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An Economic Evaluation of the Croatian Transition Policy Mix

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Abstract

The Croatian transition from socialist to market economy is the focus of this essay. The purpose is to evaluate the macroeconomic impact of the reform program with special attention to the design and to the constraints that may have limited the reformability of the Croatian economy. This is done by briefly considering the initial conditions of the Croatian transition, where the war (1991-1995) is the issue affecting the transition the most. The reform program of Croatia in terms of *Systemic reform, Stabilization Policy and Trade and Exchange Rate Policy* is outlined and the implementation analyzed. The macroeconomic evaluation of the reform program considers the variables GDP growth, trade, fiscal deficit and inflation and finds positive results except regarding GDP growth and export performance. The export performance of Croatia has been weak and GDP growth dropped considerably during the war and the recovery has been slower than expected. The design of the reform program was according to theory and implemented in a successful way. Constraints limiting the reformability of the economy were the war both in terms of creating uncertainty in the economy and the tense political situation it brought about that resulted in a state of semi-isolation throughout the 1990s. This is a probable explanation of the problems found in the evaluation and has clearly affected the outcome of the transition of Croatia.

Keywords: Croatia, transition, reform program, constraints, evaluation, macroeconomic impact

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List of Abbreviations

CEEC	Central and Eastern European Countries
CPF	Croatian Privatization Fund
CPI	Consumer Price Index
DEM	Deutsche Mark
EBRD	European Bank of Reconstruction and Development
ECB	European Central Bank
EU	European Union
GSP	Gross Social Product
HNB	Hrvatska Narodna Banka
RPI	Retail Price Index
SAA	Stabilization and Association Agreement
SFRY	Socialist Former Republic of Yugoslavia
SOE	State Owned Enterprise
USSR	Union of Soviet Socialist Republics
VAT	Value Added Tax
WB	World Bank

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1. Introduction

After years of war in the 1990s and the struggle for recovery Croatia became a candidate country for membership of the European Union in 2004. As many other countries of central and eastern Europe, Croatia has undergone the transition from socialist economy to market economy. The turbulent history of this small country calls for special interest as the war and independence in 1991 took place just years after the initiation of the transition process in the former Yugoslavia. It would not be surprising to see great difficulties lingering in the Croatian economy after such a challenge at the time of the crucial first steps towards market economy.

What also makes Croatia especially interesting along with the rest of the former Yugoslavia is its market oriented form of socialist economy. It was not a planned economy and there was a higher degree of price- and trade liberalization than in other socialist countries of Central- and Eastern Europe. [1] Also of interest is the mixed view on the outcome of the transition process. The assessments range from "one of the most successful transition countries" to "Croatia is still paying unnecessary high costs of transition in output decline, rising unemployment and rising external debt due to macroeconomic mismanagement".[2]

The first purpose of this study is to evaluate the Croatian reform program with focus on the macroeconomic impact. Also determining to the outcome is the design of the program and the constraints facing the transition process. The second purpose of this study is to evaluate the effect of the design and furthermore to identify the constraints of the Croatian transition and analyze how they may have limited the reformability of the economy.

The transitional reforms undertaken in Croatia *after* independence will be evaluated and hence the initial phase of transition as a part of former Yugoslavia will not be directly taken into account. To distinguish an "end-date" for the transition is controversial and difficult and here the signing of the Stabilization and Association Agreement (SAA) with

[1] Bicanic & Franicevic. 2003:33
[2] First quote is by Shreb.1999:1 and second quote by Vojnic & Veselica.1999:207

the EU in 2001 is used. When Croatia signed the SAA the focus had changed from transitional reforms to reform policies aimed at adjusting to the EU with the goal of increased integration and membership in the union.

The main sources and data were collected during a two months stay in Zagreb. Five interviews with people who in different ways work with the economic development of Croatia were performed. This material has been used as a complement to secondary material such as government documents, reports and literature. Statistics are mainly from the Croatian National Bank (HNB) and the European Bank of Reconstruction and Development (EBRD). The EBRD provides a set of indexes to compare European countries in transition, which here is used in some cases. This is to provide a comparison with other other Central- and Eastern European Countries (CEECs) and to clarify important differences. The methodological notes on the EBRD indexes can be found in appendix 2.

The analysis of the reform program, both in the theoretical and empirical chapters, will be divided into the policy areas of S*ystemic Reforms, Stabilization Policy* and *Trade and Exchange Rate Policy*. The topics and sub-topics have been chosen both based on the Croatian experience and the general theoretical framework available.

This essay is structured as follows. Chapter 2 provides an overview of the Croatian economy before independence as well as the effects of the war. The theoretical framework of transition economics will be presented in chapter 3. Chapter 4 identifies the reforms as well as the implementation of the reforms that were undertaken in order to transform the Croatian economy into a competitive market economy. The economic evaluation in terms of macroeconomic impact, of the transition mix in chapter 5 is based on the economic theory presented. Chapter 6 analyzes the design of the reform program and identifies the particular constraints faced by the Croatian economy and how these have limited the reformability of the country. Finally in chapter 7 the main findings of the essay are summarized and suggestions for further research are made.

2. Economic Legacy

As the focus of this study is the transition of Croatia as an independent nation this chapter provides a brief overview of the transitional, economic and political legacy that Croatia inherited when gaining independence. These initial conditions had strong influence on the design and outcome of the transition program. What also greatly affected the transition was the so called homeland war that followed the Croatian declaration of independence in 1991. The final section of this chapter surveys the effect of the war on the Croatian economy and politics.

2.1 Initial Transition of Former Yugoslavia

The characteristics of the socialist economy employed in the former Yugoslavia were different from most other socialist countries of the South and East Europe and very much from countries like the USSR. The economy was not planned, prices were liberalized to a comparatively large extent, private companies were allowed and the state owned enterprises (SOEs) where owned by the workers based on the principle of *self management*.[3] This provided favorable initial conditions for the transition.

In 1989 the dismantling of the socialist economy started with liberalization and privatization and Yugoslavia took its first steps towards democratization. There are many interpretations of why this process started, such as the pressure from abroad and the ongoing transformation of other European socialist countries. Focus here will be on the economic explanations which will provide the background and conditions for the transition process.

The economic situation was characterized by the declining growth of the 1980s. All domestic savings had been used, inflation was rising and so was unemployment. This increased the economic instability in former Yugoslavia and inefficiencies prevailed both at macro and micro levels. After nearly a decade of failed reforms, consensus for liberalization and marketization was reached. At this time Croatia was still a part of the

[3] Gros & Steinherr. 1995: chapter 12

former Yugoslavia and the federal government ruled over the economic policy. The Enterprise Law of 1989 institutionalized the beginning of transition.[4]

The first phase of transition was gradual. The institution of social ownership was kept and this was mixed with both privatized firms and a new private sector. The discourse of 'New Socialism' was used as an overall goal which can be seen as a way to gain popular support for the reforms. The liberalization and privatization of this time was only partial. The goal of the new economic policy was to reduce income inequalities between the republics of former Yugoslavia and of course increase overall growth. For Croatia this meant transfers flowing out of the republic which limited domestic development. Also constraining was that even though decentralization measures were undertaken they did not involve decentralization of investment decisions.[5]

The Croatian legacy from the initial transition concerned both economic and political aspects. Institutions, actors, and expectations of the speed and implications of transition were inherited. The economic legacy consisted of a short lived stabilization that gave optimism for the implementation of further price stabilization, privatization and entrepreneurship. The political legacies mainly concerned political pluralization. The first democratic election was held in Croatia in May 1990 and was followed by nearly a year of economic isolation from the other Yugoslavian republics before the war broke out in the summer of 1991. [6]

2.2 The Economic Structure of Croatia

The Croatian economy had to a large extent the characteristics of a developed country and Croatia was one of the richest areas of the former Yugoslavia along with Slovenia.

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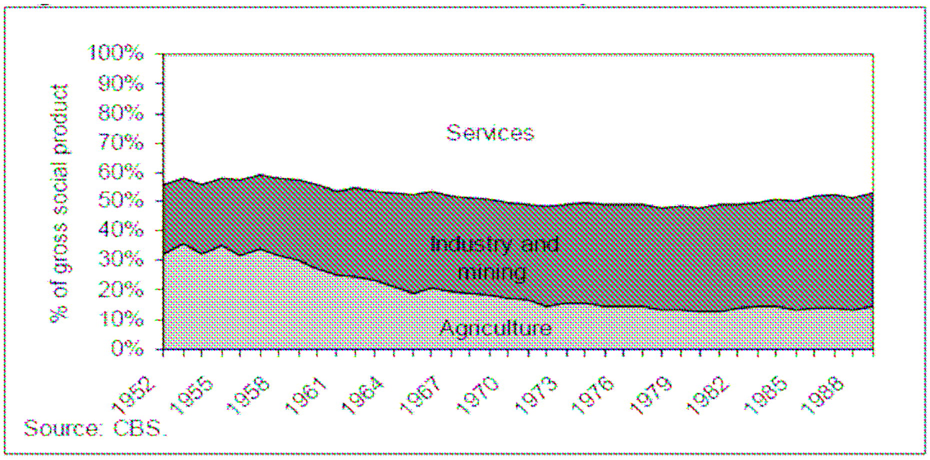
[4] Bicanic & Franicevic. 2003:2
[5] Vujčić & Lang. 2001: 5
[6] Bicanic & Franicevic. 2003:9

Figure 1: **Economic Structure of Croatia 1952-1990**



Source: Vujčić & Lang. 2001:7

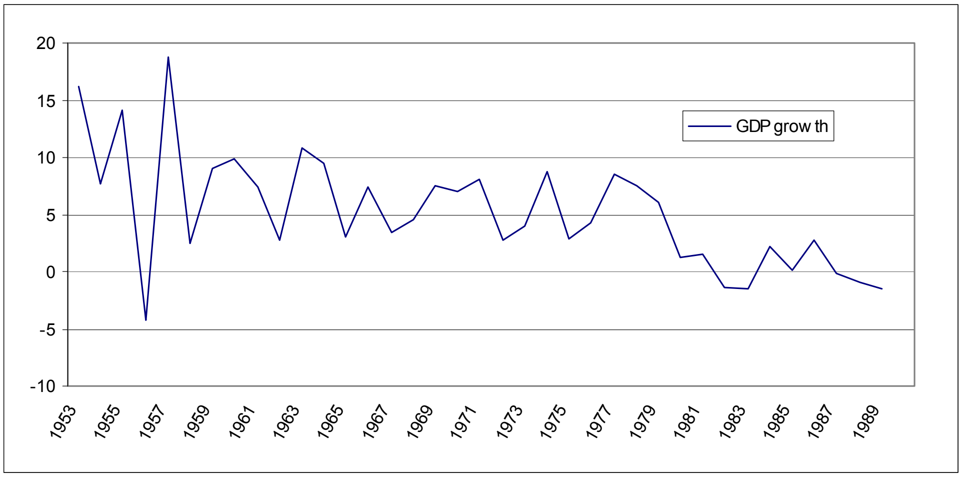
Figure 1 shows the structure of the Croatian economy and of particular interest is that the service sector was the largest and has accounted for nearly 50 % of Gross Social Product (GSP) since the 1950s, which is uncommon in socialist countries.[7] The agricultural sector drastically declined throughout the 20th century and the industrial sector grew. Compared to other transition countries, Croatia had the highest share of employment in the tertiary sector and also the smallest share in the primary sector.

The banking sector was denoted by a satisfyingly functional two-tier banking system and consisted of the National Bank of Yugoslavia and the commercial banking sector. These banks were owned by large enterprises and aimed at private savings to be invested within the enterprise. Private ownership of property and smaller businesses was allowed in Croatia, in contrast to many other socialist countries.[8]

Croatia was the second major exporting region of the former Yugoslavia with industrial products as the main exporting goods. The Croatian economy was comparatively open, especially if counting trade with the other republics of the former Yugoslavia. In the 1980s trade in goods accounted for 70% of GSP with equal parts imports and exports and the main part of the trade was with the republics of the former Yugoslavia. [9]

[7] As in other former socialist countries, the former Yugoslavia used the concept of material production, GSP. The measure was based on statistics of material production in socially owned sector. This meant that the service sector and private sector were underestimated. (Vujčić & Lang. 2001:3)
[8] Vujčić & Lang. 2001:3,6 and 10
[9] Vujčić & Lang. 2001:12, Kraft. 2002:2

Figure 2: Croatian GDP Growth 1953-1990



Source: Own compilation based on data by Družić. 2006:285-287

Noticeable regarding the growth of the Croatian economy displayed in Figure 2 is the decreasing GDP-growth in the middle of the 1980s. Already at the end of the 1970s GDP-growth slowed down and was well below zero percent growth per year Croatia gained independence in 1991.

Growth was to a large extent dependent on the industrial sector, as in most other socialist countries, and this was also the sector with the strongest growth throughout the 20th century as Table 1 displays. Unlike other socialist countries the industrial sector was well diversified and as mentioned the service sector was important. Tourism was particularly promoted even though it only accounted for 5 % of the GSP. The low percentage is probably an understatement due to the large part that informal private production is in the tourism sector.

Table 1: Growth Rates of Gross Social Product (Material Production) by Sector:

	Total Growth	Agriculture and Forestry	Industry and Mining	Services
1953-1959	9,20%	9,60%	9,20%	8,90%
1960-1969	6,60%	1,40%	8,40%	8,10%
1970-1979	6,00%	2,70%	6,90%	6,40%
1980-1989	0,20%	0,80%	1,20%	-0,70%
1953-1989	**5,10%**	**3,00%**	**6,20%**	**5,40%**

Source: Vujčić & Lang. 2001:8 (Based in data by the HNB)

2.3 Economic Effects of the War

The war started in the early summer of 1991 as Slovenia declared its independence and Croatia soon followed which was opposed by the Socialist Former Republic of Yugoslavia (SFRY). War broke out and a third of the Croatian territory was occupied. The different stages and events of the war will not be covered but rather a focus on what the war meant for Croatia in economic terms.

Table 2: Direct War Damages in Croatia, Percentage of 1995 GDP

Human loss (killed and disabled persons)	64%
Houses and apartments	21%
Budget costs	18%
Production capacity	16%
Public companies	13%
Stolen goods	9%
Utilities and infrastructure	4%
Damages incurred due to mines	4%
Property of citizens	3%
Health sector	3%
Culture	2%
Education and sport	1%
JANAF pipeline	1%
Total	**157%**

Source: Vujčić & Lang. 2001:20

Destruction during the war was extensive, both in lives and property as can be seen in Table 2 above. By 1996 the direct war damages in Croatia had cost nearly 30 billion USD which equals 157% of the 1995 GDP of Croatia. More than 10 000 people were killed and nearly 40 000 wounded, of which a large part were young men in their most productive years. Important was the damage done by the decrease in the Croatian population, with an estimated 400 000 people between the years of 1991 and 2001. A part of the immigrants were also young and well educated persons who could not find work in Croatia. [10] This also implies a long-term loss for the country as growth is dependent on skilled labor in a country like Croatia with its comparatively high wages.[11]

The war also resulted in a great loss in production, of which the loss in production capacity amounted to 16% of 1995 GDP. The loss in terms of production diverted

[10] Vujčić & Lang. 2001:19
[11] Račić et al. 2005:50

towards defence and hence the decrease in investments and production generating long-term growth is hard to estimate but is probably considerable. What did lessen the impact of the war was that the three major cities were left out of the fighting as they are situated on the western side of the country, as well as the fact that the war only lasted for a few years.[12]

To summarize, Croatia became an independent nation in 1991 but did not gain full control over all of its borders until 1998. In spite of this Croatia can be seen as a consolidated nation when the (by the SFRY army) occupied territories were won back in 1995. The Croatian transition can be divided into two phases and the first stage of transition took place during the war and was characterized by the instability and uncertainty this brought. After the implementation of the stabilisation program in late 1993 Croatia initiated its more normal transitional process similar to other CEECs.

[12] Vujčić & Lang. 2001:19

3. Theoretical Framework

When studying the theory of transition we must first identify the goal of the process and keep this in mind while studying the different reforms. In economic terms the main objective of the transitional process can be said to be an increase in growth through the creation of a structure of incentives which lead economic agents to use economic recourses in an effective way. Lack of growth and an ineffective allocation of resources have been and are common problems in socialist economies.

The aim of this chapter is first of all to show the optimal way of reforming a socialist economy into a market economy. Important to notice is that although consensus prevails on what measures are needed to achieve a successful transition process, the greater debate is about the scope, timing and sequencing of the reforms. A particularly debated question is whether to apply a fast simultaneous approach, a so-called "big bang" approach, or a gradual slower approach to the reforms. The second aim of the chapter is to show what is constraining to this process both in terms of political and economic factors that may limit the reformability of the economy.

The chapter is structured as follows; first the general aspects in terms of the design of the reform program will be pictured, followed by an overview of the different parts of the reform program. The constraints to the reformability of the economy will be discussed and finally a note on the theoretical aspects of the outcome of the reform program.

3.1 Design of the Reform Program

The optimal design of the reform program depends strongly on the initial state of the economy, the overall political situation and the level of popular support. Still, the reform program should in most cases include measures shown in Table 3.[13]

[13] Gros & Steinherr. 1995:102

Table 3: The Fundamentals of a Successful Reform Program, without Internal Order

Macrostabilization	Current account convertibility[14]
Currency reform	Small-scale privatization
Fiscal reform	Large scale restructuring and privatization
Social safety net	Autonomous banking system
Institutional reforms	Liberalization of financial markets
Price and market reform	

Source: Gros & Steinherr. 1995:102

Sequencing of reforms also carries a strong dependence on initial conditions and it is hard to make a general statement. Early privatization may be argued for to help incur macroeconomic stability as it is a way to stop the cycle of soft budget constraints, soft loans and inflation. It is important to notice that macroeconomic stability is crucial for successful implementation of many of the other reforms. Constitutional changes are a way to early on reduce uncertainty and facilitate investment decisions and by this promote growth in the private sector. Some reforms require longer time to be fully implemented which is also an aspect to be taken into account.[15]

The debated issue of whether to apply a fast simultaneous reform program or a gradual, slower reformation also depends, as always, on the state of the economy and the political situation of the country in question.

One way to picture the issue is to imagine the unlikely event of the British changing from left hand to right-hand traffic, but doing so gradually by only letting trucks drive on the right-hand side of the road and later cars and so on. This shows what the proponents of a big bang approach argue for; the best outcome of reform will be achieved through a total reform covering as many parts of the economy as possible. The irreversibility that a big bang reform creates is also seen as a positive aspect as it gives credibility to the government's commitments to reform and may give more enduring popular support, even in case of periodically worsened economic performance.[16]

Arguments for a gradual approach are the existence of political constraints and the natural bottlenecks of the economy. It is hard to gain popular support for such an extensive reform program and some sequencing of reforms is necessary as certain reforms need more preparation and some have a longer period of implementation. Such a

[14] Current account convertibility is essential to the development of foreign trade as it allows for free inflow and outflow of foreign currency used for trade-related payments.
[15] Gros & Steinherr. 1995:102
[16] Gros & Steinherr. 1995:99

great change in the economy is also likely to create many short term losers that need to be compensated.

The issues of design of the reform program are important to keep in mind and will be revisited as we move on to analyse the theoretical considerations of the different parts of the reform program.

3.2 Theoretical Considerations of Reform Program

In this section the theoretical considerations of specific aspects of the reform program will be discussed. The same structure is used in chapter 4, “Reform Program of Croatia” and

Table 4 on page 26 provides an overview.

A. Systemic Reforms

3.2.1 Liberalization of Internal Trade

Price Liberalization, Market Institutions, Competition law

Price liberalization, both in terms of goods and labor, is a very important aspect of the transition process and necessary for the introduction of the market mechanism and efficient allocation of resources. If not fully, at least predominantly liberalized prices are also in many ways a precondition for the implementation of other economic reforms.[17]

Redistributional effects that may cause a drop in the living standards of certain segments of the population tend to occur, for example when wages are adjusted to productivity. The production side of the economy will also need to adjust to market-determined prices and another often prevalent obstacle is the benefits bureaucrats receive from the persistence of price controls. All these issues tend to give rise to political constraints which may slow down the process.[18]

To overcome these constraining aspects a quick and decisive liberalization is to be preferred. A gradual solution is generally argued against as partial price liberalization creates distortions.[19]

3.2.2 Public Enterprises

Privatization

Privatization is a key aspect of every transition program and also one of the great challenges, both in terms of technical difficulties and political constraints. Privatization does not per se mean increased efficiency which is a common misperception.[20]

The technical difficulties of valuing the enterprises depend on the transition environment with often insufficient financial institutions and also macroeconomic

[17] Gros & Steinherr. 1995:93, 185
[18] Roland. 2000. chapter 6, Gros & Steinherr. 1995: 128
[19] China is presented as a success story in this aspect as dual-track liberalization was carried out. This has proved to be a good way to overcome the problems and the duality will later be phased out. It combined planned prices on deliveries between firms (factor markets) while output produced by the firms where sold at market prices. (See Roland. 2000:148-152)
[20] Gros & Steinherr. 1995:193

constraints such as lack of domestic savings.[21]

Constraining is if privatization gives opportunity to corruption which may lead to claims of reversal of the reforms. Transparency, especially regarding ownership relations, is crucial for maintaining popular support. The SOEs have commonly been used as storage for unemployed workers and therefore it is important that the economy recovers fast and that the prospect of gaining a new position after dismissal is good as privatization may result in layoffs. [22]

Finally it is important to notice that privatization tends to be a long process, mainly due to difficulty in accumulating capital, extensive bureaucracy and political constraints which proves important for the sequencing of reforms.

3.2.3 Factor Markets

Foreign Investment, Labor Market

Regulations constraining foreign investment are common in socialist economies and need to be removed as foreign investment is commonly seen as important to promote overall growth. Reforms in other areas help promote foreign investment; such as macroeconomic stability, well functioning financial institutions and legal reforms in terms of removal of obstacles for investments. In general well defined legal environment promotes foreign investment. Foreign investments may also give spill-over effects such as spreading of technical knowledge and skills and providing employment for well-educated people. A danger is that inflow of foreign capital may give rise to corruption among both government staff and private companies.

Labor market reform should consist of both a general liberalization and adjustment of labor law to a market economy. Labor laws of socialist countries, if they exist, tend to be rigid and highly protectionist of employment with little flexibility. [23]

3.2.4 Banking and Financial Sector

Financial Liberalisation

The establishment of an autonomous banking system, the privatization of banks, the

[21] Gros & Steinherr. 1995: 97
[22] Družić. 2006: 215, Gros & Steinherr. 1995:97, 182
[23] Gros & Steinherr. 1995:289-290

establishment of an independent central bank and effective financial institutions are some of the most important reforms. This is because they provide necessary conditions for the implementation of many other reforms such as monetary and fiscal policy and hence macroeconomic stabilization, which will be outlined below. Financial institutions are also crucial for privatization and for the promotion of investments as mentioned earlier.[24]

3.2.5 Redefining the Role of the State

The transition process brings a change in the organization and mandate of the state and how it is perceived, both among the public and the state itself. Instead of controlling the economy by ownership the state must let the forces of the market work undisturbed. To enforce this a new legal framework needs to be established.

Ensuring private property rights is the most important new legal feature. Facilitating transactions and the establishment of private companies, removing legal barriers to trade and adjusting the legal environment to the interventions of the open economy are other challenges for the state to accommodate in the transitional process.[25]

As the new market evolves so do the actor seeking to gain from the process. This involves criminal activity such as corruption and the development of an informal economy which demonstrates a need for developing a new kind of law enforcement.[26]

B. Stabilization Policy

3.2.6 Fiscal Policy

Reformation of the fiscal system should aim at a quick adjustment to the new market structure. Government expenditures and revenues need to be balanced based on the new conditions.

Market oriented taxation includes the introduction of VAT, commonly a broadening of the tax base to acquire sufficient revenue and the abolition of confiscatory tax rates. Taxation towards foreign companies will eventually need to be internationally competitive to attract foreign investments.

To balance the governmental budget and at the same time adjust taxes to market

[24] Gros & Steinherr. 1995:293-303,
[25] Gros & Steinherr. 1995: 95
[26] Gros & Steinherr. 1995: 185, Roland. 2000: chapter 8

economy conditions may prove difficult. Expenditures tend to be high in the beginning of the transition process due to the costs of implementing the reforms. The new market structure also brings about a need for a different kind of social security system, which differs greatly among different countries but is likely to increase expenditure, at least in the transition process. The new fiscal system and market oriented taxes may not initially yield all the potential revenues as considerable time can be required to implement the tax laws and even more time for the new tax system to generate full revenue. Incomes from privatization is a possible source for balancing the rising expenditures and monetary policy has also commonly been used to finance this kind of deficit, which is one aspect to why monetary and fiscal reform is closely intertwined.[27]

3.2.7 Monetary Policy

Monetary stability is a prerequisite for the sustainability of all reforms in transition economies. The uncertainty in the economy is limited by monetary stability and this promotes overall growth. Stability includes a credible currency, current account as well as capital account convertibility, and a low and stable inflation. For this a well developed banking- and financial sector is a necessary condition as mentioned above.

Common problems in the initial stages of transition are monetary overhang, high or even hyperinflation and an insecure currency.[28] Monetary overhang is an excess stock of cash or savings deposits that will cause inflation to rise and hence the real value of money to drop. A reason for monetary overhang can be fiscal deficits financed by monetary expansionism instead of restructuring the public expenditure. The commonly high inflation can also be caused by many other aspects of the early transition process such as gaps in time between the different reforms, for example, liberalized prices without a controlled monetary policy.[29]

All of the above mentioned factors are destabilizing and need to be addressed through a strict monetary and fiscal policy.

[27] Gros & Steinherr. 1995: 98, 178-180
[28] Hyperinflation is defined as inflation of 50% or more per month.
[29] Gros & Steinherr. 1995: 154

C. Trade and Exchange Rate Policy

3.2.8 Exchange Rate Policy

Exchange rate reform is a common step in the transition process as most socialist countries employ a fixed foreign exchange rate regime. The exchange rate regime affects output performance through international price competitiveness and as a part of the disinflation policy. The question of whether to move to a fully flexible exchange rate or keep some control at least in the transition phase is dependent on initial conditions.

The by Gros & Steinherr (2005) promoted solution is a dual exchange rate that combines a fixed exchange rate for current account transactions with a flexible rate for capital account transactions. A partly fixed rate need capital controls to avoid the effects of speculative flows.

With a completely flexible rate the national bank does not make any interventions at all. The problem with a flexible rate in a transition setting is that countries in transition commonly lack the financial institutions and the basic stability to limit the uncertainty and attract investments.[30]

3.2.9 Trade Liberalisation

External liberalization is a necessary complement to internal liberalization as it helps provide the right price signals. It enhances competition and improves the allocation of resources. Opening up to foreign trade and taking part in multinational agreements is also a good way to enter into new markets, expand trade and provide a secure environment for companies and foreign investors. This is particularly the case as many countries in transition lose their often large trade with other socialist countries. To adjust to the globalized economy lowering or complete removal of tariffs and quotas are important but may be conducted gradually. Reasons to keep some tariffs is government revenue that may be in deficit due to the reformed fiscal system and to protect SOEs temporarily so they have time to adjust and become productive and competitive in an international setting. This could also be done by support from capital markets and soft budget constraints with the deficits financed by the government.[31]

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[30] Gros & Steinherr. 1995:145
[31] Gros & Steinherr. 1995: 147-148, chapter 6

Domestic policy is constrained through the regulations of international agreements and the increasing transparency of government action that is required. This enhances the credibility of the reform program and can relieve ex post political constraints.

3.3 Constraints of the Reform Program

The transitional reform process faces several constraints that can provide a greater understanding of the outcome of the transition reforms. According to Roland (2000) these may alter the view on the optimal design of the reform program in every unique case. The extent of these problems depends on, among others, the overall political situation, the popular support and the strength of the administration. Credibility for the governments commitment to the implementation of reforms and a broad-based popular support for the measures implemented in the beginning of the process are crucial.

Roland groups the constraints as follows:

- *Political Constraints*

  These are constraints evoked by the reality of politics and are crucial for the success of the transition process. As transition is an economy-wide process involving both winners and losers, even if aggregate welfare is enhanced there may be opposing views of the optimal reforms and probably opponents to the transition as a whole. These constraints are more relevant in countries where democratization has preceded economic reform.

  A distinction between *ex ante* and *ex post* political constraints can be made. *Ex ante* political constraints concern the difficulty to *gain* popular support for transition and individual reforms often with uncertain outcome. *Ex post* constraints concern the challenge of keeping the chosen path and avoid reversal of implemented reforms, especially in times of worsened economic conditions for the public. These constraints show the importance of not separating the economics and politics of reform. As Weingast (1997) wrote, "an ironic aspect of the economist's position is that they want individuals to pursue their self-interest in markets but not in politics"[32]

- *Uncertainty*

  This prevails both on a private and aggregate level. The goal of the transition process (market economy) can be seen as unclear and even if it would be considered a clear goal there is no generally accepted theory on how to achieve the goal. The increased risk and uncertainty may also have a constraining effect on growth as investment decisions are highly dependent on a secure environment.

- *Complementaries and Interactions Between Reforms*

  Economists generally agree on these complementaries but not always on their implications. There are many examples; one is the importance to discuss trade policy together with exchange rate regime as the exchange rate affects the level of government protection needed for state-owned enterprises. Privatization also needs to go hand-in-hand with the development of financial markets. To privatize implies selling capital, and if no banks or other financial institutions can provide capital for investing, the government will de facto continue to dominate the economy. [33]

[32] Quted in Roland. 2000: 12
[33] Roland. 2000. chapter 2

3.4 Outcome of the Reform Program

The success or outcome of a transition program can be measured in different ways but since the focus of this essay is to evaluate the macroeconomic impact of the reform program, the effect on GDP growth is an important concept. Many countries in transition have experienced an often quite dramatic decrease in output at the initial stages of transition that improve as the process continues. The magnitude of the drop varies among countries and so does the time to recover.

Roland (2000) argues that the greatest fall has been seen at the time of price liberalization and particularly in countries pursuing a big bang reform.[34] Gros and Steinherr (1995) on the other hand find no support for the thesis that a faster reform would generate a greater loss in output by regression analysis of the 25 countries in Central Europe and the former Soviet Union. More important variables would be the amount of time under communism and a high inflation. One explanation of the output drop could be a gap between the fall in output in the sectors where relative prices drop and the increase in sectors where prices rise. [35]

The existence of state-owned enterprises also affects the output drop as their output decreases when a tight credit policy is being imposed. Supply-side bottlenecks evolve as the more stringent restrictions make it difficult for the companies to buy inputs. How great the effect on output will be is affected by the extent of misallocation of resources initially.

To sum up this theoretical chapter, the most important point to remember is that the initial conditions and the particular constraints facing every country in transition are very decisive to the outcome of the process. All of the above stated reforms must be undertaken at some point in order for a country to become a well functioning market economy, but the scope and timing is crucial and differs greatly among different countries. This we will see in the case of Croatia in the following chapters.

[34] Roland. 2000: chapter 7
[35] Gros & Steinherr. 1995:105, 154

4. The Croatian Reform Program

Chapter 2 "Economic Legacy" provides the initial conditions under which the implementation of the Croatian reform program took place. It was initiated in 1991, at the date of independence and was carried out to a large extent during the first years of the homeland war. The major part of the reforms were introduced and implemented before the end of the occupation in 1995. The focus is on reforms up until the signing of the SAA with the EU in 2001. After that the reforms are no longer transitional in nature but aim at integration.

The transition of Croatia was gradual but still rather quick; the initial reforms such as price liberalization, liberalization of banks and the creation of market institutions took place before independence and were fully implemented within a few years.[36] A new constitution was accepted in 1990, hence before independence. Directly after independence in 1991 several reforms were introduced; privatization was initiated, the HNB became autonomous and the initial trade liberalization took place. The stabilization program of 1993 involved the initiation of a flexible exchange, restrictive fiscal policy and an expansionist monetary policy.

The scope of the reform program must be seen as comprehensive, most sectors of the economy were reformed in a far-reaching and ambitious way. The defining issues of the Croatian transition reforms are the stabilization policy including fiscal policy and the privatization of public enterprises. It is in these areas the most extensive reformations have been made.

This overview of the Croatian reform program is divided into the policy areas of *Systemic Reforms, Stabilization Policy* and *Trade and Exchange Rate Policy* like chapter 3 regarding the theoretical aspects of the reform program.

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[36] See
Table 4: Reform Program of Croatia for an overview of the different reforms and also the structure of this chapter.

Table 4: Reform Program of Croatia

Policy Area	Date of Introduction	Implementation/legislation
1. Systemic Reforms		
Liberalization of Internal Trade		
Price liberalization	1989	
Market institutions	1989	
Competition law	1995	
Public Enterprises		
Privatization	1991-1993	Small -medium sized companys
	1993-	Large companys
Factor Markets		
Foreign investment	1993	Companies act 1995
Labor market	1995	Labor Law in force 1996
Banking and Financial Sector		
Liberalization	1989	
Privatization of banks	1995	Law on market oriented banking .
Autonomy of national bank	1993	
Redefining the Role of the State		
Constitution	1990	Constitution of the Republic of Croatia
2. Stabilization Policy		
Stabilization Programme	1993	
Fiscal Policy		
Tax reform	1993	
Control over public expenditure	1993	
VAT	1993	
Monetary Policy	1993	
3. Trade and Exchange Rate Policy		
Exchange Rate Policy		
Flexible exchange rate	1993	1991 Dinar issued
		1993 Devaluation 16%
		Managed floating
		1994 Kuna issued
Trade Liberalisation	1991	2000 Member of the WTO 2001 SAA with the EU 2002 CEFTA

Source: Own compilation based on chapter 4

A. Systemic Reforms

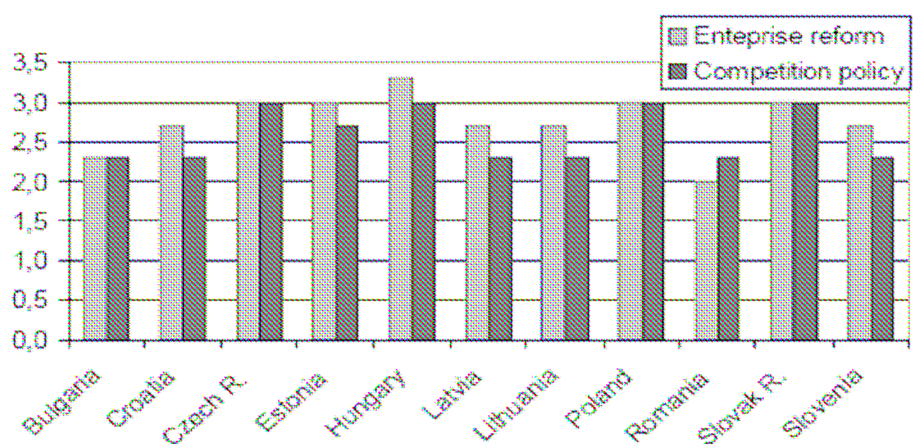
4.1.1 Liberalization of Internal Trade

A price were, as mentioned, to a large extent already liberalized and in the EBRD Index of Price Liberalization Croatia is among one of the CEEC´s with the smallest share of administered prices. The process of further liberalization has on the other hand been slow and Croatia has landed on a comparatively high level of administered prices. [37]

Price liberalization creates a good environment for competition along with competition law supported by market institutions. Market institutions were established before independence and the market competition law was passed in 1995 and established the Market Competition Agency for the monitoring of competition policy. This covers the formation of cartels, abuse of dominant market position and mergers. Market institutions and competition law have been satisfying but its implementation power and actual control less convincing. Figure 3 show the EBRD index of Enterprise reform, which Croatia has been more successful in than in the index of Competition Policy.[38]

It has been problematic that the Market Competition Agency had nothing to do with the privatization process and it does not lie within its mandate to control state monopolies. The small size of the country also gives rise to a high level of concentration in some sectors which has a negative effect on competition.[39]

Figure 3: EBRD's Index of Enterprise Reform



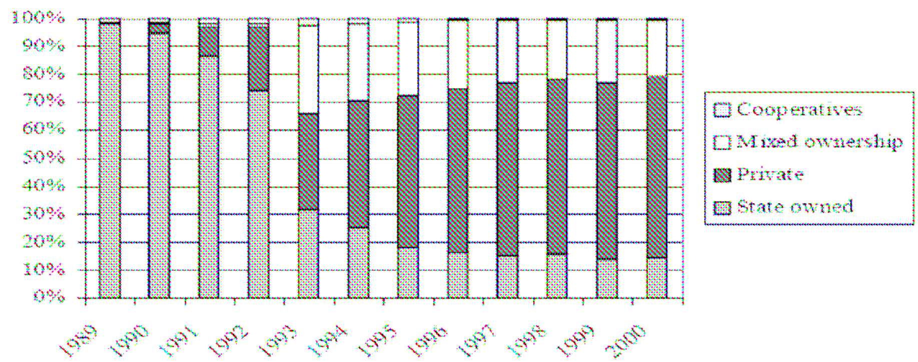
Source: Vujčić & Lang. 2001:75 EBRD Transition report 2000

[37] EBDR Index of Price Liberalization. See appendix 2 for methodology
[38] EBRD's Index of Enterprise Reform. See appendix 2 for methodology
[39] Vujčić & Lang. 2001:94, Račić et al. 2005.

4.1.2 Public Enterprises

Privatization was initiated in 1991 and continued all throughout the 1990s. Initially the motive for privatization was restructuring and ownership change but in the second half of the 1990s it also aimed at generating funds to finance budget deficits. Privatization was carried out through the Croatian Privatization Fund (CPF) that is regulated by the Croatian Privatization Fund Act and the Privatization Act.[40]

Figure 4: Type of Ownership of Commercial Enterprises. Croatia 1989-2000



Source: Vujčić & Lang. 2001: 71 Payment Transactions Agency

Figure 4 shows the development of ownership structures in Croatia and the drastic decline in the share of state ownership in the early years of the 1990s. This decline is also reflected in the EBRD Privatization index where Croatia, especially regarding small-scale privatization, fares comparatively well. Large-scale privatization has been less successful and this is also the area where problems have arisen from the process in the sense of corruption and unjust procedure. The privatization was carried out on a case to case basis which did decrease transparency and gave room for unjust procedure and government rewards for loyalty.[41]

4.1.3 Factor Markets

To establish market based relations in the capital- and labor markets posed more of a challenge than in the goods market that initially worked quite well.

The liberalisation of the labor market started before the legislative framework was in

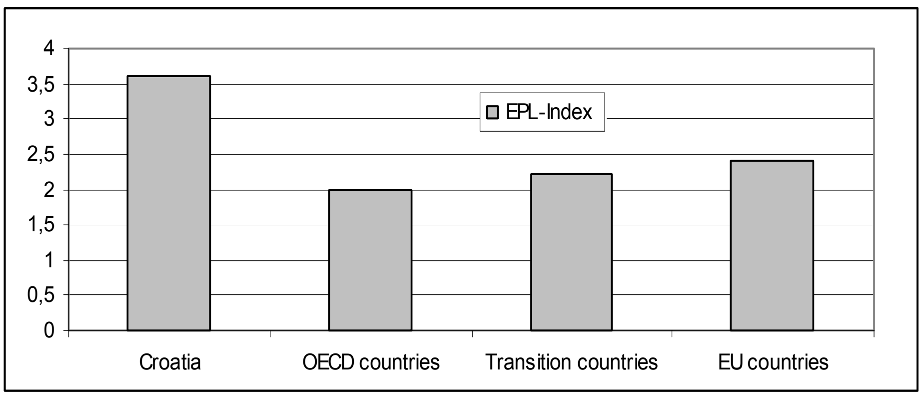
[40] Vujčić & Lang. 2001:67-68

[41] This has been argued to be the case by several authors in Croatia. For example Katarina Ott (director of the Institute of Public Finance) states that the "non-transparent way of privatization gave rise to the informal economy". (2004:58) Faulend & Sošić. 2000:11 and Račić. 2005 makes similar statements.

place, for example by the early establishment of private employment agencies. The Labor Law was then adopted in 1995, came into effect in 1996 and functioned as a building block in the new approach to labor market regulations under the market oriented paradigm.[42]

Unfortunately the labor laws implemented are rigid and especially strict regarding temporary employment. Figure 5 displays the significantly higher value (3.6) of Croatia in the composite index of the strictness of employment protection legislation (EPL) developed by OECD than the other transition countries (2.2) and also higher than the EU countries (2.4). The OECD average is no more than 2.0 and Croatia actually has the second highest value out of the countries in the index.[43] This inflexibility has implications for unemployment, investments and overall growth and will be further discussed.

Figure 5: Composite Index of Employment Protection Legislation (EPL)



Source: Own compilation based on the OECD EPL-index (Methodology in Appendix 1)

The market for foreign investment was opened soon after independence and data on FDI is available from 1993. As in the labor market the laws and administrative procedures regarding foreign investment are time consuming and complicated. This drastically decreases the incentives for foreign investments. For example, an FIAS study (2001) found that the time required to complete the administrative procedures for investing in Croatia was greater than both in developed and other transition countries. This indicates great costs for investing companies, both regarding time and money and this combined with the above stated rigidities in the labor market decreases the incentives for foreign

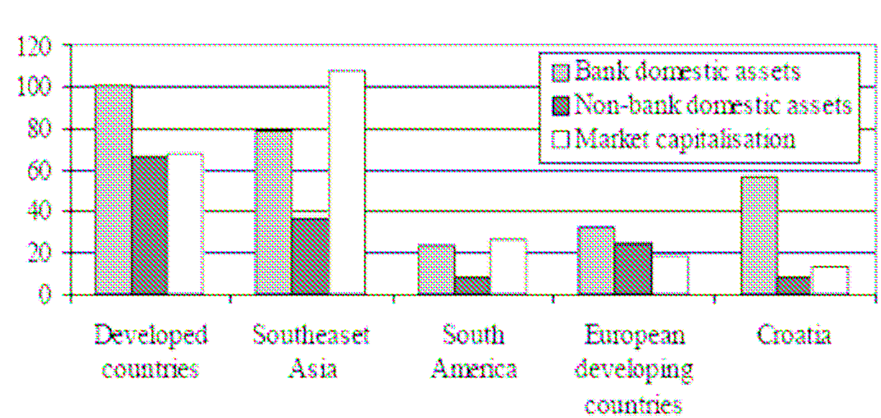
[42] Račić et al. 2005: 51
[43] World Bank. 2003:13

investments in Croatia. [44]

4.1.4 Banking and Financial Sector

The Croatian financial system has been dominated by banks while non-bank financial intermediaries have been underdeveloped. This has prevailed during the transition process and still in 2001 non-banking financial intermediaries and market capitalization as a percentage of GDP is comparatively small. (See Figure 6)

Figure 6: Indicators of Financial Development. Percent of GDP. 2001



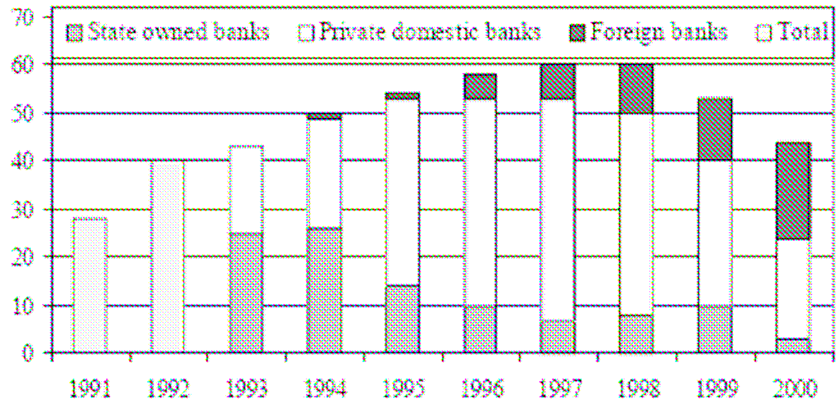
Source: Vujcic 2001: 86

The national bank of Croatia (HNB) became autonomous in 1991, apart from the election of the managerial board that was not personally independent from the government and did not become so until 2001 when the bank was adjusted to ECB standards.

In 1989-1990 liberalization of the banking system in Croatia was initiated, while Croatia was still a part of the former Yugoslavia. The liberalization was regulated through the Law on Market Oriented Banking that was passed in 1993 at the beginning of the stabilization program. The law included relative free entry, deregulated interest rates and the establishment of bank supervision.[45]

[44] FIAS. 2001
[45] Vujčić & Lang. 2001:82, Kraft. 2002

Figure 7: Number of Banks in Croatia, by Ownership. 1991-2000



Source: Vujčić & Lang. 2001: 82

Figure 7 shows the ownership structure of the Croatian banking sector, were apart from privatization of state-owned banks, a large number of foreign banks have entered the market but not usually as buyers of privatized banks. The drop in the number of banks in the late 1990s is a consequence of the banking crisis in 1998-1999 that was coupled with a recession. Apart from the crisis, the banking sector is developed, competitive and has been functioning well.

4.1.5 Redefining the Role of the State

Croatia accepted a new constitution in 1990, its first as an independent nation and it was established in a state of continuity with the previous regime.[46] Institutional reforms and the reform of public administration took place slowly during the war but after the war more focus was given to these aspects of the transition. Among the laws passed is bankruptcy law, criminal law and tax related laws. Institutions such as tax and customs administration were introduced and a financial police was established. Liberalization and privatization of the media also took place which can be seen as important for countering the informal economy and corruption.[47]

In spite of reforms the public administration has remained weak and bureaucratic and depolitization of the public administration is insufficient as many directors of institutions are appointed within the political party in power. [48]

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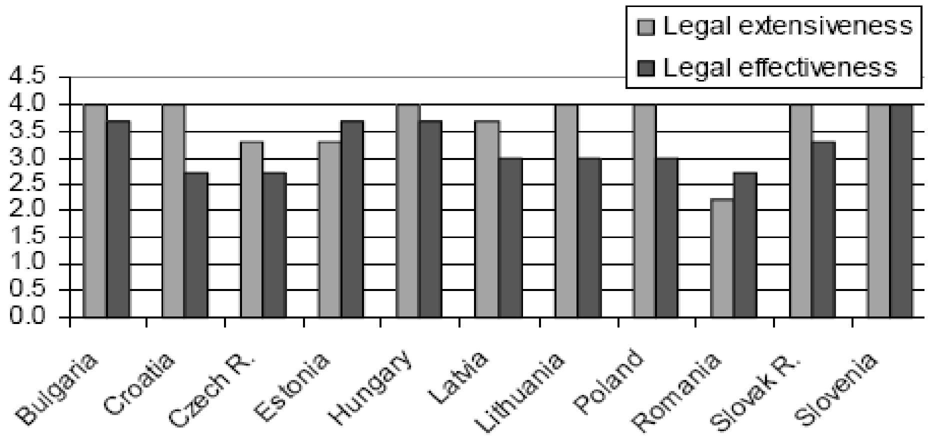
[46] The Constitution of Croatia. 1990

[47] Ott: 2004: 57

[48] This is a common opinion in Croatia and also the opinion of all the people that was interviewed.

Figure 8: EBRDs Legal Environment Index



Source: Vujčić & Lang. 2001: 89 (Methodology in appendix 2)

The legal system is underdeveloped and legal processes are often expensive and lengthy. This can be seen in the poor performance in the EBRD Legal Environment Index in Figure 8 where Croatia is a forth runner in legal extensiveness but remains among the least successful countries regarding legal effectiveness.

B. Stabilization Policy

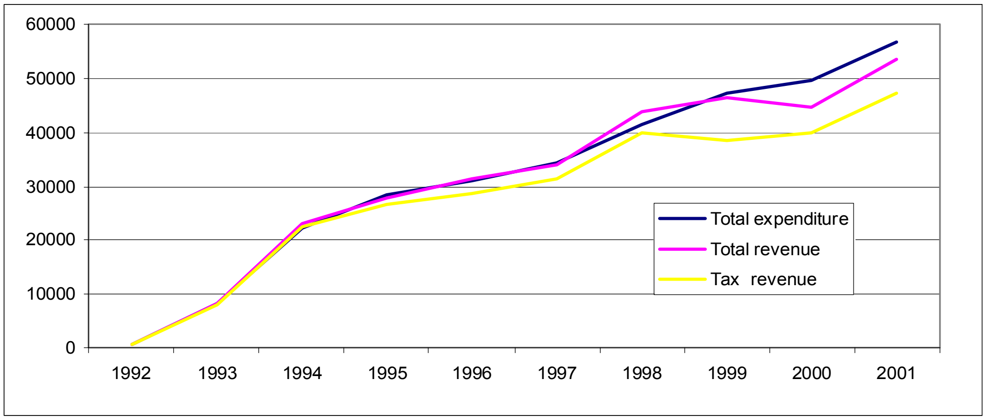
The Croatian macroeconomic stabilization program was initiated in October of 1993. Monetary, fiscal and exchange rate policies were closely intertwined as parts of the program and is here analyzed individually.

4.1.6 Fiscal Policy

To provide a good starting-point for the stabilization program the public finances had to be in balance. This was achieved through a fiscal policy aiming at increasing revenue instead of decreasing expenditure. To lower expenditure in a state of war is not really an option hence the government used tax reform to accomplish this aim.

The tax reform introduced included a broadening of the tax base, the introduction of new taxes and improvement of the tax administration procedure. The broadening of the tax base included the introduction of a single VAT-rate (22%). The more effective tax administration and the VAT that covered earlier unregistered transactions were the key points to making the fiscal reform a success and to provide a good base for the launch of the stabilization program.

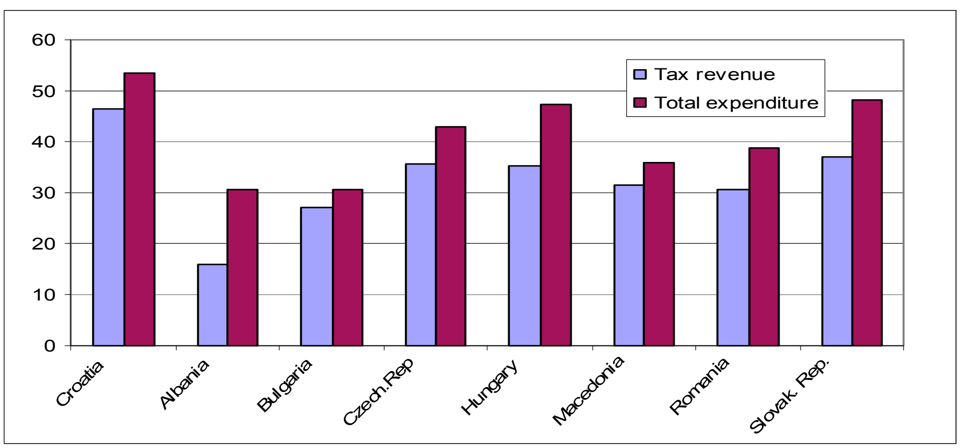
Figure 9: Total Government Expenditure, Total Revenue and Tax Revenues in Croatia. 1992-2001 Million Kuna



Source: Own compilation based on HNB statistical database

As mentioned, the war implied great costs both for defence, material destruction and health care. (See Table 2, page 12) After the stabilization program had been carried out public expenditure continued to rise due to the expenses of the war. The revenues were maintained on level, which balanced the budget and the deficits were this way kept low throughout the 1990s. As late as in 1998 the first signs of deficit showed and this was in relation to the recession.

Figure 10: Government Revenues & Expenditures in CEECs. Percent of GDP. 1998



Source: Own compilation based on World Bank Live Database

Croatia has a high level of taxes and tax revenue as a percentage of GDP compared to other CEECs as can be seen in Figure 10. The other transition economies in the example have considerably lower levels of tax revenue. The tax revenue as a part of GDP has remained more or less constant in the period analysed. Such a development is very uncommon among transition economies, most experience declining public expenditure and taxes in the first decade of transition.

4.1.7 Monetary Policy

As the Croatian economy before transition was comparatively market oriented and prices not as distorted as in other transition economies, it suffered less in terms of rising inflation when prices were liberalized. Still there was a need to adjust monetary policy and establish the necessary macroeconomic controls as administered prices no longer could provide stability on the macro level.

There was an initial lack of reserves since reserves in the former Yugoslavia had been held by the central government in Belgrade. After the preparation phase of the stabilization program the HNB carried out an expansionist policy by creating a monetary base through foreign exchange transactions with the goal of increasing net foreign assets. Supporting this process were the large capital flows into the country from Croatians living abroad. The HNB became independent in 1993 as a part of the stabilization program and the Croatian government hence made it clear that it was not intending to influence money supply. [49]

The Croatian monetary policy after the stabilization has been strict and with a low inflation target. The HNB does not employ a general rule but is still very active, commonly making interventions to defend the Kuna. The monetary policy resembles a currency board policy and the HNB continues to manage the exchange rate of the Kuna, even though this is not an official policy. [50] The monetary policy and exchange rate policy of Croatia is closely intertwined, hence we move on to exchange rate policy.

C. Trade and Exchange Rate Policy

4.1.8 Exchange Rate Policy

The exchange rate policy was a large part of the stabilization program and is a defining part of the continued Croatian monetary policy. Croatia introduced its first own currency,

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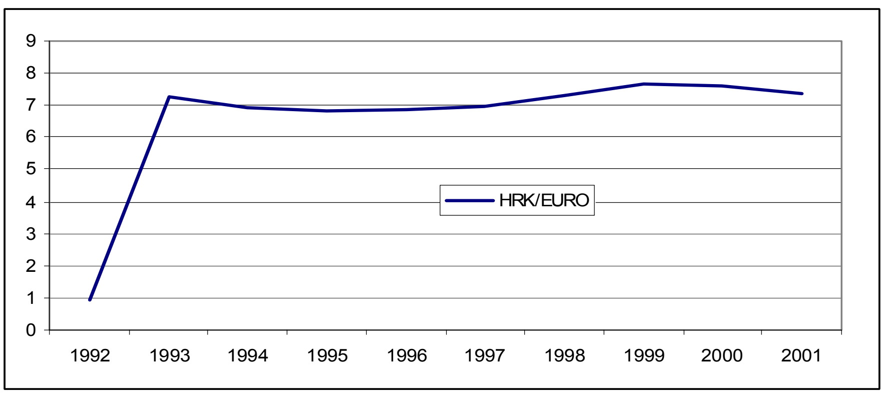
[49] Kraft. 2002:2
[50] Lang & Krznar. 2004

the Dinar, in 1991 and was replaced by the Kuna in 1994.[51]

The stabilization program involved a 16% devaluation of the Dinar and the foreign exchange market was liberalised and banks were allowed to freely set exchange rates, hence the Dinar was made flexible but still under a certain control. An asymmetrical peg was set to the DEM that was based on a lower intervention point and allowed room for the currency to appreciate. This aimed at reducing inflationary expectations and in facilitating the establishment of current account convertibility intended to promote confidence in the national currency and establish a sense of security in holding Dinars. The peg to the DEM would help reach the goal as the DEM has commonly been used as a denominator of larger transactions in Croatia and carried trust among the population. The Dinar appreciated and this had the expected effect as it decreased inflationary expectations and hence inflation.[52]

Figure 11: Midpoint Exchange Rates of the Croatian National Bank. 1992-2001



Source: Own compilation based on HNB statistical database.

After the stabilization program Croatia has applied an exchange rate policy that goes under the label of managed float. [53] The HNB has no official policy to defend the currency at any particular level but still makes interventions to keep the Kuna stable. The Kuna has in fact been kept fluctuating within a 2% range of the Euro through interventions from the national bank as can be seen in Figure 11. The HNB foreign

[51] Vujčić & Lang. 2001:76
[52] Kraft. 2002:2, Vujčić & Lang. 2001:25
[53] It has also been labeled quasi currency-board policy. Even though there is no official peg the Kuna follows the Euro closely and the HNBs foreign exchange reserves continuing are higher than the dollar value of the money supply. These are key features of a currency board. (Burda & Wyplosz. 2005: 520)

currency interventions are mostly aimed at preventing the Kuna from appreciating.[54]

4.1.9 Trade Liberalisation

Trade liberalization was a part of the preparation for the stabilization program but was not very extensive. Croatia did have an initially rather liberalized trade with few quantitative restrictions and low tariffs. But the development of trade agreements with other countries was slow and during the 1990s Croatia stayed in a (both political and economic) state of semi-isolation which affected trade liberalization in a negative way. The country did not become a member of the WTO until 2000 and signed the SAA with the EU as late as 2001. [55]

Throughout the 1990s the Croatian exporters faced higher tariffs than those of other CEECs and the rules of origin in the CEFTA countries also work against the producers of Croatia. The policy of not integrating with the EU did not favor FDI in Croatia as tariff-free access to the EU market is important for investment decisions.[56]

[54] Kraft & Stučka. 2002:8
[55] Vujčić & Lang. 2001:38
[56] Šonje & Vujčić.1999: 27

5. Economic Evaluation of the Croatian Reform Progam

This chapter evaluates the macroeconomic impact of the reform program. This is done by analyzing main macroeconomic variables such as GDP growth, trade balance, fiscal deficit and inflation. These are the base of the evaluation as they are commonly used as indicators of the economic state in a country and also as they are specifically important in transition economies. In some cases data regarding the period after the year 2000 is displayed to show the more long-term impacts of the reform program.

5.1 Macroeconomic Impact

The main indicators of the macroeconomic impact of the reform program are presented in Table 5.

Table 5: Main macroeconomic indicators: 1993- 2000

	1993	1994	1995	2000	Average 1995- 2000
GDP	10903	14585	18811	19030	**19921,8**
GDP- annual changes	-0,8	5,9	6,8	3,7	**4,1**
GDP per capita	2349	3137	4029	4179	**4372**
Retail price inflation (based on RPI)	1149,7	-3	3,7	7,4	**4,7**
Population	4,6	4,6	4,7	4,6	**4,6**
Exports of goods and services (as % of GDP)	56,8	48,8	37,7	45,5	**40,6**
Imports of goods and services (as % of GDP)	53	45,4	49,5	50,4	**50,7**
Current account balance (as % of GDP)	5,7	5,9	-7,7	-2,1	**-6,8**
Outstanding external debt (as % of GDP)	24,2	20,7	20,2	57,2	**39,1**
Gross international reserves (million USD, end year)	616	1405	1895	3525	**2685,7**

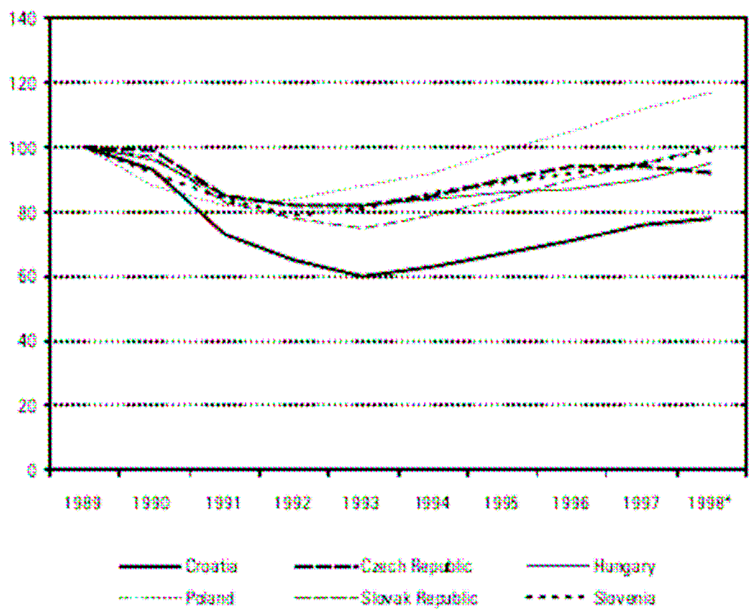
Source: Own compilation based on Vujčić & Lang. 2001:23

The averages of 1995-2000 provide a summary of the macroeconomic results of the stabilization program of 1993. By 1995 the reforms of the program had fully come into effect and the average of this period gives a value of the macroeconomic indicators needed for the evaluation.

5.1.1 GDP growth

An often considerable drop in GDP growth is common in transition economies in the first few years of transition. The so called *output drop* or *j-curve effect* and the recovery from the drop is an important variable when analyzing macroeconomic impact in economies. Croatia's GDP began to fall as early as in the end of the 1970s and the dip became even deeper after the introduction of transition reforms and the outbreak of the war in 1991. See also Figure 2 page 11 for the GDP-growth throughout the 20th century.

Figure 12: GDP in Central and Eastern European Countries. 1989-1998



Source: EBRD Transition Report Update, April 1999 [57]

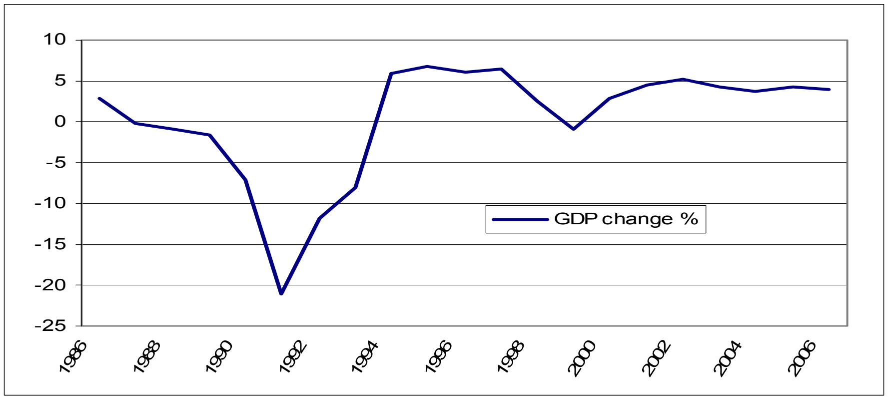
The initial position in terms of GDP-growth and the war were factors challenging the success of the reforms. Figure 12 displays Croatia's GDP development compared to a few other CEECs. Croatia had a considerably larger drop but the recovery was on the other hand in line with most of the CEECs. Noticeable is that Croatia shared the initial drop, although deeper, with its peer countries. This took place while Croatia was still a part of former Yugoslavia but instead of leveling out like the other economies Croatia experienced a continued decline, this as the war began in 1991.

Even though the drop in GDP growth was considerable Croatia managed to recover quickly and the turn upwards came soon after independence in 1991. Even more positive was the development after the stabilization program when positive GDP growth was reached and soon exceeded 5%. GDP growth has been positive ever since, apart from the

[57] Šonje & Vujčić.1999:43

regression in 1998-1999 as is shown in Figure 13. The figure shows only the Croatian GDP development, this time in terms of percent of GDP which gives a somewhat different picture than the graph in Figure 12 that is based on a comparative index.

Figure 13: GDP Annual Change 1988-2006



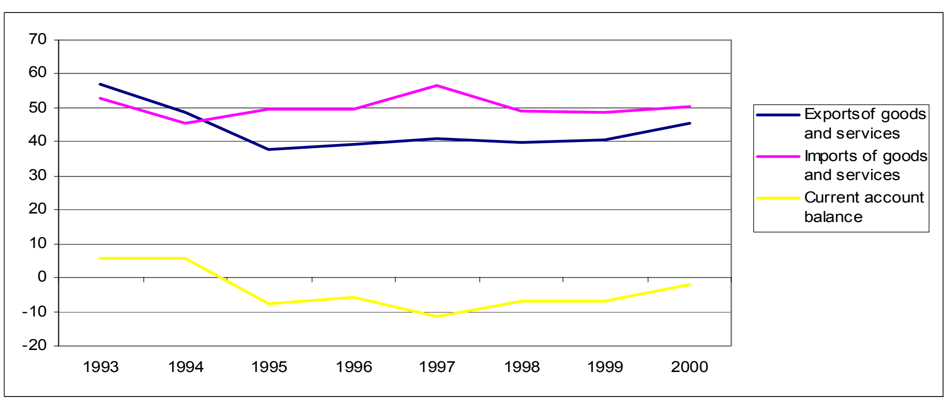
Source: Own compilation based on data by Družić. 2006: 285-287

Noticeable is that the GDP growth has leveled out, and the trend is flat and has even been slightly declining since 2002. If Croatia's initial status as a rather well-developed part of the former Yugoslavia is taken into account the macroeconomic impact of the reform program in terms of GDP growth is not impressive.

5.1.2 Trade Balance

Croatia's negative trade balance as well as its current account deficit are destabilizating factors worth scrutinizing.

Figure 14: Merchandise Exports, Imports and Current Account Balance 1993-2000. Percent of GDP



Source: Own compilation based in data by HNB

Figure 14 shows the development of the exports, imports and current account balance of

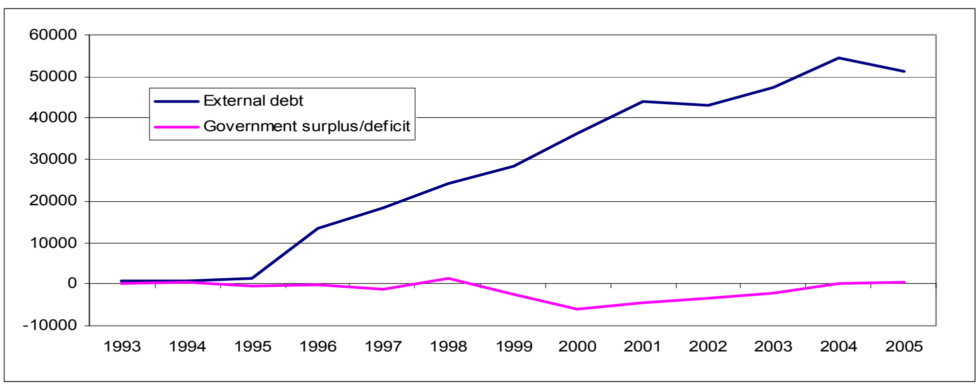
Croatia from the introduction of the stabilization program to the year 2000. The exports fell until 1995 and have after that remained on a constant level as a percentage of GDP. The imports decreased initially but after that a constant level has been kept. The imports have stayed at a higher level than the exports which results in a negative trade balance which in turn is reflected in the current account deficits from 1994 and onwards.

Since the end of the occupation in 1995 Croatia has experienced a rapidly increasing external debt. This would commonly be related to accumulated government deficits, but this is not the case in Croatia as Figure 15 shows.

5.1.3 Fiscal Deficit

Fiscal deficits are commonly financed with expansive monetary policy with the risk of causing inflation. Hence it is important to consider the two in relation.

Figure 15: Government Deficit and External Debt 1993-2006. Million Kuna



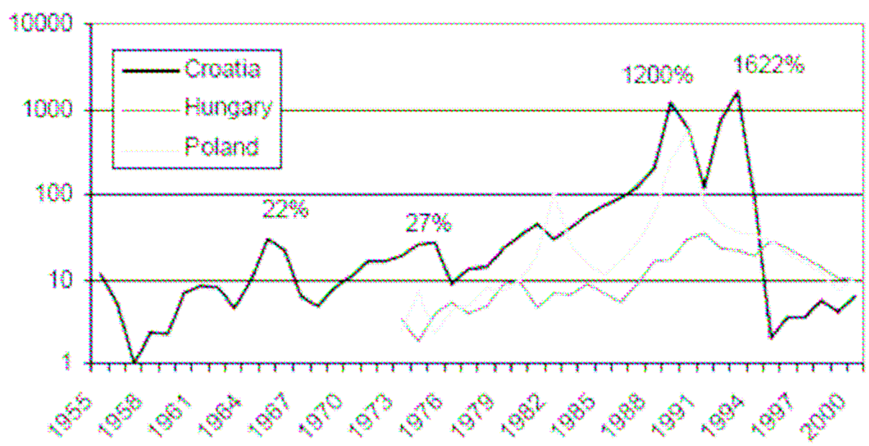
Source: Own compilation based on data by HNB

The fiscal deficit has been kept low throughout the 1990s and the only period of deficit was after the recession of 1998-1999 after which it took the government finances until 2004 to fully recover. The fiscal policy of Croatia has been successful, particulary if considering the increased pressure on the government budget from the war. Bearing this in mind, we move on to examining inflation.

5.1.4 Inflation

A government deficit can put pressure on inflation while a high inflation can inhibit GDP growth, cause disturbances in the financial markets and worsen the trade balance. In the case of Croatia inflation has been kept low and stable and hence it does not provide an explanation for the issues outlined above.

Figure 16: Inflation- Retail prices. Log scale, Percent. 1955-2000



Source: Vujčić & Lang. 2001:6

The stabilization program was very successful in accommodating the high rates of inflation. After stabilization Croatia actually had the lowest average inflation rate among the CEECs between 1994 and 1999. The drop in inflation is illustrated in Figure 16 which also shows the high rates of inflation Croatia has experienced over the past 40 years. This history of inflation makes Croatia's achieving low inflation so soon in its transition even more admirable.

To conclude this economic evaluation, the reform program of Croatia has not been a complete success in terms of macroeconomic impact, even though GDP growth has recovered and stayed positive and the inflation rate has been kept low and stable. These indicators imply a stable economy but the other factors analysed tell a different story. The current account deficit and the negative trade balance are all disturbing factors for the overall stability.

In the final chapter the results will be summarized and further analysed in terms of constraints and other possible explanations of the macroeconomic performance.

6. Impact of the Design and the Constraints of the Reform Program

The economic evaluation concluded that even though the outcome of the reform program was successful in terms of fiscal balance and inflation there are destabilizing factors and the GDP growth has been less than expected. The theory of transition as outlined in chapter 3 in terms of design and constraints can provide possible explanations for these issues.

6.1 Design of the Reform Program

The design of the transition program, the scope and sequencing of reforms was, if analysed independent of the effect of the war taking place during its implementation phase, a "text book example" of how a transition should be carried out. Prices were rapidly liberalized; a firm macroeconomic stabilization programme was introduced early on that aimed at creating both fiscal and monetary balance. The financial markets were liberalized and the banks privatized. Overall privatization also took place but at a rather slow pace and according to a disperse method and with some lack of necessary transparency and control. As the evaluation show the successful fiscal preparation for the stabilization program and the continuing balanced fiscal budget with small or no deficits has provided a good foundation for the low and stable inflation rate. This is a good example of how the well designed stabilization program gave a successful outcome. The fiscal budget was *first* balanced and *then* the inflation was brought down by monetary policy which gave good results in both the short and long term.

On the other hand, the liberalization of foreign trade was rather slow and even though it was introduced early on the true opening of the economy to trade did not take place until after the year 2000. Theory states this to be an important reform to carry out early in the transition and the late implementation has contributed to the poor export performance of the 1990s which in turn has given the continuing current account deficit and negative trade balance pointed out as problems in the macroeconomic evaluation. An open economy is also commonly stated to be a basic condition for growth. On the other hand the argument has been made that the Croatian Kuna is overvalued and a cause of the poor export performance. The stabilization program first devalued the currency by 16% but it soon appreciated to the initial level. No official policy to defend the Kuna exists and the main part of the interventions made by the HNB is to stop the Kuna from appreciating. The source of the overvaluation of the Kuna must in that case be found elsewhere in the economy. [58]

6.2 Constraints

The theory of constraints as presented by Roland (2000) in chapter 3 points out three different types of constraints. Political constraints, constraints due to uncertainty and constraints due to complementarities between reforms. Most important in the case of Croatia is the political constraints and the constraints due to uncertainty as both of these are related to the war and the tense political environment of the early transition.

6.2.1 Political Constraints

As explanations of the macroeconomic problems outlined above the most important phase of the Croatian transition in terms of political constraints is from 1995 and onwards. The stabilization program was in full effect and the war was about to be terminated. Croatia enjoyed a continuing stable economy and growth but also unofficial political and economic isolation. This came as a result of tension in the relations with the international community and naturally with the republics of the former Yugoslavia on the part of the Croatian nationalistic government. The country was rather united around its progress towards market economy and the government enjoyed a strong support for its politics but the lack of international support and cooperation did on the other hand impose a very constraining effect on the economic performance. Trade was not developed in the manner that it could have been and the tourist sector recovered at a slower pace.

In the terms Roland (2000) uses, this issue would be seen as *ex post* political constraints as the government, to keep the support for its policies, kept the economy less open and by

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[58] For further discussion on the equilibrium exchange rate of the Kuna see Kraft & Stučka. 2002

this maintained or even fuelled the nationalistic movements.

Ex ante political constraints are naturally more prevalent in democracies as the opinion of the public has to be taken into account. This is the only aspect were the war can have a positive impact as it may relieve these political constraints. During the war it was easy for the government to carry out the necessary transition reforms as the public was focused on the events of the war and not economic reforms. This was probably the case in Croatia, especially considering the stabilization program of 1993 that was extremely strict, particularly regarding the fiscal expenditure, and might have been hard to gain popular support for under normal circumstances.

6.2.2 Constraints from Uncertainty

Constraints due to both individual and aggregate uncertainty can be seen as very prevalent in Croatia due to the homeland war in the initial stages of the transition process. The war put a great strain on the transition process in general as for example the public expenditure increased due to costs of defense and the country took many refugees from the other republics.

The uncertainty caused by the war constrained trade and investments during the period of the war and important sectors such as tourism were badly harmed. After the end of the war hostilities and unrest continued in the neighboring countries which also contributed to a state of uncertainty in Croatia that made investments less attractive. This is also a likely explanation of the trade deficit as the Croatian production and imports were directed at rebuilding after the war and hence the exports declined. There was no room for export oriented production under the circumstances.

This is a possible explanation to the rather slow recovery from the drop in GDP-growth and the flat trend after positive growth had been achieved. This can be explained by that the large GDP-growth drop was very harmful for the economy as a whole as different sectors of the economy were hit unevenly due to the war. Tourism, mining and construction were the sectors that suffered most and these are also highly important sectors for the Croatian economy.

6.2.3 Constraints Due to Complementarities between Reforms

The constraints due to complementarities between reforms are not very significant in Croatia, which can be concluded from analyzing the design of the reform program. Croatia has in a successful way avoided these constraints by combining and timing different reforms. An example is that the fiscal deficits were eliminated and *then* the inflation was brought down by monetary policy which together gave a long-term low and stable inflation. The exchange rate was used in the stabilization program and the currency has remained reliable as a consequence of the successful preparation and implementation of the stabilization program. Financial markets were also developed at a quicker pace than privatization was carried out, which facilitated the privatization process.

To conclude the analysis of possible explanations constraining the Croatian transition, there are issues that have clearly limited the economic development. These are the war that brought both uncertainty and the political isolation of the 1990s that primarily constrained the foreign trade and investments. The two combined have contributed to the slow GDP growth.

7. Conclusion

The purposes of this essay have been to analyze and evaluate the Croatian reform program in terms of macroeconomic impact and constraining issues.

The economic legacy provided an overview of the background and initial conditions for the implementation of the reform program and can also pose as possible explanations for the outcome of the transition process. Regarding the legacy, two issues are of particular importance; the lighter version of socialist economy employed in Croatia and the strong impact in terms of economic loss due to the war. Croatia was also a rather rich part of the former Yugoslavia which would indicate a beneficial initial position for making the transition.

The reform program of Croatia was gradual but still rather quickly implemented, aside from issues like privatization and liberalization of foreign trade. When evaluating the macroeconomic impact, the outcome was successful in terms of fiscal deficits and inflation, but less successful when looking at trade and GDP growth.

The explanations for this are to be found in the constraints of the transition process and in the design of the reform program. The fiscal deficits were eliminated as a part of the stabilization program which provided a good foundation for the lowering of inflation. This is an example of avoiding constraints.

I conclude that the slow GDP growth is dependent on the war and the (in terms of constraints) uncertainty this brought. GDP growth was also inhibited by the slow development in trade that in turn was due to political constraints. These political constraints must also be seen in relation to the war as it was both national and international political tension that made the Croatian government stay in a state of semi-isolation.

To conclude, the war can be seen as a main cause and root of the problems of the Croatian transition identified in this essay. This implies that the reform program in itself was successful as just a few problems have arisen solely from mistakes in the introduction and implementation of the reforms. The economic evaluation of the Croatian transition policy mix must result in a positive statement, particularly if considering the different constraints imposed by the war. The macroeconomic impact has in general been positive as the main indicators; GDP growth, inflation and fiscal deficit are in a good or sufficient state.

As to further research, there are implications of the reforms that do not fit into the macroeconomic evaluation as they do not carry a clear relationship with GDP growth. Examples are economic inequality and informal economy and these are issues prevailing in Croatia. They are commonly perceived as constraining on growth, but to what extent is unclear. Although outside of the scope of this essay, these issues need to be investigated and particularly interesting in the case of Croatia is the increasing inequality in a setting of high public expenditure and high taxes. The high tax level could be explained by ambitious intentions to redistribute income but this does not seem be or at least not had the wanted effect.

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Dubravko Mijhaljek Bank of International Settlements Vienna	20060818
Ivo Družić Professor of faulty of Economics Zagreb	20060607
Josip Tica Associate Professor of faulty of Economics Zagreb	20060729
Katarina Ott Director of Institute of Public Finance Zagreb	20060811

Data

- European Bank of Reconstruction and Development (EBRD)

  Structural change indicators, Transition indicators by country

  Avaliable at http://www.ebrd.org/country/sector/econo/stats/sci.xls

- Hrvatska Narodna Banka (HNB), Statistical database.

  Avaliable at www.hnb.hr

Appendix 1

- OECD

Employment Protection Legislation index (EPL)

The methodology of calculation of the index is described in OECD (1999).

The index is a weighted average of 22 indicators of the strictness of employment protection legislation in three areas (1) regular contracts (with the weight of 5/12); (2) temporary contracts (5/12); and (3) collective dismissals (2/12). Regular contracts are divided into (a) procedural inconveniences (1/3); (b) notice and severance pay (1/3); and (c) difficulty of dismissal (1/3). Temporary contracts include (a) fixed term contracts (1/2); and (b) temporary work agency employment (1/2). The index for collective dismissals is directly computed by averaging four indicators relating to special requirements and costs associated with collective dismissals. The higher the value of the summary index, the stricter the employment protection legislation.

Appendix 2

Methodology of EBRD index

EBRD Index of Price Liberalization
Price liberalisation
1 Most prices formally controlled by the government.
2 Some lifting of price administration; state procurement at non-market prices for the majority of product categories.
3 Significant progress on price liberalisation, but state procurement at non-market prices remains substantial.
4 Comprehensive price liberalisation; state procurement at non-market prices largely phased out; only a small number of administered prices remain.
4+ Standards and performance typical of advanced industrial economies: complete price liberalisation with no price control outside housing, transport and natural monopolies.

Figure 3: EBRD's Index of Enterprise Reform
Index of Competition policy
1 No competition legislation and institutions.
2 Competition policy legislation and institutions set up; some reduction of entry restrictions or enforcement action on dominant firms.
3 Some enforcement actions to reduce abuse of market power and to promote a competitive environment, including break-ups of dominant conglomerates; substantial reduction of entry restrictions.
4 Significant enforcement actions to reduce abuse of market power and to promote a competitive environment.
4+ Standards and performance typical of advanced industrial economies: effective enforcement of competition policy; unrestricted entry to most markets.

Governance and enterprise restructuring
1 Soft budget constraints (lax credit and subsidy policies weakening financial discipline at the enterprise level); few other reforms to promote corporate governance.
2 Moderately tight credit and subsidy policy, but weak enforcement of bankruptcy legislation and little action taken to strengthen competition and corporate governance.
3 Significant and sustained actions to harden budget constraints and to promote corporate governance effectively (for example, privatisation combined with tight credit and subsidy policies and/or enforcement of bankruptcy legislation).
4 Substantial improvement in corporate governance and significant new investment at the enterprise level, including minority holdings by financial investors.
4+ Standards and performance typical of advanced industrial economies: effective corporate control exercised through domestic financial institutions and markets, fostering market-driven restructuring.

EBRD Privatization Index

Small-scale privatisation

1Little progress.
2 Substantial share privatised.
3 Comprehensive programme almost ready for implementation.
4 Complete privatisation of small companies with tradable ownership rights.
4+ Standards and performance typical of advanced industrial economies: no state ownership of small enterprises; effective tradability of land.

Large-scale privatisation

1 Little private ownership.
2 Comprehensive scheme almost ready for implementation; some sales completed.
3 More than 25 per cent of large-scale enterprise assets in private hands or in the process of being privatised (with the process having reached a stage at which the state has effectively ceded its ownership rights), but possibly with major unresolved issues regarding corporate governance.
4 More than 50 per cent of state-owned enterprise and farm assets in private ownership and significant progress with corporate governance of these enterprises.
4+ Standards and performance typical of advanced industrial economies: more than 75 per cent of enterprise assets in private ownership with effective corporate governance.
ndex of Enterprise reform

Figure 8: EBRDs Legal Environment

Legal Indicator Survey- Criterias

Speed is the most straightforward of the criteria. It is a simple test of the time that it might take from the initiation of a legal process to the point where it is, in effect, concluded. In the case of a process initiated by a creditor, it refers to the time between the initial filing of the process with the court and the court making a final determination of the result of the application. In the case of a debtor-initiated process, it is from the filing of the process to the confirmation of a reorganisation plan. In this respect, it should be noted that the prospect of and the time that might be taken with any appellate process was disregarded for the purposes of the survey.

Efficiency tests a number of factors involved in legal processes such as the formalities that might be imposed (for example, amount of documentation and the formal procedural steps), the relative cost (for example, court fees, legal representation costs) and the degree of complexity (for example, court appearances required, procedural technicalities). It is therefore a composite of a number of factors and is designed to test the extent to which legal processes are excessively formal, create procedural barriers, increase cost and, as a result, act as a barrier or disincentive and limit access to and the use of the law

Predictability/Transparency addresses, firstly, judicial predictability and competence and, secondly, the competence of office holders appointed to supervise, control or generally administer the affairs of an insolvent debtor. It also addresses the extent to which outside ‘influences’ might intrude on both the courts and the office holders (for example the influence of political patronage, cronyism and corruption).