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CROATIA

Boris Vujčić has been the Governor of the Croatian National Bank since 2012, with his current term expiring in 2024. He joined CNB in 1997 as Research Director, and was a Deputy Governor from 2000-2012. He is an economist with a PhD from the University of Zagreb, with additional studies at Montpellier University and Michigan State University. He was a Deputy Chief Negotiator in Croatia's negotiations with the European Union and a member of the Global Development Network (GDN) Board. Currently, he is a Member of the Steering Committee of the ESRB and a Chairman of the Steering Committee of the Vienna Initiative. Given his uniquely strong background in economic research and policymaking, he is active in helping to shape economic policy thinking in Europe.

Central and eastern European countries have made great progress since the early 1990's and we can say that their transition towards marked-based economies is now largely completed. Income gaps with western Europe have been narrowed but convergence is far from over. The pace of convergence has slowed down since the recent economic crisis, highlighting the need for new sources of growth. It is now clear that a new generation of reforms targeting areas such as product markets, competition policy, labour markets, public finances, and taxation (including social security systems) is needed to lift potential growth; as the low hanging fruit of productivity gains from sectoral reallocation, foreign direct investments and related technology transfers have been harvested.

However, past experience seems to indicate that readiness for reform implementation strongly depends on macroeconomic conditions and exogenous pressures. For example, [Da Silva et al. (2017.)]() show that structural reforms in EU member states in product and labour markets are more likely to take place during deep recessions and when unemployment rates are high. Also, external pressures, such as being subject to a financial assistance programme provide additional support for pro-competitive reforms. What they also suggest is that the more distant from best practices, the more likely a country is to implement reforms and that the EU single market and its numerous binding directives has facilitated pro-competitive reforms in various national product markets. However, they also show that reforms were more likely to be implemented before EU accession, which is in line with some other findings, supporting the view that candidate countries were strongly engaged in meeting accession criteria in the years prior to accession, while reform efforts tended to decline after they became full members.

The relatively recent improvement in the EU economic governance framework, which was introduced as a response to economic and financial crisis tried to address the need for stronger structural efforts. Among other things, country-specific recommendations (CSR) were introduced providing guidance on policy measures in different areas. It seems that CSRs have contributed to reform implementation in Member States but that the intensity of reform efforts has been on a declining trend since the first introduction of CSRs.

Notwithstanding the improvements in the EU governance framework, data suggest that CESEE countries still have a lot of room to improve their institutional quality and business environments and that structural efforts were stronger in the pre-accession period. One of the most commonly used indicators of institutional quality is the Worldwide Governance Indicators (WGI) published by the World Bank, which measure several dimensions of institutional quality, including government effectiveness, regulatory quality, rule of law and control of corruption. WGI data indicate that new Member States still lag significantly behind the top three global performers and most of them are below the EU average. Looking over time, most countries have improved their institutional quality over the last twenty years, but progress has in general been limited and in some cases quality has even deteriorated.

The World Bank also publishes the well-known Doing Business indicators, which are more focused on the stringency of business regulations. When looking at the last available data, one can see that some Member States still have a lot of room for improvement. On the other hand, some countries are well above the EU average and in some areas have managed to move their business environment close to the frontier. The Baltic countries, for example, are among the top performers when it comes to the ease of starting a business.

Improvements in institutional quality would give significant impetus to the convergence process. Stronger improvements in institutional quality in new Member States was in general associated with stronger increases in relative incomes. Empirical literature also suggests that differences in the starting level of institutional quality also matter for subsequent growth, implying that still sizable differences in GDP per capita in most new Member States relative to the EU average can also be linked to relatively unfavourable initial institutional conditions.

Over the past 20 years, new Member States also implemented structural changes to their labour markets and structural efforts seemed to intensify during the crisis period. The European Commission's labour market reform database (LABREF) provides detailed information on the main trends in labour market reforms in the EU across a wide range of labour market areas. One can first notice that the average number of reforms adopted by both CESEE and other EU countries exhibits an increasing trend, and the average number of reforms per country in new Member States reached a peak in 2014. Looking by policy area, most reforms in new Member States relate to active labour market policy and labour taxation. Since the start of the global crisis, reforms in the area of job protection have also gained in significance.

The LABREF database also contains information on the direction of the average number of measures in each domain, which contributed to increasing/decreasing the underlying policy settings. This provides additional insight about the purpose of labour market measures over the past 20 years. What can be noticed is that in some areas, the direction of measures significantly changed during the crisis period. For example, labour taxation in the pre-crisis period and even at the start of the global financial crisis in general decreased, as some countries tried to cushion the negative impact of the economic downturn on employment. But with unfavourable cyclical conditions putting pressure on public finances, a number of measures with a decreasing effect steadily declined and in 2011 the average number of measures aimed at increasing the tax burden dominated. This did not last for long though. As economic recovery gained momentum, the number of measures with decreasing effect again rose, although in certain cases, a lower tax burden on labour was offset by increases in other taxes. Similar developments can be observed for unemployment and other welfare benefits. A number of measures were also undertaken to improve the labour market adjustment capacity in response to unfavourable economic developments. The frequency of reforms aimed at reducing the stringency of regulations increased in domains related to job protection, wage setting and working time. What can also be noticed is that since the begging of 2000's, new Member States have continuously strengthened active labour market policies with the average number of reforms peaking in the aftermath of the global crisis.

As regards fiscal policy, it seems that the EU fiscal framework has been successful in contributing to fiscal discipline in the new Member States. In countries that were part of first wave of expansion, general government balances before the accession were relatively large and generally worse than in the rest of the member states. As countries joined the EU, fiscal balances were lowered below the -3% anchor and continued to improve until the onset of the global crisis. Unfavourable cyclical conditions in the period 2008-2009, however, led to a strong deterioration of budget balances in all the new Member States, but they started to improve again relatively quickly as a result of fiscal efforts and in 2017 were again well below the -3% threshold, though not all countries reached their medium term objectives (MTO). Strong improvement after the EU accession is also visible in Croatia, which prior to joining the EU accumulated relatively large budget deficits, but which by 2017 had achieved a budget surplus of close to 1% of GDP and was above its MTO. Furthermore, as European sovereign debt crisis emerged, the importance of prudent fiscal policy became even more obvious and the changes in the EU fiscal framework that followed also led to the strengthening of national fiscal rules as indicated by the EC Fiscal Rule Index which shows the strength of fiscal rules in the EU Member States.

We can conclude that the EU membership has to a certain extent worked as a catalyst for institutional reforms in the CESEE countries. However, structural efforts seem to have been stronger in the pre-accession phase, reflecting the need to conform to EU accession criteria. The global crisis brought the need for structural measures back into the spotlight and forced countries to increase the adjustment capacities of their economies in response to unfavourable economic developments. EU institutions also recognized the need for stronger and better-coordinated economic policies, and the recent improvement of the EU governance framework was definitely a step forward in terms of streamlining and implementing structural improvements. However, it seems that as the economic recovery gained momentum, efforts to implement CSRs started to falter. Relatively large gaps in the quality of institutional environments are still present, but that also provides the opportunity for new Member States to make substantial gains from structural reforms and step-up again their real convergence. It is up to each country to use that opportunity and reap the benefits, or risk being caught in the convergence trap.