

Editor's note

This edition of the *Croatian Economic Survey 1996-1999* presents a collection of selected articles originally published in the Croatian language in *Privredna kretanja i ekonomska politika* (Economic Trends and Economic Policy) during the 1996-1999 period.¹ To put it in a historical perspective let us say that the *Croatian Economic Survey 1996-1999* represents a continuation of a journal with the same title that was issued annually in the period 1992-1995. In the few years of its existence, the *Croatian Economic Survey* established itself as an edition with quality articles by a number of Croatian and international authors on economic issues mainly related to Croatia. In addition, it was well received in the academic community worldwide. However, circumstances have not allowed the renewal of this publication until now. The issuers' intention is to continue to publish the *Croatian Economic Survey* on regular basis, with the next edition covering the period 2000-2001, to be published during 2002.

Since the current edition covers four years of monthly editions of *Privredna kretanja i ekonomska politika*, it was a difficult editorial task to pick up a preferred number of not more than ten articles for publishing in this edition. In doing so the selection process was guided by the following rules: use of modern theoretical models and empirical analysis methods, research of Croatian economic phenomena, generality of the research and conclusions, and relevance of the article's research and conclusions for the present-day situation. I have chosen nine articles that I found to be appropriate.

The Croatian economy went through many changes in the 1996-1999 period. The end of wide military activities gave way for a post-war reconstruction. International obligations towards the Paris and London clubs

¹ Source publication *Privredna kretanja i ekonomska politika* is currently a quarterly economic journal jointly issued by Institute of Economics, Zagreb and Ministry of Finance of the Republic of Croatia.

were resolved by reprogramming in 1995 and 1996, allowing Croatia to enter international financial markets. The needs for the renewal of business equipment and business activity, as well as the release of previously suppressed household consumption resulted in a huge growth of domestic consumption, and consequently, the growth of trade and current account deficits (current account deficit amounted to 12 percent of GDP in 1997). This led to a rapid accumulation of foreign debt, which almost doubled in this period (with government share ever growing towards 40 percent). Domestic household consumption was supported by enormous growth of bank credits. Due to weak newly organised supervision by the Croatian National Bank, the credit boom ended in a banking crisis (1998/1999) which caused a minor disturbance in the exchange rate. The stability of the exchange rate and prices was maintained throughout the period, and is the best overall result of the Croatian economic policy in that period, which can be largely attributed to the prudent monetary policy. A stable exchange rate and low inflation kept the competitiveness of Croatian export and the real sector at a largely unchanged level - the need to compete in the world market resulted in the need to restructure exports and the real sector. The bulk of the restructuring in the real and exports sectors stopped during the war, or had never been started, or slowed down. The restructuring itself brought a few short-term improvements, with an increase in productivity gained by laying off the "technical surplus" of labour as the most obvious indicator that was difficult to implement politically. The official unemployment rate grew above 20 percent, and established itself as one of the key Croatian economic problems in the later part of the 1990s.

Monetary policy had to take into account the worsening of the fiscal stance in the above mentioned period - although tax reforms strengthened the revenue side, the expenditure side (especially in the extra-budgetary funds) expanded by ever-growing number of social benefits. The worsened fiscal stance required increased financing that the government found in international financial markets, due to more favourable terms (e.g. lower interest rates) offered abroad than at home (the first issue of the Croatian eurobonds came out at the beginning of 1997). The financing needs of the government received additional financing through privatisation deals in 1999. The first larger privatisation deal was the sale of bigger Croatian banks that underwent rehabilitation (before the banking crisis of 1998/1999).

The development of the financial sector was rather slow, with M4 reaching 42 percent of GDP in 1998 when the banking crisis broke out, and was powered mainly by the development of the banking sector. Non-bank financial institutions started to develop more firmly only at the end of the 1996-1999 period.

Let me draw your attention now to articles published in this issue. The first article by *Martina Dalić* "Price Effects of Value Added Tax", is an analysis of the impact of the introduction of VAT in Croatia in 1998 on the overall price level - that was made prior to the actual introduction. The author estimates the maximum direct (one-off) increase of prices that could follow the introduction. Based on the composition of the retail price index, the maximum one-off effect of VAT introduction was expected to increase the overall retail price level by 2 to 5 percent.

Andreja Pufnik in "Purchasing Power Parity as a Long-Run Equilibrium: Co-Integration Test in The Case of Croatia (1991-1996)" tests the purchasing power parity condition for Croatia, using unit root tests and the co-integration method. The author uses three exchange rates - bilateral exchange rate of Croatian kuna towards German mark, Italian lira and US dollar. The research establishes that, in the observed period one cannot accept purchasing parity even as a long-run concept, probably due to the short period of data available for the analysis, structural breaks and transition anomalies.

The next article "Public Debt Boundaries: A Review of Theories and Methods of The Assessment of Public Debt Sustainability" by *Sandra Švaljek* reviews the methods for analysing the sustainability of the public debt. The article tries to assess the sustainability of the Croatian government debt that started to rise in the second part of the nineties. In her analysis the author uses the solvency method, the debt/GDP ratio method and the time series method. The author concludes that, although Croatia at that time did not have high public debt burden, the dynamics of the public debt (especially external public debt) raised fear of unsustainability in the years to come.

Amina Ahec-Šonje and *Danijel Nestić* try to explain the observed difference in the price levels between Croatia and other countries in their article: "International Differences in Price Levels: Empirical Analysis". They use the results of the European Comparison Program for 1993 as the statistical basis for their research and try to establish key factors explaining differences in national price levels. In the regression analysis authors tested the influences of real GDP per capita and per person employed, tax revenues, government spending, population density, openness, revenues from tourism, transfers and income on the price level in Croatia. Real income per capita has proved to be the key explanatory variable, along with openness and the size of the economy.

The interrelation of economic policies and the growth in Croatia is analysed in the article "Macroeconomic Policies and Economic Growth - The Current Situation and Perspectives", by *Andrea Mervar* and *Danijel Nestić*. Authors consider the main characteristics of economic growth

in Croatia, evaluate perspectives of future economic growth and the role which specific measures of macroeconomic policy could have in promotion of these perspectives.

The contribution of tax system to the economic growth is analysed by *Marina Kesner-Škreb* in "Taxation Policy and Economic Growth". Besides the review of the theoretical linkages between the tax system and growth, the author gives an outstanding review of the Croatian tax system and its reform in the nineties. Certain novel features of the reformed Croatian tax system, like the protective interest rate in the profit tax, have interested several European governments into considering similar changes in their tax codes.

Velimir Šonje analyses the financial development and its linkage to the economic growth in "Financial Development and Economic Growth". Since the financial development in most developing countries was led by the banking sector, the author focuses on the impact of the banking sector deepness (measured by bank assets/GDP, etc.) on economic growth, and establishes a significant positive relationship between the two.

The sustainability of the economic growth through its effect on the environment is analysed by *Željka Kordej-De Villa* in "Environmental Protection Policy in Countries in Transition". The author reviews the environment protection policies in various transition countries and in Croatia, and argues that environmental policies in transition countries and Croatia have been neglected and that they should gain more attention especially in the finalisation of the process of integration of those countries in the European Union.

The final article by *Amina Ahec-Šonje*, "Leading Indicators of Currency and Banking Crisis: Croatia and the World", implements a new signals approach to the currency and banking crisis on Croatia. It analyses several indicators suggested by theory that should precede a currency and banking crisis, and analyses the event of the banking crisis in Croatia in 1998/1999 and the subsequent currency disturbance. The author argues that a system of indicators signalled a warning for both the banking crisis and the currency disturbance.

We hope that the renewal of the publication the *Croatian Economic Survey* will meet the reputation and the standards that were established by the 1992-1995 annual editions. Furthermore, we also hope that it will bring the analysis of the Croatian economy closer to the worldwide economic audience.

Guest Editor:

Ante Babić

Institute of Economics, Zagreb and Croatian National Bank

Zagreb, 10 April 2002