THE NEW ECONOMIC POLICY OF THE EU AND ITS APPLICATION IN THE REPUBLIC OF CROATIA

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Abstract

The global crisis has created new challenges and new ways of solving them in different parts of the world. In the United States it has been characterized primarily by powerful actions and financial stimuli from the central bank, the Federal Reserve Bank, or the Fed, to stabilize the banking (financial) system, and by further stimuli in the real sector. Within the EU the accent in the first period was placed on implementing structural reforms in individual countries and then on activities directed at significantly greater coordination and monitoring in achieving national goals of economic and development policy.

In this context a new control and corrective mechanism (the EU Semester) has been created through which the European Commission analyses the fiscal and structural reform policies of every member state, provides recommendations, and monitors their implementation. Also, the presence, role and activities of the European Central Bank have been enhanced to create a mechanism to prevent possible future financial crises, but also one to provide the prerequisites for stimulating economic growth.

As a full member of the EU since 1 July 2013, the Republic of Croatia is in a position for opening new opportunities but also to take on new responsibilities. The long, deep economic crisis can be resolved with the assistance of EU institutions and EU structural funds, but at the same time it demands a considerably greater degree of responsibility and effort by the executive authorities in achieving the necessary structural reforms. This work cites the causes of the economic crisis in Croatia and it then analyzes the possibility for overcoming it by a series of synchronized measures and actions: reforms that for one populist political reason or another were ignored for a long time, or postponed, contrary to the warnings from foreign and domestic professional institutions.

Keywords: *crisis, new EU economic policy, EU Semester, programs for economic adaptation, EDP procedure and Croatia, structural reforms, economic growth.*

JEL Classification: D04, E6, F68

1. INTRODUCTION

The position of the European Union today is not ambiguous. On one hand it is a community of states with a high degree of social responsibility and that also continuously identifies new instruments for stimulating development, not only of its members as a whole but also for several of its regions in particular. On the other hand, it is a collection of economies with various degrees of economic development and various capacities for future growth, but also of with a variety of conceptual views about how to achieve important goals, which have been defined in a jointly adopted development document *Europa 2020*. How to navigate the global crisis, how to make the EU economic area in general more competitive, how to encourage new investment, and how to respond to a series of challenges for sustainable development: from environmental protection to demographic trends and the relations of the working and the supported populations - are open questions that the EU must address.

With two year of experience as the newest member of the EU, the Republic of Croatia is actively engaged in achieving a real convergence with the EU, which is a long, demanding process after the political and normative one that concluded successfully on 1 July 2013.

This work has two goals. The first one is to describe the current situation and the essential guidelines for creating a common EU economic policy under the circumstances of an unfolding economic crisis. And that crisis was the basic reason for the construction of joint mechanisms to create and monitor and to correct individual national economic policies. The second goal is to analyze the current economic position of Croatia, individually but also in comparison to other EU members, to establish what must be done; which instruments and mechanisms can encourage economic growth. What are the endogenous factors and responsibilities – first for implementing structural reforms – and what are the possible contributions by the EU, beginning with the active cooperation with the European Commission in creating and implementing the necessary reforms to taking greater advantage of the resources of EU funds.

Based on these goals, the first part of the work will analyze the economic position and performance of the EU, and in the second part the economic position and performance of Croatia in the context of the requirements that the EU's common economic policy sets before each of its members. The conclusion with point to the possible positive synergies in achieving the development goals of Croatia, but also to the important challenges, responsibilities and opportunities in several areas that have become accessible with the country's membership in the EU.

2. THE EUROPEAN UNION – A NEW ECONOMIC POLICY

At the very beginning, a question is raised about the circumstances that are demanding changes in the activities of the EU and the establishment of new mechanisms, which are accepted by EU members and become obligations for future individual behavior within national frameworks.[1] The immediate conclusion would refer to the appearance of the economic crisis that moved from the United States to Europe (2007-2008) and became a global crisis. However, an awareness of the need for deep changes in the EU framework to raise the level of competitiveness as a key tool for maintaining its own position, economically and socially, was created before this event in the 1990s and was formally structured in the document of the Lisbon Strategy (2000-2010), which for about half of its life span, was subject to revisions and additions for a stronger focus on concrete goals with individual countries. Upon the expiration of the Lisbon Strategy, the EU undertook an evaluation of the current situation (the powerful shock of the 2009 crisis) and adopted a new development document: *Europa 2020*.[2]

[1] The European Semester is the first phase of the EU's annual cycle of economic policy guidance and surveillance. In the second phase, the National Semester, member states implement the policies they have agreed.

[2] *Europe 2020 - Europe's growth strategy: Growing to a sustainable and job-rich future*, European Commission, Brussels, 2010. This ten-year strategy for growth and jobs in the EU, began in 2010. Its goal was not just to overcome the crisis from which our economy is gradually recovering, but to resolve the shortcomings of our model of growth and to create the conditions for intelligent, sustainable and inclusive growth.

Table 1. EU 2020 strategic goals

Europe 2020 strategy headline indicators, EU28					
	Headline indicator	Past situation	Current situation		2020 Target
		2008	2012	2013	
Employment	Employment rate, total (% of the population aged 20-64)	70.3	68.4	68.4	75.0
R&D	Gross domestic expenditure on R&D (% of GDP)	1.85	2.01	2.02[e]	3.00
Climate change & energy	Greenhouse gas emissions* (index 1990=100)	90.4	82.1	:	80.0
	Share of renewable energy in gross final energy consumption (%)	10.5	14.1	15.0	20.0
	Primary energy consumption (Million tons of oil equivalent)	1,689	1,584	1,566.5	1,483
	Final energy consumption (Million tons of oil equivalent)	1,175	1,103	1,104.6	1,086
Education	Early leavers from education & training, total (% of population aged 18-24)	14.7	12.7	12.0	<10.0
	Tertiary educational attainment, total (% of population aged 30-34)	31.2	35.9	36.9	≥40.0
Poverty or social exclusion**	People at risk of poverty or social exclusion (million)	116.6	123.1	121.4[e]	96.6

Source: Eurostat; http://ec.europa.eu/eurostat/web/europe-2020-indicators/europe-2020-strategy

However, in contrast to the previous document (the Lisbon Strategy), a conviction within the EU had matured that it was now necessary to move away from popular declarative commitments and a rickety format for the general monitoring of the achievement of an agreed upon development policy. It was necessary to create specific control mechanisms for monitoring and measuring results and also a powerful mechanism for concrete action in the event of a lesser or greater failure to meet obligations. In other words, after the establishment of common development goals and priorities, the EU created clear and effective mechanisms for monitoring the implementation of the goals of economic policy at the national level for each member individually. For that purpose a new framework was established for creating, monitoring, and also for the quick intervention and correction of, the economic policies of individual member states based on transparent and measurable instruments.

This framework is called the European Semester. It is a mechanism for economic management that was introduced after the adoption of the Europa 2020 strategy. It has been in effect since 2011. The European Semester is not just an instrument for fiscal oversight, but also for the overall coordination of the policies of the member states with the development and economic policy of the European Union. It is aimed at achieving intelligent, sustainable, and inclusive growth. With that same goal, the member states of the European Semester coordinate their budget and economic policies with the goals and rules that have been agreed upon at the European Union level and they define and implement a series of reforms that stimulate growth. The European Semester occurs in annual cycles. Every EU member state is obligated to participate in it.

In the first phase the member states mutually coordinate budget, macroeconomic and structural policies to achieve the goals of the Europe 2020 strategy (employment, research and development, climate change, education, poverty).[3] The European Semester starts when the Commission adopts its Annual Growth Survey, usually toward the end of the year. This document sets out EU priorities to boost growth and job creation. The Commission simultaneously publishes its Alert Mechanism Report in the context of the Macroeconomic Imbalance Procedure. Based on a scoreboard of indicators, the Alert Mechanism Report identifies the member states that require further analysis, in the form of an in-depth review, in order to conclude on the possible existence and the nature of potential imbalances. Drawing on the experience from the first exercises of the European Semester, the 2015 Annual Growth Survey contains proposals to streamline the process, whose main steps are the following:

In October, member states submit their draft budgetary plans for the following year. The Commission issues an opinion on each of them in November. The Commission assesses whether the draft budgetary plans comply with the requirements under the Stability and Growth Pact.

The spring meeting of the European Council in March takes stock of the overall macroeconomic situation and progress towards the Europe 2020 targets and provides policy orientations covering fiscal, macroeconomic and structural reforms.

[3] The European Semester and the Procedure for an Excessive Deficit – Implications for industrial relations in the Republic of Croatia, European Commission, 2014.

Also in March, the Commission publishes a single analytical economic assessment per Member State analyzing their economic situation, their reform agendas and whenever deemed relevant on the basis of the Alert Mechanism Report, possible imbalances faced by the Member State.

In April, Member States present their plans for sound public finances (stability or convergence programmers) and their reforms and measures to make progress towards smart, sustainable and inclusive growth in areas such as employment, education, research, innovation, energy or social inclusion (national reform programmers).

In May, the Commission proposes country-specific recommendations as appropriate. These recommendations provide tailor-made policy advice to Member States in areas deemed as priorities for the next 12-18 months. The Council discusses and the European Council endorses the recommendations. Policy guidance is thus given to Member States before they start to finalize their draft budgets for the following year.

Finally, end of June or in early July, the Council formally adopts the country-specific recommendations.[4]

The need for this structuring and monitoring of economic policy within the EU, and mutual coordination in general, has also been confirmed by experience to date. Thus, the European Commission has stated "the crisis has shown that problems from one member state of the Euroarea can spread and have a harmful effect on neighboring states." Therefore, the enhanced supervision provided would not have prevented the spread of the problems before they became systematic.

With a packet of two measures that went into effect on 30 May 2013, the EU introduced a new cycle of monitoring, under which member states (except those included in programs for macroeconomic adaptation) submit draft budget plans to the European Commission in October of every year. The commission then publishes its opinion. This procedure ensures a more detailed monitoring of Euroarea member states with excessive deficits and closer supervision of countries that are facing more serious difficulties.

[4] Making it happen – The European Semester, European Commission, Brussels, http://ec.europa.eu/europe2020/making-it-happen/index_en.htm

- Member states for which a procedure for excessive deficits has been initiated are obligated to submit not only their budget plans but also their programs for economic partnerships with plans for broader fiscal-structural reforms (for example, in the areas of retirement, tax and healthcare systems) that will reduce their deficits.
- Member states in financial difficulties or those include in preventive assistance programs within the European Stabilization Mechanism are subject to "enhanced surveillance," which means that which means they are subject to regular review missions by the Commission and must provide additional data on their financial sectors."[5]

Member states that are facing these imbalances will be included in special, enhanced mechanisms for monitoring their achievement of the recommended corrections. "The first step of a possible EDP usually follows the identification by the Commission of prima facie non-compliance with the deficit and/or debt criterion. A Member State is prima facie non-compliant with the deficit requirement if its general government deficit is above 3% of GDP. As regards debt, the criterion for prima facie non-compliance is a general government debt greater than 60% of GDP and not declining at a satisfactory pace. A satisfactory pace is defined as a reduction of the gap between a country's debt ratio and the 60% of GDP reference value of the Treaty by 1/20th annually on average over three years. In these cases, the Commission provides a report under Article 126(3) TFEU which considers all the relevant factors and on that basis concludes whether or not the deficit and/or the debt criterion are complied with."[6]

The degree of success of each member is measured concretely and directly and it then becomes a ranking within individual groups of success. Here it may be relevant and useful to show results of the Report of the European Commission on the Achievement of the Measures of the European Semester.

[5] European Commission, MEMO 13/318, Press Release – Economic Management in the EU, Brussels, 28 May 2014, p. 5.

[6] European Semester 2015: country-specific updates, European Commission, Brussels, 26.02.2015., dostupno: http://europa.eu/rapid/press-release_MEMO-15-4511_hr.htm, p. 2

BOX. European Semester 2015 – Country specific updates[7]

The main findings can be summarised as follows:

- **Croatia**, **Bulgaria**, **France**, **Italy** and **Portugal** are considered to be in a situation of **excessive imbalance requiring decisive policy action and specific monitoring**, including regular reviews of progress by all Member States in the relevant committees at EU level:

o For Croatia and France, risks of imbalances have significantly increased. For France, this represents a stepping-up of the status under the procedure compared to last year. The Commission will consider in May, taking into account the level of ambition of National Reform Programmes and other commitments presented by that date whether to recommend to the Council to launch an Excessive Imbalance Procedure.

o For Italy, imbalances remain excessive, requiring decisive policy and specific monitoring of the ongoing and planned reforms.

o For Bulgaria and Portugal the IDRs also point to excessive imbalances. In light of this situation, the Commission will carry out specific monitoring of the policies recommended by the Council.

- **Ireland**, **Spain and Slovenia** are considered to be in a situation of **imbalance requiring decisive policy action, with specific monitoring**:

o For Ireland and Spain, this monitoring will rely on post-programme surveillance.

o For Slovenia, the Commission considers that a significant adjustment has taken place over the last year; while this is the basis to conclude that imbalances are no longer excessive, the Commission stresses that important risks are still present.

- **Germany and Hungary** are considered to be in a situation of **imbalance requiring decisive policy action and monitoring**. For Germany, the Commission considers that there is no tangible improvement in the trends of imbalances identified last time and that the policy response has been insufficient so far. For Hungary, the Commission considers that there is no tangible improvement.

7 Ibidem, p. 3.

- **Belgium, the Netherlands, Romania, Finland, Sweden** and **the United Kingdom** are considered to be in a situation of **imbalance requiring policy action and monitoring**.

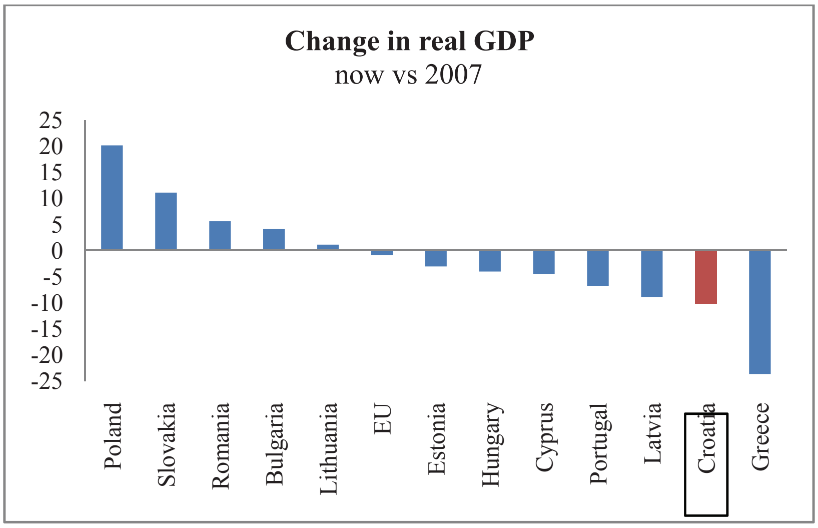
The results of the IDRs will be taken into account in the next steps of the European Semester of economic policy coordination

3. THE REPUBLIC OF CROATIA – A NEW ECONOMIC POLICY AS A FORMAL AND SUBSTANTIVE EU CONDITION

Because of the war and political obstacles, the Republic of Croatia was not able to join in the either of the two earlier waves of transition countries entering the EU (2004 and 2007). With exceptional negotiating efforts, it achieved that goal in 2013 and in doing so it closed the list of expanded membership for at least another decade or longer.[8] For almost the entire period Croatia's economic performances have not converged with those of the EU, neither with the group of *core* countries (the EU 15) nor with the group of new members (the EU 10). These performances related both to the period of high conjuncture (2000-2007) and to the period of crisis and the period of the search for mechanisms that would ease the burden of the crisis and create the conditions to exit from it (2008-present). What this means in a comparative context, and especially in the period from the beginning of the global economic crisis, is apparent from a comparison with referent countries in the EU and with the average values for the EU as a whole.

[8] This, of course, does not mean an absence of interest by the EU in the region and of possible further expansion in the future because there are continuing efforts to achieve the so-called para-membership, which means the adoption of EU practices and coordination of the legal framework in several areas of life so that formal accession will be more efficient and simpler for both side – the EU and the potential new members.

Graph 1. Deeper and longer recession than in most MSs



Source: Croatia: Is this the end of the long recession?, EBRD presentation, Macroeconomic Outlook Conference, Hypo Alpe Adria Bank, 27 March 2015, p. 2.

With the international comparison of the aggregate position of Croatia in regard to the EU environment, it is important also to observe the more detailed parameters of economic events and changes in the period of the crisis and of immediate expectations.

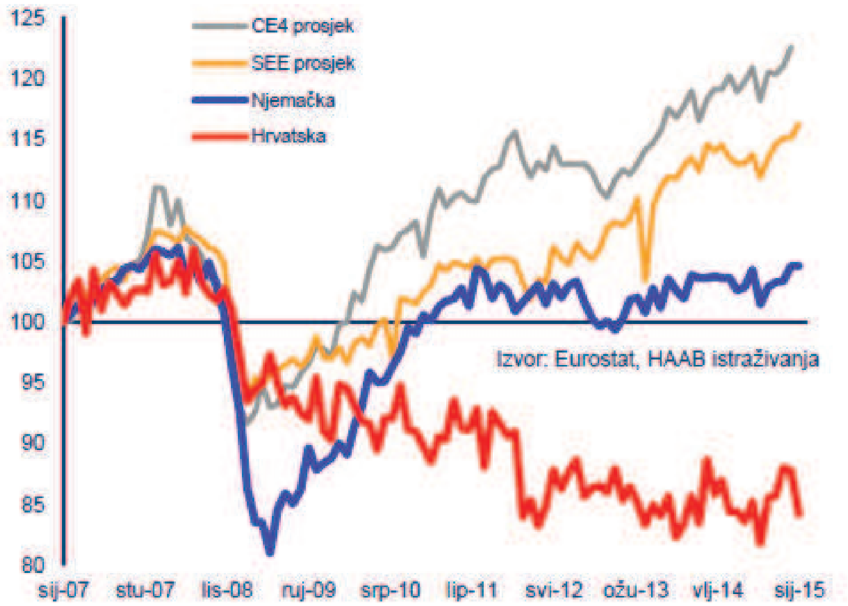
Table 2. Selected economic forecast

	2008	2009	2010	2011	2012	2013	2014	2015F	2016F
Activity									
Nominal GDP (HRKbn, current prices)	347.7	331.0	328.0	332.6	330.5	330.1	328.9	326.2	331.4
Nominal GDP (EURbn)	48.1	45.1	45.0	44.7	44.0	43.6	43.1	42.5	42.9
Nominal GDP (USDbn)	70.5	62.7	59.6	62.2	56.5	57.9	57.3	46.6	42.9
GDP per capita (EUR)	10,856	10,181	10,191	10,453	10,300	10,242	10,139	9,996	10,123
GDP per capita (USD)	16,345	14,555	13,882	14,532	13,233	13,556	13,449	10,958	10,123
Real GDP (constant prices YoY, %)	2.1	-7.4	-1.7	-0.3	-2.2	-0.9	-0.4	0.0	0.5
Private consumption, real (YoY, %)	1.2	-7.5	-1.5	0.3	-3.0	-1.3	-0.7	0.0	0.2
Fixed investment, real (YoY, %)	9.2	-14.4	-15.2	-2.7	-3.3	-1.0	-4.0	-2.0	2.1
Industrial production (YoY, %)	1.8	-9.2	-1.4	-1.2	-5.5	-2.0	1.3	1.5	2.5
Unemployment rate (ILO, average %)	8.4	9.1	11.8	13.5	15.8	17.3	17.1	17.0	16.8

Source: SEE Economic Research: Macroeconomic Outlook, Hypo Alpe Adria, Zagreb, March 2015, p. 3.

Within these parameters, and in the context of the new EU economic policy for the period to 2020 the position of industrial production in Croatia can be analyzed in absolute and comparative terms.

Graph 2. Industrial production (January 2007 = 100)



Source: Hrvoje Stojić, Economic Prospects 2015-2016 – Walking the tightrope, Macroeconomic Outlook Conference, Hypo Alpe Adria, Zagreb, 31 March 2015, p. 6.

The crisis-induced decline in industrial production in Croatia up to 2014 has been drastic and it has been accompanied by a similarly drastic decline in employment in that sector and by a subsequent stagnation of exports. At the same time the sharp decline of activity in the construction sector and of overall investment (private and public sectors) has made Croatia's position the weakest in the EU, with the exception of Greece.

The reasons for this situation can be sought primarily in the sphere of political decision making and the (un)preparedness to change, which has characterized the behavior of the executive authority in the entire period being analyzed regardless of political considerations or the party (or coalition) that formed a government in individual time periods.[9] Expert analyzes and evaluation (the World Bank, the IMF) from individual periods speak clearly and exactly about this issue. Thus, the document *Assessment of the 2013 Economic Programme for Croatia* by the European Commission underlines the important structural measures that can promote economic growth and competitiveness. The inadequate quality of the business environment and the lack of competition in key markets weigh on the growth prospects for the Croatian economy. Despite recent im-

[9] For this paper and analysis the focus is on measures and activities that were (not) undertaken in Croatia after its entry into the EU and the beginning of the use of the mechanism of the European Semester.

provements, administrative and regulatory obstacles are still a major hurdle for investment activity and for setting up a business. There is also scope to improve the efficiency of the judiciary, so that the legal framework supports a swift resolution of insolvent firms. The markets for energy, transport and postal services are dominated by single suppliers, which distorts competition and undermines the cost-competitiveness of Croatian businesses. Looking forward, productivity growth and a faster transition to a knowledge-based economy are hampered by a low level of spending on research and development and by inefficiencies in the policy framework.[10]

It further underlines the areas of activity for which the executive authority is responsible and where changes are unavoidable – and urgent. It is especially important to emphasize the need to stimulate more adequately research and innovation and the process of modernization of public administration, which is apparent from the following statements: Croatia is a moderate innovator with the research and innovation system showing a number of inefficiencies. Inefficiencies mainly concern cooperation between public research organisations and the private sector, the commercialisation of research results and technology transfer mechanisms. At the same time, the policy frameworks in the area of research, innovation and industrial policy are not sufficiently developed. In addition, the total level of R&D expenditure reached 0.75 % in 2010 and 2011, which is below the EU average and too low to advance the transition to a knowledge-based economy. In particular, public R&D investment spending in 2011 amounted to 0.41 % compared to the EU average of 0.74 %. Business expenditure on R&D stood at 0.33 % in 2011, well below the EU-27 average (1.26 %). Croatia aims to achieve a level of 1.4 % by 2020, which should be facilitated by the expected contribution of EU Structural Funds.[11]

In regard to public administration, it means the following: While a Civil Service Act is in place, the current performance evaluation system does not ensure merit-based career progression which would attract and retain qualified staff. Amendments to the Civil Service Act are currently under preparation with a view to streamlining recruitment procedures and introducing performance appraisal. A draft Act on Salaries in State Administration has been prepared but

[10] *Assessment of the 2013 Economic Programme for Croatia,*" European Commission, Commission Staff Working Document, Brussels, 29.5.2013, SWD (2013) 361 final p. 22.

[11] Ibidem, p. 25.

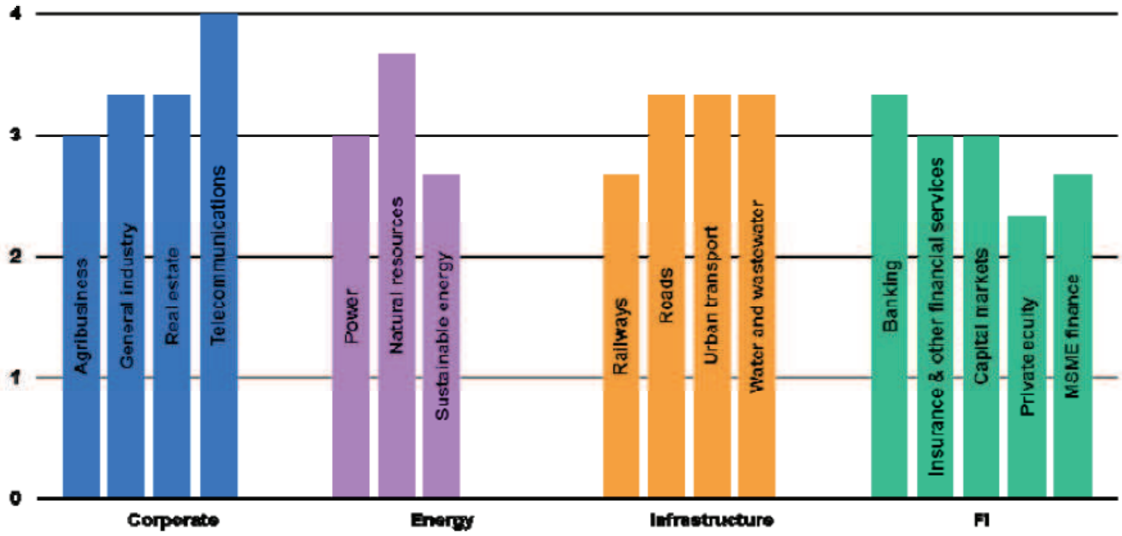
there have been delays in finalising the overall legal framework for a transparent and merit-based salary system in the whole public administration. On the other hand, a new register of public sector employees has been established, which is increasing the efficiency of processing, analysing and following up relevant civil service data. The new State School for Public Administration has improved its capacity to provide training for civil servants, local and regional self-government officials and public officials.[12]

As a complement to this assessment, we can also point to an analysis of Croatia's economic position by the EBRD in the chapter *Structural reform context,* which states, "In the Bank's annual assessment of transition challenges across 16 sectors (see the EBRD *Transition Report 2012*), Croatia lags behind most other countries in central Europe and the Baltic states – see Figure 2. The country scores well in the corporate sectors, where the remaining transition gaps are mostly assessed as small, and in some infrastructure sectors, reflecting the cumulative progress over the years, notably in the road sector. Even here, however, there are significant challenges ahead in promoting institutional reform and enhancing private sector involvement. The water and wastewater and railways sectors still present major challenges on the reform front. In the energy sector, the biggest transition gap concerns the electric power sector, particularly when it comes to market structure. In common with other advanced countries, the transition gaps in the financial sector mostly lie in improving access to finance for MSMEs and developing private equity markets."[13]

[12] Ibidem, p. 26.

[13] *Strategy for Croatia,* As approved by the Board of Directors at its meeting on 25 June 2013, Documentation of the European Bank for Reconstruction and Development. EBRD, p. 9

Graph 3. Croatia Sector Transition Scores14



Source: Strategy for Croatia, As approved by the Board of Directors at its meeting on 25 June 2013, Documentation of the European Bank for Reconstruction and Development. EBRD, p. 9.

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[14] The transition indicators range from 1 to 4+, with 1 representing little or no change from a rigid centrally planned economy and 4+ representing the standards of an industrialised market economy. The scores range from 1 to 4+ and are based on a classification system that was originally developed in the 1994 Transition Report, but has been refined and amended in subsequent Reports.

cross-country surveys and analyses of competitiveness and ease of doing business. In the latest World Bank's annual Doing Business report, Croatia ranks 84th in the world (out of 185 countries) in overall ease of doing business, down from 80th place the previous year. Indicators relating to construction permits and protecting investors are particularly low. A similar picture emerges from the World Economic Forum's Global Competitiveness index 2012-13, where Croatia ranks 81st out of 144 countries. In the 2008/09 EBRD/World Bank Business Environment and Enterprise Performance Survey (BEEPS), enterprises in Croatia singled out tax administration, the judiciary and lack of appropriate skills in the workforce as the three most significant obstacles to doing business.[15]

The existing limitation were also analyzed in detail in a document of the European Commission (2 June 2014)[16] which cited the important structural limitations in the public administration. "With the current regulatory framework for business in a Croatian enterprise are faced with major burdens, including a shortage of legal recourse, nontransparent decision making, especially at the local level, and a series of para-fiscal taxes. Furthermore, because of the very fragmented responsibilities of public administration at the regional and local level and the complex division of responsibilities among ministries and agencies at the central level, business decisions are complicated and legal procedures can be very extended. A structured approach has been introduced at the level of the central government to establish what the barriers to doing business are, but a consistent methodology is not being applied to measured administrative burdens, which reduce the effectiveness of measure already undertaken. It is necessary to rationalize and improve the control of public subsidies and guarantees, and a central register of enterprises and individuals that are receiving support would be a first step in that regard. Croatia has initiated reforms of its public administration with the goal of strengthening its administrative capacities and improving its orientation to the needs of clients in public services for citizens and enterprises. However, the quality of public administration continues to be low with weak coordination among the various levels of administration, and policies and evaluations are rarely or only formally based on evidence. Adopting a strategy for the reform of public administration is a step in the right direction,

15 Ibidem, p. 10.

16 Recommendation to the Recommendation of the Commission on the National Reform Program of Croatia, 2014 and Delivery of the Opinion of the Commission on the Convergence Program of Croatia for 2014, European Commission, 2 June 2014, COM (2014) 412 final.

but the strategy must be implemented at all levels of administration. Experience in the field of implementation of pre-accession funds points to shortcomings in regard to strategic planning and institutional capacities and in regard to preparing and monitoring projects."[17]

In addition to the trends already described and to their corresponding analyses, and to the suggestions and recommendations about what to do to start to exit from the now six-year old crisis, it is important to emphasize the evaluations and recommendations from the European Commission document *Results of In-Depth Reviews under Regulation (EU) No. 1176/2011 on the Prevention and Correction of Macroeconomic Imbalances*, prepared as part of the implementation of the European Semester. Croatia is experiencing *excessive macroeconomic imbalances, which require specific monitoring and strong policy action*. In particular, policy action is required in view of the vulnerabilities arising from sizeable external liabilities, declining export performance, highly leveraged firms and fast-increasing general government debt, all within a context of low growth and poor adjustment capacity. More specifically, after an expansionary phase, in which imbalances accumulated, Croatia is now experiencing a prolonged bust, in which a range of external and internal risks have come to the fore. External rebalancing is beset by important risks pending the reduction of Croatia's foreign liabilities to safer levels and is conditioned on improved competitiveness and broadening exports beyond tourism to support growth. The deleveraging of non-financial corporates is still at an early stage and non-performing loan developments in this segment need monitoring. State-owned enterprises, which in some sectors still play a dominant role and which are often un-restructured, are overall highly indebted and weakly profitable. Croatia has the lowest activity and employment rates in the EU, which is partly related to underlying institutions and policy settings. Better labour market functioning will be crucial to support the growth and adjustment needed in view of external and internal vulnerabilities. On nearly a range of standard indicators, Croatia's business environment ranks significantly below the average for central and eastern European Member States. These factors combine to lower potential growth, which hinders private sector balance sheet repair and increases the required fiscal consolidation effort.

[17] Ibidem, p. 7.

There is a need for significant additional fiscal consolidation efforts to curtail the deficit and prevent debt from rising unsustainably.[18]

This close and summary analysis points to the apparent problem of a deepening of the economic crisis, which has also become a social one. But at the same time there is the unpreparedness of the executive authority to initiate a more dynamic and concrete use and implementation of a program for structural reforms. As a commitment and as a response to the challenges, and the trends, that have been cited, the Croatian government has adopted a document called the *National Program of Reforms,*[19] which states, or better to say, makes an obligation to initiate, the following essential reforms. The measures that it is undertaking or is planning to undertake in the upcoming period are represented by four key areas – public finance, the financial sector, the labor market, and competitiveness, with 13 corresponding sub-categories.

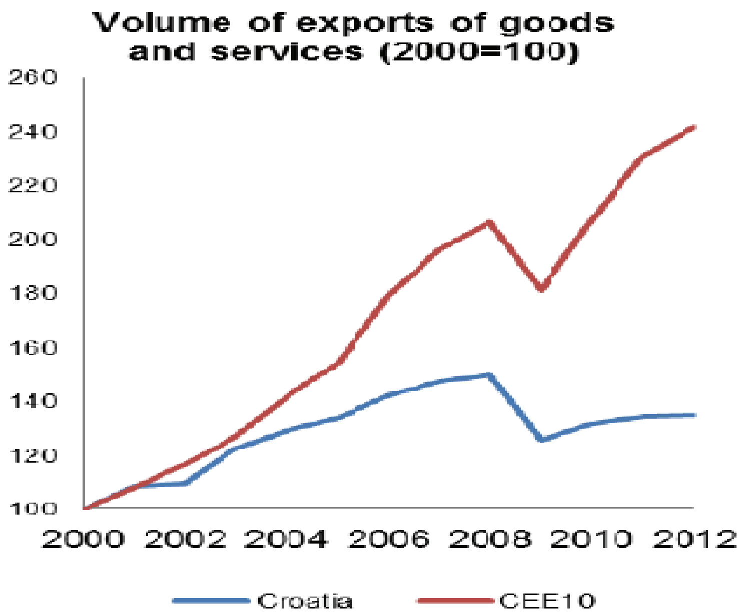
The introductory chapter, "Macroeconomic Perspectives for the Period Covered by the Program," states that the negative economic trends in Croatia continued in 2012. Based on an initial evaluation of gross domestic product (GSP), economic activity in 2013 declined by one percent in comparison to 2012, which represents a cumulative reduction of 11.9% compared to 2008. The most significant contribution to the decline of actual GDP was made by consumption of households (-0.6%) and gross investment (-0.2%). In 2013, almost all components of GDP registered a decline. An increase was observed only in government expenditure, which grew by 0.5% because of the payments of debts in the healthcare sector. The document also states that a decline was especially noticeable in the component for exports and imports. Since the decline in exports was more expressed than the decline in imports, the component for net exports was registered as a negative contribution to the growth of GDP. The reduced export of goods at a time of greater foreign demand indicates a continuation of the reduced share of Croatian companies on foreign markets. In 2013, the deficit in the exchange of good increased by 1.9%. The continuing decline in economic activity in 2013 was also reflected in the labor market. The

[18] *Results of In-Depth Reviews under Regulation (EU) No 1176/2011 on the Prevention and Correction of Macroeconomic Imbalances,* European Commission, Brussels, 5 March 2014, pp. 15-16.

[19] *National Program of Reforms,* Government of the Republic of Croatia, Zagreb, 24 April 2014. It is also the first national program of reforms that the government has adopted as a member state of the EU as part of the process for coordinating economic policy with the goals and regulations of the European Semester.

average number of workers fell 2.7%, primarily because of reduced employment in the processing industries, construction, trade and the handicraft and free professions. The polled rate of unemployment was 17.2% in 2013, which was 1.4 percentage points higher than the previous year.[20] Especially concerning is the data on the trends in export, shown in the following graph, for the period since the year 2000, and which depicts the low competitive capability of the industrial sector compared to other economies.

Graph 4. Exports fall behind regional peers, reflecting poor competitiveness



Source: Servas Deroose: European Semester 2014, Policy Recommendations – CROATIA, Zagreb, 3 June 2014, p. 11; available at: http://ec.eu/croatia/pdf/20140603_croatia-policy-recommendations.pdf

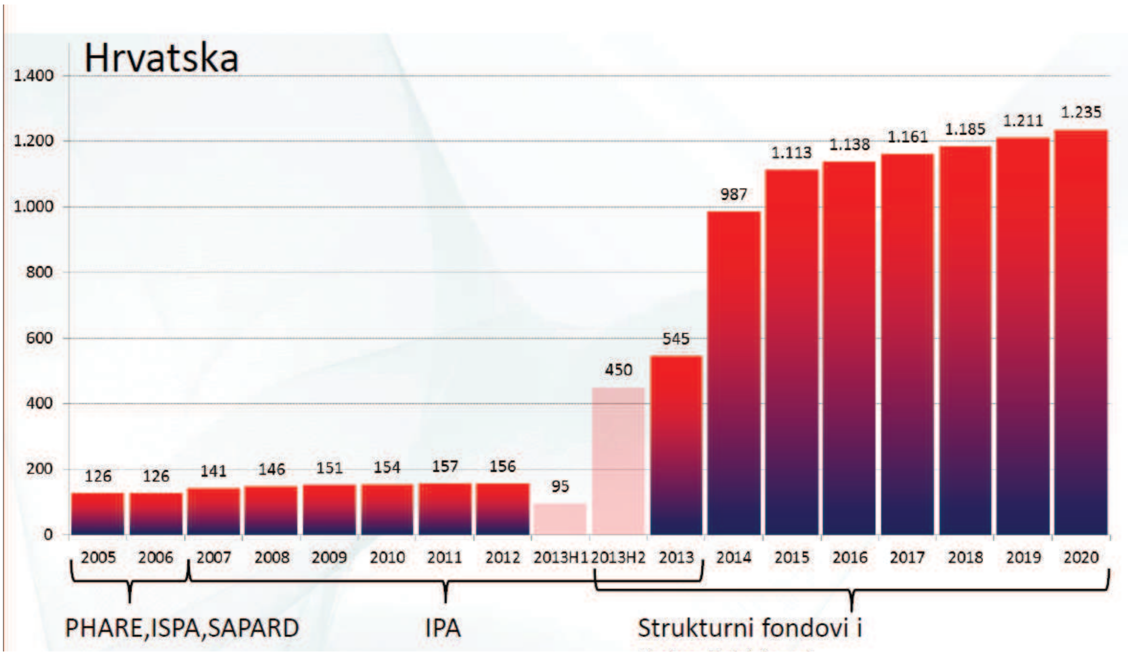
The chapter "Recent Economic Developments" in the World Bank document, *Country Program Snapshot,*[21] published in the same period (April 2014), stresses the importance of the preparation for and capability of a country absorb the resources of EU funds as an important factor in achieving the goals of national economic policy: "Beyond ensuring macro stability and increas-

[20] Ibidem, p. 3.

[21] Country Program Snapshot, World Bank Group – Croatia Partnership, April 2014, available at: http://www.worldbank.org/content/dam/Worldbank/document/Uzbekistan-Snapshot.pdf

ing Croatia's competitiveness, the government faces the strategic challenge of maximizing the use of EU Structural and Cohesion Funds. With EU accession Croatia's access to EU funds increased sevenfold. Since joining the EU, Croatia is expected to benefit from large net inflows of resources of an average size of two percent of GDP in 2013–20. While the overall effect of EU-related transfers on Croatia's economic growth is expected to be positive, Croatia will need to secure around one percent of GDP per year for pre- and co-financing. Successfully combating the challenges to the efficient utilization of EU funds, while also streamlining the budget, will ensure fiscal sustainability and foster income convergence with the rest of the EU."[22]

Graph 5. Allocations from EU funds (in millions of euros)



Source: Zvonimir Savić, European Structural and Investment Funds in Croatia, HGK, Zagreb, 10 March 2015, p. 16.

Data on the degree of preparations for the use of the resources from EU funds that has been achieved to date, followed by the actual use, point to the need for a significant strengthening of institutional capacity so that the degree of absorption will be raised to a significantly higher level.

After an extended period of warnings and highlighting problems by the World Bank, the IMF, the EU Commission and other institutions and inter-

[22] Ibidem, p. 3.

national agencies, and of the further tendencies and consequences of not doing anything, achievement of full membership in the EU now meant not just the adoption but also the full use of a new framework of monitoring EU policy with special responsibilities in regard to individual national economies.

For example, a document of the EU Commission states: "In 2014, Croatia's economy contracted for its sixth year in a row and although the recession is expected to come to an end in 2015, the economic outlook remains bleak. The pace of the contraction abated over the course of 2014, bringing the overall fall in GDP to -0.5 %. Growth is set to be just above zero in 2015 and to pick up timidly to 1% in 2016. Against this background, the unemployment rate is not expected to decline significantly from the current 17%. Internal demand should progressively start contributing positively to growth on the back of investments spurred by EU funds, while the export performance should remain strong as the recovery progresses in the EU. Significant fiscal consolidation and deleveraging needs nevertheless weigh on the growth perspectives.

In March 2014, the Commission concluded that Croatia was experiencing excessive macroeconomic imbalances. More specifically the risks stemming from high external liabilities, declining export performance, highly leveraged firms and fast increasing general government debt, all in a context of low growth and poor adjustment capacity, required specific monitoring and strong policy action. The identified imbalances strongly informed the country-specific recommendations issued to Croatia by the Council in June 2014. This Country Report assesses Croatia's economy against the background of the Commission's Annual Growth Survey which recommends three main pillars for the EU's economic and social policy in 2015: investment, structural reforms, and fiscal responsibility. In line with the Investment Plan for Europe, it also explores ways to maximise the impact of public resources and unlock private investment. Finally, it assesses Croatia in light of the findings of the 2015 Alert Mechanism Report, in which the Commission found it useful to further examine the persistence of imbalances or their unwinding.[23]

The main findings of the In-Depth Review contained in this Country Report are: **Croatia** is experiencing *excessive macroeconomic imbalances, which require decisive policy action and specific monitoring*. The Commission will take in May,

[23] Country Report Croatia 2015 - Including an In-Depth Review on the prevention and correction of macroeconomic imbalances, European Commission, Brussels, 26 February 2015.

on the basis of the National Reform Programmes (NRPs) and other commitments to structural reforms announced by that date, the decision to activate the Excessive Imbalance Procedure (EIP). In a context of subdued growth, delayed restructuring of firms and dismal performance of employment, risks related to weak competitiveness, large external liabilities and rising public debt coupled with weak public sector governance, have significantly increased."[24]

The Croatian government is required to review and to provide a qualified response by May 2015,[25] and with the additional instruments at the disposal of the EU Commission in communicating with individual members,[26] this means that a member's failure to adhere to the Commission's recommendations can result in a warning. More concrete **sanctions** (blocking structural funds, a deposit in the amount of 0.2% of GDP, a fine in the amount of 0.2% of GDP) are possible if entering the procedure for macroeconomic imbalance or the procedure for an excessive deficit. The **procedure for excessive deficit** is a corrective mechanism of the Stability and Growth Pact that is applied to member countries with a budget deficit greater than 3% and/or public debt greater than 60% of GDP (only if there is not a clear trend of reducing the debt).

4. CONCLUSION

The European Union finds itself in the grip of an economic stagnation that has now lasted for nearly a decade (2008-2014), with expectations or predictions that it may last to 2017 and even beyond. Here it is worth comparing the achieved and expected rates of growth to two global partners and competitors, the United States and the Far East – especially the Republic of China. Weakening economic power and strength leads to several other questions. Viewed externally, it is a question of the EU's relevance in decision making on issues

[24] Ibidem, p. 1.

[25] Croatia has officially bee in the procedure for excessive deficit since January 2014.

[26] With the dialogue and search for a solution to the economic crisis in Greece, there has been less dialogue and attention present on the monitoring in two other countries, Portugal and Spain, where joint agreements and jointly prepared structural programs are being achieved, not simply but step by step.
See more at:
Portugal: http://ec.europa.eu/europe2020/pdf/csr2015/cr2015_portugal_en.pdf
Španjolska:http://ec.europa.eu/economy_finance/publications/occasional_paper/2014/op193_en.htm

at a global level, participation in international institutions, and geopolitical positioning.

Viewed internally, it is a question of preserving social stability by preserving (well-paid) jobs because the EU, with less than one-tenth of the world's population, spends more than 50% of global resources for social purposes (retirement, health, social responsibility – OECD). Such expenditures will not be permanently sustainable without stable and strong economic growth. Thus, the demand for structural reforms are becoming increasingly loud and urgent and – more legitimate, as is the establishment and then control of jointly agreed economic policies at the national level.

In this regard, the established control mechanisms of the economic performances of individual national economies will receive additional significance, instrumentation and authorities. It is apparent that the process that has been initiated to create a coherent EU economic policy is accelerating and that it will require more intensive and rapid adaptation and activity at the national level because there is no question that the structuring of reforms and their implementation requires complete national orientation and responsibility.

The Republic of Croatia is faced with an ambivalent situation. Its membership in the EU has brought several new requirements and criteria for achieving (specific) reforms, which are demanding to articulate, but also to communicate and achieve. On the other hand, the decade or more that was wasted in preparing to face the need to resolve the endogenous crisis even before the appearance of the global crisis has created circumstances and conditions that do not permit further postponement. It can be concluded that a kind of win-win situation has been created. On one side is the possibility that the EU as a whole, and the European Commission in particular, test the newly created concept of monitoring the conduct of the common economic policy in an individual member state in order to systematically monitor and manage an important reform process. On the other side is the fact that Croatia, or the political elites who did not want, or did not know how, to achieve reforms independently, do that now with the support and control and also in alliance with, institutions of the EU. From the aspect of the development and national interests of Croatia, there remains the question also of how to ensure the understanding and support of the general public in implementing such reforms, and then how to find the appropriate institutions and partners to strengthen institutional capacity necessary for implementing the new economic policy.

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