Although Croatia has made some progress from independence to consolidation and recovery, the achievements as shown by the joint Bank/IFC CAS, are far from good. Croatia now faces the challenge of restructuring its economy in order to growth. Changes in ownership through privatization, the access of private companies to spur development and the design of policies to encourage competition across markets as well as in corporate control, become central to a transition to a market economy. In order to accomplish those goals the country needs to implement the appropriate set of instruments to reach the desired goals.

Some of Croatia’s weaknesses are:

**Soft budget constraints**

- The country needs to reallocate resources across activities. This means to face the interaction of ownership, competition and performance during this transition process. A new resource allocation, therefore, requires changes in the government expenditure program and also more stringent rules, regulations and institutional capabilities.
- The aim is not just to reduce the size of the state *per se*. We do agree on the benefits of a smaller state. But the main goal should be to reinforce competition. The privatization plan attempted by the government during the last years has not been comprehensive. By attempting privatization merely as a source of funding, the government is not consolidating a competitive framework. The challenge ahead is to ensure that the prevailing business environment becomes as beneficial as possible to private restructuring decisions.
- There is no clear strategy in terms of privatization within the CAS beyond expressing the need to reinforce the process. The chances of an appreciated real exchange rate are high given public expenditures increased to 54% of GDP.
- The consequence of not going ahead with budget cuts is crowding out. The tax burden
with a value added tax of 22% coupled with higher real interest rates would probably impose severe welfare losses on consumption as well as private investment.

**Fragile Enforcement**

- The CAS does not extensively analyze the consequences of payment arrears as registered at the Payments Institute that affect firms, banks and states. Its growth has highlighted the need to toughen enterprise restructuring and legal reform in the transition period. The gigantic build-up of payment arrears (to pensioners) incurred by the government affects 25% of the total population. A major pension reform through privatization is encouraged at this stage as mentioned on paragraph 26 to overcome the undesirable consequences of a “pay as you go system.”
- The parliament should signal its decision to change by issuing a new draft banking proposal for reform. The law is required to overcome an ambiguous legislative framework, to impose stricter regulation and transparency on banks and to set up the minimum capital needed to run a bank. A strong banking system is required to consolidate the financial sector, which is key in the reform period ahead.

**On the CAS Proposal we suggest**

- The first step in the structural reform agenda should be to improve the judicial system in order to enforce contract payments and bankruptcy procedures. The case for closer cooperation and collaboration with the IMF is reinforced by the need of clear bankruptcy laws.
- Tight Monetary policy: as inflation remains under control vis-a-vis neighbors and compared with recent years, there is no need for tightening. In fact, to tight monetary policy when expenditures are increasing may not be a good recipe.
- Education as the engine of economic development and equality needs a dramatic push. There are no clear statements in the CAS about the steps to be taken to reform.

**Risks**

To avoid the possibility of a bank run a clearer exchange rate regime is needed. Either a freely floating exchange system or a currency board by strictly pegging to the Euro. The latter represents a possibility to promote currency stability. Some successful examples elsewhere in the world show that a currency boards by upholding a fixed exchange rate with a foreign reserve currency, help mitigate inflation and reinforce the budget constrain.

Given weak macroeconomic performance, uncontrolled public expenditure management, and lack of direction in the regulatory and institutional framework, this Chair is concerned about the base case scenario for this CAS. Appropriate public policy decisions are much needed (such as reducing fiscal expenditures and ensuring effective competition). The ability to construct and enforce good regulation is one of the scarcest resources. Croatia needs a set of non-marginal changes in the structure of its economy.