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Mihaljek, Dubravko

Veröffentlichungsversion / Published Version
Sammelwerksbeitrag / collection article

Empfohlene Zitierung / Suggested Citation:
Mihaljek, D. (2003). Macroeconomic aspects of Croatia's accession to the European Union. In K. Ott (Ed.), *Croatian accession to the European Union. Vol. 1, Economic and legal challenges* (pp. 25-65). Zagreb: Institute of Public Finance, Zagreb. https://nbn-resolving.org/urn:nbn:de:0168-ssoar-61642

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Chapter 2

MACROECONOMIC ASPECTS OF CROATIA'S ACCESSION TO THE EUROPEAN UNION

Dubravko Mihaljek*
Bank for International Settlements
Basel

The one lesson that emerges is the need to keep trying. No miracles. No perfection. No millennium. No apocalypse. We must cultivate a sceptical faith, avoid dogma, listen and watch well, try to clarify and define ends, the better to choose means.
David S. Landes, The Wealth and Poverty of Nations (1999), p. 524.

ABSTRACT

This paper analyses the main macroeconomic conditions for joining the EU and the European Monetary Union (EMU), the readiness of the Croatian economy to meet these conditions, and the main challenges for economic policy on the road to these integrations. Croatia does not lag significantly behind the other CEE countries in fulfilling the criteria for EU and EMU membership. It has certain advantages with respect to the criteria of macroeconomic stability (with the exception of the budget deficit), investment efficiency, and potential growth. However, delays in the implementation of some structural reforms, in particular the development of a securities market,

**The views expressed here are those of the author and do not necessary represent those of the BIS. The author is taking part in this project as an independent researcher. He would like to thank an anonymous reviewer for helpful comments and suggestions.*

are estimated at about four years. The main challenges for economic policy in the run-up to EU and EMU are expected to be reducing the budget deficit and stabilising the public debt. Moreover, macroeconomic policies should remain prudent so as to strengthen external stability and maintain favourable conditions for growth.

Key words:
Croatian economy, Central European economies, enlargement of the EU, transition, convergence to the EMU, economic growth, inflation, external stability, budget deficit, public debt

INTRODUCTION

This paper analyses three topics related to Croatia's accession to the EU and EMU: the macroeconomic conditions for joining the EU and EMU, the preparedness of the Croatian economy to meet these conditions, and the main challenges that are awaiting economic policy on the road to the EU and EMU.

The second chapter describes certain differences in the process of EU integration as between Croatia and other CEE countries and analyses the economic significance of the criteria for EU membership, known as the Copenhagen criteria. These criteria relate primarily to the development of the fundamental political, economic, administrative and judicial institutions with the aim of creating as quickly as possible the conditions for the adjustment of the countries of CEE to the institutional framework of the EU. After they become EU members, the countries of Central and Eastern Europe will have the obligation to join the EMU and accept the euro as the common currency. To be admitted to EMU, countries will have to demonstrate that they are capable of maintaining macroeconomic stability for at least two years. To pass this test, countries will have to fulfil the Maastricht criteria on the rate of inflation, interest rate, exchange rate, budget deficit and public debt. Since these conditions are defined more precisely than the Copenhagen criteria and are easier to monitor, they are being thoroughly analysed in the literature, including this paper.

The third chapter assesses the readiness of the Croatian economy to join the EU and EMU. It carefully analyses comparative economic indicators for Croatia and five other Central European countries (Czech Republic, Hungary, Poland, Slovakia and Slovenia), as well as

some less developed current EU members (Greece, Ireland, Portugal and Spain). The main conclusion of these comparisons is that Croatia does not lag behind other Central European countries and even has certain advantages with respect to the main macroeconomic criteria (apart from the budget deficit), investment efficiency and potential growth. However, the delay in the implementation of some important microeconomic reforms, such as the development of non-bank financial markets and competition policy, is estimated at almost four years.

Chapter Four addresses the issues of the sustainability and stability of the process of real and nominal convergence. Although current indicators of macroeconomic stability for Croatia and other Central European countries are mostly satisfactory, the experience of some members of EMU shows that the final phase of convergence can be the most difficult. The main challenge for Croatia in this context will be to reduce the budget deficit and stabilise the share of public debt in GDP. Moreover, macroeconomic policies will have to remain prudent so as to maintain the external stability and make use of the potential for relatively strong growth. The fifth chapter concludes the discussion and provides some recommendations for economic policy.

CONDITIONS FOR JOINING THE EU

This chapter briefly considers the basic economic and institutional framework that the EU has elaborated for future members. The economically relevant criteria for the accession of Croatia to the EU can be divided into two groups: conditions that derive from the Stability and Association Agreement (2001), which the EU had expressly devised for the countries of SEE; and the Copenhagen criteria, which apply to all applicants from CEE and are also included in the Stability and Association Agreement. Criteria from the Maastricht Treaty on EMU have to be met by all EU members before they can adopt the euro as their common currency. The framework set in these three groups of criteria forms, in a way, a goal that the Croatian economy and, in particular, the public administration should aim for in the macroeconomic sphere in order to join the EU and EMU as soon as possible. In spite of frequent interpretations, most of these conditions have not been phrased extremely rigidly, but leave Croatia and other applicant countries a certain flexibility to adapt, in agreement with the European Commission, some of the conditions to the particular circumstances.

Box 1. The Stabilisation and Association Agreement

The SAA between Croatia and the EU was signed on 29 November 2001 and by summer 2002 it had been ratified by Austria, Denmark and Ireland. The Agreement governs cooperation and the framework for the gradual convergence of Croatia to European structures. The SAA contains provisions on cooperation and mutual obligations in the following areas: political dialogue, regional cooperation, free movement of goods, movement of workers, establishment of businesses, the supply of services, current payments and movements of capital, harmonisation and implementation of legislation and the rules of market competition, cooperation in the area of justice and internal affairs, the policy of cooperation and financial cooperation. Thus in the trade part of the Agreement a transitional period of three or six years in which Croatia will liberalise its market for industrial and agricultural products from the EU was agreed on. That is, as early as November 2000, the EU had decided, with certain exceptions, to liberalise its market for Croatian products.[ii] Apart from the provisions about political dialogue and regional cooperation, the provisions of the SAA closely resemble those of the Europe Agreements signed by the current accession countries.

In the regional cooperation provisions, it is anticipated that there will be a network of bilateral treaties with countries that have signed the SAA, other countries covered by the stabilisation and association process and with EU accession applicants. It is clearly stated that the goals of the regional provisions are the establishment of political dialogue, the establishment of an area of free trade in the region in line with WTO provisions, mutual concessions concerning the movement of workers, establishment, supply of services, current payments and movement of capital and other policies related to movement of persons, as well as cooperation in justice and home affairs. The creation of any kind of new state or other structures in the region is not envisaged in the Agreement, nor is it mentioned.

In the political preamble and in the appropriate parts of the Agreement it is clearly stated that Croatian accession to the EU will be based on the individual merits of Croatia. In particular, the readiness of Croatia to move from the status of potential candidate to that of official candidate for EU membership will be based on the individual capacity of Croatia to make the legal, economic and political adjustments required under the SAA and its readiness to contribute to regional cooperation and stability in SEE.

The Stabilisation and Association Agreement

Croatia's accession process differs from the accession of the current applicant countries – the Czech Republic, Hungary, Poland, Slovakia, Slovenia, the Baltic countries and Bulgaria and Romania. During the nineties, these countries initially obtained the status of associated countries after the EU entered into the so-called Europe Agreements with them. By carrying out these agreements, the associated countries, after a few years, acquired the status of candidates for membership in the Union.[i]

Because of the events of the war in the area of the former Yugoslavia, Croatia began developing closer relations with the Union only at the end of the nineties. In June 1999 the EU adopted the Process of Stabilisation and Association for the Republic of Croatia, BH, Albania, Macedonia and FR Yugoslavia) (European Commission, 2002a). The fundamental instrument for the implementation of the Process is the SAA. This treaty constitutes a new generation of agreements concerning associated membership in the EU. The main difference between the SAA and the Europe Agreements is in the contents of the so-called evolutionary clause, and in the provisions about regional cooperation (see Box 1).[iii] While the Europe Agreements specifically stated the integration of the countries of CEE into the EU as their basic goal, the SAA assigns Croatia the status of potential applicant for EU membership, on condition that it not only meets the Copenhagen criteria but also lives up to the obligations concerning regional cooperation. The rationale for these provisions is to encourage the countries in SEE to behave towards each other and work with each other in a manner comparable to the relationships that now exists between EU members (European Commission, 2002a). The requirement for the countries in the region to establish a network of close contractual relationships reflects the same logic on which the bilateral relationships with the EU (as represented by Stabilisation and Association Agreements) are built.[iv]

Joining the European Union

The basic conditions for the enlargement of the EU were already set out in Article O of the Treaty of Rome (1957), modified in 1997 in the Treaty of Amsterdam: "any European state which respects the principles of liberty, democracy, respect for human rights and fundamental freedoms, and the rule of law may apply to become a Member of the Union

(European Commission, 2001,7). In 1993, at the Copenhagen European Council, the EU adopted a decision according to which the "associated countries in central and eastern Europe that so desire shall become members of the EU" (ibid. p. 8). The decision also defined the membership criteria – the so-called Copenhagen criteria – the basic objective of which was to set out the appropriate framework for the gradual integration of the countries of CEE into the EU:

- stability of institutions that guarantee democracy, the rule of law, human rights and the respect for and protection of minorities,
- the existence of a functioning market economy as well as the capacity to cope with competitive pressure and market forces within the Union,
- the ability to take on the obligations of membership, including adherence to the aims of political, economic and monetary union.

At the Madrid European Council in 1995, a fourth group of membership criteria was added:

- the adjustment of administrative and judicial structures to EU standards in order to ensure the effective implementation of the legislative framework taken over from the EU in the context of the first three items.

The legal patrimony of the EU that applicant countries bind themselves to take over and apply is known by the name of the acquis communautaire. The acquis is divided into 31 chapters:

1. Free movement of goods	18. Education and further education
2. Free movement of persons	19. Telecommunications and information technology
3. Free supply of services	
4. Free movement of capital	20. Culture abd audio-visual policy
5. Company Law	21. Regional policy and coordination of structural instruments
6. Market competition policy	
7. Agriculture	22. The environment
8. Fisheries	23. Consumer protection, health care
9. Transport policy	24. Cooperation in teh area of justice and internal affairs
10. Taxation	
11. Economic and monetary	25. Customs union
12. Statistics	26. Foreign relations
13. Social policy and employement	27. Common foreign and security policy
14. Energy	28. Financial control
15. Industrial policy	29. Financial and budgetary provisions
16. Small and medim sized enterprises	30. Institutions
17. Science and research	31. Miscalleneous

Probably the most important macroeconomic criteria for joining the EU are central bank independence and the prohibition on central banks financing of national budget deficits. The European Central Bank assesses regularly the fulfilment of these conditions. During 2002, the ECB several times gave public warnings to the governments of the Czech Republic, Hungary and Poland that some of the proposed laws were encroaching on the independence of the central banks and hence jeopardised the chances of these countries to successfully conclude their accession negotiations.

The actual accession negotiations deal primarily with conditions under which the applicant countries will accept, apply and administratively and legally implement different chapters of the acquis. Experience to date has shown that there is enough flexibility in these negotiations for individual legislative approaches to be adapted to the specific conditions. Poland, for example, negotiated a transitional period of 12 years for the complete liberalisation of the market in agricultural land (including the right of Union residents to buy agricultural land in Poland), while the European Commission, during the negotiations, had proposed a period of seven years. In other words, how much, during the assumption of the acquis, given solutions will suit the interests of the applicant country depends, among other things, on the expertise and capacities of the relevant structures of the public administration in its negotiations with the EU.

Candidate countries are obliged to accept national programmes for implementation of the acquis, and the EU regularly assesses the progress made in the implementation of these programmes. By summer 2002, all the applicant countries from CEE had started negotiations on about 30 chapters of the acquis (apart from Romania, currently negotiating about 24 chapters). Most chapters have been agreed on with Lithuania (28), then with Estonia, Latvia and Slovenia (27 chapters each), Slovakia (26), Czech Republic and Poland (25), Hungary (24), Bulgaria (20) and Romania (12) (Deutsche Bank, 2002). Croatia is bound to meet the Copenhagen criteria pursuant to the SAA; the results achieved in this area will be considered in the next chapter.

Since considerable financial resources are necessary for accepting the acquis and meeting the other conditions for membership, the European Council earmarked up to 3.12 billion euros in its financial plan for 2000-2006 for assistance to applicant countries (European Commission, 2001). From 1993 to 2000, Croatia received a total of 358 million euros in assistance from the EU, and the value of the CARDS programme for 2001 amounted to 60 million euros (European Commission, 2002b).[v]

Joining the European Monetary Union

The eleventh Copenhagen criterion provides for the implementation of the objectives of economic and monetary union in the medium term. Unlike the current members of the EU who have not joined the EMU – Denmark, Sweden and the UK – the countries of CEE will not be able to opt out of membership in EMU when they have met the conditions for joining laid down in the Maastricht Treaty of 1992. These conditions are as follows:

- *Inflation*. A Member State has to show a price stability performance that is sustainable and an average rate of inflation, observed over a period of one year before the examination, that does not exceed by more than 1.5 percentage points that of, at most, the three best performing Member States in terms of price stability. Inflation shall be measured by means of the consumer price index on a comparable basis, taking into account differences in national definitions
- *Interest rate.* Over a period of one year before the examination, a Member State has to have an average nominal long-term interest rate that does not exceed by more than 2 percentage points that of, at most, the three best performing Member States in terms of price stability. Interest rates shall be measured on the basis of long-term government bonds or comparable securities, taking into account differences in national definitions;
- *Exchange rate*. A Member State has to respect the normal fluctuation margins provided for by the exchange-rate mechanism of the European Monetary System without severe tensions for at least the last two years before the examination. In particular, the Member State shall not have devalued its currency on its own initiative for the same period.
- *The general government deficit* may not exceed 3% of GDP, or should be falling substantially or only be temporarily above though still close to this level;
- *Gross general government debt* may not exceed 60% of GDP at market prices, or must at least show a sufficiently diminishing (rate) and approaching the reference value at a satisfactory (rate).

Since these conditions are more precisely defined than the other Copenhagen criteria, they have become in economic and business literature a synonym for the readiness of applicant countries to join the EU. For this reason, this paper will also devote considerable attention

to the comparison of Croatia's macroeconomic performance with the Maastricht criteria. It is necessary, however, to stress that these conditions need to be met only after the future members of the EU have spent at least two years in the Exchange Rate Mechanism (ERM II) of the European Monetary System.

Although at first glance these conditions seem to have been laid down very precisely, there is a certain amount of flexibility in them. This pertains in particular to the size of public debt, or the tendency of the debt to decline. Austria, Belgium, Greece, Italy and Holland entered the EMU with a public debt in excess of 60% of GDP, and by the end of 2001 only the Netherlands had reduced gross indebtedness below that level.[vi] Italy also had problems meeting the budget deficit criterion. From 1991 to 1996 the average budget deficit amounted to 9% of GDP. As a criterion for EMU entry, the European Commission accepted the promise (later fulfilled) that the deficit for 1997 and 1998 would be lower than 3%. However, as far as Croatia is concerned, it would be wiser not to rely on such precedents and meet all the criteria from the outset, for the probability that the European Commission in an enlarged EU would-be particularly well-disposed towards Croatia is very small.

THE READINESS OF THE CROATIAN ECONOMY FOR THE EU

After the main economic criteria for Croatia's accession to the EU have been laid out, i.e., the objectives that the Croatian economy should aim for in order to join the EU, this chapter considers the initial conditions on the road to EU, i.e., to what extent the Croatian economy lags behind or has any initial advantages over the EU applicant countries. The analysis is divided into four parts: (i) a review of the basic economic indicators of Croatia, the CEE countries, and the less developed current members (Ireland, Greece, Portugal, Spain); (ii) the evaluation of the EU concerning SAA implementation; (iii) a review of EBRD transition indicators, which, to a certain extent, quantify the Copenhagen criteria on the functioning of the market and the competitive strength of the economy; (iv) an evaluation of the macroeconomic performance of the Croatian economy based on the Maastricht criteria. The general conclusion is that Croatia does not lag behind the other CEE countries, or even has certain advantages in terms of the main macroeconomic indicators. However, there is a marked delay in the

implementation of some important microeconomic segments of the acquis, such as the legal system, competition policy, the development of the non-bank financial system and the share of the private sector in the economy. Since these institutions are vital for the normal functioning of the market economy and competitiveness of the corporate sector, it can be estimated that, provided macroeconomic stability is preserved, Croatia will need another four to five years of structural reforms to catch up with the level of readiness for EU already achieved by the advanced transition economies.

The main economic indicators

With GDP per capita of $4,600 in 2001 (24% of the EU average), Croatia was in the same position as Hungary and Poland (Table 1). The per capita income of the Czech Republic was 30% higher, and that of Slovenia 130% higher, while compared with Slovakia per capita income in Croatia was a quarter higher. Greece, Ireland and Spain had a considerably higher *per capita* income (in terms of EU average) before joining the EU.[vii] However, Portugal had in 1986 the same per capita income in terms of EU average as Croatia in 2001. Judging by this basic indicator of development, then, Croatia does not lag substantially behind the other applicants for EU membership.

Also surprising is the fact that Croatia does not lag behind in terms of two other basic indicators: GDP growth and labour productivity growth. From 1995 to 2001, real GDP in Croatia rose at an average annual rate of 4%, somewhat slower than in Slovenia, but 10% faster than in Hungary and twice as fast as in the Czech Republic.[viii] Only the Slovak and Polish economies grew faster on average over this period. With a productivity growth of 5.4% in the 1995-2001 period, Croatia was in the first place among the countries considered; productivity growth of more than 4% per annum was achieved only in Poland and Ireland. Wages rose twice as fast as productivity, however (by 11.4% a year in real terms), so the competitiveness of the Croatian economy was considerably reduced according to this criterion. Rapid growth in productivity was partly achieved through reduction in employment, on average by 1.3% a year, highest among the countries in central Europe.[ix] Together with Poland and Slovakia, Croatia also stands out in terms of very high unemployment; the other central European countries have reduced their rate of unemployment to below 10% and thus have converged with the EU average.[x]

Table 1. Main economic indicators for the Central European contries and the EU

	Population 2001 (mil.)	GDP 2001 (billion EUR)	Per capita GDP		Growth rate 1995-2001[1]			Unemployment rate[4,5]
			USD[2,3]	Percentage of EU average[3]	Real GDP	Productivity	Employment[4]	
Croatia	4.4	22.6	4,605	24	4.0	5.4	-1.3	16.3
Czech R.	10.3	62.1	5,530	29	2.0	2.5	-0.5	8.9
Hungary	10.0	57.4	4,660	24	3.6	3.3	0.4	8.4
Poland	38.7	197.8	4,560	24	4.8	4.5	0.4	17.3
Slovakia	5.4	22.7	3,700	19	4.4	3.8	0.6	18.2
Slovenia	2.0	20.9	10,605	56	4.1	3.1	1.0	5.9
EU members								
Greece	10.9	30.4	5,700	63	3.3	2.5	0.8	10.4
Ireland	3.9	96.7	2,420	57	9.2	4.0	5.1	3.8
Portugal	10.3	122.6	2,240	24	3.3	0.8	2.7	10.6
Spain	41.1	651.6	4,420	47	3.5	3.1	0.3	4.1
EU	377.5	8,812	19,060	100	2.6	1.5	1.1	8.0

[1] Annual average, in percent.
[2] GDP at current prices in domestic currency, converted into US dollars at annual average exchange rates.
[3] For current EU members, GDP per capita and percentage of EU average in year of joining the EU (Greece 1981, Ireland 1973, Portugal and Spain 1986); For EU candidate countries data refers to 2001.
[4] Based on labour force surveys.
[5] Average for 2001.

Sources: UN Economic Commission for Europe; European Central Bank; IMF; Eurostat; EBRD; national statistical agencies

By far the best economic performance among the countries in Table 1 was achieved by Ireland. With a growth of as much as 9.2% pa, the real GDP of Ireland increased by 70% between 1995 and 2001, and per capita income by 44% (from 18,500 to 26,600 USD). Moreover, Ireland achieved a growth rate of employment of more than 5% a year, resulting in a decline in unemployment from about 15% at the beginning of the nineties to only 3.8% in 2001. Ireland can therefore justly stand as a model for the transition economies.

Evaluation of the European Commission from April 2002

In its first stabilisation and association report on Croatia from April 2002, the European Commission evaluated that Croatia had continued to make progress in the process of transition to a free market economy (European Commission, 2002c). Concerning regional cooperation – the main additional condition for Croatia's accession to the EU – the European Commission judged that the government accepted the need to normalise relations and strengthen bilateral cooperation with neighbouring countries. However, Croatia continued to fear that closer relations with the neighbours would lead to the re-emergence of a regional identity and hold back its ambitions for European integration. As a consequence, "the authorities show a clear lack of enthusiasm for any regional initiatives with the other SAA countries" (ibid., p. 10). This evaluation does not diminish the considerable success achieved in concluding bilateral free trade agreements with BH, Macedonia, Hungary, Slovenia, Bulgaria, Czech Republic, Poland, Romania, Slovakia and Turkey, and the negotiations on free trade that started at the time with Albania and FR Yugoslavia (and have since been successfully concluded).

Regarding fulfilment of the Copenhagen criteria, the following judgements of the European Commission should be noted.

As for the political conditions, the European Commission is concerned by the situation in the judiciary, which are characterised by serious organisational problems, inefficiency of procedures, lack of expertise and long delays in the conclusion of cases. "Radical reforms are needed but no substantial progress has been made. This weakness has direct impacts on implementation of the rule of law, which remains problematic and uneven" (ibid., p. 4).

Turning to the existence of a free-market economy and structural reforms, the European Commission notes that a major part of the economy is privately owned; privatisation and restructuring of state-owned firms is proceeding slowly; and the importance of the grey economy is estimated to have declined (ibid., pp. 15, 17). However, the ability of the corporate sector to withstand competitive pressure and to cope with market forces in the Union differs considerably across sectors.

- Agricultural products (10% of Croatia's total imports, of which 42% comes from the EU, and 14% of total exports, of which 10% goes to

the EU) are considered uncompetitive on the EU market. Since the degree of protection of agriculture was very high in the past, it is estimated that agriculture will be most sensitive to trade liberalisation (ibid., pp. 20 and 25).

- Regarding industrial products, the Commission notes that implementation of the Interim Agreement (through which trade with the EU was liberalised in 2000) has not raised problems so far. Since Croatia is the largest exporter to the EU from south-eastern Europe, it is expected to be by far the most significant beneficiary of EU trade liberalisation. However, the Croatian balance of trade with the EU remains highly negative "due to the substantial reduction in Croatia's overall export level following its loss of international competitiveness – due essentially to wage growth above productivity growth, delayed enterprise restructuring and insider privatisation. This trend now seems to be slowly improving however." (ibid., p. 20).
- The SME sector, which accounts for almost 45% of GDP, is slowly becoming more dynamic, in particular by comparison with big industry. But the international competitiveness of small and medium sized enterprises is still low, and their orientation to foreign markets is small (ibid., p. 24).
- The service sector has been opening fast and performs well, with growth of service exports above 10% pa. Croatia accounts for 70% of the region's exports of services. (ibid., p. 22).
- In transport infrastructure, the European Commission sees Croatia as an important transit country for road, rail and combined transport in the Union. In the development of the energy sector, Croatia has a potentially crucial role in the region. However, the Commission is disappointed with the financial performance of HEP (electricity) and INA (oil and gas), the state-owned companies that currently dominate their sectors and enjoy a quasi-monopolistic position. This can be partly attributed to insufficient investment in the energy infrastructure. The Commission is also concerned by the fall in the production of domestic oil and gas and the faster rise in the consumption than in the production of electricity (ibid. pp., 26-17). By contrast, Croatia leads in the region in the telecom sector owing to successful privatisation, large investments and adequate regulation (ibid., p. 27).

In the financial system, the Commission notes that the results of privatisation and the consolidation of the banking system have been favourable and have strengthened the confidence of depositors in the banks. The new central bank law, which provides for greater independ-

ence of the CNB and mandates the central bank to put a strong emphasis on price stability as the basic objective of monetary policy, is also viewed positively. However, long-term finance is still scarce (because of problems with collateral); the non-banking financial system is poorly developed; and the environment in Croatia remains difficult for domestic and foreign investment due to deficiencies in the bankruptcy law and proceedings, inaccurate and incomplete cadastral records and land registry, and significant and numerous bureaucratic hurdles) (ibid., pp. 16-17).

In connection with public finances it is pointed out that the tax burden on the private sector in Croatia is among the highest in the region, which has lowered profitability and driven some activities off into the grey economy. The introduction of a single treasury account has improved the management of the budget. However, the national budget is not comprehensive and there are weaknesses in the formulation, execution and control of budgetary resources (ibid., p. 17).

With respect to the adjustment of administrative structures to EU standards, the Action Plan for the Implementation of the SAA is viewed as evidence of the seriousness of the commitment of the government. However, the timetable, which would require the government to transfer 70% of the acquis in two years, is judged as highly ambitious and, in the light of the experience of other countries, potentially unrealistic. In particular, there is a lack of capacity, in terms of staff numbers and the proper expertise necessary for the adjustment of many sectors to European standards and the gradual implementation of the acquis (ibid. p. 19). Encouraging initial results in the harmonisation of legislation have been achieved in several areas: movement of capital, protection of intellectual property rights, the company law (especially equal treatment of foreign and local investors), accountancy standards etc. In many areas, e.g., in consumer protection, industrial standards, the implementation of the legislation on market competition, the regulation of state aid to industry, considerable progress has yet to be made.

The functioning of the market and the competitiveness of the economy

Is it possible to test independently the evaluations of the European Commission on the functioning of market economy in Croatia? To assess whether some market economy functions normally and whether the corporate sector can withstand the competitive pressure

Table 2. EBRD transition indicators, 2000[1]

	Croatia	Czech R.	Hungary	Poland	Slovakia	Slovenia	Croatia/ SE-5[2]
Market	3.2	3.4	3.5	3.5	3.4	3.4	92
Price liberalisation	3.0	3.0	3.3	3.3	3.0	3.3	94
Trade and foreign exchange system	4.3	4.3	4.3	4.3	4.3	4.3	100
Competition policy	2.3	3.0	3.0	3.0	3.0	2.7	78
Enterprises	3.3	3.9	3.9	3.5	3.4	3.4	92
Small-scale privatisation	4.3	4.3	4.3	4.3	4.3	4.3	100
Large-scale privatisation	3.0	4.0	4.0	3.3	3.0	3.3	85
Enterprise reform	2.7	3.3	3.3	3.0	3.0	2.7	88
Financial institutions	2.8	3.2	3.9	3.5	2.7	3.0	87
Banking system	3.3	3.3	4.0	3.3	3.0	3.3	98
Non-bank financial	2.3	3.0	3.7	3.7	2.3	2.7	75
Infrastructure	2.6	2.8	3.8	3.7	2.6	2.9	85
Legal system	3.0	3.4	3.9	3.9	3.0	3.9	82
Commercial law	3.0	3.4	3.9	3.9	3.0	3.9	84
Financial regulations	3.0	3.5	4.0	4.0	3.0	4.0	81
Aggregate indicator[3]	**3.1**	**3.5**	**3.8**	**3.6**	**3.1**	**3.4**	**90**
Memo item:							
Private sector share of GDP[4]	60	80	80	75	80	65	79

[1] *Meaning of indicators is explained in text.*
[2] *Indicator for Croatia divided by the average indicator for five other CE countries (CE-5), in percentages.*
[3] *Unweighted average of individual average.*
[4] *In percent of GDP; EBRD estimate for mid-2001.*

Source: EBRD (2001, 2002) and author's calculations

inside the EU one would need to consider many different macro- and microeconomic indicators. But even after such detailed analysis, any final assessment of the preparedness of an economy for the EU would reflect to a certain extent subjective judgement. In other words, there is no summary indicator or a completely satisfying set of multidimensional indicators of the degree of "maturity" of a market economy. There are, however, certain approximations that can help make an informed judgement with a fair degree of confidence. Since 1994, the EBRD has been preparing it's the so-called transition indicators that rank the transition economies on a scale from 1 (the infancy of a market economy) to 4 (developed market economy) according to five groups of criteria – market, enterprises, financial institutions, infrastructure and legal system. The indicators for Croatia and for five Central European economies are shown in Table 2. The last column shows the value of the indicator for Croatia as compared with the average of the other five countries; a value lower than 100 indicates a gap between Croatia and the average of the five accession countries; a value of 100 means that Croatia has an equal starting position; a value greater than 100 indicates an advantage vis-à-vis the other countries.

According to the aggregate transition indicator, Croatia lags about 10% behind the average of the selected transition economies, and is comparable with Slovakia. The greatest progress has been made in trade and foreign exchange system and in small-scale privatisation. However, in several areas there is a pronounced difference between Croatia and other accession countries:

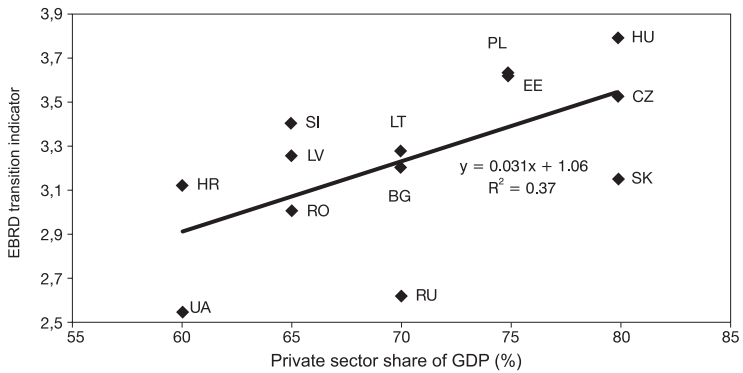
- In competition policy Croatia has scored the lowest value of any indicator in the table (2.3) and lags more than 20% behind the more advanced transition economies. The low value of this indicator reflects high obstacles to the entry of new firms to the market, and inadequate implementation of the legislation and policy of market competition with respect to firms that have a dominant market position.
- In the category of the non-bank financial institutions, Croatia lags as much as 25% behind the average of the applicant countries. The low value of this indicator reflects the existence of a shallow securities market and the low level of activity of brokers and other non-bank financial intermediaries, as well as the rudimentary legislative framework for the issuance of and trade in shares and bonds.
- In terms of development of the legal system Croatia lags about 20% behind the average. The basic reasons are the inadequate and incon-

sistent application of the financial system laws and regulations, in particular inadequate protection of the interests of creditors and owners and problems with bankruptcy laws and procedures, because of which legal uncertainty prevails. By contrast, commercial legislation is judged to be adequate and the corresponding indicator is slightly above the average for other countries.

- Because of poor corporate governance, inconsistent implementation of the laws relating to bankruptcy and the lack of commitment in strengthening market competition, Croatia still faces significant problems with large-scale privatisation and enterprise reform.
- There is also a considerable delay in the introduction of market principles in the infrastructure, which covers energy, road and rail transportation, telecommunications and water supply.

Low values of transition indicators are statistically highly correlated with the private sector share of GDP. Croatia had in 2000 the lowest private sector share in GDP of all the central European countries, only 60%, the same as Macedonia, Ukraine and some Central Asian economies. The coefficient of correlation between the aggregate transition indicator and the private sector share of GDP is 0.6. A simple regression shows that for each 10 percentage point increase of the private sector share in GDP, the aggregate transition indicator rises by 0.3, i.e., by a tenth of the average value of this indicator in 2000 (Figure 1).[xi]

Figure 1. Transition indicator and private sector share of GDP



Source: EBRD, 2002; author's calculations

How long would it take Croatia to make up the large delay in competition policy and non-bank financial institutions vis-à-vis the other central European countries? To answer this question, we calculated the time that it took the Czech Republic, Hungary, Poland and Slovenia to increase the average value of this indicator from 2 to 3. In competition policy, it took these countries 3.5 years on average for this increase, and in non-bank financial institutions 3.8 years.

It should be noted that the transition indicators in Table 2 refer to the situation as of 2000. Since then, there has been progress in some reform areas in Croatia, but also in the other CE economies, so the relative position of Croatia has probably not improved significantly

Convergence to the EMU

To what extent do Croatia and the CE transition economies already meet the macroeconomic conditions for joining the EMU? To answer this question it is necessary to recall that the decision on the initial members of the EMU was made in 1998 based on the data for 1997, and that enlargement of the EU to Cyprus, Czech Republic, Estonia, Latvia, Lithuania, Hungary, Malta, Poland, Slovakia and Slovenia is expected in 2004. Some of these countries could qualify to join the EMU as early as 2007. Hence, an assessment of the readiness of the transition economies for the EMU based on the data for 2001-2002 is equivalent to the assessment of the preparedness of Ireland, Spain and Portugal for EMU based on the data for 1993 (for Greece, based on the 1995 data). At that time, the Maastricht criteria had not been elaborated, so data for Germany served as the reference value (Table 3).

The transition economies were clearly much closer to meeting the nominal convergence criteria in 2000–2001 than the less wealthy current members of the EU were in the first half of the nineties. This relates above all to public debt, which in all the transition economies is below 60% of GDP (though Croatia and Hungary are approaching the critical level), while in Greece, Ireland, Portugal and Spain the public debt amounted to 61-109% of GDP. Croatia, the Czech Republic and Poland also meet the conditions for inflation, and Croatia, the Czech Republic and Slovenia the condition for the long-term interest rate on government bonds. All the six CE countries meet the condition for exchange rate stability. The largest deviation from the Maastricht pertains to the budget deficit. In 2001, only Slovenia had a deficit below the critical level of 3%

Table 3. Criteria for convergence to EMU

	Price stability[1]		Long term interest[2]		Exchange rate stability[2,3]		Budget deficit[4]		Public debt[5]	
	1999	2002	1999	2002	1999	2001	1999	2001	1999	2001
Croatia	4.3	2.5	12.7	5.7	-4.4	2.4	-8.2	-6.6	49	52
Czech R.	2.1	2.7	5.6	4.6	1.0	8.2	-3.1	-5.5	29	29
Hungary	10.0	5.7	13.4	7.5	-3.3	4.7	-3.7	-4.1	61	53
Poland	7.3	2.8	16.2	7.5	-2.5	8.3	-3.4	-5.3	45	45
Slovakia	10.7	3.6	15.0	7.3	-1.4	0.4	-3.4	-3.9	28	34
Slovenia	6.1	7.5	4.9	5.6	-3.9	-4.9	-0.6	-1.4	25	23
Average	*6.8*	*4.1*	*11.3*	*6.4*	*-2.4*	*3.2*	*-3.7*	*-4.5*	*40*	*39*
Reference value[6]	**0.6+1.5**	**1.3+1.5**	**4.6+2**	**4.6+2**	**± 15**	**±15**	**-3.0**	**-3.0**	**60**	**60**
Greece (1995)	8.9		23.1		0.4[7]		-9.3		109	
Ireland(1993)	1.4		9.9		-8.2[7]		-2.5		96	
Portugal (1993)	6.7		16.5		-4.5[7]		-6.8		61	
Spain (1993)	4.6		12.8		-9.0[7]		-6.7		64	
Average for 4 EU members	*5.4*		*15.6*		*-5.3*		*-6.3*		*82*	
Reference value: Germany (1993)	4.4		12.9		...		-2.4		47	

[1] *Annual average, in percent. Data for 2002 refer to the first half of the year.*
[2] *On ten-year government bonds, end of period; data for 2002 refer to mid-2002.*
[3] *Deviation of end-period exchange rate vis-à-vis the euro from average exchange rates for 1998-99 and 2000-02, respectively.*
[4] *General government deficit (accrual basis), in percent of GDP.*
[5] *Domestic and external public sector debt (general government basis), in percent of GDP.*
[6] *Inflation and interest rate data for three euro countries with lowest inflation (in first half of 2002, Germany and Finland (1.3%), and Austria and Belgium (1.4%); other criteria based on the Maastricht Treaty.*
[7] *Change in annual average exchange rate vis-à-vis the deutsche mark, 1992-93 (for Greece, 1994-94).*

Source: Economic Commission for Europe; European Commission; IMF; central banks; national statistical agencies

of GDP. Croatia had a deficit of as much as 6.6% of GDP, highest in central Europe in 2001.[xii] However, transition economies were again much closer to meeting this criterion than Greece, Ireland, Portugal and Spain five years before they joined the EMU. One should also point out that the transition economies have to meet much more stringent inflation and interest rate criteria than Ireland, Portugal and Spain in the mid-nineties. At the time, inflation and interest rates in the reference country, Germany, were considerably higher because of the macroeconomic pressures following German reunification.

Compared with the other CE countries, Croatia is in a sound position with respect to three criteria: inflation (it had the lowest rate of inflation in the first half of 2002, only 2.5%), long-term interest rates, and exchange rate stability. However, together with the Czech Republic and Poland, Croatia needs to undertake considerable fiscal adjustment: the budget deficit needs to be cut by more than 3.5% of GDP. Another cause for concern is the high level of public debt (52% of GDP), particularly if one takes into account the rapid increase in debt in the second half of the nineties. Hence, although Croatia meets the macroeconomic criteria for joining the EMU at the moment (with the exception of the budget deficit), the issue is whether the current macroeconomic performance is sustainable over the medium term. This question is addressed in the next chapter.

IDENTIFICATION OF MACROECONOMIC VULNERABILITIES

The experience of some current members of EMU indicates that hopes about a steady fulfilment of the convergence criteria can unexpectedly and suddenly go sour. At the beginning of the nineties, when it seemed that the convergence process was almost complete, the EMS did not survive the burden of speculative attacks. The grounds for the speculation were doubts that arose in financial markets that some members of the EMS would be able to mobilise adequate political support for the implementation of the remaining fiscal adjustment. There were also concerns that exchange rates of some currencies within the EMS were overvalued. The experience of Spain is particularly instructive. At the beginning of the nineties Spain was growing very rapidly, it enjoyed the confidence of international capital markets and attracted large inflows of foreign capital. Convergence seemed within striking distance. However,

wages began to rise rapidly in an environment of expansion, leading to higher inflation and undermining competitiveness of the economy, so that in 1992 Spain was forced to devalue the peseta.

Since Croatia and the other CE countries also face high current account and fiscal deficits, and inflows of capital are creating a more or less constant pressure on exchange rates and monetary policy, the question arises as to whether they too will face a similar fate, irrespective of the high degree of macroeconomic stability already achieved. To answer this question, it is necessary to establish the actual degree of macroeconomic stability and the main points of vulnerability at the macroeconomic level. This paper deals with four questions: the outlook for rapid and sustainable long-term growth, the outlook for low inflation; external vulnerability, and the dynamics of budget deficits and public debt.

Outlook for long-term growth

What are the perspectives for long-term growth in Croatia and the other countries of CE? Apart from the Czech Republic, real GDP in CE economies has expanded on average by 4-5% pa since 1995 (Table 4). Domestic demand – final consumption and gross investment – has in all the countries (with the exception of Hungary) made a greater contribution to GDP growth (1.2 percentage points a year) than net exports. In other words, only in Hungary have net exports been sufficiently large to contribute to the growth of GDP. By contrast, negative contribution of net exports has reduced the growth of GDP in Croatia and Slovakia by an average of 1.5 percentage points a year. This implies that domestic demand has grown too fast, and exports too slow, for the current composition of sources of growth in Croatia and Slovakia to be sustainable over the long term.

This conclusion is supported by an analysis of the sources of saving and investment. During 1995-2001, Croatia achieved an average investment rate of 24% of GDP. Since the rate of domestic saving was less than 18% of GDP, it was necessary to "import" more than 6% of GDP of foreign capital per year in order to close the gap between domestic investment and saving.[xiii] In this period, only Slovakia relied more heavily on foreign borrowing. By contrast, Slovenia financed more than 95% of its investment from domestic saving (Croatia, only 74%).

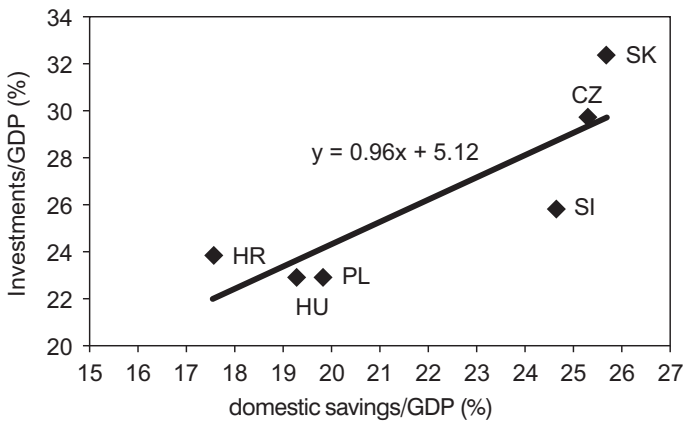
Table 4. Long-term growth, investment and saving in CE, 1995-2001

	Growth of real GDP[1]	Contribution of domestic demand to GDP growth[2]	Contribution of net exports to GDP growth[3]	Potential growth rate[4]	Investment rate	Domestic saving rate	Current account balance
Croatia	4.0	5.5	-1.6	5.0	23.8	17.4	-6.3
Czech R.	2.0	3.2	-1.2	3.5	29.8	25.3	-4.5
Hungary	3.6	2.7	0.9	4.7	22.9	19.2	-3.6
Poland	4.8	5.6	-0.8	4.8	22.9	19.8	-3.1
Slovakia	4.4	5.9	-1.5	5.2	32.5	25.7	-6.8
Slovenia	4.1	5.1	-0.9	5.6	25.9	24.6	-1.2
Average	*3.8*	*4.7*	*-0.9*	*4.8*	*26.3*	*22.0*	*-4.3*

[1] Average annual growth rate, in percent.
[2] Annual average; in percentage points.
[3] Data for Croatia based on Mihaljek (2000); for Slovakia, on Consensus Economics (2002); for other countries, on Huizinga et al. (2002).
[4] Percent of GDP-a, annual average.

Sources: UN Economic Commission for Europe; European Central Bank; IMF; national statistical agencies

Figure 2. Investment and domestic savings, 1995-2001



Source: Domestic statistical agencies; ECB; author's calculations

High current account deficits are not necessarily harmful to economic growth, provided that investment goods rather than consumer items are imported. In the structure of Croatian imports from

1994 to 2000 a relatively high 20% is accounted for by investment goods, and a moderate 29% by consumer goods, while raw materials and intermediate products accounted for 51% of total imports. This is a relatively high amount even if corrected for imports of energy (about 15% of total imports).[xiv] In other words, the main challenge for the long-term sustainability of the current account in Croatia is not excessive personal consumption, but rather insufficient domestic production of various intermediate products for industry and services. The main producers of such goods are usually small and medium-sized firms, often in cooperation with foreign partners.

It follows that the dynamic development of this sector and the acceptance of the principle of specialisation and globalisation in production are necessary to achieve long-term sustainable growth.

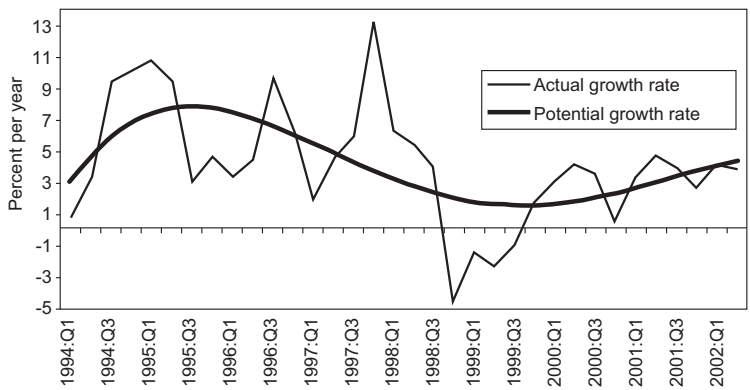
Croatia, on the other hand, stands out in terms of high efficiency of investment. With a rate of investment that is 6% of GDP lower compared to the Czech Republic and 9% lower compared to Slovakia, Croatia had achieved a growth rate of GDP that is twice as high as in the Czech Republic and almost the same as in Slovakia. Together with Poland and Hungary, Croatia has achieved a similar efficiency of investment as the USA in 1993-99, i.e., an average growth rate of 4% with a rate of investment of about 20% of GDP (Andersen, Ho and Mihaljek, 2001). Since investment efficiency in the EU is considerably lower (with a rate of investment of 20% of GDP, the EU realised an average growth rate of only 2.5% pa during 1993-99), there are good prospects that Croatia will speed up its real convergence to the EU compared with the other CE countries if it increases the rate of investment in the mid-term.

The question that arises in this context is how the additional investment could be financed. Further reliance on foreign borrowing is limited by the high level of external indebtedness. It follows that it will be necessary to increase domestic saving. This, in turn, requires the development of domestic financial markets, which are still in their infancy in Croatia. Since the investment and domestic saving rates are highly correlated (Figure 2), the development of domestic financial markets would enable not only faster but also more stable economic growth, given that Croatia would no longer be so dependent on trends in the international capital market, over which, like all small countries, it has no control whatsoever.

What are the prospects for achieving the GDP growth necessary for the convergence of per capita income to the average of the less

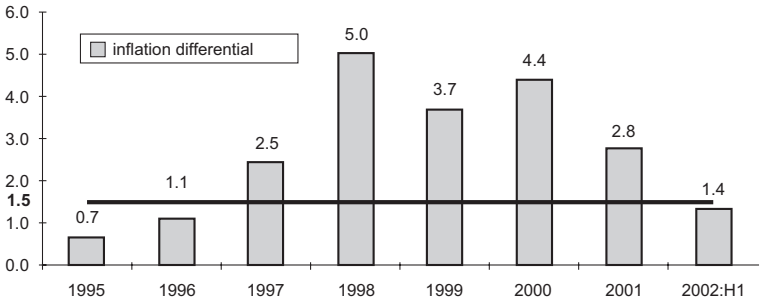
developed EU countries? The answer to this depends on the degree of convergence one wishes to achieve. In an earlier paper by this author it was shown that with an average growth rate of 5.5%, in the next 13 years, Croatia could double its current real per capita income to 10,000, USD and thus reach 50% (instead of 33% at present) of the average per capita income of Greece, Ireland, Portugal and Spain (Mihaljek, 2000). To verify whether this "desirable" growth rate is close to the current estimate of the potential growth rate, we used additional data for the period from the end of 1998 to the first quarter of 2002 (Figure 3). This test is important for the credibility of the previous estimates because in 1999 Croatia went through a recession, while in a revision of GDP data published in September 2002 earlier growth estimates for 1999-2001 were reduced. The results show that even with the recession of 1999 and downward revisions of GDP growth rates, the potential growth rate from 1994 to mid-2002 came to almost 5%.[xv] Similar potential growth rates were established for other CE countries as well (Table 4), and they range from 3.5% for the Czech Republic to 5-6% for Slovenia. Together with Slovakia and Slovenia, Croatia is thus in the group of the economies with the highest potential for long-term growth in CE.

Figure 3. Potential growth rate of the Croatian economy, 1994-2002.



Source: DZS; author's calculations

Figure 4. Difference in inflation rates Croatia vs. average of the three countries with lowest inflation in the euro area (percentages)



Source: ECB, HNB.

Outlook for inflation

Recent academic and policy discussions have challenged the rationale for the Maastricht criterion of inflation for the transition economies. Doubts about this criterion derive from the observation that less developed countries have a considerably higher growth rate of productivity in the process of catching up with the developed economies. Faster productivity growth, especially in the advanced sectors exposed to international competition ("tradables"), enables a rapid rise in wages and, since labour is mobile, wages will also rise in protected sectors (or "non-tradables", such as personal services, construction, domestic transport). In order to retain profitability, the less productive sectors are forced to increase the prices of their products, which results in a higher inflation than in the developed countries (assuming that the prices of advanced products are determined on the world market). In such conditions, if inflation resulting from the rapid productivity growth was relatively high, transition economies would be forced to increase interest rates and hence temporarily slow down economic growth in order to achieve the Maastricht criterion on inflation.

In empirical research it has been shown that the so-called differential productivity (difference between productivity in advanced and in protected sectors) has indeed risen very rapidly. In Croatia, differential productivity growth has averaged almost 4% per year (in comparison

with 1.8% in the Eurozone), and in Slovenia and the Czech Republic even higher (Mihaljek, 2002). However, most recent research has also shown that faster productivity growth can explain at most about 30% of the differences in the rates of inflation between the transition economies and the euro area (ibid., p. 17). Accordingly, if the CE countries have problems meeting the inflation criterion, the reason will probably be poor economic policy and not the operation of the Balassa-Samuelson effect.

Croatia for the time being meets the inflation criterion relatively comfortably in comparison with other CE countries; this criterion was fulfilled in the first half of 2002 and in 1995-1996 (Figure 4). However, it should not be forgotten that Croatia still has to cope with considerable adjustments of the relative prices in the protected sectors (energy, real estate, health care, education). Price increases in these sectors will probably raise inflation over the medium term. Therefore, there are strong reasons for monetary policy to remain prudent with regard to inflation.

External stability

According to standard external vulnerability indicators, the degree of external stability in Croatia is similar to that of other CE countries (Table 5). Croatia has certain advantages in the following indicators:

- *Exchange rate stability*. The real effective exchange rate of the kuna increased by less than 4% between 1995 and 2001, compared with a 25% increase for the Czech koruna and the Hungarian forint, almost 50% increase for the Polish zloty, and 20% increase for the Slovak koruna. Only the Slovenian tolar has depreciated in real effective terms (and then only slightly) in the last five years.
- *Improving exports and current account.* Contrary to the widespread beliefs, Croatian exports of goods and services have been rising relatively fast in the last few years: by almost 9% pa in dollar terms during 2000-2001, and about 3% in the first five months of 2002 due to the slowdown in the world economy. The current account balance has improved considerably, with the deficit of about 3% of GDP in 2001 being much lower than in the Czech Republic, Poland and Slovakia (5-6% of GDP).

Table 5. Indicators of external vulnerability

	Croatia		Czech R.		Hungary		Poland		Slovakia		Slovenia	
	1999	2001	1999	2001	1999	2001	1999	2001	1999	2001	1999	2001
Real effective exchange rate (1995=100)[1]	100.9	103.8	116.2	125.3	111.7	124.4	116.2	148.0	106.4	119.1	100.0	97.7
Exports of goods and services (%)[2,3]	-0.5	8.8	6.5	10.3	14.6	11.1	-1.0	-6.5	2.3	11.0	0.5	3.6
Imports of goods and sevices(%)[2,3]	-7.3	4.5	2.1	11.2	15.0	10.3	3.3	-4.0	-1.7	12.9	3.8	0.0
Current account deficit (% GDP-a)[3]	-6.9	-3.1	-2.4	-5.0	-4.6	-2.5	-5.9	-5.2	-7.1	-6.1	-2.4	-1.9
Foreign direct investement (% GDP-a)[3]	5.6	6.2	8.7	9.2	3.0	4.1	3.7	4.5	0.7	4.6	1.2	1.4
Net official reserves (billion USD)	2.8	4.5	12.8	13.9	10.8	10.7	26.4	25.7	3.4	4.2	2.5	3.5
Net official reserves (months of imports)	3.4	5.1	4.2	3.8	4.2	3.4	5.8	5.1	3.1	3.0	3.3	4.6
Total external debt (billion USD)	8.9	10.5	22.6	21.7	29.1	32.9	65.4	69.7	10.5	11.4	5.4	6.7
Total external debt (% GDP-a)	49.3	55.9	43.2	36.5	64.5	65.1	42.2	40.2	52.1	55.8	26.9	36.1
External debt service (% exports)[4]	22.4	19.6	12.7	8.6	15.9	14.7	11.8	20.9	15.4	14.6	8.0	14.7
Short term external debt (%reserves)[5]	83.5	60.4	66.4	63.4	38.0	51.8	41.1	35.6	79.0	71.7	3.7	2.9
Interest rate spread on government bonds[6]	407	187	128	97	123	119	101	164	36	113	71	43
Government bond rating[7]	Baa3	Baa3	Baa1	Baa1	Baa1	A3	Baa1	Baa1	Ba1	Baa3	A3	A2

[1] Based on CPI (for Croatia, retail prices); annual average. Increase denotes appreciation.
[2] Annual average growth of exports and imports in US dollar terms.
[3] Average for 1998–99 and 2000–01, respectively.
[4] Principal and interest payments on total external debt, in percent of exports of goods and non-factor services.
[5] Principal and interest payments on short-term (less than one year) external debt, in percent of gross usable reserves.
[6] Between dollar-denominated bonds and corresponding US Treasury bonds, in percentage points, end of period.
[7] Based on Moody's ratings of long-term foreign currency denominated government bonds.

Sources: BIS; UN Economic Commission for Europe; ECB; Institute of International Finance; IMF; central banks; national statistical agencies; Moody's Investment Service; author's calculations

- *Relatively large inflows of foreign direct investment (FID)*. As in other CE countries, the current account deficit in Croatia has been easily covered by FDI inflows. Moreover, FDI has increased in Croatia in recent years to 6.2% of GDP, larger amounts having been drawn in only by the Czech Republic (9.2% of GDP).
- *High official reserves*. At the end of 2001, disposable foreign currency reserves of the CNB covered more than five months of imports of goods and services, the same as in Poland. In 2002, the import coverage rose to 6.7 months, the highest in the region. High foreign currency reserves along with low inflation, a sound growth in exports and further foreign direct investment provide solid insurance for continued exchange rate stability.

However, foreign indebtedness and credit rating indicators are less favourable than those of the other CE countries, with the exception of Slovakia.

- *Total foreign debt as percentage of GDP* is the second highest in the region and came to 56% of GDP at the end of 2001; only Hungary was more indebted (65% of GDP). A particular concern is the tendency for the external debt to increase rapidly, by 7% of GDP during 1999 and 2001. The external debt increased at a faster pace only in Slovenia in this period (i.e., by 9% of GDP); however, this increase occurred from a much lower level of total debt (36% of GDP). The structure of foreign debt in terms of domestic sectors is relatively even. The public sector is the biggest debtor (43% of total foreign debt); followed by the non-financial sector (27%) and domestic commercial banks (19%); while 10% of the foreign debt derives from direct investment. This debt structure leaves some room for the reduction of the total level of indebtedness in the medium term without any negative consequences to economic growth. For example, while lower public debt is necessary for the sake of attaining fiscal sustainability and the reinforcement of external stability, the private sector debt and indebtedness deriving from foreign direct investment can be increased without any threat to macroeconomic and external stability.
- *Capacity to repay the foreign debt* is lower than in the other CE countries except in Poland, as 20% of export income has to be used for principal and interest payments, as against 15% in Hungary, Slovakia and Slovenia, and less than 9% in the Czech Republic.

- *The coverage of short-term foreign debt by foreign currency reserves* is relatively low: foreign debt falling due within one year would absorb 60% of disposable international reserves of the CNB if the public and the private sector were to become insolvent. This indicator is even more unfavourable in the Czech Republic and Slovakia (75-80% of reserves) and reveals potential problems with the servicing of short-term debt in the event of a sudden depreciation of the domestic currency. The Czech Republic and Slovakia, however, have greater capacities to service the foreign debt.
- Although in the last few years the *spread on Croatian government bonds* has been reduced, it is still considerably above the average for the region: about 190 basis points (1.9 percentage points) in compared to only 40 basis points in Slovenia and 100-120 points in the Czech Republic, Hungary and Slovakia. This shows that foreign investors continue to have certain reservations about the credibility of the overall economic policy of the Croatian government. Along with Slovakia, the credit rating of the government debt of Croatia is the lowest in the region, and lies at the border between speculative and mature forms of investment. By contrast, the government bonds of Slovenia and Hungary are considered investment grade, entailing a risk similar to that of the bonds of most of the countries of the EU.[xvi] A further negative factor is that the credit rating of Croatia has not improved since it was first quoted in January 1997, while the ratings of Hungary and Slovenia have improved since 1999.

What are the implications of these vulnerabilities for the sustainability of external equilibrium in the medium term? The needs for the external financing of the private and public sector in Croatia in 2002-2004 are estimated at about 3 billion USD pa (IMF, 2002a; 25). It is anticipated that about 60% of new debt will be covered by the issue of bonds and contracting of medium and long-term loans (for which the interest on the government bonds serves as a reference). With the current rate of interest of 4.6% on a ten-year German government bond and an interest spread of 190 points for Croatian government bonds, about 97 million USD would have to be spent each year on servicing the new borrowings projected for 2002–04. If the interest spread increased by one percent (100 points), because of the perception of increased risk of investing in Croatia, servicing would cost another 15 million USD pa. This amount, of course, would not threaten Croatia's external stability, but it is not insignificant for public finances: 15 million USD amounts to almost 10% of the annual budgetary resources spent on science and technology.

During a crisis, the bond spread would probably not increase by a hundred but by several hundred basis points. At the time of the Russian crisis in 1998, for instance, the spread on the bonds of the Republic of Croatia jumped in less than two months from 200 to 930 basis points. Under such circumstances, new borrowing is impossible regardless of the interest rate, because international investors seek liquidity and are not at all prepared to invest in risky securities. New issues markets can dry up completely for several months, with serious consequences for the highly indebted emerging economies. Developments since the Turkish and Argentine crises of 2001-2002 indicate that investors in the meantime have started to distinguish better those economies that are good risks from those that are bad, so that extreme cases of contagion on the financial markets (like the Asian and Russian crises of 1997-1998) are generally no longer expected (see BIS, 2002). For Croatia this is good news because currently it has found favour with foreign investors. But at the same time one should bear in mind that, given the greater ability of investors to distinguish among emerging economies, any threats to macroeconomic stability would be costly for the Croatian economy and would have long-term negative consequences for economic development.

The budget deficit and the public debt

Apart from Croatia, the CE countries were closer to having a budget deficit of 3% of GDP in 1999 than in 2001 (Table 3). The chances for 2002 and the years to come are even less favourable. A moderate revival of the world economy is expected only later in 2003. On the other hand, the needs of the public sector in central European economies are very large in the medium term because of the necessary adjustments in the health care, education, pensions system, infrastructure, agriculture and environmental protection sectors. All this will create a pressure on the budgets of central governments and local units in both Croatia and the other CE countries. The Czech Republic is expected, for instance, to record a budget deficit in the region of 6-7% of GDP in 2002, and Hungary of 7-8%.

Some public finance experts have argued that reducing the budget deficit is essentially a matter of political will, and have referred to the experience of Italy, which has managed to reduce its long-standing deficits of 9-10% of GDP to less than 3% since 1997 (Gros, 2001).

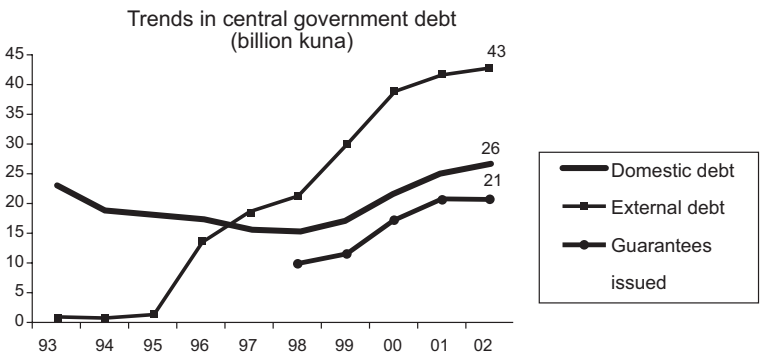
The case of Italy is, however, rather specific. Extensive development of a welfare state and economic subsidies can be reduced in the short term without negative consequences for growth, but not the expenditures for structural reforms necessary for long-term sustainable growth in the transition economies. The European Commission has therefore argued that in the period before joining the EU it would be wrong to aim fiscal policy at the attainment of the Maastricht criterion for budget deficit while neglecting structural reforms and the implementation of the acquis (European Commission, 2001e; 126). The financial markets, on the other hand, look upon large deficits with suspicion, irrespective of the possible justification of temporarily higher deficits in the transition economies. As a result, there is considerable market pressure to reduce high deficits. Croatia and many other CE countries will thus have to choose between alternatives that are politically equally unattractive: a significant fiscal adjustment in the short term (e.g., reducing the deficit by 3–4% of GDP in two years), or more moderate but disciplined adjustment spread out over several years (e.g., reduction of the budget deficit by 1% of GDP during 3–4 consecutive years), which in practice can mean during the term of office of several different governments. In both cases the key question will be whether the reduction of the deficit is sustainable over the long term.

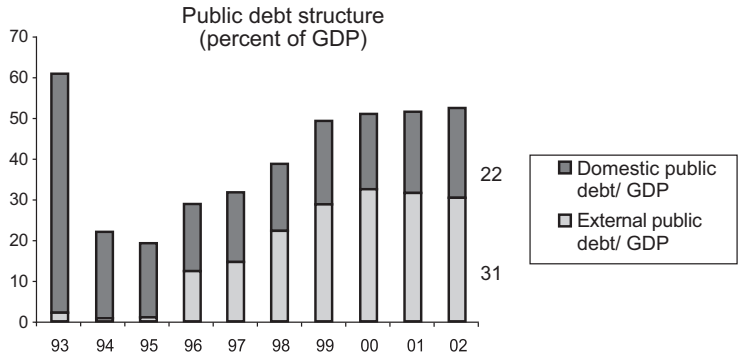
In Croatia, retaining public debt below 60% of GDP could also require considerable efforts. Since the signing of the agreements with the London and Paris Clubs in 1997, which allowed the settlement of the liabilities of the inherited foreign debt, the public debt, and particularly its foreign component, has been growing very rapidly (Figure 5, left panel). Between 1999 and 2001, the amount of guarantees issued also rose considerably. Debt servicing absorbed about 2% of GDP in recent years. The proportions of foreign and internal debt stabilised in 2001 at the level of 31% and 22% of GDP, respectively (Figure 5, right panel). In an analysis of the dynamics of public debt in Croatia, the IMF noted that the continuation of the current trends of borrowing is unsustainable over the long term, and hence that it is unavoidable to continue with recently initiated fiscal adjustment (IMF, 2002c). A similar conclusion has been reached in a recent CNB analysis (Kraft and Stučka, 2002). The IMF estimates that in order for the public debt to stabilise at 53% of GDP, it is necessary to reduce the budget deficit to 3.8% of GDP by 2005 at the latest, while maintaining real growth of 3.8% pa and average interest rate of 5%. And in order for the level of the debt to be reduced long-term to less than 50% of GDP, the budget

deficit should be cut to 3.3% of GDP by 2004, and to 2.6% by 2009. This calculation, however, assumes an acceleration of the rate of growth from 4.5% in 2003 to as much as 7% in 2006-2010, which is unrealistic when compared with the estimated potential growth rate of at most 5-6%.

What are the dangers, from a macroeconomic perspective, of too great a reliance on foreign borrowing? Currently the conditions for borrowing are favourable. On the international capital market, interest rates are low; Croatia and other countries in the region have a very low interest spread; and there is investor demand for their government bonds. This, naturally, encourages the public sector to borrow. But one should take into account the fact that the conditions for financing can quickly change. High indebtedness increases the sensitivity of the external sector and the national budget to exchange rate and international interest rate changes, over which the monetary authorities have little (the exchange rate) or no influence (the interest rates). Numerous unfavourable constellations of these parameters are possible: pressure on the exchange rate to depreciate would increase the domestic currency equivalent of interest and principal payments due, and hence the budget deficit. The government would then have to increase taxes or domestic interest rates in order to bring in extra revenue, or else issue new domestic bonds, which would slow the economy. Weaker outlook for growth would in turn increase the risk of investment in Croatia, and foreign investors would then seek higher interest on any new international issues of government bonds. Real shocks such as a slowdown in the growth of the world economy and negative trends in international capital markets would further complicate such negative dynamics.[xvii]

Figure 5. Central government debt, 1993-2002





Source: HNB

Excessive reliance on external debt also has an unfavourable effect on the development of domestic financial markets. The ratio of foreign and internal debt is currently unfavourable: 62% is accounted for by foreign and 38% by domestic public debt. Since the start of the pension reforms, there is no reason for this ratio not to be improved. According to regulations, the pensions funds must invest the major part (50%) of the contributions collected in government bonds. Against this background, it is not clear why the recent 500 million euro bond issue to cover the transitional costs of pensions reform should have been in euros instead of in kuna (see Babić, 2002). By issuing its bonds in a foreign currency, the fiscal authorities took on an unnecessary currency risk, increased total foreign indebtedness and implicitly signalled to the financial markets that not even the government has sufficient confidence in the kuna to issue long-term kuna-denominated bonds. This might affect in particular the private sector, given the interest in and the potential for issuing corporate bonds in kuna.

CONCLUSION

The Croatian public has been faced for some time with rather different views of the complex and long-lasting process of convergence between Croatia and European economic integrations. In some circles, a marked pessimism can be felt, with occasional knee-jerk statements about the incompetence of the Croatian economy, the public adminis-

tration and the society as a whole to be able to meet the conditions for membership in the EU and the EMU in the next ten to fifteen years. In other circles, unrealistic expectations about fast-track approach to the EU are being stirred up, if only we could make this or that political move to convince Brussels that we should at long last be accepted "where we really belong". The adoption of such opposing viewpoints avoids a thorough analysis of conditions for membership in the EU and EMU, and the conditions are interpreted quite simply as being very rigid or only cosmetic. Another common feature of many evaluations is superficiality in the analysis of the starting position of Croatia as against the other applicant countries. For this reason one of the basic goals of this paper was to analyse more thoroughly the economic significance of the criteria for membership in the EU and EMU and objectively to compare the initial positions of Croatia and the other CE countries. For this reason great attention has been paid to the international comparability of the statistical data and the preciseness of the economic argumentation. What are the basic conclusions of this analysis?

The rationale for the provisions concerning regional co-operation – the main additional (as compared with the other CE countries) condition for Croatian membership in the EU – is to induce the states in SEE to put their relationships on the same footing and to found these relations on the same principles as those on which inter-state relations are arranged within the EU. In spite of important advances (particularly bilateral free trade agreements), Croatia still needs to show that it is fulfilling all the provisions on regional cooperation.

The purpose of meeting the Copenhagen criteria is to create the conditions for normal functioning of market economy and public administration in CE countries before they join the EU. A certain flexibility has been built into these conditions. At the moment, Croatia does not lag significantly behind the CE average when it comes to institutional development and can be compared with Slovakia. In trade foreign exchange and banking systems, Croatia has converged considerably to the EU standards. In the non-bank financial system, competition policy, the legal system and in corporate governance, the implementation of reforms in Croatia is about four years behind the central European average. These transitional weaknesses of Croatia are closely related to the low share of private sector in GDP (about 60%).

The purpose of fulfilling the Maastricht criteria is to create stable macroeconomic conditions for the adoption of common currency and participation in European Monetary Union as a higher degree of eco-

nomic integration than that of the common market. Although they have to meet more stringent criteria for joining the EMU than Greece, Ireland, Portugal and Spain did in the mid-nineties, the CE countries are now relatively close to meeting these conditions. Croatia meets the criteria for inflation, long-term interest rate and exchange rate stability. However, there is considerable overshooting of the budget deficit, which has to be reduced by 3.5% of GDP in order to reach the Maastricht norm of 3%. The high level of public debt (52% of GDP) and its tendency to rise rapidly are an additional reason for fiscal adjustment.

The purpose of the whole process of convergence is to achieve a gradual approximation of the level of per capita income of the countries in the region to the average of the less developed members of the EU. Real convergence can be attained only with high rates of growth are sustained in the long term, i.e., if they are accompanied by macroeconomic stability and institutional effectiveness. In other words, meeting the criteria for joining the EU and the EMU is a necessary but not sufficient condition for successful long-term economic development. It is particularly important to bear in mind that hopes about sustained convergence can suddenly and unexpectedly turn sour. For this reason, the paper pays additional attention to the prospects for rapid and stable growth and low inflation, the sustainability of external positions and the problem of fiscal adjustment.

The outlook for the long-term growth of Croatia and CE is favourable: the potential growth rates in most of the countries are about 5% a year and there is plenty of room to speed up real convergence because, apart from the Polish, all the CE economies have in the last 7 to 8 years grown more slowly than their long-term potential. Croatia is in the group of economies with a high growth potential and has in additional achieved relatively high efficiency of investment. In this context, Croatia needs to increase domestic saving rate. This will require greater efforts in the development of the securities market and reducing the dependence of the economy on the imports of intermediate industrial products, which in turn requires the development of SMEs on the principle of specialisation and their linkage with foreign partners.

In the CE countries and in Croatia in particular inflation has been reduced to a very low level thanks to a firm monetary policy, cautious fiscal policy and liberalisation of foreign trade and foreign investment. In the next few years, however, Croatia still has to address considerable adjustment of the relative prices of energy, rents, services, health care and education. For this reason monetary policy in the medi-

um term too will have to carefully monitor inflationary expectations and react quickly to inflationary pressures.

Real exchange rate developments, current account, foreign direct investments and some other external sector indicators have in recent years been more favourable than is usually suggested in discussions of the international competitiveness of the Croatian economy. By contrast, some financial indicators that are often given as Croatian strong points – the credit rating and the interest spread on government bonds – are less propitious than in the CE countries. Together with a high level of foreign debt (52% of GDP, of which almost half is the public sector debt), these vulnerabilities reduce the resistance of the external sector to pressures emanating from the international capital markets. Therefore, strengthening macroeconomic stability remains a priority from an external perspective, too.

A still greater challenge for macroeconomic policy and the public sector in general will be found in the reduction of the budget deficit and the stabilisation of public debt. Achieving these objectives will require a much political will and perseverance.

There are, of course, other limitations that have not been discussed separately in this paper but could slow the Croatian economy in its achievement of nominal and real convergence. This relates primarily to the high rate of unemployment, the further deregulation and liberalisation of the economy in line with EU legislation, and reforms of the labour market and the civil service. If there is one consistent lesson to be learned from the experience of countries that have passed through the process of convergence with the EU – and indeed from the entire historical experience of the industrial countries – it is the necessity of persevering in the implementation of reforms and in the cautious handling of macroeconomic policy.

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[i] *Hungary, for example, signed a Europe Agreement in December 1991 and submitted an application for membership in March 1994. In July 1997 the European Commission recommended the European Council to start accession negotiations with Hungary (European Commission, 1997). The talks started in March 1998 and ended in October 2002.*

[ii] *Croatia can export all industrial goods to the EU, all processed agricultural products and, with certain exceptions, all agricultural products without payment of customs duties and without quantity restrictions. From 1 January 2002 Croatia liberalised the import of about 77% of industrial products from the EU; complete import liberalisation is to follow by the end of 2007. Croatia also bound itself to liberalise 75% of the import of agricultural goods by 2006, and to fully liberalise the import of agricultural products, fish and fish products, by the end of 2007.*

[iii] *The last paragraph of the Agreement says: Recalling the European Union's readiness to integrate to the fullest possible extent the Republic of Croatia into the political and economic mainstream of Europe and its status as a potential candidate for EU membership on the basis of the Treaty on European Union and fulfilment of the criteria defined by the European Council in June 1993, subject to successful implementation of this Agreement, notably regarding regional cooperation, the EU and Croatia have agreed as follows.*

[iv] *For various interpretations of the evolutionary clause, see the Ministry of European Integration (www.mei.hr) and Bartlett (2002). Of particular interest is this quote from the report of the European Integration Minister to the Croatian Parliament in 2001: "although there is no provision in our Agreement like that contained in the Europe Agreements, expressing the statement of the EU that it accepts the fact that integration into the EU is the priority political objective of the countries that were signing the Europe Agreements and that the EU is ready to help them to achieve this objective, this does not in any way depict the Croatian route into Europe in a negative light. In debates about this matter (in which Croatia asked to have the said provisions incorporated into the SAA, without the proposal being accepted) it became clearer that the EU today, in the changed circumstances after the calming of the historical enthusiasm with which it wished to embrace the transitional countries after the fall of the Berlin Wall and communism in Europe, is less ready to open up great expectations at the drop of a hat and stir up the expectations of potential new applicants, until they themselves show their ability to carry out the obligations that lead them towards accomplishment of the standards and criteria of the EU. And the Union did not adopt this more reserved stance because of Croatia or against Croatia, but simply out of caution and the difficulties with which it sees and experiences the current greatest wave of enlargement" (Minister for European Integration, 2002).*

[v] *CARDS – Community Assistance for Reconstruction, Development and Stabilisation) is the main programme of financial and technical assistance from the EU to the countries of SEE.*

[vi] *At the end of 2001, the public debt of Austria amounted to 62% of GDP, that of Belgium to 108%, Greece 100%, Italy 109% and the Netherlands 53%.*

[vii] *The relatively high per capita income of Greece in 1981 largely reflected the overvalued exchange rate of the drachma; after devaluation in 1982, the Greek per capita income fell from 63% to 40% of the EU average.*

[viii] *These data include downward revisions of GDP growth in Croatia for the 1999-2001 period, published at the end of September 2002.*

[ix] *Lower employment was not the main reason for the rapid growth in productivity; because of the relatively high rate of growth of GDP, productivity would have increased rapidly (at a rate of 3.6% pa) even assuming a rate of unemployment similar to the CE country average (i.e., about 0.4% pa).*

[x] *Unemployment figures are based on ILO methodology, i.e., household labour force surveys.*

[xi] *For the greater statistical representativeness of the sample, apart from the countries in Table 2 (Croatia, HR; Czech Republic, CZ; Hungary, HU; Poland, PL; Slovakia, SK and Slovenia, SI), this calculation also includes the Baltic countries (Estonia, EE; Latvia, LV; Lithuania, LT), Bulgaria (BG), Romania (RO), Russia (Russia) and the Ukraine (UA).*

[xii] *Data in Table 3 refer to the general government deficit calculated on accruals basis. The Croatian public is more familiar with the narrow definition of budget deficit, i.e., the*

deficit of the central government. In 1999, the central government deficit amounted to 7.4% of GDP, in 2000 it was reduced to 5.7%, in 2001 to 5.4%,and in 2002 it is projected at 4.3% of GDP.

[xiii] *In the system of national accounts, Y = C + G + I + X – M, where Y is gross domestic product, C private consumption, G government spending, I gross investment, X imports and M exports. Domestic saving, S, is expressed as S = Y – C – G. According to the definition, S – I = X – M, i.e., the shortfall in domestic saving is equivalent to the deficit in the balance of payments.*

[xiv] *See Statistical Yearbook of the Republic of Croatia, 2001, Table 21-5, p. 327.*

[xv] *To be more precise, potential growth rate was 8% in 1995, about 2% in the recession of 1999, and 4.5% in the first half of 2002. Potential growth rate changes depending on the growth of total factor productivity, production capacity and employment. The statistical method employed in Figure 3 (the Hodrick-Prescott filter) captures these factors indirectly. The 1991-1993 period is not relevant for analysis because the transition economies were in the so-called "great transformational recession" at the time, which was exacerbated in Croatia by the Homeland War.*

[xvi] *These ratings were established by the agencies Moody's, Standard and Poor's, and Fitch. Some smaller ratings agencies specialising in emerging markets have rated Croatian government bonds at the lowest level of investment grade.*

[xvii] *The difficulties Brazil is currently grappling with are a vivid illustration of these problems. In the expectation of presidential elections in October 2002, fears appeared on the financial markets already in April 2002 that if the opposition won, the new administration would give up the goal of the present government to stabilise the share of public debt in GDP. These fears were sufficient to set off a negative debt dynamics even though the government had made no policy mistakes and the real fundamentals of Brazil have been sound. Brazil's public debt amounts to 55% of GDP, and is mostly issued on the domestic market, but indexed to the exchange rate or domestic short-term interest rates.*

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