	330	340	350
annual change in %	.	11.7	-4.4	-8.2	6.5	5.5	4.3	3.1
Unemployed persons, LFS, th, average 3)	136	145	177	146	114	110	120	120
Unemployment rate, LFS, in %, average 3)	30.9	30.0	35.3	32.9	26.5	25.8	25.5	25.2
Reg. unemployment rate, in %, end of period	.	.	.	.		.	.	.
Average monthly net wages, EUR 4)	354	356	416	446	460	470	490	520
annual change in % (real, net)	-0.8	-1.2	16.4	9.0	3.0	2.0	2.5	3.0
Consumer prices, % p.a.	2.5	1.8	0.4	-0.5	0.3	0.9	1.6	2.3
Producer prices, % p.a.	1.9	2.5	1.7	2.7	-0.3	1.5	2.1	2.4
General governm.budget, nat.def., % of GDP								
Revenues	27.3	25.5	24.2	29.4	28.6	28.9	29.8	29.8
Expenditures	28.6	28.0	27.2	27.8	30.5	31.0	32.0	32.0
Deficit (-) / surplus (+)	-1.2	-2.5	-2.9	1.6	-1.9	-2.1	-2.2	-2.2
Public debt, nat.def., % of GDP	8.1	8.9	10.5	12.9	13.2	14.7	16.2	17.5
Stock of loans of non-fin.private sector, % p.a	4.4	2.6	6.2	7.2	9.9	.	.	.
Non-performing loans (NPL), in %, Dec	7.5	8.7	8.3	6.2	4.8	.	.	.
Central bank policy rate, % p.a., end of period 5)	12.24	10.90	9.29	7.69	7.22	7.30	7.30	7.30
Current account, EUR mn	-293	-179	-385	-497	-591	-658	-736	-824
Current account, % of GDP	-5.8	-3.4	-6.9	-8.6	-9.9	-10.4	-11.2	-11.8
Exports of goods, BOP, EUR mn	282	291	324	322	330	340	364	389
annual change in %	-10.9	3.4	11.3	-0.6	2.3	3.0	7.1	6.9
Imports of goods, BOP, EUR mn	2,332	2,287	2,383	2,432	2,647	2,790	2,970	3,175
annual change in %	-1.3	-1.9	4.2	2.1	8.8	5.4	6.5	6.9
Exports of services, BOP, EUR mn	894	875	929	952	955	998	1,053	1,120
annual change in %	9.0	-2.2	6.1	2.5	0.4	4.5	5.5	6.4
Imports of services, BOP, EUR mn	395	355	469	494	509	525	540	557
annual change in %	-7.0	-10.1	32.0	5.5	2.9	3.1	2.9	3.1
FDI liabilities, EUR mn	229	280	151	309	400	.	.	.
FDI assets, EUR mn	16	30	27	37	37	.	.	.
Gross reserves of NB excl. gold, EUR mn	727	694	645	734	830	.	.	.
Gross external debt, EUR mn	1,517	1,608	1,737	1,932	2,400	2,400	2,500	2,700
Gross external debt, % of GDP	30.0	30.2	31.2	33.3	40.0	38.7	38.5	38.5

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

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