

Comments on: “The sustainability of current account deficit”

Dr. Erjon Luçi and Dr. Evelina Çeliku

Something like 6 months ago I did participate on a working party in Poland organised by BIS and Bank of Poland. I was asked in one of the session what was my opinion about the large size of Albanian current account deficit. I should admit, that question got me by surprise because at that time I was not quite up to date with the all the latest development of current account deficit. My quick answer was that, despite its large size as far as there was a closed circle going from the foreign remittances to imports, for the current account deficit it wouldn't make much difference if the remittances eventually declined, hence the possibility of 'hitting the wall' (meaning currency crisis) was still small for Albania. Ever since I tried to figure out better the scenarios of a possible crisis and of any flaw in my idea.

Although Albania has been characterised by large current account deficit throughout most of the transition period, only recently its size has become a matter of concern of many domestic and international institutions. While the main worry stems from its relatively large size, a thorough analysis is required to decide whether this is an unsustainable situation, which could lead to a currency crisis, or simply a reflection of the structural developments the country is undergoing. From this perspective we welcome the effort by Dr. Mancellari and Dr. Xhepa to shed some light on this important topic.

From the presentation of Mr. Mançellari we saw that the assessment of current account deficit is a complex issue which makes its analysis very difficult to come out with clear answers. The authors have used several indicators to assess the sustainability of the current account deficit, which generally point out at the fragility of preserving its actual sustainability. One potential source of problems with authors' results is the reliability of the benchmarks used to judge sustainability. However the authors have been very careful to emphasise a number of caveats and weaknesses of these benchmarks, especially those related to structural changes which are important aspects of Albanian and other transition economies.

We tend to agree with the main conclusion of the discussion that the actual current account deficit in Albania is relatively sustainable despite its worrying size. The other consideration **about** this situation as being fragile needs to be treated more carefully because, apparently, it seems to contradict the main conclusion. The fragility of current account deficit could be classified as a case of unsustainability. **As Milesi-Ferretti and Razin (1996) put it: If the continuation of the current policy stance and/or of the present private sector behaviour entails the need for a “drastic” policy shift, or lead to a “crisis” there is a case of unsustainability.**

So, we think that a more proper conclusion based on the given evidence is that while the actual policy stance in Albania could be considered as being sustainable in the short run, in the long run it could generate some problems if certain measures, such as those proposed, correctly, by the authors, are not undertaken. However, concerns have

been expressed that several shocks might trigger unsustainability in the short-run as well, on which we want to bring particular attention.

One of those developments which is the most feared to cause problems is the decline in foreign remittances as families of emigrants join them abroad, a view supported by the forthcoming presentation of Mr. Gedeshi and Mrs. Uruçi. It is often argued in several studies (Muço et al. 1999) that remittances from abroad, so far, have played an important role in maintaining the stability of exchange rate in Albania and in financing a significant share of imports. However, it is not so clear how the decline in the foreign remittances would lead to a situation of current account unsustainability and/or currency crises.

Referring again to the forthcoming study of Gedeshi and Uruçi, a large part of foreign remittances goes for consumption and quite a few for investment purposes. Therefore, a reduction in foreign remittances would lead to a reduction in consumption. If we make the realistic assumption that a large part of this consumption comes from imports, it follows that a decline in foreign remittances will be associated by a similar decline in imports, hence would leave the current account deficit more or less unaffected. Regarding the exchange rate market, based on the above assumptions, it seems to exist a closed circle too, which makes currency crisis difficult to arise. If for example, the families of emigrants cease exchanging remittances in the market the possible impact of this reduction in foreign currency supply will be counteracted by a similar reduction of demand, as far as the importers would reduce the need for foreign currency by the same amount.

It could be argued that a time mismatch might exist between the decline of supply and that of demand, because importers might not be sure whether the decline in the demand for imports is temporary or permanent. So, a quick depreciation of currency could follow. However, we retain that this is an unrealistic situation. The movement of emigrants' families abroad will hardly occur at the same time. This means that even if there is a time inconsistency in importers' reaction to the change of demand the impact need not be large enough to generate a currency crisis. Also the experience so far has shown that significant emigrants' movement in the summer time have been manageable. There is no reason to believe that the *gradual* movement of their families would have such a disruptive effect.

Another development which could have a more significant impact on current account deficit and a higher risk of a sudden decline in the inflow of foreign currency in the exchange rate market, is the reduction in the income coming from the informal (illegal) activities as the rule of law improves. The evidence on informal market, as Mr. Olters revealed in his speech, are very poor, and any judgement on the degree that it is used to finance imports and on how much goes through the exchange rate market, remain open to speculation. Nevertheless, independently from its size, even in this case the impact need not be necessarily large enough to trigger a case of unsustainability. For the informal but legal activities the income won't be lost as they switch from the informal to formal economy. Regarding illegal activities, let alone the fact that a large part of it may not flow through markets, the experience with the tightening of illegal emigration through the sea (which might have had an important impact on reducing illegal revenues) has shown not to have been associated with any particular deterioration. On the other side a reduction in illegal activities will give a

strong signal to foreign investors that the rule of law has begun to work in Albania. Thus, that part of current account deficit could that used to be financed through illegal activities income may now be financed through FDI. However, even in this case attention should be paid to the time mismatch, so an intervention by the BoA on the exchange rate market could be justified if there are signs of currency run, until the FDI start boosting.

Political instability could be another important source of deterioration of current account deficit as the 1997 experience in Albania has shown. Although, Albania in these recent years could be classified as relatively stable country, politically-wise, as mentioned earlier the investor confidence may delay to come. In these situations of bad equilibriums an external a positive shock might be needed. Measures such as, the set up of insurance structure to foreign investors against the political and economic risk in Albania in 1997 by World Bank are very useful solution. It is important to consider their viability in the future as solution that can boost FDI and improve the sustainability of current account deficit and also solve the above problem of time mismatch.

Nonetheless, the need for further structural reforms to improve the competitiveness of Albanian economy is indispensable to ensure the long run sustainability of the current account deficit. We are not getting into the discussion of ways to accelerate exports since this will be elaborated more extensively on the following presentation by Mr. Çeku. However, we want to make a couple of comments on the issue of the real exchange rate appreciation. Leaving for the moment the ambiguity about the degree of real exchange appreciation, which depends on the method used to calculate it (Hollar, 2003), we think that econometric technique at this stage might be insufficient to give conclusive results on whether the real appreciation of lek played or nor any role in the competitiveness of Albanian economy. Considering that exports as ratio to GDP have changed very little from the outset of transition it is difficult to find any relationship with the exchange rate which has been much more variable for many reasons. However, there is always a possibility that this appreciation has increased its pressure on keeping the foreign competitiveness and exports down. We do not want to assert that this is necessary the case, but unless this situation is compared against a situation where exports are more variable it would be difficult to come to a clear conclusion. So, further investigation is needed on deciding whether this appreciation is misalignment or a reflection of structural changes

To close the discussion with a positive note, it should be mentioned that future sustainability of current account deficit may also enhance by the expected privatisation of Savings Bank, Telecom, [KESH](#), INSIG which most probably will be privatised via foreign strategic investors. Nonetheless, we should always keep an eye open to potential destabilisation shocks that could lead to a situation of unsustainability and/or any currency crisis. As a matter of fact, the Bank of Albania is planning to push this discussion further by investigating in more detail the problems related to the sustainability of current account deficit.

(in millions US\$)

	1994	1995	1996	1997	1998	1999	2000	2001	2002
CURRENT ACCOUNT	31.4	36.6	-62.3	-253.7	-65.0	-132.9	-163.1	-217.9	-406.8
Exports of goods fob	141.4	204.8	243.7	158.6	208.0	275.1	255.4	304.6	330.2
Imports of goods fob	-601.0	-679.8	-922.0	-693.5	-811.7	-937.9	-1,076.4	-1,331.6	-1,485.4
Trade balance	-459.6	-475.0	-678.3	-534.9	-603.6	-662.8	-821.0	-1,027.0	-1,155.1
Services: Credit	83.1	98.2	127.3	67.9	86.6	266.7	448.1	533.5	585.0
Services: Debit	-97.5	-106.3	-142.3	-101.1	-129.3	-165.4	-430.0	-444.2	-589.5
Income: Credit	55.6	70.8	83.5	61.6	86.1	85.6	115.9	162.5	148.3
Income: Debit	-41.4	-28.5	-12.0	-11.9	-8.7	-10.3	-9.1	-13.4	-20.6
Transfers - private	374.1	348.9	476.0	235.7	421.3	188.4	438.6	542.6	586.9
Transfers - official	117.1	128.5	83.4	29.0	82.6	165.0	94.4	28.1	38.2
Capital Account	21.6	389.5	4.9	2.1	31.1	67.5	78.2	117.8	121.2
Financial Account	24.2	-414.5	49.6	140.7	16.0	36.8	182.5	109.0	206.2
Direct investment	53.0	70.0	90.1	47.5	45.0	41.2	143.0	207.3	135.0
Portfolio investment	0.0	0.0	0.0	0.0	0.0	0.0	-25.0	-23.4	-36.8
Capital transfers (others)	-28.7	-484.5	-40.5	93.2	-29.0	-4.4	64.5	-86.9	102.7
Errors and omissions	-44.5	7.9	54.8	142.5	69.4	131.3	15.0	136.1	108.0
Overall balance	54.9	30.6	47.0	43.8	59.4	123.5	131.9	145.0	28.6
Under attention									
Change in reserves	-54.8	-30.6	-39.5	-28.3	-75.9	-97.4	-130.5	-116.2	-109.9
Foreign exchange effect	7.3	5.1	-7.3	-15.5	12.6	-26.2	-3.5	1.5	65.0