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The Role of Foreign Direct Investment in Transition Economies, with Special Emphasis on the Republic of Croatia

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ABSTRACT. This paper examines the process of transition in Central Europe. It examines the development of international trade theories as a basis for the emergence of Foreign Direct Investment (FDI), along with a brief history of FDI. Special consideration is given to FDI as a determinate of economic growth in transitional Croatia. It is argued that Croatia has reached a level of economic development where it can make use of substantial amounts of FDI.

I. Introduction

The end of the Cold War in 1989 left a number of Central and East European countries in a very difficult position. Decades spent under communist rule caused enormous economic and social deficiencies. After the "iron curtain" was lifted in 1989/1990, a number of countries started the process of transition, a transformation from centrally planned socialism to market-orientated capitalism. Transition is not an "overnight" process. It requires a number of economic, social, and institutional changes. The main purpose of transition is to diminish the inequality between developed market-orientated countries and undeveloped command economies, and to provide the latter with sustainable economic growth. One of the most important factors in maintaining long term growth is foreign direct investment (FDI). The first part of the paper examines the process of transition in Europe from an economic perspective. Two main phases and the requirements for their successful completion are studied, with a brief comparison of the progress in transition of the countries involved. The second part of the paper deals with foreign direct investment as a determinant of growth. First, a theoretical background for FDI is provided. Since FDI has its roots in the theory of international trade, the emergence of FDI is examined in that context. Some attention is given to the development of the system known as "the eclectic paradigm" that predicts FDI. The history and present trends of FDI flows are also examined, with a special emphasis on the Republic of Croatia. Croatia's readiness to receive greater amounts of

FDI from an economic point of view is shown by examining the level of macroeconomic stability, privatization and liberalization of its economy.

II. On Transition in General

According to Grzegorz W. Kolodko, a professor at the Warsaw School of Economics and visiting Fellow at the International Monetary Fund (IMF), transition is not a process that can be expected to have the same effects in every country. "The precise outcome of transformation is not going to be the same for all countries involved... Whereas some countries will expand quickly and catch up with their developed neighbors within a generation, others will experience sluggish economic growth and a relatively low standard of living" [Kolodko, 1998, 2]. There are three main reasons for the substantial differences in development of countries in transition: differences in initial conditions, the degree of free market presence at the beginning of transition, and the speed at which reforms are implemented. Nicolas Stern, the Chief economist and Special Counselor to the President of the European Bank for Reconstruction and Development (EBRD) supports this claim. "Variation in initial conditions concerned the length of central planning, the previous experience of a market economy and economic reform, levels of debt, economic structures, geography, natural resource endowments, environmental damage, and historical and cultural traditions" [Stern, 1998,3]. Countries that have implemented reforms the most quickly are showing the quickest recovery, especially with respect to privatization, which is crucial for the future of the transition. Although every country is a unique case, it is possible to identify three groups of countries that have followed similar patterns of development in the process of transition: The Baltic countries, the Commonwealth of Independent States (CIS), and the Countries of Central and Eastern Europe (CEE). The Baltic countries and the Countries of Central and Eastern Europe have responded better to reforms than the CIS. The result has been a faster recovery of real GDP, low inflation, lower unemployment, and better performance in other macroeconomic variables [Havrylyshyn and Wolf, 1999].

Every country in transition must go through *two phases*: the initial and the secondary. In the initial phase, markets are liberalized, privatization occurs and macroeconomic stability is achieved. These are prerequisites for the second phase which aims at sustainable economic growth. But before that can take place, perhaps the most difficult part of the transition must be accomplished, namely, building the institutions that will create economic growth in the long run. This part of the transition is painful because it requires both social and economic structural change. Institutions need to be built which will help maintain growth and create an attractive investment climate for foreign investment–one of the most important factors in sustaining growth. "The evidence shows clearly that the level, location and motive of foreign investment into the transition economies are all strongly associated with progress in transition" [Stern, 1998, 7]. Without the development of the necessary institutions, there will not be significant foreign investment.

> This investment is the highest in the successful economies of Central Europe and the Baltics, where it amounts to $70-$75 per capita. That the causation does not run from growth to foreign investment is suggested by the fact that even those CIS countries that have enjoyed consistent growth have not attracted anything like the same amounts of foreign direct investment (Havrylyshyn and Wolf, 1999).

Many of the countries in transition have already completed the first phase and have shown economic growth, but in order for transition to be successful, the growth needs to continue.

Another very important task for countries in transition is to become part of the global community. This can be accomplished by joining political and economic associations, such as WTO, CEFTA and EU. These will be discussed in greater detail later in this paper.

As mentioned above, one aspect of the initial phase of transition is to achieve macroeconomic stability. There are several factors that indicate *macroeconomic stability*: quick output recovery, low inflation, a small current account deficit, a legal framework, disciplined fiscal and monetary policy, developed infrastructure, a skilled labor force and implementation of IMF programs. The most noticeable disturbance in macroeconomic stability is the inevitable contraction of real GDP and the emergence of inflation. The contraction of real GDP affects the social realm. It leads to the growth of poverty, deterioration in health care and public health, declining life expectancy and problems in reallocating and restructuring pension responsibilities [Stern, 1998, 8]. All countries experience a fall in real GDP in the first years of transition. "In all transition economies, before any growth has occurred (and in some countries there is no growth yet) there has been severe contraction, ranging from 20 per cent over three years in Poland, to over 60 per cent in nine years in Ukraine" [Kolodko, 1998, 2].

Differences emerge between countries in the speed at which real GDP returns to where it was before the transition. The speed of recovery depends on the speed of liberalization of markets. Countries that liberalized quickly experienced a quick recovery of real output. For example, as Table 1 shows, Poland had only two years of declining GDP, and more importantly, it then began to grow. The result is that 1997's GDP level exceeds 1989's by 11.8%. The other extreme is Ukraine, which had 8 years of continuous GDP decline, and GDP is only 38.3% of 1989's GDP. Croatia had 4 years of output decline and has managed to recover 73.3% of 1989's GDP. It should also be mentioned that during these 4 years Croatia was at war. The war's impact will be discussed later in the paper. Inflation has been under control in many countries, with some differences with respect to size. However, one should not judge economic progress solely on the inflation rate, but also on GDP growth. In Slovenia's case, inflation has been in double figures during the transition, but has been compensated with higher economic growth, which put Slovenia's progress near the top of the list of transition economies.

Liberalization of the markets requires "the elimination of government-imposed restrictions on prices, trade and the market for foreign exchange" [Stern, 1998, 5]. Countries like Poland, Slovakia and the Czech Republic that engaged in rapid liberalization are experiencing the fastest growth. In their case, markets had already been partially transformed before these countries began the process of transition. In some other countries, especially from the CIS, this was not the case. They needed a complete rebuilding of markets because they practically eliminated market structures during the period of the command economy. They required "the restructuring of enterprises, the overhaul of the banking system, the break-up of monopolies and the establishment of securities markets and non-bank financial institutions" [Stern, 1998, 5]. This resulted in much slower development.

TABLE 1–Recession and Growth in Transition Economies, 1990-1997

Countries	Years of GDP decline	Did GDP fall after some growth?	1990-1993 GDP annual growth	1994-1997 GDP annual growth	1990-1997 GDP annual growth	1997 GDP index (1989=100)	Rank
Poland	2	No	-3.1	6.3	1.6	111.8	1
Slovenia	3	No	-3.9	4.0	0.0	99.3	2
Czech R.	3	Yes	-4.3	3.6	-0.4	95.8	3
Slovakia	4	No	-6.8	6.3	-0.3	95.6	4
Hungary	4	No	-4.8	2.5	-1.1	90.4	5
Uzbekistan	5	No	-3.1	-0.3	-1.7	86.7	6
Romania	4	Yes	-6.4	2.1	-2.2	82.4	7
Albania	4	Yes	-8.8	4.9	-2.0	79.1	8
Estonia	5	No	-9.7	4.1	-2.8	77.9	9
Croatia	4	No	-9.9	3.0	-3.4	73.3	10
Belarus	6	No	-5.4	-2.6	-4.0	70.8	11
Bulgaria	6	Yes	-7.4	-3.6	-5.5	62.8	12
Kyrgyzstan	5	No	-9.3	-2.4	-5.8	58.7	13
Kazakhstan	6	No	-6.7	-6.0	-6.3	58.1	14
Latvia	4	Yes	-13.8	2.2	-5.8	56.8	15
Macedonia	6	No	-12.9	-0.8	-6.9	55.3	16
Russia	7	Yes	-10.1	-5.3	-7.7	52.2	17
Turkmenistan	7	No	-4.5	-12.5	-8.5	48.3	18
Lithuania	5	No	-18.3	0.5	-8.9	42.8	19
Armenia	4	No	-21.4	5.4	-8.0	41.1	20
Azerbaijan	6	No	-14.5	-5.7	-10.1	40.5	21
Tajikistan	7	No	-12.2	-8.4	-10.3	40.0	22
Ukraine	8	No recovery	-10.1	-12.1	-11.1	38.3	23
Moldova	7	Yes	-12.6	-10.2	-11.4	35.1	24
Georgia	5	No	-24.1	2.9	-10.6	34.3	25

Source: Kolodko 1998, 3

Privatization is another key element in the process of transition. It is a very complicated task in which assets that were previously owned by "society" become private property. As one might expect, many difficulties arise in this transformation due to its multidimensionality, especially in the legal realm. Although there are a number of different ways to privatize, the most common is voucher privatization. More details on the privatization process will be discussed later in the paper in the section on Croatia.

Most of the countries in the CEE group have completed the initial phase of the transition, and must now complete the second stage. As mentioned earlier, the main goal of the transition is to achieve long run growth. According to Stern, the second phase of transition will require structural reforms (mainly reforms of institutions) to provide a secure environment for direct investment, which will in turn provide long term growth. [Stern, 1998, 7].

III. Theoretical Background on Foreign Investment

A. DEVELOPMENT OF INTERNATIONAL TRADE THEORIES

The need to trade and the gains from trade were recognized a long time ago, mainly because "the satisfaction of demand for goods not available domestically" [Coyne 1995,18] was recognized. There have been a number of theories trying to explain international trade.

1. Pre-classical, classical, and neoclassical theories

Probably the most famous pre-classic theory is the *Mercantilist theory*, which argues that countries engage in trade for the purpose of accumulating gold and precious metals. The wealth of a nation at that time was thought to be measured by the amount of gold that a country had. The classical economist Adam Smith changed the definition of the wealth of a nation to per capita consumption. He also introduced the *Theory of Absolute Advantage*. Smith argued that a country will produce the good for which it has an absolute advantage–*i.e.*, which it can produce most efficiently. David Ricardo expanded Smith's theory with the *Principle of Comparative Advantage*. Even when one country has absolute advantages in all goods, it will not have a comparative advantage in all goods. Therefore, trade should occur even if one country has absolute advantages in all goods, since gains from production specialization and exchange will be realized. Although the principle of comparative advantage makes many assumptions, it still remains the cornerstone in the development of neoclassical theories of international trade.

Neoclassical economists explain international trade based on extensions of classical theories. The *Heckscher-Ohlin theory of factor endowment* arose from the previous theories of absolute and comparative advantage. This theory suggests that "trade occurs because nations have different relative endowments of the factors of production" [Coyne, 1995, 20]. The country will export goods which use relatively more of the factor of production that is abundant for that country.

All of these theories were trying to explain international trade with the assumption of perfect market competition. However, it is well known that in the real world markets are imperfect. For example, corruption in governments may create "convenient" buyer-seller relationships. Since the governments had their own ideas about how to run the economy, firms started facing difficulties to the extent of possibly shutting down, due to lack of competitiveness in the home market [Coyne 1995, 21]. That was one reason businesses had to turn to international markets.

2. Market Imperfection Theories

Market imperfection theories emerged as a response to previous classical and neoclassical theories of direct investment. Previously, when explaining the phenomena of international trade, people were primarily concerned with the power of the market, and referred to markets simply as correction tools [Coyne, 1995, 23]. They were completely ignoring the aspect of firms as decision-makers. This gap between theory and reality eventually resulted in the emergence of theories that would explain the role of firm behavior in international trade.

Monopolistic Advantage Theory argues that a firm develops special characteristics during its evolution in the domestic market. These advantages are unique, and can be used in foreign markets for competitive purposes. These specific advantages result from imperfect markets, because in perfectly competitive markets there is perfect information and a lack of product differentiation. "Having gained unique capabilities and advantage in the home market...the advantage can usually be extended to foreign locations at little incremental cost plus it can potentially achieve a competitive edge in the foreign market" [Coyne, 1995, 24]. *Internalization theory* suggests that foreign investment occurs as a result of imperfect markets. Since domestic markets (due to imperfections that result from corruption) do not provide enough revenue, firms look for the opportunity of increased revenues outside the borders of the home country [Coyne, 1995, 24]. *Transaction Cost Theory* recognizes markets and firms as factors that influence transactions. Under the assumption that firms act rationally (maximizing profit), they will try to reduce transaction costs internally (at the production level) as well as externally (by putting the product on the market with lowest costs possible) [Coyne, 1995, 25]. *The theory of location* is closely related to internalization and transaction cost theories. "If firms use DFI to minimize costs, it will move the location where production costs are lowest" [Meyer, 1998, 65]. These location advantages seem to be having greater importance than previously thought. "While popular debate still focuses on production costs, research suggests that the attractiveness of the local markets is at least as important" [Meyer, 1998, 65].

A synthesis of many of the previously described theories is presented in work the of John Dunning, which is referred to as the "*general paradigm of international production*" [Meyer, 1998, 77]. The theory explains the significance of multinational companies (MNCs) as factors in foreign investment. "It seeks to explain both inter and intra firm behavior and embraces both structural and transactional market imperfections in the search for the determinants of the ownership advantages sought by MNCs" [Coyne, 1995, 29]. The theory draws heavily on Factor Endowment, Internalization and Transaction Cost theories, but also includes the role of the government [Brewer, in Coyne, 1995, 30]. Dunning argues that there are three conditions that need to be satisfied at the same time in order for FDI to occur: ownership advantages, the ability of the firm to internalize these advantages and the firm's interest in utilizing some non-home country factor endowments [Dunning, in Coyne, 1995, 30]. The firm's specific advantages (FSA) come in the form of unique technology, large company size (taking advantages of economies of scale) and special contributions from key managers [Green and McNaughton, 1995, 3]. In general, firm specific advantages provide domestic superiority to the other firms in the home market. After recognizing its special characteristics, a firm can take one of two paths. One is to stay at home and raise revenue through licensing, franchising and other FDI alternatives [Coyne, 1995, 43-45], or it can internationalize. However, it is not always most useful for MNCs to internationalize its competitive advantages. "If the dissipation of the FSA (firm specific advantages) is not a major concern, or if the product has become completely standardized, then licensing-type arrangements may be a more desirable choice of action [Vernon 1966; Rugman, Lecraw and Booth, in Green and McNaughton, 1995, 3]. The third condition that needs to be satisfied in order for direct investment to occur is choosing an appropriate location. When choosing location several factors come into consideration: trade barriers, cost factors, host market potential for sustainable growth, and investment climate [Dunning, in Green and McNaughton, 1995, 3]. In summary, Dunning's OLI paradigm predicts that FDI will occur if a firm possesses specific advantages, has an incentive to internationalize and then finds a cost minimizing location in a foreign country.

A comprehensive list of contributors in the development of international trade theories can be found in Table 2.

IV. A History of FDI

Before proceeding with the history of FDI, it is useful to distinguish between portfolio and direct investment, since the literature usually assumes that reader is comfortable with the distinction. According to Dunning, "unlike portfolio investment, direct investment implies the investing unit (usually a business enterprise) purchases the power to exert some kind of control over the decision taking process of the invested-in unit (again, usually, a business enterprise). Research suggests that portfolio investment tends to be larger in size than direct investment" [Estrin, Hughes, and Todd, 1997, 35], but the nature of each of these international capital movements is different.

TABLE 2–The comprehensive list of contributors in the development of international trade theories

Theory	Early contributors	Recent work and reviews
Capital markets approach	Aliber 1970 Agmon & Lessard 1977	----
Exchange rate analysis	Logue & Willet 1977 Batra & Hadar 1979	Froot & Stein 1991 Kogut & Kulatilala 1996
Macroeconometric analysis	Scaperlanda & Maurer 1969	Clegg 1995
Theory of location	Mundell 1957	Dunning 1993
Institutional analysis	Korbin 1987 Guisinger et al. 1985	Stopford & Strange 1991 Loree & Guisinger 1995
Developmental cycles	Vernon 1966 Kojima & Ozawa 1984 Dunning 1986	Ozawa 1992 Narula 1995
Resource based view	Hymer 1960-1976 Kindleberger 1969	Yamin 1991 Dunning 1993
Industrial organization/game theory	Knickerbocker 1973 Dixit 1980 Krugman 1983	Markusen 1995
Internalization theory	Caves 1971 McManus 1972 Buckley & Casson 1976	Dunning 1993 Casson 1995
Economic geography	Marshall 1920 Krugman 1991	Krugman & Venebles 1994 Malmberg, Soelvell & Zander 1996
Internalization process model	Johanson & Wiedersheim-Paul 1975 Luostarinen 1979	Johanson & Vahlne 1990 Nordstoern 1991 Andersson 1993
Eclectic paradigm	Dunning 1977	Dunning 1993, 1995

Source: Meyer, 1998, 61

There have been several distinct periods of FDI, each of which had a different approach to international capital movements. "The half-century prior to the First World War was a period uniquely favorable to the free movement of international capital" [Dunning, 1970, 16]. The main reasons for this were the security provided by the gold standard, political stability, absence of impediments to the free movements of international capital, migration to the cities, and a clear distinction between capital importing and capital exporting countries. The United Kingdom was the main lender at that time, while the U.S. and eastern European countries were the primary borrowers [Dunning, 1970, 16].

In the period from 1864 to 1914, "the value of world foreign long-term investment rose from under $4 billions in 1864 to $44 billions in 1913" [Dunning 1970, 16]. The First World War helped accelerate this process, and after it ended, the character of foreign investment was changed in two ways, according to Dunning [1970, 19]. First, direct investment got a bigger role in international investment by companies investing overseas. Second, an equal amount of money was used for rebuilding the world after World War I. The United States became the world's primary lender, although the overall amount of lending experienced a sharp decline. Substantial short-term capital movements and an insecure investment climate contributed to the world economic collapse of 1931 [Dunning, 1970, 20].

The Great Depression is considered to be a dividing line in the history of foreign investment. According to Dunning [1970], the crisis itself was not the main problem for the international savings-investment relations. But things that resulted from the depression, such as the replacement of the gold standard, import restrictions and bilateral trading, all contributed to a huge decrease in direct investment. The amount of direct investment in 1938 is estimated to be $55 billion, which shows the consequences of the War on the world economy. [Dunning, 1970, 21].

The Second World War had a similar but more devastating impact on the world economy. The gross value of long-term investments declined from $55 billions to between $35 and $40 billions. [Dunning, 1970, 23].

After the Second World War, international investment experienced a big expansion. The big boom in the world's market economies happened in the 1960's, when "the total flow of direct investment grew faster than gross national product (GNP), and as fast as world trade" [Andersson, 1991,15]. In the 1970's and 1980's the positive trend of direct investment continued, although it was not as rapid as in the 1960's. In the 1990's the capital spread to the developing countries.

The period until 1990s was characterized by investments mainly to developed countries. The reason lies in the fact that first flows of FDI were mainly oriented towards banking, insurance, and information systems, which could be found only in developed countries. The developing countries were not as attractive at that time. "In the late 1970s, the developing countries hosted 28 per cent of the total stock of direct investment. In the mid-1980s, they had only about 23 per cent [Andersson 1991, 15]. The main investor for the first period was the U.S., with Europe catching up in the late 1970's.

V. Countries of Destination in Central Europe

As Table 3 shows, the U.S., U.K., Japan, Germany and France are the world's biggest investors, providing 65.3% of the world's foreign investment in 1994. [Estrin, Hughes and Todd, 1995, 35]. Therefore, one would expect these countries to be the biggest investors in transition countries also, but that is not the case. Germany and U.S. predominate, while the rest of the countries hardly have a presence.

TABLE 3–Outward Stocks of FDI from Five Major Source Countries

COUNTRY	1994 ($billions)	% OF TOTAL
U.S.	610.0	25.6
U.K.	281.1	11.8
Japan	277.7	11.6
Germany	205.6	8.6
France	183.4	7.7

Source: Estrin S., Hughes K. and Todd S. (1997)

The inflow of FDI to the CEE countries is not equally distributed. The countries that started the transition the earliest and achieved the highest level of security for investment are Hungary, the Czech Republic and Poland. These countries account for two thirds of cumulative FDI. Their greater integration into the world community also proved to be crucial. "The 10 CEE countries with Europe Agreements with the EU account for over 80 percent of cumulative flows [Estrin, Hughes and Todd, 1995, 36]. Hungary seems to have attracted the most FDI in nominal and per capita terms.

As Figure 1 shows, [Estrin, Hughes and Todd, 1995, 37], Hungary attracted $6,801 millions or 32.7% of total FDI inflow in CEE countries in the period from 1989-1994. This turns out to be $660.2 per capita, twice as much as the Czech Republic's $301.1 per capita, which is the second largest recipient of FDI in the CEE countries. Since Croatia was involved in latest Balkan crisis (1990-1994), information on FDI is still not available. However, in the period from 1992 to 1998, $2,099.2 million were invested in Croatia [World Bank, 1999, 3]. The increasing trend of FDI in Croatia will be discussed later in the paper.

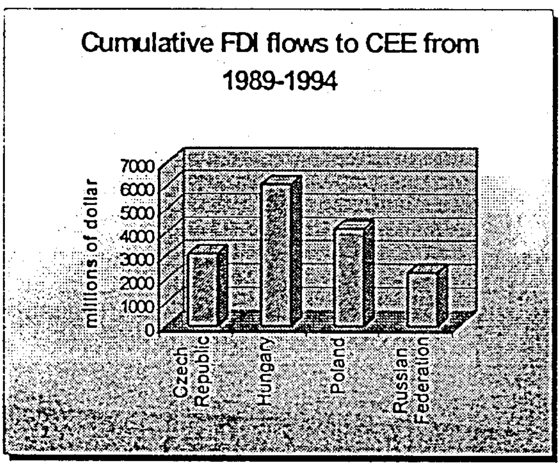


FIGURE 1. Cumulative FDI flows to CEE from 1989-1994

Because of Croatia's specific history, it will be beneficial to consider some facts which have an impact on the investment climate today prior to going into more detail about Croatia's FDI.

VI. The Situation in Europe Today

Today's Europe is divided in many ways, but one of the most recognizable divides is the level of development. People refer to western developed countries as "The West", and developing countries as "The East". This is because the geographical division corresponds to development levels. In the West there is shortage of low skilled labor, which discourages production processes which use much unskilled labor [Meyer, 1998, 82-84]. Firms in labor-intensive industries face a loss of competitiveness in domestic markets as well as barriers to growth, and have to make a decision either to stay "at home" and start producing in a different industry, or to reallocate their industry through FDI to the countries of the East. The most attractive aspects of the East are low labor costs and natural resources. Here FDI is the result of an adjustment process in the advanced economy. It usually comes in the form of Multinational Companies, either new or previously established ones. The former are more geographically tied to the main country, mainly because of sunk costs due to capital immobility and the costs of retraining employees or of firing them. As far as FDI is concerned, multinational companies are not only "facilitating institution[s] which help(s) to organize world production to optimally exploit comparative advantage" [Markunsen, 1991, in Meyer, 1998, 86], but also contribute to the development of less developed countries.

This approach is based on the difference in economic development between the East and the West. This model predicts FDI will emerge because of these differences, and the greatest motivation is low costs.

VII. Croatia

A. GENERAL INFORMATION

Croatia is a central European country with a population of 4.5 million, and an area of 56,538 square kilometers [Business forum, 1999, 4]. Croatia has frequently been involved in conflicts either to the north or to the east of the country, because of its geographic position. It has been the point of conflict for many cultures and points of view, including the Balkan Wars of the 1990's. Since it proclaimed its independence in May 1990, Croatia began the process of transition in hopes of a fast recovery. Unfortunately, the War caused many disturbances and made the transition even more difficult than it otherwise would have been. Nevertheless, it is to the point where the initial phase of transition is at its end, and where opportunities for foreign investment arise. It has macro-economic stability, private property and a legal framework provided for potential investors.

B. MACROECONOMIC ENVIRONMENT

Macroeconomic indicators such as real GDP growth, inflation, unemployment, monetary and fiscal policy, current account deficit and external debt, draw a picture of macroeconomic stability in Croatia. After the first three years of transitional shock, in October 1993 the Croatian government introduced the Stabilization Program.

> Since Croatia introduced its stabilization program in October 1993: hyperinflation was stopped by the successful implementation of an exchange rate anchor, with little damage to output; real economic growth turned positive and has remained robust since then; inflation has stayed at moderate levels; international reserves of Croatian National Bank (CNB) have increased almost steadily. [IMF, 1998]

Constant real GDP growth, low inflation, and a reasonable current account deficit support the fact that Croatia is a stable country suitable for investment. Unemployment is high, around 17.20% in 1999, which can be explained partly by the underdevelopment of industries in which Croatia might have comparative advantages and partly by the structure of the labor force–a shortage of high skilled and a surplus of low skilled labor.

The inflation rate for the past five years is comparable to the best-developed countries of Europe, and is well under typical inflation rates in other transitional countries, as shown below in Figure 2 [Croatian Government Bulletin, 1999A, 1]. Great Britain, one of the biggest economic and political powers of the world, had an inflation rate of around 3% in the period from 1995-1998, while Croatia had almost the same rate, for the same period. Public debt as a percent of GDP is extremely low (24.9% in 1998) compared to the average in the Euro zone (78.8%) [IMF, 1998]. Real GDP growth also demonstrates Croatia's macroeconomic stability. Croatia's growth rate was one of the highest in Europe from 1995-1998. [Croatian Government Bulletin, 1999A, 1]. The growth rate declined in 1998 to 2.7% from 1997's 6.5, partly because large foreign bills came due. The structure of the debt is shown in Table 4. The war caused many unexpected expenses, and the poverty that resulted from the transition process did not allow for internal borrowing. Hence, the Croatian government had to borrow from the rest of the world. Nevertheless, the Croatian National Bank maintained a stable exchange rate throughout the transition, beginning with the Stabilization Program of 1993. Croatia also showed competence in fiscal and monetary policy despite the big disturbances caused by the war.

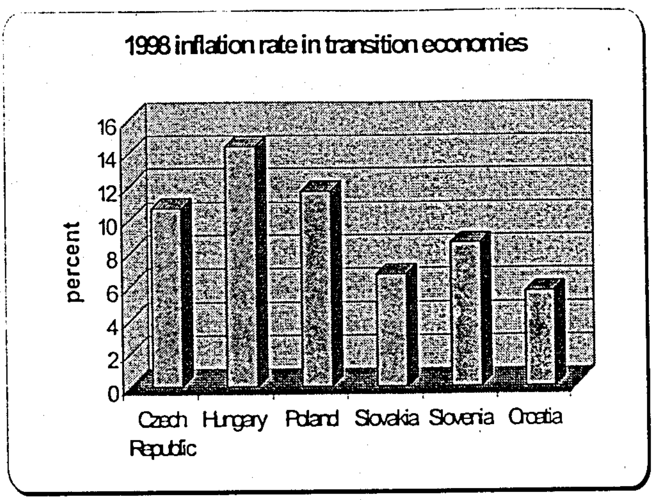


FIGURE 2. 1998 Inflation Rate in Transition Economies

"In 1998 Croatia was one of the few European countries to achieve a budget surplus, which was used to finance reconstruction and major infrastructure projects, and to cover social expenditures" [Business Forum, 1999, 13].

TABLE 4–Total Debt of the Republic of Croatia

Year	Total foreign debt in billions of $	Total foreign debt as % of GDP
Dec. 1993	3.3629	30.9
Dec. 1994	3.6985	25.3
Dec. 1995	4.2134	22.4
Dec. 1996	4.8084	24.0
Dec. 1997	6.6616	32.9
Dec. 1998	8.4887	39.0

Source: Croatian Government Bulletin (1999A)

The Croatian government introduced a VAT in January 1998 at a flat rate of 22 percent, which also helped consolidate the budget. Monetary policy is carried out by the Croatian National Bank (CNB), which is as independent from the government's influence as it can get considering the consequences of the war. The CNB is in charge of monetary policy and the supervision of the banking sector. Its competence is shown in stable prices and exchange rate, as well as increasing international reserves in the last decade, providing a secure base for further development. The latest disturbances in the banking sector caused a decrease in domestic liquidity and in the solvency of many enterprises (especially small and middle sized ones). With a New Bank Law adopted by the Parliament in December 1998, the CNB provided regulation in this crucial sector of the economy [Business Forum, 1999, 12].

C. PRIVATIZATION

The process of transition also requires a transformation of property, from socially owned to private property. Privatization in Croatia was done in two steps. The first step began with the ratification of the Law of the Transformation of Socially Owned Enterprises in April 1991. Since the transformation was not occurring at the desired speed, the Croatian Government created in November of 1994 the Department of Privatization, which set off the second stage, and was handled entirely by the Croatian Privatization Fund. Its function was to supervise privatization strategy and legislation, mass privatization and the privatization of public enterprises [Croatian Privatization Fund (CPF), 1]. In a later stage of the privatization, privatization investment funds were created. These funds were assigned shares of the companies entering privatization by the will of the people of Croatia, and act today as separate companies. The shares of investment funds are listed at the Zagreb Stock Exchange. These funds were supposed to complete the process of privatization in two ways. First, an important amount of unsold shares was distributed to widows of the war and their families, displaced persons and refugees as compensation for their suffering. Second, the rest was left to be held by the funds. To date, "an estimated 65 percent of the total value of companies that entered the privatization process in 1991 is now privately owned" [Business Forum, 1999, 14]. Also, as an example of privatization of previously state owned enterprises, 35% of Croatian telecommunications were sold to the largest European Telecommunication company–Deutsche Bank–for $850 million, which represents one of the biggest investments in Croatia so far. It is interesting to observe the difference in the structure of investment prior to the privatization of public enterprises. Before the sale of public enterprises began, foreign investment came in form of portfolio investment, mainly from the U.S. Today, when public enterprises are being sold, the investors come mainly from Europe and are interested in "control packages", *i.e.*, in foreign direct investment.

D. LEGAL FRAMEWORK

The Croatian government provides a solid legal climate for foreign investors. "Foreign investors may acquire rights and assume obligations under the same conditions and with the same status as domestic investors" [Business Forum, 1999, 32]. These rights can not be reduced by any law, and profits can be transferred out of the country as wished by the investor. Any foreign person who wishes to participate in the privatization of Croatian enterprises has the right to do so. However, there are several restrictions that they face under the Basic Property Rights Law [Business Forum, 1999, 32].

> If the ownership is acquired in any way other than inheritance... under the condition of reciprocity, foreign natural or legal person can acquire ownership only with the approval of the Ministry of Foreign Affairs, and on condition of being engaged in commercial activity in Croatia. The Agricultural law prohibits foreigners from obtaining agricultural property rights and maritime territory is excluded from sale [Business Forum, 1999, 32].

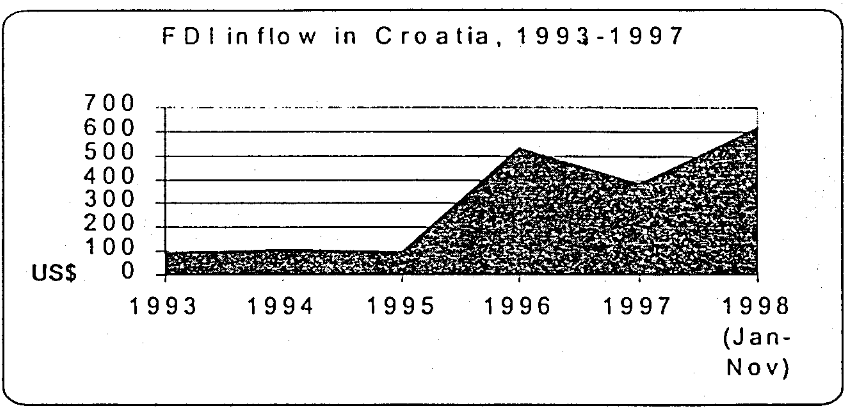
E. INTEGRATION PROCESSES

Croatia has, just like all other CEE transitional countries, replaced a socialist command with a free capitalist market system. The prerequisite for a successful transition is integration in the World Economy by joining organizations such as the World Trade Organization (WTO), Central European Free Trade Agreement (CEFTA), the European Union (EU), the IMF, the World Bank, Council of Europe, the International Bank for Reconstruction and Development (IBRD), the European Bank for Reconstruction and Development (EBRD) etc. So far, Croatia has succeeded in joining the IMF, IBRD, EBRD and Council of Europe [IMF, 2000, 30-32]. Although Croatia shows a great desire and readiness to join the rest of the mentioned organizations, it has not yet succeeded in doing so. Also, Croatia's involvement in the latest Balkan Crisis created some political obstacles. It anticipated joining the WTO at the end of 1998, but this has not yet been accomplished as of May 2000. This prevents the "Croatian product" from being competitive in international markets. This also signals investors that the climate for investment is not yet as good as it may seem. Nevertheless, EU has created several programs[1] to financially help transitional countries to transform, mainly in building institutions that would support future investment.

F. FDI IN CROATIA

Croatia's involvement in the 1990s Balkan Wars significantly disturbed investors' confidence in the country. "The inflow of foreign investments during the war years was impressive only in as much it showed that even under the most adverse circumstances foreign investors' interest in Croatia did not entirely dry up" [Business Forum, 1999, 19].

The increasing trend of FDI inflow in Croatia is presented in Figure 3. A total of $2.04 billion was invested in Croatia in the period from 1993-1998. The largest investors were the U.S. with 41.4%, Austria 24.5% and Germany 1.7%. "As to specific branches of industry from 1993 to 1997, most was invested in the pharmaceutical industry (42.9 per cent), commercial banks (14.5 per cent), cement production (5.2 per cent) and glass production (4.3 per cent)" [Business Forum, 1999, 19]. In order to assist foreign investors with economic and legal advice, the Croatian government created the Croatian Investment Promo Agency (CIPA).



Source: Business Forum, 1999, 19

FIGURE 3. FDI inflow in Croatia, 1993 - 1997

> "The principal aim of the Agency is to promote Croatia as a country with business opportunities, in order to attract foreign direct investments and to assist foreign investors and their local hosts in setting up and organizing their investments in Croatia" [Business Forum, 1999, 20].

According to the EBRD experts [Business Forum, 1999, 21-24], the investment opportunities with the greatest potential are: tourism, agriculture, forestry, manufacturing, mining, construction, telecommunication, energy, oil and gas. In order to provide easier FDI inflow, an adequate traffic infrastructure needs to be built. Table 5 shows the largest investors in that area.

TABLE 5–Major Traffic Infrastructure Investments in Croatia

Company	Amount Invested ($US millions)
Bechtel	990
Boyugues	460
Walter Bau	450
Astaldi	830
REW	250
Eneron	175
AGIP & INA	90

Source: Croatian Government Bulletin, 1999B

Once this is accomplished, or at least under way, investors' confidence will increase. The result will be greater FDI inflow. (see Table 6.)

H. INVESTORS

As mentioned before, Croatia began the process of integration in the World economy by joining prominent institutions such as the IMF, World Bank, Council of Europe, International Bank for Reconstruction and Development (IBRD) and European Bank for reconstruction and development. These institutions helped Croatia financially in developing institutions which are main prerequisites for maintaining the economic growth that Croatia is experiencing. Since Croatia showed continuous progress after the introduction of the Stabilization program in 1993, the above mentioned organizations recognized this by granting larger and relatively inexpensive loans. Some examples of investments are the following [Business Forum, 1999, 14, 42]:

- IBRD/World Bank : $US 413 + DEM 399.1 million[2] (1999)
- Council of Europe : HRK 240 million[3] (1998)
- IMF : $US 486 million (Feb 1997)

TABLE 6–The Largest Foreign Investments in Croatia

Activity	Company	Country	Croatian Company
Electrical Equipment	Telfonaktiebolaget LM	Sweden	Tesla d.d., Zagreb
Non-metal manufacturing	Hoffman & Pankl Beteiligungsgesell-schaft	Austria	Straza, d.d. Hum na Sutli
Cement production	Societe Suisse de Ciment Portland, S.A.	Switzerland	Tvornica cemenata Koromacno, d.d. Koromacno
Brewing	Interbrew, S.A.	Belgium	Zagrebacka pivovara d.d., Zagreb
Cement production	RMC group	U. Kingdom	Dalmacija-cement d.d., Kastel Sucarac
Chemical industry	Messer Grieheim	Austria	Montkemija d.d., Technicki plinovi, Zapresic
Non-alcohol beverages	The Coca-Cola Export Corporation	USA	Coca-Cola Bottlers d.d., Zagreb
Brewing	Southern Breweries Establishment	Lichtenstein	Karlovacka pivovara d.d., Karlovac
Electrical installation material	Elektro-Garaete A.G.	Switzerland	Elektrokontakt d.d., Zagreb

Source: Business Forum, 1999, 20

Croatia's first serious investor was the EBRD. It signed twenty-six investment contracts by August 1999, in total worth of ECU 515.5 [EBRD, 1999,1]. Nineteen of these investments were in the private sector, mostly in the most successful companies in pharmaceutical, food processing and banking industries. "In contrast with other countries, initial private sector transactions by the EBRD in Croatia are being developed directly with local firms" [Business Forum, 1999, 43], which provides evidence of Croatia's advanced stage in the process of transition.

VIII. Conclusion

The transition is far from over. Although it may seem that countries like Poland, Czech Republic and Slovenia have reached "the end of the tunnel", this is merely a misperception and misinterpretation of present economic indicators. One must not forget the circumstances from which transition emerged. The process itself is the product of human will, and new market economies that are emerging are more or less artificially made–rushed and forced to convert from command to free market economy. Even when economic requirements are fulfilled, a social/cultural/lifestyle change in people's minds will have to occur, in order for transition to be complete and for newly emerged systems to be sustainable.

Evidence presented in this paper suggests that Croatia has achieved economic stability. Taking into consideration the misfortune of involvement in 1990s Balkan Wars, Croatia's economic performance is better than expected (inflation, GDP growth, monetary and fiscal policy); and the factors that would suggest instability are under control (external debt, unemployment, current account deficit). The privatization progress is as good as anywhere else, since no model was available at the beginning of the process. It is mainly due to a lack of the World's experience with the problem of transformation of property, which leaves countries to experiment in trying to solve the question of property as quickly as possible, fighting corruption at the same time.

The level of FDI is expected to rise in Croatia as soon as the process of integration into major European and World economic and political organizations is accomplished. Croatia's potential is not a secret any more, but some political obstacles are still in the way. Reasonable cooperation with the West should provide the expected results, taking advantage of its potential in tourism, the pharmaceutical industry, shipbuilding, energy and resources.

This paper examined the transition problem from an economic perspective, while political, social and psychological aspects were neglected. Some of them were mentioned, but not nearly as needed in order to fully understand the transition processes.

Finally, in the future, the transition countries should not devote themselves only to the reconstruction of the economy, but should also keep track of what is going on in the rest of the World. With the information revolution occurring, the World is changing faster than ever. Advances in technology could possibly create some shortcuts in the transformation of the economies by accelerating the processes. Nevertheless, a certain amount of time will be needed for the newly formed market societies to actually become "true market societies".

Endnotes

1. A summary of the agreements can be found in IMF 2000, p. 30.
2. Exchange rate for Croatian currency kuna is fluctuating around 1DEM = 3.9 HRK
3. Exchange rate for Croatian currency kkuna is fluctuating around 1$US = 7.1 HRK

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