

SUSTAINABILITY OF CURRENT ACCOUNT BALANCE¹

Ahmet Mançellari²
Selami Xhepa³

Abstract

The trade deficit and consequently, the current account deficit, are among the essential challenges the Albanian transition is facing. The level of 24,6% of the relative indicator of trade deficit in 2002 (in percentage of GDP), corresponds to the level of 9% of the relative indicator of current account deficit, approaching to the record level marked in 1997 (11.1%), surpassing the level of 2001 by 3,7 percentage points and being about two times higher than the level of 5%, which, in economic literature, is regarded as a “warning” level. The high levels of current account deficit raise the need to analyze the deficit sustainability, an analysis that constitutes even the aim of this paper.

Comparing the theoretical criteria and particularly the practical criteria of current account deficit sustainability with current account balance position in Albania, the conclusion is drawn that in Albania’s case the current account deficit is chronic, and at very high levels. Nevertheless, given the overall considerations, current deficit may be estimated as relatively sustainable, but with a rather fragile and seriously threatened sustainability.

Given the current account deficit structure, it is concluded that the improvement of current account balance requires, first of all, the trade balance improvement. In spite of the importance the substitution of imports has, this paper emphasizes the idea that the orientation of economy towards export growth stands in the basis of a sustainable and long-term trade balance improvement.

Introduction

The Albanian transition is presented, *inter alia*, as a process of Albania’s exit from the isolation over some decades, and as a process of opening its economy to regional and global markets and developments. Economic opening in itself is a key factor to the restructuring of economy and increasing of its efficiency. However, the achievement and maintenance of internal macroeconomic equilibrium under conditions of economic opening constitutes a challenge, which in Albania’s case has taken the view of high current account deficit levels and worrying trade deficit levels.

The level of 24,6 per cent of the relative indicator of trade deficit (in ratio to GDP) in 2002, corresponds to the level of 9 per cent of relative indicator of current account deficit, that

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² Dr. Ahmet Mançellari is a professor at Faculty of Economics, Tirana University and external expert at ACIT (Albanian Center for International Trade).

³ Dr. Selami Xhepa is Director of the Department of Research at ACIT (Albanian Center for International Trade) and part-time lecturer at Faculty of Economics, Tirana University.

comes close to the record level noted in 1997 (11.1 per cent), surpassing by 3.7 percentage points the level of 2001 being about twice higher than the level of 5 per cent, which in economic literature is regarded as a “warning” level. Such levels of current account deficit raise the question: Is current account deficit “sustainable” in Albania’s case? Precisely that is the question we are going to try to answer through this paper.

Serving the above purpose, the paper is divided into three sections. Based on relevant literature, the **first section** deals with the possible meaning and criteria of assessing the current account deficit sustainability. Given that the current account deficit is identified with the difference between savings and investments of economy as a whole, to a certain extent it measures and reflects the strength of an emerging economy. But, on the other hand, the negative difference between the savings and investments may not be “sustainable” and may shake the external position of economy. Current account deficit sustainability, in substance, means sustainability of financing investments presented as a balance on national savings, under the conditions of (i) increasing imports, with rates comparable to those of real GDP growth; (ii) non-reduction of normal flow of international payments; (iii) non-reduction of foreign reserve required.

Theoretically, in a synthetic view, the degree of ability of a country’s economy to face international financial liabilities may serve as a “measurer” of current account deficit sustainability. However, on practical grounds, a number of criteria may be used, which spring from the above theoretical criterion, such as the foreign debt ratio to GDP; presence of external sector crises; ratio of investment growth rates to savings growth rates; structure of current account deficit; structure of capital inflows; dynamics of foreign reserve stock, compared to debt stock; position of the financial system and of the banking system in particular and the possibility of predictability of policies and of economic developments.

In the **second section** an effort is made to the implementation of the criteria discussed in the first section, for assessing the sustainability of current account deficit in Albania’s case. The increasing need of economy for investments, especially under conditions of very low domestic savings rates, have made possible that the current account be featured by a chronic deficit, extended over the whole transition period. The analysis of indicators tests that the current account deficit is a consequence of increasing investments at a higher rate than the rate of increasing the domestic savings. The increase of investments, particularly of those of the private sector, has impacted on the growth of import volume, which has led to the deepening of trade deficit, whose very high levels constitute a threatening to the external equilibrium of economy.

The analysis of sources of financing economic transactions with the world and their expected tendencies, especially the export position and problems; the narrowing and marketing tendencies of support by international financial institutions; the tendencies for decline in mid-term and long-term periods of migrants’ foreign currency inflows; the performance towards the narrowing and closing of illegal traffic paths, all highlight the fragility of current account deficit.

Effort is made to the **third part** to provide an answer to the question of how can sustainability of current account deficit be increased in Albania’s case. Analyzing the structure of this deficit, it is concluded that current account deficit sustainability may be equivalent to the sustainability and duration of import financing sources. Under these conditions, the question raised may be reduced into how can the trade balance be improved. The paper emphasizes that

from a long-term viewpoint, the main way to trade balance improvement is the way of promoting exports, based on the increase of competitive abilities of the country's economy.

In the economic literature on the transition countries, attention is paid to macroeconomic state of competition, especially to the real exchange rate appreciation process, a phenomenon that has associated almost all the transition countries. The analysis of this factor in Albania's case testifies its weak impact on export performance. Other factors are underlined as having more effect, such as restructuring reforms performance, smoothing and preventing the administrative barriers to the private sector development, improving the overall investment climate, improving the business microenvironment.

The end of the paper emphasizes that current account deficit in Albania's case is chronic, at very high levels. However, generally speaking, it may be estimated as relatively sustainable, but with a very fragile and seriously threatened sustainability.

1. Meaning and criteria of assessing the sustainability of current account deficit

The instantaneous achievement of both the external and internal macroeconomic balance is regarded as an essential target of macroeconomic policies. The internal balance is defined as a situation, in which the real product is at its potential limits or close to them, and the inflation rate is low and not accelerating. The external balance is frequently defined as a certain level of current account, considered as sustainable.⁴.

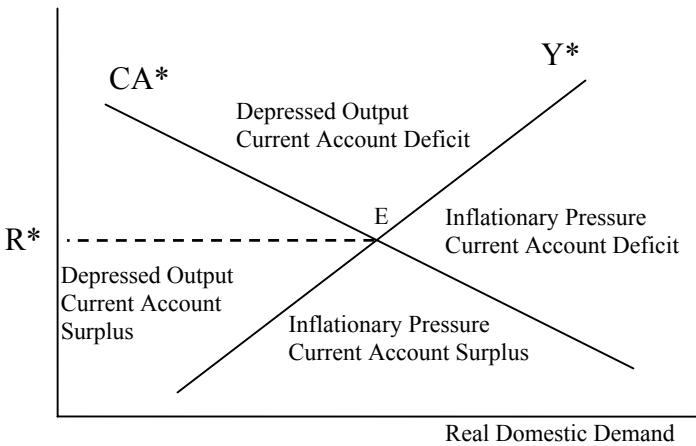
Both, the internal and external balance, are based on two essential variables: level of real domestic demand and real exchange rate. In turn, both variables reflect the macroeconomic conditions and policies. Current account deficit occurs when real exchange rate is appreciated too much, and/or there is an excessive real domestic demand. Figure 1⁵ reflects both the instantaneous internal and external equilibrium (shown by point E), and the various combinations of dis-equilibrium positions.

Figure 1: Macroeconomic equilibrium and real exchange rate.

⁴ For a detailed analysis, see Chorng-Huey Wong, 2000.

⁵ Figure is known as the Swan diagram, taking the name after the author that has used it for the first time. (see Swan, 1963).

Real Exchange Rate



In which situation presented in the Figure is Albania at present? The chronic deficit in current account balance places Albanian economy on the right of CA^* line (the line of external equilibrium). In spite of relatively high and constant economic growth rates, the presence of high rate unemployment, along with the low level of the credit to private sector/bank deposits ratio indicates GDP levels far from the potential one, mainly due to structural causes. This means that Albanian economy is at the same time on the left of Y^* line (internal equilibrium line). So, Albanian economy, characterized by a GDP below the potential one, and simultaneously by a current account deficit, is above point E of the instantaneous internal and external equilibrium, to which responds the R^* of real exchange rate level. However, the inflationary pressures deriving from emigrants' remittances and other foreign currency inflows and from structural factors, make it possible that the Albanian economy be predisposed towards disequilibrium levels on the right of E .

In this paper, we shall focus on external macroeconomic balance, meaning a "sustainable" current account balance. The current account balance, precisely the current account deficit, is an important indicator of the performance of a transition economy. The importance springs from the fact that current account balance, reflecting the savings-investments ratio, is closely related to the fiscal balance position and to that of the private savings, both very important factors for the economic growth. The importance of current account balance (deficit) is linked even with the fact that it reflects the position of exchange rate and competitive ability in economy.

Given that the current account deficit is identified as the difference between savings and investments for the whole economy ($CA=S-I$), in a certain way it measures and reflects the power of an emerging economy. But, on the other hand, the negative difference between the savings and investments may not be "sustainable" and may shake the external position of economy. The shocks or the crisis of external position of economy may appear (i) as a foreign currency crisis, associated with a drastic depreciation of domestic currency or with drastic reduction of the country's foreign reserve, (ii) as external debt crisis, in the form of insolvency of external debt and /or inability to receive new foreign loans. Even for transition economies, as emphasized by Roubini and Wachter, current account deficit reflects both sides noted above. On one hand, according to a point of view, the current account deficit reflects the success of structural changes, which have enabled capital inflows and investments and have opened the perspective of a rapid economic growth. On the other hand, according to another viewpoint, the

current account deficit is a reflection of transition processes not always well managed, with unsustainable imbalances, potential sources of foreign currency or balance of payment crises (Roubin and Wachel, 1998).

Which side of current account deficit is more important? That is, which viewpoint is more convincing? The answer, as noted by the two abovementioned authors, is difficult. The difficulty relates to numerous factors and to not rare shocks, frequently unpredicted ones, which affect the current account balance position in transition countries, without excluding even the low quality of available data. Nevertheless, without neglecting the “positive” side of current account deficit, the paper will be focussed precisely on the other side, on treating the sustainability of this deficit.

Concept of “sustainability” needs clarification. When speaking about current account deficit sustainability, in its core, it does not mean “sustainability” for “maintaining “ the existing trade deficit levels. What should be understood is the sustainability of financing investments in excess of national savings; it is the sustainability financing sources of this deficit, under the conditions of (i) increasing imports with rates comparable to those of GDP growth; (ii) non-declining of normal flow of international payments; (iii) non-declining of foreign reserve required. (Chrong-Huej Wong, 2000.)

So, the concept of trade balance sustainability is a complex concept. Under these conditions, it is impossible to find a simple rule to estimate whether a country’s current account deficit is sustainable or not. However, the economic literature recommends a number of criteria that may be used to make such estimation. (Roubini and Wachel, 1998). Theoretically, the degree at which a country’s economy can face the international financial liabilities serves as a “synthetic measurer” of current account deficit sustainability (economy solvency).

In which conditions an economy may be considered solvent and therefore its current account deficit “sustainable”? Economy solvency can be measured by a number of indicators which, at any case, relate to external debt and compare the ratio of real interest rate to economic growth rate; (real interest rate being higher than economic growth rate); real interest rate to debt increase rate (debt stock not increasing faster than real interest rate); the unrestricted amount of current account balances to original external debt (solvency means equality of two indicators) etc.

However, for practical reasons, a number of criteria may be used (precisely indicators) that spring from the above theoretical approach.

(i) One criterion of sustainability would be the *non-increasing ratio of foreign debt to GDP*.

(ii) Another practical criterion of sustainability, under the conditions of absence of external shocks, or fundamental changes of macroeconomic policies, would be the *non-occurrence of external sector crises*, in the form of foreign currency crisis or debt crisis.

(iii) Generally, it is accepted that a level over 5 per cent of the indicator of the ratio of current account deficit to GDP draw the attention to the need of estimating the sustainability, that is even to the possibility of current account deficit unsustainability. However, the estimation of sustainability is related to the analysis of deficit sources. Under the conditions of a high ratio of deficit to GDP, the deficit is more likely to be sustainable, when caused more by the national investments increase than by the savings dropping, especially when *the national savings in turn, are low*. The high investment rates, particularly those of the private investments in productive capital, though they may produce current account deficit, are expected to be accompanied by increase of productive capacities and of income from export, hence even of increasing

possibilities to serve the foreign debts. Increase of investments is consistent with high economic growth rates, therefore high current account deficits are more *sustainable under the conditions of high economic growth rates*. If we refer to decrease of savings, the reduction of national savings due to public savings reduction (budget deficit increase) is generally more problematic than the private savings reduction. This is so because the dropping of private savings is likely to be a transitory phenomenon, whereas the public saving reduction is a structural problem.

(iv) The current account deficit sustainability is impacted even by the deficit structure. If the current account deficit is caused to a great extent *by a high trade deficit*, thus reflecting structural problems relating to competitive ability of economy, its *sustainability would be more problematic*, as compared to cases when it is related mainly to the net factorial income. In this framework, the export share to GDP may serve as a criterion of current account deficit sustainability.

(v) The current account deficit is financed by foreign capital inflows. In the size of sustainability of this deficit, an important role is played even by the capital inflow structure. Generally, short-term inflows (*portfolio investments or otherwise called “hot” money*) and loans are more risky to the current account deficit sustainability than the respective long-term inflows (*foreign direct investments*) and wealth investments. In the framework of loans, in short-term periods, the loans from private creditors appear more problematic than the loans from official creditors and portfolio investments more problematic than the bank loans. Sticking to the loan portfolio frame, its foreign currency composition is of importance.

Even the size of foreign capital inflows is important for the sustainability of current account deficit. Foreign capital inflows in large sizes, especially in sizes greater than current account deficit, in spite of the positive contribution in short-term periods, with the passing of time may be accompanied with *negative consequences in competitive ability of economy*, through the impact on domestic currency appreciation, notwithstanding whether sterilizing measures are taken or not (in the negative case, the money supply is increased, hence even the inflation, affecting on the real appreciation of domestic currency; in the positive case, the maintaining of high interest rates encourages the continuation of foreign capital inflows, affecting the nominal appreciation of domestic currency). However, interventions in the foreign currency market may smooth the situation, thus increasing even the foreign currency reserves.

Generally speaking, the current account deficit may be less sustainable under the conditions of a real appreciation of domestic currency, in spite of what causes this appreciation, as long as it affects negatively the competitive ability of economy.

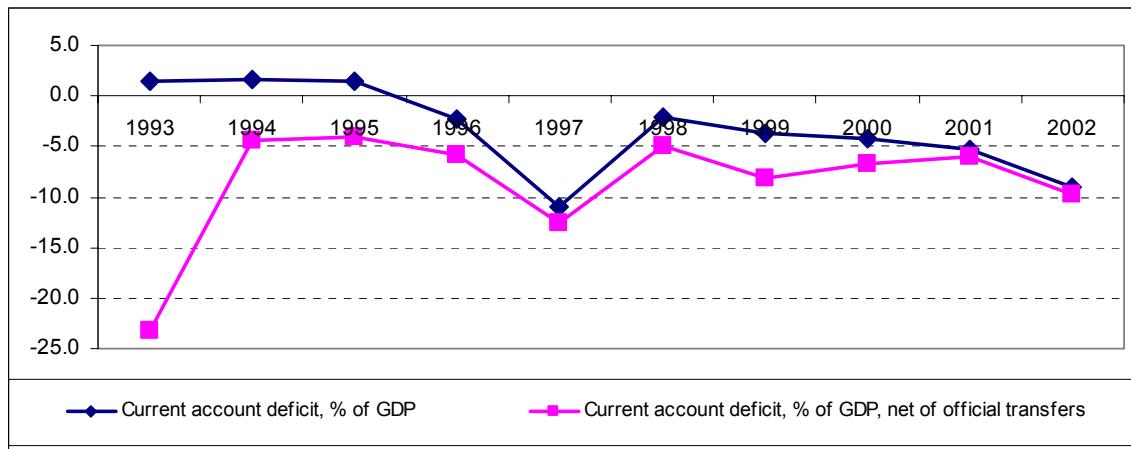
(vi) The ability of a country to face the current account deficit is affected by the foreign reserve stock of that country. A higher ratio of the foreign reserve to the debt stock is an indicator of an even higher degree of the sustainability of current account deficit.

(vii) Finally, the sustainability of a high deficit of current account depends on the country's financial system position, especially in the banking system, and the political stability degree and the predictability of policies and the economic developments.

2. Is the current account deficit sustainable in Albania?

After a three-year period with a positive balance⁶, in 1996 the current account balance deteriorated, marking a deficit of 2.3 per cent⁷ of GDP. During the crisis of 1997, the deficit level reached to 11.1 per cent of GDP, and normalized later below 5 per cent, along the entire period of 1996-2000. The deficit surpassed the critical value of 5 per cent of GDP in 2001, undergoing a very fast growth in 2002, to arrive at the level of 9 per cent of GDP. (Figure 2 and annex A, table 1.)

Figure 2: Current account balance in Albania for 1993-2002



Comparing the data on the current account balance in Albania with the respective data of other countries of the region that indicate similarity of structural problems in economy, it is noted that in general, even these countries feature high levels of the current deficit (annex A, table 3). In some of them, the deficit levels over 5 per cent of GDP have been present for a relatively long period of time, while there are not evidenced external sector crises. On the other hand, in countries having experienced economic and monetary crises, as Bulgaria's and Rumania's case, (in 1996-97), the high level of current account deficit has not served as a warning signal. Bulgaria, for example, at the crisis time (in 1997) had a positive balance of the current account of 4.2 per cent of GDP, compared to 0.2 per cent one year after the crisis. Under these conditions, we may state that for countries such as Albania, that is, generally even for the regional transition economies, which depend much on foreign aids, the limit of 5 per cent of GDP of current account deficit has not served as a warning signal of the external sector crises. The importance of this limit is presented somewhat vague, compared to countries with an established market economy.

However, to judge on the sustainability of current account deficit for Albania that from 2002 was twice as much as the warning signal, we should refer to the criteria discussed in the first section.

⁶ The positive current account balance for the first period of transition is dedicated mainly to the foreign official transfers. Figure 2 highlights this role of foreign official transfers.

⁷ It should be emphasized right from the beginning that the data quality and availability are a problem, and a serious one, which affects the accuracy of the data extracted. This becomes obvious by the significant breaking of the statistical series, which may result even due to methodological changes in measuring the indicators, by the high levels of the item "Mistakes and Omissions" of balance of payments, etc.

As long as the ability of a country to face the **external debt** stands in the core of sustainability of current account deficit, let us refer, above all, to the criteria that compares the dynamics of external debt stock, with the rates of GDP growth. At year-end 2002, net external debt accumulated reached to about 1 billion dollars or 20.9 per cent of GDP. The level of this indicator is relatively low, against the other countries of the region. Meanwhile, the external debt annual level (annual addition to the debt stock) has varied from 1,5 to 3 per cent of GDP, while the annual average growth of GDP has been to about 7 per cent. So, the external debt growth stands below the annual growth level of economy. From the viewpoint of this criterion, the current account deficit may be considered as sustainable. However, even from the viewpoint of this criterion, the sustainability appears as fragile. The ratio of external debt –exports (given the primary role of foreign currency income on exports for the service of external debt, in a long-term view) is presented as very high and with a fast growth (from 113 per cent in 1993, to 296,5 per cent in 2002). However, looking at the period under discussion, the service of external debt has been in modest levels, arriving on average to 6,5 per cent of total exports, much lower than the figure of 25 per cent generally considered as a critic level. The country is not on the threshold of facing external debt insolvency. Also, excluding the negative developments of 1997, the country has not experienced any foreign currency crisis and has not shown any signs of any such crisis approaching to it. Thus, this reinforces the argument of sustainability of current account deficit.

However, for a better judgement on sustainability of current account deficit, as emphasized even in the first part of the paper, a more attentive consideration is needed on the causes, structure and financial sources of this deficit, referring to relevant criteria.

Let us first deal with current account deficit causes, referring to the deficit meaning as a difference of **savings – investments** and the relevant indicators (Annex A, table 2). At the start of (1992) current account deficit reached to 57 per cent of GDP. The cause of such a deep imbalance was the domestic savings reduction (to minus 51,9 per cent of GDP), while investments were at very modest levels, 5,2 per cent of GDP. Later on, the picture changed. The subsequent ten-year period is featured by an increase in the savings level, contributed particularly by the increase in the public savings (the fiscal deficit reduction). From -15,5 per cent of GDP in 1993, the government savings reached to -1,2 per cent in 2001⁸, while the private savings became positive in 1994 (14,2 per cent of GDP), and remained almost at the same level even at the end of 2001 (14,3 per cent of GDP). On the other hand, investments were increased from 13,2 per cent of GDP in 1993, to 19,4 per cent in 2001. Positive changes are noted considering the investment structure. The public investments weight has been declining from 9,5 per cent of GDP in 1993, to 7,3 per cent in 2001 and 6,5 per cent in 2002). Private investments were increased from 3,7 per cent in 1993, to 12,1 per cent in 2001 and 12,5 per cent in 2002. So, for this period, the increase of investments, especially the private ones, has been the source of current account deficit. This fact, as noted in the first section, reinforces the conclusion on sustainability of current account deficit.

Let us pass now to the analysis of the structure or of the sources of current account deficit: trade balance, current transfers and the net factorial income.

The *net factorial income* has resulted positive since 1994 and its share in the current account has been increased. In absolute terms, it has been increased from 14,2 million dollars in 1994, to 126,3 million in 2002, unlike other transition countries, where the net factorial income

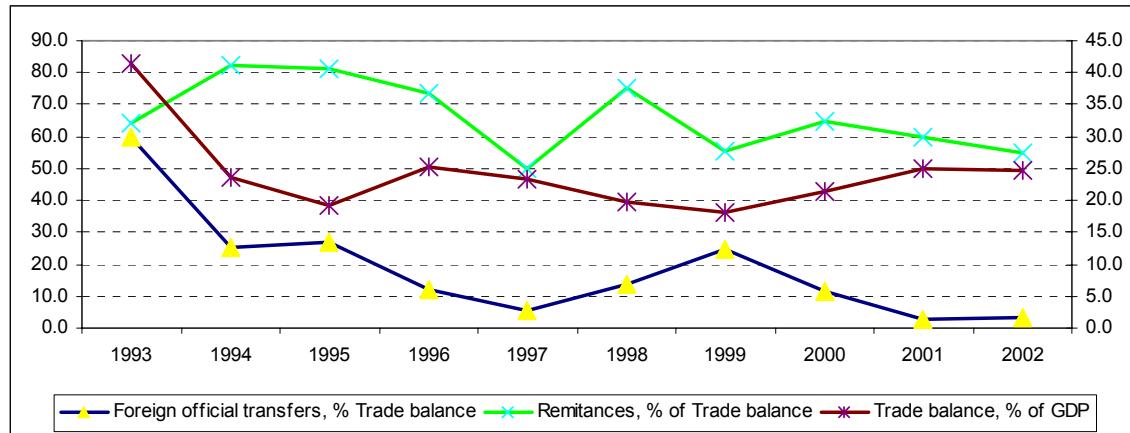
⁸ Calculated as deduction of current expenses (excluding grants) from income.

is structured in the deficit account. The reasons relate to the low figures of external debt service and also to the investment of country's reserve abroad. Therefore, the net factorial income has impacted the smoothing of current account deficit level.

Official *transfers* have also played a positive role in the current account balance. The role of official transfers has been especially important in the first years of transition. If we excluded the effect of official transfers, the current account balance in 1992–1994 would result in deficit, reaching respectively to -23,2, -4,5 and -4 per cent of GDP, from about +1,5 per cent of GDP that results for this whole period. (See figure 2, figure 3 and Annex A, table 1.) Official transfers continue still to be an important source of financing current account. However, their role has been declining and it has shown an obvious trend to gradually change towards the use of commercial term credits. So, in 2002, the official transfers represented only 2,5 per cent of the import volume.

The *remittances* have had the main share in the component of transfers. During the whole last decade, the migrants' remittances have financed more than the half of import of goods. (See: figure 3 and Annex A, table 1.)

Figure 3: Official transfers and migrants' remittances, in percentage to trade deficit



Trade deficit (in ratio to GDP) is shown on the right axle of the chart, whereas share of remittances and state transfers in financing the trade deficit is shown on the left axle of the chart.

According to balance of payments data (Annex A, table 1), the *trade deficit* of goods constitutes the most important component, which dominates the current account balance behavior. The relative indicator of trade deficit, in spite of declining compared to 1993 (from 41.4 per cent of GDP in 1993, to 24.6 per cent of GDP in 2002), remains at high levels. Meanwhile, in absolute terms, the trade deficit has increased in general, surpassing the figure of 1 billion dollars in 2002, being in a very high level if we take into account the overall level of overseas transactions. The dominating role of trade deficit in the current account deficit constitutes the main fragility of sustainability of the latter one and the main source of threatened sustainability.

Without making a detailed analysis of financing sources of current account deficit, we think that it is of importance to point out the significant share of informal sources (without saying straightforwardly the share of illegal traffic) of financing the commercial transactions. This fact increases further the fragility of sustainability of current account deficit and makes the external position of economy more threatened.

Another indicator of sustainability of current account deficit is even *the foreign reserve level*. The growth of foreign reserve level increases the economy's efficiency to meet debt obligations. In this case, the level of reserves to imports will serve as a measuring indicator. During a decade, the foreign reserve level is tenfold, facing 4,5 months of commodity imports, a level that is considered optimal.

Finally, again without referring to details, we would like to emphasize that the problems currently presented by the banking system, and the financial system in general in Albania, and the oscillations and political instabilities the country experiences time after time, contribute to its fragility and threaten sustainability of current account deficit.

Concluding the analysis of this issue, we think that it is not merely the level of current account deficit over 5 per cent of GDP that should make us feel concerned. The maintaining of high levels of economic growth, under the conditions of current rates (modest ones) of domestic savings, would require even for a certain period of time, the mobilization of foreign and the current account balance will continue to be featured by negative balances. More troubling is the domination of this deficit by a deeply negative trade balance and the potential instability of other sources, excluding income on exports, of financing commercial transactions and current account deficit. The low levels of exports and foreign direct investments on one hand, and the high share of official transfers and remittances, as well as the still high levels of illegal traffics on the other hand, under the conditions of expecting reduction of the latter ones in the future, risk to exert pressure on the reduction of overseas commercial transactions volume. This may cause reduction of the rates of economy growth.

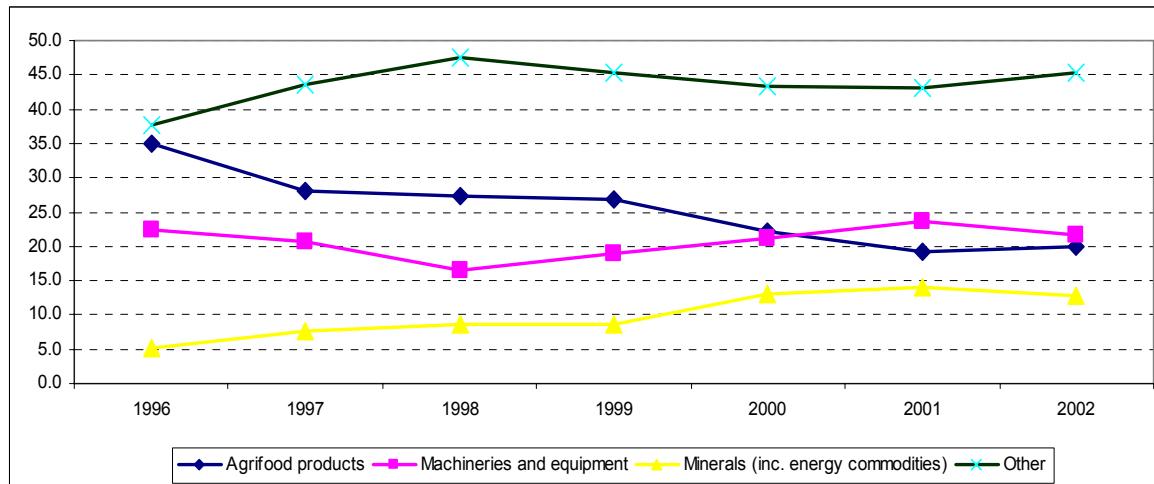
3. How can sustainability of current account deficit be increased in Albania's case?

The above analysis of the criteria of current account deficit sustainability and of the factors determining this deficit highlights the critical importance of the trade balance. Under the Albania's conditions, the sustainability of current account deficit may be equivalent to the sustainability, duration of import financing sources. Also, the sustainability improvement of current account deficit, from a long-term viewpoint, may be identified with the improvement of trade balance.

How can the trade balance improvement be achieved? Not in the "short" way of reducing the imports. Undoubtedly the imports of capital goods should be promoted and not reduced. Neither any effort to reduce consumption based on import goods would be fruitful. But, naturally, any effort to substitute imports with the domestic output at least of the same quality, would be useful. Figure 4 presents the dynamics of imports of main commodity group, where a generally increasing trend of import of machinery and equipment and raw materials is noticed⁹.

Figure 4: Dynamics of main commodity group of imports.

⁹ For more details, see Mançellari and Xhepa, 2002.



How can the substitution of imports be achieved? By placing obstacles to imports? By increasing these obstacles? In spite of existing spaces (but which are narrowing in the framework of regional and European integration of the country) to smooth the short-term protecting policies for certain products of the branches in recovery, yet, principally, the answer would be *no*. Not only would it be contrary to the liberalizing and integrating flows, especially because of the extended protectionist policies, but it would also hinder the efficient restructuring of economy, based on the market signals¹⁰. Therefore, a sustainable substitution of *imports* may be achieved only by restructuring the economy and by establishing a favorable climate of private investments.

The efforts to sustainable substitution of imports and to establishment of a favorable climate for the private business are consistent with the efforts to promote *exports*. **Export promotion may be considered, from a long-term viewpoint, as the primary way to improve trade balance**¹¹. Yet, without neglecting the importance of export oriented policies, the main path towards their promotion passes through the efficient restructuring of economy, based on the market principles. Only increasing the competitive abilities of economy the exports can increase.

How is the situation of Albanian economy competitive ability presented and how can it be improved?

The competitive ability of economy has on its basis the competitive ability of certain companies. The competitive ability of companies is based either on macroeconomic factors that determine the overall environment of their economic activity and the value of their product in terms of foreign currencies, or on microeconomic factors, which relate to the internal environment and conditions of the company. Microeconomic factors play a special role and the restructuring processes of economy are further enhancing this role. The campaigns undertaken recently for improving the internal environment of companies, so as to promote cooperation between companies and their competitive abilities through the climate of clusters¹², are expected to provide positive effects in increasing the abilities.

¹⁰ Idem.

¹¹ Idem.

¹² For more information regarding this incentive and the clusters, see Xhepa dhe Mançellari, 2003 and Tanku, Begaj, Skreli dhe Civici, 2003.

Other very important factors for increasing the competitive ability of economy, and of certain companies, are the smoothing and preventing of administrative barriers and the improvement of the overall investment climate (FIAS, 2003).

Among macroeconomic factors, we highlight the *real exchange rate*. We think to refer in a more detailed way to the analysis of this factor, since it is presented simultaneously even as a determinant variable of instantaneous internal and external macroeconomic equilibrium. The real exchange rate is nothing else but the nominal rate, adjusted to relative inflation index, determined as the ratio of a foreign country's price index to the given country's price index:

$$RER = \frac{ErP^f}{P}, \quad (1)$$

Where RER is the real exchange rate, Er-is the nominal exchange rate, P^f is the price index in the foreign country and P-is the price index in a certain country.

The real effective exchange rate (REER) considers the basket of foreign currencies of the countries, with which a certain country trades, as well as the basket of price index of these countries, thus setting up average weighted indicators.

Real exchange rate may be used even based on the price index of traded and non-traded goods:

$$RER = \frac{ErP_T^f}{P_N}, \quad (2)$$

Where, RER is the real exchange rate, E-is the nominal exchange rate, P_T^f is the traded good price index, defined in international markets and expressed in foreign currency and the P_N -is the non-traded good price index, expressed in domestic currency.

The increase of RER implies the real depreciation of domestic currency against the foreign currency. The real domestic currency depreciation implies domestic product price decrease in foreign currency, that is, increase of competitive ability of economy and promotion of exports. The RER decrease is associated with the increase of domestic product prices expressed in foreign currency, that is even with the reduction of competitive ability of economy and the restraining of exports. It is understandable that the impact on imports would be adverse.

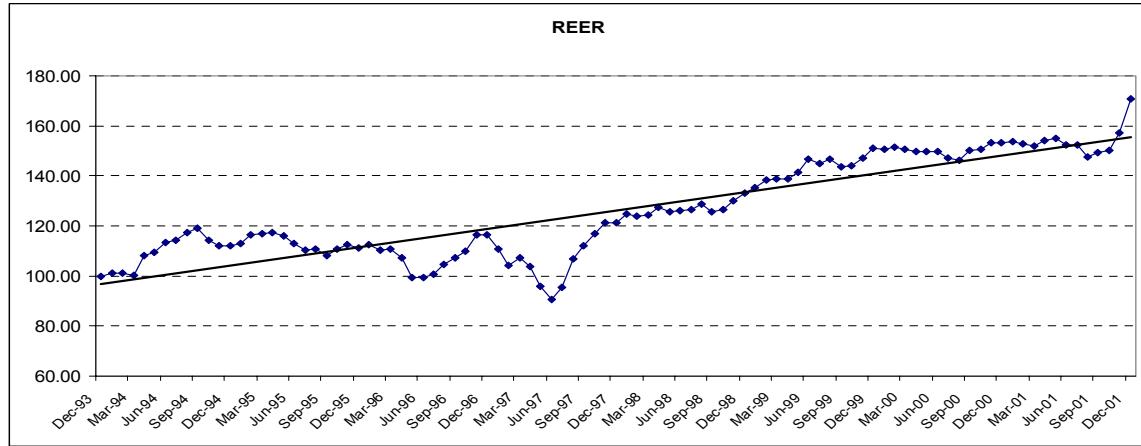
Under the assumption of the operation of One Price Law (based on the theory of Purchase Power Parity, PPP), we may state that $ErP_T^f = P_T$, where P_T is price index of traded goods, expressed in domestic currency. Hence, the real exchange rate formulae would be transformed into:

$$RER = \frac{P_T}{P_N}. \quad (3)$$

According to formulae (3), the real exchange rate is expressed as a ratio of traded good price index to the non-traded good price index. The increase of the relative price of traded goods in relation to the non-traded good price is reflected as a RER increase, that is, as real domestic currency depreciation, and is associated with the respective allocative effects and competitive ability of economy.

However, in literature, to express the real domestic currency appreciation or depreciation more directly, the inverse of RER is calculated, which is frequently, again called RER (See: I. Hollar, 2003), which expresses the ratio of the price index in the given country to the foreign country price index. The increase of RER indicator calculated in this way expresses directly the real appreciation of the currency, whereas the decrease expresses its real depreciation.

Figure 5: Real effective exchange rate behavior, 1993-2001.



The performance of real exchange rate in Albania over the transition years demonstrates a relatively sharp trend of domestic currency real appreciation, Lek, as illustrated in Figure 5¹³. Regarding this phenomenon, some questions may be raised. (i) Is this trend a deviation from the real optimal rate of equilibrium? (ii) What has impacted this trend? (iii) At what extent this trend may be regarded as responsible for the high trade deficit? (iv) May the foreign currency policies be expected to be effective for promoting exports? Let us try briefly to answer these questions.

(i) Given the Swan diagram (Figure 1), we see that a real exchange rate responds to the internal and external instantaneous macroeconomic equilibrium, which would be considered as real equilibrium rate or as optimal real equilibrium rate. However, the above diagram is more appropriate for stabilized market economy. Under the conditions of a transition economy, subject to massive structural changes, it would be very far to claim to determine a real equilibrium rate¹⁴. (Jazbec, 2002, Hollar 2003.)

(ii) Going on with the second question, it would be required to take into account the main factors that affect the real exchange rates, that are contained straightly or implicitly in the formulas for their calculation. Since the complete analysis of determinant factors on real exchange is beyond the focus of this paper, we would be satisfied by referring quickly to the formulae presenting the real exchange rate as a ratio of non-traded good price index to traded good price index¹⁵. What causes the change of relative prices of traded goods? Liberalizing reforms would be a significant factor. These reforms, along with the prevention of a number of

¹³ In Albania's case, the dynamics of real domestic currency appreciation appear better in the indicator of real exchange rate, calculated on the basis of consumer price index (CPI). The presence and weight of managed prices make the real exchange rate indicator, calculated on the basis of relative traded good prices, less reliable. (Hollar, 2003.)

¹⁴ In the debate on revaluation tendency prevailing in transition economies regarding the real exchange rate, two viewpoints are noted. One viewpoint, called the *equilibrium factor viewpoint*, considers the variations in the real exchange rate as a reflection of the real equilibrium factor variation, which is, in turn, reflected in the variation of the saving and investment balance, that is to say even as a return to the long-term exchange rate equilibrium. The other viewpoint, called the *viewpoint deviations from the equilibrium levels*, and considered as exchange rate revaluation, causes the loss of competitive ability of economy. (Roubini and Watchel, 1998.)

¹⁵ The real exchange rate is defined according to the formulae that actually calculates its inverse. (See Hollar, 2003!)

managed prices, are accompanied with increase of non-traded good prices, resulting to real domestic currency appreciation.

Another factor analyzed in the literature is the *Balassa-Samuelson effect*. Referring to this effect, real exchange rate increase has, again, on its basis the relative price increase of non-traded goods, which in turn is explained with a faster rising of productivity in the traded than in the non-traded good sector. (Drine and Rault, 2002.) Any effort made in Albania's case to analyze the price dynamics of traded and non-traded goods does not manage to prove a faster non-traded good price rise, as compared to traded good prices; Virtually, the adverse conclusion is drawn. (Josa, 2003.) However, this conclusion is probably related to the information inadequacy and the approach used.

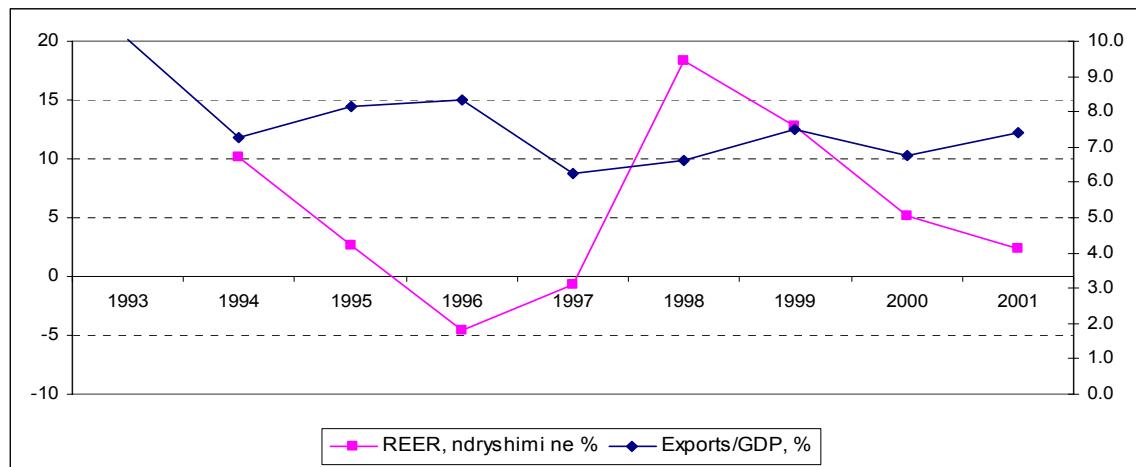
In other researches (Hollar, 2003), the Balassa-Samuelson effect is accepted in Albania's case, although the arguments are somewhat indirect and general, because of the absence of required data. According to Hollar, referring to the period of 1997, while the wage ratio in two sectors has remained more or less around the unit, the productivity ratio is increased in favor of the traded good sector. According to a study cited by the author (Halpern and Wyplosz, 2001), the analysis of data from 9 transition countries indicates that for every 10 per cent increase in traded good productivity (industrial goods), the relative price of non-traded goods to traded goods is increased 2,4 per cent in the short-term period and by 4,4 per cent in the long-term period.

Among other arguments used by the author to support the Balassa-Samuelson effect in Albania's case, valid even for other transition economies, are:

- Underdevelopment of the services sector in these countries during the period of centralized economy and increase of demand for products of this sector upon the income rise after the transition started
- The high financial inflow, especially in the form of formal and private (along with the loans and FDIs, whose share has been small). To the extent these inflows go for financing the expenses of the traded good sector, they, in the case of a small country, do not change the relative price of these goods. To the extent the expenses are increased in the non-traded good sector, the pressure for rising the prices of these goods, and even for domestic currency appreciation becomes evident. In Albania's case, the foreign financial inflows fluctuated within very high limits: 23-32 per cent of GDP. We should add here even the fact that official grants are oriented, to a great extent, to the public sector and to non-traded services.

(iii) However, leaving aside the reasons and taking for granted the real exchange rate "growth", that is the real appreciation of domestic currency, Lek, how much has this factor impacted the very low performance of exports? The analyses performed (Hollar, 2003), indicate that the impact is weak or insignificant. Relating to the weak correlation between these two variables, it is enough to refer to figure 6, which presents graphically the behavior of real exchange rate (always presented with the inverse formulae) and the export/GDP rate.

Figure 6: Variation in percentage of the REER and the export/GDP ratio.



Note: The export/GDP ratio is measured on the left axle, whereas the level of real exchange rate appreciation (depreciation) is measured on right axle of the chart.

The econometric estimation we tried to make on the relation between the real effective exchange rate and respectively imports and exports leads us to the same conclusion, being similar to other authors' findings (Hollar 2003; Mançellari, Mytkolli, Kola 1999). We have viewed the imports as a function of the real effective exchange rate (REER) and the synthetic indicators of domestic demand (GDP), whereas exports¹⁶ as a function of real effective exchange rate and the credit to private sector (DC).

The results presented in Table 1 (for more details, see Annex B) test that in long-term periods, the imports are more sensitive to the real effective exchange rate movements than exports, though in both cases, the values of *t-statistics* are insignificant.

Table 1: Conclusions of econometric analysis:

Export equation

A. Long run relationship

	Coefficient	T-stat.
Log(REER)	-0.132976	-0.408839
Log(DC)	0.862866	5.833580

Included observations 36

Adjusted R-square 0.46

B. Error correction

DLEKS(-1)	-0.457352	-0.801504
DLEKS(-2)	-0.327939	-0.582690
DLDC(-1)	-0.752461	-0.386669
DLDC(-2)	0.075185	0.036420
DLREER(-1)	0.030704	0.075862
DLREER(-2)	-0.030242	-0.074660

¹⁶ In absence of the foreign effective demand series, a simulation is carried out, using only the domestic demand of Italy, which constitutes the main market of Albanian exports. Though the results are not reported in this material, the exports would not be sensitive to changes in foreign market demand. This may be understood in the context of very low levels of our exports to the size of foreign market demand.

Included observations	33
Adjusted R-square	0,21

Import equation

A. Long run relationship

	Coefficient	T-stat.
LREER	0.339469	1.302463
LGDP	1.012716	6.583608

Included observations:	32
Adjusted R-square:	0.34

B. Error correction

DLIMP(-1)	-0.569095	-4.387924
DLIMP(-2)	-0.225827	-1.716510
DLREER(-1)	0.105371	0.723912
DLREER(-2)	-0.067519	-0.470908
DLDGP(-1)	14.42594	5.900461
DLDGP(-2)	-13.14060	-5.180513

Included observations:	29
Adjusted R-square:	0.69

In short-term periods, both imports and exports are insensitive to real exchange rate movements. The main explanatory factors are domestic demand in the case imports and credit to private sector (used as *proxy* for the investing activity) in the case of export performance.

(iv) The weak impact of real effective exchange rate on the export performance suggests that foreign currency policies would be less effective or ineffective in promoting exports. (See, also Mançellari, Mytkolli, Kola, 1999.)

Conclusions

Facing theoretical criteria, and especially the practical criteria of current account deficit sustainability vis-à-vis the current account balance position in Albania, the conclusion is drawn that current account deficit in Albania's case is chronic and at very high levels. In general, however, it may be estimated as being relatively sustainable, but with very fragile and seriously threatened sustainability. The fragility is related particularly to the dominating trade deficit weight in the current account balance and the expected unsustainability of financing sources of this deficit in medium and long-term periods.

Taking into account the current account deficit structure, we draw the conclusion that the current account balance improvement requires, above all, the trade balance improvement. In spite of the importance of substitution of imports, the paper emphasizes the idea that trying to orient the economy towards increase of exports, stands on the basis of a sustainable and long-term trade balance improvement.

Without neglecting the importance of supporting export policies, the main way to promote them is based on the efficient restructuring of economy, on the basis of market principles. The export growth is made possible only through increasing the competitive ability

of economy. Important factors in increasing the competitive ability of the economy are the restructuring reform performance, the smoothing and prevention of administrative barriers, the improvement of the overall investment climate, the improvement of business micro-environment, including the increase of cooperation between companies, especially in the form of clusters. The real exchange rate appreciation is assessed as having a weak impact on exports in Albania's case. Therefore, even the possible foreign currency policies as instruments to improve the trade balance are considered to be ineffective.

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ANNEXES

A. Table

Table 1: Main Balance of Payment data

millions of USD	1993	1994	1995	1996	1997	1998	1999
Current account	18.8	31.4	36.6	-62.3	-253.7	-65.0	-13.8
Exports	123.1	141.8	201.4	224.4	143.6	202.7	273.1
Imports	418.4	554.8	648.4	933.1	644.4	823.5	943.1
Trade deficit	- 295.3	-413.0 447.0	-	-708.7	-500.8	-620.8	-667.1
Foreign official transfers	303.9	117.1	128.5	83.4	29.0	82.6	163.1
Remittances from expatriates	325.8	377.9	384.6	499.6	266.9	452.3	368.1
Cumulative net foreign debt	139.4	186.9	250.3	298.8	332.2	460.4	550.1
Foreign debt service	0.6	17.5	4.7	8.9	11.2	15.6	1.1
Gross international reserves	72.0	147.0	204.0	240.0	275.0	306.0	384.1
Source: Bank of Albania, different statistical reports; Ministry of Finance, Fiscal Statistics, 2003 3							

Table 2: Indicators of Current Account Sustainability

	1993	1994	1995	1996	1997	1998	1999	2000
Current account deficit, % of GDP	1.5	1.6	1.5	-2.3	-11.1	-2.1	-3.6	-4.2
Current account deficit, % of GDP, net of official transfers	-23.2	-4.5	-4.0	-5.9	-12.5	-5.0	-8.2	-6.8
Foreign official transfers, % Trade balance	59.7	25.5	27.1	12.3	5.4	13.7	24.9	11.7
Remittances, % of Trade balance	64.0	82.2	81.0	73.6	49.9	74.9	55.5	64.0
Trade balance, % of GDP	41.4	23.6	19.2	25.2	23.3	19.7	18.0	27.0
Exports/GDP, %	10.0	7.3	8.1	8.3	6.3	6.6	7.5	6.0
Foreign debt service/GDP, %	0.5	12.3	2.3	4.0	7.8	7.7	4.9	5.0
Foreign debt/exports, %	113.2	131.8	124.3	133.2	231.3	227.1	199.5	238.0
Foreign debt/GDP, %	11.4	9.6	10.1	11.1	14.5	15.1	15.0	16.0
Annual foreign debt/GDP, %	5.3	2.4	2.6	1.8	1.5	3.3	3.1	2.0
M2/Gross international reserves	4.1	2.7	3.0	3.9	4.2	3.6	3.4	3.0
<i>Source: Fiscal Statistics of Government, quarterly, nr. 1/2003; ACIT (on foreign trade data)</i>								
	1992	1993	1994	1995	1996	1997	1998	1999
Saving Investment Balance in per cent of GDP								
Foreign Saving(1)	57.1	28.7	14.3	9.7	9.1	12.1	6.1	7.0
Domestic Saving	-51.9	-15.5	3.6	8.3	6.4	3.9	9.9	9.0
Public(2)	-21.9	-14.1	-10.6	-8.7	-9.0	-8.6	-5.2	-5.0
Private	-30.0	-1.5	14.2	15.0	15.4	12.5	15.1	15.0
Investment	5.2	13.2	17.9	18.0	15.5	16.0	16.0	16.0
Public	4.0	9.5	8.6	8.2	4.5	4.0	5.2	7.0
Private	1.2	3.7	9.3	9.8	11.0	12.0	10.8	9.0
(1) current account excluding net factor services and official transfers;								
(2) (2) revenues (excluding grants) minus current expenditures.								
<i>Source: Albania: Selected Issues and Statistical Appendix, IMF Country Report No 03/64; March 2003</i>								

Table 3: Current account, % of GDP for some countries

	1993	1994	1995	1996	1997	1998	1999	2000	2001
Albania	1.2	1.6	1.5	-2.3	-11.1	-1.5	-3.4	-4.3	-5.3
Bosnia Herzegovina		-9.0	-8.9	-27.3	-31.0	-28.2	-17.4	-27.4	na
Bulgaria	-10.2	-0.3	-0.2	0.2	4.2	-0.5	-5.5	-5.8	-6.2
Croatia	5.7	5.9	-7.7	-5.5	-11.6	-7.0	-7.5	-2.8	na
Macedonia	0.5	-4.6	-5.2	-6.5	-7.4	-8.8	-3.9	-5.5	na
Rumania	-4.5	-1.4	-5.0	-7.3	-6.1	-7.2	-3.8	na	na
Ex- Yugoslavia				-8.0	-10.1	-6.4	-3.6	-4.6	na
Source: WIIW data base; national central banks data published on the web pages.									

B. Regression Results

Dependent Variable: **LEKS**

Method: Least Squares

Date: 08/22/03 Time: 10:51

Sample: 1993:1 2001:4

Included observations: 36

Variable	Coefficient	Std. Error	t-Statistic	Prob.
LREER	-0.132976	0.325253	-0.408839	0.6852
LDC	0.862866	0.147914	5.833580	0.0000
R-squared	0.480785	Mean dependent var	8.578459	
Adjusted R-squared	0.465514	S.D. dependent var	0.842092	
S.E. of regression	0.615641	Akaike info criterion	1.921649	
Sum squared resid	12.88649	Schwarz criterion	2.009622	
Log likelihood	-32.58967	F-statistic	31.48348	
Durbin-Watson stat	1.680474	Prob(F-statistic)	0.000003	

Dependent Variable: **DLEKS**

Method: Least Squares

Date: 08/22/03 Time: 10:56

Sample(adjusted): 1993:4 2001:4

Included observations: 33 after adjusting endpoints

Variable	Coefficient	Std. Error	t-Statistic	Prob.
DLEKS(-1)	-0.457352	0.570618	-0.801504	0.4298
DLEKS(-2)	-0.327939	0.562802	-0.582690	0.5649
DLDC(-1)	-0.752461	1.946010	-0.386669	0.7020
DLDC(-2)	0.075185	2.064390	0.036420	0.9712
DLREER(-1)	0.030704	0.404740	0.075862	0.9401
DLREER(-2)	-0.030242	0.405064	-0.074660	0.9410
R-squared	0.332824	Mean dependent var	0.048812	
Adjusted R-squared	0.209272	S.D. dependent var	1.051357	
S.E. of regression	0.934896	Akaike info criterion	2.866203	
Sum squared resid	23.59884	Schwarz criterion	3.138296	
Log likelihood	-41.29236	F-statistic	2.693811	
Durbin-Watson stat	2.118474	Prob (F-statistic)	0.042301	

Dependent Variable: **LIMP**

Method: Least Squares

Date: 08/22/03 Time: 11:01

Sample(adjusted): 1994:1 2001:4

Included observations: 32 after adjusting endpoints

Variable	Coefficient	Std. Error	t-Statistic	Prob.
LREER	0.339469	0.260637	1.302463	0.2027
LGDP	1.012716	0.153824	6.583608	0.0000
R-squared	0.362790	Mean dependent var	10.07065	
Adjusted R-squared	0.341550	S.D. dependent var	0.612162	
S.E. of regression	0.496739	Akaike info criterion	1.498956	
Sum squared resid	7.402480	Schwarz criterion	1.590565	
Log likelihood	-21.98330	F-statistic	17.08026	
Durbin-Watson stat	1.456314	Prob(F-statistic)	0.000265	

Dependent Variable: **DLIMP**

Method: Least Squares

Date: 08/22/03 Time: 11:02

Sample(adjusted): 1994:4 2001:4

Included observations: 29 after adjusting endpoints

Variable	Coefficient	Std. Error	t-Statistic	Prob.
DLIMP(-1)	-0.569095	0.129696	-4.387924	0.0002
DLIMP(-2)	-0.225827	0.131562	-1.716510	0.0995
DLREER(-1)	0.105371	0.145558	0.723912	0.4764
DLREER(-2)	-0.067519	0.143380	-0.470908	0.6421
DLDGP(-1)	14.42594	2.444883	5.900461	0.0000
DLDGP(-2)	-13.14060	2.536544	-5.180513	0.0000
R-squared	0.752312	Mean dependent var	0.049747	
Adjusted R-squared	0.698467	S.D. dependent var	0.602765	
S.E. of regression	0.330991	Akaike info criterion	0.808540	
Sum squared resid	2.519765	Schwarz criterion	1.091429	
Log likelihood	-5.723831	F-statistic	13.97174	
Durbin-Watson stat	2.557537	Prob(F-statistic)	0.000002	