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Current Transfers as the Main Source for Covering Trade Deficit –The Case of Kosovo

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The very high trade deficit is one of the main characteristics of the external sector of Kosovo's economy, which is a similar characteristic that can be found in many developing countries and transition economies.

This paper aims to examine the empirical data regarding the performance of the trade balance of the Republic of Kosovo for a period of seven years, and in turn analyze the field of current transfers, which has historically been the main source of coverage of high trade deficit. In the current account balance of payments two main items are identified: the trade balance and current transfers. The first item shows the deficit and the other one shows the surplus on billions euros. The interest in this study arises from compensatory relation that these two items have. In the first part of this paper the literature review about the trade deficit, trends and trade balance of Kosovo is analyzed; in the second part the unilateral current transfer item is analyzed, with particular emphasis on private transfers and remittances, whereas in the third part the legitimacy of these two items is confronted, the compensation amount and the consequences.

Keywords: *balance of payments; trade balance, current account transfers, remittances.*

Introduction

Kosovo's economy is a new and a dynamic one. Its fundamentals are transformed from a centralized economy to an open market economy. Currently, one of the main goals is the increase of competitiveness and the increase of export capacity aiming to reduce the trade deficit that Kosovo currently faces.

Kosovo's economy as a minor economic structure has a few internal strengths which can boom the country's economy, having in mind that it is dependent on inflows of capital from abroad which are recorded as flows in the account and the account of capital financial balance of payments.

One of the key features of the economy of Kosovo for the postwar period (1999-2014) in the external sector is the high trade deficit amounting to billions of euros with a small increase year by year, i.e in 2013 the deficit reached the amount of 2,156,444 euros; however compared with the previous year there was a decrease of 3.4%. (It is the first trade deficit that recorded a slight decrease) (SAK, 2014). The trade deficit continues to be a major cause for the high level of current account deficit. The current account deficit in Kosovo during 2013 decreased significantly reaching the level of EUR 244.1 million in 2012 compared with a drop of nearly 36%.

As a percentage of GDP, the current account deficit in 2013 was the lowest in recent years, reaching 6.6% of GDP. The decline in imports is considered as the factor which prevented the further deepening of the current account deficit and positive position within export of services in 2013, which led to a reduction of the deficit. Moreover, the impact on reducing the current account deficit was also the category of income and current transfer’s category. (CBK, 2014). Unilateral transfers, especially the private ones have historically influenced to alleviate the large trade deficit. Private transfers include money sent from abroad such as remittances, pensions and disability payments for those who have provided a specific service. The most dominant within the private accounts are remittances which appear as an indicator of the country's stabilization and development. Macroeconomic studies and many papers which support the positive role of remittances on economic growth show that although the figure is influenced by economic cycles of the country where they work and the motherland, they usually provide an important source of foreign currency, increase the national income, finance imports and contribute to the balance of payments. (Topxhiu R. 2010).

The true size of emigrants (remittances) in Kosovo is not known for the fact that a significant proportion of them come through informal channels and is always a challenge for Kosovo to adopt remittance flows account, within the area of current transfers. For the noted reasons, the analysis encompasses current transfers and its contribution to reducing the trade deficit in Kosovo.

A brief theory overview for the trade deficit

There is a considerable number of literatures about the trade deficit. For some, the trade deficit is a problem, for others it is not a problem. An overview of the trade balance in different countries suggests that many countries have experienced a trade deficit, and this issue is discussed in the national, international, economic and political arena. The debate about the trade deficit mainly evolves around its effects on the economy, its financing method and its nature (causes, size and duration). There are studies and institutions that focus on analyzing the issue from the perspective of developed countries and developing countries. In the first case, many studies argue that the trade deficit is not a problem, but other studies point out that the trade deficit reduces growth and development by fueling the financial crisis, de-industrialization, unemployment and so on. According to the conventional view, the trade balance reflects the competitive power of the country - the lower the trade deficit; the greater the competitive power of the country and the higher the economic growth.

The most popular views about the balance of trade stemmed from a group of intellectual authors of the seventeenth and eighteenth century called mercantilists. Mercantilists have advanced the theory that the country benefits from international trade depend on whether they trade balance of "favorable" (in the sense that exports are greater than imports). The mercantilists were businessmen, and they saw the country's trade balance with the same profit and loss statement of the firms. The major expenditures are revenues to (exports over imports) more profitable (most competitive) business is (place).

Thus, they argued that a country can benefit from the protectionist policies that encourage exports and discourage imports. Since most international transactions during the seventeenth and eighteenth centuries were paid with gold and silver, mercantilists supported a trade surplus so the country gather precious metals and by their arguments country becomes richer. (Krugman, Paul R. 2010).

Later, in 1752, David Hume presented a logical inconsistency in the mercantilist doctrine. He argued that the accumulation of capital in the form of gold by trading surplus increases the supply of money circulating in the country and this causes inflation. An increase of inflation, according to him, will influence the rise in prices of factors of production. From here, the country's trade surplus will soon lose competitive advantages in prices and wages for the fact that they will be higher compared to other countries at a time when the exchange rate remains constant. (Michaely, M., D. Papageorgiou, and A. Choksi, 1991)

Decades later, after Hume's thesis, economists like Adam Smith and David Ricardo provided additional arguments against the theory of surplus mercantilist trading for profit. They have argued that for the country the terms of trade are important - that is the relative price it pays for its imports to the price it receives for its exports. In 1776, Adam Smith argued that money for an economy are different from money to an individual or firm. The firm's objective is to maximize the difference between the import and export of cash money. "Import" money is the sale of goods whereas "exports of money are supplying labor and other production factors". However, for the economy as a whole, welfare consists of goods and services rather than gold. Money or gold is useful as a means of exchange and cannot be worn or eating. More money, at short and medium, will only result in a higher level of prices. (David M. Gould, Roy J. Ruffin & M. D. Anderson, 1996).

The views of mercantilist today are very dominant among many individuals and researchers who continually on the equation of Gross Domestic Product (GDP), which represents the amount of consumption (C), investment (I), government spending (G) and net-exports (EX-IMP), namely: GDP = C + I + G + X - M. It clearly shows the increase exports volume to GDP, while imports reduce GDP. This is wrong because the definition of GDP is just a tautology, and no conclusion about the possible causes. For example, it is also true that the volume of goods and services available in an economy (C + I + G) comprises GDP plus imports - exports that is: C + I + G = GDP + M -X. If viewed in this way, the trade deficit seems to be "appropriate" because we are interested in the country's consumption.

This is a matter of defining GDP. But the issue of trade deficit whether it improves or harms the economy cannot be shown through tautological manipulation. Theory and empirical evidence is necessary to evaluate whether deficits are favorable or unfavorable for the economy. (Michaely, M., D. Papageorgiou, and A. Choksi, 1991).

Analyzing US dispute, Mueller (2006), argues that the trade deficit problem is not in itself, but the problem is how to eliminate it when there is lack of external finance. In support of the view that the trade deficit is not a problem, the author argues that the flow of capital is a sign for an economy that is attractive and growing. Byrne and Derby (2003), researchers from USA, argue that the trade deficit can create unemployment or large external debt and economic and financial problems.

According to them, in one side, the trade deficit helps to meet the country's savings and increase the welfare of people and thanks to huge consumption is not trivial in the sense that it is associated with other macroeconomic variables. In a survey of the International Monetary Fund, Ghosh and Ramakrishnan (2006) perceive the current account deficit from three perspectives: as the difference between exports and imports of goods and services; gap between national investment and savings and international trade. If the deficit is due to investments (foreign) large, according to the authors, this reflects the low level of savings and there is no need for concern, provision of investment helps to increase output. If the trade deficit is financed by foreign capital as Australia and New Zealand did, is not bad, but it can be if there are problems with funding and if it is done by private withdrawal as the case of Mexico and Thailand.

Elwell (2008) provides a critical study about the trade deficit and brings together ideas from the perspective of optimistic and pessimistic view. Depending on the nature of the import and its use the trade deficit can be assessed whether it helps or it does not help the economy. It is best if imports are made to promote the production of marketable products or investment products. It cannot be considered bad if the trade deficit does not create problems with balance of payments, or does not decrease foreign exchange reserves, or if it is caused by short-term economic cycles. If the deficit is due to the building of the country or the industrial base, or the import of raw materials due to flow foreign aid and foreign direct investment in productive sectors, there is no reason for concern as they will cover imports in a near future. Moon (2001), in his paper presents how the trade deficit hinders economic growth of countries and leads to the accumulation of external higher debt , creates dependency on other countries, affects the distortion of national priorities, impacts on growth and slow development and a potential financial crisis in Latin America and West Asia countries.

A research about the causes and consequences of the trade deficit to 91 different countries from authors David M. Gould, Roy J. Ruffin & M. D. Anderson (1996), has resulted in an interesting conclusion that the trade imbalance has little effect on the rate of economic growth taking into account the fundamental determinants of economic growth. For most cases, the trade deficit is more a reflection of international borrowing and lending over time. According to them the deficit and trade surplus are part of efficient distribution of economic resources and distribution of risk at the international level that is critical to the long term health of the global economy.

Trade balance of Kosovo and developments

Balance of Payments in Kosovo continues to be characterized by a current account deficit and the surplus on the capital and financial account. The current account deficit (led mainly by the trade deficit), despite improvements during 2012 and the first half of 2013, remains at a relatively high level. Trade of goods, as the main component of the current account is constantly being characterized by a high trade deficit. (CBK, 2014).

The trade balance represents one of the items that is most dominating in the current account and its importance lies in that it gives us information about the trade exchange with the outside world and as such enables us to identify the power production of the country, the power consumption of that country, domestic demand, foreign demand, consumer trends or savings and gives us detailed information of which countries are closely linked economically, which are the most productive sectors and more fragile of the national economy.

Kosovo is an open economy; the share of exports and imports in GDP (or factor market opening, ie. export + import / GDP) was above 0.7 in 2010 (for previous years the situation does not change significantly), while in 2013 this share was 53.4% compared with 51.0% in 2012.

Trade (both imports and exports) is vital for a successful modern economy. Trade is critical to enhancing the competitiveness of the economy in the long run. There are numerous evidences that support this view. When enterprises and products are exposed in an international competition, economies are encouraged to focus on the area of their competitive advantages. This helps to ensure that scarce skills and resources are developed where they are most productive. Trade, among other things, increases competition (promote productivity and innovation), enables firms to capitalize on economies of scale by having access to a wider market and encourages the dissemination of skills, knowledge and innovation.

Although the share of foreign trade in GDP of Kosovo is relatively large, it is mainly dominated by imports; the export level is low, resulting in high trade deficit that is one of the main characteristics of Kosovo's foreign trade and one of the biggest challenges for the Kosovo institutions.

Table 1: Flow of goods in foreign market (000 €)

Years	**Export**		**Import**		**Trade balance**	**Percentage coverage**
1	**2**	Chain index	**3**	Chain Index	**4=2-3**	**5=2/3**
2001	10 559	-	684 500	-	-673 941	1.54
2002	27 599	261.38	854 758	124.87	-827 159	3.23
2003	35 621	129.07	973 265	113.86	-937 644	3.66
2004	56 567	158.80	1 063 347	109.26	-1 006 780	5.32
2005	56 283	99.50	1 157 492	108.85	-1 101 209	4.86
2006	110 774	196.82	1 305 879	112.82	-1 195 105	8.48
2007	165 112	149.05	1 576 186	120.70	-1 411 074	10.48
2008	198 463	120.20	1 928 236	122.34	-1 729 773	10.29
2009	165 328	83.30	1 935 541	100.38	-1 770 213	8.54
2010	295 957	179.01	2 157 725	111.48	-1 861768	13.72
2011	319 165	107.84	2 492 348	115.51	-2 173 184	12.8
2012	276 100	86.51	2 507 609	100.61	-2 231 509	11.0
2013	293 919	106.45	2 450 363	97.72	-2 156 444	12.0

Source: Statistical Agency of Kosova, External trade 2014, April 2014, pg., 10, authors' calculation.

Kosovo Foreign trade of the postwar period incurred upward trends of export and import. Despite the faster growth of exports, the low size of exports displayed relatively low impact in reducing the trade deficit in Kosovo.

Although, over the years, exporting capacity has grown, at the same time imports increased, while the trade deficit remained in a high level.

Trade with Kosovo is considered to be growing, given that the imports have reached a value of over EUR 2.4 billion while exports were close to EUR 300 million in 2013. Kosovo's economy is still heavily dependent on imports (the ratio between import and export is 8:1, i.e the coverage of imports by exports in the period surveyed on average over 8%). Limited integration with regional and global markets has 'saved' Kosovo towards a more emphatic display against the global financial crisis, but on the other hand it makes even limited foreign investment interest. Remittances remain the main pillar for the financing of the Kosovo economy.

Exports during the period 2001-2013 increased on average for 32% per year, whereas in 2009, due to the impact of the global financial crisis and the collapse of prices in international markets, exports decreased by around 18%, also in 2012 compared with the previous year we have a decrease of 13.5% for exports.

Kosovo's exports reached a value of 293.9 million euros, representing an annual increase of 6.5 percent (13.5 percent annual decline in 2012). In real terms, exports recorded a growth of 3.8 percent, an increase lower than nominal growth, which reflects the effect of rising prices of some minerals products that Kosovo exported in 2013.

The category with the highest share within total exports remains the category of base metals, which fell slightly in 2013, mainly due to the fall in metal prices during this period (Figure 1).

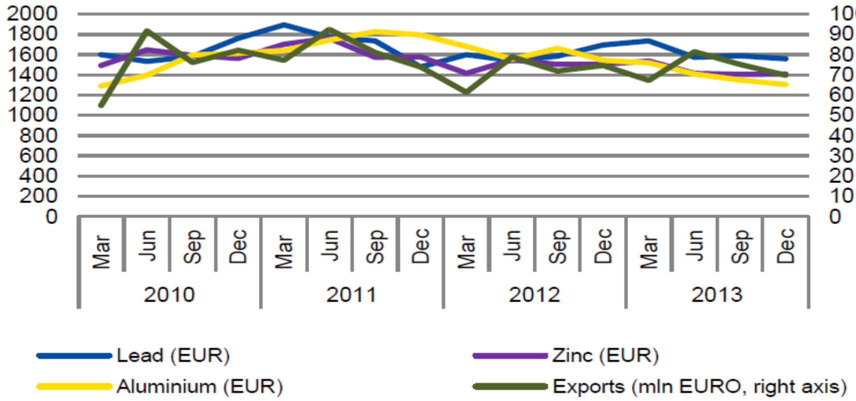

Figure 1: Total exports (non-cumulative) and international metal prices
Source: (CBK, 2013)

Meanwhile, exports of mineral products, beverages and tobacco, rubber products, and other plastics, and agricultural products contributed positively to the growth of exports to Kosovo during this period. The largest contribution to the growth of total exports during this period was the export of mineral products, which mainly consists of zinc and lead concentrate and electricity. (CBK, 2013).

An overview of the most promising would appear if taken into account the so-called "virtual" export- which includes the consumption of the international presence in Kosovo - according to which the export covers 20 per cent of imports (in the national accounts this part of export is considered "export of services") (MTI 2009). For the period surveyed, the trade balance of services has been largely positive and in 2013 it amounts to EUR 308.4 million.

Regarding trade partners, Kosovo mainly exports to European Union countries around 30.4% of total exports in April 2014 and CEFTA countries as around 47.3% in April 2014, and in other countries around 22.3 % of exports. Italy, Albania and Serbia are three countries in which Kosovo mostly exports, 16.7% respectively; 16.5%; and 12.7% of total exports. (SAK 2014).

Imports for the period 2001-2013 recorded an average annual growth for 11.2%, with an upward continued trend until 2013, however there is a decline of less than 3% compared with the previous year.

The increase in imports was slower than the growth of exports, however, the high size that imports have in the overall trade of Kosovo continues to neutralize the effect of increasing exports, so the rate of recovery in the annual average is around 7% while in 2013 the rate of coverage is 12%.

The total value of imported goods in Kosovo in 2013 was 2.45 billion euros, representing an annual decline of 2.3 percent (0.6 percent annual growth in 2012). In real terms, imports recorded an annual decline of 2.5 percent in 2013. Categories with the largest decline in imports in 2013 were imports of machinery, mechanical and electrical equipment, and vehicles.

For many years, food and related products have dominated the structure of imports (currently, this category of goods is in second place, with 12% of the total), while in recent years mineral products are the goods which were mostly imported, with 21.6 % of the total imports. The third category of imports is the machinery, appliances and electric tools, with about 11% of the total.

Growth in imports of minerals in one hand and of machinery, equipment and electrical equipment on the other hand, shows that Kosovo is steadily building its manufacturing base. Apart from trade in industrial goods, another important category of trade in goods are the agricultural products. Although considered as a sector with potentially significant comparative advantages, Kosovo agricultural producers have managed to export only products worth around 25 million € in 2011, compared with € 266 million to import. The situation has been more or less the same throughout the past decade, but a wider gap between exports and imports of agricultural products was recorded in 2011. The category of foodstuff, beverages and tobacco products, and vegetables, make up the largest amount of agricultural exports. They are mainly exported to Albania, Macedonia, Serbia and Germany. Regarding the import of agricultural products, Kosovo mostly imports prepared foodstuffs, beverages and tobacco, followed by vegetable products, live animals and animal products. (SAK 2014).

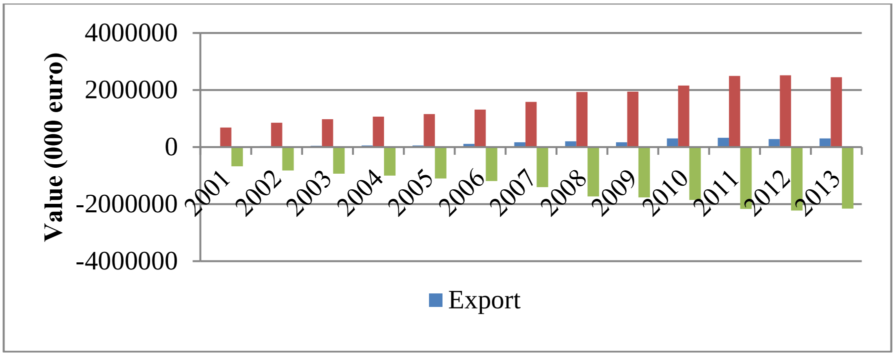

Figure 2: Dynamics of export, import and trade balance of Kosovo from 2001 to 2013 (000 euro)
Source: Statistical Agency of Kosova, External trade 2014, April 2014

Despite the positive trends in export growth over the years, Kosovo's trade deficit has been constantly deepened due to the enormous import that Kosovo has. The trade deficit from 2011 onwards reaches over 2 billion euro which represents over 40 % of Kosovo's GDP, while the share of trade deficit in the overall volume of trade (import / export + import) is an enormous, around 78 %. If the share of trade deficit in the total trade volume is small (eg. in the US about 12 %) then the trade deficit does not pose much problem for the economy (David M. Gould, et al. 1996). In the circumstances of Kosovo this high level of trade deficit seems to be quite a problem.

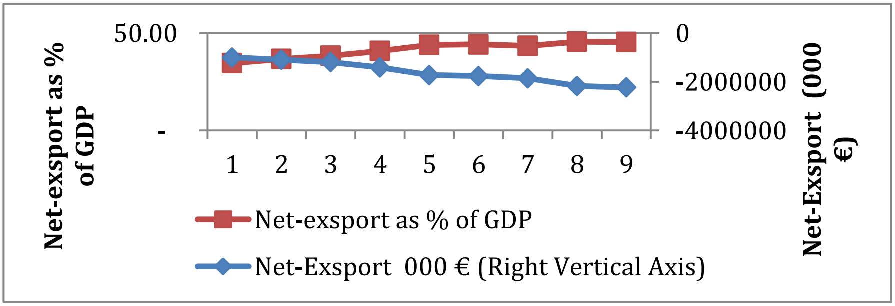

Figure 3: Trade balance as % of GDP and nominal value (2004-2012)
Source: CBK, 2012

The figures presented (fig. 2 and 3) and the noted analysis, we see that Kosovo historically has a trade deficit that ranges on average of nearly 1.5 billion for the period 2001-2013, or 41.2% of GDP on average (period 2004-2013) . This net negative export means that Kosovars money go to buy foreign goods and services, reducing local production which then causes contraction in the labor market as well as market goods. The high trade deficit of Kosovo is a reflection of an economy with weak production base and lack of international competitiveness. However, the overall terms of trade hides an important distinction between trade in goods and trade in services. Within the trade of goods, the trade balance is always in deficit. In contrast, the services sector has performed well. Kosovo since 2006 has had a positive trade balance in services. However, the surplus in services declined as a result of importing essential utility construction (highway linking Kosovo with Albania) in 2010.

Is it possible that Kosovo under these circumstances to maintain stable reserve funds? In addition for better illustration, current transfer items are initially analyzed over the years and then through the tables and graphs we will be able to see the importance of the coverage of the trade deficit as well as what shape it gives to the current account and balance of payments entirely.

Current transfers and developments

Current transfers are balancing records applied in cases of change of ownership of real values (goods or services) from residents to non-residents (debit) or by non-residents to residents (credit), which are not accompanied by compensation from the other party. Current transfers directly affect the level of disposable income and thus will affect the consumption of goods and services. Therefore, current transfers reduce the income and consumption possibilities of the donor, increasing income and consumption possibilities of the recipient. Current transfers are classified into: state transfers from abroad commonly called official transfers; and private sector transfers including remittances and other transfers. (BSH, 2006).

Official transfers represent cash aid and means from foreign states and international organizations aimed towards our country. State current transfers include subsidies or aid for the following budget (except when subsidies related to additions to the capital stock of the recipient country), technical assistance, reparations imposed by the peace treaties, the insurance premium minus the payment for the service and insurance claims over losses , government contributions to administrative budgets of international organizations. Also, included in the current state transfers (on loan) fees, fines and tickets sold by government sponsored lottery thereof; and (debit) scholarships and other assistance for training provided to non-residents to finance their education in the country of the donor or outside, the return of the amounts paid as taxes, membership fees in non-governmental organizations, aid for local non-pension extra contractual and other benefits and earned awards from government-sponsored lotteries. (BSH, 2006).

Private current transfer is included in and out shipments; Effective cash transfers of foreign exchange purchased in the stock market; and other transfers as royalties, pensions, invalidity, etc.

One of the most important categories of the balance of payments of Kosovo, which continues to contribute to the narrowing of the current account deficit are current transfers. The balance of current transfers account amounted to 1.2 billion euros (2013), which represents an annual increase of 2.5 percent.

Current transfers consist of government transfers (28.0 percent) and private transfers (72.0 percent). Government transfers amounted at euro 341.9 million in 2013, representing an annual decline of 14.8 percent. Current transfers within government transfers mainly come from donors, EULEX and UNMIK.

Current transfers of private sector dominated mainly by remittances, the net balance of which represents approximately 62.7 percent of total private sector transfers. In 2013, remittances reached a value of 620.8 million euros, representing an annual increase of 2.5 percent (CBK, 2013)

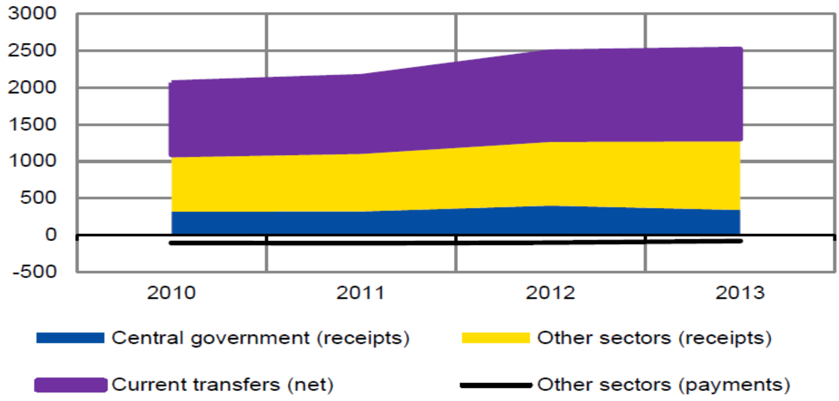

Figure 4: Current transfers, in millions of euro

In respect to geographical distribution of remittances, Germany (33%) and Switzerland (24%) have the largest share percent of total remittances received in Kosovo, followed from countries with low participation, such as Italy (7%) and Austria (6%) of total remittances. About 21.2 percent of remittances are transferred through the banking system, while 35.2 percent are transferred through money transfer agencies. The remainder of remittances is transferred through other channels that include informal channels. (CBK, 2013).

Since the end of war in Kosovo, the year 2009 is the only period when remittances declined in Kosovo. The decline in remittances was a result of the global economic crisis, which significantly affected developed countries, where are concentrated a large number of immigrants from Kosovo.

The effects of the crisis were manifested with significant job cuts where Kosovo migrants were affected too. (CBK, 2013). Remittances faced a positive growth trend over the period 2004-2012, with an annual average growth rate of 7.0%. However, despite this, in 2009 compared with the previous period, the diaspora remittances have decreased by 5.56%, down to 505.6 million euros from 535.4 million euros, as it was in 2008, a decline that is similar with the region and with developing countries generally and in global level. The fall of remittances is less than the decline of foreign direct investments in Kosovo, which has been around 25%; a trend that has followed the regional and global level countries too.

Table 2: Movement of diaspora remittances

Years	Diaspora remittances (in million Euro)	Base index: 2004=100	Chain index
2004	357	100	-
2005	418	117.086	117.086
2006	467.1	130.84	111.75
2007	515.6	144.26	110.38
2008	535.4	149.97	103.84
2009	505.6	141.45	94.43
2010	584.3	163.7	115.6
2011	584.8	163.8	100.08
2012	605.6	169.6	103.6
2013	620.8	173.9	102.5

Source: CBK, 2013

Remittances in Kosovo constitute a significant percentage of GDP (12.32% in 2012) and significantly exceed the level of foreign direct investments, support from donors, and the export of goods. In the framework of external financial resources greater participation in Kosovo's GDP are remittances which still remain the main source of financing for many Kosovan families.

Table 3: External funding sources for Kosovo (% GDP - 2004-2013)

	2004	*2005*	*2006*	*2007*	*2008*	*2009*	*2010*	*2011*	*2012*	*2013*
Money transferred from diaspora	*12.2*	*13.9*	*15.0*	*15.1*	*13.6*	*12.61*	*13.61*	*12.24*	*12.32*	*11.65*
FDI	*1.5*	*3.6*	*9.3*	*12.6*	*8.9*	*7.8*	*8.7*	*8.5*	*4.7*	*5.3*
Export (goods)	*2.2*	*2.3*	*3.9*	*5.2*	*5.7*	*4.2*	*7.10*	*6.8*	*5.98*	*5.52*
Donor support	*11.5*	*12.2*	*10.2*	*8.7*	*7.5*	*8.6*	*7.4*	*6.7*	*8.2*	*-*
Errors/deviations	*6.2*	*7.8*	*8.8*	*6.8*	*3.2*	*6.9*	*5.07*	*5.01*	*4.7*	*3.24*
GDP (million euro)	*2 928*	*3 005*	*3 118*	*3 411*	*3 940*	*4 008*	*4 291*	*4 776*	*4.916*	*5 327*

Source: WB, 2010, CBK, 2013 (calculation of authors)

Remittances from the diaspora in Kosovo, the largest source of external financing, were equivalent to 12.2 percent of GDP in 2004, marking a significant increase in 2006 and 2007 where their share in GDP was over 15% with a trend of decreasing participation in GDP in future years, so that in 2013 their share fell to 11.65 percent. According to regional and global standards, this participation is still high. To close neighbors such as Bosnia-Herzegovina and Albania remittances are also a significant part of GDP.

According to the recent data of the World Bank, Kosovo went among the first 10 countries in the world according to the participation of remittances in GDP (18%), where their participation appears to be greater than the local authorities report. World Bank (2013).

Significant balance of payments official remittances from the diaspora are an underestimation, since it may not be fully capturing informal flows. A significant proportion of errors and statistical deviations of Kosovo balance of payments are attributable to remittances and in all probabilities they should be higher than the official figures. (WB, 2011).

Almost half of the money sent by the diaspora come through private businesses, such as Western Union, although often it is the most expensive method of transferring funds. If more come through a bank transfer payment, they will help the expansion of the deposit base of banks, which in turn can extend loans and can motivate more people to use banking services. (WB, 2011).

Trade deficit and compensation to current transfers

Deficit and surplus can be seen only within the sub balances such as balance of goods and services, investment income, current transfers and the capital and financial account.

Current account deficit essentially means that the country spends more than it produces in a given period of time; the difference between consumption and domestic production in the country accounts for the accumulation of debt or selling of nonresident assets.

In Kosovo's economy, the current account deficit has increased continuously, being influenced mainly by the growth of the trade deficit. Factors affecting the trade deficit are numerous, including the continued growth of domestic demand, low level of productivity in the local economy and insufficient usage of existing production capacity in the economy. The prevalence of high levels of trade deficit in the region is also a reflection of the transition, which in many cases is characterized by the collapse of production. (CBK, 2012).

Although it is very evident that the balance of payments must be in equilibrium, the excess of expenditure requires the accumulation of debt or loss of property. These, in a way are not recorded directly in the balance of payments. They appear indirectly and so significant only later on investment income account where payments for interest, dividends and rents to foreigners are recorded as debits (debt).

One of the consequences in the long term in the current account deficit will be that more domestic assets will go into foreign ownership. Any sale of assets means the loss of local ownership and in the long-term the land loses its independence. Taking into consideration the noted specifics it clearly shows how important are transfers in the case of Kosovo to reduce the trade deficit.

How to finance the trade deficit depends on how it is financed current account deficit. If the deficit is financed through capital investment in the long run it would be beneficial for the economy. If the trade deficit is financed through short-term borrowing this will create more problems. In Kosovo case, the trade deficit is largely covered by transfers, on average around 59.5 of trade deficit is covered by transfers.

How transfers are important for the external sector of the economy of Kosovo show the calculations that we made about the current account deficit as having into account that current transfer is equal to zero. In these circumstances, the current account deficit will be very large, from 863.2 million euros (2004) to 1561.8 million euro (2014). Financial and capital account in this case could cover the trade deficit averaged only 12%. In the real circumstances of the current account deficit, the coverage ratio of the trade deficit of the financial account and capital is on average 39.5%.

Table 4: Accounts of the Balance of Payments of Kosovo 2004-2013 (In million euros)

	Current account	Current account without current transfers	Financial capital account	NET FDI	Official Reserves
2004	-208.3	-863.2	79.4	42.9	112.7
2005	-247.6	-947.9	72.7	107.6	32.4
2006	-226.1	-985.3	-14.9	289.2	-77.9
2007	-214.0	-1056	10.7	431.0	-294.3
2008	-460.9	-1333.2	298.9	341.5	-18.25
2009	-374.2	-1357.6	209.3	276.9	94.8
2010	-515.7	-1498.2	297.2	331.1	-53.4
2011	-658.4	-1679.5	418.9	378.2	612
2012	-380.2	-1572.7	143.3	213.3	-267.2
2013	-339.4	-1561.8	168.1	241.0	210

Source CBK, Annual Report 2013, Pristina, 2014

In the following figure it is shown the amount of trade deficit compensation through current transfers:

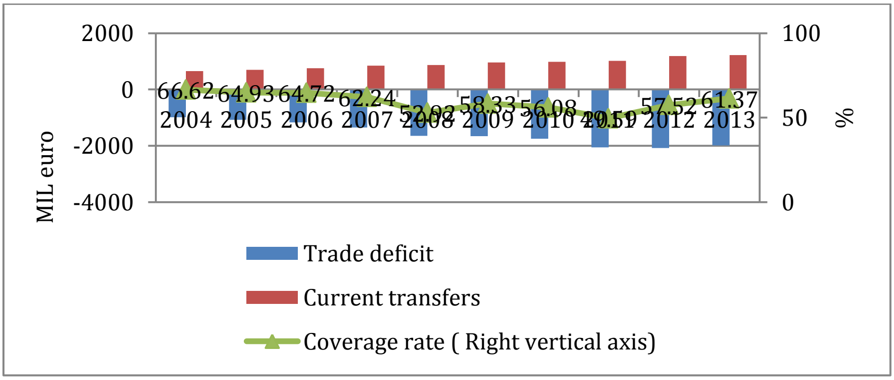

Figure 5: The amount of compensation of trade deficit with current transfers
Source CBK – Annual Report 2013

By analyzing the data from the figure above we see that the highest level of compensation of trade deficit through current transfer was in 2004 with 66.2 %, while the lowest coverage was in 2008 and 2011 with only 52.92 % and 49.59 %. This is obviously related to the level of remittances from abroad which also noted that this year their level was lower.

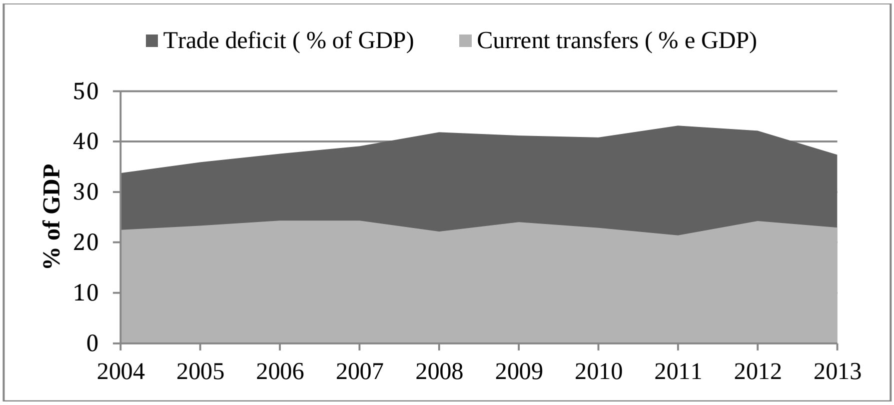

Figure 6: The remuneration of the trade deficit by current transfers (both as % of GDP)

Source CBK – Annual Report 2013

Moreover, if you look at the two items, trade deficit and current transfers as a percentage of GDP, we can observe that in average more than half of Kosovo's trade deficit is covered by transfers.

From the above we can notice that the current transfers are stabilizing items on balance of payments by consolidating the currency reserve. On the other side, the current transfers have an effect in the real sector of the economy, where in average they constitute about 23%, while the remittances constitute Kosovo's GDP on average by about 13%.

Despite the fact that the current account deficit negatively contributes to economic growth in Kosovo, the sustainability of this deficit is not considered as a threat to blow the economy from changes in the exchange rate. Kosovo in general is not endangered by exchange rate shocks and public trust in the currency due to the use of the euro currency. A slight degree of risk in the context of the exchange rate comes from certain products (eg. petroleum), which are traded in US dollars, so significant changes between the euro and the dollar may affect the prices of these

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products and thus deepening the trade deficit. Another mitigating circumstance for the sustainability of the current account in Kosovo is the fact that Kosovo's main trading partners are either fully or largely part of the Eurozone. For example, while countries with their national currency use the foreign debt to intervene in foreign exchange reserves in order to maintain the stability of exchange rate, Kosovo does not need to go into debt for these purposes since the main trading partners of Kosovo are the Eurozone countries. Also, the euro is the reserve currency that is held by most of the countries of CEFTA, so every transaction in this currency is easily workable. (CBK, 2012).

Conclusion

Based on the current analysis we recommend the following:
First, there could be two ways to minimize the high level of trade deficit: a) promotion of exports; b) import substitution, or both. In the first case efforts must be made to promote the export of secondary products, not the primary ones which is currently happening with exports in Kosovo. Kosovo's significant dependence on outside goods (including raw materials) limits the extent of import substitution. In the case of import substitution policies (protection and stimulation of domestic industry aiming to replace imported consumer goods), setting tariffs or quotas or selective bans on the importation of various specific goods can be implemented. In a globalized world, export promotion may be the first choice for Kosovo.

Second, efforts should be made to improve the balance on the capital and financial account by encouraging more foreign direct investments or portfolio investments, borrowing from international commercial banks or search public external aid. In both cases, obtaining credit and public aids always needs to consider taking obligations to be returned, but if the investments are made in productive activities this would significantly help in return of the debt and interest without difficulties. Encouragement of private foreign investment has major implications for the development of the mass transfer of financial resources or physical capital.

Third, improving the structure of foreign trade of the country, which means export diversification in terms of goods and destinations, can help mitigate the impacts from outside.

Fourth, the lack of competitiveness of manufacturing industry is a major problem and requires, inter alia, appropriate infrastructure, capable human resources, quality of raw materials, favorable fiscal policy, efficient administration and investment in research and development.

Fifth, although provision of trade services had a positive balance compared to trade of goods, however it is not sufficient to reduce the trade deficit, but it represents a potential that should be given priority and support.

Finally, Kosovo's trade policies seem healthy but lack the quality of implementation, evaluation and effective monitoring.

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