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## **STABILISATION ROLE OF MACROECONOMIC POLICY**

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### **REASONS FOR THE RELEVANCE OF KEYNES'S THEORY**

Economies of many countries in the world are faced with crises and recessions. This is so in case of many developing countries. But, even the most developed countries of Europe are unable to solve their unemployment problem. The transitional economies are in a specifically difficult position. Experiences have shown that for the last 7 years the recovery is slow, that solution are not one sided and can hardly be copied.

In this paper the central thesis is that under the above defined situation active, developmental, and anti-cyclical measures of economic policy based on Keynesian teachings are badly needed. This is especially true in the case of transitional economies which suffer severely by under-employment of capacities (in certain cases only fifty per cent or so) and unemployment rate of over 20 per cent. In this paper an attempt has been made to see the relevance of Keynes's theory, its application to transitional economies and its importance for the Croatian economy. As conclusion we try to emphasize the need for mixed measures of stabilisation policy.

Even fifty years after his death Keynes is very much alive and continues to be topical, and will perhaps remain so for decades to come for at least 3 reasons:

1. Keynes primary contribution to the theory is in his emphasis on the need achieving full employment at stable prices. At the same time, Keynes has extended his theory to the problem of crises. There are many theories on crises that carry messages for the economic policy. There are various explanations of their causes, from short-term to long-term cycles. But crises are continuously occurring and are being

repeated. Keynes is the founder of active state policy in overcoming crises. The role of the state has proved to be an important one and will undoubtedly remain so.

2. In Croatia and in a number of other countries, particularly in the countries in transition, Keynes has recently become more popular and relevant than ever because of his anti-inflationary stance. Anti-inflation programmes in these countries have been based mainly on heterodox models of economic policy which have successfully been implemented and in a short period of time. But the problem is far from being over, nor can it be without an increase in production, or without an increase in the growth rates of employment, exports and over all economic efficiency. Undoubtedly, Keynes's theory has contributed to such a concept, as well as to a strong role of fiscal policy based on it. One possibility is that investment should be stimulated. Increased supply of bonds decreases their price. The movement of interest rates and the price of bonds is reversibly proportionate. An increase in interest rates stimulates investment in bonds. The state covers the deficit by bonds and thus procures resources to stimulate production. The employment rates increase as well as incomes and consumption. And stocks are decrease. The producer's sales on the market are improved, they earn money and expand production. Together with other elements of the economic policy, this starts the movements in production and the improvement of interest rates, and then exports and efficiency picks up, thus becoming a basis of economic stability.

3. What is happening in the world in many countries is the reflection of their economic policy of controlled disequilibriums. In the mid 1970s the rates of employment in developed countries were around 5 per cent. In the following decade these rates had almost been doubled. Having considered the fact that economic equilibrium is attempted with relatively high unemployment rates, the situation requires a stronger influence of the state. The policy of the moderately positive equilibrium of payments is being abandoned. Divergent movements are occurring even in the most developed countries (surpluses in Japan and Germany). At the same time the monetary policy and anti-inflation policy are gaining precedence and strength. The efforts for liberalisation are great, but the role of the state seems to be almost strengthening in some areas. The phenomenon has been termed as economic growth with creative destruction by Robert Solow. In such conditions Keynes remains relevant as far as the role of the state is concerned. He is right on unemployment rates, on exports and everything else related to stabilisation.

Just how recent theoretical movements have made some of Keynes's basic beliefs relevant can be illustrated in by the theory of rational expectations. Theory of rational expectations has developed fast over last

decade. Eldra Shafir (Princeton), Amos Taverski (Stanford), Peter Diamond (MIT), Thomas Sargent (Chicago), Brian Arthur (Santa Fe), so to say the economists of most prominent universities (as well as others: see *The Economist*, Dec 24, 1994, London) are gradually correcting the theory of rational expectations into the theory of limited rationality (as the information is limited and expensive, short-term partial interests appearing to be of some weight and other). The economic subjects can be anticipating, only in a limited way, the solutions of the economic policy (as rationalists), are what these theoreticians are claiming. From such theoretical expositions (and from empirical analyses, particularly of Shafir and Taverski) some implications are arising. We are choosing two of them:

- a. Monetary illusion exists in significant measure and the people are thinking in nominal prices as if they were real. In the conditions of dis-inflation people in enterprises are becoming the victims of re-structuring if the efforts were not masked at least by an increase of nominal value. With the disinflation the changes of relative prices seem to be difficult (just as solved by Keynes).
- b. In insecure conditions (from different reasons) people are measuring the eventual loss in double weight against the eventual profit. It is more important not to go on losing (worsening the status further) than to gain a lot. Thus, the initiatives are limited as well as starting a business (and for economies in transitions they are undoubtedly unfavourable: privatisation, investment in stocks, restructuring). Keynes' considerations of financial illusions are obviously becoming very topical. It refers more to the totality of stabilisation role of the macro-economic policy.

## **STABILISATION ROLE OF ECONOMIC POLICY IN KEYNES' THEORY**

Key subject of Keynes's theory is how varying modalities of macroeconomic process adapt to situations in which the general equilibrium has been disturbed. Keynes has put up essential questions quite differently from his predecessors. While in Marshall's treatment of equilibrium it is the supply and demand in short term that is determined mainly by price adjustments. This leads to conclusion that the speed of adaptation of prices to the demand and supply gap is higher than the speed of the capital adaptation. According to Keynes, while in short period, population, capital, capacity and production technology are constant, the consumption, savings, investments and employment are varying variables. That means that in a short term there is varying of supply and especially of demand while the given prices remain relatively stable. Such a standpoint held by Keynes is the result of his presumption that the size of income of economic subjects is not defined by the quantity of goods and services the subjects are ready to supply at equilibrium price, but is determined by the quantity that has

been effectively sold. Thus, demand on other markets will be limited effectively by the realised income. This limitation brings the reduction of the effective demand on the product market with multiplicative effects on total income and economic activity.

In Keynesian model it is assumed that a change in equilibrium results from change in the aggregate demand. Naturally, the macroeconomic policy of balancing and stability is influenced by the aggregate demand function. Again, the Keynesian theory of demand inflation is based on the interdependability of aggregate demand and national income and not on the interdependability of money supply and national income. This is where lies the crucial difference between the Keynesian and classical, or better say between the neoclassical theory of inflation and demand.

Keynes' theory primarily points to the basic determinants of income generation, its distribution and the level of employment (Keynes, 1936, Rohatinski 1990, p 172-177). It implies that in short period the autonomous flow of investment does not bring the quantitative and qualitative changes in physical volume and structure of the capital. Thus, the focus is on the factors that determine the higher or lower degree of use of existing capacity. Keynes' model elaborates the process of forming the supply and demand as well as their adapting on the markets of goods, services and capital. The mathematical expression of the theory is well expressed through the following equations:

$$Y = C + I \quad (1)$$

$$S = I \quad (2)$$

$$S = S(Y) \quad (2.1.)$$

$$I = I \llcorner \quad (2.2.)$$

$$M = L1(Y) + L2(r,P) \quad (3)$$

$$Y = Y(n) \quad (4)$$

$$w = Y\epsilon(n) \quad (5)$$

$$W = W_0 + w(n) \quad (6)$$

$$Y = P_y \quad (7)$$

$$W = P_w \quad (8)$$

$Y, y$  = nominal and real income,  $n$  = employment,  $M$  = supply of money,  $r$  = interest rate,  $W, w$  = nominal and real wages,  $P$  = price level,  $C$  = personal consumption,  $I$  = investments,  $L1$  - transaction demand of money,  $L2$  - speculative demand of money,  $W_0$  = minimum nominal wage.

The real values of each variable represents the proportion between the corresponding nominal values and the level of prices expressed in the units of wages. The money supply ( $M$ ) is taken as an exogenously defined variable on the part of the state. The model consists of the following functions: function of savings and investments, function of liquidity, of production function and function of the supply of labour, and two

identities at the end (7) and (8). At the beginning there is the equilibrium equation according to which the income is divided into personal consumption and investments. In the model the level of income, employment and total economic activity is defined by the functions of consumption, investments and liquidity. The form of these functions is defined on the basis of three psychological rules which form the axes of Keynes's macroeconomic theory. They are:

- (i) The rule of consumption which says that people in principle and in average tend to increase their consumption with the increase of their income, though not as much as the income is increased; in other words it means that the marginal propensity to consumption is positive and less than one; on the basis of that the multiplier of income has been derived according to which the increase of consumption is multiplicatively reflected on the increase of income, and the multiplier is equal to the reciprocal value of the marginal propensity to save, in fact starting with equation (1) and the above mentioned psychological rule we obtain the expression

$$\begin{aligned} y &= c + I \\ y - C &= I \\ y - C(y) &= A \end{aligned} \quad (9)$$

where  $A$  is the autonomous expenditure.

Further, it can be assumed that in short term, the marginal propensity to consumption is constant. In that case  $A$  defines the changes in income. By differencing (9) we get (Allen, R.G.D. 1972, p 45)

$$\begin{aligned} dy/dA - dC/dY \cdot dy/dA &= 1 \quad \text{and accordingly, } dy/dA - 1/1-dC \\ &= 1/1-C \\ & dY \end{aligned}$$

As  $1 - C = s$ , the multiplier is  $1/s$  and the multiplied change of income  $y = A/s$ .

- (ii) the rule of stimulating investment according to which the level of investment activity is determined is the relation between the efficiency of capital and the market interest rate. The efficiency of capital is represented by the relation between the expected rate of return of capital and its supply price or cost of replacement.

- (iii) the rule of liquidity preference which determines the demand for money is based on speculative, transaction and precautionary motives.

Keynes's equilibrium model represents simultaneous equilibrium of supply and demand on goods, capital and labour market. The basic condition of equilibrium of the system is that ex ante the investments are equal to savings. The level of investment depends upon the marginal efficiency of investments which is a falling function of interest rate (equation 2.2.). Saving depends upon the marginal propensity to save and

are represented by the rising function of income (2.1.). The size of the income in point of equilibrium is defined by the multiplier  $\lambda$  which, under the assumption of short-term autonomy of investment, the marginal propensity to saving oscillates depending on the level of income.

Taking into account the above mentioned we now come to the first unknown in the equation (2) the marginal propensity to save, which is determined by the equilibrium income which again represents a difference between income and by it determined level of consumption (at short-term constant marginal propensity to consume). The rate of interest which influences the equilibrium level of income should also be taken into consideration here (as is done here in equation 3). While this is a condition of equilibrium in commodity market, it also determines equilibrium of the money market at which the given supply of money ( $M$ ) is equal to the transaction and speculative demand for it. Transaction demand being a rising function of income and speculative demand a falling function of interest rate are also a function of prices. Thus equations (2) and (3) determine two relations.

In the labour market the demand for labour force is defined by equations (4) and (5). Equation (4) represents the rising production function of level of production, income and the number of employed people. Equation (5) shows that real wages depend upon the falling marginal productivity of employed labour ( $n$ ). Thus, we get the integrated demand function of labour which is determined by the falling real wages. Labour supply is represented by the equation (6) and is a rising function of nominal wages.

General equilibrium in Keynes's model is reached through partial equilibriums in each market. The commitments and goals of macroeconomic policy in his theory are determined by his assumptions of supply and demand at commodity, capital and labour markets.

- a) saving is primarily a function of income and not of interest rate;
- b) the demand for ready money apart from depending upon the level of income also depends upon speculative demand which in turn is determined by the interest rate; and
- c) most significantly the labour supply depends upon nominal and not on real wages.

These are the core points which Keynes elaborates in his General Theory, according to which when the system is in equilibrium, there can exist an unemployment of labour force. This defines the primary goal of macroeconomic policy in short period i.e. ensuring full employment that is impossible to be reached by automatism of the market mechanism. Keynes wants full employment without inflation such that he stresses that occurrences of unemployment and inflation are natural and interdependently linked to extreme consequences of imperfectness of the market equilibrium aggregate supply and aggregate demand. They can be

softened or eliminated only by a conscious and organised activity of the bearers of economy policy. According to Keynes the basic reason for any disturbance in equilibrium lie in the deviation of the effective demand from the real supply of labour. Basic instruments of economic policy thus are fiscal and monetary which directly influence the size, distribution and use of income. In this manner the macroeconomic policy, according to Keynes, must immediately be directed at ensuring a stable equilibrium of the system with full employment of factors of production without inflation. Accordingly, Keynes has simultaneously defined the stabilisation role of macroeconomic policy.

## STABILISATION POLICY AND TRANSITION

Traditionally, macroeconomic stabilisation takes place of pride in economics of transition (Nutti, 1995). It is important to distinguish between stabilisation in narrow sense i.e. eliminating repressed inflation through price increases, and in broader sense i.e. eliminating all inflationary pressures by liberalising prices, reducing budget deficits, equalising balances of trade and payments, affordable domestic and external debts.

The end of repressed inflation must be an absolute pre-condition of to move towards a market oriented economic system. This is also true for the reformed systems of market socialism, let alone in a full-fledged market economy based on private ownership and entrepreneurship. All earlier attempts at reforming and finding a "third way" have failed precisely because of the failures in undertaking seriously, the measures to implement such limited notions of stabilisation. Macroeconomic stabilisation as understood in a broad sense is not a pre-condition of reform or transition, but of an orderly, efficient and affordable implementation. Failure to stabilise does not necessarily affect the viability or even the speed of transition, but only the stakes remain high.

The dilemma of the choice between "shock therapy" and gradualism in the transition period has perhaps been overplayed. Post-communist economies faced three major tasks: stabilisation, institutional change, capacity restructuring. Shock therapy in a strict sense could only be applied to East Germany through re-unification. Everywhere else, stabilisation could be and should have been as fast as possible, whereas institution-building and restructuring would necessarily take time. A choice of low or high speed was available only within a very narrow scope encompassing the elimination of subsidies, the reduction of trade barriers, the introduction of convertibility, and the privatisation of state enterprises. In these areas there is a trade-off between speed and effectiveness of change: neither shock nor gradualism have built-in superiority.

It is probably not necessary to explain the need for a stable macroeconomic framework for the purpose of increasing prosperity in a country (Škreb, 1995). Transitional economies are often confronted with high inflation at the beginning of reforms. The transformation process usually starts with price liberalisation. Price liberalisation combined with a substantial fall in production, or, generally speaking, with huge macroeconomic disequilibriums, combined with shortage, monetary overhang and continued lack of financial discipline commonly result in high inflation. Therefore, inflation has been one of the main consequences of initial economic changes in former socialist countries on their path to market oriented systems. Needless to say, within the framework of high inflation and rapidly changing relative prices efficient allocation of resources is not possible. So, macro inequilibrium have to be addressed at the very first step on the road to a market economy and sound foundations for future restructuring. Stabilisation of economy is not, however, a sufficient condition for successful transformation reforms.

The Croatian situation is quite specific. Croatia is confronted with economic problems caused by: war and occupation of parts of its territory, transformation of the economy and the disintegration of former Yugoslav and East European markets. Its independence was followed by high inflation, which turned into hyperinflation in 1993. Therefore, implementing an overall stabilisation programme (which occurred at the beginning of October 1993) was a necessary step for economic restructuring. The stabilisation programme proceeded in three, overlapping phases. The first one, aimed at lowering inflation, was successful. Monthly inflation rates of 30% had turned into deflation throughout 1994 into low inflation between 2 and 3% in 1995 and the first part of 1996. This was achieved through: reducing inflationary expectations, restrictive monetary policy, introduction of a new foreign exchange regime, fiscal restraint and tight income policies. The second phase of the stabilisation programme is directed at restructuring the economy (restructuring of large loss-making enterprises and bank rehabilitation) and can be interpreted as: changes in monetary policy framework, building-up financial infrastructure, increasing financial discipline and intensifying cooperation with international financial institutions. Speeding up the privatisation process is considered to be a necessary element for increasing efficiency in the economy. The third phase of the programme should be able to build-up foundations for the reconstruction of the economy and speed-up economic growth. The role of a sound financial system is to mobilize funds and allocate capital efficiently. Therefore financial intermediation is crucial for a successful transition and sustained growth. In spite of the success of the Stabilisation Programme (achieved in a difficult climate), certain problems are set to be resolved. Microeconomic restructuring of large loss-making, state-controlled enterprises is proceeding slowly. So is the privatisation process and bank rehabilitation. The same is true for increasing financial discipline. Right in the middle of 1996 new laws were passed that would advance the discipline. Croatia's external debt is just about to be gradually



solved. All stabilisation programmes, including áthat of Croatia, pose certain very significant and sensitive questions that are related to previously mentioned views of Keynes.

- a) Just as nothing can be done without stabilisation, áso nothing can be done with it, unless it is followed by development, áthe activation of existing potentials and increased employment. Stabilisation would prove valuable, together with the stabilisation programme of the Government if it áwere followed by a more efficient production and an increase of employment.
- b) Certain decrease of the domestic demand requires additional efforts as well as support the export by enterprises. Companis are to make their own efforts which are to be coupled with the additionalágovernmental measures, activity of its institutions, including the diplomaticáservices in expanding the market capabilities, áthus boosting export performance.
- c) The existing stabilisation programme requires foreign support and their enlarging of investment capital. The programme support and theárealisation of the programme may be reason enough for support to be offered. áIt naturally includes the additional efforts to be made by individual institutions, development institutions, chambers of commerce and enterprises. At the beginning, the problem is not the lack of foreign exchange but the lack of domestic currency. áThe primary emission is founded on the basis of áforeign exchange transactions. These are very important determinants of the programme, but in a situation where accumulation is lacking, they represent a deepening of problem of financial áflows, and without an additional foreign capital investment to help a governmental programme, the re-structuring of Croatian economy is impossible.
- d) Social unrests earlier call for an added significance of áthe social programmes which should be based on real resources. Consolidating state budget appears to be a necessary condition and an additional rationalisation is required wherever possible. Financial disciplinary measures should be considered as highly necessary for the budget and for conducting business in a gradually more and more stable legal structure in the country.
- e) A particularly important question that should be immediately considered is the organisation and consolidation of the financial sector, with particular emphasis on creation of a healthy and capable banking system and áthe revival of capital market.
- f) Apart from the afore mentioned facts, it áis áimportant áto reduce public expenditure's pressure on enterprises, meaning áthat the turnover tax should be further reduced, payroll taxing should ábe reduced, monetary instruments should be developed so that stabilisation goals may be realised. However, the facts do not support the goals. We, therefore, propose using every possible opportunity to

reduce public expenditure. The customs and excise duties on import and export of goods is a problem that needs to be solved.

The successful beginning of stabilisation programme should not make believe anyone that problem have automatically been solved. The real solutions lie deep in creation of an efficient economic structure.

## UNDEREMPLOYMENT AND COMBINED MEASURES OF ECONOMY POLICY

The ágoal of every society is to attain a higher level of áwelfare (consumption). It is because of this reason that an increase in GNP is desirable. Apart from an exceptions, any significant increase of disposable income requires a relatively long time (expanding his analysis to this aspect is another notable contribution by Keynes). In this period, a rational direction of development process is possible and desirable and it should be realised so as to reach the desired attainableáeconomic goals. The optimum is not spontaneously realised nor are our goals automatically attained only by action of economic and market laws or in the terms of our desires.

The first and main task to be performed in order to realise áthe goal of higher welfare is to activate all disposable resources. Macroeconomic policy may succeed only through unified concept of monetary and fiscal policy giving support to aggregate demand (which has proven successful in several post-recession and post-war periods). It is obvious how deeply connected are the economic and development policies are, so is the stability and development, for which we find strongholds in Keynes' theory.

Let us stress it in other words: a crucial question for devising a concept of economic and development policy is the ádegree of use of productive capacities of the economy. The neoclassical theory, except áináa special case, begins with the assumption of full use of capacity. In a such a case the supply cannot be increased in a short period. Every heating-up of demand is inflationary and causes destabilisation. The supply curve is vertical and nonelastic to a change in prices. The increase in demand lifts the point of intersection of demand and supply curves leaving the level of áinflation at same quantity of production. In such a situation the economic policy tends to be restrictive. Development policy in such a situation is áless dependent on current economic policy.

In conditions of underemployment, the combination of policy measures is totally different. In áfact, whether or not expansionary or árestrictive economic policy is going to be applied depends upon áthe estimation whether the demand is higher than the supply. The measures will depend upon considerations such as (i) the level of economic development, (ii) ábalance of payment position (iii) the degree of efficiency and competitiveness arising from the increased use of capacity and (iv)

ádifferentiated policy of restructuring áif (iii) is lower. In each case economic and development policy have to be structured differently áfrom according to the áphases and goals of development and inter-phase operational solutions.

In áthe case of Croatia, with existing underemployment, one áshould bear in mind the lower (iii) and reality of (iv). Therefore, in Croatia a stronger turn from stabilisation towards development policy is required, because the commitments of stabilisation policy are: increase in production, employment and exports at relatively stable prices. Stability being not a state of no inflation, particularly not so in Croatia, where imperatively the goal must be speedy development and speedy reconstruction. The stability of prices is a desirable but not a sufficient condition of development.

Table 1: Annual indices of basic macroeconomic indicators for Croatia

	1991/ 1992	1992/ 1991	1993/ 1992	1994/ 1993	1995/ 1994
Total output in mining and industry	71,5	85,4	94,1	97,3	100,3
Total number of employees	87,0	87,5	93,7	94,7	95,5
Total number of unemployed	157,9	105,1	94,1	97,0	98,9
Turnover in retail trade	160,1	525,9	1135,5	220,6	112,5
Producer prices	246,3	925,2	1612,4	177,6	100,7
Retaul prices	223,0	765,5	1617,5	197,6	102,0
Cost of living	224,2	734,0	1586,3	207,2	104,0
Nights spent by tourists	19,3	105,7	120,4	154,7	64,5

*Source: Central Bureau of Statistics of Croatia*

In Croatian case it is necessary to investigate áthe combination of solutions which are very much in line with KeynesÆ thinking.

1. In a newly independent ácountry the central question to be posed is that of development, and not of balancing short-term economic trends in a situation in which survival isáconsidered áa success. All this is related with the possibilities of accumulating and attracting capital. They do appear to be small (a) while the domestic currency saving is about 5 per cent of GNP and áis almost all on a term shorter than a year and á(b) áwhile áthe owners of áforeign exchange saving accounts (individuals áand firms) have significant deposits at foreign banks. At the same time, foreign banks and firms are coming in a small number to Croatia. At the same time, in the foreground there is the problem of technological gap with Europe and problem capable, young, well educated and enterprising human factor.

2. A dominant question is that of the social concept of development with all its components including law-abiding, moral and ethical behaviour of the people. The market can function well only in a proper climate.
3. Ownership and privatisation is another real issue in Croatia. Highly debatable and very slow privatisation is becoming an obstacle to speedy development in the country. We cannot talk of the effects of ownership changes and there are plenty of them, when a large part of property lies in the hands of the state. In such a condition the process of restructuring is few and far between for the state has proved to be a poor entrepreneur. It is all the more difficult as there is no successful denationalization.
4. Without a sufficiently privatised economy only a partial market can be developed but only without a proper financial market. Financial market is the key to market economy and perhaps the most crucial question in economic restructuring of our economy.
5. The economy is not entering the coming years in any favourable climate as: (1) systemic solutions, market infrastructure, institutions and mechanisms are not sufficiently developed. (2) many of current economic features are not significantly improving, (3) as far as the development cycle is concerned, the assumption of its acceleration is yet to come. Without the speeding-up of production, increase in employment, promotion of exports, and increased efficiency, Croatia will still resemble with the first phase of stabilisation programme.

Under such conditions a combination of measures of economic policy should take into consideration the following:

1. Since there are enormous costs of a sudden closure of the plants etc., the emphasis should be given to an acceleration of privatisation and reconstruction of capacities in the newly liberated areas, as well to attracting foreign private capital.
2. The basic strategy should support the crucial inputs with a further liberalisation of prices, expansion and increase of the competitiveness of domestic production. Priority should be given to investments into transport and communications, education and re-qualification of redundant workers, as well as to research and development of technological achievements, the strengthening of expert scientific international cooperation.
3. Quick and efficient help should be given to small and medium enterprises in order to facilitate their entry in the market. The state should influence the opening of new market structures by controlling take-overs and mergers, anti-monopoly policy, by stimulating foreign direct investments, by influencing opening of the new market structures and the reform of the economy by introducing stricter control of the managing of public enterprises, gradually exposing them more and more to the market laws.

4. The experiences of the developed countries and theoretical outcomes show that: (a) the government programmes should be temporary - rather bridging over than anything else; (b) the government policy should be clear and made public up to the last detail; and the relative prices should be distorted as little as possible (beheading the market allocation of the resources).

5. Fighting for the stabilisation policy means fighting for both the permeation of the economic and development policy as well as struggling for an increase of production, employment and exports with the prices being relatively stable. Stability is not characteristic only to an economy in with no inflation, particularly not so in Croatia where speedy development and reconstruction in a short time is an imperative. The stability of prices is more than necessary but not sufficient. The market for all industrial and trade activities in Croatia as well as in other countries is the world market. Small economies cannot essentially influence global trends. Therefore, a subtle system of adapting to global trends should be devised, primarily on the model of capillary development which though externalities could make the realisation of their preferences feasible.

6. Objectively speaking, the possibilities of restructuring in conditions of low and stagnant production, disinvestment, high un-employment are objectively very small. To increase the same, the measures for accelerated reconstruction, increased production, deregulation, creating stimulative and competitive environment are necessary. In present situation the protection of domestic production and fluctuations in parity of Kuna are not sufficiently favourable to the needs of restructuring. In particular sectors of economy different measures intertwine, but they can be described as having restrictive effects on stimulating development.

In such conditions a particular problem is the decreasing employment. It may be necessary to reduce the output, particularly in spheres of production which are export oriented but their financial effects and competitiveness are low. Increased exports to Croatia means increased production and jobs. The processing industry and a number of other industries remain the back bone of production and employment in many developed countries (Eatwell, 1995). The more the solutions in economic policy take care of that, more successful are the solutions to restructuring problems.

7. The areas in which the problems of policy will become bigger are mainly the budget and foreign trade deficit. Without an increase in production and employment rates there is no basis for an increase in budget revenues which would not be inflational. At the same time, the costs of reconstruction of the country grow. The possibilities to cover the foreign trade deficit by different transfers getting narrower. And in these two deficits are the majority of the problems

of áthe Croatian economic policy which is further closely connected to the development policy.

We should bear in mind that stopping inflation means time gained to settle other scores. The time should be used áto áremove áthe obstacles to development and to restructure the economy, to introduce ánew financial system etc. Devaluation would not bring in any external capital or provide more solutions. A whole set of additional solutions is needed including a complete restructuring of the economy, the privatisation of banks and enterprises, reform of the public finance system, the restructuring of crucial infrastructure servicing the market, meaning improvement not only in acquiring of ánecessary means, but also in controlling how they are spent, while activating the reduction of all expenditure pressures.

## CONCLUSION

Keynes teaching is relevant and will remain so in the áperiod áto come áowing áto the fact that Keynes is (1) one of the áundisputable founders of active state policy of in fighting crises which áoccur constantly, and (2) that macroeconomic policy can not just stop at anti-inflation policy but must also be stabilisational áand developmental - directed to improved áproduction, exports and employment. Both, are important for the economy of modern áworld, particularly Europe - which pretends to become the dominant economic power of the twenty fist century. The economic power of any national economy in twenty first century will depend on its capability to (1) maximise comparative advantages and turning them into competitive ones, and (2) áenter the world of propulsive microelectronics, ábio-technology, átelecommunications, ánew ámaterials, áhardware áand software. The possibilities of the development are áunimaginable, and áthe ultimate result will depend on selected strategy áof áthe development.

In Croatia, in many areas, the assumptions for a successful combination of the possibilities can make (1) and (2) in easy reach. Approach to a successful development áof small áeconomy essentially requires (a) transparency áof the economy, (b) devising a model of capillary development and realising the production for market niches as well as áensuring the internal economic and social stability to which should be added áthe developed mechanisms of approaching ásocial áconsensus (cooperation of the government, syndicates, owners, parties, interest groups and other forms) in forming the economy and political decisions .

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## INTRODUCTION

The paper was initiated by the Keynesian approach to the aspects of post-war reconstruction and recovery after World War I or the "Great War" and all Wars.

The paper was not looking for similarities. Respective works of J.M. Keynes just gave an incentive to try to identify crucial long lasting development problems of Croatia in an environment of huge human loss and devastation of productive capital.

This attempt has led to population changes as a long range problem with a deceiving influence on velocity and direction of economic recovery and development.