

KOSOVO

Recent developments

Population, million	18
GDP, current US\$ billion	7.6
GDP per capita, current US\$	4108
Life expectancy at birth, years ^a	716

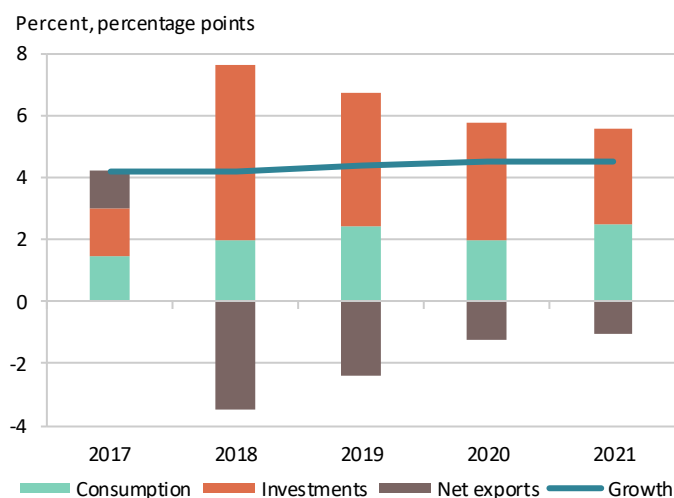
Source: WDI, Macro Poverty Outlook, and official data.
Notes:
(a) Most recent WDI value (2016).

Economic growth remained high at 4.2 percent in 2018, propelled by strong public investment and services exports. Overall fiscal deficit was at 2.7 percent of GDP in 2018, driven by higher infrastructure spending, but in line with fiscal rules. The macroeconomic outlook is positive, with a projected growth rate of 4.5 percent for 2019–2021. Fiscal risks are on the rise due to further increases in untargeted social benefits and the recently adopted law on public salaries.

Growth registered at 3.9 percent in Q3 2018 and is estimated to have reached 4.2 percent by end-2018, driven by higher public investment, a recovery in consumption, and strong services exports. Higher wages and social spending, remittance growth, albeit slower than expected, and increasing credit to households, promoted private consumption and added 2 percentage points (pp) to growth. Public investment registered a strong growth and reached 8.1 percent of GDP in 2018, up from 7.3 percent of GDP. Private investment also increased thanks to higher investment in the retail sector, residential investment fueled by continued demand from the Kosovar diaspora, and higher corporate lending. Overall, investment added 5.7 pp to growth. Net exports subtracted 3.5 pp from real GDP growth as higher imports met increasing demand for capital goods. On the production side, services were the main engine of growth, followed by industry. Whereas agriculture contributed a mere 0.1 pp to growth. Consumer price inflation (CPI) was 1.1 percent at end 2018, down from 1.5 percent in 2017, but accelerated in December. In December y-o-y inflation was 2.9 percent due to price increases for fuel, food, tobacco, alcohol, and transportation. The tariffs imposed on goods imports from Serbia and Bosnia and Herzegovina might have contributed to this increase. The fiscal deficit doubled from 1.2 percent in 2017 to 2.7 percent at end 2018.

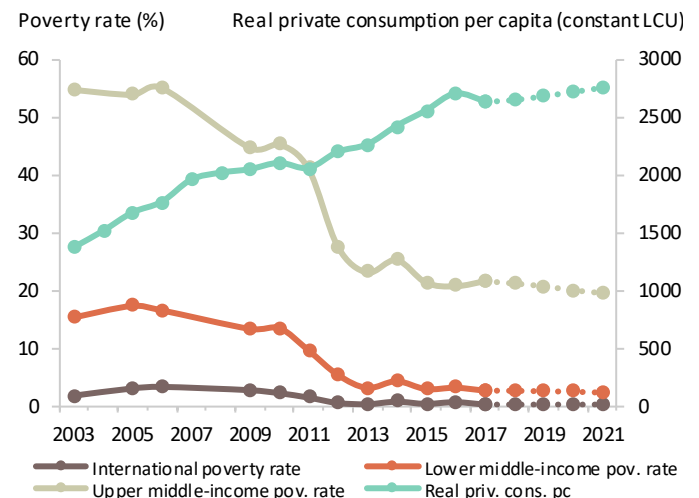
This increase was driven by higher capital investment (financed through privatization proceeds) and growing untargeted social protection benefit spending. The sharp increase in the social benefits is driven by proliferation of untargeted social benefits and new pension schemes, threatening fiscal stability. The changes to the law to cap the spending on war veteran's benefits at 0.7 percent of GDP were not implemented in 2018. The overall fiscal balance per fiscal rule was in line with legal requirements and below 1.4 percent of GDP, as it excludes capital spending financed by privatization proceeds. Public and publicly guaranteed debt was at 17.7 percent of GDP by end-2018 and is growing fast, driven by higher primary budget deficits. The current account deficit (CAD) deteriorated in 2018 as higher services exports could not compensate for the investment-driven imports. The CAD increased to 8.7 percent of GDP in 2018, up from 6 percent of GDP in 2017. Higher growth did not translate into job creation, unemployment rose in 2018 despite the reduction in labor force participation. In the third quarter of 2018, employment rate dropped by 0.3 pp yoy, mostly driven by a decline in employment in the manufacturing and construction sectors. Unemployment increased by 0.5 pp despite the 1.5 pp decline in labor force participation in the third quarter of 2018, compared to the same period last year. Youth unemployment increased by 1.7 pp y-o-y, in the same period. The poverty rate (measured at US\$ 3.2/day, 2011 PPP) decreased slightly from

FIGURE 1 Kosovo / Real GDP growth and contributions to real GDP growth



Sources: Kosovo statistics agency and World Bank staff projections.

FIGURE 2 Kosovo / Actual and projected poverty rates and real private consumption per capita



Source: World Bank. Notes: see table 2.

3.1 percent in 2016 to 2.67 percent in 2017, driven by welfare improvements in rural areas. Poverty in urban areas has been stagnant, and extreme poverty increased in urban areas. Poverty reduction in rural areas has been driven by rising labor earnings among those at the bottom of the income distribution, and pensions. Labor income has been the main driver of poverty reduction. Despite weak employment gains and persistently high unemployment, net job creation was concentrated among sectors that are characterized by low productivity/low wages, benefitting more those at the bottom of the income distribution. While growth has been poor in rural areas, in urban areas the distribution of growth benefitted the rich. This explains rising inequality, particularly in urban areas.

Outlook

Kosovo's economic growth is projected at 4.5 percent in the medium-term, driven mainly by public investment, supported by services exports and consumption. Public investment will continue to be financed through privatization proceeds and IFI-financed infrastructure projects.

Private investment is also expected to pick up because of the increase in credit from the partial credit guarantee fund for SMEs. CAD is expected to widen because of larger trade deficits driven by domestic demand for investment goods. Despite the projected increase in exports and domestic production, the increased demand for investment goods is expected to lead to a widening of the CAD. FDI inflows, including in the energy sector, and remittances are expected to continue to finance CAD.

Given the negative developments in labor market indicators and expected cost of living pressures due to rising food prices and upward trend in urban inequality, poverty, measured at the lower middle-income poverty line (U\$ 3.2/day, 2011 PPP), is expected to remain stagnant.

Risks and challenges

The positive outlook is vulnerable due to political uncertainty, lower than projected IFI investment. Moreover, the expansion of public investment as a driver of growth in 2019–2021 may suffer from capacity constraints.

Fiscal risks are on the rise. The recently approved law on public salaries, if not

regulated through prudent secondary legislation to control employment and allowances, could pose risks for macro fiscal sustainability through higher fiscal deficits or lead to a deterioration in the composition of the public spending. As the law will only come into force at end 2019, the full impact will be felt in 2020. Higher wages in the public sector can also place a pressure on the private sector wages impacting export competitiveness of Kosovar exporters. There are additional fiscal risks that might arise from further increases in untargeted social protection spending. Even if the current fiscal deficit ceiling is respected, public and publicly guaranteed debt has the potential to exceed 30 percent of GDP by 2025, if recurrent spending growth continues to exceed revenue growth. This ratio could expand further if the fiscal risks materialize risking medium-term macro fiscal sustainability.

The slower pace of poverty reduction, high incidence and long duration of unemployment is a challenges. The level of unemployment is particularly worrisome among the young (54 percent) and those with no schooling (48.4 percent), groups that tend to be over overrepresented among the poor.

TABLE 2 Kosovo / Macro poverty outlook indicators

(annual percent change unless indicated otherwise)

	2016	2017	2018 e	2019 f	2020 f	2021 f
Real GDP growth, at constant market prices	4.1	4.2	4.2	4.4	4.5	4.5
Private Consumption	6.6	1.8	2.2	2.1	2.2	2.8
Government Consumption	-6.3	-0.6	1.6	5.2	0.6	0.0
Gross Fixed Capital Investment	7.3	5.5	14.9	14.0	11.4	10.9
Exports, Goods and Services	2.4	16.8	9.0	7.4	8.5	7.4
Imports, Goods and Services	6.4	5.4	8.0	7.0	5.6	6.0
Real GDP growth, at constant factor prices	2.4	5.6	4.0	4.4	4.5	4.5
Agriculture	3.1	3.7	3.0	3.1	3.2	3.2
Industry	1.6	6.5	0.4	3.5	3.9	3.9
Services	2.8	5.5	6.4	5.1	5.0	5.1
Inflation (Consumer Price Index)	0.3	1.5	1.1	2.6	1.9	1.8
Current Account Balance (% of GDP)	-7.9	-6.0	-8.7	-8.9	-10.3	-10.7
Net Foreign Direct Investment (% of GDP)	2.9	3.3	2.7	4.0	4.5	3.5
Fiscal Balance (% of GDP)	-1.4	-1.2	-2.7	-3.9	-3.6	-3.0
Debt (% of GDP)	14.0	15.5	16.9	18.5	20.0	21.0
Primary Balance (% of GDP)	-1.0	-0.9	-2.5	-3.5	-3.2	-2.6

Source: World Bank, Poverty & Equity and Macroeconomics, Trade & Investment Global Practices.
Notes: e = estimate, f = forecast.