



Current Account in Western Balkan Countries

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Abstract

The main purpose of this paper is to analyze the structure and level of current account deficit and the ratio between the current account deficit and its determinants in the Western Balkan countries. The methodology is based on the econometric model that enables the testing of the impact of each independent variable on the dependent variable. Once the stationarity and cointegration between the variables was verified, the FMOLS and DOLS equation was used to show the relation between the variables. The econometric model consists of independent variables (trade balance, foreign direct investment, remittances), while the dependent variable is the current account balance. The econometric model has enabled the estimation of the significance and direction of movement of each of the independent variables to the dependent variable. Findings have shown that the trade balance deficit is the main determinant of the current account deficit in the Western Balkans confirming the first hypothesis of the paper, while foreign direct investment and remittances are the means of financing this deficit confirming the second hypothesis of the paper. This paper may be of interest to developing macroeconomic policies in order to direct efforts to reduce current account deficits by making reforms to structural changes in current account deficits, because the problems of this deficit stem from the structure of current account.

Keywords: current account balance; trade balance; foreign direct investment; remittances.

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1. Introduction

The current account deficit analysis in this paper is motivated by ongoing problems with the current account deficit faced by the Western Balkan countries (WBC) we have chosen for analysis; Albania, Bosnia and Herzegovina, Kosovo, Northern Macedonia, Montenegro and Serbia. There are various factors that affect current account performance. Some of the factors mentioned in the literature are: trade balance, external debt, foreign exchange regime, trade openness, real effective exchange rate, economic growth, fiscal balance, etc. All of the above-mentioned factors are different for the countries we selected for the study. In addition, trade balance, level of savings and investments, foreign direct investment and level of external debt are important factors to consider when evaluating current account performance. Kosovo is the youngest country among the countries chosen for the study and since the beginning of the evaluation of external sector statistics it has faced negative developments in the current account balance. The countries of the region have the same trend of development in the external sector. From these countries, Montenegro has the highest current account deficit to GDP, followed by Albania and Serbia, while North Macedonia has the lowest ratio of current account deficit to GDP. Analyzing the current account deficits during the period 2008-2018, this paper will discuss the level, structure and factors related to the current account deficit in Western Balkan countries. Each country has its own characteristics, which have led to a certain level of current account balance, and the commonality of these countries is that none are a member of the European Union and each is at a different stage of the process of EU integration.

2. Literature overview

External sector imbalances are one of the persistent economic problems facing Western Balkan countries. There are few empirical studies analyzing such topics for the Western Balkan countries, so this is one of the shortcomings of this paper as it does not allow comparisons of results with prior studies. In the paper "Which Development Model for the Balkans? Reflections on twenty years of transition (1989-2009)", author Milica Uvalic analyzes the economic performance of Balkan countries in the last twenty years. In recent years, Balkan countries have recorded increasing current account deficits, which until the introduction of the global financial and economic crisis of 2008-2009 was compounded by the increase in FDI inflows, foreign debt, donations and remittances. These large current account deficits have been caused mainly by growing international trade imbalances. Balkan countries have had increasing trade deficits in recent years as imports have grown much faster than exports. Concurrently, all Western Balkan countries have borrowed heavily in foreign markets, so their external debt has also steadily increased the problem of dependence on foreign aid, especially in Bosnia Herzegovina and Kosovo [1]. In the paper "Current Account Determinants in Southeast European (SEE) countries - panel approach", author Radovan Kovacevic analyzes current account determinants in South East European (SEE) countries, most of which will be analyzed in our paper (excluding Bulgaria, Croatia, Romania and Moldova). Given that all SEE countries had increased current account deficits (a large gap between savings and investments), the issue of resources to finance this deficit is important. Increasing current account deficits before 2008 were financed by foreign capital inflows. Rising interest rates have stimulated the flow of foreign resources. The increase in external debt led to an increase in the debt burden. Because of this, most countries in the SEE region have drastically improved their current account balances following the outbreak of the financial

and economic crisis in 2008 [2]. Kumar Das in his paper "Determinants of current account imbalances in the global economy: A dynamic panel analysis" used two different approaches to empirically analyze the determinants of current account deficit in developed and developing countries during 1980-2011. Both methods used yielded the same results; selected current account determinants have a significant effect on the current account balance. In particular, the current account deficit has a positive relationship with the price of goods, real GDP growth, and trade openness in developing countries; while a negative effect in developed countries. On the contrary, the current account deficit has a negative effect on net foreign assets, the real effective exchange rate, and the exchange rate stability in developed countries [3].

3. Methodology

The data needed for this paper have been collected by the responsible local and international institutions for the compilation of relevant statistics. In addition to collecting data from secondary sources, other calculations needed for the purpose of the work will also be made. So, based on the purpose of the work from the existing data, the structure, level, and relevant factors in the current account balance in the Western Balkan countries will be analyzed. The econometric model enables testing of the impact of each independent variable on the dependent variable. Once the stationarity and cointegration between the variables has been verified, the FMOLS and DOLS equation was used to show the relationship between the variables. The main empirical model of our analysis will be:

$$CA_{it} = \alpha + \beta X_{it} + \mu \quad (1)$$

CA is the current account deficit as a ratio to GDP and is the dependent variable, while X is the vector of the independent variable, which affects the current account. Through this model, we will attempt to identify the factors that affect the current account deficit. Factors affecting the current account deficit will be identified by the model results by analyzing their significance within the group, as well as the magnitude of the coefficient resulting from the model. Thereafter, the cointegration equation using the FMOLS and DOLS models will be evaluated. There are two hypothesis when it comes to analyzing the main determinants of current account deficit in Western Balkan countries:

- H1 - The trade balance is the main determinant of the current account deficit in WBC.
- H2 - The FDI and remittances are the means of financing the current account deficit in WBC.

The analysis will take the annual time series data for the last eleven years including the period 2008-2018. So, in total there will be 11 observations used in the model. There are a number of factors that affect the current account deficit, but we will focus on the most important factors mentioned in the literature and that affect the level of savings and investment. Factors to be analyzed through our model during this study will be: current account balance (CAB), trade balance, foreign direct investment (FDI) and remittances (REMIT). Based on the above-mentioned model we can express the general model including all variables:

$$CAB = \alpha_0 + \alpha_1 TB + \alpha_2 FDI + \alpha_3 REMITT + \mu \quad (2)$$

4. The level and structure of the current account in Western Balkan countries

The Western Balkan countries have experienced severe economic problems; the last one was the Global Economic Crisis of 2008. All observed countries, except Albania, experienced the stagnation of economic activity and perceptible decline in the GDP. But, that was just the beginning of the crisis period, because in the next year the crisis manifested in the even more severe form [4]. Despite this, they have managed to recover quickly and continue economic growth faster than before. Economic growth in the Western Balkan countries during the period we took to analyze was dominated by the increase in domestic demand, which was caused by capital flows mainly from developed European countries. Capital flows from banks originating in European countries contributed to improved financial sector, increased lending and increased foreign investment at the same time. The increase in demand led to the widening of the current account deficit in these countries. It is natural for countries in transition to have a negative current account balance because they require investments that increase demand, creating an imbalance between savings and investments due to increased investment activity, which exceeds savings. All this leads to a deepening deficit of external balance. So, given the economic situation of the Western Balkan countries, the current account deficit is inevitable, as investments in the country are needed to achieve economic growth and try to get closer to the developed countries. This does not justify the continued increase in the current account deficit, except in the early stages of economic development, because the continued increase in the current account deficit can create economic problems, which at worst can end in economic crises. The likelihood of a recurring current account deficit following an economic crisis depends also on the type of capital with which the deficit is financed, because different types of capital have different effects on deficit financing. In this context, FDI and longer-term investments in general are more stable and can therefore mitigate the risk of any economic crisis in the event of ongoing current account deficits. Therefore, the structure of equity and debt liabilities is also important in order to evaluate a country's ability to shocks. With regard to equity, portfolio investment is potentially more volatile than foreign direct investment. With regard to debt, its maturity structure, currency composition and interest rate structure all affect the vulnerability to shocks [5]. The trend of the current account balance in the Western Balkans and Europe is presented in the figure below.

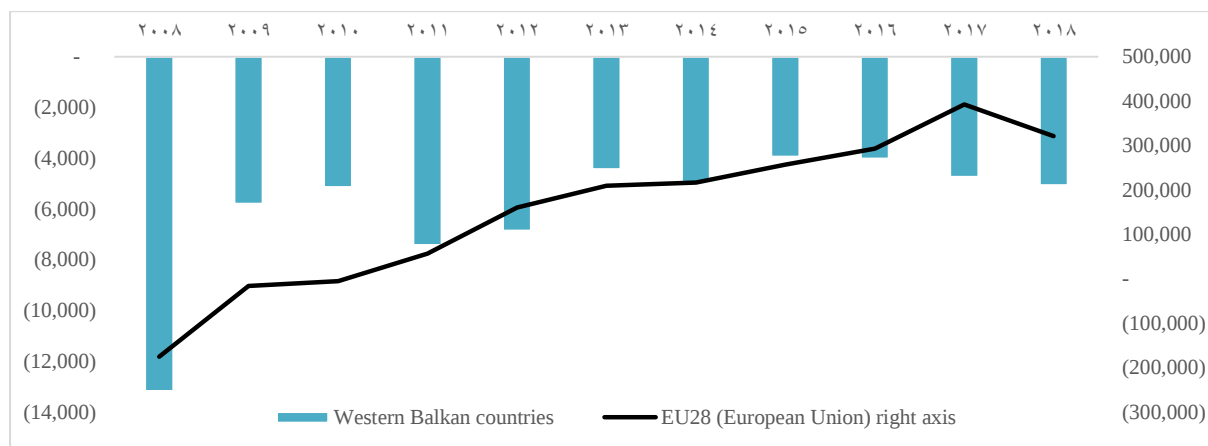


Figure 1: CA balance, WBC and EU (right axis), in millions of euro [6]

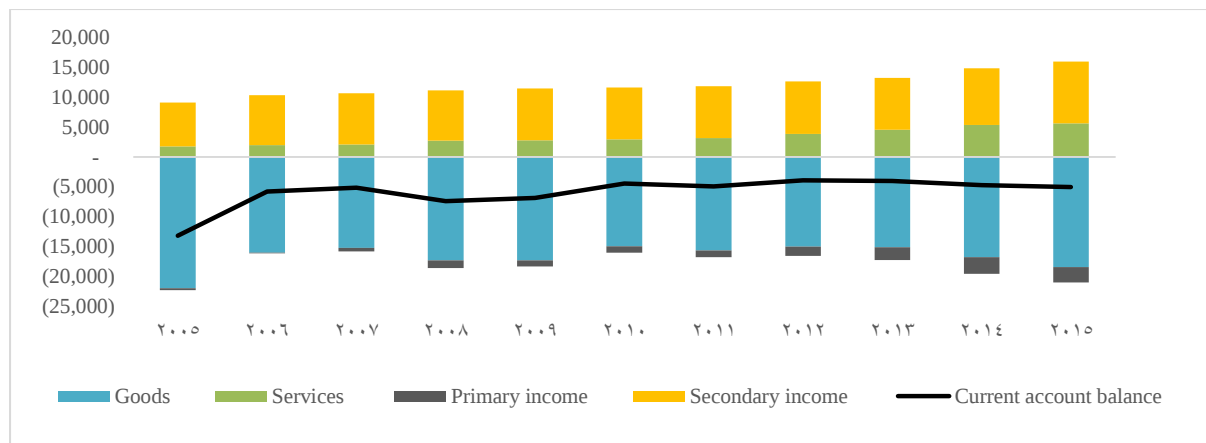


Figure 2: Structure of CA deficit in WBC, in millions of euro [6]

As shown in the figure above, the Western Balkan countries have consistently faced current account deficits, while the highest level was at the time of the global economic crisis in 2008. European countries had a negative current account balance until 2010, to mark the peak of the deficit in 2008, after 2010 the current account balance in European countries recorded a positive balance, unlike the western Balkan countries which are still facing current account deficit. The current account structure in the Western Balkans is dominated by the negative balance of trade in goods, the gap between imported and exported goods. The second largest component in the current account of these countries is occupied by the secondary income account, which represents one-sided or unilateral income and is mainly government grants, private donations or remittances (figure 2). The high level of these transfers is characteristic of underdeveloped countries that depend on foreign assistance. However, this category contributes positively to the current account balance by reducing the deficit. The services account also has a positive impact on the current account, but at lower levels compared to the secondary income. Whereas, the primary income account, which represents the income derived from the three factors of production; labor, land and capital, had a positive balance but in recent years there has been an increase in the negative balance. This should be linked to the increase in direct investment and consequently the withdrawal of foreign profits by foreign companies that have made direct investments in these countries.

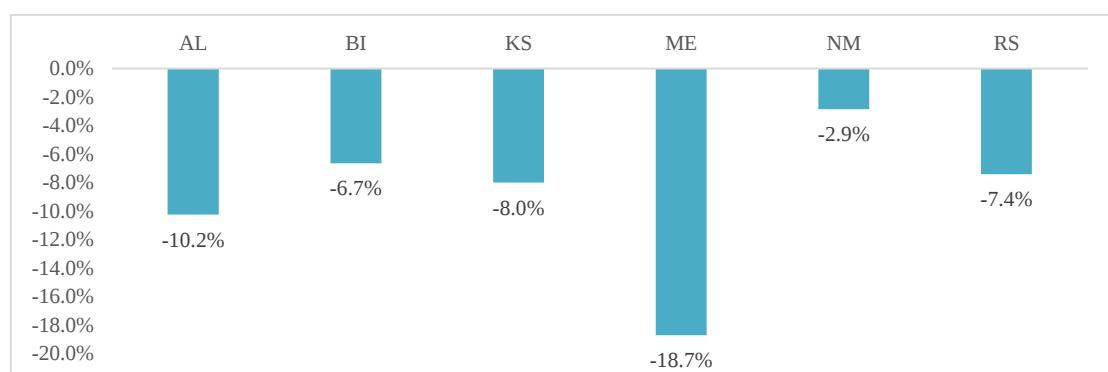


Figure 3: Current account to GDP in WBC, in percentage, average during 2008-2018 [6]

As can be seen from Figure 3, the average current account deficit to GDP over the period 2008 - 2018 is

significantly different between the Western Balkan countries. Montenegro has the highest ratio of this indicator with 18.7 percent, followed by Albania and Serbia with 10.2 percent and 7.4 percent. Kosovo is in a better position of this indicator compared to the above-mentioned countries, accounting for 8.0 percent of current account to GDP, while in a more unfavorable position compared to Bosnia and Herzegovina which has a current account ratio to GDP of 6.7 percent and North Macedonia, 2.9 percent. Given that the literature says that the current account deficit to GDP ratio of 4-5 percent is considered risky and may precede any economic crisis, in the group of countries of our analysis, with the exception of Northern Macedonia, all other countries are above this level. Therefore, the Western Balkan countries are characterized by high current account deficit to GDP, which indicates low level of competitiveness in international markets. In this context, the trade balance deficit has caused chronic problems for countries. This proves that the Western Balkan countries, in the absence of domestic production capacities and domestic resources for investment financing, use external resources to boost investment and production. The current account deficit (CAD) is expected to go up in all Western Balkan countries in 2019. Stable remittances and foreign direct investments (FDI) help finance the CAD. Nevertheless, sizeable external imbalances in several Western Balkan countries, together with elevated public debt, expose the region to adverse economic shocks. The higher public spending has thus compromised an opportunity to build the much-needed fiscal buffers to be able to cushion the impact of rising external uncertainties [7].

5. Data description

Analysis of current account deficit determinants will be done with panel data, analyzing data for six countries in the time series for the reference period 2008 - 2018 on an annual basis. So, in total there will be 11 observations used in the model. The main source of data is the IMF World Economic Outlook database, the central banks of the respective countries, the national statistical offices of the respective countries and the author's calculations. The dependent variable is the current account deficit, while the independent variables are trade balance, foreign direct investment and remittances. The definitions for each of the variables are given in the table below: Current account balance is the dependent variable in our model. A current account is a systematic statement showing the value of transactions in goods and services, the primary and secondary income received and paid between residents and non-residents over a given period of time. The fluctuation of the current account balance depends on various factors, but we have taken into account some of the more important factors that the literature suggests by adapting to the characteristics of the economies of the countries to be analyzed. Trade balance represents the difference between goods exported and imported from a country in a given period. Often in the literature, this indicator is known as net exports and is one of the most important components of gross domestic product. The excess of a country's export to import results in a trade balance surplus, while on the contrary, the excess of import to export results in a negative balance or deficit in the trade balance. In the case of our analysis, the trade balance is the independent variable. Foreign direct investments are investments in the form of ownership that the entities of one country, natural and legal persons, undertake in another country. Foreign direct investment is related to components of gross domestic product, affecting investment and consumption. In the case of our analysis, the direct investment indicator is an independent variable that affects the dependent variable, in our case the current account balance. Remittances are unilateral transfers that residents of a country send to their families in their countries of origin. Remittances can be in various forms such as cash, goods, etc. Remittances can also be sent in various forms; through bank channels, money transfer agencies, relatives, etc. In the case of

our analysis, remittances constitute the independent variable.

6. Results and discussion

In this part of analysis, our interest is to see the relationship between the dependent variables, current account deficits, and independent variables. The analysis will be done at a group level and not individually for each country. To continue the analysis of the model the variables must be first tested for their stationarity. In the case of our analysis, you can find the variables are stationary at the same level. Then they were tested for co-integration. If the variables are co-integrated, thus if it is verified that there is a relevant long-term relationship between the variables, then the right to continue the FMOLS panel test (fully modified OLS model) is obtained. The Panel Cointegration Test has three types of test, while we have selected two of them, the Pedroni and Kao test to validate co-integration between variables. These two tests then have several forms and the results of all the forms are presented in the table below.

Table 1: Panel cointegration test of the Western Balkan countries, 2008 – 2018

Test type	Panel/Group	Statistic	Prob.	Weighted Statistic	Prob.
Individual intercept					
Pedroni Residual Cointegration Test (within dimension)	Panel v-Statistic	-1.31756	0.9062	-1.28937	0.90140
	Panel rho-Statistic	0.91054	0.8187	1.04253	0.85140
	Panel PP-Statistic	-2.42805	0.0076	-2.85817	0.00210
	Panel ADF-Statistic	-2.58912	0.0048	-2.90702	0.00180
Pedroni Residual Cointegration Test (between dimension)	Group rho-Statistic	2.26541	0.9883	na	na
	Group PP-Statistic	-4.41547	0.0000	na	na
	Group ADF-Statistic	-3.70075	0.0001	na	na
Individual intercept and individual trend					
Pedroni Residual Cointegration Test (within dimension)	Panel v-Statistic	-2.06630	0.98060	-2.14185	0.98390
	Panel rho-Statistic	2.37135	0.99110	2.60071	0.99530
	Panel PP-Statistic	-0.23084	0.40870	-0.73944	0.22980
	Panel ADF-Statistic	-0.26318	0.39620	-0.50959	0.30520
Pedroni Residual Cointegration Test (between dimension)	Group rho-Statistic	3.64065	0.99990	na	na
	Group PP-Statistic	-4.71329	0.00000	na	na
	Group ADF-Statistic	-0.44911	0.32670	na	na
No intercept or trend					
Pedroni Residual Cointegration Test (within dimension)	Panel v-Statistic	-0.52857	0.70140	-0.47984	0.68430
	Panel rho-Statistic	0.31843	0.62490	0.35732	0.63960
	Panel PP-Statistic	-2.02333	0.02150	-2.48451	0.00650
	Panel ADF-Statistic	-2.02891	0.02120	-2.39221	0.00840
Pedroni Residual Cointegration Test (between dimension)	Group rho-Statistic	1.54556	0.93890	na	na
	Group PP-Statistic	-4.07725	0.00000	na	na
	Group ADF-Statistic	-3.14335	0.00080	na	na
ADF test equation					
Kao residual cointegration test	ADF	-3.79338	0.00010	na	na

The initial position in all statistical tests is the null hypothesis, meaning no co-integration between variables. Then, depending on the test results, we will accept or reject the null hypothesis. In the first type of test, the Pedroni Residual Cointegration Test are two forms of tests: within dimension and between dimension, which together comprise the 7 statistics described in the table above. Each of these gives the results for the coefficient of statistics and the corresponding probability, as well as the weighted statistics and the corresponding probability. Consequently, the first test has a total of 11 results obtained that will be considered. Of these, 6 are significant because they have a coefficient lower than 5 percent, and this constitutes the majority, so we can reject the null hypothesis, concluding that all three variables are cointegrated and have long term relationships with the dependent variable. In the second form of the test, Individual intercept and trend, out of 11 results, only 4 are significant, so we cannot reject the null hypothesis. In the third form of the test, no intercept or trend, 6 of the 11 results are significant, so we can reject the null hypothesis. Two of the three forms of the Pedroni Residual Cointegration test show that the variables are cointegrated, so we can conclude that there is a long-term relationship between the independent variables and the dependent variable. In addition, the Kao residual cointegration test shows that the variables are cointegrated, null hypothesis can be rejected and there is a long-term relationship between the variables used in the model. In both tests, it was verified that there is a long-term relationship between the dependent variable and the independent variables, which can move together, so we can construct the FMOLS model. The FMOLS model provides reliable estimates for small sample sizes as well as ensures robustness of the results. This method shows the impact of each individual independent variable on the dependent variable. In the case of our model, the three variables are significant because they have a probability lower than 5 percent, while the greater and the absolute impact on the current account deficit has the trade balance. This confirms our hypothesis that the trade balance deficit is the main cause of the current account deficit. Whereas, the other two variables have a negative coefficient confirming that there is an inverse relationship with the current account deficit. For each unit of FDI growth, the current account deficit is reduced by 0.19 units, and for each unit of remittance growth, the current account deficit is reduced by 0.02 units.

Table 2: Panel cointegration test of the Western Balkan countries, 2008 – 2018

FMOLS (fully modified OLS model)				
Variable	Coefficient	Std. Error	t-Statistic	Prob.
TB	0.504955	0.07428	6.797748	0.00000
FDI	-0.196459	0.08900	-2.207489	0.03180
REMITT	-0.023393	0.95043	5.169962	0.00020

7. Conclusions

This paper has analyzed the level, structure and determinants of current account deficit in the Western Balkan countries. The dependent variable of the paper is the current account deficit, while the independent variables are trade balance, foreign direct investment and remittances. The reason to test these variables is that the literature suggests that they have a significant impact on the current account balance and that they are relevant to the characteristics of the analyzed countries. Our analysis included panel data for the 2008 - 2018 time series

covering the Western Balkan countries; Albania, Bosnia and Herzegovina, Kosovo, Northern Macedonia, Montenegro and Serbia. The Western Balkan countries constantly face current account deficits. External sector imbalances are inherent to countries in transition where more investment and external resources are needed to meet the needs of the country's economy. However, a persistent and poorly managed deficit can lead to economic problems, which at worst can manifest themselves as economic crises. In this context, the ways in which current account imbalances are financed are important. Most WBCs use direct investment inflows to cover current account deficits and this is a good method because foreign direct investment is considered sustainable and long-term investment. Also, the WBCs have a high level of acceptance of funds from the diaspora, which is characteristic of developing countries. External sector imbalances in the Western Balkan countries derive from the trade balance, which results in a negative difference between export and import of goods. This makes nearly all countries current account deficit problems stem from structural factors. This was confirmed by our empirical model which shows that there is a long-run relationship between the variables used, of which the trade balance is of absolute importance in determining the current account position by validating the first working hypothesis that trade balance is the key determinant of the current account deficit in the Western Balkan countries. In addition, the results of the paper have shown that the current account balance in the Western Balkan countries has been positively influenced by foreign direct investments and remittances. This confirms the second hypothesis of the paper that foreign direct investments and remittances are ways of financing the current account deficit in the Western Balkan countries. There are few papers dealing with the same topic for the group of Western Balkan countries, therefore this makes it impossible to compare the results of this paper with other papers. There were no other working paper published so far that analys the same determinants of current account in Wester Balkan countries, therefor we do not have the possibility to compare the results of this working paper with the other working papers published previously.

8. Recommendation

As we have seen from the results of the paper, external sector imbalances in the Western Balkan countries derive from the trade balance, which results in a negative difference between export and import of goods. This makes nearly all countries current account deficit problems stem from structural factors. This paper may be of interest to developing macroeconomic policies in order to direct efforts to reduce current account deficits by making reforms to structural changes in current account deficits, because the problems of this deficit stem from the structure of current account. An effective way to reduce the current account deficit of these countries is the growth in exports, which is critical to the economic development and the only choice for improving the trade balance.

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