

Dynamics of the Croatian Economy

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Abstract: Croatia entered the industrialization process that initiated its accelerated growth as a 'latecomer,' being late by more than a century. By mostly using its resources for industrial development, Croatia succeeded in doing in 30-40 years after World War II, what it took developed countries 70-90 years to do. Controversial economic events in the pre-transition period, especially in light of the transition recession during the 1990s, have given rise to equally controversial professional discussion and adverse estimates concerning the (lack of) economic development success in this period. Therefore, the best effort would be to establish an analysis founded upon straightforward untempered empirical facts and their possible time frame stratifications. It is hoped that this will be a more objective path to unhindered insight into real growth mechanics.

Keywords: industrialization, transition, opportunity costs, privatization, inflation, export ratio

JEL Classification: O110

Industrialization and Rapid Growth 1952-1980

Analysis of the period after World War II, beginning with 1952, has been guided more by data availability than by relevant shifts in development trends.

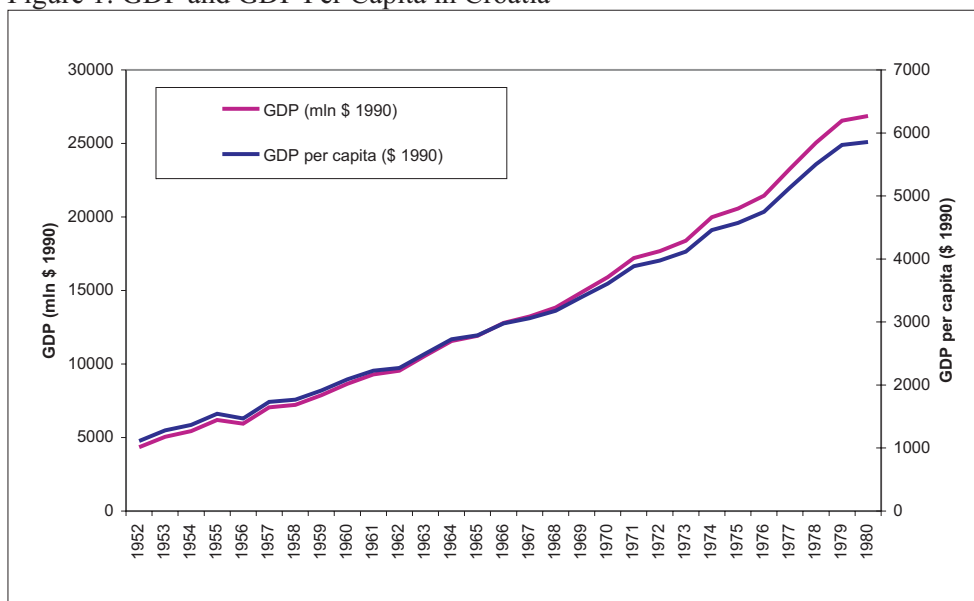
Bearing in mind analyzed economic events in the centennial and half centennial period, it can be noticed that the period between 1952 and 1980 stands out according to all key macroeconomic variables. A high average annual GDP growth rate of 6.7% was achieved together with a 6.1% GDP per capita growth rate. In this whole period, annual growth rates were mostly positive and relatively high (see Figure 1.).

At the same time, the population growth rate was 5.7%, which was twice the average annual half centennial population growth rate. In that period, the average annual employment growth rate was close to 4% (almost 3 times more than the half century average). Although the inflow of an excess labor force from rural areas to industrial sectors was the flywheel for increased GDP growth, it was also influenced

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by quality factors amplification. Labor productivity, for instance, measured by the GDP volume per person employed, rose by a respectable annual rate of 2.6%, resulting in a doubled labor productivity level in this period (see Figure 2). This was also a period of relatively low inflation, with an annual average rate of 12.6% in the period from 1953 to 1980; this was about four times lower than the average rate for the period from 1953 to 2000 (see Figure 3).

Figure 1: GDP and GDP Per Capita in Croatia

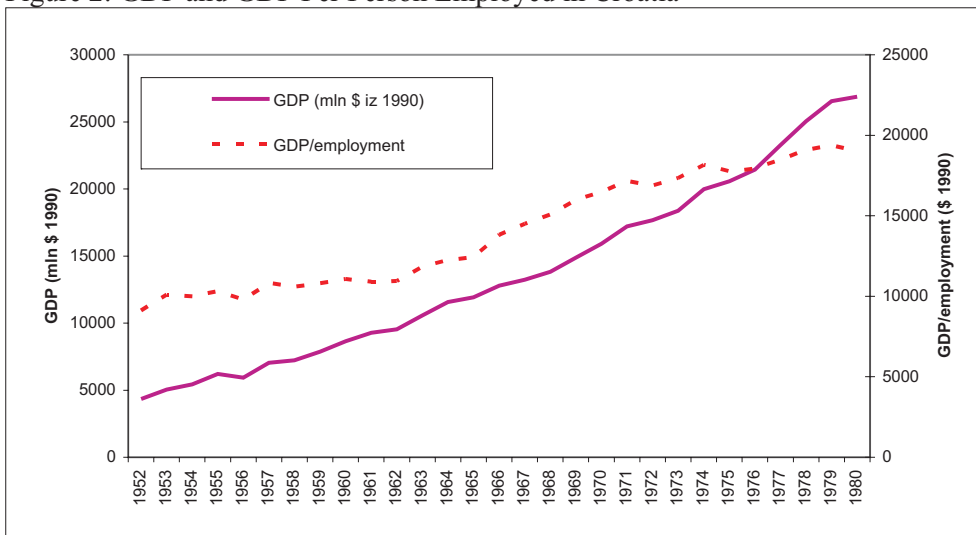


Source: Družić, 2004

A somewhat weaker performance was displayed by the fourth variable presented here, the export to import ratio. It is nevertheless of no small significance to notice that this was the only period in which there was a positive export to import ratio recognized for two years. The export to import ratio was close to 80%, except near the end of the period in the second half of the 1970's (see Figure 4).

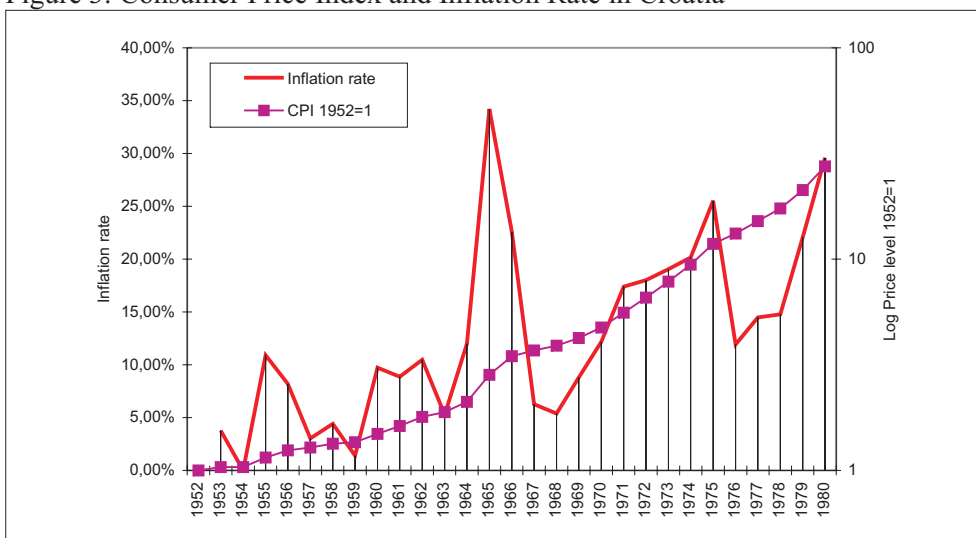
Synthesizing overall insight into the Croatian economic performance and proceeding with necessary caution, it could be determined that the interval of time from 1952 to 1980 was without a doubt the most prosperous period of development during the 20th century. In a relatively brief time fragment the country has been industrialized, and substantial general progress and the increase in living standard have been achieved as well.

Figure 2: GDP and GDP Per Person Employed in Croatia



Source: Družić, 2004

Figure 3: Consumer Price Index and Inflation Rate in Croatia



Source: Družić, 2004

Figure 4: Export/Import Ratio in Croatia



Source: Družić, 2004

Industrialization and Transition Opportunity Costs 1980-2000

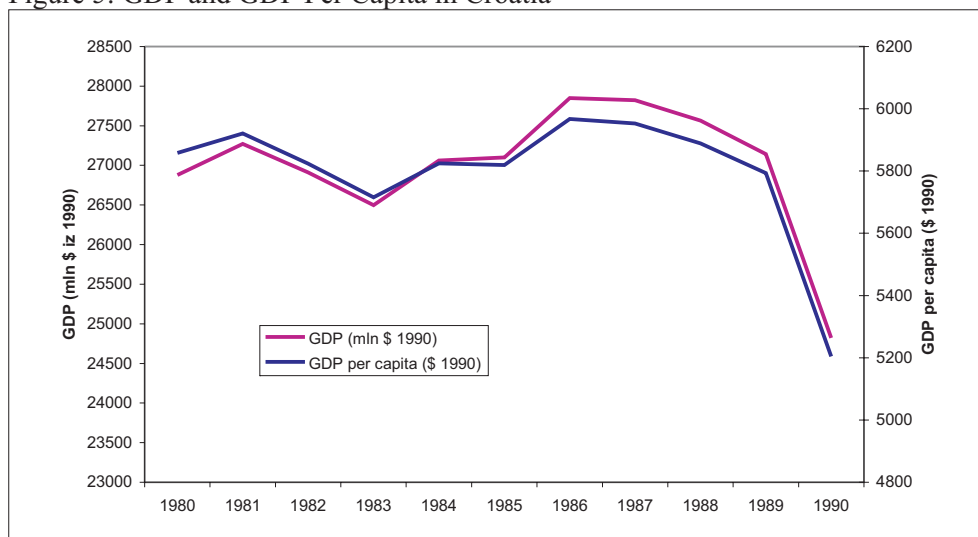
At the same time all the events discussed above amounted to unsolvable economic problems and poor economic performance in the next periods.

Economic Fluctuations, Stagnation and the Collapse of the Economic System between 1980-1990

In 1980, the Croatian economy started to lose its growth momentum and entered the negative growth rates zone. Between 1981 and 1989, the real average annual growth rate was slightly negative -0.75%, and average annual GDP per capita decreased by 1% (Figure 5).

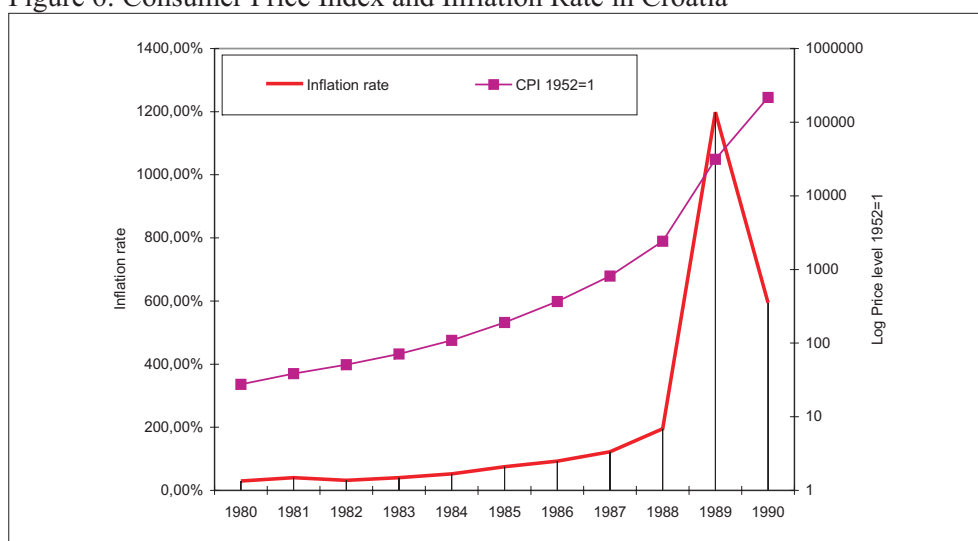
This was the period of the first stabilization program, which was implemented in 1981. This was also the beginning of an interesting history between IMF/WB and Croatia, first as a republic of former Yugoslavia and then as an independent sovereign state. We are now celebrating more than 20 years of a continuous stabilization package application in Croatia.

Figure 5: GDP and GDP Per Capita in Croatia



Source: Družić, 2004

Figure 6: Consumer Price Index and Inflation Rate in Croatia



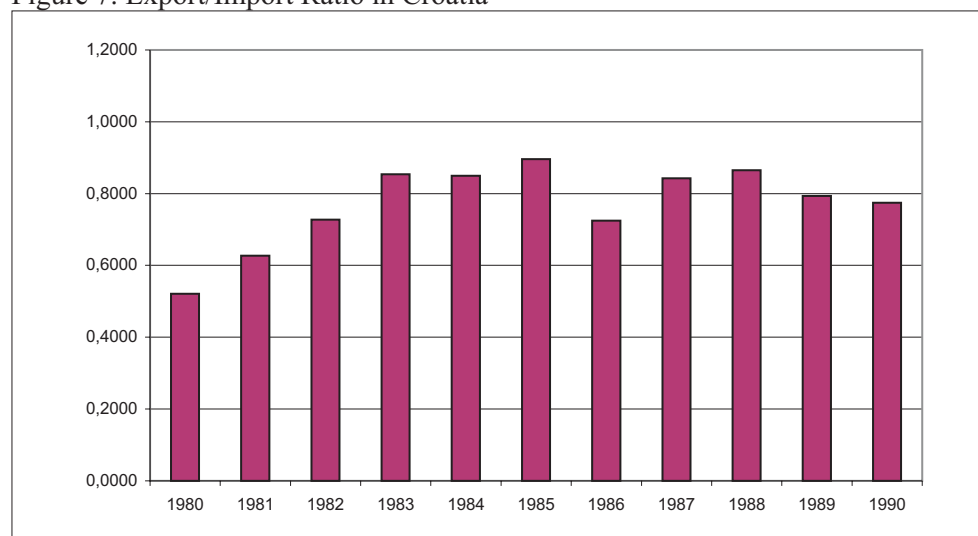
Source: Družić, 2004

In the 1980s, the stabilization agenda was concentrated on aggregate demand constraints, focusing especially on state budget expenditure control. The expected tradeoff of curbed public spending was a growth rate slow-down but not a negative

growth rate. Even less expected was the behavior of the inflation rate. Instead of bridled inflation, it practically exploded, up to an average annual rate of 150% throughout the 1980s, permanently increasing its pace to 1200% in 1989, the year of the final crash (see Figure 6).

An analysis of the behavior of macroeconomic variables has allowed the assertion that in reality the Croatian economy in 1980s experienced stagflation instead of theoretically- intended stabilization. Professional correctness requires that tremendous restructuring efforts at the expense of real wage and pension decreases, social services reduction, and falling living standards of that time should be also recognized. Stabilization restructuring policy has had some notably positive outcomes, the most prominent being an unquestionably adopted outward orientation. Export-oriented policy combined with real exchange rate policy resulted in weighty increased exports and substantially improved the export to import ratio, which was 80% on average in the 1980s (see Figure 7).

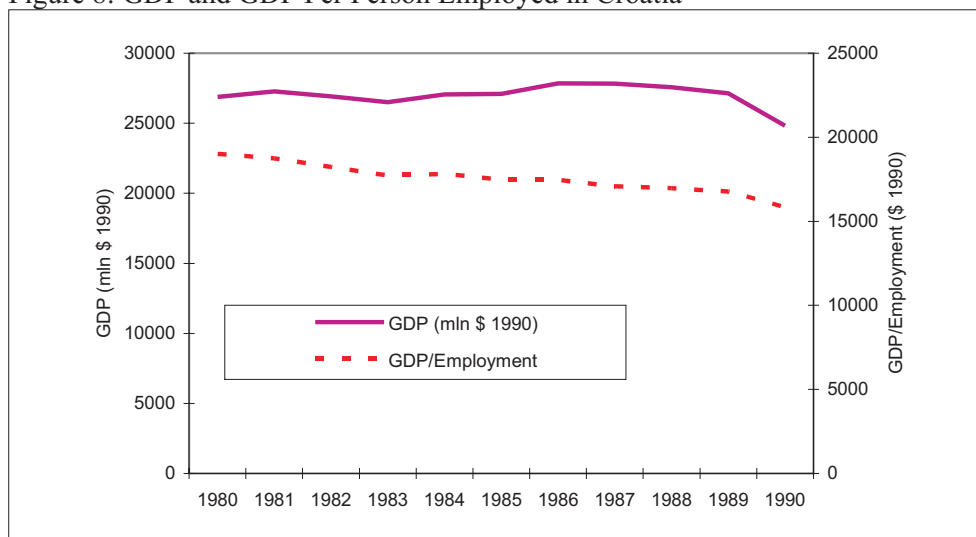
Figure 7: Export/Import Ratio in Croatia



Source: Družić, 2004

It is interesting to observe that employment grew slightly in the whole period at an annual rate of 1%. Increasing employment in a macroeconomic environment of a GDP zero/negative growth rate and high inflation had an unavoidably unfavorable impact on labor productivity, which fell by an average annual growth rate of approximately -2% (see Figure 8).

Figure 8: GDP and GDP Per Person Employed in Croatia



Source: Družić, 2004

The Devaluation-Inflation Race

It is obvious how macroeconomic analysis, relying up a simultaneous observation of key macroeconomic variables can provide relatively sound answers to some, at first sight, irrational economic phenomena.

In addition to the already stated trade-off issues among employment, growth and inflation, the Croatian economy met with an unusual occurrence while undergoing the stabilization program of the 1980s. It lived to see export expansion in an environment of a zero/negative GDP growth rate and diminishing competitiveness measured by falling labor productivity.

Increasing exports while domestic output stagnated and labor productivity decreased was enabled by a 'joint operation' of simultaneously reducing the export prices of domestic producers and contracting domestic demand. An 'elegant' way was found to decrease export prices that would encourage exports and at the same time increase domestic prices that would discourage domestic demand. The 'innovation' was to create a spiral of a continued 'race' between devaluation and inflation.

In the 'first round,' the growth of domestic prices caused a fall in external competitiveness and put pressure on devaluation. Devaluation had the momentary effect of curbing export prices (the fall of domestic prices calculated in foreign currency) and in improving the domestic economy's export performance. At the

same time, there were price rises in intermediary and finished imported goods (the rise of foreign prices calculated in domestic currency). This process augmented input costs and provoked the pressure to increase wages, thus stimulating new inflation round and calling out a new devaluation.

It is common textbook knowledge that important things happened here during the 'journey' from one to another general price level and the first and next devaluation. In the approximately 45–60 days it took the positive devaluation effects in the Croatian economy to exhaust themselves in a new inflation wave, relative price changes occurred. Imported goods, raw material and energy prices together with interest rates as a rule grew noticeably faster than wages. Real wage decrease had a stabilizing impact on domestic demand, automatically creating export surpluses. The improved export performance was primarily used to meet external commitments that multiplied in the second half of the 1970's, when foreign debt tripled.

During the 1980's, foreign debt of former Yugoslavia was always US\$18-19 bln, the Croatian part being US\$3-4 bln. During the 1980s, debt volume remained more or less the same. There were no new commitments except reprograms and restructured loans that were, in fact, new loans for the repayment of old debts. At the same time, interest, fees and duties actually paid during the 1980's amounted to almost exactly the same sum as the debt principal, US\$18-19 bln. In the meantime, external debt remained the same at the beginning and the end of the 1980s.

In the general recession of the 1980s, two time legs should be distinct. From today's perspective, it is clearly obvious that in the first leg (first half of period) there was evidently tremendous effort and high expectations that economic problems could be solved by programmed reforms. In the second time leg, the piling up of noneconomic constraints strongly influenced self-confidence losing ground, general apathy and the progressive vanquish of economic chaos, and final system collapse.

In the first half of this period, from 1981-85, identifiable trends of slowing down business activity, growth rates fluctuating around zero together with balance of payments improvements and inflation gradually getting into full swing, could be clearly observed. This was also a period of intensive formulating the stabilization program and trying out its implementation. Reform attempts were especially focused on capital market constitution and balance of payments stabilization.

In the second leg of this period, from 1986 to 1989/90, enough elements of economic and overall crash could have been discerned. Growth rates were increasingly negative and hyperinflation was getting out of control. At the end of the 1980s, a major contribution to the economic system decay and hyperinflation over of 1000% annually was administered by so called 'breaking and entering' the monetary system. It was simply the illegal money printing activity performed by the National Bank of Yugoslavia under the auspices of Serbian authorities without the knowledge and/or consent of the other republics of former Yugoslavia. A 'self-defense'

mechanism adopted by the other republics consisted of overdue nominal payments into the federal budget, avoidance of mandatory foreign currency depositing to the National Bank of Yugoslavia accounts, and other actions.

The Opportunity Costs of Rapid Industrialization

A rational analysis and evaluation of the 1980–90 period should respect the fact that certain events were caused not only by the actual economic policy model at the time but also by ‘arrived costs’ from accelerated development in the industrialization era. Irrefutably accelerated growth in the 1950–80 period had on the one hand opportunity costs in sector disequilibria resulting from lightning deagrarization. On the other hand, there were opportunity costs caused by questionable growth quality emanating from extensive investments and employment augmentation. As a consequence, extensive economic development insignificant factors’ efficiency increase. That meant that Croatia in the late phase of industrialization did not manage to attain intensive growth and relied upon the efficient utilization of scarce resources and new technologies.

These processes had a diminishing competitiveness impact on Croatian firms penetrating international markets, with the consequence of an accumulating trade deficit within the balance of payments that had to be covered by expanding external debt. Exhausted internal growth potential combined with dramatic global technological progress that the highly indebted Croatian economy had been unable to follow resulted in stagnation during the 1980s. Stagnation, for its part, contributed significantly to the growing recession and final collapse of the administratively planned economy.

It should be noted that an enquiry of growth chances relying upon Croatian economic empirical data unavoidably raises some doctrinaire questions.

Growth Rate Opportunity Costs

First is the question of the Croatian economy’s ‘natural’ growth rate. A serious lack of official long-term growth data has produced a situation where the expert estimates made by professional economists are the only available source of needed information. Therefore, a different and not always fully reliable evaluation that considers long-term growth rates requires extra caution. An even seemingly small mistake in estimation, such as the difference between 1.5% and 2% in calculated annual growth rate, would cause a 25% difference in the GDP volume. That would evidently end up in gravely dissimilar GDP volumes after, let’s say, 15 or 20 years.

With all necessary precautions taken and reservations about data accuracy pointed out, it could be presumed that the estimated average annual growth rate in 20th century of 2.19% is the Croatian economy's 'natural growth rate.' In that case, it could be asserted that achieved growth rate is relatively high, but not high enough to bring the Croatian economy closer to Western Europe, i.e. to narrow the development gap. In real terms, this gap got even wider. As the Croatian birth rate has been very low and just became negative in the 1990s, per capita GDP relations are somewhat more auspicious. Croatian per capita GDP was at the same relative distance from developed countries at the beginning and end of 20th century.

These findings point to the assertion that Croatia's 'natural growth rate' cannot enable it to close ranks with developed countries anytime in the foreseeable future. This gives room to the thesis that the country, as a latecomer to the industrialization process, has to use state intervention as a necessary mean of accelerated development. Practical confirmation of the thesis is the period from 1950–1980, which was marked by an average annual growth rate nearing 7%. Here, the notion of using utmost caution in evaluating development still stands.

The second important question is opportunity costs. Rapid economic development and high growth rates attained in one period could unravel as the performance of other key macro variables worsens in the same or next period of time. The longer the analysis is prolonged, the more this possibility is probable. Namely, it could be asserted that a high growth rate of GDP had opportunity costs in high inflation and other inflation-induced economic aberrations. Due to a very well-known planners' formula, high growth rates spring from high aggregate demand, especially investments. Investment consumption is the key element of a planning mechanism that by means of the capital/output ratio has been transformed into the growth rate. The possibility of selecting development priorities accompanied by the chance to single out particular investment projects that would realize these priorities is the crucial instrument of a planned economy. This naturally raises the question of savings (domestic and external) as investments sources. At a given GDP level, to increase investments, savings have to be enlarged, and to enhance savings, personal and public consumption has to be reduced. How then to the magnify propensity to save, while lessening at the same time the propensity to consume ?

Price distortion opportunity costs

In the period from 1945 to the early 1960s, agriculture was the main source of enlarged savings/investments. A combination of economic and noneconomic methods was used to transfer savings from agriculture to industry. Relative prices were changed by government decision and price scissors opened wide at the expense of agriculture. It was in combination with compulsory grain purchases in an earlier period that provoked income redistribution and forced savings outflow from the agricultural sector. Together with a government-implemented low wage policy and

restricted personal consumption in the industrial sector, a high savings/investment rate in industry was secured. A similar role was played by artificially setting high prices for industrial consumer goods. At this point, price policy conducted by the government was expectedly supplemented with low-rent flats, low prices for utility and infrastructure services such as electricity, gas and water supply and local passenger transport. That policy model had recognizable opportunity costs as well.

The extraction of savings in the agricultural sector by a price scissors policy caused opportunity costs of insufficient and backward agricultural output, a growing food production deficit and a long-term decrease of food products export to import ratio. The opportunity cost of an enlarged balance of payments deficit and augmented external debt followed. Savings extraction from utilities had opportunity costs, in road network devastation and underdevelopment, in energy production and the distribution of technical and commercial losses, and in run-down dwellings. Non-economic high prices for industrial products decreased external competitiveness and encouraged inflated cost calculations and other irrationalities to occur.

In the aftermath of the 1960s great economic reform and proclaimed democratization there was publicly endorsed promotion of self-management, and the persistent preaching ‘companies’ and workers’ right to freely distribute their earnings on consumption and/or savings. In this environment a consistent administrative base for non-economic instruments of compulsory savings and investments increase was not possible any more. Instead, a more market-oriented and therefore more ‘elegant’ solution like inflation was employed. The same effect was achieved with inflation in this period as had been attained by compulsory non-economic instruments in the previous period. The fundamental effect was a change in relative prices. Within a high rise in the general price level, government price control was able to manipulate a higher or lower than average price increase of certain goods and services. An income and savings redistribution followed automatically.

Next, an even more sophisticated market instrument entering the game was government interest rate policy control. This enabled an almost unlimited number of combinations between general and specific price levels and interest rates, giving the edge to or taking it from certain sectors and/or producers. The most ‘popular’ was lower than inflation interest. This negative real interest rate on investment (and other) loans that had propelled investment and other forms of aggregate demand/spending had more socially acceptable impact because there was no nominal decrease of any aggregate demand component or individual income.

An additional impact was executed by fiscal policy. Differentiating tax rates, varying custom duties, diversified public expenditure transfers, graded subsidies and other instruments were employed, extending preferential treatment to some and

discriminating against other sectors, companies and/or social/income population groups, finally effectuating (non)market resource allocation (in)efficiency.

Opportunity costs, however, were high and constantly increasing. They were mirrored in the deranged structure of the economy, general and sector disequilibria, high losses and insolvency, and finally in accelerated inflation. The other name for this overall stagnation was simply the recession of the 1980s, with a depression looming on the horizon. Growth as the dominant economic policy objective directed investments towards projects whose immensity promised the most sizeable effect on GDP augmentation. The second half of the 1970s was especially marked by investments realized in aluminum complexes, petrochemical companies, oil refineries, steelworks and large infrastructure projects. The posted high growth policy model required an annual investment rate above 30% of GDP, thus metamorphosing investments into inflation power-generating fuel.

Consequently, opportunity costs in the 1980s were painfully obvious. In the first place, capital composition was disturbed. Instead of a productive rational market relation between fixed and working capital, the dominance of big investment projects together with irrationally high construction works cost shares in total investment expenses produced a permanent working capital deficit. A lot of working capital was effectuated in factors underemployment the upshot of which were growing output costs, increased prices, and decreased competitiveness. In addition, working capital deficit nudged business entities towards increased indebtedness and magnified credit exposure. Insolvency thus created never ended in normally expected bankruptcy but in so-called losses socialization, giving birth to the specific insolvency phenomenon of the planned economy.

Insolvency as an 'original invention' of a socialist economic system in fact defined the state in which actually bankrupted companies were not allowed to be liquidated.

Why wasn't company liquidation a possible option? There were two main intermingled issues. On the one hand, company disappearance and resulting job losses in an environment of proclaimed employees' self-management would have contradicted the doctrinaire system's very foundations. On the other hand, laying off workers and closing down factories would have compromised the authorities' very existence. In fact, the ideological and political 'raison d'être' of the authorities was in the self-proclaimed role of providers and guardians of the employees' legal right to self-manage a firm and freely distribute the gains from their business activity. According to the beliefs at that time, self-managed firms once liberated from the profit race of merciless capitalists became at the same time free from business cycles, recessions, unemployment and poverty increases caused by insensitive capitalist greed and unproductive assets hoarding. If by any chance unemployed and/or inefficiently allocated resources occurred, that would then shake the (socialist)

system's very foundation. If there is bankruptcy and unemployment plaguing socialism as it does capitalism, then why go to such an extreme as a (revolutionary) socialism introduction? To admit that the whole experiment was a failure would automatically mean leaving office for the ruling party elite and therefore was not an option. Few options were left. One was to put the blame on particular low ranking officials and company managers for incompetent implementation of an otherwise excellent economic policy model. That was a good enough explanation for the stages of the initial crisis but wasn't sufficient in the phase when the general crisis went far ahead. The other option was to pretend that the problem did not really exist. That could be achieved (at least in short run) by employing euphemisms that would give a new name to an old problem. The rationale was to buy time and hope for the best, and a wicked person could say, 'unbelievers are waiting for a divine miracle to redeem them.'

At any rate, the euphemism generally applied for the clearly visible overall recession was insolvency, because admitting to a recession or depression, especially its implication for employees as the proclaimed backbone of the system, was not possible by definition. If by any chance it still appeared, that would mean that system was not impeccable. As there had been no system yet that was naturally capable of self-annulling its defining features through a wide range of reforms, a temporary 'way out' was found in 'conflictless' insolvency'. Insolvency was 'conflict-free' because insolvent companies accumulated losses had been 'socialized' by money and credit policy measures that re-melted individual losses into publicly-owned debt, burdening all taxpayers. Company recovery was conducted by monetary expansion; by selective primary emission loans that were just another name for money printing; by signing off public (tax) commitments, by budget transferred subventions; in other words, by inflation.

Inflation Expectations Opportunity Costs

Inflation, together with an active exchange rate policy resulting in the inflation/devaluation race already described, had been the omnipotent means for leveling out the peaks and valleys in the economic landscape. The opportunity cost here, however, was raising expectations with regard to inflation. Combined with a chronic foreign currency deficit, inflation expectations had stimulated business entities to the suboptimal allocation of scarce resources. Sub optimality was discernable in the metamorphosis of scarce financial resources into the raw materials hoarding process. The accumulation of (mostly imported) supplies above an otherwise economically rational volume had been an attempt by companies to sustain the necessary continuity

of business activity by procuring necessary import inputs before the next expected inflation/devaluation round.

However, such a business environment had required additional financing that could only be attainable through new loans, i.e. new indebtedness that would ignite a new inflationary round. Consequently, further indebtedness and working capital (raw materials) stock hoarding burdened production costs, decreased competitiveness and sales and increased stocks of finished goods. Increased stocks of finished goods had encouraged new indebtedness in order to square accounts with employees and input suppliers. This again was 'overcome' through inflationary deficit financing and money printing, fueling yet another round of exploding inflation.

The growth of indebtedness and the heightened inflation expectations that resulted caused the insolvency problem 'spillover' from real economy sectors to the banking industry as well. In response to described events, banks had been making efforts to constantly revalue approved loans by a hard currency clause that was supposed to sustain the real value of credits. Moreover, they had been trying to slow inflation's tempo through multiple interest rate increases.

This again started and accelerated the next round of inflation. The insolvent, highly indebted companies (therefore) loaded with stocks of unmarketable finished goods, had been seeking a 'solution' in new loans needed to sustain current business activity. The industrial producers' almost complete dependence on banks gave support to the thesis that self-managing socialism had never become an economic reality but that, in the late 1980s, state socialism had been substituted by state capitalism (Sirotković, 1989).

Regardless of doctrinarian disputes, credit expansion raised the collateral issue. A company's assets, being the property of society as a whole, were not saleable. In reality, that meant that fixed assets couldn't even be mortgaged and used as collateral against issued loans. However, raw material and finished goods stocks (working capital) were saleable and therefore usable as collateral.

An expected consequence was the 'blowing up' of stock values as a solution to expanding credit exposure. This opened another round of general price level expansion while the inflation whirlpool had become deepening and accelerating. At the end of the 1980s, it finally ate every rational base out of the system, which had been kept alive in its last years of existence by inflation alone.

This was one more plastic confirmation of the saying that the same medicine (inflation) used in prescribed doses has a healing effect, while an overdose can be fatal.

Transition and Economic Performance 1990-2000

Selected market transformation model of the Croatian economy and external factors influencing economic activity, especially great human loss and destruction committed by Greater Serbian aggression against Croatia during the Patriotic War from 1991-95 have been previously discussed (Družić, 2006). In this paper, we will therefore try to isolate the behavior of key macroeconomic variables.

In the period between 1990 and 2000, the average annual growth rate was negative and stood at about -1%. Although inflation was curbed by the implementation of a stabilization program in the second part of the 1990s, the inflation rate at the beginning of the 1990s was so high that the average annual inflation rate for the whole decade amounted to 93%. The export to import ratio decreased steadily, with an average annual value of about 50%. At the same time, foreign debt tripled. Particularly disturbing was the population growth rate, which, after slowed growth during the entire century, registered a negative average annual growth rate of approximately -1%.

This decade was also marked by a negative average annual employment growth rate of -2.76%. Employment rate behavior was radically atypical for an economy that spent more than half of the period in a war environment. As a rule, a war economy is conditioned by the full employment of its resources, especially the labor force. Even more, military conscription of able-bodied men requires retirees, women and other groups already out of the active labor force to re-enter the labor market. It seems that in the Croatian war economy, unemployment was a very rare, if not unique, experience.

Beside Homeland war and heavy human and national assets and property losses, Croatia's economic performance in the 1990s was influenced in every possible way by problems inherited from the 1980s, most particularly stagnation and recession. The impact of these economic difficulties was augmented by the disappearance of significant export markets of former Yugoslavia and the former Soviet bloc. There is no doubt that the overall fundamental reform objective was exactly a break with the unacceptable practices of the pre-transition period. At the same time, deep structural changes were expected to emancipate creative potentials swollen by national liberation and the attainment of a sovereign independent state. Despite highly unfavorable conditions and some aforementioned accommodating ones, however, it could be stated that Croatia's economic performance in this period was not only below expectations but was also well below its attainment level. In any case, it should be remembered that unlike the 1980s, this period did not display homogenous behavior of all the major variables. Two important stages could be discerned in the 1990s.

Facing Depression

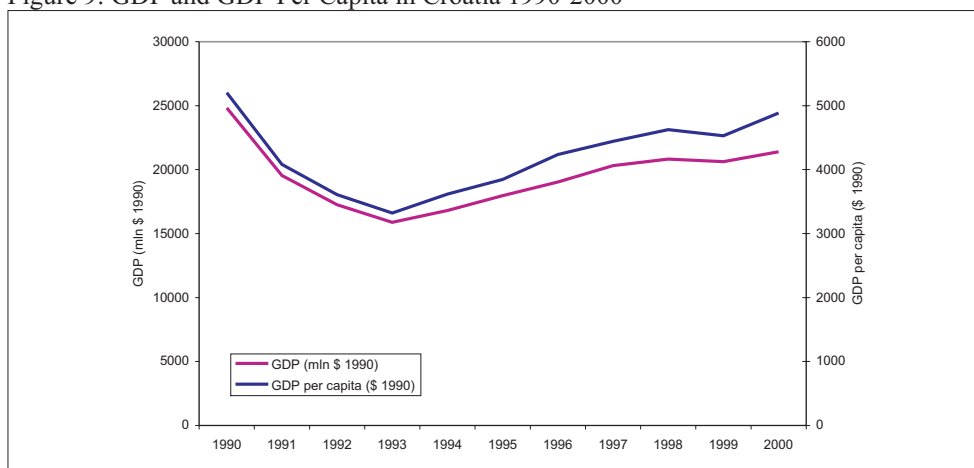
Highly unfavorable macroeconomic trends were concentrated in the 1991-1995 period, which was dominated by major operations of the Homeland War. The negative annual average growth rate was exceeding -6% (see Figure 9). War economy employment also decreased at somewhat lower annual rates without a reasonable theoretical explanation. The registered average annual inflation rate climbed over 500% annually. In these circumstances, external trade relations could have been graded as relatively auspicious, as the import to export ratio sustained an average level of 90%.

Yet, it should be taken into account that Croatia was practically under 'unannounced' international trade sanctions that artificially decreased imports. Moreover, the focus of resource allocation on the war machine's winning efforts diminished peacetime goods and services import capacity. Military equipment procurement data have not been part of official national statistic publications, which has also curtailed 'visible' imports data.

Incomplete Recovery

The second phase took place from 1996 to 2000, when significantly different trends could be observed. The growth rates showed notable recovery. With the exception of 1999, all other years had annotated positive GDP trends, so the average annual growth rate was around 3.5% (see Figure 9).

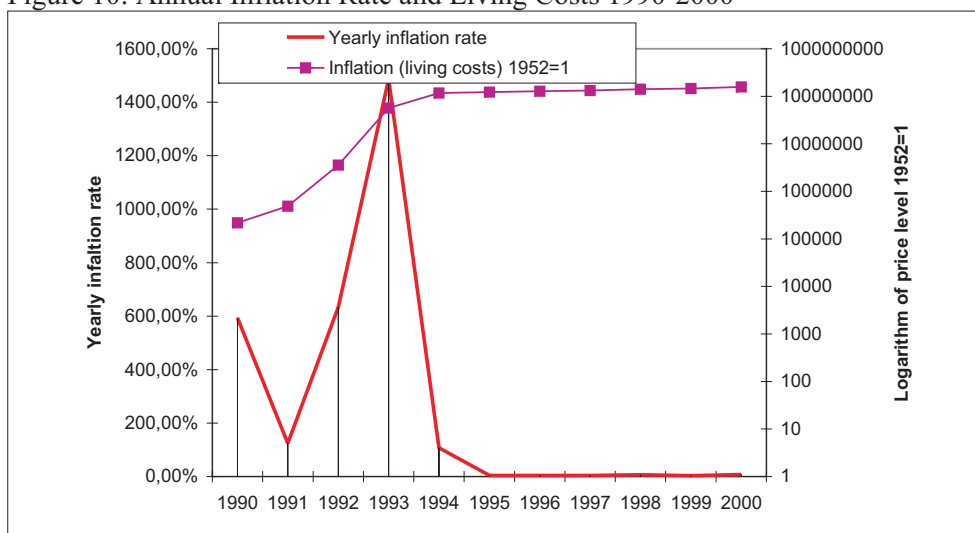
Figure 9: GDP and GDP Per Capita in Croatia 1990-2000



Source: Družić, 2004

The most substantial positive shift was evident in monetary consolidation of the economy. The effects of the stabilization program were noted first through disinflation. In a short time span, Croatia underwent a metamorphosis from a hyperinflationary to a low inflation economy (Jurković, 1995: 218). The inflation rate, in 1994, came almost instantly at zero point and during this period (1996-2000), was around 5% annually (see Figure 10). The success of the anti-inflation program had its source primarily in the 'hard budget constraints' policy that limited and reduced budget expenditure. The reduction of fiscal and para fiscal expenditure was achieved by reforming education, health insurance, and the pension system, and by restructuring defense and security forces and other parts of the state mechanism.

Figure 10: Annual Inflation Rate and Living Costs 1990-2000



Source: Družić, 2004

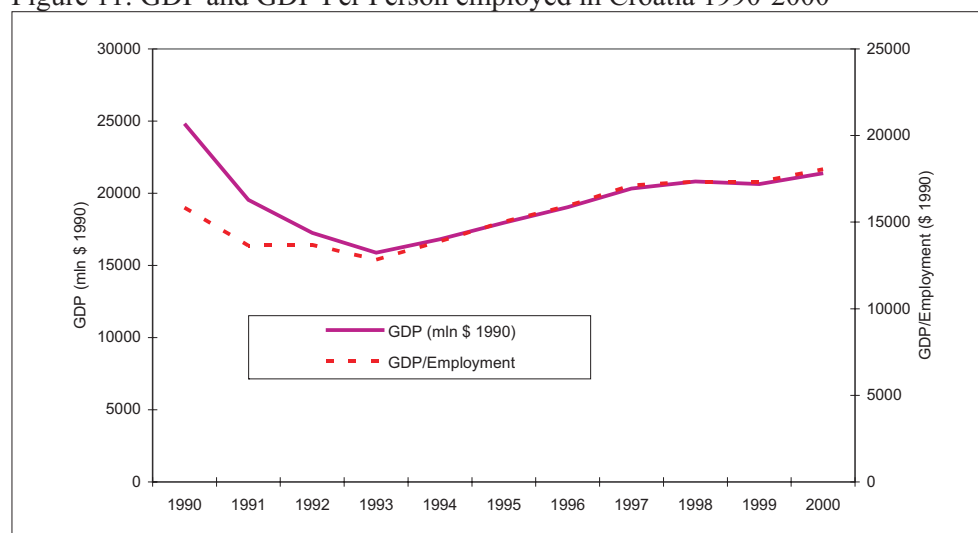
At the same time, fiscal revenues were restructured. The reorganized tax collection service combined with VAT's capture of previously unregistered transactions, drove the success of fiscal reform. It has been claimed that the nominal share of tax and quasi-tax collection in GDP increased by about 14%, reaching 46%. The VAT with a single tax rate of 22% was the 'jewel in the fiscal crown.' The VAT was considered the wheel of industrial price reduction and better performance of public finance (Spajić, 1998: 238). The additional reason for optimism was high turnover of VAT revenues in the first four months of its implementation (Ministry of Finance, 1998: 9).

Positive reform trends in this period should be compared with employment and foreign trade indicators as the remaining macro variables. Employment/

unemployment negative trends continued to be persistently unfavorable in the second half of the 1990s. The average annual employment rate remained negative at -0.65% . A situation is possible where a decrease in the number of employed is not automatically followed by an increase in the number of unemployed, because some laid-off employees might leave the active job search for good. Unfortunately, that has not been the case in Croatia. Rather, the Croatian experience has been a simultaneous decrease in employment and increase in unemployment.

Although its trends in the other half of the 1990s, when despite nominally notable relevant GDP growth rates, employment and unemployment were shown to be negative, it should be put in the context of a change in GDP composition. The nonfinancial/real sector share, which generates more labor demand, decreased permanently, while the financial sector share, which in the Croatian case generated lower labor demand, constantly increased in the GDP composition.

Figure 11: GDP and GDP Per Person employed in Croatia 1990-2000



Source: Družić, 2004

The other unusual occurrence employment-wise was that mass layoffs in the first part of the 1990s didn't materialize in a proper increase in labor productivity in the following period (see Figure 11).

The export to import ratio drop in the second part of the 1990s additionally affected employment indicators. A fall in the export to import ratio to an average of approximately 50% in this period excluded the possibility of an employment rise by means of export expansion.

Slackening export performance in combination with import increase resulted in a growing trade deficit of \$5 bln in 1997 (Nikić, 1998: 178). Rising BOP deficit was covered by a foreign debt explosion in 1997 (Lovrinović, 1999: 148). A foreign debt increase approaching \$9 bln, i.e. close to 50% of estimated GDP in 1999, was one of the most serious challenges to the stabilization policy. Finally, it has been argued that the initial stabilization success in 1994, achieved through low level equilibrium, was soon obliterated by waxing macroeconomic disequilibrium. The main consequence was increasing unemployment and decreasing investments as a result of inefficient fiscal and interest rate policies. The role of public finance was therefore essential in achieving equilibrium, by reducing and restructuring public revenue and expenditure (Sirotković, 1998: 300).

On the revenue side, optimism about the efficient and profitable implementation of VAT was soon replaced by concerns over a substantial drop in budget revenue. At the beginning of 1999, disappointment in VAT's performance was murky by addressing it to a seasonal drop in consumption (Ministry of Finance, 1999a: 9). The expected rise in VAT revenues in March was soon revoked by the sharpest drop in VAT monthly revenue at that time (Ministry of Finance, 1999b: 9). In addition, VAT's single rate implementation was censured as an exotic procedure which was adopted solely in Croatia, with a negative impact on income distribution. The undeniable upshot was an unequal distribution of the tax burden, i.e. a greater tax burden was placed on lower income groups of the population (Jelčić, 1999: 128).

The Opportunity Costs of Transition

The opportunity costs of transition can be segmented into two groups. The first is related to institutional problems of establishing an effective market mechanism, with the privatization process as its flywheel. The second applies to the problems of establishing and sustaining macroeconomic equilibrium, i.e. the stabilization program.

On the one hand, the belief that privatization was the key ingredient to a successful transition process stemmed from the costly failures of numerous reforms in the 1960s, 1970s and 1980s in former socialist countries. The cause of failure was exactly in the lack of market restructuring's chief element - transparent ownership rights.

On the other hand, international financial institutions had conditioned the inflow of foreign investment with determined swift privatization. Indeed, an additional push to more rapid privatization was foreign investment, which was considered crucial in starting economic activity in planned economies exhausted by long time stagnation/recession.

The applied Croatian economy privatization model was a combination of different variants. In the first stage, this meant selling social/state property to privileged buyers (former and actual employees) at discounted prices and to unprivileged buyers at full market prices. In the second stage, so-called coupon privatization was introduced. It consisted of the free of charge distribution of shares to particular social groups such as war veterans, disabled and displaced persons and refugees. The actual privatization process outcome has allowed the notion that the appropriated privatization model has been perceived as socially unacceptable and economically inefficient.

It is well enough known that social acceptability of any measure or law lies in its willful adoption by a majority of a certain social group or society as a whole. The Croatian privatization model, which has been almost exclusively reduced to the redistribution of existing common social property and its concentration in the hands of a clientelistic elite, has never been accepted either by the working population or by the general public. Dissatisfaction has been projected far beyond the usual aberrations and any particular unlawful privatization case. Indeed, discontent has embraced the privatization model itself. The public has considered the imposition of the privatization model as deeply iniquitous. It has enabled capital (ownership) which was, in fact, the past (invested) labor of present and former generations, to be passed into the hands of a self-elected elite by the noneconomic criteria of political affiliation.

The economic inefficiency of the model was reflected in the substitution of desired modern venture capitalism by obsolete rent-seeking capitalism, which was characteristic of early capitalism in its transition from feudal to an industrial environment two centuries ago. The main feature of the model was not efficiency and development. It strictly focused on squeezing liquid capital from enterprises by blown up debts, falsified stocks and forged credits. Especially popular was assets tunneling into tax oases outside the country by 'soft' loans using already indebted or non-existent property as collateral.

Therefore, no solution could have been found solely by dealing with consequences evident in different scandals which were treated as a sporadic aberration of a more or less well-chosen model of privatization. The solution would have been the conversion of rent-seeking into modern management capitalism which, in modern societies, relies on the participation of mass small shareholders. That would have meant starting from the restitution of actual and former employees' ownership rights, including labor and management buyout. And that would mean continuing with broad management business education accompanied by the promotion of growth-oriented business strategies.

Croatia's continuing stabilization policy officially introduced at the beginning of 1994. Stabilization policy chief architects at the IMF and WB have state often enough

that such a policy could appropriate a significant disinflation effect in limited/short period of time, but it had a suboptimal effect in the long run. Namely, hard budget constraints policy in the fiscal sphere on the one hand and high interest rates on the other drained the liquid assets out of firms. That left them without working capital and dragged them into a closed debtor/creditor circle of interest/principal interaction that in several iterations transformed a company's fixed assets into bank property. The ensuing consequences of this situation were lowered budget revenues because firms limited by a diminishing cash flow could not take a tax burden, and that indirectly influenced the increase of the country's external indebtedness.

In the monetary sphere, the prolongation of money issuing constraints was the main instrument of price stability. It has been narrowed to various methods of money supply sterilization and the manipulation of money surrogates (such as bonds and depository notes) between the central and commercial banks. This has resulted in a stabilization paradox of high stability in an environment of high illiquidity ending in increased external indebtedness.

When analyzing the opportunity costs of the transition period, it is important to point out the effect of the impact of employment and GDP trends on quality factors of economic activities. This is important most of all for labor productivity, which significantly calibrates market performances and the international competitiveness of a national economy.

It has been already mentioned that during the first half of the 1990s, there was a significantly faster decrease of GDP per employee than a decrease in GDP volume. This meant that the decrease of GDP volume during the war was accompanied by a slower decrease of unemployment, which influenced moderate trends and a higher decrease in labor productivity. In the second part of the 1990s, indicators reflected the gradual accommodation of the Croatian economy to the standard market environment, so the behavior of labor productivity was mainly accompanied by GDP growth rates.

The contradictory behavior of key macro variables in this period has allowed different professional interpretations of economic events. According to studies that observe macroeconomic stability and inflation expectations, we are considering one of the most successful transition economies with low inflation and high growth rates, thanks to the successful combination of monetary and fiscal policies (Škreb, 1999:1). The stabilization project was proclaimed a spectacular success, because in the first year of its implementation the retail price index as a measure of inflation was reduced from the monthly rate of 40% to a 1% annual inflation rate (Anušić, et. al. 1995).

On the other hand, we can find studies that stress development, employment and overall progress that should result in an increase in the population's living standard. It has been pointed out that due to bad macroeconomic management, Croatia has borne transition costs that are too high and too time extensive. This can be confirmed in an

output decrease and increasing unemployment and external debt (Vojnić, 1999: 207). In this context, stabilization program results have been interpreted differently. Criticism starts with the observation that a combination of hard budget constraints and highly conservative money policies together with an increasing tax burden and appreciated kuna exchange rate have led to a business activity slowdown and financial instability. The main contribution to this behavior has been the underdeveloped and bureaucratic monetary mechanism managed by the Croatian National Bank with the addition of an invalid public debt policy and incomplete security market (Perišin, 1999: 270).

The outstanding problem of money and credit policy has been its extremely non-market character. Real life credit and money issuing have been in direct opposition to the features theoretically ascribed to it by its creators. Instead of a market objective and neutral money policy that would restrain the parafiscal role of the monetary authority, highly selective money and credit policy has occurred. The government budget's liquid assets and CNB and other state agency revenues were allowed to be arbitrarily deposited or withdrawn from certain banks and placed into others with privileged (low) interest rates favoring or disfavoring the market position of certain bank(s). The liquidity of the banks that have been shaken by their privileged clients has been sustained by low interest CNB recovery loans. At the same time, CNB has been executing bankruptcy proceedings against the banks that didn't have enough privileged clients.

Selective monetary policy is also evident in the 'soft' loan and credit exposure policies of commercial banks to particular clients. This soft loan policy has been reflected in the extension of preferential treatment to special clients who were allowed to obtain loans with incomplete or even missing collateral and other otherwise required documents. This practice, accompanied by favorable credit conditionality, was, in fact, a specific bank's assistance the 'tunneling' out of the liquid assets of privileged companies. The side effect was increased credit exposure of commercial banks towards special clients. This hurtful practice simply could not have been possible without the knowledge and tacit consent of central monetary authorities who perform regular periodical supervision as well as daily control of commercial banks' activity.

And last but not least, the derivative of a prolonged selective money policy has been the petrification of inefficient privatization model in two directions. The first direction is outflow. For externally or internally-induced reasons, the central monetary authority was directly responsible for the uncontrolled outflow of 'tunneled' capital from privatized companies to anonymous foreign non-resident accounts. In this manner, resident privatized companies driven to bankruptcy and 'liberated' from employees and commitments (employees thrown to the street and debts conveyed to the taxpayers) could have been sold off for 'one cent' to 'foreign'

strategic investors. The second direction is inflow. For externally or internally-induced reasons, the central monetary authority was responsible for the possibility that the capital 'tunneled' out of the country could reappear as FDI and invest/buy out for 'one cent' the very same companies that it previously ruined.

One of the major tasks of monetary authority is preventing speculative financial operations and/or investments that are a front for money laundering. These include big bank investments on behalf of 'anonymous' clients conducted by its obscure branches and funds in 'third' countries and/or offshore destinations. For unknown reasons, CNB has not fully exercised its legal authority in controlling and preventing such malpractice.

Based upon the analysis conducted so far, it is apparent that there must be a gradual change in economic policy. Indeed, this is both requested and expected. Rational growth-oriented macroeconomic management that respects the need for stable public finance should be oriented to the savings and investment increases that would result from decreasing the indirect tax burden, among other things. This means lowering the VAT rate with a simultaneous increase of the tax burden placed upon nonproductive capital.

In the monetary sphere, there are at least two assumptions presumed for the model of solving internal illiquidity and the acceptability of external over-indebtedness. One is leaving the arbitrary and selective preferential treatment of some business entities. The other is a determinedly executed repatriation policy towards the illegal outflow of national assets. In such a combination, the active exchange rate policy supporting export orientation would probably result in a more favorable outcome.

However, fully respecting different, even opposing evaluations and analyses of Croatian economic events, facts introduced during the course of this analysis support the conclusion that economic development in the 1990s, as the last decade of 20th century, were unsuccessful. With the addition of noticeable 1980s stagnation, more than 20 years could be summed up during which Croatia has continuously lost development pace with developed market economies. Furthermore, there have not been objective enough reasons for such a long period of insufficient growth performance. It should and could have been better.

Hopefully, 20th century development as a whole and certainly not partial experience would be instructive for the 21st century development strategy of the propulsive, open market, and aggressive export oriented Croatian economy.

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