

GLOBAL CRISIS AND NATIONAL RESPONSES CASE OF CROATIA

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Abstract

In terms of its effects so far the global economic crisis is stronger and deeper than the economic disturbances at the time of the Great Depression. Additionally, it takes place under the conditions of a much higher level of connection and complexity of interrelations compared to the events in the period from 1929 to 1933. It started as a segmented phenomenon in two aspects: in one country – the USA and in one sector – financial industry. However, in less than a year it became global in terms of territorial coverage and universal in terms of its effects, which means that it entered the area of real economy. It has had a significant impact on the decrease of growth and employment rate and the decrease of production and exports.

However, even though this open crisis has become an evidently *global* phenomenon, it is also clear that, with all the discussions on the future global configuration of control and early detection of signals of economic disturbances, today and now every state is seeking, identifying and taking specific measures in the sphere of its national economic policy. This task lies ahead of the Republic of Croatia under the conditions that include an additional challenge: structural imbalances which, for various social and economic reasons, have been transferred from one term to the next term of office of the next legislative and executive branch of power, ever since mid-90s of the last century.

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I. INTRODUCTION

Regardless of the geographic position, current level of development or the level of attained and generally accepted democratic standards, every country is focused on the issue of economic growth and sustainable development.

The sudden onset of the financial crisis pushed, virtually *over night*, the issue of the overheated boom and consequently the issue of high and continuously growing inflation rates out of the agenda of the open issues of governments in Europe, Northern America or the Far East. All of these issues were replaced first by awareness and then by concern and responsibility of tackling the fact that extended economic crisis grew into the crisis of the real sector. This has

brought quite specific effects, first with regard to consumer confidence and their buying decisions, and then, consequently, the crisis moved to increasingly broad business sector segments. The utilization of production capacities, sustainability of the employment level, liquidity and deepened effects (multiplier) have also led to both some new views and new solution proposals in terms of the doctrine.

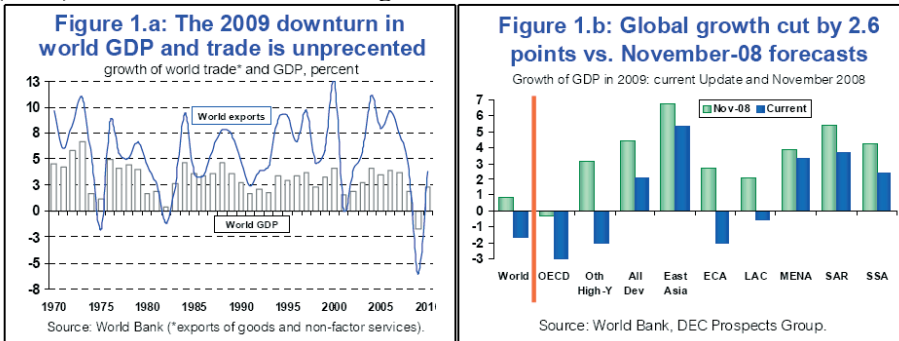
The role of government, state interventionism and protectionism of this or that type, ranging to interventions in the ownership structure in the financial and real sector have, again literally *over night*, become models of behaviour which seemed unthinkable and unfeasible even yesterday. However, this is a new reality which has become only a threshold for deliberating new measures and activities, depending on the overall developments, in particular when it comes to the interaction between the largest and most developed states that are gathered at this moment in the Group of Twenty. How to position itself under such circumstances is the question regarding the Republic of Croatia, with its economy in the process of transition undergoing intense structural changes and adjustments on its road to the EU accession, that all important players at the national scene are occupied with: starting from *decision makers* at the political scene, in the business sector and trade unions, to *opinion makers* and, ultimately, to every thinking citizen.

How to find a solution at the relation between transition – globalisation – EU adjustments – economic crisis, is a challenge requiring solutions to be found in times and under circumstances that increasingly reaffirm the syntagm – think globally, act locally. How to act externally and internally, how to find the right answers and identify the right actions, is the basic common responsibility for the executive branch of power and the economic science.

II. GLOBAL AND THE EU HORIZON

The economic growth forecasts for 2009 are subject to continuing review. The current assessment is included in the below stated values:

Charts 1 and 2. World GDP and trade growth rates – projected values (2009) and corrections with regard to the forecasts from November 2008.

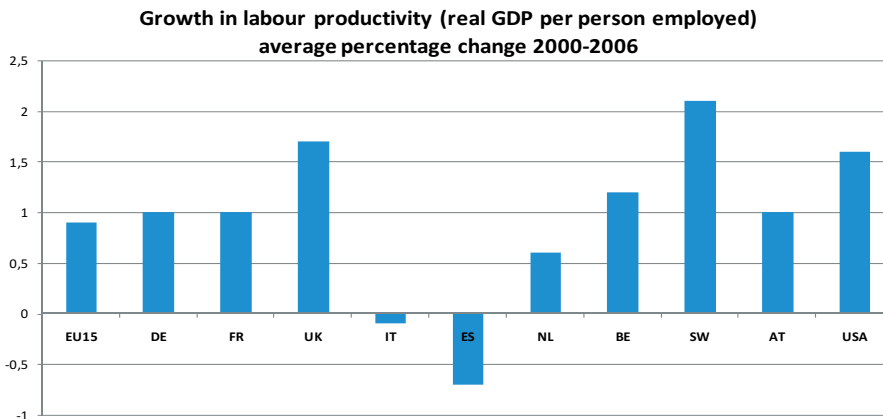


Source: World Bank: Global Economic Prospects 2009 – Forecast Update. March 30, 2009. p. 1 <http://siteresources.worldbank.org/INTGEP2009/Resources/5530448-1238466339289/GEP-Update-March30.pdf>

It is evident that, since the crisis originated in the USA, the financial sector downturn can and must first be stopped there, and then the same processes of stabilisation at first and then establishment of trust and the start of economic activities may be established in other parts of the world as well.

The position of the European Union was defined in 2000 as „... the most competitive and dynamic knowledge-based economy in the world, capable of sustainable economic growth with more better jobs and greater social cohesion“. Successful implementation, including ups and downs, of such indicative and strategic position has started, and the results achieved in the area that describes the results achieved in the aggregate – growth in labour productivity – demonstrate that.

Chart 3. Growth in Labour productivity (real GDP per person employed) - average percentage change 2000 – 2006



Source: European Growth and Jobs Monitor, Allianz Dresdner Economic Research, The Lisbon Council, Frankfurt, 2009, str. 13

The results that are above the average have been achieved in Sweden and Great Britain; it should be noted that the EU-15 growth in the aggregate was substantially below the growth achieved in the USA in the same period of time; Italy and Spain considerably lag behind, and the results in the Netherlands are (unexpectedly) modest.

A more detailed analysis would show that the main reason for this lagging behind is to be found in the low productivity growth in services, which accounts for more than two thirds of the overall economic activity in this area. This segment, along with the (new) challenges on the EU scene (energy, environment, logistics...) constitutes one of the major strategic goals and lines of action for the term of office of the new European Commission (starting from the second half of 2009).

III. CROATIAN REALITY AND LINES OF ACTION

The Republic of Croatia has encountered the financial crisis under circumstances of cautious monetary policy and, consequently, of stable national banking system. The regulatory body and the commercial banking monitoring system received domestic and international awards for such policy. The state guarantee for deposits of citizens amounting up to HRK 400,000 (introduced in autumn 2008) ensured the stability of citizen deposits and, accordingly, it ensured a balance between deposits and placements of funds within the national financial system and framework.

It is a much more complex task to deal with structural challenges that have been present for more than a decade and may be summed up in the estimates for the fiscal years 2009-2012 (*according to: World Bank, Country Partnership Strategy for the Republic of Croatia for the Period FY09-FY12, <http://www.mfin.hr/adminmax/docs/hrva.%20verz.pdf>*).

1. *Croatia's large public sector poses one of the main challenges to sustained growth.*

Public expenditure accounts for nearly half of the GDP, some nine percentage points above the average for EU10, reducing the fiscal space to finance EU accession requirements. Further fiscal consolidation is required due to Croatia's relatively high tax burden: taxes-to-GDP ratio is above 40 percent, which puts it on

par with the EU15, but approximately 8 percentage points above the EU10.

2. *Prudent fiscal policies can help ease Croatia's large current account deficit and external debt.*

In the long term fiscal reforms aimed at reducing public expenditures will be critical to containing Croatia's vulnerability. Enhancing the efficiency of public expenditure management, in particular moving from input budgeting towards performance-based budgeting, could help the fiscal consolidation process.

3. *Rationalization of public expenditure will require serious efforts to reform Croatia's health sector, social systems and state aid policies.*

The main challenge in the medium term will be to maintain and improve health outcomes while achieving a steady level of public spending under a sound fiscal policy framework. Similar issues face Croatia's social benefits system, which offers more than one hundred programs and is hindered by weak targeting efficiency, a complicated and costly administration, and disincentives for labour market participation — all of which have contributed to poverty and inequality in the country.

4. *Given the Croatian economy's high degree of euroization, its financial sector remains vulnerable to interest and exchange rate risks.*

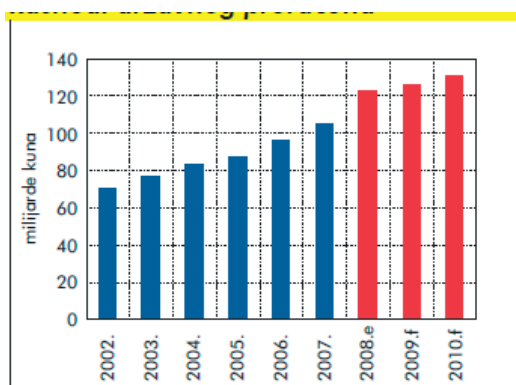
Exposure to interest or exchange rate fluctuations could raise the cost of domestic lending, and in turn, constrain private debtors' ability to service their loans. With loans to firms and households denominated in or indexed to foreign currency and largely unhedged, credit risk stemming from foreign currency exposes Croatia's banking system to external financial shocks.

5. *While macroeconomic sustainability is needed for growth, faster growth leading to higher future fiscal revenues is in turn needed for macroeconomic sustainability.*

Hence, strengthening the microeconomic foundations of growth is of critical importance. There are "sources" of additional growth that key players of overall growth in Croatia could and must seek in factors such as: (a) increase labour participation by addressing the disincentives for workers' participation in the labour market while reducing restrictions to facilitate the adjustment of the labour force to the business cycle; contain the cost of labour and address skills mismatches through vocational education and training, and life-long learning; b) enhance total factor productivity by continuing enterprise restructuring, further reforming product market regulation, improving the corporate governance regime, streamlining bankruptcy conditions, and reducing the administrative obstacles to business; (c) deepen trade integration by promoting export-oriented FDI and developing the supply of exportable goods with expansion of trade related services (standards and quality, knowledge of foreign markets) and the reduction of logistics costs; and (d) foster technological progress by expanding private R&D, improving conditions for the collaboration between universities and industry, and enabling the start up of science-based companies.

The above stated factors in Croatia require immediate and systematically conducted and organized structural reforms. Each of the above stated points indicates that it is inevitable to change the status that, by inertia, has continued for more than a decade and a half, after the intervention Anti-Inflation Programme. Because the main goal of that document and the programme was a short-term goal: to stop hyperinflationary trends (in the first year) and then continuously open the way for the balanced economic growth. From a synthetic point of view, adjustment of public expenditure to real possibilities of the fiscal capacity of the national economy is essential and absolutely necessary, which is clearly confirmed by the data on the growth of the state budget expenditure in the previous period of time in the aggregate substantially above the achieved real GDP growth.

Chart 4. Government Budget Expenditures



Izvor: MF, Raiffeisen istraživanja

Source: Ministry of Finance of the Republic of Croatia, Raiffeisen Research, based on RBA analysis, No. 32, January 2009, p. 10

Any turn for the better will have to be based on the basic commitments:

- a) To drastically improve the efficiency in the spending of budgetary funds by restructuring the relevant sectors: pension system, healthcare system, education, social benefits, subsidies...
- b) To start (in case of a major part of the public sector) or to continue (in case of the healthcare system) structural reforms that, with an increased level of prudence in spending, also open the possibilities to provide other sources of funding, including the participation of direct beneficiaries
- c) To fast-track the adoption new know-how and to introduce organizational system making it possible to raise the level of system performance, alongside with financial cost-cutting.

IV. TOOLS FOR CHANGE

Any achievement of permanent development goals of a society such as stable and sustainable GDP growth, increase in the prosperity of a nation, higher employment rate, fair and equitable distribution of income is not possible without a successful economic policy in the areas such as complex incentives to economic growth, raising the level of productivity, improving the level of qualification structure of the labour force, establishment and operations of institutions promoting investments and exports and developing and maintaining the concept of sustainable public finance.

The current situation of the global economy and, consequently, of (individual) national economies again raises the issue of the selection and application of tools (incentives) that may in the aggregate apply the instruments serving the purpose of achieving the above stated goals. This set of instruments, the tool for change is (again, more than ever!) what the industrial policy has become. How to design it, which are its up-to-date principles, may be inferred from the ten principles for its successful design (*according to D. Rodrik: Industrial Policy for the Twenty-First Century, Harvard University, September 2004, str. 8.*):

- 1) Incentives should be provided only to „new“ activities
- 2) There should be clear benchmarks/criteria for success and failure
- 3) There must be a built-in sunset clause
- 4) Public support must target activities, not sectors
- 5) Activities that are subsidized must have the clear potential of providing spillovers and demonstration effects
- 6) The authority for carrying out industrial policies must be vested in agencies with demonstrated competence
- 7) The implementing agencies must be monitored closely by a principal with a clear stake in the outcomes and who has political authority at the highest level
- 8) The agencies carrying out promotion must maintain channels of communication with the private sector
- 9) Optimally, mistakes that result in „picking the losers“ will occur
- 10) Promotion activities need to have the capacity to renew themselves, so that the cycle of discovery becomes an ongoing one.

A specific case is given, which on the whole presents the necessity of synchronized implementation of industrial policy measures.¹

¹ Source: *D. Rodrik: Industrial Policy for the Twenty-First Century, Harvard University, September 2004, p. 8, 12,13*

Box 1. Application of industrial policy,
specific case: Taiwan economy

„Consider a recent example taken from the pages of the New York Times. Taiwan has traditionally grown and exported sugar, an industry that has recently fallen into hard times due to low international prices and other reasons. What should now be grown in the fields to replace the sugarcane that is the source of income for many farmers? In many countries, the result would have been a depressed real sector, increasingly indebted farm households, and a drag on the economy. In Taiwan, the response has been a \$65 million government investment program to develop a world-class orchid industry. The government pays for a genetics laboratory, quarantine site, shipping and packing areas, new roads, water and electrical hookups for privately-owned greenhouses, and an exposition hall – in fact everything except for the cost of the greenhouses. It also provides low-interest credit to farmers to help them build the greenhouses.“....

...., Many projects require simultaneous, large-scale investment to be made in order to become profitable. Return, for example, to the orchid case in Taiwan. An individual producer contemplating whether to invest in a greenhouse needs to know that there is an electrical grid he can access nearby, irrigation is available, the logistics and transport networks are in place, quarantine and other public health measures have been taken to protect his plants from his neighbors' pests, and his country has been marketed abroad as a dependable supplier of high-quality orchids. All of these services have high fixed costs, and are unlikely to be provided by private entities unless they have an assurance that there will be enough greenhouses to demand their services in the first place. This is a classic coordination problem. Profitable new industries can fail to develop unless upstream and downstream investments are coaxed simultaneously. The Taiwanese government's investment upstream aim precisely to overcome this obstacle.”

Apart from the industrial policy as an important economic development tool and the driving force for changes, i.e. everything that needs to be done in order to form a new economic matrix, it is also necessary to establish social dialogue and partnerships in dealing with the current situation, thus providing the basic and necessary framework for managing future changes. Such concept of open communication, clear identification of goals and methods for their achievement is the only way to raise the degree of probability of attaining a broader consensus that in turn makes it possible to accomplish changes. This is evident when we look at the examples of economies of big countries, but it also applies as a general rule. The same applies to the Croatian circumstances under which it

is also possible to successfully implement structural reforms and to adapt to external crisis developments.

V. CONCLUSION

It is evident that today the world is faced with turbulent economic and geopolitical developments, in which the speed and intensity of changes and interrelations are higher and stronger, deeper and more significant than ever before. The strong neoliberal wave of thinking and behaviour that was intensely launched in the early 80s of the past century (key players: R. Reagan, M. Thatcher) implied a weakening and marginalizing of the role of government in economic and overall development.

The globalization processes that were initiated by new technology and communication tools and that gained momentum put focus on the integration of the market of goods and service, labour and capital, along with an increasingly strong role and significance of global companies. The dominance of the financial sector over the real sector started in the same period of time and ceased drastically *over night* in the present. Social disparities on the one hand and *consumerism* as a philosophy of life on the other have substantially grown in strength, supported by all types of media services.

The key question has now become the following question: how to go on? How to create an intelligent role of government under the circumstances? How to determine the boundaries of its responsibility for the stability of the overall economic system? At the same time, how to efficiently take account of taxpayers' money that is made available in order to stabilize the weakened financial sector? How can an adequate regulatory framework be attained at the global level (G-20)? The present time also creates some new theoretical paradigms on the basis of the present (painful) experiences.

In this framework the Republic of Croatia is a *niche player* and has to find its place by using *best practices* from different sources and situations that are acceptable for the country in terms of its development and culture. Using the crisis as the right opportunity to implement reforms, forming its own industrial policy and consistency in achieving the set goals must become the backbone of its development strategy within the above mentioned rectangle: transition – EU membership – global crisis – national structural reforms. The challenge is an extremely tall order, and the time available is limited.

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