

NEW CHALLENGES

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Two years from the implementation of the anti-inflation program (in October 1993), the Croatian economy is again on the verge of the situation which requires active moves in the economic policy for a significant improvement in general performances of its functioning. It seems partly to be a logical consequence of the transformed economic and geopolitic circumstances (freeing of the greatest part of the occupied territory, Dayton Agreement, Paris Club agreement, successful implementation of the stand-by arrangement) which are posing new preferences to the economic policy. But it is also arising from the wearing out of the initial effects of the positive activity of the anti-inflation program upon the financial and the real sectors of the national economy and thereby from the formation of the short-term tendencies the continuation of which is not complementary to new preferences. Changing these tendencies in accordance with the changed circumstances and new preferences and then consolidating them for a long term appears to be the basic preoccupation of the economic policy at the present moment. From the previous stopping of the hyper-inflation with the acceptable economic and social costs, the objective of this transformation into a more sophisticated and more dimensional requirements to induce the economic growth adequate to the necessities of the reconstruction and development of the country while keeping the inflation low.

This situation is not only expanding the horizon of the economic policy but it also takes the basic short-term goal of its previous activity (low inflation) as a permanent assumption and the condition for the realization of the basic long-term goal (economic growth) while making the assumption that there is no trade-off between these two economic phenomena. The experiences of many countries clearly show that such is the case in the long run, but not necessarily in the short period,

particularly if the total economy has to face the re-orientation from the modalities of functioning in the conditions of high inflation to the modalities of functioning in the conditions of the low inflation, or generally speaking from the so-called "soft budget constraint" to the "hard budget constraint". And that not at a "desired" initial level of prices or at "desired relative prices" but at the prices existing at the moment of stopping the high inflation. The situation should be changed gradually in a way and with the intensity that is not going to put the spiral of the general inflation.

In order to grow in such conditions the national economy has to establish the global efficacy with which, at a given level of prices, it could continually achieve the net savings as the basic assumption for the reproduction of the capital and the economic growth. For a country that has just got out of the hyper-inflation, additionally burdened with the consequences of war and the crisis of transition, this is not easy to realize in a short period of time.

By a successful implementation of the anti-inflation program, the prices of commodities and factors have been initially stopped at the levels they have attained as a result of a hyperinflation, which has been manifested differently on partial commodity markets, money, foreign exchange and workforce as well as the capital (fragmentary) market, autonomously and in connection with the corresponding administrative influence on the formation of some of the prices. The prices have then been kept on the level or changed in accordance with the development of the conditions on these markets. The common direction of the action of anti-inflation policy has been reflecting, in a different way and with varying intensity, on them, with of course, different initial partial determinants.

As the resultant of all the differences, the stability of the initial level of prices has been kept in practice on the commodities market and on the foreign exchange market while, simultaneously, there has been a rise in the price of money and the gross price of labour and consequently the

costs of the domestic factors. Part of the increase has been neutralised by the global elimination of the inflationary taxing of the incomes from the sale of goods and services, but a part has remained to be neutralised only by an increased efficiency of the use of these factors so to enable saving, at the lower relative prices on the commodity and foreign exchange market.

During the first year following the stopping of the hyper-inflation the problem has mainly been covered by the effects of remonetisation of the national economy and re-substitution of the foreign exchange by the national currency by which the foreign accumulation has been multiplied and transferred into domestic money flows, ensuring the general growth of income and domestic aggregate demand. As, with regard to the low initial level of the domestic effective demand and quantity of domestic money in circulation in relation to the existing level of supply of commodities and foreign exchange, the intensity of the process had not been endangering the stability of prices, it has been directly transferred to the domestic production, in the real and financial aspect, ensuring thus financing of the increased costs of money and gross costs of labor on that basis.

All this has been making, however, an illusion that the national economy is tending towards the equilibrium at the existing level and at the existing relations of the relative prices and therefrom it followed that it was possible to maintain the economic growth without a significant previous increase in the global efficacy, or that the efficacy would be gradually increasing together with the economic growth. When the real basis of the remonetization started to decrease in 1994 and when the economic policy started to limit the increase in the money supply so that a further increase in the demand would not bring the increase in the commodities and foreign exchange prices, it has been demonstrated that the existing efficacy has not only been insufficient to generate impulses for further growth of the economy but that it has not been able to ensure maintaining the reached level of the production at the existing

relations of prices. The really increased costs when related to the realized growth of the production and incomes from the sale of goods and services lead in the conditions of the slowing of the money supply increase, to the problem of nonliquidity and, with it, to the further increase in the price of money.

In accordance with that, the domestic aggregate demand stops growing, and its relatively big part is directed towards the imported products the relative price of which has, previously, not been following the real increase of the domestic incomes. Moreover, as at the moment of stopping the hyper-inflation the initial foreign exchange rates on the foreign exchange market have been established in the conditions of the high substituting of the domestic money by the foreign exchange, inducing thus the relative surplus of the by strengthening the effects of the real appreciation of the exchange rate which occurred at the time of hyper-inflation, the prices of the imported goods have been significantly lower than the prices of the domestic commodities (more so than at the time preceding hyperinflation) squeezing out the domestic products from the market. As the foreign exchange reserves are enabling it, the deficit of the foreign trade is increasing and in the conditions of the stopped growth of the domestic demand it begins to be representing the direct limitation of the placement of the domestic products. This is being reflected on the production, not only on the problems of liquidity. The initial postinflation growth is ceasing and the drop is starting - both being shortterm effects complementary to the maintaining of the low inflation as the foreign trade deficit in the real and monetary limitation of the foreign exchange demand in the financial sphere are becoming the crucial market limitations of the possible growth of the domestic prices.

Though simplified, the scenario is reflecting the essence of the process and the problems the Croatian economy has been facing during 1995.

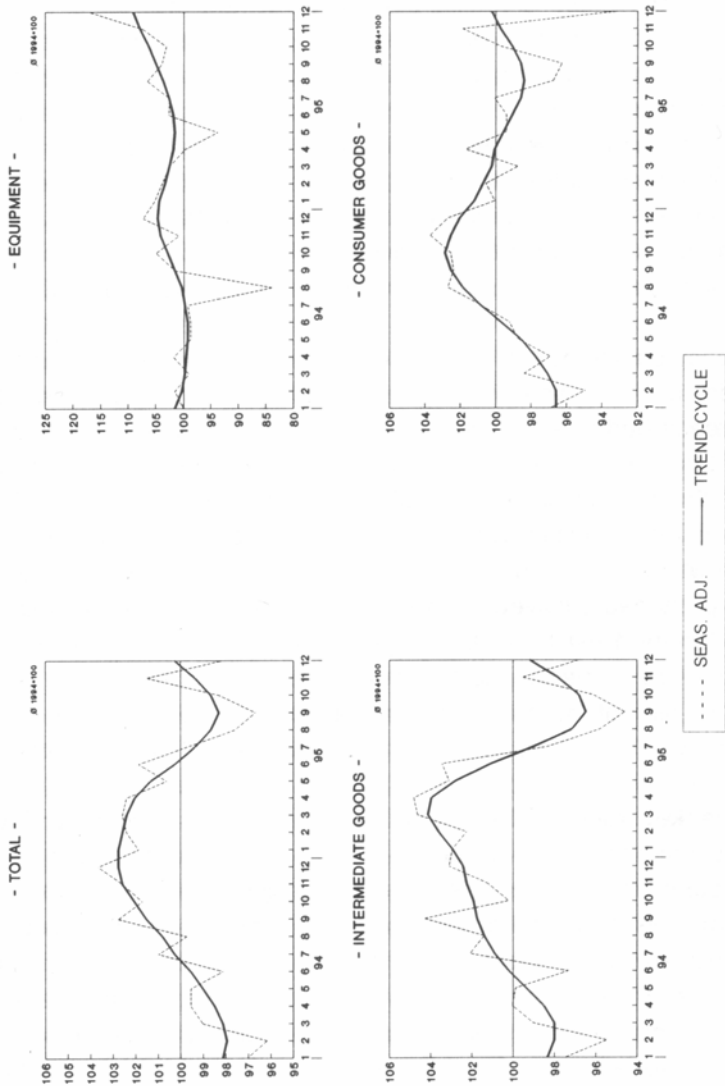
After it has shown the growth at the rate of 0.3% a month during 1994, the tendency of the growth of the industrial production had been stopped in 1995 and its dropping at the rate of 0.4% a month had started. It had lasted continually for 10 months to reach the stagnation level towards the end of the year which was by 4.0% lower than the post-inflation maximum realised towards the end of 1994 and by 1.8% lower than the average of 1995. Thus it can be said that the drop of the intensity of the industrial production in 1995 still remained lower than its growth realised in 1994, making 1995 monthly level of production, owing to the positive transfer of 2.5% 1994 level, be 0.3% higher than the previous year - the first such case since 1987.

Accompanied by branch and season atypical oscillations, such within-year and inter-year movements of the total industrial production in Croatia had been primarily determined by the relations in the sector of the intermediate goods production which accounted for about 47% of the production and about 54% of the exports of the Croatian industry. That is the sector in which the post-inflation tendency of the growth of the production generated by the domestic demand and exports had survived for the longest period, lasting continually from February 1994 to April 1995 at the rate of 0.4% a month, to drop suddenly in the May to October period at the rate of 1.3% a month, stabilising at the end of the year at the level by 4.1 % lower than the yearly average and by 6.3% lower than the end of 1994 level.

The key role in shaping of such tendencies was played by the movements in the area of the oil and ground gas production, production of oil derivatives and processing of chemical products the maximum of which has been reached in the middle of the year during the liberation operations of the occupied territories. The following drop in the production coincides with the tendency of reduction of the consumer goods production as well as with the drop in the deseasoned level of the demand for final products on the domestic market arising because of the unfavourable movements in the tourism (35% reduction of the number

INDUSTRIAL PRODUCTION

Figure 1.



of overnight stays). However, owing to the high transfer of the level of these productions from 1994 to 1995, the continuation of the growth tendency of the production in oil industry during the complete first half of 1995 as well and due to the relative continuity of the exports by which the oscillations of the movements on the domestic market have been softened, the mentioned branches have succeeded to realize the within-year growth of the production determining thus the inter-year movements of the total industrial production.

The intensity of the movement has been determined by mutually essentially different tendencies in the sectors of the means of labour and consumer goods production. In machine building industry, the branch which had been, in previous years, among the most affected by the loss of external and low demand on the domestic market, the growth of production has started at the beginning of the year at the rate of 3.4% and has been followed by 2.5% revival of the activities in shipbuilding. As the production of electric equipment and devices, the key branch in that sector, had managed, owing to the exportation, to maintain continually the level of the production in 1995 above the 1994 average, the production of the means of work has increased during 1995 by the total of 3.7% so that its average level in the year had been 4.1 % higher than in the previous year.

On the contrary and despite the tendency of the growth of the foodstuffs production, the consumer goods production had been decreasing during 1995 at the rate of 0.6% so that in spite of the 2.6% positive transfer from 1994 the 1995 interyear level has decreased by 1.0%. It is primarily the result of the continual decrease of the production of the final wood products (of 2.1 % monthly), finished textile products (of 1.5%) and leather footwear and accessories (of 3.2%) during the whole 1995, and though the result had been relatively high in the wood and textile industries with the tendency of further growth, it had not been sufficient to compensate for the problems in the placement on the

Table 1
CROATIAN INDUSTRY IN 1995

- Index

	PRODUCTION				EXPORTS		IMPORTS	
	Structure	TREND-CYCLE			Structure	1995/ 1994.	Structure	1995/ 1994.
		1995/ 1994.	12.95/ 12.94.	12.95/ φ 95.				
TOTAL	100.0	100.3	96.0	98.2	97.1	108.3	89.5	146.8
Equipment	12.9	104.1	103.7	105.3	11.6	102.2	17.5	146.3
Intermediate goods	47.3	100.1	93.7	95.9	52.7	117.8	55.3	141.8
Consumers goods	38.9	99.0	92.9	96.6	35.6	99.4	27.2	145.6
Electricity	7.9	104.9	110.2	103.1	0.0	48.0	1.1	288.7
Crude petroleum and gas	2.0	105.5	92.7	92.0	0.8	170.8	9.4	148.6
Petroleum products	3.6	126.9	75.8	80.6	7.6	103.9	0.8	114.4
Metal products	4.0	96.8	104.8	105.1	3.2	114.1	4.7	170.4
Machine	3.3	114.6	125.2	110.4	3.6	106.3	8.9	148.9
Shipbuilding	5.1	100.9	138.5	125.8	5.6	86.0	1.1	394.1
Electrical equipment	5.6	105.8	91.1	96.4	6.7	123.5	10.9	159.0
Basis chemicals	3.7	101.5	93.0	99.8	12.6	172.1	4.8	135.7
Chemical products	9.2	100.9	90.5	95.3	5.7	99.5	7.9	162.4
Building materials	4.1	99.6	104.9	105.6	0.9	81.3	0.4	205.8
Timber	1.7	95.5	91.7	100.3	3.2	107.4	0.5	141.1
Finished wood products	5.1	91.0	77.1	87.0	4.0	106.8	1.3	170.5
Textile fibre	2.9	89.7	76.9	85.5	1.9	93.9	1.9	134.1
Finished textile products	6.7	94.0	83.9	91.1	15.0	108.9	4.3	122.2
Leather footwear and accessories	1.8	76.9	67.8	82.0	5.5	82.0	3.3	110.1
Food products	15.5	104.1	103.1	103.1	6.9	98.8	6.7	151.2
Beverage	3.1	100.9	112.0	110.1	1.5	171.4	0.8	99.3
Tabacco	2.5	93.1	69.5	66.7	0.5	78.6	0.3	147.3
Printing	2.2	100.8	97.0	100.0	0.2	32.7	0.3	209.9
OTHER SECTORS					2.9	127.3	10.5	120.8

Source: Central Bureau of Statistics

domestic market on which the foreign competition had been becoming stronger.

Though we cannot generalise, the examples of these branches may illustrate the basic change in the macroeconomic conditions in which the industrial production during 1995 had been proceeding in relation to the conditions of 1994. While in the previous year the fast remonetization of the national economy at the stable prices together with the growing exports and complementary action of the imports had been giving a general impulse to the growth of production (particularly in the second half of the year) which showed in almost all the key branches, the

impact of these factors during 1995 had been more differentiated in the inter-relations and partial influence of each one on the movement in particular segments of industrial production.

With the value of US\$4633 million (97% of which belongs to the industrial products) and the yearly growth of 8.7%, the goods exportation was the global factor in the structure of aggregate demand which, in 1995, had been contributing to the growth or at least had not been dominantly inducing the drop of the production in either of the key industrial branches with the exception of the production of leather footwear and accessories.

The production of the finished textile products (US\$696 million), basic chemicals production (586) as well as the production of oil derivatives (350), of foodstuffs (320), of electric equipment and devices (312), processing of the chemical products (264), shipbuilding (260) and the production of the leather footwear and accessories (254) have been the biggest export branches, realizing 66% of the total goods exports. If there are added the production of the final wood products (185) and shipbuilding (166), over 73% of the total exports had, in 1995, been concentrated on 10 of 35 industrial branches which together participate with 60% in the structure of the industrial production. If the production of oil derivatives and foodstuffs are excluded as the above average oriented to the domestic market, the remaining 8 branches participating in the structure of the production with 40% had realized 59% of the total exports. In these branches the average value of the exports was reaching 57% of their total revenue, according to the 1994 data, and it has been almost three times as much as in other branches (22%), determining thus the average of the total industries of 34%.

Such structure of the exports which does not differ significantly from the structure in the previous year, no matter how divergent short-term tendencies in the movement of the production, is in fact only the reflection of the structure and the level of present production the total

capacities of which have been dimensioned for much greater, payment capable and more protected domestic market and for more extensive connection with the world market; the present use of the above has partially been reflecting, with different intensity, the totality of the events in and around Croatia during the past five years. In the conditions of the general drop of the production and exports in the indicated period, the drop has been less expressed in the branches which have been placing relatively larger quantity of their products on the markets on which the mentioned events had had less negative influence, in the sense of their relative closing towards Croatia, which then had directly reflected on the structure of the export offer as well.

Table 2
EXPORTS AND IMPORTS OF GOODS

- In Million of USD

	EXPORTS		IMPORTS		DEFICIT	INDEX 1995/94	
	Value	Struct.	Value	Struct.		EXPORTS	IMPORTS
TOTAL	4633	100.0	7510	100.0	-2877	108.7	143.6
EU COUNTRIES	2672	57.7	4664	62.1	-1992	105.6	150.6
- Italy	1098	23.7	1366	18.2	-268	120.7	137.3
- Germany	997	21.5	1509	20.1	-512	105.9	136.0
EFTA COUNTRIES	59	1.3	219	2.9	-160	90.6	195.8
COUNTRIES OF FORMER YUGOSLAVIA	1061	22.9	850	11.3	211	109.6	148.5
- Slovenia	608	13.1	805	10.7	-197	109.3	148.8
COUNTRIES OF FORMER USSR	185	4.0	224	3.0	-39	105.5	88.1
EAST EUROPEAN COUNTRIES	229	4.9	473	6.3	-244	119.0	152.6
OTHER COUNTRIES	427	9.2	1080	14.4	-653	129.7	122.0

The expression of this has been in the regional high concentration of the demand for the Croatian products - only four countries: Italy (US\$1098 million), Germany (997), Slovenia (608) and Bosnia and Herzegovina (383) had absorbed 67% of the total goods exports of the Croatian economy, with three countries: Austria (200), Russia (152) and France (110) covering further 10% of the exports. The structure of their demand and the level of the competition on their markets had been logically determining the present day structure of the Croatian exports, and with it partially the structure and the level of the production.

At the same time, having kept, during the whole of 1995, the increased level from the last trimester of the previous year, the imports have reached the level of US\$7510 million which is by 43.6% higher than in 1994. In the branch structure dominant are: electrical equipment and devices (816), oil and natural gas (709), machine building (666), processing of chemical products (594), transport means (522), production of foodstuffs (500), base chemicals (358), metal processing (324); those items and the agricultural products (344) make up 69% of the total exports, further 6% being made by the importation of the products of paper industry (231) and non-ferrous metallurgy (US\$208 million). In accordance with such branch structure of the imports and the general level of regional dispersion of the total foreign trade activities, 7 countries which are the greatest importers of the Croatian products with own exports of (US\$4600 million) were participating with 61 % in the structure of the Croatian imports (68% if oil imports are excluded), and together with the importation from Great Britain (455) the share was raised to 67% (74% if oil importation is excluded).

In this way, during 1995. with relatively high branch and even higher regional concentration of the exports and imports. a deficit had been formed in foreign trade of US\$2877 million which was. at the essentially unchanged level of the domestic production three Mmes bigger than in 1994 (US\$969 million) Present in the trade with all the greatest foreign trade partners, apart from the countries of the former Yugoslavia, and with the average degree of covering the imports by exports of some 61.7%, it is primarily concentrated to 8 industrial branches: production of oil and natural gas (US\$671 million), of electrical equipment and devices (504). machine building (500), of transport means (450), chemical products processing (330), metal processing (202). foodstuffs industry (180) and non-ferrous metallurgy 1,160) the agriculture (241) The sum total of the deficit for 1995 is US\$3238 million and 81 % bigger than in the previous year (US\$1785 million).

Over 32% of the deficit (US\$1044) had been covered at the level of the total trade surplus realized in trading of textile products (372), oil derivatives (292), shipbuilding products (178), sawn wood materials and panels (111) and finished wood products (91), but the surplus in these branches had been by 11 % lower than in 1994, with a simultaneous balancing of exports and imports of the leather footwear and accessories which had realized the surplus of US\$89 million in the previous year.

If the complex of oil industry is excluded from the considerations, the increase in the total deficit from US\$168 million in 1994 to US\$379 million in 1995, is the result of the war caused increase in the consumption of the oil derivatives in the country, the decrease of the surplus or increase in the deficit in the trade of in majority of key branches of the Croatian industry had been realized in 1995 mainly owing to the high increase in the imports at the growth or at least no significant drop in their exports. This has partly been the indicator of a certain complementarity of the imports and the domestic production and exports, particularly in the sector of equipment (the deficit of which has been US\$775 million, double of the 1994 figures) where it can be explained by the gradual strengthening of the investment activities in the country while partly it had been undoubtedly the factor of tightening of the import competition which is directly or indirectly limiting the possibilities of the placement of the products on domestic market (firstly in the consumer goods sector).

In connection with this, it seems indicative to mention that the deficit had been formed at the total value of exports to the areas outside former Yugoslavia of US\$3572 million, which was 89% of the value of exports in the pre-war period. As, simultaneously, the gross domestic product had been in real terms lower in 1995 in relation to 1990 by about 30% (expressed in the current value of the dollar), with the industrial production being by 44% lower, the ratio of that part of the exports in the structure of the gross domestic product had increased from 16% to 21 %. With all the methodological problems connected with

the change of inter-currency relations, with the differences between the effective rate by which the trade is controlled and the rate at which the gross product is being calculated, it was still the indicator that the Croatian economy had mainly succeeded, in the past five years, at the significantly lower level of the production to carry out relative substitution of a part of lost markets of the former Yugoslavia countries as well as of the part of the market of eastern Europe with the relative increase in the placement of products on more demanding markets of European Union, without which the drop in the domestic production would have been much more expressed. Naturally, it had to be reflected on the structure of the exports by destination, in which the share of the equipment had been reduced from the previous 20% to 12%, while the share of the exports of the intermediate goods and technologically less demanding consumer commodities (when the competitiveness of the Croatian producers was objectively greater) increased.

At the same time, the value of the imports from the areas outside former Yugoslavia amounted to US\$6660 million which was by 28% more than in 1990, increasing its share in the gross domestic products from 21 % to 39%. In this way, not only the former imports from the areas of former Yugoslavia and partly from east-European countries had been globally substituted by the imports of commodities from the European Union, but the non-substituted part of the imports had been also increased in the absolute and even more in the relative aspect. In accordance with that, connected to the drop in the domestic production and consumption of the intermediate goods, in the structure of the total imports the importation of the equipment had increased from 12% to 18%, importation of the consumer commodities from 26% to 27% while the importation of the intermediate goods had dropped from 62% to 55%.

Therefore, if considered in the long-term context, the present high deficit in the foreign trade basically is not arising from the relative decrease of the tendency to export but from the increased tendency to import. This

had partly been the result of the decrease of the domestic supply because of the non-economic reasons and of the change in the structure of the demand on the domestic market. It has partly been the logical consequence of the low domestic savings the inflow of which directed to investing had not exceeded 5% of the gross domestic product, so that in the present conditions almost two thirds of low investment activity in Croatia had been financed by foreign accumulation by means of the deficit of the current transactions of the balance of payments, arising itself from the trade deficit. Finally, partly it had undoubtedly been the result of the significant real appreciation of the exchange rate during the period of hyper-inflation so that the present day exchange rate of the national currency is about 50% really higher than the fixed exchange rate at the beginning of 1990, relatively lowering the costs of the import expenses and increasing the expenses of the export products - both expressed in the national currency.

Here it should be borne in mind that in the meantime not only had the mechanism of the forming of the exchange rate been changed, but so had the objective balance of payments situation in which Croatia as an independent country has found itself in relation to the situation in which it had been as part of the former Yugoslavia. Formally, the structure of the balance of payments had remained similar, but the effective foreign exchange flows have essentially changed. As there have been no more inter-republic foreign exchange transactions and transfers and as the realized foreign exchange inflow remains effectively in Croatia or leaves Croatia on the basis of the payments to foreign countries, its real foreign exchange position has changed with regards to the former status in the sense that the relative effective foreign exchange inflow had been increased and its relative effective outflow decreased. Owing to that, when the mechanism of the administrative forming of the exchange rate had been abandoned and the matter had been left to the work of the market it was logical that there appeared the tendency of the appreciation of the real exchange rate in relation to the previous administratively formed level both to the exchange rate of the former

Yugoslavia and the exchange rate that had been defined at the moment of Croatian independence.

This naturally does not mean that the effective appreciation of the exchange rate during the time of hyper-inflation and directly after the implementation of the anti-inflation program was exclusively of the market character. Contrary to that, during hyper-inflation it had primarily been the result of high inflation expectations which had been exceeding the effects of the administrative attempts of indexation of the rate until October 1993, and after that the result of the process of the re-substitution of the foreign exchange by the national currency, but the stabilization of the exchange rate on the market afterwards had, in a much more significant measure, been the result of just such relations. In such conditions the foreign exchange market had not reacted on the fast remonetization of the national economy during 1994 nor on the appearance of the deficit in trade during 1995 as well. With regard to the small size of the national economy, the changes in the area of the economic relations with foreign countries had, during 1995, essentially determined (in real and monetary sphere) the movements on the domestic market - with partial interventions arising from the anti-inflationary orientation of the economic policy with regard to the intensity of transferring particular effects of the changes in foreign trade onto the economy movements. The high deficit in trade and not so good results in tourism have resulted, in the January-November 1995 period, in the deficit in foreign trade of US\$2139 million which approximately corresponds to 13% of the gross domestic product, increasing by this amount the level of the aggregate supply above the domestic production. About one fourth of the deficit had been financed by the positive balance in the current transfers and incomes, so that the total deficit of the current account of the Balance of Payments had, in that period, reached the amount of US\$1635 million, representing the inflow of the real foreign accumulation at the level of about 10% of the gross domestic product. At the same time, in the conditions of the deferment of payment of part of foreign credits increased use of commercial

commodity credits and the increase in the inflow on other basis, the total surplus in financial transactions of US\$2123 million has been reached, so that despite high deficit of the current account, the foreign exchange reserves of the central bank had increased, in that period, by US\$488 million. They had remained approximately on that level until the end of December (493) and had thus been increased by 35.1 % in relation to the end of 1994. Thus, the economic relations with the foreign countries, apart from influencing the increase in the aggregate supply, had represented the real basis for creating domestic currency.

Table 3
BALANCE OF PAYMENTS

- In Million of USD

	1993	1994	1995 (I-XI)
A. CURRENT ACCOUNT	104	103	-1635
1. Goods	-763	-969	-2702
- credit	3904	4260	4298
- debit	-4666	-5229	-7000
2. Services	632	738	563
- credit	1807	2293	2372
- debit	-1175	-1550	-1809
3. Income	-141	-125	-67
- credit	112	101	157
- debit	-253	-256	-224
4. Current transfers	376	459	570
- credit	555	602	726
- debit	-179	-143	-156
B. FINANCIAL ACCOUNT (net)	270	584	855
C. NET ERRORS AND OMISSIONS	76	102	1268
D. RESERVE ASSETS	450	789	488

Source: National Bank of Croatia

In accordance with that, the quantity of the base money had increased during 1995 by 2 billion of Kuna or by 42.1 % within which (with stronger policy of sterilisation through increase of deposit of business banks at the central bank of 68.3%) the currency outside banks had been by 707 million of Kuna or by 26.6%. With the simultaneous increase in the deposit money by 22.2% the money supply (M1) had increased by 1597 million of Kuna or by 23.9% while its within-year

deseasoned tendencies coincided with the tendencies in the movement of foreign exchange reserves: until the end of September, the money supply had been really increasing at the trend rate of 2.0% to start decreasing in the last trimester at the rate of 0.9%. At the same time, corresponding with repayments on the basis of the old foreign exchange savings and increase in the foreign exchange savings, the foreign exchange means in the business banks had been raised by US\$467 million, which in totality resulted in the increase of the kung countervalue of the foreign exchange deposit by 57.8% and in the increase of their ratio in the structure of total liquid means from 48.4% at the end of 1994 to 54.9% in December 1995. Thus the means had, during 1995, increased by 39.3%.

Table 4
NET DOMESTIC ASSETS OF THE BANKING SYSTEM

- In Million of Kuna

	12.1993	12.1994	12.1995	INDEX	
				1994/93	1995/94
1. Currency outside banks	1367	2658	3365	194.4	126.6
2. Demand deposits	1772	4015	4905	226.6	122.2
I. Money supply (M1)	3139	6673	8270	212.6	123.9
3. Time deposits	1984	3103	3645	156.4	117.5
II. Total deposits in HRK (M2)	5123	9776	11915	190.8	121.9
4. Deposits in f/c	5711	9174	14479	160.6	157.8
III. Total liquid deposits (M3)	10834	18950	26394	174.9	139.3
5. Foreign liabilities (net)	5219	7493	9042	146.1	120.7
IV. Net domestic assets	5615	11457	17352	204.0	151.5
Structure (M3 = 100)					
1. Currency outside banks	12.6	14.0	12.7		
2. Demand deposits	16.4	21.2	18.6		
I. Money supply (M1)	29.0	35.2	31.3		
3. Time deposits	18.3	16.4	13.8		
II. Total deposits in HRK (M2)	47.3	51.6	45.1		
4. Deposits in f/c	52.7	48.4	54.9		
III. Total liquid deposits (M3)	100.0	100.0	100.0		
5. Foreign liabilities (net)	48.2	39.5	34.3		
IV. Net domestic assets	51.8	60.5	65.7		

Source: National Bank of Croatia

Such global relations between the deficit in the current account of the Balance of Payments, increase in foreign exchange reserves and of total of foreign exchange as well as the growth of the money supply, had, in 1995, led to maintaining the relative stability of the foreign exchange rate and prices. The rate of Kuna towards DEM, the leading currency, had nominally depreciated by 2.0% while the retail prices had increased by 3.7%, and the producer prices of the industrial products by only 1.6% which continued as a tendency during January 1996 (nominal depreciation of the rate of 0.1 % with the inflation of 0.2%), representing now the 27 months continuity of a very low inflation.

However, there are two essential differences between the initial establishing of the stability of prices on the turn of 1992 and the maintaining of the stability during 1995. While, with other different conditions, a first was realized in the conditions of the previous high demonetization of the national currency and low level of incomes, the present day stability is maintained in the conditions of by 150% really increased quantity of domestic money and 50% of incomes at the simultaneous essentially unchanged level of production, measured in physical indicators. The factors linking two so different situations are the growing deficit in the foreign trade, the way of financing it and a more restrictive approach to creating domestic money than would be possible on the basis of increased foreign currency reserves and total currency assets in the national economy.

However, at the beginning of 1995, with the slowing of the increase in the monetary aggregates the tendency of the fast growth of the domestic effective demand has been stopped on the level by 19.1 higher than the 1994 average, followed by a drop lasting until August this year at the trend rate of 0.2% a month, which is characteristic for all three components. In addition to monetary reasons, i.e. problems in allocation and use of money arising in larger measure from the slowing of its growth, such trends of the domestic demand had been mainly influenced by the absence of normal seasonal increase in the domestic demand for

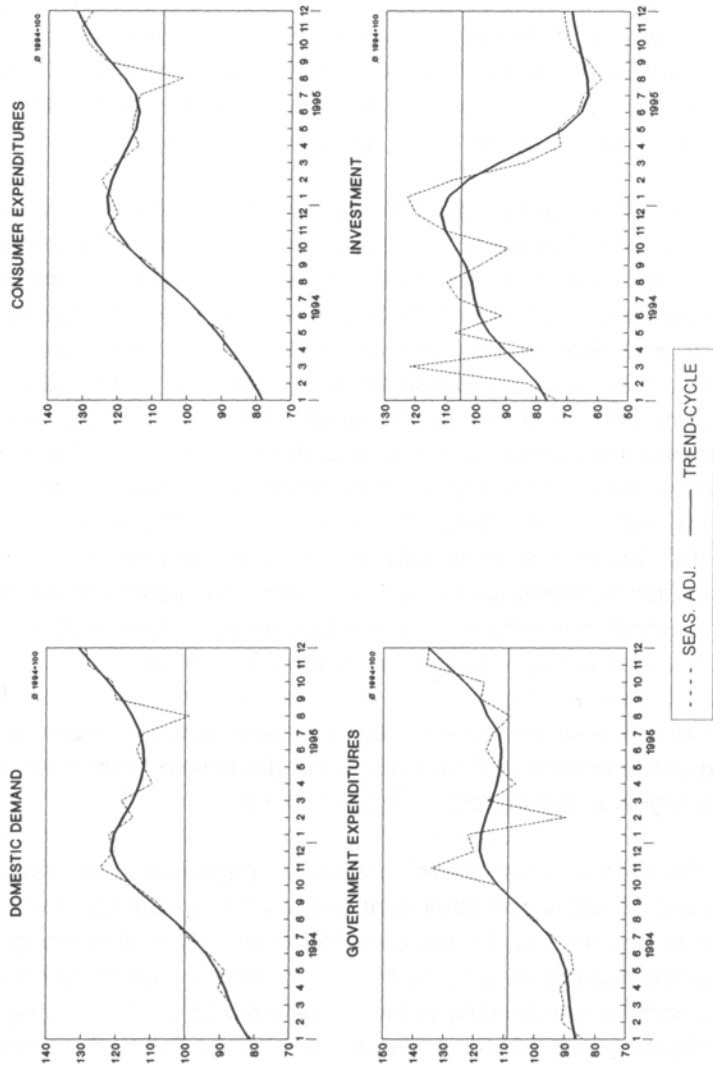
goods and services at the time of tourist season, by the problems into realization of the predicted budget income and by the changes in the structure of the distribution of the money in the economy where relatively increased apart of wages taxes and contributions had marginalised otherwise low payments for investments. The situation in this field had started to change in the last trimester, particularly in the area of material expenditure of the public sector so that, in 1995, the average level of the domestic aggregate demand had succeeded to maintain the level of the end of 1994. But it, naturally, could not globally give the direct impulse to the increase in the realization of the goods and services on the domestic market.

As, simultaneously the deficit of the current transaction of the Balance of Payments had been increasing and with it apart of the imported products realized on the market, the drop of the value of net money inflows of the domestic economy from trade had been significantly more intensive in the first 8 months of 1995 (2.1 % a month) and it was not successfully compensated by the growth realized in the last four months. In these conditions, at the stagnation of the domestic demand, the average trend value of the income in 1995 had been by 10.5% lower than the end of 1994 level, which corresponds dynamically to the estimated ratio of the deficit of current transaction of the Balance of Payments in the gross domestic product (the interyear real increase in 1995 with regard to 1994 being about 10% and entirely being the result of the transfer of the 1994 level into 1995 with the tendency of current decrease during 1995).

While at the same time the basic components in the structure of the expenses (payroll and taxes) had not decreased, it reflected on the worsening of the liquidity of the economy.

In the situation when payrolls with other payments to the employees as well as taxes and other contributions are absorbing 74.1 % of the net money incomes of the domestic economy, and servicing of the liabilities

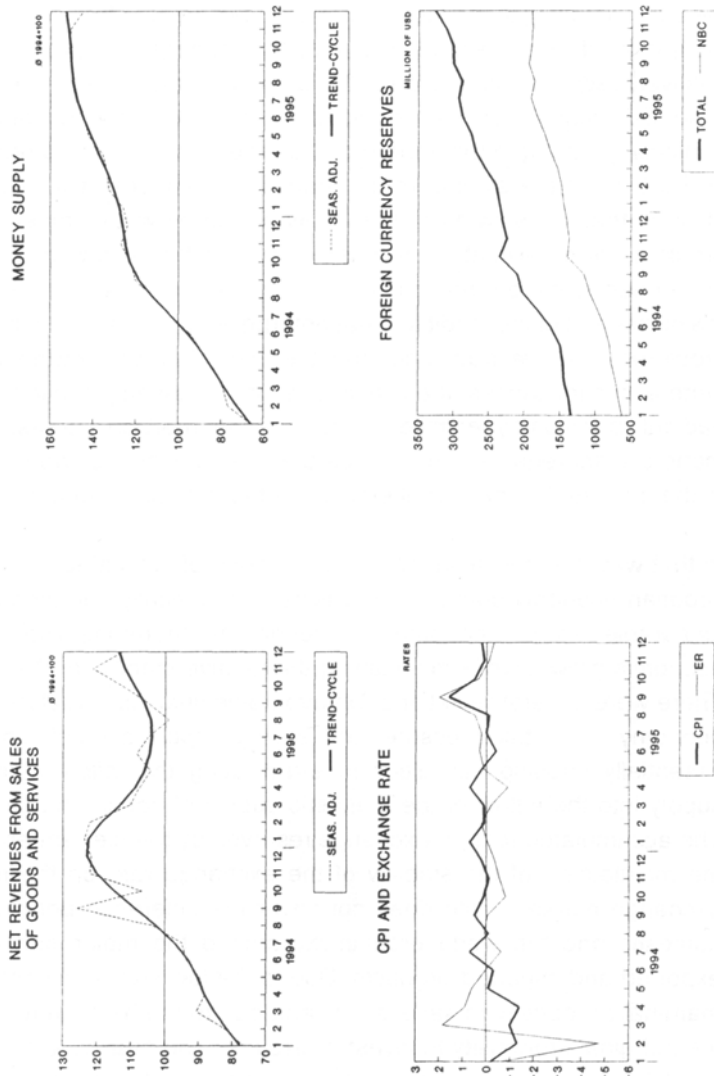
Figure 2.



additional 22.3%, the gross money accumulation of the economy is participating in their structure with only 2.7% (payments for investments with only 1.6%), which is not sufficient to cover the expenses of amortization. In such conditions, the increase is shown in the registered amount of unsettled liabilities which have, during 1995, increased from 2.9 to 6.3 milliards of Kuna, carrying its effects on the money market where the demand is double in comparison to the offer, resulting in the increase of the interest rates from 17 to 27%. Increased inflow of the money towards the importation of products and relatively reduced distribution to the domestic producers is one of the essential causes of the increase of the non-liquidity which is particularly strong in the sphere of the production. On the other side, at the time of the signing of the stand-by arrangement it has been obvious that the slowing of the inflow of money would increase the problems of its allocation. In this connection the following activities have been foreseen: rehabilitation of the banking system, limiting of the placement of the credit to great enterprises with long-term financial problems, their restructuring and the like. However, owing to the general circumstances, these activities had not taken place in 1995 or had only been partly realized, so that not even realized increase of the monetary aggregates could not be used in the way that would result in the increase of the global efficacy of the national economy.

In that way, the constellation of the relations of key categories in the Croatian economy during 1995 was neither statically nor dynamically favourable to form autonomously stronger short-term impulses for the economic growth while maintaining the relative stability of the prices. There were several limitations. Unfavourable financial structure of the economy, high tax pressure and strong import competition were essentially causing difficulties in effectuating the inflow of money supply into the inflow of the domestic supply of goods and services. The accumulated foreign exchange reserves by transfer are ensuring the maintaining of the stability of the exchange rate on the foreign exchange market which does not cover the difference between the domestic and

Figure 3.



the world productivity among the major part of the exported and imported products. Due to the low level of incomes the marginal propensity to save is low, and due to the high interest rates the marginal propensity to invest is also low. The quality, assortment, conditions of sale and technological level of the production are representing the additional impediment to the stronger expansion of the exports to more demanding markets as well as more and more limited possibilities of the sale of one part of products on the domestic market, and others.

On the other hand, the activating of the factors which could neutralize part of these limitations (integration of the capacities and production riches of the freed areas into the economic system of the country, reconstruction of the areas, direct traffic connection of Dalmatia with continental areas, impact of the reduced war risk on tourism and foreign investments, foreign financial help, acceleration of the privatisation process, beginning of the rehabilitation of bank system and other), requires a certain time so that the possibilities of the shortterm activity of the economic policy in order to stimulate the economic growth at the low level of inflation are rather limited. However, it simply is not in the position to rely exclusively on the long-term solutions as actual tendencies of the economic movements clearly show that it would not be able to use the advantages of the situation for a long time - the situation in which the prices are stable while unfavourable tendencies in the production and current transaction of the Balance of Payments have not yet reached the proportions in which the pressure on the economic policy to undertake some ad hoc measures would strengthen, which, though they may be efficient on some fields in short time, would prove problematic if considered from a long-term point of view.

In connection with it, bearing in mind the total relations in the Croatian economy and the changed geopolitical situation, the economic policy should be primarily directed towards the "supply side" with the goal to induce stronger and faster the adapting of the total expenditure of the functioning of the national economy to the stable level of prices, and

within it, such changes in relative prices at which the net savings as well as the profitability of the business will increase.

In such context it would be useful to consider the corresponding experience of other countries and the applicability of such experiences to the Croatian case, particularly in connection with four crucial components of supply side economic policy. They are: 1) great reduction in the tax rates to increase the demand and also the savings of the private sector, while expecting that it will not bring down the tax revenues due to the increase of the tax basis - so-called Laffer curve; 2) redistribution of the budget expenditure in the direction of the increase in the multiplier expenditure; 3) reduction of the government regulations in order to let the activity of the free market to influence the efficiency; and 4) limited but stable rate of the money supply as a fence for the inflation.

Today, it is generally considered that the effects of such policies have been mainly beneath the expectation, i.e. that the positive results have been realized by different combination of the activity of the economic factors than that predicted by the supply siders.

For this reason, and due to all other differences which are objectively existing between the Croatian economy and economies which apply supply side concept as a base of the economic policy, it is difficult to imagine that the economic policy in Croatia can exclusively take them as an example in its search for additional ways of stimulating the economic growth in Croatia. It is interesting, however, that the basic components of such concept quite well correspond to the crucial problems (though in a slightly different context) which the Croatian economy is facing and on the solving of which the possibilities of the future economic growth seem to be depending.

The ratio of the public sector expenditure in the structure of the domestic product of about 60% crowding out the saving and

investments which generate expenses that fall into the level of exchange rate on the foreign exchange market with a lot of difficulties while maintaining the high demand for credits to finance the current business in spite of the risk of heavy interest rates for their return, accompanied by a more significant direct and indirect influence of the state on the business of the economic subjects and without any important measures which would directly stimulate the investments of the private sector and thus open of new jobs, by a constant pressure on the banking system to socialize particular problems (if not finally directly through inflation, then by increased interest rates and other), it appears difficult to expect a dynamic economic growth at the low inflation.