*Yoji Koyama**

TRANSITION IN CROATIA

Neke napomene uz rad Yoji Koyame transition in Croatia

Nema nijedne zemlje u tranziciji koja ima tako dugu bogatu reformsku i tržišnu tradiciju kao Hrvatska i Slovenija. To, razumije se, vrijedi i za druge zemlje nastale razdruživanjem bivše Jugoslavije. Zato se na međunarodnoj znanstvenoj i političkoj sceni očekivalo da će upravo te zemlje biti na čelu tranzicijske kolone upravo onako kao što su dugi niz godina bile na čelu reformske kolone. Eksplozija balkanskog nacionalizma onemogućila je takva očekivanja. Izuzetak je samo Slovenija koja je i dalje ostala na čelu kolone.

Međutim i bez obzira na tako neočekivani stjecaj događanja brojni ekonomisti znanstvenici posvećuju daleko veću pozornost našim reformskim i tranzicijskim dostignućima nego mi sami. Da ne spominjem brojne radove iz dulje povijesne retrospektive, spomenut ću samo dvije najnovije knjige. Prvu je prošle godine u SAD objavio David Prychitko pod naslovom "Markets, Planning and Democracy, New Thinking in Political Economy". Drugu knjigu je ove godine u Japanu objavio poznati japanski ekonomist Yoji Koyama koji se dugo godina bavi sa komparativnim studijama. Knjiga je objavljena pod naslovom "South Eastern Europe in Transition". Najvećim dijelom je posvećena događanjima u zemljama nastalim na prostorima bivše Jugoslavije.

U ovoj se knjizi daje široki pogled na reformska i tranzicijska događanja u bivšoj državi. Citiraju se brojni autori koji su tijekom mnogih godina radili na reformi i tranziciji. Ova knjiga predstavlja jedan od najcjelovitijih pogleda stranog autora koji se dugi niz godina komparativno bavi reformskim i tranzicijskim događanjima

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u nas. Prilog koji objavljujemo pod naslovom Transition in Croatia predstavlja dio knjige posvećen Hrvatskoj. Interesantno je zapaziti vrlo dobro poznavanje hrvatskih autora i njihovog doprinosa u pripremanju reforme i ostvarenju tranzicije. Branka Horvata spominje kao doajena hrvatske ekonomske misli, međutim odgovarajuću pozornost posvećuje i brojnim drugim hrvatskim ekonomistima i znanstvenicima. U svakom slučaju valja pozdraviti i samu činjenicu da je jedan autor, ekonomist znanstvenik iz dalekog Japana tako mnogo vremena i znanstvenih napora posvetio istraživanju reformskih i tranzicijskih događanja na ovim prostorima. Posebnu zahvalnost mu upućujemo zbog suglasnosti da se ovaj tekst tj. dio spomenute knjige objavi u našem časopisu.

Some Remarks on Yoji Koyama's "Transition in Croatia"

No country in transition has such a long and rich reform and market tradition as Croatia and Slovenia have. That also concerns the other countries which grew up after disintegration of ex-Yugoslavia. Therefore the international scientific and political scene expected that these very countries would be at the top of transitional group, exactly in a way they had been at the top of reform group for many years. The explosion of the Balkan nationalism prevented such expectations. The only exception is Slovenia which is still at the top of group.

Regardless to such unexpected occurences, many economic researchers pay much more attention to our reform and transitional achievements than we do ourselves. To avoid numerous works from a long historical retrospective, I will mention only two most recent books. "Markets, Planning and Democracy, New Thinking in Political Economy" by David Prychitko, is published in USA last year. The second book "South Eastern Europe in Transition" by a well known Japanese economist Yoji Koyama, who has been engaged in comparative studies for many years, has been published this year. It is mostly dedicated to the countries of ex-Yugoslavia.

The book gives a broad consideration of reforms and transitional efforts in former state. Numerous authors, for many years connected with reform and transition, have been cited. This book is one of the most complete prospects gathered in one work by a foreign author who has been comparatively involved in reform and transition. "Transition in Croatia" is a part of book dedicated to Croatia. It is very interesting to note a very good knowledge of Croatian authors and their contribution to reform preparation and realization of transition. Branko Horvat is mentioned as a doyen of Croatian economic thought, but the author also pays a corresponding attention to other numerous Croatian economists and scientists. It is praiseworthy that one author who is the economic scientist from remote Japan, has spent so much time and effort to do research in reform and transitional happenings on these territories. We would like to thank him for his agreement to publish the part of the mentioned book in our journal.

Dragomir Vojnić

Transition in Croatia had to be carried out simultaneously with its hard independence war. Western countries responded warmly to Croatia at the time of independence, but Tudjman's too open nationalistic course has gradually repelled these countries. In 1991-1995, the financial aid from the EU has been limited only to the aid for humanistic purposes[1]*. Towards the end of 1990s Tudjman's course became deadlocked. Increasing dissatisfaction among people led to a victory of opposing parties at the general elections in January 2000. The new coalition government, with Social Democratic Party as its center, embarked on the economic restructuring and the efforts for the EU membership.*

Croatian Economy after Independence

Although Croatia attained its independence, the sacrifice was not small. 1n autumn the Croatian army entered the state of war against JNA (Yugoslav Federal Army). In spring 1992 foci of the battle removed to the territory of Bosnia and Herzegovina, and Croatia regained calm. However, a third of its territory came under the rule of Serbian forces, and such an `irregular condition' continued until July 1995. Manufacturing industry was severely hit by the war, with about a third of its capacity damaged (Fujimura, 1996, p.77). As a result, GDP in 1993 was lower than the 1990 level by 39%. At the same time, prices were galloping, and the annual rate of inflation exceeded 1100% in 1993 (see Table 1).

In October the Stabilization Programme was implemented. It was a program of two phases: The first phase as a heterodox anti-inflationary programme and the second phase as structural reforms. During the first phase, the central bank tightened monetary policy and liberalized the foreign exchange market, while the government realigned prices of public utilities to eliminate losses burdening the budget, and placed controls on wage in the public sector. Only in a year the inflation has calmed down, and the central bank's reserve began to increase. In May 1994 a new currency Kuna was introduced, replacing Dinar. The second phase of the

[1] Its continuous discrimination against Serbs, who were ousted from Krajna district by the Croatian army's blitz tactics in August 1995, and the inducement of Bosnian Croats to settle in their houses contravened the Dayton accord of November 1995. Under pressure from the US, the World Bank cancelled a US$ 30 million loan for the reinforcement of banking system in Croatia, and the IMF also postponed a loan to Croatia. The negotiation for its membership in the WTO was suspended under pressure from the US and the EU. Its negotiation with the EU on cooperation agreement, which began in June 1995, was also suspended in August. Although in June 1995 Croatia was officially included in the group of recipients of PHARE programme, its implementation was also suspended in August.

Stabilization Program involved structural reforms which were intended to assure long-term economic stability. Its key points were fiscal reform, acceleration of privatization, restructuring of loss-making public sector enterprises, restructuring of the banking system and development of financial system (Jovancevic, 1999, pp.240-241).

Before its independence, Croatia's total foreign trade volume amounted to 100% of its GDP (Samardzija, 1997, p.107). Croatian exports in 1990, including trade with other republics of former Yugoslavia, as well as trade in material services

Table 1

CROATIA'S MACRO ECONOMIC INDICATORS,1992-2000

	1990	1992	1993	1994	1995	1996	1997	1998	1999	2000
Real Economy (percentage change)										
GDP	-6.7	-11.7	-8	5.9	6.8	6	6.5	2.5	-0.9	3.7
Industry	-11.7	-14.6	-6	-2.6	0.3	3.1	6.8	3.7	-1.4	n.a.
Agriculture	-2.9	-13.5	4.5	-0.3	0.7	1.3	4	10.2	n.a.	n.a.
GDP per capita (US$)	5,106	2,291	2,349	3,137	4,029	4,422	4,396	4,806	4,456	4,227
Unemployment rate* (annual average)	9.3	13.2	14.8	14.5	14.5	10	9.9	11.4	13.6	n.a.
Retail prices (annual average)	610	666	1,518	97.6	2	3.5	3.6	5.7	4.2	6.5
Government Balance/GDP (in %)	n.a.	-3.9	-0.8	1.2	-1.4	-1	-1.4	-0.4	-6.2	-6.7
Interest rate (in %)										
Deposit rate	n.a.	435	27.4	5	6.1	4.2	4.4	4.1	4.3	n.a.
Lending rate	n.a.	2,333	59	15.4	22.3	18.5	14.1	16.1	16.1	n.a.
External performance (US$ million)										
Merchandise exports	4,020	3,127	3,904	4,260	4,633	4,546	4,210	4,605	4,372	4,590
Merchandise imports	5,190	3,430	4,646	5,432	7,900	8,236	9,435	8,773	7,674	7,904
Tradebalance	-1,170	-303	-742	-1,172	-3,267	-3,690	-5,224	-4,169	-3,302	-3,313
Current account	1,050	326	606	826	-1,451	-1,148	-2,343	-1,550	-1,537	-798
Current account/GDP (in %)	n.a.	3	6	6	-8	-6	-12	-7	-8	-4
FDI inflow	n.a.	n.a.	120	117	121	516	551	1,013	1,635	1,126
Debt service (in % of current account revenue)	n.a.	8.8	9.7	8.9	9.6	8.9	10	13.1	14	n.a.

Source: EBRD (2000), p.153; Date for 1990 are taken from EBRD (1997), p.220.

Note: * A sharp decrease in unemployment rate from 14.5% in 1995 to 10.0% in 1996 is strange because in 1996 demobilized soldiers appeared on the labour market, and this must push up the unemployment rate. I guess there was a change in methodology of measurement of unemployment between these two years. According to a different source (Jovancevic, 1999, p.246), the unemployment rate is 16.4% in 1996, 17.5% in 1997, 17.6% in 1998 and 19.0% in 1999.

was estimated at US$ 13.7 billion, approximately two thirds of the GDP. However, following the overall downturn in the economy, a sharp fall of the revenue from services, and a loss of markets in two neighboring countries, the total export figure was more than halved to a mere US$ 5.7 billion in 1993 (Samardzija, 1997, p.35). With the year 1993 as a bottom, in 1994 Croatian economy began to recover quickly. Then wages increased more quickly, which might have negative effects on economic performances, as Samardzija concerned herself. In 1995 only, real wages increased by almost 40% in Croatia. It seems to me that this is because wages had been suppressed for a while and abruptly at this time increased on the rebound. Anyway, this resulted in a boom in domestic demand and a 44% upsurge in imports but no real progress in terms of GDP (Samardzija, 1997, p.104). There remained a slump in export, which covered only 62% of import in 1995. In this connection, Croatia's ratio of export to import was 93.7% in 1973 and 86.3% in 1988, one of closing years of the former Yugoslavia. Compared with these figures, a slump in export in 1990s was very serious (SGJ 1989, p.325, p.418).

The composition of foreign trade partners has gradually changed. The share of West European countries has increased. In 1992 the share of EU in the total export accounted for 52.45%, former Yugoslavia 31.97% and Central East European countries (CEEC) and ex-USSR 5.79%. In 1995 the share of EU in the total export has increased to 58% while the share of former Yugoslavia and CEEC and ex-USSR accounted for 23% and 9% respectively. In 1992 the share of EU in the total import accounted for 46.79%, former Yugoslavia 23.24% and CEEC and ex-USSR 13.58%. In 1995 the share of EU in the total import has increased to 62.16% while former Yugoslavia and CEEC and ex-USSR accounted for 11.31 % and 9.31 % respectively. Let me see Croatia's foreign trade by countries. In 1995 the first place in its export was occupied by Italy (23.7%), followed by Germany (21.5%), Slovenia (13.1 %), Bosnia and Herzegovina (8.3%), Austria (4.3%), Russia (3.3%), France (2.4%), Liberia (2.3), USA (1.8%) and Netherlands (1.7%). In the same year the first place in Croatia's import occupied by Germany (20.1 %), followed by Italy (18.2%), Slovenia (10.7%), Austria (7.7%), UK (6.1%), USA (2.7%), Libya (2.5%), France (2.5%), Netherlands (2.3%), Switzerland (2.2%) (Samardzija, 1997, pp.106-109).

Nowadays the implementation of the second phase is negatively mentioned (Chamber of economy, 2000, p.2). Indeed such a violent inflation has calmed down within in a short time in 1993-1994. In this regard, Stabilization Programme of the economy was a success story as Ivan Teodorovic admits. However, he criticized the implementation of the second phase of the Stabilization Programme, saying as follows: "Economic policy that allowed for increasing domestic consumption and rising foreign debt in hand with a softening of the budget constraint had to end up with a softening of the entire fiscal system. Thus, a slowing down and in some aspects the reversal of the reform process had threefold effects: stagnant growth rates, increasing unemployment and social differentiation" (Teodorovic, 2001, p.2766).

Economic Restructuring

"State Dominated" Privatization

In April 1991 the law on transformation of social enterprises (the so-called law on privatization) was adopted. This law defined permissible paths and the general framework, and two of the supplementary laws provided the basis for direct state involvement in any sector of the economy. The strategy of privatization in Croatia had some characteristics: First, the state nationalized social capital and became an owner of 80% of the social capital; Secondly, the legislation provided the government with a prominent role and extensive discretionary powers in the privatization of re-nationalized enterprises; Thirdly, the legislation did not include any voucher schemes, but instead it introduced a system of discount in purchase of shares and gave priority to employees of the enterprise concerned; Fourthly, it was "revenue oriented" privatization (Bicanic, 1993, p.426). In this regard, more definite explanation was given by Kalogjera, describing that one of basic objectives of the privatization is to obtain funds necessary for paying public debts and financing recovery of the country by the sale of enterprises (Kalogjera, 1993, p.63).

As for the point that in initiating the privatization a big power was given to the state, the two doyen of the Croatian academic circles in economics critically described. Stressing the fact that in the years 1950-52 the process of shifting from a command economy to a market economy was firmly initiated in Croatia (former Yugoslavia) and in the following eight years, 60 per cent of the prices were completely liberalized, Branko Horvat characterized the privatization implemented in 1990s as backward transition. Similarly; in the keynote speech at the international conference in 1999 Dragomir Vojnic said as follows:

> Among all its advantages, Croatia only exploited market tradition to a certain degree. Thus, during the war, it did not have to introduce the war economy. However, all other advantages are not used. That refers to social ownership which represented by itself a very good basis for efficient realization of the fundamental segment of transition, that is, privatization. Already in the first step of privatization, the method of transformation abolished all advantages of social ownership, a step backward in the direction of state was made. Although state ownership had to have only a temporary character of transitive

form of ownership, the consequences were very difficult. It appeared to be a legal and institutional vacuum. The process of circulation and concentration of capital did not develop on the basis of entrepreneurship and entrepreneurial capability, but on the basis of political fitness (Vojnic, 1999, p. 17).

Although Croatia was ostensibly democratized, the political style represented by the former President Franjo Tudjman was rather authoritarian. Croatian Democratic Union (HDZ) had power since the election in Spring 1990. Owing to the single-member constituency system, with 48% of the total votes, HDZ was able to gain 65% of the seats in the Parliament. The first party in opposition has rotated at every general election in such a way that it was the former Communist party in 1990, Liberal party in 1992 and another party in 1996. Therefore, the political predominance of HDZ had never shaken until 2000. Ironically enough, such frailty of the opposition has brought a kind of stability of the regime at that time[2]. According to Puhovski, "All the really important decisions are made in some kind of court around president Tudjman, officially called the national defense and security council"(Puhovski, 1999, p.20).

The Process of Privatization

In 1991 the Privatization Agency and the Development Fund were established as organizations which should inherit the legal framework of the Federation and promote privatization. The role of the Privatization Agency was to check the submitted plans and supervise and monitor the privatization of enterprises. The proceeds of the sale went to the Development Fund. These were powerful organizations. The Agency had the power to install managers into loss-making enterprises. The Fund had equally great powers and no direct accountability. In its portfolio it had shares from almost all enterprises in the economy, making it the largest asset owner and thereby a market maker on the nascent stock exchange. For enterprises which it owned, it appointed managers and could initiate privatization when and how it saw fit. The two organizations merged into the Croatian Fund for Privatization in January 1993 (Bicanic, 1993, pp.422-428).

According to Bicanic, the privatization itself involved three rounds of share selling as well as allocating packages of shares to the development and pension funds. The first round was the sale of shares at a discount to employees, the second round was the sale of shares at full price to employees, and the third was the sale

[2] Interview with Professor Ivan Grdesic at Faculty of Political Science in Zagreb on July 9, 1997.

of shares without a discount to the general public. Shares in the first two rounds could be purchased by paying in installments for a period up to five years. Largest discounts were given to the employees when buying shares of "their" enterprises. The discounts were limited up to the value of 20,000 DM per individual purchase. These discounts were contingent upon the mode of payment and years of employment. The total value of shares sold in the first round was not allowed to exceed 50% of the total estimated value of the enterprise's assets (Bicanic, 1993, p.433).

It is said that managerial buyouts were preferred in the actual privatization. In this regard, Bicanic pointed out the problems, using an odd expression such as "the frequency and form of bending and rules and breaking the law". The most frequently reported way that managers attempted to buy a dominant position in companies were "managerial loans", "manager's insurance schemes", and "ghost buyers on one side and by undervaluing assets on the other"(Bicanic, p.435). "Managerial loans" are part of completely untransparent system by which top managers receive large and favorable loans from banks (whose managers are their established business partners and often friends) up to ten thousand DM. Sometimes the banks accept as collateral the shares themselves, overvalued real estate, or frozen "foreign currency savings deposits" (Bicanic, 1993, p.435; Kalogjera, 1993, p.81). The second way involved enterprises paying large insurance premiums for their managers which were then cashed for a discount at banks and the cash was used by managers to buy shares. The third way was to pay workers to act as ghost buyers of shares with large discounts and then sell them on the black market or cede them to a manager. Managers as sellers were frequently the main buyers due to the large number of managerial buyouts. Nevertheless, regarding asset evaluation, the legislation offered opportunity for undervaluing and incorrectly valuing assets (for example, location was not used in evaluation, book value was used in spite of inflation). Managers were not the only ones breaking and bending the rules. The privatization agency has been often accused of using privatization legislation for noneconomic (mostly political) goals. The most noted examples that Bicanic mentioned were the replacement of enterprises managers by party faithfuls in Istra and attempts to influence the media by putting the independent dailies and weeklies into receivership or regulating privatization by preventing employee buyouts so that the funds (and thus state) become majority power (Bicanic, 1993, pp.436).

Privatization at a Stalemate

In 1997 the privatization came to a standstill. According to the research by KopintDatorg, a Hungarian research organization, a deficiency of privatization practice so far has been that it has not been extended to the banking sector, the energy industry, public utilities companies and armament industry. The most widespread method of privatization has been the sale of a half of the share of a company to employees at a discounted price. A majority of non-privatized equity was handled by the Privatization Fund, another part was controlled by the pension funds, while five per cent was used for compensation. In the course of privatization, small and medium-sized companies have been purchased by employees and management using preferential credits. In contrast, large companies, which were nationalized at first, came under the management of confidants of the ruling party (E T, Vol.6, No.3, pp.176-177). As Drazen Kalogjera said, “every privatization is carried out favorably to ruling parties”[3]. In the case of Croatia, where the Croatian Democratic Union (HDZ) headed by Tudjman occupied a majority of the seats in the Parliament and maintained the Government from the election in April 1990 till January 2000, the evil is evident.

As of 1997 it was said offcially that 50% of all the enterprises were privatized. However, Kalogjera was skeptical to such a viewpoint. He argued that as a matter of fact 80% of all the enterprises were in hands of the State or under the control of the State. Nenad Zakosek depicted the situation in 1996 as follows: About 560,000 shareholders (which corresponded to some 12 % of Croatian population) in different companies, including both employees and managers, emerged out of the privatization process. There are unfavourable features: (a) ineffective capital markets, (b) negligible foreign investments, (c) lack of domestic capital, and (d) the fact that main privatization transaction are still controlled by the State instead of being channelled through stock markets. These features are limiting the privatization process (Zakosek, 1996, p.93).

According to Vojnic, hundreds of thousands of small share-holders found themselves in a very specific situation. This specific situation reflects the fact that besides formal rights given by the law, -they were plundered; because of restricted purchasing power, they could not repay their shares. Thus, a small number of tycoons supported by the ruling structures, concentrated huge wealth in their hands. These deviations cover a broad range from mass small crime, bribery and corruption, all to the organized crime on various levels of economy and society. Using expressions such as the classical appearance of “mafiacracy”, “savage capitalism” and “primitive accumulation”, Vojnic criticized the practice of privatization in Croatia. He said that in such a situation, the akeady relatively developed middle class, which is the foundation of civic society, has almost disappeared. In Croatia, which was best prepared for transition, the situation similar to that of Russia has appeared. Vojnic ascribed such deviations to the fact that advice of the World Bank and the IMF,

[3] Interview with Professor Drazen Kalogjera in Zagreb on July 10, 1997.

based on the concept "Washington Consensus", was applied to a macroeconomic and macropolitical environment specific to Croatia (Vojnic, pp.17-20).

Reorganization of the Banking System

According to Jovancevic, the break-up of the monetary system of the former Yugoslavia caused Croatian banks to become insolvent in technical terms. Large amount of banks claims on the National Bank of Yugoslavia became impossible to collect and, hence, household foreign currency deposits has been frozen since 1991. In addition, numerous companies found themselves in serious difficulties and were unable to repay their debts to banks. Consequently, the government recapitalized a number of major companies through the issue of treasury bonds called "big bond", which were used by these companies for their repayment of debts (Jovancevic, 1999, p.241).

The real enlargement of fixed assets from domestic sources was very small in 1990s. There are several reasons for that. Firstly, except a short period (1995-1997), the deposit rate has always been lower than the inflation rate since independence (see Table 1). As a result, the marginal propensity to save has been small; Second, highly fixed exchange rate did not encourage domestic industries to export orientation, so that the volume of production remained relatively low (proportionate to the size of domestic market) with high fixed costs of unit value of production. Consequently, the performance of domestic manufacturers and service activities have been not so profitable. As a result, savings on the enterprises' side remained also very low level; Third, the limited amount of domestic funds makes the price of capital (i.e. interest rate) more expensive. For example, the lending rate in 1995 was 22.3%, which was extraordinarily high, taking into consideration that the inflation rate in that year was 6.1 % (see Table 1). This might be related to the circumstances that the banking system was inefficient at that time; Fourth, as capital markets did not function sufficiently yet, it was not easy for enterprises to finance their equipment investment through this route. Thus essential modernization of production capacities became more difficult (Jovancevic, 1999, pp.255-256).

As domestic sources of funds were extremely limited, the objective condition of the Croatian economy keenly needed foreign direct investment, but the amount of FDI inflow was quite small until mid 1990s (see Table 2). As mentioned above, it reflected reluctant Croatian side's resistance to foreign investment as well as bad external relation of the government (Chamber of Economy, 2000, p.2). At length in August 1996 the both governments of Croatia and FR Yugoslavia accorded diplomatic recognition each other. This was greatly welcomed by the international community (Samardzjia, 1997, p.24). In the early 1997 Croatia received its first credit rating from three important foreign rating agencies, indicating the arrival of the period of peace and reconstruction and the end of the period of extreme political risk (Jovancevic, 1999, p.242).

Table 2

BANKS ACCORDING TO THE KINDS OF OWNERSHIP

Banks	1990	1994	1995	1996	1997	1998
State-owned	21	19	15	15	9	9
Privately-owned	5	32	39	43	51	51
Total banks	26	51	54	58	60	60

Source: Jovancevic (1999), p.242

The participation of foreign banks made it easier to rehabilitate Croatian banks. The process of bank rehabilitation started in 1996 with four large banks (Slavonska, Splitska, Rijecka and Privredna banka). Till then, the banking system in Croatia remained concentrated, which means that a small number of banks controlled a relatively large share of total assets and revenue. The privatization of banks proceeded in such a way that the existing banks were privatized and new private banks were established (see Table 2). Foreign banks have participated in the process. Whereas only one bank entered the Croatian market before 1996, during the period between late 1996 and 1997 six foreign banks opened branches or subsidiaries, that has contributed to an atmosphere of intensified competition. In 1998 majority of banks (85%) were predominantly privately owned. The shares in total banking assets were 70.2%. The other 9 banks (15%) were state-owned (or by majority), managing 29.8% of total banking assets (Jovancevic, 1999, pp.241-243). In the course of intensified competition among banks, some banks went out of business. In 1998 four banks (Dubrovacka, Zupanska, Glumina and Gradska banks), which had a huge amount of bad debts, became bankrupt. The losses of those four banks were reported about 600 million (Jovancevic, 1999, p.257).

Croatian Economy during the Second Half of 1990s

The economy started to recover in 1994. From 1995 to 1997 its growth rate recorded around 6 %. Above all the best performance was shown by building industry which was closely related to the reconstruction of the war-damaged-area. Even in 1998, however, Croatian economy could not recover its 1990 level, and it fell into a negative growth in the second half of 1998. Why?

As mentioned above, domestic sources of funds were limited, and it was, therefore, very difficult for companies to get bank loans. Until 1995 the amount of FDI remained very small. Per capita FDI was decisively small compared with other transitional countries in Central Eastern Europe. Due to the fact that capital investment in manufacturing industries and services has been unsatisfactorily already from the last years of the former Yugoslavia, technologies in Croatia began to become obsolete. For example, not so long ago the Croatia was the world's third biggest ship-builder and produced mainly for the world market.. After gaining independence, however, the shipyards stagnated in state hands and lost international competitiveness. Croatia is now the thirteenth in ship-building in the world (Horvat, 1999, p.55; BCE, May 2000, p.30).

On January 1, 1998 the value-added tax with a flat rate of 22% was introduced, replacing sales tax. The annual report of the Ministry of Finance denied its negative impact on the economic growth. The Ministry viewed the introduction of VAT successful because the 22% VAT meant a substantial reduction of tax rate from 26.5% to 22% and, at the same time, it succeeded in increasing the tax revenue through a wider grasp of considerable part of the informal economy. Instead, the annual report mentioned the negative impact of the financial crisis in East Asia, saying that negative perception of investors and increased sensibility to risk in the second half of 1997 have resulted in decreased capital investments of foreign investors in transition countries (Republic, 1999, pp.9-14).

In the 4th quarter of 1998 the GDP decreased by 0.8%. As causes of the decrease in economic growth, the annual report mentioned aggravating possibilities for borrowing in the domestic and foreign markets, the high cost of capital, difficulties in collecting outstanding -debts, decreased growth rates of domestic demand, and a lack of higher tourist consumption (Republic, 1999, p.11). This explanation might be valid for short-term changes in the economy, but the more fundament cause should be sought in the fact that Croatian economy has lost dynamics for its development. Under the fact lie structural problems such as decreased competitiveness in the manufacturing industry and the service industry, a delay in restructuring of enterprises and the banking sector and hypertrophied public expenditures. During the first quarter of 1999 the number of employed persons decreased by 3.2%. The unemployment rate jumped from 18.6% in December 1998 to 19.6% in March 1999. With the recession, the position of the central budget deteriorated. Although the budget registered surplus in the previous year, the budget deficit grew to 1,837 million kuna during the first quarter of 1999. In order to prevent further deterioration of the balance, in May the government approved a restriction package containing the saving of 3.5 billion kuna in expenditures. At the same time, due to the series of banking bankruptcies, large sums had to be spent to replenish the deposit insurance fund and to reduce the deficit of the welfare funds. In addition to restrictions in the area of fiscal policy, monetary policy also had to be tightened (E T, Vol.8 No.2, pp.129-130).

In 1999 exports and imports both declined. Exports attained US$ 4.27 billion (i.e. 5.8% less than in 1998). Imports amounted to US$ 7.77 billion (i.e. 7.2% less than in 1998). Although the trade deficit slightly (US$ 345 million) decreased, its amount remained as high as US$ 3.49 billion. Weak performance in the foreign trade is ascribed to the fact that no trade preference agreement exists with the EU, customs border came into effect with Bosnia-Herzegovina, and structural modernization has hardly begun in the industry (ET, Vol.9 No.1, p.39).

For a long time, Croatia has had a big amount of the deficit in foreign trade of goods. Only a part of foreign trade deficit has been covered by surplus in services and remittances by workers abroad, Therefore, a deficit in current account has remained, and it has been covered by receipts of sales of Croatian wealth (real estate, etc.) to foreigners and by rising foreign debt. In this respect, disastrous occurrences in the Balkans have negatively affected Croatian economy. Since autumn 1998 the tensions between Yugoslavia and the NATO were rising over conflicts in Kosovo, culminating at last in the NATO's air attacks on Yugoslavia from March to June. This time Croatia was not a battlefield. During the attacks, however, air fighters flied from basis in Italy to Yugoslavia across the Adriatic Sea. Such tensions discouraged foreign tourist who should have visited the Adriatic coast. As a result, the revenue from tourism decreased by half. Due to a decrease in the revenue from the tourism and the transportation, surplus in the balance of services decreased drastically. The accumulated external debts has doubled in four years from US$ 3 billion 699 million in 1994 to US$ 8 billion 489 million (Republic, 1999, p.97). In September 1999 the debt amounted to US$ 9.3 billion, so that the debt due in 2000 equaled US$ 1.7 billion, which became a heavy burden to the economy (Hrvatski, 1999, p.5).

The problem of inter-companies' debts became more serious. According to the data of the Institution for payment transactions, in June 1999 the companies' non-collected overdue debt amounted to 23.3 billion kuna, being 7.3% higher compared to the previous month. In August 1999, the amount of the recorded non-collected overdue debt increased by almost 62%, or by 8.9 billion kuna, compared to late 1998 (Hrvatski, 1999, p.7).

Whereas consolidated spending of the state accounted for 40.5% of GDP in 1994, it grew to 47.9% in 1998, and its share was expected to grow to 49.1 %. If the budgets of local authorities are added to government spending and non-budget funds, then the total public spending was estimated to ~. account for 70% of GDP (Chamber of Economy, 2000, p.9). In the central government budgetary expenditure of 1997 the biggest share was occupied by defense (20.32%), followed by social security and welfare affairs and services (18.76%), public order safety affairs (12.12%), education (11.78%) and transport and communication (9.98%). The budget of 1999 shows a different order with the biggest share being occupied by social security and welfare affairs and services (23.07%), followed by defense affairs and services (12.88%) and education (12.56%), transport and communication (11.65%) and public order and safety affairs (9.73%). In this way, although the expenditure for defense and public order has decreased, its share in the state budget remained high level. Among non-budget funds the most important were the pension fund and the health fund. Deficits in non-budget funds have been compensated by transfers from the central budget. 50.8% of the total transfer from the central budget in 1998 went to the pension fund, and 13.9% to the health fund (Republic, 1999, pp.47-48). As of March 1999, the number of retired persons was nearly one million, which seemed too much in a small country with the population of only 4.6 million. This meant that 1.6 active insured person worked for one retired person while in 1990 the relation was 3.2 to 1 (Republic, 1999, p.19). In this regard, the working programme of the new government critically mentioned problems such as a lack of discipline in the payment of pension and health care insurance, the recognition of claims regardless of financial conditions, and greatly uneven rights (Government, 2000, p.4). In order to conclude a stand-by credit agreement with the IMF, the expenditures of the budget had to be trimmed. As transfers from the central budget could not be maintained, it became inevitable to reform the pension and health care systems. Similarly, an agreement had to be reached with social partners in order to limit wage and price increases. In this way, Croatian economy came to a standstill towards the late 1990s (ET, Vol.9 No.1, pp.39-40).

Political Change

The economic difficulties show that Tudjman's methods have failed. People were dissatisfied with the situation in which Tudjman's adherents had amassed wealth while many people suffered poverty. Journal Business Central Europe reports the situation in the early 1999: "Opinion polls credit his ruling party - the badly divided Croatian Democratic Union (HDZ) - with a dismal 20% level of support. Worse, the man himself has dropped from the second most respected person in the country in January last year, to a pathetic 35th place now" (BCE, Feb. 1999). When Tudjman died in December 1999 after a long illness very few heads of foreign countries attended his funeral. In the face of increasing dissatisfaction among people, HDZ won only 40 seats out of 151 seats of the Parliament (24.38% of the total votes) at the general election held on January 3, 2000. A centrist and leftist union composed of the Social Democratic Party and the Social Liberal Party won 71 seats with a share of 40.84% of the total votes. As a centrist and rightist union, which won 24 seats, decided to support from outside of the Cabinet a coalition government was formed. A Presidential election taken place January 24, 2000 was contested practically by three candidates: former foreign minister Mr. Granic from HDZ, Mr. Budisa from the centrist-leftist union, and Mr. Mesic from the centrist-rightist union, composed of four parties including Peasant Party and National Party. As no candidate won a majority of the votes at the first ballot, the second ballot was to be held on February 7 between Mr. Budisa, a student leader of `Croatian Spring' in 1971, and Mr. Mesic, who has acted the last President of the former Yugoslavia in 1991 and Prime Minister and President of the Parliament of newly independent Croatia. As there was no big difference between commitments of both candidates like the reduction of the President's power, the EU membership, etc., `personality' of the candidates became a focus. Finally Mr. Stipe Mesic won with 56.21 % of the total votes[4].

The new Prime Minister of the coalition Government was Ivica Racan, the last leader of League of Communists of Croatia and the leader of the Socio-Democratic Party. The program of the new Government, based on the public commitment of the coalition groups, was a program of change in the Republic of Croatia, aiming to build civil society and a democratic and market-oriented state integrated in the EU. One of the most important tasks is to change the political system primarily by reducing the powers of the President of the State and by strengthening the role of parliament and the government. In addition, the new Government was obliged to aim to attain such very basic tasks as follows: the promotion of dialogue and tolerance for development of democracy and building of civil society; the establishment of an independent judiciary and the rule of law; the transformation of the Croatian Television from a state-controlled one to a public, independent and responsible medium, etc. The new Government aimed to join the WTO and the CEFTA. As for the EU, for the time being it aims to be an associate member (Government, 2000).

Prime Minister Racan called on the leaders of state enterprises and institutions to resign in order to wind up Tudjman's economic estate (ET, Vol.9 No.1, p.38). Racan administration broke off the nationalistic course. This is exemplified by its cooperative position toward The Hague's international tribunal on war criminals in the former Yugoslavia. Leaders of the West welcomed the new government in Croatia and tried to put an end to this country's international isolations[5]. In June

[4] My description on the elections is based on To oh Fairu [East European File](Kyodo Tsushin [Kyodo Correspondence Company]), No.521-522, pp.4-S, Niigata Nippoh [Niigata Daily Newspaper] February 9, 2000, and other Japanese Newspapers.

[5] According to Journal Business Central Europe, Mr. Racan has handed over sensitive documents to the International Criminal Tribunal on war crimes in former Yugoslavia, despite threats from war veterans to disrupt the all-important tourist season. He has also invited to UN officials to Croatia to investigate mass graves, prompting criticism from war veterans (BCE, June 2000, p.43).

2000 the NATO invited the Croatian government to participate in `Partnership for Peace'. This move was enough to upgrade the rating of this country. Meanwhile the Croatian government negotiated with the M' about a new loan. In July 2000 Croatia was admitted to the WTO. The relation with the EU has improved, and the Agreement on Stabilization and Association with the EU was concluded in October 2001.

Challenges of Croatia

In the period of Tudjman's rule, the economic restructuring has been inconsistently implemented. The new government is burdened with numerous tasks to be solved. Among others, a cutback in public expenditures entails painful measures such as reduction in the number of government employees and their wages, a cut in subsidies, reform of pension and medical care systems, etc., but the new government is pressed to implement this task first of all. At the same time, the government has to tackle with challenges such as the promotion of export, the introduction of foreign capital, the restructuring of enterprises and banks, the improvement of capital market, the acceleration of privatization with participation of foreign investors, the support to development of agriculture, a decrease in unemployment, minimum social protection, etc. In addition, the government must take care of 46,000 displaced persons and 140,000 Croatian refugees from Serbia, Montenegro and BiH (Government, 2000; Chamber of Economy, 2000).

The privatization is not completed yet. The challenge to accelerate the privatization with participation of foreign investors is especially important. According to Borozan and Barkovic (2002), the situation can be depicted as follows: During the first decade (1991-1999) 2,650 companies were involved in privatization. In 1991 the Croatian Privatization Fund (CPF) possessed 86 billion kuna of the state-owned portfolio. As a result of the selling, in 1999 there remained a non-privatized portfolio for 3.8 billion kuna. However, many companies have ruined under the management of Croatian `tycoons'. In that particular year they returned the shares of these companies to CPF, so that the portfolio drastically increased again. By September 2001 the CPF held 1,203 companies, whose stock capital amounted to 63.6 billion kuna with the state portfolio being 25.5 billion kuna. The government intends to speed up privatization, but most of the available portfolio is not attractive due to excessive indebtedness of companies, insolvency, technical obsolescence and inadequate structure of personnel. Only about 100 companies in industry, insurance and tourism are attractive enough to get foreign investors' participation.

FDI, which remained a low level in the first half of 1990s, began to increase in 1996. It is worthy of notice that FDI increased to US$ 1.6 billion in 1999 (see

Table 1). This shows that the Croatian government turned its course to actively introduce foreign capitals. In 1999, 35% of shares in Croatian Telecom was sold for US$ 850 million to Deutsche Telecom (in 2001 Deutsche Telecom purchased another 16% of for US$ 422 million). In the same year 66% of shares of Privredna Banka Zagreb was sold to Banca Comerciale Italiana. During the period between 1993 and 2001 the cumulative FDI in Croatia amounted to US$ 66.4 billion. The biggest investor in Croatia is Austria (27.23%), followed by Germany (25.81%), USA (18.17%), Luxembourg (5.59%) and Netherlands (3.63%). Data on FDI during the same period by sectors show that the most attractive sector is telecommunication (29.37%), followed by banking (17.26%), pharmaceutical industry (15.41 %), cement (5.05%), petroleum and gas (3.11%), hotels and catering (2.66%), trade (1.67%), bricks and roof tiles, etc.(1.53%), and beer brewery (1.35%). As we have seen, nearly half of the total FDI went to telecommunication and banking. Apart from pharmaceutical industry, FDI in manufacturing industry is very small. FDI in tourism is unexpectedly small. Hereafter it will be necessary to introduce bigger amount of foreign capital in these sectors. As the most prosperous type of investment, Borozan and Barkovic (2002) mentioned bluefield investments - sea investments, which are officially neglected and ignored.

It is indispensable to improve investment climate in order to attract bigger amount of FDI and activate business in the country. Sophisticated communication technology and transport infrastructure, which are indispensable in the era of global economy, have not sufficiently developed yet. In addition, there are administrative barriers which are hampering the inflow of FDI. Foreign businessmen have been often annoyed by troublesome and time-consuming procedures at various phases such as application for entry visas and work permits of foreign managers and workers, company registration and other business establishment procedures, location of business, i.e. land acquisition, construction-related permits, usage permit for utility services, etc. Foreign investors commonly complain of such “administrative harassment” (Borozan and Barkovic, 2002). In this regard, the Croatian government should learn active attitude of the Hungarian government toward FDI.

Croatia aims to join the EU by 2007, but the process seems to be uneasy. As other candidate countries have done so far, also Croatia is requested to accept acqui communautaire, revise its domestic legal system and restructure its economy in order to harmonize with the EU standards. This is an enormously time-consuming and energyconsuming process. Bartlett (2002) points out disadvantage of latecomers compared with Central East European countries and Baltic countries which will be admitted in 2004. The states left out of membership will face higher non-tariff barriers, lesser access for their workers to European labour markets, and fierce competition from the new member states than before. The support from the EU is very precious for Croatia, but the amount of the support itself has been not so large. In connection with the Stability Pact of South Eastern Europe, the EU offers the CARDS programme, which replaces the PHARE for the Western Balkans. Croatia became one of its recipient. The aim of the CARDS programme is more political rather than economic. It is a complementary factor to EBRD and World Bank support. It is geared towards actions in political areas, such as democratization, return of refugees, fights against organized crime and security of borders (Bartlett, 2002, p.11).

Although Croatia has the Adriatic coast with an abundance of tourist attractiveness, it seems very difficult to adopt the Norwegian approach[6] to the EU. Consequently, for several years Croatia will be requested to endeavor to satisfy the conditions for the EU membership.

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[6] As Norway is content to keep its rents from North Sea Oil to itself, it founds non-member association to be a satisfactory arrangement. Also Iceland has the same position because it is afraid of the adverse impact of the Common Fishery Policy on its fishing revenues (Bartlett, 2002, p 14).

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