European Journal of Business and Management
ISSN 2222-1905 (Paper) ISSN 2222-2839 (Online)
Vol.7, No.11, 2015

The Impact of Sovereign Risk in the Business Cycle – Case Albania

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Abstract

The sovereign credit risk is becoming one of the most concerns for the international financial community, and understanding its nature and its effect on the real financial market is very crucial. The sovereign defaults tend to cluster at business-cycle frequencies, the business itself defaults tax authority payments and loan repayments, in turn all serving to creating a vicious cycle in the entire financial market. Country Risk is the major factor, indicating in the default of credit swap, and this is more intuitive, rather than taken from frequency macroeconomic data, which are highly missing in the transition economies like Albania. Country sovereign rating for Albania, assessed by the International Intelligence Agencies, historically shows that Albania is a risky country and that is why the Foreign Direct Investments had been in a moderate level through the time. Beyond borrowing in foreign currency from Albanian Government, accompanied by a devaluation of national currency during crises, the higher debt service cost has contributed in a comparably lower level of Foreign Debt. Notwithstanding the positive developments in the country, the Albanian market economy, it is still far from being a stable & developed one in a longer term, and be considered as an attractive country for foreign investments. The global economic crises revealed real problems of the economy, by showing that positive trends of GDP growth, during the first years, failed to create an essential and steady base for a sustainable development. The sovereign credit risk is a combined product of many country-specific factors, and also global ones, which in turn should be diminished by installing and applying modern portfolio diversification methods.

Keywords: *sovereign Credit risk, Country sovereign rating, credit default swap, debt servicing, foreign debt.*

1. INTRODUCTION

A nation, or country, is a supreme entity, and any risk coming from the potential fail of a government to repay back its dues, or that does not respect the loan agreement, is called sovereign risk**.**

Sovereign risk may happen during instability economic time or political one, or in case of self-confidence by the misuse of its independence. We can mention lots of countries during the global economical crises that commenced by end-year 2008, like Greece, Spain, Italy, Ireland, etc.

In a macro level, Albania is considered a risky country, thus the credit risk, as an important category influenced by the sovereign risk, catch the high level during the past 4 years and on.

As known, the sovereign risk is measured based upon some categories, like: Political risk of economy; exogenous risk, or so-called environmental risk, that has to do with natural catastrophes or regional economic crises; other country risk, like threat from any political instability or social tension that can undermine effective implementation policies against poverty and social impact.

For measuring the country risk level, many alternative resources like: Euro money Country Index, Economist Intelligence Unit and Institutional index for investments, are usually used. Those three country risk assessments models, considered as outsider risk assessments, have provided mostly an identical sovereign risk assessment for Albania over time.

Albania as other countries of the Balkan region, has a similar financial system, built up mostly by foreign banks which brought a lot of know - how and access to foreign funds, but it is still limited to be a financial modernized system. The adverse effect of the bank competition brought up the credit boom which contributed in aggravating the financial crises to the region by the end of 2000s. Albania experienced extra inflow of money from remittances, except of that from the banking system, which influenced in extra funds allocated to risky projects which failed to success.

After incomplete reform that led to banking crises across the region in the 1990, almost all countries adopted a model based on strong bank supervision and high participation in local banking sectors by western European parent banks. This brought much needed know-how and access to foreign financing – but also contributed to the major credit boom in the 2000s, exacerbating the effects of the global financial crises at the end of decade. Current priorities include addressing crises legacies of bad debts and slow credit growth as well as adapting to the new regulatory. [1]

[1] James Roaf, Ruben Atoyan, Bikas Joshi, Krzysztof Krogulski and an IMF staff team "25 Years of

Like other developing countries, Albania lack funds to finance planned investments, thus fill such gap with foreign and domestic resources. If the gap it is not upturned over time, by increasing export versus import, the rate of return on development projects fails to grow. Government borrowing can be an essential ingredient for economic development, and this has been for centuries.
The borrowing in foreign currency from Albania government, accompanied by the devaluation of national currency during crises, it makes the cost of Debt Servicing. The experience shows that by year 2008, the exchange rate was 126 Albanian currencies, ALL per 1 Euro, nowadays is around 140 Albanian currencies, ALL, per one Euro, this way cost of debt servicing it is much higher.

Developing country debt is risky because the debt is most often denominated in a foreign currency, so when interest rate rise or the value of national currency falls, (on its own or relative to its creditors), the cost of debt servicing can sky rocket.[1]

2. The impact of Sovereign risk in the business cycle for Albania

It is already known the fact that sovereign risk does impact the business performance, and for the developing countries, this is stronger in the period of economic downturn.
Albania, as most developing countries, has its own unique experience and causes that differs from other ones, but still has a lot of commen features with neighboring developing countries. I will try to bring macro economic data for the past 8 to 9 years for Albania and the neighboring countries in order to see how Albanian economy is performing comparably.

Minsky point out that "When left unchecked, debt markets are too often pro-cyclical- there is a lot of liquidity during boom times and thus nation tend to borrow. But liquidity tends to dries up during recessions and can make it difficult for nations to rollover or increase debt"[2]

The Albanian Government increased the public debt in favor of foreign debt before the the crisis' outbreak in 2008 - 2009, and as it is in a foreign currency, which helped to increase the cost of debt servicing, indicated by the rise of interest rate and fall of the value of national currency, during the crisis period. On the other side, the increase of debt servicing cost has influenced Albanian Government by not borrowing at such high cost and in turn has put reins on investments in the public sectors, which creates a liquidity problem in the coming years.
During the current financial crisis, the Albanian debt was broken downed in domestic and foreign debt, in the ratio of 60% to 40%, respectively. Such fact has served slightly to a certain extent at easing the cost of debt servicing.
During 2008-2009, just in the blast of the economic crises, Albanian government double its foreign debt comparing with period before 2007, the cost of this debt is higher than the borrowing before 2007, that were taken for the developing projects with soft interest rate. Besides that, the repayment period of this debt is short for only 2 to 3 years.[3]

As Herman stress "Even nations with low budget deficits can quickly be affected as government borrow to stimulate an economy during a recession but than experience slow growth and low tax revenues thereafter. These tensions are exacerbated for developing nations that are overly exposed to international financial markets. Any number of the factors discussed above could cause massive inflows of debt and large savings in outflow that can cause financial instability[4]

transition post communist Europe and the IMF" Regional economic issues, Special report,October 2014, pg 30

[1] Kevin P. Callager "The New Vulture Cultures: Sovereign debt restructuring and trade and investment treaties" paper no. 02/2011

[2] MINSKY 1986; Minsky's Theory of Financial Crises in a Global Context

[3] *open.data.al/.../**Borxhi**-Publik-i-Brendshem-dhe-i-**Jash**.*

[4] Herman et al; 2010

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Table no 1. The structure of the Public debt for Albania Government, and the GDP level during 2006 to Q3 2014

Albania	2006	2007	2008	2009	2010	2011	2012	2013	Q3 2014
Domestic Debt	348,9 35	369,53 6	400,456	415,028	407,372	438,58 2	470,35 8	520,786	554,934
Domestic to tot Debt in %	71%	71%	67%	61%	57%	57%	57%	59%	58%
Foreign Debt	14580 2	147,49 5	195,427	267,509	307,999	333,93 5	357,62 2	363,906	405,867
Foreign to tot Debt in %	29.5%	28.5%	32.8%	39.2%	43.1%	43.2%	43.2%	41.1%	42.2%
Public Debt stock	494,7 37	517,03 1	595,883	682,537	715,371	772,51 7	827,98 0	884,692	960,801
increase of Public debt in %	**5.7%**	**4.5%**	**15.3%**	**14.5%**	**4.8%**	**8.0%**	**7.2%**	**6.8%**	**8.6%**
GDP	882,1 99	915,91 0	1,055,5 94	1,148,0 82	1,222,4 62	1,282,3 00	1,326,0 00	1,358,0 00	1,418,0 00
Debt/GDP	56.1%	56.5%	56.5%	59.5%	58.5%	60.2%	62.4%	65.1%	67.8%

Resource: The Ministry of Finance, Bank Of Albania

All these inputs together contributed that cost of debt servicing to skyrocket. This fact can be easily seen in the table 1, and chart 1, chart 2, (attached), where foreign debt for Albania during 2008 and 2009 increased annually over 33% compare to previews year. The table 1 provides historical data by 2006 to Q3 2014 on the structure of the Albanian debt and GDP during the same time. Chart no 1 and no 2, easily shows respectively the increase of foreign debt during financial crises and chart no 2 shows the structure of the Albanian debt historically, by indicating the increase of total debt for Albania mostly supplied by foreign debt.

Chart no.1 Foreign Debt for Albania during y 2006 to Q3 2014

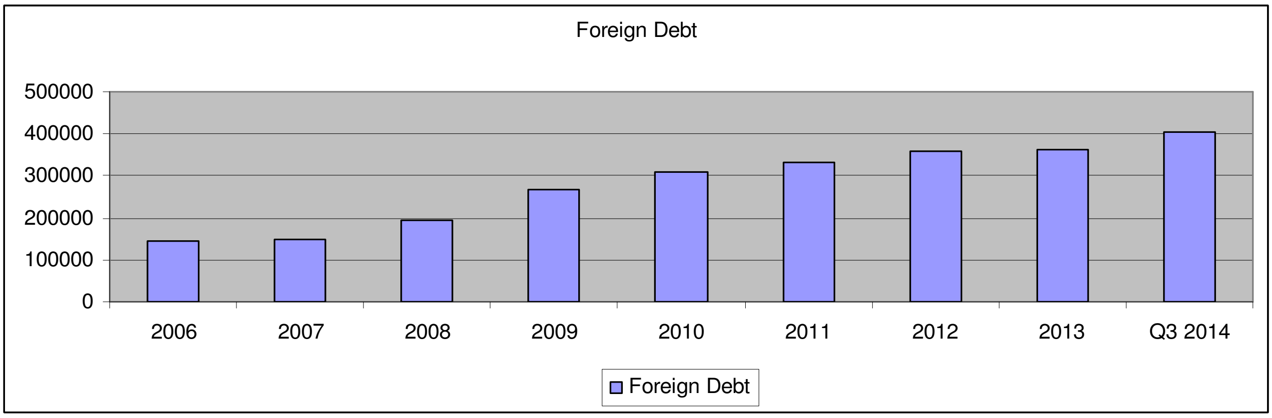


Chart no 2. Domestic debt compare to Foreign debt during year 2006 to Q3 2014

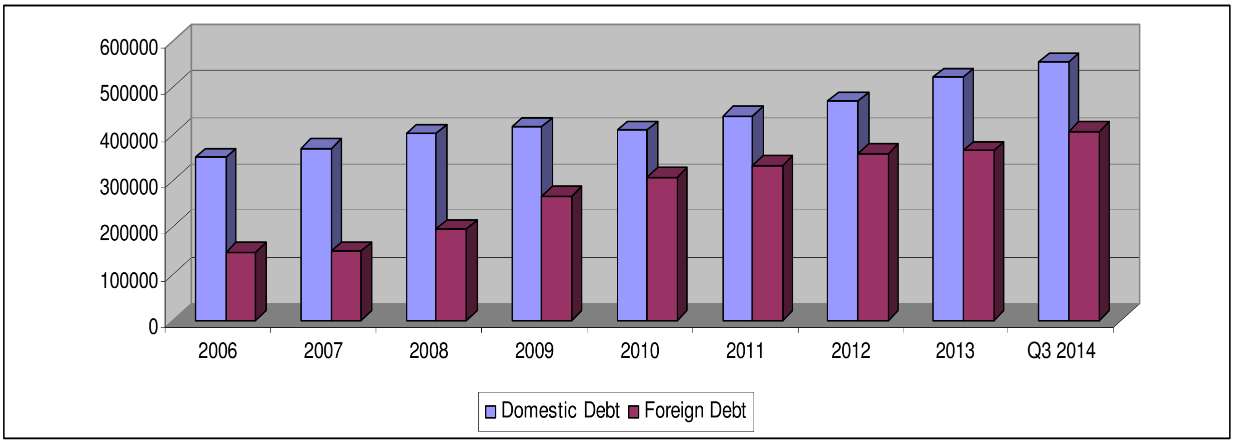
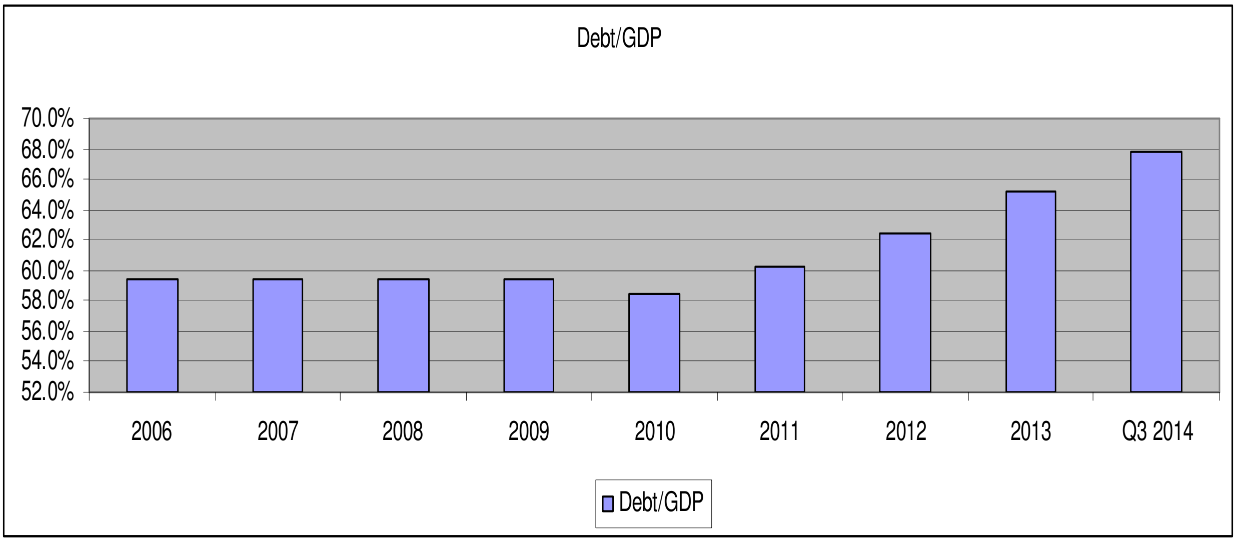


Chart no 3. The trend of Public debt toward the GDP during year 2006 to Q3 2014



Increases in external debt systematically help predict increases in the share of Countries in default and the comparable share of emerging markets with systemic banking crises. The decade leading to the global financial crisis, which began with the sub prime debacle in the United States in 2007, in effect, the average external debt/GDP ratio doubles during this period.[1]

We can see this ratio of Debt to GDP during 2006 to Q3 2014 in Albania to see how this fits into the Albanian economy situation. See chart no 3 above. Surprisingly during 2010 the ratio debt/gdp is in the lowest point and this is indicated by the Berisha's Government who put all priorities to the public investment mainly in road construction with the money which was not reported as domestic debt. (Contracted businesses to do the public works were not paid in time, this debt was calculated around 200 million euro). Albania seemed to underperforms its figure from 2012 compare to 2011, so percentage of Debt to GDP for 2012 is 61,6% versus 58,9% for 2011. The Current Account Balance it is slightly the same for both years cumulative -1,374 versus -1,356 for 2011. Country Risk according to Standard and Poor's rating is B+. The same trend of figures for 2013 until Q3 2014 is indicated because the new government took new loan to repay back the unpaid invoices of businesses for their public work during 2009 to 2012. After year 2010, the DEBT/GDP ratio shows the increase trend that it is higher during 2014 even GDP increase significantly this year.

[1] Carmen M Reinhart and Kenneth Rogoff "From Financial crash to debt crises" 2010,

The evidence confirms a strong link between banking crises and sovereign default across the economic history of great many countries, advanced and emerging alike.

Country risk has become a topic of major concern for the international financial community over the last two decades. The importance of country ratings is underscored by the existence of several major country risk rating agencies, namely the Economist Intelligence Unit, Euro money, Institutional Investor, International Country Risk Guide, Moody's, Political Risk Services, and Standard and Poor's. These risk rating agencies employ different methods to determine country risk ratings, combining a range of qualitative and quantitative information regarding alternative measures of economic, financial and political risk into associated composite risk ratings.

From the publication of the "Sovereign rating list", for year 2014, got selection only for the neighboring countries to Albania, and surprisingly the data shows the same or mostly the same assessment comparably from the three Rating Agencies. So, the three Assessment country Risk Agencies, like Moddy's, Standard & Poor's and Fitch, Sovereign rating for Albania is comparably with the neighboring countries. As can be easily noticed in the Table 2 below, Albania is closer with Greece and Bosnia & Herzegovina, where both these countries of the Balkan region, according the grade of the three respected agencies considered "highly speculative" and these countries are followed by Macedonia and Montenegro which considered as "Non-investment grade speculative"[1]

Table no 2 Rating from three Assessment Agencies for Albanian neighboring countries'

2014	Moody's	S&P	Fitch
Albania	B1	B	n.a
Bosnja and Hercegovina	B3	B	n.a
Greece	Caa3	B-	B-
Macedonia	n.a	BB-	BB+
Montenegro	Ba3	BB-	n.a

source: countryeconomy.com

Note: 1. Non-investment grade speculative Ba1 BB+ BB+ Ba2 BB BB Ba3 BB- BB-
2. Highly speculative B1 B+ B+ B2 B B B3 B- B-

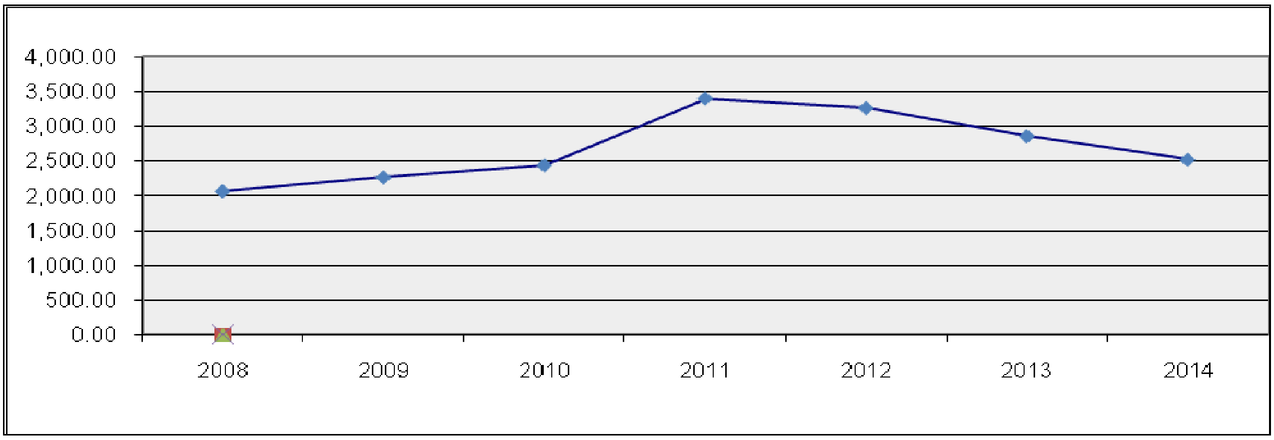
The statistics on the Foreign Direct Investment in Albania just in the blast of the global financial crises and afterwards might be an evidence/ proof of the concerns by the international investors about the Sovereign Credit Risk. The level of FDI for Albania is considered in a modest level compare to a region countries and during the last 4 years the statistics shows no improve. The government was forced to privatize some hydropower plants during 2013 in order to ensure extra funds to pay its dues, and this has influenced in increasing the level of FDI for this year. (see table 3 and Graf 4 below).

Table no 3. FDI cumulative for Albania during 2008 to 2014

Albania	2008	2009	2010	2011	2012	2013	2014
FDI	2,061.15	2,261.44	2,435.97	3,399.90	3,261.53	2,854.19	2516.922

[1] countryeconomy.com

Graff no 4. The trend of FDI for Albania



Economic policy uncertainity, as an important indicator of the Sovereign risk, might happen in the event of financial crises, region conflicts, when new governement coming from general election, and so on, and this is very sensible index which have an important effect in the economic stability of a country.

The same facts are stressed by Scott R. Baker, Nicholas Bloom, and Steven J. Davis in their paper published in Jan 2013,: “Economic policy uncertainty might be caused by: First that it increased after the start of the 2007-2009 recessions, because of businesses and household uncertainty about future tax, spending, regulatory, health-care and monetary policies. Second, that this increase in policy uncertainty slowed the recovery from the recession by leading businesses and households to postpone investment, hiring and consumption expenditure.- The resulting EPU (Economic policy uncertainty) index looks sensible, with spikes around consequential presidential elections and major political shocks like the Gulf Wars and 9/11. Recently, it rose to historic highs after the Lehman bankruptcy and TARP legislation, the 2010 midterm elections, the Euro zone crisis and the U.S. debt-ceiling dispute.[1]

As above, we can comparably evaluate/estimate the EPU in Albania, by bearing in mind the results of the international studies about EPU index, that is based on political and economical event which has influenced in economical growth or prolonging the economic recovery. We can mention the lately political events related to the economic policy of the new government in Albania about local election map, the amendment of the tax law, governmental reforms referring the tourism strategy, which influence negatively the financial performance of the businesses which have invested in the Albanian coast and also prevent the new investment in this economic sector. And that has to do specifically with the uncertainty related to geographical maps and the governmental plans of territory regulation.

The above mention results of these political events can be measured by the trend of GDP, level of unemployment, decline of the investment trend etc. The GDP level of Albania for 2013 touched the lower level during the economic crises at the level of 0,9%. The unemployment level increased by the end year 2013 at 16,9%, the Investment in Albania decline 30% during 2013 compare to 2012,[2]

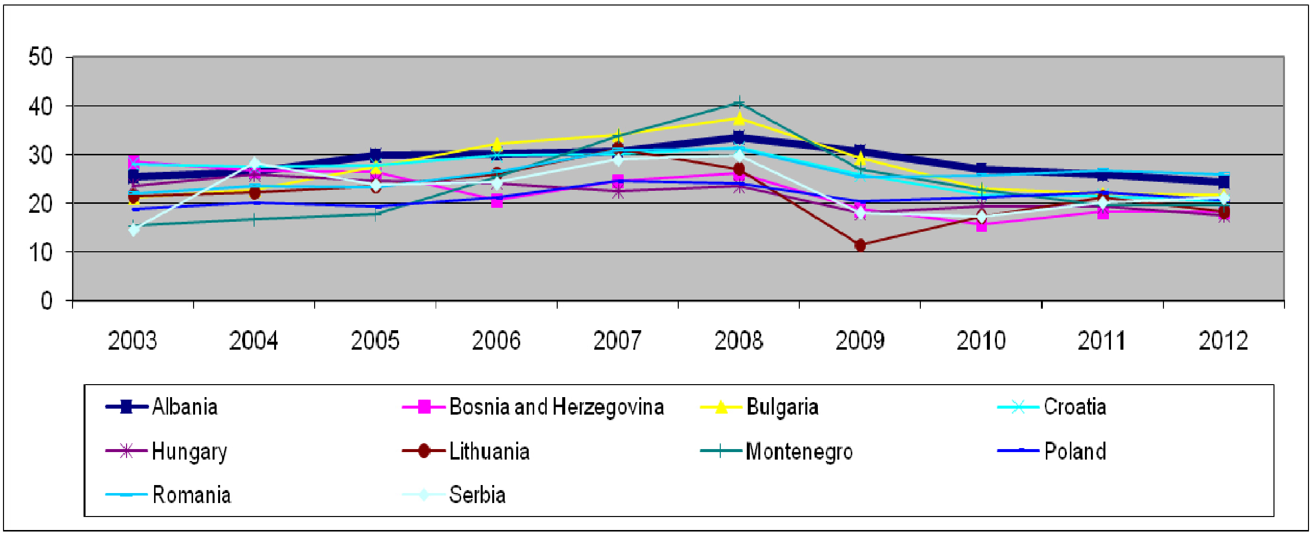
The increase of debt servicing cost, has influenced Albanian Government not to borrow at such high cost and in turn to stop investment of the public sectors, which create a liquidity problem in the coming years
So investment of the public sector toward the GDP in percentage is another important ratio to be considered for comparing the Albanian economy to other region’s countries. See table no 4, and chart no 5 attached, which shows that during 2008 in the blast of the financial crises Montenego and Bulgeria had invested mostl of its GDP, while Albania keep slightly the same trend as most of the region’s countries.

[1] Scott R. Bakera, Nicholas Bloomb, and Steven J. Davisc, in paper “Measuring economic policy uncertainty’ Jan 2013
[2] According to INSTAT (Albanian Institute of Statistics)

Table 4. Total investment to GDP in percentage for Albania as compared to region's countries

Countries	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012
Albania	**25.434**	**26.308**	**29.737**	**30.203**	**30.618**	**33.485**	**30.521**	**26.885**	**25.816**	**24.321**
Bosnia and Herzegovina	28.421	26.618	26.329	20.516	24.519	26.058	18.583	15.553	18.145	18.143
Bulgaria	21.155	22.746	27.552	32.141	34.093	37.542	29.366	22.887	21.923	21.742
Croatia	28.085	27.423	27.81	29.894	29.945	31.331	25.897	21.9	21.471	20.492
Hungary	23.649	25.905	24.536	24.141	22.433	23.544	18.018	19.275	19.212	17.451
Lithuania	21.425	22.3	23.602	25.992	31.231	27.053	11.431	17.309	21.255	18.312
Montenegro	15.414	16.631	17.727	25.445	33.806	40.671	27.121	22.793	19.534	19.522
Poland	18.742	20.069	19.266	21.052	24.445	23.9	20.347	20.998	22.058	20.47
Romania	21.968	23.67	23.286	26.458	30.975	31.26	25.37	25.568	26.845	25.988
Serbia	14.5	28.282	23.741	24.126	28.973	29.749	18.045	17.236	20.143	21.066

Graph 5. Total investment to GDP in percentage for Albania as compared to region's countries



Of course, once uncertainty falls back down, firms start hiring and investing again to address pent-up demand. Other reasons for a depressing effect of uncertainty include pushing up the cost of finance (e.g., Gilchrist et al. (2010), Fernandez-Villaverde et al. (2011) and Pastor and Veronesi (2011a)) and increasing managerial risk-aversion (Panousi and Papanikolaou, 2011).

As Nicola Borri LUISS, Adrien Verdelhan MIT and Sloan & NBER point out in their paper regarding the Sovereign Risk "The importance of risk aversion is intuitive. There is a tendency for emerging countries to default when they experience adverse economic conditions. If these adverse economic conditions correspond to an economic downturn in the U.S., then countries tend to default when risk averse U.S. investors experience harsh economic conditions"[1]
When lenders experience a series of bad growth shocks, their behavior becomes very conservator to their subsistence level and their risk aversion increases.

During the recession period, this experience is much the same in Albania during the recent years of the economic crises, when most of the operating commercial banks in Albania stopped lending and in some cases, even ask the borrower to repay back the loan before the maturity period of time. This is proven by the reported statistical data published by the commercial banks themselves, where the lending trend before crises compare to that of during crises it is quite different. During the lending bum, the stock of loan portfolio was increased by over 230% and

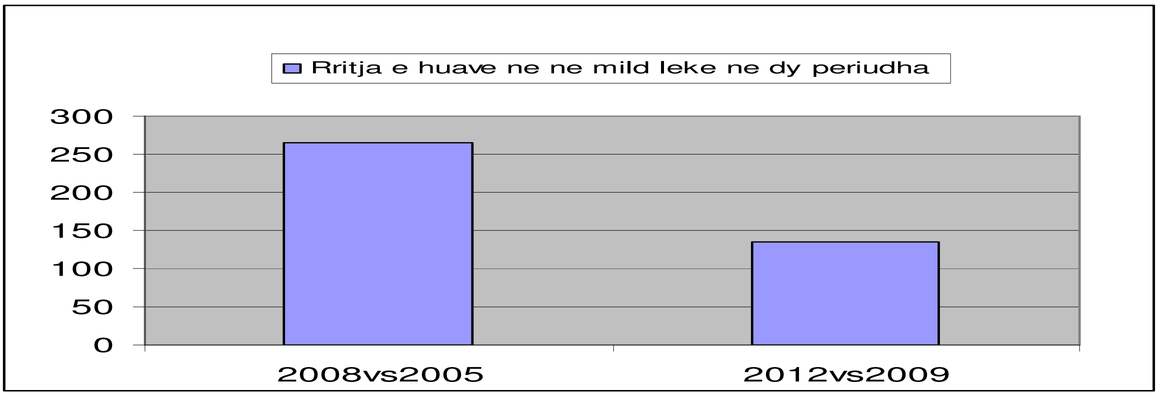
[1] Nicola Borri LUISS, Adrien Verdelhan MIT and Sloan & NBER " Sovereign Risk Premia" pg2, Sept 2011.

during the recession period increased only by 30%, resulting in a much higher NPL level. See Table 5 and the chart no 6 below.

Table no 5. The trend of lending by the Albanian banks during the booming v/s financial crises period

Periudha ne vite	2005	2008	2008 vs 2005	2009	2012	2012vs2009
Rritja e huave ne mild leke	112.5	377.5	265	437	572	135
Niveli i Huave me Probl	3%	6%	3%	11%	23%	12%

Chart no 6. The increase of loan portfolio in value during two picks periods, booming and financial crises



More or less this conclusion is proved by the group of authors in their research paper "How sovereign is sovereign credit risk?", who point out that "Understanding the nature of sovereign credit risk is of first-order importance in many financial and economic contexts. If sovereign credit risk is driven primarily by idiosyncratic or country-specific factors, then standard portfolio diversification methods are available to manage sovereign credit risk. On the other hand, if sovereign credit risk is driven primarily by systematic global factors, then there are major implications for the optimal allocation of investment capital across individual countries and regions of the world"[1].

According to the "One world Nations on line" web page, which lists the countries with the "highest default probabilities" in percentage of being unable to honor their debts within the next five years: Greece 98.54%, Cyprus 70.08%, Argentina 55.36%, Portugal 51.87%, Pakistan 48.92%, Venezuela 47.74%, Ukraine 44.05%, Illinois/State of 38.67%, Spain 37.45%, and Ireland 35.73% (data from 1 August 2012).[2]
Credit ratings are the most widely observed measure of credit quality of a specific debt issue or the issuing entity in general and remain the most commonly used information for the default process and the hazard rate λ[3]

Conclusion:
Country sovereign rating for Albania assessed by the International Intelligence Agencies historically shows that Albania is a highly risky country and that is why Foreign Direct Investments in Albania had been contributed in a modest level. Also notwithstanding the positive developments in the country, the Albanian market economy, it is still far from being a well natural diversified ones, which is the base for the sustain and developed economy in a longer term. The global economic crises brought out the real problems of the economy, by showing that the positive trend of the GDP during the first years did not create an essential base for e steady development.

[1] Francis A. Longstaff;Jun Pan; Lasse H. Pedersen; Kenneth J. Singleton. Working Paper 13658 "How sovereign is sovereign credit risk? Pg.21. December 2007.
[2] One world nations on line.org, Country Risk Analysis "List of Sovereign Debt and credit rating of countries" data from 1st August 2012
[3] Daniel AUNON NERIN, Diddier Cossin, Tomas Hricko, Zhijiang huang "Exploring for the determinants of credit risk, in credit default swap transaction data: is fixed – income market's information sufficient to evaluate credit Risk?" pg 27, Dec.2002

The task of building a full market economy has been difficult and protracted. Liberalisation of trade and prices came quickly but institional reforms –in area such as governance, competition policy, labor markets, privatisation and entreprise restructuring –often faced opposition from vested interests. [1]

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1. Kevin P. Callager "The New Vulture Cultures: Sovereign debt restructuring and trade and investmenttreaties" paper no. 02/2011
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[1] James Roaf, Ruben Atoyan, Bikas Joshi, Krzysztof Krogulski and an IMF staff team "25 Years of transition post communist Europe and the IMF" Regional economic issues, Special report,October 2014, pg 5

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