

**Accounting and Auditing****The Impact of Trade Balance in the Current Account of Kosovo's Balance of Payments****Safet Merovci<sup>1</sup>, Edona Sekiraça<sup>2</sup>**

**Abstract:** The trade deficit and specifically the current account deficit are the main challenges that Kosovo's economy is facing. According to the Balance of Payments Statistics (BOP), the trade balance of goods is the largest component, expressed in absolute and relative terms and consequently it determines the behavior of the current account balance. Trade deficit to GDP ratio is very high - more than 50 percent. Regarding this, financing the constant deficit of the current account is becoming a real problem, because in the long run it is impossible for a country to spend more than its income without becoming a debtor to the rest of the world. Given the unchanged structure of the current account of the Balance of Payments, we conclude that, an improvement of the trade balance is a precondition to the improvement of the current account balance. This can be done through long-term and sustainable substitution of imports with domestic production and also with effective export promotion. Increasing foreign direct investment and export promotion can be considered, in the longer term, the main way to improve Kosovo's Trade Balance.

**Keywords:** trade balance; payment; account

**JEL Classification:** F36

**1. Introduction**

Recent developments in the economies of most countries of the world, testify to the deepening of economic and financial interdependence between countries. Many goods and services produced in specific countries are exchanged in international markets. Additionally, the financial interdependence - movement of assets/equity from one country to another - has deepened to the same extent. Today it is impossible for an economy to function in isolation from other countries or from the international markets of goods, services, capital and labor. This dependence is valid for all countries of the world, regardless of their size and/or their economic

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development. However, we can say that, for small economies of developing countries (such as Kosovo) international trade is indispensable.

The interdependence between countries has increased especially in recent years, due to the globalization of the world economy. The main economic indicators: the absolute and relative growth rates compared to GDP ratios and the relative weight of exports and imports to GDP, show greater extent of economic dependence between countries.

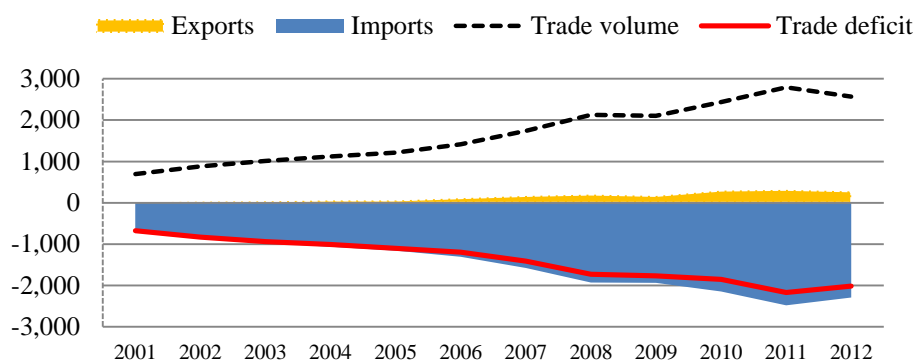
Kosovo's economy possesses all the features of a small economy of a country in transition and thus it is characterized by heavy dependence on international trade. It is an economy based on imports; since the end of the war, the country faces high trade deficit, as a result of the large amount of imported goods. Although export capacity has grown over the years, at the same time the imports increased, thus resulting in the worsening of the trade deficit.

High trade deficit is the only and biggest contributor to the deepening of current account deficit in the balance of payments of Kosovo, the latter reflecting economic relations with other countries recording all economic transactions in goods, services, income, assets and financial transfers between Kosovo residents and the rest of the world - the nonresidents.

Consequently, the object of study of this working paper is the Trade Balance and its impact on the Current Account of the Balance of Payments of Kosovo.

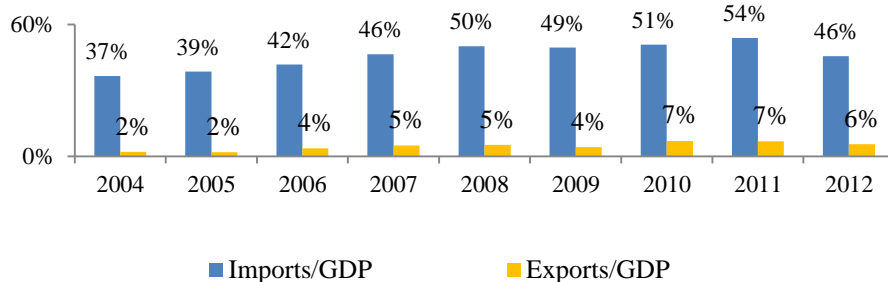
## **2. Key Characteristics of Foreign Trade of Kosovo**

Exports and imports of goods constitute an important mechanism for Kosovo's economy, given its characteristics of a small country. An important characteristic of Kosovo's foreign trade is the great value of imports compared to the relatively small value of exports, resulting in high trade deficit. Since the end of the war, Kosovo faces high trade deficit which is constantly growing. Consequently, the economy of Kosovo is considered dependent on imports, which account for more than 45% of GDP (average 2004-2012). From 2001 until 2012 the trade deficit has increased continuously with an annual average of 10.8 percent. The figure below shows exports, imports, trade deficit and trade volume during the period 2001-2012.



**Figure 1. Kosovo's Foreign Trade: Exports, Imports, Trading Volume and Trade Deficit for the Years 2001-2012, in Million Euros<sup>1</sup>**

The high level of openness estimated by the increasing trade volume shows the small dimensions of the economy and the necessity for the use of imported goods. The trade volume at the end of 2012 was 60 percent of GDP, the largest part of 89 percent of which are imports, while exports participate with 11 percent of the total trading volume. This has caused for the trade openness of the economy of Kosovo to be unilateral, which means it is based solely on imports. The chart below shows the trade volume of Kosovo in relation to GDP, over the years.



**Figure 2. Exports and Imports of Kosovo Compared to GDP<sup>2</sup>**

Although the exporting capacity increased, at the same time the imports increased resulting in the deepening of the trade deficit, which is considered the main challenge for the country's economy. Relative growth rates of imports were more stable compared with exports. Imports have increased with 12 percent, while exports increased with 43 percent per year (2001-2012 average). The level of

<sup>1</sup> Foreign Trade Statistics, Kosovo Agency of Statistics (KAS).

<sup>2</sup> IMF publications "International Financial Statistics", April 2012 and Kosovo Agency of Statistics.

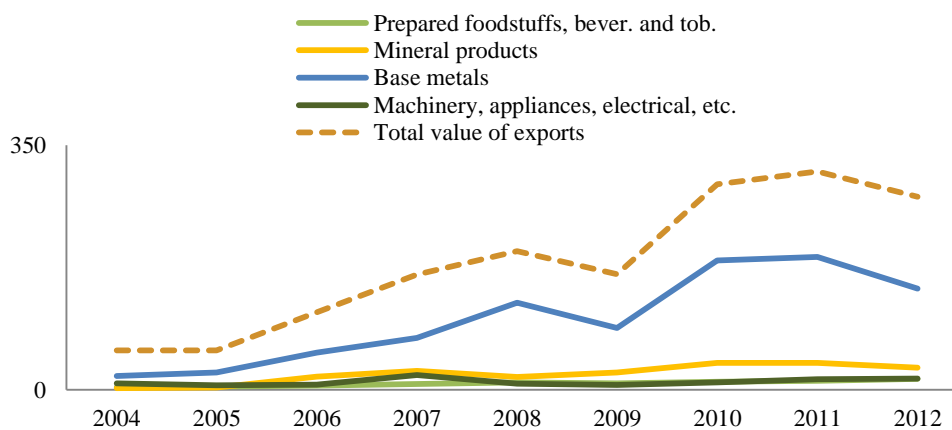
coverage of imports by exports, still remains very low, although compared to ten years ago it is nearly ten times bigger: in the postwar years, the rate of coverage of imports by exports was very low, 2-3 percent, compared with a rate of 12 percent in 2012.

### **2.1. Exports Structure**

Exports are a measure of the stability and sustainability of the economy and of the ability to compete in international markets. Kosovo, compared to the countries of the region, has the lowest level of exports. The small value of exports indicates a low level of competitiveness of Kosovo in international markets. If we look at the trend of the exports from the postwar period, they have recorded satisfactory growth, but this growth has started almost from zero. In 2001 the exports were 10.6 million Euros, while in 2012 they were 276.1 million euros, marking an increase of close to 26 times bigger. The structure of goods exported is dominated by exports of base metals, which represent about 60 percent of the total value of exports. The high concentration of exports in the category of basic metals has made Kosovo's exports more sensitive to fluctuations in the international market. This was proven also in 2009, when as a result of the implications of the global financial crisis the total value of exports decreased, due to the falling demand and base metal prices on the international market. Reliance on exports of natural resources and commodities processed as raw material, cannot guarantee a reduction of the gap in the trade balance, respectively, cannot ensure the sustainability of the balance and increase productivity or create new employment.

The ratio of exports to GDP, an indicator that measures the sustainability of exports to gross domestic product shows a low tendency of Kosovo's economy to export. In 2010 and 2011 this indicator recorded the highest level at about 7 percent (Figure 2).

**Structure of exports by categories of goods** – a characteristic of the structure of exports is the very high participation of basic metals in the total value of exports (60 percent), which indicates high concentration of Kosovo exports in this category. This can be seen from Figure 3, which shows an almost parallel increase of the total value of exports and base metals exports, which makes us understand that the growth of total value of exports came due to the increase of exports of base metals.



**Figure 3. Main Categories of Goods Exported for the Period of 2004-2012, in Million Euros<sup>1</sup>**

Other important categories include mining products, machineries and food products.

**Structure of exports by trading partners** - The structure of exports by trading partners is represented by the member states of the EU and CEFTA. By 2007, the exports of products were mainly done with the countries of the region. Since 2007, thanks to the Preferential Measures Agreement with the EU, the largest markets for Kosovo's exports are the EU countries.

## 2.2. Imports Structure

Imports constitute about 90 percent of Kosovo's trade with other countries, making the economy dependent on imports. The level of production in the last decade has been very low. Consequently most of the goods imported are raw materials and consumer products. Imports have grown steadily, from 684.5 million of euros in 2001 to 2,290 million of euros in 2012. In relative terms, the increase in imports was smaller than the increase in exports. If we compare 2001 and 2012, an import increased by 3.3 times more, while exports increased by 26.1 times more. It is worth noting that in recent years there was an increase in the imports of productive materials and machineries which could lead to an increase in production and substitution of imports with domestic production and thus improve export performance.

<sup>1</sup> Foreign Trade Statistics, KAS.

The ratio of imports to GDP shows the strong dependence of the economy on imports. It also shows the large negative contribution of imports in the domestic production of the country. This indicator in the recent years has increased to a rate of more than 50 percent of GDP.

**Structure of imports by categories of goods** – Unlike exports which are concentrated in the category of base metals, categories of imported goods are diversified into different groups where each category has a significant proportionate percentage to the total value of imports. Distributions of goods imported in different groups can be seen in the figure below. The structures of imports is represented by category of mineral products with 20 percent, prepared foodstuffs, beverages and tobacco with 14 percent, machinery, mechanical and electrical equipment with 12 percent and base metals and articles thereof with 9 percent. Distributions of goods imported in different groups can be seen in the figure below.

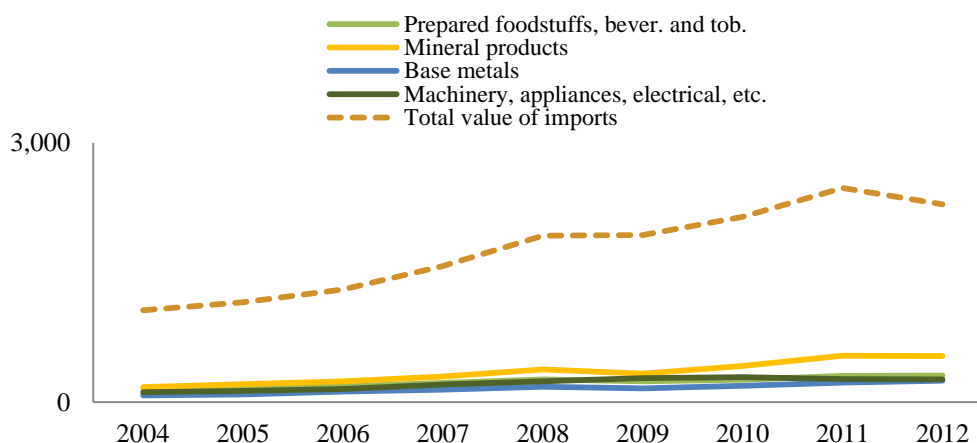


Figure 4. Main Categories of Goods Imported for the Period of 2004-2012, in Million Euros<sup>1</sup>

**Structure of imports by trading partners** – the structure of imports by trading partners is dominated by member states of the EU and CEFTA. From the year of 2004 and 2012, more than ¾ of Kosovo trade exchanges were conducted with these groups of countries. 38 percent of the goods imported in Kosovo come from EU countries, while a similar share of 37 percent come from CEFTA countries.

<sup>1</sup>Foreign Trade Statistics, KAS.

### 3. Key Characteristics of the Current Account of Kosovo's Balance of Payments

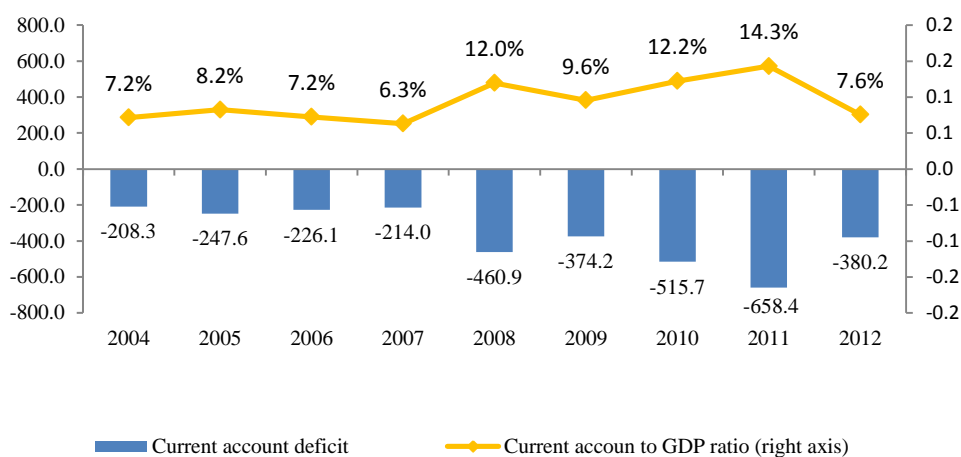
The balance of payments summarizes the financial aspects of international trade. In the case of Kosovo's trade with the rest of the world, the balance of payments is the summary of all transactions including export and import of goods, services, investment income, transfers, movements of assets - such as foreign direct investments, investments in securities and other investments, debt foreign investment and international reserves.

A characteristic of the Balance of Payments of Kosovo is the huge current account deficit which is caused by the trade deficit. The current account is defined as the sum of the difference between exports and imports of goods, services, income and current transfers. Another definition of the current account highlights the difference between national savings and national investments. In this context, the current account deficits natural for the case of Kosovo considering the fact that the country's economy is in the development stage and needs investments. As such, Kosovo's economy cannot fulfill the necessity of investments with the accumulated savings. This results in excess of investments versus savings. So, the current account deficit of balance of payments shows that Kosovo is investing more than it is saving, it produces less than it spends and therefore it is using the resources of other economies to meet consumer demand and investments. Kosovo owes to other countries the negative value that is recorded in the current account and therefore measures need to be taken in order to find a way to pay of this part where expenses exceed income.

Since 2004, the current account deficit has increased continuously with the highest level reached in 2011, scoring 15 percent of GDP (Figure 5)<sup>1</sup>. During the period 2004-2007 the increase was smaller and the current account deficit was generally more stable. It deteriorated in 2008 when it scored a double value compared to the previous year, from 214 million to 460 million euros. The criteria of 5 percent of the current account deficit to GDP, obviously does not apply to the balance of payments of Kosovo as it was violated repeatedly throughout the history of the balance of payments. The lowest level of the current account deficit to GDP, which was 1 percent above the criteria, was recorded in 2007. The ratio in 2007 was about 6 percent. While the highest level of current account deficit to GDP, which is considered a critical level, was recorded in 2011, about 15 percent, which should draw attention to the need to assess affordability, meaning the possibility to sustain the deficit. The figure below shows the time series of the current account deficit and its ratio to GDP.

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<sup>1</sup>Balance of payments (BOP) statistics are compiled and published by Statistics Department in Central Bank of the Republic of Kosovo. During the period 2004-2008 BOP statistics are compiled on annual basis. Starting from 2009, BOP is compiled on quarterly basis.



**Figure 5. Current Account Deficit of Kosovo's BOP and Its Ratio to GDP for the Period of 2004-2012<sup>1</sup>**

According to the balance of payments statistics, the trade deficit is the most important component that determines the behavior of the current account balance. The trade balance is the only component that contributes to the current account deficit. The three other components of the current account (services account, income and current transfers) have a positive impact on alleviating its deficit. Consequently, Kosovo is a net importer of goods and a net exporter of services, income and unilateral transfers.

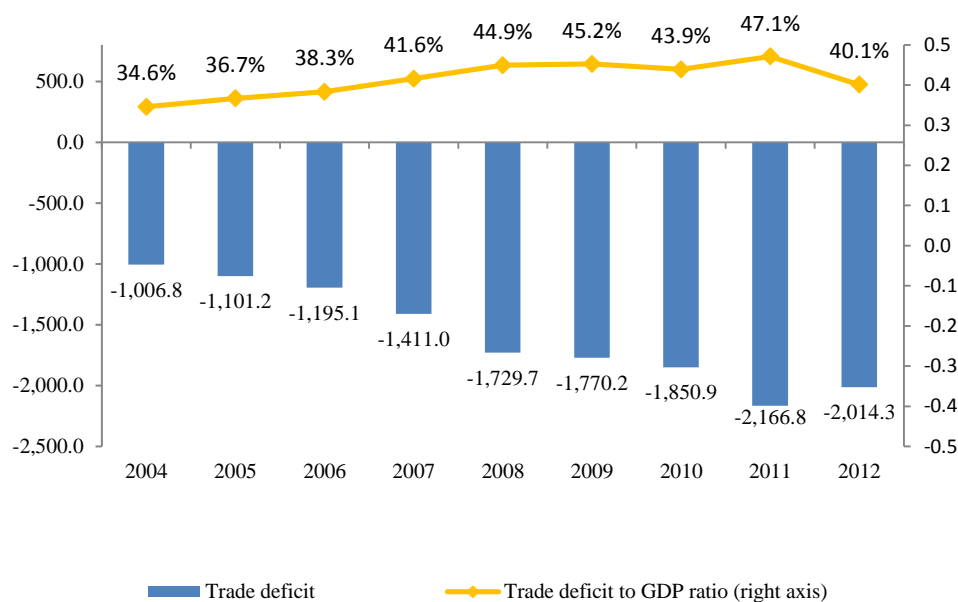
### 3.1. The Impact of Trade Balance in the Current Account

The trade balance has the leading role in the balance of payments of Kosovo in absolute and relative terms. It reflects the difference between the value of goods exported and goods imported for a certain period of time. The trade balance represents the debits and credits created when countries exchange goods. Kosovo's trade balance is the main cause of the current account deficit. Also, in most countries of the region, the main cause of the current account deficit is the trade deficit. The main factors affecting the trade deficit of these countries are the lack of competitiveness and productivity, given that most countries in the region have faced prolonged transition periods and production problems.

<sup>1</sup>Time series statistics, CBK.



The behavior of trade deficit during 2001-2012, and its ratio to GDP is shown in the following figure.

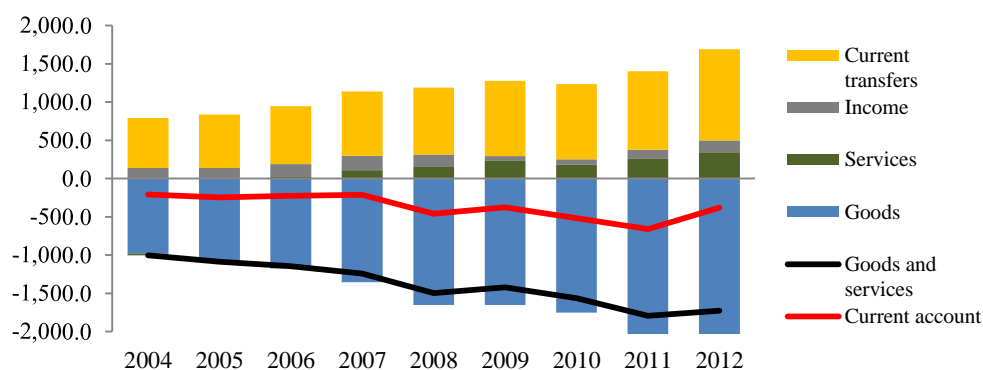


**Figure 6. Trade Deficit in Million Euros and the Ratio to GDP (Right Axes)<sup>1</sup>**

As seen from the figure, the trade deficit ratio to GDP has decreased, though it still remains quite high. However, in absolute terms, the deficit has increased continuously, amounting to 2 billion euros in 2012, which is a very high level considering the overall level of foreign transactions.

Transactions of trade in goods in 2012 comprise more than 50 percent of all transactions recorded in the current account. Consequently, the trade deficit as a permanent feature of the foreign trade has consistently dictated high levels of current account deficit. The figure below shows the relative importance of each of the components that make up the account. The only component that marks a negative value is the trade balance, which due to its weight, determines the behavior of the current account. The three other components - services, income and current transfers - have a positive impact in narrowing the negative value caused by the trade balance.

<sup>1</sup>Time series statistics, CBK.



**Figure 7. The Impact of Trade Balance and Other Components on the Current Account Deficit during the Period 2004-2012, in Million Euros<sup>1</sup>**

Services account has been consistently positive, although the impact of this account in the current account balance cannot be considered important. However, the surplus of the services account makes Kosovo a net exporter of services to the rest of world. This causes the sum of goods and services balance to be smaller than the trade deficit. The travel services, which are largely provided to migrants visiting Kosovo, have the largest contribution within the services account.

Apart from the services, the income account has also a positive impact on the current account. Compensations of Kosovo residents working abroad have the greatest contribution to the surplus of the income account. The other component of income account, which is investment income has a negative balance which indicates that payments for investments within the country are greater than the receipts from investments abroad, thus contributing negatively to the balance of the income account.

The current transfers account has the most important role in reducing the current account deficit. Current transfers take the form of workers' remittances which represent an important source for the economy by providing a continuous flow of deficit financing. The contribution of remittances to deficit financing is estimated to be around 35 percent (2004-2012 average), while the positive balance of current transfers account is more than two times greater than the negative balance of the current account. This shows that the gap between the positive balance of the transfers account and the negative balance of the current account is filled by the trade deficit which at the same time determines the behavior of the current account.

Figure 7 shows the amount of goods and services account marked in black, and the current account marked in red. These two indicators are parallel to each other,

<sup>1</sup>Time series statistics, CBK.

which confirm what has been said so far: the trade deficit determines the behavior of the current account deficit, while the difference between the two is attributed to the current transfers.

### **3.2. Affordability and Financing of the Current Account Deficit**

The concept of affordability of the current account deficit is a complex concept. It is very difficult to find a simple rule to estimate whether the account deficit that a country is facing is sustainable or not. In economic literature, however, there are many criterias recommended to be used for this kind of assessment. Theoretically, the degree to which the economy fulfills its international financial obligations is an effective way to measure the sustainability of the current account deficit. It is generally accepted that a level above 5 percent in the current account deficit to GDP ratio should draw attention to the need to assess affordability, meaning the possibility to sustain the current account deficit. The deficit affordability is also affected by the deficit structure. If the current account deficit is caused by the trade deficit, which reflects a lack of competitiveness of the economy and therefore affordability becomes problematic.

If we compare the data of the current account balance of Kosovo's BOP with the respective data of the neighboring countries we can see similar structural problems of the economies, which shows that in general they are also characterized by high levels of deficit. In some of them, the deficit levels above 5 percent of GDP have been present for a long period of time, while they are not recorded as external sector crisis. For example, in Albania, after three years of positive surplus, in 1996 current account deteriorated recording a deficit of 2.3 percent of the GDP. During the 1997 crisis, the deficit reached 11.1 percent of the GDP, just to get back to normal – below 5 percent - in the years 1999-2000. The deficit surpassed the critical level of 5 percent of GDP in 2001, undergoing a very rapid growth in 2002, to reach the level of 9 percent of GDP. Therefore, we can say that for countries like Kosovo and Albania, and generally, transition countries of the region which depend largely on foreign aid, the limit of 5 percent has not served as a warning sign of potential crisis of the external sector.<sup>1</sup>

The ratio of current account deficit to GDP, based on the data from of the beginning of Kosovo's BOP statistics is 10 percent on average, which can be interpreted as twice the warning limit. While the focus of the sustainability of the current account deficit is the country's ability to withstand external debt, let us refer to the criterion that compares the dynamics of the stock of external debt, with growth rates of GDP. In late 2011, the accumulated net external debt (public and

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<sup>1</sup>Ahmet Mançellari and Selami Xhepa "Sustainability of the current account balance".

private) reached about 1.43 billion euros<sup>1</sup>, or 31 percent of GDP. The level of this indicator is relatively low compared with other countries in the region. Meanwhile, the annual level of external debt (annual additions of the stock of debt) in 2012 was about 2 percent of GDP, while the average annual growth of GDP was around 3 percent. Thus, the increase of external debt is below the annual growth of the economy. In the point of view of this criterion, the current account deficit can be considered affordable.

The current account deficit of Kosovo's BOP is largely financed by migrant's remittances and foreign direct investments.

The negative effect of the current account deficit is mitigated by the positive balance of the current transfers' account, which mainly consists of remittances. The current transfers account is continually characterized by a positive balance. Migrant's remittances have a positive effect on the current account balance and represent one of the most important components of consumer financing in the country. They make up about 12 percent of GDP in Kosovo (2012).

### **3.3. Sustainability of the Current Account Balance**

Foreign direct investments continue to be an important source of capital flows and economic development. Foreign direct investments include investments of foreign individuals and institutions in the local economy, if the investment makes the investor owner of more than 10% of the equity of an enterprise. In Kosovo, the direct investments have increased, but not at a satisfactory level considering the emergent need to increase employment and improve the country's prosperity. Furthermore, FDI can be the most effective solution to improve Kosovo's trade balance. But the situation is worrying because, since 2007 when FDI reached the highest level, they continued to decline, and, given the country's unilateral eurization they are a *conditio sine qua non* for economic stability. Domestic investments can also be considered as a good opportunity to improve the economic situation of the country. Our domestic natural resources, human and material resources are abundant, although measures need to be taken to improve the processing and encourage exploitation of these resources.

## **4. Conclusions**

Kosovo's economy has all the characteristics of a small economy of a country in transition. As such, it has a greater dependence on international trade, which is represented by a high degree of trade openness. In 2011 this indicator marked the highest level in the last decade, about 61 percent of GDP, which is also the highest compared with the countries of the region. Kosovo trade volume consists of 90

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<sup>1</sup>Time series statistics, CBK.

percent imports and only 10 percent exports. Consequently, the trade deficit is very high and as such it is one of the challenges of our economy.

The dominant role of the trade deficit in the current account deficit is one of the main threats concerning the sustainability of the latest. Therefore, improvement of the current account balance in the longer term can be identified with the improvement of the trade balance. This may not necessarily be achieved by reducing imports, because imports of capital goods should be encouraged. Also, an attempt to reduce consumption of imported goods would not be useful. However, efforts should be made regarding the substitution of imports with domestic production and exports promotion. In this context, based on the comparative advantages that Kosovo has, some indications can be drawn based on the potential factors of production, natural resources and human capital. Extractive industries and the energy sector remain industries with comparative advantage. Kosovo has obvious advantages in the production of electricity, given the huge demand for power in the region and beyond, and the low cost of coal based energy. Besides, other mineral resources have a significant production potential.

Given the structure of the current account of Kosovo's BOP, we can conclude that improving the current account balance requires first of all an improvement of the trade balance. Related to in, the growth in exports is critical to the economic development of our country and the only choice for improving the trade balance. In this context, the proposed recommendations are:

- Kosovo institutions should take urgent steps aimed at promoting the export sector. This requires improvement of fiscal policies and stimulation of production. Export promotion can be considered the main way to improve the trade balance;
- FDI is an important source of financing the economy. In this context, policymakers should focus on increasing investments towards export-oriented activities. Also, domestic investment can also be viewed as an opportunity to improve the economic situation of the country. Therefore an improvement of the investing environment is required. Kosovo has potential in the mining and energy industry;
- Remittances remain a very important factor in the dynamics of economic activity in Kosovo, but this also requires to find ways of diverting remittances from consumption towards capacity building of small and medium-sized enterprises, which would result in the reduction of imported goods and increase the exports of services.

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