Bank of Albania

ANALYSIS OF DEVELOPMENTS IN THE EXTERNAL SECTOR OF THE ECONOMY

2014 Q4

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The views expressed herein are solely of the authors and do not necessarily reflect those of the Bank of Albania.

C O N T E N T S

I. BALANCE OF PAYMENTS HIGHLIGHTS[1]

Albania's net current account balance recorded a deficit of EUR 377.5 million in 2014 Q4, maintaining an expansive trend for the fifth consecutive quarter. For this quarter, the deficit increased around 12%, in annual terms, and was estimated at 14.5% of nominal GDP. For 2014, this deficit was estimated at around 12.9% of nominal GDP, expanding by around 25.7% from 2013. By item of the current account, the deterioration of the deficit in primary income and net exports contributed to the expansion side. Meanwhile, secondary income surplus increased at accelerated pace, in annual terms, contributing to the narrowing of the annual current account deficit. In structural terms, measured by the national gap between savings and investments, the public sector played a major role in the formation of the current deficit.

In this quarter, external demand did not help restore the uptrend in the exports of goods and services. Imports of goods and services showed a downward trend, but the recorded pace was more moderate than those of exports. The balance of the primary income account remained in negative territory for the fifth consecutive quarter, deepening further the registered deficit compared to 2013 Q4. On the other hand, during this quarter, secondary income registered around 12.9% increase, notably the annual increase in remittances by around 22.1%.

Net inflows in the capital account increased to EUR 21.1 million, from EUR 18.2 million in the fourth quarter of the previous year. Net inflows in the financial account expanded by around 26.5% annually, and financed 75.7% of the current account deficit. Foreign direct investments fell slightly by around 0.8% in annual terms, and financed around 60.8% of the current deficit. Moreover, other net investments were estimated in reduction of assets owned abroad by around EUR 122.2 million, due to the reduction in assets in the form of currency and deposits. However, the latter are offset somewhat by an increase of assets in the form of portfolio investments owned by residents, by around EUR 104.7 million.

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[1] *The latest data on the balance of payments are as at 2014 Q4. As of 2014 Q1, the Financial Stability and Statistics Department at the Bank of Albania prepares the Balance of Payments Statistics, in compliance with the International Standards laid down in sixth edition of the Balance of Payments and International Investment Manual (BPM6), released by the International Monetary Fund. Earlier, they were published based on the fifth edition of the Balance of Payments Manual. The main differences between the two methodologies are synthesised in the guideline "Publication of external sector tables according to BPM6", published by the Bank of Albania at:*
http://www.bankofalbania.org/web/pub/01_commentary_for_changes_in_the_publication_of_external_sector_statistics_according_to_bpm6_june_2014_6689_1.pdf
For the purposes of internal analysis, the Balance of Payments data from 2002 to 2012 are reclassified in line with the new methodology by the Monetary Policy Department.

Division of the current deficit financing according to debt-creating and non-debt creating flows reveals a more pronounced support for the second type of financing. After a significant expansion during the previous two quarters, financing supported by debt-creating flows fell in the last quarter of the year.

The overall balance of payments resulted in decreased foreign reserve assets by about EUR 38.9 million. At the end of December, the stock of foreign exchange reserve was around ALL 2.19 billion, sufficient to cover 5.5 months of imports of goods and services and 181% of the short-term foreign debt.

Table 1 Balance of Payments indicators

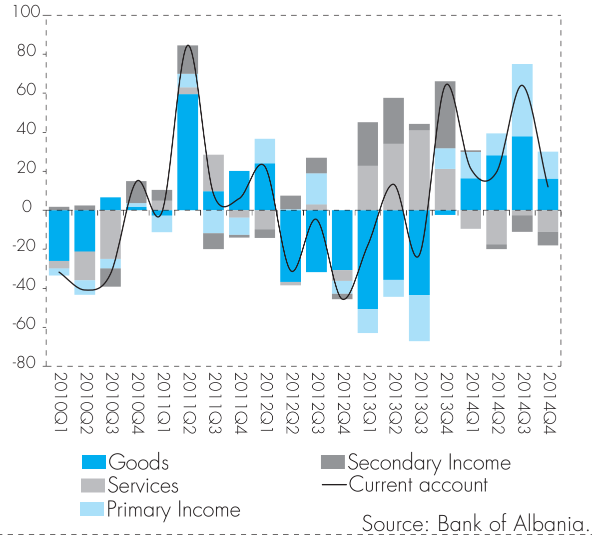
	2013 Q2	2013 Q3	2013 Q4	2014 Q1	2014 Q2	2014 Q3	2014 Q4
Current account (in EUR million)	-285.3	-191.0	-337.0	-271.5	-341.0	-313.2	-377.5
y-o-y (%)	13.3	-22.9	63.7	21.3	19.5	64.0	12.0
/ GDP (%)	-10.9	-8.2	-13.4	-11.7	-12.8	-12.6	-14.5
Goods and services	-442.8	-395.4	-518.9	-396.2	-473.3	-462.8	-536.0
Exports, f.o.b.	662.2	861.3	808.7	608.8	752.0	838.8	757.1
Imports, f.o.b.	1105.1	1256.8	1327.6	1005.0	1225.3	1301.6	1293.1
Travel - net	-31.5	26.1	34.0	-21.8	10.6	32.0	66.0
Primary income	-11.0	22.2	0.0	-20.6	-43.3	-48.7	-47.0
Credit	35.7	40.2	33.4	28.7	25.7	28.3	27.8
Debit	46.7	18.0	33.4	49.3	69.1	77.0	74.8
Net FDI income	-20.1	6.2	6.9	-30.4	-47.1	-56.2	-38.6
Secondary income	168.4	182.3	181.9	145.3	175.6	198.3	205.4
Credit	200.5	216.5	213.5	172.6	204.4	230.6	244.1
Debit	32.0	34.2	31.6	27.3	28.8	32.3	38.8
Net remittances	129.6	152.5	140.1	118.2	137.5	165.1	171.0
Capital account	4.8	15.0	18.2	22.5	22.4	20.7	21.1
Net borrowing/net lending	-280.5	-175.9	-318.8	-249.0	-318.7	-292.5	-356.4
Financial account	-262.4	-70.9	-226.1	-199.1	-214.5	-206.1	-285.9
y-o-y (%)	213.8	78.4	-16.2	57.2	-18.3	190.7	26.5
/ GDP (%)	-10.0	-3.0	-9.0	-8.6	-8.0	-8.3	-10.9
Direct investments	-270.5	-307.0	-231.2	-168.0	-150.4	-253.4	-229.4
Portfolio investments	104.4	6.2	-18.1	14.5	14.0	-12.4	104.7
Financial derivatives	1.1	0.0	-2.4	0.0	0.0	0.0	0.0
Other investments	-183.8	195.4	18.6	-5.2	-100.6	-94.2	-122.2
Reserve assets	86.4	34.5	7.1	-40.3	22.5	154.0	-38.9
Errors and omissions	18.1	105.1	92.7	49.9	104.2	86.4	70.5
Net borrowing/net lending	-280.5	-175.9	-318.8	-249.0	-318.7	-292.5	-356.4

Source: Bank of Albania.

II. CURRENT ACCOUNT[2]

Albania's net current account position recorded a deficit of EUR 377.5 million in 2014 Q4. The trend in the current deficit was expansive for the fifth consecutive quarter. In this quarter, it expanded by around 12.0% in annual terms. The registered deficit was estimated at around 14.5% of nominal GDP, or about 1.1 percentage points higher than in the same period a year earlier.

Grafik 1. Contribution to current account deficit by item (in percentage points)



Source: Bank of Albania.

The current account deficit continued to deepen, attributable to the annual performance of the balance of net exports of goods and services. Imports of goods and services fell by about 2.6% in annual terms. In the meantime, exports of goods and services showed a similar trend, falling 6.4% in annual terms. The deficit of net exports expanded, subsequently, by around 3.3%, in annual terms. The worsened net position of primary and secondary income accounts contributed to the same side[3]. Secondary income[4] grew by 12.9% in annual terms, contributing to the narrowing side in the annual performance of the current account deficit.

According to the gap approach between savings and national investments, in this quarter, the public sector's contribution to the formation of the current account deficit increased[5]. This development contrasts the performance in the earlier part of the year, when the private sector made the main contribution. The gap between savings and private investments was estimated at 11.4% to the nominal GDP, about 9.2 percentage points higher from the same quarter in the previous year. Unlike in the first three quarters of the year, the gap between savings and private investments narrowed at faster rates, in both annual and quarterly terms.

[2] *Overall, the shift to the international standards laid down in Sixth Edition of the Balance of Payments Manual does not envisage changes in the overall presentation of the current account, compared to the previous standards. The most significant changes consist in the goods and services accounts. Their composing sub-items are reclassified, renamed and further detailed.*

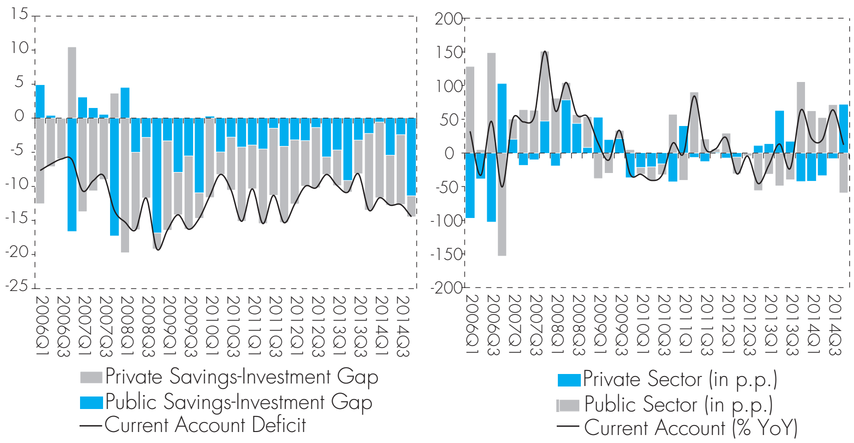
[3] *In accordance with the standards set forth in the Sixth Edition of the IMF's Balance of Payments and International Investment Position Manual, "primary income" corresponds to "income" in the Fifth Edition of the IMF's Balance of Payments Manual.*

[4] *In accordance with the standards set forth in the Sixth Edition of the IMF's Balance of Payments and International Investment Position Manual, "secondary income" corresponds to "current transfers" in the Fifth Edition of the IMF's Balance of Payments Manual.*

[5] *An alternative but equivalent measuring of the current account net position for a definite period is the gap between savings and national investments. Thus, the net realised position of current account is equal to the amount of gap realised between savings and public and private investments in period t.* $CA_{t=(Spublic-Ipublic)t+(Sprivate-Iprivate)t}$

The share of the public sector in the formation of the current account deficit stands above its historic average, whereas the contrary is true for the share of the private sector. As discussed earlier, the formation of the current deficit from the gap between and private sector savings and investments is better in terms of economic development than the formation from the gap between savings and public sector investments[6]. Regarding the annual expansion of the current account deficit by 12%, the public sector contributed to the narrowing side (-59.7 percentage points), whereas the private sector contributed to the expanding side (+71.8 percentage points).

Chart 2 Gap between savings and private and public investments to GDP (left) and their contribution to current account annual performance (right)



Source: Bank of Albania, Ministry of Finance.

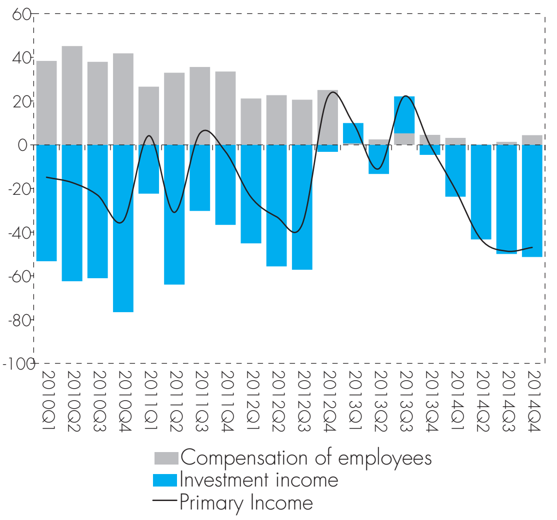
OTHER CURRENT ACCOUNT ITEMS[7]

The services account resulted as improved in 2014 Q4. Net income balance of this account recorded a net surplus of EUR 102.3 million, mainly attributable to the increase in foreign currency inflows form "travel services (personal and business)". The surplus of this sub-item almost doubled in annual terms. By foreign currency flow for personal travel expenses, the outflows fell and inflows rose. On the other hand, net income in the "transport services" account remained in negative territory for the fifth quarter consecutively.

[6] *Various studies conclude that when the current deficit is formed by the private sector, in an economy, under the conditions of capital accumulation, the latter becomes more tolerant against persistently high current deficit. That differs from the cases when the public sector provides the main contribution to the formation of the current deficit. See: Milesi-Ferretti & Razin (1996), 'Sustainability of Persistent Current Account Deficits', NBER, WP5467.*
Cusolito & Nedeljkovic (2013), 'Toolkit for the Analysis of Current Account Imbalances', WB, WP83248.

[7] *In the process of alignment with the international standards of the BPM6, the constituent sub-items of the services account were subject to a series of reclassifications and renomination. Thus, the most important changes relate to the sub-items of services account "processing services on physical inputs owned by others" (Manufacturing services on physical inputs owned by others BPM5) and "services for maintenance and repair" ("goods for repair in BPM5), which are reclassified from "goods" to "services". "Merchanting" (net exports of goods under trading intermediation) and other services related to trade are re-classified from "services" to "goods. Due to methodical changes, net balance of goods and services account reveals changes, particularly significant in the case of the services account.*

Chart 3 Income balance (net flows, in EUR million)

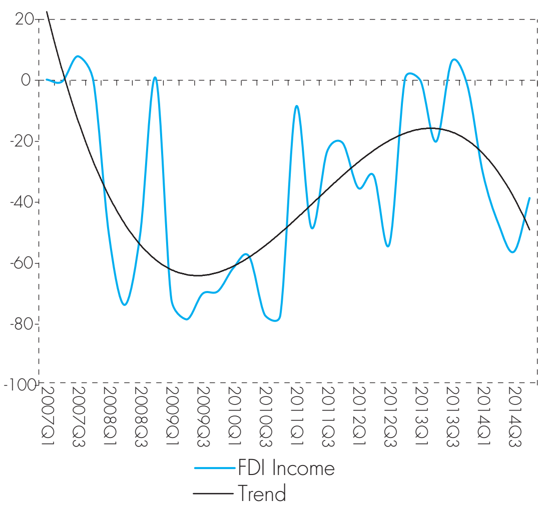


Source: Bank of Albania.

Net balance of primary income account closed in negative territory in 2014 Q4. This trend characterised this account throughout 2014. Net foreign-currency flows resulted in deficit by about EUR 47.0 million. The latter was lower than in the previous quarter, while a year earlier the primary income account ended in balance. The widening of the deficit in the sub-item "income from investments" determined the direction of developments in this account during the considered period. Net "income from work" resulted EUR 0.2 million less than in the same period in the previous year.

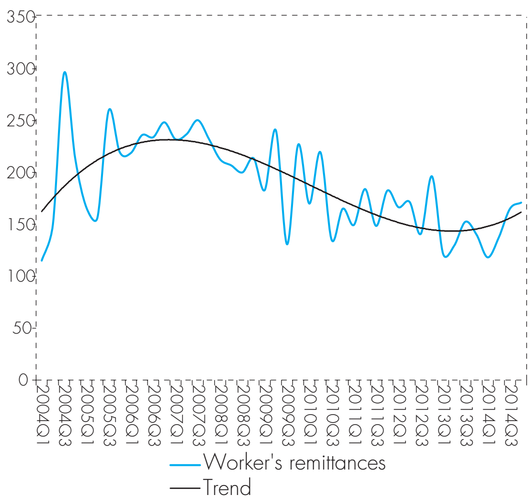
"Income from investments" sub-item recorded a considerable widening of deficit, by around EUR 51.3 million, from EUR 4.6 million in the same period a year earlier. The increase in FDI income outflows determined the direction of developments in this account. In 2014 Q4, net income deficit from "foreign direct investment" income widened further standing at EUR 38.6 million. Among them, repatriation of earnings from capital investments and shares in investment funds played the major role. At the same time, the balance of income from "portfolio investment" recorded the negative value of EUR 9.5 million).

Chart 4 FDI income (net flows, in EUR million)



Source: Bank of Albania.

Chart 5 Remittances (net flows, in EUR million)



Source: Bank of Albania.

The net balance of the secondary income account continued the upward trend of the surplus that had started three quarters earlier. In this quarter, this account recorded net inflows amounting to EUR 205.4 million. In terms of nominal GDP, the foreign currency flows in the secondary income account were estimated at 7.9%. The increase in remittances made the main contribution to this performance. During this period, they resulted in around EUR 171.0 million, up by 22.1% in annual terms. Against the nominal GDP, net remittances were estimated at 6.5%.

III. CAPITAL ACCOUNT

Capital account debits and credits all the transactions on the acquisition and disposal of non-produced, non-financial assets/goods[8] and the capital transfers[9] between residents and non-residents (on which there is no economic value in the exchange). In 2014 Q4, the capital account recorded a surplus of about EUR 21.1 million, up from around EUR 18.2 million recorded in the same period a year earlier. Net capital flows in this account amounted to about 0.8% of nominal GDP. Net capital transfer for the account of "central government" amounted to EUR 10.5 million, while those in "financial and non-financial corporates", "households and non-profit institutions serving households" were about EUR 10.6 million.

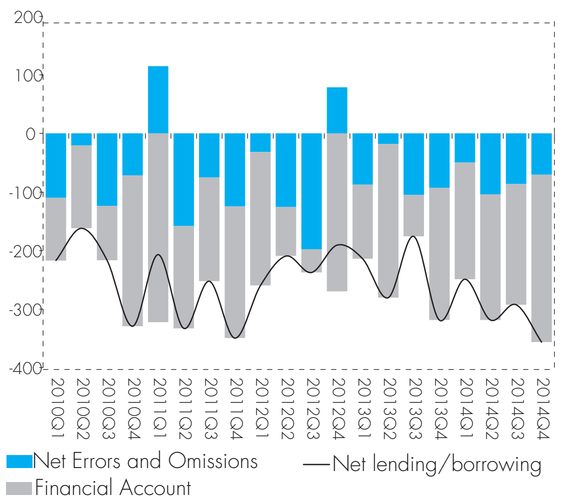
The combination of net non-financial transactions of the current account and capital account provides the net position of the domestic economy, as net lender (surplus) and net borrower (deficit) versus the non-resident economies. This result should be equal to the net balance of the financial account, which reflects how the net lending or net borrowing by non-residents is being financed. In quantitative terms, our economy reveals a net borrowing position, about EUR 356.4 million, which is financed by the income in the financial account (minus errors and omissions).

[8] *Acquisition and disposal of non-produced, non-financial asset include: 1.Acquisition and disposal of non-produced, non-financial asset include: 1. Natural resources (land, mineral rights, forestry rights, water, fishing rights, air space, and electromagnetic spectrum); 2. contracts, leases, and licenses (intangible goods); 3. marketing assets (brand names, mastheads, trademarks, logos, and domain names)*

[9] *Capital transfers consist in: 1. debt forgiveness; 2. non-life insurance claims; 3. grants; 4. guarantees; 5. taxes (inheritance taxes, gifts, etc.); 6. other capital transfers.*

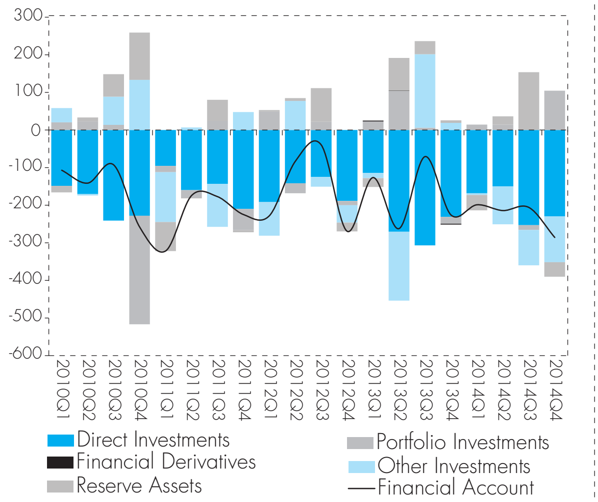
IV. FINANCIAL ACCOUNT[10]

Chart 6 Financial account, errors and omissions (net flows, in EUR million)



Source: Bank of Albania.

Chart 7 Financial account components (net flows, in EUR million)



Source: Bank of Albania.

Net position in the financial account resulted in a balance of around EUR 285.9 million during 2014 Q4. Net inflows in this account financed around 75.7% of the current deficit registered during the period. Financial flows rose about 26.5%, accounting for about 10.9% of nominal GDP, relative to the same period a year ago. The increase in foreign currency flows in the financial account was mainly attributable to the increase in net flows in the form of other investments.

Residents' financial liabilities to non-residents fell at an annual rate of 3.8%. On the other hand, the total of domestic assets invested abroad decreased by around EUR 54.7 million, compared to the EUR 14.2 million surplus recorded in 2013 Q4[11]. The decrease in assets in the form of other investments was the main determinant of developments in Albanian assets invested abroad.

Net foreign direct investments fell by around 0.8%[12], from 2013 Q4. In the meantime, foreign direct investment inflows, excluding privatisations with foreign capital, increased 3.2%. Domestic assets invested as foreign direct investments abroad rose EUR 12.1 million, from EUR 4.9 million in the previous year. Against the nominal GDP, net FDIs stood at 8.8%.

[10] *In accordance with standards laid down in the Sixth Edition of the IMF's Balance of Payments Manual, increase in assets and liabilities is shown with a positive sign; decrease in assets and liabilities with a negative sign. Net financial account balance is calculated as a difference between assets and liabilities. Also, main items in financial account are: 1. Direct investment; 2. Portfolio investment; 3. Other investment; 4. Financial derivatives and employee stock options; 5. Reserve assets.*

[11] *In addition to methodical amendments stipulated in BPM6, total domestic financial assets invested in foreign economies include also the foreign assets (reserve assets).*

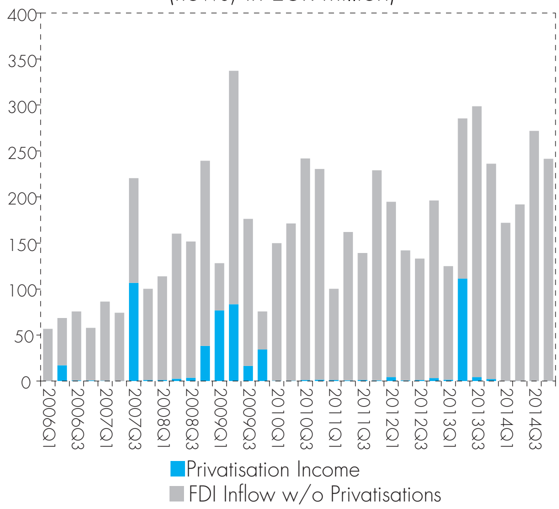
[12] *Quarterly estimation on foreign direct investments is made based on the data obtained from banks and are not included in the information on borrowing/lending in the foreign direct investment relationship in Albania. This information is provided only by the annual survey of Foreign Direct Investments (FDI) at the enterprises, which is published in September of the successive year. Due to the data taken from this survey, FDIs values are reviewed for each quarter. Thus, FDIs value for each quarter of 2014 shall be reviewed after the FDIs survey for 2014. With the publication of data for 2014 Q4, net FDIs were revised up for the previous three quarters, by around EUR 45.9 million.*

This ratio stands 0.4 percentage point higher than in the same period in the previous year.

In accordance with the instruments used for investments[13], net direct investments as "capital and stocks as investments fund" increased by about 20.5% in annual terms. At the same time, net FDIs in the form of "reinvested earnings" resulted higher in this quarter. Direct investments in the form of "debt instruments" were used less during the year.

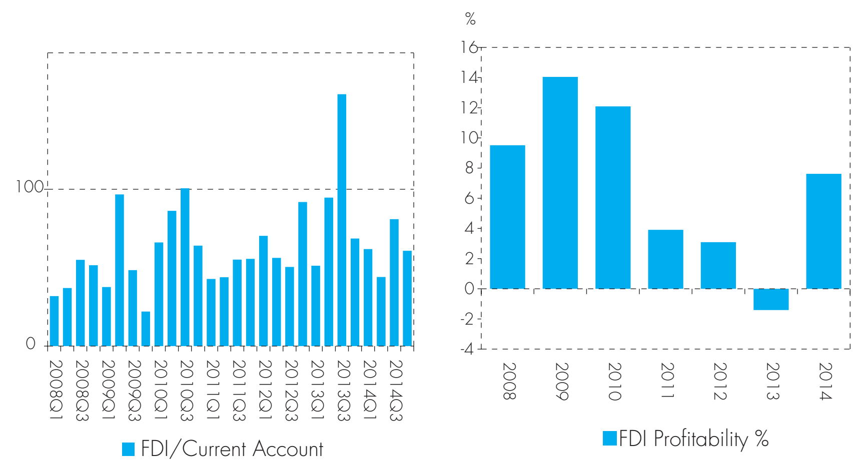
In the long run, FDIs are an important foreign-currency inflow in financing the current deficit in Albania. Against the backdrop of deceleration of inflows from remittances since the beginning of 2009, they have gained a dominant position in financing the current account. For this quarter, the ratio of net FDI flows against the registered current deficit stood at 60.8%. However, it must be noted that the attraction of FDIs in manufacturing sectors has a short-term mutual relation, with the trade deficit as the main component of the current account. The first inflows are accompanied by an increase in short-term imports and deterioration of trade position with abroad. In a second moment, after the completion of the initial investment and the start of the activity of exporting FDIs, the impact on the trade deficit reverses. An important factor for attracting new FDIs is profitability of existing FDIs with a consolidating activity, which serves to send signals for potential future investors. To assess this indicator, we use the stock of FDIs, the flow of invested earnings and net flow of income from FDIs. Albania has turned out to be a market generating steady profit from foreign investments. The latter showed a downward trend during 2011-2012 and moved to negative

Chart 8 Composition of foreign direct investment (flows, in EUR million)



Source: Bank of Albania.

Chart 9 Ratio of financing the current deficit with net FDIs (left) and FDIs profitability, at home, by year (right)



Source: Bank of Albania.

[13] *In accordance with BPM6 standards, direct investments are realised through three main instruments: 1. shareholders capital in investment funds; 2. reinvested earnings; 3. debt instruments.*

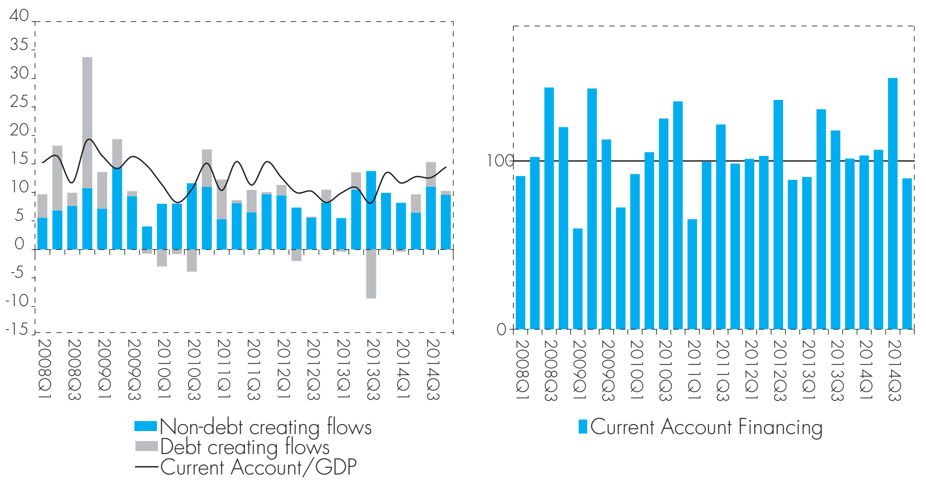
territory during 2013. For 2014, profitability returned to positive territory, thought at lower levels than those recorded before 2011.

Net portfolio investments in 2014 Q4 recorded an increase in assets invested abroad by EUR 104.7 million. For the period under review, residents' assets (depositing corporates, excluding the Bank of Albania) invested abroad rose by around EUR 108.4 million. Liabilities in the form of portfolio investments recorded also positive position at EUR 3.7 million.

Other investments account closed with an increase in residents liabilities by around EUR 122.2 million. In the "other investments" account, Albanian assets invested abroad fell by around EUR 136.2 million. On the liabilities side, non-residents reduced investments by around EUR 14.0 million. In 2014 Q4, assets in the form of "currency and deposits" fell by around EUR 171.6 million. It must be noted that, during the first nine months of 2014, the sub-item "borrowing" had the main share in the increase of Albania's liabilities in the form of other investments. The higher borrowing by the central government was the key factor contributing to this performance. For the last quarter of the year, assets invested in the form of loans were higher than new liabilities.

As regards the profile of financing the current deficit, it is important to monitor the reliance on debt-creating inflows rather than the more desirable non debt-creating inflows[14]. Thus, in 2014 Q4, non-debt-creating inflows from net FDIs and from the capital account were estimated at 9.6% of nominal GDP, standing about 0.4 percentage point lower than in the same period a year earlier. On the other hand, after trending up for two consecutive quarters, debt-creating flows were lower, estimated at 0.7% of the nominal GDP. The overall financing of the current account deficit is estimated by adding net errors and omissions to net debt-creating and non-debt creating foreign-currency flows. In the quarter under review, the ratio of the current account financing

Chart 10 Debt creating and non-creating financial inflows (to nominal GDP, left) and the financing of current account (right)



Source: Bank of Albania.

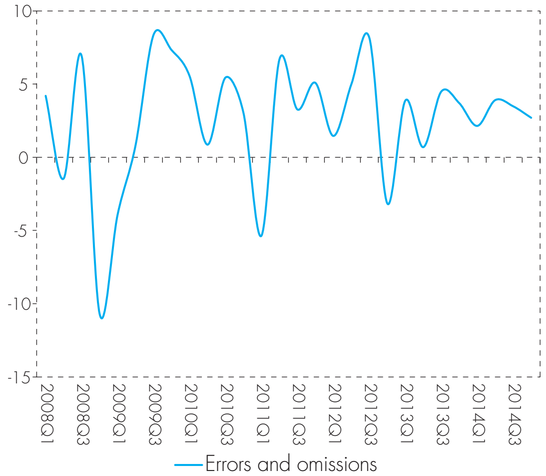
[14] This breakdown serves to monitor the impact of financial and capital flows on Albanian's external debt. FDI and capital inflows are classified as non-debt-creating flows. Portfolio investment and other net investment are included in debt-creating flows

stood at 89.7%, implying a reduction in the foreign exchange reserve stock.

Foreign exchange reserve assets expanded by about EUR 154 million. This performance was determined mainly by the decrease in assets in the form of "other reserve assets". At the end of December, the stock of the foreign exchange reserve stood at around EUR 2.19 billion, sufficient to cover 5.5 months of imports of goods and services and 181% of the short-term foreign debt.

V. ERRORS AND OMISSIONS

Chart 11 Errors and omissions (against GDP)



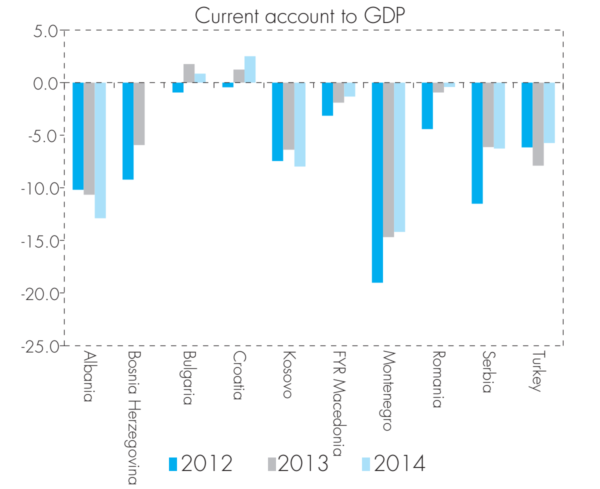
Source: Bank of Albania.

Due to the problems that may be faced in information sources and during the compilation of external sector statistics, the balance of payments may have discrepancies. Thus, in the balance of payment statistics, they are summarised under the omissions and errors item, that is calculated as "the rest" (difference between the balance in financial account and the balance in current account plus the balance in capital account). The "errors and omissions" recorded a positive value of EUR 70.5 million, estimated at around 2.7% of nominal GDP.

VI. REGIONAL OVERVIEW ON THE BALANCE OF PAYMENTS

Current account data for the countries of our region, in 2014, present an improved trend of external balances in the respective economies. Thus, the current account deficit to the GDP narrowed in the Former Yugoslav Republic of Macedonia, Montenegro, Romania, and Turkey. In Bulgaria, the current account surplus narrowed somewhat compared to 2013, whereas in Croatia it expanded. The external position, in terms of the current account, deteriorated only in Kosovo, Serbia and Albania. Compared to the other two countries in the region, Albania's deficit expanded most. In Kosovo, the fall in export of goods and services made a substantial contribution. In Albania, the annual growth in the combined imports of goods and services and the worsened net position of primary income made major contribution. In the meantime, in Serbia, the expansion of the primary income deficit was the main factor contributing to the trade deficit in 2014. In relative terms, Albania and Montenegro have the highest rates of the current deficit in the region.

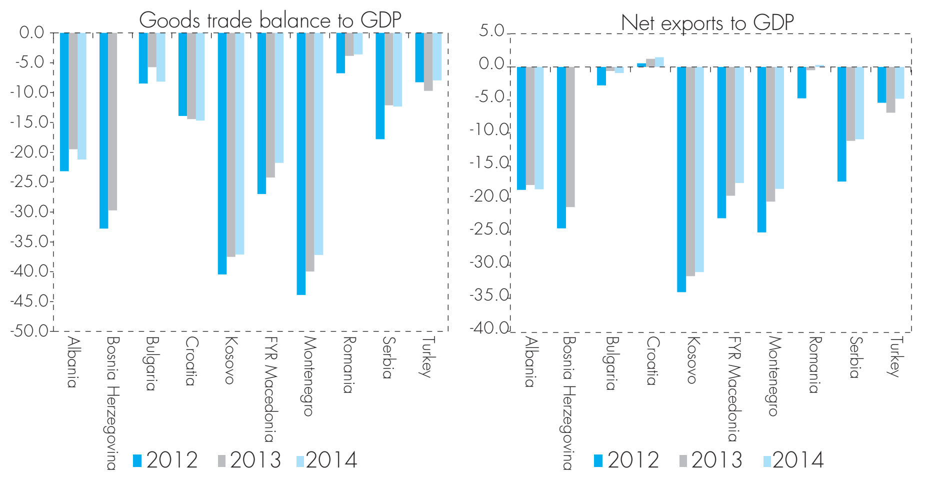
Chart 12 Current account to GDP in the countries of the region during 2012-2014



Source: EUROSTAT, respective central banks, IMF.

Export of goods and services trended up in most countries of the region, during 2014. Thus, against the respective nominal GDP, it was up in Bulgaria, Croatia, Former Yugoslav Republic of Macedonia, Romania, Serbia, Kosovo and Turkey. Meanwhile, the export of goods and services fell in Albania and Montenegro.

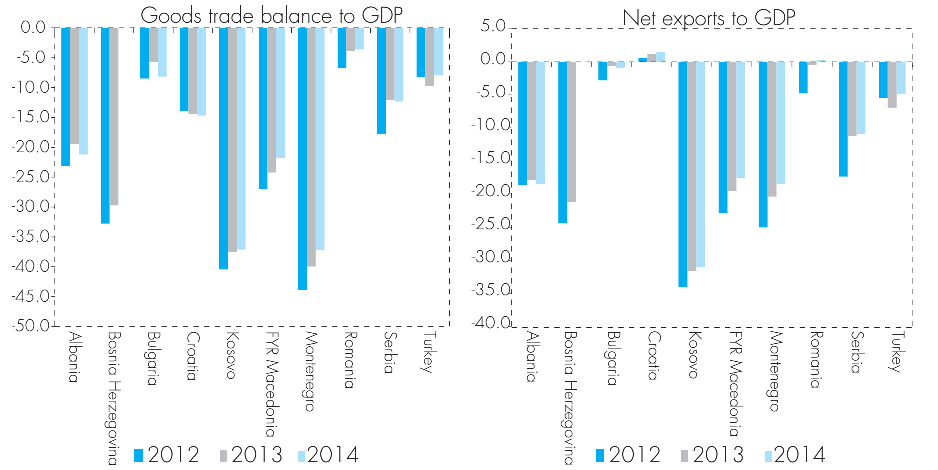
Chart 14 Trade balance in goods to GDP (left) net exports to GDP (right)



Source: EUROSTAT, respective central banks, IMF.

All the countries in the region are characterised by deficit in their trade balances. Montenegro and Kosovo are the countries having the highest trade deficit to GDP, while Romania and Bulgaria are the countries having the lowest trade deficit. During 2014, Albania, Bulgaria, Croatia and Serbia saw their trade deficit expand. The net balance of trade in services plays a major role in net exports in Croatia, Bulgaria and Montenegro. Net exports in Croatia and Romania stood in positive territory in this year. Compared to other countries, Kosovo and Albania recorded the highest deficit in net exports.

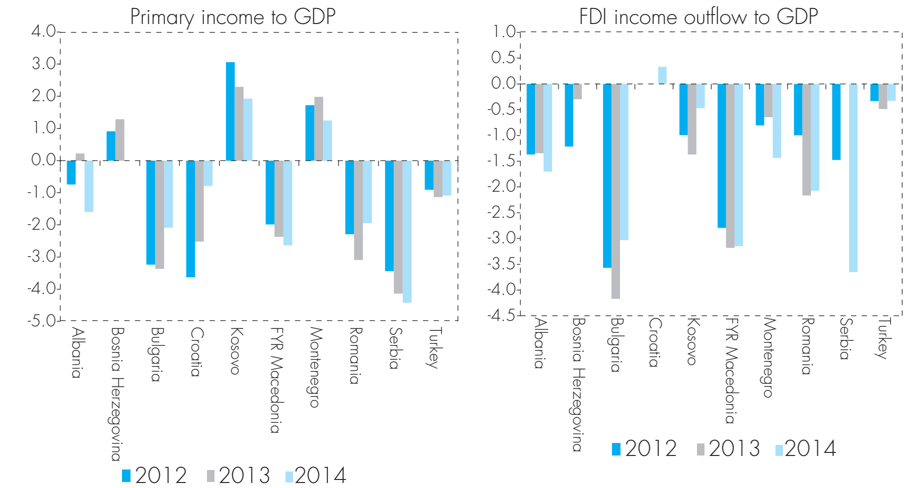
Chart 14 Trade balance in goods to GDP (left) net exports to GDP (right)



Source: EUROSTAT, respective central banks, IMF.

The balance of primary income in the countries of the region was mainly negative, except for Bosnia and Herzegovina, Kosovo and Montenegro. The deficit of this account deepened in Albania, Serbia and Former Yugoslav Republic of Macedonia. By contrast, the trend in Bulgaria, Croatia, Romania and Turkey was the opposite. FDI income outflows made the major contribution to this performance. In comparative terms, the latter were higher in Serbia, Bulgaria and Former Yugoslav Republic of Macedonia.

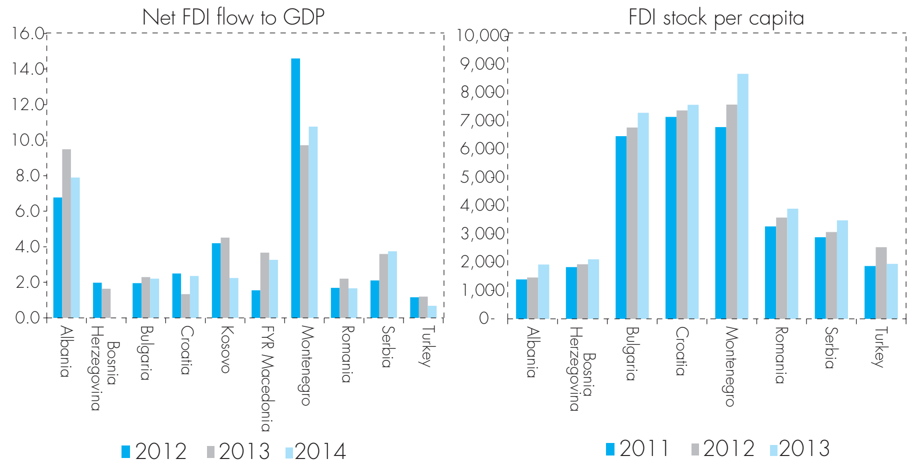
Chart 15 Primary income to GDP (left) and FDI income outflows (right)



Source: EUROSTAT, respective central banks, IMF.

In most countries of the region with current account deficits, net FDI inflows are the main financing method. Only Turkey is an exception. From a comparison of the countries, net FDI flows to GDP for 2014 was higher in Albania, Montenegro and Serbia, standing at 7.9%, 10.8% and 3.7%, respectively. It must be noted, however, that the initial period of attracting FDIs and opening markets to foreign capital conditions the trend of FDI flows in a second period. Thus, countries that have started earlier policies for attracting FDIs and have restructured their economies to liberalise their markets for foreign capital, have the highest FDI stock per capita. Consequently, until 2013, Albania had the lowest FDI stock per capita in the region[15].

Chart 16 Net FDI flows to GDP (left) and FDI stock per capita (right)



Source: EUROSTAT, respective central banks, IMF, UNCTAD.

15 *Kosovo is not included in this analysis.*