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Ministria e Tregtisë dhe Industrisë–Ministarstvo Trgovine i Industrije–Ministry of Trade and Industry

# Annual Report #1

## 15 Years of Transition in Kosovo: Implications for Trade

EU Trade Policy Project

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## ACRONYMS

| | |
|---|---|
| ATM | Autonomous Trade Measures |
| CEFTA | Central European Free Trade Area |
| EFTA | European Free Trade Area |
| EU | European Union |
| ERP | Effective Rate of Protection |
| FDI | Foreign Direct Investment |
| FTA | Free Trade Agreement |
| GATT | General Agreement on Tariffs and Trade |
| GDP | Gross Domestic Product |
| GL | Grubel-Lloyd index |
| GSP | Generalized System of Preferences |
| HDI | Human Development Index |
| HH | Herfindahl-Hirschmann index |
| HS | Harmonized System |
| KAS | Kosovo Agency of Statistics |
| KFVA | Kosovo Food and Veterinary Agency |
| KIESA | Kosovo Investment and Enterprise Support Agency |
| MCB | Municipal Business Centres |
| MFN | Most-Favoured Nation |
| MoFTR | Memorandum on the Foreign Trade Regime |
| MTI | Ministry of Trade and Industry |
| NCED | National Council for Economic Development |
| NTB | Non-Tariff Barriers |
| NTM | Non-Tariff Measures |
| OECD | Organisation for Economic Co-operation and Development |
| PAP | Processed Agricultural Products |
| PPP | Purchasing Power Parity |
| RCA | Revealed Comparative Advantage |
| SAA | Stabilisation and Association Agreement |
| SITC | Standard International Trade Classification |
| SOE | Socially Owned Enterprises |
| SPS | Sanitary and Phyto-Sanitary Measures |
| TaB | Trading –across-Borders |
| TARIK | Integrated Tariff of Kosovo |
| TBT | Technical Barriers to Trade |
| ToT | Terms of Trade |

| | |
|---|---|
| TPWG | Trade-Policy Working Group |
| TRIPS | Trade-Related Aspects of Intellectual Property Rights |
| UNCTAD | United Nations Conference on Trade and Development |
| UNMIK | United Nations Mission in Kosovo |
| VAT | Value Added Tax |
| WBDB | World Bank Doing Business |
| WTO | World Trade Organisation |

## FOREWORD

The Ministry of Trade and Industry of Kosovo is above all responsible for the conduct of trade policy. In fulfilling its mandate MTI uses specific instruments to influence the flow of goods and services between the Republic of Kosovo and the rest of the world.

The MTI is also responsible for international economic integration and in this regard it represents Kosovo in a number of international and regional mechanisms and organizations. It conducts trade negotiations both bilaterally with partner countries and also within the framework of international organizations. At present, MTI is involved with negotiations on liberalization of trade in services, within CEFTA. Moreover, in 2013, the country concluded important trade negotiations on goods with the European Union; it is a major component of the Stabilization and Association Agreement that will start with implementation next year. Kosovo has also negotiated a Free Trade Agreement with Turkey and it is preparing for the application at the World Trade Organization, World Tourism Organization, and other specialized international organizations, e.g. quality infrastructure structures.

*De facto*, since 1999, the country is integrating slowly into the global economy; this process is seen as essential for strengthening the domestic economy, enlarging the scope of economic activities, creating more jobs and raising the welfare of the people.

The Report, prepared by the staff of the Trade Department, with the support of the EU funded Trade Policy Project, summarizes the changes which have taken place in the sphere of trade over the past 15 years. It is a rather comprehensive document. It starts with an overview of Kosovo's economy, which permits to assess the importance of international trade for the country. Considering trade *per se*, a large number of indicators allow the reader to know more about the features of trade flows, in terms of dynamic and structure, comparative advantage and competitiveness, and actual and future levels of protection, following the implementation of free trade agreements. The role played by the private sector is also analysed, as well as the institutional framework, referring to the MTI and its relations with other state bodies. The last chapter addresses the broader issues of trade and development, from a comparative perspective.

This Report should be seen as a reference document by various types of audiences such as: trade analysts, policy makers, academia, research and think tanks, business associations and companies, private and public. It may lead to further work on key-trade issues, including linkages between trade, liberalization and growth, the role of institutions and the interface between public and private sectors.

Hykmete Bajrami

Minister, Ministry of Trade and Industry

## EXECUTIVE SUMMARY

The report "15 Years of Transition in Kosovo: Implications for Trade", the first in a series of regular annual reports, provides an in-depth analyses of trade and trade-related developments in Kosovo in the last 15 years. Annual reports are only a part of the whole new series of publications on trade that the Trade Department initiated in 2015. These include briefs, periodical reports – quarterly and annual – and policy papers. The aim of this new approach is to produce analyses that may inform evidence-based policy making in the area of international trade. This is paramount for the Government of Kosovo, especially to MTI. The current report is the first major contribution in this direction.

Generally speaking, the report analyses the following issues:

- The persisting negative trade balance and its implications for sustainable development in Kosovo;
- The sectorial composition of trade, with a specific attention to trade in goods and services;
- The geographical structure of trade;
- The existing trade regime, and the effectiveness of tariff policy, non-tariff instruments, and trade liberalisation for the development of the manufacturing sector;
- Trade institutions, legislation, and policy-making in the area of trade;
- Private sector, business environment, and trade facilitation; and,
- In terms of future prospects, the report places trade in the broader context of economic development in Kosovo.

In terms of methodology, the report utilizes the official trade data produced by the Kosovo Agency of Statistics. The report employs various trade indices common in trade analysis. These indices enable us to have an in-depth understanding of trade patterns and dynamics.

As expected, the analysis shows that there are great challenges ahead. The major conclusion of the report is that the increase in export activity in Kosovo is primarily constrained by supply-side factors. While trade facilitation issues – complex border processes and the like – remain an issue, "beyond-the-border" constraints – i.e. market access issues – do not seem to greatly impede the international expansion of Kosovo's businesses. Even if they ever did,

they certainly no longer constitute an impediment now that around 80% of Kosovo's external trade has been/will be liberalised. Hence, the Government should step up "inside-the-border" policies to reduce supply bottlenecks and support the development of the private sector and its international expansion. In principle, these policy measures should be aimed at promoting investment and increasing firms' productivity levels. A large amount of evidence shows that only high-productivity firms are sufficiently competitive to succeed in export markets. Moreover, in a highly competitive environment such as the one in Kosovo, being internationally competitive is a prerequisite even to compete domestically. Hence, targeted government interventions in the market are necessary at this stage, if Kosovo's businesses are to thrive domestically and internationally, create jobs, and generate growth and welfare.

Specifically, the report touches on the following points:

- The Kosovar economy is still encountering various structural problems. Trade-related institutions are still weak (especially when it comes to enforcement), the workforce is poorly equipped, while the business environment requires fine-tuning. This, in turn, affects the overall performance of the economy, particularly the development of a strong private sector, which would make the country internationally competitive. In these circumstances, Kosovo's weak domestic production base, resulting also in a poor performing external sector, is not contributing to economic growth and development.

- The structure of the external sector shows high levels of concentration of exports in unprocessed minerals and base metals, and other related products. This makes the Kosovar economy vulnerable to price and demand shocks in international markets. Hence, diversification of economic activity is paramount, especially into higher-value added manufacturing sectors. The performance of services in export markets shows encouraging signs, but the data are biased by the presence of "virtual exports", which are not a proper indicator of the level of *international* competitiveness of service sector in Kosovo.

- The persisting structural problems that the economy faces have created a high-risk/low-return environment for businesses, negatively affecting firms' investment decisions. As a result, firms in Kosovo generally lack technical capabilities and skilled human resources. The latter two are a precondition of high levels of productivity – a major ingredient in strategies aiming at the international expansion of firms. An encouraging sign is a closer coordination between the government and

the private sector through trade coordination mechanisms introduced by MTI, as well as a comprehensive legislative framework on trade.

- The tax policy introduced in the aftermath of the 1999 war has narrowed immensely the scope of trade policy-making in Kosovo. In particular, it has constrained the use of tax instruments to protect/support domestic industries. The current tariff levels hardly provide any protection to domestic sectors. Non-tariff measures on the Kosovo side are virtually non-existent; even when applied, they do not discriminate against imports. On the other hand, Kosovo's exporters face significant non-tariff barriers when entering foreign markets (especially advanced-country markets); at the same time, many of the non-tariff barriers erected by Kosovo's CEFTA partners lack a serious economic rationale.

- For Kosovar producers, market access is no longer a major issue (if it ever was at all). With CEFTA in place, and the SAA with the EU and the FTA with Turkey impending, over 80 percent of outward trade is/will be liberalized. Still, the liberal trade policies of recent years have largely fallen short of delivering the expected results – that is, a creation of a strong manufacturing base and a well-performing private sector emerging from increased levels of competition. On the contrary, the liberalisation of international trade has further aggravated Kosovo's import dependency, widening the trade deficit. The Government of Kosovo has to take into account these developments before it decides on the course it takes on WTO membership. In principle, the latter decision should conform to Kosovo's development goals, and should be based on a clear understanding that WTO membership (or further liberalization) would indeed support manufacturing development and export-led growth.

- Border-related procedures still remain an issue for Kosovar and regional businesses. Cumbersome inspection procedures, documentary requirements, poorly equipped and corrupt administrations, lack of technical capabilities, insufficient flow of information, poor cooperation between border agencies, and the like, greatly affect many businesses around the region. Hence, trade facilitation reforms in the form of simplification, harmonisation, and standardization of procedures and documentary requirements either bilaterally or (preferably) within CEFTA should be encouraged.

- For Kosovo producers, including exporters, the most pressing problems at the moment are on the supply side, rather than on the demand side (e.g. accessing markets duty-free). In particular, they relate to producing internationally competitive goods that can meet product quality standards and satisfy consumer demand. This

calls for a more active role of government through targeted industrial policy mechanisms. This would aim at developing supply-side measures to upgrade technical skills and production capabilities in promising sectors, with a view to quickly reduce costs, increase quality, and become internationally competitive. In addition, the Government should continue to undertake measures to improve the business environment.

The report is by no means exhaustive. Some issues require further attention, especially FDI and the quality infrastructure. The latter two issues have not been analysed in great depth, but nonetheless are vital for a competitive export sector. Other issues require more in-depth analysis (i.e. econometric modelling), longer time-series, or better information from the ground (especially, micro-level analysis). These issues include the trade/growth relationship; the relationship between trade liberalisation and Kosovo's manufacturing base; productivity constraints and private sector development, and the like. Nevertheless, the report offers a rich repository of information and analysis on trade and trade-related developments based on which the Government, and especially MTI, can base their future actions, fine-tune their policies and strengthen institutions to trigger export growth.

## INTRODUCTION

The report "15 Years of Transition in Kosovo: Implications for Trade", is the first in a series of annual reports prepared by the Trade Department at MTI. In 2015, the Trade Department has initiated a whole new series of publications on trade that include briefs, periodical reports – quarterly and annual – and policy papers. The aim of this new approach is to provide information to a wider audience on trade developments in Kosovo, but also to inform trade-related policy-making in the country. Moving towards evidence-based policy making in trade is a key goal of the Kosovo Government, in general, and MTI, in particular. The current report is the first major contribution in this direction.

The present report goes beyond yearly developments in trade. To mark the start of the series, this report covers trade developments throughout the period of post-war transition in Kosovo, i.e. since 2000. However, due to data limitations a number of trade indicators are reported only after 2005. In general, the report sheds light on the following issues: the state of the trade balance and its relationship with economic performance; the sectorial composition of trade, with a specific focus on goods and services; the major trade partners; further, trade policy developments with special focus on tariff policy, non-tariff instruments, and trade liberalisation; trade institutions and policy-making in the area of trade; trade facilitation; and finally, a broader view on trade and development issues in Kosovo.



The report builds on official trade data produced by the Kosovo Agency of Statistics. For the first time, the report applies to Kosovo various trade indices common in trade analysis. These indices enable us to have a much better understanding of geographical/sectorial diversification/concentration of exports/imports; terms of trade; protection levels; and even comparative advantages. In short, the report highlights the persisting negative trade balance in goods as one of the most pressing issues for policy-making in Kosovo. In addition, the report emphasises the high degree of sectorial concentration of exports in goods, and the need to diversify in order to achieve higher and more sustainable economic growth rates. Further, it gives an extensive overview of trade policy developments in the post-war years, and it warns that future trade policy measures, especially further trade liberalisation, should comport with Kosovo's development needs and goals. Next, it highlights the need for further coordination and alignment between trade-related institutions and the private sector. It argues that the overall business environment, and especially trade facilitation measures, need to be improved in order to achieve a more active presence of Kosovo's private sector firms in international markets. Finally, the report suggests possible strategies for a more active engagement of government in generating dynamic comparative advantages in Kosovo.

Chapter 1 provides an overview of developments in the Kosovar economy after the war. Next, a detailed quantitative analysis of trade patterns is provided. Chapter 3 discuses Kosovo's trade regime. Chapter 4 concentrates on market access issues and further liberalisation prospects. Chapter 5 and 6 discuss trade institutions, the role of the private sector, and the business climate in Kosovo. Chapter 7 focuses on border-related issues and trade facilitation mechanisms. The final chapter brings together trade and development issues in Kosovo, with a special emphasis on the need to boost domestic industry and, especially, manufacturing. The final section concludes the report.

# 1. BACKGROUND TO KOSOVO ECONOMY

The external trade sector must be looked at against the backdrop of Kosovo's economic performance more generally. This chapter briefly charts the main macro-economic developments in the Kosovo economy since 1999.

## 1.1 Growth performance

Looked at broadly, since the beginning of the post-war transition process in 1999, Kosovo has experienced promising rates of economic growth. The growth spurt of the immediate post-war period (which peaked at 27 per cent in 2001) was overwhelmingly driven by extremely high inflows of development and reconstruction aid – both of which promoted household and government expenditure and thus catalysed economic activity. Net official development assistance reached 72 per cent of GDP in 2001, the first year when aid data are available. Since the initial post-war aid windfall dried up and aid inflows levelled off at around 10 per cent of GDP, growth has been sustained at moderate levels. Between 2002-2014, GDP growth ranged between 0 per cent and 7 per cent, while average growth of per-capita incomes hovered around 3.1 per cent (Table 1).

Table 1. Kosovo – main macroeconomic indicators, 2001-2014

| Indicators | 2001 | 2004 | 2007 | 2010 | 2014 | Average[b] |
|---|---|---|---|---|---|---|
| GDP (constant, m €) | 2,946.6 | 3,181.9 | 3,782.8 | 4,145.4 | 4,714.0 | 3,847.6 |
| GDP growth (annual, %) | 27.0 | 2.6 | 7.3 | 3.3 | 2.5 | 3.7 |
| GDP per capita (constant, €) | 1,732.1 | 1,866.7 | 2,182.3 | 2,334.5 | 2,585.6 | 2,188.1 |
| GDP per capita growth (annual, %) | 26.9 | 2.5 | 6.4 | 2.5 | 2.2 | 3.1 |
| Unemployment, total (% of total labour force) | 57.0 | 39.7 | 46.3 | - | 30.9[a] | 44.5 |
| Inflation, consumer prices (annual, %) | - | -1.0 | 4.3 | 3.5 | 0.4 | 2[c] |

*Source*: World Bank *World Development Indicators* (various years)
*Note:* [a] 2012
[b] Average between 2002-2014
[c] Average between 2003-2014

While nominally moderate, Kosovo's overall growth performance remains weak and fragile.[1] High rates of GDP growth mainly reflect the low initial GDP levels caused by the war-induced economic collapse. They are also largely driven by a recovery process involving a large-scale return of refugees who had left the country during hostilities. At the same time, the high levels of economic informality suggest that the figures for per-capita incomes may underestimate the actual levels of household disposable income.

## 1.2 Sources of growth: aid and remittances

The structure and drivers of GDP growth in Kosovo shed further light on the country's serious economic challenges. First of all, much of the recent growth was only possible because of the unusually large inflows of "unearned" national income in the form of aid and remittances. Jointly, aid and remittances amounted to a staggering average of 45.8 per cent of GDP over 2000-2013, and made possible the expenditure boom which in turned fuelled economic activity (e.g. trade) and GDP growth. While the initially large inflows of aid for post-war reconstruction and humanitarian assistance quickly tailed off, aid still looms large in the structure of economic activity, accounting for some 10.9 per cent of GDP during 2009-2013. Over the same time period, remittances accounted for an average of 17.1 per cent of GDP, having only slightly declined compared to the pre-Euro crisis period (2000-2008) (Table 2). Overall, "unearned" income – what economists call "rent" – adds up to an average of 28 per cent of GDP between 2009-2013. Since aid and remittances tend to decline over time (because of geopolitical reasons and the natural erosion of trans-national family ties), the growth pattern experienced by Kosovo so far is unlikely to be sustainable in the future.

Table 2. Kosovo – "unearned" income: aid and remittances

| Indicators | 2000-08 | 2009-13 |
|---|---|---|
| Workers' remittances and comp. of employees, received (current, m€) | 811.4[a] | 1,070.9 |
| Workers' remittances and comp. of employees, received (% of GDP) | 18.6 | 17.1 |
| Net Development Assistance (current, m €) | - | 631.9 |
| Net Development Assistance (% of GDP) | 45.0 | 10.9 |

*Sources:* World Bank *World Development Indicators* (various years)
*Notes:* [a] Average over 2004-2008

[1] See, for instance, the 2011 *EU Progress Report on Kosovo.* http://ec.europa.eu/enlargement/pdf/key_documents/2013/package/brochures/kosovo_2013.pdf (accessed on: June 05, 2014).

## 1.3 External sector and the balance of payments

With a trade deficit exceeding 34 per cent of GDP in 2014, the external position remains Kosovo's single most challenging economic issue. The high share of external rent earnings (aid and remittances) in national GDP explains why Kosovo can maintain a balance of payments with the rest of the world in the face of a gaping – and, indeed, growing – trade deficit (see Table 3). Households, firms and government agencies consume imported goods and finance the trade deficit through cash earnings remitted by migrant workers and aid grants from development organizations.

Table 3. External trade indicators

| Indicators | 2005 | 2008 | 2011 | 2014 |
|---|---|---|---|---|
| Exports of goods and services (current, m. €) | 324.3 | 595.4 | 944.4 | 1095.2 |
| Goods exports (current, m €) | 56.3 | 198.5 | 319.2 | 324.6 |
| Service exports (current, m €) | 268.0 | 396.9 | 625.2 | 770.6 |
| Exports of goods and services (% of GDP) | 10.8 | 15.1 | 19.8 | 19.9 |
| Imports of goods and services (current, m €) | 1,432.3 | 2,178.5 | 2,861.2 | 2,972.7 |
| Goods imports (current, m €) | 1,157.5 | 1,928.2 | 2,492.4 | 2,538.2 |
| Service imports (current, m €) | 274.8 | 250.3 | 368.9 | 434.5 |
| Imports of goods and services (% of GDP) | 47.7 | 55.3 | 59.9 | 54.0 |
| Trade balance on goods and services (current, m €) | -1,108.0 | -1,583.2 | -1,916.9 | -1,877.6 |
| Trade balance in goods (current, m €) | -1,101.2 | -1,729.8 | -2,173.2 | -2,213.7 |
| Trade balance in services (current, m €) | -6.8 | 146.6 | 256.3 | 336.1 |

*Source*: Central Bank of Kosovo (various years)

Over 2005-2014, the negative trade deficit amounted to an annual average of €1,621.43 million. While the best part of this deficit is closed by the inflow of remittances and aid grants (which amounted to €1,654.8 million in 2013), the current account balance (which includes several other international flows besides trade) remains negative, at €451.4 million in 2013 (Table 4).

In turn, the persisting current account deficit is financed through other components of Kosovo's external balance of payments (remember that a deficit on the current account ledger may be cancelled out by a surplus on the capital and financial account ledgers, as long as the net sum is zero). In Kosovo, net capital flows are positive, and they finance a portion of the current account deficit (e.g. foreign investors purchasing imported capital

goods to install at foreign-owned plants in Kosovo). Much more significantly, though, spending on imports has been financed through inward financial flows, as evidenced by the fast-growing deficit on the financial account (signified by a net positive financial balance, meaning more debt money is coming in that is going out). These inflows accrue mostly in the form of private external debt (mostly bank-to-bank), which result in households taking out commercial loans in order to purchase imported consumption goods such as cars, home appliances or luxury items, or to buy properties that were built using imported inputs.

Total external debt (which is mostly private, rather than public debt) has grown at an average of 19 per cent per annum since 2008, reaching 14.1 per cent of GDP in 2013. Thus, debt flows have contributed to increasing (import-dependent) household consumption and stretching the international purchasing power of Kosovar consumers beyond the levels afforded by aid and remittance inflows.

Table 4. Kosovo – balance of payments, 2005-2013

| Indicators (current, m €) | 2005 | 2009 | 2013 | Average |
|---|---|---|---|---|
| Current account balance | -307.7 | -547.0 | -451.4 | -586.2 |
| Net capital account | 23.6 | 147.5 | 46.3 | 41.1 |
| Net financial account | -66.9 | -176.2 | -176.8 | -260 |

*Source*: World Bank *World Development Indicators* (various years)
*Notes:* conceptually, current account balance + net capital account = net financial account

## 1.4 Structure of the economy: consumption and production

Import (and, increasingly, debt) dependence is compounded by a pronounced "consumption bias" in the external trade sector and the wider economy more generally. For instance, between 2002-2011 prepared foodstuffs alone on average accounted for nearly 15 per cent of the total value of imported goods, while capital goods made up a comparable 12 per cent of the total yearly volume of imports. A similar bias can be detected in the economy at large. Between 2010-2013, final consumption expenditure (including households and government) averaged a staggering 108.6 per cent of GDP. The credit market is also heavily skewed in favour of consumption, as the (wholly foreign-owned) banking sector usually does not provide instruments for venture capital and high-risk projects, preferring instead to lend to households and SMEs in the service sector.

Thus, consumption bias is evident both in inward trade and in the structure domestic financial flows – that is, in the use of both foreign exchange and domestic savings to purchase consumer goods rather than capital goods. This bias has led to a steadily declining

role of industrial production in the economy, which in turn precludes opportunities for nurturing successful export industries. Since 2006, manufacturing value-added amounts to an annual average of some 11 per cent of GDP, which is both below the average for lower-middle income countries (17.2 per cent) and for the OECD (15.3 per cent).

## 1.5 Savings and investment

Suffering from "consumption bias" does not mean that the economy does not invest at all. While the savings rate (GDP minus final consumption expenditure) remains negative (Figure 1) – chiefly owing to the negative external balance – investment is actually relatively high in aggregate terms. At an average of 29.0 per cent of GDP between 2005-2009, capital formation is above OECD levels (21.3 per cent over the same period). Since high rates of capital formation normally reflect the existence of dynamic economies oriented towards capital accumulation, these data might suggest an economic trajectory of dynamic catch-up. However, a breakdown of the structure of investment suggests otherwise. First of all, over 28 per cent of total investment is financed by foreign capital, as compared to an average of 10.7 per cent in the OECD. A relatively high dependence on FDI for capital formation reflects, amongst other things, the inherent difficulty of mobilizing domestic resources for development in an intensely "consumption-biased" economic environment such as Kosovo's. In fact, at an average of $240.2 annually, FDI per capita is higher in Kosovo than in many other developing countries – largely thanks to the contribution of a relatively large and industrious diaspora community with enduring familial ties to the homeland (see Table 5).

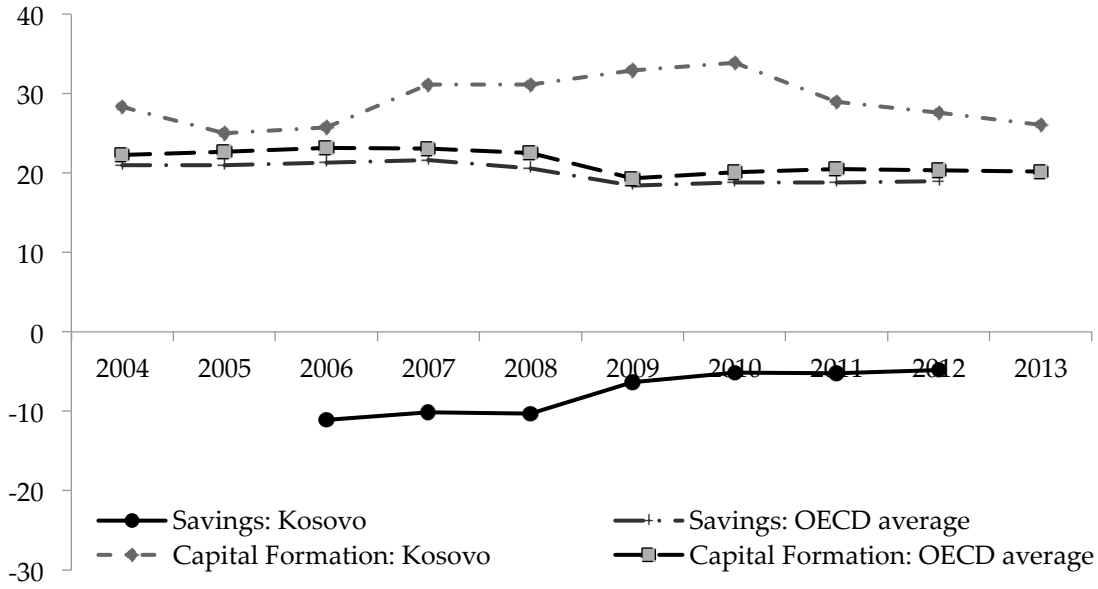


Table 5. FDI inflows per capita, selected developing countries, 2000-2013

| Country | In $ |
|---|---|
| Kosovo | 240.2 |
| *Successful Developing Countries* | |
| China | 121.3 |
| Botswana | 210.4 |
| *Stagnant Developing Countries* | |
| Cameroon | 17.6 |
| Pakistan | 12.4 |

*Sources:* Author's calculations from World Bank *World Development Indicators* (various years)

Figure 1. Gross domestic savings and gross capital formation (in % GDP): Kosovo vs. OECD, 2004-2014




*Sources:* World Bank *World Development Indicators* (various years)

Furthermore, the presence of relatively high FDI volumes (by developing country standards) does not demonstrate that foreign capital is actually taking advantage of investment opportunities in export-oriented sectors of Kosovo's economy. On the contrary, the overwhelming share of FDI (75.3 per cent) is directed into non-tradable sectors (construction and services), whereas only slightly over 15 per cent of total FDI flows are absorbed by manufacturing (Table 6). This explains why existing levels of foreign investment are not closely associated with industrialization and export growth. It also shows that foreign capital inflows in Kosovo effectively contribute to establishing economic activities (e.g. services) that maintain and reproduce the overall consumptive character of the economy.

Table 6. Kosovo: net foreign investment flows, by sector, 2007-2014

| Sector (% of total net FDI flows) | 2007 | 2011 | 2014 | Average |
|---|---|---|---|---|
| Agriculture | 1.79 | 0.14 | 0.11 | 1.16 |
| Industry | 26.95 | 10.89 | -10.85 | 15.78 |
| Construction | 1.17 | 34.63 | -13.13 | 9.1 |
| Services | 66.23 | 37.89 | 122.95 | 66.2 |
| Other | 3.83 | 16.43 | 0.91 | 7.75 |

*Source*: Central Bank of Kosovo *Times Series* (various years)
*Notes:* averages over the whole time period

As a result, the share of industry in national income has remained stationary at around 16 per cent of GDP, while services and construction have increased to over 53 per cent, pointing to the ongoing process of tertiarization of the economy – at least as compared to pre-transition levels. Similarly, upwards of 66 per cent of the formal labour force is employed in services and (less so) construction – not to mention the large absorption of informal labour into the urban and rural informal sectors (e.g. petty trade and commerce, subsistence agriculture, etc.).

The ancillary position of manufacturing in the structure of the economy, and the lack of sustained levels of capital formation in the industrial sector go a long way towards explaining the increasing deficit registered in the external balance of tradable goods. To sum up: the investible surplus realized by the economy (mostly thanks to foreign FDI inflows rather than domestic savings) is used largely to import consumption goods; this worsens the trade balance; at the same time, not much money is left for investment in the real economy (industry, manufacturing); as a result, no new productive capabilities are developed to produce goods that could become competitive in global markets, redressing the trade deficit. The "consumption bias" built into the Kosovo economy is the backdrop against which Kosovo's worrying external position should be situated.

## 1.6 Unemployment and poverty



Low rates of investment in industry and manufacturing, a booming consumptive economy and the decline of industrial production also explain the intractably high rates of unemployment and poverty recorded in post-war Kosovo. During 2008-2012, total unemployment (as a per cent of the registered labour force) fluctuated between 48 per cent and 31 per cent (Table 1). Unemployment reaches alarming levels when it comes to women (57 per cent). In fact, the share of employed women in the total female working-age population (that is, the employment ratio) is astonishingly low at only 12 per cent in 2009.

Due to high levels of economic informality, poverty rates should be taken with caution. Still, estimates range between 34 per cent and 48 per cent for absolute poverty and from 12 per cent to 18 per cent for extreme poverty (i.e. inability to meet even basic survival needs). Crucially, these rates are not substantially decreasing as in other transition economies. Persisting levels of poverty, unemployment (and under-employment) in the low-wage informal sector are the direct result of Kosovo's inherent macro-economic bias in favour of a consumptive use of economic resources: lack of investment in productive activities such as manufacturing limits opportunities for decent job creation and skill accumulation. More specifically, the economy's "consumption bias" has drained economic resources away from

the productive sector (notably, industry), limiting employment creation and perpetuating high rates of poverty.

## 1.7 Fiscal and monetary policy

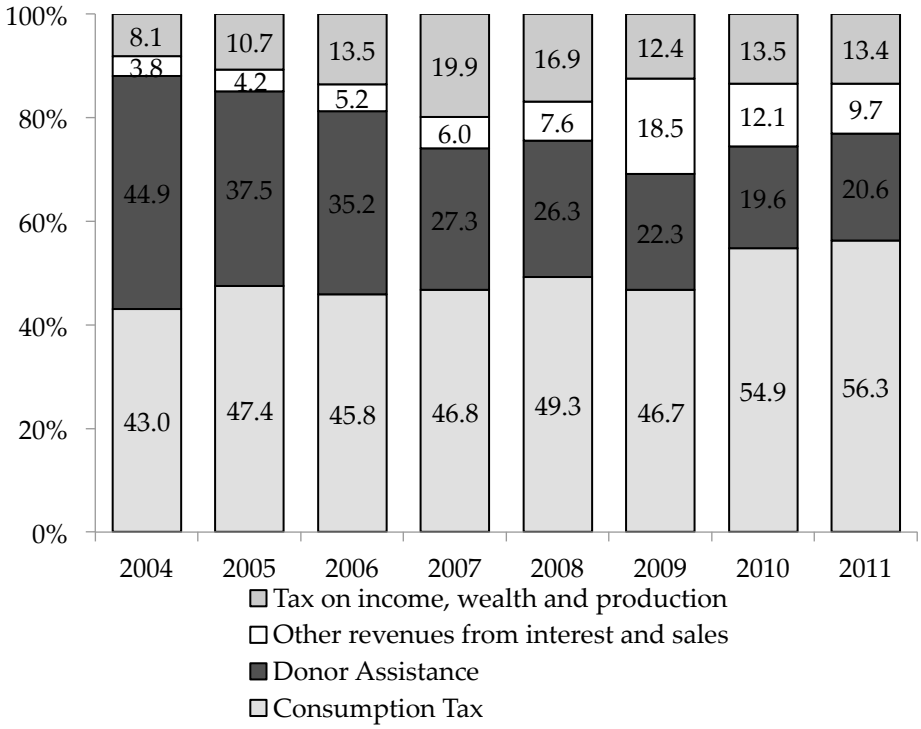
Another reason why consumption levels have increased dramatically despite low levels of growth in the productive economy is that inflation has remained relatively low, thus safeguarding the domestic purchasing power of Kosovo's consumers. Consumer price changes averaged as little as 2 per cent between 2001-2014 (Table 1); in fact, years 2004, 2005 and 2009 saw a negative rate of inflation (that is, deflation). To the extent that price increases do occur, they are not fundamentally driven by expansionary monetary and fiscal policies; rather, they are strongly correlated with inflationary trends in the countries were Kosovo's imports originate (notably, Serbia). This suggests that inflation is also related to import-dependence.

Since Kosovo decided unilaterally to adopt the Euro as legal tender, monetary policy options remain limited to setting domestic interest rates. On the one hand, lack of monetary sovereignty has the advantage of preventing forms of reckless monetary financing (e.g. quantitative easing leading to artificially low debt-servicing costs for the government). This has the effect of promoting fiscal discipline.

On the other hand, several studies indicate that Kosovo's adoption of the Euro promotes trade, especially exports, to Eurozone countries, relative to non-Eurozone markets, through the classic common currency effect (that is, through reduced transaction costs). However, the common currency effect suggests that Kosovo's adoption of the Euro artificially distorts outward trade, making Kosovo's euro-denominated products too expensive for non-Eurozone countries, and limiting the competitiveness of, and potential markets for, Kosovo's export products. By the same token, Kosovo's adoption of the Euro might artificially inflate the international purchasing power of Kosovar consumers in world (and especially European) markets, once again entrenching import-dependency.

VAT and customs duties constitute the single most important source of government revenue, having grown from a share of 43 per cent to 56 per cent of the total government budget. At the same time, tax on income and profits have never exceeded 20 per cent of the total income structure of the government. Again, this reflects the overall structural bias in favor of consumption that characterizes the economy at large. Furthermore, the Kosovo consolidated budget is still largely dependent on donor grants – for as much as 20 per cent of expenditure in 2011 (Figure 2).

Figure 2. Kosovo: structure of general government revenue, 2004-2011




*Source*: KAS (various years)
*Notes:* Averages over the whole time period



On the expenditure side of public finance, it is yet to be seen whether the recent wave of government capital spending (e.g. the Kosovo-Albania highway, which cost nearly a quarter of the country's annual GDP over a period of 5 years) will lead to significant dynamic gains in economic performance (e.g. new investments, reduced unit costs, access to trading routes and new markets at lower costs, etc.). While the government's capital spending certainly did stimulate economic growth in the short term, it also somewhat jeopardized macro-economic stability, tipping the government budget into a deficit for the first time since 2005 (Table 7).

Table 7. Kosovo – Government budget balance, in € m., 2004-2011

| | 2008 | 2009 | 2010 | 2011 | 2012 | 2013 | 2014 |
|---|---|---|---|---|---|---|---|
| Revenues | 959.88 | 1142.39 | 1138.97 | 1311.26 | 1383.41 | 1355.72 | 1349.48 |
| Expenditure | 957.64 | 1138.01 | 1220.03 | 1362.69 | 1444.96 | 1490.24 | 1512.15 |
| Budget Balance | 2.24 | 4.38 | -81.06 | -51.43 | -61.55 | -134.52 | -162.67 |

*Source*: KSA (various years)

In sum, while growth rates have been nominally high since 1999, there are many reasons to take these figures with much caution. Crucially, Kosovo's macro-economic environment has been plagued by many structural distortions, including a strong bias in favour of consumptive, rather than productive, uses of the (few) available economic resources. This bias is visible everywhere in the economy – from the structure of GDP to the trade balance, to the structure of government revenues – and makes a backdrop to Kosovo's "dynamism" in importing consumables, its and simultaneous inability to nurture export-oriented industries (including high-value added services, such as consulting). The macro-economic environment and its deep problems are the lens through which Kosovo's external trade sector and the country's trade policies and institutions should be analyzed.

## 2. TRADE PATTERNS IN THE LAST 15 YEARS

This section describes a number of indicators/measures that inform us on the structure, performance and geography of Kosovo's external trade sector, as well as its significance for the domestic economy.

### 2.1 Trade performance and the domestic economy

Table 8 reports some basic indicators about the performance of Kosovo's external trade sector. As the data suggest, one of the main issues with this sector is its gaping deficit. During 2005-2014, export earnings only covered about 11 per cent of the cost of annual imports. Import coverage is thus alarmingly low, although it has improved slightly over the years, up from around 5 per cent in 2005. In absolute terms, however, the trade balance (i.e. exports – imports) has actually worsened recently, reaching over 2.2 billion euros in 2014.

Table 8. Basic performance indicators of Kosovo's external sector

| Indicator | 2005 | 2007 | 2009 | 2011 | 2014 |
|---|---|---|---|---|---|
| Export-import coverage index (%) | 5 | 10 | 9 | 13 | 13 |
| Trade balance, m., € | -1,101 | -1,411 | -1,772 | -2,173 | -2,214 |
| Normalized trade balance | -0.91 | -0.81 | -0.84 | -0.77 | -0.77 |

*Source*: Author's calculations based on KAS data (various years)

Although the absolute gap between import costs and export earnings has widened (essentially owing to imports growing at an average relative year-on-year growth rate of about 10 per cent during 2005-2014), exports have also grown (at an average rate of 27 per cent per annum over the same time period, albeit from much lower base levels). Yet, export trends also show a high degree of volatility: the standard deviation of year-on-year export growth rates between 2005-2014 was nearly 40 percentage points. At the same time, imports have grown at a relatively stable rate, with standard deviation of year-on-year growth rates of just over 9 percentage points.

Thus, the low rate and instability of export growth is such that export levels are not actually converging – or catching up – to import volumes. This pattern of limited export growth in the context of rising trade imbalances is reflected in the slow but evident improvement (from -0.91 in 2005 to -0.77 in 2014) in the *normalized* trade balance, which measures the difference between exports and imports to total external trade (see Box 1).

Box 1. Normalized Trade Balance

**The Normalized Trade Balance index measures a country's trade balance relative to its level of integration in the global economy (i.e. the volume of total external trade). It reflects the notion that a trade deficit, for instance, means different things at different levels of trade integration. A deficit of -€2 billion is quite alarming if total external trade also amounts to only €2 billion (because the country does not export). The very same absolute deficit (-€2 billion) is less alarming in the context of a country exporting €100 billion worth of goods and buying €102 billion worth of imports. Formally, the Normalized Trade Balance is defined as (Exports – Imports)/(Exports + Imports) and it ranges between -1 (signifying no exports) and + 1 (signifying no imports), with 0 meaning a trade balance. In 2014, Kosovo's Normalized Trade Balance equalled -0.77.**

***Source:*** **Gashi and Linotte (2015).**[2]

Figure 3 reports the performance of Kosovo's foreign trade sector relative to the domestic economy. As a small, developing economy, Kosovo is quite globalized from the point of view of international trade.[3] As suggested by the trade dependence index (which measures a country's total external trade relative to domestic GDP), Kosovo's level of trade integration with the world economy peaked in 2011, when the external sector amounted to as much as 59 per cent of domestic GDP.

Export propensity (share of exports in GDP) measures the degree of reliance on foreign markets by domestic producers. In Kosovo, this index has remained consistently low during 2005-2014. This trend reflects not so much a lack of export orientation in Kosovo's productive economy. More fundamentally, it reflects the slow pace of reactivation of Kosovo's productive capabilities – whether for export or domestic consumption – in the aftermath of war and the transition to a market economy. On the other hand, import dependency – which measures the proportion of domestic demand satisfied by imports (see Box 2) – has remained steady at around 30 per cent.[4] Since 2011, reliance on imported goods has somewhat declined, conceivably due to the relative loss of international purchasing power by households following the Euro crisis and the consequent reduction in migrant remittance flows (and possibly also due to high inflation in Serbia, one of Kosovo's principal import markets).[5]



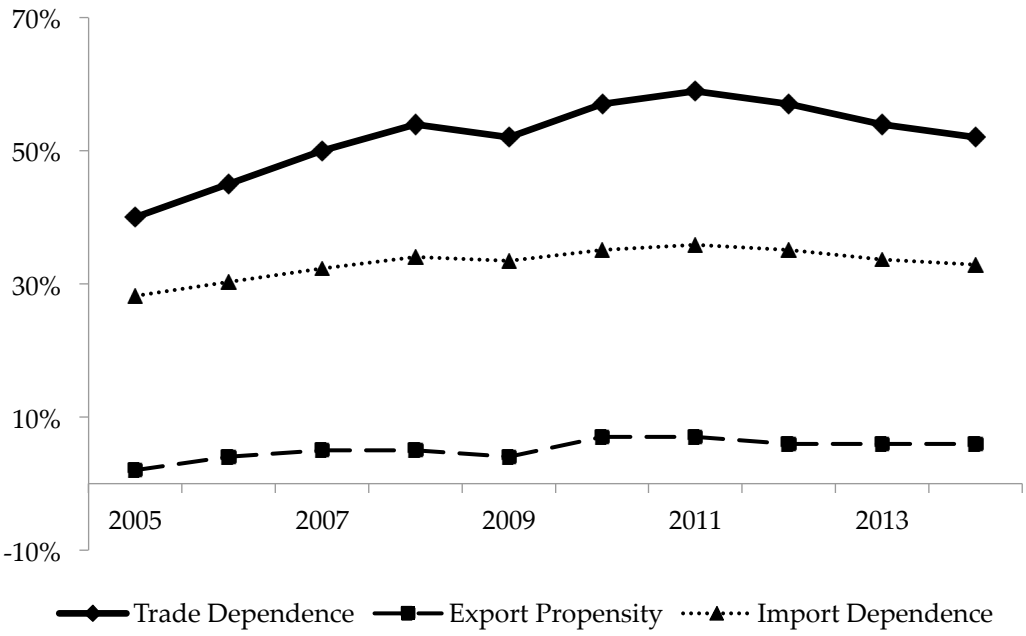
[2] Gashi, P. and Linotte, D. (2015). *Handbook on International Trade Indicators*. EU Trade Policy Project. http://www.eutrade-ks.eu/kosovo_content_3734384.html.

[3] The openness of the economy (the level of trade integration in global markets) should not be confused with the openness of the trade regime, which is related to trade policy and tariff regimes.

[4] Dependency on imports is likely to be significantly higher when it comes to consumer and, especially, capital goods. Overall, import dependency is mitigated by import substitution in the production of intermediate goods (e.g. metal and plastic products for the construction industry).

[5] See Pula B. (2014): "Effects of the European Financial and Economic Crisis in Kosovo and the Balkans: Modes of Integration and Transmission Belts of Crisis in the 'Super-periphery'", *East European Politics*, 30 (4): 507-525.

Figure 3. External trade and the domestic economy




*Source*: Author's calculations based on KAS data (various years).

Box 2. Import Dependency Index (IDI)

**IDI measures the share of domestic aggregate demand (whether for consumption or investment) that is satisfied by imports rather than own-produced goods and services.**

**It is calculated as Imports / Total Domestic Demand. To calculate Total Domestic Demand, it is helpful to think of GDP (expenditure approach) as Consumption (government and households) + Investment + Exports – Imports. Since Total Domestic Demand = Consumption + Investment, it follows that it can be calculated as GDP + Imports – Exports. Thus, IDI = Imports / (GDP + Imports – Exports). Alternatively, we can think of Total Domestic Demand as domestic production (i.e. GDP production approach)- Exports (i.e. domestic production that is not consumed domestically) + Imports (i.e. foreign-produced goods consumed at home).**

***Source:*** **Gashi and Linotte (2015).**

Lastly, the propensity of Kosovo's economy to import is evidenced in the marginal propensity to import index, which measures how much imports rise (in a given period of time, e.g. year-on-year), for a given increase in the country's income (i.e. GDP) over the same time period. Between 2005-2014, the index averaged 0.73, suggesting that 73 per cent of any annual GDP increment is used to purchase additional foreign goods and services (whether for consumption or investment). To be sure, marginal import propensity has actually declined slightly over the years, from 0.91 in 2006 down to 0.55 in 2014. This trend reflects the recent

marginal build-up in domestic productive capabilities, which enables Kosovo's income-earners to satisfy a slightly larger proportion of their annual aggregate demand by purchasing domestically produced goods (mostly consumption goods, but – increasingly – some capital goods). That said, there is still a clear correlation between GDP and import growth[6], confirming the enduring consumptive and import "dynamism" of the Kosovar economy.

## 2.2 Structure of trade and sectorial composition

This part of the report presents a number of indicators that reveal changes in the commodity structure of trade, and are thus very useful in trade policy analysis and design.

### 2.2.1 Trade in goods

There is an emerging consensus in economics suggesting that what matters from the point of view of economic growth is not only *how much*, but also *what* countries export.[7] Due to low income and price elasticity of demand, some products (usually primary commodities) suffer from static or even declining aggregate demand in global markets, as reflected in their declining shares in OECD's total imports. The relative price of primary commodities and simple manufactures might even decline as new productive capabilities in basic industries come online in developing countries, with global supply increasing as a result. At the same time, more complex manufactures afford better opportunities for learning technical skills that may be applied to other sectors, often leading to positive multiplier effects in the domestic economy. This leads one prominent Cambridge economist to conclude that "growth is a 'product specific' phenomenon".[8] Looking at export (and import) structures is thus very important for designing growth-enhancing trade policies.

#### 2.2.2.1 Exports of goods

Based on a 2-digit product classification (HS), the following product categories were dominant in Kosovo's export structure in 2014: articles of iron and steel such as ferronickel ingots[9] (which account for as much as 40.2 per cent of total exports), ores and concentrates[10] (7.4 per cent), electrical energy, coal and bitumen (5.68 per cent) and manufactured articles

[6] See also Gashi P. and Pugh G. (2015): "Kosovo's Trade with the European Union: Looking beyond the Stabilisation and Association Agreement", KFOS: Prishtina.

[7] Palma G. (2008): "Flying Geese and Waddling Ducks: The Different Capabilities of East Asia and Latin America to "demand-adapt" and "supply-upgrade" productive capacity", available at http://unctad.org/sections/gds_ecidc/docs/gds_ecidc_2010d07Palma_en.pdf, p. 2.

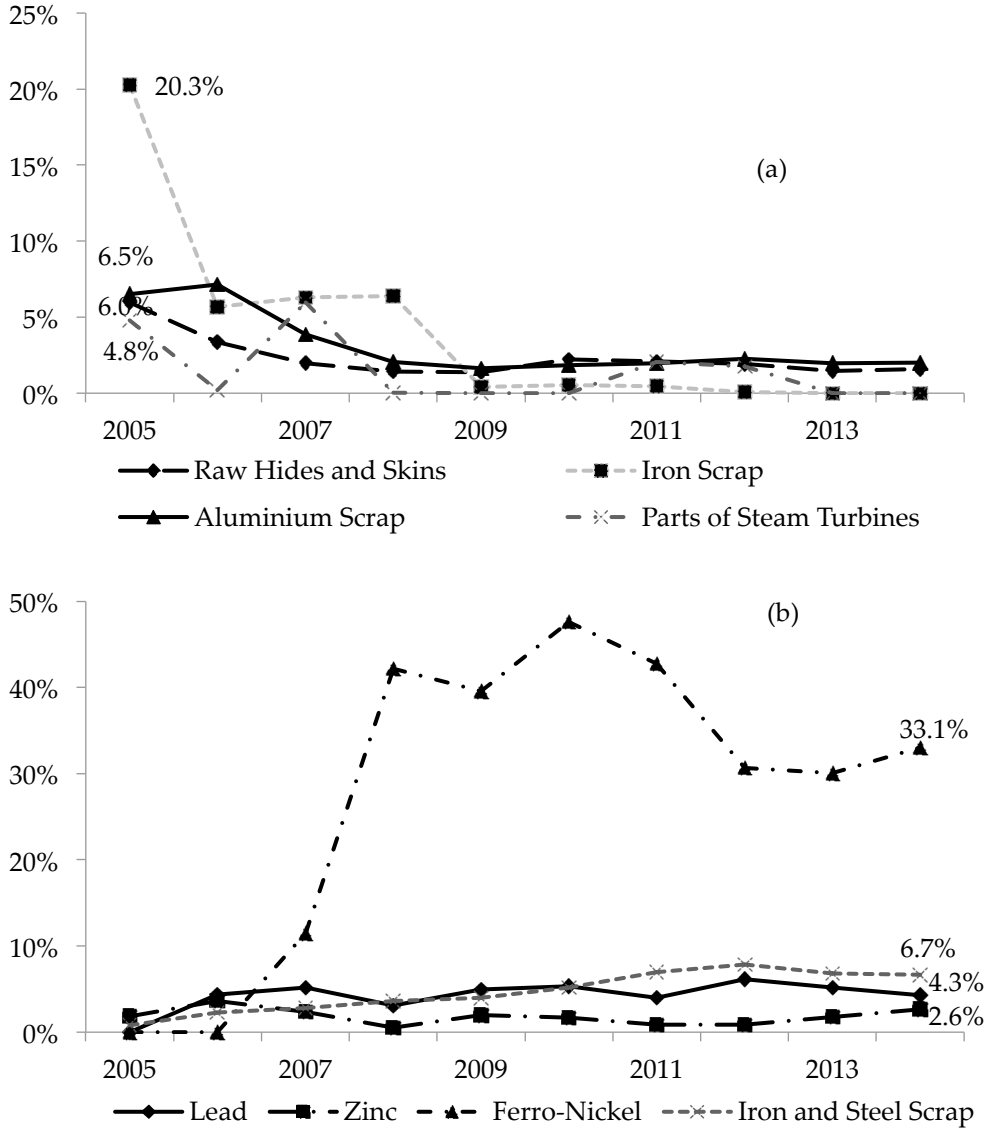
[8] See Palma (2008).

[9] Produced by companies such as NewCo Ferronikeli.

[10] Mostly from the Trepça Mining and Metallurgical Complex in Mitrovica.

of iron and steel such as tubes and pipes[11] (5.21 per cent). These are also the product categories that recorded the largest year-on-year growth rates during 2005-2014.

Figure 4. Four largest export shares in 2005 (a) and 2014 (b)




*Source*: Author's calculations based on KAS data (various years).
*Notes:* Sectorial export shares are defined as the proportion of total exports that is accounted for by a specific product category; HS classification, 6-digit

To obtain a finer picture of Kosovo's export profile, we zoom down to a 6-digit product classification (HS). Figure 4 compares the change over time of the four largest export shares in 2005 (a) and 2014 (b). The data reveal a transformation of Kosovo's export structure in line with the structural developments of the domestic economy in the last 10 years. In 2005, Kosovo's main exports were metal scrap and machine parts removed from the ailing

[11] From companies such as NewCo IMK Pipe Factory and Intersteel.

equipment stock of former state-owned enterprises. By 2014, the extractive industry had resumed production and mineral exports had risen (adding about €2.5 million in export sales every year). Most notably, the successful privatization of the formerly socially-owned Ferronickel plant led to a sharp rise in ferronickel exports, which have grown at an average rate of €12.9 million a year, making up nearly 50 per cent of total export volumes in 2010. Still, the sale abroad of metal scrap and parts remains prominent, as many privatized plants have failed to resume production and instead generate profits by depleting existing capital stocks.

A similar trend is visible in Table 9, which disaggregates Kosovo's export structure in between 2005 and 2014 by main export partner. In 2005, the four largest export shares referred to the sale of scrap metal and depleted equipment stocks. This export profile characterized Kosovo's trade with *both* of its main export regions, namely the EU and CEFTA. By 2015, Kosovo's export profile with the EU and CEFTA had significantly diverged. EU markets absorbed mostly processed metals (ferronickel ingots) and manufactured goods (synthetic yarns), while CEFTA's countries continued to purchase metal scrap and unprocessed minerals. The only notable exception is tubes and pipes, Kosovo's single most important manufactured export to CEFTA. Hosting the only producer of large-diameter metal pipes in the region, Kosovo arguably possesses an absolute advantage in this segment of the metal industry. Lastly, Kosovo's trade profile with China and Turkey – two important trading partners in the developing world – displays significant differences. Exports to China have remained exclusively dominated by base metals and primary commodities (with no significant structural variation over 2005-2014), while Turkey has become an important destination for Kosovo's nascent manufactures, notably conveyor belts from the former SOE "NewCo Ballkan" and textile products from the former SOE "Rematex" – both privatized by Turkish investors.

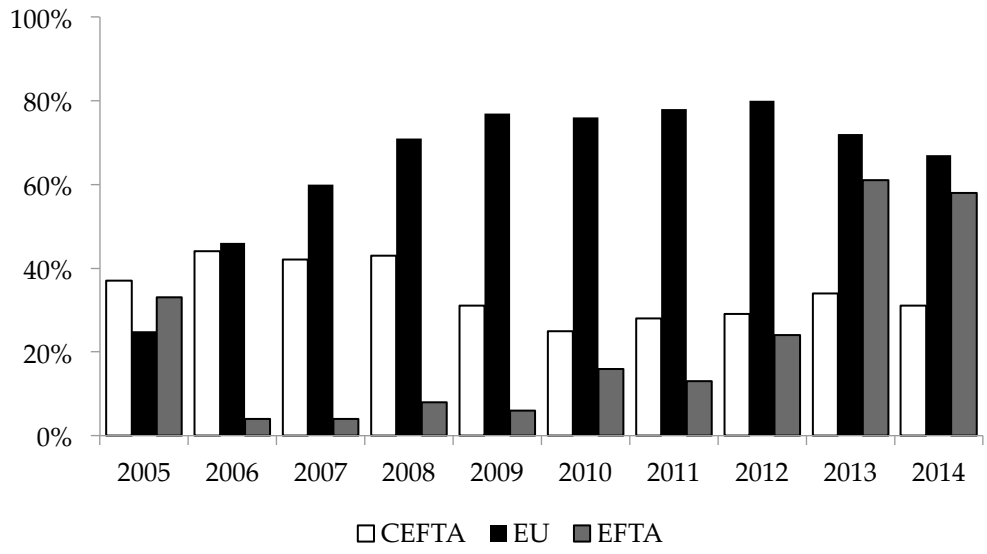
Table 9. Four largest export shares by export destination, 2005-2015

| | 2005 | | 2015 | | Ave. over 2005-2015 | |
|---|---|---|---|---|---|---|
| | EU | CEFTA | EU | CEFTA | China | Turkey |
| *Scrap and sale of equipment stocks* | | | | | | |
| Raw hides and skins | 11.2 | 9.4 | 9.6 | - | - | - |
| Scrap iron | 21.6 | 22.3 | - | - | - | - |
| Other ferrous scrap | - | - | - | 14.1 | - | - |
| Other non-ferrous scrap | 21.6 | 5.8 | - | 14.5 | - | 14.8 |
| Rail locomotives | - | 4.6 | - | - | - | - |
| Parts of steam turbines | 11.9 | - | - | - | - | - |
| Ash and slag | - | - | - | - | 10.4 | - |
| *Raw materials and metals* | | | | | | |
| Lead ores and concentrates | - | - | - | 8.9 | - | - |
| Zinc ores and concentrates | - | - | 5.2 | - | 1.6 | - |
| Other ores and concentrates | - | - | - | - | 3.1 | - |
| Ferro-alloys | - | - | 57.5 | - | 84.5 | - |
| *Manufactured goods* | | | | | | |
| Tubes and pipes | - | - | - | 7.1 | - | - |
| Conveyor belts | - | - | - | - | - | 19.7 |
| Synthetic yarns | - | - | 4.6 | - | - | - |
| Coated textile fabrics | - | - | - | - | - | 8.7 |
| Special Textiles | - | - | - | - | - | 15.9 |

*Source*: Author's calculations based on KAS data (various years).

Generally speaking, the average level of industrial processing of Kosovo's exports has somewhat increased since 2005 (Figure 5). In fact, when it comes to exports to the EU, the share of processed goods in total exports reached as much as 80 per cent in 2010. However, most of this increase is due single-handedly to the rehabilitation of the Ferronikeli smelting plant, whose nickel ingots are actually quite low-grade (in terms of level of processing). Thus, the average technology intensity of manufacturing remains very low in Kosovo. In fact, with the exception of the EU (and, since 2013, EFTA), most of Kosovo's exports (e.g. to CEFTA, China, etc.) are still primary commodities.

Figure 5. Share of manufactured goods in total exports, 2005-2014




*Source*: Author's calculations based on KAS data (various years).
*Notes:* manufactured good are defined as SITC categories 1, 5-9, while primary commodities correspond to SITC categories 0, 2, 3, 4.

Not only has the Kosovo economy failed to significantly "industrialize" its exports, but it has also failed to *diversify* its export profile. Figure 6 reports the Herfindahl-Hirschmann index of sectorial concentration for Kosovo's trade structure (see Box 3). The data reveal that Kosovo's export basket in 2014 was nearly three times more concentrated than its import basket, arguably owing to the slow pace of reactivation of Kosovo's industrial economy (which was formerly more diversified) following the 1999 war and the transition to a market economy. Lack of diversification, coupled with specialization in primary commodities, makes the Kosovar economy vulnerable to price and demand shocks in the product markets it specialised in.

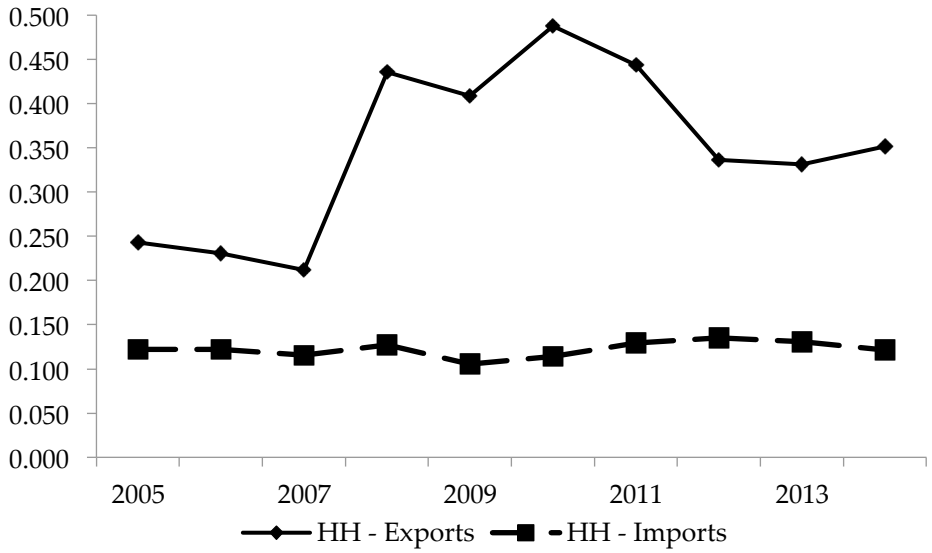
Box 3. The Herfindahl-Hirschmann (HH) Index

**The HH Index measures the degree to which a country's exports are dispersed across different economic activities. It is calculated using the formula below, where $x^k$ stands for exports (to the world or to a given trading partner) in product category k, and $X$ stands for total exports (to the world or to a given partner):**

$$\sqrt{\sum_k \left(\frac{x^k}{X}\right)^2}$$

***Source:*** **Gashi and Linotte (2015).**

Figure 6. HH index of sectorial concentration, 2005-2014




*Source*: Author's calculations based on KAS data (various years).
*Notes:* Values closer to 1 indicate more sectorial concentration, while values closer to 0 indicate more sectorial diversification; HS classification, 6-digit.

Lack of product diversification is particularly acute when it comes to Kosovo's exports to developed country markets (EU, EFTA) and to China (Table 10). On the other hand, exports to CEFTA (as well as Turkey) are substantially more diversified, perhaps owing to the legacy of trade integration and productive diversification inherited from the Yugoslav socialist economy.[12]



Table 10. HH Index of sectorial concentration by trade partner

| | Exports | Imports |
|---|---|---|
| *Developed Countries/Regions* | | |
| EU | 0.520 | 0.173 |
| EFTA | 0.601 | 0.280 |
| *Developing Countries/Regions* | | |
| CEFTA | 0.248 | 0.251 |
| Turkey | 0.489 | 0.107 |
| China | 0.844 | 0.104 |

*Source*: Author's calculations based on KAS data (various years).

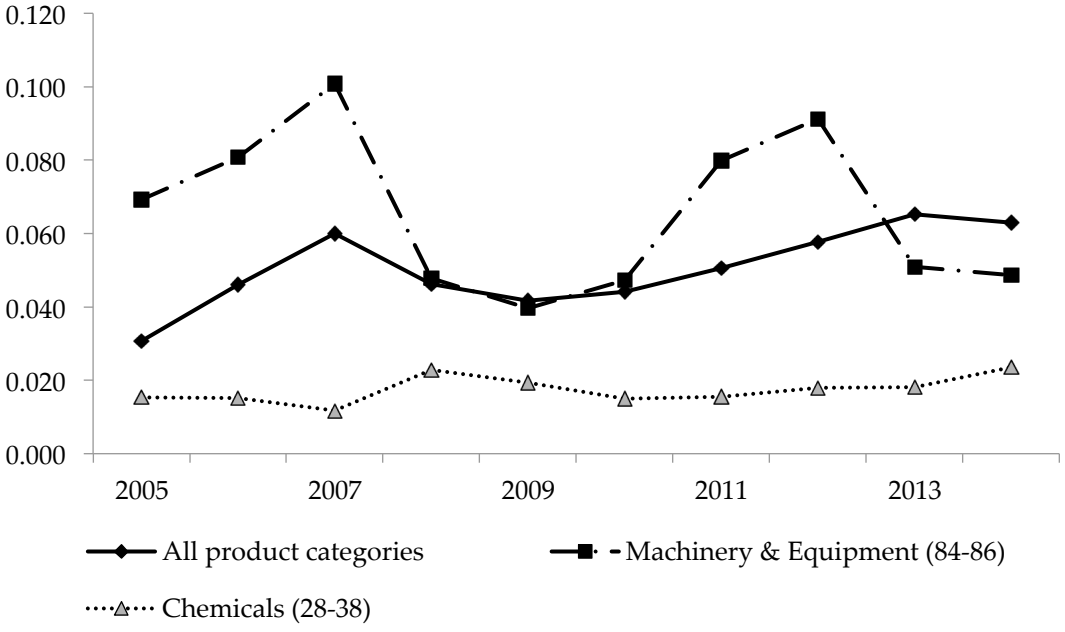
*Notes:* values closer to 1 indicate more sectorial concentration; calculations based on SITC product classification, 4-digit; averages over 2005-2014; EFTA includes Switzerland, Norway, Iceland and Liechtenstein.

[12] All CEFTA countries, with the exception of Moldova and Albania, are Yugoslav successor states.

A related aspect of Kosovo's trade profile is the low level of intra-industry trade. Intra-industry trade is the mutual exchange of products belonging to the same product category. Unlike inter-industry trade, which reflects international specialization along comparative advantage lines, intra-industry trade is the outcome of product differentiation dictated by economies of scale and consumer preferences. It is usually a feature of advanced country trade, rather than trade between developing and developed countries.

Unsurprisingly, Kosovo's trade with the rest of world is overwhelmingly of the inter-industry variety: there is very little similarity between Kosovo's import and export matrices, with export-oriented production in Kosovo exhibiting a pattern of narrow specialization. A measure of the relative importance of intra-industry trade in an economy's trade profile is the Grubel-Lloyd (GL) index (see Box 4), which ranges between 0 (pure one-way, inter-industry) and 1 (perfectly two-way, intra-industry). Although slightly on the increase, the GL index measure for Kosovo is very close to 0 (Figure 7). This points to Kosovo's orderly insertion in the international division of labour, with near-total specialization in just a handful of products – which, in the case of Kosovo, tend to be conspicuously low-value added and, consequently, not very growth-enhancing.

Figure 7. Grubel-Lloyd (GL) Index, trade-weighted averages, 2005-2014




*Source*: Author's calculations based on KAS data (various years).

*Notes:* 0 means pure inter-industry trade, while 1 means pure intra-industry trade; the GL index measure at time t is a weighted average over the stated range of product categories (weighted by trade volumes); calculations based on HS product classification, 6-digit.

Box 4. The Grubel-Lloyd (GL) Index of intra-industry trade

**The GL index measures the degree of overlap between an import and an export profile, whether for a single economy (e.g. Kosovo's exports to and imports from the world), or for a bilateral trade relationship (e.g. Kosovo's exports to and imports from CEFTA). The $GL^k$ for product line k is calculated using the formula below, where $X^k$ and $M^k$ stand for total exports and imports in product category $k$, respectively:**

$$1 - \frac{|X^k - M^k|}{X^k + M^k}$$

**When averaging over several product lines, it is good practice to use trade weights, so that the GL for the whole import/export profile (at time $t$) becomes:**

$$\sum_k GL^k \left( \frac{X^k + M^k}{TotX + TotM} \right)$$

*Source:* Gashi and Linotte (2015).

For purposes of exemplification, Figure 7 also reports the GL index measures for one above- and one below-average product category (machinery and equipment and chemicals, respectively). In chemicals, there is practically no intra-industry trade, due to the post-war near-total collapse of production (and hence exports) in this industrial sector. On the other hand, machinery and equipment records a relatively higher incidence of intra-industry trade. This is a somewhat paradoxical trend, considering that Kosovo does not actually produce many capital goods. Effectively, high levels of intra-industry trade in this sector reflect a convergence of two factors, both related to de-industrialization. For one thing, imports of foreign technology have been relatively low, and relatively uniform across different industrial sectors. For another, many companies in the former socially owned sector turned to making profits by depleting and selling used equipment stocks, leading to a generalized increase in machinery (re)-exports.

Similar results are obtained looking at the incidence of intra-industry trade within specific bilateral trade relations (rather than between Kosovo and the world). As expected, in 2014 there was relatively more intra-industry trade between Kosovo and its CEFTA partners (0.081), than between Kosovo and Turkey (0.047) or between Kosovo and the EU (0.039).[13]

#### 2.2.2.2 Imports of goods

Unlike exports, Kosovo's imports over the past 10 years have been dispersed across a much wider variety of product categories (Figure 6), with no significant variation in degrees of

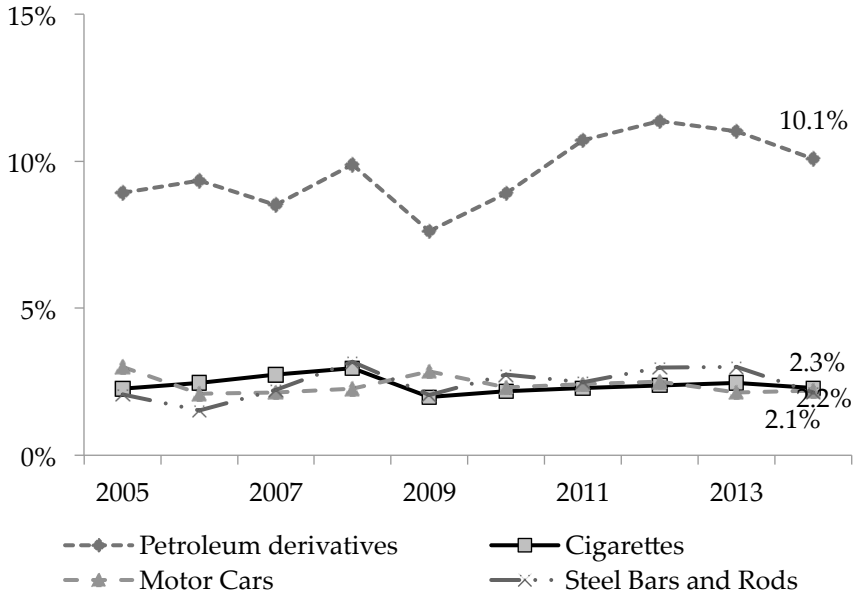
[13] Trade-weighted averages over all product categories, based on SITC product classification, 4-digit. Note that since the sectorial data are at a different level of aggregation, these figures cannot be compared with the index measures reported in Figure 2.5.

diversification across trading partners (Table 10, second column). At the 2-digit HS level of product aggregation, the four largest import shares are taken up by mineral fuels (15.8 per cent) – understandably so, given that Kosovo has no oil resources and no refinery – industrial machinery and appliances (6.4 per cent), motor vehicles (5.5 per cent) and plastics (5.0 per cent).

With the exception of plastics granulates – an important intermediate good used by Kosovo's fast-growing plastic manufacturing industry – a finer product breakdown (6-digit) suggests that imports are actually dominated by consumer goods, rather than intermediate or capital goods. For starters, the four most important import products in the machinery and appliances category (HS 84) are actually household appliances such as boilers (3.5 per cent of total imports in HS category 84), washing machines (2.8 per cent) and computers (2.7 per cent), or machine tools used in the construction industry (e.g. excavators). Secondly, the three largest 6-digit import shares in 2014 – jointly amounting to 14.6 per cent of total imports (that is, €369 million, or 6.7 per cent of GDP) – were motor fuels, cigarettes and motorcars (Figure 8). This highly uneven sectorial distribution of import products confirms the deep "consumption bias" built into the Kosovar economy (see Chapter 1) and shows that, in the main, scarce foreign exchange is not being used to purchase foreign technology and upgrade production capabilities, but rather to sustain the economy's high levels of (import-dependent) consumption.



Figure 8. Four largest import shares in 2014




*Source*: Author's calculations based on KAS data (various years).

*Notes:* HS classification, 6-digit

Kosovo's import profile has not changed any significantly over time. However, it does change considerable across import partners. In both 2005 and 2014, the largest import shares in Kosovo-EU trade were high-technology manufactures, while all four largest imports from CEFTA were raw materials, base metals or light manufactures. Similarly, most of the largest import shares from Turkey and China were light manufactures – food and paper products from the former, and leather and footwear from the latter (Table 11).

Table 11. Four largest import shares by country/region of origin, 2005-2014

| | 2005 | | 2014 | | Ave. over 2005-2014 | |
|---|---|---|---|---|---|---|
| | EU | CEFTA | EU | CEFTA | China | Turkey |
| *Raw materials, metals and non-metallic minerals* | | | | | | |
| Petroleum derivatives | 4.8 | 27.6 | 17.9 | 8.4 | - | - |
| Aluminium alloys | - | - | - | - | - | 1.9 |
| Steel bars and rods | - | - | - | 7.5 | - | - |
| Cement | - | 4.5 | - | 4.7 | - | - |
| Ceramic bricks and tiles | - | 5.2 | - | - | - | - |
| *Light manufactures* | | | | | | |
| Non-alcoholic beverages | - | 5.6 | - | 4.8 | - | - |
| Yoghurt | - | - | - | - | - | 3.2 |
| Cakes and biscuits | - | - | - | - | - | 3.8 |
| Cigarettes | 2.3 | - | 5.1 | - | - | - |
| Pulp and paper | - | - | - | - | - | 2.7 |
| Sports footwear | - | - | - | - | 2.6 | - |
| Rubber footwear | - | - | - | - | 2.9 | - |
| Leather footwear | - | - | - | - | 2.7 | - |
| Furniture | - | - | - | - | 3.4 | - |
| *High-tech. manufactures* | | | | | | |
| Medical drugs | - | - | 2.2 | - | - | - |
| Telephone sets | 2.3 | - | - | - | - | - |
| Motor cars | 13.7 | - | 8 | - | - | - |

*Source*: Author's calculations based on KAS data (various years).

### 2.2.3 Trade in services

Services represent the fastest-growing sector of the global economy and account for two thirds of global output, one third of global employment and nearly 20 percent of global trade.[14] Similarly, services are vital to the Kosovo economy. According to the World Bank, in 2010 the contribution of services to Kosovo's GDP amounted to as much as 68 per cent.[15] The largest contributors in the service industry were retail and wholesale trade, accounting for 8.5 per cent to GDP in 2007, and real estate and business services, at 11.6 per cent of GDP.[16] That said, most service-sector firms tend to be small or micro-firms and are mostly family-run. Their value-adding potential is limited, as reflected in their labour-intensity. Between 2007-2013, the service sector was indeed the largest provider of employment in the country, accounting for over 70 per cent of total formal employment – not to mention the incidence of informal or semi-formal employment, which is all the more acute in this sector of the economy.

Approximately 82 per cent of all registered businesses operate in the service sector, as compared to 2 per cent in agriculture and 16 per cent in industry. There is a high level of business creation in the service industry, but most companies do not actually achieve growth, and a significant number of them never even begin operations.[17]

Table 12. Kosovo trade in services, € m., 2005-2013

| Year | Exports | Imports | Balance |
|---|---|---|---|
| 2010 | 573.0 | 386.1 | 186.9 |
| 2011 | 618.5 | 352.8 | 265.7 |
| 2012 | 635.1 | 288.8 | 346.2 |
| 2013 | 622.0 | 313.7 | 308.4 |
| Total | 4,312.5 | 2,690.1 | 1,622.4 |
| Average | 479.2 | 298.9 | 180.3 |

*Source*: Central Bank of Kosovo (http://bqk-kos.org/repository/docs)

Although most services are inherently non-tradable, Kosovo is a net exporter of services. Indeed, in some years the surplus was twice the value of imports (Table 12). Between 2005-2013, service exports amounted to over €4 billion in total, while the positive trade balance adds up to a cumulative €1.6 billion. The international performance of the service industry

[14] http://www.wto.org/english/thewto_e/whatis_e/tif_e/agrm6_e.htm

[15] World Bank (2012)

[16] Kosovo Agency of Statistics (2012)

[17] European Commission (2012)

was particularly good in recent years: in 2014, for instance, Kosovo's service exports reached €771 million (or 13 per cent of GDP), which is over *twice* the total value of goods exports in the same year (€325 million). The two main contributors to service exports were tourism, with over €400 million in revenues, and communication (including ICT), with almost €60 million (Table 13). The former is primarily driven by the seasonal influx of Kosovo's diaspora community.

Table 13. Major service sectors in Kosovo, € m., 2013

| Sectors | Exports | Imports | Balance |
|---|---|---|---|
| Travel | 406.0 | 100.6 | 306.0 |
| Communication | 56.8 | 23.7 | 33.1 |
| Construction | 9.4 | 2.9 | 6.5 |
| Other services | 44.3 | 40.6 | 3.6 |
| Insurance | 22.7 | 32.1 | -9.4 |
| Financial | 1.8 | 2.7 | -0.8 |

Source: Central Bank of Kosovo (various years)

Despite the positive nominal performance of trade in services, it must be noted that the contribution of so-called "virtual exports" looms large in this sector. "Virtual exports" refers to the sale of (consulting, tax-auditing, accounting) services to foreign individuals, non-government organisations, diplomatic representations, and donor agencies residing in Kosovo. In other words, many of Kosovo's service providers are only actually meeting domestic demand. Thus, the claim that Kosovo's service surplus supposedly reveals Kosovo's international competitiveness in service provision needs considerable qualification. Even to the extent that Kosovo does have a competitive advantage in service provision (which is inherently more labour-intensive than industry), this is mostly due to low labour costs in the context of low incomes, rampant unemployment (and under-employment) and low rates of labour mobilization in industry and agriculture.



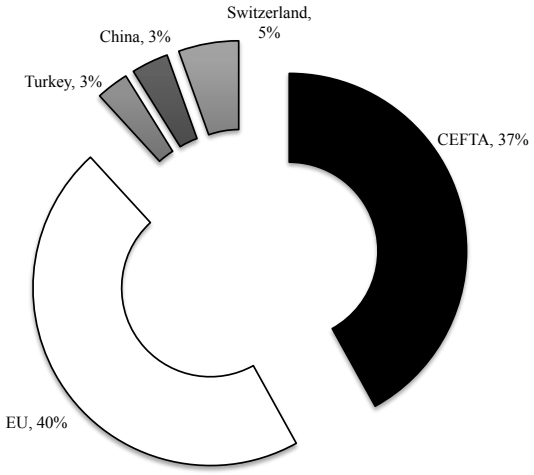
## 2.3 The geography of trade

### 2.3.1 Export destinations

The geography of Kosovo trade has remained rather similar throughout the post-war years. As graphs below show, the structure of partners remains largely the same, for both exports and imports, respectively (see Figure 9). Over the last ten years, Kosovo has been exporting,

on average, around 40 per cent of its production to the EU countries. The EU market is followed by neighbouring countries, which constitute, on average, 37 per cent of the total exports, over the period 2005 – 2014. In mid-2000 the shares were favouring CEFTA countries, largely due to the proximity, and smaller trade costs. However, as the impediments to the regional trade were increasing (especially after the declaration of independence in 2008), Kosovo businesses begun moving more to other markets, especially the EU and the likes of China and India, where the demand for natural-based resources is greater.

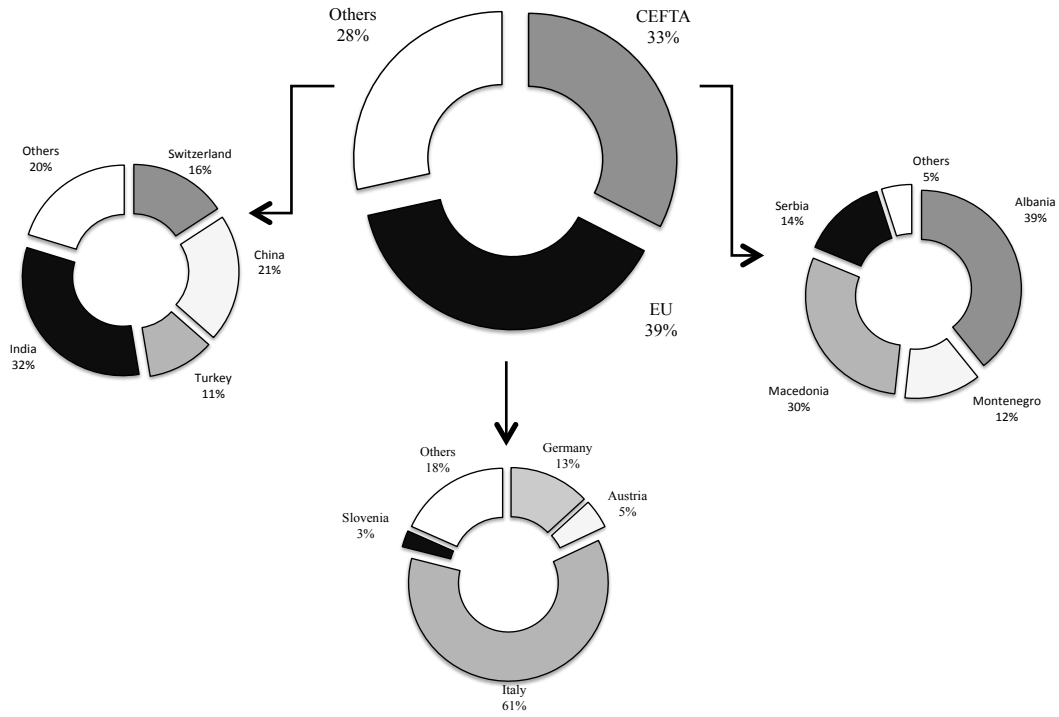
Figure 9. Export shares of goods, % 2005 – 2014




*Source:* KAS (2015)

Figure 10 breaks down the export destinations for the last five years. On average, over the last five years, Italy has been the most favourable destinations for Kosovo's goods, followed by Germany, Austria and Slovenia. Italy has been absorbing over 60 per cent of the total exports of Kosovo to the EU. In the region, Albania has been the major destination in the last five years. A stream of measures, including infrastructure developments and trade facilitation measures, contributed to the significant presence of the Kosovo products in the Albanian market. Other significant regional markets are Macedonia, followed by Serbia and Montenegro. On a last note, the last five years show that countries outside Kosovo's two major trading blocks are becoming increasingly important. In 2005 only 3 percent of Kosovo exports were targeting Turkey, China, and Switzerland, while in 2014 the percentage has risen to 19 per cent.

Figure 10. Export shares of goods, averages in %, 2010 – 2014



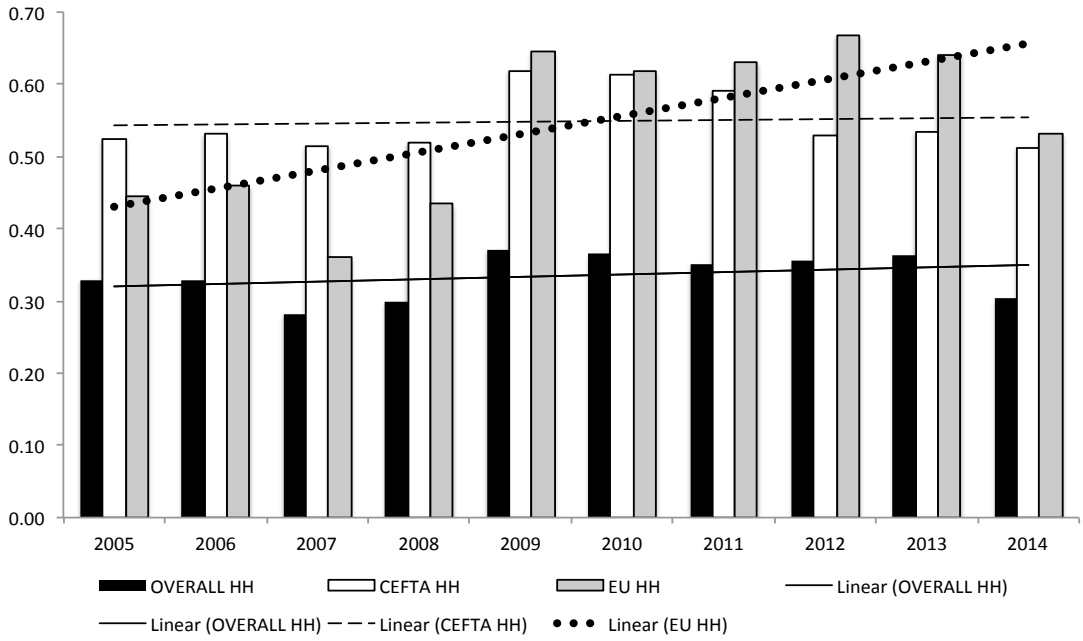

*Source:* KAS (2015)



In order to look in more detail on the structure of trade partners, we have calculated a number of indices, which shed additional light on the geographical dimension of Kosovo's trade. The widely used measure is the Herfindahl-Hirschmann Concentration Index[18], which measures geographical concentration of exports. In other words, the index shows the degree to which Kosovo's exports are dispersed across different destinations. The index takes values from zero to one, with higher values indicating greater levels of concentration of exports (i.e. exports are concentrated in fewer markets). The greater the disaggregation the higher the degree to which the country under study is integrated with the world economy, or, the higher the concentration, the greater the vulnerability of the country to shocks in a limited number of partners.

[18] Trade entropy index, another measure of the geographical concentration or dispersion of exports, has been calculated giving similar results to the Herfindahl-Hirschmann concentration index.

Figure 11. Herfindahl-Hirschmann Concentration Index for Kosovo exports, 2005-2014




*Source*: Author's calculations based on KAS (2015) data.

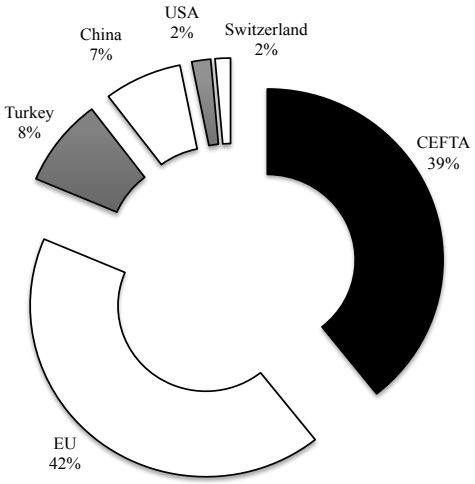
The Herfindahl-Hirschmann concentration index of Kosovo exports has been calculated in three variants, that is, for the CEFTA, EU countries, and the entire Kosovo export matrix (see Figure 11). The former two are calculated on the total exports to these regions, and show a rather high degree of concentration of exports in a few CEFTA or EU countries. As it was made obvious earlier, the bulk of Kosovo exports are concentrated in countries like Italy, Germany, Slovenia, Serbia and Macedonia. This was reflected on the average level of the index for CEFTA and the EU of 0.55 and 0.54, respectively, over the period 2005 - 2014. The trend lines show that the exports to the EU are steadily showing signs of greater concentration, while the CEFTA trend line remains constant. However, the index suffers from the aggregation bias, hence the results for small number of partners do not accurately show the degree of concentration of exports. As a result, the index was calculated for the entire matrix of Kosovo exports, and as expected the value of the index has decreased significantly. The average value of the index for all export partners over the period 2005 – 2014 is 0.34 (lowest value in 2007 of 0.28 and the highest in 2009 of 0.37), indicating a significant dispersion of Kosovo trade partners, hence smaller chance for Kosovo exports to be affected by vulnerabilities in specific countries.

### 2.3.2 Sources of imports

Imports, as pointed out, show similar tendencies as exports: the structure of partners is similar (see Figure 12). Again, two major trading blocks, the EU and CEFTA countries,

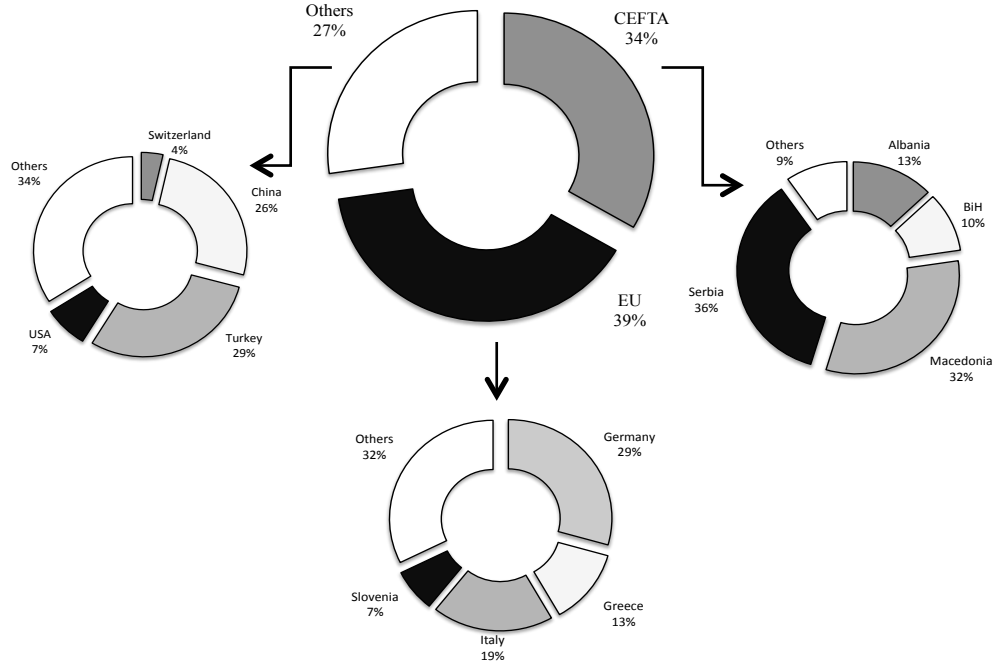
dominate import structure. On average, together they constitute over 80 per cent of total goods imports, over 2005 - 2014. Countries such as Turkey, China, Switzerland, USA, etc. cover the rest of total import in goods.

Figure 12. Import shares of goods, %, 2005 – 2014




*Source:* KAS (2015)

Figure 13. Import shares of goods, %, 2010 – 2014




*Source:* KAS (2015)

The picture doesn't change much even if we look in more immediate past (see Figure 13). In the last five years the relative importance of the two major trading blocks has been reduced. Now the EU and CEFTA countries cover 75 per cent of total goods imports. Other countries, such as Turkey, China and the USA are increasing their chare in total imports. Within the EU block, Germany was the major source of imports, followed by Italy and Greece. From the regional countries, Serbia, together with Macedonia, are major source of imports with 75 percent of the total CEFTA imports.

## 2.4 Comparative advantages and competitiveness of Kosovo's economy

One of the challenges for Kosovo's economic policy-makers is to identify sectors of comparative advantage, so that appropriate trade and industrial policies may be designed to support promising export sectors.

A country's comparative advantage in a given product refers to the country's ability to produce that product at the lowest opportunity cost – that is, relative to all other products (rather than at the lowest absolute cost – that is, relative to other competitor countries). Economic theory predicts that, under free trade, countries naturally adjust to their comparative advantage, and that the resulting pattern of international specialisation maximises welfare. Recently, however, a more dynamic view of comparative advantage has taken hold in institutions such as the World Bank (primarily related to the work of the Bank's chief economist, Justin Lin). On this view, it is seen as economically efficient for developing countries to sometimes diversify away from their comparative advantage sectors (e.g. primary commodities and light manufactures). The expectation is that marginal departures from (static) comparative advantage will allow developing countries to upgrade their technological and productive capabilities and progressively *acquire* new comparative advantages, thus reaping the superior benefits associated with more complex industries.

A country's comparative advantage is determined by a number of factors. These include, chiefly: the level of technology (which affects labour productivity and, therefore, the relative costs of producing different products); the existing balance of factor endowments – which, for instance, makes natural resource-rich countries such as Kosovo more effective in resource-based industries than resource-poor countries; and other country-specific characteristics.

Since according to economists trade along comparative advantage lines is the pattern that emerges "naturally" at equilibrium, one way to measure Kosovo's comparative advantage in a given product is to simply observe the relative importance of that product in Kosovo's

export structure, as compared to the world average – what we may call Revealed Comparative Advantage (see Box 5).

A different, and better, approach is to measure the product's share in total exports, as compared to the typical export share of that product in countries *at a similar level of income to Kosovo.* This approach singles out one source of comparative advantage, namely the level of technology (which may be proxied by income per capita), and allows to better evaluate both the causes of, and any departures from, comparative advantage. In other words, by looking at the export matrix of countries with a similar GDP per capital, we measure what Kosovo "should" be exporting given its level of (technological) development (see Annex A.1).

A departure from this "normal" level (called "Chenery norm") may be due to a number of factors. Firstly, it could be that Kosovo's factor endowments or other inherent characteristics (e.g. consumer preferences) give Kosovo a comparative advantage above (or below) that of countries with a similar GDP per capita *but* with different factor ratios (for example, countries with access to the sea but fewer mineral resources than Kosovo). Secondly, it could reflect a temporary departure from comparative advantage due to transient economic shocks (e.g. a drought or an economic crisis in Kosovo's main export markets, e.g. the EU). Thirdly, it may reflect a genuine departure from comparative advantage due to market failures or policy "distortions" (e.g. export subsidies "artificially" inflating a product's exports).



Box 5. Measuring a country's Revealed Comparative Advantage (RCA)

**One approach to calculating country i's RCA in product k is to compare k's export share in i's total exports to the world average, as follows:**

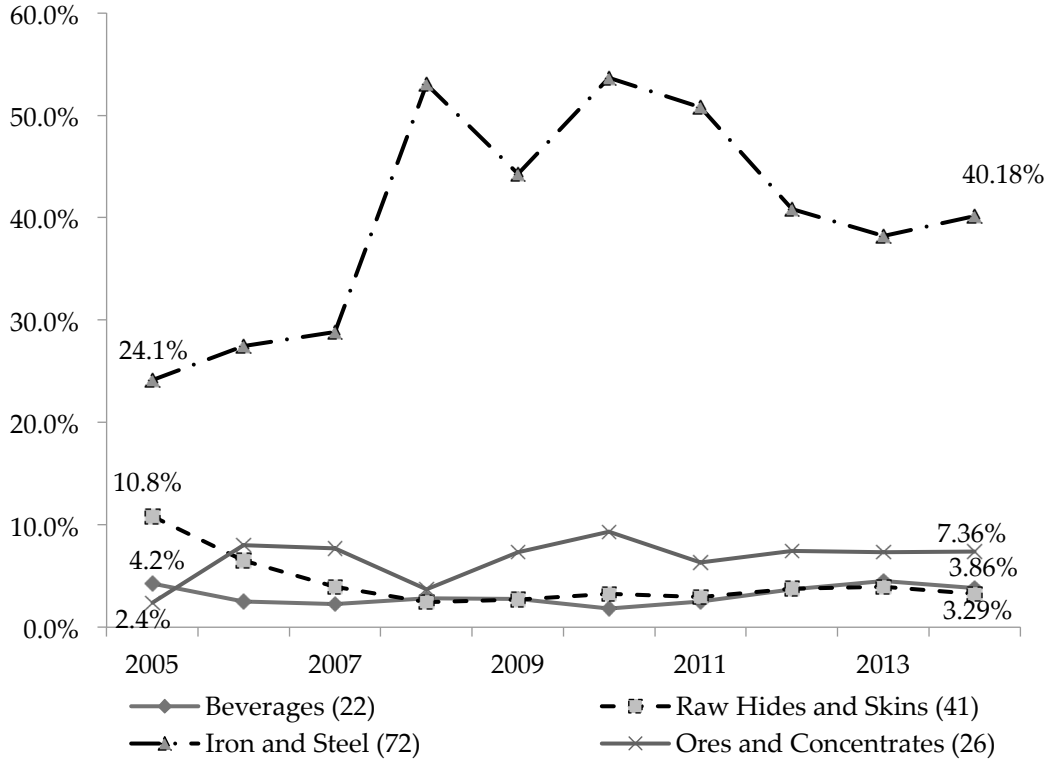
$$\frac{\left(\frac{x_{ik}}{X_k}\right)}{\left(\frac{WorldTrade_k}{WorldTrade}\right)}$$

**where $X_k$ is k's total exports, $WorldTrade_k$ is total world exports of product k, and $WorldTrade$ is total world trade (i.e. total world exports). If the ratio is higher than 1, then we can conclude that i has a comparative advantage in k.**

**A better approach involves comparing i's export share of k with the "average" recorded in countries at a similar income level, and measure the difference between the actual and the "average" share. To do so, we regress country j's export share in k on j's GDP per capita (current US$), with j ranging over all countries for which data are available. We then use the regression equation to predict country i's export share, given its per capita GDP. Lastly, we compare the predicted share (the "Chenery norm") with the actual recorded share (Figures 15 and 16). See also Annex A.1.**

*Source:* **Gashi and Linotte (2015).**

Figure 14. Relative change in export shares for four of Kosovo's main export products




*Source*: Author's calculations based on KAS (various years) data.
*Notes:* HS codes in brackets, 2-digit level of aggregation



From the point of view of trade and industrial policy, it is important to know whether Kosovo's export structure conforms to or departs from Kosovo's comparative advantage. To find out, four of Kosovo's most important export products were selected (Figure 14)[19]: one product that increased its export share considerably between 2005-2014, namely iron and steel (from 24 to 40 per cent); one that increased its share only slightly, i.e. mineral ores and concentrates (from 2.4 to 7.36 per cent); one that maintained its relative position at around 4 per cent – that is, beverages; and finally, one that lost importance relative to other products, namely raw hides and skins (down from 10.8 to 3.29 per cent).

Then, we calculate the "normal" export shares that these products "should" have occupied in 2014 given Kosovo's GDP per capita in the same year. This is done by looking at the export shares of countries at different levels of income and by identifying a trend (i.e. a correlation) linking GDP levels and export shares, product by product. Finally, the "normal" export shares predicted by the correlations are compared with the actual shares recorded in Kosovo in 2014.

[19] At the 2-digit level of aggregation.

Table 14. Kosovo's Revealed Comparative Advantage, 2014

| | Correlation Coefficient[1] ($x10^{-7}$) | Kosovo - predicted export share (Chenery norm), % | Kosovo - deviation from norm, % |
|---|---|---|---|
| Raw Hides and Skins (41) | -0.79** | 0.56 | +2.73 |
| Ores and Concentrates (26) | -8.89* | 5.74 | +1.62 |
| Beverages (22) | +0.63 | 1.49 | +2.37 |
| Iron and Steel (72) | -2.37 | 3.02 | +37.2 |

*Sources:* authors' calculations based on data from UN Comtrade, KAS, and the World Bank *World Development Indicators* (various years);

*Notes:* [1]** means significant at the 5 per cent confidence level, *means significant at the 10 per cent level; the number of observations ranges between 101-113.

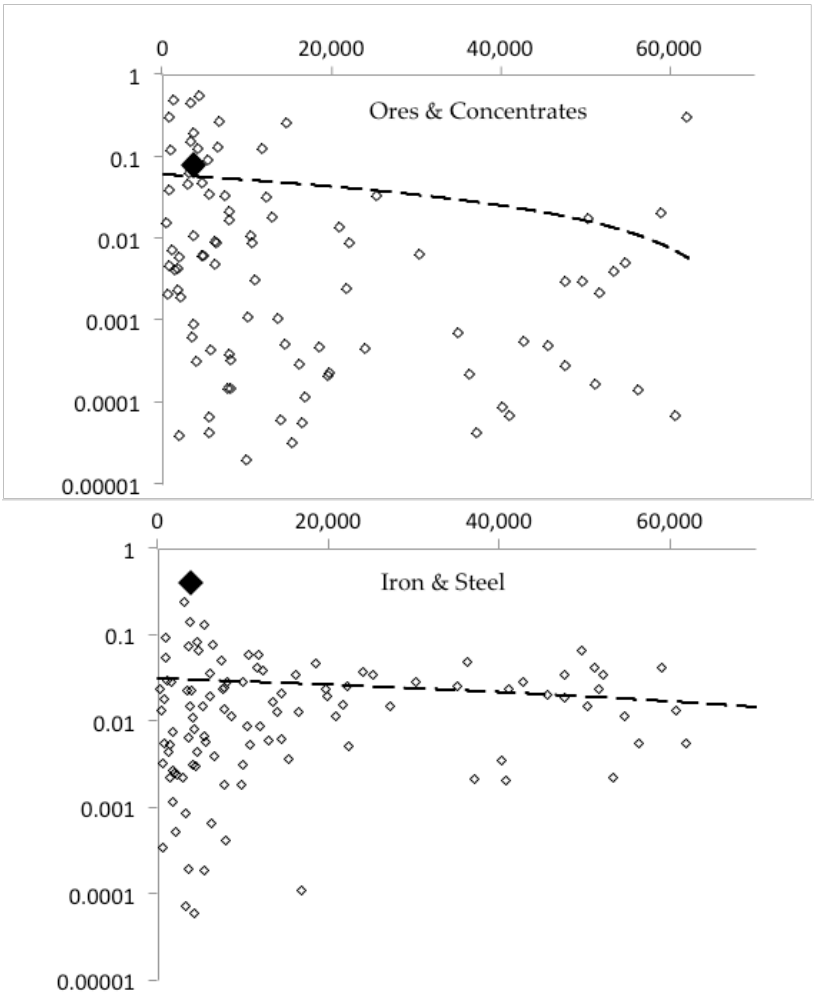
The results are reported in Table 14. First of all, the correlation coefficients show that none of Kosovo's main exports are products whose export share increases with the level of income. In other words, none of them are typical "advanced-country" products. In fact, two of them (raw hides and skins and ores and concentrates) are primary commodities whose export share tends to *decline* as a country develops. Thus, Kosovo's export profile clearly reflects its developing country status.



The predicted export shares are reported in the next column, while the actual deviation from the predicted "norm" is reported in the last column of Table 14. The regression "norm" (dotted line) and Kosovo's export share (bold dot) are also plotted in Figure 15.

As the results show, Kosovo's exports of raw hides, mineral ores and beverages are broadly in line with Kosovo's level of technological development (Table 14, third column). Thus, the recent relative reduction in raw hides' exports, which declined from 10.8 per cent to 3.9 per cent of total exports during 2005-2014, might reflect a "natural" adjustment to least-cost production, as predicted by the theory of comparative advantage. Albeit in line with the level of technology in Kosovo, the recorded export shares of mineral ores are surprisingly low if we also take factor endowments into consideration. Kosovo is, after all, a mineral-abundant country. Thus, current shares of mineral exports might reflect a deviation *below* the actual level of comparative advantage, probably due to the distortions caused by the halted production of the Trepça mining and metallurgical combine (where most lead and zinc exports originate). The recent pattern of (admittedly sluggish) growth in this sector might bring export levels closer to the actual level of comparative advantage in the near future.

Figure 15. Kosovo's export shares (bold dot) and the Chenery "norm" (dotted line), 2014




*Sources: A*uthor's calculations based on data from UN Comtrade, KAS and World Bank;
*Notes:* logarithmic scale on the y-axis (ranging from 0 per cent to 100 per cent), GDP per capita on the x-axis; the empty circles represent the data points (countries) over which the regression line (the "norm") is estimated..

Although goods and service exports have noticeably increased over the past 10 years, the data show a "mixed bag" for the overall performance of Kosovo's external trade sector. The trade deficit is widening in absolute terms, and capital goods do not feature prominently in the import structure, suggesting that the current deficit is unlikely to lead to more export-oriented industrialization and hence a trade surplus in the near future. Indeed, Kosovo's export structure is highly concentrated around (low-grade) base metals and primary commodities, with only a few basic manufactures featuring in the export mix. Similarly, exports are highly concentrated in a few destination countries – something that increases vulnerability to demand and price shocks. The challenge for future trade and industrial policy will be to enable Kosovo to better exploit its existing comparative advantages and develop new and more value-adding productive capabilities.

# 3. KOSOVO TRADE REGIME

## 3.1 Tariff policy

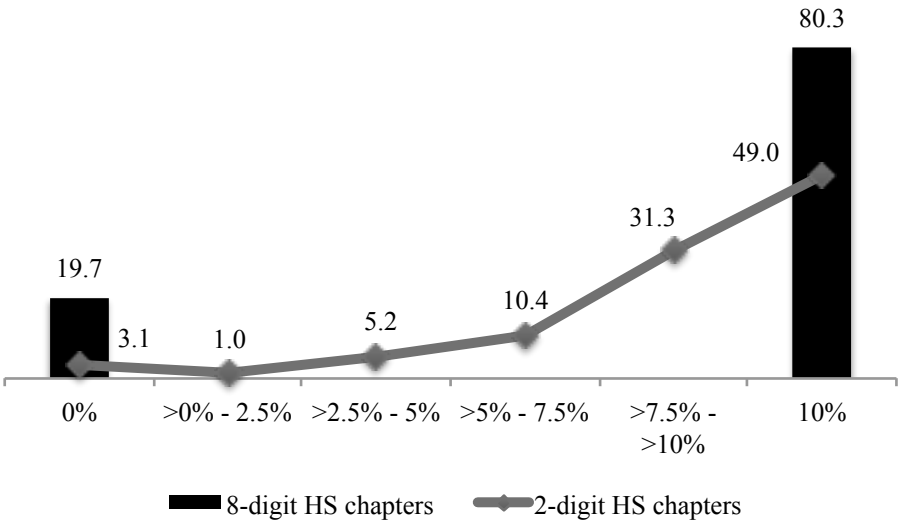
Countries use tariff policy as a means to tax imported or exported goods and services. One of the main goals of tariff policy is to raise money for government revenues. By imposing a tariff, the importing country raises the consumer price of a particular imported good, thus, benefiting domestic producers at the expense of domestic costumers.

This suggests that, in addition to raising money for government revenues, countries that impose tariffs on specific goods or sectors also aim to protect domestic industry from foreign imports that would possibly be sold at lower prices, thus jeopardizing the viability of domestic industry. As a result, tariff protections create an opportunity for domestic industry to increase production. In this context, tariff policy is also (if not primarily) used to create incentives for domestic producers and consumers.

In Kosovo, the tax system deemed simple and transparent. Tax rates are generally low. If we compare Kosovo's customs duties with that of other countries in the region or in European Union, it is clear that our level of tariffs is the lowest, and while other countries typically adopt non-uniform tariff schedules, Kosovo applies a simple dual-tariff rate of 10 per cent and 0 per cent. According to 2013 data, at the HS 8-digit level of disaggregation, the average simple tax rate was 8.03 percent, while the weighted average tariff rate – which takes into account the volume of imports in each product category –was 7.07 per cent. Figure 16 shows that over 80 percent of chapters were subject to the 10 per cent rate, while the rest were subject to no import duty. The line in the graph shows the share of chapters (at the 2-digit level of aggregation) whose average tariff rate falls within a given interval. The majority of chapters fall into the range of an import duty of over 5% and above – with 10.4 chapters between 5 – 7.5 %, 31.30 chapters between 7.5 – 10%, and 49 chapters with 10% tariff rate.

Tariff averages only provide a partial picture of Kosovo's tariff structure. As a result, we measure the Tariff Dispersion Index, which shows how widely tariffs are spread out within the overall schedule, or parts thereof. Based on 9,978 tariff lines for 2013, the value of the Tariff Dispersion Index for Kosovo is 3.98%. This shows that Kosovo has a low dispersion of tariff rates in the tariff schedule, as a result of the two-flat rate system that Kosovo applies. A low level of tariff dispersion is often supposed to minimise the distortionary effects of tariffs on market prices, As such, Kosovo's tariff regime can be supposed to favour development prospects.

Figure 16. Average nominal tariff rate by 2 and 8-digit HS classification




*Source:* Author's calculations based on KAS (various) data.

Subject to a zero tariff rate are the products exempted in the "Law on Goods Released from Customs Duties and Goods with Zero Tariff of the Customs Duty" (Law No. 04/L-163, 2014), and also products coming from CEFTA countries. Kosovo's exports are tax-free. It is worth mentioning that the 10% tariff was adopted during Kosovo's administration by the United Nations Interim Administration Mission in Kosovo (UNMIK). The main aim of this tariff policy was to generate government revenues. The simple tax system designed by UNMIK worked well in early post-war years, when the administration was poorly equipped and domestic production inexistent. At latter stages, a policy shift would have been desirable to ensure that tariff policy could serve Kosovo's development needs. However, Kosovo maintained a rather similar course after independence, except for reducing customs duties to 0 per cent for raw materials and technology to induce domestic production. By lowering the cost of foreign inputs and technology, and raising the price of imports of competing finished products, this policy is likely to have raised the Effective Rate of Protection in many sectors, successfully protecting domestic industry from foreign competition (see Box 6).

Box 6. The Effective Rate of Protection (ERP)

**The ERP measures the percentage increase in domestic value addition made possible by the level of protection. When a tariff on an imported finished good is imposed, domestic companies can raise the price of domestic substitutes up to the after-tax price of similar international goods, increasing the value-added (i.e. output – intermediate consumption) that they generate. However, the cost of intermediate consumption for domestic producers might increase (thus, reducing value addition) if domestic producers rely on imported inputs and the latter are subject to a customs duty – which raises their domestic price. Thus, a tariff schedule has the**

**greatest protective effect for domestic producers when it combines high tariffs on competing final goods with low or no tariffs on imported inputs.**

***Source:*** **Gashi and Linotte (2015).**

Kosovo levies excise duty on certain imported and domestically produced goods. A specific excise duty is levied on goods falling into 21 4-digit HS categories. These include: water, tobacco, wine and related products, certain beverages, alcohol products, oil and petroleum derivatives, some types of organic chemicals, some types of chemical products, some plastic and rubber products, specific types of electric machinery, and motor cars and vehicles.

VAT is another ingredient of the tax system in Kosovo. Due to limited administrative capacities VAT is largely collected at the border by Kosovo Customs. Although some production inputs have been exempted from VAT, importers have been demanding a progressive move towards internal collection of VAT, on account of the cash-flow constraints imposed by VAT collection at the border, which is paid ahead of the product's final sale. On the other hand, exporters have been also complaining about cumbersome VAT refund procedures.

On a final note, Kosovo tariff structure will soon change with the entry into force of the two Agreements that Kosovo has negotiated, i.e. the SAA with the EU and the FTA with Turkey. Specific tariff exemptions have been agreed with the EU and Turkey. These two Agreements, and other trade liberalization developments, will be discussed in more detail in Chapter 4 of the report.



## 3.2 Non-Tariff Measures

The difficulty faced by Kosovo exporters in penetrating foreign markets is partially explained by the Non-Tariff Barriers (NTBs) that Kosovo products are confronted with in international markets. In this respect, barriers to trade are regularly used by CEFTA countries (especially by Serbia) against both Kosovo's agricultural and non-agricultural exports, imports to Kosovo, as well as against goods transiting through their territory.

Regarding the former, the NTBs enacted by CEFTA countries are of typically of a diverse nature, including Technical Barriers to Trade (TBT) and Sanitary and Phytosanitary Standards (SPS). At the same time, the transit of Kosovo products through Serbia is confronted with administrative obstacles.

### 3.2.1 Defining Non-Tariff Barriers and their Classification

NTBs generally refer to all policy measures other than tariffs that restrict or otherwise distort trade flows, whether by changing quantities, prices or both

Thus, NTBs include well-known trade distorting policies such as import quotas and bans, safeguards measures, and voluntary export restraints (VERs). Many of these traditional NTBs are banned under WTO rules and are no longer very common amongst CEFTA countries (see Figure 17).

Besides the likes of import bans and quotas, UNCTAD (2013) identifies three main categories of NTBs, namely: SPS measures, TBTs, and Pre-Shipment Inspection and other formalities. SPS measures include regulations and restrictions to protect human, animal or plant life or health. It includes restrictions on specific substances and measures to ensure food safety, as well as measures for preventing the spread of disease or pests. They also include all conformity-assessment measures related to food safety, such as certification, testing and inspection, and quarantine. On the other hand, TBTs address all other technical regulations, and standards. It refers to measures such as labelling, standards on technical specifications and quality requirements and other measures protecting the environment. As in the case of SPS measures, TBTs include also all conformity assessment procedures imposed with a non-trade objective. Finally, Pre-Shipment Inspections and other requirements include various quality, quantity, and price controls prior to shipment, consignment controls, import monitoring and surveillance controls, etc.

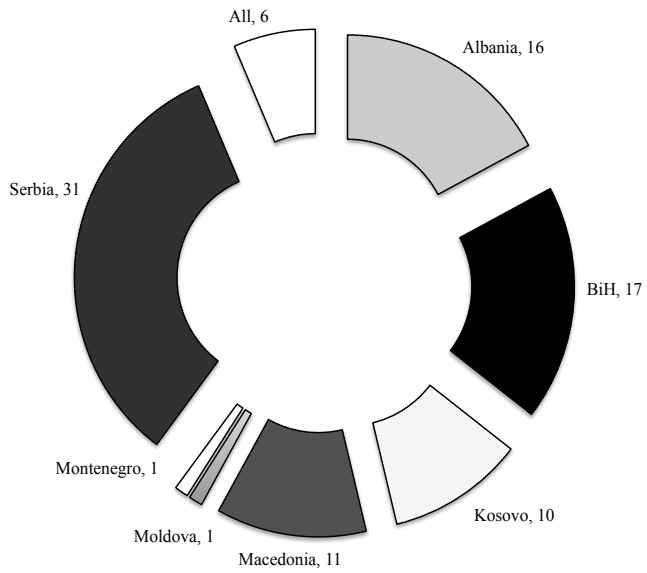


### 3.2.2 NTBs within CEFTA

NTMs are covered under the CEFTA Agreement, and it is the responsibility of contracting parties to report or notify NTBs on a regular basis. Hereafter, we describe the nature of the problems that Kosovar companies are being confronted with when exporting to CEFTA countries, or transit problems when importing from EU countries, and crossing/transiting through Serbian territory.

CEFTA secretariat has designed a very efficient electronic platform/portal to record the NTBs between the member parties. Figure 17 shows that Serbia is more prone to imposing NTBs on her regional partners than any other CEFTA member state. Indeed, one-third of NTBs reported by CEFTA member countries have been enacted by Serbia. A significant number of barriers, as reported by the portal, have also been erected by Bosnia and Herzegovina and Albania (18.3 and 17.2 per cent of the total number of NTBs reported, respectively), Macedonia and Kosovo are next, with 11.8 and 10.8 per cent of all NTBs, respectively.

Figure 17. Number of cases by party applying the measure




*Source*: CEFTA secretariat (2015)

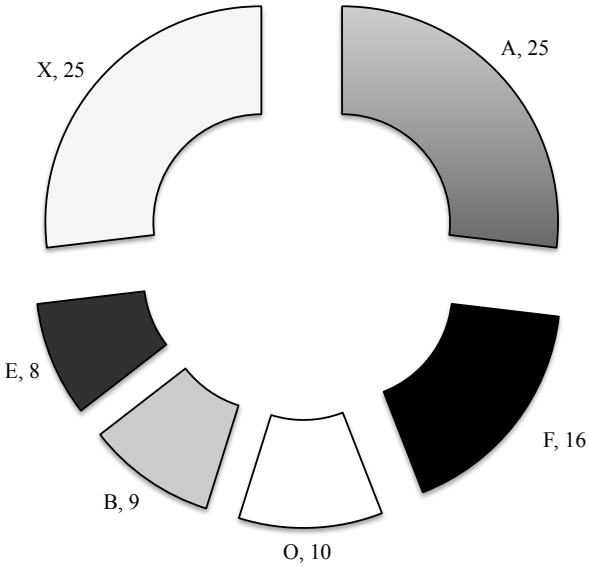
The structure of the cases raised reflects largely the impediments in the Kosovo – Bosnia and Herzegovina – Serbia triangle. The latter two countries are opposed to Kosovo's independence, actively taking retaliatory measures to impede Kosovo's integration with the regional and global economy.



As it can be seen on Figure 18, most NTBs within CEFTA are of the SPS kind. Out of the total number of NTBs reported, 27 per cent falls in the category of SPS measures. According to the CEFTA Agreement, the application of SPS by CEFTA countries should be governed by the "WTO Agreement on the Application of Sanitary and Phyto-sanitary Measures". Following the WTO Agreement, "the Parties shall cooperate in the field of sanitary and phyto-sanitary measures, including veterinary matters, with the aim of applying relevant regulations in a non-discriminatory manner. Each Party, upon request of another Party, shall provide information on sanitary and phyto-sanitary measures." (CEFTA, Article 12). The same applies for TBTs. However, the number of TBTs within CEFTA is not as high as the region trades mainly in food and agriculture products.

Under normal conditions, SPS measures and TBTs aim to provide quality and safety assurance for agricultural products and, as a result, increase consumer confidence. But, frequently, as against Kosovo, they can be used as real barriers with the aim of distorting trade among countries.

Figure 18. Cases according to NTB categories




*Note:* A – Sanitary and phytosanitary measures
B – Technical barriers to trade
E – Non-automatic licensing, quotas, prohibitions and quantity control measures other than for SPS or TBT reasons
F – Price control measures including additional taxes and charges
O – Rules of origin
X – Other

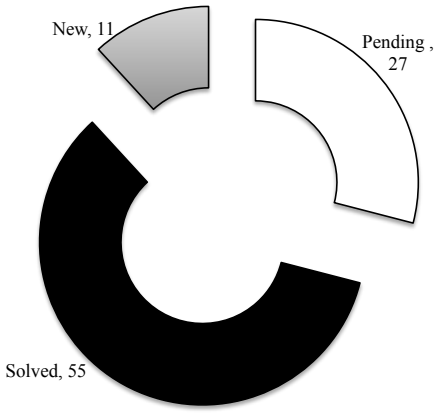
*Source*: CEFTA secretariat (2015)



In the case of Kosovo most NTBs fall under the heading of SPS measures. A related issue is the non-recognition in other CEFTA countries of existing product quality certificates issued by Kosovo's official bodies (i.e. sanitary, phyto-sanitary and veterinary certificates for agro-food products). This has become a serious problem for Kosovar exporters in some sectors.

Besides SPS and TBT, other significant NTBs include price control measures, including additional taxes and charges, and rules of origin. The former include measures to control or affect the price of imported goods. Typically, these measures are implemented for three different reasons: first, to support the domestic price of certain products when the import price of these goods is lower; second, establish the domestic price of certain products because of price fluctuation in domestic markets, or price instability in a foreign market; finally, to increase or preserve tax revenue. In the CEFTA region, violations with customs valuation procedures, reference pricing, and various administrative fees and charges that alter prices, are sporadic.

Figure 19. Complaints by status




*Source*: CEFTA secretariat (2015)

Rules of origin are another area of contention within the CEFTA region. Although the Agreement has laid out specific provisions on the preferential origin of goods within the signatory parties, including diagonal cumulation based on the pan-European rules of origin, problems still persists. Around 10 per cent of total NTB reported to the CEFTA Secretariat are related to rules of origin (see Figure 18).

On a final note, as Figure 19 shows, most complaints raised by CEFTA members (around 60 per cent) have been resolved, indicating the readiness of member parties to resolve differences internally. However, a significant proportion of complaints remain unresolved (27 per cent).



### 3.2.3 Transit issues

One of the objectives of CEFTA is "to eliminate barriers to and distortions of trade and facilitate the movement of goods in transit and the cross-border movement of goods and services between the territories of the Parties" (Article 1). However, since 2008, the issue of transit through Serbia has become a significant barrier for Kosovar companies. There are many Kosovar trading companies importing from EU countries. Even when in possession of all required import/export documents, Kosovo's companies often face problems transiting through Serbian territory. These are largely of an administrative nature. For instance, the Ministry of Trade and Industry has received complaints from Kosovar companies stating that Serbian customs authorities have requested a certificate that is supposed to be issued by UNMIK, an institution which is no longer in a position to issue trade-related certificates. On other occasions, MTI has received complaints related to veterinary and phytosanitary certificates not being recognized. This significantly increases the cost of trading for Kosovo's

businesses, forcing some of them to seek alternative, and more expensive, transit routes. Additional transit costs forced some businesses to quit some foreign markets altogether.

## 3.3 Services and the trade regime in Kosovo

Unlike trade in goods where Kosovo enjoys a liberal trade regime with CEFTA countries and preferential treatment with EU, USA and Norway, trade in services remains much less liberalised. Currently our legislation on most key service sectors offers a very liberal regime, enabling foreign service suppliers, investors and skilled labour great opportunities to access the Kosovo market.

In the context of the regional market, the situation is different. Kosovo is only in the initial phase of trade liberalization with CEFTA countries (see the schedule of negotiations in Table 15). Liberalisation of services in the CEFTA region and the consequent access to 24 million potential consumers, is highly significant and an immense opportunity for Kosovar business and professional service providers. Although the Kosovo's economy is still fragile and less experienced than its neighbour's in many sectors, having a liberal trade regime in services will potentially enable its service suppliers and skilled labour to sell and move freely in a much larger market, and thus increase their export revenues, further improving the balance of trade.

Table 15. Schedule of service negotiations within CEFTA

| Rounds | 1st & 2nd round | 3rd round | 4th round | 5th round | 6th round |
|---|---|---|---|---|---|
| Conclusion | 09/2014; 02/2015 | 06/2015 | 09/2015 | 02/2016 | 06/2016 |
| Services | Professional (legal, auditing, accounting, tax, architecture, engineering, planning, urban, medical, veterinary, nursery, physiotherapeutic) | Tourism<br>Environmental<br>Recreational | Communication<br>Construction | Distribution<br>Education<br>Medical | Financial<br>Transport<br>Audio-visual |
| Status | Concluded | Concluded | In progress | Not initiated | Not initiated |

*Source*: CEFTA secretariat (2015)

As shown in Table 15, negotiations on professional, tourism, environmental, and recreational services have been concluded. The third round is currently in progress, while

the conclusion of negotiations on all service sectors is foreseen by mid-2016. The first two rounds of negotiations concentrated solely on the free movement of persons and the mutual recognition of qualifications that would enable professionals to preform services in other CEFTA countries.

One important recent development was the establishment of an institutional mechanism within CEFTA Secretariat and the Regional Cooperation Council for the mutual recognition of qualifications in the member countries.

On a final note, the SAA between Kosovo and the EU covers services only superficially. Kosovo and the EU have agreed to grant respective businesses a right to establishment. In the context of free movement of people, the Agreement covers only the movement of key personnel, and even that is tied to specific conditions.

# 4. TRADE LIBERALIZATION AND MARKET ACCESS

Post-war Kosovo has made significant steps in liberalizing its economy, notably trade. One major step was the membership in CEFTA, established in 2006. In addition, Kosovo benefits from the EU's Autonomous Trade Measures (ATMs), a preferential trading scheme under the WTO's GSP. The GSP is a WTO scheme that allows developed countries to grant preferential tariff reductions to developing countries in breach of the WTO's Most-Favoured Nation principle (MFN). The ATMs will soon be replaced by the Stabilization and Association Agreement. The SAA will likely enter into force in 2016. Moreover, the FTA with Turkey was initialled in September 2013, although the ratification process is not yet finalized .Finally, the Ministry of Trade and Industry, in particular the Trade Department, as a coordinator in the WTO accession process, is working towards the identification of the steps needed to move closer to the WTO. Next, these aspects of Kosovo's foreign trade policy will be analysed in more depth.

## 4.1 Regional trade agreement

Until 2006, Kosovo had negotiated bilateral FTAs with Albania, Croatia, and Bosnia. In addition, it had endorsed the Agreement of 1997 between Macedonia and what was then Yugoslavia. All these steps were taken with the aim of liberalizing trade and integrating with the countries of the region. By December 2006, all the countries in the region signed into CEFTA, which consolidates the matrix of existing bilateral free trade agreements between countries in the region into a single regional free trade agreement. CEFTA was introduced in the region in order to foster regional cooperation. It was thought (notable by EU officials) that peace in a war-torn region can only be achieved through economic integration. In this light, regional cooperation is seen an essential element towards economic development and EU integration.

Kosovo became part of CEFTA as an UNMIK-administered territory. To this day, the contracting party to the Agreement is UNMIK, rather than the Republic of Kosovo. Besides Kosovo, the Agreement includes Serbia, Albania, Bosnia, Macedonia, Montenegro and Moldova. The Agreement has reduced tariff levels to zero for trade between member states. However, the Agreement is much deeper, as it includes provisions on investments, intellectual property protection, trade facilitation, etc. Ever since the entry into force of CEFTA, Kosovo's exports to CEFTA members have increased by nearly 40 per cent, but imports have increased too.

In November 2014, Kosovo has started the negotiations on the services sector with other CEFTA members (see previous discussion).

## 4.2 SAA and the trade liberalization with the EU

Kosovo currently benefits from the EU's Autonomous Trade Measures scheme; this non-reciprocal scheme grants Kosovo duty-free access to the EU market for over 95 per cent of Kosovo's export products. As pointed out, the ATMs will soon be replaced with the SAA, a reciprocal agreement which will gradually move both parties towards a bilateral free trade area. The SAA represents the first contractual relationship between Kosovo and the EU, and it is seen as an important milestone in Kosovo's European integration process.

For Kosovo, a deal with the world's largest trading bloc is most attractive, as it will provide access to 500 million consumers in 28 EU member states. Businesses will benefit from the SAA through creation of a more stable and predictable trade and investment environment. Moreover, the SAA commits Kosovo to undertake major reforms in areas such as intellectual property, public procurements, competition policy, and trade and sustainable development.

The Kosovo's negotiating position for the SAA has been based on consultations with various stakeholders, including local producers and the business community. The agreement is largely a result of consultations which the Negotiating Group has held with the business community and their representatives in the frame of the National Council for Economic Development and Trade Policy Sub-groups at the MTI. Based on the decision by the Government of Kosovo, the role of the chief negotiator has been delegated to the Ministry of European Integration, but MTI was leading the process of negotiating the trade part of the agreement. In addition, other Kosovo institutions were involved in the process, including the Office of the Prime Minister, Ministry of Finance, Ministry of Agriculture, Ministry of Foreign Affairs and Ministry of Justice.

Kosovo's negotiating position relied on a detailed analysis of the potential impacts that the agreement would have on the Kosovar economy and specifically on its external sector, output, employment and government revenues.[20] Regarding the impact on specific sectors, MTI formulated its position based on a specific methodology. It identified sensitive products by taking into account two main reference indicators: the trade balance ("does Kosovo import or export more of the relevant goods?") and the tendency of the trade balance ("is the deficit/surplus growing or decreasing?"). In particular, cases where there is a trade deficit but the deficit has been declining in the past years were of crucial importance for the Kosovar economy, and as such were deemed sensitive in the process of negotiation. It was considered that the sectors displaying these characteristics were actually performing import

[20] Linotte, D., Gashi, P., Dalladaku, Rr., Mahmudi, B., Fetahu, M., and Islami, M. (2013), Preparing Kosovo for the Trade Aspects of the Stability and Association Agreement Negotiations with the EU. A part of the EU funded project "Further Development of Kosovo's Trade Policy" implemented by GFA Consulting Group/ACE/CARDNO.

substitution, with Kosovar industries catching up with global or at least regional competitors. Also, there were sectors with persisting trade deficit, thus they were seen as sensitive to the time frame of liberalization.

Although reciprocal, the Agreement with the EU is rather asymmetric in favor of Kosovo; thus, all Kosovo products are immediately exempted form customs duty, except baby beef, sugar, and wine, which are subject to quantitative restrictions. On the other hand, Kosovo will phase out custom duties according to specific transitional periods. Kosovo has entered into an agreement with 99.7% of Kosovo products, thus 0.3% of products are not part of the SAA (see section comparing the SAA with FTA with Turkey).

## 4.3 FTA with Turkey

On the 27th of September 2013, the Republic of Kosovo signed a Free Trade Agreement with Turkey. This agreement guarantees Kosovo's exporters duty-free access to the Turkish market for 8,336 industrial products. In exchange, Kosovo has agreed to eliminate customs duty immediately on 2,292 industrial products, with a total import value of €55.4 million before liberalisation. These are products which are not produced in Kosovo and for which there is no production potential. Another 1,395 products are already part of the draft Law on Customs Exemptions (Law No. 04/L-163) and 201 industrial products are protected for 4 years, 1,247 products for 6 years, 2,722 products for 8 years and 470 for 10 years. The total value of imports from Turkey in all these product categories together is close to €108 million.

With regard to agricultural products, Kosovo has negotiated the complete and immediate elimination of Turkish customs duty on 2,442 products, except for meat products. In Turkey, the pre-FTA average customs tariff on agricultural products is 47%. In return, Kosovo will immediately eliminate customs duty on only 493 agricultural imports from Turkey, which have an aggregate import value of about € 14 million. These are mainly products which are not produced in Kosovo due to its climate conditions (e.g. bananas, citrus, olives, etc.) and tariff liberalization will thus benefit consumers without harming domestic producers. Some 52 other agricultural products, which are considered to be sensitive and within Kosovo's comparative advantage, are protected for 10 years. These include dairy products, fruits and vegetables, flour products, water and beer.

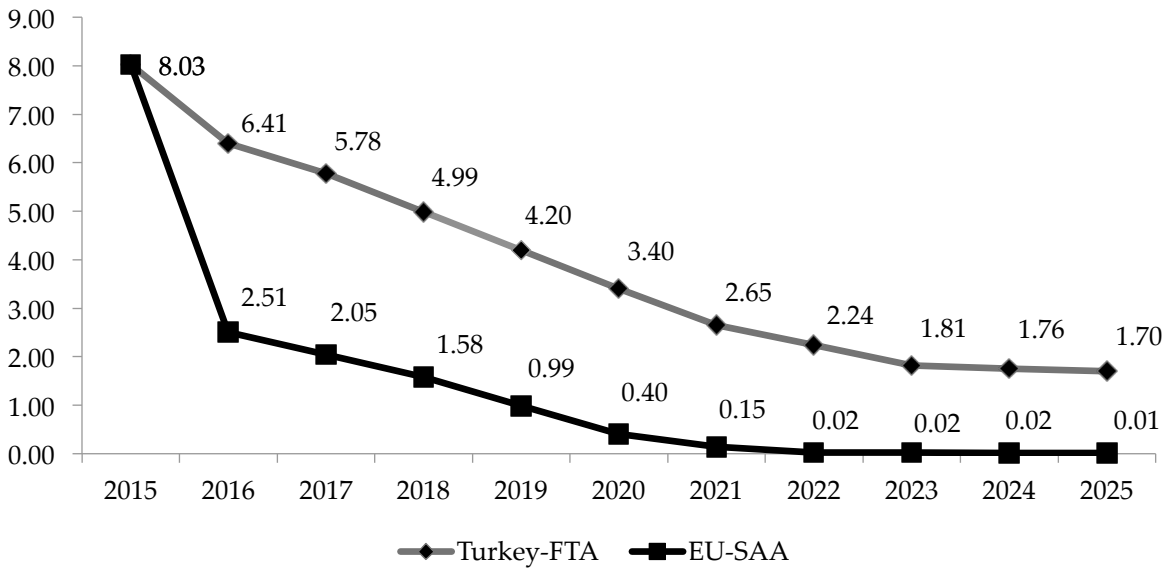
As in the case of SAA, extensive consultations were undertaken with other branches of Government, private sector, and civil society. From the Government's side, while the Ministry of Trade and Industry was leading the process, the Negotiating Group for the negotiation of the Agreement with Turkey was established by the decision of the

Government of Kosovo, and it comprised other state institutions including the Office of the Prime Minister, Ministry of Finance, Ministry of Agriculture, Ministry of Foreign Affairs and Ministry of Justice. From the business sector, representative of major chambers of commerce were involved in the process.

## 4.4 Concessions granted to EU and Turkey: a comparative analysis

In the section above we discuss and compare the tariff concessions granted to Kosovo by both EU and Turkey. We have seen that both partners offered significant concessions,. However, although Kosovo committed to only reducing customs duties progressively, the fiscal implication, as shown in Figure 20, will be significant. The calculations are based on the assumption that both agreements will enter into force in 2016.

Figure 20. Average nominal tariff rates for EU and Turkey before and after agreements enter into force




*Source:* Author's calculations based on KAS (2015) data.
*Note:* Averages have been calculated based on the total number of tariff lines in Kosovo Customs' TARIK for 2012. The same has been used to negotiate with the EU and Turkey counterparts.

As the figure shows, the FTA with Turkey imposes significantly less tariff reduction commitments upon Kosovo that the SAA. Currently the average nominal tariff rate is 8.03 per cent for all imports. Once the SAA enters into force the average nominal tariff rate for EU imports will drop sharply to 2.5 per cent, to then taper off to nearly 0 per cent over the next nine years. The initial sharp drop is expected as the tariff on over 70 per cent of the product lines will be abolished immediately (see Table 16). Apart from 14 tariff lines that

have been excluded from negotiations, the rest of tariff lines will be abolished progressively over 10 years: around 17 per cent of product lines within five years; less than 13 per cent over seven years; and only 0.13 per cent in ten years.

Table 16. The schedule of concessions granted in the SAA and the FTA with Turkey

| Sectors | SAA with EU | | FTA with Turkey | |
|---|---|---|---|---|
| | Schedules (years) | Products covered (HS-8 digit) | Schedules (years) | Products covered (HS-8 digit) |
| Agriculture Sector | Zero | 1,204 | Zero | 433 |
| | Five | 353 | Six | 214 |
| | Seven | 180 | Eight | 39 |
| | Ten | 8 | Ten | 19 |
| | - | - | Ten-A | 16 |
| | Excluded | 11 | Excluded | 1,035 |
| Processed Agriculture Products (PAPs) | Zero | 135 | Zero | 69 |
| | Five | 98 | Six | 94 |
| | Seven | 76 | Eight | 32 |
| | Ten | 4 | Ten | 6 |
| | - | - | Ten-A | 10 |
| | Excluded | 3 | Excluded | 105 |
| Fish Products | Zero | 490 | Zero | 29 |
| | Five | 1 | Six | 6 |
| | Seven | 1 | Ten | 1 |
| | Excluded | 0 | Excluded | 456 |
| Industrial products | Zero | 4,763 | Zero | 2,254 |
| | Five | 1,131 | Four | 210 |
| | Seven | 925 | Six | 1,234 |
| | - | - | Eight | 2,651 |
| | - | - | Ten | 470 |
| | Excluded | 0 | Excluded | 0 |

In the case of Turkey, the immediate drop in the average tariff rates will not be as sharp as in the case of SAA. This is largely because only 30 percent of tariff lines will be abolished completely once the FTA enters into force. Also, 17 per cent of tariff lines were excluded altogether from negotiations. According to the agreement, the majority of tariffs will be abolished within eight years, that is, 29 per cent, followed by 16.5 per cent of lines that will be abolished within six years. For 5.5 per cent of products tariffs will be reduced progressively within 10 years; only a fraction of products has been granted a grace period of two years (Ten-A category), whereby the progressive reduction will start in the third year following the entry into force of the FTA.

Table 16 shows that for around 70 per cent of agriculture and industrial products tariff duties will be abolished once the Agreements enters into force. The rest will be abolished progressively within five to seven years. For PAPs the picture is much the same, while the fishery sector will be almost fully liberalised once the Agreement enters into force. In the latter case, only two product lines will enjoy gradual tariff reductions within five and seven years.

Table 17. Comparison of concessions for SAA and the FTA with Turkey (HS-8 digit classification)

| Sectors | SAA with EU | FTA with Turkey | | | | | | |
|---|---|---|---|---|---|---|---|---|
| | Liberalisation schedule | Liberalisation schedule (years) | | | | | | |
| | | Zero | Four | Six | Eight | Ten | Ten-A | Excluded |
| Agriculture sector | Zero | 392 | - | 92 | 39 | 3 | 2 | 676 |
| | Five | 25 | - | 95 | - | 2 | 4 | 227 |
| | Seven | 11 | - | 27 | - | 13 | 4 | 125 |
| | Ten | - | - | - | - | 1 | 6 | 1 |
| | Excluded | 5 | - | - | - | - | - | 6 |
| Processed agriculture products (PAPs) | Zero | 51 | - | 11 | 27 | - | - | 46 |
| | Five | 13 | - | 55 | 5 | - | - | 25 |
| | Seven | 2 | - | 27 | - | 6 | 7 | 34 |
| | Ten | - | - | 1 | - | - | 3 | - |
| | Excluded | 3 | - | - | - | - | - | - |
| Fish products | Zero | 29 | - | 6 | - | - | - | 455 |
| | Five | - | - | - | - | - | - | 1 |
| | Seven | - | - | - | - | 1 | - | - |
| Industrial products | Zero | 2,182 | 135 | 700 | 1,546 | 200 | - | - |
| | Five | 56 | 33 | 361 | 456 | 225 | - | - |
| | Seven | 16 | 42 | 173 | 649 | 45 | - | - |

In the FTA with Turkey, the situation is rather different: around 60 per cent of agriculture products have been excluded from negotiations, while only about 25 per cent of all tariff lines will be abolished once the Agreements enters into force. For the rest of products the reductions will be completed within six and eight years. Again we see a rather similar picture regarding PAPs, while the majority of fish products have not even been included in negotiations because presumably there was no major production from either party. Only 33 percent of industrial products will have zero tariff rate once the Agreement enters into force, while the tariff for the remaining product lines will be reduced progressively over six to eight years.

Table 17 cross-tabulates the distribution of concessions granted to Turkey based on the EU agreed schedules. The table confirms the more demanding nature of the SAA (in terms of

import liberalization) as compared to the FTA with Turkey. For instance, only for 392 product lines (32 per cent) tariffs will be abolished immediately, compared to 1,204 lines in the case of the EU-Kosovo agreement. In the case of industrial products, only 45 per cent of the zero-tariff product lines granted to the EU have also been offered to Turkey. A similar picture holds also for PAPs and fish products.

## 4.5 GSPs and Kosovo

In addition to the agreements mentioned above, Kosovo benefits from Generalized System of Preferences (GSP) schemes with a number of countries. Under the GSP, developed countries offer non-reciprocal, better-than-MFN preferential treatment (such as zero or low duties on imports) to products originating in developing countries.[21]

Preference-giving countries unilaterally determine which countries and which products are included in their schemes. The GSP with the United States, which came into force in 2008 offers preferential duty-free access for more than 4,650 products (including light manufactures, minerals, building materials and certain agricultural products). As the previous discussion shows, the United States is gradually becoming an important trade partner.

Kosovo also benefits from similar GSP arrangements with Japan, and with two EFTA members, Norway and Switzerland.

## 4.6 Prospects for joining WTO

The Ministry of Trade and Industry, in particular the Trade Department, is in charge of leading the process of WTO membership. Currently, the Trade Department is working on the preparation of the document needed for application, namely the so-called Memorandum on the Foreign Trade Regime (MoFTR). This document is required when Kosovo applies either for full membership or as an observer. So far, Kosovo has not taken a formal position as to whether it will seek full membership in its application.

For the Government of Kosovo, WTO membership is of significant importance, as it will open the path to participate in the international trading system and support the reform-

[21] "The Enabling Clause" is the WTO legal basis for the GSP. This mechanism, officially called the "Decision on Differential and More Favourable Treatment, Reciprocity and Fuller Participation of Developing Countries", was adopted under GATT in 1979.

agenda of the Government. From the political perspective, different reasons underpin the need for Kosovo to initiate the path to WTO membership:

- The decision to integrate with the multilateral trading system will further support the vision of state building set forth by the Government of Kosovo;
- Informally, Kosovo's integration with the EU goes hand in hand with obtaining WTO membership, as all existing EU member states from the former Socialist block first became members of the WTO. In the Balkan, Macedonia, Albania, and Montenegro are full members, while Serbia and Bosnia are still negotiating accession;

From an economic and institutional perspective, the rationales include:

- The expected economic benefits deriving from WTO membership are coherent and supportive of Kosovo's long-term economic integration objectives.
- The accession negotiations underpinning the path to WTO membership will further enhance the quality of Kosovo's institutions, and support the political and reform-oriented agenda of the Government. In addition, The preparatory work (including institutional, regulatory and legal reforms) required for Kosovo to fulfil the conditions for WTO membership (through implementation of WTO Agreements) will help Kosovo to fulfil the conditions for EU integration, and especially attain the objectives mentioned below:
    - Creating conditions for the functioning of a market economy (also condition for EU SAA and integration process);
    - Increasing competitiveness and strengthening of the private sector;
    - Supporting employment generation;
    - Improving the image of Kosovo for investment;
    - And creating a more secure and stable environment for business.

On a final note, the Government of Kosovo is aware that despite the many opportunities that WTO membership presents, threats are also substantial. In this context, it has been argued that WTO membership might weaken Kosovo's domestic industries. In addition, stringent patent/industrial design protection rules under TRIPS might hamper technological learning and accumulation (by preventing reverse engineering), thus hindering, rather than supporting, capital accumulation and employment generation.

# 5. TRADE INSTITUTIONS AND THE BUSINESS CLIMATE IN KOSOVO

## 5.1 Trade institutions

The main player in trade-policy making in Kosovo is MTI, mandated to design and implement trade policy. MTI has a number of trade related mechanisms and agencies within its umbrella that deal with designing trade policy (Department of Trade), supporting the private sector, promoting exports and investments (KIESA), ensuring quality and product standards (Kosovo Standardization Agency/Kosovo Metrology Agency), and protecting intellectual property rights (Industrial Property Agency). Beyond MTI, other public institutions are tied to trade policy, including the Ministry of Finance, the Ministry of Agriculture, the Ministry of Economic Development, and even the Ministry of Foreign Affairs who is formally responsible for international trade agreements. The Ministry of Finance is an important institutional link in trade policy-making as it hosts Kosovo Customs. There are also other public non-governmental institutions related to trade, such as Central Bank of Kosovo and the Kosovo Agency of Statistics. Equally important are private sector representatives, such as business associations that advocate and promote international trade.

## 5.2 Coordinating trade policy related institutions

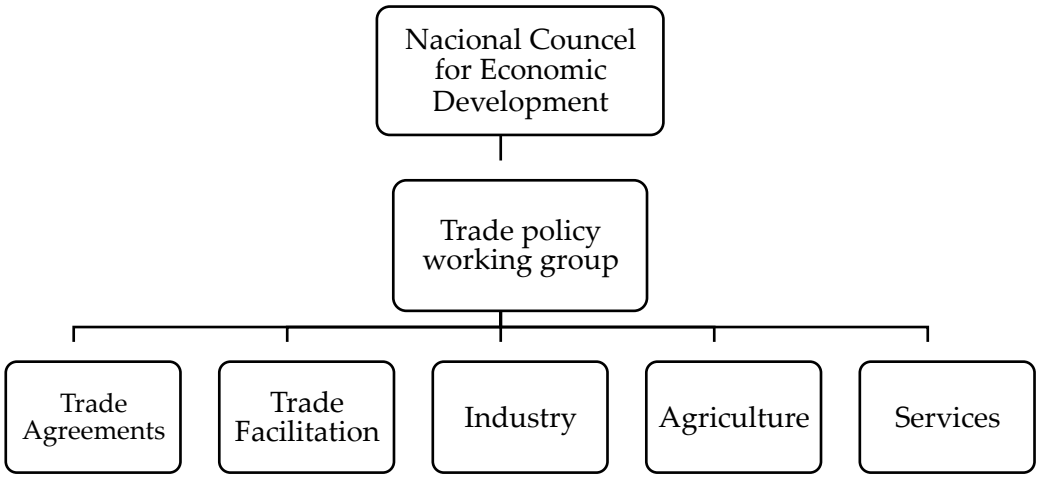
Following the adoption of Trade Policy of Kosovo 2009, the Government of Kosovo embarked on establishing a number of coordination mechanisms in order to fast-track implementation of trade and economic policies, and strengthen the involvement of the private sector in policy-making. Prior to the establishment of these mechanisms, trade policy coordination was virtually missing in Kosovo. These mechanisms have been formally recognized by the Law on External Trade adopted in the second half of 2011. One of these mechanisms is the National Council for Economic Development (NCED), which acts the main advisory and decision-making platform for economic policy-making and reforms, including trade policy. The NCED comprises the Prime Minister's Office, the Ministries of Trade and Industry, Economic Development and Finance, European Integration, Agriculture, Forestry and Rural Development, Foreign Affairs, Infrastructure and Public Administration, as well as the Parliamentary Committee on Economic Development, Infrastructure, Trade and Industry, three business associations (Kosovo Chamber of Commerce, Business Alliance of Kosovo, American Chamber of Commerce) as well as donor representatives. NCED was envisaged to focus on facilitating inter-Ministerial consultations

and public-private dialogue at the highest level. The Prime Minister chairs the NCED, while the MTI Minister is a co-chair.

With regards to trade policy, MTI has established the Trade Policy Working Group (TPWG), which feeds into NCED and consists of representatives of various Ministries, private sector representatives and donor agencies (see Figure 21). The TPWG was established in 2011 with the aim of coordinating all activities conducted in the context of trade policy and trade-related developments. The TPWG was operationalized through the establishment of five technical working groups on the following areas: agriculture, industry, services, trade facilitation, and trade agreements.

The five technical working groups are supposed to coordinate government activities with the private sector on their respective issues. The aim of the technical working groups is to identify and support businesses in terms of problems that they face, whether on the technical, legislative, of administrative level. The representatives of the following institutions are involved in the technical working groups: Ministry of Trade and Industry, Ministry of Finance, Ministry of Agriculture, Ministry of Economic Development, Ministry of European Integration, Ministry of Foreign Affairs, Statistical Agency of Kosovo, Tax Administration Office, Kosovo Customs, Food and Veterinary Agency and Central Bank of Kosovo.

Figure 21. Trade policy coordination mechanisms




The Trade Policy Coordinator of the Trade Department is in charge of organizing, facilitating and chairing all five sub working group. The two co-chairs from other Ministries and the private sector have the role to support the chair and to set the agenda together with the chair.

So far the most active sub-groups were the sectorial ones (see Table 18).

Table 18. Barriers reported at the sub-group meetings

| | Agriculture | Industry | Services |
|---|---|---|---|
| Number of issues raised | 30 | 25 | 10 |
| Number of issues solved | 22 | 15 | 7 |
| Pending issues | 8 | 10 | 3 |

In general, most issues addressed in the sub-groups are of different nature, including technical issues, legislative, administrative, fiscal issues, obstacles related to electricity supply, and other non-tariff barriers faced by Kosovo's companies when importing and exporting. The identified problems are discussed within sub-groups, evidence is gathered, and finally problems are addressed through the responsible institutions.

## 5.3 Trade-related legislation

The fundamental legal instrument in the trade policy area is the Law on External Trade, adopted in 2011**.** The purpose of this Law is to define the general rules for the functioning of external trade between persons settled within and outside the territory of Kosovo in compliance with the best international practices, including WTO agreements, EU Directives, and CEFTA provisions.



The Law on Anti-Dumping and Countervailing Measures was adopted by parliament in May 2014. With the Law on Safeguard Measures on Imports, Kosovo has completed the legal infrastructure on trade remedies/contingency measures. The Law on Anti-Dumping and Countervailing Measures applies in cases when imports are sold below market prices or costs of production, and harm a particular industry in Kosovo. In addition, it is applicable also in cases when a specific industry is subsidized in the exporting country and imports of those goods may be artificially competitive, harming domestic industries in Kosovo. However, in order to make a legal case for dumping or illegal subsidization in the country of origin, additional indications and proofs of material injury to domestic industries must be provided. Thus, evidencing a case for anti-dumping or countervailing duties requires considerable institutional and technical capacities and resources.

Under the Law on Anti-Dumping and Countervailing Measures, MTI has an inspection committee tasked with investigating when there are suspicions that a particular product might be subsidized or under-priced by other country. The process of designing the secondary legislation for implementation of this law is currently underway within MTI.

So far, very few cases have been brought under the Law on Anti-Dumping and Countervailing Measures. An interesting example is a decision taken to protect the local producers of clay bricks, threatened by cheap imports from Serbia, where the brick industry is suspected to be subsidized. After four years in force, the measure is currently being reviewed, while in May 2015 MTI has decided to temporarily set aside the previous decision until a new evaluation is conducted.

The third piece of the legislative framework pertaining to trade remedies is the Law on Safeguard Measures on Imports. This Law sets out the principles and procedures relating to the application of safeguard measures in cases where there is an unexpected surge of imports that cause material injury to domestic producers of similar or identical goods. The Law on Safeguard Measures on Imports has been used as a legal basis to enforce measures against cement imports from Albania in June 2012. Currently the Ministry is discussing some actions that need to be taken for the protection of local producers against unfair imports of diary and meat products.

The Customs and Excise Code has been adopted in 2008 and later amended in 2012. This Code sets out the legal framework for trade and customs administration, and it is a very important instrument for the collection of Government revenues. The Code sets out specific regimes and procedures regulating international business transactions. These include: inward processing; customs warehousing; outward processing; temporary import; and processing under customs control. Currently, 79 businesses are using customs warehousing, 61 utilize inward processing, while only 10 businesses are making use of processing under customs control.



In order to incentivize domestic production, the Government of Kosovo has recently adopted the Law on Goods Exempt from Custom Tax and Goods with Zero Rate of the Custom Tax 04/L-163 (January 2014). This law enables companies to import raw materials with zero customs duty. This Law is currently being amended by the Ministry of Finance to extend the list of goods exempt from the 10 per cent tariff rate.

Lastly, the Law on Internal Trade, adopted in 2004 and amended in 2011, has some implications for external trade, too. This instrument stipulates the conditions for developing trade in the domestic market, including wholesale and retail trade, auctions, intermediation in trade, restriction practices and safeguard measures for developing trade activities, unfair competition, supervisory measures, administrative measures and penalty provisions. Other relevant laws include the Market Inspection Law, regulating product inspections and supervision of law enforcement, and setting out the duties and responsibilities of inspectors at the Trade Inspectorate, an MTI entity.

Finally, intellectual property rights are covered by a number of laws, including the Laws on Patents, Industrial Design, Trademarks, Copyright and Related Rights, Protection of Plant Varieties, the Law on Customs Measures for Protection of Intellectual Property Rights, and the Law on Determining the Rights and Protection of Topographies of Integrated Circuits. Compliance with international standards and practices in protecting property rights is vital in Kosovo's accession path towards the EU and WTO.

Kosovo is also in the process of drafting the Law on Services based on the EU Services Directive 2006/123/EC. This Law is of significant importance for Kosovo since 70 per cent of the economy is based on services, and service exports are performing better than goods.

## 6. TRADE AND THE PRIVATE SECTOR

Kosovo's economy since 1999 has been mostly supported by international assistance, public sector and remittances. The role of the private sector, especially SMEs has been relatively weak. Nevertheless, Kosovo is still in the transition phase in which entrepreneurship and small business creation is expected to play an important role on the road to a modern economy, free market and thus towards development and economic growth.

As discussed in Chapter 2, Kosovo suffers from a large negative trade balance. Part of the problem is the fact that Kosovo's SMEs are not internationally competitive. SMEs weak export competitiveness hinders the contribution of SMEs to GDP, job creation, and welfare in general. The growth of SMEs in Kosovo has been limited as a result of various factors, mainly related to the business environment, energy supply, and so on. According to EC Kosovo Progress Report (2010)[22] there are several barriers to doing business in Kosovo. The first is unreliable electricity and water supply, the second is limited access to finance for private sector companies to expand output and production capacities, and the third is related to weaknesses in law enforcement and weak rule of law.

The MTI's Department of Trade has recognized that more effort is needed to remove barriers to business investment, growth, and job creation at all levels of government, and to simplify bureaucracy is a key to promoting development in the SME sector. This is especially significant since regulatory and legislative barriers tend to have greater impact on SMEs than on other businesses. The challenge is to build on and integrate the regulatory reform components of the various initiatives underway relating to European integration, investment, and legal and competitiveness reforms.

Since the 2008 declaration of independence, a tax reform was enacted and VAT collection was reorganized with the introduction of electronic fiscal register cashiers. These major steps were an attempt to reduce informality in the private sector and to improve relations between the business community and the state. Tax revenues have significantly increased due to the decrease of the tax rate from 20% to 10% in combination with improved compliance, a broadening of the tax base and a larger and more efficient reorganization of the tax collection process.

Some improvements have also been made with regards to legal and administrative procedures: business registration can now be completed through the Municipal Business Centres (MBCs) established with World Bank support. The Kosovo Business Registration Agency (KBRA) publishes an online registry and issues a single identification number for

[22] http://ec.europa.eu/enlargement/pdf/key_documents/2010/package/ks_rapport_2010_en.pdf.

each company that applies to all state institutions such as the business registry, tax authority and the pension fund. This allows for a reduction in the number of administrative and registration steps that companies need to undertake.

Trade links to the region will improve as infrastructure improves. The highway to Albania is completed and access to ports enables Kosovo businesses faster and cheaper transportation costs, while on the other hand the highway to Skopje, currently under construction, will further reduce transport costs and increase regional trade integration.

## 7. TRADE FACILITATION

Distance still plays a major role in international trade. Indeed, it is the most significant determinant of trade costs. The existence of political borders and other logistical impediments further increases trade costs. Sources of unnecessary trade costs include: cumbersome procedures, documentary requirements, excessive and underdeveloped risk-based inspection systems, poorly equipped and corrupt administrations, lack of technical capabilities, insufficient flow of information, poor cooperation between border agencies, etc.

To reduce unnecessary trade costs, in 2013 the WTO members signed the Agreement on Trade Facilitation, which will enter into force once two-thirds of members have completed the domestic ratification process. The Trade Facilitation Agreement contains provisions for expediting the movement, release and clearance of goods, including goods in transit. It also sets out measures for effective cooperation between customs and other appropriate authorities on trade facilitation and customs compliance issues. It further contains provisions for technical assistance and capacity building in this area. The expected cost reductions in international transactions from this Agreement are sizable (Box 7 provides estimates by OECD).[23]

Box 7. Trade costs and the WTO Trade Facilitation Agreement

**The OECD has calculated the potential benefits of the Agreement for various groups of countries, using the original OECD Trade Facilitation Indicators. In general, the scenarios reveal that:**

- **The potential cost reduction from a "full" implementation of the WTO Trade Facilitation Agreement is 14.1 per cent of total costs for low-income countries (LIC), 15.1 per cent for lower middle-income countries (LMIC) and 12.9 per cent for upper middle-income countries (UMIC).**
- **If counties limit themselves to the mandatory provisions of the agreement, the potential reduction reaches 11.7 per cent for LICs, 12.6 per cent for LMICs and 12.1 per cent for UMICs, 2.4, 2.5 and 0.8 percentage points less than if they "fully" implemented best practices.**

**Specifically, calculations show:**

[23] More generally, others have also estimated the benefits from overall trade facilitation reforms. A report by the World Economic Forum (2013) shows that lowering supply chain barriers could deliver a significant global economic growth. Improving even a restricted set of supply chain hurdles – border administration and transport and communications infrastructure – halfway to global best practice could lead to increases of 15 per cent in trade and of nearly 5 per cent in global GDP. By comparison, completely eliminating tariffs could have a much less significant effect: it would increase global GDP by barely 0.7 per cent, and exports by 10 per cent.

- **Harmonising and simplifying trade documents would reduce trade costs by 3 per cent for LCI and by 2.7 per cent for LMIC;**
- **Streamlining border procedures would bring further trade costs reductions of 2.8 per cent for UMIC and 2.3 per cent for LMIC;**
- **Automating trade and customs processes would also reduce trade costs by 2.4 per cent for LIC, 2.3 per cent for UMIC and 2.1 per cent for LMIC;**
- **Ensuring the availability of trade-related information would generate cost savings of 1.7 per cent for LIC;**
- **Advance rulings on customs matters would also bring cost reductions of 1.3 per cent for UMIC;**
- **The opportunity cost is expected to be lower for the group of UMICs because many of the countries already implement some of the measures that are now formulated on a "best endeavours" basis.**

***Source:*** **OECD (2014).**[24]

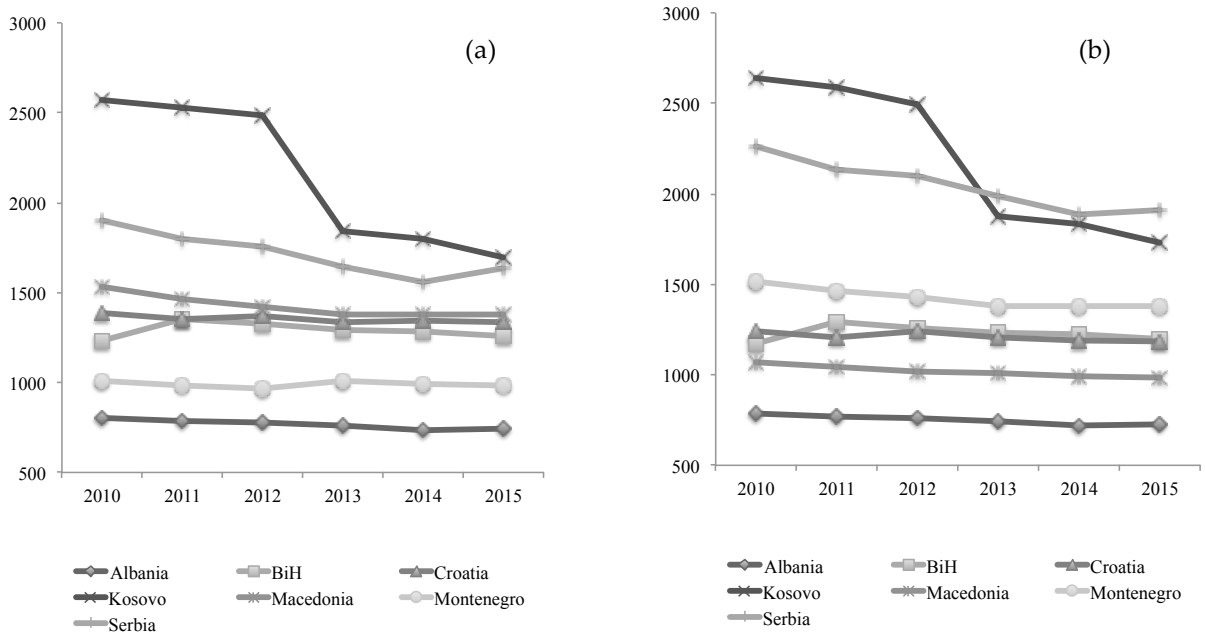
Similarly, CEFTA countries, including Kosovo, have identified logistical and border-related barriers as one of the most significant impediments to a greater flow of goods between regional partners, but also to a deeper integration with the rest of the world. The analysis shows that the region lags behind many advanced countries in terms of trade facilitation reforms. As the World Bank Doing Business (WBDB) Trading across Borders (TaB)[25] indicator shows, the cost of importing and exporting are on par with the average in Latin America and the Caribbean, while much higher than in OECD high-income countries and East Asian and Pacific countries. Based on the TaB "distance-to-the frontier" measure[26], the CEFTA region scores 72.6, which is similar to East Asia and Pacific countries and Latin America and Caribbean, and much worse than the OECD, which scores 86.1. In CEFTA, poor scores tend to be related to the number of documents required for both imports and exports, which is double the average of what OECD countries require. In addition to high import and export costs, the time required to clear goods through customs in CEFTA countries is over 30 per cent higher than that of high-income OECD countries.

[24] http://www.oecd.org/trade/tradedev/WTO-TF-Implementation-Policy-Brief_EN_2015_06.pdf.

[25] WBDB TaB indicator measures the time and cost (excluding tariffs) associated with exporting and importing a standardized cargo of goods by sea transport. The time and cost necessary to complete 4 predefined stages (document preparation; customs clearance and inspections; inland transport and handling; and port and terminal handling) for exporting and importing the goods are recorded; however, the time and cost for sea transport are not included. All documents needed by the trader to export or import the goods across the border are also recorded.

[26] This measure illustrates the distance of an economy to the "frontier", which represents the best performance observed on each Doing Business topic across all economies and years included since 2005. An economy's distance to frontier is indicated on a scale from 0 to 100, where 0 represents the lowest performance and 100 the frontier. For example, a score of 75 in 2012 means an economy was 25 percentage points away from the frontier constructed from the best performances across all economies and across time.

Figure 22. Cost to exports (a) and imports (b)




*Source*: www.doingbusiness.org.

Disparities in trade costs exist even within the CEFTA region. In the overall TaB ranking, Montenegro is the highest-ranking country, coming 52nd, followed by Macedonia (85th), and Albania (95th). Kosovo is ranked the lowest at 118 out of 189 countries. Kosovo, and other CEFTA poor performers on average require more documents to import and export, and the costs of import and export for a regular container are higher. For instance, Kosovo and Serbia have the highest average cost for imports and exports, although in the last two years Kosovo has managed to reduce import costs significantly (see Figures above). As the World Economic Forum (2013) notes, the most direct benefit of eliminating supply chain barriers is a reduction in cost to trading firms and thus lower prices for consumers and for businesses that import materials used in their production activities. If so, for Kosovo the reduction of import costs is of great importance as Kosovo's manufacturing sector relies heavily on imported inputs. All countries require between six and eight documents to export, while documents required to import vary between five in Montenegro and eight in Albania, Bosnia, and Macedonia. The number of days to complete an export transaction ranges between 12 days in Macedonia to up to 19 days in Albania.[27]

However, improving logistics and border-related issues is a complicated undertaking. First, many border agencies are involved (e.g. customs, food and animal protection, police),

[27] All these figures should be taken with caution. The reader is advised to consult the methodology of constructing WBDB TaB indicator at http://www.doingbusiness.org/data/exploretopics/trading-across-borders.

frequently with different objectives and mandates. What makes matters even more complicated is the fact that the success of the logistics and border-related reforms undertaken by one country is dependent on what the other countries that it shares its borders with do (especially if the former country uses the latter as a gate to international markets). Hence, when talking about trade facilitation reforms, a two-fold approach is required, one at the national level (part of improving overall business environment) and another one at the bilateral/regional level.

Unilaterally, the Government of Kosovo has initiated trade facilitation reforms as part of a broader set of reforms aimed at improving the business environment. The most important reforms were undertaken after 2010. In October 2011, the Kosovo Customs decided to remove most of the then required documents for import and export. According to Administrative Instruction 2011/01, Kosovo Customs requires only three documents for export, and two import documents. However, this development seems not to have had much effect in practice as the eliminated documents are required by other international conventions (e.g. bill of lading, CMR, etc.), so businesses have to produce them in any case in order to complete goods transactions.

Red tape in trade-related procedures is still evident. For instance, apart from other administrative requirements to establish a business in Kosovo, in order to operate internationally, businesses have to obtain an import/export license by Kosovo Customs. Obtaining the export/import license is a cumbersome process that requires submitting ten different documents/information. Second, for specific products there are specific documentary requirements. For instance, the Kosovo Food and Veterinary Agency (KFVA) requires a specific set of documents and applies different procedures for plant and animal goods. For instance, a typical list of documents required by the KFVA for an import of plant/animal good are as follows: declaration of goods, invoice, health certificate issued by the competent authority in the country of origin, lab results from a recognized authority in the country of origin, Common Veterinary Entry Document, and certificate of origin. In cases when KFVA requests laboratory testing for imported products, the completion of procedures takes even longer. Finally, a number of goods requires a specific import license, frequently from different institutions. For instance, MTI issues eight import licenses in the oil industry; the Ministry of Environment and Spatial Planning issues two special import licenses; the, Ministry of Agriculture issues six types of licenses; KFVA issues two; Kosovo Medicines Agency issues 18; while the Kosovo Agency for Radiation Protection and Nuclear Safety issues three types. All these requirements increase the burden to business in terms of costs and time.

At the bilateral level, Kosovo has worked closely with its Albanian counterparts to facilitate

trade, specifically transit. Before the construction of the highway between Kosovo and Albania, Kosovo businesses primarily using Greek ports for transport of goods. Since the completion of the highway to Albania, Kosovo's import/export companies increasingly rely on Albanian ports for transit to/from Kosovo. In view of these developments, the Kosovo and Albanian Government in 2014 decided to sign a Transit Facilitation Agreement with the aim of easing the procedures for transit of goods entering through the Port of Durres and destined for Kosovo by reducing physical checks and the level of inspections. The Agreement aims at producing a more streamlined exchange of data and information between the respective border agencies, including Customs and the Food and Veterinary agencies.

At the regional level, Kosovo is partaking in trade facilitation reforms through CEFTA mechanisms. The latter's trade facilitation agenda is linked to the WTO Trade Facilitation Agreement. Based on this Agreement, and within the framework of the South East Europe 2020 Strategy, CEFTA is in the process of transforming its internal organisational structures. Bearing in mind the importance of trade facilitation, in November 2014 CEFTA has established a Committee on Trade Facilitation. The Committee is responsible "to develop and broaden cooperation among CEFTA Parties … particularly to address the issues which are related to facilitation the regional trade in CEFTA with a view to reduce costs caused by the inefficient all types of clearance procedures, while balancing trade facilitation with the increasing requirements for safety and security measures in the international and regional supply chain". The national counterpart will be the National Trade Facilitation Committee, which will be established in each CEFTA member state by the end of 2015.



The major area of intervention within CEFTA trade facilitation framework will be the simplification, harmonisation, and standardisation of procedures and documentation. Simplification incorporates the process of eliminating all unnecessary elements and duplications in formalities, processes, and procedures. Harmonisation, on the other hand, means the alignment of national procedures, operations and documents with the EU Acquis, and other international conventions, standards and practices. Finally, standardisation is the process of developing internationally agreed formats for practices and procedures, documents and information.

Finally, in May 2014 Kosovo has produced a self-assessment based on the WTO Trade Facilitation Agreement. The exercise aimed at identifying the major policy and institutional gaps in relation to the Agreement. According to the assessment, a number of issues require immediate action, including: information exchange, post-clearance audit, risk management, pre-arrival procedures, electronic payment, notification procedures, consultation procedures, fees and charges on imports and exports, authorized operators, and other areas.

# 8. TRADE AND DEVELOPMENT ISSUES IN KOSOVO

This section discusses the relation between trade and development, and offers an assessment of how trade policy and performance over the past 15 years have contributed to promoting economic and social development in Kosovo.

## 8.1 Concepts and relations

Promoting international trade is a fundamental component of any successful development strategy. World markets – especially OECD markets (e.g. the EU) are an important source of demand for developing countries' manufactures. They are also an important source of technology and capital – two production factors which are scarce by definition in lower-middle income economies such as Kosovo. As such, hardly any late developer has ever succeeded in increasing incomes and reducing poverty under conditions of autarky. Unsurprisingly, the balance of existing evidence suggests that "outward-orientation" – meaning a relatively high share of external trade in GDP – is correlated with higher rates of economic growth.[28]

What this correlation tells us for purposes of policy-making is, however, ambiguous: is it domestic growth that increases foreign trade, or is it foreign trade that promotes productivity and output growth at home? In all likelihood, both processes are at work: growth of domestic productivity and consumer demand will lead to higher volumes of exports and imports (respectively), while exposure to world markets will intensify competition and force productivity improvements upon domestic firms.

If trade is at least partly a *consequence* of development, the question arises as to how we can get firms over the initial hump of competitiveness, and enable them to break into export markets. Outward-orientation per se is not a solution to the problem of nurturing export sectors at *early* stages of industrial development, although it is undoubtedly essential to consolidate and expand already-competitive sectors.

In addition to this, there is a growing consensus that some modes of integration into the global economy are better for growth than others. A highly integrated import-dependent economy that does not export might grow in the short haul; but it is bound to run into balance-of-payment problems that will inevitably bring growth to a sudden halt at some point down the line.

[28] E.g. D. Dollar and A. Kray (2004), "Trade, Growth and Poverty", *Economic Journal,* 114: 22-49; J. Bhagwati (2004): *In Defense of Globalization,* Oxford: Oxford University Press, pp. 60-64

The forces of comparative advantage might also push an economy into specializing in primary commodities (e.g. mineral ores) or low-value added manufactures (e.g. apparel assembly). This might lock the economy in what Jagdish Bhagwati called in 1958 the "paradox of immiserizing growth"[29]: production of exportables goes up, but the international purchasing power of export revenues is rapidly eroded. Essentially, immiserizing growth occurs because of declining or deteriorating terms of trade – i.e. the tendency of the unit price of resource-intensive goods to decline in the long run relative to the unit price of technology-intensive goods. In low-value added export sectors, there is very little space to upgrade product quality and variety. Typically, these sectors do not have the capacity to induce positive externalities in the economy at large – in the form of investment, innovation and agglomeration. Moreover, rich-country demand for raw materials (e.g. minerals and many agricultural products) and low-technology goods (such as textiles) tends to decline over time, essentially due to the relatively low income elasticity of demand that characterises these products: as countries become wealthier, they consume more iPhones, but just about the same amount of coffee, copper and undershirts.

A good exemplification of the limits of investing in low-technology sectors – even when they conform to comparative advantage – is given by Mexico. After 1980, Mexico invested heavily in labour-intensive industries such as apparel, but stopped short of upgrading above a "cut-make-and-trim" model of sub-contracted manufacturing. As a result, a dynamic performance of the export sector was accompanied by a relative poor performance of overall GDP growth.[30]



These qualifications suggest that policy should not so much focus on promoting integration *as a goal in itself*. Rather, policy should harness integration selectively as a *tool of* and *means to* development. The purpose should be to catalyse *growth-enhancing* trade integration (Box 8), in order to maximise the value captured by the Kosovo economy from its participation in international markets. This means not only promoting exports, but also targeting those export sectors with both rising terms of trade and the potential to catalyse further (export-oriented) industrialization at home.

Box 8. Growth and development

**The relation between growth and development is highly disputed: is growth a sufficient indicator of genuine "development"? Are all growth episodes good from the point of development? In order to generate widespread and**

[29] See Bhagwati (2004), p. 55 for a summary of the argument.

[30] Palma G. (2008): "Flying Geese and Waddling Ducks: The Different Capabilities of East Asia and Latin America to "demand-adapt" and "supply-upgrade" productive capacity", available at: http://unctad.org/sections/gds_ecidc/docs/gds_ecidc_2010d07Palma_en.pdf.

**equitable gains in terms of poverty-reduction and increased standards of living, episodes of economic growth often necessitate complementary social policies to allow the poorest segments of the population to access expanding opportunities in a growing economy. These include the provision of public services, as well as equitable health and education policies to allow the poor to benefit from new employment opportunities. Recent evidence suggests that growth is "good for the poor", provided the appropriate policies are implemented to ensure that economic growth translates into genuine human development*. While "good" growth can be good for the poor, not all episodes of growth are exactly "good". In the short term, growth may be spurred by aid or oil windfalls, or speculative bubbles and consumption sprees. These episodes of growth do not represent "genuine" growth: no social policy can possibly render them equitable and developmental, and their unsustainable nature means they are bound to result in a growth collapse at some point. On the other hand, genuinely developmental growth is always accompanied by *structural change* in a country's productive economy: production is expanded through new investments, re-organized or made more efficient through technological improvements. Growth without structural change is bound to be short-lived**.**

**Source: Bhagwati (2004) and Palma (2008).**[31]

This raises the question of what governments and donor agencies should do to achieve this goal. The injunction to increase outward orientation is somewhat misleading because the share of exports in GDP is not something that governments can control directly. What governments control are trade *policies*. On this score, the available evidence is far from unanimous or conclusive. As noted by former Harvard economist Dani Rodrik, "there is no convincing evidence that trade liberalization is *predictably* associated with subsequent economic growth"; in fact, "the available studies reveal no systematic relationship between a country's average level of tariff and nontariff restrictions and its subsequent economic growth".[32] If anything, there is a long list of studies suggesting that both the currently advanced countries and the successful late developers (including, recently, the likes of China) grew behind significant trade barriers.[33] Whether trade liberalization makes economic sense should be decided on a case-by-case basis. What is sure is that sudden "big bang" liberalization more often than not leads to de-industrialization, increased unemployment and informality, and lower rates of economy-wide productivity, not least because it takes time (and, often, nurturing) for new sectors to emerge and replace the

[31] Bhagwati J. (2004), *In Defense of Globalization*, Oxford: Oxford University Press.

[32] Rodrik D. (2007), *One Economics, Many Recipes: Globalizations, Institutions and Economic Growth,* Princeton and Oxford: Princeton University Press, pp. 215, 217.

[33] O'Rourke K. and Williamson J. (2000): "Tariffs and Growth in the Late 19th Century", *Economic Journal,* 110: 456-83; Irwin D. (2000), "Did Late-Nineteenth-Century US Tariffs Promote Infant Industries? Evidence from the Tinplate Industry", *Journal of Economic History* 60(2): 335-60; Wade R. (1990): *Governing the Market: Economic Theory and the Role of Government in East Asian Industrialization,* Princeton: Princeton University Press.

previously protected sectors.[34] This insight is particularly relevant for transition countries such as Kosovo, which are confronted with the challenge of restructuring, and often entirely replacing largely uncompetitive state-owned sectors.

Thus, once again, the objective should be to focus not on trade openness *per se*, but rather on (export-oriented) growth. Trade openness is certainly an important component of growth enhancing export promotion. However, increased market access may prove a blunt instrument if not coupled with policy and institutional measures aimed at improving the business environment and developing nascent (export) sectors in the face of intensifying import competition.

## 8.2 Trade and (under-) development in Kosovo

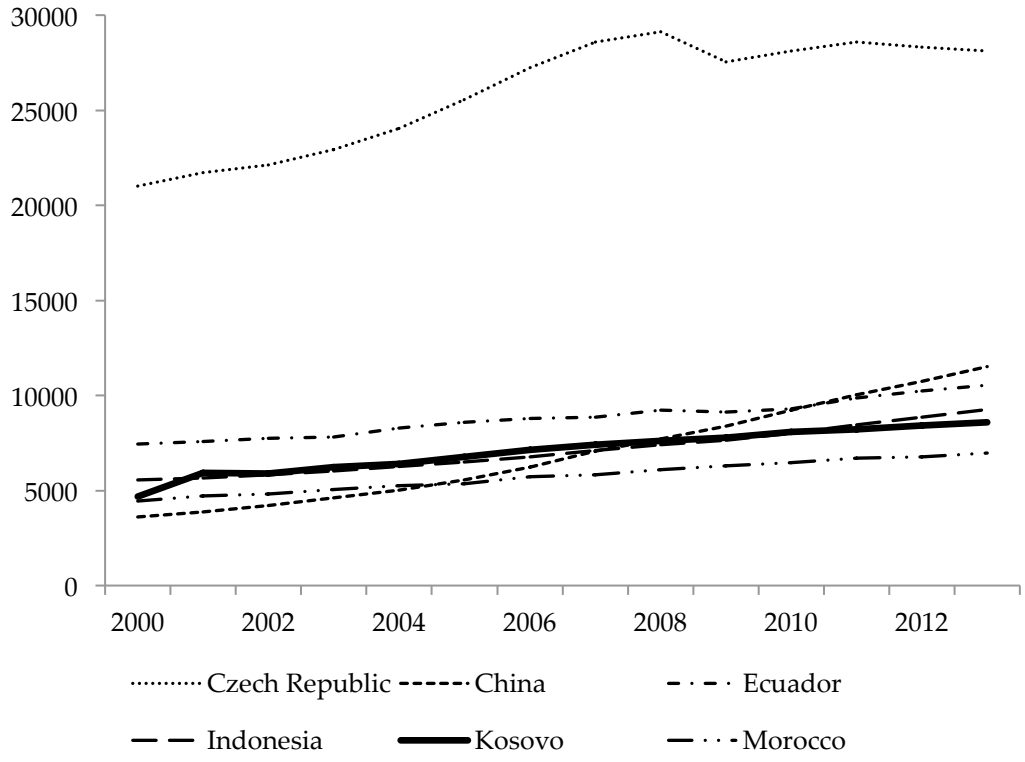
With external trade accounting for over 50 per cent of GDP ever since 2007, the Kosovar economy has achieved a significant degree of outward orientation, although mainly because of import growth. Thus, trade integration as such has not been growth enhancing, let alone developmental. This can be seen by looking at Kosovo's economic performance in relation to that of other late developers. Non-percentage growth rates of per-capita incomes – which measure the *absolute* rate of increase of GDP per capita – are well below the rates of change recorded in successful countries at similar per-capita incomes (e.g. China), not to mention the rates achieved by other high-performing late developers at higher incomes per capita (e.g. Botswana, Mauritius, Chile). Over the last 15 years, Kosovo has not been able to kick-start "catch-up" growth – that is, growth that puts a country on a trajectory of convergence to advanced-country incomes. In fact, Kosovo shows no sign of converging even to the levels of other post-communist countries that are now part of the EU: between 2001 and 2013, the income wedge between Kosovo and the Czech Republic has increased by nearly 25 per cent, the latter now being about 3.3 times as rich as the former (in per-capita terms).

This is the case even when GDP is measured at purchasing power parity (PPP). As shown in Figure 23, Kosovo remains a lower-middle income economy with GDP levels (and GDP growth trajectories) comparable to Ecuador, Morocco or Indonesia. This is paradoxical, considering that Kosovo – unlike China or Indonesia – has a small population, it is well endowed with natural resources, it enjoys proximity to advanced-country markets and has benefited from large volumes of development aid – indeed, amongst the largest in the world – and receives remittance payments from a vibrant diaspora community.



[34] Collier P. (2007): *The Bottom Billion: Why the Poorest Countries are Failing and What can be Done about it*, Oxford: Oxford University Press, p. 161; Rodrik (2007), p. 220.

Figure 23. Kosovo's GDP per capita (PPP, constant 2011 US$) in comparative perspective, 2000-2013




*Sources:* KAS (various years), and the World Bank *World Development Indicators* (various years)



The positive side of this story is that whatever growth has been achieved has indeed translated into relatively high levels of human development, essentially due to the high median years of schooling. In 2013/2014, Kosovo was no longer the country with the lowest HDI in the Balkan region. Indeed, it had the highest (excluding Croatia). From a broader perspectives, however, Kosovo's HDI, although classified as "high", is far below developed-country standards, and ranks in the same region as that of Belarus and Libya (Table 19). [35]

Crucially, Kosovo's recent growth experience has not been driven by structural change in the real economy. As discussed in Chapter 1, growth since 2001 was largely driven by (import-dependent) consumption – which averaged a staggering 105.6 per cent of GDP during 2006-2014[36] – leaving hardly any space to mobilize domestic savings for productive investment. For comparison, China (which has a similar GDP per capita but much higher real growth rates) has succeeded to effectively cap consumption expenditures at around 50 per cent of GDP since the early 1990s.[37] At the same time, investment volumes relative to

[35] Since Kosovo is not a UN member, the HDI is calculated by the UNDP Kosovo.

[36] Household consumption alone amounted to an average of 88 per cent of GDP during 2006-2014.

[37] These and the following figures are author's calculations based on data from the World Bank *World Development Indicators.*

GDP are well below levels recorded in late developers overtly pursuing catch-up strategies. For instance, during 2005-2013 capital formation in China and Botswana averaged 45.2 per cent and 33.8 per cent of GDP, respectively, while Kosovo invested, on average, 29.4 per cent of its GDP – and mostly in non-tradable sectors such as construction and services (see Chapter 1). As a result of limited growth-inducing structural change, the share of manufacturing in GDP (11 per cent on average since 2006) is well below the level recorded in successful late-developers, including China (32.3 per cent), Malaysia (24.8 per cent) and Thailand (34.5 per cent).

Table 19. Kosovo's HDI in Comparative Perspective, 2013/2014

| Country | HDI score |
|---|---|
| Czech Republic | 0.861 |
| Kosovo* | 0.786 |
| Belarus | 0.786 |
| Libya | 0.784 |
| Serbia | 0.745 |
| Albania | 0.716 |

*Sources:* UNDP datasets; UNDP Kosovo, *Human Development Report 2014,* p. 85; *Notes:* 2014



While there are many reasons for Kosovo's poor economic performance, some have to do with the way Kosovo has become integrated with the world economy over the last 15 years. For one thing, most of the outward orientation of the Kosovar economy is due to its reliance on imports to satisfy domestic demand, rather than its capacity to produce goods that are in demand in world markets. Kosovo's import dependence is bound to generate serious balance-of-payment problems in the future, especially when aid and remittance inflows will start to tighten, and if debt continues to grow as an increasingly important source of finance for (import-dependent) consumption (see Chapter 1). A sudden contraction in aid and remittance earnings, coupled with non-performing loans, could generate a growth collapse, which would not only force painful adjustments at the level of the current account, but also squeeze domestic demand for domestic products (since Kosovo uses the Euro as legal tender). A squeeze in domestic demand would force many manufacturing companies into bankruptcy, with negative effects on employment and exports.

Secondly, it is difficult to argue that exposure to import competition has prompted domestic firms to increase productivity and raise their competitiveness, promoting growth in

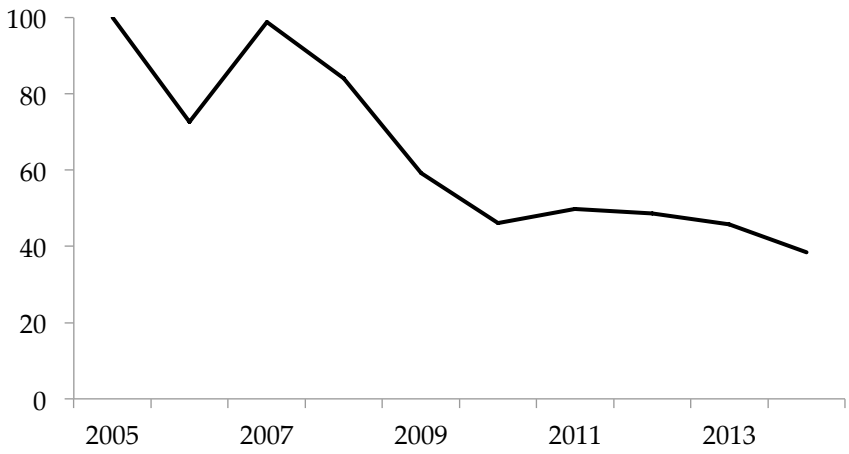
manufacturing value added. If anything, the rapid and sudden increase in import volumes may have contributed to "stifling" Kosovo's productive economy. Indeed, since the early 2000s, imported goods substituted and displaced domestic production in a number of sectors, most notably in intermediate goods (since Kosovo produced very few finished manufactures while under Yugoslavia) but also in some finished-goods sectors. To give a few examples: nickel ores imports (mostly from Indonesia and Guatemala) have increased at a year-on-year average of 18.8 per cent since 2005 (or €1.8 million a year), slowing down the re-activation of nickel mines in Drenas; imports of batteries and accumulators (HS 8506-7), formerly produced in Peja, Mitrovica and Gjilan, have grown 9 per cent a year (or €335,000); cigarette imports from the EU have increased at a yearly rate of 11.3 per cent (or € 3.5 million), adding further difficulty to the reactivation of tobacco processing plants in Prizren and Gjilan.

The ailing state-owned sector needed time and resources to re-structure and overcome the legacies of war damage and neglect in the 1990s; new start-ups required investment and nurturing in order to travel up the learning curve and reduce costs to internationally competitive levels. Sudden import liberalization in the aftermath of the war might have contributed to thwarting both processes, preventing Kosovar firms from getting on a productivity escalator. This is because most of Kosovo's industrial firms are actually *below* the threshold level of competitiveness above which import competition becomes a catalyzer, rather than an inhibitor, of productivity growth.

In a survey of 111 industrial-sector firms in Kosovo[38], 54 per cent of respondents indicated that they either "agreed" or "strongly agreed" with the statement: "one of the main barriers to growth in your industrial sector is import competition"; only 27 per cent "disagreed" or "strongly disagreed" with this statement, and most of these respondents were from sectors producing goods that are effectively non-tradable due to low value-to-weight ratios and therefore enjoy "natural" protection from import competition (e.g. concrete, stones). In this respect outward orientation as promoted by a rather liberal policy has proved far from growth enhancing.

[38] Luca J. Uberti (2015): *Survey of Industrial-Sector Firms in Kosovo,* Regional Research Promotion Programme, University of Fribourg (the data are available from the author upon request).

Figure 24. Kosovo's terms of trade, 2005-2013 (base year 2005)




*Sources:* Authors' calculations based on data from the KAS data, HS classification, 2-digit level of aggregation (excluding chapter 97); 2005 = 100.

Thirdly, due to its recent (re-)specialization in primary commodities and base metals, Kosovo's economy is likely to suffer from declining terms of trade (see Box 9), suggesting that its "mode of insertion" into the global economy is not growth enhancing. Figure 26[39] shows that, at least in the short-run Kosovo's ToTs with the rest of the world have worsened quite significantly. Since 2005, the average unit price of exports has declined by over 50% relative to the average unit price of imports, indicating a deterioration of Kosovo's international purchasing power.



Box 9. Terms of trade

**The net barter terms of trade index (ToT) measures the average unit price of exports relative to the average unit price of imports. The values in Figure 26 are obtained by calculating the percentage ratio of the export price index to the import price index. The price index is the weighted average of each product category *k*'s unit price (trade value *X* in US$ divided by net weight *w*), with the current year's trade shares as weights*:**

$$\sum_k \left( \frac{X_k}{w_k} \frac{X_k}{\sum_k X_k} \right)$$

**The unit prices for each year are then normalized relative to a base year. When calculating ToTs for specific product categories (as in Table 20), it is sufficient to simply divide trade values by net weights. This reduced formula assumes that 2-digit product categories may be considered enough homogenous internally to not require a calculation of averages between sub-categories.**

***Source:*** **Gashi and Linotte (2015).**

[39] Chapter 97 ("Works of Art, Collectors' Pieces and Antiques") was removed, as the data were deemed to include errors. The calculations with Chapter 97 are available from MTI upon request.

Table 20. ToTs by main export product, averages over 2005-2013 (base year 2005)

| | Export Share | ToT |
|---|---|---|
| Iron and Steel (72) | 42.90% | 470 |
| Ores and Concentrates (26) | 7.07% | 680 |
| Copper and Articles Thereof (74) | 4.06% | 107 |
| Raw Hides and Skins (41) | 3.66% | 61 |
| Articles of Iron and Steel (73) | 3.49% | 60 |
| Beverages (22) | 3.11% | 107 |
| Aluminium and Articles Thereof (76) | 2.99% | 99 |
| Rubber and Articles Thereof (40) | 2.17% | 109 |
| Plastics and Articles Thereof (39) | 2.03% | 128 |
| Man-made Staple Fibres (55) | 1.62% | 130 |

*Sources:* Authors' calculations based on data from the KAS data, HS classification, 2-digit.

Of course, a short-term decline in the terms of trade might be dictated by temporary fluctuations in world market prices (as is evident between 2005-6). Thus, the trend in Figure 26 does not necessarily imply that Kosovo is bound to fall prey to Bhagwati's paradox of "immiserizing growth". Still, this short-term trend is consistent with the widely accepted notion that primary commodity exporters are likely to suffer from declining terms of trade in the long run (Prebisch-Singer thesis).

What is encouraging is that *sector-level* ToTs – which compare import and export prices *in specific product categories*, rather than across the external sector at large – display *improving* ToTs for many of Kosovo's export products (Table 20). For instance, the unit price of Kosovo's main export product (i.e. ferronickel) increased nearly five times since 2005 *relative to* the unit price of imports in the iron and steel category (e.g. metal sheets and rolled coils for the metal processing industry). Similarly, the international price of Kosovo's main mineral exports (e.g. lead and zinc) increased nearly seven times since 2005 *relative to* the unit price of raw material imports (e.g. copper and nickel ores).

Primary commodity and base metals are typically subject to large and frequent price swings, so these results should be interpreted carefully. In fact, Kosovo's manufactured exports, including the metal tubes and pipes (HS 73) and Kosovo's wines and beers (HS 22), display stable or deteriorating terms of trade. On the upside, the unit price of Kosovo's plastics exports (e.g. PVC windows, plastic bags and tubes) has increased nearly 28 per cent relative

to the price of plastics imports (e.g. intermediate goods for plastics manufacturing), suggesting that Kosovo's plastics products are finding a niche in international markets. The same applies to Kosovo's artificial fibre exports (HS 39). That said, the average unit price of Kosovo's main exports actually declined if compared to the average price of imports more generally (rather than to the unit price of imports in the same categories as the main exports), as demonstrated by Figure 26.

## 8.3 Trade policy for development

While trade liberalization is often associated with developmental outward orientation, Kosovo's "big-bang" approach to liberalization is likely to have contributed to the decline of domestic manufacturing, partly inhibiting export growth. With an average tariff rate of just over 8 per cent and close proximity to OECD markets, a large influx of highly competitive manufactures (mostly from the EU) was bound to make its way into the Kosovo market (see Chapter 2). A low rate of import protection also contributed to the decline of former trade relations between Kosovo and other Yugoslav successor states.

At the same time, it is possible that market access into the EU might not have had a very large effect on Kosovo's exports, which are dominated by products with low price and income elasticities of demand (that is, products where demand does not increase significantly if the price goes down or if the buyer has a higher income).[40] That said, market access might prove crucial in future if Kosovo is to develop higher-value added export industries, which tend to be characterised by higher price elasticities of demand, and hence greater sensitivity to tariff rates in the destination countries.

Having secured almost unrestricted market access in a large developed-country market (through the SAA with the EU), Kosovo should now focus its future trade policies on the supply side of outward trade. For Kosovar exporters, market access is not as pressing a problem at the moment as supply bottlenecks or import competition. Indeed, many successful export sectors in Kosovo (e.g. food and beverages, metal-processing[41]) arguably developed thanks to a relatively high Effective Rate of Protection made possible by the joint effect of a 10% tariff rate on competing foreign goods and a tariff waiver on imported inputs (e.g. metal sheets) and machinery. Additionally, trade policy should focus on developing



[40] Gashi P., and Pugh G. (205): "Kosovo's Trade with the European Union: Looking beyond the Stabilisation and Association Agreement", KFOS: Prishtina

[41] Including the production of large-diameter pipes and radiators for export.

* This is the definition and methodology used by the World Bank (see http://data.worldbank.org/indicator/TT.PRI.MRCH.XD.WD).

supply-side measures aiming to upgrade technical skills and production capabilities in promising sectors, with a view to enabling them to quickly reduce costs and become internationally competitive. Targeted measures to improve the business environment in specific export sectors should also be developed.

## CONCLUSIONS

The aim of this report, as the first in a series of annual reports, was to provide a bird's-eye view on trade developments in Kosovo from a broader policy and institutional perspective, and how trade affects private sector development, growth, and welfare in general. Moreover, the report argued that the policies employed so far (notably trade liberalisation and market access related policies) have had limited results in boosting Kosovo's export sector, and other policy approaches should be taken into consideration, notably supply-side industrial policies.

The report utilizes various data sources, and relies heavily on a number of indices to show tendencies in the external trade sector. The following points provide a summary of the aspects discussed/analysed in the report:

- The Kosovar economy is still encountering various structural problems. Trade-related institutions are still weak (especially when it comes to enforcement), the workforce is poorly equipped, while the business environment requires fine-tuning. This, in turn, affects the overall performance of the economy, particularly the development of a strong private sector, which would make the country internationally competitive. In these circumstances, Kosovo's weak domestic production base, resulting also in a poor performing external sector, is not contributing to economic growth and development.

- The structure of the external sector shows high levels of concentration of exports in unprocessed minerals and base metals, and other related products. This makes the Kosovar economy vulnerable to price and demand shocks in international markets. Hence, diversification of economic activity is paramount, especially into higher-value added manufacturing sectors. The performance of services in export markets shows encouraging signs, but the data are biased by the presence of "virtual exports", which are not a proper indicator of the level of *international* competitiveness of service sector in Kosovo.

- The persisting structural problems that the economy faces have created a high-risk/low-return environment for businesses, negatively affecting firms' investment decisions. As a result, firms in Kosovo generally lack technical capabilities and skilled human resources. The latter two are a precondition of high levels of productivity – a major ingredient in strategies aiming at the international expansion of firms. An encouraging sign is a closer coordination between the government and

the private sector through trade coordination mechanisms introduced by MTI, as well as a comprehensive legislative framework on trade.

- The tax policy introduced in the aftermath of the 1999 war has narrowed immensely the scope of trade policy-making in Kosovo. In particular, it has constrained the use of tax instruments to protect/support domestic industries. The current tariff levels hardly provide any protection to domestic sectors. Non-tariff measures on the Kosovo side are virtually non-existent; even when applied, they do not discriminate against imports. On the other hand, Kosovo's exporters face significant non-tariff barriers when entering foreign markets (especially advanced-country markets); at the same time, many of the non-tariff barriers erected by Kosovo's CEFTA partners lack a serious economic rationale.

- For Kosovar producers, market access is no longer a major issue (if it ever was at all). With CEFTA in place, and the SAA with the EU and the FTA with Turkey impending, over 80 percent of outward trade is/will be liberalized. Still, the liberal trade policies of recent years have largely fallen short of delivering the expected results – that is, a creation of a strong manufacturing base and a well-performing private sector emerging from increased levels of competition. On the contrary, the liberalisation of international trade has further aggravated Kosovo's import dependency, widening the trade deficit. The Government of Kosovo has to take into account these developments before it decides on the course it takes on WTO membership. In principle, the latter decision should conform to Kosovo's development goals, and should be based on a clear understanding that WTO membership (or further liberalization) would indeed support manufacturing development and export-led growth.

- Border-related procedures still remain an issue for Kosovar and regional businesses. Cumbersome inspection procedures, documentary requirements, poorly equipped and corrupt administrations, lack of technical capabilities, insufficient flow of information, poor cooperation between border agencies, and the like, greatly affect many businesses around the region. Hence, trade facilitation reforms in the form of simplification, harmonisation, and standardization of procedures and documentary requirements either bilaterally or (preferably) within CEFTA should be encouraged.

- For Kosovo producers, including exporters, the most pressing problems at the moment are on the supply side, rather than on the demand side (e.g. accessing markets duty-free). In particular, they relate to producing internationally competitive goods that can meet product quality standards and satisfy consumer demand. This

calls for a more active role of government through targeted industrial policy mechanisms. This would aim at developing supply-side measures to upgrade technical skills and production capabilities in promising sectors, with a view to quickly reduce costs, increase quality, and become internationally competitive. In addition, the Government should continue to undertake measures to improve the business environment.

The report is by no means exhaustive. Some issues require further attention, especially FDI and the quality infrastructure. The latter two issues have not been analysed in great depth, but nonetheless are vital for a competitive export sector. Other issues require more in-depth analysis (i.e. econometric modelling), longer time-series, or better information from the ground (especially, micro-level analysis). These issues include the trade/growth relationship; the relationship between trade liberalisation and Kosovo's manufacturing base; productivity constraints and private sector development, and the like. Nevertheless, the report offers a rich repository of information and analysis on trade and trade-related developments based on which the Government, and especially MTI, can base their future actions, fine-tune their policies and strengthen institutions to trigger export growth.

# ANNEXES

## A.1. Identifying comparative advantage using a residual method

According to modern trade theory, the comparative advantages of countries are determined fundamentally by the level of technology.[42] This is because the availability of labour-saving technology leads to increases in labour productivity, effectively determining what a country can produce at the lowest opportunity cost (see Chart below).


Assuming that the level of technology can be proxied by income (with low-income countries having less labour-saving technology than high-income countries), a country's comparative advantage in a given product $k$ can then be seen as a function of GDP per capita. Since according to economic theory trade patterns do in fact conform to comparative advantage under conditions of free trade (i.e. comparative advantage is "revealed"), it follows that a country $i$'s export share in product $k$ may be written as:

$$\frac{x_{ik}}{X_i} = \hat{\alpha}_k GDPpc_i + \hat{\beta}_k \qquad (1)$$

where $\beta_0$ is a constant (or intercept). For technology-intensive goods (e.g. semi-conductors), $\alpha_k$ is positive, meaning that country $i$'s export share in $k$ increases with $i'$ income. Conversely, for labour-intensive goods (e.g. garments), $\alpha_k$ is negative, indicating that export shares in good $k$ decrease as a country grows: after all, at higher incomes (i.e. at higher levels of technology), a country's comparative advantage will naturally shift to high-technology goods[43].

The residual approach consists of measuring the degree to which a country $i$'s export matrix (the structure of export shares) differs from the "normal" export matrix that the country may be expected to have given its income level (i.e. its technology endowments). The "normal" export share for product $k$ is called "Chenery norm". Departures from the " Chenery norm" may suggest that sources of comparative advantage other than technology are operative

[42] Ray, D. (1998): *Development Economics,* Princeton University Press: Princeton, NJ, p. 631.

[43] Of course, high-technology countries are still likely to also be more efficient in textile production in *absolute* terms (i.e. relative to all other countries, including low-technology countries). Still, the prediction of economic theory is that countries specialize along *comparative,* rather than *absolute,* advantage lines.

(e.g. factor endowments); alternatively, they may signify genuine departures from comparative advantage due to market failures or policies "distorting" free trade[44].

The calculation procedure might be summarised as follows:

- Select the products $k$ in which you want to ascertain whether country $i$ has a comparative advantage. Ideally, calculations should be performed for all products $k$ making up country $i$'s export matrix.

  In Chapter 2, we selected, amongst others, Iron and Steel (HS 72), which are an important export product for Kosovo.

- For each $k$, estimate $\alpha_k$. To do so, regress the share of $k$ in country $i$'s total exports ($x_{ik}/X_i$) on country $i$'s GDP per capita. The regression should include as many countries $i$ as possible.

  For Iron and Steel, we regress export shares in 2014 on GDP per capita in 2014 for a sample of 113 countries (using STATA software and data from the UN Comtrade Database). The regression coefficient is $-2.37 * (10)^{-7}$, which turns out to be statistically insignificant, suggesting that export shares of iron and steel products do not change significantly with the level of technology (meaning that other sources of comparative advantage are more important in this sector, e.g. factor endowments).

- Use the estimated coefficients ($\alpha_k$) and equation (1) to calculate the predicted export shares of country $i$: i.e. the export share of $k$ that $i$ "should" have given its GDP per capita.

  For Kosovo, the predicted export share is ($-2.37 * (10)^{-7}$ * Kosovo's GDP per capita – the constant/intercept) = 0.0302 (i.e. 3.02%), considering that Kosovo's GDP per capita in 2014 was 3,989.717 (US$) and the constant estimated by the regression model is equal to +0.0311.

- Finally, compare the predicted shares with the actually observed export shares for country $i$. Subtracting predicted shares off actual export shares gives you the residuals, which signify a deviation from the "norm".

  While the share predicted by the model is 3.02%, the actual share (the empirical value) is 40.18%. This implies that the difference (the deviation from the "norm") is

[44] Jalilian H. and Weiss J. (2000): "De-Industrialization in Sub-Saharan Africa: Myth or Crisis?", *Journal of African Economies*, 9(1): 24-43

+37.2 percentage points. Statistically, this is equal to the magnitude of the error term for the Kosovo observation in the dataset.

- Interpret the deviation from the "norm" in terms of other sources of comparative advantage (e.g. factor endowments) or in terms of trade policy distortions.

  In the case of Iron and Steel in Kosovo, we interpret the deviation in terms of both comparative advantage (which seems to be determined by factor endowments rather than the level of technology) and policy distortions (the post-privatization subsidy).

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