

STRATEGIC ISSUES IN THE CROATIAN ECONOMY

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The process of development in Croatia is confronted with problems and factors which coincide, reinforce each other, and are partially interdependent. The most important of them are technological transformation in the world, the collapse of Communism, and the transition to the market economy which is brutally interrupted by war and destruction. Croatia is faced with the need for technological and institutional modernization, and for the rebuilding of what has to be repaired in order to increase production to the level needed for survival, and for the creation of the surplus required for economic stabilization and investment into modernization of the economy. The sources are very meagre, and this is why internal conditions have to be created for the international community to absorb Croatia, and to give it an impetus for development. To achieve this, Croatia should implement the essential reforms of the economic system. It may be achieved by different strategies, so the elements of alternative options and scenarios for process of renewal and recovery of economic activities are discussed in this paper.

1. Introductory questions of development strategy

In its effort to rebuild the country and start a new process of development, Croatia is confronted with three historical problems which coincide, reinforce one another, and are partially interdependent. First, a far-reaching technological transformation is under way in the world. There is a cycle of change of structure based on new

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technology which is at work worldwide, and which is so powerful that it has become an external necessity. There is a need to adapt to these changes, to learn to think and work in a manner appropriate to the new technology. Economic development has been slowed down by the transformation. The slowing down has taken place in many countries, but in the developed world a new technological core has already been established, which will start providing an impetus to the growth of the world economy. There should now follow an upturn in economic growth, and maximum efforts should be made to use this upturn for our own development.

The second problem is the collapse of Communism. It has failed as a social and political system, as a concept of social development, and as an ideology. This collapse has left a negative mark in Croatia. It is not unconnected with the above mentioned technological transformation, because the groundwork of Communism was laid at the time of an earlier industrial system. Owing to its ideological and political rigidity, this industrial system could not be transformed and therefore it rapidly began to lag behind, becoming a hindrance to development. This is why it lost its historical battle. The technological problems left behind in Communism, especially in the context of institutional frameworks, exacerbate the problem of development. The entire system has to be changed rapidly, but the problem is that Communism has not created any vital forces of change.

The third problem, peculiar to Croatia, is that the transition has been taking place through the break-up of state, leading to war and destruction.

Croatia is therefore, faced with the need for three kinds of modernization: technological modernization, institutional modernization, and the rebuilding of what has to be repaired in order to increase production, as soon as possible, to the level needed for survival and for the creation of the surplus required for investment into the modernization of economy. The sources, however, are very meagre, and a situation is a very difficult one. It is precisely this stage

of development, and this state and level of production, that requires a far-reaching intervention into the redistribution of revenue in order to maintain at least minimum consumption and the necessary conditions for the functioning of essential services. At this moment Croatia's resources are being drained due to exigencies of defence, health care, refugees, etc. From this aspect, it is essential to find a way of preserving motivation for work and business initiative. The traditional approach to investment and development will obviously not be of much use here. There is insufficient internal strength, savings in the country are meagre, and a great deal of time would be needed for Croatia to implement its reconstruction and its technological transformation with its own resources. This is why conditions now have to be created for the international community to absorb Croatia and to give it an impetus for development. Croatia should open up to the world so that development may take place according to the principle of connected vessels. Developmental factors and impulses should be allowed to come from outside. Of course, the necessary conditions have to be created for this to happen, and the country needs to become attractive. It must not remain passive, although the general conditions in the world may be favorable, and money, capital, new technology, and contacts with the world will not follow automatically. Croatia must be actively present in the world. To achieve this, the first thing that must be done is to implement the most essential reforms of the economic system. This task may be spelled out in four essential points.

The first is stable currency. However difficult it may be in the present circumstances, there must be a firm measure of value, a stable currency with a constant value, which will allow calculations to be made with confidence. It is impossible to be open to the world without a stable currency.

The second of these points are ownership rights. Besides establishing a country governed by law in all respects, i.e., a modern democratic state based on law and order, ownership rights have to be guaranteed, firm, and easily accessible to foreign and Croatian citizens alike.

Croatian resources have to be exposed to the world market so that they may be valued according to international criteria. For others to see their chance of development in Croatia, they must be offered security, rights, and guarantees. In this context, the problem of privatization becomes an absolute priority. Privatization must be carried out as soon as possible, but it must be carried out in a way that will not cause social traumas and conflicts. An acceptable democratic formula of distribution must be established which will respect legitimate claims and which can be implemented rapidly. This would open up a capital market on which everyone would do business with what he has received, thus finding out how much it is worth. Each individual would judge from his own perspective how much it is worth, whether to keep it or sell it, for how much to sell it, etc. It is useless to talk much about the capital market, its functions and institutions, before there are goods which are actually on offer on that market. Buying and selling must start with something.

Appropriate taxes are required. A policy which would make the country more expensive to do business in than other countries must be avoided. Taxes must be low to make investments profitable, whether they are made by domestic or foreign businessmen. This is an important factor in any investment decision. The tax system has to be clear, simple and easily understood.

Open frontiers are essential. An open border, allowing the free flow of goods, capital, know-how, people, etc., is a prerequisite for easier and more successful cooperation with the world.

This does not mean that we should rely uncritically on the European interest in Croatia. Europe will become involved where it sees a clear economic interest, and other reasons, e.g. strategic ones, should be seriously counted on. Croatia is not-nor were it in the past, as we can see today-in the strategic focus of the world. It must also be pointed out that there is a shortage of capital in the world today, that vast regions of the world are hungry for capital, and that Croatia is a high-risk area.

It is very important to develop a creative and high-quality supply. The supply must originate from innovativeness, and the developmental programs. Concrete programs of development must be created. If possible, they must correspond, from the standpoint of business and technology, to wider international programs so as to fit into international business systems directly. Instead of wondering whether something can be sold, how it can be sold and under what conditions, it should be possible to simply operate within these systems. However, in order for this to happen, acceptable quality must be assured.

Croatia is situated in a favorable geographical location. It has a great tourist potential and developed exports, so a convertible stable currency could be established relatively quickly on the basis of considerable hard currency reserves. There are also interesting natural and other resources. The quality of the human resources needs to be improved considerably, and much needs to be done in the educational system. It must be open to the world, creative, and oriented towards the highest values.

It is not to be expected that market forces can realize these goals on their own, or that individuals left to their own devices will do so. There must be a certain coordination between private initiative, scientific and social institutions, and the state.

2. The state of the economy and recovery policy

The proportion of the former Yugoslav market and the market of the rest of the world in Croatia's total exports is now the reverse of what it was before the war. This fact has contributed to the considerably lower level of production of the Croatian economy at the present time. The foreign exchange revenue arising from exports of goods, and from services and workers' remittances, is the only source of financing the imports of production materials, raw materials and spare parts for the Croatian economy. Before the war, the production matrix depended by about 40% on the import of production materials, energy, and spare

parts from abroad and from parts of the former Yugoslavia. About 37% of the imports, i.e., 15% of the total requirements, came from areas outside the former Yugoslavia. A similar situation prevailed in the case of sales of Croatian goods and services. These facts must be taken into account in developing the strategy of future development of Croatia, but the renewal of one part of this market, the Eastern market, particularly that of the former Yugoslavia, cannot be counted on. Croatia must reckon with the realignment of parts of the former socialist, East European and Soviet market and the creation of new trading zones with more clearly defined mutual relations. Croatia will then find itself in a far more natural economic environment than that of the former Yugoslavia and Eastern Europe. The countries in question are primarily those of Central Europe, which will rely more and more on the free trading zone of Europe and the European Economic Community, as well as on other, non-European markets in the development of their market institutions and economic relations.

It may be said in conclusion that the conditions in which Croatia is developing at this moment are marked by a crisis of demand and a low level of utilization of capacities (i.e., low operating rate), especially in the service sector, and that the activation of the available capacities will depend primarily on the revitalization of export demand, and then of domestic demand, as well as on the possibilities of financing production, i.e. on the working capital.

The level of production in Croatia depends, in general, on a number of limitations, including the possibility of obtaining production materials and energy from abroad and from the some territories of the former Yugoslav republics, which are now economically foreign countries. The substitution of supplies of production materials and energy from the territories of the former Yugoslav republics by those from elsewhere depends on how fast Croatia can be integrated into the flow of West European, Central European and East European trade, but also on renewing trade with Slovenia and with Bosnia-Herzegovina.

The process of renewal of economic activities could more or less proceed in the following sequence:

- when the war ends, the economic sectors that are active foreign exchange and revenue earners (tourism, transit, traffic, pipeline transport, road and rail transit, seafaring, air traffic) will start operating;
- in the coming years, the development of agriculture will depend on the restoration of agricultural regions to Croatian sovereignty, as well as on the rate at which lost production in other parts of the country;
- in the industrial sector, the key factor of growth will be export relying on the proper utilization of the existing capacities (textiles, ship-building, electrical-engineering products); the flexibility of exports is very great, i.e., there is sufficient room for export in some branches of industry; the high flexibility of exports compared to the growth of the social product is a precondition for a faster recovery of industrial production; in the case of shipbuilding, the great problem is financing production, owing to the scarcity of domestic capital and to the fact that customers are not inclined to accept the risk of war;
- the metal manufacturing industry, especially the capital goods industry, will have to wait for greater investment-driven demand, which will not be revived very fast, especially not its foreign component; this industrial complex will be the last to be revived owing to the loss of the markets in the East and the great difficulty of entering the market in the West; this branch of industry is faced with structural and technological developmental problems;
- the problems arising from the fact that industry depends on imports from the international market for its production materials, especially under conditions in which substitutes need to be found for imports from the former Yugoslav republics, are exacerbated by the lack of working capital, hard currency and the interruption of trade due to the war; unit costs are growing

as a result of the low operating rate, tending to increase inflation;

- the devastation caused by the war and the fact that tens of thousands of employees are cut off from their workplaces, but are receiving guaranteed salaries either directly through the budget or indirectly through the banking system, is a serious source of inflation (in 1993).

The limitations on the revival of production have been imposed from the outside. At this stage of development, production can be increased primarily by exports of goods to hard currency markets, and only partially to the Central and Eastern European markets. It is only on the basis of an export income multiplier and hard currency support from outside that the revival of domestic demand may be expected to expand.

3. Stages in the strategy of development

Starting from what has been said, the Croatian strategy of development may be divided into two stages. In the first stage, the present state of the economy, with its low level of utilization of the total economic potential, should be surmounted. This stage is easily recognizable and implies a specific economic policy, the goal of which is to surmount the present depression in production. The aim is to activate and reactivate the existing capacities. This is the dominant goal of economic policy at this stage.

One of the goals of economic policy is increasing the foreign exchange revenue. If this is the primary criterion, it is logical that a certain amount of working capital will need to be provided even for those branches of production which would not otherwise be competitive enough on the world market under the conditions of stabilization. Even those economic groups which have found themselves, with regard to financing and demand, within the narrow framework of the small Croatian market will be supported to a certain extent. They must seek a

way out through integration into international capital markets, thus financing their production and sales and their development.

The second stage, in view of Croatia's aspiration to become a part of the European market and the European economy, will be a stage of development under conditions of stabilization and developed market institutions and mechanisms. This is the ruling doctrine on the international market today, and this is the kind of strategy that must be developed in Croatia. We must then judge the right time when we can embark more rigorously on a stage of development with strong elements of stabilization.

Stabilization means that the basic market parameters have their real value; it also means an appropriate policy, i.e., a positive interest rate, a definite, stable exchange rate, a suitable wage and income policy, an appropriate fiscal policy, deregulation in the domain of protection, primarily towards the European market. This implies the beginning of integration into the European market and European Community. At present, we are still simply fighting hyperinflation.

According to the criteria of the institutions of the European Community and the OECD, the first stage in our strategy of development may be described as follows:

- an autonomous monetary and credit policy linked with the exchange rate and foreign exchange reserve policies: this autonomy is thought to be a prerequisite for achieving full employment; in this strategy, the mobility of the capital is reduced to the current financing of the trade deficit; the level of the country's integration into the international capital is insufficient and the criteria, institutions and mechanisms of this integration are unsatisfactory.

The second stage is characterized by a strategy of opening towards the international capital market; this option presupposes-and helps to create an economic structure which is competitive on the world market;

the caution with which some developed countries are opening toward the international capital market shows how delicate such a strategy is. Today this is the prevailing strategy in the countries of the DECD. Some countries were very cautious in their handling of the process of opening, but there are some recent examples of a fast opening of the domestic financial market to the international market.²

The second stage represents an "open strategy" of development of the financial market and has a strong impact on the degree of autonomy in conducting monetary policy, which is linked with the exchange rate policy. A fixed exchange rate policy, for example, soon leads to the inflow or outflow of international capital depending on how high the real interest rate is; a high interest rate encourages the inflow of capital into the country, inducing demand and expansion of the domestic currency, whose exchange rate is fixed; as a result, the interest rate becomes closer to the interest rates on the international market owing to the induced greater supply of money, which implies the reduction of the interest rate. The parity of interest rates among the countries participating in the market is achieved through the market mechanism. Under the conditions of a flexible exchange rate policy, the monetary policy must also follow the economic effects of the exchange and interest rates on economic growth and, depending on what those effects are, it must regulate the interest rate level by a policy of restriction or expansion, thus attracting capital or supporting exports and helping to balance the exchange rate.

The aim of a fixed exchange rate policy and the appropriate monetary and income policy is to help adjust the structure of the economy to the international market. Under these conditions, the fixed exchange rate policy, along with deregulation, is an instrument of pressure on producers not to establish prices according to their costs, but according to the laws of the market. It is, therefore, one of the instruments of structural adjustment in the real economic sphere.

² Cf. *Liberalization of Capital Movements and Financial Services in the OECD*

It is obvious that an open strategy of development of the financial market, i.e., of the system of expanded reproduction, presupposes, at the second stage, the existence of developed financial institutions and mechanisms such as the stock exchange, central bank or state budget operations on the open market, the functioning of a policy whereby commercial banks must keep compulsory reserves in the central bank, a general confidence in the stability of financial institutions, full convertibility of the national currency, etc. The macroeconomic policy relies, therefore, on mechanisms and institutions that function efficiently, but react to the measures undertaken by the monetary and fiscal authorities.

The principal consequence of the integration of the domestic financial market into the world financial market is that the domestic monetary, credit, and fiscal policies are shaped by that integration, i.e., by the maintenance of a balance between the inflow and outflow of capital from the country.

4. The legacy of socialism and the starting point of the development strategy

Apart from the above mentioned general characteristics of the stages in a possible strategy of development of the Croatian economy, the starting point of that strategy has to be described from the aspect of the legacy of socialism. The starting point viewed from the aspect of the war and the collapse of the East European and former Yugoslav markets was already described. In the context of the legacy of socialism, the starting point may be described as follows:

- the real economic structure developed in that system was characterized by a strong inertia and inability to make fast adjustments to a competitive market environment; this structure poses definite demands on monetary policy and the system of

protection which cannot simply be passed by under conditions of a deep recession; an issue that is linked with this is how to reconcile the policy of stabilization and the policy of growth in the sphere of monetary policy with the policy of protection, i.e., to what extent it is possible and necessary to make compromises with the existing economic structure and its level of efficiency;

- the method of allocating primary (base) money is still dependent on the real economic structure and its falling rate of accumulation (agriculture, until recently tourism, the export of industrial equipment and ships, etc.); the recession trend is pushing accumulation down to negative figures, and parts of the existing capital is used for consumption; the financing of development by economic subjects themselves is still far from being able to meet the needs;
- the self-financing of the economy as an element of the reproduction system is constantly declining; this is the chief indicator of the collapse of the entire system of extended reproduction; investments into fixed assets in the former Yugoslavia fell from 35% of the GDP in 1979 to under 18% in 1990; in 1991 the drop was already partly caused by the war; the gross accumulation of the economy fell and, compared to the losses, was negative.

The average state of capital formation to finance development in the developed economies (Germany, etc.), leads to the conclusion that the source of financing of growth and replacement of fixed assets, i.e., the non-financial part of investments (gross amount of fixed assets, net growth and replacement, and growth of inventories) is of a "non-financial character", which means that these are companies' own means arising from the depreciation of fixed funds, retained profits, and various reserves (85-90% of the total funds), including shares. Shares are treated as means, but they are a less important source of financing of fixed assets within the global economy.

Of the total sources of investment and current production financing, and financing of financial assets, the financial market (excluding shares) supplies from 15 to 40% of the required funds (short-term securities in the form of bonds, commercial documents, commercial credits, long-term bonds, long-term loans).³

Expectations about shares as an element in the extended reproduction system within the Croatian privatization scheme should be reduced to a realistic level, both as regards changes in the management structure and the extent to which shares can be the source to finance development, i.e., as regards the efficiency of the system as an element of the extended reproduction system.⁴

The present state of affairs in Croatia, which is partially caused by exogenous factors of aggregate demand, necessitates a development strategy of a "mixed" character with regard to the above mentioned two stages or options in the development of a financial market and a system of extended reproduction. This fact must be taken into account when developing the macroeconomic policy as the major element of that strategy.

5. Sources of financing for the revival of production and development

1. The effectiveness of the strategy of development in the first phase, as described above, presupposes the identification of the "wartime structural problems of development" of the Croatian economy as an exacerbating factor. This fact underlines the need for a "multistage approach" to the policy of development in Croatia. There is, therefore, a need to develop a strategy of reviving production in such a way that

³ Cf. *Non-financial Enterprise Financial Statements*. Paris, OECD, 1990, p.11.

⁴ This is discussed extensively in the monograph *Privatizacija u politici gospodarskog razvoja (Privatization and Policy of Economic Development)*. The Institute of Economics Zagreb, March 1991. The same point is made in a different context at the beginning of this study.

the available capacities, which are not being utilized because of the war, should be put into operation.

The following points should be taken into consideration:

- the growth of production is accompanied by increasing stocks of productive materials, work-in-process, and finished products;
- the growth of production presupposes the growth of the domestic market and of exports;
- considering the fact that the stocks of finished products and production materials needed to revive production have been depleted during the war, considerable sources of financing the growth of inventories and thus increasing production, have to be found, as well as funds for reconstruction of fixed assets.

Under such conditions, the marginal capital coefficient, as the ratio of growth of fixed assets and production, is low. The funds needed to reconstruct fixed assets or a given growth of production are lower than those needed for a given growth of production on the basis of completely new projects, i.e., new investments. However, relatively larger investment into working capital are required. The structure of investments shifts in favor of working capital.

As a rule, developed economies record the stagnation of inventories, so that a small rate of annual growth of production does not require a growth of inventories on the macroeconomic level. This is due to the fact that marginal growth of production, due to the rationalization of inventory control does not require additional investments. At such stages of development, gross investments grow only as investments into fixed funds.

The stage of the postwar revival of the Croatian economy is, therefore, structurally highly specific. Under these conditions, the sources of working capital financing can be both domestic and foreign. The importance of the foreign exchange component from abroad in the

financing of the import of production materials has already been explained.

Attention should be drawn to the developmental aspect of this foreign component, i.e., to the importance of foreign financing of the revival of production. In the context of the reviving production, there are two possible scenarios:

- according to the first scenario, reliance would be placed on foreign exchange revenue which would make possible the import of production materials, semi-finished products, spare parts, etc., only on the basis of exports of goods, followed by an increasing export of services; the prerequisite for this is that Croatia can capture foreign markets, as well as the possibility of financing working capital in both the dinar and foreign exchange component; considering the prevailing scarcity of domestic savings for financing the process of increasing stocks as a result of increasing production, the process of reviving production according to this scenario would be slow and protracted;
- the second scenario of reviving production is based on an additional influx of funds for financing working capital from abroad, as well as from domestic sources; this scenario of revival provides for a far faster process of revival of production, but also for the expansion of domestic market, i.e., consumption and a rising standards of living.

It should be noted that the revival of production does not include only the rebuilding of the physical capacities which have been devastated, but that it requires a much more complex economic policy since it refers to the entire economy and its revival. Under the circumstances prevailing in Croatia, where the economy is highly dependent on imports, the policy of stabilization must start at the revival stage. The policy of stabilization has to start, at least on the global level of public consumption, with the elimination of large deficits and identification of spots of deficit financing in parts of the economy, as has been

described above. Putting public consumption in order is the basic prerequisite for a policy of stabilization⁵ in the sphere of the monetary-banking and balance of payments systems.

The following policies will serve the goal of reviving production:

- at the commercial level, the opening of short-term credit lines, using advance payments by foreign importers; buying imported production materials, equipment for the renewal of damaged plants, materials for rebuilding damaged houses, etc., on credit; the insurance system when importing into the European Economic Community must be remembered, as well as the system of insurance against wartime and political risks undertaken by exporters from those countries into Croatia, all of which acts either to support or to limit the renewal of production;
- at the level of financial institutions and the state, the important items to count on included revenue in the form of humanitarian aid, donations for the rebuilding of houses, the sale of government bonds (to Croatian citizens at present), direct credits for the construction of infrastructure (World Bank and European Bank for Reconstruction), as well as the rescheduling of foreign debts from the pre-war period.

The goal of economic policy must be the realization of at least the second scenario of revival. This scenario still belongs to the first option or stage of the strategy of development. It is important to see this because of the structural aspect of reconstruction. At this stage, the "restructuring" of the economy is not the first priority; the first priority is the revival of production.

⁵ Cf. *The Stabilization Programme of the Government of the Republic of Croatia, January 1993. In this paper we are dealing with the developmental aspect of stabilization policy in those areas which have hitherto been neglected by analysis.*

A distinction must therefore be made between the structural problem arising from the war and the structural problem arising from the policy of stabilization. This must be done because the structural problem at the stage of reconstruction and war will not be a problem at the stage of "revived production". We are dealing with a specific operationalization of the first strategic option, i.e., the first stage of development, the conditions of revival, as defined above. With this policy the existing economic structure is adapted to the level of effective (solvent) demand in the country, which has been considerably reduced due to wartime conditions.

Under the conditions prevailing today, Croatian economic policymakers must try, as they are already doing, to steer the process of reviving production according to the second scenario, so that the process of reconstruction may be as brief as possible. The implementation of this strategy is influenced to a great extent by international financial institutions with their demand that an appropriate stabilization policy be strictly adhered to. Putting in order all forms of public consumption and securing real sources of revenue to cover it is a top priority. What is required, therefore, is the elimination of the direct monetization of various deficits of budgetary and para-budgetary nature. The next explicit demand concerns privatization and a firmer monetary policy. Such a concept of stabilization⁶ finds its application in the instruments of other policies, such as tax policy, income policy, interest rates policy, pricing policy, and exchange rate policy. The fundamental issue in implementing this kind of policy is how to secure real sources of revenue for the elimination of deficits in public consumption. This is followed by the issue of what kind of policy can provide for sufficient savings (accumulation) revenue from real sources for the revival of production. When these two conditions have been fulfilled along with fine tuning of the monetary policy, the effect will be to reduce inflation, as well as to ensure development, i.e., the revival of economic activity (production).

Suffice is to say that the market solution starts with the policy of increased supply of foreign exchange, which will take place in Croatia through the following channels:

- exports of goods and services, including tourism,
- workers' remittances,
- the import of capital, long-term and short-term, in all forms.

The first channel will be realized through the revival process itself, provided there is a sufficiently strong real source to finance production. This can be ensured by importing capital and providing savings incentives to the Croatian population (at home and abroad), i.e., by means of the third channel listed above. This will not happen unless a sufficiently convincing stabilization policy is adopted to guarantee capital repatriation and unless interest rates on the savings of the population are made attractive enough. To achieve this, a hard monetary policy is required, as well as conditions of full competition in the financial system, especially the banking system. This means that banks must be in a position to create, on their own, a competitive environment to attract monetary deposits, especially time deposits, for which they will be able to pay real positive interest.

It may be concluded that increasing the supply of foreign exchange is a process which is simultaneous with increasing accumulation, domestic and foreign, and that only this will have a stabilizing effect on the exchange rate of the domestic currency in relation to hard currencies.

A policy thus conceived obviously contains a mixture of both of the above mentioned strategic options, as well as a strategy of revival which reinforces the "mixed" character of the strategy of stabilization and development at this stage.

⁶ Cf. *The Stabilization Programme of the Government of the Republic of Croatia, January 1993.*

The revival of production in postwar Europe from 1947 to 1951 may be seen as simple financing of the payments deficit from additional savings for financing production and maintaining the foreign exchange liquidity. The policy of reviving production was shaped by the well known Marshall plan.

A comparison of the conditions under which production was revived in Western Europe and those prevailing in present-day Croatia leads to the conclusion that the conditions prevailing in Croatia today are more difficult. The difference is primarily in the lack of support for the financing of the payment deficit, so that there has been an actual outflow,⁷ and not an inflow, of real sources for financing production and development in the balance of payments up to the present time.

It is obvious that the time needed to revive the production in Croatia depends to a considerable extent on various forms of international assistance, especially on support in financing current production and the physical reconstruction of industrial plants, agriculture, transport and tourism. In this respect, the economic policy of the Croatian government is pessimistic. The projection of available funds for 1993 is negative, i.e., it forces a net outflow of foreign capital, as well as a zero growth of domestic savings. The only source of financing increased production and development would thus be depreciation, which would amount to 6-10% of the GDP. However, the use of medium-term and long-term credits for equipment, reproduction and reconstruction should increase in 1993, so that this item would make possible, in spite of the outflow of funds, the maintenance of production and its growth, but would not increase the utilization of funds within the country to a significant extent.

The above analysis of the situation and of the alternative strategies indicates that the first strategic option and the second scenario of revival containing some elements of the second strategic option are realistic. This means that the strategy of development must find

instruments for the inflow of capital through the mechanisms of the financial market, i.e., the market of medium-term and long-term capital. This market has two levels:

- financial institutions (banking consortia, International Monetary Fund, World Bank, the European Bank) and foreign governments;
- the second level is private capital arriving through various commercial channels, especially in the form of direct investments. This group includes concessions and leasing.

To activate these mechanisms and institutions, the legal and institutional groundwork has to be laid in the economic system of the country, and at the same time the financial system, i.e., the internal and external balance, has to be stabilized. This must include a comprehensive programme of stabilization and development.

In the macroeconomic and developmental context, the policy of privatization should make available additional, both domestic and foreign, sources of financing production and development. Under the circumstances prevailing at present, a certain inflow of foreign capital may be expected through the mechanism of privatization and the mechanism of direct investments which it includes.

It is obvious however, that we are dealing here with investments into specific projects thus into equity, at least to a certain extent. Investment into equity is, from the aspect of the receiving country, the most favorable form of investment. The policy of privatization must encourage this. For investments to be beneficial for the development of the country and to be sufficiently attractive for foreign investors, investments must take the form of buying shares of primary issue, i.e., those issued by the economic subjects to which the funds are to go.

⁷ Cf. *The Stabilization Programme of the Government of the Republic of Croatia, January 1993.*

The above analysis indicates that Croatian economic policy, in its strategy of reviving production, may count with considerable confidence on the set of mechanisms and instruments belonging to the first strategic option, but partially to the second strategic option also. The second option includes the inflow of capital on the basis of privatization with the aim of direct investment, and to a far lesser extent investments into financial instruments such as government bonds, the bonds of large corporations, and investment funds (Privatization Fund and the Croatian Credit Bank for Reconstruction, Privredna banka Zagreb and other commercial banks). Capital will arrive in the form of bank or institutional loans, but for specific projects. These will also be arranged by the European Development Bank, at least in the reconstruction stage.

It is clear that stable macroeconomic conditions and an ordered institutional social and economic environment are required for the inflow of capital through the instruments of a developed financial market.

2. The central place belongs to the banking system with its mediating function in finding and promoting real sources (all kinds of savings) for the financing of development, the priority being the revival of production. It is precisely this function of the Croatian banking system that is undeveloped as a result of the social legacy, but also owing to the type of underdevelopment which is typical of developing countries.

A special policy must be implemented to render the banking system capable of performing the above mentioned function and operating in a competitive environment.⁸ The "extraction" of dubious assets in the banks and the debiting, as a rule, of the state for these assets, i.e. the transformation of such outstanding debts into a public debt, is the usual

⁸ *This will not be discussed in detail in this paper. See the analysis dealing with the issues of improving the financial state of banks: Martić, Relja. Sanacija bankarskog sistema (The Rehabilitation of a Banking System). Zagreb, The National Bank of Croatia, 1992; Brainard, L.J. Reform in Eastern Europe: Creating a Capital Market. The AMEX Bank Review, Special Papers No. 18, November 1990.*

"recipe" recommended to ex-socialist countries by international financial institutions. The state should schedule these liabilities so as to make them bearable for the budget.

After an operation of this kind, a monetary policy must be established which will not break the real framework of creating the money supply, i.e. which will prevent the granting of credit to production by means of inflation (chiefly through the primary issue of money). This is highly complicated problem which has absorbed the interest of researchers and exponents of economic policy in all developing countries for the past quarter of a century at least. As a rule, developing countries have "priority sectors" which are unable to pay the market price of capital in stable, non-inflationary conditions. The makers of economic policy try to temporarily transfer the cost of the capital, i.e., the cost of development, to other sectors - the population, "healthy" sectors of the economy - most often through the banking system.

This kind of a monetary policy under the conditions prevailing in Croatia today requires a great deal of delicacy in "bridging" possible scarcity of credit at the moment of its implementation. For such a policy to produce results in its developmental function, the gap arising in "real" deposits must be filled with sufficient speed. This is possible only if the population and the economy gain the confidence in the stabilization policy, and if, as a result, deposits of all kinds of time structure increase significantly. The size of the deposits thus activated is crucial. Under the present conditions in Croatia, this source would obviously not be large enough to meet the credit demand. This follows from the fact that the operating rate in industry is far below the prewar level and consequently the gross domestic product which is generated is low. The primary consequence of this is, already pointed out, the lack of domestic savings.

Taking all these circumstances into consideration, the program of stabilization, revival of production and growth of the GDP cannot be realized without a strong support of foreign and international financial institutions and sizeable loan arrangements. These sources, however,

will not be activated to a sufficient degree without a clear decision by Croatian policy-makers to insist on the stabilization programme.

Likewise, the Croatian economic policy must insist on considerable foreign support in the form of loans and credits in order to bridge the gap during the process of activating and creating domestic savings and putting the financial system in order. Should this policy fail, the time required for the revival of production and the growth of the economy will be considerably longer, i.e., it will be much more difficult to overcome the stage of poverty, and the long-term negative consequences, especially demographic ones, will be much worse.

The economic policy delineated above will not be easy to implement, but unless these goals are achieved the market economy will not be able to function. Moreover, without the realization of these goals the market economy does not exist, even if private ownership is "introduced" in managing the economy. Privatization alone is not, therefore, a sufficient condition for the functioning of a market economy, although it is necessary one.

In other words, the process of privatization, the policy of stabilization and the policy of the revival of production are simultaneous and mutually interdependent processes.

6. Conclusions

1. Croatia is faced with the need for three kinds of modernization: technological modernization, institutional modernization, and the rebuilding of what has to be repaired in order to increase production as soon as possible, to the level needed for survival and for creation of the surplus required for investment into the modernization of the economy.

Besides establishing a country governed by law in all respects, i.e., a modern democratic state based on law and order, ownership rights have to be guaranteed, and easily accessible to foreign and Croatian citizens alike. Croatian resources have to be exposed to the world market so that they may be valued according to international criteria. For others to see their chance of development in Croatia, they must be offered security, rights, and guarantees. In this context, the problem of privatization becomes an absolute priority.

2. The present state of Croatian economy is the result of the dissolution of the former Yugoslav federation and the disintegration of the pertinent and East-European and Middle-European markets; at the root of all this was the crisis and collapse of the socialist socioeconomic system of historic significance. A drastic consequence of all these historical developments is the war on the territory of Croatia and Bosnia-Herzegovina. All these factors manifested themselves in the low indices of growth of the gross domestic product, employment, investment, consumption, exports, imports, the level of utilization of economic potentials, a high monthly rate of inflation, and especially the adverse social situation and problems as early as 1990, which flared up in the second half of 1991 and throughout 1992, to continue in 1993. Under such conditions a distinction must be made in current economic policy between war structural problems (transport, tourism, electricity generation, parts of agriculture and industry, certain banks) and ordinary structural problems created by insufficient competitiveness on the world market. Recovery of production is connected with the war structural problems, but also with a reorientation in exports of goods and services to new markets, i.e. in

great measure to the replacement of the former East-European and Yugoslav markets. The fundamental objective of the policy of recovery is to raise the level of utilization of the country's economic potentials and to reconstruct part of physical facilities destroyed during the war. Stabilization policy must take into account the objectives of recovery and these will for some time act as limiting factors. Recovery should at the same time proceed from the objectives of the stabilization policy.

3. In determining the development strategy of the Croatian economy it is necessary to distinguish two strategic stages and the stage of recovery as the initial step in the first stage. The basic characteristic of the first stage is a relative autonomy of monetary and credit policy associated with the policy of the currency rate of exchange and foreign exchange reserves, with the aim of achieving full employment and reconstruction of productive facilities, which are not markedly structural problems. It should be expected that the inflow of capital into the country will predominantly evolve for the purpose of financing the current balance of trade deficit, especially in the stage of recovery. Since the instruments and mechanisms of the financial market are underdeveloped, macro-economic regulation will have up to some level an administrative character.

The second stage in development strategy will be characterized by opening up towards the world capital market on the basis of market mechanisms. This stage will presuppose an appropriate development level of financial institutions and mechanisms, such as: a securities market, central bank open-market operations, full convertibility of the domestic currency, automatic equilibration of the balance of payments through the functioning of the capital market and the sale of goods and services by a competitive economy.

The integration of the financial market into the world (European) financial market will demand coordination of monetary and fiscal policies and the exchange and interest rate policies with partner countries (OECD, EEZ, EFTA, for example). This means that Croatia should be ready and prepared to join these economic communities.

4. The need to distinguish stages in the country's development strategy is imposed by the inherited social economic system, the inertia and non-competitiveness of part of the economic structure, the way of allocation of high-powered money, a low self-financing ability of economic entities and the inability to provide funds for current operations and development on the financial market. The situation calls for the establishment of a "mixed" strategy with elements of policies of the various development stages and strategic options.

5. In the substage of the production recovery two scenarios are possible: according to the first the inflow of foreign exchange, growth of production and formation of savings for financing working capital would be only based on merchandise exports and a gradual increase in invisible exports and, in addition, on gradual revival of domestic market; current economic policy and economic development would, owing to the external circumstances, for the time being evolve according to the first scenario.

The second scenario of the production recovery would be based on the additional inflow of funds for financing working capital from abroad, but also on an additional inflow of funds from domestic sources; the second scenario would entail a much faster process of production recovery, but also a faster process of the expansion of the domestic market and a rise in living standards.

The second scenario would evolve on a commercial level (short-term credit lines, advance-money, commodity credits in the form of raw and intermediate materials, spare parts and equipment, materials for the reconstruction of houses, infrastructure) and at the level of financial institutions (humanitarian help, donations, the World Bank and the European Bank for Reconstruction and Development, deferment of the repayment of external debts).

The objective of economic policy is to realize the second scenario. In this connection especially interesting and instructive is the experience of the European countries after the Second World War with the

Marshall plan, by means of which the USA helped recovery of production in Europe. Croatia's economic policy concerning recovery of production and reconstruction of production units should make use of some mechanisms and instruments in the implementation of the first strategic option (stage), but also instruments of the second strategic option (stage). This primarily relates to direct investments by foreign investors on the basis of privatization in the form of additional capitalization. Government bonds, bonds of large corporations and of investments funds are instruments of a developed capital market and would belong to the second strategic stage. Since, however, the elements of individual stages (or options) interweave, it is necessary to develop a legal regulation and pursue a stabilization policy in order to make it possible to combine several instruments from individual stages to ensure inflow of capital into the country.

6. The banking-monetary system has a central place in the recovery and development strategy. In order for the banking system to be able to function as a mediator in the collection and investment of real sources of savings, it is necessary to carry out a credible stabilization programme. The preconditions for the successfulness of this programme are as follows:

- financial rehabilitation of banks and infrastructural public enterprises and the solution of major "structural problems" in the remaining part of the economy; in the procedure for overall rehabilitation the Government should take over banks' "bad assets" and obligations of public enterprises that can be rescheduled, balance current budget expenditures and revenues, maximally avoid monetization of the current deficit, and reschedule external debts; the fulfillment of these preconditions is already built into the Government's programme;

Proceeding from the foregoing, it will be possible to implement stabilization monetary policy in a way that will ensure that credits granted by commercial banks are based on real deposits of households and the economy; in this connection it is necessary to

examine possibilities for changing the mechanism of high-powered money; credit supply should correspond to credit demand which is able to pay real positive interest rate on deposits of varied term-structure should be attractive to depositors. Credit supply for the economy on the basis of real sources should be such as to ensure a positive real growth rate of gross domestic product. This would in view of the level of economic activities in the current period only be possible with foreign financial support. If the Government is to obtain this support, its stabilization programme should be credible. The said mechanism is an argument for obtaining financial support. The aim of stabilization programme is not only to lower the inflation rate, but also to ensure economic growth. Under our conditions this should have a pronounced development character. This could be ensured by a new approach in monetary policy, whose basic aim would be to place banks in a competitive setting; banks should strive to collect real sources for deposits (from the economy and households) rather than rely and depend on the central bank within the system of quotas and similar instruments.

In the transitional period it will be in particular necessary to solve such great problems as food and exports. However, they should not be a basis upon which the banks would be using direct credits from the central bank earn interest and would therefore not be interested in collecting deposits from other sectors, primarily households. To finance working capital for such activities many countries have special financial institutions, but that they do this so that their sources of financing also rely on real deposits of commercial banks through the reserves of the central bank.

7. Privatization as a source for financing reconstruction and development and financing working capital will under Croatian circumstances not yield good results, save exceptionally and in cases where additional capitalization that must be approved by a government body is involved. The financial goal of privatization is to increase budget revenues and thus also possibly help finance the reconstruction of destroyed and damaged physical capital. The role of stock

exchanges, primarily of those dealing in shares, is also in developed countries to change the owners of, rather than to finance the development of corporations. Stock exchanges were in the past an important mechanism for collecting funds for development in the form of primary share issue. Similarly to the developed countries now, our stock exchanges function as a secondary shares market, consequently as a mechanism for seeking new owners to replace the state. Financial resources derived therefrom will go into budget. This means that the new owners will be impelled to seek credits from banks to finance their working capital needs. In view of the foregoing analyses, the question is whether or not this will result in increased pressure on high-powered money, which would be contrary to the stabilization objectives.