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Secondary income as a major positive item in the current account in Macedonia

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Abstract

Current account in balance of payments is an important indicator of the performance of an economy in transition and quite used indicator for external imbalance which plays a significant role in the economic analysis of policy makers. According to some researchers if account deficit is higher than 5% of GDP, it sparks a red alarm. Generally, developing countries have problems with high trade deficits which in Macedonia in recent years brought to the extent of 24 of GDP. A persistent deficit in the trade balance continuously causes deficit in current account and this represents its financing need by borrowing from abroad or by reducing the reserves. Secondary income headed from remittances represents a real voice stabilizer which on average in recent years has moved to the level of 18% of GDP, which in recent years has compensated 77% of the trade deficit, by relaxing the balance of payments , official foreign currency reserves and monetary policy. It deserves a deeper study this item in a complex flow in balance of payment, in particularly in current account, to demonstrate its importance and to study more depth on this phenomenon.

Keywords: secondary income, remittances, current account deficit, trade deficit

1. Introduction

Macedonia's economy as a small economic structure, there is little internal strength which can give the country's economic boom, having always been dependent on capital inflows from abroad. Inflow of capital from abroad who register as flows in the current account and financial account in balance of payments. To study we take flow from the outside, without any form of compensation, which are grouped in the voice of secondary income.

The unique characteristics of secondary income and their impact economic potential have attracted the attention of policy makers and researchers in recent years, as evidenced by a growing literature that aims analysis of remittances and their consequences for individual countries. Often in our paper in place of the term "secondary income" will refer to remittances, or income from remittances or private transfers because income from immigrants really are position that creates the form of secondary income.

First, regarding the size of remittance flows, the literature offers ample documentation on how large they have become in recent years. The level of remittances, using the item workers' remittances from the World Development Indicators (WDI) database (World Bank, 2006), rose from US$48 billion in 1994 to US$114 billion in 2003. Efforts to examine both official and unofficial remittance flows (World Bank, 2005) suggest that this level could be substantially higher. For many developing countries, the level of remittances received is equal to or exceeds the amount of foreign direct investment, portfolio flows from financial markets, and official development assistance. Since remittance flows are large in size and permeate a significant number of households in the recipient economies, they undoubtedly have effects at the macro level, influencing market prices and the interactions among households, firms, financial intermediaries, and the government. Some countries' total remittance receipts amount to a substantial portion of their imports and a nontrivial fraction of GDP.

Second, there are key distinctions between remittances and other international flows, and while it may be convenient to view remittance flows through the same lens as official aid and private capital flows, there are good reasons to believe that remittances behave differently and, in turn, have different economic impacts. The widely accepted definition that prevails in the literature is that remittances are unrequited, nonmarket personal transfers between households across countries. Remittances differ significantly from official aid flows, since the latter are government-to-government transfers, whereas remittances are composed of numerous small transfers between private individuals. Furthermore, one crucial element sets remittances apart from both official aid and private capital flows: the presence of familial relationships. This element introduces well-known economic issues concerning interactions among family members and fuels the uniqueness of remittance behaviour[1].

Secondary income that take the form of private transfers between individuals and families have a variety of effects on the economy in different dimensions:

- Fiscal policy: Trasnferet private inflows mostly oriented towards consumption (according to surveys up to 70%) by creating a form of state income from taxes imposed on consumption;
- Debt sustainability. Remittances can lead to reduced country risk and improve the sustainability of government debt. In addition to increasing household saving, significant inflows of remittances can directly or indirectly increase the government's revenue base, thereby reducing the marginal cost of raising revenue.
- Fiscal discipline. Remittances may reduce the government's incentive to maintain fiscal policy discipline. The empirical evidence suggests that governments take advantage of the fiscal space afforded by remittances by consuming and borrowing more.
- Economic growth. Remittances are not necessarily associated with an increase in domestic investment or a more efficient allocation of domestic investment. Remittance recipients rationally substitute unearned remittance income for labor income and, since labor and capital are complementary goods in production, this negatively affects the rate of capital accumulation. Analysis reveals that remittances have no statistically significant effect on GDP growth.
- Dutch disease effects. Although remittances may constitute a source of financing in the balance of payments, empirical evidence suggests that remittances are positively correlated with real exchange rate appreciation. Hence, there is some

[1] R.Chami et al., "Macroenomic Consequences of remittances",occasional paper, International Monetary Fund, 2008, Washington DC, pg.3.

evidence of Dutch disease effects in remittance-receiving countries. Policymakers must find ways to mitigate this real exchange rate effect or address any loss of competitiveness arising from equilibrium real exchange rate appreciation.

- Achieving equilibrium in the balance of payments and macroeconomic indicators. Inflows of private transfers (recorded in the income account Secondary) in developed countries compensate big trade deficits. these create favorable positions for the consolidation of official foreign currency reserves, a very important instrument for developing countries, especially those with fixed rate. Their consolidation creates opportunities to be maintained parity of exchange rates determined, this a political anchor to a strong currency in order to maintain a low inflation levels.

In our paper we try to shed light regarding the effects of the last paragraph submitted by private transfers. Macedonia's economy is characterized by low levels of investment, low productivity and high trade deficits. Trade deficit reaches levels of two billion euros, foreign direct investment as the main voice of financial account does not go beyond 200-300 million euros. Under these circumstances, the Macedonian economy has grown an average of 2% in the last six years. In the middle there is the question which is the voice of the balance of payments which can compensate the high trade deficit. Secondary income, especially remittances ones have softened historically high trade deficits. In a macroeconomic context, remittances increase consumption, covering the trade deficit and contribute to the stability of the exchange rate (Kireyev 2006).

Why not taken for analysis remittances but secondary income? The reason is that on account of remittances recorded only official flows. While a large proportion of them are made unofficially, this item is not a reliable indicator of the true power of remittances. According to a study (Roberts, 2008), the families who receive remittances from migrants more than half of remittances are not registered in formal ways. Then this gives us a secondary income account which itself includes foreign currencies which exchanged in the exchange market believed that most comes from remittances from abroad.

2. Current account and its developments

Current account itself includes several items: the trade balance which shows transactions that result from productive activities (exports and imports); services including transactions between residents and non-residents (such as transport, tourism, etc.); primary incomes including primary income flows between residents and non-resident institutions (such as the interests of the possession of shares, dividend payments, earnings of firms working abroad, etc.); secondary income including transactions between residents and non-residents for which there isn't any particular service (such as remittances, external social benefits, pensions, gifts, etc.) [2].

The Current account balance is an important indicator of the performance of an economy in transition and it plays crucial role in the analysis of economic developments policymakers. Firstly, the importance derives from the fact that the current account balance, reflecting the savings-investment ratio, is closely linked with fiscal balance and private savings which are the main factors of economic growth. Secondly, the balance of a country's current account is the difference between exports and imports, reflecting the totality of internal transactions with

[2] "Balance of payments and international investment position manual", 6th edition, IMF, 2009

residents of foreigners in the markets for goods and services[3]. This shows the importance of studying the complex trade deficit in the current account and this is an important indicator for policy makers.

In the period 2007-2014 in Macedonia trade deficit marked the extent of 24% of the GDP, while the current account deficit of 4.63% of GDP. Unfortunately there is no single answer as to which is the level that is acceptable and sustainable. According to Milesi-Ferreti and Razin (1996), the current account deficit which is higher than 5% of GDP, red alarm lights. According to the Watchel Roubini (1998), there isn't a rule that can help us to determine which level of current account is sustainable.

(in millions euros) Table 1: Current account of balance of payment for Macedonia

	2009	2010	2011	2012	2013	2014
1.Current account	-457,1	-144	-189,2	-223,7	-146,8	-113,7
1.1.Trade balance	-1.742,5	-1.532	-1.904	-2.007	-1.858,1	-1.855,6
1.1.1.Exports	1.350,9	1.981,3	2.396,5	2.307,2	2.370,3	2.779,2
1.1.2Imports	3.093,4	3.513,3	4.301,3	4.315,1	4.228,4	4.634,9
1.2.Services net	205,3	132,0	359,2	309,4	360,6	358,1
1.3.Primary income	-47,3	-99,7	-131,0	-147,6	-211,8	-224,8
1.4.Secondary income	1.127,4	1.355,8	1.487,5	1.622,3	1.562,5	1.608,6
1.4.1.State	35,3	30,6	76,6	60,3	74,3	82,8
1.4.2.Nonpublic sector and who serve households (Private transfers)	1.092,2	1.325,2	1.410,8	1.562,0	1.488,2	1.525,8

Source: NBRM (Central Bank of Macedonia), externs statistics, data for BP.

The current account can be expressed as the difference between the value of exports of goods and services and the value of imports of goods and services. A deficit then means that the country is importing more goods and services than it is exporting—although the current account also includes net income (such as interest and dividends) and transfers from abroad.

The current account can also be expressed as *the difference between national (both public and private) savings and investment*. A current account deficit may therefore reflect a low level of national savings relative to investment or a high rate of investment—or both. For capital-poor

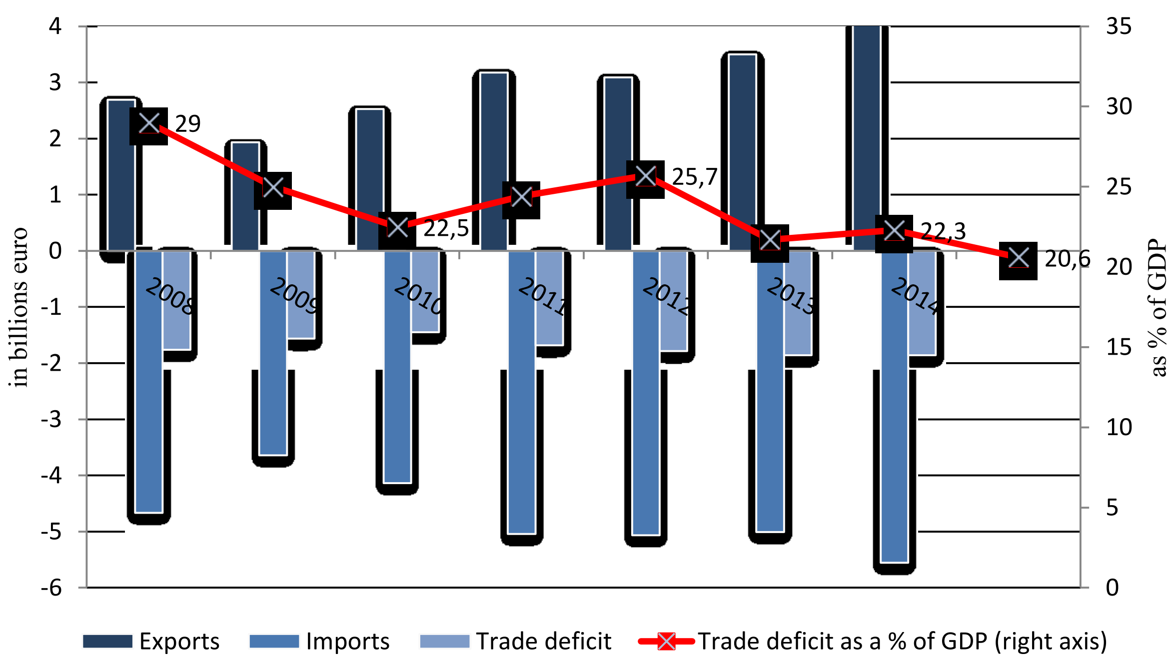
[3] A.Aristovnik, "The Determinants and Excessiveness of Current Account Deficits in Eastern Europe and the Former Soviet Union", The William Davidson Institute, University of Michigan, paper no.827, 2006, pg. 3.

developing countries, which have more investment opportunities than they can afford to undertake because of low levels of domestic savings, a current account deficit may be natural[4].

Various studies show the importance of the current account which has to do with growth. So for example Kandil and Greene (2002) through a model using quarterly data and bulletin found that the changes in real GDP also came as a result of changes in the current account. Bagnai and Manzocchi (1999), China s Prasad (2000) through their studies showed a strong link exists between economic growth and the current account deficit.

Current account in Macedonia is dominated by two forces; trade balance and secondary income, one big item of deficit and another surplus big voice. In reality almost eliminate one another in their current account events.

Figure 1: The trade balance (exports and imports) in euro and as % e GDP between 2008-2014



Source: NBRM (Central Bank of Macedonia), externs statistics, data for BP.

Trade balance represents one of the most dominating items in the current account and the balance of payment, its importance is derived as a result of what it gives us information about commercial exchange with the outside world and as such enables us to identify a manufacturing power country, that country's power consumption, domestic demand, foreign demand,

[4] A.Ghosh and U.Ramakrishnam, “Current account deficits:Is there a problem?”,IMF, 2012.

consumption or saving trends and gives us detailed information that which countries are closely linked economically, what are our sectors more productive and more fragile national economy[5].

As seen from the graphs and analysis, we see that historically Macedonia has a trade deficit, which ranges on average from 1.7 billion euros a year or 24% of the GDP (the last six years, the Table 1, figure 1). The negative net export means that our money goes for buying foreign goods and reducing domestic production, which then causes contraction as in the labour market and goods market. In addition to this influence, also foreign importer, denar gained, the euro trades or other currency, which means a surplus of supply in the market of the denar, which contains preconditions for currency devaluation.

3. Secondary income and its developments

From the above division of the current account balance of payments it was emphasized that secondary income include transactions between residents and non-residents for which there wasn't any particular service (such as remittances, external social benefits, pensions, gifts, etc.) [6].

From Table 2, we can see that when you do not enter secondary income account, the current account deficit leads to the trade deficit and it reaches 1.5-2 billion levels. Under these circumstances capital financial account, on average, only 31% will be able to compensate the current account deficit.

(in millions euro) Table 2: Some of the main item of balance of payment, Macedonia

	2007	2008	2009	2010	2011	2012	2013	2014
Current account	-421.2	-862.2	-457.1	-143.6	-224.3	-291.4	-146,8	-113,7
Current account without secondary income	-1 433	-1 847	-1 590	-1 510	-1 704	-1 911	-1 709	-1 722
Financial-Capital account	555.8	810.9	506.9	204	559.2	392.4	175.1	491
Direct investment net	506.4	409.4	136.9	158.6	336.8	110.7	263.8	278

Source: NBRM (Central Bank of Macedonia), externs statistics, data for BP.

But who would be the consequences on the official foreign reserves? Foreign reserves would decrease every year with almost 1 billion euros on average. It would be impossible for the central bank to maintain a fixed exchange against the euro. Official reserve would be spent and in that case the devaluation of the denar would happen[7].

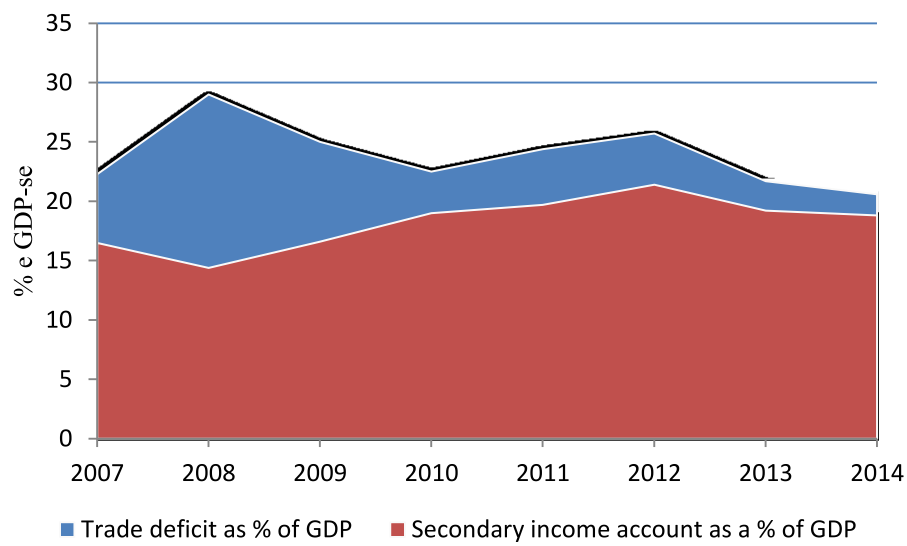
But in between we have abstracted a real stabilizing force and development, secondary income, led by remittances, which on average in the last six years have offset close to 75-80% of

[5] R.Ademi, "Bilanci i pagesave dhe ekuilibret makroekonomike në R.M (Balance of payment and macroeconomic equilibriums in R.M", (master thesis), Tetovë, 2011, fq.32.
[6] "Balance of payments and international investment position manual", 6th edition, IMF, 2009
[7] R.Ademi, "Transfertat korrente si burim kryesor i mbulimit të deficitit tregtar në R. e Maqedonisë (Current transfers as a main source for covering the trade deficit in Macedonia)", Insituti i Financave të Kosovës, 2013, fq.8

the trade deficit (see Chart 2). Current transfers in the balance of payments consist of: official transfers, which represents cash assistance and goods from foreign countries and organizations which run our country. This item represents 3.3% average of current transfers, so their importance is small. What we are interested in as a researcher is the trend of private transfers and their impact on macroeconomic balances.

From figure 2 we can see that the secondary has moved an average income level of 18% of the GDP in recent years, while the trade deficit is brought to the level of 24% of the GDP. From here it can be concluded that secondary income, led by remittances stabilizes the current account and balance of payments in general. It is this element which represents a stabilizing force in the very balance of payments, the official foreign reserves (this is a very important instrument for a country with a fixed exchange rate), for the exchange rate and other macroeconomic variables. In many other countries the inflow in the financial account mitigate the capital current account deficit, as a result of entries in the name of foreign investment, the voice that compensates Macedonia about 18% of the trade deficit for the period 2007-2014[8].

Figure 2: Trade deficit and compensation from secondary income



Source: NBRM (Central Bank of Macedonia), externs statistics, data for BP.

Reviewing the importance of the secondary income (private transfers), we can conclude that it is really one stabilizing element in the balance of payments, consolidating the foreign reserves by keeping the fixed exchange rate against the euro. However, on the other hand it also has effects on the real sector, where average private transfers brought about 18% of GDP (see Chart 2). According to the survey (S. Xhaferi, 2002) 55% of remittances are used for household needs, tools which are intended for consumption, which immediately converted into denars on the

[8] B.Stafai, “The Trade Balance as one main item in the current account in Macedonia”, Czech Institute of Academic Education, 2014, pg.7.

FX market. Close 600-700 million euros in 2012, the remittances are oriented to consumption and taking into account the multiplier effect, you can imagine this financial infusion on the Macedonian economy. 15.3%, or 200-240 million euros of remittances are used for capital investment in the Macedonian economy. The inflow of remittances not only affects growth to the receiving economies savings and investment but it also has short run effects on aggregate demand and output all the way through Consumption (Solimano, 2003).

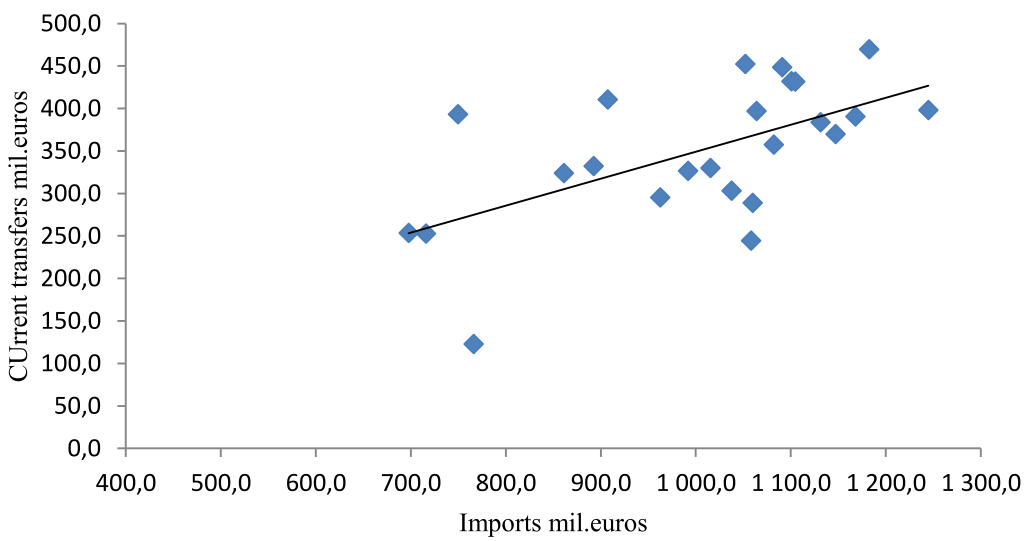
As seen from datas, are not the effects of private transfers that greatly exceed foreign direct investments (which averaged 270 million euros behave or 4.15% of GDP last six years, Table 2), but we can also see remittances for capital investments ranging approach to foreign direct investment.

Problems with private transfers real measure consist the belief that more than half of the transfers go through informal channels. According to a recent survey conducted for the purpose of remittances (S. Xhaferi, 2002), it appears that 56% of money sent himself down and only 16% through the bank. These findings through the survey show that many money transfers are conducted outside the banking system.

Therefore the total value of foreign net-effective which banks sell exchanges was believed that most of the exchanges in this market come from the remittances of migrants from informal channels.

In the currency structure of foreign exchange market, the supply side of foreign effects most appear in euros represented in 58%. Then comes the 28% Swiss franc, the US dollar and 10% are others. The reasons why the euro has a large representation in the foreign exchange market, except that the denar is fixed against the euro, have an impact: the large number of migrants in the countries of the euro area, the high rate of bank deposits in euros, higher trade exchange in euros, use the euro as a vehicle currency for payment out etc. From this it can be said that the indication of the geographic distribution of immigrants, has a significant impact on the structure of the effective foreign currency in foreign exchange markets.

Figure 3: Correlation between the current exports and imports of transfers Q12009-Q42014

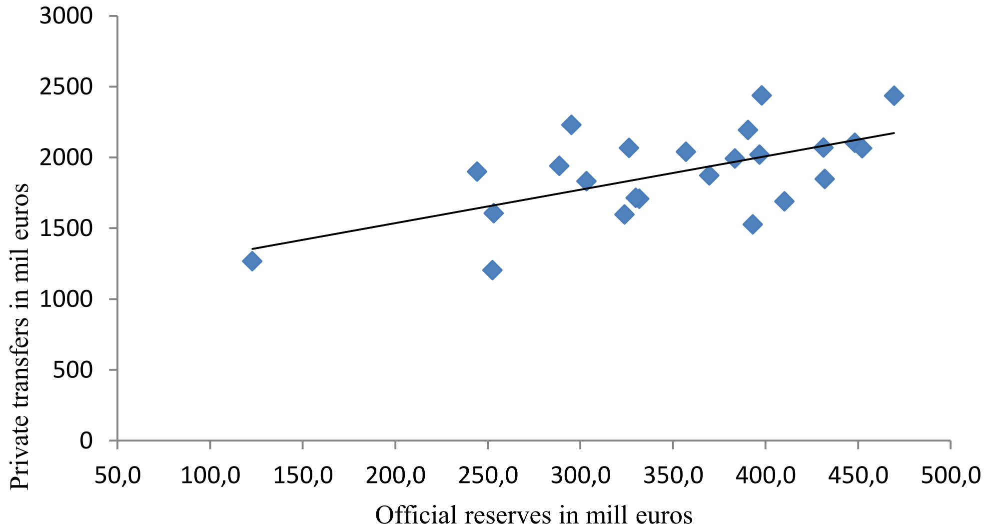


Source: NBRM (Central Bank of Macedonia), externs statistics, data for BP.

A number of literatures show the relationship between remittance and import. Remittances sent by the migrants have grown over time in the Macedonian economy with the increasing external demand for its manpower. The remittances contribute to the GDP as well as foreign exchange earnings of developing countries at a greater extent. According to a World Bank report, workers' remittances provide valuable financial resources to developing countries, particularly the poorest (Source: World Development Finance, World Bank 2005). Remittance plays a vital role toward economic development of any country especially for the developing nations. With remittances, an economy can spend more than it produces, import more than it exports or invest more than it saves, and this might even be more relevant for small economies (Connell and Conway 2000). Remittances play a potentially important role in the import demand functions both at the aggregate and disaggregated levels, particularly where there is a foreign exchange problem (Zaman and lmrani, 2005). Macedonian import is higher than export which results negative Balance of Trade situation and this gap can be fulfilled by improving foreign exchange reserve through remittance earnings. Remittances are considered a major source of foreign exchange for labour exporting countries used to pay import liabilities (Azad, 2005). Besides making payment of import, remittances are also used for productive investment by the government (Salim, 1990). The marginal propensity of imports and remittances are found to be positively related with imports (Khan et al, 2007). As household income of migrant families increases due to receipt of remittance, so they may have propensity to consume more which will increase the demand of goods. The propensity to import out of remittances will be lower than out of ordinary income because remittances usually go to the subsistence of low-income groups, which have limited taste for foreign articles of consumption (Kindleberger, 1965). On the other hand, Paine (1974) argue that the propensity to import out of remittances will be high as recipient families now have taste of foreign goods and living standards which is intense in case of after returning of migrant worker to their home. Durand and Massey (1992) find that most of income of migrant households from remittances is used for consumption rather productive investments. Zaman and Imrani (2005) found that remittances have no impact on the demand for imported consumer goods where remittances have a positive impact on import of capital goods and raw materials. Adams (2006) finds that a smaller share of income of remittance-recipient households is used for food and other non-durable goods consumption where larger share for housing, education and healthcare financing. Glytsos (2005) analyzes the effect of remittances on investment, consumption, imports and output and finds that the effect of reducing remittances would be greater than the effect of raising them. If remittance is used for productive investment then the increased output will help to reduce the upward pressure of demand. Barua et al (2007) found a negative correlation between remittance inflow and inflation.

According to all the surveys conducted in the region, in Macedonia, the bulk of the remittances goes to consumption, in order to increase the standard of living and quality of life. It turns out that besides the importances that have private transfers to cover the high trade deficit, on the other hand they are deepening it. This assertion is confirmed by Chart 3, where there is a rather strong connection between these two indicators, where unilateral transfers increased and imports grow, because households have more to spend and while a large part of the shipments go to households with a low standard of life, they have priority consumption and not other economic activities.

Chart 4: Correlation between the oficial reserves and private tansfers in the period between Q12009-Q42014



Source: NBRM (Central Bank of Macedonia), externs statistics, data for BP.

In the last couple of decades we have observed a significant increase in international reserves around the world. This rise in reserves – mainly concentrated in the holding of U.S. dollars – has been sharp, with estimates by the International Monetary Fund (IMF) indicating that they have tripled in the last ten years, placing it at 13 percent of global GDP in 2009 (IMF (2010a)). This trend is expected to continue, as many emerging economies take into consideration that a stronger position in reserves can allow them to reduce the impact of fluctuations in capital flows, like those experienced during the recent economic crisis.

Higher reserves have always raised questions about the optimality of their level as Central Banks balance safety, liquidity, and return concerns against the opportunity cost incurred in holding reserves. While this issue is important in its own right, here we concentrate on the underlying reasons giving rise to the accumulation of reserves, and explore the role that external factors play in the determination of international reserves as a percentage of GDP, emphasizing the importance of remittances. Understanding the importance of remittances in the accumulation of international reserves is important because reserves are a measure of foreign exchange liquidity and are commonly used to gauge the creditworthiness of a particular country. To the extent that the inflow of foreign currency from remittances improves the foreign exchange position of these countries, it enhances the solvency of the country.

A paper on Latin American countries studying the effect of remittances on the accumulation of official foreign reserves show some results that foreign reserves positively influenced by a positive net export, a devaluation of the exchange rate, the difference in interest rates and the increase in revenues from remittances. In fact, the influence that the remittances have in official reserves is the most stable and strongest of the determinants. If remittances increased by 1% as a ratio to the GDP, results in average official reserves increased by 0.93% as a ratio to GDP.

From most of the studies that have tested this report is that they come up with a strong and positive attitude, as it shown to us for testing the correlation between these two indicators in figure 4, which is obtained based on the performance of private transfers and reserves FX official Q12009-Q42014 period. With increased inflows of private transfers, increased foreign exchange reserves, a fact that shows us the chart above. In fact, inflow from secondary income who create form from remittances are the biggest item, positive, who consolidates balance of payments, cover the trade deficit and official reserves fills. For this fact little has been studied in Macedonia.

4. Conclusions:

Current account in Macedonia is dominated by two forces; trade balance and secondary income, one big item of deficit and another surplus big voice. In reality almost eliminate one another in their current account events.

Macedonia historically has a trade deficit, which ranges on average from 1.7 billion euros a year or 24% of the GDP.

Secondary income include transactions between residents and non-residents for which there wasn't some particular service (such as remittances, external social benefits, pensions, gifts, etc.). The secondary has moved an average income level of 18% of GDP to close the trade deficit commenced with 75-80%.

The secondary income, led by remittances stabilizes the current account and balance of payments in general. It is this element that represents a stabilizing force in the any balance of payments, the official foreign reserves (this a very important instrument for a country with a fixed exchange rate), the exchange rate and other macroeconomic variables.

According to all the survey that has been made in the region and also in Macedonia, the bulk of the remittances goes to consumption, to increase the standard of living and quality of life. It turns out that besides the importances that have private transfers to cover the high trade deficit on the other hand they are deepening it. This assertion is confirmed by correlation tests where there is a rather strong connection between these two indicators.

From most of the studies that have tested the impact of inflows from remittances and official foreign reserves the conclusion is that they come in as strong and positive, as it shows us the correlation test, which is taken into account the performance of private transfers and official reserves for Q12009-Q42014 period. Inflow from secondary income that create form from remittances are the biggest item, positive, who consolidates balance of payments, cover the trade deficit and official reserves fills.

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