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BACKGROUND TO THE INVESTMENT CLIMATE IN SLOVENIA, CROATIA AND THE FEDERAL REPUBLIC OF YUGOSLAVIA

by Christopher Cviic

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SLOVENIA

Slovenia has since achieving indepndence in 1991 grown apart from the other republics of the former Yugoslav federation to which it belonged - although as an increasingly semi-detached member - for 46 years from 1945 till 1991. However, its integration into Western Europe has been neither as fast nor as smooth as most Slovenes - and Western governments - had hoped. Slovenia is in the 'first wave' of candidates for EU membership with whom substantive negotitaions stared on 10 November 1998. But despite strong backing from Italy as well as the support from France, Spain and some other smaller NATO countries. Slovenia's bid to be among NATO's 'first wave' of candidates was unsuccessful, not so much because of Slovenia's shortcomings but rather because the Clinton Administration's desire to minimise resistance in Congress to NATO's enlargement by offering as few candidates as possible in the first round.

NATO's decision has caused disappointment in Slovenia and has strengthened many Slovenes' doubts about the costs for their small country of joining Europan and Atlantic institutions. The growing unceretainty about Europe and Slovenia's position in it has crystallised in the national debate - echoing that in some small EU members like Denmark - over whether foreigners should be allowed to buy proprty in Slovenia. The Slovene parliament has, after much agonised debate, ratified the Association Agreement with the EU which has opened the way to formal negotiations for entry. But Slovene legislation concerning the right of foreigners to purchase property in Slovenia is not yet fully in line with that prevailing in the rest of the EU. Meanwhile, naitonal debate has spread to the issue of the role of foreign investment in Slovenia's economy and its central bank's controversila decision to curb foreing capital inflows. Only four of Slovenia's 28 banks are foreign-owned amd account for only a 5% market share. In October 1998, Hans van den Broek, the EU's External Affgairs Commissioner, singled out Slovenia, together with the Czech Republic, in terms of slow adaptation to key EU legislation - not only in the banking sector. Another example is that Slovenia's tax reform and transition to value-added tax (vat) is not yet on the statute book.

But the Liberal Democrat-People's Party coalition government, in office since February 1997 and led by Janez Drnovsek, an experienced politician and one-time member of Yugoslavia's collective state presidency, is firmly in favour of Slovenia joining both the EU and NATO, So is President Milan Kucan, who has few formal powers but wields considerable infoluence behind the scenes and was comfortably re-elected for another term in November 1997. A token of Slovenia's seriousness about Europe was the appointment, in December 1997, of Boris Frlec, an able diplomat from Yugoslav days and former Slovene Ambassador to Bonn, to the post of Foreign Minister to replace the volatile Zoran Thaler.

Western government have urged the Slovene government to use the period before the next batch of countries (including Slovenia) start their accession talks with NATO to settle outstanding problems with neighbours - Croatia, for example. Behind this lies the voisinage factor - fear that new members may import into NATO problems from their neighbourhood. This has led to a revision of Slovenia's previous policy of ostentatious distancing from the region of former Yugoslavia. There is also an eocnomic calculation behind this U-turn.

Though 65% of Slovenia's exports now go to the EU, there is nevertheless a growing realisation that some of the trade with the reigon of froemr Yugoslavia, which used to account for 70% of Slovenia's export markets, could usefully be reclaimed. The government in Ljubljana has in recent months made efforts to speed up the settlement of its political and eocnomic differences with Croatia, which include:

- the issue of Slovenia's access to the Adriatic through Croatian territorial waters in the Bay of Piran;
- the Ljubljanska Banka's outstanding debt to its former depositors in Croatia;
- the future of the jointly-owned nuclear-power station in Krsko, Slovenia, close to the Croatian border;
- and Croatia's desire for a corridor through Slovenia to Austria.

A meeting between the respective foreign minsiters i January 1998 ushered in a round of talks meant to lead to the resolution of outstanding issues. At another Croatian and Slovene foreign ministers' get-together in August it was decided to spend another three months seeking solutions to outstanding issues and then, if necessary, for for arbitration. But meanwhile relations between Ljubljana and Zagreb were ruffled by a quarrel about the functioning of the Krsko power station. The Slovenes accused the Croats of failing to keep up with their payments and thereupon cut off the supply to Croatia which was forced to increase imports from Yugoslavia. Zagreb-Ljubljana-Vienna 'trilateral' may be emerghing as a deliberate Slovene (and EU) effort to improve relations between Slovenia and Croatia and thus help stabilise the region.

In response to Western unease about Slovenia's policy towards its minorities - and a special gesture towards Austria - the ocuntry's (tiny) German-speaking minority was officially recvognised for the first time in January 1998. In the financial field, Brussels is pushing Slovenia towards faster reform of the country's banking system and greater readiness to to allow forteing capital in on the grounds that this would both help with the infdrastructure projects and with the speeding up of privatisation. Under strong American pressure, Slovenia has modified its original refusal to have anything to do with the (American-sponsored) initiative project for cooperation in South-Eastern Europe (SECI). Without prompting from outside, Slovenia is palying anactive role both in the Central Euroepan Initative (CEI), a 16-member body which grew out of the (Italian-promoted) Pentagonale and Hexagonale projects in the late 1980s and ealry 1990s. Slovenia belolngs, together with Poland, Hungary, the Csech Republics, Slovakia and Romania, to the Central European Free Trade Area (CEFTA) and is edeveloping within the Central European framework close cooperation (particularlky in transport) with Hungary and Italy.

CROATIA

Few European Union enlargement scenarios mention Croatia as a potential member and, if at all, then bracketed with Bosnia, FR of Yugoslavia and Albania as forming part of the 'outer ring' of no-hopers. This is no doubt one of the reasons why it has attracted so little foreign direct investment - only US1,78bn since 1993. This is puzzling because in terms of economic fundamentals, Croatia should be a leading candidate for early membership.

In the section of its working paper on South-Eastern Europe dealing with Croatia published in March 1998, the European Commission noted that Croatia had 'established a strong track record of policy implementatiton' and continued that 'this good economic performance was confirmed in 1997, with gdp growth estimated at 5,5% and inflation at 3.7%'. It also noted that there had 'been some strenghtening in recent months of macroeconomic institutions and policies necessary to ensure a stable economic environment'.

According to the World Bank's World Development Report, Croatia is in Group 1 of seven transition economies (Poland, Slovenia, Hungary, Croatia, Macedonia (official name: Former Yugoslav Republic of Macedonia or FYROM), Czech Republic and Slovakia). Ranked by gdp per capita, it is the fourth richest country in Central Europe (after the Czech Republic, Hungary and Slovenia).

Trade liberalisation has progressed very far in Croatia - too far in the view of some of its leading economists who claim that the rate of de-industrialisation has been too fast and harmful to the economy. Roughly speaking, some 60% of Croatia's trade is with the EU where its principal partners are Italy and Germany. Another 17% goes to CEFTA (Central European Free Trade Area) of which Slovenia is a member. About 19% of Croatia's total external trade is accounted for by the former Yugoslavia region (Bosnia, FR Yugoslavia and Macedonia) with exports to the region responsible for 30% of Croatia's total exports.

Annual hyperinflation of up to 1,000% ended with the launch in October 1993 of the stabilisation programme. In May 1994 the new Croatian currency, the kuna, was introduced, replacing the Croatian dinar. Since its launch, the kuna has been pegged to the D-Mark. Inflation was brought down to 3.7% in 1995 and 3.4% in 1996 but went up slightly to 3.7% in 1997 and following the introduction of value-added tax on 1 January 1998 to 5.8% by mid-1998 with a downward tendency after that. Since the end of 1995 Croatia's economy has been growing at a steady rate: its gdp grew by 5.9% in 1994, 7.1% in 1995, 6% in 1996 and 6.5% in 1997. On 1 January 1998 value-added tax (vat)at the flat 22% rate replaxced complex set of turnover taxes averaging 26.5%. In early January it was announced by the government that the central government budget deficit for 1997 was 1,1bn kuna (US$173m) - around 1% of estimated gdp, compareed with the budgeted deficit of 2.6% of gdp. On 19 December 1997, the lower house of the Croatian parliament adopted the 1998 government budget, with the projected deficit set at 1.6%. of gdp. Larger-than-expected receipts from vat enabled the government to raise peansions payments but also led to a liqudity crisis for in a large number of firms.

Croaita does not yet qualify even for the membership of CEFTA - let alone for that of the European Union but it was not always so. While still a federal republic of Yugoslavia, Croatia enjoyed a privileged position towards the EU. It received twofold treatment by the EU. The general approach and the institutional framewwork for cooperation were defined within the EU Mediterranean policy (Cooperaton Agreement, signed in 1980) while in the programmes of mutilateral assistance it was treated as a Central European country and was included for a short while in the PHARE pregramme. The Cooperation Agreement was terminated by the European Council in November 1991. Since then the EU has been unilaterally extending the trade regime defined by the Agreement. Negotiations with the EU about a new Cooperation Agreement started in June 1995 but were suspended in the summer of 1995 following Croatia's military offensives Bljesak (Flash) and Oluja (Storm) to recapture areas that had been occupied by the Serbs since 1991. Political considerations are also blocking Croatia's path to memberhip of NATO and even of NATO's Partnership for Peace (PfP) programme.

The result is that, apart from the Council of Europe, the only other European body of substance that Croatia belongs to is the Central European Initiative (CEI), the 16-member organisation which - apart from Croatia - also includes Albania, Austria, Bosnia, Bulgaria, Belarus, the Czech Republic, Hungary, Italy, Macedonia. Moldova, Poland, iomania, Slovakia, Slovenia and Ukraine, As chairman of CEI in 1998, Croatia is trying to use this position to get closer to CEFTA and ultimately to join it in the not-too-distant future. With that aim in view, Croatia is negotiating bilateral free-trade agreements with individual CEFTA members. In 1997 it signed a freee-trade agreement with Slovenia, and it opened talks abouta free-trade agreement with Romania, anothjer CEFTA member. It is holding talks with the World Trading Organisation (WTO), whose senior representative visited Croatia in May 1998. Membership of CEFTA and of the WTO are pre-conditions for joining the EU, but the third pre-condition, an Association Agreement with the EU, is not yet in sight.

Croatia has, however, had its economic successes which reflect not only its free-market reforms implemented since indepndence but also its achievements in Yugoslavia until 1991. Together with Slovenia, Croatia was the main industrial exporter in Yugoslavia as well as, thanks to its well-developed tourism and remittances from Croatian workers in Western Europe, the biggest earner of hard currency in Yugoslavia. Under the de-centralised Yugoslav economic system, economic enterprises enjoyed a lot of freedom in their day-to-day operations which they made full use of. Croatian companies had a lot of trading experience with the EU. This made it easier for them to replace the markets lost in 1991 when Yugoslavia broke up than it was, for exmaple, for Czech, Hungarian or Polish companies to replace their lost Comecon markets after its collapse in 1990-91. The presence of a large Croatian diaspora in Western Europe also favoured close trading links.

Croatia's economy was damaged by the war in 1991, but the damage was less than assumed at the time. Less than 10% of industrial capacity was damaged by war. Some of the enterprises which were damaged belonged to the category of socialist dynosaurs that would have had to be pulled down anyway. The Serb occupation of nearly a third of Croatian territory, which was completed with the peaceful reintegration of Eastern Slavonia, Western Srijem and Baranja in January 1998 had little direct effect. The bulk of the land, which was retaken by the Croats in two operations in May and August 1995, was of little economic value. The fertile territories in the east,where Vukovar is situated which were integrated last, will - though devastated first by war and then by neglect during the subsequent Serb occupation - be an important addition to Croatia's economic potential.

The biggest downturn occurred in the service sector and in infrastructure. Tourism on the Adriatic coast declined dramatically. There was a shortage of capital to finance tourism's recovery. Loans by the World Bank and the European Bank for Reconstruction and Development (EBRD) were held up for a full two years after Croatia's diplomatic recognition in January 1992 for political reasons: Western governments, using their influence in those institutions, were in this way punishing the Tudjman regime for making war on Bosnia's Moslems while at the same time continuing to plot the partition of Bosnia with the Milosevic regime in Belgrade. Political barriers to those funds were subsequently removed and tourism is on the way to becoming, once again, a big foreign-exchange earner for Croatia. There are a number of structural economic problems in key sectors that even a Croatia whose political path to the EU was clear would have to tackle before it could seriously contemplate moving towards membership.

Those structural problems are chiefly to be found in three main sectors: manufacturing, tourism and- banking.

The manufacturing sector generates approximately a quarter of Croatia's gdp but this share has been shrinking in recent years in favour of the service sector. The share of the manufacturing industry in the Croatian economy as a whole has diminished from 26% in 1990 to 20.3% in 1996, thus approaching the EU average level of participation of industry in gdp.

The year 1996 was a turning point for the Croatian economy as a whole,not least for the industrial sector. In that year, industrial output went up by 3.1%, the first annual increase after a long period of declining industrual productionthat had begun in 1990. The upward trend was continued in 1997 with a 3.9% increase. In the first eight months of 1998 industrial output went up by 6.8% compared with the January-August period in 1997. But Croatia's current industrial output is still 40% lower than in 1990.

The most important sectors are: food and beverage industry (22.1% of total industrial output); manufacture of coke, refined petroleum products (12.7%); chemical industry (10.4%); textile and clothing industry (5.9%). According to the most reecent available statistics (for 1997), Croatia's manufacturing industry employs 279,000 workers - 50% fewer than in 1990. Most of them work in tne textile and clothing industry (16.8%0;8

Restructuring in industry is proceeding very slowly. The only company that has so far made much progress in this respect is the pharmaceutical firm Pliva which, unlike many other Croatian companies, Pliva had not been as much affected by the war. Pliva's revenue from the United States - licence fees paid by the American Pfizer Corporation for the use of Azithromycin, an antibiotic discovered by the Croatian company's scientists in the early 1980s - continued to come in, Pliva managed to regain its prewar level of turnover alreayd by 1995. ts strong market results enabled Pliva to complete its privatisation programme by early 1996. It was then that its shares were listed on the London Stock Exchange. The sale of the second tranche was held in the spring of 1998. The European Bank for Reconstruction and Development (EBRD) has granted it a loan which has enabled its management to speed up the restructuring of the company. Since 1996 Pliva has been expanding. It has invested $100m in a new factory it is building at Savski Marof near Zagreb, Croatia's capital. In October 1997 it bought Polfa Krakow in Poland for more than $200m. Pliva's net profits in 1997 were - at 604,3m kuna - 31.8% higher than in 1996.

Unfortunately few of Croatia's companies can match Pliva's record of success. Privatisation of the country's industrial sector has in effect meant little more than laying off excess labour, It has brought in little new capital and no extra management expertise. Since the banks have not been lending, there has been no new investment worth speaking of. The sell-off, via a mass privatisation programme, has raised little cash either for the companies or for the government. The latter has collected more revenue from sales of state-owned apartments.

The main reason for this has been the 1991 privatisation law which allowed the companies themselves to decide how they were to be privatised. It also provided a strong incentive for management and employees to buy shares. They were given a pre-emption to buy half the company. The pricce paid by each employee was set at a discount of 20% to nominal plus an additional 1% discount for every year the employee had spent working for the company. The other half of the shares were sold through tender offers. Employees were also allowed to take part in those - although without preferential treatment. Unsold shares were transferred to the Croatian Privatisation Fund and two state pension funds.

As a result, most company shares hsve been sold, in instalments, to employees. Few companies received fresh capital or outside shareholders with an incentive to force management to concentrate on making a profit. The complicated ownership strucuture has made it hard for companies to restructure at all. In effect, the first stage of privatisation was in most companies a worker buyout combined with a transfer of shares to the state. Since none of the industrial companies had been in state hands - under the Yugoslav self-manangement system they were socially-owned - Croatia's privatisation scheme amounted to large-scale de facto nationalisation of industry. The privatisation fund, instead of making use of a 1996 legal amendntment allowing it to repossess shares if employees default, has lengthened the repayment period from five to 20 years. The complications caused by the scheme have discouraged foreign investors, allowing managers to consolidate their power. Shareholders who are also employees are often faced with the unpleasant choice of voting with the management or losing their jobs.

More companies have been lined up for privatisation since then. Podravka, the large food processing company in Koprivnica, which produces packet soups under licence for the Oetker company in Germany and has developed its own food seasoning called Vegeta,,has emerged from the red, ending 1997 with a profit. Podravka is now considering offers of credit as well as of capital from abroad to help it finance the DM 31m investment in a factory it is planning to build in Poland and which would be producing Vegeta and soup packets. Other Podravka projects include the building due to start in August of a new DM 52m factory in Koprivnica and the DM 67m Belupo pharmaceutical complex combining a distribution centre, production plant and laboratories with the aim of embarking on the development and production of a range of new products and raising Podravka's overall output by 10%. All this raises the possibility of a share issue like that of Pliva's though the international financial crisis has caused a delay here and in the case of some other candidates for a share issue.

The most prominent are: the Croatian Telecoms, the oil company INA, the enginering group Koncar and the Adriatic pipeline operator Janaf as well as a number of banks and hotels. The biggest of those privatisations is likely to be that of Croatian Telecoms. After much hesitation, the issue was decided on 10 June 1998 by VONS, the Council for Defence and National Security which, under President Tudjman's chairmanship takes strategic decisions not only on defence and security but also major economic matters which the government then carries out. The telecommunications system will be hived off from the Post Office be sold off to private investors from Croatia and abroad. It was a announced in November 1998 that a 31% stake in the new telecommunicstions company will be offered to international and domestic investors. A 30% stake will be offered to the State Pensions Fund and 21% stake to theState Privatisation Fund with the rest available to small domestic shareholders.

A new scheme under which privatisation vouchers are since January 1998 being distributed to 225,000 war victims (estimated at 5% of the population) and former political prisoners has proved controversial. The original list of 450 companies - some of them valuable like Podravka, Janaf and chocolate producer Kras - has been drastically reduced, provoking anger among the powerful lobbies representing war veterans and former political prisoners. The main charge is that prime companies have ended up in the hands of members of the ruling party (HDZ) or those with party connections.

Under the Bill on Privatisation and Investment Funds, adopted by the Croatian parliament in October 1997, strict rules aimed at preventing malpractices observed wlsewhere in Central Europw have been set for the investment funds that are going to handle the vouchers. They must deposit $2m in cash and collect at least 100m voucher points before starting a fund and can only charge fees based upon capital appreciation. The result has been that only a handful of fund managers have shown interest in taking part.

Tourism is one of Croatia's key industries, as can be seen from the fact that it has today 480 modern, world-class hotels, 77 tourist resorts, 40 marinas and around 300 camping sites. In 1990, the last year before the war when Croatia was still a republic of the Yugoslav federation, tourism accounted for 6.1% of Croatia's gdp, 61.2% of service exports and 6.3% of employment. In additionto this direct impact, there was also an indirect, undeclared one as only 50% of tourist spending, 30% of tourist traffic and around 14% of tourist trade were recored. When this undeclared activity is taken into account, it is estimated that as much as 12% of gdp and 10-12% of jobs were generated by tourism. In the best tourist years, about 10m or so toruists visited Croatia. Tourism was estimated to have contributed about $4-5bn to the country's gdp. Foreign tourists contributed 65% of the total of 69m bed nights in 1989. Croatia's share of the international market was just over 1%.

The war with the Yugoslav People's Army (JNA) and the Serb paramilitaries in 1991 brought the industry to a standstill. The war in Croatia ended in January 1992 but the war in neighbouring Bosnia continued to hamper Croatian tourism's recovery. The signing in November of 1995 of the so-called Dayton Accords which ended the war in Bosnia. Also in 1995, Croatia retook by military action two of the three of its territories held by rebel Serbs since 1991 and took the firsat steps in cooperation with the international community towards the peaceful re=integration of the third - in Croatia's Danubian region.In 1997 a substantial number of foreign tourists returned to Croatia. The number of foreign tourists rose 36% in 1997 compared to 1996 to 3,4m, still well down on 1990.

But Croatia's tourist industry will have to work hard to win back the tourists and become profitable. One barrier to profitability is the short duraiton of the season. The temperature may be very satisfactory on the coast - especially further south towards Dubrovnik - for six months of the year but 90% of the tourists in 1997 came in June. July and August. It is difficult to make hotels profitable during the reemaining nine months of the year. Tourist officials would like to abandon mass tourism and instead go for the higher end of the market. But this is easier said than done. In fact, the reverse seems to be happening in the 1990s. In 1997 there were 950,000 visitors from Hungary, the Czech Republis, Slovakia and Poland. With 650,000 Slovene and Bosnian tourists, that represented around 45% of the 3,7m tourists last year. Most of them came on packaga deals sold on tiny margins. The same applies to the 1,1m Croatian tourists. The number of visitors from Britain and Germany is still well down on pre-1990 figures - though more Italians are coming back.

Other problems are high prices (due, not least, to the strong kuna) which make Croatia an expensive country for the average tourist, and sub-standard levels of service.

Many waiters and chefs left the country when the war started. Most have not returned.

Large amounts of investment will be needed to repair the hotel stock. Many hotels were used to house refugees from Bosnia and other parts of Croatia from 1991 on till quite recently and require complete renovation. Many of those hotels, last refurbished in the 1970s, were not of the highest standard anyway. Ownership structure is complex. Many hotels went into debt after 1991. Banks did debt-for-equity swaps and ended up by beocming major owners in the tourist industry. Previously, under Communism, hotels used to be owned by groups belonging to the local municipality. Some of those have now been fully or partially privatised.

Like in manufacturing and tourism, restructuring still has some way to go in Croatia's banking sector. Croatia's financial system is dominated by banks; capital markets are less developed. There is a two-tier banking system, with the National Bank of Croatia acting only as a central bank and not engaging in commercial banking. Croatia has a floating ezxchange-rate regime operated by the National Bank as a 'managed float' - ie, the NBC intervenes to limit fluctuations.

For a small country of 4,8m inhabitants, Croatia has too many banks - 6i licensed commercial banks and 31 savings banks as well as a development bank, the Croatian Bank for Reconstruciton and Development which is fully funded by the government. In addition, there are 17 insurance companies, most of which are small institions, active only in some areas of insurance business. The financial structures are underdeveloped and markets are both shallow and narrow. There is an interbank money market in Zagreb operating as a joint-stock company founded by comemercial banks. The Zagreb Stock Exchange (Zagrebacka Burza), first established in 1918, was revided by 25 banks and insuranc eocmpanies in July 1991.

One of the features of the banking sector is that the already wide gap between the big ones doing well - like the Zagrebacka Banka - and the smaller fry strugging to survive has widened in the past year. The large domestic banks grew very fast in 1997. Corporate lending rose in the first ten months of the year by 40% and consumer lending by nearly 70% as a result of a increase in the number of car loans. That has increased banks' profits. The state's rehabilitation programme started in 1995 when four banks embarked on the rehabilitation process, The second, third and fourth largest banks have undergone rehabilitation in the past year and are government-owned. Privredna Banka, formerly the largest bank in Croatia, has finished the first stage of its rehabilitation programme. The government has invested $2m to to recapitalise Rijecka Banka and Splitska Banka and is now seeking private investment for them. Zagrebacka Banka. now the largest bank, is mostly privately owned and has a substantial foreign shareholding. Slavonska Banka in Osijek, an important regional bank, is now part-owned by EBRD.

But many of the smaller, under-capialised banks have been hit hard by the growing competition and ever smaller margins. ome of the competition comes from foreign banks. Reiffeisenbank Austria opened a Croatian subsidiary in 1994. In 1996 it was joined by Bank Austria, Creditanstalt and volksbank - all Austrian - but also by Societe Generale of France. Another French BNP/Dresdner is opening a branc this year. It is a profitable business: Reiffeisen mad a net profit of 30m kuna in 1997 and claims that it ithad not doubled its capital, it owuld have recorded a 40% return on equity.

A shock was sent through the Croatian banking system by the crisis amid signs of a political power struggle in March 1998 in Dubrovacks Banka, the oountrry's fifth largest, whose general manager, Neven Barac, had enjoyed the reputation of a dynamic but also conservative bankerand had made the bank extremely profitable. The story behind the crisis is still not quite clear but it appears that the bank's biggest client, Miroslav Kutle, a millionaire businessman originally from Hercegovina and with strong HDZ connections, got into severe trouble. Barac had Kutle's account blocked, whereupon Kutle used his links with the powerful 'Hercegovina lobby' in the Croatian political establishment to have Barac sacked and arrested on charges of illegal dealings (he has since been released). The Croatian government took over the bank and appointed a temporary general manager charged with the task of sorting out the Kutle business. This proved too much for this highly unpopular lobby's numerous opponents who feared that, yet again, Kutle who had acquired most of his huge wesi enormous weaklth through HDZ connections, would get away with it leaving the Croatian tax-payer to foot the bill.

To the regime's intense embarrassment, a popular weekly Nacional revealed that Kutle's secret backer and partner in Dubrovnik was none other that Ivic Pasalic, President Tudjman's chief political adviser and himself a Hercegovinian. Hrvoje Sarinic, a former Prime Minister and now head of the President's office, demanded a full inquiry and threatend to resign unless his demand was granted. Tudjman whose personal links to the 'Hercegovina Lobby' are close (though he - like the late President Tito - hails from Zagorje in northern Crotia) at first agreed but later backtracked. Since then Sarinic has has resigned - as has Andrija Hebrang whom Tudjman had appointed earlier in the year as Minister of Defence with the brief to reorganise it while also reducing defence costs (Croatia spends about 6% of its gdp on defence). Pasalic's hardline faction has since increased its hold over the HDZ.

The government, where most of the HDZ moderates are to be found, does not dissent from the the European Commisison's Working Paper on the region of March 1998, which notes that progress in the banking sector is still too slow. This is, in the Commission's views, 'because institutions taken over by the government required rehabilitation, restructuring and privatisation'. It goes on to say that a further improvement of banking supervision and and disclosure rules was needed as well as modernisation of capital markets and notes that measures to that ewffect have been announced. The National Bank of Croatia has for several months now been refusing to issue licences to Croats wanting to start new banks and is drafting an amended banking law designed ot help it to strengthen bank supervision

Croatia faces a number of serious difficulties in its attempt to introduce a functioning market economy. Some of those problems are common to all countries in transition from Communism to post-Communism. Others are specific to Croatia as a country that in additon had to cope with war in 1991 which did not really finish until 1995. Some of the current problems spring from the changing demographic picture. The number of retired people reached 893,000 at the end of 1998 but 84% of those were etired early. Since 1991 early retirement has been favoured by firms as a means of shedding excess labour. This has placed huge new burdens on the country's state pension fund (private pensions hardly exist). Together, the large army of the unemployed (the unemployment rate is 18%) and the retired people number 1,2m people. As the number of people in employmewnt - minus the army, police and individual farmers - is 1,04m, This means that there is a serious imbalance here. Hence the government's decision to raise the retirement age for men to 65 and for women to 60. Taxation is high but so is tax evasion (the 'grey economy' is estimated at 25-30% of totasl economic activity).

In order to meet its obligations, the government has had to increase foreing borroiwng. At the end of 1997 Croatia's total external debt (including interest arrears) stood at US$5.9bn, up from US$4.9bn at the end of 1996. By July 1998 it had gone up to US $7,36 bn. The bad thing about this growing indebtedness is that most of the money borrowed has gone not into new investment but into paying pensions and salaries. Fortunately, the debt burden is still manageable at just over a third of gdp. Financing its deficits and servicing its debt will mean that Croatia Croatia will have to continue to borrown heavily on the einternational capital markets in 1999 and to do so in the less favourable conditions due to the crises in Asia and Russia.

In Croatia the overall economic outlook remains positive but there are concerns. One of them is the widening current-account deficit (9% of gdp in 1997) despite a continuing growth in exports. In the first nine months of 1998 Croatia's exports totalled US3,3bn which was 6% more than in the corresponding period of 1997. Imports, at US$6,2bn, were 2% lower than in the corresponding period of 1997. Imports from Italy, at US1,1bn, during that period were 9.3% lower than in the January-September period of 1997. At US$602m, exports to Italy in that period were 1.6% lower.$6,2bn, which was 2% less than in the same period of 1997. Another worry is the overvalued currency, but the government is resisting devaluation fearing that dearer imports would add to the already growing inflationary pressures in the economy.

However, the chief concern remains Croatia's political situation. The government presided over by Franjo Tudjman, Croatia's leader since 1990, is under strong pressure from Western governments on several fronts: over the return of its Serb citizens who had left since 1991; over Croatia's policy towards the impelemntation of the Dayton Accords of 1995 in Bosnia which Western governments still consider insufficiently cooperative; and over the pace of its democratisation (especially in the field of the electronic mredia) which Western governments would like to see speeded up. In order to secure Croatia's compliance, Wstern governments are using economic and financial presures including the threat of economic sanctions. Meanwhile, Croatia is kept out in the cold as regards prospects for EU and NATO memberhsip. Many Croats, including the (relatively weak) 'moderate' wing of the HDZ, agree with what the West is demanding from Croatia because they see it in Croatia's own interest. But there is strong resistance from hardliners in the 'Hercegovina Lobby' whose members have benefitted enormously from the 'soft border' between Croatia and Hercegovina). Keeping its present political and military stake in Bosnia via the HDZ there and the Croat Bosnian army (HVO) is costing Croatia a lot and the burden is deeply unpopular with the majority of the Croatian electorate.

The opposition - particularly thew Social Demcrats (former Communists) has grown in strength in the past year.. The ruling party is deeply unpopular and could easily lose an election if one was held now, Tudjman is still given credit for leading Croatia into independence but the widespread corruption his Bosnia policy have dented his popularity. In any case, at the moment the HDZ has a majority in the lower house of the Croatian parliament, but the elections are due in 1999. Over the whole situation falls the shadow of President Tudjman's illness. He has cancer, and it is not sure whether he will be able to serve out his third (and last) presidential term which expires in 2002. It is clear that as long as Tudjman and the HDZ remain in sole power in Croatia, the political climate in its relations with the West will not improve. This in its turn will continue to have an adverse affect on its prospects for closer cooperation with the West and its eventual memberhsip of the EU and

NATO. By the same token, a speedier political change resulting in a new government could bring about a dramatic improvement in Croatia's international prospects.

FEDERAL REPUBLIC OF YUGOSLAVIA

In the Federal Republic of Yugoslavia, which since socialist Yugoslavia's break up in 1991 consists of the former federal rpeublics of Serbia and Montenegro, the near-catastrophic economic situation is closely related to the equally serious political crisis. From 1945 till 1991 today's rump Yugoslavia as well as the now independent republic of Macedonia (official name: Former Yugoslav Republic of Macedonia, or FYROM, for short) was subsidised by the richer western republics of Croatia and Slovenia. But a much bigger factor in the present economic situation are both the direct and indirect costs of the wars Belgrade had waged first in Croatia in 1991 and in Bosnia from 1992 to 1995. No material damage of any kind was caused within Serbia or Montenegro because the was waged entirely outside their broders but the cost of prosecuting it ever indirectly has been high. So is the cost of the combined police and military operations conducted by Serbian police and army units since February 1998 in the majority-Albanian Kosovo province.

In the earlier operations in Croatia and Bosnia, there was not only the cost of actual military operations but also that of keeping afloat financially the Serb regime. Republika Srpska Krajina that controlled about a third of Croatia's territory until the Croats took it back in two successive military operations in 1995. Although also nominally independent of Belgrade, the other Serb regime outside Serbia - that in Bosnia, Republika Srpska - was also totally financed from Belgrade. Its armed forces, like those of the Serbs in Croatia, wwere integrated into the Yugoslav armed forces renamed after 1992 Yugoslav Army (Vojska Jugoslavije).

In addition to the cost of prosecuting those wars, Serbia has had to cope with economic sanctions imposed on its by the UN Security Council in May 1992 for its role in Bosnia. Those were lifted after the signing, in December 1995, of the Dayton Accords which ended the war in Bosnia. But the 'outer wall' of sanctions against FRY still remains in force, barring its access to the Intenraional Monetary Fund and membership of the UN. In the summer of 1998 following Serb security forces' attrocities against the Albanian civilian population in Kosovo and Belgrade's refusal to poull those forces back, a ban was imposed by the European Union and some other states, exclusing Russia. on flights by FRY's national airline JAT. In addition, a ban was imposed on arms exports to FRY; the state's financial holdings abroad were frozen; a ban on credits and invesatments to help with privatrisation projects was imposed together with a ban on journeys to the West by officials concerned with Kosovo policy. But in October following a last-minute deal over Kosovo (see below) between President Milosevic and Richar Holbrooke, the American special envoy, the government in Belgrade narrowly escaped bombing of its military targets by NATO planes and rockets. However, the deal did not lead to any relaxation of Western financial and economic pressure on Belgrade.

At US1,600, FRY's per capita domestic product is half the 1989 level. Foreign debt is about US$20bn. In October 1998 inter-enterprise debt stood at 140bn dinars (1 dinar=DM7). In addition, the banks were owed by the enterprises another 70bn dinars. In October 1998, average monthly pay was about 1100 dinars (US$108). Unemployment -

officially 26% - was in reality much higher - and growing. The middle class has been all but wiped out. It is estimated that, since 1991, more than 200,000 people with university and/or secondary-school qualifications have left the country. So far, the Milosevic regime had got by but the going is getting tougher. The introduction of financial reform in early 1994 presided over by the then governor of the National Bank, Dragoslav Avramovic, helped stabilise the dinar and also led to a spurt of renewed economic activity. In 1997 help for Milosevic came in the shape of an excellent harvest in the fertile province of Vojvodina in the north. Another lifeline was the sum of DM 1,6bn from the sale of 49% of Serbia Telecom to Italy's Stet and OTE of Greece.

However, the money was not spent on restructuring Serbia's obsolete heavy industry and on modernising the badly run down communications network. The bulk of the money went towards paying the backlog of pensions and wages ahead of the autumn 1997 elections. Now FRY urgently needs an injection of about US$1bn immediately to be able to carry on, according to the former Governor Dragoslav Avramovic (Ekonomska politika, 12 October 1998), with another billion badly needed to improve the modernise the country's infrastructure. But there is at the moment no sign of where such an injection could come from in view of the lack of domestic capital and the ban on foreign investment in FRY that stops from coming in even those willing to take a chance. With little or no chance of selling more assets like the telecoms or of raising significant foreign credit, Milosevic may soon, perhaps this winter, face massive public unrest that would - unlike that earlier one in 1996-97 - involve not only Belgrade's thinned-down middle class and the students, but also the workers and even the population in the countryside which has hitherto remained politically passive.

The new crisis in Kosovo, far from helping him by uniting public opinion around him and his regime, has put him on the defensive. It was in Kosovo back in 1987 while socialist Yugoslavia still existed that Milosevic, then still only Party leader in Serbia, put himself forward as the self-appointed champion of Kosovo's Serbs. It was from there that in 1987 he started his campaign for total power in Yugoslavia that two years later, in 1989, led to the dismantlement of Kosovo's considerable autonomy granted to it by President Tito in 1974. For nearly a decade while Milosevic tangled with, first and briefly, Slovenia, then, equally unsuccessfully, with Croatia and finally - also without success - with Bosnia, Most of Kosovo's Albanians lost their jobs in the province's administrationn, schools university, health service amd industry but they offered only passive resistance fearing a head-on clash with the far stronger Serbian forces. They remained, as opinion poll after opinion poll showed, totally committed to independence - rather than the status quo or union with Albania. A parallel state-within-state was established in Kosovo, with an elected parliament, president, prime minister and government, schools and health centres supported by an unofficial but functioning system based on remittances sent by 500,000 or so Albanians living and working in the West. But as years went by and with the war in Bosnia over, the Kosovo Albanians patience ran out. There was a backlash against the 'Ghandian' policy of Kosovo's informally elected president, Ibrahim Rugova. He was re-elected in the unofficial election on 22 March 1998 his main critic and rival Adem Demaci having decided not to stand against him. Demaci, who spent 28 years in Yugoslav (to the Albanians, Serbian) jails and is popularly known as Kosovo's Nelson Mandela, had accused Rugova of having interpreted non-violent struggle as passivity and thus weakened Albanian political resistance to Serbia domination in Kosovo. He predicted that most Albanians would be driven by a sense of powerlessness and frsutration towards armed struggle being advocated by a shadowy body calling itself the Kosovo Liberation Army (KLA) which had since the autumm of 1997 started appearing in Kosovo and attacking Serb police.

Demaci's sombre predictions were borne out by the punitive raids carried out on 5 March and repeatedly afterwards by Serbian police supported by helicopters, tanks, aremoured vehicles and artillery against villages in various parts of Kosovo. In the first of those raids in the region of Drenica 8o Albanian women and children were killed. The Serb reprisals were said to be for the killing of two Serb policement by the KLA. As the conflict in Kosovo escalated, Western governments issued reepeated warnings to both sides to start negotiating instead of fighting. After a series of atroctities committed by Serb forces during the summer Milosevic was warned of the possibility of air raid against Yugoslav military instasllations unless Serb security forces and army units were pulled out of Kosovo and the refugees - by then almost 300,000 of which 50,000 had had their homes destroyed by Serbian forces - were allowed to return home. Explicit threat of a NATO intervention in October claiming the authority of a Security Council resolution in September persuaded Belgrade to back down - though Russia had continued to oppose any armed action against Yugoslavia and even some Western governments had had doubts not only about the wisdom but also the legality of such action.

Under a deal negotated in October by Milosevic and Richard Holbrooke, the American specail envoy who had brokered the Daytong Accord which ended the war in Bosnia, Belgrade agreed to a pullback of the bulk of its forces from Kosovo to be accompanied by the return of all the refugees. The implementation of the agreement was to be watched by 2,000 international 'verifiers' under the authority of the Organisation for Security and Cooperation in Europe (OSCE), protected by NATO planes from the air and a special NATO force of 1,500 men stationed in neighbouring Macedonia and Albania. Milosevic also agreed to meaningful talks with the Kosovo Albanians and the holding of elections within a year. The arrangement was to be reviewed in three years.

The Kosovo Albanians, badly battered by the Serbs but confident that history and demography were on their side, agreed to the deal which had meanwhile formalised the position of the KLA as one of the negotitating partners on the Albanian side. On the Serbia side, however, there was widespread dismay. Ultranationalists and the Serbian Orthodox Church accused Milosevic of selling out. The regime's reaction was the introduction of a draconian information law which was immediately put into operation. Several independent newespapers and radio stations were closed down and their editors subjected to crippling financial fines. Observers in Belgrade see Milosevic now as seriously weakened and liable to be replaced in the not-too-distant future replaced by Vojislav Seselj, an ultranationalist and former paramilitary leader who is now vise-premier in the Serbian government. He is leader of the Radical Party whose member, Nikola Poplasen was in September winner of the presidential election in the Serbian entity in Bosnia. The outlook in Serbia is, therefore, for more turbulence which the small and disheartened democratic opposition is unable to influence. Belgrde will be unable in the longer run to keep control over Kosovo. The internationalisation of the Kosovo issue is in the longer term likely to lead to the province's independence rather than its union with Albania and the majority-Albanian parts of Macedonia. Montenegro, which has been increasingly restive during the Milosevic years and has used every devise short of o-penly seceding to distance itself from Belgrade, is also likely to regain its independence which it hadf lost when it joined the new state of Yugoslavia in 1918.This the longer-term prospect but in the shorter term there are likely to be further crises and alarums thought not a war. This year has seen the Kosovo boil lanced with much pain and suffering involved for its Albanian inhabitants but also the possibility of a solution. As in Croatia and Bosnia before, Serbia is going to be the loser. However, the end of Serbian domination over Kosovo is the precondition for the establishment od democracy in Serbia which will, unfortunately, take time. (End)