*Stjepan Zdunić**

UDK 330.101.541 (497.5)
JEL Classification O 190, O 110
Izvorni znanstveni rad

CROATIAN STABILIZATION AND DEVELOPMENT POLICY IN THE 1990s

This study deals with the purpose and the different forms of programme arrangements with international financial institutions. It deals with the principles and the meaning of the so-called financial programmes providing an analysis of the results of their general application, and especially with the role of the IMF and the World Bank in establishing Croatian economic policy. The final outcome of the study is a review and an assessment of the current state and future prospects of the Croatian economy as the long-term development implications of the structural adjustment policy that has been stipulated by the national government in coordination with the IMF and the WB.

It is possible to outline a national development strategy based on the results of this analysis:

The strategy could be a stage approach to development : in the first stage higher monetary sovereignty is necessary , and an export stimulating exchange rate; by means of an exchange rate policy and developmentally acceptable interest rates, consumption would in the beginning be restricted and then redirected towards domestic products; in that way export competitiveness would be supported by relative prices rules in accordance with the global productivity of the economy ; a development programme of an exclusively microeconomic orientation stipulated by the World Bank doctrine is not complete, and in certain segments it is one-sided and premature for the development moment of the Croatian economy; the stage of stability when short-term and long-term capital is prone to inflow into the country will be a sign of beginning a mature stage of recovery and developmnet ; in that stage

* S. Zdunić, dr. sc., znanstveni savjetnik u Ekonomskom institutu, Zagreb. Ovaj je članak prethodno objavljen u časopisu "Ekonomija/Economics" god. 10, br. 4/2003. str. 887-938.

the market mechanism will regulate development-stimulating interest rate; this stage presumes a developed institutional infrastructure and developed mechanisms of the country's financial system.

The kuna appreciation policy i.e. the policy of stability on a misaligned level of the kuna in the state of underemployment equilibrium, contradicts the industrialization of the country and imply an excessive tertiarization of the economic structure, which endangers the future external equilibrium, but also the optimal economic and employment structure .

From these theories it can be concluded that the monetary policy, especially the exchange rate and fiscal policies, in its macroeconomic and microeconomic aspects, should be coordinated with the recovery and development policy and with the policy of stabilization and banking and foreign trade system liberalization.

Key words: stabilization policy; restructuring; balance-of-payments current account deficit; currency exchange rate; financial programme; net domestic assets of the Croatian National Bank and the banking system; appreciation; depreciation; competitiveness of the economy; economic recovery and growth.

- Note: This paper was written in 1997 as a part of the study "Globalization and the Liberalization of the Croatian Financial System and Economic Development" by the Institute of Economics Zagreb, and has not until now been formally published. Since this paper gives quite a precise outline of the roots of our current development and debt uncertainty, it could be useful in understanding the principles of Croatian macroeconomic policy and its consequences. The text as a whole is entirely current so that the readers might only at certain points notice that this is an analysis of six years ago. It illustrates, in its own way, the Croatian low "time propulsion" of understanding its own economic and social processes.

Introduction. The Croatian development strategy has still not been specified in any formal document adopted by the Parliament. The elements of this strategy, however, are quite clearly shown in the arrangements of the Croatian Government and the Croatian National Bank with the International Monetary Fund and the World Bank. The Parliament deals with this strategy in cases of debating and adopting "systemic laws" and the budget that approve or regulate loan arrangements of the government and the world financial institutions, providing collaterals to external loans for financing infrastructure programmes as well as some specific companies in other sectors of the economy. Some important elements of the long-term development strategy are contained in the institutional restructuring legislation, such as the laws on privatization, banking, accountancy, foreign trade system, the Central Bank, the tax and pension insurance systems, the labour and capital markets.

So the arrangements with the International Monetary Fund and the World Bank are the subject of parliamentary discussions only in the process of accepting external loans which need to pass through the parliament. The Government and the Croatian National Bank are obliged to ask for approval from the Parliament for any international loan arrangement. The IMF prefers this method of dealing with their arrangements. However, the IMF and the World Bank do not take explicit responsibility for the efficiency and the success of the realization of the aims determined by such arrangements. The risk of success is on the client country, while the Bretton-Woods institutions play a "catalyst" role in the reform and stabilization processes, without a special quantitatively determined development goal, which is the usual starting point of national development strategies. Under these circumstances, which are determined by the lack of a development strategy formulated by the Parliament and where institutional (and legal) restructuring is a long-term process, the research on development issues and economic recovery should start by studying the role of the world financial institutions, the IMF and the World Bank, in creating Croatian economic policy. Such an approach enables a concrete insight into and understanding of Croatian development policy but also helps in forming an opinion about it.

So this study deals with the purpose and the different forms of programme arrangements with international financial institutions. It deals with the principles and the meaning of the so-called financial programmes providing an analysis of the results of their general application, and especially with the role of the IMF and the World Bank in establishing Croatian economic policy. The final outcome of the study is a review and an assessment of the current state and future prospects of the Croatian economy as the long-term development implications of the structural adjustment policy that has been stipulated by the national government in coordination with the IMF and the WB.

The Purpose And Forms Of The International Monetary Fund Programme Arrangements With Countries Experiencing Stabilization And Development Difficulties

According to Guitian[1], during the last several decades the general aim of the International Monetary Fund programme has been to establish a sustainable equilibrium of the balance of international payments of countries with external liquidity problems. Hereby the notion of the balance-of-payments sustainability for many developing countries means "a balance-of-payments current account deficit that

[1] See: / 1, p. 18 / .

can be financed, on a sustainable basis, by net capital inflow which is compatible with the growth and development perspectives of the country “.

In 1988 an operational directive was specified, and it defines the limit of the balance-of-payments current account deficit. This is the level that can be financed by capital inflow “which in the future will not put into question the external debt servicing of the country”. This is the purpose of stimulating the creation of foreign exchange reserves with the aim of protection against unfavourable events, in order to secure the ability to repay the loan granted to the country by the Fund.[2]

Eventually the programmes expand in the direction of achieving sustainable balance-of-payments equilibrium in the conditions of an open and liberalised foreign trade and payment system. Economic growth, too, gradually becomes an element of an “objective function” and criteria supported by the arrangements. The member countries of the Group of Twenty-Four suggest to the IMF an elaboration of development scenarios of a country before accepting and determining the financial programme. Development scenarios should be the basis for determining external sources necessary for financing the growth. A financial programme should precisely determine the necessary funds of supplementary external financing.[3] Including growth criteria into programme goals expands the so-called “conditionality” criteria of the programme, from the common policy of domestic demand restrictions in order to achieve a short-term equilibrium of the balance of payments, to the supply side policy which deregulates the repressive economic and especially the financial system. The conditionality has insisted on “open economic policy” aiming to increase international competition in order to improve the efficiency of economic growth. This is the reason for establishing longer (three-year period) arrangements, alongside the earlier year-and-a-half periods. The main goal of medium-term financial and development programmes is to achieve long-term balance-of-payments sustainability.[4]

The expansion of the programme’s aims includes different kinds and subjects of arrangements:

- Stand by arrangements cover a period from one to two years, and are based upon a conditioned macroeconomic policy, such as fiscal, monetary and currency exchange rate policy, the aim always being to overcome current deficits and other difficulties in the balance of payments.[5] The instruments of such policies are the “performance criteria” given by the financial programme. Performance criteria are usually in the form of restrictions of

---

[2] See: / 1, p. 21 / .

[3] According to / 1, p. 149 - 150 / .

[4] See: / 2, p. 1-3 / .

[5] See: / 2, p. 1-3 / .

credit increases of the banking system as a whole, restrictions of budgetary expenditures, demands for increasing foreign exchange reserves and limiting the increase of the public debt (external and internal). Applying these instruments is a condition for using the IMF loans, in installments during the arrangement; the loan repayment usually has a grace period, and is repaid in three to five years;

- Extended Fund Facility (EFF) provides the financial support of the Fund for a period of three to four years with the aim of overcoming balance of payments deficits caused by the macroeconomic and structural problems of the country. Such arrangements distinctly require the implementation of specific structural adjustment policies, such as liberalization of the financial and foreign trade system. The financial means (loans) are conditioned by the application of the "performance criteria", similar to a stand-by arrangement. The withdrawal of the loan goes on in stages, after a favourable report on fulfillment of the "performance criteria".

Extended financial arrangements, according to the required supply side policy, are very close to the conditionality requirements for structural adjustment loans of the World Bank. Such arrangements are often, especially in the last several years, linked arrangements of both institutions, and are even mutually conditioned.

Loans of both institutions, in fact, do not represent a particularly abundant financial support so such arrangements are often justified by their "catalyst" function. If they are successful they represent a guarantee for private capital that the country is conducting an appropriate stabilization policy and that the macroeconomic environment is favourable for the entry of foreign financial capital and for foreign direct investments. This basically means that the financial credibility of a country, considering the ability to repay both public and private loans, is granted by the sustainable current and capital balance of payments.

Financial Programme, Its Results And Neoliberalism

(1) In its simple form, a financial programme is based on a "monetary approach" to the country's balance of payments policy.[6] A financial programme model, by means of a simple equation, links the following: monetary aggregates in a broad sense (M3 i.e. M4 when considering the banking system as a whole) equals net ex-

[6] This is J.J. Polak's model, upon which the IMF methodology of financial programmes is based. See: / 4 / and / 5 / . In the latest arrangement in Croatia the performance criteria were the net assets of the central bank but the surrender of foreign exchange was not compulsory!

ternal assets of the banking system plus net domestic assets of the banking system. Net external assets of the banking system can be reduced to net external assets of the central bank in the conditions of a compulsory surrender (cession) of commercial banks' foreign exchange funds. The interrelation of the mentioned aggregates is defined so that the increase of money demand "in a broad sense", that is equal to the increase of supply of money, is equal to the sum of the net domestic assets increase (loans given by the banking system) and the net external assets increase of the banking system. This model can be shown in various forms, according to the purpose of the analysis and the statistical possibilities.

The efficiency of the limits set in terms of increase of the mentioned aggregates depends considerably on the current condition in absolute values, especially as far as the real money demand, as a function of national income, is concerned.

In the Keynesian sense, this model can show in an appropriate way the surplus of domestic absorption over income, which becomes a balance-of-payments deficit, and which is closely connected with the domestic credit expansion surplus. In the IMF's interpretation, the domestic credit expansion surplus (and basically the deficit financing of public consumption) is pointed out as the basic cause of a country's balance of payments destabilization. In this context the importance of currency exchange rate for the sustainable equilibrium of the balance of payments stands out.[7]

In order to achieve the equilibrium of the balance-of-payments current account and price stability, it is of vital importance to abide by the following performance criteria, i.e. nominal anchors[8] given in the following form:

- in the function of disinflation a fixed nominal currency exchange rate is appropriate; equally, "there is no better alternative" in order to change relative prices to promote the competitiveness of the export sectors of the economy than adjusting the exchange rate of the currency[9]; the development structural effect of the real currency exchange rate is important; in the case that the currency exchange rate is the anchor of the programme, wage and price control are in the beginning often taken as supplementary anchors;
- usually, the central part of the programme is demand limitation by reducing (relatively and absolutely) public consumption i.e. the budget deficit; this is achieved especially by limiting state and broader public consumption using credit restrictions in the banking system, and the central bank in particular;

---

[7] See: / 1, p. 130 / .

[8] A nominal anchor should be understood as a nominal variable which is controlled and set on a predefined level in order to stabilize prices; basically the money supply, the wage rate or the currency exchange rate can serve as an anchor; see: / 3, p. 67 / .

[9] See: / 1, p. 138 / .

the relationship between the restriction of deficit financing as performance criteria and credit expansion ceiling is very close;

- the role of exogenously determined credit expansion as a nominal anchor is connected with the required increase of foreign exchange reserves of the central bank; this requirement is given in the form of the lower limit of the periodic cumulative growth of foreign exchange reserves;
- generating cumulative periodic foreign exchange reserves by increasing the net foreign exchange assets of the central bank, as the performance criteria, supports external liquidity and the credibility of a country, and grants the ability to repay external loans; this is considered to be the basic aim of a financial programme, whose basic instrument is limiting the growth of domestic loans above the growth of the money supply in a broader sense.[10] Accordingly, if the target variable is the increase of external net assets (foreign exchange reserves), with the given expected increase of the national income as a variable which defines the money demand in a broader sense (the income variable is in fact given exogenously by projection),[11] then the instrumental variable, defined by the central bank, is the increase of the domestic net assets of the banking system. In other words, exogenously defining the upper limit of the domestic loans growth (for public consumption and certain sectors of the economy) affects the realization of the given cumulative growth of the foreign exchange reserves, as a policy of sustaining the country's external liquidity and credibility. This is, in essence, a limitation of the aggregate consumption growth i.e. of the domestic absorption above, and possibly below, the gross domestic product in order to realize balance-of-payments equilibrium; the first consequence should be a reduction of the current deficit to the point of its possibility of stable financing from external capital (savings) inflow, and the second consequence could be the creation of a surplus in the balance-of-payments current account so that external debts could be serviced.

Experience with the implementation of the described financial programme in the conditions of high capital mobility proves that an absolute limitation of the net domestic assets does not suffice to stop the monetary aggregate growth in a broader sense (M4). Usually, monetary growth exceeds the set restrictions. In conditions when the currency exchange rate is given as a nominal anchor, the restrictions set

---

[10] This is the expression D R = D M - D D, where DR represents the increase of the external net assets of the central bank (or the banking system), D M represents the increase of the monetary aggregate (in a broader sense) and D D stands for the domestic net assets increase.

[11] Money demand can be expressed as D Md = f (D Y, D P), where D Md stands for the increase of the money demand in the broad sense, D Y represents the increase of the national income, and D P price growth.

for the net domestic assets and monetary growth (in a broader definition of the term) are usually implemented. It is much harder to implement the set limitations if the exchange rate is not an anchor.[12]

When the currency exchange rate is a nominal anchor, a credit restriction breach can occur if the net external assets increase, thus causing monetary growth in a broad sense (M4). However, in such conditions a breach is much less likely to occur and it is easier to achieve anti-inflationary aims. [13] In such circumstances a real appreciation of the national currency occurs, which can only partially be compensated by the growth of the global productivity of the national economy. Current experience, although not sufficient, shows that those countries using the exchange rate as a nominal anchor suffer a decrease in the competitiveness of their economies to a greater extent than the countries that have not specified the exchange rate as a nominal anchor. This is evident from the increase of imports compared to the period before the implementation of a financial anti-inflationary programme. In the other group of countries, which do not have the exchange rate as a nominal anchor, the relative increase of imports was not noted. A conclusion can be drawn that, when specifying a programme, the "trade off" should be considered between possible inflation (price stability) and a decrease in competitiveness on the foreign market.

(2) The results of the implementation and the experience of the IMF financial programmes in arrangements with certain countries are controversial:

- it is pointed out that the financial programme is of a deflationary character and that it "produces" poverty; the recession consequences of applying the programme are brought in connection with insufficient funds provided by the programme; the strict insistence on the net external assets and other norms of execution has recessionary consequences;[14] a need arose for integrating the financial programme into an appropriate growth model with the explicit aim of the GDP growth, with the conditionality of a balance-of-payments equilibrium;
- The group of countries which were the most successful in the structural adjustment and growth policy in Eastern Asia did not abide very strictly by the "orthodoxy" of the International Monetary Fund; according to their experience, a bigger role of domestic experts and the domestic political structure is a guarantee for a better national development priorities setting,

[12] See: / 3, p. 79 - 80 / .

[13] This is evident from the following relation: D Md = D D + D R; if D D is given then D Md will grow "on the basis " of a bigger DR; monetary policy uses its instruments to bring "harmony" into the relations by protecting the currency exchange rate set in advance.

[14] See: / 1, p. 147 - 152 / .

better adjustment of the corresponding policies to the needs of growth; the experience shows that the IMF has so far not shown enough inclination to "local programmes" i.e. to the elaboration of programmes with the corresponding involvement of local experts;

- it is pointed out that structural adjustment with the condition of growth should be the direction of the arrangement with the IMF; the strict application of the financial programme i.e. the strict conditionality of the credit support, however, is justified by the so called "catalyst effect" of the stabilization programme implementation; the results of this kind of catalysis, however, are not satisfactory [15]

(3) Although the dominant aim of the IMF stand-by and the extended financial programme is to secure the sustainability of the balance-of-payments equilibrium, and then the sustainability of the financial and price stability within the country, eventually the IMF experts' analyses increasingly asses the effects of the arrangements on the national economies' growth rate as well as the growth of national savings and investment rates.

In the light of this, the results of the Monetary Fund's stand-by arrangements with the transition countries of Middle Europe are considered unsuccessful according to the criteria of GDP growth rates, investment and savings until 1992/1993. The arrangements with these countries are also conditioned by the transition reforms enforcement. The results of the arrangements as a whole showed that the recovery and growth process are not observed until the third year of implementation.[16] The reasons for such results in the first stage of the transition countries' reform are considered to be (a) the structural impact of outdated technology, (b) the disintegration of the eastern socialist market and (c) the deterioration of the terms of trade.

The effects of aggregate demand restrictions are under these circumstances quite controversial. So, for example, in Poland the ceiling on the credit growth in real terms and a strict limitation of the fiscal deficit defined by the programme have, besides the deterioration of the terms of trade, caused a decline in production.[17] In the period from 1990 to 1993 no European transition country, except Czechoslovakia, managed to follow the program through or to carry it out with no interruptions. So a thesis can be formulated that the "big bang" reform model has only enhanced the cumulative decline in production in these countries. This means that had, for example, a gradualist reform model been applied, a decline in production would not have occurred to such an extent. The decrease of investments is especially drastic. In spite of that, such a drastic decline in production cannot be ascribed to

---

[15] The stated remarks according to / 1, p. 170 - 180 /.

[16] See: / 2, p. 43 and 44 / .

[17] According to / 2, p. 43 / .

a decrease of investments, because of the abundance of idle capacities. Basically, there has been a contradiction: the stagnation and the decrease of the investment share in GDP signifies an unattractive environment for investments, especially for foreign investments; on the other hand, the possibility of financing excessive imports i.e. creating a sustainable balance-of-payments current account deficit as well as generating foreign exchange reserves due to stabilization measures should be considered as a confidence providing factor. This should be a sign for investors that the stable financial policy and deep structural changes can be trusted. [18] However, confidence of this kind is low in this period.

(4) The assessment of the success of the developing countries' arrangements with the IMF is quite uncertain considering the savings rate: there has been a general increase of the savings rate by approximately one percentage point, but in a way that the public sector savings increased by 2.5 percentage points, with a decrease of the private rate by 1.5 percentage point. These results are considered to be weak. It should be concluded that the arrangements in most countries (from the analysis sample) are unsuccessful regarding the increase of the savings rate as a precondition of economic prosperity and growth.

Therefore it can be concluded that the real interest rate policy, the real currency exchange rate policy, defining the credit policy and the financial system reform have not, in the observed period and for the analyzed group of countries, had a systematically favourable effect on the formation of national savings. On the contrary, the effect on savings has remained weak and unpredictable.[19]

(5) The financial programme is founded upon a basic assumption: that the control of domestic credit expansion solves the problem of the balance-of-payments current account deficit, but also achieves the reduction of inflation as one of the targets. If at the beginning there is a surplus of available production potentials, then the increase of domestic credits, DD, would result in an output increase. Price increases would be the main consequence of the increase of credits in the circumstances of the full utilization of the country's production capacities, i.e. full employment of the labour force. The interpretation of the monetary approach policy to the balance of payments equilibrium is classical: an increase of nominal income leads to increased imports, and then to the exhaustion of foreign exchange reserves, which causes a decrease in the money supply. A decrease in the money supply causes a fall of prices and the consequence is better competitiveness of export sectors of the economy. So, the process circulates from the beginning to the end level and vice versa.[20] It is a problem to endure the whole adjustment cycle when foreign exchange reserves

[18] According to / 2, p. 44 / .

[19] Conclusion from / 2, p. 46 / .

[20] See: / 10, p. 69 / .

are insufficient. This is why there is a need for government intervention using the financial programme instruments, primarily credit expansion control in order to restrain the aggregate demand. In developing countries, as well as in transition countries, when there are no abundant consumer credits granted by the banking system for mass consumption, and in conditions of an undeveloped financial market and a lack of corresponding instruments, credit restrictions dominantly affect manufacturing companies. This is because additional credit restrictions primarily affect the financing of the working capital of the economy. In the first iteration, this limits the supply level, even more than the level of aggregate demand, so the supply and demand gap increases further. [21] Investment financing can also be considerably limited by this mechanism, especially because of the interest rate growth, so that economic growth is also put into question. Therefore, the most important objection to the monetary approach is that it basically does not resolve the problem of growth i.e. production recovery, both on the basis of aggregate demand and on the basis of supply. Recession implications are therefore inevitable.

As a consequence of the so-called neoliberal doctrine domination in international financial relations from the beginning of the 1980s, with the assumption that the main reason of the developing countries' debt crisis, i.e. balance of payments crisis, is the uncompetitiveness of their national economies, a new stage of implementing the financial programme criteria begins. The new stage is characterized by including a microeconomic approach to the conditionalities of the arrangement with the Fund. This means that restructuring and institutional reform policies become the components of the balance-of-payments long-term equilibrium strategy, by which the typical short-term characteristics of the earlier financial programmes and their dominantly macroeconomic character are overcome. In the balance of payments domain this causes the domination of the balance-of-payments current and capital account liberalization doctrine with far-reaching development and structural implications. The equilibrium and stability of the balance of payments should be based upon the freedom of circulation of short-term and long-term capital on the basis of exchange rate stability and differences in real interest rates. In order to achieve this, the instruments of capital flow control should be abandoned. This is what actually determines the new stage of the world economy globalization, which is primarily based on financial market mechanisms, as well as on some other well-known GATT and WTO mechanisms. The basic precondition for establishing those global systems is macroeconomic adjustment i.e. creating macroeconomic stability, specified by the arrangements with the Bretton-Woods institutions. The debt crisis has considerably increased the requirements for macroeconomic equilibrium so there were demands that the debtor countries' balance-of-payments deficits, amounting

[21] See: / 10, p. 71 / .

to a couple of percentage points of GDP, should be transformed into a surplus in a very short period of time.[22]

Such requirements and the need for a turn have been justified by the supposedly wrong development policy of export substitution of the developing and former socialist countries. This was the main "development argument" of the neoliberal doctrine. It was especially supported by countries with strong transnational companies, which are at the same time the main stockholders of the International Monetary Fund and the World Bank.[23]

Therefore, the role of the IMF financial programme with the performance criteria has been significantly extended. Its aim becomes a complete institutional reform of the economic system as well as of macroeconomic and balance-of-payments equilibrium policy. Stand-by and extended arrangements become strictly conditioned by accepting wide economic system reforms, what means that they are medium and long-term by character and postulated financial obligations. As it has so far been explained, the IMF makes the arrangements with the prevailing policy aim of achieving macroeconomic and balance-of-payments equilibrium, while the role of the World Bank is mostly determined by the neoliberal doctrine, and the policies are medium and long-term by their character. The basic policies and their objectives and targets in the arrangements with the World Bank are the following:[24]

- first, the aim of structural "adjustment" is an increase of GDP growth rate; the main method of achieving this is improving the allocative efficiency of the pricing mechanism; price distortions should be eliminated, which contributes to economic growth in real terms; real wages, as the labour cost factor, should be reduced, which contributes to a greater demand for labour and therefore to increased production;
- second, the liberalization of the foreign trade system should mean replacing the import quotas by a tariff system adjusted to the WTO demands; the aim is to adjust internal relative prices to world prices; liberalization of the capital account follows, but usually after the stage of foreign trade liberalization, and capital account liberalization means abolishing foreign exchange transactions' control, especially those connected with profit and the return of invested foreign capital; in connection with this there can be problems of speculative capital and its impact on the stability of the balance of payments, the exchange rate and prices;

---

[22]See: / 9 , p. 146 / .

[23]See: / 9 / .

[24]Review according to / 9, from p. 149 on / .

- third, the deregulation of the internal financial system, with the aim of achieving real interest rates and equalizing the return on various financial assets; the growth of real interest rates should stimulate savings and entice the efficiency of resource allocation; deregulation, on the other hand, supposes an efficient control and auditing of the financial activities in order to secure the stability and credibility of the financial system and market; some problems arise in the area of equity capital related to financial market stability, especially during the privatization of large companies in the infrastructure sector; a great amount of portfolio investments from the developed countries can, through an induced appreciation, have an unfavourable effect on the current foreign trade balance;
- fourth, a labour market deregulation policy as well as tax system rationalization are required;
- fifth, the World Bank particularly insists upon the privatization of public companies; a strong stimulus for this policy came from Great Britain's experience at the end of the 1980s, implemented by the Conservative government.

The policy of liberalization and privatization has also had a social and political motive: this policy was expected to restrain the business circles' inclination towards corruption and reduce so-called rent seeking behaviour. The experience in this matter is, however, disappointing.

(6) In summary, it can be concluded that the results of the combined policies of stabilization, liberalization and privatization, on which the Bretton-Woods institutions insist, are often doubtful (and negative), which can be explained by the following: stabilization, as has already been pointed out, often causes a decrease of production or of the GDP growth rate for too long a period; the optimal structure of relative prices is not achieved: real interest rates are too high in cases of the exchange rate being used as an anchor; as a consequence of the foreign trade and the financial system liberalization, the appreciation of the national currency is exaggerated, the purchasing power of wages is reduced, while at the same time they increase as an expense for exporters.[25] Financial instability often appears on the stock and securities market, which is created through the privatization process of public companies, or state and socially owned companies in transition countries. Such instability is especially likely in the circumstances of an intense movement of capital into the country or away from the country, which is enabled by the liberalized balance-of-payments capital account.[26]

[25]For Croatian circumstances see / 15 / .

[26]See / 9, p. 150 / .

The political implications of the above mentioned possible economic developments are manifold, so the reform processes, conditioned by the IMF and the World Bank when making stand-by and other structural adjustment arrangements, should be carefully considered. A number of measures for improving or revising the functions of the Bretton-Woods institutions are suggested by many experts, scientists and in the general literature: those measures are concerned with national development priorities and their adequate inclusion into structural adjustment arrangements. In the following chapters of this study, the Croatian stabilization and structural adjustment arrangements with the Bretton-Woods institutions are analyzed from this point of view.

The International Monetary Fund and The World Bank in Croatian Economic Policy

(1) The basic instrument of the so-called monetary approach, as has already been described, is a "financial programme" which (using a simple equation) links the domestic credit expansion (domestic net assets) of the banking system with the monetary aggregates, i.e. liquid money in a broad sense (M4) with the net external assets of the banking system as a whole or base money with the net external assets of the Central Bank. In order to realize the ceilings of the domestic net assets growth, administrative instruments should be applied. If the financial market of the country is underdeveloped, more restrictive measures are necessary. The more developed the market, the more indirect are the monetary policy instruments. In any case the administrative mechanism produces certain indicators, with a real and nominal significance, such as the currency exchange rate, the interest rate, prices, and wages. This determines the level of investments, exports and imports, and then the appropriate gross domestic product.

In 1994, under the first stand-by arrangement, Croatia accepted to implement a similar set of measures. The basic purpose of accepting the arrangement was maintaining price and balance-of-payments stability. This had already been achieved by the government's price and fiscal policies. The aim of making the arrangement was to get the confidence necessary for Croatian foreign debt rescheduling through the Paris and London Club. The new "extended arrangement" in 1997 expanded the earlier stand-by in two aspects:

- first, according to the term it is almost medium-term (three years);
- second, it very explicitly includes institutional restructuring in terms of liberalization and privatization

As far as the performance criteria are concerned, the difference between the first and the second arrangement is in abandoning credit restrictions for the banking system as a whole but keeping the restrictions for the central bank (and its net domestic assets). The restrictions remain for special groups of companies and the public sector. It was possible to abandon the growth criteria of the net domestic assets of the banking system as a whole because their aim had already been achieved: the growth of foreign exchange reserves, although of not very clear origin, had been achieved, as well as a slight rise in prices, the stability of the national currency exchange rate and the budget deficit criteria were not overrun. The growth rate of GDP and of unemployment i.e. underemployment was included neither in the aims of the package, nor in the performance criteria. Thus, according to the definition, an external balance could be achieved, but also an internal balance according to the commodity price stability criteria.

The internal balance criteria in the form of full employment of the production capacities of the country and of the labour force was simply left out, i.e. it has been postponed as an aim for a future time. This means that the discount rate of the future social wellbeing equals zero. In other words, the urgency of this aim as a social and political priority was ignored. This is standard practice with these kinds of arrangements. The World Bank creation of policies for achieving this aim is considered to be a long-term goal. As has been shown before, the primary aim of the IMF's policy is always achieving a balance-of-payments equilibrium, but in a short period of time, regardless of the short-term losses in terms of social wellbeing. There is a very strict conditionality for getting credit support and national governments should accept this aim. Conditionality is expressed by "performance criteria", as has been demonstrated, usually in terms of the rate of growth of domestic net assets of the banking system, i.e. in terms of the so-called nominal anchors. The performance criteria have on occasions successfully provided the wanted result, but often that was not the case. Regarding the performance, Croatia has been exemplary. It could even be said that Croatia was the most successful among the transition countries. The social cost, however, was among the highest if it is expressed in total unemployment rate and losses in GDP. An important reason for this are the appreciated exchange rate caused by the programme, as well as high interest rates, a credit shortage, and too low domestic and export demand in the circumstances of unutilized production capacities of the country.

(2) Regarding the currency exchange rate policy, the following fact is important:

- in the beginning of the IMF practice the currency exchange rate policy, national currency depreciation, was a conditionality item, and in a later stage it was expected before making the arrangement; later the exchange rate became an anchor in the anti-inflationary policy.

The Ex-Yugoslav arrangement also included a fixed exchange rate as the nominal anchor. That could not be realized by the implemented instruments, due to political relations in the country and the character of the economic system. Croatia, on the other hand, has been very successful in applying the required instruments and maintaining a stable nominal exchange rate against DEM. The currency exchange rate as a nominal anchor is actually included in the Croatian stand-by and extended arrangement, and its aim is achieving price stability. Over the short and medium-term, however, it does not include increasing the competitiveness of the economy on the world market, in order to support exports with the aim to overcome the balance-of-payments current account deficit and employment recovery. A policy of preventing further appreciation is mentioned in the arrangement, though. In other words, the current level of the exchange rate is considered to be adequate i.e. in long-term real equilibrium rate, so the criteria of adequate monetary and fiscal instruments of the economic policy, that keep a stabilized current nominal exchange rate against the DEM, are fulfilled.

It is estimated that a stabilization policy of this kind implies a GDP growth rate of 5% at most, with no guarantee that it will be long-term, so that policy can be considered consistent with such a growth rate. It, however, implies completely reduced or ignored priorities of the Croatian society regarding the once achieved level of employment.

An important question arises, whether such a development strategy is the only possible strategy. Furthermore, whether it is a consequence of the cooperation with the IMF and the World Bank, implied by their current policy packages orientated towards neoliberal economic systems. In the first three decades after Bretton Woods, financial programmes were basically not in conflict with the Keynesian doctrine according to which the national priorities of a country were attempted to be achieved, expressed in full employment, at least over the medium-term.

Croatian arrangements with the Bretton-Woods institutions obviously do not take into account the recession and post-war economic circumstances. The consequences of these arrangements are such as if we were dealing with full employment circumstances, so the aim of the programme could only be price and balance-of-payments stability, with moderate long-term growth.[27] The problem is that the recession of the economy was not taken into consideration.

(3) The first stand-by arrangement of the Government of the Republic of Croatia and the IMF is of a standard type and very similar to the arrangements with other transition countries, which, besides the short-term aim of achieving a macroeconomic and balance-of-payments equilibrium, has the aim, and in certain elements the performance criteria, of institutional restructuring i.e. the reform of the

---

[27] See in / 15 / .

whole socialist economic system. In a narrow sense, the programme (arrangement) is conditioned by fulfilling the usual criteria in the form of the set limits:

- an upper limit of the cumulative changes of the net credit of the banking system for the country as a whole;
- an upper limit of the cumulative deficit of the country as a whole;
- an upper limit of cumulative changes of the net domestic assets of the banking system;
- lower limits of cumulative changes of the net foreign reserves of the banking system;
- additional quantitative restrictions for some sectors of the economy.

There are additional limitations in the changes of the average wages i.e. of the "wage-and-salary fund" as a whole, limitations of foreign debt or providing government collaterals for such debt, if required.

It is evident from the performance criteria review that the first Croatian arrangement was made according to a general "formula".[28] In the first arrangements of Poland, other transition countries, and Croatia as well, the basic aim is achieving a macroeconomic and balance-of-payments equilibrium, as it is customary, while reforms are assumed. In the beginning reforms are partially required. Extended arrangements, on the other hand, are very explicit concerning the conditioning of the reforms i.e. institutional restructuring. In the case of Croatia, this conditionality is mostly expressed in the following:[29]

- in the fiscal system and policy, besides the usual conditions, it is not allowed to finance the consolidated budget deficit from banking sources, except for overcoming seasonal liquidity; an increase of the domestic public debt is not allowed; obligations of the tax system reform are introduced, such as value added tax, expansion of the tax base, tax discipline is strictly asked for;
- subsidy reduction is required over the medium-term period, especially for the Croatian Railways; agriculture subsidies are transformed from an indirect system into a direct system; budgetary expenditure restructuring is directed towards the stimulation of growth;[30] a 4-5% share of public investments in GDP is considered desirable; the budget deficit is financed only through external loans in the form of a government bond issue; in con-

---

[28]An overview according to / 11 / ; / 12 / .

[29]See the Croatian extended arrangement from the early 1997 in / 13 / . An overview from the point of view of the main points of our analysis is given here.

[30]Consult the World Bank's materials on this topic / 14 / , but for 1995 in / 16 / and in / 17 / .

nection with the budgetary expenditure restructuring, stabilization efforts and structural adjustment in general, social welfare expenditures increased for an additional 1.4% of the GDP;

- pension insurance reform, in the form of the so-called three pillars, should support the national rate of savings and consequently long-term economic growth; the healthcare system should also be adjusted to narrower financing possibilities; followed by a number of administrative improvements in budget and public debt administration, and for that purpose the market of treasury bonds and earlier public debt securities (the so-called old foreign exchange savings, "big bonds" and their refinancing) will be improved and reorganized upon new bases; a secondary equity market should be developed;
- in the area of the monetary system, reforms and stricter auditing and control of financial institutions and equity markets are supported; privatization is supported as well; restructuring and recapitalization of many banks through privatization is assumed; it will be attempted to reduce the implementation of statutory reserve instruments in order to enable the better development of the financial market; the process of creating investment funds and securities market will be completed institutionally; a Securities Commission, investment funds etc. will be founded; the company sector will be much more involved in the capital market (primary issue of stocks, a secondary stock and bond market);
- the privatization of the public companies is accelerating absolutely, and mass privatization is drawing to an end; privatization through "debt-equity swaps" is supported, as well as the use of Croatian Privatization Fund shares in the settling of renovation debts; the rest of the Croatian Privatization Fund portfolio should be privatized through sales to strategic investors, both foreign and domestic;
- in the area of the foreign trade system, the process of liberalization is intensely stimulated and the protection comes down to the standards that meet the World Trade Organization criteria; this adjustments should be completed by 1997;
- in the area of balance of payments, the liberalization of the balance-of-payments capital account transactions will be on the agenda, including the removal of external portfolio and direct investments restrictions for residents and non-residents, as well as the transfer of capital; a gradual liberalization process is predicted here;

Policies regarding the macroeconomic and balance-of-payments equilibrium assume standard measures and criteria, on the basis of an efficient market mechanism[31]:

[31] An overview of the main points according to / 13 / .

- using the national currency in all domestic transactions is stimulated, as well as the stabilization programme credibility;
- the exchange rate policy is the main support of the stabilization programme, along with maintaining the floating of the exchange rate against the DEM according to very narrow limits; a depreciation of the exchange rate will not be allowed, and its stability will be maintained by the necessary restrictions in the financial policies; the appreciation of the kuna on the basis of a greater foreign capital inflow will be neutralized, if necessary, by money sterilization although perhaps not entirely; other not strictly sterilization measures will be used, which insure that inflation stays within the bands; if necessary, the representatives of the Fund will be consulted;
- the current account balance of payments deficits are probably exaggerated due to statistical vaguenesses; the trade balance deficit should be resolved by far-reaching structural reforms; the restructuring of banks and companies, development (financial) support to the infrastructure and tourism should neutralize the current balance-of-payments deficit; considering the vague sources of the foreign exchange inflow (and the problems of statistical analyses) the foreign exchange rate and reserves, as well as the inflow based on foreign debt accumulation, represent a great support for the current balance of payments equilibrium[32]. For this purpose it is important to continue increasing foreign exchange reserves, a particular aim is increasing the confidence in the value of the kuna i.e. the stabilization programme and financial credibility on the world financial market;
- quantitatively, the balance-of-payments current account should be reduced to about 4% of GDP by the year 2000 (in 1996 it amounted 6.5%, and in 1995 to 10% of the GDP); this can be achieved through increased tourism revenues, through commodity exports growth of 8% annually, and through the increase of commodity imports at the growth rate of the GDP (in average, approximately 5% annually); financing imports by withdrawing deposits from abroad should gradually be abandoned;[33]
- external debt will be restricted at the limit of 30% of GDP; the servicing coefficient should not exceed 13% of the value of commodity and services export; the London and Paris Club have already accepted the policy of consolidating the external debt of the country;
- it is estimated that the foreign capital inflow is too high; possible initial signs of inflation will be carefully monitored, and because of that the corresponding instruments might have to be adjusted, such as sterilization to

[32]See / 13, p. 36 / .

[33]According to / 13, p. 36 / .

a certain point; hereby the effect of appreciation on the competitiveness of the country will be assessed and the instrument (mechanism) of movement of capital out of the country liberalization will be implemented, as well as the use of regulation and control measures of the financial operations of the banks, which might prevent the excessive capital entry;[34] in order to neutralize the risk of a two-way capital flow, increasing the foreign exchange reserves is supported;

- the wage policy (growth), especially in the public sector and state-owned companies, will be strictly controlled; the cost of labour per employee should not exceed the current level (mid 1997); the salaries of the groups under special regime will be strictly controlled based on the monthly reports to the Fund; the employment i.e. unemployment statistics will be improved; according to the ILO methodology the unemployment rate would amount to 10%, and not 15.5%, as it is usually announced; thus, it is estimated that unemployment is overrated; unemployment support will be restricted to the imperiled groups; public companies will not be allowed to borrow abroad, except if they have permission from the Ministry of Finance for the needs of restructuring within the approved strict plan; all of this will be the concern of the Office for Restructuring and Economics of State-Owned Companies; the Croatian Privatization Fund must respect the discipline in terms of holding on to the criteria of the net credits of the banking system.

The arrangement, as it is evident, has been very minutely elaborated, with very strict restrictions and obligations, which do not leave a lot of space for various interpretations. The question, however, is how adequately it is suited for our real possibilities, needs and priorities. Only a scrutinized analysis of the state of the economy can provide the right and founded answer.

The State Of The Croatian Economy And Structural Adjustment Policy

(1) The Croatian economy is still in the stage of a prolonged recession but gradually signs of recovery are appearing, measured by some macroeconomic variables.

Firstly, the Croatian economic recession was caused by well-known factors: the disintegration of the Eastern European socialist system and market (including

[34]This would be a free interpretation of the Memorandum and evaluation reports of the Fund's Commissions, and to a certain extent the Bank's analysts.

ex-Yugoslavia), and the war. These are both institutional and historical factors. The policy of getting out of such a recession is much more complex than the usual economic recovery policy of developed market economies. This is caused by insufficiency of institutions, mechanisms and instruments based on which the government could formulate and implement the strategy of production and growth recovery. Such insufficiency was present in developed capitalist countries during the 1929-1933 recession, also known as the Great Depression. The transition countries today are burdened by a much larger institutional insufficiency, but also, theoretically and politically, with the problem of a correct perception of their own social and economic condition. In Croatia, the war has also caused, due to defense expenses, low investment activity, and this is an important cause of the stagnation of our economy.

Secondly, the privatization policy, as it is being implemented here and in some other transition countries, should be considered as a cause of stagnation i.e. of too slow an economic recovery. Privatization policy has not taken into account the preservation and the rational utilization of the existing economic potentials and the introduction of modern management methods. It has been dominated by an explicit policy to change the ownership system, using inappropriate privatization methods. Economic agents have been acting in circumstances of high uncertainty, which has lead to the collapse of big companies and business systems, as well as to the absence of an appropriate development policy. The private sector of the economy was fragmented and has been stabilizing slowly.

However, it is evident that the arrangements with the Bretton-Woods institutions, of all transition countries, ascribe the recession mostly to institutional insufficiency, so, besides the macroeconomic and balance-of-payments equilibrium policy, they include a structural policy. An aggregate demand stimulating policy with the aim of economic recovery is not included in the arrangements. Only recently such policies began to be mentioned:[35] "Extended financial programme of the IMF (in Poland) for the period from 1991 to 1993 supposed a very optimistic growth rate of 15% annually for that level of investment. In 1990 it was considered that investments and net export would secure production recovery. It was, however, predicted that after a sharp decrease of production and real income, the recovery would be possible by stimulating consumption. The Polish programmes required a redistribution of expenditure from personal consumption to investments and net export, but the real growth took the opposite direction. This did not change until 1994 when a "classic recovery and growth model" began to be implemented. According to all of this, the economic recovery and growth then became a more explicit aim of monetary policy:

[35]See / 11, p. 332 / and / 10 / for foreign literature, and for Croatian literature see / 15 / .

- Polish GDP grows at a steady and high rate, 5.2% in 1994, 6.5% in 1995, and 5.5% in 1996, while industrial production grows at the rates of 12%, 9.7% and 8.6% for the respective years, and they do not decrease in 1997.

The question remains what the cause of the obvious turn in the production of the Polish economy was. Poland, besides, belongs to the group of countries experiencing many problems with the realization of stand-by and extended arrangements with the IMF. A realistic theory is that the cause of the turn might be the elements of demand stimulating policy. This is a possible interpretation of the statement "when a classic recovery and growth model began to be implemented" in the article by S. Gomulka.[36] Here lies the importance of the central bank and the instruments it uses. The illustration of this role in Poland is evident from the following:

- the instrument of interest rate maximization was abandoned in 1990 and the credit expansion limitation was abandoned in 1993; in the Czech Republic this occurred in 1992 and 1993, respectively;
- the real currency exchange rate as an indirect aim of the monetary policy target was kept in Poland until 1994, but in 1995 and 1996 it was replaced by the nominal exchange rate policy in the given range of ±7%; similar tendencies in the field of exchange rate policies which existed in other transition countries. This means that after overcoming the high inflation stage and achieving a certain level of macroeconomic stability, the dominant criteria of the exchange rate policy was "avoiding such a (real) currency exchange rate development which would contribute to the unsustainability of the external equilibrium".[37] In the future, as has been pointed out, these countries will have to resort to much more stable currency exchange rates, when they reach the stage of preparations to join the European Monetary Union, <u>but for the time being, it is more rational to keep a higher level of monetary autonomy in order to overcome problems of excessive foreign capital inflow, but also to maintain external equilibrium.</u>

(2) The extended arrangement between Croatia and the International Monetary Fund from 1997 also includes some new elements, which in the field of monetary policy might be interpreted as an improvement i.e. as abandoning some rigid monetary restrictions with the orientation towards indirect instruments, which have been implemented for some time in other transition countries:

- the most important novelty is abandoning the strict net domestic assets restrictions of the banking system as a whole, but keeping it at the level of the Croatian National Bank; this practically means an issue of base money only in the framework of foreign exchange coverage; foreign exchange

[36]See / 11 / .

[37]See / 18, p. 51 / .

reserves have practically become the only channel of monetary base creation in Slovenia[38] since 1991; in Croatia the M1 aggregate has a more than 100% coverage in the foreign exchange reserves of the Croatian National bank, and base money even more; the monetary aggregate growth in the broad sense is ever more frequently based on the net external assets of the banking system, and the role of the net domestic assets in money creation is decreasing: in December 1994 the share of the domestic net assets in the M4 aggregate amounts to 93.5%, net external assets to 6.5%, and in March 1997 the analogue percentages are 68% and 32%; domestic credit expansion is significantly slower than the M4 monetary aggregate as well as from the net external assets of the banking system. The analogue increases of monetary aggregates in the mentioned period are: index 132 for domestic credit, index 224 for M4 aggregate, and for net external assets of the banking system the index is 1113 (171 for the Croatian National Bank), for M1 aggregate the index is 166, and for the base money in the period from December 1994 to March 1997 the index is 179; it is evident that the growth dynamics of the foreign exchange reserves of the Croatian National Bank, of the base money and M1 is quite steady (around index 170), that the domestic placement of loans is significantly behind (index 132), but that they are considerably exceeded by the M4 money demand index; the main component of the M4 are foreign exchange deposits.

From all these figures and their relationships it is evident that a ceiling on net domestic assets, that is on crediting the domestic economy, has given very convincing results in the growth of foreign exchange reserves, the official ones as well as those of the banking system as a whole; the official foreign exchange reserves have been transformed into national monetary aggregates, while the private ones were transferred as foreign exchange savings to foreign banks and have been returned to a certain extent as loans for the domestic economy. So the abundant foreign exchange supply and low domestic credit supply secured a stable nominal exchange rate, which is now becoming an explicit nominal anchor.

(3) On the central bank level this is evident from the interrelations of the net domestic assets D, net external (foreign exchange) assets RI, base (reserve) money B, and the nominal effective exchange rate index IET (Table 1).

[38] See / 18, p. 42 / .

Table 1

MOVEMENTS OF THE NOMINAL CURRENCY RATE AND THE MONETARY AGGREGATES OF THE CROATIAN NATIONAL BANK FOR THE PERIOD FROM THE 4TH QUARTER 1993 TO THE 4TH QUARTER 1996

Year Quarter	IET*	D million kuna	RI million kuna	B million kuna
1	2	3	4	5
1993 IV	84.89	-1.642	3.892	2.248
1994 I	81.80	-1.593	4.269	2.676
1994 II	82.59	-1.871	4.978	3.107
1994 III	79.42	-2.217	6.549	4.332
1994 IV	78.46	-2.478	7.192	4.714
1995 I	73.61	-2.453	7.000	4.547
1995 II	72.69	-2.462	8.020	5.558
1995 III	76.09	-2.589	9.026	6.437
1995 IV	75.61	-2.156	8.900	6.744
1996 I	75.47	-2.451	9.126	6.675
1996 II	75.67	-2.703	9.828	7.125
1996 III	74.69	-3.421	1.303	7.882
1996 IV	75.53	-2.889	11.659	8.770

* Note: Indexes based on 4 October 1993 =100; data according to the Croatian National Bank Bulletin and Main Statistical Indicators NBC, various numbers; data from the end of the stated quarters.

The table shows that during the whole observed period the foreign component of the monetary base – the net external assets RI – in the period from 1993 to 1996 (last quarter) increased from index 100 to index 300, base money increased over the same period from 100 to 390, so the share of base money in external assets rose from approximately 0.58 (58%) to 0.75 (75%). The base money is still sufficiently covered by the official foreign exchange reserves, which secures the convertibility of the kuna in the present monetary aggregate relations, but also points to the possible larger expansion of base money, and then by multiplication of M1 money supply and domestic credit. The room for increasing base money is up to at least zero value of the domestic component, D, of the monetary base B i.e. up to the equating net external assets RI with the monetary base B.[39]

[39]It should be noted that D = B - RI, i.e. in case that D=0 it turns out that B=RI. In that case column 3 of the Table I/1 would keep the zeros, and columns 4 and 5 would be equal.

The new extended arrangement of the Fund and the Croatian Government determines the growth of the share of the domestic component of base money from negative absolute values to zero value, which means that for future increases the B/RI ratio will rise to approximately number one; it means that the future growth of the external net assets of the central bank would not be sterilized on the base money level. This creates more room for the supply of money, and thus for credit expansion. So the arrangement does not include a credit ceiling for the economy as a whole, after singling out a group of 31 companies.

The sterilization of the money supply with the aim of reducing the credit supply will be conducted by other mechanisms of a market character, if the nominal anchor in the form of currency exchange rate and price growth bands would be breached. Namely, in the financial programmes of the IMF based on the so-called Polak model[40], target values for the increase of the general price level are determined, as well as the increase of the real domestic product and the level of foreign exchange (international) reserves. The target value of the foreign component of the base money is determined by the aim of the foreign exchange reserves, and thus the foreign components of the money supply are determined. As the target increase of the general prices level should be consistent with the money supply level (M1) and with the target increase of the real domestic product, and then with the assumption of the constant speed of money circulation, this necessarily determines the level and the rate of the domestic component of base money.

Should, however, an expected abundant foreign exchange inflow occur on the basis of the service sector of the economy and if the foreign debt accumulation of the domestic economic sector and the state continues, the monetary authorities will, because of the nominal anchors' target, implement a restrictive monetary policy through sterilization of the foreign exchange inflow. This means that the increase of the net domestic assets will again be constrained, all the way to negative values, if necessary. This will keep the appreciated exchange rate of the national currency and the nominal currency exchange rate on the exogenously given level. And this will diminish the export ability of the Croatian economy i.e. diminish the ability to reduce the current deficit, as has been predicted by the new extended agreement. The goods and services trade deficit will cause a need for financing through further debt accumulation abroad. All of this calls for a reconsideration of the monetary, exchange rate, credit and development policy, because the current economic policy can lead to unsustainability of the country's balance of payments over the medium and long-term.

(4) The announced nominal exchange rate stability should be maintained by the following instruments:

[40] See: / 1 / and / 4 / and in Croatian literature / 21 / and / 22 / .

- restriction of placing the loans, i.e. financing the working capital until it reaches a 7% growth, to 31 specially determined clients after "cleaning" their books; before the "cleaning" the credits to special clients amounted to one quarter of total credits granted by all banks, after the "cleaning" they should not amount to more than 10%; in the first four months of 1997 the share of these companies in new loan placement amounted to 12%, while in the following two months it was only 2.5%; the space for recovery and growth of these companies is obviously very narrow;[41] those companies that are undergoing the process of privatization, however, are not limited on the credit market; in this way the stabilization policy was integrated into the policy of restructuring i.e. privatization;
- M1 money supply rate should be faster than at the moment, related to the foreign exchange reserves; should the credit supply for the rest of the economy increase, net domestic assets might increase faster than the current dynamics; should such an accelerated increase cause a depreciation of the kuna, the Croatian National bank is obliged to take measures in order to keep the nominal anchor in the given framework; such measures are standard procedure in such circumstances;[42]
- increasing legal reserves (the programme predicts a reduction!); issue of National Bank bills as an instrument of sterilization;
- if necessary, direct credit expansion restrictions should be implemented, as well as restricting the wage growth; a reduction of interest rates as a result of softening the monetary policy is predicted, but this is not an explicit target variable; the softening (through legal reserves reduction, for example!) is understood in the framework of the exchange rate target;
- in the case of too high a foreign capital inflow (short-term, above all) abolishing the outflow control of domestic capital in the capital account of the balance of payments is predicted; this means that keeping the stability of the nominal exchange rate against DEM by means of instruments consistent with market mechanisms in the financial system will be attempted; this policy had, to a certain extent, been implemented by the instrument of high legal reserves for foreign exchange deposits (over 50% of the foreign exchange deposits); the target of that instrument was covering foreign exchange liquidity risk in Croatian specific circumstances.

It can be concluded that the new financial programme might produce greater credit expansion, and thus a growth of GDP. The growth is estimated, as an implication and not as an explicit aim of the programme, at about 5% a year in average.

[41]See / 19, p. 16-17 / .

[42]Measures should be approved by the IMF.

If it is taken into account that Croatian economy is experiencing a recession and that capacities are underutilized, this should not be a very difficult task: tourism, construction and traffic with some locally oriented industries can easily achieve that aim with a small credit expansion. The cost in terms of lost GDP in order to maintain the nominal anchor under such circumstances, therefore, can still be very high. Such a conclusion will be correct until we reach at least the prewar GDP and employment level.

(5) The question of an alternative approach to financial programming arises due to the high costs of tightly keeping the set exchange rate as a nominal anchor. Such an alternative would have the following starting points:

- an appropriate GDP growth rate should be explicitly set (say 8-9%) and the instruments of the programme should be adjusted to this aim, with strict criteria of consistency in terms of available economic capacities and the real domestic and foreign demand; that should be the basic analytical starting point i.e. a development aim; net domestic assets of the banking system should follow the growth rate target set in this way; it should not violate the rule of net domestic assets, broadly defined liquid money[43] and net foreign exchange external assets; the consistency of these relationships should secure the criteria of stabilization and the balance-of-payments equilibrium sustainability. The quantitative performance criteria should be set in such a way that the demanded growth is not threatened, and that the transition towards a market economy is guaranteed. Our monetary authorities would have the delicate and difficult task of "servicing" the needs of growth, and at the same time maintaining price, interest rate and exchange rate growth within the targeted bands, as well as keeping the balance-of-payments equilibrium. It should be noted that the financial programme methodology in fact usually starts from the analytically assumed GDP growth rate. In the Croatian circumstances it should be a rigid target variable, and not an assumed implication. In this way, there are financial possibilities for achieving targeted variables in Croatia, as has already been analytically shown.[44]

Finally, a great rigidity of monetary transmission mechanisms point to the need of their restructuring, in order to produce acceptable indicators (interest rates, exchange rate and prices) for entrepreneurs and the financial market. Quantitative ceilings in the form of performance criteria of stand-by arrangements are partly motivated by the need to restrict the placement of loans to unprofitable companies

[43]The matter is better use of liquid money in conditions of excess capacity analogous with the quote from / 10 / and in Croatian literature with quotes from / 15 / and / 21 / .

[44]This is a matter of better utilization of liquid money in conditions of excess capacity excess capacities as it is shown in / 10 / , / 15 / and / 21 / .

and projects i.e. to banks. They have not succeeded to resolve the problem of money and credit allocation efficiency. This efficiency is supposed to be produced by the market transmission mechanism within the postulated restrictions. As this has not been achieved, the question of the necessary restriction restructuring arises. It is being done, for now, in cases of some large public and state-owned companies. After that, the market mechanisms were supposed to "produce" economically acceptable indicators, interest rates and exchange rate. Since the market transmission mechanisms are still producing high interest rates and an appreciated exchange rate, these questions arise:

- whether the performance criteria were set too narrowly regarding Croatian financial and real potentials, and the monetary policy instruments' relationships are inconsistent; whether the exchange rate anchor matches the price deflation criteria and the criteria of targeted economic growth rate at the same time; whether a better performance of the market mechanism, that could be expected on the basis of the interest rate indicator, would generate as a consequence larger net domestic assets, also based on short-term foreign capital inflows, and thus enable the higher utilization of available economic capacities; whether this has been prevented by the postulated quantitative restrictions of the net assets being too low, which has been implied by an absolute priority of price stability criteria within the range of a three-percent inflation rate; this priority was prerequisited by psychological factors, and has been realized by an a priori accepted low GDP growth rate as a spontaneous consequence, regardless of the underemployment of the available economic and financial potentials of the country.
- The conflict of the interest rate and exchange rate function with the function of the quantitative restrictions of net domestic assets on the financial market i.e. of the statutory reserves as the primary instrument of the monetary policy is apparent. This is an issue of inadequate connection of aggregate goals, intermediate targets, performance criteria and the standard monetary policy instruments. It is obvious that redefining the financial programme and the GDP growth projection should be done in the next step, so as to adjust the projection with the peculiarities of the monetary transmission mechanisms, in order to achieve acceptable indicators, exchange rate and interest rates. The new extended arrangement includes elements of that kind of redefinition, but firmly keeping the exchange rate and price growth rates as nominal anchors does not promise production and employment recovery.

(6) Hence, it can be expected that the development consequences of such instruments of the stand-by and the extended arrangement will be very similar:

- the export and import substitutable sectors are exposed to too strong external competition due to the appreciation of the kuna, which continues to cause a current balance-of-payments deficit, which is unsustainable over the long-term;

- the tradable goods' price stability has been kept by import competition which also disables a larger increase of exports i.e. the local goods and services generate pressure on the global price index growth, so this is the basis of the appreciation of the kuna and of the decreasing profitability of the export sector of the economy;
- the latest statistical data on the current balance of payments still do not show an achievement of the aim of closing the trade deficit; that is an explicit aim of the extended arrangement; the main support for closing the deficit will continue to be the service sector (primarily tourism, remittances, traffic) but this has proven to be insufficient; the structural consequences on this basis take two directions: first, the sector structure of the economy is dominated by the service sector and local and small-scale industry; and second, the regional mapping of such an economic structure, due to losing formerly strong regional export sectors (the engineering industry, metal industry, textile industry, shipbuilding, and agriculture), creates an unacceptable structure of job supply; this causes too great development disparities among the regions; economic migration as well as interregional labour reallocation could be very strong; in essence, the Croatian economy is growing into a regional appendage of Central Europe and the European Union, with a characteristically developed infrastructure and tourism and local economy as the basic activities; industry and agriculture lose their importance as base export activities. This is very clearly shown by some projections, elaborated as analytic scenarios and in which the elasticity of commodity exports in relation to the GDP rate of growth is less than one. On the other hand it can be noted that this is postulated correctly in the extended financial arrangement with the IMF: commodity exports should grow at a rate of 8%, and GDP at a rate of 5% annually on average. Considering the fact that the exchange rate as a nominal anchor should maintain its current established stable level and that the instruments were set according to this criterion, the question remains whether this aim is achievable during the arrangement period. That this question is well founded is confirmed already by the statistical data from August 1997.

The key question here is whether adjustment with the aim of establishing a long-term macroeconomic and balance-of-payments equilibrium, as well as the required growth rate, can be achieved over the medium-term using the instruments of institutional restructuring, liberalization and privatization policy, as has been set by the extended arrangement. The exchange rate and interest rates policies have in the programmes been connected only with the stabilization goals but not with the goals of economic growth. In the given framework, set by the IMF arrangement, the World Bank is attempting to find room and an appropriate development policy for the development of the Croatian economy. The framework given by the IMF arrangement is the following:

- GDP growth at an average annual rate of about 5% ;
- stable nominal exchange rate of the kuna against the DEM;
- stable prices at the global level of Western Europe.

As has already been pointed out, regarding the available unutilized real and financial capacities of the country, the realization of the postulated aims will not be a problem. Structural implications and higher growth dynamics are key social and political requirements of the Croatian medium and long-term strategy. In order to clarify this, the basic findings and the World Bank's recommendations for medium-term development of Croatia follow on the next pages. It is done according to a preliminary study presented to the departments of the Croatian Government.

The World Bank analysis[45] starts from the framework given by the IMF arrangement and by "supply side" policy instruments and is attempting to achieve the following:

- Achieving a cost adjustment of the economy to external competition by keeping the policy of a stable nominal exchange rate and relatively stable prices, like in the European Union. This means a real wages reduction and a reduction of the number of the employed, a reduction of the cost of capital (interest rates), reduction of "public expenditure" i.e. tax payments on the level of companies and citizens, reduction of fixed unit costs, as well as a reduction of operating and variable costs of all sorts by management improvements. The result of all that would be an improvement of the ability to maintain the given level of the exchange rate on the market. The antimonopoly policy should be improved by foreign trade system liberalization along with a stable nominal exchange rate policy. The problem is how to reduce costs and adjust them to nominal stabilization anchors in conditions of high public expenditure, in conditions of a narrowed domestic and foreign market and, above all, in conditions of a low long-term capital supply and low direct investments into the tradable sector. Due to high interest rates and the appreciated kuna, investments into financial instruments and short-term credit become more attractive. The risk on the financial market has been increasing due to the inflow of short-term speculative capital. This is exaggerated by the fact that our economy is not yet involved in any regional trade integration.

[45]See / 14 / .

Then, concrete economic policy measures are also suggested in the following areas:[46]

- company restructuring, privatization, bank restructuring and improving the supply function of the banking system as well as the capital market reform together amount to a kind of supply side measure;
- public sector reforms should be development-oriented, especially the pension and healthcare system reforms; budgetary expenditure restructuring in the post-war period together with tax system reform should be appropriate.

(7) The strategy suggested in this way should be compared with a possible alternative development strategy that would be specified in stages, in accordance with the development moment of the economy. The priority of an alternative strategy would be getting out of recession, i.e. achieving the warranted and required GDP and employment growth rate.

(a) In the World Bank's study in the first place there is a conclusion of weaker performances of the Croatian economy in relation to other Central European transition countries in the period from 1989/90 to 1996. It is stated that other transition countries experienced the recession stage and the macroeconomic imbalance just like Croatia. When stability was achieved, the more successful countries gradually performed a healthy production and productivity recovery cycle, with favourable effects on real wages, national savings and investments. In Croatia such development did not occur: productivity did not recover like in those countries, and real wages recovered much faster and reached the level from 1989/90.[47] The lag of industrial recovery is especially evident in Croatia, where the production remains at barely 50% of prewar production. So, the real wages and consumption recovery diminishes national savings and external equilibrium, which represents a serious obstacle for future growth. The idle capacity and the increase of efficiency could help the recovery in the first stage (as was the case in 1996 and 1997), but the current savings and investments level could help long-term recovery. The reasons for such a condition, as it is pointed out in the study,[48] are twofold:

- firstly, structural reform lags are obstacles for the improvement of the economic system's allocative efficiency and productivity gains in terms of GDP; reform lag is caused by the state ownership of major companies (infrastructure also) and "insider privatization" by employees; this is why the influence of the traditional interest groups remains; the banking system has made it possible to keep "soft budget constraints" for some time, because

[46] For further details see / 14 / the corresponding chapters, especially the abstract and Chapter 1 through page 17.

[47] See the World Bank's Study / 14, p. XI / .

[48] See / 14 / .

such new owners of the companies became the owners of the banks; the actual implementation of the banking system reform is supposed to change that environment;

- secondly, the volume and the public finance structure diminish national savings and growth.

This is followed by a recommendation that Croatian economic policy should stimulate both the companies and the financial system in the direction of an adequate supply reaction. Then, the public sector must be oriented in the same direction through structural reform improvement. Public investment should attract private investments.

The necessity of budget expenditure restructuring and its reduction is especially pointed out. It could be an additional source of development financing.

Along with these conclusions and recommendations, the following should be noted:

- the restructuring, foreign trade system liberalization[49] and privatization recommendations are of a typically "supply side" microeconomic orientation;
- the macroeconomic policy and environment is simply taken as it was given by the IMF arrangements;
- analytical comparisons with other transition countries are on the level of pure comparison of the achieved economic results and microeconomic policies; <u>different macroeconomic environments with the corresponding policies are not analyzed as possible factors that could have generated the differences in the results.</u> The different concept approaches in the recovery are not separately analyzed. The different strategic approaches, however, have caused the differences of the macroeconomic and microeconomic policies. It is obvious from the following: although a recession perception of the economic condition, Croatian as well as those of other transition countries, has partly been adopted in the World Bank's study, the lag with the structural reforms has been taken as the main factor of a prolonged recession in Croatia, because of which a possible "productivity gain" was absent; then "insider privatization" is taken as an important lag factor. It should be stressed that the public expenditure volume and structure caused by war circumstances are accepted but only as a temporary cause of the lag. Gradualism in reducing the volume and restructuring public expenditure are accepted but are supposed to be market-oriented.

A realistic approach in the analysis of the Croatian economic lagging behind other transition countries should, in our opinion, <u>distinctly</u> (and not sporadically),

---

[49]Chapter 3 of the Study / 14 / . In our literature, further details in / 25 /.

start from the recession perception of the state of the national economy. That perception would require a substantially higher GDP rate of growth and labour force employment rates. In this way, over the medium-term, the elementary social priority of the country expressed in full labour force employment and the employment of the financial and economic potentials of the country could be achieved. This does not mean disregarding the necessary institutional and production restructuring of the economy but not according to the criteria of mainstream neoliberal doctrine. It is important to note and accept that the need for economic recovery and growth is in certain conflict with the long-term character of the institutional, technological and production restructuring. This fact requires establishing the development strategy of the country by stages. The sequence and time limit of the corresponding structural policies stipulated in the strategy are essential. The urgency of recovery must be simultaneously accepted as early as the first strategic stage.

(b) The comparison of our labour costs with the costs of other transition countries expressed in dollars shows the following:

- a high national currency depreciation in the transition countries compared to a highly appreciated kuna gives an image of low wages expressed in dollars in the competitive transition countries, while Croatian wages are substantially higher;
- when wages are expressed in purchasing power parity of the dollar in individual countries, it is evident that the wages purchasing power is quite balanced, with the exception that in the Czech Republic the wages are higher than in Croatia; in Croatia the wages expressed in purchase power parity and in current commercial exchange rate of the national currency are very close (almost the same), while in other transition countries these differences range between 1.5 and 3 i.e. wages expressed in dollars should be multiplied by these coefficients in order to calculate their real purchasing power. In 1995 this ratio barely reaches 1.11 and 1.13 in Croatia and Slovenia. It is obvious that the currency exchange rate policy was not taken in Croatia as an instrument of export stimulation i.e. of the reduction of cost expressed in dollars; other transition countries, apart from Croatia and Slovenia, due to low productivity, use the exchange rate policy to support their economy on the world market. Croatia can settle this difference in costs only through productivity on the European level, and not with relative prices on the domestic market. A longer period of time is required to achieve the European productivity level, and other transition countries have taken it into account, while Croatia exposed its tradable sector to the severe world market competition too early. This is the reason for requiring protection measures, especially in agriculture and industry.

This is not a simple problem, but it is obvious that it is not being perceived by the domestic economic policy and the analyses and attitudes of the Bretton-Woods institutions.[50]

(c) In the monetary sphere, as a consequence of the financial programme included in the stand-by and extended arrangement, the current state of the economy should be taken into account when the programme starts to be implemented.

In the analysis of the credit expansion effects, it is important to evaluate the <u>initial state</u> of the economy. Namely, if the initial state of the monetary aggregates is not in equilibrium wrong conclusions can be derived:

- if the share of the net external assets of the banking system in the initial status is, for example, 14% of the GDP, and the share of placed loans 40%; then, if the share of the external net assets in the GDP increases by 4 percentage points, which will at the end of the process amount to 18 percentage points, and if the share of placed loans increases by additional 8 percentage points, which will in the end amount to 48 percentage points of the share, the result of all that will be that the increase of the net external assets in the end amounts to 28%, and of the placed loans only 20%. This shows that the aggregate movements worked more to the advantage of the external net asset growth i.e. the growth of foreign exchange reserves than by means of a monetary transmission mechanism, for the benefit of credit expansion; after all, in Croatian circumstances that was the aim of the ceiling on the net domestic assets growth by the stand-by arrangement. So, the conclusion that there was room for credit expansion is correct, but the reason why that did not occur is in the financial programme of the stand-by arrangement.[51]
- it can easily be concluded from a comparative analysis that the Croatian initial state is not in equilibrium: in Spain, for instance, in 1988 the share of net domestic assets in the GDP amounted to about 8% and of the banking system placement of loans to the economy, non-state sector, amounted to as much as 62%. In Croatia in 1995/96 these shares amount to approximately 13% and 35-40% respectively; the experience of the countries using the exchange rate as a nominal anchor and with inflation of over 10% in the stabilization programme period in 1991/92 shows that the M4 monetary

[50] See / 14, especially chapter I / . The exchange rate problem, on the other hand, is very present in the analyses of the European institutions when comparing transition countries. Further details in / 24, part III / .

[51] See the World Bank's analysis on the subject in / 14 , chapter 4, items 4.2., 4.3. and 4.15 / . The conclusion on credit expansion space is very important. The two institutions disagree on the matter!

aggregate growth is, on average, primarily based on the domestic net assets growth, and always to a smaller extent on the net external assets growth (approximately 22% and 18%, which results in M4 growth of 40%);[52] in Croatia these relations are reversed, that is external net assets are in the first place, followed by domestic net assets.

The specific characteristics of individual countries are too different from the comparative analysis point of view to give a final opinion on the character of developments in Croatia. However, indications of insufficient credit expansion are evident and can be considered as one of the important factors of the Croatian economic recession. Exchange rate stability is an initial prerequisite of constrained credit expansion. As credit expansion possibility exists in the financial (monetary) sphere, this possibility also exists in the real sphere in the form of unused capacities. This conclusion, however, does not refute the conclusions about the need for a structural policy in the areas of the banking and economic system as a whole. It only confirms that there must not be a conflict between a different macroeconomic policy (both credit and exchange rate policies!) and a restructuring policy.

The extended arrangement with the IMF in this respect would mean an improvement, if it is connected with the suggestions from the World Bank's analysis.[53] It means that abandoning the commercial banks' obligation of redepositing 55 % foreign exchange deposits in foreign banks would mean a "softening" of monetary restrictions and a significant reduction of domestic statutory reserves and a way of developing a system of possible sterilization by national bank bills. Such measures should have strong implications on money and credit supply, they would not exceed the financial potential of the country and they would support the supply of economic agents on the market of the country. The question remains whether these suggestions are coordinated between the Bretton-Woods institutions i.e. whether they are correctly stipulated in the complete development strategy. The issue of interrelationships and consistency of such suggestions with the aim of a stable nominal exchange rate of the kuna against the DEM and inflation within the bands of the European Union is of great importance. Due to its feedback effects the sustainability of exogenously strictly set nominal anchors could be put into question.

This is usually a current issue in countries with an undeveloped financial market, with an underdeveloped stock and equity market of the non-banking economic sector. Under such circumstances, the so-called monetary credit channel transmission mechanisms[54] operate in the following way: a restrictive monetary policy reduces the excess reserve money of the banking system due to a sudden

[52] See / 2, p. 25 / and / 14 /.

[53] See / 14, Chapter 4, item 4.15 / .

[54] See on the subject in / 15 / .

increase of the central bank's legal reserves; the reduced excess reserve money reduces the possibility of granting credits, that is the monetary multiplicator and money supply is reduced; due to the resulting reduction in the credit supply the commercial orders reduce; followed by a decrease of production, investments and supplies as well as net export, and finally GDP decreases; then the credit channel transmission mechanism indirectly links the interest rate and currency exchange rate mechanisms with their own implications.

In Croatian circumstances there are clear signs of monetary transmission mechanism inconsistency, because the initial anti-inflationary state of the monetary-credit mechanism was neither equilibrated nor stable. This means that the interrelations of the basic monetary aggregates were not balanced in the beginning, because the state of the national economy was underemployed. The monetary policy, hereby, renounces its role in the production recovery and the reactivation of idle economic capacities in the framework of the available financial resources. From the fastest growth of the primary (base) money in the observed period, for example, related to the monetary aggregates of the money supply and to the placement of loans, it can be concluded that the primary money multiplication through the transmission mechanism was too low. The consequence was not meeting the total credit demand. In the production recovery and the available economic capacity reutilization stage this multiplication should be much higher.

Monetary transmission processes always take place in a certain period of time, and the beginning of the period was given by a certain monetary shock in the form of a monetary restriction which generates specific transmission indicators. The research on the length of the transmission process in the USA for the period from 1965 to 1993, which had the aim of establishing the reaction of the variables to a monetary shock caused by the monetary policy with an indirect (transmission) aim of increasing the short-term interest rate in the banking system, showed that the adjustment time was actually quite brief, i.e. that the recovery comes relatively soon after the monetary shock. The long time shock recovery process in the Croatian economy actually points to a high level of transmission mechanism underdevelopment and rigidity in the Croatian banking system and inflexibility of the real economic structure. This means that the assumption that the transmission will be performed in a "standard" way under Croatian circumstances should be abolished. In terms of this, it is possible to interpret Croatian economic processes in the following way: 1) the reactions of the main economic variables to the monetary shock caused by the stabilization programme do not match the (shorter) duration of such reactions in a developed economy; economic activities were at the beginning of the monetary shock at the level of approximately 55% of the total economic potential of the country, which is not typical of developed countries. In Croatia the first reactions caused by the shock are remaining for the fourth year, with still a weak tendency of improvement in spite of the initial low level of activity. This means that the monetary transmission mechanisms with respect to the improvement of economic indicators are very rigid; 2) the low comparability of transmission mechanisms in Croatia was caused by special external factors: financial transfers and short-term external credit financing enabled a rise of the final demand on the domestic market; the excessive foreign competition entry on the domestic market substituted the domestic supply by foreign supply, so there was no recovery of GDP; 3) the weak performance of the financial market, especially under war circumstances, caused the interest rate to grow steadily and be very rigid, as well as the appreciation of the exchange rate. The appreciation level was incurred by low national income, and in that way by the weak demand for foreign money. That was the consequence of the monetary-credit policy, which caused the so-called underemployment equilibrium of the real and financial sectors of the economy.

In the following pages, therefore, we will examine the currency exchange rate policy and the foreign trade system liberalization from the competitiveness point of view. These aspects are very important in the medium-term recovery and growth policy. This aspect of analysis is absent from the Bretton-Woods institutions' documents regarding the Croatian arrangement.

(d) Adjusting the currency exchange rate and the competitiveness of the economy. The economic aim attempted to be achieved by an appropriate exchange rate policy comes down to two things:

- first, the stabilization of prices which implies the nominal exchange rate as an anti-inflationary policy anchor;
- second, the competitiveness of the economy on the foreign and domestic market which over the short- and medium-term implies a real exchange rate depreciation policy.

This is a question of finding a certain trade-off between the two aims; it could be said that this is a question of combining appropriate policies, which would meet the dynamic growth demand but stay within the stabilization framework. The purpose of supporting competitiveness is improving growth. The real question, when exchange rate policy is concerned, is its real level that will maintain or improve the competitiveness of the economy. It is essential to make a distinction between the current commercial exchange rate and the purchasing power parity rate. The current commercial exchange rate is usually lower than the purchasing power parity rate for developed countries, while in developing and transition countries the current commercial equilibrium exchange rate is higher than the purchasing power parity rate.

It is characteristic of developed countries that their currencies have a long-term mild appreciation tendency i.e. the difference between the purchasing power parity rate and the current commercial exchange rate is small. In the CEFTA countries the approximation of the exchange rates is forecast for a period of over five years, starting from today. Croatia has already completed this process of approximation.

At the beginning of the process the distance index of the current exchange rate and the purchasing power parity rate in transition countries was as much as 4 to 6 times, while at the moment it is still 1.5 to 3 times.

The appreciation of the kuna after 1992 reduced the export competitiveness of the Croatian economy and increased the inclination towards import expansion and the substitution of domestic production with import products. With the possible joining of the Central European Free Trade Area, the Croatian economy would be exposed to strong competition from the economies of those countries because the data on the prices level demonstrate that those are "cheaper" countries, that is they have a larger distance between the actual currency exchange rate and long-term real equilibrium exchange rate[55].

Thus, in Croatian development strategy, the aim of the exchange rate policy should be to improve the competitiveness of the domestic exporters on the world market by means of a real depreciation, with the purpose of eventually achieving the current balance-of-payments equilibrium. The depreciation policy also directs the demand towards domestic goods and so stimulates the growth of domestic production ("expenditure switching policy"). Finally, a general production increase occurs. However, the efficiency of depreciation (devaluation) depends on a consistent credit policy, budget deficit policy and wage policy. Over the medium-term other basic economic factors which determine the real exchange rate are connected with this. Such factors are the terms of trade, technological advances, tariff and non-tariff protection, one-way transfers, personal incomes and the purchasing power of the population based on one-way transfers

Under current Croatian circumstances, as has been elaborated earlier, the economic policy has so far been oriented towards maintaining price stability by monetary and credit restrictions in order to stabilize the nominal exchange rate on a practically fixed level against the DEM. Still, a question of starting the development cycle remains, while the real domestic currency appreciation prompts the problem of the production and institutional restructuring of whole branches of the economy.

It should be concluded that the exchange rate stability is a desirable aim of any development strategy. The problem, however, is what is the level the real exchange rate is set on.

(e) <u>Foreign trade system liberalization and exchange rate policy</u>. The appreciated exchange rate of the kuna is the main reason for the tendency of increasing

---

[55] On the subject consult / 22 /.

imports and the substantial export lag of the Croatian economy, that have been very persistent. Exposed to external competition because of the appreciated kuna and long-term savings shortage as well as the modest long-term foreign capital entry, the economy is unable to lower the costs through technological advance over the short and medium-term and thus improve competitiveness on the domestic and foreign markets. This is also connected with the protection system that could be able to protect and improve the competitiveness of the economy on the domestic market in a certain period. The aim of the protection policy, as a part of economic policy, is limiting imports by means of various tariff and non-tariff protection measures in order to protect the economy from foreign competition. This policy, however, can "preserve" the domestic market for some producers and branches but it does not stimulate exports, and without export expansion there can be no recovery of the economy as a whole and no prosperity for the country.

This is why the increase of the kuna real appreciation causes tensions, depending on the economic sector, and increases the pressure for greater domestic production protection. This demonstrates that the exchange rate policy and the foreign trade policy should be linked into a consistent policy of stabilization and development of the Croatian economy.

By means of a tighter integration with regional trade systems, and with global trade systems (GATT, WTO), the exchange rate policy and especially the real depreciation policy become the basic instrument of the development strategy, particularly in small open economies. Only after reaching the appropriate level of development, the fixed exchange rate policy gains importance in the development strategy, with the aim of further structural adjustment to the world market. In the first stage of development according to the IMF and the World Bank, the aim is to include the country into the financial system and market. This is a stage of liberalizing the capital account of the balance-of-payments. The problem of sequences arises in this stage.

Joining the CEFTA or the EU with the current renouncing monetary sovereignty of the country which causes the inability to influence the economic growth and the competitiveness of the economy by means of a monetary policy, the accumulated structural development problems, low global competitiveness and underemployment, would expose the Croatian economy to a high pressure of foreign competition. Because of this, long-term economic development policy has to establish the preconditions for Croatia to join the economic and monetary union, in order to experience the positive effects of integration over the long-term.

The current Croatian system of the exchange rate that is actually tied ("pegged") to the DEM and its rigid monetary policy do not represent a sovereign monetary system. Structural development problems caused by the disintegration of a wider market, the disruption of joint custom and monetary zones, excessive fear from inflation and relatively abundant foreign convertible money and a supply of short-term (speculative) capital have created a vague situation which prevents the use of the already available financial and production capacities of the country. Undefined monetary transmission mechanisms produce developmentally unacceptable indicators of interest rates, exchange rate and production factor prices. The productivity of the country is generally too low to be able to support the highly appreciated real exchange rates.

The Basic Issues Of The Stabilization, Restructuring And Development Policy - Conclusion

Based on the analysis of the role and the purpose of the activities of the Bretton – Woods institutions in developing and transition countries and in Croatia, important questions arise:

- how has the Croatian development strategy defined its own development goals; which social and national priorities does it include;
- how has the Croatian development strategy interpreted the role of the arrangement with the International Monetary Fund and the World Bank in terms of the expected economic and social priorities in terms of recovery and full employment of the economic and financial capacities of the country; whether the arrangements themselves have been understood as a complete development strategy, or they have been interpreted only as a stage of economic stabilization in order to overcome structural imbalances caused by the disintegration of socialism, the former federal state and the war;
- whether the Croatian economic strategy has, under the influence of Bretton-Woods institutions, been reduced to the aims of globalization and regional integration of the Croatian economy regardless of its “social costs” during that process in the current medium-term period with long-term implications;
- to what extent is it possible to create and implement a sovereign development strategy of a small country in the described circumstances.

If it is possible to outline a national development strategy during the current “neoliberal doctrine” domination, for the implementation of which, in its “eclectic” form, the Bretton-Woods institutions were engaged, then the questions of the Croatian economic strategy, based on the results of this analysis, could be expressed in the following way:

1. The strategy of accelerating economic recovery is opposed to (it is in conflict) with the strategy of underemployment equilibrium implying de-

flationary stabilization; the solution of that conflict is creating a strategy in stages i.e. a kind of sequencing strategy;

2. Deflation contradicts recovery, growth and development criteria and induces production restructuring in the underemployment stage with unfavourable structural consequences;
   - The solution could be aggregate demand expansion through credit expansion within the limits of fiscal discipline, and with ceilings of the net external assets of the banking system and liquid money in a broad sense (M4); the aggregate demand expansion should be implemented with appropriate wage control; lower real interest rates and depreciation are an implication of credit expansion, which stimulates development and employment; it means that it is possible to resolve the conflict between the anti-inflationary policy and the growth policy by the rules of fiscal discipline, monetary expansion control and restriction and with the wage policy; in Croatian circumstances, the room for such a policy is still unused.
3. Insufficient presence on the international financial market, especially in the area of direct investments, the stabilization policy still produces too high real interest rates and the appreciation of the kuna and induces production restructuring too early in a state of high underemployment;
   - The solution could be a stage approach to development strategy: in the first stage higher monetary sovereignty, and an export stimulating exchange rate; by means of an exchange rate policy and developmentally acceptable interest rates, consumption would in the beginning be restricted and then redirected towards domestic products; in that way export competitiveness would be supported by relative prices rules in accordance with the global productivity of the economy; a development-oriented arrangement with the IMF is required, if it is really necessary; a development programme of an exclusively microeconomic orientation stipulated by the World Bank doctrine is not complete, and in certain segments it is one-sided and premature for the development moment of the Croatian economy; in the stage of stability when short-term and long-term capital is prone to inflow into the country is a sign of beginning a mature stage of recovery; in that stage the market mechanism will regulate development-stimulating interest rate; this stage presumes a developed institutional infrastructure and developed mechanisms of the country's financial system.
4. The kuna appreciation policy i.e. the policy of stability on a misaligned level, that is in the state of underemployment equilibrium, contradicts the industrialization of the country and implements an excessive tertiarization

of the economic structure, which endangers the future external equilibrium, but also the optimal economic and employment structure:

- Regional integration processes will put Croatian industry into an economic environment similar to that from the late 19th century; however, the competitiveness of the environment will be much higher: the currency exchange rate, the cost of labour and interest rates will become of high importance; at the present moment, Croatian industry is evidently uncompetitive on this market; this is of special importance for "small and medium-sized enterprises" which will be under the pressure of market expansion; much of Croatian industry traditionally belongs to this category of companies and enterprises; the problem of big-scale industry in Croatia will particularly depend on specific government incentives; similar to Eastern-Asian countries; the question arises whether it is not too late for creating such an industrial policy;
- The resolution is to put a foreign exchange system (fixed, floating, fixed-but-adjustable) that would be consistent with the basic economic fundamentals i.e. foreign trade system liberalization coordinated with capital account liberalization; a stage approach is necessary to be implemented as a part of the recovery policy, industrial policy and structural policy in the circumstances of European integration processes; consistency of the real equilibrium exchange rate policy and protection and liberalization of the foreign trade system is necessary and required.

5. Premature foreign trade system liberalization and the appreciation of the kuna have structural consequences that contradict the aims of the full employment policy i.e. the underemployment overcoming strategy;
   - The solution for these issues could be a stage development strategy approach on the aggregate level, as well as on the level of sectors, branches and groups of the economy; the importance of the exchange rate increases with the level of foreign trade system liberalization.
6. From these theories it can be concluded that the monetary policy, especially the exchange rate and fiscal policies, in its macroeconomic and microeconomic aspects, should be coordinated with the recovery and development policy and with the policy of stabilization and banking and foreign trade system liberalization.
7. At the end, it is useful to state L. Taylor's opinion concerning the influence that the Bretton-Woods institutions have on national development strategies[56]

[56] According to / 9, p. 151 / .

- "First, there should be less conditionality in terms of micro and macro management and price formation by means of their "policy matrix"; the conditionality could be reversed so that the countries present their economic programmes to the two institutions, instead of the present reversed situation; the volume of conditionality could be limited to only, for example, balance-of-payments aims while the countries should follow their own path when inflation, national income distribution and growth are concerned.
- Second, the Bretton-Woods institutions could redirect their resources towards their original role, which means support for the countries with external account problems.
- Third, in the past few decades the two institutions have deserved credit for making the countries aware of the danger of fiscal indiscipline and of the benefits of avoiding balance-of-payments restrictions through export support. They have become aware how growth can be hindered due to the distortion of prices, such as terms of trade for agriculture, as well as real currency exchange rate and interest rates distortions. On the micro level, the two institutions have helped by their support for company reforms. It is said that the Bretton-Woods institutions learn from their mistakes. <u>This is the basic contradiction – the Institutions react to the mi</u>
- <u>stakes but they do not cover the expenses".</u>

REFERENCES AND LITERATURE

1. T. Killick, <u>IMF Programmes in Developing Countries</u>, Design and Impact, Overseas Development Institute, Routledge, London - N. York, 1995
2. IMF, S. Schadler, Editor, <u>IMF Conditionality</u>: <u>Experience Under Stand-by and Extended Arrangements,</u> Part I: Key Issues and Findings, <u>Occasional Paper 128,</u> Washington D.C., September 1995
3. IMF, S. Schadler, Editor, <u>IMF Conditionality: Experience Under Stand-by and Extended Arrangements</u>, Part II: Background Papers, <u>Occasional Paper 129</u>, Washington D.C., September 1995
4. IMF, <u>Theoretical Aspects of the Design of Fund - Supported Adjustment Programs, Occasional Paper, No 55</u>, Washington D.C., September 1987
5. J.A. Frenkel, M. Goldstein, M.S. Khan, <u>International Financial Policy</u>, Essays in Honour of J. Polak, IMF, De Nederlandsche Bank, 1991, Chapter "The Monetary Approach to the Balance of Payments".

6. IMF, Reinvigorating Growth in Developing Countries, Lessons from Adjustment Policies in Eight Economies, Occasional Paper No 139, Washington D.C., July 1996
7. T. Killick, ed., The Quest for Economic Stabilization, The IMF and the Third World, Overseas Development Institute - London Gower, 1985
8. UNCTAD, Globalization and Liberalization, United Nations, N. York - Geneva, 1996
9. L. Taylor, The Revival of the Liberal Creed-the IMF and the World Bank in a Globalised Economy, World Development, Vol. 25, No 2, 1997
10. E.V.K. Fitzgerald, Rob Vas, Financing Economic Development, A Structural Approach to Monetary Policy, Gower, 1989
11. S. Gomulka, The IMF - Supported Programs of Poland and Russia, 1990-1994: Principles, Errors, and Results Journal of Comparative Economics, Vol. 20, 1995
12. ***, Memorandum Vlade Republike Hrvatske o gospodarskoj politici, I.; Privredna kretanja i ekonomska politika, No 32., June-July 1994
13. ***, Memorandum Vlade Republike Hrvatske o gospodarskoj politici, II.; Privredna kretanja i ekonomska politika, No 56, April 1997
14. World Bank Economic Mission, Croatia - The Challenge of Peace, The Report by O. Godson and Others, draft, 1996
15. Zdunić, S.- Grgić, M., Elementi za politiku oporavka hrvatskog gospodarstva, Economics, No. 2, Zagreb, November 1996
16. Zdunić, S.: Možemo li sustići Austriju, Banka, No 9, September 1995, Zagreb
17. Zdunić, S.: Razvojni trenutak hrvatskog gospodarstva i socijalna država, Revija za socijalnu politiku, No 3-4, Zagreb 1996
18. M. Krzak, A. Schubert, The Present State of Monetary Governance in Central and Eastern Europe, Focus on Transition; No 1, 1997 Oesterreichische National Bank
19. NB of Croatia, Bulletin, Year II. No 16, June 1997.
20. P. Havlik, Exchange Rates, Competitiveness and Labour Costs in Central and Eastern Europe, The Vienna Institute for Comparative Studies - WIIW, No 231, October 1996
21. A. Babić, Monetarni pristup bilanci plaćanja Republike Hrvatske, doctoral dissertation, Faculty of Economics, Zagreb, 1996
22. S. Zdunić - M. Grgić, Monetarni faktor u politici razvoja, Institute of Economics - Zagreb, Croatian Chamber of Commerce - Zagreb, 1996.

23. A. Mervar, Estimates of the Traditional Export and Import Demand Functions in the Case of Croatia, Croatian Economic Survey 1993, Institute of Economics, Zagreb and Croatian National Bank, Zagreb, 1994
24. Exchange Rate Policy and Real Exchange Rate Developments in Bulgaria, the Czech Republic, Lithuania, Poland and Romania, European Economy - Reports and Studies, No 2/1997
25. D. Vojnić, Ekonomska politika ostvarivanja druge faze stabilizacijskog programa, Economics, year 3, No 3, Zagreb, December 1996
26. Z. Baletić, How Keynes came to Croatia, Discussion Paper, Institute of Economics Zagreb, 1997
27. J. Sirotković, Hrvatsko gospodarstvo - Privredna kretanja i ekonomska politika, Croatian Academy of Arts and Sciences, Zagreb, 1996
28. R. Lang, Koncepcija i strategija razvoja, Institute of Economics Zagreb, Zagreb, 1986
29. M. Crkvenac, Ekonomska politika s elementima ekonomike hrvatskog gospodarstva, Informator, Zagreb, 1997
30. Z. Anušić, Ž. Rohatinski, V. Šonje, urednici, Put u nisku inflaciju - Hrvatska 1993-1994., Government of the Republic of Croatia, 1995

POLITIKA STABILIZACIJE I RAZVOJA U HRVATSKOJ 90-ih

Sažetak

Studija analizira svrhu i različite oblike programskih aranžmana s međunarodnim financijskim institucijama. Obrađuju se načela i značenje opće primjenjivih financijskih programa, a naročito uloga MMF-a i Svjetske banke u uspostavljanju hrvatske ekonomske politike. Konačni rezultat studije je pregled ocjene aktualnog stanja i budućih izgleda hrvatske ekonomije, kao dugoročnih implikacija politike strukturnog prilagođavanja koju je odredila nacionalna vlada u koordinaciji s MMF-om i Svjetskom bankom.

Moguće je iznijeti nacionalnu strategiju razvoja koja se temelji na rezultatima ove analize:

Strategija može biti fazni pristup razvoju: u prvoj fazi potrebni su viši monetarni suverenitet i tečaj stimuliran izvozom; pomoću tečajne politike i razvojno prihvatljivim kamatnim stopama potrošnja će u početku biti ograničena a zatim preusmjerena prema domaćim proizvodima; na taj način izvoznu konkurentnost će poduprijeti pravila relativnih cijena u skladu s globalnom produktivnošću ekonomije; razvojni program jedne isključivo mikroekonomske orijentacije koju je odredila doktrina Svjetske banke nije završen, i u izvjesnim segmentima je jednostran i preuranjen za razvojni trenutak hrvatske ekonomije; faza stabilnosti kada kratkoročni i dugoročni kapital pritječu u zemlju će biti znak početka zrele faze oporavka i razvoja; u ovoj fazi će tržišni mehanizam regulirati razvojem stimuliranu kamatnu stopu; ova faza pretpostavlja razvijenu institucionalnu infrastrukturu i razvijene mehanizme financijskog sustava zemlje.

Politika aprecijacije kune t.j. politika stabilnosti na iskrivljenoj razini kune u fazi ravnoteže nedovoljne zaposlenosti, osporava industrijalizaciju zemlje i uključuje tercijarizaciju ekonomske strukture, što ugrožava buduću vanjsku ravnotežu, kao i optimalnu ekonomsku i strukturu zapošljavanja.

Iz ovih teorija se može zaključiti da monetarna politika, naročito politika tečaja i fiskalna politika, u svojim makroekonomskim i mikroekonomskim aspektima, moraju biti koordinirane s oporavkom i razvojnom politikom, politikom stabilizacije te liberalizacijom bankarskog i vanjskotrgovinskog sustava.

Ključne riječi: stabilizacijska politika, restrukturiranje, deficit tekućeg računa platne bilance, devizni tečaj, financijski program, neto domaća aktiva HNB i bankovni sustav, aprecijacija, deprecijacija, konkurentnost gospodarstva, gospodarski oporavak i rast