BANKA SLOVENIJE

BANK OF SLOVENIA

EUROSYSTEM

PRICE STABILITY REPORT

APRIL 2011

Published by:

BANK OF SLOVENIA
Slovenska 35
1505 Ljubljana
Tel: 01 47 19 000
Fax: 01 25 15 516

This publication is also available in Slovene.

ISSN 1855-1424

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Abbreviations used in the Price Stability Report

AJPES	Agency of the Republic of Slovenia for Public Legal Records and Related Services
AT	Austria
BE	Belgium
BIS	Bank for International Settlements
BoS	Bank of Slovenia
cif	cost, insurance and freight
CPI	consumer price index
CZ	Czech Republic
DE	Germany
EA	euro area
ECB	European Central Bank
EE	Estonia
EFSF	European Financial Stability Facility
EMU	Economic and Monetary Union
ES	Spain
ESA 95	European System of Accounts (1995)
ESCB	European System of Central Banks
EU	European Union
EUR	euro
EURIBOR	euro interbank offered rate
Eurostat	Statistical Office of the European Communities
FAO	Food and Agriculture Organisation of the United Nations
Fed	Federal Reserve
FI	Finland
fob	free on board
FR	France
FRED	Federal Reserve Economic Data
GDP	gross domestic product
GR	Greece
HICP	harmonised index of consumer prices
HR	Croatia
HU	Hungary
IE	Ireland
IMAD	Institute of Macroeconomic Analysis and Development of the Republic of Slovenia
IMF	International Monetary Fund
IT	Italy
LT	Lithuania
MFIs	monetary financial institutions
NACE	Statistical Classification of Economic Activities in the European Community
NFCs	non-financial corporations
NL	Netherlands
OECD	Organisation for Economic Cooperation and Development
p.p.	percentage points
PL	Poland

PMI	purchasing managers' index
PPI	producer price index
Q	quarter
SI	Slovenia
SK	Slovakia
SMA	Surveying and Mapping Authority of the Republic of Slovenia
SORS	Statistical Office of the Republic of Slovenia
UK	United Kingdom
ULC	unit labour costs
US	United States of America
USD	US dollar
VAT	value added tax

Executive Summary

Despite the gradual strengthening of economic growth as a result of an increase in foreign demand, this growth is not sufficient to improve the two pronounced macroeconomic imbalances that arose in the crisis, namely high unemployment and the large general government deficit. Low activity, low consumption and low growth in unit labour costs have contributed to very low core inflation, while the sharp increase in prices of imported commodities means that energy and food prices are contributing the most to overall price growth. Economic growth is expected to stand at around 2% this year, in line with the preliminary projections, and is expected to gradually increase to around 3% over the next two years. This means that additional measures are vital to improve the two macroeconomic imbalances, particularly in the areas of cost competitiveness, fiscal consolidation and structural reforms. As a result of external price shocks inflation could temporarily rise to around 3% this year, most notably around the end of the year, but will then gradually decline to around 2% by 2013.

The main features of the global economy in the second half of 2010 were moderate economic growth in the majority of developed countries, and rapid economic growth in emerging countries. The main engine of global economic growth was the strong growth in international trade. Monetary policy remains accomodative, while fiscal policy in developed countries is transitioning into a period of urgent fiscal consolidation. Ratings of several of the periphery countries in the euro area were downgraded as a result of a potentially unsustainable rise in public debt and other macroeconomic imbalances. This additionally hindered the external financing of these countries. An additional cause of uncertainty in developed countries is the labour market, as unemployment has remained high in the early part of this year. A notable feature of the international environment is rapid growth in commodity prices. The growth rate increased further as a result of the political unrest in some countries in early 2011, which is causing inflationary pressures.

Economic growth in Slovenia in 2010 was below the euro area average at 1.2%. The situation on the labour market deteriorated. The low economic growth was primarily a reflection of the deepening of the crisis in construction, in relation to a significant decline in construction-related investment, and a decline in value-added in financial intermediation. Growth was highest in sectors primarily dependent on foreign demand. The latter was the key factor in domestic economic growth. A gradual increase in capacity utilisation is contributing to an increase in investment in machinery and equipment, while a significant contribution to domestic demand came from renewal of inventories. Final household consumption growth remains low. Despite the recovery in economic growth, unemployment is still rising, the registered unemployment rate increased again at the end of the year to reach around 12%, while the surveyed rate was at around 8%. Corporates are delayed in responding to the downturn in economic activity by cutting jobs, which at the same time reflects the need for adjustments in unit labour costs.

After declining sharply in 2009, the current account deficit was further slightly reduced in 2010 to stand at 1.1% of GDP. The largest contribution to the decline in the current account deficit came from current transfers, which moved from deficit to surplus last year as a result of a high inflow in official transfers, EU funds in particular. Other factors in the narrower current account deficit were a larger surplus in labour income and smaller interest payments, which resulted in a smaller net outflow in factor income. Merchandise imports grew faster than exports in value terms, primarily as a result of price factors. The significantly deteriorated terms of trade accounted for just over two-thirds of the merchandise trade deficit. The surplus of trade in services also declined slightly last year. The harmonised indicators of price and cost competitiveness improved slightly in the first half of last year, but less than the average improvement recorded in the main euro area trading partners. The deterioration in the indicators since the outbreak of the crisis is a reflection of the shallower adjustment of the Slovenian economy.

Growth in loans to non-financial corporations was low, the stock of long-term loans increasing in 2010 while the stock of short-term loans declined. At the same time corporates were reducing their liabilities from loans in the rest of the world, which were partly replaced by trade credits and by financing via foreign capital markets. The high year-on-year growth in loans to households, which was partly triggered by banks diversifying their risks, was solely the result of growth in housing loans. Consumer loans declined overall in 2010. The restructuring of the banks' funding continued last year. The shares of household deposits, corporate deposits and debt securities increased, while the shares of funding at foreign banks, at the ECB and through government deposits declined. This raised the funding cost of the banking system, which had an impact on interest rates, and thus on the supply of loans. The latter is being reflected in particular in short-term loans.

Inflation in Slovenia in 2010 and early 2011 is the product of movements in energy and other commodity prices on one hand, and of weak domestic demand and domestic costs on the other. Growth in the harmonised index of consumer prices stood at 2.1% in 2010, up 1.2 percentage points on 2009. Core inflation was significantly lower than in the euro area overall, as a result of the macroeconomic situation and several one-off effects. The situation in the international environment led to faster growth in commodity prices in 2010, particularly energy and food prices. The latter have already partly passed through into domestic final consumer prices, with a lag, via higher import prices, which has led to a rise in food prices in the early months of this year. Energy prices contributed 1.8 percentage points to inflation last year, compared with 0.7 percentage points in the euro area overall.

GDP growth is forecast at just below 2% for this year, but is expected to gradually increase to around 3% by 2013. Compared to the autumn projections, the contribution made by domestic demand excluding inventories will be smaller, while by contrast the contribution of net trade to GDP growth is expected to increase, given the better prospects for foreign demand. Total investment will decline, despite an increase in investment in machinery and equipment, primarily as a result of a decline in investment in buildings and structures, while public spending will also be reduced for the purposes of fiscal consolidation. Given the adverse situation on the labour market, growth in household consumption will remain low this year. Inflation is forecast at 2.7% in 2011, and is expected to fall to around 2% by 2013. The inflation projections for 2011 and 2012 are higher than in the previous round of projections, primarily as a result of higher commodity prices on global markets. Core inflation will remain low this year, in accordance with the adverse domestic economic situation. The disappearance of base effects from one-off drops in certain prices will also act to raise core inflation in 2012 in particular.

The risks in relation to economic activity are on a downside, while the risks in relation to inflation are on the upside. The main risks that could have an adverse impact on domestic economic activity in the short term are weak foreign demand, *the need for additional fiscal consolidation measures abroad and in Slovenia, and the possible effects of rises in commodity prices on consumer purchasing power and corporate earnings. The situation in the construction sector also remains uncertain and unfavourable. In the medium term economic potential could be hampered by an increase in structural unemployment and possible corporate financing problems as a result of high indebtedness and insufficient funding in the banking system. High growth in commodity prices will be reflected in future inflationary pressures. The rises in certain tax rates and excise duties that might occur should there be a need for even stronger fiscal consolidation are risks that could lead to a rise in inflation. Other risks include rises in costs in certain segments of the economy with restricted competition.*

The situations on the labour market and in the public finances demand action in the areas of cost competitiveness and fiscal policy. In light of the macroeconomic projections and the deterioration in cost competitiveness in 2009, a faster and stronger fall in unemployment will require fundamental adjustments to labour costs and the structure of the economy. The domestic indicators of price and cost competitiveness improved in the first half of last year, mostly as a result of a fall in the euro exchange rate. However, the cost adjustment of the Slovenian economy remains behind that of the main euro area trading partners. In the coming years this dictates a need for productivity growth to outpace growth in labour costs by more than in the trading partners. An insufficient improvement in competitiveness could lead to sustained low growth, inadequate investment in the economy, and a more sustained rise in unemployment with the accompanying deterioration in social conditions.

The Stability and Growth Pact is dictating the pace of fiscal consolidation. Credible consolidation is the basis for maintaining a relatively favourable sovereign debt rating, which also has a significant impact on the private sector's access to financing and on private sector confidence, and thus on economic activity and demand. According to SORS estimates, the general government deficit in 2010 stood at 5.5% of GDP, slightly less than forecast in the Stability Programme. With revenues, particularly tax revenues, recording low growth, the narrowing of the deficit by 0.5 GDP percentage points from the previous year was the result of measures to restrict growth in expenditure. The general government debt increased in 2010, despite the use of pre-financing funds. In accordance with the Stability Programme, it is expected to reach 42% of GDP by 2013. A further reduction in the general government deficit is planned for this year. Under the excessive deficit procedure, Slovenia must reduce its deficit to below the reference value of 3% of GDP by 2013 at the latest. However, certain measures to adjust government expenditure have come across opposition from interest groups, which could cause fiscal consolidation to be delayed or to be insufficient.

Appropriate structural reforms would have a long-term impact on potential economic growth and on labour productivity, and would also contribute to fiscal consolidation in the medium term. In the reform of the labour market, the right combination should be found between job and income security for workers and flexibility for companies in hiring and firing to adapt more easily to the changing situation on the market. Reform of the pension system must secure the long-term sustainable financing of the public sector, and, in conjunction with health reform, an increase in efficiency in this part of the public sector. In the longer term it is of vital importance to encourage the development of human capital, market competition, particularly in the service sector, and corporate efficiency and innovation. These factors widen the scope of commercial opportunity, increase the attractiveness of the business environment to new investment, and thus promote economic development.

								Projections					
								2011		2012		2013	
	2004	2005	2006	2007	2008	2009	2010	**Apr**	Δ	**Apr**	Δ	**Apr**	Δ
Activity, employment and wages	*real growth %*												
GDP	4.3	4.5	5.9	6.9	3.7	-8.1	1.2	**1.8**	-0.1	**2.7**	-0.2	**3.1**	...
Employment	0.3	-0.2	1.5	3.0	2.8	-1.9	-2.2	**-1.4**	-1.1	**0.0**	-0.3	**0.5**	...
Compensation per employee	7.8	5.6	5.3	6.4	7.0	1.7	4.1	**3.8**	0.7	**4.0**	0.6	**4.2**	...
Productivity	4.0	4.7	4.3	3.7	1.0	-6.3	3.4	**3.2**	1.0	**2.7**	0.1	**2.7**	...
ULC (nominal)	3.7	0.9	1.0	2.6	6.0	8.5	0.6	**0.6**	-0.3	**1.2**	0.4	**1.5**	...
Contribution to GDP growth	*percentage points*												
Domestic demand, excl. chg. in inventories	3.5	3.0	5.0	7.1	5.0	-6.1	-1.2	**0.2**	-0.6	**1.9**	-0.3	**2.5**	...
Net exports	-0.5	2.2	0.2	-2.0	-0.4	2.0	0.8	**1.2**	0.2	**0.8**	0.2	**0.6**	...
Changes in inventories	1.3	-0.7	0.7	1.8	-0.8	-4.0	1.6	**0.4**	0.2	**0.0**	0.0	**0.0**	...
Domestic demand	*real growth, %*												
Domestic demand	4.8	2.3	5.6	8.9	4.1	-9.8	0.4	**0.6**	-0.4	**1.9**	-0.4	**2.6**	...
Private consumption	2.7	2.6	3.0	6.7	2.9	-0.8	0.5	**0.8**	0.3	**1.7**	0.0	**2.0**	...
Government spending	3.4	3.4	4.0	0.7	6.2	3.0	0.8	**-0.4**	-0.4	**1.1**	0.8	**1.6**	...
Gross fixed capital formation	5.6	3.7	10.1	12.8	8.5	-21.6	-6.7	**-1.0**	-2.9	**3.0**	-1.9	**5.0**	...
Balance of payments	*real growth, %, unless stated*												
Exports of merchandise and services	12.4	10.6	12.5	13.7	3.3	-17.7	7.8	**7.2**	0.6	**6.7**	-0.8	**6.6**	...
Imports of merchandise and services	13.3	6.7	12.2	16.7	3.8	-19.7	6.6	**5.5**	0.2	**5.6**	-1.0	**6.0**	...
Current account: EUR billion	-0.7	-0.5	-0.8	-1.6	-2.5	-0.5	-0.4	**-0.6**	0.1	**-0.4**	0.5	**-0.4**	...
as % GDP	-2.7	-1.7	-2.5	-4.8	-6.7	-1.5	-1.1	**-1.6**	0.1	**-1.1**	1.1	**-0.9**	...
Terms of trade*	-1.0	-2.0	-0.5	0.9	-1.5	4.3	-2.5	**-2.4**	-1.3	**0.2**	1.0	**0.0**	...
Prices	*average annual growth, %*												
Consumer prices (HICP)	3.7	2.5	2.5	3.8	5.5	0.9	2.1	**2.7**	0.6	**2.3**	0.3	**1.9**	...
HICP excluding energy	3.2	1.2	1.7	3.8	4.9	1.7	0.3	**1.5**	0.0	**2.2**	0.3	**2.0**	...
HICP energy	7.0	11.9	8.5	3.4	9.4	-4.5	13.9	**9.6**	3.6	**3.0**	0.4	**1.2**	...
International environment	*average annual growth, %, unless stated*							**Assumptions**					
Foreign demand**	10.3	8.2	11.6	11.2	6.0	-14.0	11.0	**6.8**	1.4	**6.3**	-0.2	**6.0**	...
Oil (USD per barrel)	38	54	65	73	98	62	80	**110**	26	**108**	21	**108**	...
Non-oil commodities	22.1	12.0	29.1	17.4	10.1	-23.0	37.1	**27.5**	16.5	**1.0**	-3.0	**5.0**	...
EMU inflation	2.1	2.2	2.2	2.1	3.3	0.3	1.6	**2.3**	0.6	**1.7**	0.2	**1.8**	...
PPI Germany	1.6	4.4	5.4	1.3	5.4	-4.0	1.5	**2.8**	0.6	**2.2**	0.2	**1.8**	...

* Based on national accounts deflators

** Quantitative imports from basket of foreign partners

Δ: Difference between current projections and projections in October 2010 Price Stability Report

Sources: Bank of Slovenia, Consensus Economics, Eurostat, JP Morgan, OECD Outlook, SORS, ECB

1 International Environment

Moderate economic growth in the majority of developed countries, and rapid economic growth in emerging countries were the main features of the global economy in the second half of 2010. The main engine of global economic growth was the rapid growth in international trade. Ratings of several periphery countries in the euro area were downgraded as a result of a potentially unsustainable rise in public debt and other macroeconomic imbalances, which was also reflected in downgradings of banks ratings. While monetary policy remains accommodative, fiscal policy in developed countries is transitioning into a period of urgent fiscal consolidation. In the developed countries additional uncertainties arise from the weak labour market, as unemployment has remained high in the first quarter of this year. Rapid growth in commodity prices is another feature of international environment in early 2011, partly as a result of the political unrest in certain countries in North Africa and the Middle East. High growth in oil prices and other commodity prices, food in particular, is already passing through into consumer prices. Growth in consumer prices has thus already begun to outpace the targets of certain major central banks.

Economic developments

Accelerated international trade and the recovery of private consumption, which also occurred in the euro area and the US at the end of 2010, made the largest contributions to the continuation of global economic growth. According to IMF estimates, global economic activity increased by 5.0% in 2010, with a vital role being played by emerging countries, which are already recording growth rates typical of the pre-crisis period. The proportion of global GDP accounted for by Brazil, Russia, India and China has already reached 25%, and emerging countries together accounted for almost 70% of global growth in 2010. Economic growth in the euro area reached 1.7% in 2010, the final quarter recording growth of 0.3% over the previous quarter. The largest factors in

Figure 1.1: GDP growth

adjusted for the season and number of working days; growth, %

Sources: Eurostat, FRED

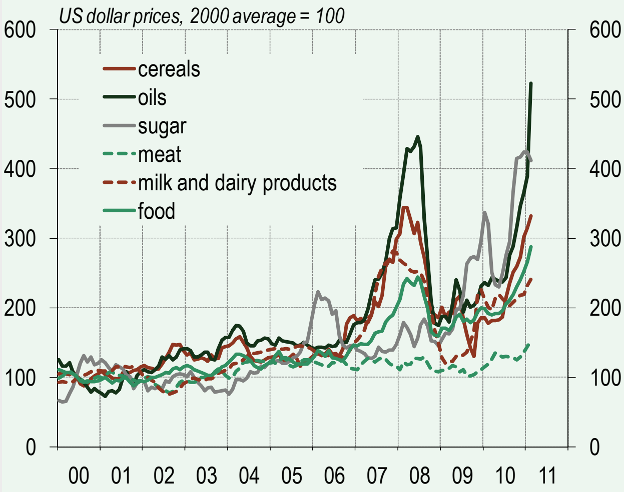
Box 1.1: Price developments on global food markets[1]

Food prices on global commodity markets began rising sharply in the second half of 2010, reaching record levels in February 2011. The monthly rate of growth in food prices is comparable to that seen in 2007 and 2008. Between June 2010 and February 2011 food prices rose by 27.4%, exceeding their levels from June 2008, when they rose sharply as a result of low production of agricultural products in less-developed countries, and increased demand, from India and China in particular. Recent year-on-year growth in food prices on global markets is nevertheless still a third down on that in 2008, which for now entails less pressure for rises in consumer prices than at that time. Prices of food on global commodity markets fell slightly in mid-March.

This rise in food prices again contains elements of temporary effects and structural changes on global food markets. The temporary effects are primarily being reflected in the adverse weather conditions, which are acting to reduce supply. The structural effects relate to the introduction of protectionist measures, an increased role for biofuels, and further growth and structural changes in demand for food from emerging economies. High food prices do not solely entail problems because of the pass-through into prices of processed products, but also increase the possibility of political unrest, particularly in less-developed countries, and thus also instability on global commodity markets.

Upward pressures on food prices were first reflected on cereals markets. Prices of wheat, barley and corn rose significantly in late July and early August 2010. Wheat prices in July were up around 25% on June, and had risen by more than 40% by the end of February 2011, to 22% below the record high of February 2008. Prices of barley and corn rose even more sharply in August, with barley prices rising by around 28% between July and February 2011, and prices of corn by around 90%. The main reason for the rapid rise in cereal prices in the second half of last year was drought and fires in Russia, Kazakhstan, Canada, the EU, Ukraine and several countries in North Africa. Russia, one of the world's largest wheat producers, ceased exports of cereals on 15 August 2010, to prevent rises in domestic food prices and to expand cereal reserves. The ban on exports was first applied until the end of 2010, and then extended to the end of June 2011. Snowstorms in the US, floods in Australia and drought in

Figure: Commodity prices



Sources: ECB, FAO (milk and dairy products)

certain African countries also contributed to the rise in cereal prices on global markets in the early part of this year. Further growth in cereal prices could be triggered by drought in China, which is endangering the wheat harvest.

Prices of edible oils and fats rose despite sufficient supply. Between July 2010 and February 2011 they rose by 114%, exceeding the levels of June 2008 by 17%. A major factor in this rise in prices was growing concern over the ability to meet demand for these products in the future, particularly given the possibility of restrictions on exports of soy in certain exporting countries while there is no change in imports to China, which is the largest consumer of soy. In addition, prices of edible oils and fats are also being affected by rising energy prices and the low US dollar, which is allowing inventories of commodities to be built up more cheaply in national currencies.

Higher sugar prices were the result of increased global consumption and the adverse weather conditions, which caused a decline in exports by the majority of producing countries. Sugar prices rose by 65% between June 2010 and February 2011, reaching their record highs of the last 30 years. Although Australia, the world's third-largest sugar exporter, announced a decline in production of a fifth this year because of storms, sugar prices are expected to ease in the coming months. This was largely because of Brazil, the world's largest sugar cane producer, where production is expected to be around 5% higher than last year. In addition, India has slightly relaxed its export quotas, and the EU has released commodity reserves.

Meat prices jumped this February to the highest levels seen in the last 10 years. The main reason for the increase was demand from Asian countries and Brazil at the same time as a decline in supply on the global market. The latter was the result of a decline in meat production in Argentina as a result of the serious drought in 2009, and low purchase prices of meat. Meat production also declined in Australia, New Zealand and the US. Meat prices on commodity exchanges are not expected to fall in the future, as demand is still increasing, while prices of corn, the main feed for cattle, are also rising.

High demand from Asian countries and Russia and a decline in production were the main factors in the very high prices of milk and dairy products in the second half of 2010. The main reason for the low production of milk and dairy products was a decline in beef herds in certain exporting countries. Further rises in cereal prices could increase pressure on feed prices, and hence on prices of milk and dairy products.

[1] Source: ECB (weighted by share of euro area imports), unless stated otherwise.

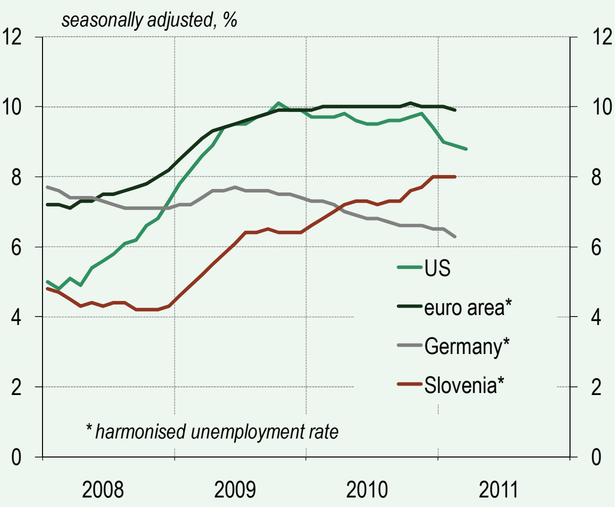
this were growth in private consumption, which stood at 0.4%, and growth in exports. Growth in exports reached 4.4% in the second quarter of 2010, but slowed to 1.8% in the final quarter. Within the euro area significant variation arose between different countries in the pace of economic recovery. Growth was high in Germany, but considerably slower in the periphery countries. Further evidence of this comes from the economic sentiment indicators, which also vary considerably from country to country. Economic sentiment indicators are reaching high values in the euro area primarily as a result of high confidence in Germany. Higher domestic consumption, which increased further to1.0%, contributed mainly to the 0.8% GDP growth in the final quarter of 2010 in the US Overall, GDP increased 2.9% in 2010. At the beginning of this year the IMF raised its forecast for global economic growth for 2011 by 0.2 percentage points to 4.4% on the basis of encouraging economic figures in the second half of 2010.

Despite moderate growth in activity, the majority of developed economies are continuing to see an adverse situation with high unemployment on the labour market. The unemployment rate in the two largest economies has been rising since mid-2008, and stabilized at around 10% in the second half of 2010 in the euro area. Unemployment among those aged under 25 is particularly problematic: it stood at just under 20% at the beginning of 2011. The situation on the labour market is nevertheless improving slightly, as the number of hours

Figure 1.2: Retail trade and industrial production

Sources: Eurostat, FRED, Bank of Slovenia calculations

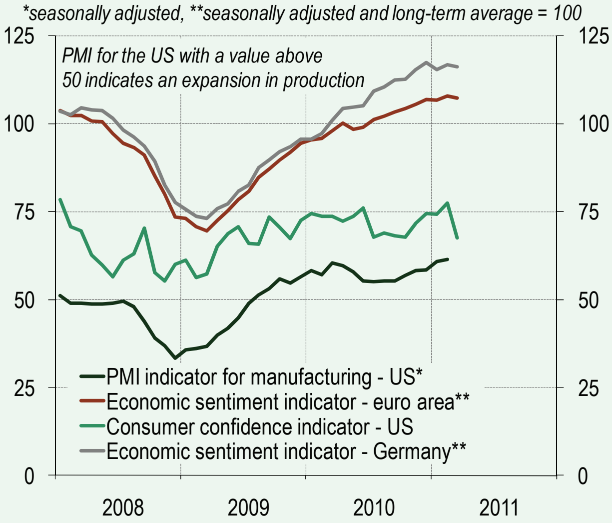
Figure 1.3: Unemployment rate



Sources: Eurostat, FRED

Figure 1.4: Economic sentiment indicators

**seasonally adjusted, **seasonally adjusted and long-term average = 100*



Sources: Eurostat, FRED

Figure 1.5: Euro / US dollar exchange rate and central bank interest rates

Sources: ECB, Federal Reserve

worked has been increasing since mid-2009, while employment has been stable since the beginning of 2010. The confidence indicators for future employment growth are also improving, although expectations on the labour market vary greatly from country to country. The unemployment rate in the US was just below 10% in 2010, despite stimulative policies. It had fallen to 8.8% by March 2011. Job creation is still very low in the two largest economies.

Foreign demand for Slovenian products is increasing, but remains behind growth in foreign demand for the products of Slovenia's largest trading partners. Growth in foreign demand for Slovenian products was estimated at 11.0% in 2010, partly as a result of the low basis from 2009. GDP in Germany, which accounts for around 20% of Slovenia's exports, grew by 3.6% in 2010, the highest figure since 1991. Its imports increased by 12.6%. According to initial estimates, imports by Italy increased by 10.3%, while its GDP grew by 1.2%. Economic growth in Russia stood at 4.0% in 2010, below the pre-crisis level, while Croatia remained in recession.

Financial markets and commodity prices

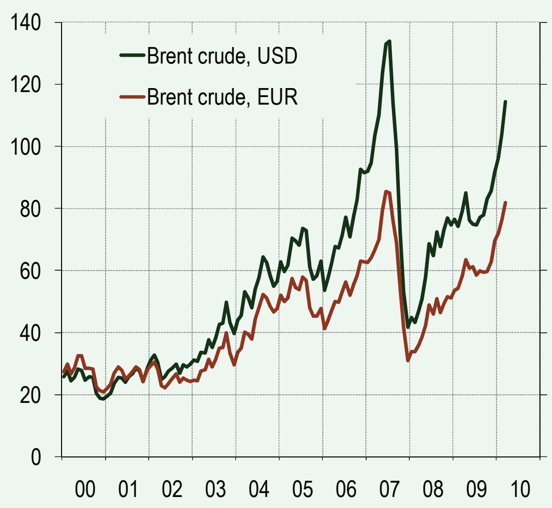
The majority of central banks in the developed economies have continued to run a stimulative monetary policy, but in emerging countries the period of relatively low interest rates is already ending. The ECB's key interest rate has stood at 1% since May 2009. The Fed's key interest rate has remained unchanged since December 2008 at the interval between 0% and 0.25%. In November 2010 the Fed announced the second round of purchases of government bonds in the amount of USD 600 billion, which is expected to take place by the end of the second quarter of 2011. The Bank of England is also continuing its non-standard measures, and its base rate has remained at 0.50% since March 2009. The Bank of Japan's key interest rate has remained at 0.05% since October 2010. Given the inflationary pressures and the need to prevent the economy from overheating, in October 2010 the Chinese central bank was one of the first to raise its key interest rates, and also began raising its reserve requirement ratio. Rise in the key interest rate was followed by central banks in India, Brazil, Russia and certain developed countries.

The euro fell against the US dollar towards the end of last year, but rose again in the first quarter of 2011.

The euro fell against the US dollar in the final two months of 2010 as a result of the worsening public finance situation in certain euro area periphery countries, and the consequent downgrading of countries[1] and commercial banks ratings. It rose again in the first quarter of 2011, partly as a result of higher demand for the periphery countries' government bonds and solid economic growth in certain euro area countries in the final quarter of 2010. The differing expectations for monetary policy stance of the two central banks were also a factor in the euro's rise against the US dollar. The euro averaged USD 1.3680 in the first three months of 2011, up 3% on its 2010 average.

Although the situation on the financial markets remains fragile, there are slight signs of improvement. Rising public debt and problems with servicing their high general government deficits forced Greece and Ireland to ask the EU in conjunction with the IMF for assistance in April and November 2010 respectively (see Box 5.1). Given the uncertainty surrounding the EU's future measures to bail out the afflicted countries, the premiums over the highest investment grade bonds rose sharply in both countries in the final quarter. Premiums also rose in Spain, by slightly less, which further increased the need for consolidation of public finances in euro area countries. Despite a small decline in early 2011, premiums over the lowest-risk bonds remain high.

Figure 1.6: Oil prices per barrel



Sources: Bloomberg, ECB, Bank of Slovenia calculations

Recent renewed sharp rise in oil and other commodity prices is another emerging problematic factor. Prices of certain commodities have already exceeded their pre-crisis levels. A barrel of Brent crude averaged USD 80 in 2010, up 28% on 2009. The main reason for the faster rise in oil prices in the first three months of 2011 was the political unrest in Egypt and in certain other countries in North Africa and the Middle East. With the release of results showing solid global economic growth, a barrel of Brent crude averaged USD 114 in March. Other commodity prices have also risen: the 2010 average was up 37% on 2009, food prices rising by 16%. Commodity prices rose sharply in the early part of this year, year-on-year growth reaching 47.1% in February.

Inflation

High growth in energy prices and food prices remains the main reason for the faster growth in consumer prices in developed economies in the early part of this year. Inflation in the euro area as measured by the HICP averaged 1.6% in 2010, which was also the average inflation rate in the US as measured by the CPI. In both economies the largest year-on-year increase was recorded by energy prices, at 7.4% in the euro area and 9.9% in the US. As a result of continued growth in energy prices, inflation also increased in early 2011, reaching 2.6% in the euro area in March and 2.1% in February in the US. Core inflation remains relatively low, as a result of the adverse macroeconomic situation, particularly on the labour market. Core inflation in the euro area as measured by the index of prices excluding energy and unprocessed food stood at 1.1% in February, having averaged 0.9% in 2010. Core inflation in the US as measured by growth in prices excluding energy and food stood at 1.1% in February, having averaged 1.0% in 2010.

[1] e.g. Greece, Spain, Ireland and Portugal.

2 Economic Trends and the Labour Market

Economic growth in Slovenia stood at 1.2% in 2010, 0.5 percentage points less than the euro area average, and the situation on the labour market deteriorated further. The low economic growth was primarily a reflection of the deepening of the crisis in construction, in connection with the significant decline in construction-related investment, and a decline in value-added in financial intermediation. Growth was highest in sectors primarily dependent on foreign demand, which is the key factor in domestic economic growth. A gradual increase in capacity utilisation in manufacturing is contributing to an increase in investment in machinery and equipment, while a significant contribution to domestic demand came from renewal of inventories. Final household consumption increased last year, but remains low. The contraction in employment slowed during the first three quarters of 2010, but increased again in the final quarter. The fall in employment in construction has continued to increase, as it has in industry and transport. Employment in the public sector increased last year. The number of vacancies and the number of new hires are increasing, but the proportion of unfilled vacancies is also increasing, an indication of imbalances between the structure of supply and demand on the labour market. The registered unemployment rate rose again at the end of the year to stand at around 12%, while the surveyed rate rose to around 8%.

Economic growth in Slovenia in 2010 was lower than in the euro area, primarily as a result of the crisis in construction and a decline in value-added in financial intermediation. GDP grew by 1.2%, 0.5 percentage points less than in the euro area overall. The lower economic growth in Slovenia was primarily the result of stagnation in the final quarter of 2009 and the first quarter of 2010, while the overall euro area economy continued to grow thanks to the extremely high contribution from Germany during this period. Later in 2010 the quarterly rates of growth in GDP in Slovenia began to outpace the euro area average, primarily as a result of a continuation of the relatively rapid growth in export-oriented sectors, which in Slovenia account for a greater proportion of total value-

Figure 2.1: GDP and employment

Source: Eurostat – national accounts

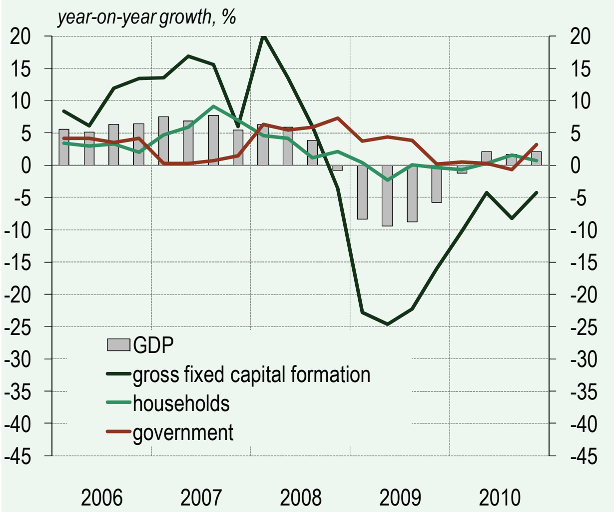
added than in the euro area overall. The contribution made by domestic consumption also turned positive in the second half of the year, with an increase in investment in machinery and equipment, renewal of inventories, and increased final consumption by the government sector and, in part, by households. By contrast, last year also saw the intensive contraction in investment in buildings and structures continue, which reduced last year's economic growth by 2.2 percentage points. Value-added in construction declined by over 14%, compared with merely just over 4% in the euro area overall. Value-added in financial intermediation also declined, which reduced overall growth in value-added in financial intermediation, real estate and business services to 0.8%. Growth in value-added in this group of sectors stood at 1.5% in the euro area.

Aggregate demand

After making a pronounced negative contribution to GDP in 2009, domestic consumption increased in 2010. A sharp decline in gross fixed capital formation and a contraction in inventories contributed 10 percentage points towards the 8.1% decline in GDP in 2009, while the sole increase in domestic final consumption was recorded by government spending, as part of the government's counter-cyclical fiscal policy. Inventories began to be renewed in 2010 as a result of the continuing rapid growth in foreign demand, but the contribution to GDP growth made by gross investment was neutral. Final household consumption also increased last year, despite the continuing adverse situation on the labour market, although the rate of growth was low. Action to consolidate public finances meant that growth in final government consumption was down on 2009.

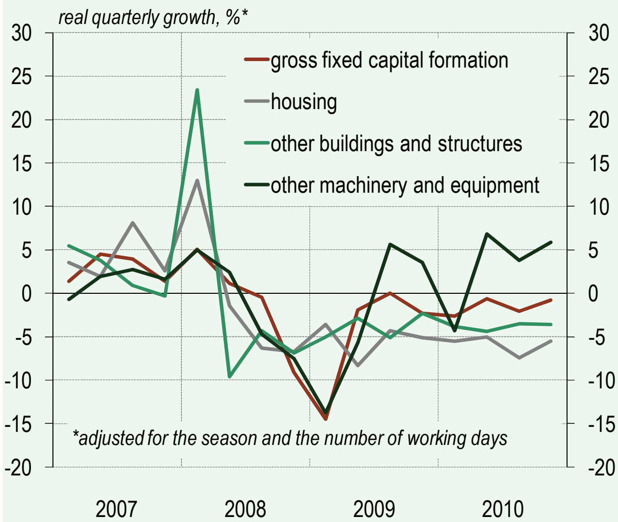
After declining by a third in 2009, gross investment stagnated last year, but solely as a result of the continuing contraction of investment in construction. Construction investment declined in all quarters. Investment in buildings and structures declined by almost 16% last year on average, investment in housing declining by just over a fifth. The majority of indicators also show a continuation of the adverse situation in construction. The construction confidence indicators remain at the lowest levels of all private sector activities. The number of newly issued building permits and the floorspace that they cover again declined sharply last year. The figures for construction companies' unsettled past-due liabilities are further evidence of their liquidity difficulties. The real value of new contracts in the construction of residential and non-

Figure 2.2: Domestic demand and GDP



Sources: SORS, Bank of Slovenia calculations

Figure 2.3: Gross fixed capital formation



Sources: SORS, national accounts

residential buildings increased by just over a tenth last year, although performance of the contracts is uncertain. Residential construction is also being hindered by large inventories of unsold housing and limited demand as a result of excessive prices. The value of new contracts for civil engineering work, which accounted for approximately half of all construction put in place in 2010 overall, declined by a quarter last year. It is mainly the government that could contribute to ending the decline in construction investment, having significantly increased public funding in the budget memorandum for 2011 to 2012 for the construction and maintenance of state roads and for the modernisation of railway infrastructure, where significant co-financing from the EU budget is also anticipated.

Inventories began to be renewed in 2010, and the increased investment in machinery and equipment continued, having displayed a trend of increase since the second half of 2009. The main factors in this were the continuing growth in foreign demand, and expectations for favourable rates of its growth in the future. The contribution made to GDP by inventories was positive in all quarters last year, and amounted to 1.6 percentage points over the whole year (see Box 2.1). Quarterly growth in investment in machinery and equipment turned positive in the second half of 2009. It remained so last year, with the exception of the first quarter, the annual rate reaching almost 7%. Growth in investment in machinery and equipment is linked to the gradual increase in capacity utilisation in manufacturing, which reached 79% in the final quarter of last year, very close to its long-term average. According to surveys, last year's investment in industry was nevertheless related mainly to the replacement of existing equipment, and less to an increase in production capacity. This is in line with the level of production, which at the end of the year only exceeded its pre-crisis level in a few export-oriented sectors.

Final household consumption increased last year, despite the deterioration in the situation on the labour market, although the rate of growth was low. The gross wage bill declined for the second consecutive year in real terms. Household consumption nevertheless increased by 0.5% in real terms last year, although only the third quarter recorded positive quarterly growth, of 1.3%. Despite high growth in volume turnover in motor vehicles, consumption of durables continued to decline, which was in line with the high income elasticity of demand for these products. Increased consumer caution and the fall in purchasing power caused by the adverse situation on the labour market were reflected primarily in a 6% decline in real volume turnover in retail of furniture, household appliances, construction material and audio-visual equipment. Consumer confidence remains low. The major purchases suitability indicator is also extremely low.

Growth in final government consumption last year was significantly lower than in the previous years, partly as a result of low expenditure on goods and services. Final government consumption was up just under 1% in real terms, compared with 3% in 2009. Growth in the gross wage bill in the group of other services with a prevailing component of public services[2] also declined significantly. Last year the gross wage bill in these sectors increased by 2% in nominal terms, 5.5 percentage points less than in 2009, when the high growth was primarily the result of the beginning of the elimination of wage discrepancies in the public sector. Growth in employment in the government sector remained relatively high, reaching 1.5% last year, a comparable figure to 2009, which is in opposition to plans for the consolidation of public finances, which envisage a reduction in employment in the government sector. According to the figures for general government revenues and expenditure, expenditure on goods and services declined by about 2% in real terms for the second consecutive year.

[2] Sectors L, M, N and O according to NACE rev. 1.1: L) public administration and defence; compulsory social security, M) education, N) human health and social work activities, O) administrative and support service activities.

Box 2.1: Inventories in Slovenia during the crisis and upon exit from the crisis

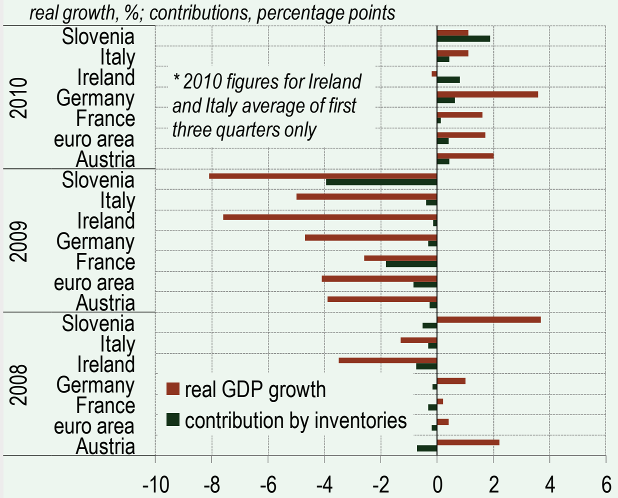
The inventories in Slovenia during the crisis moved in line with theoretical underpinnings and with the changes in inventories in the euro area, although the fluctuations were larger than those in the euro area. Because the build-up of inventories in the period before the crisis was lengthy and more pronounced, at the outbreak of the crisis inventories declined more in relative terms, thereby contributing more to the decline in economic activity than in the euro area. During the crisis inventories declined in manufacturing and in wholesale and retail trade, but increased in real estate activities and in construction.

When demand fluctuations occur, corporates try to maintain output as smooth as possible by adjusting inventories. In crisis times in particular, when more pronounced adjustments are necessary, the dynamics in inventories can have a profound impact on aggregate economic indicators. If the creation of inventories is linked to fluctuations in foreign trade, changes in imports and exports can be even greater than changes in output or sales. In situations where corporates are facing financing difficulties in particular, the role of the costs of financing inventories, which can be relatively high can not be ignored.[1]

According to national accounts figures,[2] inventories in Slovenia increased without interruption from the end of 2001, and in the most recent cycle the more pronounced build-up of inventories began in 2005. It was not until 2009 that inventories declined sharply, and they began increasing again in early 2010. The total cumulative decline in inventories during the decline in economic activity at that time was nevertheless the highest in the last decade and a half, the period for which figures are available. The contribution to GDP[3] by inventories in Slovenia was significantly more responsive to developments in the crisis than in other euro area countries, which was related to the significant fluctuations both in output and in domestic and foreign demand. The average contribution to GDP growth by inventories in Slovenia in 2010 was the highest among euro area countries.

Figure 1: GDP growth and contribution to GDP growth by inventories

real growth, %; contributions, percentage points

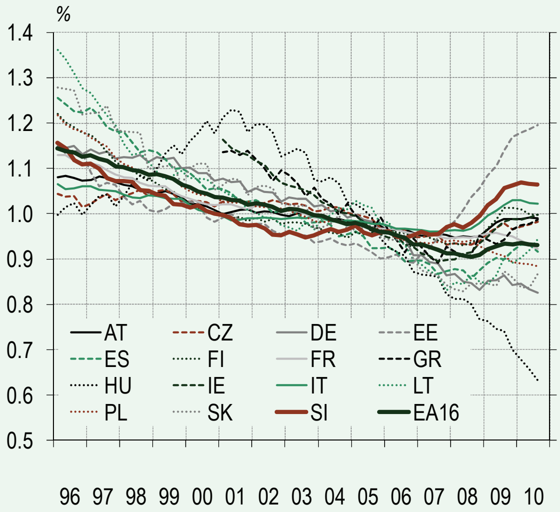


Sources: Eurostat, ECB

The changes in the ratios of inventories to GDP and inventories to sales in the last decade and a half were reasonably similar in Slovenia and the EU overall. The ratios of inventories to GDP and inventories to sales in EU countries mostly fell before the crisis, and then increased at the outbreak of the crisis. In Slovenia the ratios of inventories to GDP and inventories to sales fell more quickly in the decade before the crisis than in the euro area overall, which was partly a reflection of high (expected) growth in GDP. After the outbreak of the crisis, the ratios in Slovenia increased more quickly, even though the negative contribution to GDP growth was larger than in the euro area. These movements reflected the delayed response on the part of corporates to the unexpected decline in economic activity, as they were later or slower in reducing their inventories compared with the decline in economic activity.

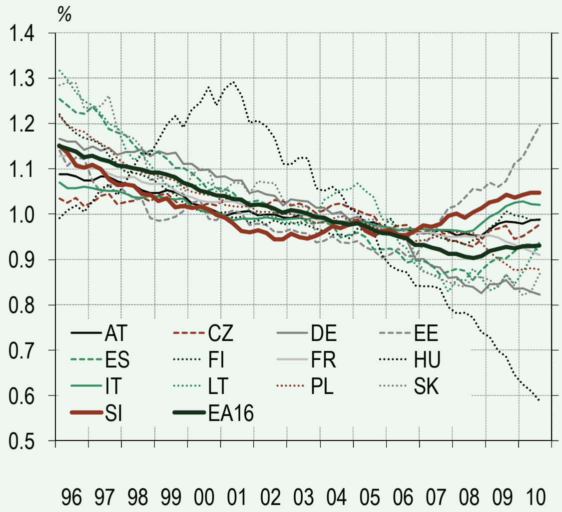
The largest increases in inventories before the crisis were recorded by real estate activities and by wholesale and retail trade, while the increases in construction and manufacturing were slightly smaller. In line with the rapid growth in domestic and foreign demand, the largest increases were in inventories of work-in-progress and merchandise. After the outbreak of the crisis in 2009, the largest decline was in inventories of merchandise, while inventories of raw materials and other materials also declined. These developments reflect the rapid response of manufacturing companies to signals of deterioration in the economic situation in the main trading partners. By contrast, inventories of work-in-progress and finished goods increased further, albeit significantly less than in the previous years. In the crisis year of 2009 inventories in construction and real estate activities continued to increase, primarily as a

Figure 2: Ratio of inventories to GDP*



Sources: Eurostat, Bank of Slovenia calculations

Figure 3: Ratio of inventories to sales*

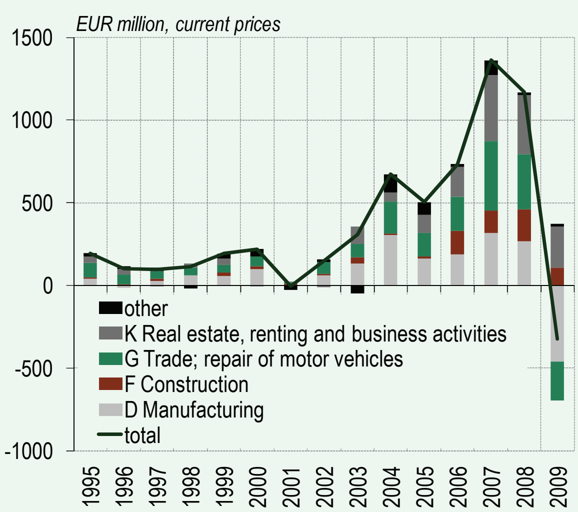


Sources: Eurostat, Bank of Slovenia calculations

** Normalised figures are shown for the ratios of average inventories to GDP and inventories to sales throughout the observation period. A ratio of inventories to GDP of 60% was set for all the countries at the beginning of 1996 on the basis of the long-term average of the ratio of inventories to GDP in euro area countries, while in other years the ratio of inventories to GDP is calculated on the basis of actual changes in inventories and GDP.[4] The exceptions are Greece and Ireland, where a lack of data means that a ratio of inventories to GDP of 60% was set for the beginning of 2001. Sales are defined as the difference between GDP and the increase in inventories.*

result of an increase in inventories of work-in-progress, but less than in the two previous years.[5] A decline in inventories in these two sectors is likely in the future, while inventories in manufacturing are expected to increase again as activity increases. A comparison of inventories, based on the survey data with economic activity reveals that inventories in manufacturing responded to the outbreak of the crisis approximately half a year before those in the retail sector, as the crisis hit manufacturing first and more profoundly, and impacted service sectors only with a lag.

Figure 4: Change in inventories by sector



Source: SORS

Just before the crisis there was a significant increase in inventories of housing, the increase only diminishing at the end of 2009. There are no official figures for inventories of housing,[6] and all estimates of inventories of housing are therefore approximations only. The approximation used to estimate the change in inventories of new housing is the difference be-

[1] The cost of financing inventories, which on the basis of corporate balance sheet figures amounted to just under EUR 10 billion in Slovenia in 2009 (around 9% of corporates' total assets), was approximately 1.5% of GDP (Bank of Slovenia estimate), the average interest rate on short-term corporate loans having been taken into account.

[2] Inventories in the national accounts include work-in-progress and finished products at producers, inventories of merchandise in wholesale and retail trade, and inventories of raw materials, other materials, spare parts, etc. at all market producers. In the national accounts inventories have the role of balancing item between the calculation of GDP according by the production and the calculation of GDP by the expenditure method. Inventories are disclosed in the national accounts as a flow (change in the stock of inventories in a specific period).

tween the number of completed residential properties and the number of transactions in new residential properties. Although the number of transactions in new residential properties had already begun to significantly decline at the end of 2007, construction of new residential properties actually increased in 2008. There was therefore a significant increase in inventories of new residential properties in both years. It was not until the end of 2009 that the increase in inventories of new residential properties diminished significantly, when the number of completed residential properties declined and the number of transactions increased.

[3] The contribution to GDP growth made by inventories does not reflect the change in inventories, but rather changes in the change in inventories, i.e. acceleration or slowdown in the change in inventories. A positive contribution to GDP growth by inventories is not necessarily a reflection of an increase in inventories, but could instead entail a slowdown in a decline in inventories over a specific period.

[4] According to AJPES figures, the ratio of the average level of inventories in Slovenia during the last decade to corporates' average value-added was just below 50%.

[5] According to corporate balance sheet figures, the largest ratios of inventories of finished products and work-in-progress to assets were in construction and real estate activities.

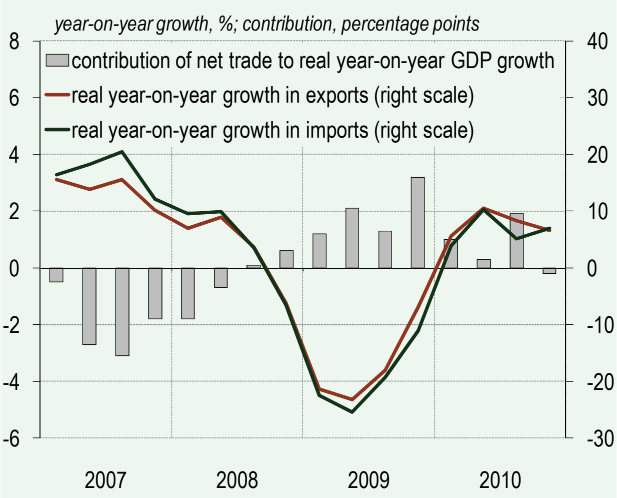
[6] In contrast to infrastructure projects and commercial buildings, housing is mostly built for the market or for unknown customers.

The contribution to GDP growth made by net trade was again positive last year, but was smaller than in 2009 as a result of the impact of increased domestic consumption on imports and a decline in the real value of orders from foreign markets in the third quarter. Under the influence of faster growth in foreign demand, net trade contributed 0.8 percentage points to economic growth last year, compared with 2.0 percentage points the previous year. Growth in imports stood at 6.6%, and growth in exports at 7.8%. Quarterly growth in merchandise trade was highest in the second quarter, as a result of faster growth in key export markets in association with the continuing rapid growth in import demand from Asian economies. The main factor in growth in imports was imports of intermediate goods, as a result of rapid growth in industrial production and the renewal of inventories. Merchandise exports declined in quarterly terms in the final quarter as a result of the previous decline in the real value of new orders from foreign markets, but the decline is likely to have merely been temporary, as there was renewed growth in foreign demand towards the end of the year. Growth in total exports was also lower as a result of a decline in exports of services, which was partly related to a decline in estimated average daily spending by foreign tourists. This reduced exports of tourism services by EUR 160 million according to the balance of payments figures.

Supply side

Some indicators are showing that the negative output gap is gradually closing. At the same time growth in potential output is expected to slow. Evidence of the gradual closing of the negative output gap comes from indicators of capacity utilisation, manufacturing confidence and deficiency of demand, which are approaching their long-term averages. Estimates of potential output remain very uncertain in the current situation, but the available figures for the high level of structural unemployment and the renewed decline in gross fixed capital formation suggest a slowdown in its growth. The level of investment in public infrastructure also declined after the

Figure 2.4: Foreign trade

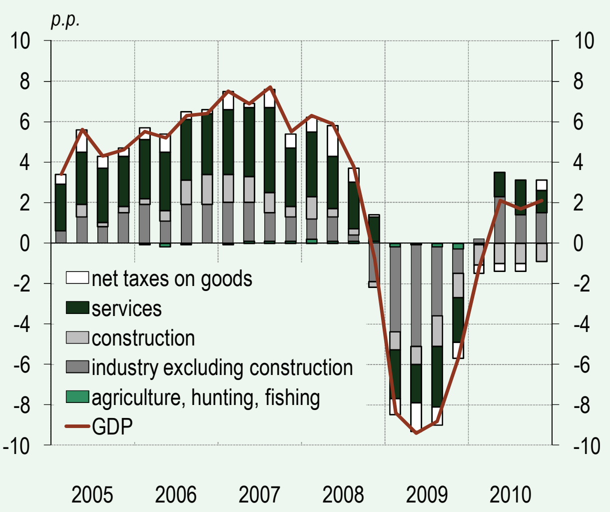


Source: SORS

Figure 2.5: Business trends in manufacturing

Source: European Commission

Figure 2.6: Contributions to GDP growth



Source: SORS

completion of the primary motorway network. Whether growth in potential output will approach the long-term average of economic growth in the pre-crisis period depends on the success of structural reforms on the labour market and the restructuring of less-productive parts of the economy.

Manufacturing made the largest contribution to GDP growth in 2010. It contributed 1.4 percentage points towards GDP growth of 1.2%, its value-added increasing by 8%. Growth in manufacturing was primarily driven by

Figure 2.7: Construction: activity and employment

Sources: SORS, Bank of Slovenia calculations
Note: Real value of construction put in place

foreign demand, which has been increasing since the second half of 2009. Industrial production was up 6.5% last year, but nevertheless remained below its level of 2006. Manufacturing accounted for approximately 6 percentage points of this growth in 2010. In terms of economic purpose of use, intermediate goods made the largest contribution to last year's growth in industrial production, at approximately 5 percentage points. The highest growth in industrial production last year was recorded in the second quarter, the rate gradually declining towards the end of the year. The lower growth in the second half of the year was the result of a decline in growth in manufacturing output in the euro area and the EU27. Value-added in transportation, storage and communications increased by 5.7% in 2010, as a result of an increase in international trade.

The continuing sharp contraction in construction reduced last year's economic growth by 1 percentage point. Despite a low basis, value-added in construction declined by a further 14% last year; value-added has been declining in quarterly terms since the end of 2008. The proportion of GDP accounted for by construction is also correspondingly declining, having peaked at close to 8% in the third quarter of 2008, before falling to just over 5% in the final quarter of last year. During this period the

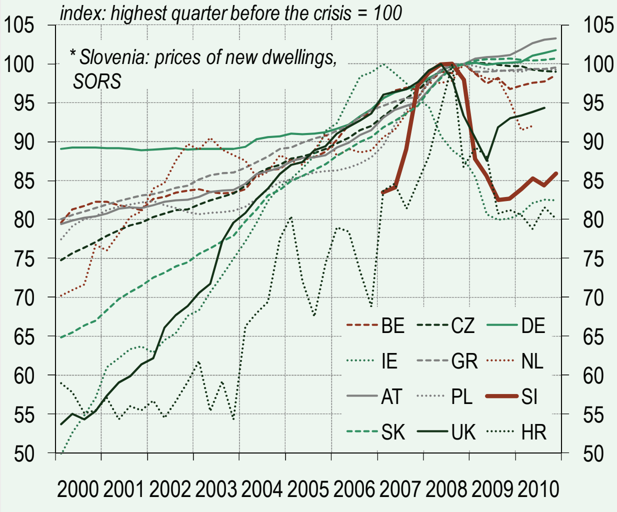
Box 2.2: A brief review of price developments in the housing market in Slovenia and other EU countries

Developments on the housing market can be a significant crisis factor, as housing is often one of the most important components of household assets. Analysis of the housing market is therefore vital to understanding the key economic aggregates. The housing market is part of the real estate market, which also includes commercial buildings. According to estimates by *The Economist*, transactions in housing account for 77% of the global real estate market.

During times of above-average economic growth, housing prices are usually close to or even above advertised prices. By contrast, during a period of declining economic activity, sellers of housing cannot make sales, and the volume of housing sold can decline by more than 50% compared with the pre-crisis period. This has particular significance, because the income and wealth effects that derive from price developments on the housing market have an impact on aggregate demand.

There are a number of features of the housing market and the overall real estate market. Among the key features is that fundamental prices[1] mostly provide little explanation for transaction prices in the short term, and it is therefore difficult to forecast future real estate prices. Analysis of price movements, supply and demand on the Slovenian real estate and housing markets is even more specific. International comparisons are rendered difficult in part because of the relatively

Figure: Prices of new real estate in selected countries



Sources: Eurostat, SORS

high ownership of housing by private individuals, as Slovenia has one of the highest rates of home ownership in the EU, at 81%. In addition, Slovenia's housing market is subject to local specifics, which according to some estimates can alter prices by up to 30%, more than in comparable countries. The most notable local specific is location, but distance from the centre of town, infrastructure and regional development, etc. are all important.

During the global economic and financial crisis there were sharp falls in housing prices in certain EU countries in particular. According to SORS figures, prices of new dwellings in Slovenia fell less than in certain EU countries that had comparable growth in prices before the crisis. Comparable figures show that prices fell most in Ireland (from the peak in the first quarter of 2007) and Croatia (from the peak in the third quarter of 2008), by around 20%. In Slovenia prices of new dwellings fell by around 18% from the peak recorded in the third quarter of 2008. Prices fell by less than 5% in Belgium, Germany, Austria, the Czech Republic and Slovakia. The largest fall in prices was in countries where growth was highest in the pre-crisis period (e.g. the Baltic States). It should be noted that a significant part of growth in real estate prices in the pre-crisis period was the result of convergence processes in the new Member States.

Figures for real estate prices from different sources vary, although the directions of the movements in available figures are usually similar. According to SMA figures, transaction prices of housing fell by around 10% between their peak in the second quarter of 2008 and the final quarter of 2010. According to SLONEP figures, advertised prices in Ljubljana in 2009 were down around 8% on 2008, and prices in 2010 were down further by just over 1%. This was less than the fall in transaction prices, as a result of the withdrawal of some housing from the market. Slovenia is aiming to gain a better overview of developments on the real estate by establishing a register of real estate.

Future movements in real estate prices in Slovenia are very uncertain. Factors that could affect price movements include a possible change in the action of the Housing Fund and heavier government intervention on the housing market, and potential faster sales of inventories of unsold housing in certain segments of the market. Factors that could lower prices in the future include stricter terms for obtaining housing loans and a rise in interest rates, an inability to sell the inventories of unsold new dwellings built up during the financial crisis, low economic growth with increased unemployment that could permanently reduce disposable income, and tax legislation that would tax real estate more heavily.

[1] The fundamental prices reflect the fundamentals of the economy, such as demographic factors, disposable income, employment and rent levels.

Figure 2.8: Construction: limiting factors and housing market

Source: SORS

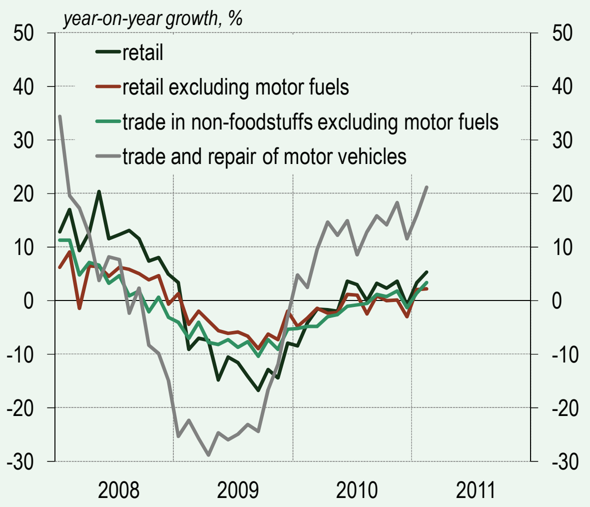
real value of construction put in place declined by 43% overall, and by 54% in residential construction. The value of construction put in place in civil engineering work declined by just under a fifth in 2010. The decline began to slow towards the end of the year, the year-on-year decline reaching around 10% in December. The real value of construction put in place in the construction of non-residential buildings declined by just over 6% last year. The smaller decline than in other segments of construction was the result of year-on-year growth in the first half of the year, in association with work on a major sports/commercial complex. The real value of residential construction put in place declined by more than a third last year, although activity in residential construction actually began increasing in the final quarter.

Although insufficient demand remains the most important limiting factor for construction companies, they failed to respond last year by adjusting prices. The available survey indicators reveal that the proportion of construction companies facing insufficient demand peaked at 65% last March. The figure declined between March and November, then started to rise again, reaching 60% by this February. Companies in the housing market failed to respond to insufficient demand by adjusting prices (see Box 2.2). After peaking in the third quarter of 2008, prices of new residential properties declined by 18% until the third quarter of 2009, and have been gradually rising again since. The year-on-year rise in prices stood at almost 4% in the final quarter of 2010. Given the growth in the number of transactions in new residential properties, demand for new housing increased in the second half of last year, which was partly facilitated by the banks being more active in making relatively favourable mortgage loans. Inventories of unsold new housing nevertheless remain large.

The crisis also began to be reflected, with a lag of one year, in value-added in financial intermediation, which declined by 3% last year. The banking system recorded an operating loss last year, which was primarily the result of higher impairment and provisioning costs. The number of corporates unable to make regular loan repayments is rising, which is leading to a deterioration in the quality of the banks' investments, thereby restricting their lending activities. Corporate difficulties are also being reflected in the performance of financial holding companies, as the decline in their earnings no longer allows them to settle their liabilities to banks, and they are also burdened by the excessive risk taken up in the pre-crisis period. The banks have significant exposure to holding companies, as a result of lending in previous years.

After a large decline in 2009, value-added in trade and repair of motor vehicles increased by 1.6% last year. The growth in value-added was related to an increase of over 3% in volume turnover in the retail trade and in trade in motor vehicles. The retail confidence indicator also

Figure 2.9: Volume turnover in trade



Sources: SORS, Bank of Slovenia calculations

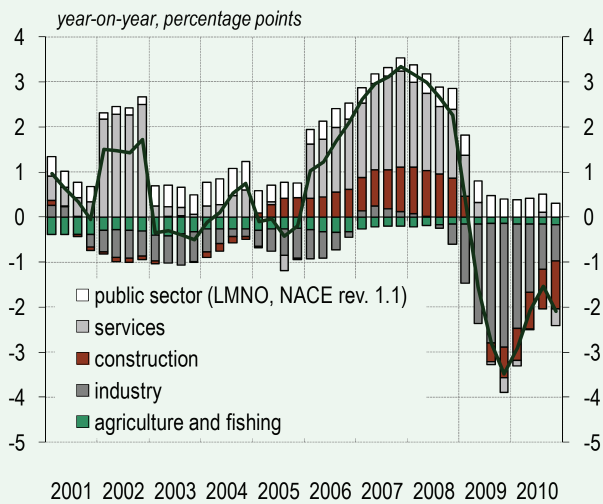
rose last year, in line with the movement in total volume turnover. Annual growth in volume turnover was relatively low as a result of negative developments in the first quarter. Total turnover increased primarily as a result of growth in volume turnover in the trade and repair of motor vehicles, which began to increase in monthly terms in late 2009, and increased by 11.6% last year. Dealers sharply increased sales of motor vehicles by cutting prices. Volume turnover in the retail trade excluding motor vehicles only began to increase in the second quarter of last year, albeit primarily as a result of an increase in turnover in trade in fuels, and was down 0.4% in annual terms. The decline in volume turnover in trade excluding motor vehicles and fuels stood at 1.4%. Given the uncertain situation on the labour market, consumers are remaining cautious and are spending less on durable goods, whose income elasticity of demand is higher. This was reflected in last year's year-on-year decline of just under 2% in volume turnover in trade in non-foodstuffs excluding motor vehicles and fuels. The figures for the first two months of 2011 indicate slightly higher growth in volume turnover compared with the second half of last year.

Labour market

The pace of the contraction in employment slowed during the first three quarters of 2010, but increased again in the final quarter. The contraction in employment began in early 2009, with the average quarterly fall standing at 0.8% in 2009. The quarterly rate of decline in employment slowed in early 2010, averaging 0.4% over the first three quarters of the year. The quarterly fall increased to 0.7% in the final quarter. Employment averaged just under 950,000 in 2010, down 2.2% on the previous year. Employment was down 1.5% in year-on-year terms in the third quarter of 2010, and down 2.1% in the final quarter.

Employment in the private sector continued to fall in 2010, most notably in manufacturing and construction. The only notable increases in employment were recorded by the financial and insurance activities sector and the real estate activities sector. Employment in manufacturing fell by 6.0% on average in 2010. The quarterly fall in employment in this sector slowed between the beginning of 2009 and the third quarter of 2010, but increased again in the final quarter, to 0.9% from 0.4% in the third quarter. The year-on-year fall in employment in construction during 2010 stood at 9.5%, significantly more than in 2009, when employment was

Figure 2.10: Contributions to employment growth by sector



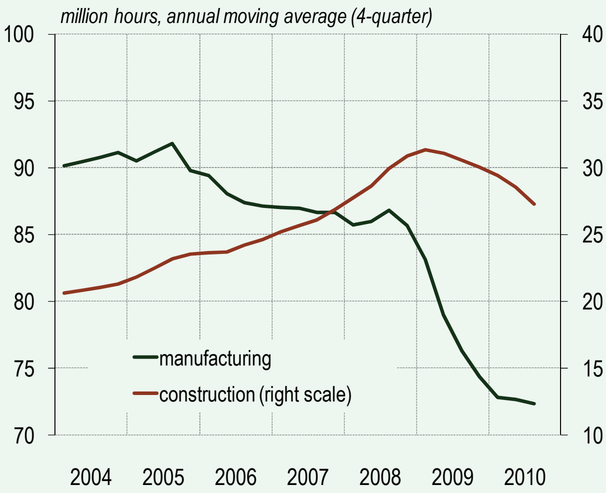
Sources: SORS – national accounts; Bank of Slovenia calculations down 1.8% in year-on-year terms. The fall in the sectors of wholesale and retail trade, accommodation and food service activities, and transportation in 2010 were larger than in 2009. In the private sector employment only increased significantly in the sectors of financial and insurance activities and real estate activities, where the year-on-year rate of growth reached 2.4% in the final quarter.

Employment in the public sector increased by 1.8% in 2010. This trend was in sharp contrast to the government's plans to reduce employment in the public sector. Growth in employment in the public sector nevertheless slowed, having stood at 2.2% in 2009. Employment increased last year in all segments of the public sector, most notably in education.

Short-term changes in the demand for labour are most evident in the number of hours worked in the private sector, which was still declining in 2010. Employers are more flexible in adjusting the number of hours worked, for example by ordering overtime or by cutting work hours, and in hiring and firing. The number of hours worked[3] in the private sector peaked at the end of 2008, and has been falling since. The number of hours worked in the private sector during the first three quarters of 2010 was down 3.9% in year-on-year terms on average, and in the third quarter it declined to its level of early 2006.

In the majority of segments of the private sector, the decline in the number of hours worked has continued, most notably in construction, where the decline is still accelerating. The number of hours worked in manufacturing during the first three quarters of 2010 was down 7.1% in year-on-year terms, but the quarterly rate of growth has indicated a gradual end to the negative trend since the beginning of 2010. The average number of hours worked in construction in the first three quarters declined by 7.6% in year-on-year terms, the rate of year-on-year decline increasing. The decline in the number of hours worked in construction follows a period of very high growth in previous years. The number of hours worked in

Figure 2.11: Hours worked: manufacturing and construction

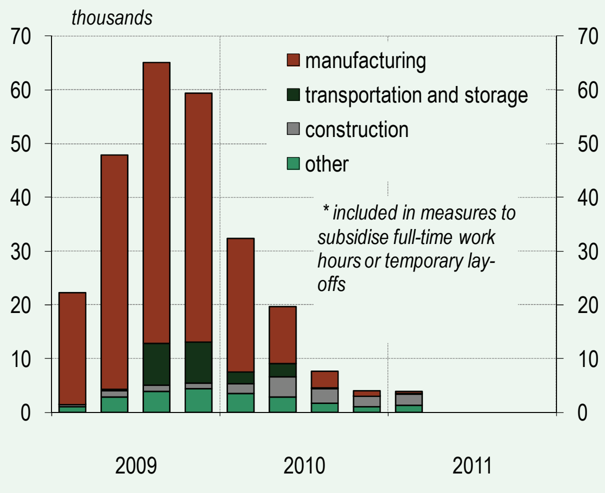


Sources: SORS, Bank of Slovenia calculations

construction increased by around 30% between the beginning of 2006 and the end of 2008, and by more than 60% from the beginning of 2002. By the third quarter of 2010 the number of hours worked had reached the level seen in the beginning of 2008. On this basis it can be concluded that the number of hours worked in construction will decline further.

Only a small number of employees are still included in government measures to preserve jobs. During the

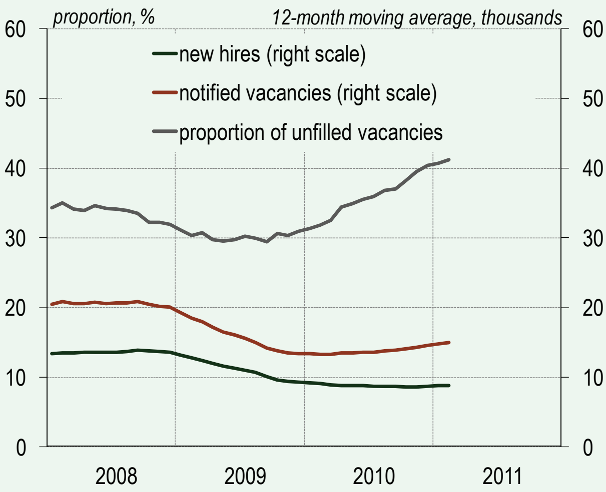
Figure 2.12: Number of employees included in labour market measures*



Sources: Employment Service, AJPES; Bank of Slovenia calculations

[3] Work hours have a very large seasonal component, and therefore for the purposes of analysis they are monitored as a moving average calculated on the basis of the last four quarters.

Figure 2.13: Vacancies, new hires and proportion of unfilled vacancies



Sources: Employment Service, Bank of Slovenia calculations

Figure 2.14: Unemployment - inflows, outflows and net changes

Source: Employment Service

crisis the government attempted to mitigate the fall in employment primarily by means of two measures: the partial subsidisation of full-time work hours and the subsidisation of temporary lay-offs.[4] The first measure applied until September 2010 and covered a total of around 66 thousand employees, while the second applied until this March, and covered a total of around 25 thousand employees. Only around 3,000 employees are still included in the second measure at present. In both measures there was a risk that employers would simply delay lay-offs until after the end of the subsidisation period. This risk was not realised, as the rise in unemployment in terms of number and time did not correspond to the fall in the number of employees covered by these measures.

The number of vacancies and the number of new hires are increasing, but the proportion of unfilled vacancies is also increasing. The number of notified vacancies in 2010 was up 8.2% on average on the low value in 2009. The number of vacancies during the first two months of the year was around 14,700, up 21.0% in year-on-year terms on average. The number of vacancies for temporary jobs is increasing in particular, although the level remains down around a quarter on the pre-crisis period. Meanwhile the number of notified vacancies for permanent employment remains unchanged, and down almost a half on the pre-crisis period. The number of new hires increased in the final quarter, the year-on-year rate reaching 11.1% in the first two months of 2011. The proportion of unfilled vacancies is nevertheless increasing, as the number of vacancies is increasing faster than new hires. The proportion of unfilled vacancies during the first two months of 2011 stood at 40.2%, compared with an average of 29.6% for the first two months of the five years before the crisis. This is a sign that structural imbalances between labour supply and demand are increasing on the domestic labour market.

After the number of registered unemployed stopped rising in the middle of 2010, it rose sharply again at the end of the year, the registered unemployment rate rising to a high 12%. Alongside the usual seasonal movements, other major factors in the rise were one-off effects related to pension reform, and increased inflows into unemployment of workers whose temporary employment has ended. The number of unemployed rose by around 18% between September 2010 and February 2011, from around 98,000 to just over 115,000. It is estimated that about 5 percentage points of the rise consisted of older workers who registered with the Employ-

[4] For more on government measures on the labour market during the crisis, see Price Stability Report, April 2010, p 26.

ment Service last December in order to exploit old pension legislation and old labour market legislation. A similar contribution to the rise in unemployment during this period came from workers whose temporary employment contracts ended. Seasonal effects mean that this inflow is usually higher in December and January, but this year it was significantly higher not just compared with the pre-crisis period, but also compared with the two previous years, when unemployment was rising sharply. Outflows from unemployment (into employment, non-activity or other records) in the second half of the year were high in absolute terms, but close to the long-term average relative to the number of unemployed. Against this background, the seasonally adjusted surveyed unemployment rate rose from 7.3% in September 2010 to 7.8% in January 2011, while the seasonally adjusted registered unemployment rate rose from 11.0% in September to 11.8% in December.

The fall in the workforce in employment since the outbreak of the crisis has been larger than the rise in the number of unemployed, which to a certain extent is the result of a fall in the number of foreign workers.[5] The number of foreign workers peaked in the third quarter of 2008, when 70,300 were employed, accounting for 8% of the workforce in employment. There were approximately 86,000 valid work permits for foreign workers at that time. These included around 35,000 personal work permits, whose holders are potentially entitled to unemployment benefits when their employment terminates.[6] Holders of the other two types of work permit are not entitled to unemployment benefits. The seasonal work permit is tied to seasonal work, and the employment permit is tied to a specific position and employer. The total number of valid work permits fell by around 17,000 between the peak of the economic cycle and the beginning of 2011, which corresponds approximately to the difference between the fall in the workforce in employment and the rise in the number of registered unemployed during this period. While the number of valid employment permits and seasonal work permits has fallen considerably in the last three years, the number of personal work permits has risen significantly: in the first quarter of 2011 there were 65% more than in the third quarter of 2008, and they now account for 78% of all valid work permits. Personal work permits have become more desirable among foreign workers, as they also allow jobs to be sought in Slovenia via the Employment Service.

Figure 2.15: Valid work permits for foreign workers

Sources: Employment Service, Bank of Slovenia calculations

In addition to the fall in employment, the private sector is adjusting to the decline in activity through other means of reducing labour costs, with wage growth remaining moderate once temporary effects are taken into consideration. After recording an extremely high figure of 7.9% in 2008, and slowing significantly to 1.8% in 2009, year-on-year growth in the average nominal gross wage stood at 4.9% in the second half of 2010. In the last year the major factors in the movement in wages have been the statistical effect of the rise in the average wage in the private sector as a result of extensive lay-offs among the low-paid, a rise in the minimum wage, and a rise in wages for employees whose wages were temporarily reduced during their inclusion in

[5] EU citizens are not included in the figures, as they do not require a work permit to work in Slovenia. Employment of EU citizens is relatively low: a total of 5,614 were employed in Slovenia in 2010.

[6] The conditions for obtaining a personal work permit vary, but a general condition is that the foreign worker has legally resided or worked in Slovenia for two years before obtaining the personal permit.

Figure 2.16: Wage bill and average gross wage per employee

Note: The wage bill is calculated as the product of the average gross wage for employees at legal entities that received wages and the number of employees at legal entities.
Sources: SORS, Bank of Slovenia calculations

the government measure to subsidise temporary lay-offs. Lay-offs and the curbs on wage growth are also being reflected in the wage bill, which better reflects private-sector cost-adjustment. Year-on-year growth in the wage bill in the private sector was negative in the second half of 2009 and early 2010, and then stalled at around 2.5% in the second half of 2010.

Growth in the average nominal gross wage in the public sector remained low in the second half of 2010. Wage growth in the public sector was high in 2008 and early 2009 as a result of wage rises to eliminate wage discrepancies. According to an indicator[7] that combines sectors under the standard classification of economic activities into the public sector, average wages in the public sector in the second half of 2010 were up 0.4%

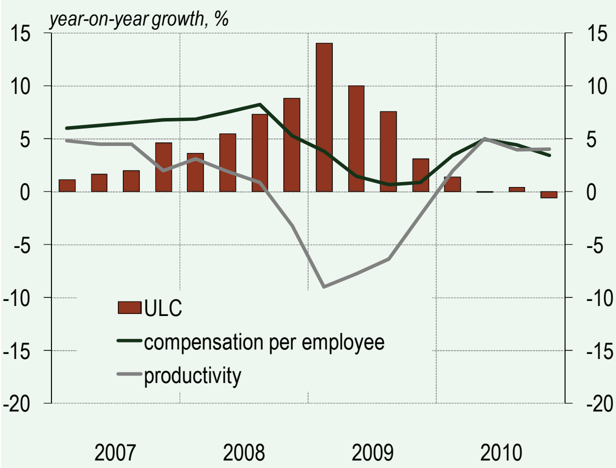
Table 2.1: Labour costs

	2006	2007	2008	2009	2010	4Q09	1Q10	2Q10	3Q10	4Q10
	nominal year-on-year growth, %									
Gross wage	4.8	5.9	8.3	3.5	3.9	1.7	3.7	4.3	4.2	3.3
Gross wage in the private sector	5.5	6.8	7.9	1.8	5.1	1.5	5.0	5.7	5.4	4.4
Gross wage in the public sector[1]	3.4	4.0	9.8	6.6	0.0	0.8	-0.6	-0.3	0.6	0.1
Gross wage in manufacturing	5.6	6.9	7.6	0.9	8.9	3.7	10.2	10.0	8.7	6.8
Labour costs per hour worked[2]	4.4	4.5	9.1	3.6	1.1	-2.7	3.6	-0.5	-1.2	2.8
Labour costs per hour worked in manufacturing[2]	3.7	5.1	10.5	5.7	3.1	-0.6	5.9	-0.6	3.0	4.3
Gross wage per unit of output	0.5	2.1	7.3	10.5	0.4	4.1	1.9	0.0	0.9	-0.9
Gross wage in manufacturing per unit of output	-3.2	0.0	7.0	9.8	-5.2	-3.0	-2.4	-9.6	-4.2	-4.7
Unit labour costs[3]	1.0	2.5	6.0	8.5	0.6	3.3	1.7	0.7	1.1	-0.9
Labour costs per employee[3]	5.3	6.4	7.0	1.7	4.1	0.9	3.4	5.0	4.4	3.4
Output per employee	4.3	3.8	1.0	-6.4	3.4	-2.3	1.7	4.3	3.3	4.3
Output per employee (manufacturing)	9.1	7.0	0.5	-8.1	15.0	6.8	12.9	21.7	13.4	12.1
HICP	2.5	3.8	5.5	0.9	2.1	1.4	1.7	2.4	2.3	2.0
GDP deflator	2.0	4.2	4.0	3.2	0.7	1.9	0.2	1.0	1.4	0.1

[1] Public administration, education, health and culture according to NACE rev. 2
[2] Labour costs according to SORS calculations
[3] Labour costs calculated on the basis of employee compensation (national accounts)
Source: SORS, Bank of Slovenia calculations

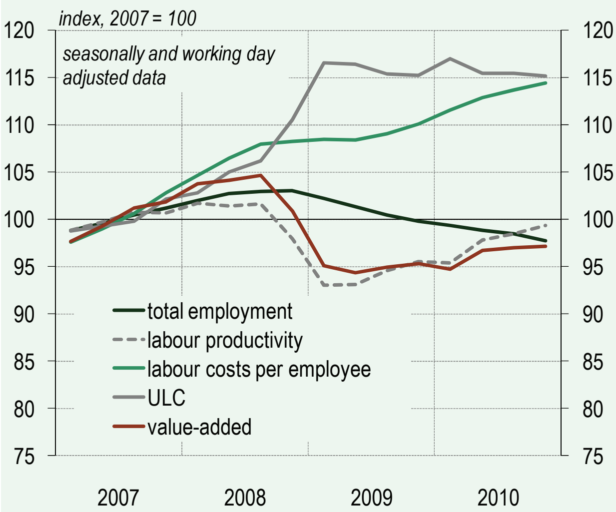
[7] Under this indicator, the public sector consists of public administration, education, health and culture according to NACE rev. 2. Its weakness is that it also includes legal entities that do not belong to the public sector, while its advantage is that the data time series are available over a longer period.

Figure 2.17: Productivity, unit labour costs and compensation per employee (total economy)



Sources: Eurostat, Bank of Slovenia calculations

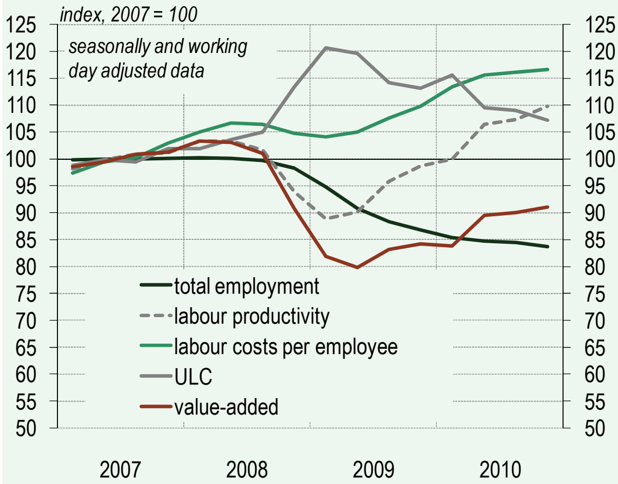
Figure 2.18: Cost adjustment of the economy (total economy)



Sources: Eurostat, Bank of Slovenia calculations

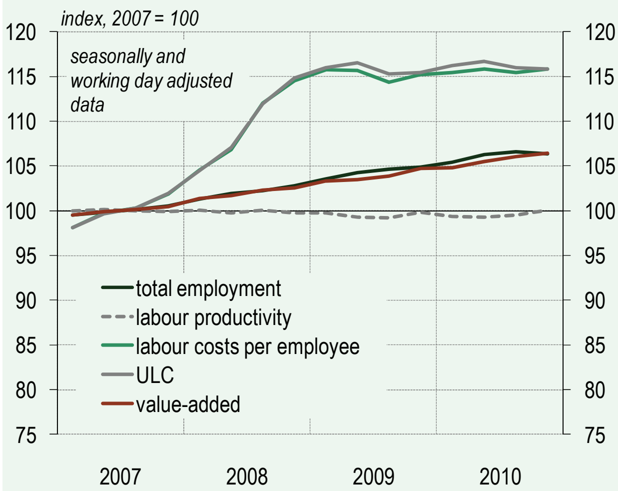
in year-on-year terms. According to an indicator that includes employees in the institutional sector of the government,[8] average wage growth in the second half of 2010 stood at 0.5%. The low wage growth in the public sector was the result of government austerity measures, although in the second half of 2010 the wage bill grew at a rate similar to that in the private sector as a result of a rise in employment.

Figure 2.19: Cost adjustment of the economy (manufacturing)



Sources: Eurostat, Bank of Slovenia calculations

Figure 2.20: Cost adjustment of the economy (public sector*)



Sources: Eurostat, Bank of Slovenia calculations
** Includes Sectors L, M, N, O, P under NACE 1.1*

Labour productivity fell sharply at the turn of the year between 2008 and 2009, but has recently been rising again with the revival of economic growth and the further fall in employment. GDP per employee in the first quarter of 2009 was down 8.7% in year-on-year terms, as there was a significant fall in output and the number of employees had not yet adjusted to the new situation. With the gradual increase in output and continued fall in employment , productivity gradually rose, and

[8] The institutional sector of the general government is defined under the ESA 95, and includes Central government (S.1311), Regional government (S.1312), Local government (S.1313) and Social security funds (S.1314). The figures are only available for the last few years.

by the final quarter of 2010 it had almost reached its level of 2007. The fluctuation in productivity was particularly pronounced in manufacturing. As a result of the sharp decline in output, productivity in the first quarter of 2009 was down 15.4% in year-on-year terms, but this was followed by a sharper adjustment in the number of employees, which meant that productivity in the final quarter of 2010 had already exceeded its pre-crisis level by around 9%.

After an extremely high increase in early 2009, year-on-year growth in nominal unit labour costs stalled, manufacturing recording the largest decline in unit labour costs. As a result of the rapid decline in economic activity, unit labour costs in the first quarter of 2009 were up 13.7% in year-on-year terms, almost 9 percentage points above the average year-on-year rate in the last ten years. Year-on-year growth began to slow towards the end of 2009, and turned negative in the final quarter of 2010. After a sharp fall in productivity, firms succeeded in holding down growth in labour costs by reducing employment. In manufacturing the gross unit wage in the first quarter of 2009 was up 18.2% in year-on-year terms, but the year-on-year rate has been declining since the final quarter of 2009. The gross unit wage in the final quarter of 2010 was thus down 4.7%. The decline in unit labour costs is the result of a significant fall in employment in the sector and the gradual recovery of economic activity. Unit labour costs in manufacturing in the final quarter of 2010 were nevertheless still around 3% higher than in the third quarter of 2008.

3 Foreign Trade and Competitiveness

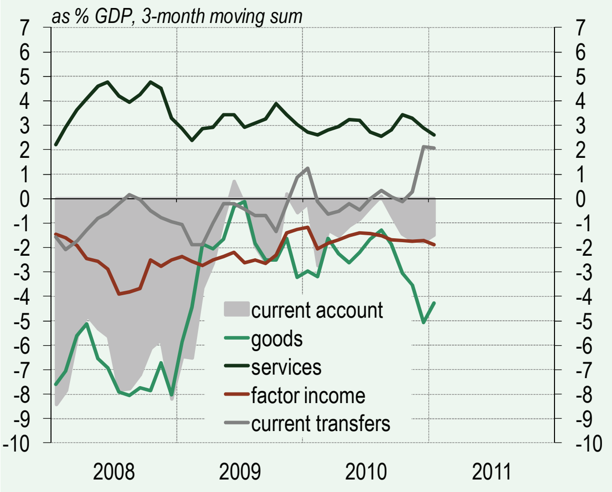
After declining sharply in 2009, the current account deficit declined slightly further in 2010 to stand at 1.1% of GDP. The volume of foreign trade increased at the end of last year as a result of higher foreign demand, stronger exports of intermediate goods and slightly higher domestic demand. The largest contribution to the decline in the current account deficit came from current transfers, which moved from deficit to surplus last year as a result of a high inflow of official transfers. Other factors in the decline in the current account deficit were a smaller deficit in capital income and a larger surplus in labour income. Imports of goods grew slightly more quickly than exports in value terms, primarily as a result of price factors, the sharply deteriorated terms of trade accounting for just over two-thirds of the goods trade deficit. The surplus of trade in services also declined slightly last year. The competitiveness indicators of the Slovenian economy mostly improved in 2010, both those expressed in terms of prices and those related to labour costs, although less than the average of the main euro area trading partners. The deterioration in the indicators since the outbreak of the crisis reflects the slower adjustment of the Slovenian economy.

Foreign trade

Having widened until 2008, the current account deficit has declined over the last two years, reaching 1.1% of GDP in 2010. After the outbreak of the financial and economic crisis, in addition to foreign demand there was a sharp decline in domestic consumption in 2009, and thus in imports, the current account deficit narrowing to 1.5% of GDP. The current account deficit continued to narrow in 2010 with slightly lower intensity, reaching EUR 409 million or 1.1% of GDP. Under the influence of the recovery of economic activity in Slovenia's most important trading partners, Germany in particular, exports of goods and export-related imports (intermediate goods) in particular increased during the first three quarters of last year. In the final quarter there was an increase in domestic demand alongside foreign demand, and thus in imports of goods for domestic consumption. The recovery of economic activity in the rest of the world also stimulated the goods trade with the rest of the world, but widened the goods trade deficit as a result of adverse price factors. Growth in trade in services, tourism in particular, has lagged behind the growth in goods trade. With imports growing faster than exports, the surplus of trade in services actually declined. With net factor income declining by a fifth, the main factor in the smaller current account deficit was the net outflow in current transfers.

The largest factor in the current account deficit in 2010 was the increase in the goods trade deficit. The recovery of economic activity in Slovenia's most important EU trading partners, those from the euro area in par-

Figure 3.1: Components of the current account



Source: Bank of Slovenia

ticular, sharply accelerated growth in goods trade, in both the trend and in year-on-year terms, in the first half of 2010. Growth in the second half of the year slowed. Other than in the middle of the year, growth in nominal imports of goods outpaced growth in exports as a result of a deterioration in the terms of trade. The goods trade deficit thus widened by EUR 275 million in year-on-year terms to EUR 974 million[9] or 2.7% of GDP, up 0.7 GDP percentage points on 2009. Trade in goods had begun to gradually rise in the second half of 2009 in value terms, the contraction in the volume of goods trade diminishing in the final quarter in particular. Growth in terms of both value and volume peaked in the second quarter of 2010, since which the rates have been slowing, although they remain positive. Increased domestic consumption meant that year-on-year growth in imports of goods in the final quarter (17.8%) outpaced growth in exports of goods (14.9%). Growth in imports of goods averaged 14.8% in 2010, while growth in exports averaged 13.7%.

Alongside the ongoing fiscal stimulus, another factor in last year's recovery of Slovenian exports was the indirect effects of higher import demand from emerging Asian countries and certain EU Member States outside the euro area. As a result of fiscal incentives for new car purchases, most notably in Germany and France, quarterly growth in exports was positive from the second quarter of 2009. After the termination of the measures to encourage demand in Germany, exports primarily increased as a result of indirect effects of higher import demand from Asian countries, China and India in particular.

The terms of trade deteriorated in 2010, primarily as a result of growth in commodity prices on global markets, and were a significant factor in the goods trade deficit. The terms of trade had improved by 4.7% in 2009, and accounted for over a third of the narrowing of the current account deficit. The position changed last year. The indices of goods trade prices rose sharply from the second quarter. The average price of exports rose by 3.0% in 2010. As a result of rapid growth in prices of commodities, food, non-food agricultural products and energy, the index of import prices rose by 6.4%. The terms of trade thereby deteriorated by 3.2%. Another factor in slightly higher growth in import prices was the euro's fall against the US dollar. The deterioration in the terms of trade with the rest of the world contributed EUR 630 million or 1.7% of GDP to the goods trade deficit.

Figure 3.2: Trade in goods

Source: Bank of Slovenia

[9] According to SORS figures (fob for exports, cif for imports), and excluding adjustments in coverage applied in balance of payments methodology, the merchandise trade deficit stood at EUR 1,390 million (explained in the Methodological Notes appendix to the Bulletin).

Among the different categories of goods trade, the largest increases in 2010 were recorded by exports of intermediate goods and consumer goods, while exports of capital goods were unchanged from 2009. The decline in foreign demand as a result of the financial and economic crisis in early 2009 hit exports of intermediate goods fastest and hardest, but demand for these goods has also increased fastest during the recovery of economic activity in the rest of the world. Exports of intermediate goods were up 22.9% last year, growth reaching 27.2% in the second quarter. Exports of consumer goods recorded their first year-on-year growth since the outbreak of the crisis in the final quarter of 2009, at 1.9%, although the rate of 5.6% recorded in 2010 was significantly less than that of intermediate goods. The decline in demand and the great uncertainty in the recovery of output and sales acted to curb investment activity, both at home and abroad. Only a lengthy recovery of economic activity has once again encouraged investment activity, and demand for capital goods. This is having an impact on exports of capital goods, which increased in the second half of the year, and overall in 2010 were up 1.5% on the previous year.

Similar movements were seen in imports of goods. While imports of intermediate goods and consumer goods recorded high growth, imports of capital goods in 2010 were down on the previous year. Alongside volume factors, growth in foreign demand in particular, another factor in the increase of 22.4% in the value of imports of intermediate goods was higher import prices. The crisis had the largest impact on imports of

Table 3.1: Components of the current account

	2004	2005	2006	2007	2008	2009	2010
				EUR million			
Current account balance	-720	-498	-771	-1646	-2489	-526	-409
1. Goods	-1009	-1026	-1151	-1666	-2650	-699	-974
2. Services	688	920	993	1047	1493	1114	1057
2.1. Transport	324	398	456	525	561	425	450
2.2. Tourism	608	743	783	834	970	832	838
- of which, exports	1312	1451	1555	1665	1918	1800	1743
2.3. Other	-245	-221	-247	-312	-38	-143	-231
3. Factor income	-322	-295	-440	-789	-1030	-782	-597
3.1. Labour income	138	128	107	50	7	85	149
3.2. Capital income	-460	-424	-547	-839	-1038	-867	-745
4. Current transfers	-76	-97	-173	-239	-302	-159	104
				as % GDP			
Current account balance	-2.7	-1.7	-2.5	-4.8	-6.7	-1.5	-1.1
1. Goods	-3.7	-3.6	-3.7	-4.8	-7.1	-2.0	-2.7
2. Services	2.5	3.2	3.2	3.0	4.0	3.1	2.9
2.1. Transport	1.2	1.4	1.5	1.5	1.5	1.2	1.2
2.2. Tourism	2.2	2.6	2.5	2.4	2.6	2.4	2.3
- of which, exports	4.8	5.0	5.0	4.8	5.1	5.1	4.8
2.3. Other	-0.9	-0.8	-0.8	-0.9	-0.1	-0.4	-0.6
3. Factor income	-1.2	-1.0	-1.4	-2.3	-2.8	-2.2	-1.7
3.1. Labour income	0.5	0.4	0.3	0.1	0.0	0.2	0.4
3.2. Capital income	-1.7	-1.5	-1.8	-2.4	-2.8	-2.5	-2.1
4. Current transfers	-0.3	-0.3	-0.6	-0.7	-0.8	-0.4	0.3

Sources: SORS, Bank of Slovenia

capital goods. After declining in 2009 and the first half of 2010, they gradually increased in the second half of 2010, so that the decline of just over a third in 2009 was followed by a decline of 0.7% in 2010. This was the result of a decline in the nominal value of imports of capital goods in the early months of 2010 due to low capacity utilisation, risks associated with the sustainability of the economic recovery and a decline in import prices of these goods. Imports of capital goods began to increase in the second half of the year, together with their import prices.

According to SORS figures, trade in goods with EU Member States grew faster than trade with non-EU countries last year. Extensive fiscal measures to encourage domestic consumption and the fall in euro led to GDP growth in the most important EU trading partners outpacing that in the most important non-EU markets. After the beginning of the recovery in the second half of 2009, exports of goods to EU Member States increased faster than those to non-EU countries in 2010. Year-on-year growth in exports to EU Member States averaged 16.8% in 2010, compared with 7.0% for non-EU countries. The regional differences in imports of goods widened in the opposite direction, primarily as a result of faster growth in imports of intermediate goods from non-EU countries in the second half of the year. Growth in merchandise imports from non-EU countries averaged 17.5% in 2010, outpacing growth in merchandise imports from EU Member States at 14.0%. The largest increase in trade with non-EU countries was recorded by exports to non-European members of the OECD. Goods exports to the former Yugoslav republics declined by 0.8% last year, while imports increased by 27.0%. Trade with Russia expanded sharply, particularly on the import side (import growth of 45.9%, export growth of 3.0%). The goods trade deficit with EU Member States widened by EUR 4 million to EUR 2,296 million. The majority of the increase of EUR 303 million in the overall goods trade deficit was thus the result of a decline of EUR 299 million in the surplus in goods trade with non-EU countries to EUR 895 million.

Figure 3.3: Trade in services

Source: Bank of Slovenia

Growth in trade in services has lagged strongly behind the growth in goods trade. With imports of services growing faster than exports, the surplus of trade in services declined by EUR 57 million in year-on-year terms to EUR 1,057 million. The decline in the services surplus in 2010 was the result of a deterioration in the net result in the majority of services, most notably intellectual property services, although the contributions made by transport, tourism and government services remained positive. Imports of services in 2010 were up 3.7% on the previous year at EUR 3.3 billion, while exports of services were up 1.4% at EUR 4.4 billion. The largest increase was in exports of financial and communications services, while on the import side, alongside communications services, there was an increase of 28.2% in expenditure on intellectual property services, which has more than tripled in the last three years. Among the major services, imports and exports of transport services recorded above-average growth of 10.2% and 8.4% respectively in 2010, as trade in goods increased rapidly. Imports and exports of construction services declined by almost a third, as a result of the persistent weakness in construction and investment at home and abroad. The crisis also resulted in a decline in tourism trade, imports of tourism services declining by 6.5% and exports by 3.2%. The decline in tourism exports in the context of year-on-year rises of 2.0% in the number of arrivals and 1.0% in the number of overnight stays by foreign tourists indicates that there is an increasing proportion of transit tourists on brief stays in Slovenia with less inclination to spend.

The majority of the sharp narrowing of the deficit in factor income was the result of a smaller net outflow of earnings from FDI, a decline in net interest expenses and a larger surplus in labour income. The deficit in net factor income narrowed by EUR 186 million to EUR 597 million in 2010, making a significant contribution to the narrowing of the current account deficit. Outflows of labour income halved in 2009 as a result of the decline in domestic economic activity and in the employment of foreign workers in Slovenia. Last year they further declined by just under a third, resulting in a surplus of EUR 149 million in labour income. The deficit in capital income narrowed sharply in year-on-year terms, by EUR 122 million to EUR 745 million. Receipts of capital income were up 43.7%, while expenditure was up 6.2%. The increase in receipts originates in estimated reinvested earnings last year, these having had an adverse impact on receipts from Slovenian corporates' outward FDI in the first half of 2009 as a result of corporate losses. The deficit in income from FDI declined from EUR 614 million in 2009 to EUR 522 million in 2010. Heavy government borrowing in 2009 and 2010 meant that the largest factor in the deficit in capital income was the net outflows of income from investments in securities. As a result of low interest rates and a decline in the banks' indebtedness in the rest of the world, the largest decline in any item of capital income was recorded by net interest payments to the rest of the world, from EUR 319 million in 2009 to EUR 155 million in 2010.

Another major factor in the narrower current account deficit in 2010 was current transfers, which swung from a deficit of EUR 159 million in 2009 to a surplus of EUR 104 million in 2010. The largest change was in official transfers, which swung from a deficit of EUR 118 million to a surplus of EUR 151 million. Inward official transfers amounted to EUR 818 million, while outward official transfers amounted to EUR 667 million. There was an above-average increase in the net inward official transfers at the end of the year, primarily as a result of increased use of available EU funds. The realisation of the forecast flows with the EU budget was 69.7% on the receipt side (compared with 73.1% in 2009), and 96.1% on the expenditure side. The net inflow of current and capital transfers thus amounted to EUR 326 million, approximately EUR 170 million more than in 2009.

Competitiveness

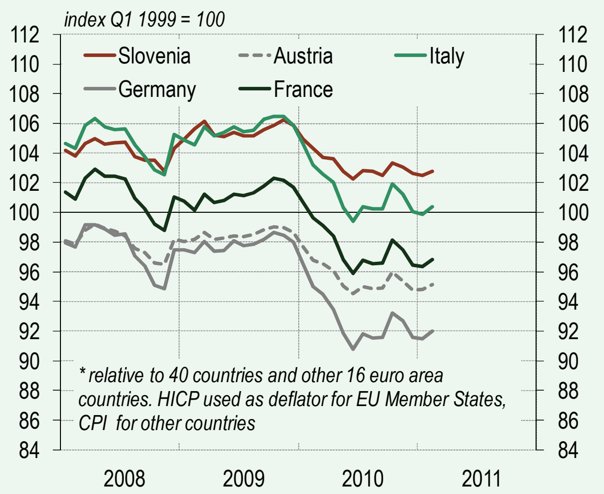
In the middle of 2010, the nominal harmonised competitiveness indicator[10] reached its lowest level since

Figure 3.4: Harmonised national competitiveness indicators*

Source: ECB

[10] From the point of view of competitiveness, an increase (decline) or a high level (low level) in the indicator is unfavourable (favourable). The PSR discusses with the harmonised competitiveness indicators published by the ECB (http://www.ecb.int/stats/exchange/hci/html/index.en.html). The nominal competitiveness indicator and the real competitiveness indicator deflated by the consumer price index are measured for 40 different countries and the other 16 members of the euro area, while the indicators that use the GDP deflator and unit labour costs in the total economy are measured for 20 countries and the other 16 members of the euro area. The European Commission also publishes price and cost competitiveness indicators (http://ec.europa.eu/economy_finance/db_indicators/competitiveness/index_en.htm). These differ from those of the ECB because of methodological differences resulting from the countries covered, the different sources for the deflators and the data conversion methods.

Figure 3.5: Harmonised price competitiveness indicator*



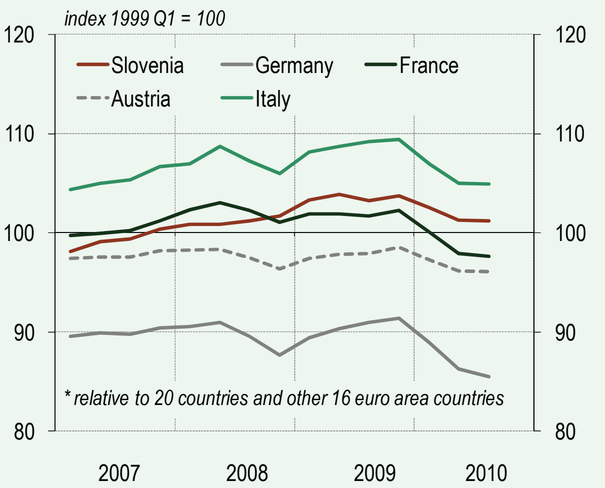
Source: ECB

Slika 3.6: Harmonised price competitiveness indicator* (year-on-year growth)

Source: ECB

the outbreak of the crisis after declining significantly in late 2009 and early 2010. The indicator rose slightly in the second half of last year, and remained at a high level in early 2011. The indicator recorded an average decline of 2.2% in 2010. It was the euro's fall of 4.9% against the US dollar that contributed to the decline of the indicator, alongside the euro's decline of 8.5% against the Swiss franc, 3.7% against the pound sterling and 10.7% against the Japanese yen. The index reached its low last June, when it was down 3.3% in year-on-year terms. It

Figure 3.7: Harmonised competitiveness indicator (GDP deflator)*



Source: ECB

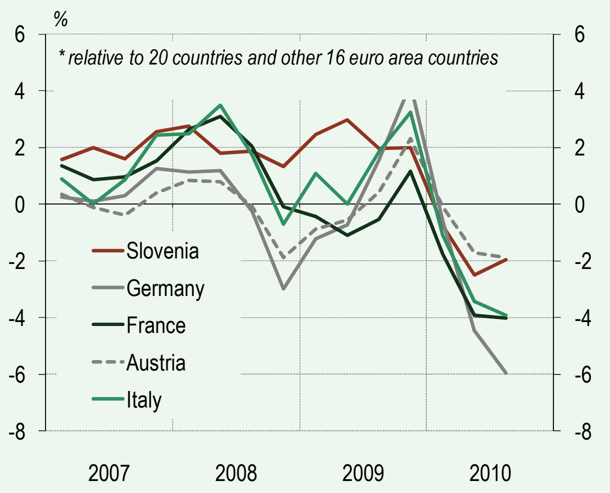
rose slightly in the second half of the year, the year-on-year decline averaging 2.6%. In February 2011 the index was down 1.1% in year-on-year terms.

The main factor in the improvement in Slovenia's harmonised indicator of price competitiveness was the fall in the euro. Last year's movement in domestic consumer prices was similar to that of the basket of foreign prices, with small monthly variations. The year-on-year decline in the indicator averaged 2.2% in 2010. The harmonised indicator was down 1.5% in year-on-year terms in February of this year.

In 2010, the improvement in Slovenia's price competitiveness as measured by the HICP was less than the average improvement in Slovenia's main euro area trading partners. Last year's improvement in Slovenia's price competitiveness was 1.7 percentage points less than the average improvement in price competitiveness in the main euro area trading partners. In the early part of this year Slovenia's price competitiveness remained at its level from the end of last year. The gap by which Slovenia's price competitiveness trails that of the main euro area trading partners thus continued.

The harmonised index of price competitiveness as measured by the GDP deflator, which reflects the

Figure 3.8: Harmonised competitiveness indicator (GDP deflator, year-on-year growth)

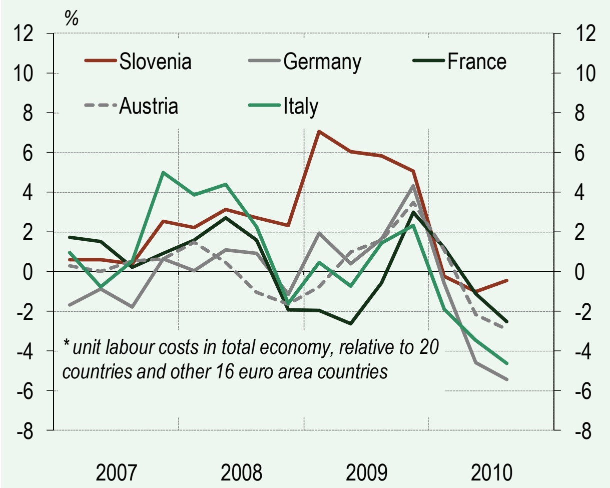


Source: ECB

Figure 3.9: Harmonised cost competitiveness indicator*

Source: ECB

Figure 3.10: Harmonised cost competitiveness indicator* (year-on-year growth)



Source: ECB

general level of prices in the economy, improved slightly in year-on-year terms in the first three quarters of last year. The improvement in the first half of 2010 was partly the result of a base effect from 2009, when the indicator deteriorated significantly. In the third quarter the year-on-year decline was 0.5 percentage points less than that in the second quarter at just under 2%. Competitiveness as measured by the GDP deflator also deteriorated slightly relative to the major euro area trading partners, where the average year-on-year decline stood at 3.9% in the third quarter.

After a significant deterioration at the outbreak of the crisis, the harmonised indicator of cost competitiveness as measured by unit labour costs in the total economy improved slightly in year-on-year terms during the first three quarters of 2010. The significant deterioration in the indicator in 2008 and 2009 was partly the result of the reform of the public sector wage system, and partly the result of the rapid decline in productivity at the outbreak of the crisis, which impacted upon a rise in unit labour costs in the total economy. In 2010 unit labour costs in the total economy remained high, although labour productivity rose in certain sectors as a result of significant adjustments in employment. The harmonised indicator recorded a year-on-year improvement in the first half of the year for the first time since 2006, but deteriorated by 0.5 percentage points from the second quarter to stand at -0.5% in the third quarter.

The gap by which Slovenia's cost competitiveness trails that of the main euro area trading partners widened further last year. A comparison of the competitiveness indicators reveals that Slovenia's cost competitiveness deteriorated significantly after the outbreak of the international economic crisis, as growth in unit labour costs was high relative to other countries as a result of slower adjustment of labour costs to diminished output. Similar movements were seen last year. The year-on-year decline in the cost competitiveness indicator stood at 0.5% in the third quarter of 2010, 3.4 percentage points less than the average of the main euro area trading partners. Most notable is Germany, where the indicator recorded a year-on-year decline of 5.4% in the third quarter.

4 Financing

The features of the low growth in corporate loans in 2010 were an increase in long-term loans, and a decline in short-term loans. At the same time corporates were reducing their indebtedness from loans in the rest of the world, which were partly replaced with trade credits and with financing via capital markets. The main factor in last year's high year-on-year growth in loans to households was housing loans, while consumer loans declined. The restructuring of the banks' funding continued last year. The proportions accounted for by household deposits, deposits by non-financial corporations and debt securities increased, while the proportions accounted for by funding at foreign banks, funding at the ECB and government deposits declined. This is raising the cost of the banks' funding, which is having an impact on interest rates and the supply of loans. The latter is being reflected in particular in short-term loans.

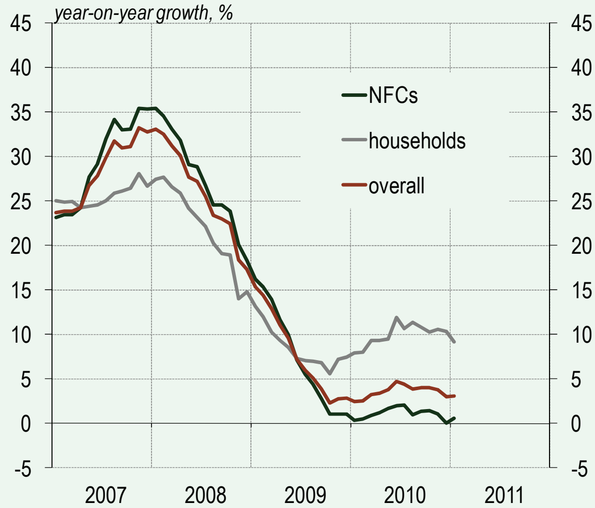
Financing of non-financial corporations and households

Non-financial corporations'[11] financial liabilities amounted to EUR 61.7 billion in the third quarter of 2010, up just EUR 84 million on the end of 2009. There was an increase in liabilities from loans and from trade credits and advances, and a decline in liabilities from shares and other equity. Financial liabilities from loans amounted to EUR 30.3 billion in the third quarter of 2010, up EUR 405 million on the end of 2009. The main factor in the increase in loans was long-term borrowing, while the stock of short-term loans declined. The monthly figures show that the trend of increase in long-term borrowing continued in the final quarter, but not to a sufficient extent to compensate for the reduction in short-term borrowing. Corporate financing was not undertaken solely via loans raised at other MFIs,[12] but partly also via short-term operating liabilities. Liabilities in the form of accounts payable to suppliers, which account for the largest proportion of short-term operating liabilities, increased sharply since the outbreak of the crisis, reflecting lack of payment discipline in the corporate sector. Corporate financing via trade credits and advances increased last year, corporates increasing their financial liabilities from this source by EUR 278 million. The decline in corporate financial liabilities from shares was exclusively the result of the drop in the market value of shares.

Some indicators show that the main factors in the low growth in corporate loans were on the demand side, although supply-side factors might become increasingly important. After a sharp decline in 2009,

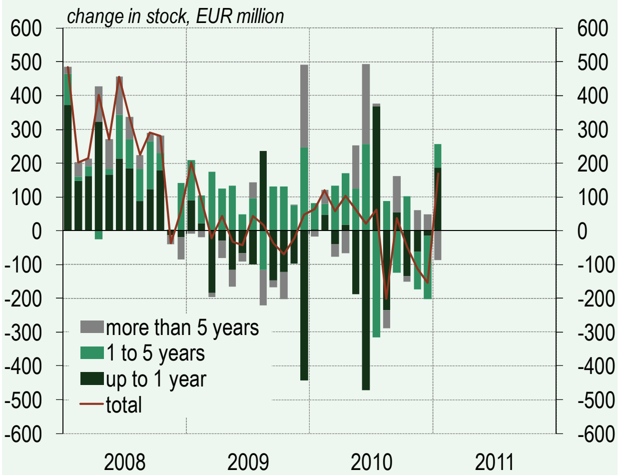
[11] According to the ESA 95 definition, non-financial corporations (NFCs) are legal entities that are market producers of goods and non-financial services. In this section the general term "corporates" is used for NFCs, solely for the purpose of simplification.
[12] Under the ESA 95 definition, other monetary financial institutions (other MFIs) comprise banks, savings banks and money-market funds. In this section the general term "banks" is used for other MFIs, solely for the purpose of simplification.

Figure 4.1: Loans to households and non-financial corporations



Source: Bank of Slovenia

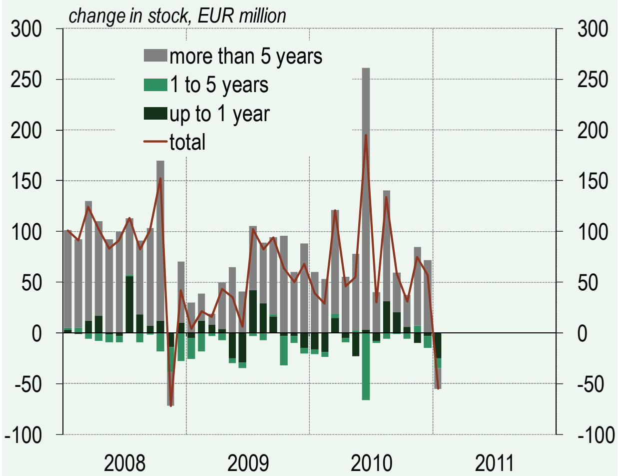
Figure 4.2: Loans by domestic MFIs to domestic NFCs, by maturity



Source: Bank of Slovenia Bulletin

year-on-year growth in corporate loans stabilised at low levels in 2010, averaging 1.1% over the year. The low year-on-year growth in corporate loans last year was still primarily the result of the large decline in economic activity, which sharply reduced corporate investment activity and consequently corporate demand for loans. Further evidence of this comes from certain surveys.[13] An increase in the importance of other limiting factors on the supply side of corporate loans could nevertheless be discerned in 2010. The banks remain cautious in approving loans, particularly to excessively indebted corporates with meagre prospects. Stricter collateral requirements have also contributed to the low growth in corporate loans, and represent an additional limiting factor in a highly indebted sector such as corporate sector.[14] The introduction of the new Basel III international banking standard will also have an impact on the supply of loans. This envisages a rise in capital adequacy (an increase in Tier 1 capital), which would raise the cost of bank funding and consequently that of loans to the private sector. Additionally, in order to diversify risk the banks are lending more to households, which in the event of limited access to bank funding could limit the amount of lending available for corporates.

Figure 4.3: Loans by domestic MFIs to domestic households, by maturity



Source: Bank of Slovenia Bulletin

Last year the domestic banks primarily approved loans of longer maturities for corporates, and continued to reduce the stock of short-term loans. Loans of up to 1 year declined in 2010, while loans of 1 to 5 years and loans of more than 5 years increased. As a result of favourable short-term financing in the pre-crisis period, corporates often raised short-term loans to finance longer -term activities, these loans being regularly refinanced. With the outbreak of the crisis and the increase in uncer-

[13] For more, see Stability of the Slovenian Banking System, December 2010.
[14] The relatively high corporate indebtedness in Slovenia and its rapid increase during the crisis are also evident from European Commission analysis of the indebtedness of institutional sectors (Quarterly Report on the Euro Area, October 2010).

tainty, the banks became more cautious, and were no longer ready to refinance short-term loans to the same extent as before the crisis. Another factor in the decline in the stock of short-term loans was the high costs of short-term financing, which reflect higher risk premiums, perceived by the banks. This is also being reflected in the interest rate spread, which on short-term loans has almost doubled since the outbreak of the crisis, while the spread on long-term loans has remained almost at the pre-crisis level. The stock of long-term loans increased again last year, partly as a result of higher investment in machinery and equipment. The contributory factors were the high growth of foreign demand and also government guarantee schemes aimed at financing corporates with good credit ratings.

In 2010 corporates replaced loans raised in the rest of the world with other foreign sources of financing. After a short-term decline in indebtedness in 2009, last year corporates reduced both short-term and long-term debt in the total amount of EUR 263 million. Similarly to domestic loans, the vast majority of repaid foreign loans were those of shorter maturities. Corporates then replaced a portion of the repaid loans with borrowing on foreign capital markets. Non-residents' investments in the securities of domestic corporates, primarily equities, thus increased by EUR 105 million. As a result of the sale of certain corporates to non-residents, financing via FDI also increased. As a result of the revival of international trade, corporates have again started to finance themselves via trade credits; after a net financial outflow in 2009, there was a net financial inflow via trade credits in 2010 in the amount of EUR 126 million.

Households' financial liabilities increased by EUR 645 million in the first three quarters of 2010, mostly as a result of borrowing in the form of loans. Borrowing in the form of loans, which accounts for around 88% of total household liabilities, increased by EUR 559 million during this period, compared with EUR 375 million in the same period of 2009. The increase in the stock of loans to households was entirely the result of increase in long-term loans, which increased by EUR 616 million. The stock of short-term loans declined by EUR 57 million. Other household liabilities, predominantly trade credits and advances, increased by EUR 87 million in the first three quarters of 2010.

The relatively high year-on-year increase in loans to households in 2010 was solely the result of housing loans, as evidenced by the aforementioned breakdown of loans by maturity. The stock of consumer loans declined last year. Year-on-year growth in loans to households stood at 9.2% in January 2011. The growth in long-term loans was primarily the result of growth in housing loans, the year-on-year rate averaging 24% during the second half of 2010, before declining to 21% in January 2011. The high growth in housing loans is a result of low households' indebtedness, low interest rates on newly approved loans and, on the demand side, lower real estate prices. The decline in the stock of short-term loans to households entails a reduction in indebtedness via consumer loans, and is in line with low household consumption. The year-on-year decline in consumer loans averaged 0.7% over 2010, the figure reaching 2.8% in January 2011.

Domestic and foreign sources of financing

The public sector deficit last year exceeded the increase in the private sector's savings, and it was therefore necessary to finance the difference at the level of the total economy by borrowing in the rest of the world. After a large increase in the private sector's net saving in 2009, last year it stabilised and stood at around 4.4% of GDP. There was an increase in the net financial savings[15] of households and banks, and a decline in the net financial deficit of corporates. Despite the decline, the deficit was still much higher than in the euro area overall. The public sector net financial deficit

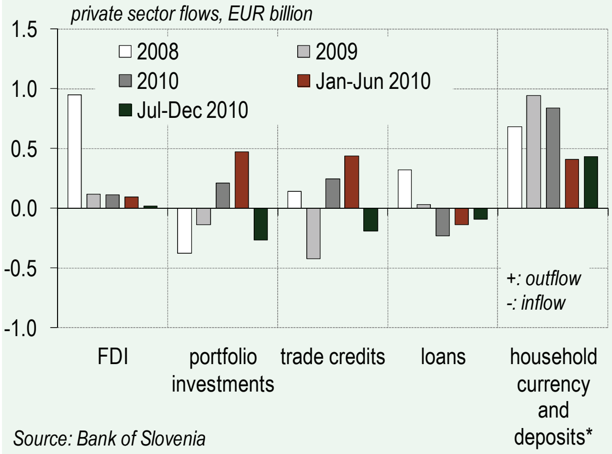
[15] Net financial savings are defined as the surplus in net financial assets.

Figure 4.4: Savings-investment gap

Sources: SORS, Bank of Slovenia

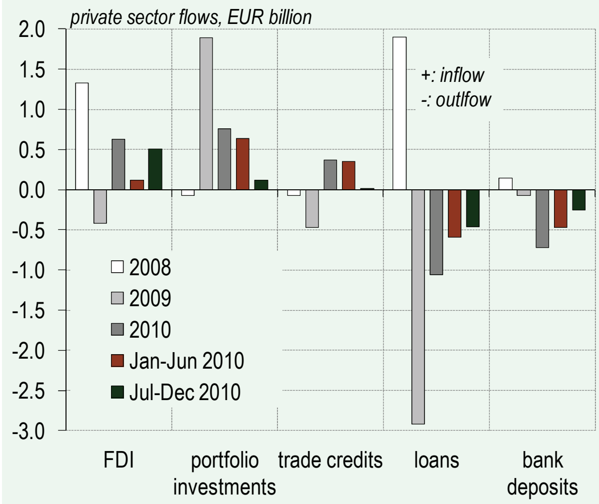
** The net savings of the public sector are defined as the consolidated public sector position using the ESA 95 methodology. Net borrowing from the rest of the world is defined as the negative of the current account position. The net savings of the private sector are defined as the difference between the current account position and the net savings of the public sector.*

Figure 4.5: Financial claims against the rest of the world



Source: Bank of Slovenia
*Note: * Household currency and deposits includes deposits held by households in BIS member states, and household currency transactions in progress. For a detailed explanation, see the Methodological Notes in the Bank of Slovenia Bulletin*

Figure 4.6: Financial liabilities to the rest of the world



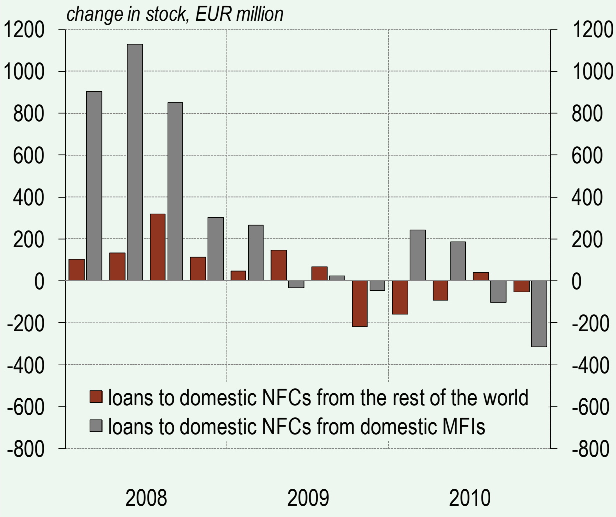
Source: Bank of Slovenia

amounted to EUR 1,987 million or 5.5% of GDP last year. The difference between the public sector deficit and the private sector's savings was financed in the rest of the world, which was reflected in a deficit in the current account. The net external debt increased again last year, to EUR 11.3 billion. This amounts 31.7% of GDP, which is 1.5 percentage points higher compared to 2009. The gross external debt increased by EUR 621 million last year to stand at EUR 40.9 billion or 113.4% of GDP at the end of the year. Gross external claims stood at EUR 29.5 billion at the end of 2010, having declined by EUR 116 million over the year.

Households hold just over half of their investments in the form of currency and deposits, which increased additionally in 2010. Currency and deposits account for more than half of household financial investment, and increased by more than EUR 1 billion during the first three quarters of 2010. There was an increase in households' investments in currency and deposits redeemable at notice, while deposits with an agreed maturity declined, albeit not all maturities. Only deposits of up to 1 year have declined in the last year, while the stock of household deposits with maturities of more than 1 year have increased. The stock of household investments in shares and other equity, which accounts for around 28% of the sector's total investments, declined last year as a result of a fall in equity prices.[16] Net equity of households in life insurance reserves and pension fund reserves in-

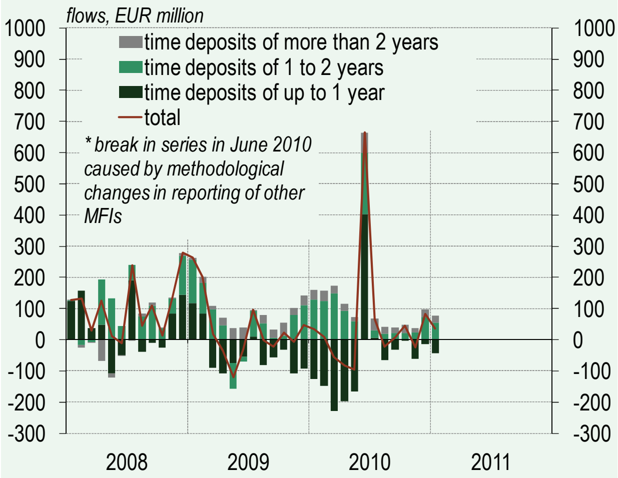
[16] Cumulative transactions during the first three quarters of 2010 were greater than in the same period of 2009.

Figure 4.7: Loans to domestic non-financial corporations



Sources: Bank of Slovenia, SORS

Figure 4.8: Euro time deposits by households and non-profit institutions serving households



Sources: Bank of Slovenia, ECB

creased by EUR 297 million during the first three quarters of the year.

Corporate investment are more diversified than those of households, trade credits and advances accounting for more than a third, having recorded the largest increase in 2010. Trade credits and advances increased by EUR 553 million over the first three quarters of last year, which is in line with the recovery of foreign trade and domestic economic activity. The stock of corporates' investments in shares and other equity declined by EUR 100 million last year, which, as for households, was the result of a fall in the prices of these instruments. Investments in short-term deposits with an agreed maturity also declined during this period. The stock of long-term deposits with an agreed maturity increased, although not to a sufficient extent to compensate for the decline in short-term deposits with an agreed maturity.

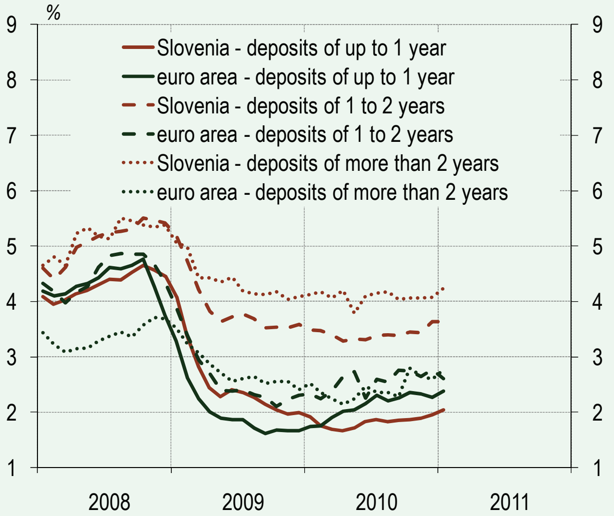
The banks continued to restructure their funding in 2010. The proportions accounted for by household deposits, corporate deposits and debt securities increased, while the proportions accounted for by funding at foreign banks, funding at the ECB and government deposits with an agreed maturity declined. Last year the banking sector again reduced its indebtedness on foreign interbank markets and with the Eurosystem, which it partly replaced primarily by means of bond issues and household and corporate deposits, which are relatively more expensive forms of funding. The government reduced its deposits at banks by around EUR 1,400 million last year, in order to finance the budget deficit. The possibility of renewing bank funding will have an increasing impact on growth in loans to the private sector. The decline in foreign funding and the withdrawal of government deposits means that the banks have been forced to find replacement funding. This they had already made a partial start to by obtaining deposits by non-banking sectors, the aim being to improve the LTD ratio.[17] A deterioration in the quality of the loan portfolio as a result of adverse developments in certain sections of the economy, such as construction, and rising bank funding costs could make a significant contribution to the appearance of limiting factors on the supply side of lending activity in the future.

Interest rates

The decline in government deposits, the maturing of temporary funding obtained at the ECB, and the

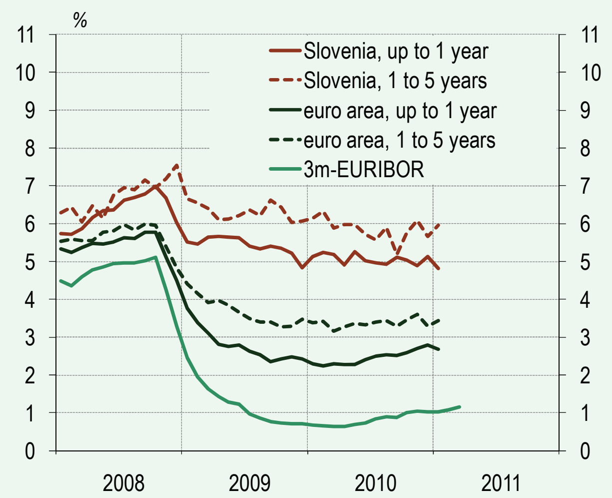
[17] Loan-to-deposit ratio.

Figure 4.9: Interest rates on household deposits, by maturity



Sources: ECB, Bank of Slovenia

Figure 4.10: Interest rates on loans to non-financial corporations



Sources: Bank of Slovenia, ECB

higher cost of new funding are raising the banks' funding costs and having an impact on interest rates on household deposits at banks. The switch to more expensive funding such as debt securities, and the higher premiums on funding obtained on the wholesale market are preventing any larger cut in asset interest rates. In order to replace funding the banks were forced to be more active in obtaining private sector deposits, particularly those with longer maturities. Interest rates on deposits of up to 1 year have been below the euro area average since the second quarter of last year. Interest rates in Slovenia on household deposits of longer maturities – between 1 and 2 years and more than 2 years – are higher than the euro area average, which is contributing to an increase in longer-term saving.

Interest rates on new corporate loans also remained relatively high in 2010, and only moderately approached interest rates in the euro area overall. This is the case for both short-term and long-term loans. The higher cost of funding and high net impairments and provisioning are forcing the banks to increase net interest income by raising asset interest rates. This is continuing to be reflected in the short-term loan segment. Having stood at 67% in 2008, the proportion of all short-term loans tied to the EURIBOR declined sharply at the outbreak of the crisis, and averaged just 24% in 2010. The falling EURIBOR and the rising cost of funding meant that after the outbreak of the crisis the banks approved more short-term loans with a fixed interest rate, to avoid reducing net interest income. For this reason interest rates on short-term loans are still more than 2 percentage points above the euro area average.

After falling sharply in 2009, interest rates on new loans to households stabilised on average last year, and began to rise in the second half of the year. The fall in interest rates on lending for house purchase seen since the end of 2008 ended last year. Interest rates on consumer loans averaged 4.7% last year, down 0.8 percentage points on 2009. Average interest rates on short-term consumer loans fell, while average interest rates on long-term consumer loans remained at their level of mid-2009. While interest rates on consumer loans were significantly below the euro area average in 2009, the gap narrowed in the second half of 2010. Average interest rates on housing loans also fell last year, although a rise in the rates could be seen in the second half of the year. Interest rates on housing loans in Slovenia are still higher than in the euro area overall, but the gap was smaller than in 2009.

5 Public Finance Developments

According to SORS estimates, the general government deficit in 2010 stood at 5.5% of GDP, slightly less than the planned in the Stability Programme. The narrowing of the deficit by 0.5 GDP percentage points from the previous year was the result of measures to restrict growth in expenditure. Given the high deficit, the need for stabilisation of the debt, and the financial consequences of an ageing population, the consolidation of public finances is a government priority. The general government deficit is expected to decline further this year. Under the excessive deficit procedure, Slovenia must reduce its deficit to below the reference value of 3% of GDP by 2013 at the latest. The general government debt increased in 2010, despite the exploitation of sources from pre-financing. Under the Stability Programme, it is expected to reach around 42% of GDP by 2013.

With economic growth low, the general government deficit declined slightly in 2010, but remained high. The general government debt increased. Growth in tax revenues remains low. The general government deficit declined to 5.5% of GDP in 2010, while the general government debt increased to 38.0% of GDP. There were similar developments in other euro area countries. According to European Commission estimates, the euro area's general government deficit remained unchanged last year at 6.3% of GDP. The euro area's general government debt increased from 79.1% of GDP in 2009 to 84.1% of GDP in 2010.

After recording negative year-on-year growth in the first quarter of last year, general government revenue later recorded a year-on-year increase. The main fac-

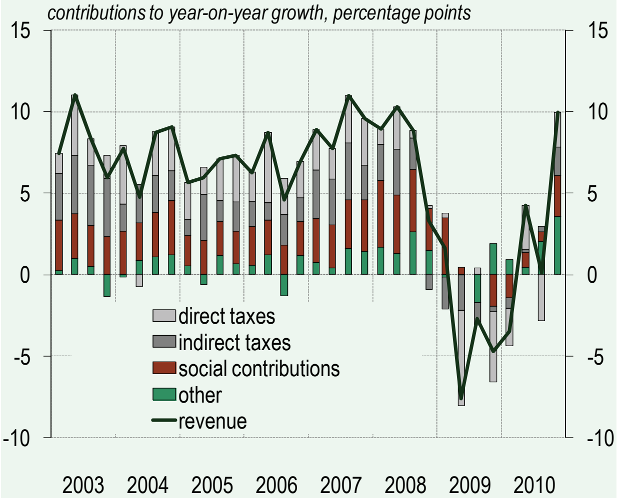
Table 5.1: General government deficit and debt in Slovenia, 2007–2013

	SORS				Stability Programme					European Commission		
as % GDP	2007	2008	2009	2010	2009	2010	2011	2012	2013	2010	2011	2012
Revenue	42.4	42.3	43.1	43.5	42.4	43.2	42.9	42.7	42.5	43.9	43.7	43.7
Expenditure	42.5	44.1	49.0	49.0	48.1	48.9	47.1	45.9	44.2	49.7	49.0	48.3
of which: interest	1.3	1.1	1.3	1.6	1.2	1.8	1.8	2.0	2.1	1.6	1.7	1.8
Net lending (+) / borrowing (-)	-0.1	-1.8	-6.0	-5.5	-5.7	-5.7	-4.2	-3.1	-1.6	-5.8	-5.3	-4.7
Structural balance	…	…	…	…	-4.8	-4.2	-2.8	-2.1	-1.0	-4.0	-3.8	-3.8
Debt	23.1	21.9	35.2	38.0	34.4	39.6	42.0	42.7	42.1	40.7	44.8	47.6
Real GDP *(growth, %)*	6.9	3.7	-8.1	1.2	-7.3	0.9	2.5	3.7	3.5	1.1	1.9	2.6

Sources: SORS (realisation), Ministry of Finance (January 2010), European Commission (November 2010)

Figure 5.1: General government revenue

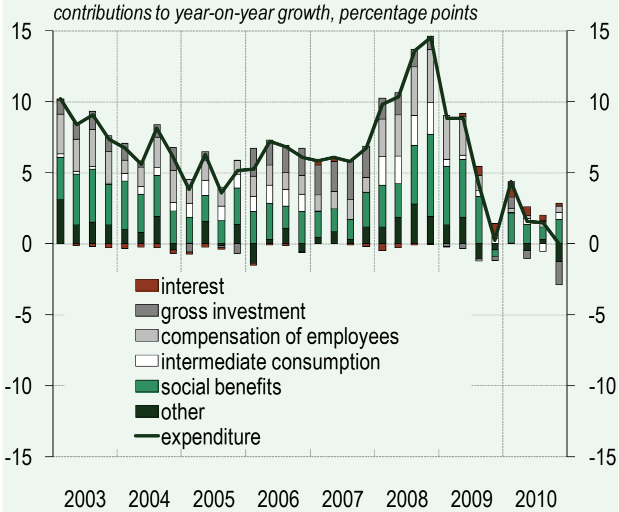
contributions to year-on-year growth, percentage points



Sources: SORS, Bank of Slovenia calculations

Figure 5.2: General government expenditure

contributions to year-on-year growth, percentage points



Sources: SORS, Bank of Slovenia calculations

tor in the growth in revenue was current transfers from the rest of the world. General government revenue increased by 2.8% in 2010. The largest increase was in transfer revenues from the EU, which were up just over a quarter. Social contributions were up 2.0%, as a result of the adverse situation on the labour market. The situation on the labour market is also being reflected in the low level of household consumption, which is having an impact on revenue from indirect taxes, where excise duties are important alongside VAT. Revenue from excise duties increased last year. Revenue from direct taxes recorded the least favourable developments last year. In the context of low earnings for corporates and sole traders, corporate income tax revenue increased by just under 1%, while personal income tax revenue was down just over 1%. The portion of personal income tax revenue related to business results is declining, while personal income tax revenue on the basis of wages actually increased slightly last year. The government's discretionary decisions in 2010 did not have a major impact on general government revenue. There were increases in excise duties, but the general allowance for personal income tax was raised in connection with the enactment of the minimum wage. The corporate income tax rate was also cut by 1 percentage point.

General government expenditure grew more slowly in 2010 than in the previous years, which was the result of fiscal consolidation. General government expenditure increased by 1.8%, 3.6 percentage points less than in the previous year. The government adopted several measures to restrict spending. The government reached agreement with the public sector unions to delay the elimination of wage discrepancies and on other wage-related measures, as a result of which the average wage in the public sector last year remained almost unchanged from the previous year. Compensation of employees in the public sector increased by 1.3% last year, primarily as a result of a rise of 1.5% in the number of employees in the government sector (S.13 under the ESA 95), similar to the previous year. The reduction in the number of employees planned under the Exit Strategy was not achieved last year. Expenditure on intermediate government consumption increased by just under 1%. An intervention act restricted growth in pensions and other social transfers, as a result of which growth in social benefits was lower than in the previous year. Expenditure on pensions increased by 3.7%. The number of old-age pensioners rose by 4.1% last year, while the total number of pensioners rose by 2.3%. There was a large increase in the number of old-age pensioners in the last two months

Box 5.1: Mechanisms for ensuring financial stability in the EU

The economic and financial crisis raised the need to provide assistance to countries with debt servicing problems. These were reflected in rising costs of new borrowing, which increase the fiscal burden, and also the costs of financing the private economy. Because the strong financial integration of the euro area means that the consequences of a crisis can be transferred from one country to all the others, it was necessary to build a system to ensure financial stability for the euro area. In addition to the bilateral loans that were approved for Greece in 2010 by the euro area countries on the basis of an inter-governmental agreement, there are two mechanisms operating within the framework of the European Commission and the euro area.

The two mechanisms were created in mid-2010 for a period of three years. On their basis countries whose borrowing on the markets is subject to high cost should have access to cheaper funds. The two mechanisms are rated AAA, thereby creating the conditions for lower costs in financing countries that find themselves in debt problems. The IMF is also involved in the provision of assistance in addition to loans from the two funds, with an additional sum of EUR 250 billion.

The first mechanism is the European Financial Stability Mechanism[1] (EFSM), which is similar to the already functioning EU mechanism aimed at countries that are not members of the euro area. The latter has provided assistance to Latvia, Hungary and Romania in recent years, in conjunction with the IMF. Although the EFSM was originally intended for euro area countries, all EU Member States can ask for assistance. Assistance in the form of loans is provided by the European Commission by means of bond issues secured by EU budget funding. Funds of around EUR 60 billion have been secured within the framework of this mechanism. To date only Ireland has made use of the funds, in January 2011, when 5-year EFSM bonds were issued with a nominal value of EUR 5 billion and a coupon rate of 2.50%. The EFSM's margin, set by the European Council, stood at 2.925% on this transaction, and was divided between EU Member States.

The other mechanism, the European Financial Stability Facility[2] (EFSF), is intended solely for euro area countries. The basis for action is a request by a Member State and an agreement on the implementation of appropriate economic policy by the recipient. The EFSF provides loans to bridge financial difficulties, to recapitalise banks or to purchase government bonds. The funds for the loans are obtained via bond issues or other debt instruments. The Member States' guarantee commitments for the issued bonds are limited to EUR 440 billion. This exceeds the largest possible total bond issue by approximately 20%. The share of the guarantee commitments contributed by each country is determined with regard to the ECB capital key, Slovenia's share amounting to approximately EUR 2 billion. The proceeds of EUR 5 billion from the first EFSF bond issue were disbursed to Ireland in February 2011, the coupon rate standing at 2.75%. The next EFSF bond issue as part of the assistance for Ireland is planned for the second quarter of 2011.

At the same time there are preparations to provide for a permanent mechanism of financial assistance. In December 2010 the European Council adopted a decision to establish a European Stability Mechanism (ESM), to replace the EFSM and EFSF. The system is expected to begin operating in 2013, after the EFSM and EFSF expire. It is expected to be upgraded into a new system of macroeconomic management in the EU. According to the March 2011 decision by the council of euro area finance ministers, the ESM's financial capacity is expected to be EUR 500 billion. Claims from ESM loans will be given seniority in repayment (i.e. ahead of private sector loans), and will thus have a similar status to IMF loans.

One of the newly created institutions that aims to prevent the occurrence of financial crises in the future is the European Systemic Risk Board (ESRB), which primarily has the task of macroeconomic supervision of the entire EU financial system. It is expected to help prevent systemic risks in the EU, and to help the markets function more efficiently. The ESRB began operations on 16 December 2010, and is part of the European system of financial supervision, which also comprises the European Banking Authority (EBA), the European Insurance and Occupational Pensions Authority (EIOPA), the European Securities and Markets Authority (ESMA), the Joint Committee of European Supervisory Authorities, and the supervisory authorities of Member States.

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[1] http://ec.europa.eu/economy_finance/eu_borrower/efsm/index_en.htm
[2] http://www.efsf.europa.eu/about/index.htm

of last year and in January of this year. Expenditure on interest payments continued to increase last year, in association with the rise in debt. Growth in expenditure on transfers to the unemployed was again high, as a result of the situation on the labour market.

The central government accounted for the majority of the general government deficit. According to SORS estimates, the central government deficit amounted to 4.7% of GDP, less than in the previous year. The deficit in local government was again relatively high, at 0.4% of GDP, 0.1 percentage points less than in the previous year. The social security funds disclosed a deficit of 0.4% of GDP.

The general government deficit is to a great extent structural in nature. Eliminating the deficit will require measures to improve long-term fiscal sustainability. The available estimates indicate that the structural general government deficit amounted to around 4% of GDP in 2010.[18] Structural measures in the area of public finances are required to reduce the deficit, to stabilise the debt, and to maintain confidence on the international financial markets. A pension reform was adopted last December, but it has not yet been implemented and is the subject of a referendum initiative. Its implementation would improve the long-term sustainability of public finances, on which not only the ageing population but also the lower potential economic growth in the post-crisis period will have an impact. Changes are also being prepared in healthcare, and are currently the subject of public debate. The aims of healthcare reform are to ensure the sustainability of the healthcare system by means of a clearly defined system of compulsory health insurance entitlements, and the introduction of voluntary supplementary insurance that is separate from compulsory insurance.

The general government debt increased by 2.8 GDP percentage points in 2010 to 38.0% of GDP, primarily as a result of the financing of the general government deficit. The general government debt stood at EUR 13,704 million at the end of December 2010, up EUR 1,254 million on a year earlier. The central government debt accounted for 96% of the total debt at the end of 2010. The central government also recorded the largest increase in debt, which arose primarily as a result of the financing of the state budget deficit. The ratio of government debt to GDP in Slovenia at the end of last year was still lower than in the majority of euro area countries. According to the European Commission's autumn forecasts, the euro area debt stood at 84.1% at the end of last year, up 5 GDP percentage points on a year earlier.

The government sector primarily borrowed via long-term bonds in 2010. The situation is expected to be similar this year. State budget borrowing was in line with the state budget financing programme for 2010, which set maximum borrowing of EUR 4.4 billion. The state budget recorded actual borrowing of EUR 2,525 million. The majority of the borrowing was carried out via the issue of two government bonds on the domestic market: a 10-year bond issued in January with a nominal value of EUR 1.5 billion, and a 5-year bond issued in March with a nominal value of EUR 1 billion. Short-term borrowing in the form of treasury bills amounted to EUR 25 million, down a half on the previous year. Under the state budget financing programme, borrowing for the budget in 2011 may not exceed EUR 4.2 billion; according to Ministry of Finance estimates, borrowing is expected to amount to EUR 3 billion. The majority of the borrowing will proceed via long-term instruments; short-term borrowing in the form of 3-month treasury bills is envisaged only up to the amount of EUR 30 million. Borrowing in the form of 3-month treasury bills in January 2011 was even lower than forecast at just EUR 22.5 million, and two bonds were issued in the first quarter of this year. A 10-year bond was issued in January, and a 15-year bond in March. The proceeds of each issue were EUR 1.5 billion.

The stock of government guarantees and sureties stood at EUR 7.7 billion or 21.5% of GDP at the end of

[18] In the current situation estimates of the structural deficit are less reliable, and the subject of frequent revisions.

2010. Compared with the end of the previous year the stock was more than 1 GDP percentage point higher, similar to the years before the economic crisis. The increase in the stock of government guarantees was considerably larger in 2009. It amounted to around 8% of GDP, and was primarily related to guarantees granted to banks to mitigate the effects of the financial crisis. Although measures aimed at mitigating the effects of the financial and economic crisis were still in force in 2010, the exploitation of guarantees of this type was EUR 1.9 billion less than in the previous year, and the stock of guarantees increased by around EUR 310 million. The stock of government guarantees and sureties granted to mitigate the financial crisis stood at EUR 2.5 billion or 6.9% of GDP at the end of the year. The stock stood at 6.2% of GDP at the end of the previous year, in which guarantees of this type were introduced as part of a package of government measures. According to state budget figures, guarantees in the amount of EUR 8 million were redeemed in 2010.

In 2010 Slovenia joined the programme of financial assistance to Greece, and the programme to ensure financial stability in the euro area. Slovenia approved a loan of EUR 103 million for Greece in 2010 on the basis of the adoption of the Loan to the Hellenic Republic Act.

Figure 5.3: Premiums of 10-year government bonds over German bonds

Sources: Bloomberg, Bank of Slovenia calculations
Note: The premium is calculated as the difference between the yield on 10-year government bond and the yield of German benchmark bond on a daily basis, as a reflection of the sovereign risk attributed by market participants. After 11 Jan 2011, the SLOREP 01/21 bond is illustrated for Slovenia

The state budget envisages a sum of EUR 141 million for this purpose in 2011, of which EUR 104 million in loans was approved for Greece in the first quarter of this year. Under the aforementioned law, the entire sum of Slovenia's loans to Greece will be allocated across three years, and may not exceed EUR 388 million. In July the National Assembly adopted the Act on Republic of Slovenia Guarantees for Ensuring Financial Stability in the Euro Area, thereby ensuring Slovenia's participation in the European Financial Stability Facility (see Box 5.1). Slovenia's total guarantee commitments within the framework of the EFSF could amount to a maximum of EUR 2,073 million. Ireland asked for assistance from the EFSF at the end of last year as a result of its public finance difficulties. Slovenia's portion of the guarantee for the loan to Ireland amounts to EUR 160 million.

Slovenia's still-relatively-favourable credit rating is evidenced in the premiums on 10-year government bonds over the yields on German bonds of equal maturity, which have not changed significantly since last summer. The premiums on 10-year Slovenian government bonds over the German benchmarks have fluctuated around 120 basis points since last June. They remained close to this level last December, when Ireland and Portugal were downgraded. During the issue of the new Slovenian RS69 10-year reference bonds in the middle of this January the premiums rose slightly, with the premium on the aforementioned bond standing at 156 basis points at issue. The premiums then gradually fell again towards their average of the second half of last year. The premium on the RS69 averaged 124 basis points in February 2011.

The government is planning a restrictive fiscal policy in 2011 and 2012. The government adopted the latest update to the Stability Programme in January 2010. In line with the new European semester, a new update to the Stability Programme is under preparation, which is expected to be ready by the middle of April 2011. The current Stability Programme envisages adjustments primarily on the expenditure side. Given that expenditure on interest will increase further throughout the period because of the continued financing of deficits via borrowing and the expected rise in interest rates, the cuts in primary expenditure will have to be even greater. The state budget deficit is forecast at 4.5% of GDP this year. On the revenue side, the budget as adopted envisages greater revenue from excise duties as a result of last year's rises in excise duty rates and this year's projected rise in excise duties on tobacco. However, with oil prices high, this will be difficult to achieve. The government lowered excise duties on mineral oils between December 2010 and March 2011, which will reduce revenues from this source by around 0.5% of GDP. On the expenditure side, under the intervention act passed by the National Assembly last November, growth in pensions and social transfers is limited to a quarter of the legally determined rate. Thus the majority of pensions were increased by just 0.4% in February 2011. Civil servant pay was also adjusted in January by a quarter of the projected inflation rate, i.e. 0.55%. Growth of wages in the public sector is expected to remain low this year.

Under the excessive deficit procedure Slovenia must cut its deficit to below 3% of GDP by 2013. Slovenia has been undergoing the excessive deficit procedure since December 2009, and consolidation of the public finances is one of the government's top priorities. The goal is to gradually reduce the general government deficit to below 3% of GDP, and to stabilise the public debt. The deadline for eliminating the excessive deficit for Slovenia is 2013. According to the European Council recommendations of December 2009, the structural deficit should be reduced by an average of 0.75% of GDP each year until 2013.

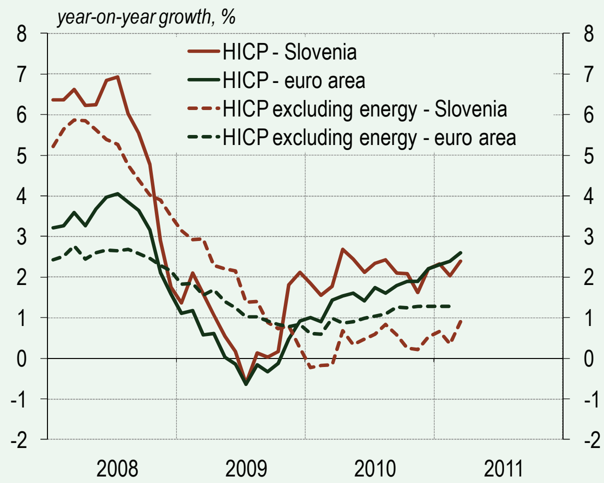
6 Price Developments

The movement of inflation in Slovenia in 2010 and early 2011 was affected by energy prices and non-energy commodity prices on one side, and by weak domestic demand and domestic costs factors on the other. Growth in the harmonised index of consumer prices stood at 2.1% in 2010, up 1.2 percentage points on 2009. In the difficult macroeconomic situation, core inflation was significantly lower than in the euro area overall. The conditions in the global economy led to faster growth in commodity prices in 2010, particularly energy and food prices. The latter have already partly passed through into domestic consumer prices, with a lag, via higher import prices, which has led to a rise in food prices in the early months of this year. Energy prices contributed 1.8 percentage points towards inflation last year, compared with 0.7 percentage points in the euro area overall.

Macroeconomic factors and core inflation indicators

Core inflation has remained low in the early part of this year. All core inflation indicators show growth in prices to be below that in the euro area overall. Core inflation as measured by the HICP excluding energy and

Figure 6.1: Inflation

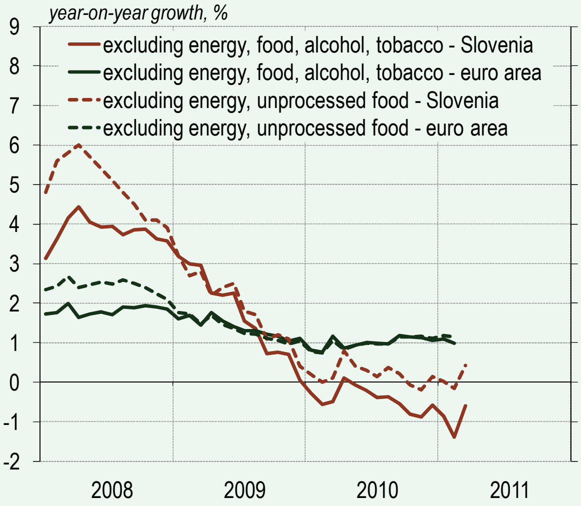


Sources: Eurostat, SORS, Bank of Slovenia calculations

unprocessed food averaged 0.2% in 2010, and stood at 0.4% this March. The largest factors in this core inflation measurement were the rise in prices of processed food, primarily as a result of rises in excise duties on alcohol and tobacco, and the pass-through of higher commodity prices on global markets into the prices of certain food products at the beginning of the year. According to the narrowest core inflation indicator, the HICP excluding energy, food, alcohol and tobacco, the year-on-year decline in prices averaged 0.4% over 2010, and stood at 0.6% this March. According to the widest core inflation indicator, the HICP excluding energy, price growth averaged 0.3% in 2010, and stood at 0.9% this March. The core inflation indicators have been lower than those in the euro area since the end of 2009; the narrowest indicator was 1.4 percentage points lower on average in 2010, and the widest indicator was 0.7 percentage points lower.

The adverse economic situation remains the main factor in low core inflation. The conditions on the labour market and the low real growth in income have resulted in low household consumption. Together with the unutilised capacity in the economy this is restricting suppliers of goods and services from raising prices. At the same time unit labour costs have been falling since the second half of 2009, and were in line with productivity growth in the second half of the year, while nominal growth in labour costs also remains relatively low. However, with US dollar prices of oil and other commodities rising, last year's fall in the euro against the US dollar further increased corporate operating costs in the euro area. Higher commodity prices also increased import prices in Slovenia, which averaged 7.4% in 2010, although to date the only impact has been on prices not included in core inflation. In the medium term the decline in price and cost competitiveness could have an impact on inflation, which would require additional downward adjustment in price and cost factors vis-à-vis countries that the Slovenian economy trades with.

Figure 6.2: Core inflation



Sources: Eurostat, Bank of Slovenia calculations

Microeconomic factors and the structure of inflation

After recording a year-on-year fall in 2009, energy prices rose sharply last year and in the early part of this year, primarily as a result of higher oil prices. Average year-on-year growth in energy prices stood at 13.9% last year, up 18.4 percentage points on the previ-

Table 6.1: Breakdown of the HICP and price indicators

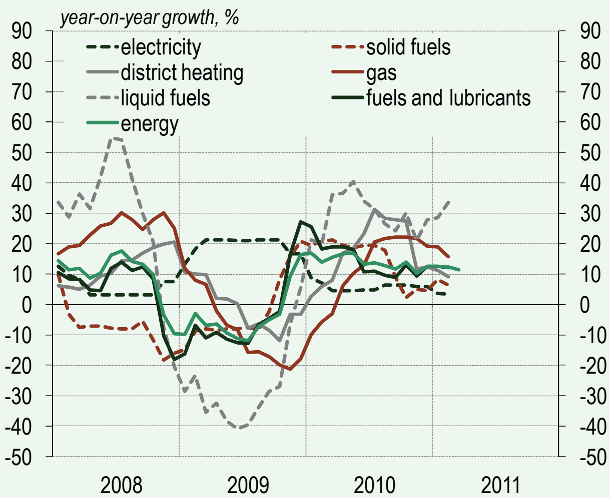
	weight 2011	average year-on-year growth, %					year-on-year growth in quarter, %					
		2006	2007	2008	2009	2010	4Q09	1Q10	2Q10	3Q10	4Q10	1Q11
HICP	*100%*	2.5	3.8	5.5	0.9	2.1	1.4	1.7	2.4	2.3	2.0	2.2
Breakdown of HICP:												
Energy	*14.3%*	8.5	3.4	9.4	-4.5	13.9	7.0	15.4	15.6	12.7	12.3	12.1
Food	*22.6%*	2.7	7.1	8.1	1.8	2.5	0.9	0.6	2.1	3.9	3.6	5.2
processed	*15.3%*	2.5	6.3	9.9	2.7	2.9	2.7	2.4	2.9	3.1	3.1	4.5
unprocessed	*7.3%*	3.1	8.7	4.6	0.0	1.7	-2.9	-3.3	0.3	5.5	4.7	6.6
Other goods	*29.0%*	-0.9	0.3	2.2	0.0	-2.2	-1.6	-3.1	-2.3	-1.7	-1.6	-1.3
Services	*34.1%*	3.5	4.9	5.3	3.2	1.2	2.4	1.9	1.9	0.8	0.0	-0.7
Core inflation indicators												
HICP excluding energy	*85.7%*	1.7	3.8	4.9	1.7	0.3	0.6	-0.2	0.5	0.7	0.3	0.6
HICP excluding energy and unprocessed food	*78.4%*	1.5	3.4	5.0	1.9	0.2	0.9	0.1	0.5	0.2	0.0	0.1
HICP excluding energy, food, alcohol and tobacco	*63.1%*	1.3	2.7	3.8	1.7	-0.4	0.5	-0.4	-0.1	-0.4	-0.8	-0.9
Other price indicators:												
Industrial producer prices on domestic market		2.4	5.5	5.6	-0.4	2.0	-1.1	0.2	2.0	2.8	3.2	...
GDP deflator		2.0	4.2	4.0	3.2	0.7	1.9	0.2	1.0	1.4	0.1	...
Import prices[1]		3.3	1.4	2.7	-4.6	5.8	-4.4	1.4	6.5	7.1	7.8	...

[1] National accounts figures
Sources: SORS, Eurostat, Bank of Slovenia calculations.

Figure 6.3: Energy prices

Sources: Eurostat, Bank of Slovenia calculations

Figure 6.4: Individual energy price categories

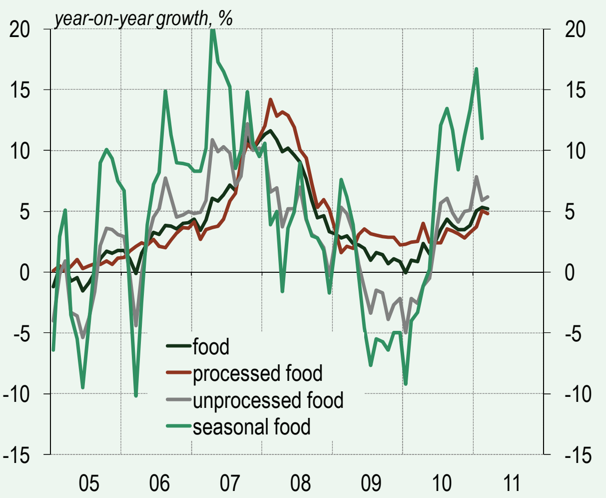


Sources: Eurostat, Bank of Slovenia calculations

ous year. This growth outpaced growth in energy prices in the euro area, which stood at 7.4%, although the gap began to narrow towards the end of the year. Growth in energy prices in Slovenia began to slow in the second half of the year, but nevertheless remained high. The main factor in last year's rise in energy prices was the rise in the price of oil, which averaged USD 80 per barrel last year, up USD 18 on the previous year. Another factor in the rise in energy prices was the rise in excise duties on electricity, natural gas and motor fuels. Year-on-year growth in energy prices has remained high this year, averaging 12.1% over the first three months of the year. This was nevertheless down 3.3 percentage points on the same period last year, in the context of lower average year-on-year growth in prices of motor fuels, solid fuels and electricity. The price of a barrel of oil exceeded USD 100 this year for the first time since September 2008, and averaged USD 105 over the first three months of the year. As a result of the simultaneous adjustment of excise duties the impact on growth in prices of motor fuels was smaller in Slovenia, while prices of heating increased significantly as excise duties were raised.

Growth in food prices in the second half of the year increased, primarily as a result of high growth in prices of food on global markets and the adverse weather conditions. The high growth in food prices was also the result of growth in energy prices, which are a significant input cost. Growth in food prices averaged 2.5% last year, up 0.7 percentage points on the previous year. The largest increase last year was recorded by prices of processed food, although prices of seasonal food rose sharply in the second half of the year. Prices of processed food rose by 2.9% in 2010, despite weak final household consumption. The main factor was excise duties on alcohol and tobacco, which the government raised

Figure 6.5: Food prices

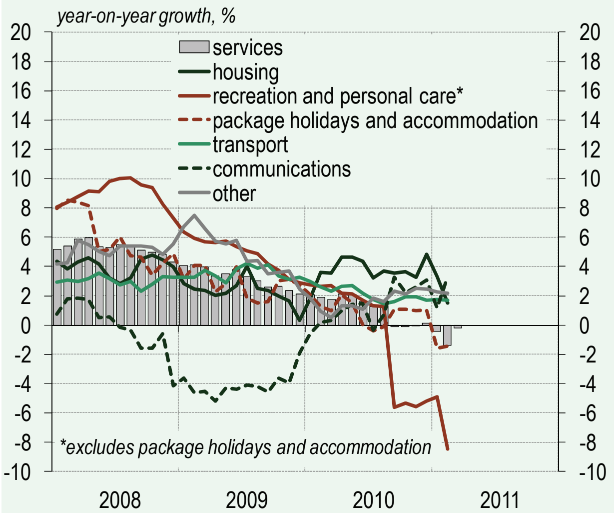


Sources: Eurostat, Bank of Slovenia calculations

Slika 6.6: Services prices and prices of non-energy industrial goods

Sources: Eurostat, Bank of Slovenia calculations

Figure 6.7: Services prices



Sources: Eurostat, Bank of Slovenia calculations

in April, July and August. Having been negative in the early part of 2010, year-on-year growth in prices of unprocessed food rose sharply in the second half of the year to average 1.7%. The growth was primarily the result of adverse weather conditions, which led to a rise in food prices on global markets, which was also reflected in prices of seasonal food in Slovenia. Year-on-year growth in prices of vegetables averaged 18.3% in the second half of the year, while year-on-year growth in prices of fruit averaged 8.8%. Certain food prices that had already begun rising on global markets last summer passed through into retail prices with a significant lag, which was evident in the first three months of this year. Year-on-year growth in food prices increased during this period to average 5.2%, compared with 0.6% over the same period last year. There were rises in prices of oils and fats, bread and other cereal products, milk and dairy products, and eggs and meat.

Year-on-year growth in services prices declined in 2010, and towards the end of the year was below average growth in services prices in the euro area. Growth in services prices averaged 1.2% last year, down 2 percentage points on the previous year. The main factors in the low growth in services prices were the slowdowns in prices of food services and hospital services, and prices of package holidays. In September 2010 there was a break in year-on-year growth in services prices due to introduction of subsidies for school meals for students in primary school. Services prices recorded an average fall of 0.7% during the first three months of 2011, having risen by 1.9% over the same period last year. The decline in year-on-year growth in services prices in early 2011 was the result of the decline in prices of radio and TV subscription in February, base effects in prices of refuse disposal, and VAT exemptions for certain postal services.

Figure 6.8: Prices of non-energy industrial goods

Sources: Eurostat, Bank of Slovenia calculations

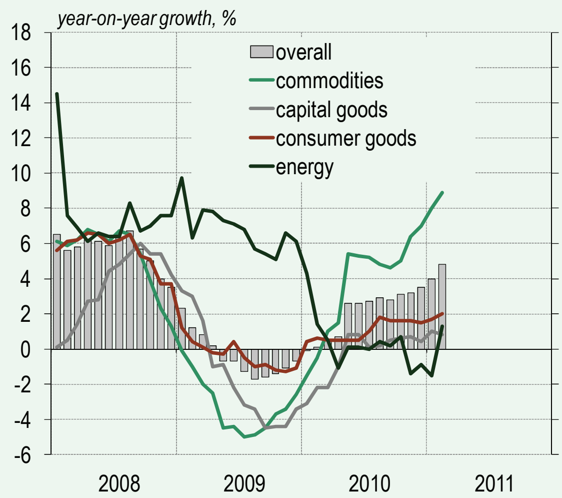
Prices of non-energy industrial goods declined further last year. They continued to fall in year-on-year terms in the first quarter of this year, although less than in the same period last year. Prices of non-energy industrial goods in Slovenia fell by 2.2% on average in 2010, compared with a rise of 0.5% in the euro area overall. The largest factors in the fall in prices of non-energy industrial goods in 2010 were car prices and prices of clothing and footwear. Car prices have been falling since the end of 2004, and fell by 11.7% on average last year. Prices of clothing fell by 3.4% last year, and prices of footwear by 1.2%. Prices of non-energy industrial goods in the first three months of 2011 were down 1.3% in year-on-year terms, compared with a fall of 3.1% in the same period last year. The lower growth in the prices of this sub -category in Slovenia compared with the euro area is primarily a reflection of internal macroeconomic factors. However, the gap is smaller than that recorded by services due to the higher level of international competition in this category of goods.

The rise in administered prices averaged 5.5% in 2010, 3.2 percentage points more than in 2009, taking their contribution to headline inflation to 0.3 percentage points. Year-on-year growth in prices of heat energy averaged 17.4% last year. Prices of water supply and refuse disposal recorded high year-on-year growth in late 2009 and early 2010 as a result of upgrades to services and the introduction of new services aimed at ensuring higher standards of supply and environmental standards. This brought average growth of 11.7% in prices of basic utilities in 2010, up 9.2 percentage points on 2009. Prices of domestic passenger rail transport rose by 5.5% on average in 2010, as a result of reductions in discrepancies in transport prices compared with scheduled bus services. In line with the plan for managing regulated prices, rail transport prices rose by 6% in March 2011. In early 2010 and 2011 there were rises in the energy distribution network costs for household consumers as part of the electricity prices category, which each time contributed 0.08 percentage points towards the HICP.

Industrial producer prices

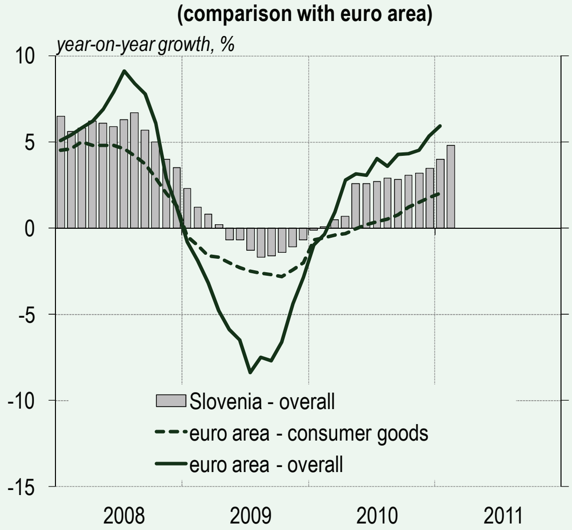
Industrial producer prices on the domestic market rose by 2.0% on average last year, compared with 2.9% in the euro area overall. Growth continued in the early part of this year; the main factors were growth in commodity prices and prices of consumer non-durables. Prices in the manufacture of basic metals, which rose by 16.9%, were a major factor in last year's rise in commodity prices, which averaged 3.7%. Growth in prices of consumer goods stood at 1.0%, and growth in energy prices at 0.3%, while capital goods prices re-

Figure 6.9: Industrial producer prices on the domestic market



Sources: SORS, Bank of Slovenia calculations

Figure 6.10: Industrial producer prices on the domestic market (comparison with euro area)



Sources: Eurostat, Bank of Slovenia calculations

corded a year-on-year fall of 0.4%. In the euro area the highest growth was in energy prices, which averaged 6.5%, primarily as a result of high growth in producer prices of refined petroleum products, which stood at 22.4%. Growth in industrial producer prices in Slovenia over the first two months of the year increased to 4.4% as a result of growth in prices in the manufacture of basic metals and, in manufacture of food products.

7 Projections of Economic Trends and Inflation 2011–2013[19]

GDP growth is projected at just below 2% this year, but is expected to gradually increase to around 3% by 2013. The similar dynamic in aggregate activity to the October projections hides a difference in its structure. The contribution made to GDP growth by domestic demand excluding inventories will be smaller, and the contribution made by net exports will be considerably larger, thanks to better promises of foreign demand. Despite an increase in investment in machinery and equipment, total gross investment will decline, and public spending will also decline as a result of the need for fiscal consolidation. Given the adverse situation on the labour market, growth in household consumption will remain low this year. Inflation is projected at 2.7% in 2011, and is expected to fall to around 2% by 2013. The inflation projections for 2011 and 2012 are higher than in the previous round of projections, primarily as a result of higher commodity prices on global markets. Core inflation will remain low this year as a result of the adverse domestic economic situation. The disappearance of base effects from one-off falls in certain prices will also act to raise core inflation in 2012 in particular.

The distribution of risk has changed from the previous projections, when risks relating to both economic activity and inflation were assessed as balanced. The risk relating to economic activity has turned downwards, as there is now a greater probability of economic growth being lower than in the baseline scenario. With regard to inflation, there is a greater probability that it will be higher than projected in the baseline scenario. The risks that could have the greatest short-term adverse impact on domestic economic activity include potential slower growth in foreign demand, the need for additional measures within the framework of fiscal consolidation, and the effects of rises in commodity prices on consumer purchasing power and corporate earnings. The situation in the construction sector also remains uncertain and unfavourable. In the medium term the economy could also be crippled by an increase in structural unemployment and corporate financing problems as a result of high indebtedness or insufficient funding in the banking system. High growth in commodity prices will be reflected most in temporary inflationary pressures. The rises in indirect tax rates that might occur should there be a need for even stronger fiscal consolidation are among the risks that could lead to a rise in inflation. At the same time the impact of inadequate cost controls in certain parts of the economy with limited competition cannot be ignored.

[19] The projections were made on the basis of the data available and the statistical methodology applicable on 2 March 2011. The projections of macroeconomic variables presented in this report are based on assumptions for the variables in the international environment and certain domestic factors dependent on economic policy decisions. The assumptions for the variables in the international environment are taken from Consensus Forecasts and Eastern Europe Consensus Forecasts (February 2011), JP Morgan (Global Data Watch, 27 February 2011), OECD Outlook (December 2010) and the IMF WEO Update (January 2011). The domestic factors under the influence of economic policy and exogenously included in the forecasting process are public sector spending and investment, public sector wages, the movement of administered prices and certain other variables of a fiscal nature. The assumptions used in the projections are not the same as those used by the ESCB in its projections. For the relationship between the Bank of Slovenia projections and those of the ESCB, see the annex in the April 2008 Price Stability Report.

Figure 7.1: Forecasts of foreign economic growth for 2011

Sources: Consensus Economics, European Commission

Figure 7.2: Forecasts of foreign economic growth for 2012

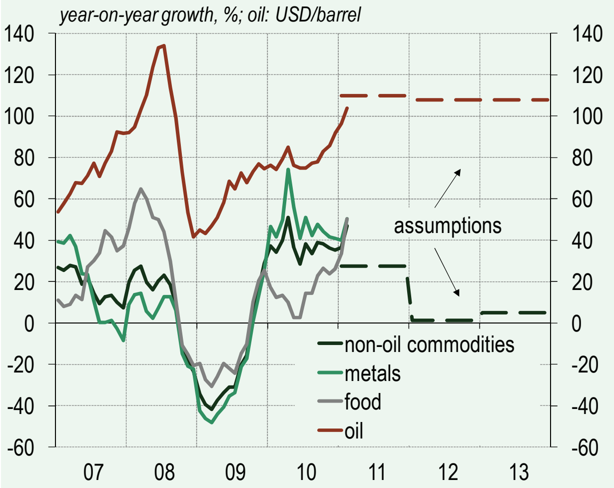
Sources: Consensus Economics, European Commission

International environment and external assumptions

Forecasts by international institutions for growth in imports by Slovenia's most important trading partners are more favourable primarily because of economic activity in Germany, which was also higher than expected in the second half of last year. The recovery in global economic growth is expected to be more balanced than in the last few years. Although the engine of global economic growth will remain the emerging Asian economies, there is a recovery in domestic demand in developed countries. The new assumptions for import demand have been revised upwards from the previous projections for the entire projection horizon, and are higher for all the most important trading partners other than Croatia. The largest upward revision was in the assumption for import demand for Germany. The assumption for this year's growth in foreign demand was raised by 1.4 percentage points from the previous projections to 6.8%. Although growth in foreign demand at the end of 2010 was lower than in the first half of the year, the indicators for the beginning of this year show a return to relatively high growth, and point to the long-term average being gradually approached over the projection period. Growth in foreign demand in 2011 will be slightly lower than last year as a result of the need for fiscal consolidation, which was only encouraged by the debt crisis in certain euro area countries, and the projected end of the cycle of renewal of inventories. Another factor in the slower growth in foreign demand over the projection horizon will be the beginning of the withdrawal of stimulative monetary policy, which was already happening in fast-growing economies in the second half of last year, and is expected to continue in developed economies this year.

US dollar prices of oil and other primary commodities will grow rapidly in 2011 in particular, but the rate will then slow. In the current projections the average oil price for 2011 is taken as USD 110 per barrel, taking into account price developments on the futures markets. This is up USD 26 or approximately 30% on the previous projections. The assumption for the euro oil price has also been revised upwards by just over a quarter. Alongside the tensions in the Middle East and North Africa, which brought stronger growth in oil prices in the early part of this year, another factor in the rise in the oil price was the higher demand at the end of last year. Growth in prices of other primary commodities is also increasing as a result of the recovery of the global economy, and partly as a result of adverse weather conditions and natural disasters, which have stimulated growth in food prices (see

Figure 7.3: Commodity prices on global markets



Sources: ECB, Bloomberg, Bank of Slovenia forecasts

Box 1.1). Growth in commodity prices is expected to slow in 2012 and 2013, provided that there are no further supply-side shocks.

Inflation in the euro area is expected to be higher than 2% this year, while inflation in the US is expected to remain low over the entire projection period. Core inflation in the euro area and the US will remain below its long-term average. This year's average inflation is assumed at 2.3% in the euro area, and 1.5% in the US. This entails an upward revision of 0.6 percentage points in the euro area, and a downward revision of 0.2 percentage points in the US. The higher inflation in the euro area is expected to be the result of larger impact from energy prices, and an upward revision of the economic growth for the euro area. Significant pressures on core inflation are less likely, as growth in demand and labour costs is expected to remain relatively low, despite the economic recovery. Higher energy prices will also raise producer prices in Germany, the 2011 growth assumption for which has been revised upwards by 0.6 percentage points from the previous projections to 2.8%. Producer prices in Germany are assumed to increase by around 2% in 2012 and 2013.

Domestic demand

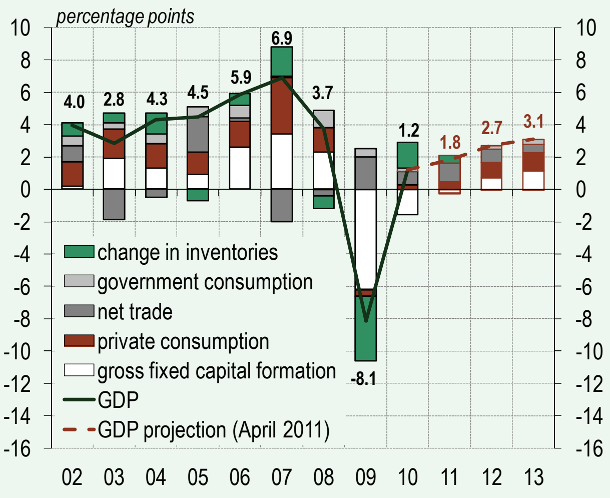
Household consumption will gradually increase over the projection period. The current situation does not indicate any possibility of a significant reversal in household consumption this year. Volume turnover in trade other than vehicles and fuels and indicators of consumer confidence are at low levels this year because of the situation on the labour market. With inflation higher and the fall in employment slightly lower than last year, this year real disposable household income will remain almost unchanged from last year. Growth in household consumption is expected to become more pronounced next year, in line with the recovery in employment, and is expected to stand at close to 2% in 2013.

Table 7.1: Assumptions regarding factors from the international environment

						Assumptions					
						2011		2012		2013	
	2006	2007	2008	2009	2010	**Apr**	**Δ**	**Apr**	**Δ**	**Apr**	**Δ**
	annual growth, %, unless stated										
Foreign demand*	11.6	11.2	6.0	-14.0	11.0	**6.8**	1.4	**6.3**	-0.2	**6.0**	...
Oil (USD/barrel)	65	73	98	62	80	**110**	26	**108**	21	**108**	...
Non-oil commodities	29.1	17.4	10.1	-23.0	37.1	**27.5**	16.5	**1.0**	-3.0	**5.0**	...
EMU inflation	2.2	2.1	3.3	0.3	1.6	**2.3**	0.6	**1.7**	0.2	**1.8**	...
PPI Germany	5.4	1.3	5.4	-4.0	1.5	**2.8**	0.6	**2.2**	0.2	**1.8**	...

** Quantitative imports from basket of foreign partners*
Δ: Difference between current projections and projections in October 2010 Price Stability Report
Sources: Bank of Slovenia, Eurostat, Consensus Economics, ECB, JP Morgan, OECD Outlook

Figure 7.4: Projections of contributions to GDP growth by expenditure components



Sources: SORS, Bank of Slovenia projections

Investment is likely to decline again this year. There could be growth in gross investment in the next two years, but it will depend on the sustainability of the economic recovery and the limiting factors, financing conditions and corporate earnings in particular. Inventories of unsold housing are still relatively large, hindering new investment in construction, while the uncertainty surrounding the sustainability of the global economic recovery suggests that gross fixed capital formation could decline again this year. In addition to greater caution on the part of the banks in approving long-term loans, a gradual rise in interest rates is expected, which will gradually increase the cost of financing investment. The decline in investment will nevertheless be smaller than last year, primarily as a result of the rapid recovery in exports and favourable export expectations, and an increase in capacity utilisation in industry. Survey data indicates a projected increase in growth in total investment in 2011. The recovery in activity in the domestic and foreign environment could raise investment by approximately 5% in 2013.

Investment in buildings is expected to decline further, while moderate growth in investment in machinery and equipment is projected. The decline in investment in construction is the result of past major investments in this area, in particular investments in non-residential structures. Many construction companies are facing liquidity difficulties, which is additionally contributing to payment indiscipline. Confidence indicators in construction are still extremely low. Given the improvement in the business situation and the expected orders and order books in manufacturing, corporates are already opting to invest in new equipment while the excess capacity gradually declines. Investment in transport equipment and in other machinery and equipment is expected to increase in the coming years, in line with the projected continuing recovery in exports.

In the context of higher foreign demand and a gradual increase in activity in industry and domestic fixed capital formation, inventories will increase. As a result of a continuing recovery in domestic industrial production, the main indication of which is growth in orders from the

Table 7.2: Components of domestic demand

						Projections					
						2011		2012		2013	
	2006	2007	2008	2009	2010	**Apr**	Δ	**Apr**	Δ	**Apr**	Δ
	real growth, %										
Domestic demand	5.6	8.9	4.1	-9.8	0.4	**0.6**	-0.4	**1.9**	-0.4	**2.6**	...
Private consumption	3.0	6.7	2.9	-0.8	0.5	**0.8**	0.3	**1.7**	0.0	**2.0**	...
Government spending	4.0	0.7	6.2	3.0	0.8	**-0.4**	-0.4	**1.1**	0.8	**1.6**	...
Gross fixed capital formation	10.1	12.8	8.5	-21.6	-6.7	**-1.0**	-2.9	**3.0**	-1.9	**5.0**	...

Δ: Difference between current projections and projections in October 2010 Price Stability Report
Sources: SORS, Bank of Slovenia

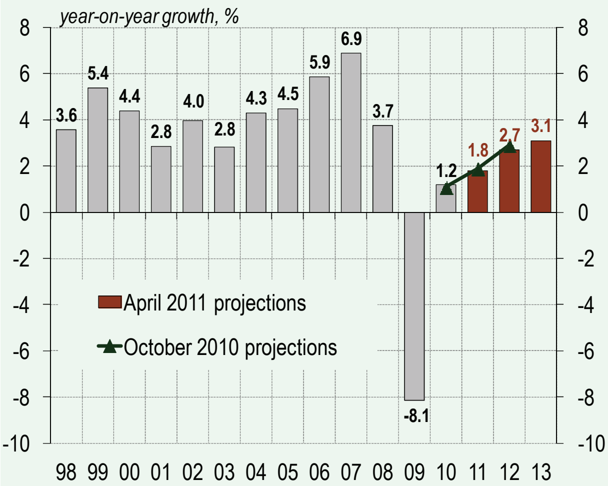
rest of the world, inventories in industry will increase, particularly raw materials and intermediate goods. The partial renewal of inventories of merchandise is also expected. Because the number of new building permits continues to fall, there is no expectation of a major increase in inventories of unsold housing in the construction sector. The contribution made by inventories to domestic demand growth is expected to amount to around 0.5 percentage points in 2011, expressed as a contribution to GDP growth. The contribution is expected to be neutral in 2012 and 2013.

Government spending will decline this year, and the projected growth in government spending during the next two years is relatively low, given the need for fiscal consolidation. According to estimates on the basis of the budget assumptions approved for 2011 and 2012, government spending is expected to grow by just over 2% over the projection period. The projections of a real decline of 0.4% in government consumption this year are based on a fall of 0.5% in employment in the government sector, and savings on material costs. Employment policy is expected to remain restrictive in 2012 and 2013. The assumption for growth in government spending in the final two years of the projection horizon of between 1% and 1.6% is significantly below the long-term average. The nominal average wage in the government sector is expected to increase by less than 1% this year, and by slightly more in the next two years.

GDP growth and developments on the labour market

GDP growth is projected at just below 2% for this year, but is expected to gradually increase to around

Figure 7.5: GDP growth projections



Sources: SORS, Bank of Slovenia projections

Table 7.3: Activity, employment and wages

						Projections					
						2011		2012		2013	
	2006	2007	2008	2009	2010	**Apr**	Δ	**Apr**	Δ	**Apr**	Δ
	real growth, %										
GDP	5.9	6.9	3.7	-8.1	1.2	**1.8**	-0.1	**2.7**	-0.2	**3.1**	…
Employment	1.5	3.0	2.8	-1.9	-2.2	**-1.4**	-1.1	**0.0**	-0.3	**0.5**	…
Compensation per employee	5.3	6.4	7.0	1.7	4.1	**3.8**	0.7	**4.0**	0.6	**4.2**	…
Productivity	4.3	3.7	1.0	-6.3	3.4	**3.2**	1.0	**2.7**	0.1	**2.7**	…
ULC (nominal)	1.0	2.6	6.0	8.5	0.6	**0.6**	-0.3	**1.2**	0.4	**1.5**	…
Contribution to GDP growth	*percentage points*										
Domestic demand, excluding changes in inventories	5.0	7.1	5.0	-6.1	-1.2	**0.2**	-0.6	**1.9**	-0.3	**2.5**	…
Net exports	0.2	-2.0	-0.4	2.0	0.8	**1.2**	0.2	**0.8**	0.2	**0.6**	…
Changes in inventories	0.7	1.8	-0.8	-4.0	1.6	**0.4**	0.2	**0.0**	0.0	**0.0**	…

Δ: Difference between current projections and projections in October 2010 Price Stability Report
Sources: SORS, Bank of Slovenia

3% by 2013. The pace of the recovery is slightly lower than envisaged in the October round of projections. The projected GDP growth for 2011 remained at the same level as in the previous projections. Despite an increase in the contribution made by net trade in the context of strengthened foreign demand, the contribution to economic growth made by domestic demand is smaller. This year's economic growth is expected to remain at the level seen in the final quarter of last year. GDP growth in Slovenia will be similar to the euro area average this year, but is expected to be slightly higher again in 2012 and 2013.

The main factors in value-added growth will be export -oriented sectors and certain services, while the contribution made by construction will be negative over the projection period. The risk of a continuing decline in investment in construction is still being materialised, while last year investment in machinery and equipment and in transport equipment was higher than in 2009. Construction activity is expected to contract slightly further in the future, but the recovery in manufacturing activity will continue this year. The contribution made by wholesale and retail trade and repair, accommodation and food service activities, transportation and communications to GDP growth is likely to be positive this year, although there are major uncertainties in relation to private consumption in particular.

Employment will fall by more in 2011 than projected in the previous round of projections, while the projected economic growth will not suffice to significantly reduce unemployment by the end of the projection period. The fall in employment in manufacturing slowed last year, although the pace of the fall in employment increased slightly at the end of the year. The dynamics of the fall in employment in construction has not slowed down yet. Total employment is expected to fall again in 2011, most notably in construction, as a result of bankruptcies and cuts in labour costs that corporates will be forced to make in light of high commodity prices. In light of these developments, and considering the weak activity in certain service sectors, the projections envisage a fall in employment of around 1.5% in 2011. This fall is expected to be followed by very slow growth in employment until the end of projection period. The surveyed unemployment rate is expected to peak in the middle of 2011. The fall in unemployment is expected to be very small, despite economic recovery in 2012 and 2013. These developments are to a great extent a reflection of the increase in structural unemployment.

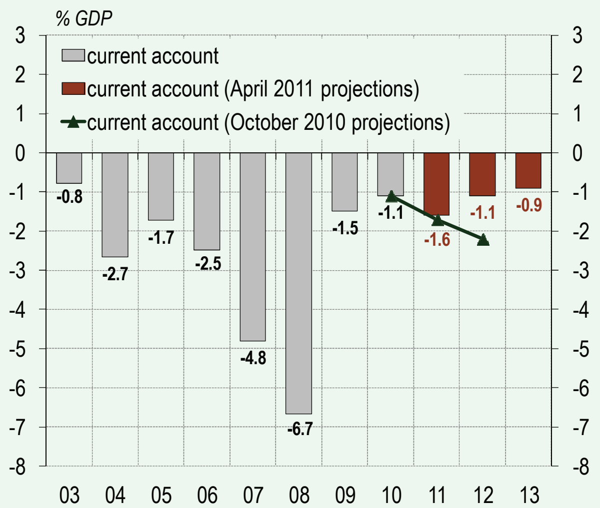
In addition to the economic recovery, the private sector wage developments will be subject to certain temporary factors. After the relatively high contribution made by the rise in the minimum wage in March 2010 to last year's wage growth, the direct contribution made by this measure is expected to be small this year. Ministry of Labour, Family and Social Affairs data shows that relatively few employers have agreed a gradual increase in the minimum wage with the unions as allowed by the Minimum Wage Act. Average wages will also grow slightly slower this year as a result of a lesser impact from the change in the structure of the workforce, while at the same time there will be significantly fewer workers switching from regimes of subsidised jobs to full employment. Wages in the private sector are expected to rise by around 4.5% in 2011, less than in 2010. In the next two years the change in the structure of the workforce will have less impact on growth in average wages, and wage growth in the private sector will therefore decline slightly to around 4.3% in the context of relatively low economic growth.

An agreement between the government and certain public sector unions restricted wage growth in the public sector, but only temporarily, as it is again primarily a case of the deferral of planned increases to eliminate discrepancies in public sector wages. The agreement limits wage growth in the public sector under the baseline scenario primarily in 2011 and 2012. It involves merely partial wage indexation, limits on wage increases for certain public sector professions, an unchanged annual leave allowance, non-payment of performance-related bonuses and restrictions on promotions. Wage increases as part of the elimination of wage discrepancies in the public sector are currently planned for the first two years after the year in which GDP growth exceeds 2.5%. Given that GDP exceeds 2.5% in 2012 under the baseline scenario, the first elimination of wage discrepancies is projected for 2013.

Foreign trade

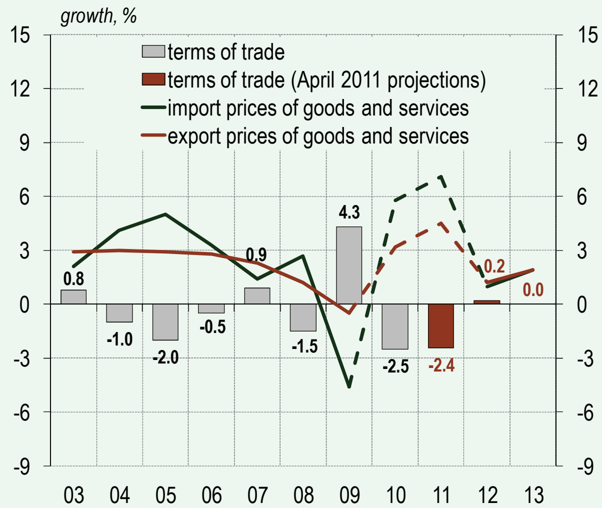
The current account deficit is expected to widen slightly this year, and then to narrow to around 1% of GDP. The main reasons for the widening current account deficit this year are a deterioration in the terms of trade and a wider deficit in factor income. The current account deficit is projected at around 1.5% of GDP for this year. An increase in the deficit this year is solely the result of a deterioration in the terms of trade, which are expected to worsen by more than 2% this year as a result of high commodity prices. Higher growth in volume terms in exports of merchandise and services than in imports will make a positive contribution to the current account position throughout the projection period. Alongside the adverse terms of trade, another factor in the widening current account deficit in the coming years will be an increase in the deficit in factor income. This increase will be the result of the assumed rise in interest rates and

Figure 7.6: Current account projections



Sources: SORS, Bank of Slovenia projections

Figure 7.7: Terms of trade projections



Sources: SORS, Bank of Slovenia projections

Table 7.4: Current account

						Projections					
						2011		2012		2013	
	2006	2007	2008	2009	2010	**Apr**	Δ	**Apr**	Δ	**Apr**	Δ
Exports of goods and services	12.5	13.7	3.3	-17.7	7.8	**7.2**	0.6	**6.7**	-0.8	**6.6**	...
Imports of goods and services	12.2	16.7	3.8	-19.7	6.6	**5.5**	0.2	**5.6**	-1.0	**6.0**	...
Current account: EUR billion	-0.8	-1.6	-2.5	-0.5	-0.4	**-0.6**	0.1	**-0.4**	0.5	**-0.4**	...
as % GDP	-2.5	-4.8	-6.7	-1.5	-1.1	**-1.6**	0.1	**-1.1**	1.1	**-0.9**	...
Terms of trade*	-0.5	0.9	-1.5	4.3	-2.5	**-2.4**	-1.3	**0.2**	1.0	**0.0**	...

** Based on national accounts deflators*
Δ: Difference between current projections and projections in October 2010 Price Stability Report
Sources: SORS, Bank of Slovenia

the large size of the external debt. Transfers are expected to be in surplus this year and in the coming years, primarily on account of government transfers.

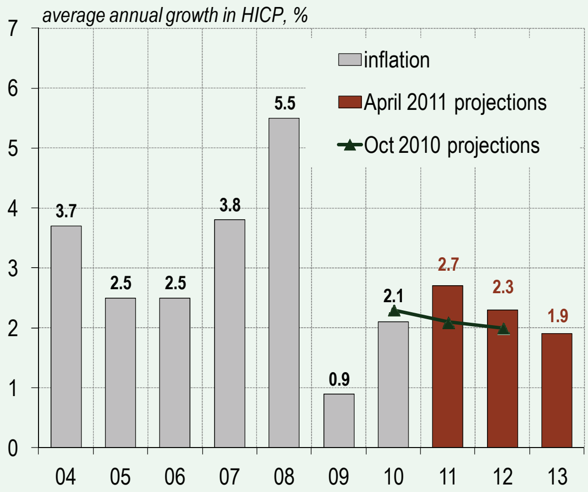
After a rise this year, the merchandise trade deficit is expected to narrow again in the future, while the surplus of trade in services is expected to increase. The merchandise trade deficit is projected to increase from just below 3% of GDP in 2010 to around 3.5% of GDP in 2011, and then to narrow to around 2.5% of GDP by 2013. The adverse terms of trade will be a factor in the increase in the deficit in 2011, as the balance of merchandise trade would be positive should this year's terms of trade remain unchanged. Growth in exports in volume terms will also outpace growth in imports for the remainder of the projection period, but the gap will narrow. The position in trade in services will remain positive throughout the projection period, and will amount to around 3% of GDP as in 2010. The gradual growth in economic activity and foreign demand is expected to have an impact on services related to merchandise trade. The prime examples are transport services and business and technical services. As a result of the assumed recovery in the investment activity in the rest of the world, net revenues from construction services are expected to increase in the coming years. The gradual recovery in activity in Slovenia's most important trading partners is also expected to have a beneficial impact on growth in tourism revenues.

The projections for the deficit in factor income show an increase in the deficit as a result of an rise in the deficit in capital income. The surplus in transfers is expected to widen to around 0.5% of GDP in 2011, and to remain at a similar level until the end of the projection period. The relatively high gross external debt and the expected rise in interest rates will result in an increase in the net outflow of factor income. The continuing economic recovery is expected to see a rise in non-residents' inward FDI in Slovenia. This should bring a gradual increase in expenditure on dividends and distributed earnings. Another factor in the widening deficit in factor income will be a smaller net inflow of income from investments in foreign debt securities. Falling employment of foreign workers means that the net inflow of labour income this year and in the next two years is projected at around 0.4% of GDP. Private transfers and other official transfers are projected to record a smaller deficit during this period. The surplus related to the disbursement of EU budget funds is expected to widen over the projection horizon, as it did last year. The surplus in transfers is expected to increase to 0.5% of GDP in 2011, and to remain close to this level in the coming years.

Inflation

Inflation is expected to be higher than 2.5% in 2011 as a result of renewed rises in import prices. It is projected to fall below 2% by the end of the projection period. The inflation projections for 2011 and 2012 are higher than the October projections, primarily as a result of energy and food prices. Weak domestic demand and the uncertain situation on the labour market, which are preventing cost pressures on inflation, will also bring very low core inflation this year. Average growth in the HICP excluding energy, food, alcohol and tobacco is expected to be negative this year. This measure of inflation is projected to rise to around 1.5% in 2012, in line with the economic recovery and the carry-over of higher growth in

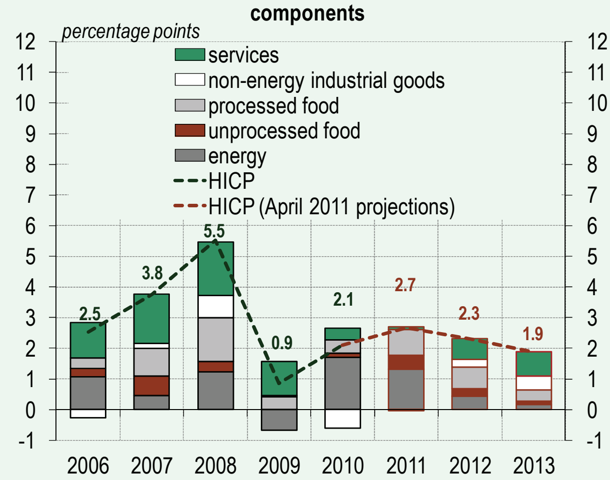
Figure 7.8: Inflation projections



Sources: SORS, Bank of Slovenia projections services prices in the absence of base effects from September 2011, and to close to 2.0% in 2013. The two other core inflation indicators are expected to rise in 2012, but to stop rising in 2013, primarily as a result of lower growth in prices of processed food.

The contributions made by energy prices and food prices are expected to be prominent this year, while in the next two years the contribution made by services prices will increase. Growth in energy prices is projected at 9.6% this year, in line with the projected movements in oil prices and the euro. Growth in energy prices is expected to decline to 3.0% in 2012 and to 1.2% in 2013. Compared with the previous projections, growth in prices of processed and unprocessed food is expected to be higher, as a result of high growth in food prices on global commodity markets. Growth in food prices is projected at 5.8% this year, and is expected to be lower in the next two years. Growth in prices of non-energy industrial goods is expected to gradually increase in the next two years, in line with the recovery of the domestic economy and the partial pass-through of high import prices. The projection for growth in services prices is lower than the previous projections for 2011 and 2012, partly as a result of the one-off effects of the cut in radio and TV subscription in February of this year and slower growth in prices of accommodation and food services. Year-on-year growth in services prices will be higher from September 2011, as the effect of last September's fall in prices of school meals will have disappeared. Annual growth in services prices is expected to average 1.5% in the projection period, compared with 0.4% for prices of non-energy industrial goods.

Figure 7.9: Projections of contributions to inflation by components



Note: Rounding means the sum of the components may differ from the aggregate value
Sources: SORS, Bank of Slovenia projections

Table 7.5: Inflation

						Projections					
						2011		2012		2013	
	2006	2007	2008	2009	2010	**Apr**	Δ	**Apr**	Δ	**Apr**	Δ
						average annual growth, %					
Consumer prices (HICP)	2.5	3.8	5.5	0.9	2.1	**2.7**	0.6	**2.3**	0.3	**1.9**	-
food	2.7	7.1	8.1	1.8	2.5	**5.8**	1.8	**4.3**	0.9	**2.0**	-
energy	8.5	3.4	9.4	-4.5	13.9	**9.6**	3.6	**3.0**	0.4	**1.2**	-
other goods	-0.9	0.3	2.2	0.0	-2.2	**-0.6**	0.2	**0.5**	0.0	**1.3**	-
services	3.5	4.9	5.3	3.2	1.2	**0.2**	-1.6	**2.0**	-0.1	**2.3**	-
Core inflation indicators (HICP)											
excluding energy	1.7	3.8	4.9	1.7	0.3	**1.5**	0.0	**2.2**	0.3	**2.0**	-
excluding energy and unprocessed food	1.5	3.4	5.0	1.9	0.2	**1.0**	-0.3	**2.0**	0.1	**2.0**	-
excluding energy, food, alcohol and tobacco	1.3	2.7	3.8	1.7	-0.4	**-0.1**	-0.8	**1.4**	0.0	**1.9**	-

Δ: Difference between current projections and projections in October 2010 Price Stability Report
Sources: SORS, Bank of Slovenia.

According to the plan for managing administered prices for 2010 and 2011, administered prices are expected to make an insignificant contribution to headline inflation in 2011. Prices of railway tickets rose by 6.0% this March, which will contribute 0.012 percentage points to headline inflation. Two further rises in administered prices are envisaged in the remainder of 2011, taking their overall contribution to headline inflation to 0.017 percentage points. Euro exchange rate and the oil price developments on global markets are major factors in changes in other prices subject to various forms of regulation. These directly determine prices of liquid and motor fuels and prices of heat energy in Slovenia, for which the government merely prescribes the price-setting mechanism.[20]

The available monetary indicators and indicators of prices and costs relative to the rest of the world show that in the medium term, no strong price pressures are expected. Year-on-year growth in loans to households has fluctuated around 9% in the early part of this year, but this was primarily the result of relatively high growth in housing loans, consumer loans having continued to record negative growth. Growth in loans to corporates was also very low in the early part of this year. These movements in loans do not indicate any possibility of a potential reversal in domestic demand in the projection period. No expectation of price pressures in the projection period stem from the point of view of the cost competitiveness or price competitiveness of the Slovenian economy. The gap by which its competitiveness trails that of the most important trading partners, as reflected in unit labour costs, is a factor hindering the recovery of the Slovenian economy and labour market. This situation is limiting the possibility of raising consumer prices.

The absence of stronger longer-term inflationary pressures has also been reflected in the longer-term inflation forecasts. Consensus Forecasts sees a gradual fall in annual inflation in Slovenia to 2.0% by 2016, and the rate is expected to remain at around 2.1% until 2021. The forecasts of the IMAD and the IMF are slightly higher: the IMAD is forecasting inflation to average 2.6% in 2013 and 2014, while the IMF is forecasting inflation of 2.9% in 2015.

Risks and uncertainties

The risks in the projections relating to domestic economic growth remain tied to the uncertainties arising in foreign demand, although these uncertainties have recently diminished and become more balanced. Despite a recent decline, uncertainties in the euro area sovereign debt markets remain relatively high. The potential

Table 7.6: Direct impact of government measures on inflation in 2011

Measure	Change	Impact on HICP in 2011, percentage points
– Changes in prices of selected textbooks	average price increase of 2.3%	0.005
– Changes in prices of railway tickets	average price increase of 6.0%	0.012
– Planned increase in contribution to mandatory reserves of refined petroleum products	increase in contribution of 10%	0.000
Total impact on inflation		**0.017**

Source: Plan for managing regulated prices in 2010 and 2011

[20] At a correspondence session of February 2011 the government adopted the Decree amending the decree on environmental tax for the pollution of air with carbon dioxide emissions, which postponed the introduction of the CO2 tax from 1 March to 1 October 2011. On introduction the CO2 tax will primarily burden those entitled to refunds of excise duties, as it will replace the corresponding portion of the excise duty in the amount of 0.3225 cents per litre.

increase in fiscal difficulties in the euro area periphery countries and the adoption of restrictive budgets in a number of euro area countries continue to represent the principal risk to growth in foreign demand in the projection period. Other factors that could affect foreign demand include the financial markets' potential doubts surrounding fiscal sustainability in certain countries outside the EU and the potential faster withdrawal of stimulative economic policy measures in these countries. Higher commodity prices could reduce household consumption via a contraction in disposable income, and could have an impact on corporate investment via higher costs and lower earnings, leading to lower import demand. A reversal of monetary policy in emerging economies into a restrictive direction could reduce economic activity in Slovenia's most important trading partners. However, there could also be a stronger pass-through of the positive effects of export developments in Slovenia's most important trading partners into their domestic demand. The current high level of the majority of confidence indicators in these economies could contribute to this. Such developments would lead to higher growth in foreign demand for Slovenian products than currently assumed.

The economic sector with greatest uncertainties remains construction, which is leading to unreliability in the projections of investment activity and employment trends. Falling employment in construction and the possibility of falling employment in construction-related sectors could have significant consequences for household consumption and public finance developments. Construction could additionally be slowed by insufficient adjustment in real estate prices, which would limit the pace at which inventories of unsold housing are reduced. Despite the government planning certain infrastructure projects, the return of construction activity to the pre-crisis level is not possible, as the government is not planning infrastructural investments of a size comparable to the construction of the motorway network. The current plans are also relatively uncertain, particularly with regard to investment in energy infrastructure.

The uncertainties on the labour market and the uncertainties surrounding the labour costs developments are increasing the possibility of an additional deterioration in the competitiveness of the Slovenian economy. Because no major collective agreements were concluded in the private sector in 2010, there remains a potential risk relating to wage pressures in wage brackets that as a result of the rise in the minimum wage in March 2010 are *de facto* equalised with the lowest wage brackets. Excessive growth in labour costs relative to productivity could strongly contribute to high unemployment, and could simultaneously have an adverse impact on competitiveness. The effects of the new arrangements for student work, envisaged for January 2012, are currently uncertain. The most flexible form of employment would be abolished and replaced with a higher-taxed and more-restricted form of employment, although this would provide for flexible employment for a significantly wider group of population. Given the uncertainty surrounding the pace of the rise in employment, there could also be restrictions in household consumption and in the long term a decline in economic potential as a result of the adverse impact on human capital.

The adverse fiscal position together with high implicit government liabilities, also requires Slovenia to undertake credible long-term consolidation of public finances and to return to the framework of the Pact by 2013. The main features of the fiscal position in 2010 were a large general government deficit of 5.5% of GDP and a continuing increase in the general government debt, to 38.0% of GDP. These developments were more favourable than those projected February 2010 in the Exit Strategy. The amendments to the state budget for 2011 adopted last November and the state budget for 2012 nevertheless foresee a larger deficit than that envisaged in the Exit Strategy. Any deviation from the expected gradual decline in the deficit, which could occur in a election year in particular, would entail, in connection with the uncertainties surrounding economic growth, a risk to the removal of the excessive deficit by the agreed deadlines

Table 7.7: Comparison of forecasts for Slovenia and change from previous forecasts

	Publication of new/previous forecast	GDP annual growth, %				Inflation annual average, %				Current account as % GDP			
		2011		2012		2011		2012		2011		2012	
		new	Δ	new	Δ	new	Δ	new	Δ	new	Δ	new	Δ
Bank of Slovenia	Apr 11 / Oct 10	**1.8**	-0.1	**2.7**	-0,2	**2.7**	0.6	**2.3**	0.3	**-1.6**	0.1	**-1.1**	1.1
EIPF	Mar 11 / Sep 10	**2.7**	0.0	**2.9**	…	**2.9**	1.1	**2.3**	…	**-1.7**	1.1	**-1.1**	…
IMAD	Mar 11 / Sep 10	**2.2**	-0.3	**2.6**	-0.5	**2.2**	-0.5	**3.0**	0.8	**-2.3**	-1.3	**-2.4**	-1.3
Consensus Forecasts	Mar 11 / Sep 10	**2.1**	0.0	**2.5**	-0.7	**2.6**	0.4	**2.5**	0.2	**-1.4**	0.5	**-1.1**	…
European Commission	Nov 10 / May 10	**1.9**	0.1	**2.6**	…	**2.0**	0.0	**2.2**	…	**-0.6**	1.0	**0.8**	…
OECD	Nov 10 / May 10	**2.0**	-0.4	**2.7**	…	**1.9**	0.6	**2.2**	…	**-3.9**	-3.8	**-4.5**	…

Δ: Difference between current projections and previous projections
Sources: Bank of Slovenia, EIPF, IMAD, European Commission, Consensus Economic Forecasts, OECD; Bank of Slovenia calculations

and under the agreed timetable. The rating agency Moody's lowered its rating outlook for Slovenia from stable to negative at the end of last year. This indicates a potential downgrading for Slovenia in the future. This would lead to a deterioration in its future financing conditions, which was at least partly indicated during the issue of long-term bonds in the early part of this year. By contrast, Fitch left its rating for Slovenia unchanged at AA this March, with no change in the stable outlook. The long -term sustainability of public finances would slightly improve with the enactment of the pension law, which has not yet been finally adopted. It currently contains amendments that would entail reforms being less deep-seated than originally planned. Healthcare reforms are also under preparation.

Rising uncertainty on the international financial markets and refinancing difficulties for the domestic banking sector could further raise the costs of financing or hinder access to financing. The price of borrowing could increase with continuing instability on the financial markets, and higher premiums on reference interest rates for government borrowing could also be reflected in the price of private sector borrowing. A rise in market interest rates, expected by the financial markets, will additionally increase the debt-servicing burden for Slovenian corporates, which are more indebted than corporates in the euro area overall. Further bank downgrades due to a deterioration in the credit portfolio could additionally raise refinancing costs for the banks, which would further curtail growth in loans to the private sector.

From the point of view of lending activity, the risks of its decline are rising. The risks are on a rise due to the potential for difficulties in the banks' refinancing in the rest of the world in the context of the gradual withdrawal of non-standard monetary policy measures by the ECB and in the generation of deposits in Slovenia, the maturing of government deposits, and the increase in impairment and provisioning costs. The latter could lead to the banks tightening their loan approval policies. Lending activity has recently been increasing in the financing of housing purchases by households, which in a situation of limited funding could crowd out the financing of corporate activity. In the future, lending activity could also be restricted by the adoption of an envisaged law to tax the total assets of banks and the introduction of Basel III, which requires improved capital adequacy at banks. Payment indiscipline is an additional factor whose deepening could particularly hinder the financial operations of smaller corporates and thus their activities.

The risk of a temporary sharp rise in inflation as a result of rises in certain prices is increasing, as a result of possible further pressure from high growth in commodity prices on international markets. The political unrest in the Middle East and North Africa could also cause restrictions in the supply of energy, in addition to problems in the production of energy products. In the context of simultaneous growth in energy prices, which represent a major cost in food production, high food prices on global markets could pass through into domestic retail prices. Other factors could be the relatively inefficient agricultural and food processing industries, and the relatively low income elasticity of demand for food products. In addition to a rise in food prices, there could also be a rise in services prices, particularly those of restaurants, where food is used as an input. High growth in commodity prices could cause a rise in prices of imported manufactured goods, which in previous years have grown very slowly or even fallen.

The main domestic factors that could contribute to higher inflation are additional tax measures within the framework of fiscal consolidation, and price pressures in sectors with limited competition and insufficient cost management. Given continued rises in oil prices on global markets, the government could be faced with imposing the lowest possible excise duties on refined petroleum products. Its room for manoeuvre in this area could thus become very limited. Although the government did not approve the second planned rise in excise duties on electricity in November 2010, it left open the possibility of raising them in the near future. Any need for additional budgetary resources could trigger an increase in excise duties and indirect taxes. Although the chance of a rise in labour costs is relatively small in the current macroeconomic environment, it could happen in sectors with limited competition or in protected sectors. This applies in particular to basic utilities, where any abolition of the restrictions on setting maximum prices[21] could trigger a new wave of price rises in the sector similar to those seen at the end of 2009. This would have a significant demonstrative effect. Demands for excessive wage growth could also arise as a result of overestimated expectations of the possibility of future economic growth. Although in sectors exposed to competition demand for higher wages would probably be reflected primarily in a fall in employment, rises in labour costs in sectors with limited competition could create the conditions for upward pressure on prices.

By contrast, inflation could be lower mainly because of the situation on the labour market and an additional slowdown in consumption and cost factors. A slower recovery in the labour market could contribute to lower inflation, and would lead via a decline in household confidence to lower domestic consumption than currently expected. This would additionally restrict retailers' abilities to pass through higher import prices into final consumer prices on the domestic market. In addition, in the event of diminished consumer purchasing power as a result of higher nominal expenditure on basic goods, spending on non-basics such as durables and services could be cut. This would increase downward pressure on the prices that make up the majority of core inflation.

[21] At the end of February 2011 the government adopted the Decree setting the maximum prices of basic utilities, which sets the maximum allowable prices for environmental utilities provided by local government as a public service obligation, and which is valid for six months. A new decree on the methodology for forming prices of environmental utilities provided by local government as a public service obligation is currently being drafted.