Exchange Rate and Protection Policy in 'Croatian Development Strategy'

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Abstract: In this article authors critically examine the Croatian economic development strategy in context to country's exchange rate and protection policy. The paper also discusses the internal and external equilibrium as a policy criteria. Questions such as the policy of external and internal equilibrium: protection policy and liberalisation of the foreign trade; purchasing power parity exchange rate and the policy of foreign trade competitiveness, etc., are also embraced.

Policy of External and Internal Equilibrium

The criterion of external and internal equilibrium refers to a state of national economy at which both the current and capital accounts, are in equilibrium; and where in the domestic market, equilibrium prices prevail ensuring an appropriate use of economic capacities, i.e., when the criteria of full employment of production factors is fulfilled. The equilibrium condition denotes the absence of inflation, balanced state budget,

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equilibrium (real) interest rate, and particularlly equilibrium (real) foreign exchange rate, (a key variable). In other words, the macroeconomic policy must be consistent with the monetary and fiscal policies, such that it leads to a real rate of exchange and to a sufficient aggregate domestic demand. In turn, the real exchange rate ensures equilibrium of the current balance of payments, and the aggregate domestic plus the export demand ensure a full utilisation of national economic capacities. In literature, it is the famous Swan-diagram (Corden, 1992; Pilbeam, 1992; Mead, 1954). The purpose and goal of macroeconomic policy is to re-establish a disturbed equilibrium condition, or to strengthen its stability. Consequently, the state of national economy must be in equilibrium and stable. Stability condition implicitly implies the ability of the market to get back to the equilibrium condition, whenever it falls out of it because of an external 'shock'.

Macroeconomic policy helps this process through its instruments. A key role in a small open market economy belongs to the real equilibrium rate of exchange, maintenance of which is influenced by the expansionary or restrictive monetary and fiscal policy. The objective of a real equilibrium rate of exchange policy is to struggle with the inflationary economic tendencies, ensuring full employment of countiy's potentials. However, these objectives should be consistent with the equilibrium criterion in both current and capital balance of payments. Current deficit in balance of payments of the country should be sustained by capital inflows over a reasonable period of time and financed.

The expansive or restrictive monetary and fiscal policy, in context to interest rate and exchange rate policies, or balance of payment equilibrium policy, are key instruments of macroeconomic co-ordination of policies in economically advanced countries. Such a co-ordination on a global level is also under way among the members of the International Monetary Fund which is now trying to develop its 'supervision' function of the exchange rate policies in member countries (Crockett, et al 1987). The stabilisation programme of Croatian government in the form of a *Memorandum on Economic Policy*, was presented to the International Monetary Fund. It included corresponding 'supervision' of the accomplishment of performance accepted by the stand-by arrangement. The 'surveillance' particularly includes the monetary and fiscal policy in realation to the exchange rate policy and is linked to domestic economy's competitiveness on the world market (Government of Croatia, 1994).

In Croatian context, the government and the central bank policy is oriented towards the solution of inflation problem through measures such as: monetary restrictions, exchange rate fluctuations within a narrow band, and stabilisation policy. The Central bank defends these 'limits' by interventions on the foreign exchange market. Until recently, all that has led to a system of ceiling on the purchases of the offered foreign exchange, both by the citizens and the business sector, in order to

keep the money supply within the given antiinflationary framework. In other words, the Central Bank, only within such ceilings, increases the foreign exchange reserves, while the commercial banks are restricted by their credit potential in buying of the offered foreign exchange. This is how monetary policy can successfully keep price stability, if the budget deficit monetisation is eliminated.

Restrictive monetary policy along with direct control of wages has kept the aggregate demand low enough, making the Croatian kuna stronger, i.e. appreciated. If Croatian kuna is appreciated because of the weak demand for foreign exchange for the import of raw materials and capital goods, then the relatively high interest rates suggest a too strong restrictiveness of the monetary policy, that keeps the business sector away from the production increase on the basis of existing capacities by taking too costly loans to finance the working capital.

It could be said that a sustained insistance on the use of anti-inflationary policy instruments produces a conflict of too rigorous anti-inflation objectives with the production recovery policy.

Under conditions of maximum fiscal discipline, enormously low utilisation of economic potentials of the country, raises the question of rationality of economic stabilisation policy not recognising the recovery problem of the economy in time. Appropriate policy of promoting aggregate demand would with a certain delay, depreciate the local currency and gradually improve the competitiveness of the economy in short and medium term. Such a policy gives slower effects than the policy of one-time devaluation.

In present-day circumstances in Croatia high inflation is not a danger so long as the real depreciation can be carried out by credit expansion (e.g. through decrease of legal reserves), maintenance of fiscal discipline and a certain degree of control of wages without wage indexsation. Last two of the mentioned policies are being strictly implemented. The total sum of wages would increase by credit expansion, partly through the increase in employment, and partly by an increase in productivity.

The Protection Policy and Foreign Trade Liberalisation

Nominal tariff protection (explicit tariffs) is expressed by tariff rates on the imports of finished products. The system of protection increases product prices on domestic market. Increase in imported goods prices decreases their consumption (at the given income) and enables domestic producers to increase their product prices and to be competitive on the domestic market. Thus, nominal tariff protection system changes the structure of consumption. However, in order to strengthen the effect of tariff protection on particular sectors and allocation of resources, along with nominal tariff protection of finished products, it is also necessary to take into account the protection

of intermediary products. Tariffs on intermediary inputs increases prices of products, and thus decreases the profitability of production on domestic market and in this way determines the allocation of economic resources. Therefore, so as to ascertain the tariff protection of particular sectors it is necessary that from the nominal tariffs on the products of these sectors the amount of tariff protection of intermediary products that are used in their production, is deducted. In such a way we will have an effective tariff protection of particular sectors of the economy, because the effective protection implies the value added to an economic sector. In order to analyse the influence of tariff protection on allocation of resources, it is necessary to calculate the effective tariff protection rate of the particular sectors (the percentage increase in the value added per unit of production of the sector affected by the tariff) (Zdunić, 1993).

In analysis of protection and exchange rate policy in any development strategy, it is necessary to expand the content of effective tariff protection by including non-tariff protection of domestic inputs, and to show how foreign exchange rate policy (of appreciation/depreciation) influences protection of particular sector of the economy.

However, if we take into consideration changes in the foreign exchange rates, the protection rate of particular sectors will be changing. Thus, appreciation of foreign exchange rates can be considered as import subsidy (negative tariff) and as export tax on export sectors. Consequently, changes in foreign exchange rates influence the protection structure and effects. If appreciation rate is e.g. 30 per cent, all export sectors with a rate of effective protection less than 30 per cent will be taxed in relation to goods sold on domestic market, and only the rate of effective protection over 30 per cent could really protect domestic producers. If we subtract it from each rate of effective protection along the commodity list we get the scale of net effective protection rates. Only sectors with positive net effective protection rates are really protected. Accordingly, in order to asses correctly the effects of the whole protection system on resource allocation it is necessary to evaluate the level of appreciation and depreciation of national currency in context of a given protection structure.

Nominal protection in Croatia is implemented through the instruments, some of which have protective purposes while others a fiscal character.

Because of Croatia's desire to join the WTO, it is necessary to re-examine the measures of its non-tariff protection and to adjust them to the rules of GATT, particularly with regard to the rules of the Uruguay Round negotiations. It is necessary to analyse the role of non-tariff protection from its consistency point of view with regard to the foreign exchange rate policy under a more liberalised regime of the foreign trade system. Transforming non-tariff protection into 'implicit tariffs' we get a measure of the total nominal protection (explicit plus implicit tariffs). On that basis it would be easy to get a real measure of effective protection of the whole Croatian economy.

Sekulić (1994a) has estimated effective tariff and non-tariff rates of protection for Croatian economy. It is an experimental estimate (by adding 16 per cent to each sector as an estimation of the non-tariff protection) of only indicative effective rates of protection. To estimate the effective tariff protection rate of the Croatian economy the available regional input-output model for the year 1987 was used and the interregional (former interrepublics) trade flows were considered as foreign trade flows. In this way an interregional input-output table was constructed consisting of domestic and foreign flow of goods with old and new (former Yugoslav republics) foreign countries. Customs tariffs for Croatia for 1991/1992 were used to estimate the effective tariff protection and its explicit and implicit component.

According to the purchasing power parity theory, foreign exchange rates trends are explained by trends of domestic and external prices. Indicators of real foreign exchange rates are obtained if nominal rate indices of the local currency based on foreign currency (e.g. Deutschmark) is divided by the corresponding relative price index series in a given period. If the indicators of real foreign exchange rates are greater than 100 it is a sign of a real depreciation of the local currency, and if the values are below, it indicates a real appreciation of the local currency in relation to the base period. For estimates of the real rate in relation to Deutschmark (DEM) for the period I/1985 until XII/1997, monthly data on the price trends in the industry of Croatia and the wholesale prices in Germany were used. Trend indices of the wholesale prices in the country and abroad, as well as the trends of nominal rates, are recalculated to a permanent base (June 1992=100). June 1992 is chosen as the base period because trends of nominal foreign exchange rates followed the best trends of prices beginning December 1989. Besides, there was no public request for changing foreign exchange rate in that period. By applying above methodology and approach, the indices of real exchange rate of Croatian kuna based on DEM, are shown in the Figure 1. Especially interesting period is from 1990 to 1997. That period can be divided into three subperiods:

I period: I/1990 to VIII/1991 represents real appreciation of Croatian kuna;

II period: IX/1991 to VI/1992 represents its real depreciation; and

III period: VII/1992 to XII/1997 represents a renewed real appreciation of the currency.

This holds good if we presume that the period around June 1992 was of a real equilibrium exchange rate. As can be seen in Figure 1. the first and the third period are characterised by a real appreciation of local currency. After June 1992 there is a period of continuous appreciation of the local currency with a tendency to speed up. By December 1997 in relation to June 1992, Croatian kuna as against the DEM has actually appreciated by 41.32 per cent.

The effects of any real appreciation on the foreign trade trends are well known. Namely, it creates incentive for purchasing of foreign goods and discourages exports

Figure 1: Indicators of real exchange rate of Croatian kuna related to DEM on industrial price index basis. Services and personal incomes (June=100)
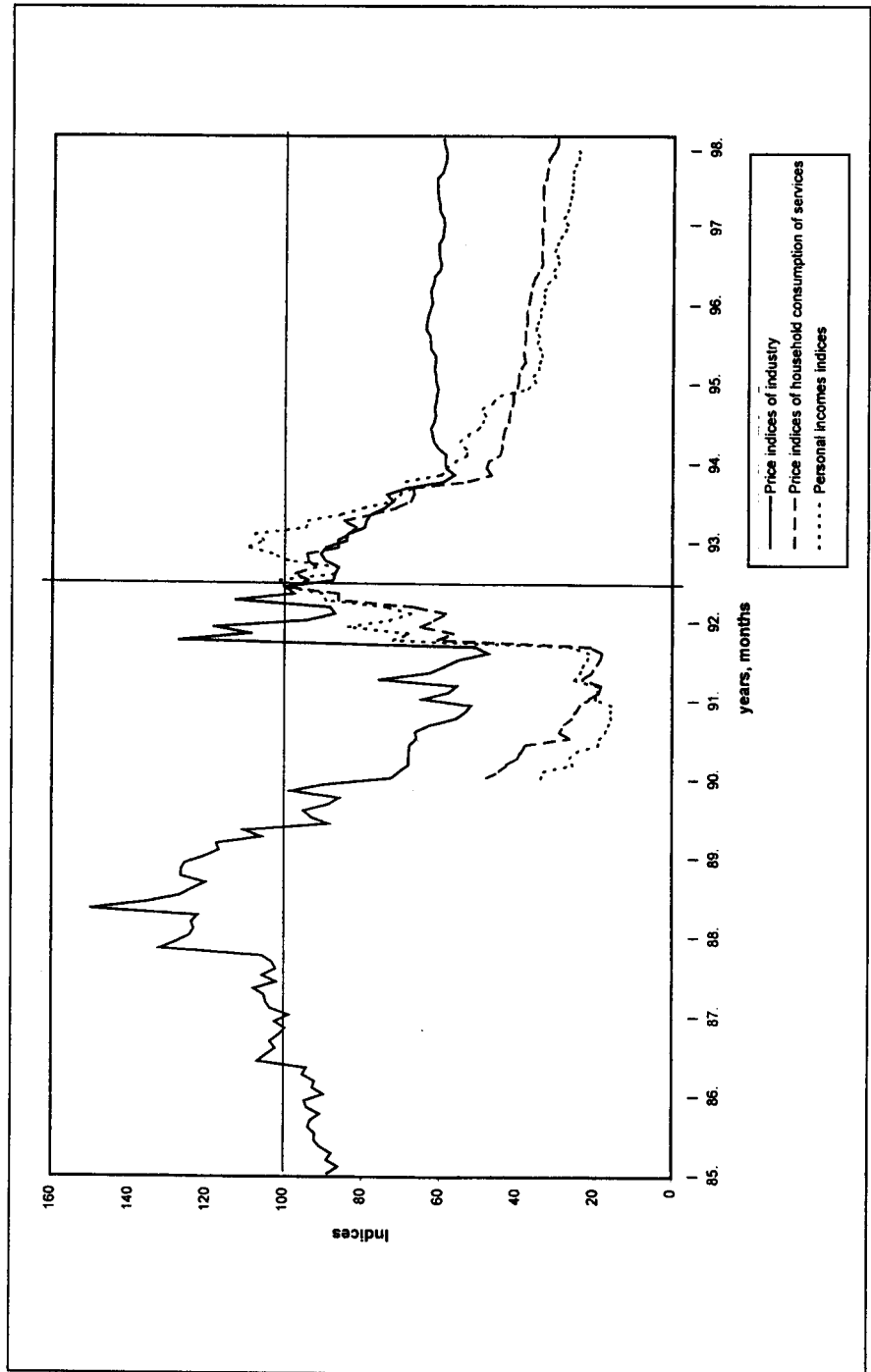
and purchase of domestic goods. This being a result of a higher purchasing power of the domestic currency (kuna) abroad. On the other hand, real depreciation stimulates exports, discourages imports, and decreases deficit in the trade balance with foreign countries.

Trends of commodity exports and imports of the Republic of Croatia are given in Table 1.

Table 1. shows that during the period of a real appreciation of Croatian kuna after 1992, the result was an increase in the deficit in foreign trade balance of Croatia from US\$ 303 million in 1992 to US\$ 5244 million in 1997. Trade balance deficit increased during the slow export growth and the fast import growth. Trade balance deficit increase shows an unfavourable trends in commodity flows with foreign countries (without the former republics of Yugoslavia with which a surplus in commodity exchange of US\$ 353 million in 1996 and US\$ 311 million in 1997 was registred). Such trends are usually a consequence of a real appreciation of domestic currency. As the world prices prevail it is well-known that an appreciated domestic currency worsens the position of the export sectors in a small country. In these conditions they receive a continuously smaller value equivalent in kuna terms for exported goods.

However, exchange rate policy is one of the factors influencing the competitive position of the country, export and import trends, and the balance of payment equilibrium. Since, Croatia is a 'small country' it behaves as an 'acceptor' of the world prices, such that the Croatian export trends depend upon internal rigidity of export supply and elasticity of export to world prices. Croatian export trends have been influenced not only by economic factors, but also by other non-economic events in the war and post-war period, such as trade embargo (1991, 1992), distribution of quotas of ex-Yugoslavia etc.

In addition, it should be noted that in future process of development more non-price factors competitiveness such as: quality of products differentiation, level of development of products, technological competitiveness, selling conditions etc., will become significant.

Real appreciation of the local currency brings about a higher dispersion of relative prices of non-traded goods in relation to the prices of traded goods. It means an increase in internal terms of trade,[1] which suggests that production in the exposed export sector becomes less profitable than the production in the non-export domestic sector. As a result, real appreciation in medium-term stimulates the redistribution of profits in favour of domestic non-export sectors and supports sectoral reallocation of resources from exporting to non-exporting domestic sectors (Dornbush, 1975).

Thus, it can be said that an appreciated local currency can have unfavourable effect on export competitiveness, and that under conditions of a more intensive liberalisation policy it will be necessary to adjust the import and export policy by

Table 1.: Commodity export and import of Croatia, 1990-1997

	1990	1991	1992			1993			1994		
			Without former republics of ex-Yugoslavia	Former republics of ex-Yugoslavia	Total	Without former republics of ex-Yugoslavia	Former republics of ex-Yugoslavia	Total	Without former republics of ex-Yugoslavia	Former republics of ex-Yugoslavia	Total
Commodity export	4020	3292	3127	1470	4567	2938	966	3904	3293	968	4268
Commodity import	5188	3828	3430	1031	4461	3894	773	4667	4657	572	5229
Balance	-1168	-536	-303	439	136	-956	193	-763	-1364	396	-968
Export/Import (%)	77,9	86,00	91,17	142,6	103,0	75,45	124,97	83,67	70,71	169,23	84,7

	1995			1996			1997		
	Without former republics of ex-Yugoslavia	Former republics of ex-Yugoslavia	Total	Without former republics of ex-Yugoslavia	Former republics of ex-Yugoslavia	Total	Without former republics of ex-Yugoslavia	Former republics of ex-Yugoslavia	Total
Commodity export	3572	1061	4633	3293	1219	4512	2918	1283	4171
Commodity import	6660	850	7510	6922	866	7788	8162	942	9104
Balance	-3088	210	-2877	-3629	353	-3276	-5244	311	-4933
Export/Import (%)	53,63	124,82	61,69	47,57	140,76	57,93	35,75	133,01	45,82

Note: Commodity export and import data for Croatia for years 1990 and 1991 include inter-republic trade as inland trade. Since 1992 ex-Yugoslav republics are considered as foreign countries. Accordingly, the data for Croatia is shown separately for ex-Yugoslav republics, and for the rest of foreign countries.

designing an appropriate real equilibrium exchange rate. Moreover, it is necessary to design a more active policy of export expansion, from 'soft' export market areas to 'hard' markets where non-price competitiveness is more important.

As Croatian export has a higher import content, export expansion will require a greater increase in import. Therefore, the consequence of a possible import restriction policy, would result in a decrease in production and exports. The solution lies in co-ordination of export-import policy so as to attain faster economic growth and external equilibrium.

If the former Yugoslav market outside Croatia is treated as a foreign market it is supposed that the income export multiplier will be lower today than it was before the Croatian sovereignty. This fact has a very important consequence for the growth projection of gross domestic product, i.e. lower export multiplier implies lower GDP growth rate, but also a convertible liquidity on a higher level.

From effective protection point of view, it is necessary, at this stage, to asses the kuna appreciation . In December 1997, for example, if the rate of real appreciation of kuna to DEM in relation to selected base period of June 1992, amounted to 41.32 per cent it can be concluded that every sector with an effective rate of protection less than 41.32 has a negative rate of net-effective protection. Accordingly, such activity is not really protected by the given structure of tariff and non-tariff protection system. If we illustrate the point by indicative data of the effective tariff and non-tariff protection of the Croatian economy (Sekulić, 1994b), it can be seen that no sector of the economy is really protected, because all the rates of tariff and non-tariff protection range between 16.01 per cent and 35.84 per cent and they are smaller than 41.32 per cent. Negative difference between the rate of real kuna appreciation and a particular rate of effective tariff and non-tariff protection shows the level of taxation of exports of the given activity, and not of its protection.

However, the ability of the economy to ensure a partial profitability in spite of the appreciated kuna is maintained temporarily due to an increase in cheaper imports of raw materials, spare parts and equipment from abroad (outside the former Yugoslav region) with decreased tariff and non-tariff protection rates. Such policy measures increase the possibilities of savings on the cost side. As a matter of fact, in 1987 the share of domestic inputs in intermediary consumption amounted to 59.4 per cent, imports from the former Yugoslav republics to 25.5 per cent, and from other countries to 15.1 per cent (Sekulić, 1994b). Since the import of intermediary inputs is nowadays mainly oriented to convertible area, there are possibilities of some cost savings due to the relative appreciation of the local currency. Supposing that the share of domestic inputs remains 59.4 per cent, and the rest (40.6 per cent) is import of inputs from convertible area, the overvaluation of kuna by 41.32 per cent in relation to DEM means a cost saving of 16.8 per cent on an average for the whole economy.

Since individual sectors have a different import dependence, there are different sectoral effects of kuna appreciation on the cost side.

Continuous increase in the real kuna appreciation will induce pressures for introducing higher protection of the domestic economy.

The policy of exchange rate adjustment, therefore, becomes necessary in order to release tensions and pressures which are evidently increasing.

The methods of exchange rate and protection policy adjustments belong to the sphere of macroeconomic policy, thus the same becomes a part of the whole development strategy of the country. However, it is necessary to stress, as to how the importance of exchange rate policy shall increase the foreign trade liberalisation. We strongly feel that this importance will result with the expected entry of Croatia in the World Trade Organisation, the application of the rules of the Uruguay Round of negotiations.

In priciple, exchange rate policy must support development and an efficient allocation of resources in the long run, but it should also follow antiinflationary foreign and internal equilibrium policies. It means, therefore, that it is necessary to interlink exchange rate, trade, monetary and interest rates policies into a consistent stabilisation policy and development strategy of the Croatian economy.

Purchasing Power Parity (PPP) Rate and the Competitiveness of the Economy

Starting from internal and external equilibrium as a development criterion of the national economy, exchange rate policy on the PPP is important. The rate based upon the PPP is considered as the long-term real equilibrium exchange rate to which the current market equilibrium exchange rate converges. Usually there is a significant volatility of current market exchange rates around the long-term trends of exchange rates and the PPP rates. The PPP of a currency is defined as the value of that currency, which means 'that with a given amount of money, when converted into different currencies on the PPP exchange rate, the same basket of goods and services in all countries can be bought. In other words, PPP is the rate of a currency which removes the differences in price levels among countries' (OECD, 1992). Current market equilibrium rate of exchange evidently differs from the PPP rate.

Above definition is the so-called absolute PPP. The relative PPP denotes changes in the absolute parity in current period in relation to the base period. An ideal base period would be when the current (market) rate of exchange is equal to the purchasing power parity exchange rate . That would offer a firm support for the measurement of conformity or deviation of future changes in the current (market) rate of exchange from PPP rate of exchange. The simplification of the procedure of measuring disturbances of market rates in relation to PPP rates consists in selection of the base

period assuming the equality of both rates in that period. Then we simply measure their deviations by deflating the current market exchange rates by price (retail or producer prices), indices of nominal wage, or cost of labour indices, etc (Balassa, 1964).

Developed countries statistical research reliably confirms that the current market exchange rates as a rule are lower than the exchange rates based on the PPP basis. For the developing countries reverse is true. We know that

- the growth of labour productivity in export sectors of the economy is faster than in local (domestic) sectors; and
- differences in the labour productivity growth among the countries are smaller in local (domestic) sectors than in export sectors of the economy.

Explanation of these trends can be found in the old and new literature (Officer, 1976; Turner, et al 1993).

The consequence of the faster global growth in labour productivity in developed countries involves a faster growth of wages than productivity in their local sectors of the economy. It moves the labour force into export sectors which because of their higher productivity can attract workers by paying higher wages. So, these export sectors in competitive world markets enable these countries to appreciate their currencies. Higher labour productivity and the possibility of higher wages in the export sectors compensates relatively slow productivity growth and a faster growth of wages (in relation to developing countries) of the local sectors. The consequences of these trends are that the relative prices of the domestic sectors in underdeveloped countries are lower in comparison to the same in developed countries. The prices in export sectors in developed countries are, on the other hand, relatively lower than the prices of these products in developing countries. The entire domestic sector basically consists of tourism and related services sector. Therefore, the tourist sector of underdeveloped countries easily competes with that of the developed countries, because their labour rents are distinctively lower than the wages in service sector in the developed countries. It should be noted that labour force is the basic input in service sector activities.

As the market mechanism leads to relatively higher prices in export sectors of developing countries the current market equilibrium exchange rate in developing countries is higher than the real equilibrium exchange rate on the PPP basis. External prices of export sectors of all countries in world currencies are equal due to the mechanism of competitiveness. Thus, relatively lower domestic prices of local goods and services in developing countries are a certain reserve for cost savings (on labour force, first of all) for export sectors. In developed countries it is just the reverse.

Above analysis indicates the importance of relative prices of goods and services in export sectors as opposed to domestic sectors. In developing countries a relatively slow growth of prices in local sectors of the economy as against the price growth in export sectors is expected. A better measure would be an absolute level of prices of the 'basket' of goods and services from export sectors compared to such a 'basket' of domestic sectors. Such differences in the price level are evident in the differences between the purchasing power parity exchange rates and the current exchange rates. Since there is no available 'stylised' statistics of domestic sector prices and export sector prices of the country, we can use an approximation of decrease or increase in their relative price relationship indices in industry, indices of nominal personal incomes and price indices of services.[2]

The Croatian situation should be judged in the light of above analysis. The exchange rate of Croatian kuna against DEM is deflated using these three series of indices taking into account the price inflation in Germany. Time period of statistical observations is 1985-1997 and 1990-1997. Monthly series of real exchange rates of Croatian kuna against DEM are constructed on the following basis:

- real exchange rate of Croatian kuna against DEM based on industrial price indices show that local currency was appreciated during 1990-1991, if June 1992 is taken as the base.

 - on an average in 1992 Croatian kuna depreciated compared to 1990/1991 and later years. It means that the appreciation period from 1993 to 1997 is similar to the period of 1990/1991 compared to the base period;

- trend of indices of real exchange rate based on service sector prices in relation to the base period indicates a similar characteristic in the industrial (export) sector. It, however, contains a systematic 'over appreciation' after early 1993, which means that the domestic sector gradually lost its 'cost reserve' function of export sectors;

- real exchange rate based on personal incomes during January 1990-1993 was appreciated, meaning that for the exporters labour costs were relatively increasing. Only for a short period from the beginning of 1993 (because of strike threats) real exchange rates were depreciated or costs declining. After the first quarter of 1993 the trend of the Croatian kuna appreciation reassumed its increasing trend leading to a real increase in costs for exporters. In 1994 through 1997 real exchange rate calculated on the basis of services and personal incomes show appreciation of Croatian kuna more than price indices of industrial products. In December 1997, according the price index of services, kuna appreciated 69 per cent, while according to personal incomes indices 76 per cent. This fact suggests that for the exporters the costs grew faster than the revenues. These percentages of the appreciation indicate tendencies of diminishing competitiveness of export sectors on the domestic market.

As it would be expected in a developing country, local goods and services did not show a tendency of 'cost reserve' to exporters. Current costs appreciation of Croatian

kuna compared to 1992 denotes a process of gradual diminishing competitiveness in export, as well as in domestic market where products could be substituted by imported goods. The corrections of such a conclusion is cheaper import of raw material and spare parts for production. Growing demands for protection in the form of import licenses, surtaxes and tariffs undoubtedly refer to this.

The competitiveness of the export market has three essential aspects:

- export competitiveness ensures balance of payment equilibrium as well as full employment of the entire national economic potential;

- developing countries by real depreciation of their currencies achieve better results on the world competitive market, as well as in the dynamics of global growth of their economies;

- for all countries integration into regional and global trade systems, exchange rate policy (especially policy of real depreciation), becomes a fundamental instrument in development strategy of an open economy. This is especially true for a small open economy if it takes into account the effects of an expenditure switching policy.

After reaching an adequate level of development measured by per capita income, a greater importance in development strategy can be attributed to the policy of fixed and stable exchange rate in order to achieve structural adjustment to the world market. At current stage of development of Croatia the basic goal of development strategy should be full inclusion of the country into the world financial system and market. This is the phase of the liberalisation of capital accounts and the entire balance of payment which was preceded by a gradual liberalisation of the foreign trade system and the domestic financial system (Grgić, 1998). All this need to be co-ordinated through the macro-economic stabilisation policy.

NOTES

[1] Internal terms of trade represent the relationship between price indices of the non-traded goods.

[2] All data on the basis of which indices are calculated, as well as the real exchange rates of Croatian kuna against DEM, are from the official statistical sources.

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