

## YEAR OF ANTI-INFLATION POLICY

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In October 1994, it has been a year from the beginning of implementation of the Stabilisation program in Croatia. As at the time its passing and, particularly, its basic principles have been the subject of a series of discussions burdened with partial problems, so are now the process and modalities of its previous and future realisation undergoing different evaluations and attitudes, ranging from the glorification of the "economy miracle" to the partial criticisms of the scenarios and the method of the Program implementation. The fact is that this Program has represented the basis for the conclusion of the stand-by arrangement with International Monetary Fund, so in this context it is explained either as a very important step on the way to international affirmation of Croatia, or as a self-initiative "hasting into" more restrictive regulations of economic behaviour forced on by international financial system but not adequate at the economic instant of Croatia, nor are the regulations used internally by the countries-creditors.

If the estimates, only declaratively referring to the Program, though in fact reflecting the attitude towards the immediate protagonists, are excluded, the difference of the evaluations on the Program and its implementation must be proving the existence of vast differences not only in the sphere of comprehending the "essence" of the Program and the possible implementation results, but also in the sphere of effective consequences its implementation might have on particular segments of Croatian economy and the society as a whole.

The differences are, in a way, brought about by the Program itself, by its contents, the manner of presentation and mostly by the concrete results which do not appear easy to be stereotyped and put into the limits of a dogmatised knowledge and the expectance of the desired. Though, in fact, it has begun its existence as the element of a continuity

of economic policy, realised at the very moment the economic, political and other conditions had ripened, the Program could not have contained the characteristics of continuity and even its passing had been forced by the escalation of hyper-inflation which itself had arisen from the effective stands of the previous policy. Thus, it is marking the kind of crash of some of essential segments of the previous policy and populist philosophy on which it had been, whether with awareness or not, founded.

However, it does not mean that the situation in the country as well as its relationship with the international environment had not been changed with regard to the previous state, nor does it imply that within the previously organised economic policy some moves to facilitate and even directly to assure the implementation of the Program had not been made - including the changes of the relative prices and the preparations for the beginning of the implementation of the Program presented in the crucial passing of the Law on Foreign Exchange System - but it was the Program that had given rise to the essentially changed relation of the economic policy with the activities occurring in the country. The policy had been transformed from the instruments of discovering the ways to survive within the given economic conditions to the means to create conditions in which it might be possible to start on radical changes. The forced speed of preparations and passing of the Program as well as the related constellation of the relations within the society has had significant implication on the Program's character, goals and general conditions of its implementation.

Basically, inspite the reference to the large concept of stabilisation, the Program does not seem to be exceeding the limits of a consistent set of anti-inflation measures, or is in fact containing the elaboration of only the first phase of the stabilisation policy, while the other phases are connected to the changing of the economic system and totality of the process of transition and are not defined in details. This is a logical conclusion as the stopping of inflation represents the condition for the beginning of the re-structuring of economy and introducing the development components into the economy policy, but the fact

remains that "parallel drive on two lanes" leaves enough space for the occurrence of disharmony and of the reduction of the global efficacy of economic policy.

The problem was difficult to avoid owing to the necessity of an urgent anti-inflation intervention in the given economy and system conditions the changes of which might require a lengthy period of time as well as to the reason of the transition of the economic system, with the attempts to take over and modify the standard solutions of the practice in the world, being partly burdened with the same populist spirit which was present in the economic policy preceding the Program. The fact mainly refers to the complex of transformation of ownership, its economic and social aspects, implying the double role of the state - on one side as the creator and the subject implementing the economy policy, while on the other as the major (at least temporarily) owner of state-owned part of economy on which the measures of the economy policy are to be implemented. The dualism has been brought out in a series of forms of mutual intermingling of interests on the relation state-enterprise, the point of contact being in the banking system, thus influencing its relationship with the central bank. Therefore, in practice, there have not been made attempts to realise some elements of the Program more fully, or these must have been introduced into the Program outside the context of the basic scenario. Fortunately, the elements have later proved to be non-essential from the point of view of the realisation of the basic goal posed by the Program.

That way, the bearers of the economy policy have been given chance of being widely active by methods of indirect, and even direct influencing the activities of the economy subjects (through inducing the changes of the relations on the market, particularly the foreign exchange one; through the power of legal provisions and rights of the major owner), but still in the relatively limited intermingling of different interests and with the limitations of the direct goal. Therefore, the results of the implementation of the Program should be considered within the above limitations.

On the basis of such approach, the success of the Program is undoubtful. The implementation had immediately shown that, no matter what the initial driving forces, the preceding progression of the inflation to the monthly level of 30% had not been the necessary result of the supposed surplus of the aggregate demand over the war depressed real level of the domestic production and supply, nor was it the product of the structural disbalance arising from the limited capabilities of the mechanisms of non-inflation distribution of incomes to harmonize the primary distribution with the rigid sector structure of effective demand, but that the phase of inflation progression represented the typical self-reproductive hyper-inflation in which, by various mechanisms of indexation, upon which the growing inertia of inflatory expectation has been built.

Hence, it has been demonstrated that the stopping of such a type of inflation could be done quickly by using the shock therapy, not the gradualism, directed to the destruction of the mechanisms of the reproduction of inflatory expectations, not by moves of drastic administrating, but the purposeful use of market disbalance deepened previously by the hyper-inflation itself. The key role has belonged to the opening of foreign exchange market and to the introduction of internal convertibility of national currency, which helped the previous inflation drastically reduced quantity of real money to be inducing a significant rise of supply through transferring of accumulated foreign exchange, thus stopping not only indexation but bringing about the appreciation of the exchange rate as the basic indicator of inflatory expectations. The effectively insufficient real level of domestic aggregate demand connected to it, particularly with regard to the supply with indexed expenses which has become obvious at the moment of the decrease of credit activity of the banks.

Due to the disbalance at the beginning of the Program implementation, the inflation did not only stop, but economy entered the deflation process, to be arriving to the stabilisation of the prices on the level which has been 12% lower at the producer of industrial products level than the price before the Program implementation, which corresponds

to the intensity of performed appreciation of the exchange rate. It has reduced and then stabilised the expenses of input in the infra-structural branches with mainly high, direct or indirect, importation content, which resulted in above-average reduction of the prices (in production of oil and gas by 20%, of oil derivatives by 27%, of chemical products by 17% and in the electrical industry by 30%) and on that basis in the relative reduction of total material expenditure of the domestic economy. At the same time, the appreciation of the exchange rate has directly influenced the prices of the output in the mainly export branches which cannot put the exchange rate difference on the importer, and due to the limited domestic market they cannot be building them into the domestic prices (14% decrease of prices in machine construction, 13% in production of electric devices and equipment, 20% in the finished textile products etc.), while the fact that part of the infra-structure branches (oil derivatives, chemicals) are, at the same time, the significant exporters seems to be stressing the influence of the appreciation of the exchange rate upon the decrease of production prices.

Simultaneously, the prices were receiving impact from the low liquidity and relatively high price of domestic money, implying also the high demand for money and limited demand for commodities and services on the domestic market. As the first one is resulting in keeping a relatively high level of interest rates, the other one, in combination with the appreciated exchange rate is strengthening the relatively high influence of the foreign competition, they have been directing the producers, in the entirety of the activity, to seek for the solution of the insolvency problem in the real sphere, or in the increase of the trade and realisation.

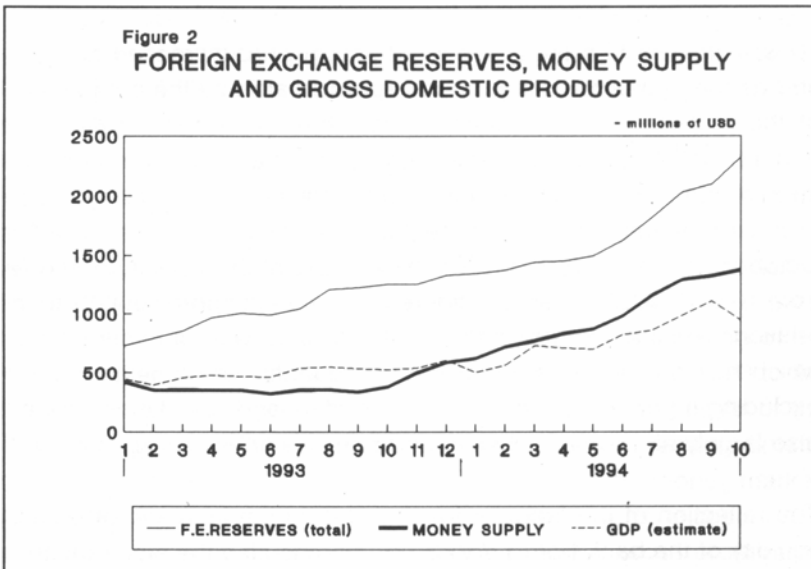
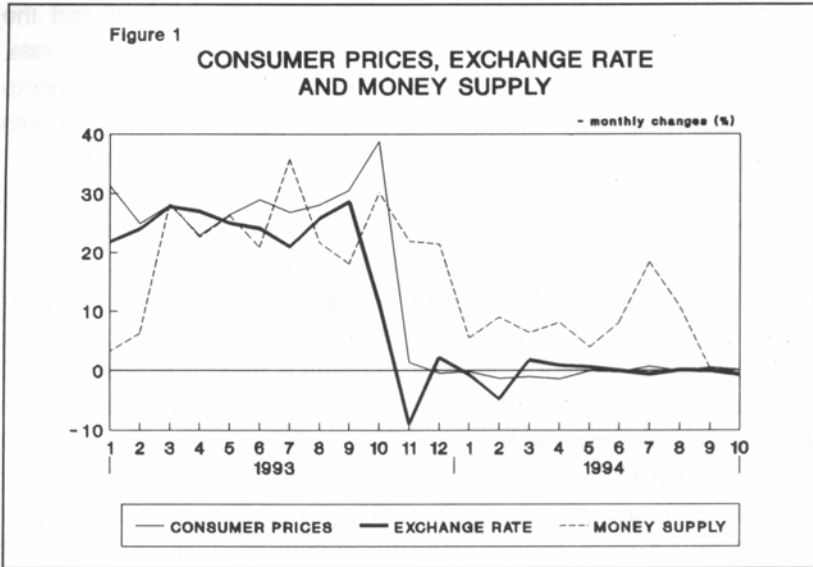
That way, the relation between the supply and demand on the domestic market, has begun to be gradually influencing the price moves, and depending on it the quantity of products and services, making them psychologically weaker, while the market elements have been strengthening in structure of price forming. In the trading the situation appeared similar, so that the retail prices have been following the general tendency of the decrease of producer prices, though with the

slower intensity and, in October 1994 they have been by 2% lower than in the same month of the last year.

The intensity of such moving of the price aggregate appears to be as important as the extension of the basis which points to the powerful presence of demonstration effect and it arises from the changes in the sphere of inflation expectations. For that reason the activity of the Program regarding the movement of the prices has been all-inclusive and unvarying, which only seems to confirm that the determinants of the past inflation have been general but not partial.

Thence, the stopping of inflation and the realised reduction of the prices, have made the reform of the tax system result in positive activity of solving the problem of one of the crucial initial factors of inflation - budget deficit. This only confirms the thesis of the multiple reverse activity of hyper-inflation on intensifying of problems in fiscal sphere and it varies from the impact the deficit may have in transforming the normal inflation into hyper-inflation, as well as the thesis that the problems by themselves do not always lead to hyper-inflation. And the last was the case in Croatia, at least in the domain of fiscal changes which have arisen directly as the consequence of war. If it were not so, the hyperinflation would not have been stopped so quickly inspite the character of the anti-inflation program and the decisiveness in its application.

Together with the realisation of such primary results of the implementation of the Program, the significance of the expenditure, i.e. the cost of its implementation, has increased, and on that very question the differences in evaluations of its success have arisen. That appears logical, as the experience of countries has been so varied, despite many theories of the possibilities of dis-inflation of the national economy without significant macro-economic expenditure in the area of the drop of the production, employment rates and standard in the programs in which the central position is held by the currency rate policy and non-worsening of the relation in the balance of payments. Therefrom, within the context of totality of conditions in Croatia, there



are still present the beliefs that the stopping of inflation and the occurrence of de-flation with the appreciation of the exchange rate, which all bespoke of the restrictions in monetary policy, will have to have negative reflection on the production and exportation though with a time difference.

However, the facts are proving that it has not occurred, at least not in the sense of the direct global impact. The basic reason for that lies in the fact that the monetary policy, by its implementation of the Program, has ceased to be as accommodating, as it used to be in the hyperinflation conditions, without becoming really restrictive. Quite opposite, after the October "coup", using effecting of until then un-operative dis-balance between the quantity of domestic money at hand and foreign exchange reserves, with which the direct connection between the growth of money and domestic prices has been interrupted (at least temporarily), the continuation of relatively high increase of money mass has made a fast re-monetisation of the national economy possible.

Thus, in the last 12 months, the money supply has increased by 190%, and as the realised social product, approximated by the net payment of the realised products and services, has increased by 44%, the quantity of the real money measured by the relation between nominal level of the money supply and monthly value of the realised social product has augmented from the October last year 0.725 to 1.461 in October this year, which implies the slowing of the velocity of money from 16.55 to 8.21 a year. The figures correspond approximately to the relations existing in 1992, before entering the cycle of hyper-inflation which has drastically reduced the real quantity of domestic money, excluding it not only as the measure of value and calculation unit, but also largely as payment choice, and particularly as savings choice.

The reflection of the fact can be detected in the increase of primary liquidity of the bank from 1.7 to 2.7%, there is also the stabilisation of the relation on the money market, where the demand has been globally harmonized with supply and has become 6 times lower than



in the first months of the stabilisation program implementation, remaining on the level of 6% of the money supply compared to the previous 65%.

The basis of the remonetization has been represented by the conversion of a part of the foreign exchange reserves, which have reached US\$2,300 million at the end of October in 1994, showing almost US\$1,100 million increase in comparison to October 1993. Within the figure, the foreign exchange reserves of the central bank have increased from US\$500 to US\$1,370 million (thus increasing their part in the structure of total reserves from 40 to about 60%), determining the increase of the monetary base in the countervalue of US\$530 million. At variations of the share of monetary base in the money supply around 55% average, it has resulted in the increase of about US\$1,000 million or by 162%. That way the combination of the monetary multiplier and initial appreciation of the exchange rate has lead, during the present implementation of the stabilisation program, to the increase of the relation of the money supply and foreign exchange reserves of the central bank from 0.76 to 1,0 as well as of the relation of the money supply to the total foreign exchange reserves from 0.30 to 0.59, which represents the foreign exchange aspect of the remonetisation.

As such has been the basis, the remonetisation could have had the intensity and extension to neutralise the structural problems in allocating the money means, which always implies the existence of significant differences in the distribution of the liquidity. Owing to the fact the price of money remains very high despite the lowering of the discount rate of the central bank from 34.5% at the end of 1993 to the present day 8.5% a year. Thus the average year interest rate of the business banks for the short-term non-marked credit-loans mounts to 17%, the same as the level of the interest rates on the money market, while the interest rate for the investment credit-loans exceeds 20% which is objectively much higher than tie potential gross profit rates. It is, however, the problem the monetary policy cannot solve by itself.

Figure 3

**GOVERNMENT REVENUES AND PERSONAL INCOMES**

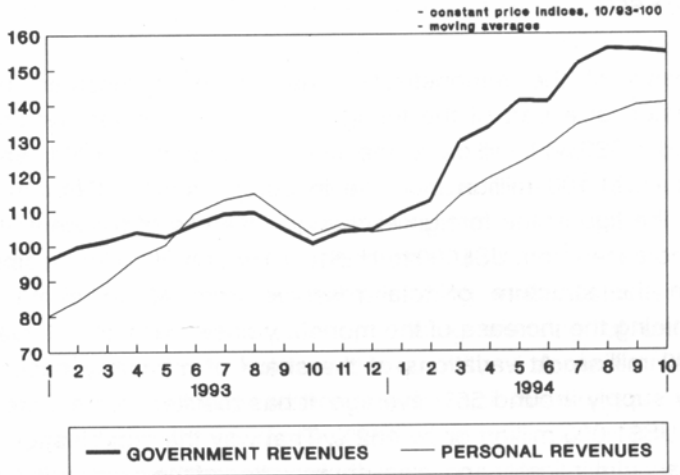
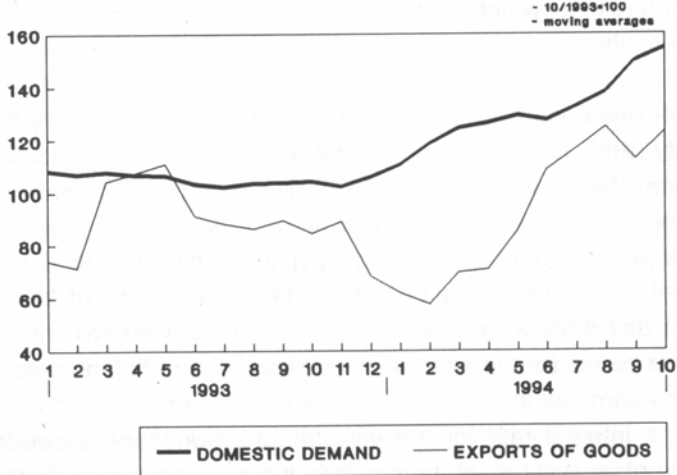


Figure 4

**DOMESTIC DEMAND AND EXPORTS OF GOODS**



However, despite the high price of money, the remonetisation of the national economy in the condition of stable prices of commodities and services on the domestic market, has made the fast real increase of the incomes and domestic aggregate demand possible. Thus, the mass of net wages has increased by 38% from October last till October this year, and the fact has not been forced by social reasons, but has been the logical economical result of the positive influence of stopping of inflation and performed remonetisation on the real growth of net revenues of enterprises.

The share of the net wages in the revenue has decreased with the previous indexation of over-dimensional 28% in October and 31 % in November and December of the last year to 22% in September and October this year, while the whole period January-October 1994 the average has been 27%. The fact that in the same period of last year the share had been lower (24%) only points to the fact that the mechanisms of the inflation taxation of the months preceding the bringing of the Stabilisation program have decreased the production potentials of the economy.

During summer months, for the first time since 1991, such moves of the basic component in the forming of the paymentable demand of the population on the domestic market have been connected to a significant increase of tourism, so that the consumer's expenditure for commodities and services have been continually increasing, reaching, in October 1994, the 69% higher level than the preceding year one, and being by 30% higher for the January to October period than in 1993.

This rises the tax basis and, with the effects of introduction of excise duties, reduction of the tax evasion and the occurrence of Tanzi-Oliver effect, it is corresponding to the gross collection of budget revenues increase of 50%, its level being 33% really higher than in 1993.

Primary effect of such movements of incomes is the occurrence of the surplus in the budget (4% of total revenues), making the reduction of

net liabilities with the central bank and the increase of liquidity possible. The fact brings the increase of material expenditure of the public sector - either current or based on the earlier established liabilities towards the economy. The expenditure has risen in the last 12 months by 43% and thus the level has really increased by 22% in comparison to 1993 figures.

The tendency of acceleration is pointing to the third component of the domestic aggregate demand - payment for investment, rather low level and high monthly oscillations are still not pointing to the conclusion that there have been some significant moves in that sector. This differentiates the structure but does not reduce the total dynamics of the growth of the domestic aggregate demand, the level of which has increased from October last year to October this year by 59%. This situation has been analogous to the situation in the sphere of money means, where, naturally, there also exist problems of structural character, particularly in non-essential consumer commodities and investment equipment area, but globally it is shown that stopping of the inflation accompanied with the remonetisation of the national economy has not brought, contrary to expectations, the contraction of the domestic market.

On the other side, however, the influence of the appreciation of the foreign exchange rate, as well as the increase of the domestic demand for commodities from more substitutive markets, upon the movement of exports appear more problematic and consequently, they are the subject of far more pronounced differences of viewing the problems, as the question of exports is regarded within the really increased prices of work and capital on the domestic market. Connected to the afore said is the fact that the exportation of commodities has been on a very low level at the beginning of 1994, though due to longer cycles of contracting of business and delivery of goods one should be very careful in interpreting the changes of short-term tendencies in movement of foreign trade.

It is the matter of too great a drop to be explained only on the basis of one factor, particularly not the movement of the exchange rate, or primarily as the consequence of the producers definite reluctance to make contracts and realise export trading in the conditions of the appreciation of the exchange rate at the beginning of the stabilisation program implementation which has preceded the reduction of the prices on the domestic market, either due to relative drop of the rentability of the exports and to the distrusting of the Program and expectations that the monetary reform (performed at the end of May) will be accompanied by the devaluation. But the increase of exportation occurring in the middle of 1994 points to the fact that this element can offer explanation on only one, more speculative, aspect of the movements of exportation following the implementation of the Program, from the point of view of real determinants and the totality of motifs.

At least two relevant factors should be added. The first is referring to the change of external conditions of decision making and the realisation of export business connected to the adequate changes of political circumstances in the expanses. Significantly low level of exports, but the imports as well, i.e. total foreign trade with all the important partners at the beginning of the year, followed by the general continuity of the increase of the trade business are indicators for the above. The other factor arises from the cumulated effects of the remonetisation of the economy with simultaneous relatively high foreign exchange liquidity of the business banks, which allows two groups of factors.

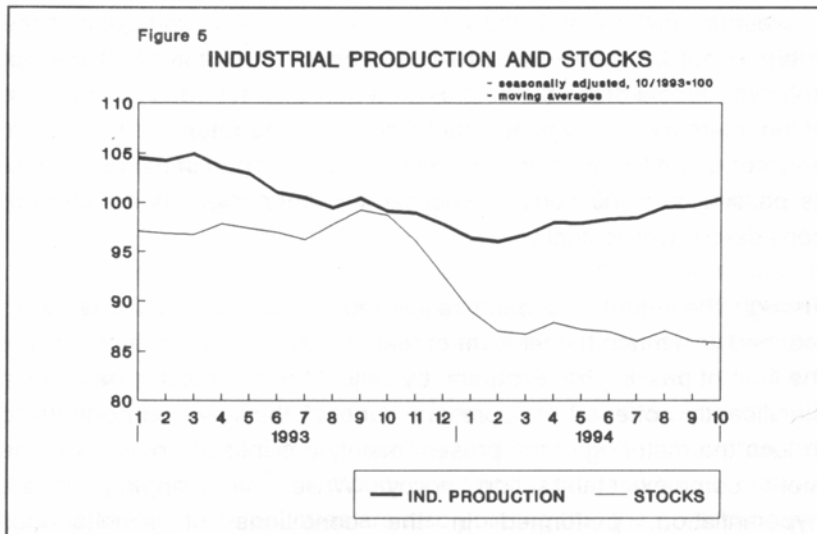
On one side, the passability of the channel is being increased in the sphere of financing the production and the preparations for exports particularly regarding internal and external components, the reflection of which is the powerful boost of importation of production materials in the last months. On the other side, the same combination of elements has made the significant increase of importation of consumer goods possible, intensifying the competition on the domestic market regarding the quantities as well as the prices. Thus, with the

stabilisation of the exchange rate and domestic prices, the manoeuvring space for the autonomous selection of partially substitutive markets for product placement has been reduced.

If the above is connected to the movement of the domestic demand, the answer is reached regarding the expenditure of the Stabilisation program implementation.

If the stopping of the inflation has made the real increase of incomes and demand on the domestic market possible, and the way in which it was done has not resulted autonomously in significantly worsening of the exports problems, then the macro-economic expenses of the Program implementation in the past period must have been small. Particularly in the fact that the resultant of the movement of the total demand has begun the formation of the basis for the industrial production growth. While, the initial post-inflatory growth of domestic aggregate demand, at the beginning of the year, in the conditions of low exports, caused first the drop of stocks of finished products, particularly of consumer goods which, from October last year to April this year, have been reduced at the average monthly deseasoned rate of 3.5%, inducing the drop of total stocks at the rate of 2%, the simultaneous increase of exports and domestic demand is beginning, accompanied now with the stagnation of stocks accumulation, to reflect on the movement of the production. Due to the problems in the sector of equipment and, in general, investments, the growth does not appear to be particularly intensive nor time nor structurally balanced, but the deseasoned level of industrial production in October this year is 6% bigger than the February minimum (when the problems of exports have been more striking), reaching again the level of October last year.

On the other hand, there is also the tendency of balancing the trade, and with the significantly increased exports of services it is resulting in forming of the surplus in current transactions of the balance of payments.



However, it does not mean that further unchanged form of the implementation of the anti-inflation could keep the stability of the prices on a more permanent basis. In fact, the experience shows that anti-inflation programs are not "constant consumer goods", they are quickly being exhausted, and the effects realised by them are frequently changing the total economic situation in a way that the further implementation of unchanged scenario might quickly become counter-productive with regard to the goals. And that is exactly the case in Croatia.

The basic results of the present implementation of the Program: it was possible to achieve the stopping of the inflation with simultaneous remonetisation, with only the constellation of relations among crucial economic variables that existed on the crest of inflation wave, and with the influence of the Program implementation the constellation has begun to be slowly changing in its "natural" direction of mutual long-term inconsistency of high increase of money supply, stability of the exchange rate on the foreign exchange market and stability of prices.

It appears logical that in the limits of the stand-by arrangement the International Monetary Fund has insisted on firm limiting of the net domestic assets of the banking system with simultaneous de-limitation of the interest rates - which in fact represents the return to the original concept of the Program, which has been abandoned in the process of its passing and the current practical implementation as it has been considered over-restrictive.

Though the return has been relativised by the fact that it is to be reached at a much higher level of real money from the one existing at the time of passing the Program, by which the implications have been significantly softened, it represents one of the key components to induce the maturing of the present mainly anti-inflation policy into the more complex stabilisation policy. While the stopping of the hyper-inflation, performed in the conditions of simultaneous remonetisation, still has not lead to more important changes in the structure of the economy, the direct monetary limitations (connected to the reduced possibility of para-fiscal re-distribution of the means by the monetisation of the deficit) will inevitably lead to a certain re-allocation of money means among the economic subjects, and this will strengthen the mutual differentiating and gradual establishing of new economic structure able to function in the conditions of low inflation.

Further maintaining of the stability of prices and strengthening of the financial discipline are necessary assumptions not to make the differentiation developmentally counterproductive, i.e. that it may be in the function of increasing the global efficacy, which again requires the successful balancing between two opposite tendencies which are accompanying autonomously the limiting of money supply, if it is under-balanced, and these are forms of the pressure for increasing the already high interest rates and the appreciation of the exchange rate on the foreign exchange market. Whether it is possible to achieve the situation is essentially depending on the initial quantity of the real money, i.e. on the question if its *very* limited increase in the following period be sufficient to make, in the conditions of relatively decreased



mobility, the appreciation not to reach the level which would induce greater disturbances in balance of payments and production, without it simultaneously leading to the inflation of the demand while not, at firmly limited increase of net domestic assets, reducing the monetary multiplier so much that it may induce thus also the drop of production through interests and the level of credits to economy.

It is difficult to give the reply to the question, in the sense of precise and empirical defining of "optimal" quantity of money in the present moment of Croatian economy, though the velocity of money had significantly approached the average values of the pre-war period, and the interruption of the de-Elation tendency can also be explained as the indicator pointing to the fact that the remonetisation has approached the level above which it is inducing a short-term inflation as, contrary to that, the high interest rates are also pointing that the great problems in the allocating of money, i.e. in the structure of the bank assets, just as the pressure for the appreciation of the exchange currency are showing to a still relative lack of demand for foreign exchange with regard to the need for the domestic currency or, said otherwise, to limited possibilities of the absorption of accumulated foreign exchange reserves into domestic money flows at the existing level of economic activities and prices.

In connection with it, it appears important to state that, according to the regulations of stand-by arrangement, the quantity, structure and sector distribution of money will be regulated through 4 nominal anchors, the first two being relevant for global supply, and the remaining two for the structure of demand. The first group includes the top level limiting of the increase of net domestic assets of the banking system and determining of the bottom level limit of the increase of net foreign assets of the central bank. As the two components total is dominantly determining the change of total liquid means in the national economy, they are determining the potential of total money supply, but only in the way which would be leaving the structure flexible.

That is occurring because the primary emission is not formally limited by which the central bank is keeping a relatively significant space for interventions on the foreign exchange market. However, if, in some operations, the central bank was to be emitting the ready money faster than the allowed increase of the net domestic assets, the space of autonomous creation of deposit money by the business banks, i.e. the monetary multiplier would be reduced. Thus, in such conditions, to enable the banks to satisfy the demand for credit-loans from the economy subjects it appears necessary to be consistently realising another group of anchors which would be limiting the increase of crediting the state and selected enterprises in which the state is major owner, in order to reduce their share in the use of credit-loans.

It is the matter of a simple principle of joined containers by which the stability of prices is to be attempted as well as the normal financing of "healthy" part of economy made possible. The success needs all the parts of the mechanism to function harmonically. In case of success there is no more great danger from sudden drastic changes of exchange rates and interest rates which would be sure to arise from the reduction general liquidity.

It seems logical to conclude that the whole situation carries, in itself, certain risks, but these are directly arising from basic principles of the Stabilisation program the further realisation of which, after the first successful, anti-inflationary, phase requires adequate moves in the policy of economy.