Factors Affecting Current Account in the Balance of Payments of Selected Western Balkan Countries

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Abstract

This paper tries to elaborate on the difficulties and challenges of the selected Western Balkan countries (Albania, Kosovo, Macedonia, Bosnia and Herzegovina, Serbia, Montenegro) that all seems to have serious problems with regard to the sustainability of their current account. After providing some insights about main approaches use for analyzing the balance of payments in general, this paper focus on data related to the stance of the current account of selected countries and it tries to explain some of the factors that are driving of the current account deficit. The paper claims that domestic production and increased volume of exports accompanied by stable flow of FDIs are the key elements of the framework for improving the current account of the balance of payments in this part of the world.

Keywords: Western Balkan, approaches in analyzing balance of payments, current account deficit, financial account, financing, foreign direct investment

1. **Introduction**

In this paper we focus on factors affecting the sustainability of the current account in the balance of payments. There is no unique approach on this due to countries' specifics. However, literature shows that since the 50s and 60s of the last century there has been a consensus on three fundamental approaches in the analysis of the balance of payment known as elasticity, absorption, and monetary approaches.

The common characteristic of these three approaches is that in their equations these approaches take into account mainly the local variables thus observing the impact of their change under the operation of the measures of national economic policies targeting the equilibrium of the balance of payments of the country.

The elasticity approach shows how the change in the value of the currency affects the balance of payments. Hence, changes in the exchange rate of the local currency vis-à-vis the currency in which the external trade takes place results in different balances of the current account within the balance of payments. In this context, a devaluation of the local currency has an outcome same as we were increasing custom duties on imports and subsidies on exports. The same happens in case of the currency appreciation but in vice versa effects, i.e. identical to the effect of reducing the customs on imports and subsidies on exports. Provided that balance of payments is in equilibrium then the devaluation could improve balance of payments, but in order for the devaluation to be productive there must be an increase in the total elasticity of the prices in the domestic and external demand for imports. When the country devalues its currency, then it significantly improves the balance of payments conditions and this improvement is known as Marshall-Lerner condition. The Marshall-Lerner condition states that the currency devaluation will eventually improve the balance of payments and in order to achieve this, amount of elasticity of the demand for imports and exports should increase. When the country devalues its currency, the price of exports will decline and theoretically it will increase demand for these exports. However, in order to come to the increased demand, the exported products must be products with elasticity.

The above mentioned effects have impact on the price conditions of internationally tradable goods and services thus affecting the internal demand for imports and external demand for exports of local goods and services. At the end, all this is reflected in the change of the balances of the balance of trade, i.e. the balance of the current transactions of the balance of payments.

Unlike the elasticity approach, the absorption approach assumes that the basic income and expenses change and that this change affects the performance of the balance of payments. So the absorption approach ignores the effect of the change in the exchange rate, which as noted earlier is a feature of the elasticity approach. Consequently, this approach advocates for running an active policy in managing the domestic demand so it can help reduction of current account deficit of the balance of payments - because as it is known with an slow down in domestic demand compare to the domestic supply, we can achieve to reduce the current account deficit. Therefore, the absorption approach starts with the equation of GDP:

$$Y = C + I + G + X - M$$

Where Y = GDP, C = individual consumption, I = private investment, G = government consumption, X = Exports, M = imports

Component C + I + G often called domestic demand or absorption.
A (absorption) = C + I + G (by definition)
By definition, the balance of current account is:
CAB (current account balance of the balance of payments) = X - M
Where X = Exports, M = imports
From the equation above it is easy to be proved that:

X - M = Y - A
Or even the simple CAB = Y – A

In other words, the current account balance represents the excess of the GDP (annual production value of the country) compared to the absorption, respectively domestic demand (consumption and the value of annual investment in the country). Since consumption can be divided into taxes (T), savings (S) and personal consumption(C), the GDP can be written as the following equation:

Y = C + S + T
If we equate the two formulas of the GDP, then we get:
C + I + G + X - M = C + S + T
I + G + CAB = S + T
CAB = (S - I) + (T - G)

Simply we have surplus in the current account when the country consumes less than it produces and the opposite in the case of the deficit - that the country spends more than it produces.
The state of the current account deficit poses a serious problem for policymakers and this deficit can be reduced either by increasing GDP and / or by reducing domestic demand. It follows that the increase in GDP represents the supply side challenge, while reducing absorption is the challenge on the demand side. Usually, this means implementing harsh measures like "belt-tightening" - reducing the budget or the money. In order to accomplish the reduction of the current account deficit on the side of aggregate demand, it is necessary to implement one of the measures indicated below and in that case at least one of the factors must be in equilibrium:

(i) increase the level of savings (S ↑), under the given level of investment (I) and government consumption (GT)
(ii) reducing the level of investment (I ↓), under the given level of savings (S) and government consumption (GT)
(iii) reduction in government consumption (GT ↓), under the given level of savings (S) and investment (I)

The devaluation of the local currency under the conditions of unemployment or not full employment can stimulate additional production which can lead to the improvement of the trade surplus or deficit reduction. On the other hand, devaluation under the full employment brings to the inflationary pressures because in this case we face with an increased external demand for exportable domestic products but local exporters will not be in a position to raise the level of production in short term.

The monetary approach puts at center monetary terms, namely it treats the balance of payments as a monetary phenomenon and therefore calls for analysis of the balance of payments by using monetary theory. In general, although the real factors are not entirely excluded, this approach mainly focuses on the relationship between supply and demand for money as the main basis for analyzing the balance of payments.
Polak (2001) gives a detailed description about the development of two main monetary approach schools for analyzing the balance of payments – first school developed in the framework of the International Monetary Fund as a continuation of the model of the multiplier in the economy as developed by Kahn / Keynes and another school developed by an Harry Johnson of the Chicago and proclaimed by him as revolutionary and anti-Keynesian.

2. Current account in selected Western Balkan countries

The current account is an important macroeconomic indicator, since it is close with other important components of national savings and investment - balance budget and private savings have important implications for overall economic growth and competitiveness.
The selection of countries from Western Balkan was made taking into account not only their geographical proximity, but more taking into account the different currency regimes that characterize these countries. For instance, Kosovo and Montenegro here represent a unique regime in the region known as unilateral euroisation, while Bosnia and Herzegovina is characteristic for its currency board arrangement, with Albania claiming to run aflexible exchange rate regime.
In fact, since Western Balkan countries are running current account deficits for a long period of time, it is important to try to assess the main drivers of external imbalances in these countries. In fact, the selected countries have a common characteristic being related to their common final destination - the integration into the European Union. While foreign savings can be obtained to some extent as a substitute for national savings, it seems that economic growth in these countries is through investment facilitation of opportunities that otherwise would have remained unfunded. Thus, the increase in demand for investment at the time of acceleration for integration into the European Union, undoubtedly contributes to the deterioration of the current account position of these countries. Of course, what kind of capital that comes in these countries is very important as it's important not to forget that financial openness contributes to the fragility in general.

The issue of sustainability of the current account deficit is also complex for the fact that there does not exist a unique measure of the sustainability of the current account deficit due to the specific characteristics of individual countries. In this context, it is very important to analyze the trend of the current account deficit of the balance of payments. A deficit in the current account is the result of a balance between domestic savings and investment which reflect the increased activity of the investment which exceeds domestic savings (and create conditions for future obligations for the purpose of repayment of debt) or with growth consumption, which results in the accumulation of debts that cannot be managed carefully.
The current account deficit is considered stable if the deficit does not lead to the emergence of a crisis of external sector .One external sector crisis may appear in the form of a currency crisis or crises related to external debt. A currency crisis can be described as panic that affects the fast devaluation national currency and reduction of foreign exchange reserves, while the crisis of

external debt means the impossibility of borrowing further and inability to perform current liabilities arising from external debt. The problem of sustainable deficit of the current account specified in this way is that we can only talk about its sustainability.

Table 1: Current account balances in Western Balkan countries, in% of GDP

Country	2008	2009	2010	2011	2012	2013
Albania	*-15.6*	*15.3*	*-11.5*	*-13.1*	*-10.4*	*-10.8*
BiH	*-14.2*	*-6.6*	*-6.1*	*-9.8*	*-9*	*-5.4*
Kosova	*-11.9*	*-9.2*	*-11.7*	*-13.7*	*-7.5*	*-6.4*
Macedonia	*-12.8*	*-6.8*	*-2*	*-2.5*	*-3*	*-1.9*
Montenegro	*-50*	*-27.8*	*-23.2*	*-17.6*	*-19*	*-15.1*
Serbia	*-21.7*	*-6.6*	*-6.8*	*-9.1*	*-12.3*	*-6.5*

Source: Calculated by the UNCTAD data, for Kosovo taken from the CBK web site

Modern literature on the sustainability of the current account deficit is strongly influenced by the theoretical work of Milesi-Ferretti and Razin, who consider the current account deficit to less sustainable if they are high in relation to GDP in if they are due to lower domestic private savings than investment activities, and if they are accompanied by a low level of national savings. The current account deficit of all countries as can be seen from the Table 1 has been improving. Also, Kosovo during the period 2008 - 2013 marks continuous improvement and as such it remains significantly more favorable than in Albania and Montenegro, while slightly deteriorated in comparison with Bosnia and Herzegovina. In fact, even in Kosovo we have a year when the deficit reaches double figures (2013) as a result of a high level of consumption (consumer goods had the highest participation in total imports) and a serious lack of exports. Kosovo and most countries in Western Balkans are characterized by relatively high deficits in relation to GDP (an extreme example is Montenegro). As such these deficits reflect higher consumption compared with the investment and are accompanied by stagnation and declining domestic savings, which are much lower than in other developing countries. A mitigating circumstance for Western Balkan countries is the fact that the rate of flow of short-term portfolio investment ('hot money') is relatively low and that foreign exchange reserves were accumulated in earlier periods.

In the case of Western Balkan countries the main cause of the current account deficit appears to be the deficit of the foreign trade balance. A deficit in the current account is considered less sustainable if it is a consequence of the deficit of the balance of foreign trade, and high trade deficits point to the existence of serious problems of competitiveness of the economy, and the insufficient inflow of foreign currency into regular basis to face export activity that comes to the submission of the question in relation to the country s ability to service external debt in the future.

Figure1. Kosovo's current account deficit and its financing

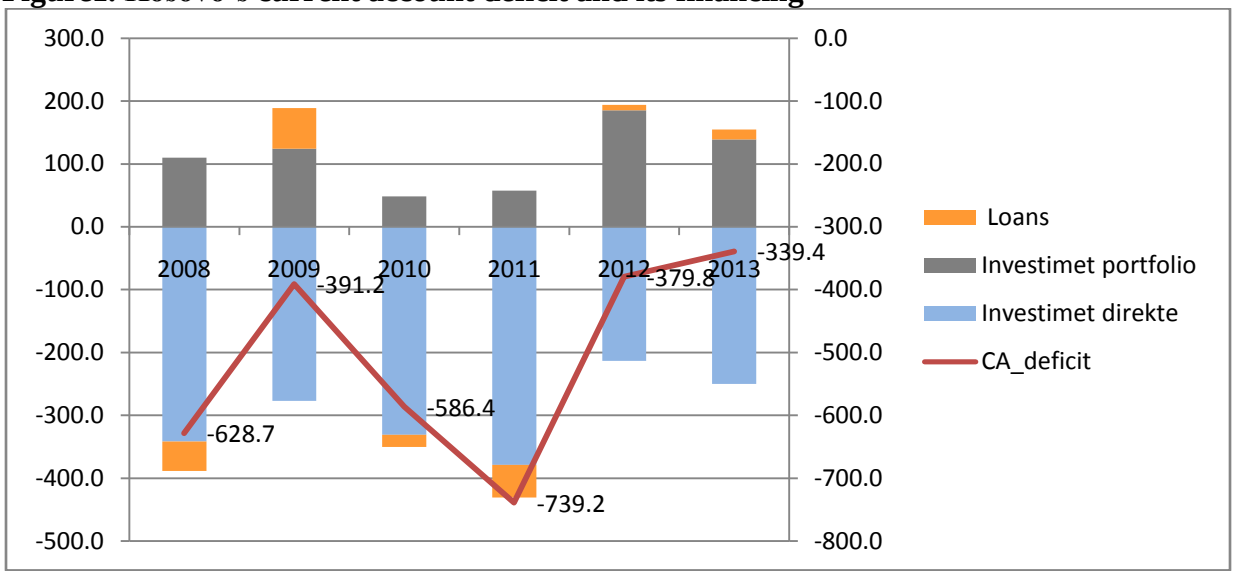

Table 2.Western Balkan countries – the share of FDI in financing the current account deficit, in %

Country	2008	2009	2010	2011	2012	2013	Average (2008-2013)
Albania	*48*	*54*	*78*	*52*	*68*	*90*	*65%*
BiH	*38*	*22*	*39*	*28*	*23*	*34*	*31%*
Kosova	*80*	*77*	*71*	*60*	*60*	*76*	*71%*
Macedonia	*47*	*33*	*107*	*179*	*31*	*172*	*95%*
Montenegro	*43*	*133*	*80*	*71*	*81*	*69*	*79%*
Serbia	*34*	*82*	*71*	*85*	*16*	*305*	*99%*

Source: Author's calculations based on data from the central banks of countries in the sample

In 2008 Kosovo had the biggest share of FDI in financing the current account deficit. The degree of coverage of the current account deficit by FDI has declined as a result of the decline in FDI and it shows a high sensitivity to the sustainability of the current account from the level of FDI. Furthermore, even here the situation is worrying because since 2007, when FDI reached the highest level, Kosovo continues to get decrease in FDI which in terms of unilateral euroisation of the country are conditio sine qua non for economic stability. In the other side, in 2008 Serbia and Bosna e Hercegovina were worst with regard to this indicator. The calculated average for the six years shows that Kosovo is ranked in the fourth place of financing current account deficit. Serbia and Macedonia are the countries that have the largest share of foreign direct investment in financing their current account deficit, which enables those to have an extremely large current account deficit relative to GDP. Countries with strong economic growth can maintain a constant current account deficit without increasing their external debt relative to gross domestic product.

If the real rate of growth exceeds the real interest rate on external debt it leads to reduction in the share of external debt relative to GDP, and therefore reduced indebtedness. Growth based on increasing physical capital, human capital creation, and increased productivity creates the conditions for future servicing of external debt. Growth based on a high level of consumption, the growth of services, bank credit expansion and foreign borrowing is unsustainable in the long term. The problem of Kosovo and most other Western Balkan countries of is that the main generator of growth is consumption (as can be seen in the Figure below), and this consumption is financed by inflows of foreign capital. Furthermore for sustainable economic development in the future period Kosova needs healthy economic growth based on increased levels of investment and productivity.

3. Conclusion

Based on the consulted literature and analyzed data of Western Balkan countries we may conclude that the concept of sustainability of the current account as a key indicator of the quality of balance of payments remains the most challenging macroeconomic issue for all these countries and as such also a topic that requires more comprehensive research.

Reliance on exports of natural resources and / or goods processed as raw materials or on remittances and international aid can not guarantee the reduction of the gap in the trade balance, respectively it cannot ensure not only the sustainability of the current account but overall macroeconomic stability of these countries as well. In particular in Kosovo we observe a huge dependent on imports and at the same time on remittances which makes the issue of the sustainability of the current account highly challenging.

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