

BALANCE OF PAYMENTS, NAMELY THE CURRENT ACCOUNT DEFICIT AND THE EFFECT ON THE EXCHANGE RATE.

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Abstract

An important part of economic activity is not only a country's internal activity, but also transactions with the rest of the world. Exactly the totality of economic transactions carried out by a country with the rest of the world is the Balance of Payments. A very important item is its current account. In the context of the global crisis is important, the analysis of the situation and the current account deficit and exchange rate impact. This is because the global data showed that countries that were found with a high deficit of current account were affected by the crisis to a greater extent. So, the purpose of this paper is to identify and measure the state of the current account deficit in the context of the global crisis and the effect on the exchange rate.

Keywords: Balance of payments, Current account, Exchange rate, Trade balance, Depreciation, Appreciation.

1. Introduction

This paper presents the state of the balance of payments, especially the current account and the impact in the exchange rate.

Meaning of the balance of payments. The reason of this paper is related with the fact that during the transition period, the attention of Albanian academics has been mostly focused on the analyses of the inflation and of the economic growth and less on the situation of current account and the factors of its deficit. Meanwhile, it is important to stress out that the trade balance which makes the dominance of the current account is an important part of the aggregate demand and as a consequence it directly impacts the real economy.

Current account view. This heading represents data on the deficit of current account. The initial data prior to the global financial crisis, that is the period from 1993-2006, and the data after the crises have been presented. Such distinction has been drawn to make clear the crises impact in this indicator.

Effect on the exchange rate. This heading defines what the exchange rate is and its influence in the inflation, especially in the first period transition. Meanwhile, the reciprocal effect of the current account deficit and of the exchange rate in the apex of

the crises and the depreciation of the national currency has been analyzed.

Methodology: This work is prepared based on the analysis of the data found in the statistical year-books of the Bank of Albania, Ministry of Finance, etc., as well as in the works of different authors on the state and development of the banking system in Albania.

2. Meaning of the balance of the payments.

One of the main macro-economic equilibriums of a country's economy is the equilibrium in the market of goods; this is the reason why the factors that condition this equilibrium have been the object of the economist's research and analyses. Aggregate demand as an *entirety of the products and services* demanded in a country for a certain period and with an aggregate price, is made up by the following:

- consumption effectuated by family economies
- investment effectuated by the companies
- government's expenditures
- difference of export-import

In the general analyses of the aggregate demand, the fourth component that is the difference of export-import is enormously important. Export-import of goods, effectuated in a country, or otherwise called: the trade balance is part of the payment balance of

that country's economy. *The payment balance is a statistical mirror that comprises in a systematical manner and for a defined period of time, the economic transactions of a country with the rest of the world.* The payment balance comprises two accounts; Current account and Capital account.

The current account is made up by the trade balance and the transferable payments of a country with the rest of the world [3]. The capital account registers the purchases and sales of the actives, such as obligations, share holds, land etc. Current account is the object of the analyses in the following. During the transition period, the Albanian economy has been characterized by a sustainable economic growth, a relatively controlled inflation and a high deficit of the current account [7]. The focus of the academics and researchers in this period have been least drawn in the analyses of the deficit of current account. The publication by the Bank of Albania, of the study "*Is the deficit of current account stable?*" has emphasized that there are two factors that make indispensable the analyses and the focus of attention of the academics in the current account deficit:

- Study of the effects and consequences of the economic crises in Latin America, Asia and Russia, as well as the actual global crisis, has shown that the countries that were most severely faced with the crises, were those countries that had a high deficit of current account against the GDP.
- The instruction of Milesi –Ferreti and Razin (1996) defined a general rule: ".....the deficit of current account above 5% of GDP, give a red signal, especially if the deficit is financed by the short term debt or the reserves of foreign currency and if it reflects high consume expenses.....".[1]

Considering that from the 90-ies, the deficit of the current account of the Albanian economy is more than 5% of the GD, its analyses and study is necessary.

3. View of current account

3.1 The situation of current account prior to the global financial crisis.

Since the beginning of the 90-ies, the current account has been continuously deficient. In the following, the progress during the 90-ies is presented. In the year 1993 and in 1997, the heights amounts of the current account deficit has been noticed, respectively 15.7% and 12.2% of GDP. The lowest values result in the year 1994 and in 1998, respectively 4.1% and 5% of GDP. During the 2000s, the deficit has always been above the limit defined above, by reaching the maximal level of 10 %, in 2002. This is shown in figure 1

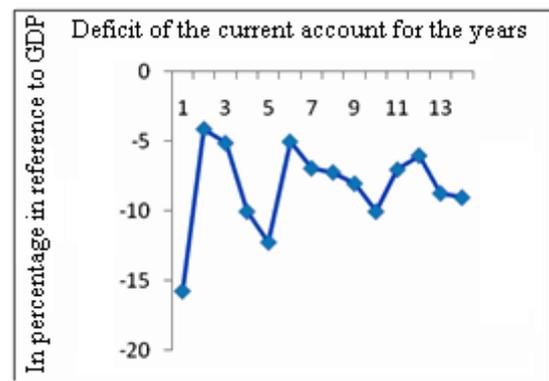


Figure 1: The deficit of the current account for the period 1993-2006. Source: Bank of Albania, discussion material "*Is the deficit of the current account stable?*"

Considering that the trade balance is the most important part of the current account, its analyses is important. The trade balance in Albania has reflected a growing deficit since the beginning of the transition. The reason is the slow progress of exports, approximately 7% of the GDP and the escalated growth of import, estimated at around 30% of the GDP. This is shown in figure 2. This view shows that the Albanian export is facing competitiveness problems, whilst a large growth of consume, represented in the progress of the import, has been noticed [1].

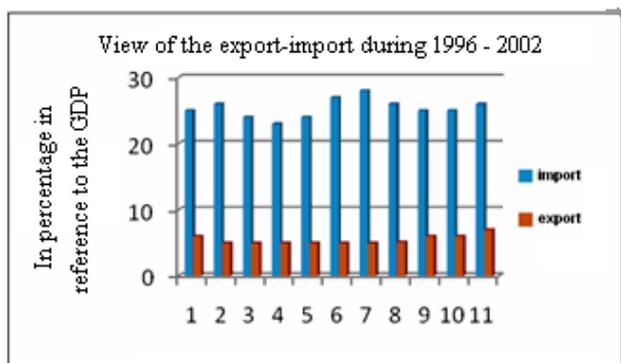


Figure 2: Export-import during 1996-2002.
Source: Bank of Albania, discussion material “Is the deficit of the current account stable?”

State of the Current Account in the year 2009 and the effect of the Global Financial Crises.

During the years 2006-2009, the deficit of the current account increased significantly. This deficit reached its apex in the end of 2008, by reaching 23% of the GDP. The factors that influenced the deepening of the current account deficit and that at the same time are the effects of the global crises are the following:

- Fast growth of imports
- Significant decrease of remittances
- Growth of state budget deficit

In the end of the year 2009, the deficit of the current account was decreased in 16% of the GDP.

This diminution is explained by the reduction of the trade deficit [4]. This is shown in figure 3.

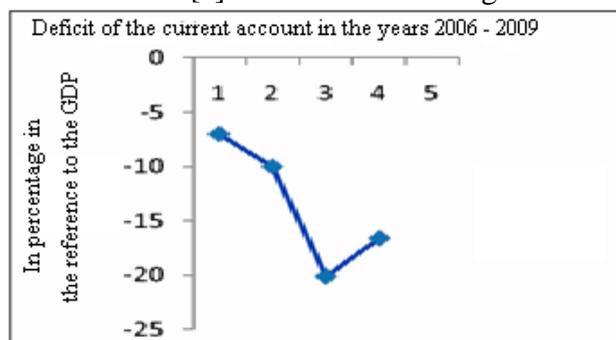


Figure 3: Deficit of the current account.
Source: Bank of Albania, the rapport of the

monetary policy, first trimester of the year 2010

Slowness of the inner demand and the decrease of the global trade activity had a dominant effect in the trade balance, by influencing in the country, the decrease of imports in reference to exports. The deficit of the trade account had its heights level in the year 2008, by reaching 27.9% of the GDP. This deficit implies high levels of consume and of economy investments which are not covered by the national savings but by foreign saving in the form of capital income.

The deficit of the trade balance has shown narrowing tendencies during the two last trimesters of the year 2009, compared to the same period of the previous year, thus by softening the negative impact in the aggregate demand [4].

This is shown in figure 4

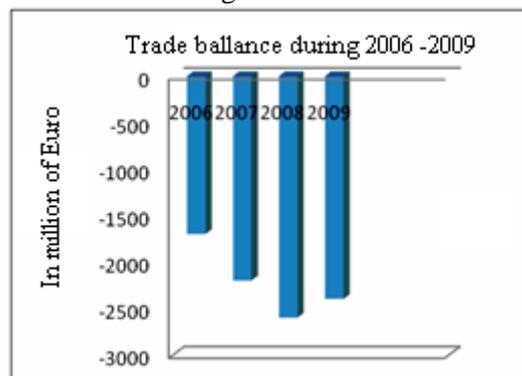


Figure 4: Deficit of the trade balance during 2006-2009. Source: Bank of Albania. Annual report 2010

The deficit of export-import has shown amelioration tendencies in the end of the year 2009 which are explained by:

- Growth of incomes by tourism
- Reduction of import of goods
- Extension of positive balance of current transfers.

This amelioration has softened the negative influence in the aggregate demand, compared to the previous year. The improvement has continued during the two first months of the year 2010 and the trade deficit was reduced with around 19.6 per cent,

compared to the same period of the last year. The ratio of the coverage of imports by exports is evaluated in the amount of 33.7 percent, approximately 10.2 % higher compared to the same period of the year before. The factors that influenced in the improvement of our exports for this period are:

- The increase of the price of the raw material.
- The increase of the presence of the Albanian products in nontraditional markets, as a result of the regeneration of the world economic activity.

4. Exchange rate

Considering that the export – import of the goods, is accomplished through the exchange of the local currency with the currencies of different countries, it is clear that the state of the current account influences directly in the *cost of the local currency against the currencies of other countries*, therefore in the exchange rate. The stability of the exchange rate, during the transition period according to Muca et al (2004), had a fundamental role in keeping the inflation in normal levels. Following, it has been indicated the progress of the indicator NEER, that represents the annual changes of the ALL in effective nominal terms, as well as the inflation indicator for the period 1994-2007 [6].

It is noticed an almost zero conduit of the fluctuation of the exchange rate in the consume prices. This is shown in figure 5.

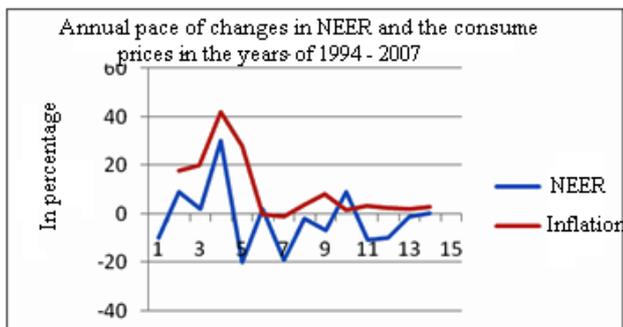


Figure 5: The change of the NEER and the consume price for the years 1994-2007. Source: Bank of Albania. “Conduit of the

exchange rate in Albania”. Klodian Istrefi, Valnetina Semi, 2008

Let’s focus concretely the effect of the exchange course in the deficit of the current account. The commercial balance depends on:

- Level of GDP that has an influence in long time period, in particular in the amount of exports.
- The change of the relative prices of goods that has an influence in the volume of the imports.
- Changes in the exchange rates that influence the offer of exports, more then the relative prices.

In the following it has been demonstrated that in the first period of transition, the fluctuation of the exchange rate followed the progress of the trade balance, which verifies the influence of the third factor [1]. This is shown in figure 6.

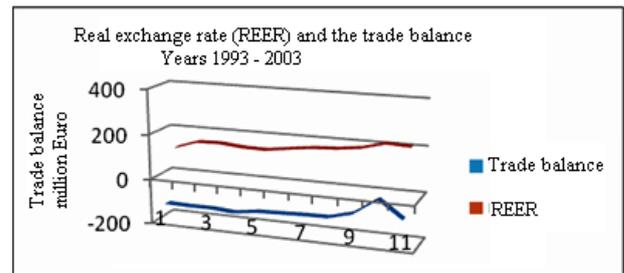


Figure 6: The real exchange rate (REER) and the trade balance. Source; Bank of Albania, Material for discussion “Is the deficit of the current account stable?”, Altin Tanku, Evis Rucaj, Argita Frasher. 2009.

The progress of the exchange rate for the year 2003 and after is given as below:

In March 2008, the ALL has been depreciated with 10 %. This depreciation is explained by the influence of the global crisis. In the first trimester of the year 2010, the local currency has continued to present tendency of depreciation, but in a much moderated manner. The ALL has been depreciated with approximately 6.4 percent, compared to the same period of the previous year and with 2.4 per

cent, compared to the following trimester.

This is shown in figure 7.

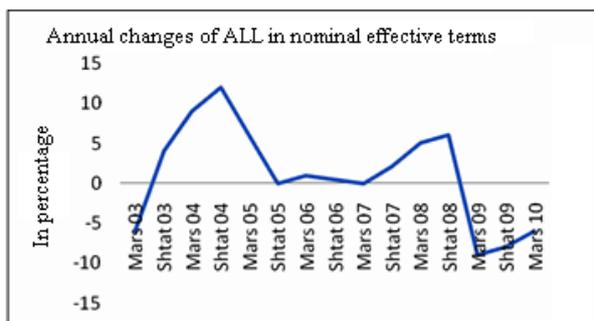


Figure 7: Progress of the NEER, for the period March 2003- March 2010. The Source: The publish of Bank of Albania: In: Definition of the exchange rate in Albania. Evidence of the autoregressive vectors. 15-32.

The attenuation of the depreciated tendency in the exchange market for the first trimester of 2010 has been caused by;

-The improvement of the trade deficit as a consequence of the reduction of imports and increase of exports,

-The effect of the seasonal factor that is a feature of the first trimester of each year has been attenuated. [2]

The attenuation of the seasonal effect is explained by macroeconomic and technical factors.

The following graph contains data based on which in the year 2010, from January until March, it has been attenuated the seasonal effect, which is much apparent for the year 2009. This is shown in figure 8.

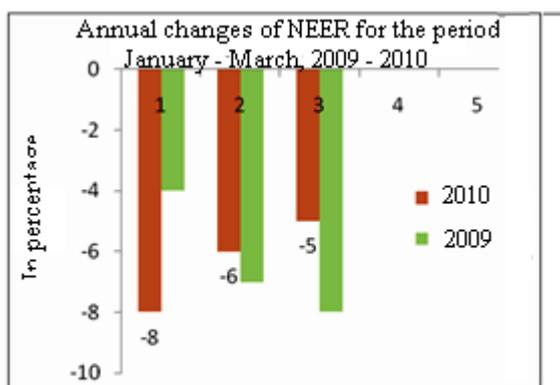


Figure 8: Changes of the NEER for the period January – March, 2009-2010 The Source: The publish of Bank of Albania: In: Definition of the exchange rate in Albania. Evidence of the autoregressive vectors. 15-32.

In the discussions on the influence of the exchange rate in the deficit of the current account, one of the issues raised, is on which side the exchange rate influences the deficit of the current account. Based in the econometric model of Marshal –Lerner, Ilir Vika has performed a study in which verifies that the *depreciation of the local currency has positive effects related to the trade deficit [5]*.

In addition Roubin and Watchel (1998), notice that the deficit becomes less sustainable, when it is associated with the appreciation of the local currency, compared to other currencies. However, the exhaustion of this problem with more specific data is object of a separate work.

5. Conclusions and recommendations

- During the transition, the Albanian economy has been characterized by a high deficit of the current account. However, the attention of the economists and analysts has been less focused on the analysis of this problem, rather than on the problems related to inflation and the economic growth.
- The data on crisis have showed that countries that have a high deficit of the current account face the crisis in a higher level than others.
- The trade balance in Albania has reflected an increasing deficit, during transition. The cause is the slow progress of exports and the escalated increase of imports.
- The global crisis has deepened this deficit in a significant manner.
- The transition has been characterized by a stability of the exchange rate that has influenced in maintaining the inflation in country in normal levels.

- The global crisis has influenced significantly in the depreciation of ALL.
- The method to attenuate the deficit of the current account and the influence in the exchange rate is the improvement of the quality of goods and the facing of the problems related to the competition in the international market.
- The problem of the deficit of the current account and the influence on it of the exchange rate side should be more in the focus of the academics.

6. References

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