

Zagreb International Review of Economics & Business, Vol. 11, No. 2, pp. 95-115, 2008  
© 2008 Economics Faculty Zagreb  
All rights reserved. Printed in Croatia  
ISSN 1331-5609; UDC: 33+65

## Croatian Economy Challenges in the Posttransitional Period

*Ivo Družić\**

*Irena Raguž\**

*Ivan Tolić\*\*\**

**Abstract:** Current global economic trends create a new economic environment for Croatia. They could be described, by two processes amongst others. The first is clear enough abandonment of basic determinants of transitional economic policy defined as ‘Washington consensus’. Change of ‘tide’ could be observed in redesigned behavior of both transition architects, International Monetary Fund and World Bank. Even before recent global crisis IMF was revising its approach towards fixed exchange rate and WB has been displaying ‘change of heart’, placing development instead of stabilization on its core agenda sheet. The other process is global financial and expected overall economic crisis seemingly comparable to the Great Depression. It will have far reaching impact on the mainstream economic paradigm.

**Keywords:** posttransition, Croatia

**JEL Classification:** O520

### External Challenges of Post Transitional Period

Observation of post transitional period is determined by its definition, or more precisely by the point of ‘return’ of main macroeconomic indicators to their ‘starting’ pretransitional level. In simpler version the whole process is being reduced to a level of per capita GDP with installed assumption that reaching its pretransitional level signalizes the end of transitional period.

On the first sight, it is a simple analysis of easily understandable facts. However, even here the unexpected space for dissonant interpretations has been created. Their origin is mainly in alternative choices of base period.

---

\* Ivo Družić and Irena Raguž are at the Faculty of Economics, University of Zagreb, Zagreb, Croatia.

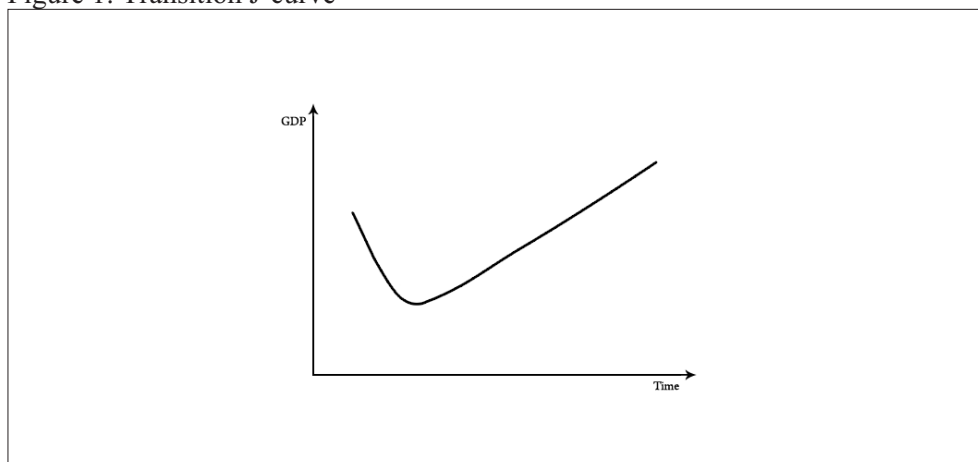
\*\* Ivan Tolić is at ZET, Zagreb, Croatia.

Promoters of so called ‘Washington consensus’, i.e. shock therapy that has enveloped swift privatization, price and capital BOP account liberalization and hard budget constraints fiscal stabilization policy have been performing their analysis on base 1990 year.

Promoters of ‘Transitional gradualism’, so called ‘gradualists’ who have been warning primarily about the problem of institutional vacuum, which occurs in the space between sudden destruction of planned mechanism and still inadequate market institutions stimulating reconstitution of ex-political nomenclature into a new economic mafia, are using 1989 as the base year.

Proponents of shock therapy have derived their economic ‘recipes’ from Schumpeterian version of ‘creative destruction’. By exploring failures of economic/market reforms dating from 1980’s in planned economies, they have come to a conclusion that a democratization and political transition are not possible without destruction of an economic fundament of central-planned economies. Any delay in this matter would disable transition and open a possibility of reverse process. Process of ‘instant’ transition was theoretically explained by famous J-curve (Figure 1).

Figure 1: Transition J-curve



The interpretation of J-curve distills to a statement that determined market transformation of ex-planned economies, i.e. fast privatization, decomposition of giant state owned industry conglomerates and hard budget constraint implementation, will lead to a temporary fall of business activity i.e. GDP, but soon benefits of market allocation of scarce resources will take place which will result in fast growth. The estimated recovery time and reaching pretransition level of GDP varied from couple of months to couple of years (usually three).

Proponents of shock therapy concentrated in research enclaves sponsored and technical missions financed by funds of international financial institutions, primarily IMF (International Monetary Fund) and WB (World Bank), have encountered, amongst others, two problems which made validity of their concept questionable.

The first problem is that a decade of real GDP trends, bearing in mind that it is not precisely determined whether J-curve implies movements of rates of change or level of GDP, does not confirm existence of J-curve for numerous transition countries, especially Russia and countries of south-eastern Europe (Gabrisch/Holscher, 2006:13).

The second problem is that reaching pretransitional level of GDP took much longer than predicted transitional recession, thereby overtaking characteristics of real depression that can be compared by its effects with Great Depression in developed market economies in the 1930's. Probably in the need for more convenient interpretation of effects of transition recipes, sublimed in 'letter of intent' and 'Stand-by' arrangements between transition economies and above mentioned institutions, the 'silent' revision of base year begun. In the early 90's base year was 1989, evidently the last year of planned economies in Eastern Europe i.e. the last year of pretransitional period. However, later on 1990 became more common as a base year. Since there is an evident fall in real GDP of 10-15% in most of transition economies between 1989, the last year of old, and 1990, the first year of new economic system, it is evident that by changing the base year the base becomes lower i.e. it registers smaller decrease in GDP later on. But even in this methodological 'innovation' data show that even after 10 years of transition a great number of countries has not reached pretransitional level of their economic activity measured by GDP per capita. For instance in the year 2000, only 5 out of 12 European transition countries reached 1990 level of GDP. At the same time, out of 12 countries that were created after USSR dissolution none of them has managed to reach the 1990 level by the year 2000 (The World Bank, 2002:5).

Promoters of gradualism ('gradualists') take off from a concept of transition as fundamental institutional, social, political and cultural change. The most important effect of these changes in economic sphere is fundamental change of government role in economic activity. Emphasized need for gradualism emerges from the fact that, as oppose to developed market economies where government holds external position by defining set of rules according to which the participants in economic activity will behave, in transition economies the government role is 'internalized' because it itself becomes a participant in changes i.e. a part of transition process. In this situation the problem of asymmetric information and moral hazard is accentuated, which can instead of transition from plan to market, lead to 'transition' from 'dictatorship to disorder' (Djankov et.al. 2003). By stressing out a problem of missing institutions 'gradualists' pay their critical attention to neglected institutional framework of shock

therapy concept. According to them, the main problem in dominant shock therapy implementation is that by emphasizing the need for faster decomposition of government-planned mechanism, as the basic obstacle to potential reverse processes, they have 'overlooked' irreplaceable role of formal and informal institutional frame. That resulted in doubtful outcome and unnecessarily decelerated transition process. To support their assertions 'gradualists' rely, amongst others, on the analysis of economic indicators claiming 1989 as base year. In such an analysis results i.e. successes are notably modest. In 2002 out of 16 European transition economies 9 of them did not reach pretransitional level of GDP and 3 of them have just slightly exceeded it. When the level of GDP per capita is 1989=100, more eminent role play only Poland (127), Slovenia (118), Hungary (117) and ex-Eastern Germany (115) (Gabrisch/Holscher, 2006:14).

In addition to the base year the other problem is the mere measurement of GDP. Between various ways of GDP accounting increasingly dominating became purchasing power parity method (PPP). It surely has its advantages because it partially explains the difference between 'real' and 'nominal' life standard which is 'hidden' in significant volume of barter trade in less developed countries, and in 'unofficial' economy i.e. in 'gray' sector and 'black' market of developed and transition countries. But its problem, amongst others, is in lesser key macroeconomic variables behavior comparability. Namely, while GDP is calculated in 'virtual' PPP USD, balance of payments data, external debt, foreign investments etc. are being calculated in 'hard' USD according to an official exchange rate of national currency. Problems of accelerated increase of external indebtedness and increasing external-trade deficit are trade marks of post transitional Croatian economic developments. That is the reason why official exchange rate 1990 USD as a GDP measure has been used in analysis of Croatian economy performances here conducted.

The further problem is the other variables' i.e. indicators' actual performance that illustrates entire complexity and controversial results of transition. Firstly, the employment i.e. unemployment trend represents one of not yet surpassed transition problems. Even the substitution of regular registered unemployment data with the Labor Force Survey indicator of unemployment does not provide encouraging enough results, so two-digit unemployment rate is the characteristic of the most transition countries even today. In addition, absolute fall in volume of industrial production in most transition countries still is not compensated.

All those trends have directed of Croatian economy analysis towards a broader scope encompassing prices and inflation, employment/unemployment and labor productivity issues in addition to economic growth controversies.

## Growth and Investments

GDP growth rate trend shows evident signs of recovery. Undoubting growth rate recovery should be put in a context of phenomena which could be described as growth rate paradox. In standard analysis growth is measured by both average growth rate and average per capita growth rate. The difference between these two growth rates is the population growth rate. In this sense it was believed in mainstream economic analysis that per capita growth rate was more realistic (lower) indicator, because it includes population growth. However, since the middle of 1990, there has been an inverse trend in Croatia due to which the average rate of GDP growth is lower than the average rate of GDP per capita growth (Figure 2).

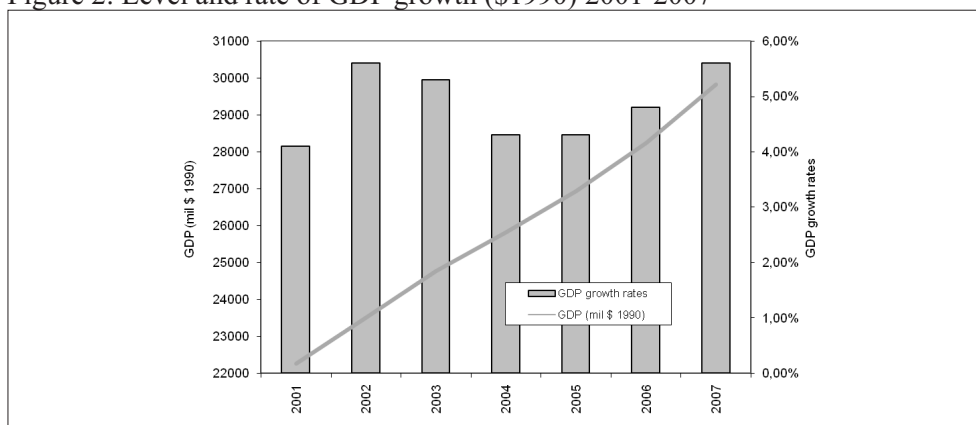
The paradox of lower GDP growth rate compared to per capita GDP growth rate is the consequence of negative Croatian population growth rate. During the 1990's and in 2000's Croatian population is decreasing, due to homeland war, lower birth rate and intensified migrations. Particularly concerning is negative birth rate as a result of mortality exceeding fertility rate.

In earlier population analysis main cause of unfavorable trends has been migration trends with higher emigration than immigration. These trends were in the past mostly overcome by positive birth rate which guaranteed population vitality. But, in the second half of 1990's and beginning of 2000's combined unfavorable effect of both birth rate and migration escalated into a situation where crucial questions of reason and need of every day business activity and economic growth are being set in the new light. This 'new' light was produced by recent statistically documented demographic research. Thorough analysis of population trends during 20th century has made relevant projections for 21st century possible. Middle fertility rate simulation model has been constructed with the assumption that after 2015 migrations will be positive. This 'strong' assumption is based on the expectation that Croatian several centuries long negative migration trends will be turned about in 21st century and will make a significant contribution to improvement of demographic balance. However, even with these assumptions, Croatian population projections indicate that by the end of a century Croatia will have less than 3 millions of residents i.e. almost 30% less than at the beginning of 21st century (Gelo et. al. 2005:219). These projections are supported by two processes. The first is exact fact that Croatian population was decreasing for around 10000 people annually between year 2001 and 2005. The second follows from the fact of increasing social sterility. Researches show that the number of women who will not have children during their fertile period, due not to biological sterility but to their own choice, will increase in Croatia to 20%. It should be added that social sterility of this group will not be 'compensated' with higher number of those women's children who have decided to give birth,

because over 80% of newborns in Croatia are first and second born children (Akrap/Čipin, 2006:108).

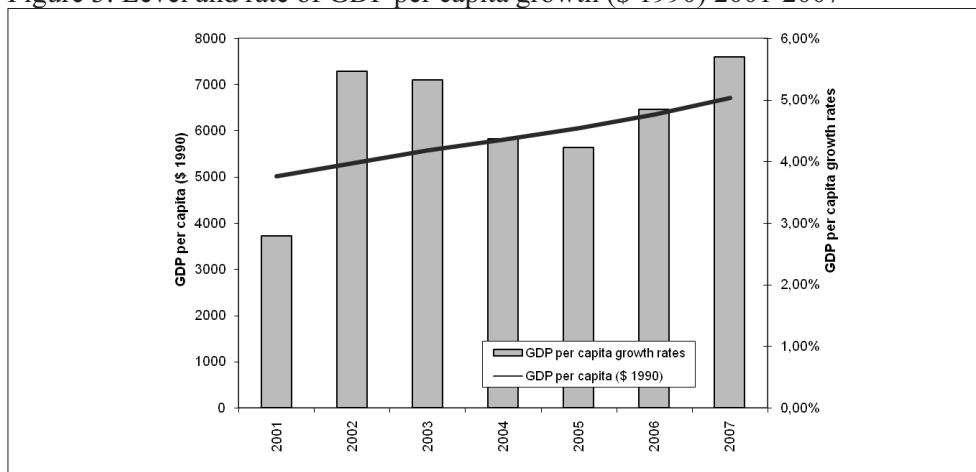
Having in mind the effect of population trends, we can see that the average annual GDP per capita growth rate was close to 5%, hence higher than rate of GDP growth which was approx. 4,8% in a period of seven years, 2001-2007 (Figure 3).

Figure 2: Level and rate of GDP growth (\$1990) 2001-2007



Source: Statistical yearbook DZS (annual level), authors' calculation

Figure 3: Level and rate of GDP per capita growth (\$ 1990) 2001-2007



Source: Statistical yearbook DZS (annual level), authors' calculation

While analyzing growth rates one should notice their relative volatility. Growth rates have no continuous stable trend but sinusoid shape. Increase and the first 'peek'

is noted in the year 2002, followed by decrease in growth rates until 2004/05. Afterwards there is an increase in growth rates in 2005 and 2006 with the second 'peek' in a year 2007 when a growth rate of 5,6%, the same as in 2002, was reached (Figure 3). Recent developments initiated by global crisis in the second half of 2008 make expectations about decreasing growth rates realistic, which will give sinusoid shape of business cycle to growth curve once again.

Positive and relatively satisfying growth rates in this period gain additional significance when it is taken in consideration that they continue themselves on already 'recovered' 2000 base year when (after short-term drop in 1999) the growth rate was almost 5%. It should be noted that 21st century growth is mainly result of increased investments which gives it special feature that should be additionally analyzed due to various interpretations.

Differences can occur already while evaluating dynamics and level of investments. That is why an interpretation could be found that share of investments in GDP was highly increased in 2003, 2004 and 2005 (Babić, 2006:38). At the same time, equally professionally relevant analysis claims about investment growth deceleration in the second half of 2003 with even more evident slowdown in 2004 (Jankov, 2006:23).

In investment composition analysis, mistake can be caused by different approaches. If investments are analysed according to ownership structure, the economists who give advantage to influence of private investments on growth will determine how, despite of progress of privatization process, it has not come to more significant increase in share of private investments which is lower than 60% of total investments (Babić, 2006:39). On the other hand there are some points of view that consider every increase in GDP, in which more importantly participate investments (especially private) as oppose to other aggregates, as encouraging sign of growth rate quality (Martić, 2006:5).

Real developments, regardless of professional disagreements, still allow an interpretation according to which it has come to significant changes in growth rates quality. Namely, as oppose to former periods when consumption, especially personal, generated growth, after 2000 investments gradually increase their share in total expenditures. It is our belief that the government role in encouraging investment activity is not disputable. On a contrary, due to the 'paradox of thrift' the government is expected to intervene in economic activity whenever the economy is in long-lasting recession or depression. We have seen that Croatian economy for 20 years, from the beginning of 1980's till the end of 1990's, was in a stagnation or recession with mild signs of recovery in the second half of 1990's. But regardless of oscillations, when average annual growth rates are observed, Croatian economy has been experiencing zero or negative growth rates in a long period from 1980-2000 ending with lower level of GDP in 2000 compared to 1980 as a consequence.

In this type of situation, according to multiple empirically verified facts in several market economies, occurs so called 'paradox of thrift'. Paradox of thrift, as it is well known, is fundamental for anti-recession i.e. economic policy of full employment in (post) Keynesian tradition. More simply, individual virtue that is prudence and caution in spending when signs of economic activity deceleration are observed, becomes macroeconomic flaw that additionally causes and deepens economic recession and/or depression. In fact, rational behavior of every individual motivates him to compose of his income distribution according to expectations about future economic trends. Since individual income is divided to a part which is being consumed and a part which is being saved, concrete division will be carried out depending on propensity to consume i.e. save. In this way, when a person expects a period of prosperity, propensity to consume increases, and when a person expects a drop in economic activity with possible consequences on its own position (possible loss of job etc.), propensity to save increases. But when these rational individual behaviors are 'aggregated' national economy level, 'unexpected' results occur. Increased individual propensity to save results in 'extraction' of the part of overall/national income from the circular flow and in its 'storage' into savings. In this way, lower current income decreases consumption i.e. demand. Lower demand causes decrease in supply i.e. decreased output. In the 'second round' decrease in output lowers employment and thereby also income and therefore consumption in two ways. Firstly, by the lower amount of compensation to (formerly) employed. Secondly those who remained employed are increasing their propensity to save due to lower employment expectations. The result is lower current income and demand which 'backfires' in further output decrease. In this manner a 'down turned' spiral is created that leads to recession and in particularly unfavorable cases to economic depression too.

This is the environment that calls for anti-recession government full employment economic policy. What we have here is actually the case of asymmetry of information about market occurrences between individuals and government, because of which intervention is desired and necessary. Each individual according to his/her qualification and occupation attains information that is according to his/her own choice relevant for his/her existence. In this sense, he/she is not interested in macroeconomic consequences of his/her behavior. He/she is just concerned by his/her own position. On the other hand, government and its economic institutions and bodies dispose with complete information about interaction and overall effect of key economic activity variables. At this level it is possible to notice early warning signs of economic activity deceleration caused by insufficient demand i.e. intensified 'withdrawal' of current income into savings.

At that point, the government steps into the picture creating substitutes to insufficient individual demand/consumption. It should be noted that when individual



consumption is concerned it comprises both personal consumption of each individual household member and investment consumption of an individual entrepreneur. The government therefore by means of economic policy instruments, creates ‘missing’ demand in order to maintain full employment macroeconomic equilibrium and is tasked to ensure preconditions for continuous growth.

In order to lead economic, particularly anti-recession policy, government in market economies has instruments of monetary and fiscal policy on its disposal as the main interventionist leverages. In the contemporary 21st century environment until recently it has been common belief among professionals that stable currency and low inflation were key preconditions to successful development as well as efficient approach to international financial markets and optimization outward orientation.

That would also mean that the possibility of using monetary policy in enhancing growth and attaining full employment has been significantly constrained by thus proclaimed neutrality of monetary policy. Monetary institutions orientation towards almost exclusively securing monetary stability, hard currency convertibility and low inflation does not allow relaxed money issuing policies, growth oriented base money creation, special loans, and subsidized interest rates any more.

Therefore the government is mostly left with instruments of fiscal policy i.e. policy of government revenues and expenditures as instruments of active economic policy. On the revenue side the main instrument is tax policy. Here anti—recession policy would mean that lower taxes increases income and respectively demand/consumption which encourages economic activity. If the government desires to act through expenditures in encouraging aggregate demand/consumption, it can make it through government social and other transfers that directly increase income.

The additional ways to do it are government purchases and/or investments especially in public construction works. Economic profession determined a long time ago that public construction works has quantitatively and temporally very favorable effect. That is why it is calculated that each kuna invested in construction has multiplying effect on overall increase in income by three kunas i.e. multiplier of 3. Besides, these investments, due to their long-term infrastructural effect, constitute essential physical precondition for successful market operation.

Thus, this aspect of national economic policy in (post) transitional Croatian economy conditions, that uses public investments in road construction and utilities to encourage growth and employment, can be judged as almost textbook case study of required policy instrument in specific posttransition recession. This surely does not exclude the need for precise and objective costs efficiency analysis of said investments. On the contrary, transparency, modern standards and procedures implementation in all government purchases and procurement contracts are important preconditions for public works efficiency. In addition, it should be

accentuated that infrastructural investments market justification is given by professionally legitimate concept of infrastructural facilities excess supply. Especially the concept of railway and road network construction by means of excess supply is very well known since the beginning of industrialization particularly in those economies that could be defined as 'late comers' into the speeded up industrialization process (Čavrak, 2004:12). That was the case of 19th century railway construction in the USA, in English colonies primarily Hong Kong and South African Republic. Neoclassical concept of 'waiting' until overall economic development create demand for necessary infrastructure facilities, that is market situation when existing infrastructure becomes a constraint to business activity and growth, has been practically turned about in this manner. Therefore it should be additionally noted that the positive role of public infrastructural investments in recession/depression stage of business cycles is unquestionable in macroeconomic sense.

It should be specially emphasized that (post) transition character of national economy strongly arguments validity of the concept. Ex-planned economies, among which Croatia was included, had almost 'endemically' undeveloped infrastructure. Due to specific way of national output accounting and 'exotic' data processing in evaluating certain forms of economic activity, permanent underinvestment in transportation infrastructure and its overall underdevelopment was more than evident. That is why investments in transportation/communication infrastructure facilities represent unavoidable condition for successful market transformation of ex-planned economies.

Analysis of growth rates at the beginning of 21st century does not essentially change general evaluation of Croatian economic growth during 20th century. Although the recovery of growth rates is evident, their level is not enough to achieve convergence towards EU average. Namely, to reach the average of (15 'old') EU countries, it ought to reach average 7% annual growth rate for the next 30 years. In this sense, acceleration of growth surely remains among priorities of economic policy (Družić, I. 2004:227). More precisely, fundamental redesign of economic policy in direction of full employment and accelerated growth is needed.

### **Prices and Inflation**

Price changes characterized by continuity of low inflation, is the main stronghold of stabilization program positive evaluation which began in 1994. It is the economic policy stronghold up to these days. In the economy that keeps 50 year period of hyper and even galloping inflation deeply imprinted in its 'historical' collective the price stability issue is never enough accentuated. Almost traumatic experience of not only

disturbed relative prices relation but of entire system of (economic) values, wearing discussions about peripheral economic issues, rent-seeking dominance in business activity, permanent devaluation of money and labor etc. has significantly contributed to discouragement of individual business initiative paralyzing Croatian economic emancipation process. That is why stabilization program success confirmed in low inflation and stable exchange rate as well as internal convertibility of domestic currency it is of crucial importance.

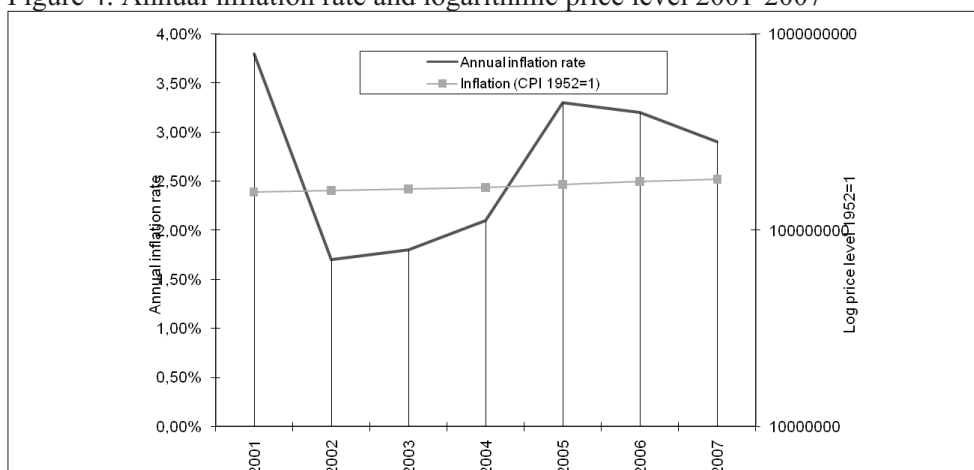
Average annual inflation rate in a period 2001-2007 was around 2,7% which can be rated as very satisfying. It annually varied from 1,5% in the year 2002 to 3,5% in 2005 and 3,7% in 2001 (Figure 4). In this relatively short period of time it is difficult to assess the impact of price changes on business activity level. In this way it can be empirically observed that in a period of increasing i.e. higher growth rates between 2001 and 2003 from 4,4% in 2001 to 5,6% in 2002 and 5,3% in 2003 the inflation rate had a tendency of 2,5% to 1,5% drop, while in a period of lower growth rates from 3,8% in 2004 and 4,3% in 2005 the inflation had tendency of rising from 2,5% to 3,5%. The increase in growth rates in 2006 and 2007 resulted in decrease in inflation rate below 3%. At the first sight it could be observed that famous 'trade off' between inflation rate and growth rate, according to which stabilization and low inflation result in growth rate decrease and vice versa does not exist. However, these statements could be premature since we are discussing short periods of time. In addition the probable time lag should be taken into the account. It is possible for low inflation i.e. additional measures which decrease inflation in one year to have full effect on economic growth in the next year.

While measuring inflation, one should bear in mind that various interpretations, depending on index i.e. indicator used in the analysis, are possible. Here, we mostly use Consumer Price Index (CPI). In more recent studies the main indicator of this index is so called 'base inflation' (Core Inflation). Full positive stabilization effect becomes clear here, because it were primarily decreasing rates of meat, clothes and footwear prices that affected decrease of base and consequently total inflation. While these free market prices display rational behavior depending on between supply and demand relations, controlled prices behavior has been entirely different. The so called 'administrative' prices that are set by government and/or local administration decisions, such as water or utilities prices have risen for over 16% just in first eight months of 2006 (Jankov, 2006: 3-4).

In order to get to the bottom of the 'hidden' inflation phenomena more detailed analysis should also include cost, price and currency disparities. Namely, when statistically lower inflation in Croatia in period 1994-2000 compared to some other surrounding countries such as Czech, Hungary, Poland and Slovenia, is put in a context of relative price ratio, analytical image changes. In that period, according to certain interpretations, prices of essential products in above mentioned countries

were 20-40% lower than in Croatia, which was 'hidden' by appreciated kuna exchange rate. So instead of 'statistical' annual inflation rate of 4,2% in that period, inflation 'corrected' for 'hidden' price increase, could be possibly estimated at nearly 7% level (Bilušić, 2001:341).

Figure 4: Annual inflation rate and logarithmic price level 2001-2007



Source: Statistical yearbook DZS (annual level), authors' calculation

Some recent claims estimate 15% appreciated kuna exchange rate in 1994-2005 period. In addition, risks of maintaining monetary stability (and thereby low inflation) by exceptionally high degree of eurization in a situation of undeveloped domestic capital market and significant exposure of commercial banks to exchange rate risks are pointed out (Domazet, 2005: 118).

In this situation it does not hurt to remind one more time that the Croatian economy's highest growth rates period in 20th century from the second half of 50's till the beginning of 70's coincides with inflation rates which were high (around 13%), but still almost four times lower than annual average 1950-1990. Similar confirmation is given also by the data for American economy in 1990's. High GDP growth rate and full employment policy resulted in decrease (instead of expected increase) in inflation rate, quite opposite of the IMF and World Bank predictions.

### Employment and Productivity

Employment along with accompanying unemployment is multiply contestable subject. Its significance is primarily of everyday existence nature. Job which

provides an income for an individual and a family living standard is always of great public interest. Inflation, price increase, GDP growth and balance of payments are relatively abstract themes of interest to a narrow professional circle, whereas employment is literally survival issue for many and therefore under a strong scrutiny of almost every citizen. On the same practical i.e. empirical level is a fact that both structural and cyclic unemployment are one of the 'diseases' 'plaguing' the market economy in a manner that repeatedly question its efficiency.

Finally, there is also a separate environment of (post) transition economies that has 'naturally' given birth to remarkable drop in employment and accompanying high unemployment during the complex overall market restructuring and stabilization process despite the significant older workforce 'crowding out' from the labor market.

Observed empirical changes have been gradually shaped into more or less successful theories. One of the famous is Phillips curve formulated through research of relationship between inflation and unemployment in England and in the USA in a period from the middle of 19th until the middle of 20th century. Analysis was formalized in recognizable curve which plainly speaking shows that high unemployment results in low inflation i.e. how low unemployment (full employment) is accompanied by high(er) inflation. Fiercely debated 'trade off' between inflation and unemployment, according to which a price of low inflation is high unemployment and price of full employment is high inflation, crumbled at the beginning of 1970's when developed market economies faced stagflation i.e. situation where both high inflation and high unemployment along with stagnating economic activity existed at the same time. That brought to modification/extension of Phillips relation through implementation of expectations. The result was 'dynamized' curve which describes the relation between unemployment increase/decrease rate and inflation increase/decrease rate. Practically it means that high(er) unemployment does not result in low inflation but in decreasing inflation rate i.e. decrease of inflation in long term. Conversely, low unemployment (full employment) does not lead to high inflation but to increasing inflation rate i.e. to an increase of inflation in long term (Blanchard, 2006:166-188).

Regardless of how effective this 'adaptation' of Phillips curve is in terms of developed market economies, in (post) transition conditions even such 'dynamization' has not been successful. Vast econometric tests on 50-year period that have included both pretransition and post transition period show that there is no significant connection between inflation and unemployment rate, not in simple nor in Philips curve model modified by expectations (Družić/Tica/Mamić, 2006:57). Econometric findings direct to deeper analysis of long-term structural impacts on a transition (especially Croatian) labor market. Possible explanation for non-existent Phillips curve in pretransition period is specific category of illiquidity that has

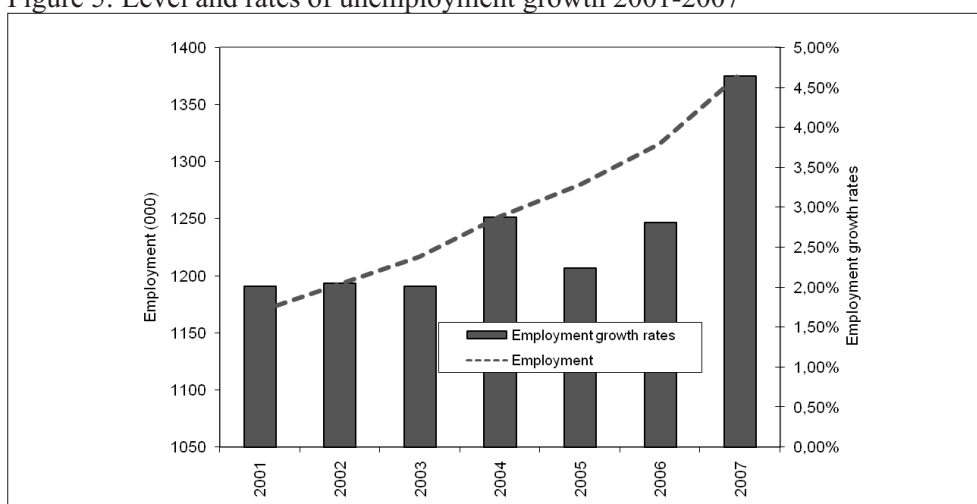
allowed insolvent companies existence through 'virtual' stocks enabling growth of both employment and inflation at the same time (Družić, 2004:220). In post transitional period regression analysis indicates that there is negative correlation between unemployment and inflation. However, established relation is so weak that an inflation process in Croatia in post transitional period can not be explained by unemployment rate trend, but its explanation should be looked for outside of economy's real sector (Botrić, V. 2005). One of the possible directions of professional research is more detailed insight in structural causes of long-term disparities of transition, and thereby Croatian, labor market. Econometric model 'matching-functions' tested on middle-European transition labor markets points to a conclusion that long-lasting mismatch of supply and demand is primarily result of simultaneous combined influence of structural changes characterized by processes of deagrarization, deindustrialization and terciarization (Obadić, 2005:231). Additional and ever more significant factor is educational process which essentially calibrates the labor market supply composition. It should be more closely investigated just how 'wide spectrum' Croatian educational system, that was relatively successful in a period of the 'third wave' i.e. industrialization, is adjusted to post industrial environment of knowledge economy respecting initial beliefs that existing process is incompatible with cyber/ knowledge society postulates (Polšek, 2004:272).

Analyzed theoretical debates place empirical analysis in the area of minuteness section and cautious claims. Such analysis required 'purification' of available labor statistics, concerning especially the category 'active farmers'. Namely, their number is not so much a result of accounting exact number of market surpluses producing registered farmers but is a product of their propensity to pay contributions for retirement or health insurance which serves as a base for their statistic records. Since farmers' propensity to pay contributions highly fluctuates in certain time periods, (in)consistency of time series demanded their exclusion from the observation. It should be added that employment data are less, and unemployment more, affected by changes in way of recording both unemployed and employed. Special establishment of Labor Force Survey unemployment next to registered unemployment along with increasing 'bureaucratization' of unemployment/employment registration process can in Croatian case increase/lower the number of unemployed for 60-80000. Importance of conclusions that are being imposed by empirical research, has made it necessary to stress constraints regarding the reliability of findings that are the consequence of frequent methodological changes and constant harmonization with Eurostat standards among other issues. These constraints give ground to partial softening of relatively unfavorable evaluations of long-term employment trends.

Positive fact that ought to be highlighted is the shift of unemployment changes trend. After entire decade 1990-2000 of stagnation and negative employment rates, long expected and desired changes finally occurred. At the beginning of 21st century

in a period from 2001-2007 encouraging employment growth could be noted. Average annual growth rate varied around 2,8% which resulted in total increase in number of employed of around 200 000 or on average near 34 000 annually. (Figure 5)

Figure 5: Level and rates of unemployment growth 2001-2007



Source: Statistical yearbook DZS (annual level), authors' calculation

Analysis impartiality requires confrontation of above mentioned desired employment trends with accompanying notably worrying developments.

The first unfavorable factor is productivity curve. Despite thorough structural changes that resulted in significant and long-lasting unemployment growth which was expected to enable growth of productivity and competitiveness in a situation of positive GDP growth rates, the real trends are different.

Croatian economy has entered 21st century 'cleansed' from the burden of so called 'socialist mastodons' i.e. former large companies burdened by low productivity, high 'hidden' unemployment, out-of-date technology and old-fashioned business organization. Significant number of companies has vanished in several bankruptcy waves and the others have undergone thorough market restructuring. Employees at the time have either left labor market their working activity (to the greater extent) or have entered liberated labor market actively looking for a job (to the lesser extent). At same time regardless the high (tax) expenses of two bank crisis on one hand and inefficient privatization process on the other hand, relatively efficient financial market has nevertheless been established. Capital market has been liberalized which resulted in significant inflow of foreign investments and

growth of foreign (more developed/more modern) capital ownership portfolio in the Croatian economy.

These are recognized ingredients of quality and fast growth based on productivity growth as the main indicator of increasing competition potential of developed economies.

However, actual performances of this quality growth factor in Croatia clearly indicate stagnation. In the 2001-2007 period labor productivity measured by GDP per worker (in 1990 USD) increases slowly from below 20 000\$ in 2001 to around 22 000\$ of annual output per employed in 2007. (Figure 6) This performance of one of the key macroeconomic indicators directly and indirectly affects behavior of all other important macroeconomic variables. It especially refers to international competitiveness of national economy that represents one of the important dividing lines of independent economic survival in case of a small open economy such as Croatian.

Figure 6: GDP and GDP per employed (\$ 1990) 2001-2007



Source: Statistical yearbook DZS (annual level), authors' calculation

The second unfavorable factor is low work force participation. Two different calculations display hardly understandable findings. Participation of work force share (employed + unemployed) in total population has been around 36%. Since participation share is between 50-60% in developed countries, these indicator places Croatia in a group of world's most unsuccessful economies such as Mali or Chad (Družić/Tica, 2002:123). Work force participation calculated as a share in population older than 15 years gives a participation rate of around 50%, whereas participation in



transition countries from Lithuania and Latvia, to Czech and Slovakia to Slovenia is around 70% (Katić, 2006:34).

Third unfavorable factor is that, although positive, Croatian employment growth rate at the beginning of 21st century can not contribute significantly to the solution of unemployment problem. Namely, with existing annual employment growth rate Croatian economy would reach pretransitional level of employment in 7-8 years or quarter of century after the beginning of transition.

Fourth unfavorable factor is connected to reaching full employment as final goal of stable market economy growth. Full employment is defined as the employment where frictional unemployment does not exceed 4-5%. If we quantify full employment at the participation rate of reasonable (middle-European) 70%, Croatian economy would reach full employment in approx. 30 years via existing employment growth rates.

Clearly, these tentative findings must be subdued to strict economic analysis and verification. However, that will not essentially influence the fact that active structurally redesigned economic policy of full employment supported by pro-birth population policy is unavoidable.

### **Change of Global Context**

At each moment these long-term Croatian economy challenges should be put in a context of actual global occurrences to which clearly point still uncomprehended immensity of world (for now) financial crisis. Financial collapse tide wave that gradually spills over to real economy sectors impacts overall business activity in each economy including Croatian. It has also an additional impact on (post) transition economies because the Washington consensus abandoning and 'hands washing' is in progress.

Abandonment of up to recently unquestionable paradigm of stabilization package; structural (privatizational/denationalizational) adjustments, hard budget constraints, monetary anchors and fixed exchange rate, evolves gradually and as it seems pressured by recent occurrences. Revision has begun at unexpected place in Sweden, country that usually is not in any arrangement with international financial institutions. Its economic renesance with growth rates over 5% is attributed to industrial export growth whose share in GDP has increased from 27% in 1990's to 52% in 2000's. However, export growth is almost exclusively attributed to real devaluation of Swedish crown (Munchau, 2006). Detailed comparative sector analysis of Swedish economy conducted in 1990's and 2000's has shown productivity growth as the key instrument of successful growth, especially annual productivity growth in private sector of 3,3% in 12 years from 1992-2004

(McKinsey, 2006:22). But the main obstacle to further growth next to public sector is services sector. That is how, for instance, productivity in commerce is more than 10% lower than in the USA, and achieved productivity growth is attributed to decrease in number of employed, not to output growth (McKinsey, 2006:124). Analysis strongly suggests that real exchange rate, i.e. devaluation by itself can not result in growth of export competitiveness if it is not followed by important shift in labor productivity in key industrial exporting sectors. Similarly, productivity growth will not give expected results unless it is followed by monetary/exchange rate policies. Here, one can recognize one possible lesson for Croatian economy and Croatian economic disputes. The right question is not the one of real exchange rate i.e. for or against devaluation. The real question is how to get to substantially and temporally consistent combination of economic/industrial and exchange rate policy which will in programmed stages result in growth of export competitiveness and real sector export growth.

However, final act of complete renunciation of Washington consensus came from World Bank itself which has experienced complete turnabout of until recently 'untouchable' neoclassical cannons of market and institutional fundamentalism by producing 'Spence commission' report. Unquestionable receipts for liberalization, deregulation and free market prescribed everywhere independently of each country's specific context, vanished from WB economists' professional radar. By explaining reasons for breakdown of universally prescribed, reforms 'cooked', in Washington, the need for gradual unconventional approach in each country, with respect to social and economic context, is accentuated. Nevertheless, the most damaging impact to neoliberal concept came from empirically confirmed spectacular growth of entire spectrum of countries, especially India and China, that were led in their (different) economic policies by goals and instruments essentially different from stabilization IMF/WB packages (Rodrik, 2008:1-2). These are strong lessons/messages to Croatian economy conveying that only growth based on productivity, employment and domestic savings growth has positive long-term instead of short-term/sporadic results.

Finally, the unexpectedly dramatic effect has been produced by actual global economic crisis, initiated primarily by the collapse of unregulated US financial derivatives market that has swiftly spread to regulated financial markets and through them is gradually influencing real economy sectors as well. Concentric circles of crisis have begun in a form of different 'bubbles' or more precisely, different forms of 'financial bubble'. Real estate industry bubble, mortgage bubble, securities bubble, bonds bubble, credit bubble, hedge funds bubble now burst in a form greatest real and financial sector collapse since the Great Depression at the end of 1920's. It is claimed that the collapse of security markets in one week of 2008 equals the drop which occurred in two days in 1929 (Roubini, 2008a). Actual situation has been

described as 'the most inflated' financial bubble in a history of market economies and therefore probable outcomes of overall global crisis are widely discussed. In most cases conclusion is that the way to avoid catastrophe is to conduct far more radical market and institutional reforms than the ones for which American (and other) government(s) has (have) been prepared implement. At the beginning it has been confined only to injecting ever bigger amounts in billions and trillions of dollars into nonperformed loans of bankrupt financial sector. All of these measures were proved insufficient and their calming effect on stock exchange and general financial sector lasted not long enough to achieve stability.

Pressured by depth and scale of economic collapse, even conservative governments, particularly the one in the USA, had to make radical i.e. 'heretical' policy turnaround. Vehement preachers of unbounded free market, that have evaluated the very democracy/civilization progress of certain countries by the degree of 'market freedom' and minimal government interference into the economy, were forced to accept 'yesterday' still unimaginable measures of 'socialization' of their economies. These 'interventionist pills' encompass the new round of global decrease in interest rates, temporary guarantee for all saving and other deposits until the decision which banks will be liquidated, which will be partially nationalized. Following is fast release of household debt burden (mostly by mortgage loans) and freezing the foreclosures. In addition, the government policy of unlimited public/budget financing of solvent but momentarily illiquid companies, massive government package of direct financing that includes public works has been proposed. Finally, infrastructural works are planned, together with unemployment compensation, tax relieves for low-income households etc. (Nouri, 2008b).

(Post) transitional environment of Croatian economy demands, however, more thorough investigation of morphology of most recent American/global economic crisis due to possible multiplying effects. It is important in this type of analysis not to confuse roots/causes with inducement of the crisis. That is way the lack of confidence in financial markets and institutions is inducement or result, but not the root of the problem in this case. The first cause is a bad 'soft loan' policy. It has been displayed in real estate bubble that has overheated the economy and whose burst will mean drastic drop in real estate prices, thereby lowering the prices on mortgage market and damaging financial institutions balance sheets in the process whose bad loans nobody wants to buy.

The second cause of American breakdown is growth generated by (personal) consumption financed by high leverage borrowing that will have to be decreased, and that will (in recession conditions) even more clearly mirror the weakness of financial system (Stiglitz, 2008:2).

Every aspect of global economic crisis evidently reflects challenges of Croatian economy in sharpened perspective. Positive (medium high) annual Croatian GDP

growth rates close to 5% in 2000's were stimulated by high personal (housing) and government (infrastructure) consumption. Constraint to such growth is, amongst others, in the fact that both of these components of final consumption were financed by galloping external debt increase that practically equals the GDP volume.

Main challenge in this environment is the economic policy redesign in a way to encourage those real economy activities (especially small and medium size entrepreneurship) that would create new jobs, productivity increase i.e. higher competitiveness. Financial industry should be encouraged to commit more diligently to the real economy projects promising growth and new more efficient and productive jobs. Simultaneously, profound policy redesign can not surmount transparent instruments creation that would efficiently restrain speculative drainage of healthy and necessary financial 'bloodstream' in rapidly disappearing international financial oasis. This kind of parasite behavior particularly endangers 'narrow' and 'shallow' financial markets like Croatian. Exclusive groups of 'asymmetric' information holders and protagonists of different 'clique/oligopolistic' groups and arrangements could be particularly dangerous to stable market conditions. With privileged access to the bills and bylaws creation process and beforehand knowledge of future government economic policy measures they can lead to a catastrophe both by reckless risks in a race for high profits in expansion and uncontrolled panic in recession. It seems that especially certain investment funds behaviors in actual Croatian capital market situation consistently follow this pattern.

Possible positive effect of these challenges is that their analytical aggregate makes a good starting point of departure towards prudent development-oriented market policy option for the Croatian economy. It would probably be close to Scandinavian model that mostly avoided Great Depression in 1929, and up to now seems to be coping well with its 'vampire awakening spirit' of the 2008 Great Breakdown. Success of this modern designed market economic policy crucially depends on long-term social consensus among main political options about its basic components. Such desired consensus must be socially acceptable to the healthy population majority, and thereby out of reach for daily political practice.

## REFERENCES

- Akrap, A, Čipin, I. (2006) 'Social Sterility in Croatia' Ministarstvo obitelji, branitelja i međugeneracijske solidarnosti, Zagreb (in Croatian)
- Babić, M. (2006) 'From Disinflation to Indebtness' Binoza press, Zagreb (in Croatian)
- Bilušić, A. (2001) 'Croatian Economy Macroeconomic Indicators Disparity in Comparison With the Transition Countires' in Veselica, V. et.al. ed 'Ekonomska politika Hrvatske u 2002.' Inženjerski biro, Zagreb str. 334-346 (in Croatian).
- Blanchard, O. (2006) 'Macroeconomics' Prentice Hall, USA

- Botrić, V. (2005) 'Relation Between Inflation and Unemployment in the Republic of Croatia' Ekonomski fakultet Zagreb (in Croatian)
- Čavrak, V. (2004) 'Macroeconomic Implications of Traffic Network Construction in Croatia', Zbornik Ekonomskog fakulteta u Zagrebu vol 2. No. 1. str. 1-18. (in Croatian)
- Djankov, S., Glaeser, E., La Porta, R., Lopez –de- Salinas, F., Shleifer, A. (2003) 'The new comparative economics' Journal of Comparative Economics, No 31. pp 595-619
- Domazet, T. (2005) 'GDP Losses 1990-2005" in Veselica V. ed. 'Ekonomska politika Hrvatske u 2006." Inženjerski biro, Zagreb str. 103-147
- Družić, I., Tica, J. Mamić, A. (2006) "'The challenge of Application of Philips Curve: The Case of Croatia" ZIREB, Special Conference Issue, str. 45-59
- Družić, I (2004) 'Resources and Markets of the Croatian Economy' Politička kultura, Zagreb (in Croatian)
- Družić, I., Tica, J. (2002) 'Dynamics and Controversies of Croatian Economic Development' in Družić, I ed. 'Stabilizacija-Participacija-Razvoj' Zbornik znanstvenog skupa povodom 80. godišnjice rođenja akademika Jakova Sirotkovića, Ekonomski fakultet Zagreb, str. 107-125. (in Croatian)
- Gabrisch, H, Holscher, J. (2006) 'The Successes and Failures of Economic Transition' Palgrave Macmillan
- Gelo, J. Akrap, A. Čipin, I. (2005) 'Fundamental Issues of Croatian Population Changes' Ministarstvo obitelji, branitelja i međugeneracijske solidarnosti, Zagreb (in Croatian)
- Jankov, Lj. ed. (2006) 'Bulletin 119" CNB, Zagreb
- Jankov, Lj. ed. (2004) 'Annual Report 2004" CNB, Zagreb
- Katić, M. (2006) 'Trends in Croatian Labour Market' Ekonomski misao i praksa, Dubrovnik, vol. 15 No.1 str. 27-50.,
- McKinsey Global Institute (2006) 'Sweden's Economic Performance: Recent Development, Current Priorities Executive Summary' McKinsey&Company
- Martić, R ed. (2006) 'Macro Prudential Analysis' CNB, Zagreb
- Munchau, W. (2006) 'The devaluation saga of Sweden's industrial rebirth' (wolfgang.munchau@ft.com)
- Obadić, A. (2005) 'Macroeconomics of the Croatian Labor Market' Politička kultura Zagreb (in Croatian)
- Polšek, D. (2004) 'Higher Education in Croatia and EU Requirements' in Katarina Ott ed. 'Pridruživanje Hrvatske Europskoj Uniji' – drugi svezak, Institut za javne financije, Zagreb (in Croatian)
- Ridrik, D. (2008) 'Spence Christens a New Washington Consensus' The Berkley Electronic Press, July 2008
- Roubini, N. (2008a) 'Governments got religion after peering into systemic meltdown abyss' RGE Monitor, Oct 13, 2008.
- Roubini, N. (2008b) 'The world is at severe risk of global systemic financial meltdown and severe global depression' RGE Monitor, Oct 9, 2008
- Stiglitz, J.E. (2008) 'We Aren't Done Yet: Comments on the Financial Crisis and Bailout' The Berkley Electronic Press
- World Bank (2002) 'Transition The First Ten Years' Washington.