FOREIGN EXCHANGE RATE AND PROTECTION POLICY IN CROATIAN DEVELOPMENT STRATEGY

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1. MACROECONOMIC POLICY OF THE EXTERNAL AND INTERNAL EQUILIBRIUM

1. The criterion of the external and internal equilibrium denotes such a condition of the national economy when the current and capital balance, taken together are brought into equilibrium; and when in the domestic market equilibrium prices exist with the appropriate use of the economic capacities, in other words when the criteria of the full employment of the production factors are fulfilled. The equilibrium condition denotes the absence of inflation, the balanced budget, the equilibrium (real) interest rate, and especially the equilibrium (real) currency exchange rate, which is the key variable in this. Macroeconomic policy must be consistent in relation to monetary and fiscal policies, that result in a real equilibrium rate of exchange and the real aggregate domestic demand. The real foreign exchange rate ensures the equilibrium of the current (and capital) balance of payments, while the aggregate domestic demand with the export demand ensure the full utilization of the national economy capacities. Theoretically, it is famous Swan-diagram[1], which in such a way defines the equilibrium condition. The purpose and the goal of the macroeconomic policy is to re-establish a possibly disturbed equilibrium condition or to strengthen its stability. Consequently, the national economy condition must be in equilibrium and stable. The equilibrium stability condition includes implicitly the ability of the economic mechanism (market) to get back to the equilibrium condition, whenever it falls out of it because of the external "shock".

[1] *See (2), (3) and (14).*

The macroeconomic policy helps it by its instruments. The key role in a small market and open economy belongs here to the real equilibrium rate of exchange, the maintenance of which has been influenced by the expansive or restrictive monetary and fiscal policy. The objective of the real equilibrium rate of exchange policy is the struggle with the inflationary economic tendencies, as well as the full employment of its potentials. However, these objectives should be consistent with the equilibrium criterion in the balance of payments, both current and capital taken together.

Disturbances of the current exchange rate from the real equilibrium rate of exchange are frequent, momentary or lasting. The reasons for these deviations are basic economic factors or current "shocks". The fundamental economic factors which determine the equilibrium rate of exchange are: relative prices of export commodities and services on the world market ("terms of trade"), the real interest rates on domestic and external financial market, the international transfers of capital and aid, technical progress and the level and growth of productivity within and outside the country. Particularly important here is the economic policy of the country, such as the protection policy, the foreign exchange system and the foreign trade regime in general, as well as the possible expansive and restrictive fiscal policies.[2]

In the period in which the equilibrium rate of exchange is maintained arises the question of its stability. From the current point of view the external equilibrium can be achieved owing to some momentary foreign exchange earnings which suffice for the necessity of external payments of the current short- term period (e.g. transfers, private or official). Therefore, it is important to establish some longer term which can promise the maintenance of the stable exchange rate, and determine the variables which form and maintain the stable rate. This would enable a conclusion about the stability and thereby the stability of the rate in the middle-term at least. The most important are two

[2] *See (5) and (6)*

fundamental variables which must be taken into account in estimating the rate stability: first, the protection of domestic economy and the incentive of the export economy sectors, and second, the level of employment of the national economy potentials with the stability of prices.

Therefore, for the stability criterion of the exchange rate to be fulfilled, account should be taken of the factors which define it for a middle and longer term. The currency exchange rate is as a matter of fact always in equilibrium, but only with some established factors or policy, which ensures it. This is first of all the protection policy (tariffs, quantity import restrictions, customs quotas, import or export permissions, export tax reliefs etc.), and the foreign exchange system which regulates the conditions of the access of the economic agents to the a foreign exchange market. Consequently the important questions are: is the currency convertible for domestic and foreign residents for the needs of current transactions, and how far for the capital transactions. In the case of the disturbance in the current balance of payments equilibrium, i.e. in its part of the autonomous transactions, the economic policy introduces a series of measures from the protection and incentive sphere and foreign exchange system, in order to restore and maintain the equilibrium. Both the current balance of payment deficit and the exaggerated foreign exchange surplus are considered as the equilibrium disturbance. This is defined as the disturbance of the "external equilibrium", while the disturbance of the internal equilibrium is represented by the increased level of unemployment and inflation.

2. The policy of the establishing external equilibrium has two aspects:
   - first, the establishment of the external equilibrium, respectively liquidity through the central bank financial interventions, such as the intervention on the foreign exchange market from or in favor of the foreign exchange reserves; the moving in or out of the private short-term capital with the purpose of financing the current deficit or of the surplus elimination; taking the central

bank's loans on the world market of the short-term capital in order to strengthen the foreign exchange reserves with the purpose of interventions on the foreign exchange market. The final equilibrium establishment on the foreign exchange market or the policy of the elimination of the exaggerate a surplus or deficit in current transactions is the function of the central bank, and this is the so called official-settlements balance. That kind of establishment of the external equilibrium basically does not cause the changes in the exchange rate, in domestic prices and incomes, nor in profits. In other words it does not influence the reallocation of resources (factors) in domestic economy, and its purpose is the maintenance of the external liquidity of the country;

- second, contrary to the policy of the liquidity maintenance (external equilibrium) through financial instruments of the central bank for short-term disturbances, the economic policy of the structural adjustment to the middle-term establishment of the balance of payments equilibrium, implies the "reallocation of production factors, the restructuring of the trade of commodities, services and investments under the influence of the changes in relative prices, incomes and the foreign exchange rates."[3]

As an equilibrium disturbance can be in the form of the exaggerated foreign exchange surpluses or deficits each of these cases demands its own specific group of economic instruments. For the case of the balance of payment deficit the following policies are adequate:

- the accelerated changes in exchange rate by means of the local currency devaluation;
- the introduction of the restrictions and initiatives of various kinds in the foreign trade and foreign exchange system;

[3] *See (13, pp. 80).*

- the abolishing of the local currency convertibility until there are conditions for its returning;
- the stimulation of the short-term financial capital entry as in the case of interventions in the policy of maintaining the short-term equilibrium.

In the case of the exaggerated foreign exchange reserves surplus, that is of the receipt surplus over payments in the current transactions with foreign countries, the following policies are pursued:[4]

- the expansive financial policy (monetary and fiscal); local currency revaluation; the abolition of various restrictions and subventions in the foreign-trade system; the removal of controlled allocation of foreign exchange; the stimulation of outward movements of short term capital.

The interrelationships of domestic and external equilibrium are obvious. The instruments of the described policies often influence both objectives: the internal and external equilibrium as the target variables. The corresponding combination of the instrumental variables (policies) can differently influence both target variables. In principle, in the pure theoretical sense, to the number of the target variables it should correspond the same number of instrumental variables. It is possible in our case that one instrumental variable favorably influences both target variables, e.g. the internal and external equilibrium.[5] Let us take as the internal equilibrium the adequate income level and the price stability (equivalent for full employment). The price stability here is connected with the stability of the foreign exchange rate or with the supply and demand equilibrium on the foreign exchange market. The adjustment policy which wants to ensure the adequate income level is the expansive (restrictive) fiscal, but also the monetary (credit) policy The

[4] *According (13, pp. 91).*
[5] *See (14, chapter 9 and 10). J. Tinbergen wrote about this (63), and with us the first who wrote were P. Jurković and Z. Jašić, see (61).*

exchange rate policy, and the income (wage) policy will influence the level of domestic prices, or their stability. Likewise, the exchange rate policy together with the financial policies will influence (through the influence on the rate and the foreign exchange demand) the external equilibrium, i.e. the coordination of the foreign exchange demand and supply.

Theoretically, the policy of the local currency depreciation or devaluation is oriented in two directions:

- the increase in import prices increases domestic goods demand, and stimulates exports, which help in establishing and keeping domestic and external equilibrium. Consequently, the selection of one or more policies can be done with the estimation of their effects on desirable target variable, but also of their possible side-effects.

3. With regard to the foreign exchange rate policy the foreign exchange system can be:

- first, the system with the fixed exchange rate and subvariants: more or less frequent pegged fixed exchange rate, fixed and temporarily adjustable exchange rate;
- second, the systems with floating and flexible rates.[6]

The choice of the foreign exchange system depends upon concrete circumstances in the country, international arrangements, regional trade zones and integrations, and its aim is always to reach and maintain the external and internal equilibrium, and the competitiveness of the economy.

[6] *This is the so-called Breton Woods-system which was adopted at the UN conference on monetary and financial system on 22 July 1944. valid from 27 December 1945.*

The purpose of the introduction of the freely floating foreign exchange systems is an easier maintenance of the competitiveness of domestic economies on the world market, and then the maintenance of the current balance of payments equilibrium.

It is thought that by this policy domestic economy is isolated from the shocks of the world market (inflation, depreciation of foreign currencies, and the local currency appreciation). The monetary policy of the central bank in this system has got larger autonomy (sovereignty) in development and full employment policy, as well as in the possible budget deficit policy. The European Union has restricted this sovereignty by the coordination of macroeconomic policies. To this coordination belongs first of all the exchange rate policy in the accepted ranges, as well as the policy of interest rates. The expansive or restrictive monetary and fiscal policy, in connection with interest rate and exchange rate policies, or balance of payment equilibrium policy, are key instruments within the macroeconomic coordination of the policies among the world economic big powers. Such a coordination on the world level is under way among the members of the International Monetary Fund which is going now to develop its function of the "supervision" of the exchange rate policies of the member countries, both developed and developing countries.[7] The stabilization program of the Croatian government in the form of the Memorandum on economic policy presented to the International Monetary Fund, includes the corresponding "supervision" of the accomplishment of the performance criteria later accepted by the stand by arrangement. The "surveillance" especially includes the monetary and fiscal policy in connection with the rate of exchange policy and connected with domestic economy competitiveness on the world market.[8]

[7] *See (8)*
[8] *See (9. item 25).*

4. In the development strategy the most frequent objective of the exchange rate policies is the following:

- by real depreciation of the exchange rate to promote the competitiveness of domestic exporters on external market with the purpose to establish and keep the current balance of payments equilibrium;
- the consequence of such depreciation is a decrease of the domestic aggregate demand with its orientation towards domestic goods; that leads to the increase in production, or in the growth rate of the gross domestic product in export a sectors, as well as in the sectors which substitute imports due to the more competitive prices of domestic producers on domestic market; the positive economic effects usually develop within a year or two; the successful real depreciation according to some analyses produced by a nominal devaluation, lasted from one to twelve quarters, i.e. up to three years.

It means that the positive effects of a nominal devaluation, the objective of which is the real devaluation or depreciation, are exhausted in a shorter or longer period depending upon the supporting monetary, fiscal and wage policies.[9]

However, the local currency appreciation is usually connected with the liberalization of the capital account within the balance of payment as a whole. These are usually the favorable conditions for a short-term borrowing of domestic entrepreneurs in foreign countries, on the basis of high domestic interest rates and appreciated exchange rate in the phase of repayment of loans. In the first phase it produces a high supply of short-term capital on domestic market, as well as the increase of the foreign exchange reserves of the country. It creates the expansion of the monetary aggregate M1, and the credit expansion which is followed by gradual decrease of interest rates up to the "equilibrium level", if the process is sustained long enough.

[9] *See (6, pp. 60-62).*

In the Croatian current circumstances, the government and the central bank policy is oriented to the solution of the inflation problems by monetary or credit restrictions, as well as by the stabilization policy of the exchange rate which eventually becomes fixed or stabilized in very narrow limits. The Central bank defends these "limits" by interventions on the foreign exchange market. Until recently that all led to the system of ceiling on the purchases of the offered foreign exchange funds, 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 accepts to increase the foreign exchange reserves, while the commercial banks are restricted by their credit potential in buying foreign exchange offered. In this way monetary policy can successfully keep price stability, if budget deficit monetization is eliminated. From the point of view of the conversion into local currency and savings formation, the following items in the balance of payments are relevant in the Croatian circumstances:

- the foreign remittances represent at least partly the basis for the demand of Croatian kung deposits, or time deposits savings;
- mobilization of the foreign exchange savings that are kept outside the monetary institutions by our citizens for purchasing apartments and shares is an additional source of savings; these savings by using an appropriate economic policy, i.e. converting it into local currency, can stimulate public consumption (or investments) of the state through the financial system, and strengthen the credit potential of the banks for private investments;
- transfer of the foreign exchange deposits of the commercial banks, and of the business as well, from abroad into the country, would have at least partly the character of the repatriation of domestic capital.[10] In the convertible payment

[10] *Along with the simultaneous increase in the official foreign exchange reserves of the central bank.*

system interest policy should be adjusted to this in such a way that the market interest rate is attractive enough for the repatriation of the exported capital, as well as for demand of the Croatian kung deposits by the citizens; besides, the interest must not be discouraging for the investor;

- the financial arrangements with IMF will have the character of financing, first of all, of the working capital of the economy by approving some rehabilitation loans to commercial banks; in this way that programme will have more a character of "supply side" arrangement than of a support to external liquidity of the country; the rescheduling of the external debt would have a similar effect.

A high share of transfers (workers' remittances, humanitarian assistance, state official transfers etc.) and services (tourism and transport) in the total foreign exchange inflow produce the illusion of the so-called "Dutch Disease".[11] The characteristic of this "disease" is the phenomenon of the appreciation of the local currency and monetary expansion, which if not sterilized in a corresponding measure, acts inflationary.

It can produce in the middle-term period unfavorable structural strokes in the economy because of the quick opening of domestic economy towards too strong world competition. If appreciation lasts too long it usually actualizes restructuring problems of the entire economic branches.[12]

[11] *See: (11, pp. 33-48).*

[12] *In such cases the phenomenon of the "tertiarisation" of the economic structure is known: the modern industrial sector cannot resist the competitiveness ors the domestic and external market, so that the entering capital chooses the tertiary sector which is protected from the competition (tourism. housebuilding. infrastructure) In a middle-term period it appears as a non-optimum structure of employment.*

Therefore, it is necessary in Croatian circumstances to investigate very carefully the sources of the relatively (apparently) substantial foreign currency supply, from the point of view of the balance of payment projection for the full employment level of domestic economic capacities. In such a projection it is necessary to balance carefully the trade deficit with the surpluses of services and current transfers, and the sub-balance of capital. It will be probably shown that the "Dutch disease" may be also explained by the fact of the internal overall economic disequilibrium caused by only partial use of available economic potentials, and by the weak purchasing power of the population, which does not induce the imports of consumer goods and foreign currency demand.

If for example total imports of goods and services in relation to the gross domestic product amount to 50%, that is to the level of gross product from 1993 of about USD 6 mlrd., then for the level of gross product around the year 2000, if it increases by the rate of 7% yearly, the total imports should be USD 10 bln. at least. It is possible to finance these imports by the exports of goods and services (with tourism), transfers (workers' remittances mainly), the entry of foreign capital, and by net foreign exchange savings. The importance of goods and services exports in share terms in total supply of foreign exchange will be higher than in the current period. Gross domestic product will depend upon the foreign convertible market far more then in the pre-war period, and it will require a substitution of the earlier export regions (Eastern world and the regions of ex-Yugoslavia) mostly by markets of the Central and Western Europe. This means that the foreign exchange inflow will depend much more upon the goods and services exports of the real sector, because different oneway transfers (including the foreign exchange workers' remittances) will loose the weight they have today. However, direct investment capital inflow as well as the probable entry of financial capital should be realistically estimated within the mechanism of financial market. By balancing different possible sources of the foreign exchange supply within the

current and capital balance of payments, it can be easily concluded that the export policy must design real balanced rate of exchange, that will be able to support a necessary increase in the present-day goods and services export for at least 60-80%, at the end of approximately a six-year period. That export increase regarding its term and size could enable a still insufficient increase of the gross domestic product in relation to the pre-war level. In this period it will be necessary to reckon with a real equilibrium rate of exchange policy of the Croatian kuna, which would correspond to the global productivity of the Croatian economy.

It should be concluded from what was previously mentioned that the present-day "abundant" foreign exchange supply and the substantial coverage of real money by foreign exchange reserves has a momentary character, and that the monetary indicators will considerably change at the higher level of use of the available economic potentials. In addition, substitution of clearing-payment system by convertible currency payment system of the Croatian trade with some former Yugoslav republics and with former East European and Central European clearing-payments markets[13] will make stronger that kind of arguments. The relation of the real interest rates for credits to business sector and the rates of exchange determines the profitability level of imported foreign capital compared to the such profitability in other competitive countries. A worsening these relations at the expense of the domestic economy leads to the flight of this capital at a high scale. Then it produces an increase in nominal interest rates again in order to maintain the existing credits and to attract new ones for the economy of the country. That kind of interactions causes macroeconomic instabilities (price increase, unemployment, frequent devaluations, fall of real wages) which cause political problems and finally the necessity of elaboration of a complex program of development strategy and controlled liberalization. The entry of the short-term capital, however, presupposes developed market of securities: bonds, commercial papers,

[13] *See (15).*

secondary market shares, but also the primary issue of shares. So it is especially important for the Croatian financial policy of liberalization:

- the Croatian economy suffers exactly from the shortage of the circulating capital which could, provided the existence of a developed[14] financial market, flow in from abroad, motivated by the high interest rates and the appreciated rate of exchange;
- direct investments, as the long-term investments, are also possible by activating to-day's instruments, but under the condition of disappearance of the war risks;
- ways of the capital entry for the working capital purposes in to-day's circumstances are very specific and they are connected with the concrete exports trade agreements (ships, industrial goods, investment works). The most frequent is the credit financing of raw-materials import, spare parts and equipment, whether directly or by the help of the so-called short-term credit lines, through the mediation of commercial banks, with the support of the insurance institutions of particular countries.

Finance capital in the form of portfolio investments has not yet a complete basis for the entry into Croatian economy due to the underdeveloped securities market, unfinished transition processes, non-market value of shares and the absence of the country credibility on the world financial market. However, it should be expected that the foreign capital will be entering to a certain extent by means of buying shares of the large and interesting enterprises, banks and future financial investment funds, and of course indirectly by buying the old foreign exchange savings, but in the conditions of no war risk.

5. Foreign exchange system in the economic policy depends on the choice of development strategy of the national economy. This choice consists in the strategy of the open economy or of the economy i oriented to domestic market, i.e. on the import substitution development strategy. The policy of the fixed exchange rate is

[14] *Nowadays undeveloped!*

consistent with the development strategy of the open economy, while the policy of the free floating rate is consistent with the strategy of the closed economy. Depending on the chosen foreign exchange system, a higher or lower level of the autonomy belongs to national monetary policy, fiscal policy. or financial discipline. Assuming labour cost rigidity, weak mobility of labour force, or rigidity of the employment level, for the policy of equilibrating current disturbances in the balance of payments the appropriate system would be the system of adjustable, floating exchange rate. This policy, in a short or middleterm. may avoid or diminish the costs of adjustment in terms of the unemployment rate, or of the non-use of the available potentials of the national economy. In the case of "overshooting" devaluation (depreciation), or of a too strong monetary expansion or budget deficit, inflationary spiral threatens and higher costs of a future stabilization policy are more probable.

The present-day situation of the Croatian economy, as it was already pointed out, is characterized by a strong increase in foreign, exchange reserves on the basis of current balance of payments, and on the basis of capital accounts in amounts in which the rescheduling of the external debt keeps foreign capital from the outflow. Capital account of the balance of payments does not function according to the rules of the liberalized flow of capital to the country and out of it. It was mentioned already that different transfers strengthen the growth of foreign exchange reserves, together with the repayment moratorium of foreign middle-term and long-term loans. On the other side, the import is determined by the low level of production, and by the low level of aggregate consumption, especially personal consumption and investments. Public consumption, due to firm "performance criteria" given by "stand by" arrangements is strongly restricted by the low budget deficit financing. Restrictive monetary policy along with the direct control of wages keeps the aggregate demand low enough, so that Croatian kung is becoming stronger and stronger. i.e. appreciated. If Croatian kuna is appreciated because of the weak demand of foreign

currency for import of raw materials and capital goods (investment equipment), then the relatively high interest rates suggest a too strong restrictiveness of the monetary policy's. that keeps the business sector from the production increase on the basis of existing capacities by taking too expansive loans to finance the working capital.

It could be said that a too long insisting on the instruments of the antiinflation policy produces a conflict of the too rigorous antiinflation objectives with the production recovery policy. That means that the previous Croatian stabilization program from October 1993 versus the program resulting from the "Memorandum on the economic policy[15] coordinated by International Monetary Fund designed more restrictive monetary policy than needed, e.g. the level of restrictiveness is too strong even according to demands of the Memorandum. Consequently, net domestic assets of the banking system could be higher if all financial resources especially gross foreign exchange reserves would be considered There is still a question whether the business sector is restrained in investment activity (in the sphere of the existing physical capacities) due to high interests on the revolving credits or due to the low domestic and export demand Domestic demand, from its sides is connected with the credit expansion, whereas the foreign demand is more connected with the low competitiveness[16] of exporters. and the lack of trade arrangements with other countries and associations.

In the conditions of the full fiscal discipline, enormously low use of the economic potentials of the country (50-55%), it arises the question of the rationality of the economic stabilization policy not recognizing[17] the recovery problem of the economy in time. Appropriate policy of promoting aggregate demand would with a certain delay depreciate the local currency rate and gradually improve the competitiveness of the

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[15] We do not treat here the problem of big "interest spreads" caused by a high share of nonperformance assets in total assets of our banks.

[16] The reactions of the entrepreneurs from the wood, paper and textile industries shows this clearly enough.

[17] See (16).

economy in a shorter and middle term. Such a policy gives effects more slowly than the policy of one-time devaluation.

In the present-day circumstances high inflation is not a danger until the real depreciation can be carried out by credit expansion (through decrease of legal reserves, e.g.), with the maintenance of fiscal discipline and a certain control of wages, avoiding wage indexation. Those policies are already strictly implemented. The total sum of wages would increase by credit expansion, partly through the increase in employment, and partly by the increase in productivity. In these conditions it would be also possible to implement the formal devaluation, in which nominal devaluation would have the real effect in such a way that the incorrect current rate would approach the real equilibrium exchange rate.

It is hard to estimate which way of the monetary adjustment policy would have more advantages: the one-time devaluation or the monetary expansion as the first step. It is more likely that the process of monetary expansion would, in the conditions when "remonetization" has not been finished, give the results which would not threaten the antiinflationary objectives of the stabilization policy. The control of wages and the fiscal discipline which is already under way, would maintain domestic prices at the level which would not threaten the aim of the real depreciation of the local currency.

2. THE PROTECTION POLICY AND FOREIGN TRADE LIBERALIZATION

1. The objective of the protection policy as the component of the economic policy is to restrict the foreign trade by the means of different measures (instruments) in order to protect the economy from the influences of foreign competitiveness, and to influence indirectly the realization of the long-term objectives of the economic development. If the protection policy autonomously defines objectives of protection that are inserted in the long-term policy of economic development, it can be considered as an active protection policy, and a part of the industrial and overall economic development policy. If the protection policy is oriented only to eliminate the foreign competition using different measures to prevent imports of goods and services, it is taken as a passive protection policy.

The protection policy starts with the national and foreign conditions in the economy and it is determined by their differences (present and future), such as: 1) differences in the productivity level, 2) differences in the level of development, dynamics and structure of economic development, 3) differences in the monopolistic-competitive behavior of the participants in the foreign trade, 4) differences in foreign exchange rates and systems. The protection policy aims to insure the optimal protection of the interests and objectives of the economic development of the country. In order to fulfill its objectives the protection policy must be defined according to the following criteria: what to protect (qualitative criterion), how high protection to introduce (quantitative criterion), how long to protect (time criterion), and in what way and how to protect (instrumental criterion).

The economic policy makers can restrict the foreign trade and protect domestic production through: mechanism of prices (customs, taxes and incentives); quantity restrictions (quotas, contingents); and foreign

exchange restrictions (foreign exchange system, access to the foreign exchange market, foreign exchange controls).

Historical experience shows that the periods of stronger protectionism and the stronger liberalization have followed each other. The increase in protectionism appeared especially after the recession in 1974/1975, so that it was talked about a new form of protectionism - "neoprotectionism" and "neomercantilism".[18] In all countries it came to the increase in protectionism and the use of a very diversified system of tariff and non-tariff protection.

Many empirical investigations of the structure of protection system in developed countries show that the protection of their economies was increasing, even though the explicit nominal tariff rates were decreasing.

Namely, the non-tariff protection by means of the above instruments has similar effects on the international trade as the tariff protection.

2. Along with the process of increasing and simultaneously decreasing protectionism (neoprotectionism) in the world, a process of stronger regionalization was also arising, together with the aspiration to multilateralism, which on their side had to remove restrictions in the international trade and establish higher trade liberalization. For this purpose on October 30, 1947 GATT (i.e. General Agreement on Tariffs and Trade) was signed by 23 country-members. Since then GATT is acting in three directions:[19]

- the formation of multilaterally coordinated and accepted rules which influence the behavior of the governments of individual countries in foreign trade;
- it is the institution for trade negotiations and liberalization of national markets;

[18] *See (22).*
[19]

- as the international "court" where each government can resolve disagreements with other members of GATT

Within GATT, the circles of multilateral trade negotiations have always the objective to decrease trade restrictions among the member countries. The number of country-members was increasing all the time, from 23 members (1947) it increased to 116 in 1993. Nowadays, the share of the country-members of GATT amounts to over 90% of the whole world commodity trade. It can be said that the multilateral trade system functions in the changed economic and political conditions with a great number of diversified members and supports in that way economic growth and development in the whole world. Up to now the circles of the multilateral negotiations primarily decreased tariff protection. They succeeded to a considerable extent to lower the average tariff rates. GATT expanded its influence on tariff protection and some other fields of liberalization move extensively, especially in '[the last stage of multilateral negotiations, within the so-called Uruguay j round, which started in 1986 and ended in 1993.

The final act of the Uruguay Round[20] was signed in April 1994 by 116 countries - participants of the negotiation, and after the ratifications within each state it was introduced in 1995. The application of the measures will give the. results not before the beginning of the following century.

The results of the Uruguay Round can be put in four categories: a) the alleviation of the access to the market, b) the inclusion of "old" sensitive sectors into rules of GATT, c) the expansion of the GATT's rules to new fields, such as services and intellectual property, d) the establishment of the World Trade Organization - WTO.

One of the results of the Uruguay Round of negotiations is **the establishment of the World Trade Organization** - WTO, which

[20] *See (33)*

should integrate all the agreements achieved within GATT, including all the results of negotiations within Uruguay Round. The future members of WTO must accept all annexed agreements in the package, and not, like at the time of Tokyo round, make a choice of the agreement "a la carte" and accept only those which suit them. Before accepting the Agreement on the establishment of WTO, the countries - participants in negotiations which are not contracting parties of GATT must first conclude negotiations for the access into GATT. WTO will supervise the implementation of the agreement of the Uruguay Round, supervise trade policies and become a forum for future multilateral trade negotiations.

3. In May 1993 the Republic of Croatia obtain the status of observer in GATT. On the basis of the letter of intention of the Government of the Republic of Croatia to become a valid contracting party of GATT, in October 1993 the GATT Council decided to establish a Working group for the acceptance of the Republic of Croatia to GATT. Since then started the procedure of the accession of the Republic of Croatia to GATT. In view of a very diversified system of the non-tariff protection in the Republic of Croatia, considerable remarks concerning the conditions for the acceptance can be expected. Considerable efforts will be needed to coordinate our foreign trade system with demands and criteria of GATT, which follow from the Uruguay Round of negotiations. According to GATT, developing countries have special privileges which denote certain deviations from the fundamental principles. This is due to the need of these countries to solve problems of development, regarding the balance of payments and the protection of domestic production.

By accession to GATT and then to the World Trade Organization, Croatia will have to accept rules and principles of the foreign trade liberalization in its foreign trade policy. It means to decrease tariffs and remove non-tariff protection.

The accession of the Republic of Croatia to GATT will in the case of its possible connections with some regional integrations in Europe give rise to additional questions. By the independent accession to GATT corresponding obligations are taken towards all the participants in negotiation, and also towards particular regional integration. By becoming a member of some regional integration the Republic of Croatia would carry over its national competencies in the foreign trade policy on that integration. Croatia shows interest for accessing to some existing European integrations. Thus parallel with the multilateralism which is promoted by GATT, Croatia intends to join some regional trade integrations. Although contradictory[21] these two processes are developing simultaneously. However, a gradual inclusion of regionalism in the system of GATT's multilateralism can be expected. The access of Croatia to that process necessarily imposes the following questions:

- can it fulfill conditions for the inclusion in these integration processes;
- the question of choice of the integration group to which to join;
- the question of the benefit and consequences of the economic and non-economic nature, and the time of accession to the chosen integration group.

From this point of view the Central European Free Trade Area which was formed in 1992 by the Czech Republic, Hungary, Poland and Slovakia, under the name "Vishegrad agreement" is of interest. The basic objective of the agreement is the liberalization of the mutual trade of different groups of products, including also the so-called "sensitive products", such as steel, textile and agricultural products. It starts from the results of the Uruguay Round of negotiations which they intend to include in its agreement. The European Union supports this integration and intends to establish relations with it as with an entity and to create in this way the basis for its final access to EU. Up to now, the European Union has already concluded bilateral agreements with these countries about the accession to its market. A gradual

[21] *See (37).*

liberalization, i.e. the removal of restrictions for "insensitive" and "sensitive" products is expected. The objective is to establish a free trade area.

The bilateral connection of the Republic of Croatia with particular Central European countries and its accession to the free trade area could be also an indirect way of integration into the European Union.

In 1991 the European Community Council suspended the agreement of cooperation with former Yugoslavia from 1980. On the basis of this agreement former Yugoslavia used trade privileges based on reciprocity which were more favorable than those it would realize on the basis of Generalized System of Preferences - GSP[22] which the European Community approved to developing countries. Otherwise, the European Community has different treatment of particular groups of countries in its trade policy. Thus, towards the EFTA countries it japplies the principle of the reciprocal decrease of tariff and non-tariff barriers, towards the "Group of African, Caribbean and Pacific countries" (Lome - convention) it implements unilateral decrease of tariffs and quantity restrictions. Towards Mediterranean countries (Turkey, Cyprus, Malta, Algeria, Morocco, Tunisia, Egypt, Jordan, Lebanon, Syria and Israel) it implements the policy of tariff reduction and quantitative restrictions (except textiles), and towards "Other developing countries" it applies unilateral tariff concessions GSP and MFA. After disintegration of the Council for Mutual Economic Assistance (SEV), the Economic Community does not treat the former members of SEV in the same way. Thus it treats the Czech Republic, Slovakia, Hungary and Poland similarly as the member countries of EFTA, Bulgaria and Romania like Mediterranean countries, and the Community of independent states (CIS) as the "Other developing countries".[23]

[22] *See (38).*
[23] *See (57).*

Foreign trade relationships of Croatia with the European Union, (specially with Germany and Italy) suggest that direct relations should be established with it. These relations could be based upon the gradual abandonment of unreciprocity. In any case, Croatia is expected to reach bigger openness of the economy towards foreign countries, a stronger liberalization in the foreign trade system and decreasing possibilities to use a diversified system of the protection of domestic producers and exporters. By accepting the international trade agreements and joining regional trade integrations, Croatia will have to work out a strategy of gradual opening of the economy towards the world market, i.e. to design the phases of liberalization.

3. THE EFFECTIVE TARIFF AND NON-TARIFF PROTECTION AND THE COMPETITIVENESS OF THE ECONOMY IN DEVELOPMENT STRATEGY

1. Nominal tariff protection (explicit tariffs) is expressed by tariff rates on the imports of finished products according to customs tariff. That system of protection increases products' prices on domestic market. Increase in imported goods prices decrease their consumption (at the given income) and enables domestic producers to increase their product prices and to be competitive on the domestic market. So nominal tariff protection changes the structure of consumption. However, to strengthen the effect of tariff protection on particular sectors and allocation of resources, beside the nominal tariff protection of finished products it is also necessary to take into account the protection of intermediary products. Tariffs on intermediary inputs increase prices of products, and thus decrease the profitability of production on domestic market and in this way determine the allocation of economic resources. Therefore, to ascertain the tariff protection of particular sectors it is necessary from the nominal tariff protection of the products of these sectors to take away amounts of tariff protection of intermediary products that are used in their production, and that enter the international trade. In such a way we get the effective tariff

protection of particular sectors of the economy. The effective protection refers to value added of an economic sector. In order to analyze the influence of tariff protection on the allocation of resources it is necessary to calculate **the effective tariff protection rate** of the particular sectors. The rate of the effective protection is the percentage increase in the value added per unit of production of the sector affected by the tariff.[24]

Therefore, the effective protection rate of a sector depends upon the nominal tariff rate on finished products of that sector, upon the tariff rate on the imported intermediary products (inputs) of the sector and upon the share of intermediary consumption in the value of production of that sector. The effective protection rate shows the influence of protective measures on domestic production structure and on the allocation of resources.

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

2. It has been already mentioned that in many countries the non-tariff protection has more important significance than the tariff protection in its narrow sense. Therefore, it is necessary to include the non-tariff protection in the calculation and analysis of the effective protection. That kind of protection includes quantitative import restrictions, taxes, incentives and other protective measures influencing the level of value added, both in the sectors of import - substitution and the exporting sectors. Measures of non-tariff protection like those of the tariff protection cause an increase in prices in the amount of the elasticity effect of the rate of protection of importable goods and services. In the

[24] *See (41, pp. 285-287) and (43).*

case of a small country, import duty raises the domestic price of a commodity in relation to the world price by the amount of the duty, under the condition of inelastic demand. The same difference in price can be achieved if **quantitative restrictions** (quotas and contingents), decrease the import supply in the country. This price difference expressed as the percentage of the world price can be denoted as **the tariff equivalent** of the quantitative restrictions or as **the implicit tariff.**[25]

Taxes (direct and indirect) influence the net value added in the enterprises, decreasing or increasing it. Turnover tax introduced on finished products of domestic producers, either on producer prices or on the value added, decreases producer's value added and tariff protection effect. Introduction of import taxes has the same protective effect as the tariff.

Therefore, it is necessary to take into account different tax rates of imported and domestic products in calculating the effective protection rate. Tax rates have the effect of the implicit tariff protection. In the calculation of the implicit tariff it is necessary to take into account taxes that discriminate, i.e. where different tax rates on imported and domestic products exist. It should be estimated how far some economies sectors get more convenient position, and how the taxes can have a protective influence.

3. We have defined the effective protection disregarding problems of real equilibrium foreign exchange rates. However, if we take into consideration changes in the foreign exchange rates, the protection rate of the particular sectors will be changing. Thus the appreciation of foreign exchange rates can be considered as the 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%, all export sectors with the

[25] *See (42, pp. 246).*

rate of effective protection smaller than 30% will be taxed in relation to goods sold on domestic market, and only the rate of effective protection over 30% could really protect domestic producers. If we subtract figure 30 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, it is necessary to evaluate the level of appreciation and depreciation of national currency in the context of a given protection structure, in order to asses correctly the effects of the whole protection system on economic resource allocation.

Four indicators that show the real protection of one sector are:

- first, the economic sector is protected if **nominal protection** is **positive.** However, nominal protection is relevant for consumption analysis, and it is not measuring the effects on production.
- second, the sector is protected if its **effective protection** is **positive.** That would be a case when the prices of domestic products are given and when foreign exchange rate has no influence on prices. So the sectors enjoying positive protection will attract domestic resources to expand their production.
- third, regarding effects of foreign exchange rate appreciation or depreciation, a sector will be protected only if its **rate of net effective protection is positive.**
- fourth, the sector is protected if all elements of protection bring the increase in value added of the sector. That is considered as **the total protection.**

4. Legal framework of the protection system of the Republic of Croatia consists of the Foreign Trade Operation Act (Narodne novine, no. 53/91; 26/93 and 109/93), Customs Tariff Act (NN no. 53/B/91, Customs Service Act, Customs Act (NN no. 53/A/91; 33/92; 26/93 and 106/93), Free Areas Act and other belonging regulations (decisions, decrees and orders of the Government of the Republic of Croatia).

Nominal protection in the Republic of Croatia is implemented by the application of different instruments: some of which have protective purposes and others are of a fiscal character.

Surveying the instruments of protection policy it can be concluded that the Republic of Croatia has a very diversified system of non-tariff protection. There are altogether 27 different instruments by means of which the state protects domestic production from the external competition. Because of the intention of Croatia to enter GATT (or VVT"O) it is necessary to reexamine measures of its non-tariff protection and to adjust them to the rules of GATT, especially with regard to the rules of the Uruguay Round of negotiations. It is especially necessary to analyze the role of the non-tariff protection from the point of view of its consistency with foreign exchange rate policy in the context of more intensive liberalization of the foreign trade system. Transforming non-tariff protection into the "implicit tariff" we would get a measure of the total nominal protection (explicit plus implicit tariff). On that basis it would be easy to get a real measure of effective protection of the whole Croatian economy.

M. Sekulić[26] estimated effective tariff rates and non-tariff rates of protection for Croatian economy. It is an experimental estimate of only indicative effective rates of protection. The total effective protection is estimated by adding 16% to each sector as an estimation of the non-tariff protection. To estimate the effective tariff protection rate of the Croatian economy the available regional input-output model for 1987 was used and the interregional (former interrepublics) trade flows are considered as foreign trade flows. In this way an interregional input-output table was constructed consisting of domestic goods flow and a foreign trade flows with old and new (former Yugoslav republics) foreign countries. Customs tariffs from 1991/1992 of Croatia were used to estimate the effective tariff protection and its explicit and a implicit component.

[26] *See (47).*

5. According to the purchasing power parity theory, foreign exchange rates trends are explained by trends of domestic and external prices.[27] The indicators of real foreign exchange rates are obtained if nominal rate indices of the local currency on the basis of foreign currency (DEM, USD, LIT) is divided by the corresponding relative price index series in the given period, related to the chosen base 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 bellow 100 it indicates a real appreciation of the local currency in relation to the base period. For the estimate of the real rate in relation to German mark, American dollar and Italian lira, for the period (/1985 until X/1995 there were used monthly data on the price trends in the industry of Croatia and the wholesale prices in Germany, USA and Italy.[28] Trend indices of the wholesale prices in the country and abroad, as well as the trends of nominal rates, are recalculated to the permanent base (June 1992=100). June 1992 is chosen as the base period because trends of nominal foreign exchange rates followed in the best way trends of prices with the beginning in December 1989. Besides, there was no public request for changing foreign exchange rate in that period. By applying the above methodology and approach the indexes of real foreign exchange rates of Croatian kung on the basis of DEM, USD and LIT were calculated, and the results are given in the graph 1. and table 1. (according to DEM). Graph 1. shows the real foreign exchange rate trends in the period 1985-1995. The especially interesting period is from 1990 to 1995. That period can be divided into three subperiods: I period: (/1990 to VIII/1991 represents real appreciation of Croatian kung; II period: 1X/1991 to VI/1992 represents real depreciation of Croatian kuna rate; III period: VII/1992 to X/1995 represents renewed real appreciation of the Croatian kuna.

All that is valid assuming that the period around June 1992 was a period of a real equilibrium foreign exchange rate. Starting from that it

[27] *See chapter 4.*
[28] *Source (48).*

can be seen on the graph 1. that the first and the third period were characterized by the real appreciation of local currency. After June 1992 there is a period of continuous appreciation of the local currency with the tendency to speed up; thus in October 1995 in relation to June 1992, Croatian kung was really appreciated about 36,37% in relation to DEM, 39,89% in relation to USD and 52,26% in relation to LIT. Therefore, depending upon the applied method of weighing, the unique indicator (index) of the real effective foreign exchange rate of Croatian kuna would be between 36,37 and 52,26%.

The effects of the real appreciation on foreign trade trends are known. Namely, this creates initiatives for purchasing of goods in foreign countries and discourages exports and the purchase of domestic goods on the domestic market. That is the consequence of higher purchasing power of domestic money (kung) in foreign countries than at home. On the other hand, real depreciation stimulates exports and discourages imports, and decreases the deficit in the trade balance with foreign countries.

Trends of commodity exports and imports of the Republic of Croatia are given in table 2. for the period from 1990 to 1995.

Table 2. shows that during the period of the real appreciation of Croatian kuna after 1992 it came to the increase in the deficit in foreign trade balance of Croatia (without the regions of exYugoslavia), so that the deficit increased from USD 303 mil. in 1992 to USD 956 mil. in 1993 and USD 1364 mil. in 1994, and in I-X/1995 to USD 2603 mil. Trade balance deficit increase happened during the slow export growth and the fast import growth. Trade balance deficit increase shows the unfavorable trends in commodity flows with foreign countries (without the republics of ex-Yugoslavia with which the surplus in the commodity exchange from USD 396 mil. in 1994 and USD 176 mil. in the period I-X/1995) was realized. Those trends should be a consequence of the real appreciation of Croatian currency kuna. It is a well-known

experience that the appreciated domestic currency worsens the position of the export sectors that in a small country can only take over prices from the world market. 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 a receiver of world prices, so that the Croatian export trends depend upon internal factors of the rigidity of the export supply (there is no domestic market) and elasticity of export to world prices. Croatian export trends are influenced not only by economic factors, but also by other non-economic events in the war and post-war period, such as the embargo (1991, 1992), distribution of quotas of ex-Yugoslavia etc.

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

Real appreciation of the local currency brings about higher dispersions of relative prices of non-traded goods in relation to the prices of traded goods. It means that the internal terms of trade increase (ITOT).[29]

Increase in internal terms of trade means that production in the exposed export sector becomes less profitable than the production in the local non-export domestic sector. As a result, real appreciation in medium-term stimulates the redistribution of profits in favor of

[29] *The internal terms of trade represent relation between price indices of the nontraded and traded goods.*

domestic non-export sectors and supports sectoral reallocation of resources from exporting to non-exporting domestic sectors.[30]

The analyses on the example of Austria also showed that in time of the "hard" monetary policy (Hartwaehrungspolitik), real effective appreciation of shilling led to:[31]

- increase in internal terms of trade in favor of non-exporting sectors;
- decline of relative profitability in exporting sectors.

It can be concluded that the appreciated local currency can have an unfavorable influence on export competitiveness, and that it will be necessary to adjust the import and export policy by designing an appropriate real equilibrium foreign exchange rate in the conditions of a more intensive liberalization policy. Moreover, it is necessary to design a more active policy of export expansion, especially of spatial foreign trade reallocation from the "soft" export market to a "hard" market where non-price competitiveness is more important.

As Croatian export has a higher import content than the other final consumption categories, export expansion will acquire a greater import increase. Therefore the consequence of a possible import restriction policy, would consist in a decrease of the production and even exports. It depends on the applied structural approach in such a policy. The solution is to coordinate the export-import policy so as to attain faster economic growth and external equilibrium.

It is supposed that the income export multiplier will be lower today than before the Croatian sovereignty, if the former Yugoslav market outside Croatia is treated as a foreign market. That has a very important consequence for the growth projection of gross domestic

[30] *See (51, pp. 863).*
[31] *See (52, pp. 334-339).*

product, i.e. lower export multiplier implies lower growth rate, but also a convertible liquidity on a higher level also.

It is necessary now to asses the kung appreciation from the effective protection point of view. For example, if the rate of real kuna appreciation in relation to selected base period of June 1992 towards German mark amounted to 36,37% in August 1994 it can be concluded that every sector with the rate of effective protection smaller than 36,37% 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 that by indicative data of the effective tariff and non-tariff protection of the Croatian economy,[32] 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 % and 35,84% and they are smaller than 36,37%. Negative difference between the rate of real kung 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 kung is maintained temporarily due to the 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 the intermediary consumption amounted to 59,4%, imports from the former Yugoslav republics to 25,5%, and from other countries to 15,1%.[33] Since the import of intermediary inputs is nowadays mainly oriented to the 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%, and the rest (40,6%) is the import of

[32] *See (47, pp. 34).*
[33] *See (64, pp. 86).*

inputs from the convertible area, the overvaluation of kuna of 36,37% in relation to DEM means the cost savings of 14,8% on the average for the whole economy, due to cheaper inputs import for the intermediate consumption. Since the individual sectors have a different import dependence, there are different sectoral effects of kung appreciation on the cost side.

Continuous increase in the real kuna appreciation will induce pressures for introducing higher protection of domestic economy.[34]

Therefore, the policy of rate adjustment becomes necessary in order to release tensions and pressures which are evidently increasing.

The methods of exchange rate adjustments belong to the macroeconomic policy and protection policy as a part of the whole development strategy of the country. It is necessary to stress that the importance of the foreign exchange rate policy increases in the strategy of the foreign trade system liberalization. That importance will result from the expected accession of the Republic of Croatia to GATT and World Trade Organization, and from the application of the rules of the Uruguay Round of negotiations.

Foreign exchange rate policy must support development and an efficient allocation of resources in the long run, but it should follow the antiinflationary foreign and internal equilibrium policies. That means that it is necessary to connect foreign exchange rate policy, foreign trade policy, monetary and interest rates policy into a consistent stabilization policy and development strategy of the Croatian economy.

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[34] This can be seen from the numerous articles in daily press: "Injections to wood and ' paper industry", Vjesnik, 28.10.1994., pp. 5; "The protection of production-return of inflation?", Večernji list, 9.11.1994., pp. 11; "Does tobacco remain one of the main agricultural export branches?", Vjesnik, 11.11.1994., pp. 12; "Oil-producers won I cattle-breeders", Večernji list, 16.11.1994., pp.10-11; "Protective price increase of ten percent", and "There are few competitive export products", Večernji list, 23.11.1994., pp. 26; and "Between lobby and development" and 'Agriculture protection-cycles of pig crises", Banka, No. 12, Zagreb, December 1994.

Table 1.

INDICATORS OF REAL EXCHANGE RATES OF CROATIAN KUNA ON THE DEM BASIS (JUNE 1992=100)

month \ year	1985.	1986.	1987.	1988.	1989.	1990.	1991.	1992.	1993.	1994.	1995.
I	88.67	89.73	98.79	124.36	120.51	72.42	64.29	94.12	84.10	58.81	61.13
II	85.91	92.57	103.67	123.30	116.83	70.39	57.72	87.00	83.90	58.52	61.24
III	88.96	92.01	104.78	123.96	117.51	68.01	55.62	88.32	79.46	60.56	61.56
IV	87.70	95.22	105.15	122.26	105.94	68.01	75.73	112.96	79.08	61.69	61.29
V	90.65	94.17	107.98	150.21	110.41	67.88	62.63	97.68	77.87	62.00	61.28
VI	92.11	106.91	102.04	135.63	88.74	67.75	58.71	100.00	74.26	62.46	62.45
VII	91.93	104.70	105.70	127.11	92.98	65.95	55.02	87.55	72.14	61.64	62.59
VIII	93.71	102.28	102.24	123.87	95.07	66.28	47.51	87.06	73.64	61.25	62.65
IX	93.12	103.72	103.15	120.30	88.56	62.65	50.90	86.06	68.70	61.50	63.73
X	90.72	101.42	105.75	126.67	85.78	55.89	127.50	89.61	59.13	61.12	63.63
XI	94.07	99.72	132.13	126.66	98.26	53.38	108.97	90.77	56.32	60.93	
XII	94.69	102.48	128.03	125.69	89.84	51.96	118.12	89.40	58.45	60.59	

* *Notes: The indicators of real exchange rates of Croatian kuna on the DEM basis are calculated by indices of the nominal exchange rates of Croatian kuna related to DEM divided by corresponding indices of relative prices. Indices of relative prices are obtained by dividing wholesale price indices of Croatian industry by wholesale price indices of Germany.*

- *Since wholesale price indices in Germany were not available for the period March-October 1995, they are estimated for that period.*

Table 2.

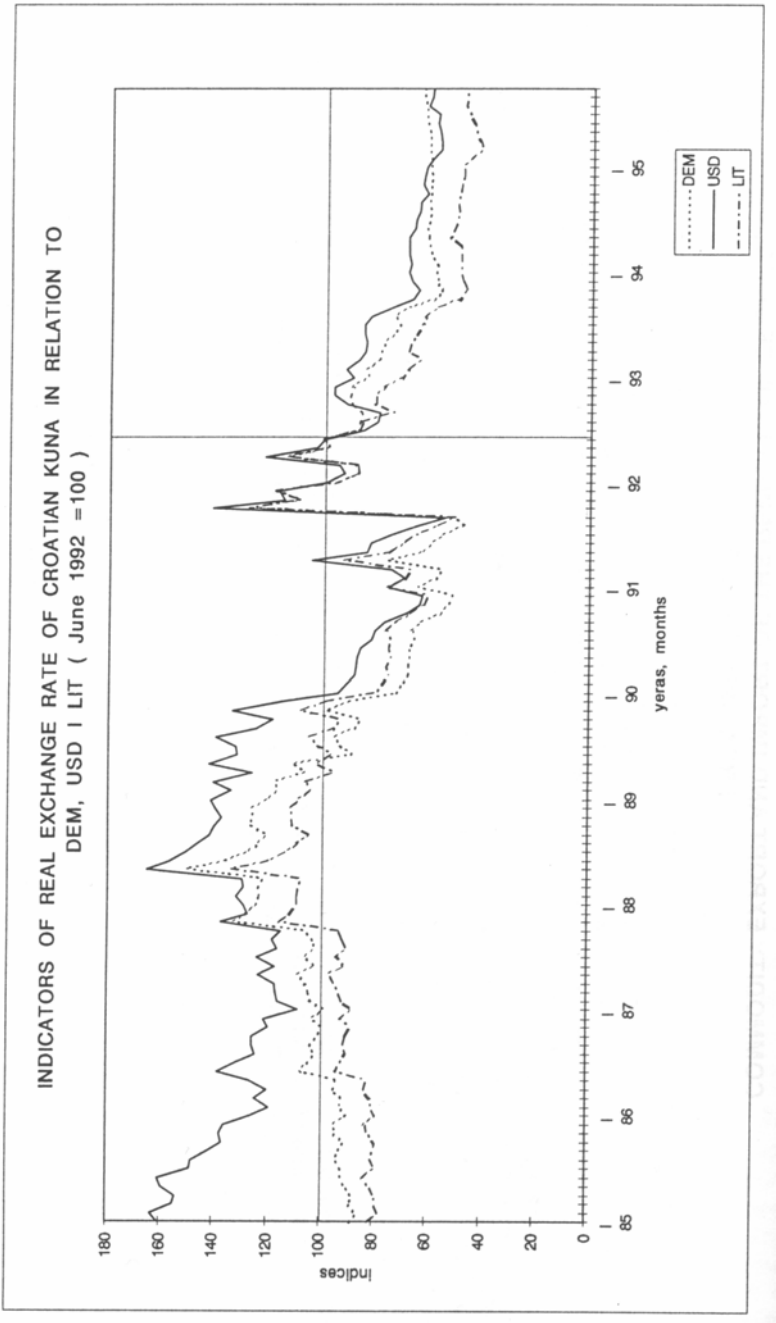
COMMODITY EXPORT AND IMPORT OF THE REPUBLIC OF CROATIA FROM 1990 TO 1995

- in mill. USD.

	1990.	1991.	1992.			1993.			1994.			I-X 1995.		
			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	Without former republics of ex-Yugoslavia	Former republics of ex-Yugoslavia	Total
	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)	(10)	(11)	(12)	(13)	(14)
Commodity export	4020	3292	3127	1470	4597	2938	966	3904	3293	968	4260	2990	881	3871
Commodity import	5188	3828	3430	1031	4461	3894	773	4666	4657	572	5229	5593	705	6298
Balance	-1168	-536	-303	439	136	-956	193	-762	-1364	396	-969	-2603	176	-2427
Export/Import (%)	77.49	86.00	91.17	142.6	103.05	75.45	124.97	83.67	70.71	169.23	81.47	53.46	124.96	61.46

Note: Commodity export and import data of Croatia for years 1990 and 1991 include inter-republic trade, as inland trade. Since 1992, data of the commodity export and import of Croatia are presented separately for ex-Yugoslav republics and other foreign countries. Since that year ex-Yugoslav republics are considered as foreign countries.

Graph 1.


INDICATORS OF REAL EXCHANGE RATE OF CROATIAN KUNA IN RELATION TO
DEM, USD I LIT (June 1992 =100)
indices
180
160
140
120
100
80
60
40
20
0
85
86
87
88
89
90
91
92
93
94
95
yeras, months
DEM
USD
LIT

4. PURCHASING POWER PARITY EXCHANGE RATE AND THE COMPETITIVENESS OF THE ECONOMY

1. Starting from the internal and external equilibrium as the development criterion of the national economy the exchange rate policy on the purchasing power parity basis is important. The rate upon purchasing power parity basis is considered as the long-term real equilibrium exchange rate to which the current market equilibrium exchange rate converges.

There is usually a significant volatility of current market exchange rates around the long-term trends of exchange rates and the purchasing power parity rates as well. The purchasing power parity 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 upon the purchasing power parity exchange rate, the same basket of goods and services in all countries can be bought. In other words, the purchasing power parity is the rate of the currency which removes the differences in levels of prices among the countries".[35] The current market equilibrium rate of exchange evidently essentially differs from the rate of exchange on the purchasing power parity basis.

The above definition determines the so-called absolute purchasing power parity. The relative purchasing power parity denotes the changes in the absolute parity in a current period in relation to the base period. The ideal base period would be when the current (market) rate of exchange is equal to the purchasing power exchange rate parity. That would offer a firm support for the measurement of the conformity or deviation of future changes in the current (market) rate of exchange from the purchasing power parity rate of exchange. The v simplification of the procedure to measure the movement of disturbances of market rates in relation to PPP rates consists in the selection of the base period assuming the equality of both rates in that period. Then we simply

[35] *See (7, PP 3).*

measure their deviations by deflating of current market exchange rates by price indices (retail prices or producer prices), by indices of nominal wage growth of employees, or cost of labor indices, etc.

Statistical research rather reliably confirms that the current market exchange rates as a rule are lower than exchange rates on the purchasing power parity basis for developed countries. For the developing countries reversed a rule is confirmed. It means that the current market equilibrium exchange rate for developing countries is higher than the exchange rate on the purchasing power parity basis. Table no. 3 undoubtedly confirms it.

Table 3.

FOREIGN EXCHANGE RATES ON THE PURCHASING POWER PARITY BASIS AND CURRENT MARKET EXCHANGE RATES, EXPRESSED IN NATIONAL CURRENCY UNITS ON THE USD BASIS IN THE YEAR 1990.[36]

Country	Purchasing power parity rate	Current market rate
1	2	3
Germany	1.840	1.610
Italy	1251.000	1195.000
Austria	12.400	11.300
Sweden	8.220	5.920
Norway	8.570	6.260
Japan	172.000	145.000
France	5.820	5.430
Ireland	0.608	0.603
USA	0.880	1.000
Turkey	1313.000	2613.000
Portugal	91.300	142.200
Spain	96.400	101.600
Greece	124.000	158.000
Former YU[37] 1985	131.000	310.000 225.000

[36] *See (7) table 2.5 and 3.1*

[37] *The purchasing power parity exchange rate is an "average" for 1985; the market exchange rate is given for the end of December (310 DIN) and for the end of January (225 DIN) of the 1985 year. The market exchange rate is on an average 2.36 times higher than exchange rate on purchasing power parity basis.*

Economic explanations of these rules can be found in the older and in the new literature,[38] and their content is as follows:

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

The consequences of the global faster growth of labor productivity in developed countries involve the faster growth of wages than productivities in their local sectors of the economy. It moves the labor force into export sectors which because of their higher productivity can attract workers by higher wages. So export sectors in developed countries on the competitive world markets, enables them to appreciate their currencies. Higher labor productivity and the possibility of higher wages in the export economy sectors compensate relatively slow productivity growth (not less than in developing countries) and the faster growth of wages (in relation to developing countries) of the local economy sectors. The consequence of these relative trends is that the relative prices of the local economy sectors in undeveloped countries are lower in comparison with these prices in developed countries. The prices of products in export sectors in developed countries are on the contrary relatively lower than the relative prices of these products in undeveloped, or in developing countries. The local economy sector consists almost entirely of the services sector with tourism. Therefore the tourist sector of undeveloped countries easily competes to developed countries, because labor wages in them are distinctively lower than the wages in developed countries service sector. It should be noticed that labor force is the basic input in service sector activities.

[38] *See: (19), (5) and (17, pp. 95-102).*

Besides, the construction industry as the production of the fixed capital in tourism is also the local activity, what furthermore represents the cost and price advantages.

Accordingly, the market mechanism leads to relatively higher prices in export sectors of developing countries compared to their local sectors (including tourism). As a result the current market equilibrium exchange rate in developing countries is higher than the real equilibrium exchange rate on the purchasing power parity 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 labor force, first of all) for export sectors. In developed countries it is just reversed, the export sectors "finance" local sectors through the labor market mechanism.

2. The entire previous analysis indicates the importance of relative prices of goods and services in export sectors opposite to local sectors. In developing countries it is expected a relatively slow growth of prices in local sectors of the economy opposite to the price growth in export sectors. A better measure would be the absolute level of prices of the "basket" of goods and services from export sectors compared to such a "basket" of local sectors. Such differences in the level are shown in the difference between the exchange rates on purchasing power parity basis and the current market exchange rate, as shown in table 3. Since there is no available "stylized" statistics of local sectors prices and export sectors prices of the country, we use as an approximation of the decrease or increase on their relative price relationships price indices in industry, indices of nominal personal incomes and price indices of services.[39] The exchange rate of Croatian kung against German mark is deflated using these three series of indices taking into account the price inflation in Germany. Time period of statistical observations is from

[39] *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.*

1985 to 1995 and from 1990 to 1995 (see tables no. 1, 4 and 5). Monthly series of real exchange rates of Croatian kung against DEM are constructed on the above three bases:

- index of prices in industry, as the representative of export sectors (table 1);
- index of nominal personal incomes, as the representative of labor costs (table 5);
- index of costs of services in household consumption, as the representative of relative prices of local sector of the economy (table 4).

Indicators of three series of real exchange rates obtained in this way are also plotted on the Graph no. 2. The obtained series of indicators suggests the following conclusions for the period January 1990 to August 1995:

- real rates of exchange of Croatian kung against DEM on the basis of industrial price indices show that local currency was appreciated in the period from 1990 to 1991 (stabilization program of ex-Yugoslavia), if June 1992 is taken as the basis.

  (The Government of the Democratic Unity). On average in 1992 Croatian kuna depreciated compared to 1990/1991 and compared to the later period: 1993, 1994 and 1995. It means that the appreciation period from 1993 to 1995 is similar to the period of 1990/1991 compared to the basic period of June, 1992.
- trend of indices of real exchange rates on the basis of service sectors prices in relation to the base period indicate a similar movement characteristics as the industrial (export) sector, but it contains a systematic "over appreciation" after the beginning of 1993; it means, that local economy sector is gradually loosing its "cost reserve" function of export sectors;
- real exchange rates on the basis of personal incomes in the whole period from January 1990 to the end of 1993 was appreciated, what means that for the exporters labor costs

were relatively increasing; only a short period from the beginning of 1993 (the time of strike threatenings) real exchange rates on that basis were depreciated or costs declining; finally after the first quarter of 1993 the trend of the Croatian kung appreciation assumed again its increasing characteristics leading to the really increasing costs for exporters; in 1994 and 1995 real exchange rates on the basis of services and personal incomes appreciate more strongly the Croatian kung than price indices of industrial products. In August 1995 on the basis of price index of services Croatian kung really appreciated 62%, and on the basis of personal incomes indices 66% in relation to the base period of June 1992=100. It suggests that for the exporters on the foreign market costs grow faster than revenues. But the revenues of exporters decrease for the same quantity exported due to 36% appreciation of the Croatian kuna on the industrial price index basis in August 1995 related to the base period. Those three percentages of the appreciation in August 1995 indicate tendencies of diminishing competitiveness of exportable sectors on the domestic market as well.

In other words, local goods and services did not represent a tendency of "cost reserve" to exporters, as it would be expected for an undeveloped or developing country. Current costs appreciation of Croatian kung in comparison to 1992 denotes a process of gradually diminishing competitiveness in export economy, as well as in local economy where products could be replaced by imported goods. Demands for protection in the form of import licenses, surtaxes and tariffs undoubtedly refer to this.

It can be concluded that the competitiveness of the export economy has three essential aspects:

- export competitiveness ensures balance of payment equilibrium as well as the employment of the entire national economy 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;
- to the countries, developed as well as undeveloped, integration into the regional trade systems (EU, EFTA, CEFTA, NAFTA) and into the world global trade systems (GATT, WTO), exchange rate policy, especially policy of real depreciation becomes a fundamental instrument in development strategy of an open economy. This is especially true of the small open countries.

After reaching an adequate level of development measured by per capita income, a greater importance in the development strategy belongs to the policy of fixed and stable exchange rate with the goal of a stronger structural adjustment to the world market. In this phase of the development the goal of development strategy is full inclusion of the country into the world financial system and market. This is the phase of the liberalization of capital accounts in the entire balance of payments which was preceded by a gradual liberalization of the foreign trade system and the domestic financial system. All this must be coordinated by the macro- economic stabilization policy.

Table 4.

INDICATORS OF REAL EXCHANGE RATES OF CROATIAN KUNA RELATED TO DEM ON THE BASIS OF PRICE INDICES OF SERVICES OF HOUSEHOLD CONSUMPTION (JUNE 1992=100)

year / month	1990.	1991.	1992.	1993.	1994.	1995.
I	47.81	21.38	61.26	86.28	47.62	39.81
II	44.62	18.98	58.45	83.58	44.93	39.76
III	42.73	18.31	66.48	81.72	44.06	39.41
IV	39.76	23.02	86.09	84.73	44.03	38.01
V	39.01	20.89	86.21	77.54	43.71	38.38
VI	37.91	19.89	100.00	71.29	43.34	38.36
VII	26.42	18.65	93.91	67.65	42.32	38.15
VIII	28.98	18.15	97.31	66.76	42.17	37.98
IX	27.79	21.20	92.06	66.98	41.77	38.09
X	26.01	60.55	93.86	52.90	41.04	
XI	24.89	56.59	94.31	46.80	41.15	
XII	23.76	64.96	86.24	48.15	40.24	

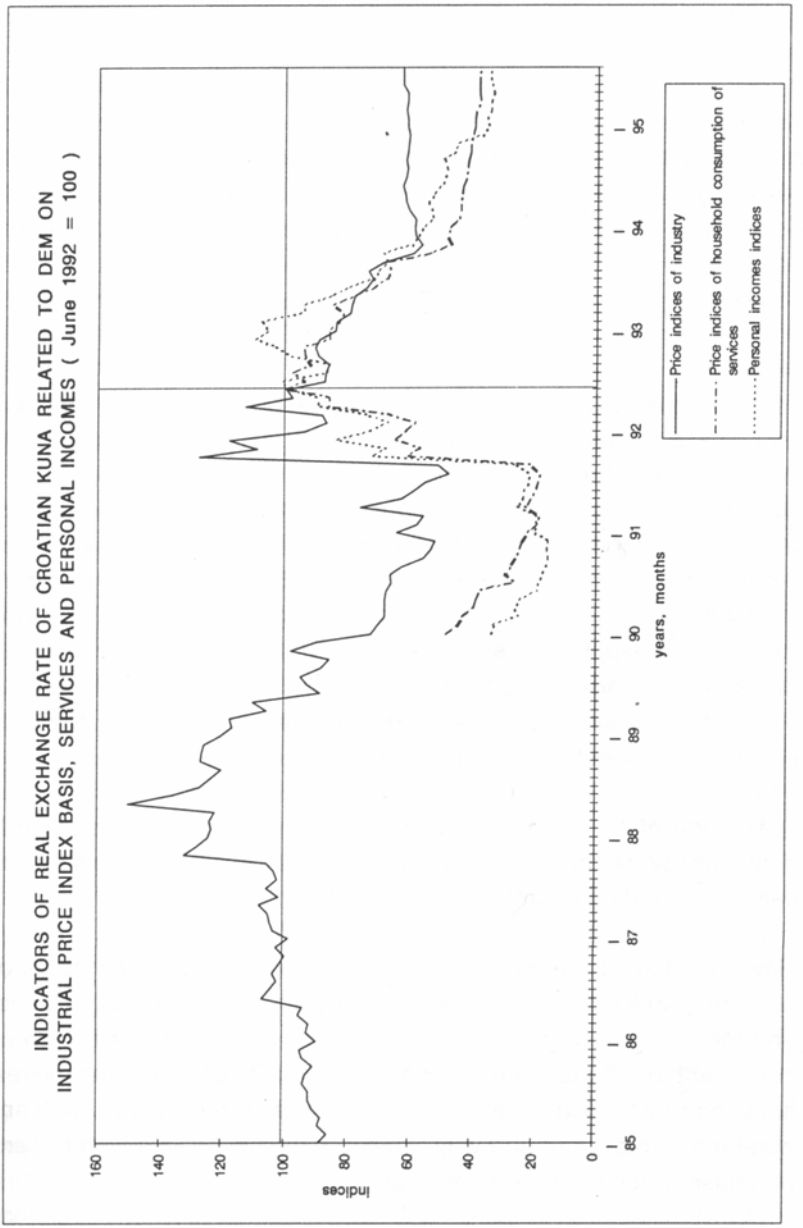
Table 5.

INDICATORS OF REAL EXCHANGE RATES OF CROATIAN KUNA RELATED TO DEM ON THE BASIS OF PERSONAL INCOMES INDICES (JUNE 1992=100)*

year / month	1990.	1991.	1992.	1993.	1994.	1995.
I	33.75	19.83	72.89	105.68	56.11	35.38
II	32.92	19.34	67.49	107.78	53.15	36.07
III	25.42	19.34	73.81	94.67	53.31	34.57
IV	26.25	25.37	89.29	94.08	54.78	34.42
V	24.44	23.75	90.43	85.33	52.80	33.60
VI	19.14	23.24	100.00	79.72	50.36	34.05
VII	18.94	21.94	101.37	72.01	49.12	35.02
VIII	17.41	21.49	87.10	70.30	48.39	34.37
IX	16.56	25.91	86.30	67.50	49.08	
X	15.85	72.06	99.15	68.80	46.23	
XI	15.97	68.12	103.40	59.94	44.44	
XII	15.81	83.58	109.37	58.25	37.14	

* *Note: Since the end of the year 1994 "net wages" include the equal amount per employee of social subsidy ("hot meal"); so it additionally influenced the growth of nominal personal incomes and thereby stronger kuna appreciation.*

Graph 2.


INDICATORS OF REAL EXCHANGE RATE OF CROATIAN KUNA RELATED TO DEM ON
INDUSTRIAL PRICE INDEX BASIS, SERVICES AND PERSONAL INCOMES (June 1992 = 100)
indices
160
140
120
100
80
60
40
20
0
85
86
87
88
89
90
91
92
93
94
95
years, months
Price indices of industry
Price indices of household consumption of services
Personal incomes indices

5. SUMMARY AND CONCLUSIONS

1. The analysis of exchange rate policy, the policy of protection and liberalization of foreign-trade system and their interrelationships with the strategy of economic development of Croatia have given a series of results that are significant for the policy of internal and external equilibrium. External and internal equilibrium is defined as the equilibrium of the current and capital balance of payments and stable equilibrium prices on the domestic market, coupled with the full employment of production factors.

2. The expansive or restrictive monetary and fiscal policy connected with interest and foreign exchange rate policy or the balance of payments equilibrium policy are key instruments of macroeconomic policy coordination. Such coordination on the world level develops within the members of the International Monetary Fund. Stabilization program of the Croatian government in the form of the Memorandum on economic policy coordinated by the International Monetary Fund includes corresponding "surveillance". The Memorandum comprises monetary and fiscal policy connected with foreign exchange rate policy. Surveillance comprises expected problems of the domestic economic competitiveness on the world market.

3. The goal of the real depreciation policy is to switch demand towards domestic goods and thus to increase domestic production. It is the so-called "expenditure switching policy".

However, the efficiency of the depreciation (devaluation) depends upon the consistency of the credit policy, the policy of budget deficit and the policy of wages. In the middle term these policies should be consistent with "fundamental economic factors" that determine the real exchange rate, such as "terms of trade", technical progress, tariff and non-tariff protection, one-way transfers, as well as incomes and purchasing power of the population.

4. In Croatian current circumstances the policy of the government and central bank is preoccupied in the first place by inflation problems. Their insistence on the orie-way over restrictive monetary policy ' leaves the question of development recovery still open. Too long maintenance of the appreciated practically fixed exchange rate by means of monetary and income policy mainly enables high profits to importers of goods, but produces unprofitability of exporters.

5. Due to foreign exchange transfers (workers' remittances, humanitarian assistance, the state official transfers) and due to the moratorium on foreign debt capital repayments, an illusion of oversupply of foreign exchange is created in Croatia. It makes in the middle term inconvenient structural blows to the economy because of a sudden opening of the domestic economy to a strong world competitiveness. In this way the signs of the so-called "Dutch disease" are met. It can be also explained by the internal structural disequilibrium caused by the low level use of available economic capacities and low purchasing power of the population. It should be added that short-term and speculative capital in different forms begins to finance the current trade deficit, attracted by extremely high interest rates. Monetary policy unintentionally supports these processes.

6. In the future, foreign exchange inflow will far more depend upon export of goods and services of the real sector of the economy because different one-way transfers and speculative inflows will loose the weight they have today. Therefore, the export policy and exchange rate policy have to design a real equilibrium exchange rate aiming to expand the present-day export of goods and services additionally at least 60-80% at the end of the approximately six-year period.

7. The foreign exchange system in the economic policy is determined by the choice of priorities in the development strategy. The policy of fixed exchange rate is consistent with the strategy of open economy and the policy of floating exchange rate with the strategy of the closed

economy. Due to the employment level rigidity advantage will have the system of floating exchange rates. Floating exchange rate system in the middle term decreases the costs of adjustment in terms of unemployment rate, or the unuse of available economy capacities.

8. The floating exchange rate policy if in conformity with the stabilization objectives of the stable equilibrium on the domestic market in the form of stable prices and full employment, supports competitiveness of the domestic economy on world market, and the domestic economy becomes more isolated from external shocks. Autonomous monetary policy and fiscal discipline is supposed to maintain a non-inflationary environment in the country. Fixed exchange rate policy, on the contrary, does not enable the isolation and automatic protection of the economy. Monetary and fiscal policy in that case must protect fixed exchange rate which is usually fixed to some world stable currency. In present-day Croatian circumstances high inflation is not possible until the real depreciation can be achieved by credit expansion with a supposed fiscal discipline and control of wages.

9.The growth of foreign exchange reserves on condition of the monetary non-sterilization increases by itself the money supply and thereby the basis for credit expansion. It increases demand in short term and by this also prices on domestic market, what appreciates by itself local currency if exchange rate is fixed, and decreases the competitiveness on the world market. If the economy strongly depends upon the foreign market, as it is the case with the Croatian economy, then if it is on the contrary supposed an over strong monetary sterilization, deflationary or depressive characteristics will arise. Then the financial equilibrium will be established on the under-equilibrium level, the so-called "underfullemployment equilibrium" of the economy potentials.

10. The appreciated exchange rate of kung is an important reason of a fast increase in imports and a very slow export increase in the Croatian

economy. Exposed to foreign competitiveness (due to the appreciated kuna) and to the shortage of long-term savings and capital and too modest inflow of foreign direct investments, the economy is not able to decrease costs in the short and middle term by technological improvements so as to increase competitiveness on the domestic and foreign market. The main objective of the protection policy as a component of economic policy is to restrict foreign trade by different measures of tariff and non-tariff protection in order to protect the economy from foreign competition. In order to realize its objectives the protection policy must be determined according to the following criteria: what to protect (qualitative criterion), how high protection to introduce (quantitative criterion), how long to protect (time criterion), with which and how to protect (instrumental criterion).

11. Simultaneously with the process of strengthening and decreasing the protectionism (neoprotectionism) in the world, goes the process of a stronger liberalization and an increased aspiration to the multilateralism which has to remove restrictions in international trade. GATT as an universal institution is supposed to deal with the problems of world trade. Uruguay Round of negotiations completed a reinterpretation of decisions by GATT from 1947. The results of the Uruguay Round can be summarized as follows:

a) alleviation of the access to the market,
b) inclusion of the "old" sensitive sectors into the system of GATT ordinary rules,
c) expansion of the rules of GATT to new fields of economic activities, such as different services and intellectual property, d) establishment of the World Trade Organization.

12. By its access to GATT and then to the World Trade Organization Croatia will have to accept the determined rules and principles of foreign trade liberalization in its foreign trade policy. It means to decrease tariff and non-tariff protection. By becoming a member of a regional integration, Croatia will be obliged to carry over a great deal of its national decision making authority in the foreign trade policy to that

integration (e.g. to European Union or Central European Free Trade Area).

In any case, Croatia is expected to implement more openness of its economy to foreign countries, a stronger liberalization in the foreign trade system and a decrease in the use of the diversified system of protection of its domestic production. Consequently, the significance of the exchange rate policy in keeping and improving competitiveness of the economy will increase.

13. The estimation of the real exchange rate of Croatian kung in relation to the German mark, American dollar and Italian lira is done on the base period June 1992=100. Indicators of the real exchange rates of Croatian kung show that it was really appreciated in relation to the base period. In October 1995 in relation to June 1992 kung was really appreciated by 36,37% against DEM, 39,89% against USD and 52,26% against LIT.

The indicative rates of the effective tariff and non-tariff protection of the Croatian economy show that the rates of the effective tariff and non-tariff protection in individual sectors spread between 16,01 % and 35,84%.

If indicative rates of the effective tariff and non-tariff protection are compared to the exchange rate of the Croatian kung appreciation, it may be concluded that all rates of the effective protection by sectors are smaller than the rates of real appreciation of Croatian kuna in October 1995 in relation to June 1992. Accordingly, the rates of net-effective protection are negative or around zero.

However, the ability of the economy to ensure a given profitability in spite of the appreciated kuna is kept for a time due to the increase in cheaper imports of raw materials, spare parts and equipment from abroad (outside the former Yugoslav area) with decreased tariff and

non-tariff protection rates. This policy measures increase possibilities of savings on producer's costs side. Namely, in 1987 the share of domestic inputs in intermediary consumption amounted to 59,4%, the imported inputs from former Yugoslav republics 25,5%, and from other countries 15,1 %. Since the import of intermediary inputs comes usually from the convertible area, that makes it possible to keep costs lower due to the local currency appreciation. Assuming that the share of domestic inputs remains 59,4%, and the rest of 40,6% of inputs are imported from the convertible area, the appreciation of the Croatian kung of 36,37% against DEM makes possible a cost decrease of about 14,8% in the average of the economy. Lower prices of inputs imported from abroad decrease costs additionally. As every economic sector has different import content, there are different sectoral effects of appreciation of the Croatian kung on the cost side of producers.

Therefore, the real appreciation of local currency kung creates tensions depending upon the sector of the economy, and makes different pressures for the protection. Evidently, it is necessary to make exchange rate policy and foreign trade policy consistent with each other and with the stabilization policy.

14. Data on commodity export and imports of Croatia reveals that imports exceed exports which makes a deficit trade balance. That trade balance deficit (without the regions of ex-Yugoslavia) increased from USD 303 mil. in 1992 to USD 1371 mil. in 1994, and to USD 2603 mil. in the period from January to October 1995. That is not only a consequence of a real appreciation of the local currency. It is also a consequence of different war and post-war causes, as f.e. trade embargo of EC in the year 1991 /1992. The fast increase in trade deficit (without former republics of ex-Yugoslavia) in 1995 revealed a main influence of the appreciated kuna and high interest rates.

Finally it can be concluded that the high rate of appreciation of the local currency decreases export competitiveness, and that it is necessary to

establish a closer link between the exchange rate policy and foreign trade liberalization policy. Besides, it is necessary to establish a specific strategy of promoting regional reallocation of exports from the "soft" export market to the "hard" market, where other rules of the price and non-price competitiveness simultaneously dominate.

15. It can be expected that the export income multiplier will be lower than in the prewar time, if the former Yugoslav market outside of Croatia is considered as a foreign country. This is caused by a twoway import substitution: the main part of inputs will come from foreign countries (without former republics of ex-Yugoslavia), but the smaller part of those inputs will be substituted by the domestic Croatian supply. Hence it follows that projected growth rates of gross domestic product will be lower due to the implied lower export income.

16. It is confirmed for many countries that the current equilibrium market exchange rate is as a rule lower than the exchange rate on the purchasing power parity basis in developed countries, while in developing countries market equilibrium exchange rate is regularly higher than the exchange rate on purchasing power parity basis. It is explained by a relatively faster growth of labor productivity in export than in local sectors of the economy. But differences of growth rates of labor productivity are smaller in local than in export sectors among developed and developing countries.

The market mechanism gives relatively higher prices of export sectors in developing countries compared to their local sectors. Thus, the current market equilibrium exchange rate in developing countries is higher than the real exchange rate on the purchasing power parity basis. Relatively lower domestic prices of local goods and services in developing countries appear as specific cost savings for export sectors, white on the other side in developed countries export sectors "finance" local sectors.

17. The estimate of the real exchange rate of kung against DEM on the basis of price indices of the industry as an export sector representative, then on the basis of nominal personal incomes indices as a representative of labor cost data, and finally household consumption of services in terms of service costs indices as a representative of local economy sector allow to conclude that the indicators of real exchange rate of the Croatian kung on the basis of services prices and personal income give higher level of kuna appreciation than the real exchange rate on the basis of industrial prices.

Since the real exchange rate on the basis of services prices and personal incomes more strongly appreciates Croatian kuna .than on the basis of price indices of industrial products, it means that the costs of exporters are faster growing than their revenues. As a result, the local factor of production does not represent a "costs reserve" to the Croatian exporters.

18. Developing countries by real depreciation of their currencies usually achieve better results on the world competitive market. Export competitiveness ensures balance of payments equilibrium and full employment of the national economy. But, by higher level of integration into regional trade systems, as well as the world global trade system (GATT, WTO), the exchange rate policy and especially policy of its real depreciation becomes more important instrument in the development strategy, especially of a small open economy. When an adequate level of development is achieved, the policy of fixed exchange rate with structural adjustment objectives becomes more important in the development strategy. In this phase of development priority of the strategy is the accession of the country into the financial world system and world market. That is the phase of the capital account liberalization along with a complete convertibility of national currency both for current and capital transactions.

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