Croatia Well Positioned, but Without Advancements in 2008

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EBRD Transition Report

Croatia Well Positioned, but Without Advancements in 2008

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According to the *Transition Report 2008* of the European Bank for Reconstruction and Development, Croatia is well positioned among transition countries, but, unfortunately, the transition stagnated in Croatia during the last year. In addition, all basic Croatian macroeconomic indicators, except inflation, are worse than the average for South Eastern Europe and the average for all transition countries. The basic Croatian problems lie in the slow advancement of privatisation, deregulation, reforms of health care and pension schemes, fiscal consolidation and transparency.

Recommendations to Croatia for faster transition and higher economic growth, whether written by competent domestic or foreign experts, are usually the same – privatisation, deregulation and public expenditure reforms, particularly in the health care and pension systems.

The latest recommendations are put forward in the *Transition Report 2008* of the European Bank for Reconstruction and Development (EBRD) which regularly publishes indicators that show countries' positions on the transition path and enable cross-country comparisons.[1] The indicators are in a range from little or no progress in transition (indicator 1) to standards equivalent to those of a hypothetical advanced market economy (indicator 4+). The Report covers three groups of countries: Central Europe and Baltics which joined the European Union in 2004 (excluding Czech Republic), South Eastern Europe including Croatia, and the Commonwealth of Independent States plus Mongolia.

This year, the Report shows a higher number of upgrades than in the previous year. However, the upgrades do not necessarily mean improvements made during the past year but may reflect a cumulative process of reforms over several years. The most significant advances are observed in South Eastern Europe countries, and the least in Central European and Baltic countries. The reason for stagnation in Central European and Baltic countries might be the "reform fatigue" and already reached advanced stages of transition (all Central European and Baltic countries have general indicators from around 3.5 to 4, but none yet reached 4+).

Transition reforms can be divided in three stages: (1) market-enabling reforms (small-scale privatisation and liberalisation of prices and exchange rates), (2) market-deepening reforms

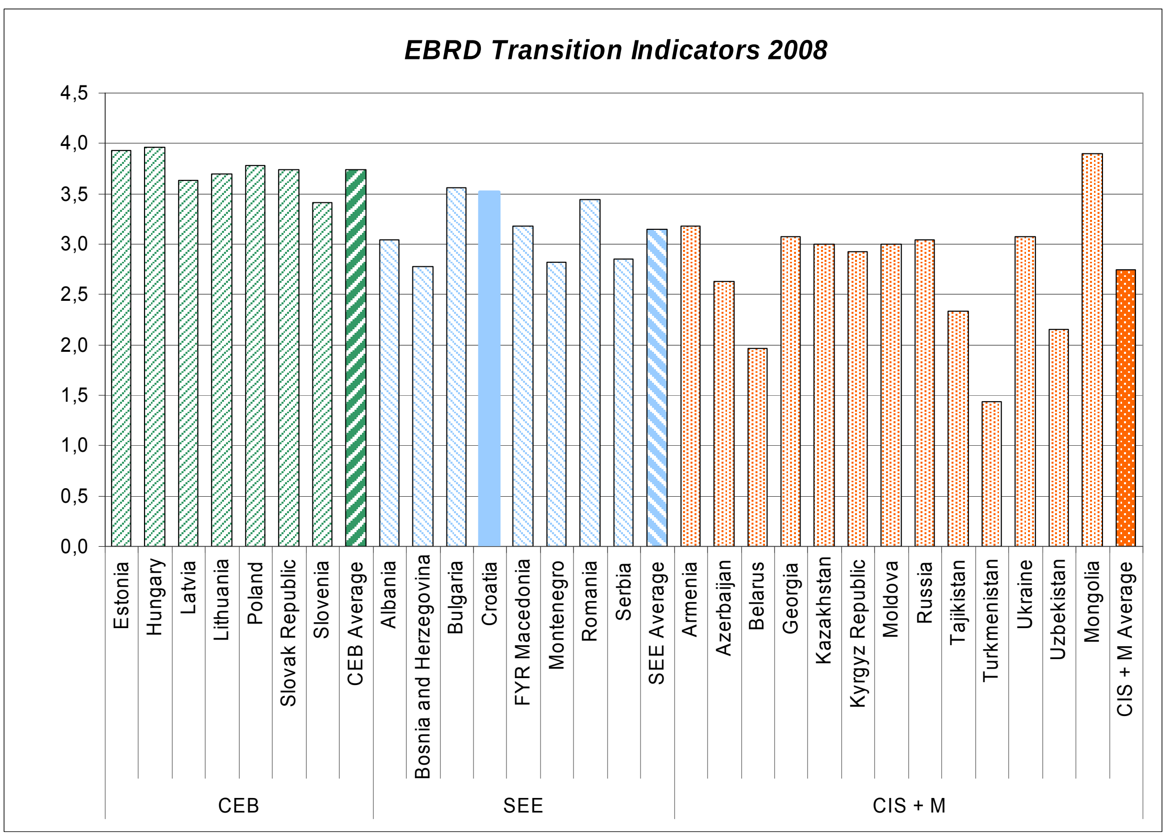
[1] European Bank for Reconstruction and Development (EBRD): *Transition Report 2008: Growth in Transition*, published in November 2008, presented in Croatia on January 27, 2009.

(privatisation of larger enterprises and the strengthening of financial institutions) and (3) market-sustaining reforms (fundamental reforms of the governance of enterprises, development of institutions to protect and promote competition and more commercial approach to the provision of infrastructure services).

Particularly important is the established strong positive link between the progress in reforms and subsequent economic growth. The rise in indicator by 0.1 – e.g. from 3.0 to 3.1 – implies an increase in economic growth of more than one percentage point in each subsequent year. Some other factors, like the starting position and fiscal position of a country, influence economic growth too, but advancement of transition, particularly advancements made in the most difficult, third stage (market-sustaining reforms) have the strongest impact on subsequent growth. This finding is particularly important for countries in more advanced stages of transition, including Croatia.

What is the standing of Croatia?

Not bad. The following graph shows that Croatia is not far from Central European and Baltic countries. It is actually a bit better than Slovenia (3.52 vs. 3.41). Among South Eastern Europe countries, only Bulgaria is better than Croatia (3.56). But, what is worrying is that Croatia did not move in any direction during the last year. All indicators are the same as in 2007, i.e. the general indicator (3+), and individual indicators ranging from the lowest (3-) for competition policy to the highest (4+) for small-scale privatisation and trade, and foreign exchange system. It is true that countries in more advanced stages of transition are slower in upgrading their indicators. However, Slovenia, for example, managed to improve its indicator for securities markets and non-bank financial institutions.



Source: Author's calculations based on data from EBRD (2008).

Besides the cross-country comparisons of transition indicators, the Report enables cross-country comparisons of some macro-economic indicators. From the following table we can see that all Croatian basic indicators except inflation are unfortunately worse than average indicators for South Eastern Europe and the average for all transition countries.

Basic macroeconomic data for Croatia, South Eastern Europe and all transition countries' averages, 2007 and 2008

	Croatia		**South Eastern Europe average**		**All transition countries' average**	
	2007	**2008**	**2007**	**2008**	**2007**	**2008**
Growth in real GDP (%)	5.6	3.8	6.2	6.5	7.5	6.3
General government balances (% of GDP)	-2.3	-2.0	0.1	-1.5	0.0	0.2
General government expenditure (% of GDP)	47.8	48.3	39.0	40.1	35.2	36.6
Current account balances (% of GDP)	-8.6	-9.9	-14.6	-16.7	-6.0	-6.0
Inflation (% annually)	2.9	6.5	4.5	7.8	6.7	10.7

Source: Author based on data from EBRD (2008).

What are Croatia's challenges?

Privatisation progressed slowly during the past year, and, in order to accelerate it, the Government has to reassess its privatisation objectives and align them with the relevant EU regulations, decide on the role of the Croatian Privatisation Fund and make plans for majority state-owned companies.

The progress in the deregulation programme, known as the "regulatory guillotine", has been slower than expected. Reforms should include regulatory impact assessments for county and municipal regulations to further reduce state intervention in the economy and improve the business climate.

Further progress of reforms in health care and pension schemes plus more fiscal consolidation is necessary, particularly the inclusion of all off-budget operations in the general government accounts to increase transparency. However, fiscal consolidation should not prevent financially healthy local governments from investing in essential infrastructure.