

BUILDING SOUND FINANCE IN CROATIA

Legacies and prospects

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1. Introduction

The main aim of this paper is to point out that warranted transformation in transitional economies is not possible without firstly, stabilizing the economy and secondly implementing bold financial reforms. Building sound finance in an emerging market economy is not an easy task indeed. The role of a sound financial system is to mobilize funds and allocate the capital efficiently. Therefore sound financial intermediation is crucial for transition. The paper has three main parts. They are: a) transformation (including a brief description of the economic structure) b) present situation including stabilization and financial reforms in the Croatian economy, and c) future prospects and possible problems that lie ahead.

Some of Croatia's problem are common in other transitional economies. For example, it is generally accepted that economies in transformation need substantial reforms and restructuring. Financial sector always plays a very important role in those reforms (see: Caprio and Levine, 1994, Saunders and Sommariva, 1993 or Vittas, 1993). Without efficient financial intermediation structural changes cannot take place, or they will be much slower than warranted.

Transitional economies are often faced with high inflation. Transformation process usually starts with price liberalization. Combined with a substantial fall in production, or generally speaking with huge macroeconomic imbalances, price liberalization and continued lack of financial discipline commonly results in high inflation. Therefore, inflation has been one of the main consequences of initial economic changes in former socialist countries on their path to market oriented systems. Needless to say, within the framework of high

inflation and rapidly changing relative prices (see: Sonje, 1993) efficient allocation of resources is not possible. So, macroimbalances have to be addressed as soon as possible and sound foundations made for future restructuring.

But, stabilization of the economy is not a sufficient condition for successful reforms. Five years after the fall of the Berlin wall, optimism that has swept across formerly planned economies in the late eighties (due to dramatic political changes) is losing ground and pessimism seems to be the prevalent mood in most of economies in transformation. In some of those countries we observe the return of former communist politicians into power.

Why? The recession has proved much deeper than anyone expected (see Kornai 1993a, or Bićanić and Škreb, 1992). A long and continuous fall in production is causing very serious damage to the economy and society as a whole, leading to: falling living standards, very poor health services, low quality education and infrastructure. It is important to point out that none of those problems can be worked out with redistribution. Only a growing economy can slowly, but surely resolve this problem. On top of this, economic inequalities seem to be on the rise. The emergence of "instant new capitalists" and their conspicuous consumption is causing frustration among impoverished population. If the "production problem" is not settled soon, this could lead to serious political and social unrest in those countries eventually leading to Weimarization (Kornai, 1993a).

Therefore it is clear that the main task in transitional economies should be to increase production. But, of course, not the same structure of the economy that caused huge macroeconomic imbalances. Restructuring the real and financial sector is a difficult task, indeed. At the same time, inflation should be kept at moderate levels, balance of payments should be under control and unemployment (with social safety net) closely scrutinized not to endanger the transition process. In short, these countries are faced with truly formidable challenges.

2. Transformation Process

2.1. Real sector developments

Following its independence, Croatia was and still is confronted with serious economic troubles caused by: a) aggression and occupation of parts of its territory, b) transformation from socialist economic system to a market oriented one and c) disintegration of former Yugoslav market (see for example: Škreb and Bićanić (1994) and Bićanić and Škreb (1994)). It has to be kept in mind that eighties were a period of a long lasting recession. GDP in 1993 was estimated to about US \$ 12 billion. Therefore it is of no surprise that cumulative fall in Croatia's GDP in the period from 1991-1993 has been estimated at about one third. The economy was, till October 1993, faced with hyperinflation.

War damages alone are estimated at more than US \$ 15 billion.

Unemployment rate throughout 1994 was at a level of about 17%. The rate has been stable in the last year. Number of unemployed persons is about 250 thousands. Unfortunately, there are no reliable data on the overall employment. It seems safe to assume that employment in the private sector is much higher than shown in statistics. Unregistered economy represents probably more than one third of the overall registered production and employment.

Balance of Payment data for 1993 and the first nine month of 1994 look very encouraging. Croatia had a current account surplus, capital account surplus and has increased its international reserves. Croatian economy has been traditionally service-oriented and a trade deficit is easily covered with other items in current account.

A large number of refugees and displaced persons (in mid-1994 about 500 thousands) remain to be a heavy burden for the economy and especially for the central budget.

Table 1
BALANCE OF PAYMENTS
of the Republic of Croatia¹⁾

Millions of USD

	1993	1994 ²⁾ I -IX
I CURRENT ACCOUNT - BALANCE	277	525
1. Balance of trade	-763	-360
1.1. Merchandise exports f.o.b.	3904	2923
1.2. Merchandise imports c.i.f.	4666	3283
2. Balance of services	632	650
2.1. Services credit	1807	1758
2.2. Services debit	1175	1109
3. Balance of income	-143	-93
3.1. Income credit	112	60
3.2. Income debit ³⁾	254	153
4. Balance of current transfers	551	328
4.1. Official - net	250	170
4.2. Private - net	301	158
II CAPITAL ACCOUNT BALANCE	93	194
1. Foreign investments	72	66
1.1. Foreign investments in Croatia	74	69
1.2. Foreign investments abroad	3	4
2. Capital	21	128
2.1. Liabilities	-131	99
2.1.1. Banks assets	-211	-226
2.1.2. Other assets - net	80	325
2.2. Long term capital	-214	-128
2.2.1. Disbursements	154	113
2.2.2. Repayments ⁴⁾	367	241
2.3. Short term capital	365	157
2.3.1. Short term loans	251	191
2.3.2. Other short term loans - net	115	-33
III NET ERRORS AND OMISSIONS	75	-171
IV CHANGE IN FOREIGN RESERVES	-446	-548

¹⁾ Transactions without former Yugoslav Republics

²⁾ Temporary data

³⁾ Interest arrears included

⁴⁾ Principal arrears included

But, one of the basic elements of genuine restructuring is to change incentives of managers in enterprises. Within this framework clear ownership rights and predominantly private ownership are needed for the increase in the efficiency of management.

2.2. Transformation of Ownership and Privatization

Croatia has a unique privatization model. It is envisaged to proceed in two steps. Its first step was to transform ill defined concept of social ownership (which existed under the socialist self-managed economic system) into known forms of ownership, either private or state. The second step is to privatize parts of state ownership.

Under the initial stage of ownership transformation former socially owned companies (actually former selfmanagers - workers) could apply to the Croatian Privatization Fund to buy part, up to 50%, of company's shares under very favorable conditions (hefty discounts and deferred payments of shares).

Nonprivatized shares of firms and shares of firms that did not apply for own privatization scheme till June 1992 (deadline for submission of autonomous privatization to CPF) were transferred to the portfolio of the Croatian Privatization Fund (CPF) and (smaller parts) to Pension and Health Funds.

Before the transformation of ownership begun (in April 1991) there were 3500 socially owned companies. At the end of April 1994 out of 2877 requests for autonomous privatization by enterprises themselves, 85% have been approved. The difference between the total number of companies which should have undergone transformation of ownership (about 3500) and the number of requests for autonomous privatization (2877) is due to an estimated number of 500 firms in Serb-rebel controlled areas (occupied parts of Croatia) and firms that did not submit their privatization plans by the deadline (June 1992). Ownership transformation has been completed in about 2200 enterprises. Their

total equity capital value is DEM 20 billion. Out of 2200 enterprises whose ownership structure has been transformed 48% have been totally privatized, 36% are mostly in private ownership and 16% are mostly in the hands of the CPF. It is interesting to point out that totally privatized companies are much smaller with the average value of DEM 1,7 million, than companies that are mostly still in the hands of CPF and funds. Their average value is DEM 23,9 million.

The CPF is offering shares from its portfolio on the Zagreb Stock Exchange in the hope to sell them on the market. It has to be pointed out that enterprises that are not privatized more than 50% remain under control of the CPF. Until the end of April 1994 total revenue from privatization was DEM 858 million, which is less than expected.

3. Stabilization and Financial Reforms in Croatia

3.1. Stabilization Program

Unfortunately, Croatian economy has a well documented history of high inflation, much longer than its political independence. But, in 1993 inflation was at its peak. During the first ten month of 1993, the average monthly rate exceeded 28%. Therefore, antiinflationary measures were an immediate necessity.

The Government announced the Stabilization Program in October 1993 (see Rohatinski, 1993, Šonje, 1993 and Škreb, 1993). Its immediate aim was to swiftly slow down the inflation rate. The Program is envisaged to proceed in three, overlapping phases. The first one is aimed at achieving rapid disinflation. The second phase comprises of structural changes in the economy. They include: speeding up of the privatization process, demonopolization of the economy, restructuring of loss-making industries like shipbuilding, rehabilitation of the banking sector, etc.. The last one should build up sound foundations for reconstruction of the Croatian economy and start sustained economic growth path.

Graph 1

Retail Price Index



- from 1992 till 1994 -

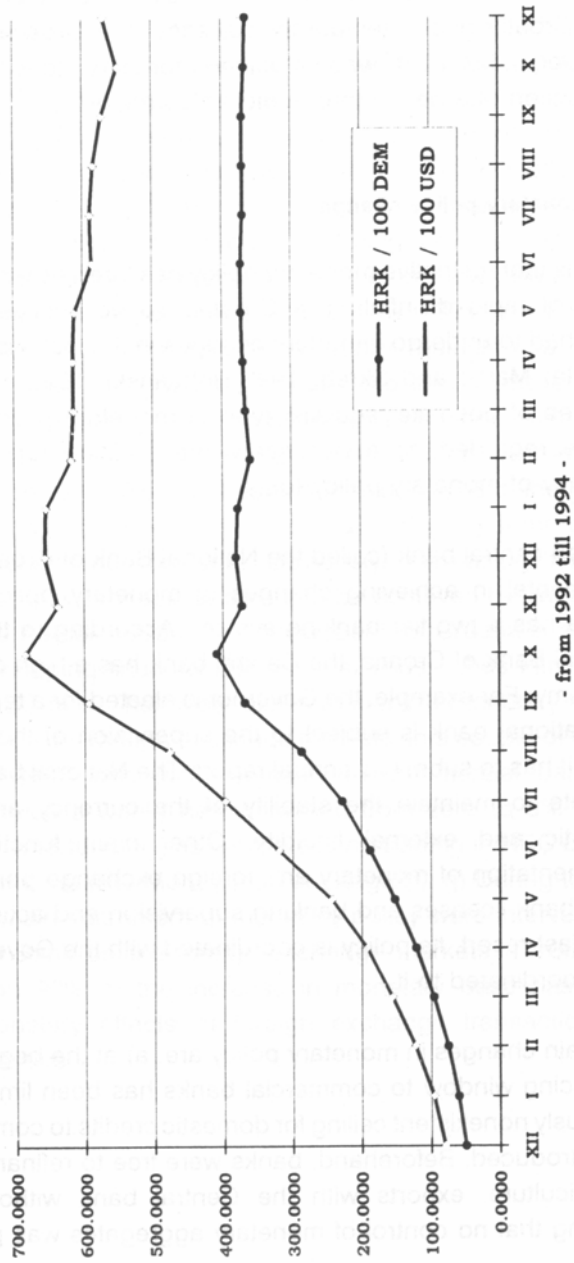
The first phase, rapid disinflation, relied mostly on the following areas (on top of breaking down of inflationary expectations): restrictive monetary policy, restrictive fiscal policy, incomes policy and structural measures (like introducing internal convertibility of the domestic currency and lifting previously numerous foreign exchange controls).

The first stabilization phase has been conceived as a heterodox type of antiinflationary measures. Based on the fact that very high inflation rates are mostly generated by inflationary expectations, the Program diminished them substantially. Since November 1993 (till the end of November 1994 - last available data) Croatia experienced a deflation of 3% (cumulatively) in CPI and about 12% in producer prices indicating that the first phase has been very successful.

In a highly inflationary environment, there is a genuine need for adjusting the behavior to inflation, which can be done by indexation. Indexation is usually done either ex-post, based on monthly consumer price indices, or almost on a daily basis by adjusting to changes in the exchange rate. Information on the exchange rate data can commonly and at very low costs be observed from newspapers. It seems that the latter mechanism was very common in Croatia. At the very beginning of the implementation of the program, the exchange rate was briefly fixed, and later on, as the foreign exchange market started to operate, the exchange rate appreciated rather strongly (about 20%). All economic transactors were surprised by this occurrence, as everyone expected regular depreciations to continue. Through appreciation, not only did imported inputs become cheaper, but there was no indication of future inflation. So, the strong signalling effect of the exchange rate was an important element in diminishing inflationary expectations and deflating the inflationary bubble. Other main instruments of antiinflationary package will be described in more details.

Graph 2

NBC Exchange Rates at the End of Month



- from 1992 till 1994 -

Permanent currency, the kuna (HRK) was introduced at the end of May 1994. Croatia had a temporary currency, the Croatian Dinar (HRD) since December 1991, when it gained monetary independence, till the introduction of a permanent domestic currency.

3.2. Monetary policy changes

It seems that restrictive monetary policy has been essential in the initial phase of rapid disinflation in Croatia. To be successful, monetary policy had to undergo important changes in the last two years (see for example: Martić and Škreb, 1993 Rohatinski, 1993 or Škreb, 1994. Changes of obsolete "socialist type of monetary policy instruments" can be regarded as a necessary precondition for increasing the efficiency of monetary policy tools.

Croatian central bank (called the National Bank of Croatia - NBC) was instrumental in achieving changes in monetary policy instruments. Croatia has a two-tier banking system. According to the Law on the National Bank of Croatia, the Central bank has a high degree of legal autonomy. For example, the Governor is elected for a term of six years. The National bank is subject to the supervision of the Parliament to whom it has to submit its annual report. The National bank has a clear mandate to maintain the stability of the currency and to manage domestic and external liquidity. Other main functions are: the implementation of monetary and foreign exchange policy, banknote issue, bank licenses and banking supervision and acting as a lender of the last resort. Its policy is coordinated with the Government, but is not subordinated to it.

The main changes in monetary policy are: a) at the beginning of 1992 refinancing window to commercial banks has been limited, namely a previously nonexistent ceiling for domestic credits to commercial banks was introduced. Beforehand, banks were free to refinance their loans to agriculture, exports with the Central bank without any limits, meaning that no control of monetary aggregates was possible; b) at

the beginning of 1993, the selective refinancing credits have been completely phased out; Selective credits represent a refinancing window for commercial bank loans earmarked for selective purposes like agriculture, shipbuilding, etc. This was a legacy of the socialist system and a typical parafiscal (allocative) function of monetary authority. On top of their parafiscal role, those credits more often than not were heavily subsidized meaning their price was negative in real terms. c) general refinancing quotas (meaning not earmarked for selective purposes) to commercial banks have been slowly phased out and finally dwindled to zero by the end of May 1994 d) domestic credit to central government has been legally restricted to 5% of budgetary revenues. The government can take only short-term (so called "bridging") loans which have to be repaid till the end of the fiscal year, thus they do not finance the budget deficit e) a lot of effort is put in increasing financial discipline of commercial banks. But, the overall financial discipline of the economy in general, including some banks, still can be considered too soft. Obviously, increasing financial discipline is a lengthy process, and cannot be achieved overnight (for explanation see Kornai, 1993b) f) National Bank of Croatia is actively engaged in developing financial instruments. Thus, it has introduced the so called NBC bills. Their main aim is to sterilize monetary effects of interventions on the foreign exchange markets. In a couple of month the amount of NBC bills (sold primarily to commercial banks at auctions held twice a week) has increased from zero to 8% of the money supply. Unfortunately, as yet there is no trading in NBC bills on the secondary market (like Money market - Zagreb). g) During the last two years, the main instrument of monetary policy were interventions of the National Bank on the foreign exchange markets. Throughout 1993 more than 90% of the increase in monetary base has been caused by monetary effects of foreign exchange transactions of monetary authorities.

Table 2
NBC BALANCE SHEET (net)

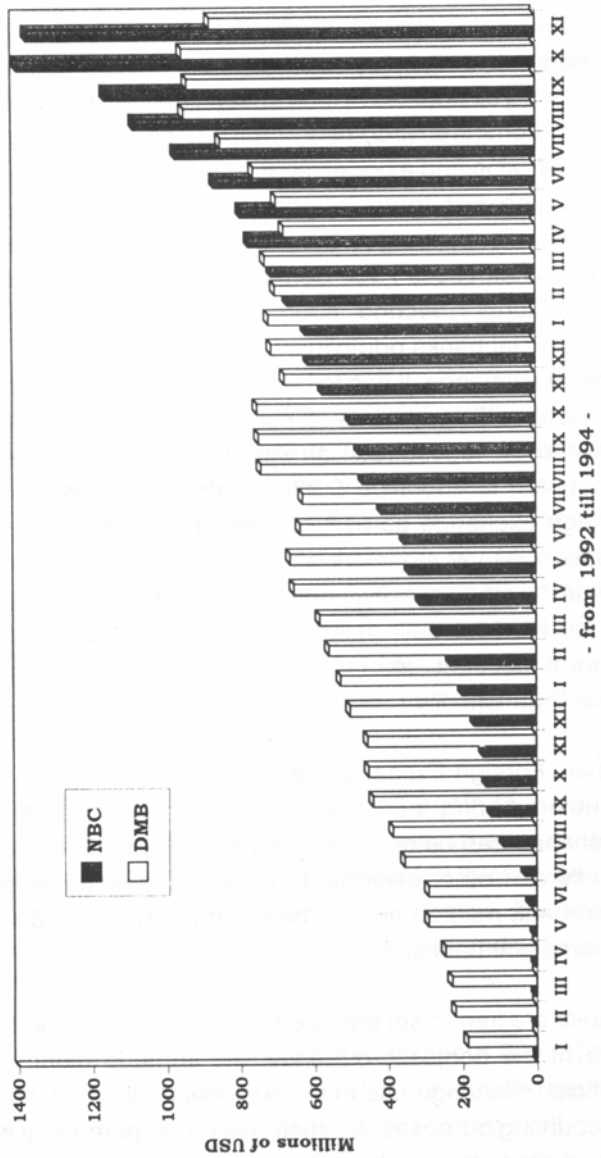
	1991 XII	1992 XII	1993 XII	1994 IX
Structure in %				
ASSETS				
NBC Foreign Assets	0.0	45.2	84.8	92.9
Claims on Government	37.8	18.0	11.2	4.8
Claims on Banks	62.2	36.7	4.0	2.4
Total	100.0	100.0	100.0	100.0
LIABILITIES				
Monetari Base	82.9	70.4	47.6	66.7
Foreign Liabilities	0.0	0.0	3.2	1.3
Other Liabilities (net)	17.1	29.6	49.2	31.9
Total	100.0	100.0	100.0	100.0

3.3. Foreign Exchange Reserves and Regulations

With the substantial reduction of refinancing facilities to banks (decrease in domestic credits), the primary source of monetary base creation have been the monetary effects of foreign exchange transactions (increase in net foreign assets in the balance sheet of the monetary authorities). During 1992 and 1993 one of the strategic aims of monetary policy was building up of foreign exchange reserves. Having in mind that international reserves (IMF definition) at the National Bank of Croatia were virtually zero at the end of 1991, this aim was completely justified. At the end of November 1994 gross international reserves reached almost US \$ 1,4 billions.

Graph 3

**Gross International Reserves
and DMBs' Foreign Assets**



- from 1992 till 1994 -

How come this substantial increase in international reserves in two years? The main causes of foreign exchange inflow seem to be the following ones. Households in Croatia traditionally had large foreign exchange savings due to developed tourism industry and unilateral transfers (remittances) from Croats working in developed countries. In an inflationary environment, households kept foreign exchange as a store of value and a hedge against inflation. As real wages were halved during the last three years, to maintain their "permanent income" households exchanged their foreign exchange savings (usually kept "under mattresses") for domestic currency to finance their current expenditures. Second source of foreign exchange supply were commercial banks portfolios. Commercial banks are relatively liquid in foreign exchange. It has to be kept in mind that Croatia has temporarily suspended its payments to Paris Club and London Club creditors. At the end of August 1994 arrears in external debt were important and amounted to about US \$ 880 million. For commercial banks keeping foreign exchange as part of their assets was a good hedge against inflation. As the monetary authorities in Croatia started to decline their domestic credit activity, commercial banks, more often than not, turned to the NBC for their daily liquidity management. Balance of payment current account surplus in 1992 and 1993 added to this foreign exchange liquidity.

A new Foreign Exchange Law (enacted in October 1993) instituted a genuine market for foreign exchange. Buying and selling of foreign exchange can be done: a) between authorized commercial (licensed) banks and other persons, b) between commercial banks themselves (interbank market) and c) between the National Bank of Croatia and commercial banks.

Banks are free to set their exchange rates, meaning that the exchange rate of the domestic currency, the kuna, is market-determined. The "official" exchange rate of the National Bank of Croatia (used solely for accounting purposes like customs) is computed as a weighted average of previous day interbank transactions.

The new Foreign Exchange Law has introduced current account convertibility. Croatia will soon be able to accept all obligations coming from IMF Article VIII (IMF Article of Agreement). There are still some restrictions on the capital account convertibility. It has to be pointed out that authorized banks can sell unlimited amounts of foreign exchange to natural persons. Households can hold foreign exchange savings accounts since mid-sixties and the new Foreign exchange Law has enabled legal persons to hold a foreign exchange account (under some conditions).

3.4. Fiscal Policy and Incomes Policy

Another pillar of the Stabilization program is fiscal restraint. Fiscal sector, especially central budget, has undergone important changes. The basic aim in fiscal reform is to decrease the central budget by increasing tax revenues and limiting expenditures. For that reason the tax system has been transformed. At the beginning of 1994 a new Income Tax and Profit Tax were introduced. It is envisaged that the Value-Added Tax will be introduced in 1996. A large number of tax exemptions have been abolished as well. Tax rate has been broadened, and marginal sales tax rates have been lowered. For example, the highest marginal income tax rate is 35%.

Much more emphasis is put on control of tax payments to increase financial discipline. Customs duties have been lowered as well, but exemptions have been severely reduced. Strict control is expected to ensure that revenues from customs duties should increase. Subsidies to agriculture and other traditionally high budgetary expenditures (like shipbuilding) will be lowered.

Central budget revenues for 1994 are estimated at about 28% of the (estimated) GDP for that year. Compared to GDP the estimated central budget deficit will be negligible. Public sector deficit in 1994 will most probably be higher. Public Enterprises and Funds (more specifically Pension and Health Fund) have not been fully transformed as yet.

Therefore, their deficits will be closely monitored. At this point of time it is essential to limit further increase in their deficits. As some relative price distortions have been corrected in the past - during hyperinflation (like electricity), some public enterprises do not have operational losses any more.

Restrictive incomes policies helped to achieve rapid disinflation. At the beginning of the Stabilization program the Government has set very severe limits on total wage bill of the government controlled sector (which represents about two third of the economy) through a set of decree laws. Wages in the private sector (enterprises whose equity capital is more than 50% privately owned) were not limited. Tight incomes policies in the future will most probably be ensured through a set of collective bargaining processes between trade unions and the Government. This is a very important area of Stabilization program as budget constraints are still soft in some areas - like large non-privatized companies (as will be explained later on) and a rapid increase in wages (above the increase in labor productivity) can easily increase aggregate demand, revive inflation and inflationary expectations.

Up till now the costs of the stabilization are few. Unemployment has remained stable, industrial production is falling the third consecutive year, so the fall cannot be attributed to rapid disinflation, exchange rate changes have not had significant effect on foreign trade, number of bankruptcies has not increased significantly, etc. Till end of 1994 the main negative effects of the stabilization program were: very high real credit interest rates (about 18 % on a yearly level). Such high rates can deepen the recession. Additionally, we have observed rapid increase in interenterprise arrears, which are still manageable, but growing. Increased illiquidity of the banking system has shown up as well. It can be concluded that up till now the sacrifice ratio has been extremely low. But, stabilizing the economy is neither an aim in itself nor is a sufficient condition for economic growth. Based on stable macroeconomic conditions financial reforms must follow.

The changes in the financial system in Croatia, following the country's independence, started under very unfavorable macroeconomic conditions. Banking sector in Croatia represent the most important segment in financial intermediation (like in other transitional economies). Hence, it deserves special attention (see Skreb, 1994, and Banking in Croatia, 1994.)

3.5. Banking sector

Commercial banks in Croatia detached themselves from the central banking system (monobanking) and direct government control in mid-sixties, considerably much earlier than other ex-Communist countries. Banks inherited from the previous system were characterized by a strong influence of non-economic, social and political factors. Bad assets were quite common. Throughout 1991 and 1992 measures for restructuring of the economy and linear bank rehabilitation have been passed. They resulted in an improved balance sheet of the overall banking system. End 1993 data indicate that about 40% of total banks assets in Croatia are claims against central budget. Therefore, at that time, capital adequacy ratio has been very high - 18%, way above the required minimum of 8%.

The present Croatian banking system comprises some 50 universal banks. Concentration is high in the banking industry. Half of the banking capital refers to two largest banks both with their headquarters in Zagreb. According to end-1993 data, concentration ratio for the four largest banks (measured by their assets) was 75% and Hirschmann-Herfindahl index was 0,1814.

By mid-1994 banks were partially in private ownership, partially owned by para-governmental funds, and partially by enterprises whose major owner is the Croatian Privatization Fund (CPF). Through the privatization process for enterprises ownership structure of banks should change as well. But today, the financial position of some large banks is still closely linked with the performance of large, sometimes

loss-making, enterprises. A series of new private banks, unburdened by old dubious operations, but financially quite insignificant, have recently been established.

The new Banking Law (enacted in October 1993) envisages an open banking market. The Law indicates that banks may be established by one legal or physical person, resident or non-resident as joint stock companies. Barriers to entry are low as minimum equity capital to found a bank is the equivalent of DEM 15 million in domestic currency for full international licence. New possibilities have been established for issuing working licenses by the NBC (as well as for their withdrawal), foreign auditing, internal supervision and central bank authority. A number of new rules related to the existing international capital adequacy ratio (and other banking supervision coefficients) have been introduced as well.

3.6. Other financial institutions

At mid-1994 there were 87 savings banks in Croatia and one development bank fully funded by the government (Croatian Credit Bank for Reconstruction - HKBO). Savings banks are usually local institutions, and their scope of activities is limited in comparisons with commercial banks. They are specialized in taking deposits. From the beginning of 1995 the activity of savings banks will be supervised by the National bank of Croatia and they will be subject to reserve requirements as commercial banks today are. There is a large number (about 170) of small credit unions and credit cooperatives, but financially they are insignificant.

At mid-1994 there were 14 insurance companies operating in Croatia. Most of them are small and active only in some areas of the insurance business. A large part of the insurance market is restricted to a few of insurance companies with one large company still being in a near-monopoly position. As its equity capital is 85% owned by the state, it is obvious that increasing competition and privatization in the insurance

market is a priority. Insurance companies usually have relatively large financial surpluses and are active (very short term) lenders on money market.

As in other transitional economies, financial structures in Croatia are underdeveloped and markets are shallow. There is an interbank money market in Zagreb. Money market - Zagreb is a joint stock company founded by commercial banks. It is dealing mostly in overnight credits (which are automatically granted and repaid the next morning) and very short-term credits. The Money market plays an important role in daily liquidity management of banks, but the amount of transactions is modest. Total average daily turnover (comprising of daily and overnight transactions) is about 2-3% of the money supply with overnight transactions representing about 80% of the total amount.

The Capital market (Stock exchange - Zagreb) is starting to operate. Its role in the economy will probably become more important, once the privatization process will be finished. Only a couple of companies' shares are quoted and traded in secondary market (which meets twice a week). Throughout 1994 Croatian Privatization Fund will use the stock exchange as the primary market for privatization (selling) of shares in Fund's portfolio.

For the time being both money market and capital market in Croatia are underdeveloped. One of the problem is that there are not enough securities outstanding to be traded. Therefore, the National Bank of Croatia tries to actively enhance its open market operations, which are very limited at present. With short-term Government bonds nonexistent and other securities very scarce, the NBC bills are the most important instrument of indirect money control (as explained before).

Pension fund is managing substantial funds. Its average monthly revenues are about 10% of the money supply. Intramonth variations are very high with surpluses in the second half of the month and a deficit at the beginning of each month. But the Pension fund is not yet

an active player on the financial markets. On top of this, the Pension fund has gained enterprises shares in the process of ownership transformation - privatization. Shares that are not privatized yet are distributed among Croatian Privatization Fund, Pension fund and Health fund. Thus, the Pension fund has a diversified portfolio, but is not active on the Stock exchange either. This can be attributed both to undeveloped financial markets, high uncertainty and lack of human capital.

3.7. Cooperation with International Financial Organizations

Croatia is a fully fledged member of the: International Monetary Fund (IMF), World Bank Group (IBRD, IFC, IDA, MIGA), European Bank for Reconstruction and Development (EBRD) and some other institutions. This mere fact is a necessary condition for becoming a part of international financial market. Croatia's external debt of about US \$ 2,6 billion is not considered excessive. Croatian debtors are in the process of reconciling their relationships with foreign creditors, notably the Paris Club country members and London Club commercial banks. It is expected that the approved stand-by/systemic transformation facility with the IMF in October 1994, will mean a clear signal to other organizations that they should be more active in Croatia. The World bank and the European bank for Reconstruction and Development have approved loans to Croatia in 1994.

Financial reforms look like an additional (on top of low inflation - stable macroeconomic conditions) necessary condition for speeding up of growth rates in the economy. Bold financial reforms are necessary to proceed with meaningful transformation of the real sector.

4. Future prospects and problems ahead

Having in mind difficult conditions for transition in Croatia, one could argue that a lot has been accomplished already. But, there are problems that still have to be resolved. They will be briefly explained.

The state has emerged, directly or through the CPF, as the largest single owner in the economy. It is estimated that more than 2/3 of the economy is still under state control. The share of private ownership must be increased and the role of the state as a major owner, or manager, in the economy reduced. Through privatization, the efficiency of the markets should increase.

Further reforms, aimed at changing the behavior in the economy by imposing hard budget constraints (increasing financial discipline) and optimizing resource allocation, especially in large loss-making still state-controlled enterprises are urgent. It is amazing to see how vested interests are deeply rooted. Microeconomic restructuring is something that we have to be confronted with on the winding road of transformation to a market economy. To achieve this goal organizing an efficient payment system, necessary for good financial intermediation is a prerequisite. Rules for exit out of the market must be simplified and the process speeded up.

Rehabilitation of banks is high on the agenda. Large banks are burdened with consequences of previous bad loans. The Croatian Government has already recapitalized banks. More than 40% of banks' total assets are claims on Central Government (public debt). Part of the remaining banks assets can be classified as non-performing loans. Therefore, some banks are faced with severe liquidity problems. As, out of 50 banks, 25 are state controlled it is no surprise that moral hazard problem is common in the behavior of their management. Banks in Croatia are of- universal type, therefore risks are high and strict control is required. Supervision of banks (and savings banks) must be ameliorated. Banks' role in the allocation of capital is very important in Croatia's system. Therefore, a viable banking system is a prerequisite for speedier growth.

Another question is how to increase the quality of the state and minimize state failures. It is obvious that the role of the state in transition is prominent (see Bićanić and Škreb, 1992). The state can

either stimulate further reforms or can block them completely. Neither the state nor the domestic private sector alone can accomplish all the tasks of transformation, least accomplish them efficiently.

But, one of the greatest obstacles to rapid transformation lies in the minds of some people. It is sometimes difficult to realize that the philosophy of the market is the philosophy of constant threat of failure. Therefore, bankruptcies must become a common reality. Simple and clear rules for exit from the market are necessary for greater financial discipline. Enterprises must realize that the state will not bail them out on every occasion that they fail. Management of banks must understand that they will not be bailed out unconditionally and as many times as necessary.

Financial discipline cannot be achieved overnight and probably takes a longer period of time. Increasing financial discipline requires long preparations for the government to change the rules of the game and time period for economic transactor to adapt to the new rules. Learning-by-doing seem to be slow. Credibility of government willingness is essential here (see Kornai, 1993b).

The success of transition does not rely solely on the country involved (Croatia in this case). Foreign help can be an important element in the transformation process. Opening up of international markets is probably the most important single factor which will help transitional economies in their restructuring and sustained growth. Financial assistance is another significant element. For example it can secure an adequate social safety net and facilitate transformation. We have repeatedly pointed out that privatization is a necessary condition for efficient markets. With the lack of domestic savings, the role of foreign capital (in equity) is prominent. Domestic private sector is booming, but it is increasingly difficult for private firms to cope with difficulties of start-up. Transfer of know-how is not just transfer of know-how in modern production or information technologies, but an efficient help in establishing institutional underpinnings for financial markets.

Foreign help to economies in transformation should not be regarded as charity, but the most efficient way to increase globalization of world economy and to exploit mutually beneficial cooperation between countries.

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