CURRENT ACCOUNT SUSTAINABILITY[1]

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Abstract

Trade deficit and the related Current Account deficit, are major challenges for the Albanian transition. A trade deficit of 24.6% (of GDP) in 2002, is accompanied by a Current Account deficit of 9%, being close to the peak level recorded in 1997 (11.1%), exceeding by 3.7 percentage points the 2001 level and being twice as high as 5%, which is considered a warning level in the economic literature. High levels of the Current Account deficit require an analysis of the sustainability of this deficit, which is the goal of this paper.

Comparing theoretical and especially practical criteria of the Current Account deficit sustainability with the Current Account balance status in Albania, we can conclude that the Current Account deficit in the Albanian case is chronic, in rather high levels. However, in a comprehensive view it can be considered as relatively sustainable, but marked by a fragile and seriously threatened sustainability.

An analysis of the Current Account deficit structure shows that improvement of the Current Account balance requires above all improvement of the trade balance. Despite the importance of imports substitution, it is stressed in the paper that a long-term and sustainable improvement of the trade balance can be achieved through exports growth.

Introduction

The Albanian transition can be considered inter alia as a process of breaking a long lasting isolation of several decades and of economic opening towards regional and global markets and developments. Economic opening per se is a very important factor vis-à-vis economic restructuring and efficiency improvement. Nevertheless, attainment and sustainability of domestic macroeconomic equilibrium in the conditions of economic opening is a challenge, which in the case of Albania is reflected in the high levels of current Account deficit and seriously high levels of trade deficit.

A relative trade deficit level of 24.6% (of GDP) in 2002 is accompanied by a relative current Account deficit level of 9%, which is close to the peak level recorded in 1997 (11.1%), exceeding by 3,7 percentage points the 2001 level and being twice as high as the 5% level, which in the economic literature is considered as a "warning" level. Such high levels of current Account deficit lead to the question: Is the current Account deficit sustainable, in the case of Albania? This paper tries to answer this question.

To this end, the paper is divided in three parts. In the first part, according to the relevant literature, the meaning and the possible criteria of evaluation of sustainability of the current Account deficit are discussed. Given the fact that the current Account deficit is identified by the difference between saving and investment for the overall economy, it somehow measures and reflects the strength of a developing economy. On the other hand, the negative difference between saving and investment can be unsustainable and may hit the external economy. The sustainability of the current Account deficit essentially implies the sustainability of investment financing that appears as an excess of national savings, in the conditions of (i) growing imports, with a pace comparable to that of real GDP growth; (ii) no reduction of the normal international payments flows; (iii) no reduction of gross internal reserves.

Theoretically, in a synthetic approach, the economy's ability to sustain international financial obligations may serve as an indicator of sustainability of the current Account deficit. Nevertheless, a range of criteria stemming from the above theoretical criterion can be used for practical purposes, such as the foreign debt to GDP ratio; external sector crisis incidence; investment growth rates rapport compared to the pace of saving growth rates; the current Account deficit structure; structure of capital inflows; gross internal reserves' dynamics, compared to debt stock; financial system status and especially the banking system status and the predictability of economic policies and developments.

In the second part, efforts are made to put into practice the criteria discussed in the first part, in order to evaluate the sustainability of the current Account deficit in the case of Albania. The increasing need for investments in the economy, especially in the conditions of rather low domestic saving rates, have caused the current Account to suffer a chronic deficit, which extends almost throughout the entire transition period. The index analysis proves that the current Account deficit is a consequence of a faster pace of investment growth compared to the domestic savings growth rate. Investment increase, especially in the private sector, has

influenced the growth of import volumes, which in turn has lead to an escalation of the trade deficit, with its seriously high levels being a threat for the external economic equilibrium.

The analysis of the financial sources of economic transactions with the world and expected tendencies, especially the exports' problems and status; the restrictive and commercializing trends concerning international financial institutions' support; the tendency to reduce value remittances, in the medium and long-term; the policy of restricting and closing the paths to illegal traffic, reveal the vulnerability of the current Account sustainability.

In the third part an effort to answer the question concerning the ways in which sustainability of the current Account deficit can be improved in the case of Albania, is made. Analyzing the structure of this deficit we can conclude that the current Account deficit sustainability can be matched with the sustainability of imports financing sources. Against this background, the question posed, can be reduced in the problem: how can the Trade Balance be improved? It is stressed in the paper, that from a long-term perspective, the main way to improve the Trade Balance is through export stimulation, based on the increasing competitiveness of the country's economy.

In the economic literature concerning transition countries, a great deal of attention has been focused on the macroeconomic conditions of competitiveness, especially on the process of appreciation of the real exchange rate, an almost universal feature in transition countries. The analysis of this factor in the Albanian case reveals a weak impact on the performance of exports. Other factors such as the restructuring reforms procedure, the easing and elimination of administrative bottlenecks vis-à-vis private sector development, improvement of the general investment environment, and the business microenvironment improvement are considered more effective.

Summing up, it is stressed that the current Account deficit in the Albanian case is chronic, in rather high levels. Nevertheless, from a global perspective, it can be considered as relatively sustainable, but marked by a fragile and seriously threatened sustainability.

1. The meaning and the criteria of Evaluation of the Current Account Deficit Sustainability

Simultaneous achievement of domestic and external macroeconomic equilibrium is considered to be a central goal of macroeconomic policies. Domestic balance is defined as a situation where the real output is in its potential limits, or close to them, and the inflation rate is low and not accelerating. External balance is often defined as a current Account status, which is considered sustainable[5].

Both domestic and external balances are based on two fundamental variables: the real domestic demand level and real exchange rate. In turn, both variables reflect macroeconomic conditions and policies. The current Account deficit, takes place when the real exchange rate is

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[5] For a detailed analysis, please see Chorng-Huey Wong, 2000.

overestimated, and/or there is an excessive real domestic demand. Figure 1[6] shows a simultaneous domestic and external equilibrium (represented by E), as well as the different combinations of disequilibrium conditions.

Figure 1: Macroeconomic equilibrium and the real exchange rate

Real Exchange Rate
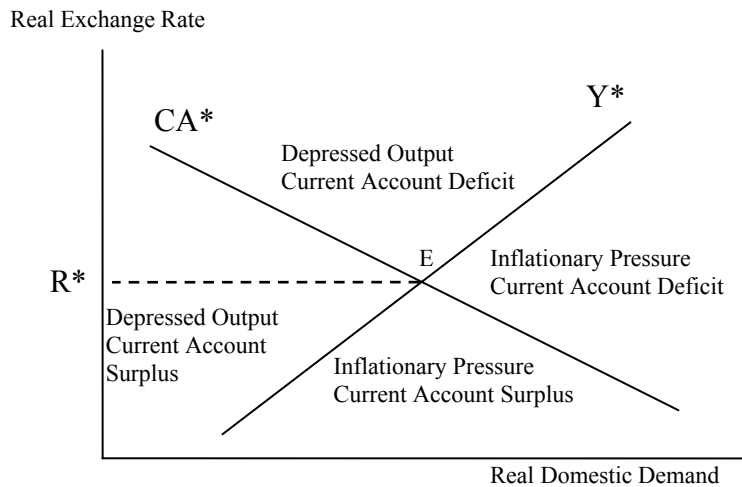
Which of the situations in the figure represents the current status of Albania? Chronic deficit in the balance of Current Account keeps the Albanian economy on the right side of the CA* line (the line representing external equilibrium). Despite relatively high and sustainable paces of economic growth, the high level of unemployment along with the low *credit for the private sector/bank deposits* ratio show that the GDP is far from its potential level, mainly because of structural causes. This means that the Albanian economy stands on the left of the Y* line in the same time (the line representing domestic equilibrium). Thus, the Albanian economy, suffering a lower GDP than its potential limits and a simultaneous deficit of the Current Account, stands over point E, which represents simultaneous domestic and external equilibrium that has a corresponding level of real exchange rate represented by R*. Nevertheless, inflationary pressure caused by remittances and other value inflows as well as structural factors cause the Albanian economy to tend towards disequilibrium levels on the right of point E.

In this paper, we are going to concentrate on external macroeconomic balance, which implies a sustainable balance of the Current Account. The Current Account balance, especially the Current Account deficit, is an important indicator of the performance of a transition economy. Its importance stems from the fact that Current Account balance, reflecting the saving-investment ratio, is closely related to the status of fiscal balance and private savings, which are key factors for economic growth. The importance of Current Account balance (deficit) is also based in the fact that it reflects the status of exchange rate and economic competitiveness.

Given that Current Account deficit is identified by the difference of savings and investments for the whole economy (CA=S-I), it measures and reflects the power of a developing economy, to a certain extent. But, on the other hand, a negative difference between

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[6] The figure is known as the Swan diagram, after the author that first used it (see Swan, 1963).

savings and investments might be unsustainable and hit the external economy. The shock or crisis of external economy can appear (i) *as a value crisis,* accompanied by drastic depreciation of domestic currency or a drastic reduction of gross internal reserves, or (ii) as a *foreign debt crisis*, in the form of inability to pay back foreign debts and/or inability to borrow from foreign sources. According to Roubini and Wachel, the Current Account deficit in transition countries reflects both aspects mentioned above. From one viewpoint, the Current Account deficit reflects the success of structural changes that have made possible capital and investment inflows and have opened the perspective of fast economic growth. On the other hand, from another perspective, the Current Account deficit reflects frequently mismanaged transition processes, featuring unsustainable imbalances, potentially a source of value or Balance of Payments crisis (Roubini and Wachel, 1998).

Which aspect of the Current Account deficit is more important? Which is the most reliable view? Answering this question is difficult, as stated by the authors mentioned above. This is a result of many factors as well as frequent and often unpredictable shocks that affect the Current Account Balance in transition countries, without neglecting the poor quality of available data. However, without underestimating the "positive side" of the Current Account deficit, this paper will focus on the other aspect: the sustainability of this deficit.

The concept of sustainability demands a thorough explanation. Sustainability of the Current Account deficit does not imply sustainability of the existing level of trade deficit. The concept implies sustainability of financing sources of this deficit, in the conditions of (i) growing imports, with paces comparable to those of real GDP growth; (ii) no reduction of the normal international payment flows; (iii) no reduction of the gross internal reserves. (Chrong-Huej Wong, 2000).

Thus, sustainability of the trade balance is a complex concept. Under these circumstances, it is impossible to come up with a simple way of finding out whether the Current Account deficit is sustainable or not. Nevertheless, a number of criteria that can be used to perform such an evaluation are recommended in the economic literature (Roubini and Wachel, 1998). Theoretically the economy's sustainability of international financial obligations (solvency), can be considered as a "synthetic indicator" of sustainability of the Current Account deficit. Nevertheless, using such a criterion is difficult, because of a certain indefiniteness in a given moment of time, which is a result of operating with an intertemporal budget limitation and real interest rate. For instance, according to this criterion, any level of the Current Account deficit, in the conditions of real interest rate being higher than the economic growth rate would be considered sustainable (Roubini and Wachel, 1998).

As a result, a number of practical criteria that anyway stem from the theoretical criterion, being related to the economy's solvency are required.

(i)   A non-accelerating *foreign debt to GDP ratio* is a sustainability criterion.

(ii)   A lack of crisis incidence in the external sector, in the form of value or debt crisis, is another practical criterion of sustainability in the conditions of a lack of external shocks or substantial changes in macroeconomic policies.

(iii)   It is generally acknowledged that a Current Account deficit to GDP ratio higher than 5% justifies the need for an evaluation of sustainability, and possibly unsustainability of the Current Account deficit. Nevertheless, sustainability evaluation is related to the analysis of deficit sources. In the conditions of a high deficit to GDP ratio, the deficit is more likely to be sustainable if *it is a result of national investments growth rather than a result of savings decrease, especially when the very national savings are*

low. Even though high paces of investments, especially private investments in production capital can generate a Current Account deficit, they are expected to bring about higher production capabilities and revenues from export, and consequently possibilities to serve foreign debts. Investments growth is consistent with high paces of economic growth, and thus high Current Account deficits are *more sustainable in the conditions of fast economic growth*. Referring to the savings decrease, a drop in national savings caused by a drop in public savings (an increase of budgetary deficit) is generally more problematical than the drop of private savings. This is because a drop in private savings is likely to be a transitional event, while a drop in public savings is a structural problem.

(iv)   Deficit structure also affects the Current Account deficit sustainability. If the Current Account deficit is largely caused by *a high trade deficit*, consequently reflecting structural problems related to the competitiveness of the economy, its *sustainability will be problematical*, compared to the cases in which it is primarily related to net factorial revenues. In this context, *the level of the export to GDP ratio* can be an indicator, consequently a criterion of sustainability of the Current Account deficit.

(v)   The Current Account deficit is financed through foreign capital inflows. The structure of capital inflows has an important effect on the sustainability of this deficit as well. *Short term inflows (portfolio investments or "hot" money) and loans are usually more dangerous than long-term inflows (foreign direct investments) and ownership investments concerning the Current Account deficit sustainability*. Loans from private creditors are more problematical compared to loans from official creditors; as well as portfolio investments compared to bank credits. Value composition of the loans' portfolio is also important in this context.

The amount of foreign capital inflows is also important for the Current Account deficit sustainability. *Large scale inflows of foreign capital*, especially in amounts surpassing the Current Account deficit, despite positive contribution in the short term, *may bring about negative consequences regarding competitiveness with the passing of time*, through stimulation of the appreciation of domestic currency, regardless of whether sterilizing measures are carried out or not (if not, the monetary volume, and thus inflation increases, stimulating a real appreciation of domestic currency; if sterilizing measures are carried out, the preservation of high interest rates stimulates the continuance of foreign capital inflows, bringing about a nominal appreciation of the domestic currency). Nevertheless, interventions in the value market may smooth the situation, and also increase gross internal reserves.

In general, *the Current Account deficit can be less sustainable in the conditions of a real appreciation of domestic currency, in spite of the causes of this appreciation*, as long as it has a negative impact on economic competitiveness.

(vi)   Gross internal reserves also affect the Current Account deficit sustainability. A higher ratio of gross internal reserves to debt stock, also indicates a better sustainability of the Current Account deficit.

(vii)   Finally, the sustainability of a high Current Account deficit is contingent on the domestic financial system status, especially the banking system status, political stability and predictability of economic policies and developments.

2. Is the Current Account deficit in Albania sustainable?

After a three-year period of surplus[7], in 1996 the Current Account balance got in a path of negative performance, recording a deficit of 2.3%[8] of GDP. During the 1997 crisis, the deficit reached 11.1% of GDP, and then fell back to less than 5% during the whole 1996-2000 period. The deficit surpassed the critical level of 5% of GDP in 2001, experiencing a fast growth in 2002, standing at 9% of GDP (Figure 2 and Annex A, Table 1).

Figure 2. The Current Account Balance in Albania, 1993-2002
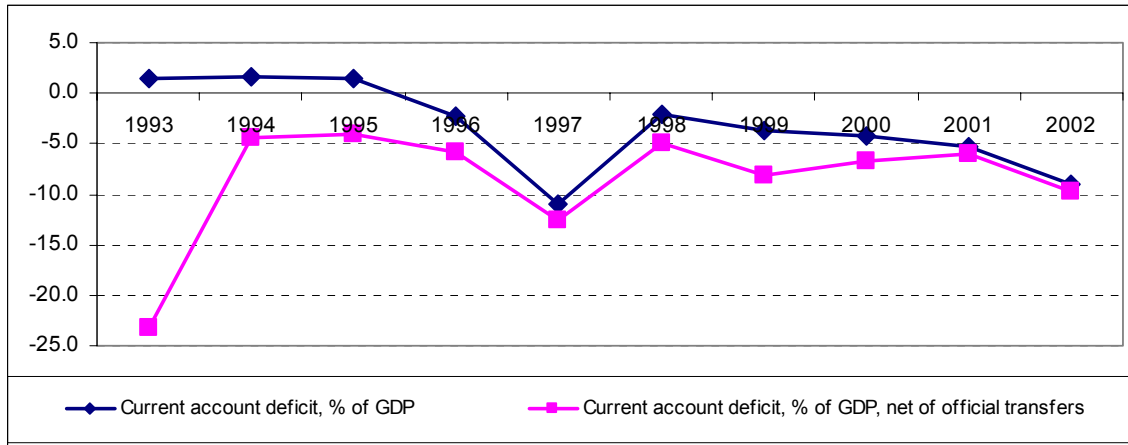
A comparison of data from the Current Account balance in Albania with respective data from other countries in the region that have similar structural problems in the economy, demonstrates that high levels of the Current Account deficit generally characterize these countries too (Annex A, Table 3). In some of these countries, deficit levels higher than 5% of GDP have been present, for a relatively long period, while no crisis of the external sector has been reported. On the other hand, the high level of Current Account deficit has not served as a warning signal in countries that have gone through economic and monetary crises, such as Bulgaria. During the crisis period (1997), Bulgaria enjoyed a Current Account surplus of 4.2% of GDP, compared to 0.2% one year before the crisis. Under these circumstances, the Current Account deficit limit of 5% of GDP has not served as a warning signal for crises of the external sector in countries such as Albania, and generally transition countries in the region that rely heavily on foreign aid. This limit is less important in Albania, compared to consolidated market economies.

However, we have to refer to the criteria discussed in the first part in order to estimate the Current Account sustainability for Albania, which was almost twice as high as the warning level in 2002.

Given that **foreign debt** sustainability is determinant for the Current Account deficit sustainability, let us refer to the criterion that compares foreign debt stock dynamics with GDP growth paces. Net accumulated foreign debt was roughly 1 billion dollars, or 20.9% of GDP in

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[7] The positive surplus of the Current Account balance for the first period of transition is mainly a result of foreign official transfers. Figure 2 illustrates the role of foreign official transfers.

[8] It must be emphasized that the quality and availability of data constitute a serious problem, which affects the accuracy of conclusions. This is evident from the presence of significant gaps in statistical series, which may result from changes in the methodology of measuring indicators, from numerous "Mistakes and Forgotten " items in the Balance of Payments, etc.

the end of 2002. This is a relatively low level compared to other countries in the region. On the other hand, the foreign debt annual level (annual increment of debt stock) has varied from 1.5 to 3% of GDP, while GDP annual growth has averaged 7%. Thus, *foreign debt growth is slower than annual economic growth.* According to this criterion, the Current Account deficit can be considered sustainable. Nevertheless, sustainability appears fragile even from this point of view. The foreign debt-export ratio (taking into account the central role of export value income to serve foreign debt in the long-term) is rather high and growing fast (from 113% in 1993 to 296,5% in 2002). However, for the period taken into consideration, foreign debt serving has reached modest levels, averaging 6,5% of total exports, and thus being much lower than 25%, which is generally considered a critical level. The country is not in the brink of facing inability to pay the foreign debt. In addition, Albania has experienced no value crises and no threatening signs of such crises are present, except for negative developments in 1997. This reinforces the argument of sustainability of the Current Account deficit.

Nevertheless, a more careful approach on the *causes, structure and financing sources* of this deficit, referring to the respective criteria is considered necessary for a complete view on the Current Account deficit sustainability, as stated in the first part of this paper.

Let us first deal with the causes of the Current Account deficit, referring to the deficit concept as a **savings-investments** difference and the relevant indicators (Annex A, Table 2). The Current Account deficit stood at 57%[9] of GDP in the transition onset (1992). A drop in domestic savings (minus 51,9% of GDP) triggered such a clamorous imbalance, while investments stood at a rather low level, 5,2% of GDP. Then, the situation changed. Growing savings, supported especially by public savings growth (reduction of the fiscal deficit) characterized the following decade. Government savings reached −1.2% of GDP in 2001[10] starting from −15.5% in 1993, while the level of private savings became positive in 1994 (14.2% of GDP), and was almost constant until the end of 2001 (14.3% of GDP). On the other hand, investments increased from 13.2% of GDP in 1993, to 19.4% in 2001. Positive developments regarding the structure of investments are also evident. The volume of public investment has been decreasing (from 9.5% of GDP in 1993, to 7.3% in 2001 and 6.5% in 2002). Private investments increased from 3.7% in 1993, to 12.1% in 2001 and 12.5% in 2002. Thus, growth of investments, especially private investments has been the source of Current Account deficit during this period. This fact supports the conclusion on the Current Account deficit sustainability, as emphasized in the first part of the paper.

Let us pass on the analysis of *structure*, or sources of the Current Account deficit: the trade balance, current transfers and net factorial revenues.

Net factorial revenues have been positive since 1994 and their volume in the Current Account has been increasing. In absolute terms, they have increased from 14.2 million dollars in 1994, to 126.3 million in 2002, being in contrast with other transition countries, where net factorial revenues are structurally in deficit. The causes are related to low figures of foreign debt serving and investments of reserves abroad. As a result, net factorial revenues have eased the level of Current Account deficit.

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[9] Without taking into consideration official transfers and net factorial revenues
[10] Calculated as a difference between current revenues (excluding grants) and current expenditures

Official transfers have also had a positive impact on the Current Account balance. Their role has been especially important in the early years of transition. If the effect of official transfers would be disregarded, the Current Account balance in the 1992-1994 period would result in deficit, standing at respectively –23.2%, –4.5% and –4% of GDP as opposed to roughly +1.5% of GDP, which is the actual level of this period (see Figure 2, Figure 3 and Annex A, Table 1). Official transfers are still an important financing source of the Current Account. Nevertheless, their role has been lessening and there is an evident and suggestive trend towards the use of credit on commercial terms. Thus, by the end of 2002, official transfers accounted for merely 2.5% of the imports' volume.

Remittances have been the most important component of official transfers. Throughout the past decade, remittances have financed more than half of the goods' imports (see Figure 3 and Annex A, Table 1).

Figure 3: Official transfers and remittances, in % of trade deficit.
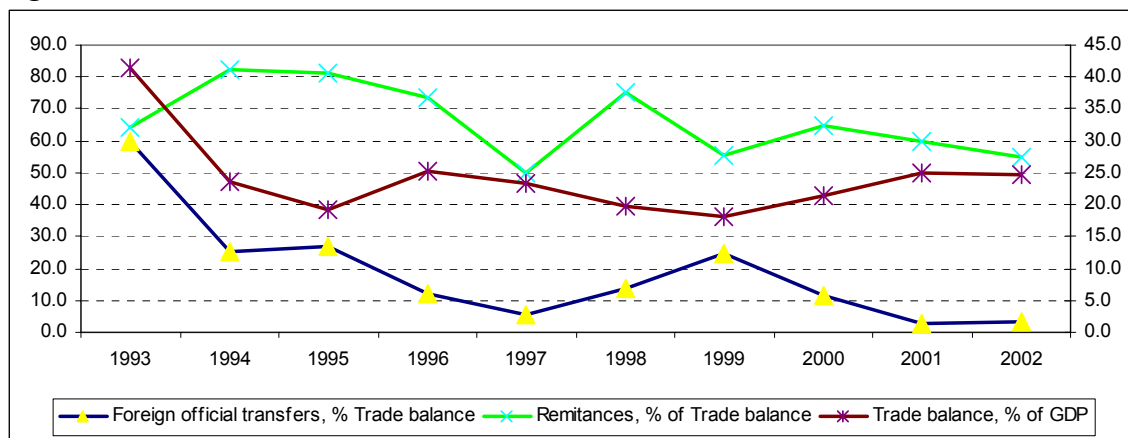
Note: The trade deficit (in relation to GDP) is measured on the right axis of the graph, while the volume of remittances and government transfers in trade deficit financing is measured on the left axis.

According to data from the Balance of Payments (Annex A, Table 1), **the trade deficit** of goods is the main component dominating the performance of the Current Account balance. The relative level of trade deficit is still high in spite of a decline compared to the 1993 level (from 41.4% of GDP in 1993, to 24.6% of GDP in 2002). Whereas, in absolute terms, the trade deficit has been generally increasing, exceeding 1 billion dollars in 2002, a rather high level, if we take into account the overall level of transactions with other countries. The fundamental role of trade deficit in the Current Account deficit is a key vulnerability of sustainability of the Current Account deficit and one of the main threat sources for this sustainability.

Without making a detailed analysis of the *financing sources* of the Current Account deficit, we think it is important to notice the considerable volume of informal sources (without identifying them directly as revenues from illegal trafficking) of financing trade transactions. This makes the Current Account deficit sustainability even more vulnerable, and threatens the external economy.

The level of *gross internal reserves* is another indicator of the Current Account deficit sustainability. An increasing level of gross internal reserves brings about a higher sustainability of liabilities for the economy. The ratio of reserves to imports volume can serve as an indicator

in this case. The level of gross internal reserves has become tenfold during the decade, sustaining over 4.5 months of goods' imports, which is considered an optimal level. The ratio of gross internal reserves to foreign debt stock is also relatively high. This indicator has been generally increasing, starting from 51.6% in 1993, and peaking in 2001 with 87.1%. It stood at 75.2% in 2002, giving additional proof of sustainability of the Current Account deficit.

Finally, without making a detailed analysis, we would like to emphasize that the current problems involving the Albanian banking and financial system in general as well as occasional fluctuations, instability and political bottlenecks in the country, make the Current Account deficit sustainability even more vulnerable and threatened. Summing up this analysis, we think the level of Current Account deficit standing at over 5% of GDP is not our single concern. Preserving high paces of economic growth, in the conditions of current (modest) domestic saving rates, will require the activation of foreign savings for an additional period and the Current Account balance is consequently going to have negative excess. Domination of this deficit by a deeply negative trade balance and the potential instability of other financing sources (except for export revenues) of commercial transactions and the Current Account deficit are more disquieting. Low levels of exports and foreign direct investments and the large volume of official transfers and remittances, as well as high levels of illegal trafficking on the other hand, in the conditions of reduction likelihood of the latter in the future, threaten to pressure and reduce the volume of foreign transactions. This may bring about a drop in the paces of economic growth.

3. What are the ways of improving the Current Account deficit sustainability in the Albanian case?

The above analysis of the criteria of Current Account deficit sustainability and factors defining this deficit makes evident the critical importance of the trade balance. Sustainability of the Current Account deficit in the Albanian case can be considered equivalent to the sustainability of imports' financing sources. Improvement of the Current Account sustainability in the long run, can also be identified with the improvement of trade balance.

How can improvement of the trade balance be achieved? Not in the "short" way of reducing imports. Capital goods' imports should obviously be encouraged, and not reduced. Other endeavors to reduce consumption based on imported goods would be useless too. But any endeavor to substitute imports with domestic production of at least the same quality would naturally be useful. Figure 4 represents the dynamics of imports of the main groups of goods, where a generally increasing trend of machinery, equipment and raw materials imports[11] is evident.

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[11] See Mançellari and Xhepa, 2002 for more.

Figure 4: The dynamics of imports of the main groups of goods
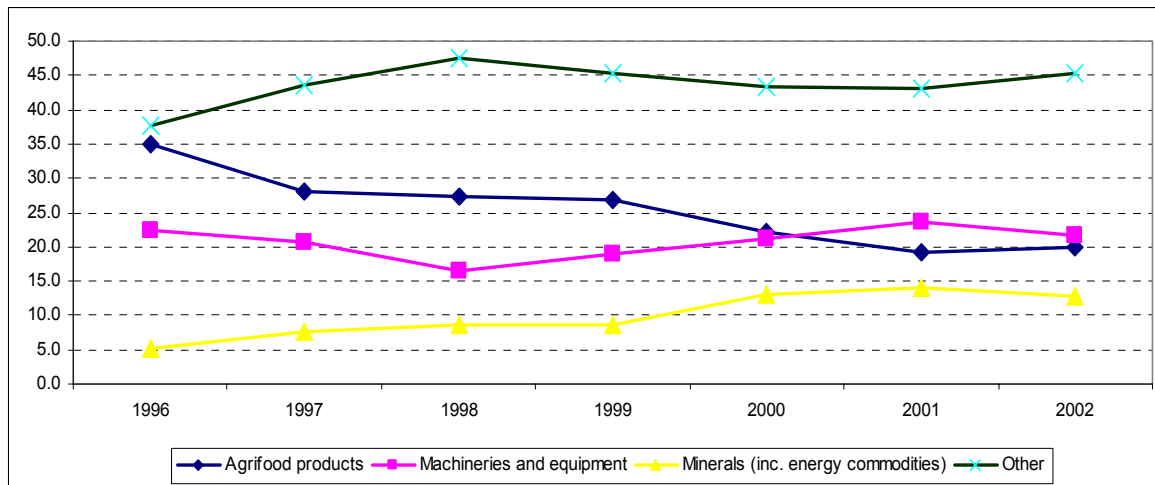
How can imports' substitution be achieved? Through imposition of import barriers? Through increasing barriers? In spite of current opportunities (which nonetheless are lessening in the context of regional and European integration trends of the country) to apply short-term protective policies for specific products of recovering branches, once more the answer would be *no* in principle. Not only because this would oppose liberalization and integration trends, but especially because large-scale protectionist policies would impede efficient economic restructuring, based on market signals[12]. Consequently, a *sustainable substitution of imports* can be achieved only through economic restructuring and creation of a favorable environment for private investments.

Endeavors to provide a sustainable substitution of imports through economic restructuring and creation of a favorable environment for private businesses are consistent with endeavors to *promote exports*. **Export promotion can be considered, as the main way of improving the trade balance in the long run[13].** Once more, without denying the importance of export-stimulating policies, the main way of export promotion is through efficient economic restructuring based on market principles. Exports' growth can be made possible only through increasing competitiveness of the economy.

What is the competitiveness status of the Albanian economy and what are the ways of improving it?

Competitiveness of the economy is based on the competitiveness of individual firms. Competitiveness of firms is based on macroeconomic factors defining the general environment of their economic activity and the value of their product in terms of foreign value, as well as on microeconomic factors related to the firm's microenvironment and its internal conditions. Microeconomic factors play an especially important role and restructuring processes of the economy are further consolidating this role. Recent initiatives to improve the business microenvironment, and promote cooperation between firms in order to increase their

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[12] Idem
[13] Idem

competitiveness through creation of clusters[14] are expected to give positive effects in capability improvement.

Easing and elimination of administrative bottlenecks and improvement of the general investments environment are other key factors for increasing competitiveness of the economy and thus competitiveness of individual firms (FIAS, 2003).

We are going to focus on the *real exchange rate* among macroeconomic factors. We think it's important to thoroughly analyze this factor because it is also a variable determining simultaneous domestic and external macroeconomic equilibrium. Real exchange rate is the nominal rate, adapted according to the relative inflation indicator, defined as a ratio of price index in the foreign country to price index in the given country:

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

where RER represents the real exchange rate, Er represents the nominal exchange rate, p^f represents the price index in the foreign country and P represents the price index in the given country.

The real *effective* exchange rate (REER) takes into account the group of values of countries with which the given country performs trade transactions, as well as the group of price indexes of these countries, creating average weighted indicators.

The real exchange rate can also be defined based on price indexes of marketable and unmarketable goods:

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

where RER represents the real exchange rate, E represents the nominal exchange rate, P_T^f represents the price index of marketable goods, defined in international markets and calculated in foreign currency, and P_N represents the price index of unmarketable goods calculated in domestic currency.

The increase of RER implies a real depreciation of domestic currency vis-a-vis the foreign currency. Real depreciation of domestic currency implies a drop in domestic goods' prices calculated in foreign currency, and thus increasing competitiveness and export stimulation. The decrease of RER brings about higher prices of domestic goods calculated in foreign currency, and thus decreases competitiveness of the economy and holds back exports. It's obvious that imports would be affected inversely.

Supposing that the Law of One Price is applicable (based on the theory of Purchasing Power Parity, PPP) we can write $Er P_T^f = P_T$, where P_T represents the price index of marketable goods, calculated in domestic currency. Thus, the real exchange rate formula can be transformed:

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[14] For more information on this initiative and clusters, see Xhepa and Mançellari, 2003 and Tanku, Begaj, Skreli and Civici, 2003.

$$RER = \frac{P_T}{P_N}.$$ \hspace{2cm} (3)

According to formula (3), the real exchange rate is calculated as a ratio of price index of marketable goods to price index of unmarketable goods. An increase of the relative price of marketable goods compared to the price of unmarketable goods is reflected as an increase of RER, and consequently as a real depreciation of domestic currency, accompanied by relevant effects in allocation and competitiveness.

However, the inverse of RER, which is often called RER as well (see I. Hollar, 2003), expressing the ratio of price index in a given country to price index in the foreign country, is calculated in literature in order to illustrate more explicitly real appreciation or depreciation of domestic currency. The increase of RER calculated this way, directly shows real appreciation of the currency, while a decrease of RER shows a real depreciation of currency.

Figure 5: Real effective exchange rate performance, 1993-2001
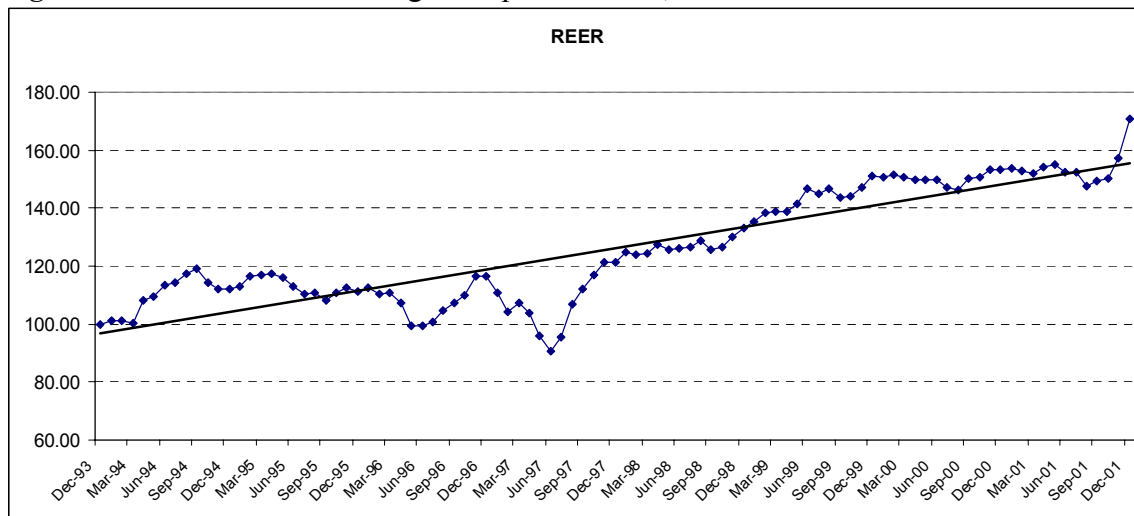
The real exchange rate performance in Albania during transition reflects a relatively strong tendency of real appreciation of domestic currency (lek), as shown in Figure 5[15]. A number of questions can be posed concerning this fact. (i) Is this trend a deviation from the advisable real exchange rate of equilibrium? (ii) What are the causes of this trend? (iii) In what extent can we consider this trend responsible for the high trade deficit? (iv) Can we expect value policies to be effective concerning export stimulation? Let's try to briefly answer these questions.

(i) According to the Swan diagram (Figure 1), simultaneous domestic and external macroeconomic equilibrium is consistent with a real exchange rate that can be considered as a real exchange rate of equilibrium, or desirable real exchange rate. Nevertheless, the above diagram is more suitable for stabilized markets.

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[15] The dynamics of real appreciation of domestic currency in the Albanian case is better reflected by the real exchange rate calculated based on the Consumer Price Index (CPI). The presence and volume of administered prices make the indicator of real exchange rate calculated based on relative prices of marketable goods less credible (Hollar, 2003).

It would be too pretentious claiming to define a real exchange rate of equilibrium[16] in the conditions of a transition economy, which undergoes massive structural changes (Jazbec, 2002; Hollar 2003).

(ii) We should take into account the main factors that affect real exchange rates, included explicitly or implicitly in the formulas mentioned above in order to answer the second question. Given that a thorough analysis of the factors determining real exchange rates is out of this paper's scope, we are going to briefly refer to the formula representing real exchange rate as a ratio of unmarketable goods price index to the marketable goods price index[17]. What is the cause of changes in the relative price of marketable goods? Liberalizing reforms comprise a factor that's worth considering. These reforms, accompanied by exclusion of a number of administered prices, bring about an increase in unmarketable goods' prices, resulting in a real appreciation of domestic currency.

The *Balassa-Samuelson effect* is another factor analyzed in the literature. According to this effect, the increase of real exchange rate is once more based on the increase of relative price of unmarketable goods, which in turn, is justified by faster improvement of productivity in the marketable goods sector, compared to the unmarketable goods sector (Drine and Rault, 2002). Attempts to analyze the dynamics of marketable and unmarketable goods' prices in the Albanian case are unable to prove the existence of a faster growth of unmarketable goods' prices compared to marketable goods' prices; they actually prove the contrary (Josa, 2003). Nevertheless, this conclusion is probably related to insufficient information and the method employed.

It is maintained in other studies (Hollar, 2003), that the Balassa-Samuelson effect is also present in the Albanian case, providing somewhat general or indirect arguments, in the conditions of being unable to formally test the Balassa-Samuelson hypothesis as a result of unavailability of necessary data, according to the author. According to Hollar, referring to the period after 1997, the ratio of productivities has increased in favor of the marketable goods sector, while the wages ratio in these sectors has been more or less constant. According to a study cited by the author (Halpern and Wyplosz, 2001), an analysis of data from 9 transition countries shows that for every 10% increase in productivity of marketable goods (industrial goods) production, the relative price of unmarketable goods to marketable goods increases by 2.4% in the short-term and 4.4% in the long-term.

Other arguments used by the author to support the presence of the Balassa-Samuelson effect in the Albanian case, which are relevant for other transition countries as well:
- Underdevelopment of the services sector in these countries under central planning and the increasing demand for products of this sector as a result of higher revenues after the transition onset.
- Large financial inflows in the country, especially in the form of official and private transfers (along with loans and foreign direct investments, the volume of which has been smaller). These inflows don't change the relative price of marketable goods in the case

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[16] There are two points of view regarding the prevalent appreciation trend concerning real exchange rate in transition countries. The first one, *the viewpoint of equilibrium factors*, maintains that changes in the real exchange rate reflect changes of real equilibrium factors, which in turn are reflected in the change of savings and investments balance, and consequently as a return in the long-term equilibrium of exchange rates. The other point of view, which is referred to as *the viewpoint of deviations from the equilibrium level*, maintains that exchange rate appreciation brings about a deterioration of competitiveness (Roubini and Watchel, 1998).
[17] The real exchange rate is actually calculated according to the inverse formula (see Hollar, 2003).

of a small country to the extent that they are used to finance expenditures in the marketable goods sector. Pressure inflicting an increase of these goods' prices, and thus appreciation of domestic currency becomes evident to the extent that expenditures in the unmarketable goods sector increase. Foreign financial inflows in Albania have been fluctuating in rather high levels: 23-32% of GDP. The fact that official grants have been largely directed to the public sector and unmarketable services should be mentioned here.

(iii) However, leaving aside the reasons and taking for granted the increase of real exchange rate, i.e. real appreciation of domestic currency (lek) what is the extent of this factor's effect on the poor performance of exports? Analyses (Hollar, 2003) show that this effect is weak or insignificant. Figure 6, which is a graphic illustration of the real exchange rate performance (calculated according to the inverse formula) and the export/GDP ratio, demonstrates the weak correlation between these two variables.

Figure 6: REER evolution and the export/GDP ratio evolution, in %.
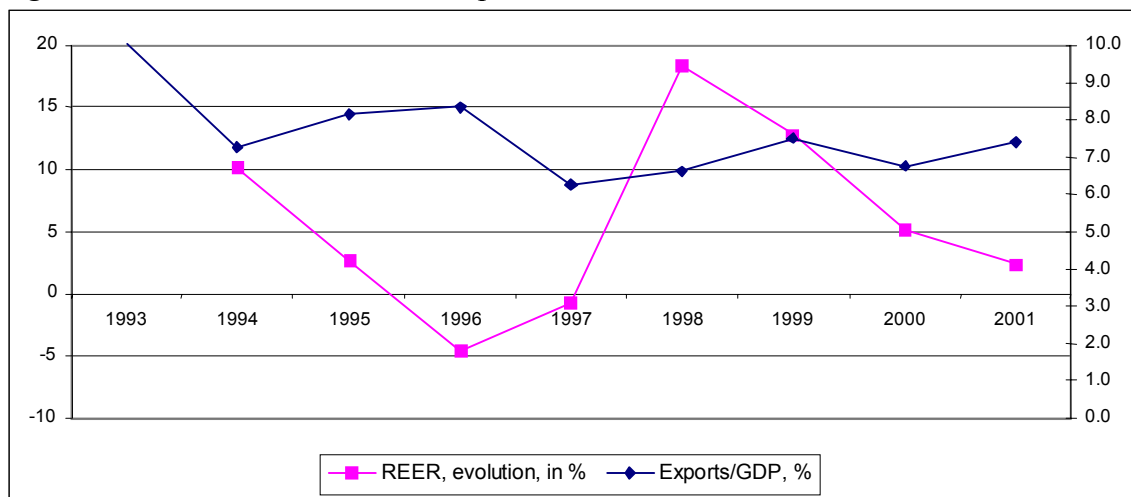
Note: The export/GDP ratio is measured on the left axis, while the appreciation/depreciation level of real exchange rate is measured on the right axis.

The above econometric evaluation of the relation between real effective exchange rate and respectively imports and exports brings us to the same conclusion, similarly to other authors (Hollar 2003; Mançellari, Mytkolli, Kola 1999). We have considered imports as a function of the real effective exchange rate (REER) and synthetic indicator of domestic demand (GDP), and exports[18] as a function of the real effective exchange rate and credit for the private sector (DC).

The results represented in Table 1 (see Annex B for a more detailed information) prove that in the long term imports are more sensitive than exports to shifts in the real effective exchange rate, though *t-statistics* values are irrelevant in both cases.

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[18] As a result of missing series of foreign effective demand, a simulation using the Italian domestic demand (which is the main market for Albanian exports) as an approximate indicator has been carried out. Though results are not reported in this paper, exports do not appear to be sensitive to foreign market demand changes. This can be explained in the context of rather low levels of Albanian exports compared to the dimensions of foreign market demand.

Table 1: Conclusions of the 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

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

Imports as well as exports are insensitive to real exchange rate shifts in the short-term. Domestic demand is the main factor explaining this performance of imports while credit extension for the private sector (used as *proxy* for the investment activity) explains the performance of exports.

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

Conclusions

Comparing criteria of the Current Account deficit sustainability with the Current Account balance status in Albania, we can conclude that the Current Account deficit in the Albanian case is chronic in rather high levels. Nevertheless, considered as a whole, it can be considered relatively sustainable, but marked by a fragile and seriously threatened sustainability. Its vulnerability is especially related to the dominant volume of trade deficit in the Current Account balance and the potential unsustainability of financing sources of this deficit in the medium and long run.

An analysis of the Current Account deficit structure, shows that improvement of the Current Account balance requires above all, the improvement of trade balance. Despite the importance of imports substitution, it is stressed in the paper that long-term and sustainable improvement of the trade balance is contingent on growing exports.

Without disregarding the importance of export-stimulating policies, the main way of promoting exports is through efficient economic restructuring, based on market principles. Exports' growth is possible only through increasing competitiveness. The performance of restructuring reforms, easing and elimination of administrative bottlenecks, improvement of the general investments environment, improvement of the business microenvironment, including increasing cooperation between firms, especially in the form of clusters are important factors for increasing competitiveness. The estimated effect of real exchange rate appreciation on exports is weak in the Albanian case. As a result, possible value policies used as instruments of improving the trade balance are thought 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	2000	2001	2002
Current account	18.8	31.4	36.6	-62.3	-253.7	-65.0	-132.9	-163.1	-217.9	-420.8
Exports	123.1	141.8	201.4	224.4	143.6	202.7	275.7	258.9	304.9	330.4
Imports	418.4	554.8	648.4	933.1	644.4	823.5	943.0	1089.4	1337.5	1,506
Trade deficit	-295.3	-413.0	-447.0	-708.7	-500.8	-620.8	-667.3	-830.5	-1032.6	-1175.4
Foreign official transfers	303.9	117.1	128.5	83.4	29.0	82.6	165.0	94.4	28.1	38.2
Remittances from expatriates	325.8	377.9	384.6	499.6	266.9	452.3	368.1	530.8	614.9	631.5
Cumulative net foreign debt	139.4	186.9	250.3	298.8	332.2	460.4	550.1	617.0	697.7	979.6
Foreign debt service	0.6	17.5	4.7	8.9	11.2	15.6	13.6	15.4	16.4	41.4
Gross international reserves	72.0	147.0	204.0	240.0	275.0	306.0	384.0	485.0	608.0	737
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	2001	2002
Current account deficit, % of GDP	1.5	1.6	1.5	-2.3	-11.1	-2.1	-3.6	-4.3	-5.3	-9.0
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	-6.1	-9.8
Foreign official transfers, % Trade balance	59.7	25.5	27.1	12.3	5.4	13.7	24.9	11.5	2.7	3.3
Remittances, % of Trade balance	64.0	82.2	81.0	73.6	49.9	74.9	55.5	64.7	59.9	54.7
Trade balance, % of GDP	41.4	23.6	19.2	25.2	23.3	19.7	18.0	21.4	25.0	24.6
Exports/GDP, %	10.0	7.3	8.1	8.3	6.3	6.6	7.5	6.7	7.4	7.0
Foreign debt service/GDP, %	0.5	12.3	2.3	4.0	7.8	7.7	4.9	5.9	5.4	12.5
Foreign debt/exports, %	113.2	131.8	124.3	133.2	231.3	227.1	199.5	238.3	228.8	296.5
Foreign debt/GDP, %	11.4	9.6	10.1	11.1	14.5	15.1	15.0	16.1	17.0	20.9
Annual foreign debt/GDP, %	5.3	2.4	2.6	1.8	1.5	3.3	3.1	2.7	2.2	3.1
M2/Gross international reserves	4.1	2.7	3.0	3.9	4.2	3.6	3.4	3.6	3.0	2.9
Gross international reserves/foreign debt, %	51.6	78.7	81.5	80.3	82.8	66.5	69.8	78.6	87.1	75.2
Source: Fiscal Statistics of Government, quarterly, nr. 1/2003; ACIT (on foreign trade data)										
	1992	**1993**	**1994**	**1995**	**1996**	**1997**	**1998**	**1999**	**2000**	**2001**
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	7.2	7.0	6.3
Domestic Saving	-51.9	-15.5	3.6	8.3	6.4	3.9	9.9	9.6	12.0	13.1
Public(2)	-21.9	-14.1	-10.6	-8.7	-9.0	-8.6	-5.2	-5.8	-2.6	-1.2
Private	-30.0	-1.5	14.2	15.0	15.4	12.5	15.1	15.4	14.6	14.3
Investment	5.2	13.2	17.9	18.0	15.5	16.0	16.0	16.8	19.0	19.4
Public	4.0	9.5	8.6	8.2	4.5	4.0	5.2	7.4	6.5	7.3
Private	1.2	3.7	9.3	9.8	11.0	12.0	10.8	9.4	12.5	12.1

(1)   current account excluding net factor services and official transfers;
(2)   (2) revenues (excluding grants) minus current expenditures.
Source: Albania: Selected Issues and Statistical Appendix, IMF Country Report No 03/64; March 2003

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

	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002
Albania	1.2	1.6	1.5	-2.3	-11.1	-1.5	-3.4	-4.3	-5.3	-9.0
Bosnia Herzegovina		-9.0	-8.9	-27.3	-31.0	-28.2	-17.4	-27.4	na	na
Bulgaria	-10.2	-0.3	-0.2	0.2	4.2	-0.5	-5.5	-5.8	-6.2	-4.4
Croatia	5.7	5.9	-7.7	-5.5	-11.6	-7.0	-7.5	-2.8	na	na
Macedonia	0.5	-4.6	-5.2	-6.5	-7.4	-8.8	-3.9	-5.5	na	na
Romania	-4.5	-1.4	-5.0	-7.3	-6.1	-7.2	-3.8	na	na	na
Ex- Yugoslavia				-8.0	-10.1	-6.4	-3.6	-4.6	na	na

Source: WIIW database; national central banks data published on the web pages.

B. Results of the regressions

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