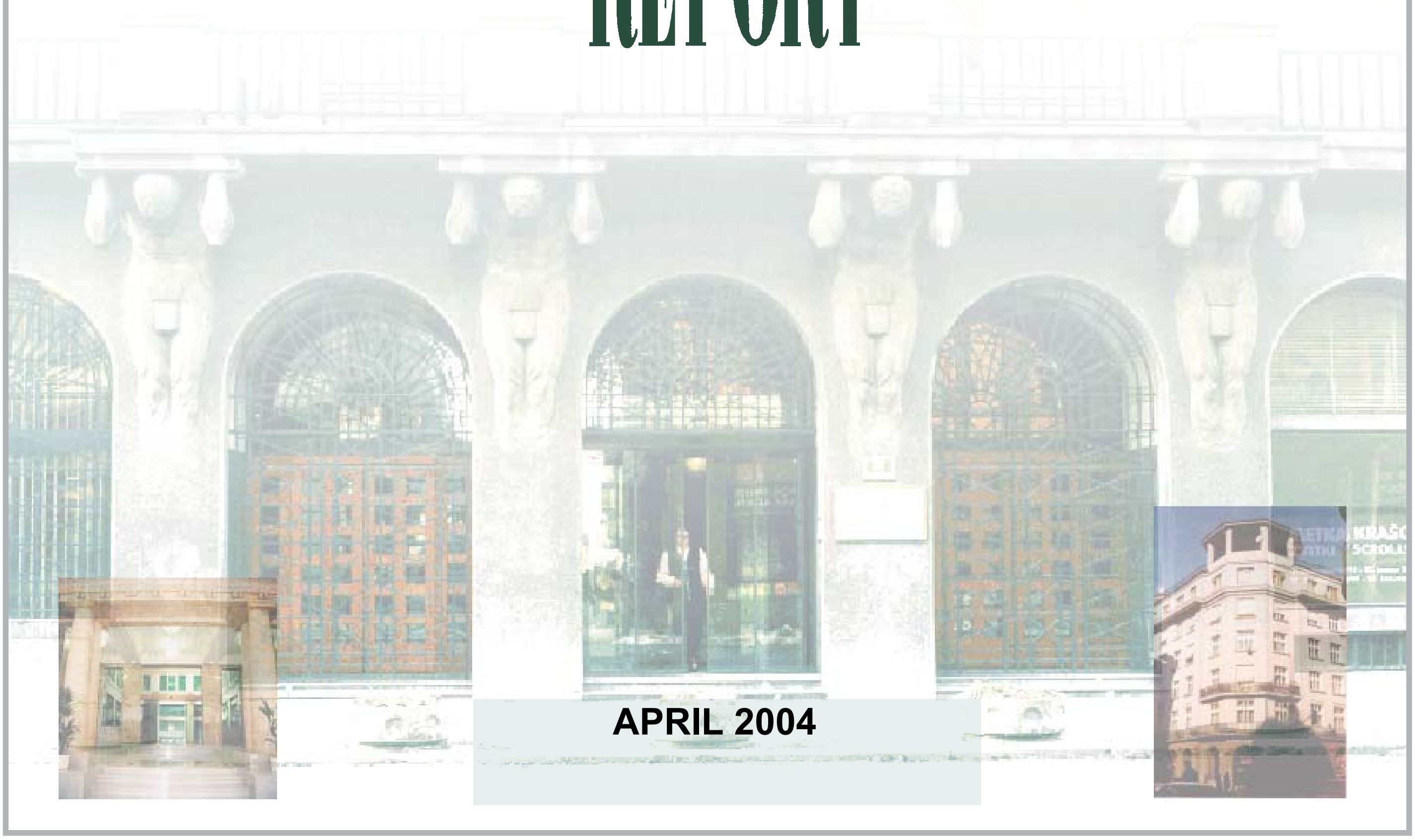
BANKA SLOVENIJE

BANK OF SLOVENIA

MONETARY POLICY IMPLEMENTATION REPORT



APRIL 2004

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1. INTRODUCTION AND SUMMARY

With inflation having come down substantially, Slovenia is already very close to achieving price stability. The reduction in inflation has been achieved in a sustainable manner, in line with expectations, and results primarily from the coordinated action of economic policies. Year-on-year price growth currently stands at 3.5%. The disinflation trend is forecast to continue, with the price growth rate falling to around 3.2% at the end of 2004, 2.8% at the end of 2005 and stabilising at that level in 2006.

Economic growth will begin to pick up this year, although it will remain below its long-run equilibrium rate in the next few years. Two factors driving economic growth will be the improved prospects for global economic recovery and increased domestic consumption. Improvement in activity levels in the global economy will accelerate export trends, although a stronger recovery in Slovenia's most important trading partners is unlikely. A strong euro and poor labour market conditions will keep the EU economy relatively weak, while demand from the former Yugoslavia and central Europe is likely to be limited by the need for balance of payments and public finance consolidation. Increased domestic consumption will predominantly be import oriented and thus make a low contribution to economic growth. The import orientation of domestic final consumption and the relatively low level of exploitation of production capacities mean that significant demand-side price pressures are not anticipated.

Monetary policy strategy will remain unchanged in the period prior to EU entry and during preparations for earliest possible entry into ERM II. In line with the commitment to prepare the conditions for inclusion in EMU and adoption of the euro at the earliest opportunity,[1] the Bank of Slovenia's strategy is oriented towards bringing inflation down and is based on maintaining an appropriate level of real interest rates, money supply control and a gradual stabilisation of the exchange rate while taking into account the principle of uncovered interest parity. The Bank of Slovenia has lowered nominal interest rates in several stages and slowed the depreciation of the exchange rate, which will enable a smooth transition to ERM II. Moderately restrictive monetary policy, the slowdown in economic activity, the weakness of

[1] In November 2001 the Governing Board of the Bank of Slovenia approved and announced a clear-cut medium-term policy orientation: to put in place the conditions for joining the European Economic and Monetary Union (EMU) at the earliest opportunity. Pursuit of this aim is the most effective way for the Bank of Slovenia to fulfil the task of achieving price stability laid down for it in the Bank of Slovenia Act. The Bank also undertook to prepare a regular inflation report as a way of reporting publicly on the implementation of its short-term monetary stance. This will contribute to greater transparency in the implementation of monetary policy. This is part of a regular series of reports that the Bank of Slovenia publishes on inflation together with forecasts of macroeconomic trends and explanations of short-term monetary policy orientations. The next inflation report will be prepared in autumn 2004.

domestic consumption, weak credit activity and the tight labour market conditions have enabled a reduction in inflation and inflationary expectations

Following entry into ERM II, the monetary policy will focus on exchange rate stability and the setting of interest rates will become subordinated to exchange rate policy. Monetary policy independence will decline appreciably after Slovenia enters ERM II and other economic policies will have to operate in line with the joint programme for ERM II entry and adoption of the euro.

A suitable combination of economic policies after ERM II entry will be key to ensuring stability and growth and adoption of the euro at the earliest opportunity. In the programme for ERM II entry and adoption of the euro the Bank of Slovenia and the Slovenian Government recognised that monetary policy within ERM II will be less restrictive. Consequently, with a view to ensuring macroeconomic stability and continuation of the disinflation trend, fiscal and incomes policies will need to prevent or respond to shocks in a timely manner.

Along with fiscal and incomes policy, the social partners, too, will have to cooperate in ensuring the appropriate conditions for operating within ERM II and ensuring economic competitiveness. In the social agreement for the period 2003-2005 the social partners undertook to act in line with the goal of ensuring a lower level of price growth and to strive for public and private sector wages policies that will contribute as far as possible to inflation reduction. The signing of an agreement on the adjustment of basic wages in the public sector marked an important step towards achievement of the incomes policy goal, but a similar agreement also needs to be concluded by the private sector social partners as soon as possible. Failure to achieve a full deindexation of private sector wages could seriously jeopardise fulfilment of the Maastricht criteria.

The Bank of Slovenia believes the preparations for inclusion in ERM II are proceeding in line with expectations. With a high degree of nominal convergence achieved, the instrumental framework for monetary policy action within ERM II is in place. When Slovenia joins ERM II the Bank of Slovenia and the Slovenian Government will have to determine the central parity for the tolar against the euro, as well as the exchange rate band, in negotiations with the European Central Bank, the European Commission and the representatives of the EU member states.

2. INFLATION TRENDS

Slovenia is close to achieving the target of price stability. Inflation has fallen appreciably in the last twelve months to 3.5% year-on-year. The rate of reduction is in line with expectations, and sustainable because all the basic equilibria in the economy have been maintained.

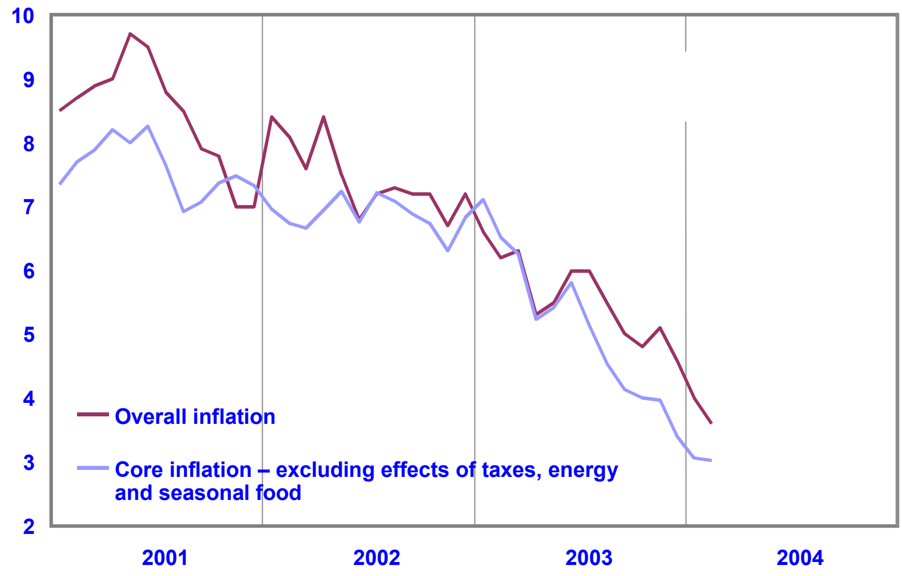
The reduction in inflation results from appropriate economic policies and a decline in inflationary pressures as a consequence of unfavourable economic conditions. The improvement in economic policy coordination has played an important role in bringing inflation down. The Bank of Slovenia maintained a relatively restrictive monetary policy enabling inflationary pressures of a monetary nature to be avoided, while the Slovenian Government kept administrative price growth within the inflation target and restricted pressure on inflation through fiscal adjustments. At the same time it also prevented volatility stemming from the international environment being passed on to domestic prices. The slowdown in economic growth, difficult labour market conditions and the absence of inflationary pressures from abroad also contributed to the reduction in inflation. Expectations of increased competition in the market for goods and services after Slovenia joins the European Union and ERM II have also resulted in a lowering of inflationary expectations and consequently of inflation.

2.1 Achieving price stability

Inflation has fallen appreciably in the past year. Year-on-year price growth has dropped to its historically lowest level. The year-on-year growth rate of consumer prices in March was 3.5%, having more than halved in the last twelve months. Core inflation has also fallen, and stabilised at a low level of around 3%.

The rate of inflation reduction is in line with expectations. The falling inflation trend began in mid-2001. Last year the rate of reduction accelerated after coordination was achieved between the Government's economic policies and the monetary policy of the Bank of Slovenia. Inflation has continued to come down this year. The rate of growth of consumer prices fell by more than one percentage point in the first three months.

Figure 2.1: Overall and core inflation (percentage year-on-year growth rate)

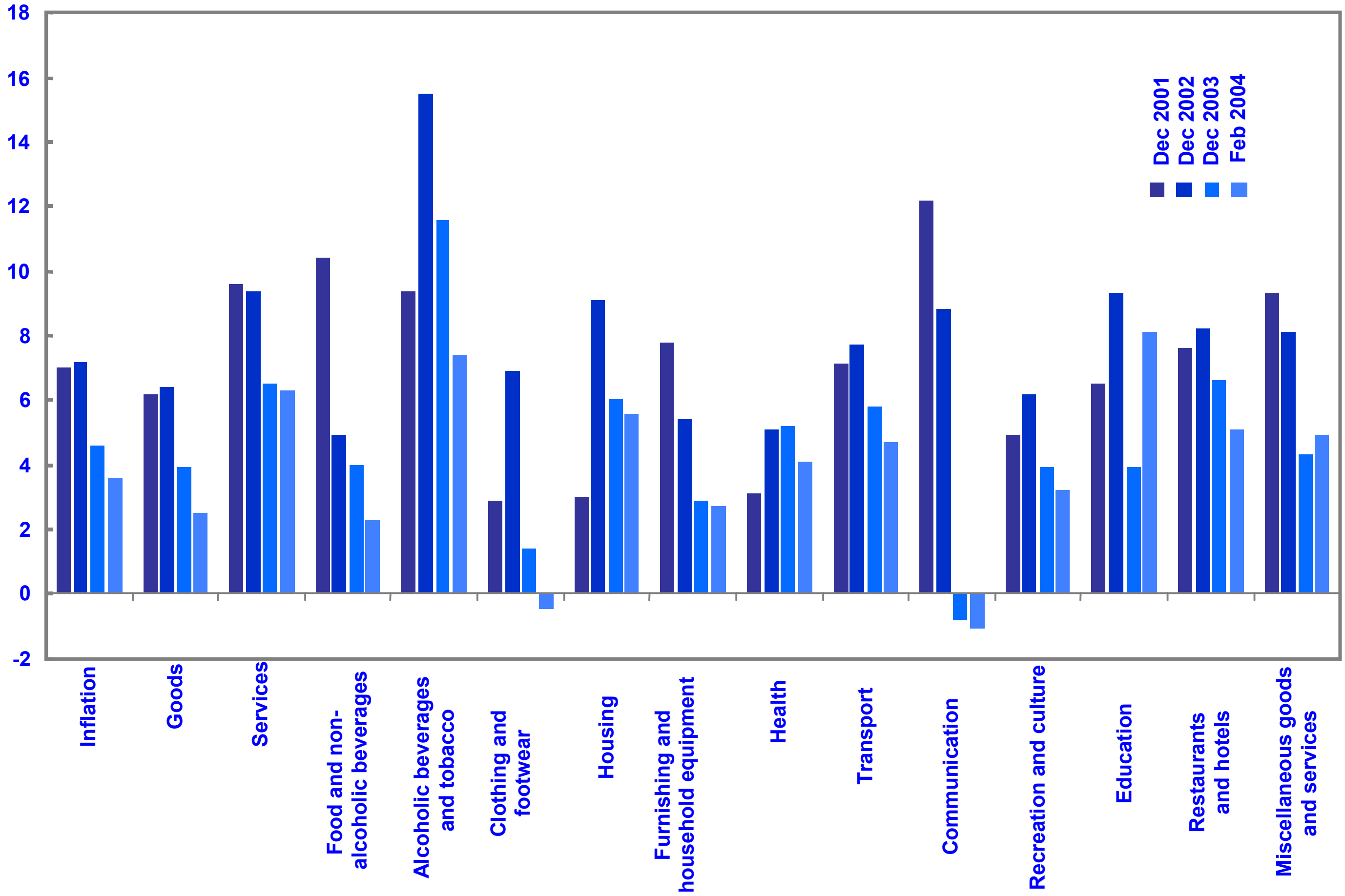


Source: Statistical Office of the Republic of Slovenia; calculations by Analysis and Research Department

Disinflation was achieved in a sustainable manner. The basic macroeconomic equilibria were maintained, meaning that such a reduction in price growth rates will not give rise to new inflationary pressures in the future. Several aspects point to the sustainability of the inflation reduction:

- The most important macroeconomic equilibria have been maintained. Although the current account surplus fell last year, the slightly positive balance indicates that it remains in equilibrium. Slovenia's fiscal position is similarly favourable. The budget deficit is on target and within the limit set by the Maastricht criteria, Government indebtedness remains low and the tolar exchange rate is gradually being stabilised.
- Price growth rates have come down more or less proportionally in all the groups comprising the consumer price index, with an average decrease of four percentage points between the beginning of last year and February 2004. Structural changes mean certain price groups have not followed the trend, e.g. price growth in the alcoholic beverages and tobacco group because of increased excise duties on tobacco products and higher VAT rates on wine in line with EU rules. Another exception was housing, where prices rose by an average of 5.6%, mostly as a result of increases in non-profit rents. Following a Constitutional Court ruling, non-profit rents were increased by 15.6% in May last year and by 5.2% in January this year. Prices of food and non-alcoholic beverages rose slowest of all. In the twelve months to February 2004 this group recorded an average price increase of just 2.3%. Food price growth is likely to remain low in the coming period because import duties on foreign food products will be cut when Slovenia joins the EU and competition will increase.

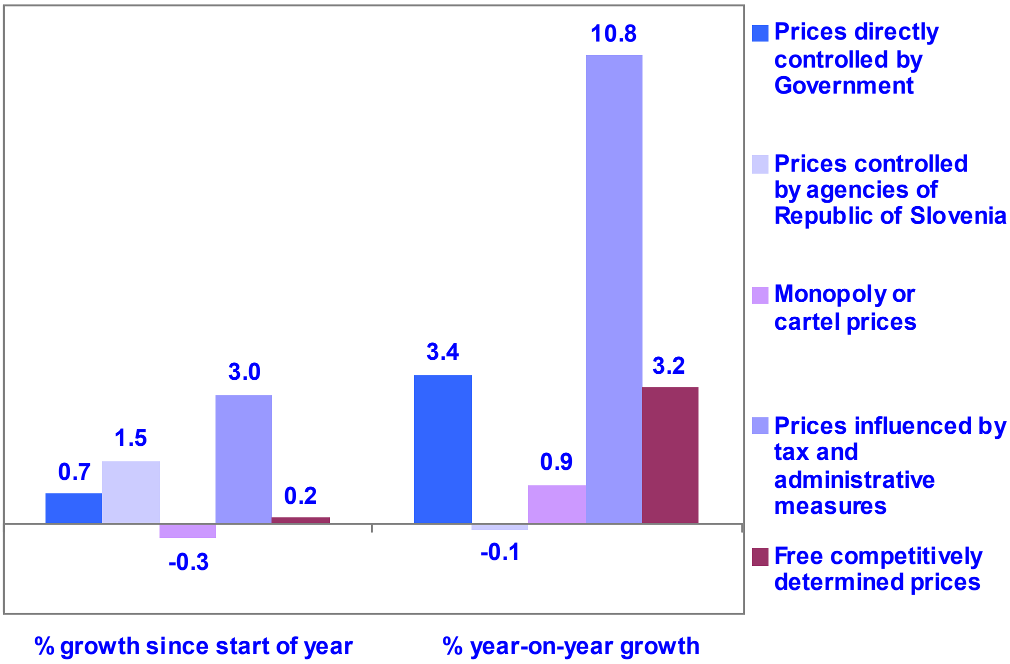
Figure 2.2: Comparison of percentage year-on-year inflation by main groups



Source: Statistical Office of the Republic of Slovenia; calculations by Analysis and Research Department

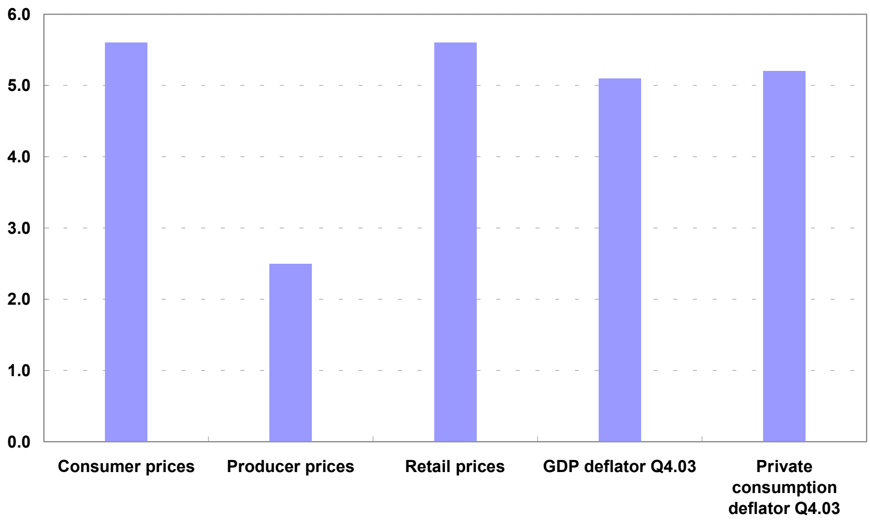
- **Administrative price** trends were appreciably more aligned with inflation than in the past. For the first time in a number of years administrative price growth was not substantially higher than free price growth. The growth in administered prices in the twelve months to February this year was 3.4%, while free price growth (net of tax effects) was 3.2%. In 2003 smaller contributions to inflation also came from one-off tax effects and other non-market measures such as higher excise duties on tobacco and higher VAT rates on wine resulting from convergence with EU regulations, from administrative measures such as a Constitutional Court ruling resulting in increased rents, and from increases in prices of medicines resulting from pharmacies exploiting their monopoly position. These non-market measures contributed around 0.9 percentage points to inflation. Smaller inflationary pressures coming from administrated prices are a result of consistent implementation of the plan for adjustment of administered prices, taking into account the high degree of relative price conformity already achieved in relation to prices in the euro area. The price adjustments did not mean a deterioration in the economic position of companies whose prices were under Government control because the adjustments mainly brought about a rationalisation of labour costs, which are significantly higher than average in companies whose prices are controlled. This year the Slovenian Government has again drawn up a plan for administered price adjustments under which the overall growth in administered prices will not exceed free price growth, and individual price rises should not significantly exceed the level of increase of free prices.

Figure 2.3: Consumer price growth by mode of price setting (February 2004)



Note: Prices that were directly influenced by tax and administrative measures in the past twelve months were excluded from the group of prices formed freely and competitively. The following products were included in this group: cigarettes, wine, non-profit rents and medicines, which account for 6% of all the products in the consumer price index. These changes have meant a corresponding reduction in the share of products whose prices are formed freely from 78% to 72%. The composition and shares of the remaining indices remained unchanged.
Source: Statistical Office of the Republic of Slovenia; calculations by Analysis and Research Department

Figure 2.4: Price growth indicators (December 2003)



Source: Statistical Office of the Republic of Slovenia; calculations by Analysis and Research Department

2.2 Inflation detetminants in 2003

The reduction in inflation results not only from appropriate economic policy action but also from a number of other factors. These include the unfavourable conditions in the domestic economic environment and the absence of inflationary pressures from abroad.

Economic policy coordination played a key role in bringing inflation down. Government policies last year were more coordinated in the fight against inflation than in previous years and did not differ significantly from the measures outlined. The Bank of Slovenia maintained a relatively restrictive monetary policy enabling inflationary pressures of a monetary nature to be avoided, while the Slovenian Government kept administrative price growth within the inflation target and restricted pressures on inflation through fiscal adjustments. At the same time it also adjusted excise duties using temporary measures in order to even out fluctuations in oil prices. More consistent implementation of administered price policy and a partial deindexation of public sector wages have enabled a decline in inflationary expectations.

Smaller inflationary pressures have also resulted from the unfavourable conditions in the domestic economy. The slowdown in economic activity, tougher labour market conditions and restrained domestic consumption have made a clear contribution towards reducing inflationary pressures. Expectations of increased competition in the market for goods and services when Slovenia joins the European Union and ERM II have also resulted in a lowering of inflationary expectations and consequently of inflation.

The absence of inflationary pressures from abroad, with a weak dollar compensating for high oil prices, also contributed to the reduction in inflation. And low inflation in the European Union and the United States had an indirect impact on domestic inflation.

* * *

The absence of inflationary pressures stemming from the international environment contributed to the lowering of inflation. A weak dollar and adjustments to the excise duties on refined petroleum products compensated for high oil prices. Inflation in the European Union and the United States remains low, as slow economic growth and tougher labour market conditions have meant an absence of inflationary pressures.

Inflationary effects associated with the high oil price were present mainly in the first half of last year and in March this year, when the price of crude oil rose to one of its highest levels ever. In the past year oil prices on world markets have been highly volatile, and despite expectations to the contrary they have persisted at relatively high levels. In the first half of the year, following the attack on Iraq, the price of oil fell slightly, but it remained at a high level primarily on account of the United States renewing its oil stocks. In the second half of the year oil prices were slightly lower, although still within the upper part of the OPEC target band of between 22 and 28 US dollars per barrel. Currently the price of oil is above 32 dollars per barrel.

The weakness of the dollar against the euro partly neutralised the high price of oil. The fall in the value of the US dollar has meant exchange rates having a favourable impact on import prices via lower commodity prices and thus on movements in imported inflation. Last year the US dollar lost around 20% of its value against the euro. The average value of the euro in 2003 was USD 1.13. The most important reasons for the fall in the value of the dollar were the large budget deficit and trade deficit. Recovery in the US labour market is also slow.

Low inflation in the European Union and the United States, Slovenia’s most important trading partners, of around 2% also contributed to lower domestic price growth last year. The main cause was, and remains, the slowdown in economic growth.

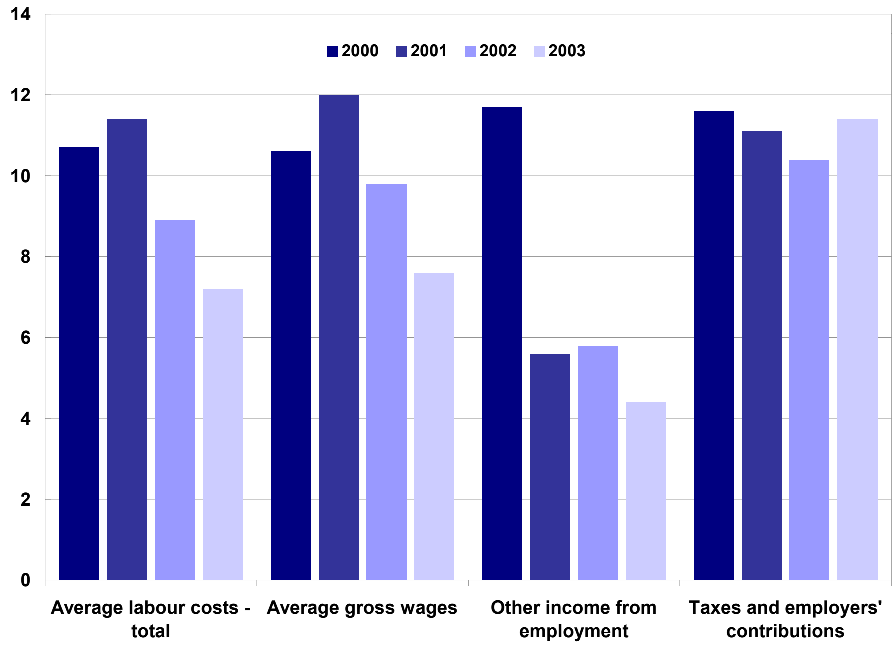
Sluggish economic activity and tighter labour market conditions in Slovenia also contributed to reduced inflationary pressures. Wage movements reflected the economic downturn and grew relatively slowly, thanks in part to low wage growth in the public sector. Domestic final consumption was restrained.

Tighter economic conditions last year at home and abroad prevented additional inflationary pressures. The gap between potential and actual economic growth was also reflected on the labour market, which was characterised by slow wage growth and employment stagnation last year. Private sector labour costs have been adjusted relatively effectively to the deterioration in the economic situation.

Tighter labour market conditions were also apparent in the **employment** trend, which was rather modest last year and reflected movements in economic activity. A gradual improvement at the end of the year followed a clear period of stagnation in the first six months. Nevertheless, even in the second half of the year the decline in employment continued, particularly in the labour intensive branches, with little prospect of an imminent turnaround. The uncertain employment situation acted as an additional constraint on labour costs, and hence inflation.

Reflecting the economic downturn, **wages** grew relatively slowly last year, primarily on account of low wage growth in the public sector. Average year-on-year growth in gross wages was 7.6%, or 1.9% in real terms. Annual average real gross wage growth in the tradable sector was 2.7%, just 0.5 percentage points below productivity growth. In the public sector the August wage increase in 2003 was replaced by the payment of a collective insurance premium. And an agreement relating to the adjustment of basic wages and bonuses for the period 2004-2005 was concluded under which the adjustment mechanism will take into account expected domestic inflation, inflationary expectations in the EU and the expected growth in the tolar/euro exchange rate. However, the social partners have yet to agree an adjustment mechanism for future wage setting in the private sector. Deindexation of wages last year already contributed towards a gradual and sustainable lowering of inflation, and will have an even bigger effect in the future.

Figure 2.5: Average labour costs (nominal percentage growth)



Source: statistical Office of the Republic of Slovenia; calculations by Analysis and Research Department

Domestic demand was restrained last year and was not a source of upward pressure on prices. We see the gradual recovery of domestic final consumption and, in particular, investment spending as a consequence more of the exceptionally low level of consumption in the last few years and the rapid reduction in interest rates than of the start of a new consumer cycle. Moreover, a large proportion of domestic demand is import oriented so that the increased domestic consumption is reflected more in a reduction in the trade surplus than in inflationary pressures. The maintenance of relatively low household consumption was assisted last year by slow economic growth, tougher conditions on the labour market and structural factors such as the need for retirement saving that has emerged with the pension reforms.

Expectations of increased competition resulting from Slovenia joining the EU and the removal of customs duties on food items are exerting a downward pressure on prices. Accession to the EU and ERM II is generating expectations of increased competition in the market for goods and services, partly because of the entry into the Union itself and partly because of the removal of the last import duties on food items from the European Union. These expectations of increased competition once inside the European Union and ERM II have accelerated the process of rationalisation and cost control in enterprises. Inflationary expectations and inflation have fallen as a result.

Monetary policy and fiscal policy action last year and this year have been far better coordinated in decreasing inflation.

The Bank of Slovenia has pursued the goal of achieving a gradual and sustained reduction in inflation. Its monetary policy continues to be based on adjusting the nominal interest rates, taking into account the inflationary expectations and the need of closing the uncovered interest parity, using both interest rates and exchange rate movements. An appropriate level of real interest rates and gradual stabilisation of the exchange rate have helped to ensure that **again this year there have been no inflationary pressures of a monetary nature.**

The Bank's monetary policy will continue to be oriented towards bringing down inflation. Interest rate policy until ERM II entry will be oriented towards a gradual lowering of nominal rates. Exchange rate policy will accompany the gradual reduction in nominal interest rates with an appropriate closing of the interest parity. The gradual convergence of nominal interest rates will narrow the gap between interest rates at home and abroad to the extent that stabilisation of the exchange rate will be possible on entry to ERM II.

More appropriate economic policies on the part of the Slovenian Government have also contributed to the lowering of inflation. More consistent implementation of administered price policy and the consequent downward pressure on costs in enterprises or sectors whose prices are under Government control, action to prevent volatility in world oil prices from being passed on to domestic inflation, and more modest increases in tax elements that have a direct impact on inflation all helped bring about appreciably smaller inflationary pressures in 2003 and at the start of 2004 than in previous years. The Government has consistently implemented the price control plan, which is designed to ensure that the average growth in administered prices does not exceed the growth in free prices.

Discretionary Government measures of tax nature last year contributed around 0.6 percentage points to inflation, which is substantially less than the 2.5 percentage points such measures contributed to inflation in 2002. An important tax measure that had a direct effect on inflation last year was the two time increase of excise duties on cigarettes and tobacco, with a total contribution to inflation of approximately 0.5 percentage points. In addition, the VAT rate on wine was increased from 8.5% to 20%, which further contributed around 0.1 percentage points to inflation. The purpose of both measures was to bring tax rates into line with the rates applying in the EU.

The Government's policy of preventing volatility in world oil prices being passed on to domestic inflation has proved correct. Timely adjustments in **excise duties on refined petroleum products** meant that the large fluctuations in world oil prices were not passed on to domestic prices. The Government reduced the excise duties at the beginning of the year when oil prices rose on world markets, before raising them again in the second half of the year to make up for the shortage in budget revenues resulting from lower excise duties in previous months.

Administrative measures for which the Government is not responsible contributed an additional 0.3 percentage points to inflation last year. The main administrative measures contributing to price growth last year were rises in the prices of medicines, which contributed approximately 0.1 percentage points to inflation, and the rise in non-profit rents irrespective of when the rental contract was signed, which contributed around 0.2 percentage points to last year's inflation.

Box 2.1: **Administered price policy**

A relatively small proportion of consumer goods prices are under control of one form or another in Slovenia. Slovenia has the lowest proportion of prices under regulation of all the newly acceding members of the EU.[2] Currently it is 18% of all the prices included in the consumer price index. We can distinguish two main forms of regulation: administered prices for which the Government is responsible and administered prices for which independent agencies are responsible.

Most administered prices can be classified into one of the following four main groups:

- Prices of energy products, including refined petroleum products (here price regulation is linked to the model for adjusting domestic prices in line with external market conditions) and electricity (for which the Energy Agency of the Republic of Slovenia has responsibility).
- Prices of communications services, including the prices of fixed telephony telecommunications services (for which the Telecommunications, Broadcasting and Post Agency of the Republic of Slovenia is responsible), postal services, road tolls and similar services.
- Prices of municipal services, where in spite of an increase in the number of basic municipal service providers, competition is limited due to the local monopoly structure of price setting. In relative terms, this is the least regulated of the areas of administrative price setting owing to a lack of criteria for determining prices and a lack of price comparability.
- Other regulated prices, such as prices of textbooks.

Administered price policy in previous years was characterised principally by a lack of control and a lack of competition, reflected in rapid price rises. In certain years administered price growth far exceeded overall inflation and free price growth, sometimes by as much as 10 to 15 percentage points. These rapid increases did not reflect underlying microeconomic factors but, above all, inadequate cost control in the companies concerned owing to the absence of market pressures and a low elasticity of demand to changes in administered prices.

Slower growth in administered prices in 2003 compared to previous years resulted primarily from the implementation of a less flexible regulation policy. This policy forced companies in regulated sectors to improve productivity because it removed the expectation that they could make up for cost inefficiencies through price increases. In line with the joint programme for ERM II entry and adoption of the euro, the Government adopted a plan for restrictive increases in administered prices in 2003.

- This included the policy stance that the growth of administered prices should not, on average, exceed free price growth, and that no price increase for an individual product or service in the administered prices group should substantially exceed the overall growth in administered prices.
- The plan also encompassed increases in indirect taxes (on liquid fuels for transport and heating and municipal charges). These policy orientations were retained in the plan of administered price increases in 2004 and 2005.
- The plan envisages the Government replacing discretionary adjustments to energy prices with a model for adjusting retail prices at regular intervals in line with changes in energy prices on the world market. In addition, the Government cushions the effect on inflation of large fluctuations in world oil prices by adjusting excise duties on refined petroleum products.

Not only have these measures contributed to slower growth of administered prices, they have also reduced their fluctuation, and hence diminished the secondary effects of administered price growth.

The sustainability of the policy of gradual increases in administered prices is supported by the operating results of companies that provide products and services whose prices are subject to various forms of regulation. Indicators show that a large majority of these companies are operating profitably,

[2] A comparison of the EU applicant countries showed that in 2001 Slovenia had the lowest proportion (16%) of its consumer price index made up of regulated prices (*Key Structural Challenges in the Acceding Countries*, Economic Policy Committee, Brussels, 29 April 2003).

some of them very profitably. Nevertheless, cost indicators, particularly relating to labour costs, show scope for further rationalisation when compared to average labour costs in Slovenia.

Analyses also show that the prices of most goods and services that are subject to some form of regulation are comparable with the lowest prices in the euro area, and in some cases even with average euro area prices.

2.3. Favourable outlook for a further reduction in inflation and for maintaining it at a low level

The outlook for further reducing inflation and stabilising it at a low level remains positive. Despite an expected increase in consumption, recovery in both the domestic and European economies will be slow. Increased competition will mean labour market conditions remain difficult, which reduces inflationary pressures. A partial deindexation of public sector wages is an encouraging start, but the process will need to be continued and extended to the private sector. In view of the joint programme for ERM II entry and adoption of the euro, significant shocks are not expected from fiscal measures or administered price policy. Moderately restrictive monetary policy until ERM II entry and the subsequent stabilisation of the exchange rate will enable a gradual and sustained reduction in inflationary expectations and adoption of the euro at the earliest opportunity.

3. MONETARY POLICY SINCE OCTOBER 2003

3.1. Monetary policy and exchange rate policy framework

The Bank of Slovenia's monetary strategy remained unchanged in 2003 and 2004 and is operating under conditions of a managed floating exchange rate. This exchange rate regime allows the Bank to pursue a relatively independent monetary policy even in conditions in which restrictions on capital flows have been relaxed. With the aim of ensuring moderate money supply growth, the Bank of Slovenia's monetary policy conduct targets two variables: interest rates on its instruments and the rate of growth of the exchange rate. The Bank adjusts the interest rate according to the required degree of restrictiveness, i.e. the desired growth rate of monetary aggregates, and depending on inflation trends and inflationary expectations. Managing the rate of growth of the exchange rate allows the uncovered interest parity to be closed, taking account of the premium for country and exchange rate risk. As a rule the rate of growth of the tolar/euro exchange rate should close the difference between domestic and foreign interest rates, except for that part of the difference reflecting a supplement for country risk. This is the only way to prevent interest elastic inflows or outflows of foreign money and to ensure domestic monetary policy independence.

In November 2003 the Bank of Slovenia and the Slovenian Government adopted a joint programme for ERM II entry and adoption of the euro.[3] This document notes that Slovenia is adequately prepared for entry into ERM II. It highlights the risks of entry and sets out the economic policy adjustments necessary in the period prior to the introduction of the euro. Both the Bank and the Government advocate entry into ERM II by the end of 2004, and the creation of conditions that will ensure participation in ERM II for the shortest possible time. This will make adoption of the euro possible at the start of 2007.

3.2. Context of monetary policy and exchange rate policy action

Favourable external and internal factors have enabled the Bank of Slovenia to gradually lower nominal interest rates and to reduce the rate of exchange rate depreciation. Balanced supply and demand in foreign money markets meant frequent exchange rate intervention was not required. The Bank of Slovenia continued the

[3] See Programme for ERM II Entry and Adoption of the Euro (November 2003), http://www.bsi.si/html/publikacije/evropa/ERM2%20_BS_Vlada_200311.pdf

process of bringing its monetary policy instruments into line with ECB standards, thereby readying itself for ERM II.

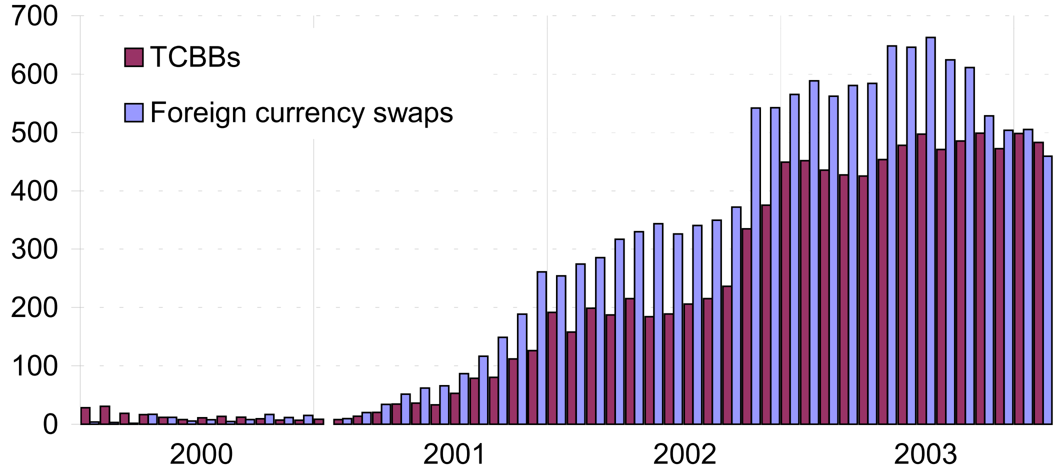
The external factors of international interest rates and Slovenia's risk premium have remained unchanged since the middle of 2003 and so have not additionally limited the scope for monetary policy action. The ECB interest rate has remained unchanged since June 2003 at 2.0%. Slovenia's risk premium fell quite sharply up until the end of 2003, but since then the falling trend has slowed appreciably. It appears that the markets have already factored in Slovenia's accession to the EU. Given the infrequency of exchange rate intervention there was no expectation of a bigger reduction in the rate of growth of the exchange rate and hence a further fall in the risk premium.

The fall in inflation and moderate consumption indicate an absence of substantial demand-side inflationary pressures. Inflation has been falling steadily. The year-on-year rate in March 2004 was 3.5%, compared to 5.0% in September 2003. The downward trend in other indicators of price growth (core inflation, retail prices) is also continuing, and price growth forecasts are favourable. Administered price growth is in line with the Government's commitment, and currently is slightly below the growth in the overall CPI. The growth of private consumption is gradually strengthening. Since the second quarter of 2003 it has grown faster than real GDP. In the last quarter of 2003 growth in private consumption was 3.6%. However, in the context of a negative output gap this does not mean an increased inflationary pressure.

Given moderate lending, a relatively savings-oriented structure of monetary aggregates and weak financial inflows, the volume of financing still does not indicate any inflationary pressures. The somewhat stronger lending to households and businesses (13.2% for households and 19.5% for businesses in the twelve months to February) reflects the gradual recovery in economic activity. The growth of broad monetary aggregates is slowing down and was already below 6% in February. M1 growth is gradually strengthening as a result of slightly stronger activity levels and falling inflation. Financial inflows from abroad last year were more or less matched by financial outflows.

In order to control the quantity of money in circulation, with balance of payments flows in equilibrium the Bank of Slovenia had to provide a relatively high level of sterilisation papers. The level of tolar-denominated central bank bills (TCBBs) has remained more or less unchanged since the end of 2002. The balance of TCBBs is approximately twice the balance of base money and represents a potential danger of surplus liquidity. Therefore the Bank of Slovenia takes a cautious approach to lowering interest rates. This liquidity can be absorbed in the case of increased balance of payments outflows or can support credit activity associated with economic growth.

Figure 3.1: Balance of swaps at the Bank of Slovenia and of central bank bills (SIT bn)

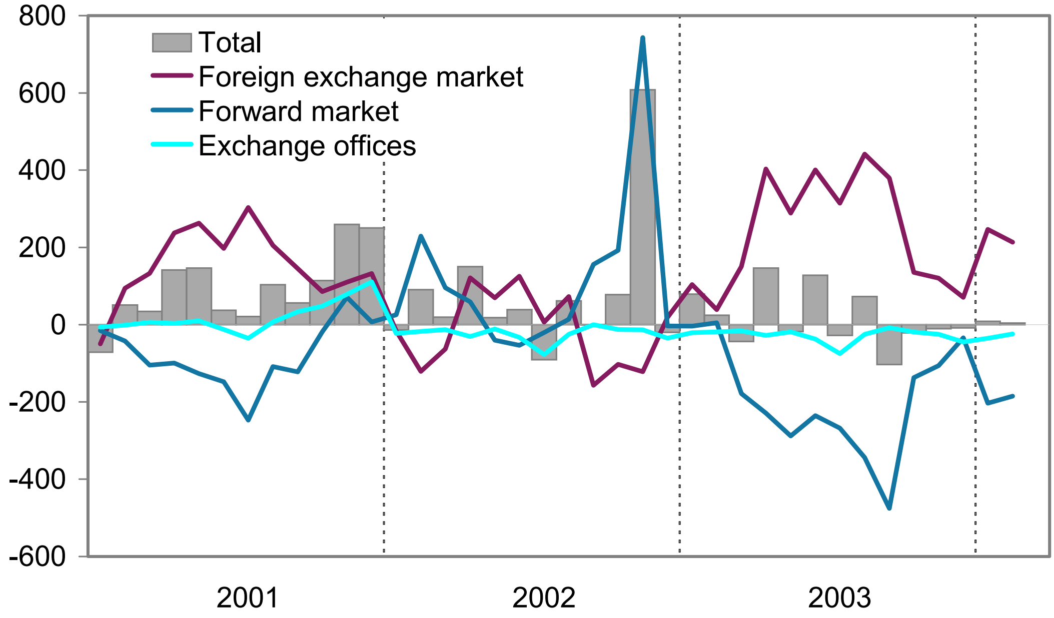


Source: Bank of Slovenia

The Bank of Slovenia only intervened on foreign money markets in order to signal a change in the desired rate of growth of the exchange rate. From October 2003 to February 2004 total demand on foreign money markets exceeded total supply by just EUR 28 million. Even in the short run there were no substantial foreign exchange surpluses or deficits. And because there was consequently no strong pressure on the exchange rate there was also no need for frequent exchange rate intervention by the Bank of Slovenia. Only on a few occasions (four times, for a total of eleven days) did the Bank of Slovenia signal a desired (lower) rate of exchange rate growth. The Bank of Slovenia has reduced the desired current annual rate of growth of the exchange rate from 2.8% in September 2003 to 1.75% in April 2004.

By reducing the balance of foreign currency swaps, adjusting the mandatory reserve instrument in line with ECB standards and removing all restrictions on foreign exchange lending, the Bank of Slovenia has prepared the conditions for ERM II. Since October 2003 the Bank of Slovenia has enabled the banks to sell outright not only foreign currency from 270-day foreign currency swaps but also part of the foreign currency from 7-day foreign currency swaps. As a result, from October 2003 to the end of March 2004 the banks sold SIT 248.0 billion worth of foreign currency outright to the Bank of Slovenia, while the balance of foreign currency swaps (270-day and 7-day) fell by SIT 238.4 billion. The 270-day foreign currency swaps were released outright in December. At the end of March the balance of 7-day foreign currency swaps was SIT 385.8 billion, which was already lower than the balance of tolar-denominated central bank bills.

Figure 3.2: Excess supply of foreign currency on foreign exchange markets



Source: Bank of Slovenia

3.3. Bank of Slovenia activities since October 2003

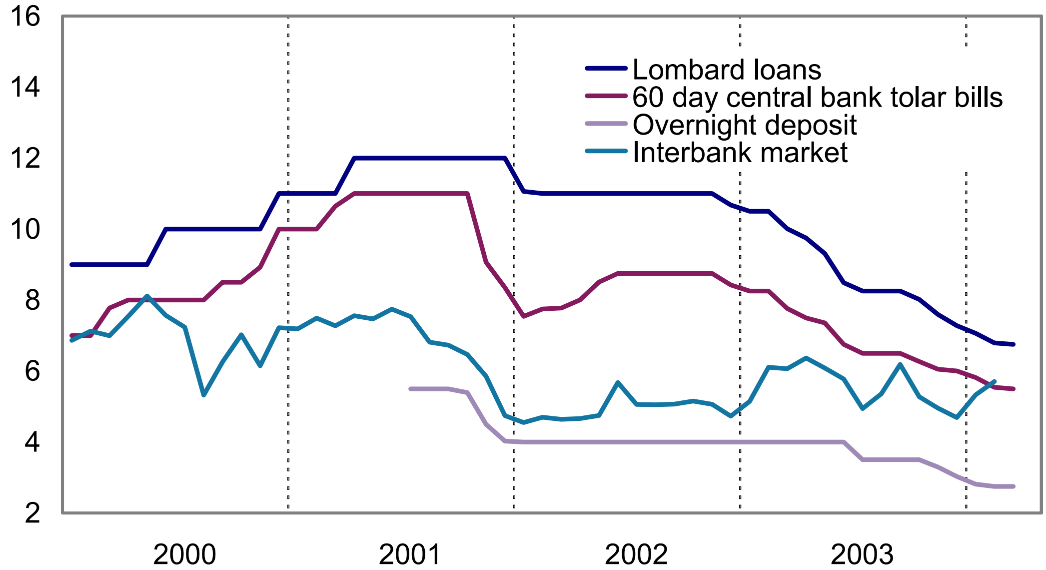
Since the end of 2003 the Bank of Slovenia has lowered the interest rates on its instruments several times. During this period the interest rates have been lowered on:

- refinancing at the Bank of Slovenia from 5.5% to 4.25% (1.25 percentage point cut),
- placements with the Bank of Slovenia from 4.0% to 2.75% (1.25 percentage point cut),
- 7-day foreign currency swaps from 3.5% to 2.25% (1.25 percentage point cut),
- 7-day reverse foreign currency swaps from 3.0% to 1.75% (1.25 percentage point cut),
- lombard loans from 8.25% to 6.25% (2 percentage point cut),
- 60-day tolar-denominated central bank bills from 6.5% to 4.75% (1.75 percentage point cut),
- 270-day tolar-denominated central bank bills from 7.5% to 5.0% (2.5 percentage point cut),
- overnight deposits from 3.5% to 2.5% (1 percentage point cut).

The Bank of Slovenia reduced the interest rates on its instruments because of the sustained fall in inflation and inflationary expectations. Between September 2003 and

March 2004 inflation fell from 5.0% to 3.5%. As nominal interest rates have been decreased, real interest rates have remained at a suitably high level between 1% and 2%.

Figure: 3.3: Bank of Slovenia interest rates



Source: Bank of Slovenia

At the same time as lowering interest rates the Bank of Slovenia has gradually reduced the desired rate of growth of the exchange rate and thereby closed the interest rate parity. Between September 2003 and April 2004 the desired rate of growth of the exchange rate fell from 2.8% to 1.75%. The reduction in the rate of growth was achieved with the aid of exchange rate intervention to signal the desired rate of growth (2.5% in November, 2.25% in January, 2.0% in February and 1.75% in April). When it cut interest rates the Bank of Slovenia did not always simultaneously lower the desired rate of growth of the exchange rate. In this way it closed the interest parity, bringing it into line with the reduction in the risk premium. The Bank thus closed the interest parity in October 2003 and in March and April 2004 with a bigger reduction of interest rates than the exchange rate. By lowering the price of foreign currency swaps the Bank of Slovenia reduced the cost to banks of acquiring tolar liquidity by means of temporary monetisation, as the difference between the price of foreign currency swaps and the desired rate of growth of the exchange rate was cut from 0.7 to 0.5 percentage points.

The interest rate on 270-day tolar-denominated central bank bills (TCBBs) was cut by 0.75 percentage points more than the interest rate on 60-day TCBBs. With this bigger reduction in interest rates on longer maturity central bank bills the Bank of Slovenia adjusted the slope of the yield curve to conditions on the market and attempted to limit the balance of

270-day TCBBs, which at the end of February already made up almost 90% of all TCBBs. The Bank additionally restricted subscriptions to 270-day TCBBs to the balance of foreign currency swaps at the central bank.

Table 3.1: Closing uncovered interest parity

	Change				Level			
month	**TCBB 60 day**	**swap rate**	**signalled ER dynamics**	**ECB refi rate**	**TCBB 60 day**	**swap rate**	**signalled ER dynamics**	**ECB refi rate**
	Application of principle of uncovered interest rate parity in 2002							
January					7.5	5.0	4.0	3.25
January	0.25	0	0	0	7.75	5.0	4.0	3.25
March	0.25	0	0	0	8.0	5.0	4.0	3.25
April	0.25	-0.25	-0.25	0	8.25	4.75	3.75	3.25
May	0.5	0	0	0	8.75	4.75	3.75	3.25
December	-0.5	-0.25	-0.25	-0.5	8.25	4.5	3.5	2.75
	Application of principle of uncovered interest rate parity in 2003							
March	-0.75	-0.5	-0.5	-0.25	7.5	4.0	3.0	2.5
Maj	-0.25	0	0	0	7.25	4.0	3.0	2.5
June	-0.75	-0.5	-0.2	-0.5	6.5	3.5	2.8	2.0
October	-0.25	0	0	0	6.25	3.5	2.8	2.0
November	-0.25	-0.5	-0.3	0	6.0	3.0	2.5	2.0
	Application of principle of uncovered interest rate parity in 2004							
January	-0.25	-0.25	-0.25	0	5.75	2.75	2.25	2.0
February	-0.25	-0.25	-0.25	0	5.5	2.5	2.0	2.0
March	-0.25	0	0	0	5.25	2.5	2.0	2.0
April	-0.50	-0.25	-0.25	0	4.75	2.25	1.75	2.0

Source: Bank of Slovenia

The release of liquidity from 360-day TCBBs in the last quarter of 2003 was not neutralised with a new issue of 360-day TCBBs but through special issues of 270-day TCBBs. The Bank issued 360-day TCBBs in order to sterilise the surplus of liquidity, stemming from strong financial inflows at the end of 2002. With special offers of 270-day TCBBs, the interest rate on which was set at the level of the auction interest rate in the ordinary offers, it largely neutralised the effects of the maturing of the 360-day TCBBs. From October to December a total of SIT 220 billion in 360-day TCBBs fell due for payment, but SIT 173 billion in surplus liquidity was absorbed through the special offers of 270-day TCBBs. The Bank of Slovenia spread the maturity of these instruments over eight to ten months in order to achieve a more balanced maturing of liquidity and easier sterilisation in 2004.

In the first few months of 2004 the Bank of Slovenia has responded actively to the tougher liquidity conditions. This has been reflected in an increase in interbank interest rates and an increased demand for Bank of Slovenia loans. The reasons for the poorer liquidity were:

- smaller than expected balance of payments inflows, and therefore modest foreign currency surpluses for the banks to sell to the Bank of Slovenia,
- relatively small volumes of tolar-denominated central bank bills maturing.

As a result, the Bank of Slovenia actively adjusted the auction quotas and the interest rates for 7-day repo bills and the auction quotas for 270-day TCBBs in line with the market conditions. The low level of interest at the daily auctions for 7-day repos meant this instrument was temporarily withdrawn at the start of January. But it was reactivated at the end of January when the liquidity situation deteriorated. The interest rate on the 7-day repo bills reflects conditions in the market and is set between the rate on lombard loans and the rate on 60-day TCBBs. Since 15 March 2004 the quota volumes have no longer been restricted. In addition, the Bank of Slovenia lowered the interest rate on 270-day TCBBs twice (by 0.75 percentage points) and the interest rate on 60-day TCBBs once (by 0.25 percentage points) in March. These measures reduced the opportunity cost of holding surplus liquidity and consequently improved the liquidity situation.

Box 3.1: **Chronology of monetary actions by the Bank of Slovenia during 2003 and 2004**

13 January 2003

- The Bank of Slovenia passes a decision to stop issuing 360-day TCBBs.

29 January 2003

- The offer of temporary purchase of central bank bills in foreign currency with compulsory repurchase after two months is temporarily withdrawn.

12 March 2003

- The Bank of Slovenia lowers the rate of growth of the intervention exchange rate from 3.5% to 3.0%. The interest rate on refinancing at the Bank of Slovenia is lowered from 7.25% to 6.75% and the interest rate on placements with the Bank of Slovenia from 5.25% to 5.00%. The price of temporary purchase of foreign exchange from banks is also reduced from 4.5% to 4.0% and the price of temporary sale of foreign exchange from 2.5% to 2.0%. The Bank of Slovenia lowers the interest rate on 60-day TCBBs from 8.25% to 7.50%, on 270-day TCBBs from 9.5% to 8.75%, on 7-day repo foreign currency central bank bills to 8.25% and the lombard rate to 9.75%.

25 March 2003

- The Bank of Slovenia ends its intervention in the foreign currency market through the setting of the rate of growth of the intervention exchange rate.

3 – 7 April 2003

- Reacting to interest parity considerations, the Bank of Slovenia intervenes in the foreign currency market by setting the rate of growth of the intervention exchange rate.

14 May 2003

- The Bank of Slovenia lowers both the deposit rates and lending rates on its instruments. On the deposit side the interest rate on 60-day tolar-denominated central bank bills is cut from 7.50% to 7.25%, and on 270-day tolar-denominated central bank bills from 8.75% to 8.25%. On the lending side the interest rate for temporary purchase of central bank bills in foreign currency is cut from 8.25% to 8.0% and on lombard loans from 9.75% to 9.0%.

11 June 2003

- The Bank of Slovenia again lowers both the lending and deposit rates on its instruments. The interest rate on lombard loans is cut from 9.0% to 8.25%, and for temporary purchase of central bank bills in foreign currency from 8.0% to 7.25%. The interest rate on 60-day TCBBs is also cut from 7.25% to 6.50% and on 270-day TCBBs from 8.25% to 7.50%. Interest rate on temporary purchase of foreign currency is lowered from 4.00% to 3.50%. These interest rate adjustments reduce the gap between domestic and foreign interest rates by 0.25 percentage points.

30 June 2003

- The Governing Board of the Bank of Slovenia amends its resolution on the minimum liquidity levels for commercial banks, the purpose of which is to allow the banks more effectively to use domestic foreign currency sources for lending to businesses.

1 July 2003

- The Bank of Slovenia cuts the interest rate on overnight deposits with the central bank from 4.0% to 3.5%.

9 – 23 July 2003

- The Bank of Slovenia intervenes in the foreign currency market by reducing the rate of growth of the intervention exchange rate.

26 – 28 August 2003

- By intervening in the foreign exchange market the Bank of Slovenia lowers the exchange rate but leaves the rate of growth of the intervention exchange rate unchanged.

August 2003

- The Bank of Slovenia purchases SIT 15.0 billion in foreign currency outright from banks.

September 2003

- The Bank of Slovenia purchases SIT 15.0 billion in foreign currency outright from banks.

3 October 2003

- The Bank of Slovenia lowers the interest rate on 60-day TCBBs from 6.50% to 6.25%, on 270-day TCBBs from 7.50% to 7.25%, for temporary purchase of foreign currency central bank bills from 7.25% to 7.0% and for lombard loans from 8.25% to 8.0%.

24 October 2003

- The Bank of Slovenia lowers the price of foreign currency swaps from 3.5% to 3.25% and of reverse foreign currency swaps from 2.0% to 1.75%.
- The Bank of Slovenia abolishes the restrictions on foreign currency lending introduced in May 2000.

October 2003

The Bank of Slovenia purchases SIT 18.1 billion in foreign currency outright from banks.

7 November 2003

- The Bank of Slovenia reduces the price of foreign currency swaps from 3.25% to 3.0%, and of reverse foreign currency swaps from 1.75% to 1.5%. The interest rate on 60-day TCBBs is cut from 6.25% to 6.0%, on 270-day TCBBs from 7.25% to 7.0%, on 7-day repos from 7.0% to 6.75%, on overnight deposits from 3.5% to 3.25%, and on lombard loans from 8.0% to 7.5%.

10 – 11 November 2003

- The Bank of Slovenia intervenes in the foreign exchange market to lower the rate of growth of the exchange rate from 2.8% to 2.5%.

November 2003

- The Bank of Slovenia purchases SIT 88.4 billion in foreign currency outright from banks.

5 December 2003

- The Bank of Slovenia lowers the interest rate on 270-day TCBBs from 7.0% to 6.75%, on overnight deposits from 3.25% to 3.0% and on lombard loans from 7.5% to 7.25%.

December 2003

- The Bank of Slovenia purchases SIT 22.6 billion in foreign currency outright from banks.

9 January 2004

- The Bank of Slovenia reduces the price of foreign currency swaps from 3.0% to 2.75%, and of reverse foreign currency swaps from 1.5% to 1.25%. The interest rate on 60-day TCBBs is cut from 6.0% to 5.75%, on 270-day TCBBs from 6.75% to 6.5%, on overnight deposits from 3.0% to 2.75%, and on lombard loans from 7.25% to 7.0%.
- The Bank of Slovenia continues to bring its compulsory reserve instrument into line with the ECB system.
- The Bank of Slovenia temporarily withdraws the offer of a 7-day repo as there has been no demand for it for some time. The option is left open to reactivate the instrument if needed.

12 – 16 January 2004

- The Bank of Slovenia intervenes in the foreign currency market to lower the rate of growth of the exchange rate from 2.5% to 2.25%.

6 February 2004

- The Bank of Slovenia reduces the price of foreign currency swaps from 2.75% to 2.5%, and of reverse foreign currency swaps from 1.25% to 1.0%. The interest rate on 60-day TCBBs is cut from 5.75% to 5.5%, on 270-day TCBBs from 6.5% to 6.25%, and on lombard loans from 7.0% to 6.75%.

9 – 10 February 2004

- The Bank of Slovenia intervenes in the foreign currency market to lower the rate of growth of the exchange rate from 2.25% to 2.0%.

February 2004

- The Bank of Slovenia purchases SIT 52.3 billion in foreign currency outright from banks.

5 March 2004

- The Bank of Slovenia lowers the interest rate on 270-day TCBBs from 6.25% to 5.75%.

18 March 2004

- The Bank of Slovenia lowers the interest rate on 270-day TCBBs from 5.75% to 5.5%, and on 60-day TCBBs from 5.5% to 5.25%.

2 April 2004

- The Bank of Slovenia reduces the price of foreign currency swaps from 2.5% to 2.25%, and of reverse foreign currency swaps from 1.0% to 0.75%. The interest rate on 60-day TCBBs is cut from 5.25% to 4.75%, on 270-day TCBBs from 5.5% to 5.0%, on lombard loans from 6.75% to 6.25%, and on overnight deposits from 2.75% to 2.5%.

7 – 8 April 2004

- The Bank of Slovenia intervenes in the foreign currency market to lower the rate of growth of the exchange rate from 2.0% to 1.75%.

4. ECONOMIC PROJECTIONS TO THE END OF 2006[4]

Economic growth is expected to pick up this year. GDP growth in 2004 will be around 3.1%, and with a global economic recovery and relatively strong domestic demand it will increase gradually until 2006. The decline in inflation rates will continue. By the end of 2005 price growth will stabilise at a level below 3%. Forecasts indicate a rate of price growth of around 3.2% at the end of this year, 2.8% at the end of 2005 and then remaining at approximately the same level in 2006.

The first section of this chapter presents the anticipated trends in selected variables in the international environment. This is followed by an account of the projections of economic activity, employment and wages. The third section shows the trend in domestic demand broken down by expenditure components. The external balance and conditions of financing are analysed in sections four and five. The final section presents forecast price movements. A summary of the forecasts and a comparison with the October 2003 estimates are presented in Table 4.8 at the end of the economic projections.

4.1 International environment

The global economy is expected to strengthen this year, but oil and commodity prices will remain at relatively high levels. Expectations regarding economic growth in the euro area have been quite optimistic in recent months. Despite the strength of the euro, export activity is expected to be the main impetus behind economic growth. Domestic consumption in the euro area will pick up somewhat more slowly, mainly as a result of the unfavourable labour market conditions. The slowness of the global economic recovery means that no substantial demand-side price pressures from abroad are anticipated. Although oil and commodity prices are currently high in US dollar terms, the weakness of the dollar means they are not pushing up import prices. Moreover, these prices are expected to come down gradually. Supply-side factors (particularly geopolitical tensions in the commodity producing countries and restrictions on oil production quotas), which are adding to effect of already strong demand for commodities in causing high commodity and oil prices, will continue to

[4] The forecasts were made on the basis of data available as of 15 March 2004 and the statistical methodologies then in force. The projections of macroeconomic factors contained in this section rest on assumptions about the movement of international economic variables and on certain domestic factors that are linked to economic policy decisions. Domestic factors that are influenced by economic policy and exogenously included in the forecasting exercise include the exchange rate of the domestic currency, government spending and investment, public sector wages, administered price inflation and other variables of a fiscal nature.

represent the most important source of risk as far as a substantial increase in inflationary pressures from abroad is concerned.

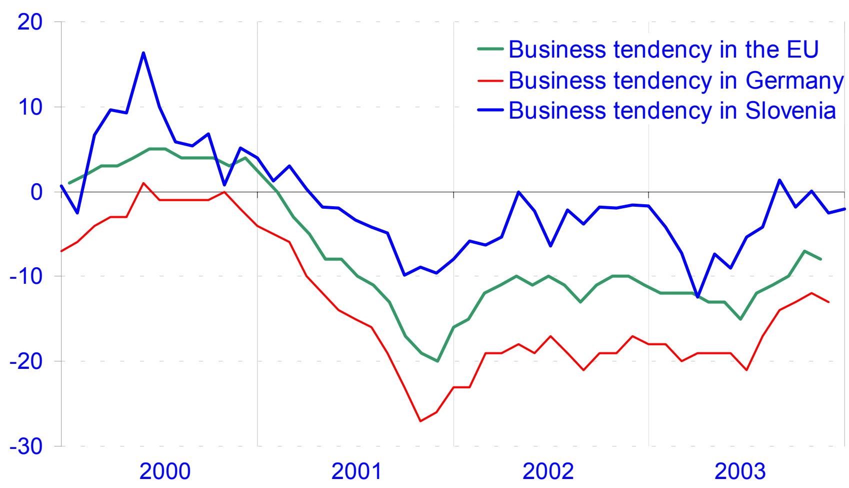
Table 4.1: Exogenous variables in the international environment

					2004			2005			2006	
				Oct	Apr		Oct	Apr		Oct	Apr	
	2001	2002	2003	03	04	chg.	03	04	chg.	03	04	chg.
Foreign demand	4.5	2.7	2.6	6.0	4.7	-1.3	6.0	5.6	-0.4	…	5.6	…
USD/EUR	0.90	0.94	1.13	1.10	1.26	0.16	1.10	1.26	0.16	…	1.26	…
Oil USD/barrel	24.4	25.0	28.8	27.0	29.0	2.0	27.0	27.0	0.0	…	26.0	…
Commodities	-6.5	4.6	11.3	3.0	10.0	7.0	3.0	3.0	0.0	…	3.0	…
Inflation in EMU	2.6	2.2	2.1	2.0	1.8	-0.2	2.0	1.7	-0.3	…	1.7	…
PPI Germany	1.3	-0.3	1.7	0.6	0.6	0.0	0.6	1.2	0.6	…	1.2	…
EURIBOR 3m	4.3	3.3	2.3	2.4	2.4	0.0	3.0	2.6	-0.4	…	2.9	…

Note: Foreign institutions have not yet published their 2006 forecasts for most of the variables presented in the table. Therefore for these variables we have mostly assumed the same values as the forecasts for 2005.

Source: Consensus Forecasts, JP Morgan, OECD Economic Outlook, IMF World Economic Outlook, International Petroleum Exchange London; calculations by Analysis and Research Department

Figure 4.1: Business tendency abroad and in Slovenia

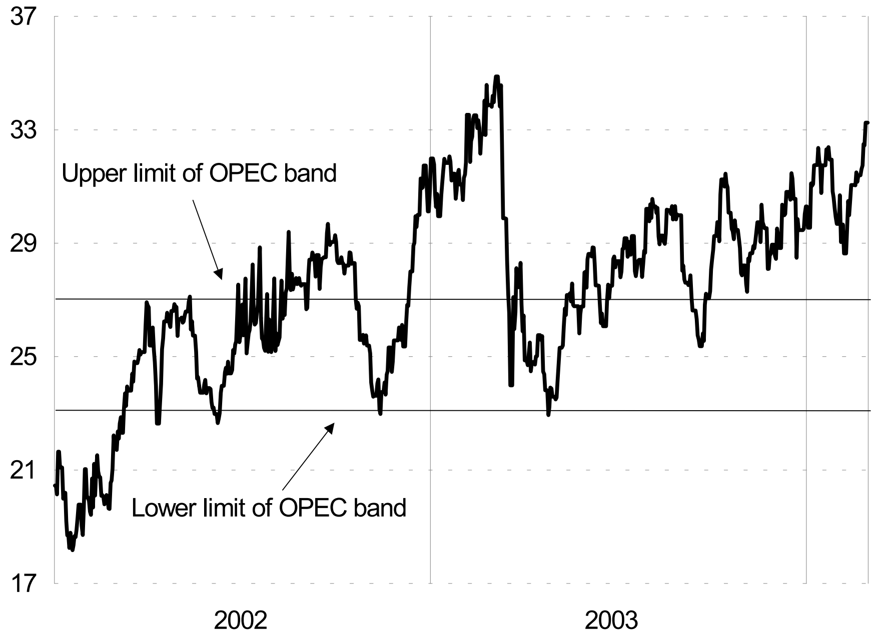


Source: Statistical Office of the Republic of Slovenia

Foreign demand will increase this year and next year. Evidence of this trend comes from the confidence indicators in Slovenia’s most important trading partners over the last few months (at their highest level for two years) and the slight recovery in economic growth in late 2003 and early 2004. In spite of the strong euro, economic growth in the euro area countries is expected to be based primarily on increased exports this year as a result of rapid growth in other parts of the global economy. Domestic demand in the euro area will also be boosted by increased purchasing power stemming from the appreciation of the euro, although uncertainties in the labour market will ensure that it remains relatively modest. Consequently, economic growth will continue to be considerably lower in Europe than in the United States and Asia. Somewhat more restrained demand from the countries of eastern and south-eastern Europe than in previous years is expected, as they set about tackling their fiscal imbalances and large current account deficits.

An assumption that in the next three years the euro will be worth USD 1.26 was used in our projections. Analysts put the long-term equilibrium value of the euro at approximately USD 1.26, which is the same as its average value against the dollar in the first two months of 2004. We have used this level, almost 15% higher than the value of the euro in the previous forecasts, as a technical assumption of exchange rate levels over the entire period of the projections.

Figure 4.2: Changes in oil prices in the period January 2002 – February 2004 (Brent oil, USD/barrel)



Source: Reuters

An average oil price will amount to USD 29 a barrel this year and will then fall gradually. Current trends reflect not only the increased demand, the weakness of the dollar and the low levels of oil stocks, but also a determination on the part of OPEC members to persist with low levels of output on the supply side. Gradual growth in the world economy and the strong likelihood that because of low utilisation of production capacities in Iraq, OPEC will no longer be as successful as it has been in recent months in controlling production, will contribute to the anticipated gradual fall in oil prices towards the middle of the target band. In addition, non-members of OPEC are expected to increase production strongly. Concluded contracts indicate that the gradual fall in oil prices will continue in 2005. We anticipate oil prices falling in 2006 too, although remaining in the upper half of the OPEC band.

Commodity price growth in 2004 will be around 10% and is not expected to decline until 2005 and 2006. After a brief dip in the middle of 2003 the growth in commodity prices in dollars climbed to nearly 20% at the end of last year and in the early part of this year. In the last six months the fastest rise has been recorded in metal prices. These trends are principally a reflection of the weak dollar, strong demand for commodities from China and the recovery in the global economy. Consequently, we expect the growth in commodity prices to continue in 2005, although at a slower rate than in the last year and a half.

Euro area inflation has been below 2% in the most recent period. We expect the rate of consumer price growth to remain below the ECB target value (2%) in the coming period. The major contributory factors will be the higher value of the euro, which will counter the effects of higher energy and commodity prices, and increases in certain indirect taxes that have been announced for this year. The slowness of the economic recovery means that demand-side inflationary pressures are not expected. German producer price forecasts for 2004 by foreign institutions are unchanged from the assumptions in the autumn forecasts. The strong euro will continue to compensate for high prices of energy products and other commodities in 2004, but in 2005 producer prices will grow somewhat more appreciably.

Euro interest rates will rise only slowly. Interest rates for euros began rising slightly in the summer of 2003 but the trend stopped at the end of the year. Over the very short run analysts are even expecting a reduction in ECB interest rates. But looking ahead to early 2005, interest rates are expected to rise by around a quarter of a percentage point, primarily on account of the economic recovery and despite the relatively low price growth. The same level of increase is also expected in 2006.

4.2 Activity, employment and wages

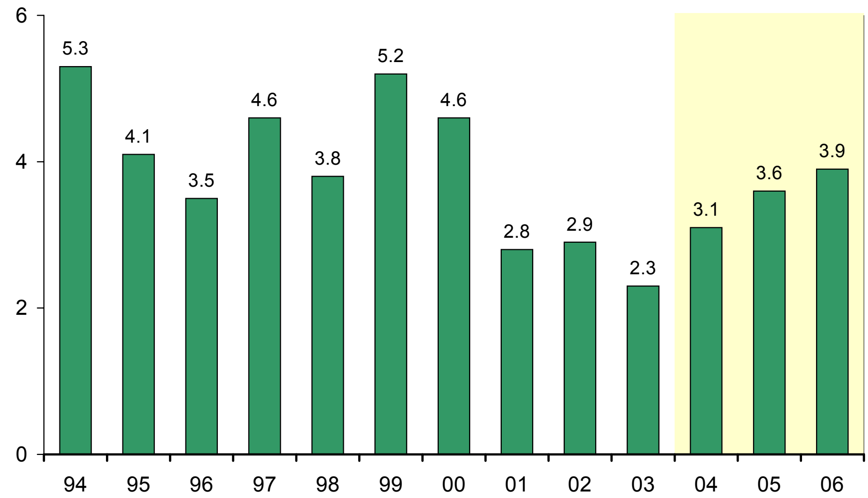
Economic activity in Slovenia will strengthen in the period to 2006. Despite the low level of economic growth in 2003 the GDP growth estimates are more or less unchanged from the previous forecasts. There are, however, changes compared to the previous forecasts in the determinants of economic growth. In 2004 domestic economic activity will grow somewhat faster than last year. According to our projections GDP growth will amount to around 3.1%. In the context of a gradual recovery abroad and a relatively high level of domestic consumption, the rate of growth of economic activity will gradually pick up to around 4% by 2006. This will continue the process of real convergence towards the EU average as economic growth in Slovenia will be faster than in the EU.

Table 4.2: Economic activity, employment and wages

				Forecast			2004			2005			2006		
							Forecasts			Forecasts			Forecasts		
	2001	2002	2003	2004	2005	2006	previous	new	chg.	previous	new	chg.	previous	new	chg.
	annual percentage change in real terms unless indicated														
Real GDP	2.8	2.9	2.3	3.1	3.6	3.9	3.2	3.1	-0.1	3.6	3.6	0.0	…	3.9	…
GDP per capita (EUR)	10,801	11,508	12,052	12,491	13,304	14,215	12,765	12,491	-274	13,595	13,304	-291	…	14,215	…
Employment	1.0	0.4	-0.4	0.4	0.5	0.8	0.1	0.4	0.3	0.1	0.5	0.4	…	0.8	…
Net wages	3.1	2.1	2.2	1.8	2.3	2.1	2.3	1.8	-0.5	2.3	2.3	0.0	…	2.1	…
Productivity	1.8	2.5	2.7	2.7	3.1	3.1	3.1	2.7	-0.4	3.4	3.1	-0.3	…	3.1	…

Source: Analysis and Research Department

Figure 4.3: Economic activity (real annual percentage growth of GDP)



Source: Analysis and Research Department

We anticipate somewhat more favourable trends on the labour market in line with the improvement in economic conditions. Weakness in the economy contributed significantly to the tougher labour market conditions in 2003. In our employment forecasts for future years we have assumed a gradual recovery of economic growth, but also increased competition potentially giving rise to difficulties, particularly in labour intensive activities, in the period following entry into the European Union. It is these difficulties that represent the biggest source of risk in relation to the forecast employment trends in the private sector. The plans for public sector employment envisage a relatively high level of employment growth primarily on account of increased needs in the context of setting up a Schengen border and Nato membership.

We anticipate restrained wage growth in coming years. Real wages will rise at around 2% a year, which is less than anticipated productivity growth. This will largely be due to the anticipated low level of public sector wage growth. Based on the agreement concerning the adjustment of basic wages in the public sector, which takes into account anticipated price growth in Slovenia and in the EU and the growth in the tolar/euro exchange rate, we believe that real wage growth in the public sector will not exceed 0.5% in 2004, and in 2005 will not significantly exceed 1%. Although a wage adjustment mechanism has yet to be agreed between the private sector unions and employers, we believe the relatively subdued economy will keep wage growth low in the private sector too, and not significantly exceeding 2%. If the method used to adjust basic wages in the private sector were to differ substantially from the agreed method for the public sector it would mean deviating from the implementation of a restrictive incomes policy and represent a risk to both domestic consumption forecasts and price trend forecasts.

Box 4.1: **Wage adjustment mechanism for the public sector**

In July 2003 the social partners in the public sector adopted an agreement relating to the adjusting of basic wages and to the amount of the bonus for 2004 and 2005. An important difference in this agreement compared to previous agreements is the transition to wage adjustment in line with the anticipated values of macroeconomic variables.

Basic wage increases in 2004 and 2005 will take into account the anticipated growth in consumer prices in Slovenia excluding alcoholic beverages and tobacco (a weight of 52% in both years), the anticipated growth in consumer prices in the EU (a weight of 38% in 2004 and 48% in 2005), and the anticipated growth in the SIT/EUR exchange rate (10%; 0%). Based on the anticipated growth in these variables the increase in basic wages will be 3.1% in 2004 and 3.0% in 2005. The size of the agreed increase in 2005 though will depend on whether there are any changes in the forecasts of the variables used at the end of September 2004. Basic wages will be adjusted by half of the anticipated adjustment, while the other half will be allocated to removal of disparities in basic wages. If the outturn values for the variables used in the adjustment deviate up or down from the anticipated values, basic wages will be readjusted to take account of the difference in January 2005 and/or January 2006.

4.3 Components of GDP expenditure

In the next few years domestic consumption will remain the most important factor determining economic growth, while the negative contribution of foreign trade will shrink. Although economic growth in 2003 was modest, domestic consumption had already picked up. The main reason for the low GDP growth was the negative contribution of foreign trade. Household consumption and investment spending each contributed a little over two-fifths of the increase in domestic consumption. We believe the sources of economic growth will remain relatively unchanged in the next few years. Household consumption is expected to strengthen somewhat while the negative contribution to domestic economic growth made by foreign trade is expected to fall gradually. We have revised upwards the projected trend in household consumption primarily in view of movements at the end of last year. The general government expenditure forecast has similarly been revised upwards.

Table 4.3: Components of demand

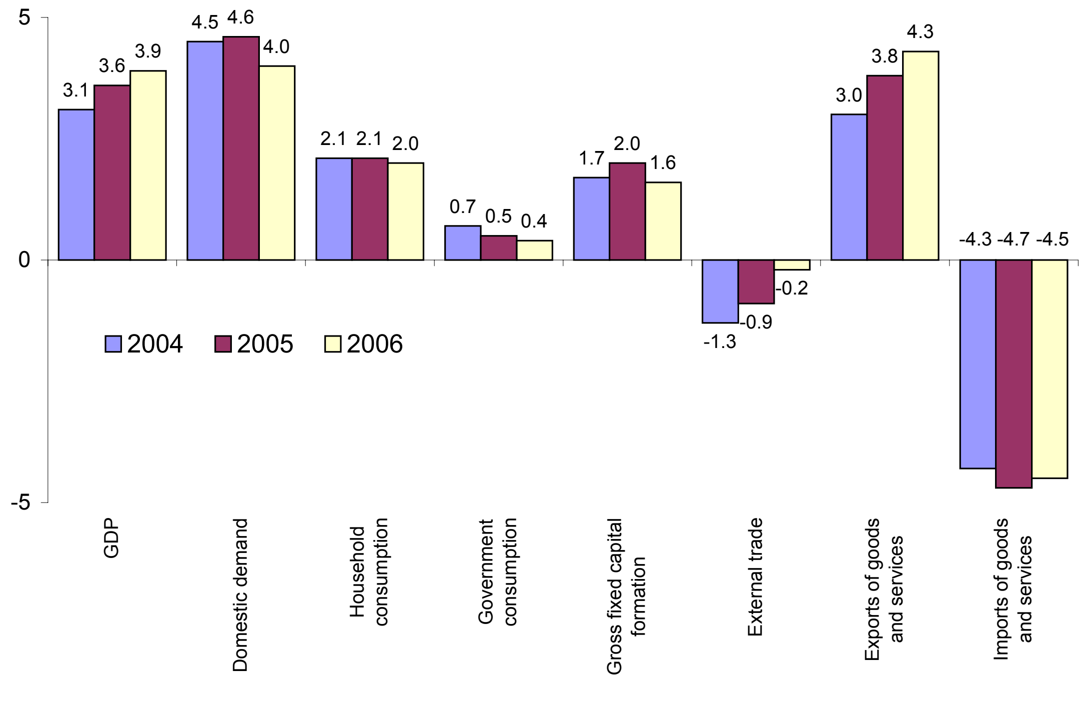
				Forecast			2004			2005			2006		
							Forecast			Forecast			Forecast		
	2001	2002	2003	2004	2005	2006	previous	new	chg.	previous	new	chg.	previous	new	chg.
	real annual percentage change														
Gross domestic product	2.8	2.9	2.3	3.1	3.6	3.9	3.2	3.1	-0.1	3.6	3.6	0.0	…	3.9	…
Domestic demand	0.9	2.1	3.9	4.4	4.4	3.9	3.8	4.4	0.6	3.6	4.4	0.8	…	3.9	…
Household consumption	2.3	1.2	3.0	3.7	3.8	3.6	3.1	3.7	0.6	2.9	3.8	0.9	…	3.6	…
Government consumption	4.0	2.5	2.8	3.4	2.4	2.2	2.8	3.4	0.6	2.7	2.4	-0.3	…	2.2	…
Gross fixed capital formation	-4.6	4.1	7.0	6.3	7.3	5.5	6.1	6.3	0.2	5.7	7.3	1.6	…	5.5	…
Exports of goods and services	6.5	6.5	3.4	4.6	6.0	6.7	4.1	4.9	0.8	4.2	6.0	1.8	…	6.7	…
Imports of goods and services	3.0	4.9	6.3	6.7	7.2	6.5	5.1	6.7	1.6	4.2	7.2	3.0	…	6.5	…

Source: Analysis and Research Department

Household consumption will be higher than in certain previous years but will not deviate from the long-term average. Household consumption was rising throughout 2003, following a number of years in which spending by households remained at a low level. The growth rate was highest at the end of the year. We believe the main cause of the rise in household consumption over the next few years will be the anticipated reduction in interest rates as part of a nominal convergence and real appreciation of the tolar increasing residents' purchasing power. We have revised upwards our earlier forecasts of household consumption by 0.6 percentage points for 2004 and 0.9 percentage points for 2005. A demand outburst will be prevented by restrained growth in wages and disposable income, which will be around 2% in real terms. Uncertainties in relation to the household consumption forecasts relate principally to risks associated with private sector employment trends, which could be less favourable than our projections as a result of increased competition after Slovenia becomes a member of the EU. The effects of tax reforms aimed at reducing the burden on labour and increasing the burden on capital, which could potentially lead to increased consumption in the future, remain uncertain. Lower tax burden on labour will predominantly ease the burden of the lowest earners who have a high marginal propensity to consume. On the other hand, increasing the burden on capital could trigger, depending on the motivation for saving, not only an outflow of bank deposits abroad or into the securities market but also a substitution of bank deposits by consumption.

Investment expenditure will result from strong private and government sector investment. Investment spending was one of the main factors driving economic growth in 2003. Growth in inventories contributed a little over one-quarter of the growth in investment spending, but certain one-off items also had an important impact in boosting investment. The incidental nature of these events, however, means we cannot apply them to our forecasts. Investment growth in 2004 will therefore be a little lower than in 2003. Last year's strong growth in inventories represents a significant source of uncertainty in relation to the investment spending forecasts because the extent to which movements in inventories will affect investment spending depends on the reasons why they were accumulated in the private sector – low costs of finance and weakness in the economy. Nevertheless, we believe that strong investment activity in 2004 and 2005 will be encouraged by improved signals from abroad, favourable conditions of financing at home and abroad, and, particularly in 2004, by strong government activity in the construction of infrastructure.

Figure 4.4: Contribution of individual components to GDP growth in the period 2004 – 2006 (percentage points)



Source: Analysis and Research Department

General government expenditure will remain relatively restrained. After a strong first half of 2003, general government spending declined in the second half of the year. In the forecasts for 2004 we have taken into account the public sector wage agreement, which will act as a constraint on expenditure, but we also anticipate relatively slow growth in spending on goods and services. Our forecasts do not include the effects of the health reforms in the form of increased revenues and expenditures that were taken into account in the budget documents for 2005. Consequently, the volume of government expenditure in 2005 is relatively small.

4.4 Balance of payments

The current account will be in deficit over the next few years. In 2003 the current account balance deteriorated by more than EUR 300 million, or 1.4% of GDP. The main reasons for this decline were increased domestic demand reflected in stronger imports along with weak foreign demand causing weak exports. Despite the recovery in foreign economic activity, rising exports in the coming years will not wholly compensate for increased imports resulting from the growth of domestic expenditures. Thus the biggest contribution to the deterioration in the current account balance will come from the increased deficit in goods trade. The terms of trade will have a positive effect on the current account balance.

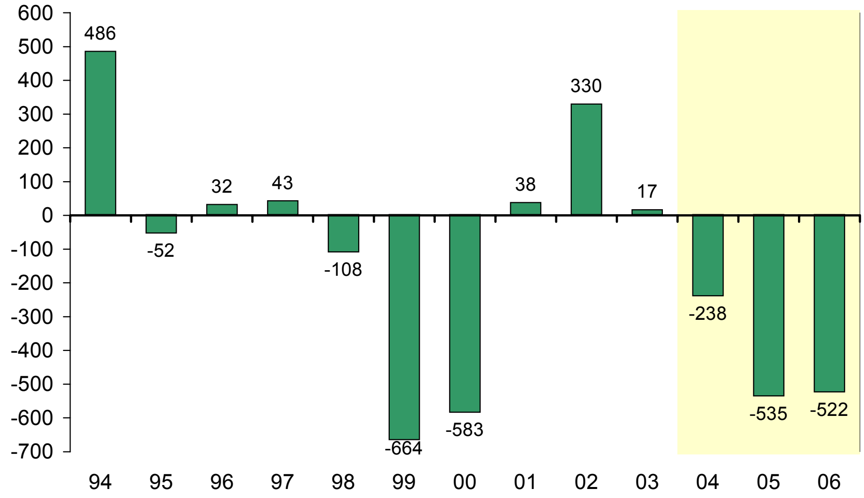
Table 4.4: Balance of payments current account

				Forecast			2004			2005			2006		
							Forecast			Forecast			Forecast		
	2001	2002	2003	2004	2005	2006	previous	new	chg.	previous	new	chg.	previous	new	chg.
Exp. of goods and services	6.5	6.5	3.4	4.9	6.0	6.7	4.1	4.9	0.8	4.2	6.0	1.8	…	6.7	…
Imp. of goods and services	3.0	4.9	6.3	6.7	7.2	6.5	5.1	6.7	1.6	4.2	7.2	3.0	…	6.5	…
Current account: EURm	38	330	17	-238	-534	-522	-204	-238	-34	-294	-534	-240	…	-522	…
as % of GDP	0.2	1.5	0.1	-1.0	-2.0	-1.8	-0.7	-1.0	-0.3	-1.0	-2.0	-1.0	…	-1.8	…
Terms of trade	2.7	2.7	0.2	0.6	1.0	0.0	0.3	0.6	0.3	0.1	1.0	0.9	…	0.0	…

Source: Analysis and Research Department

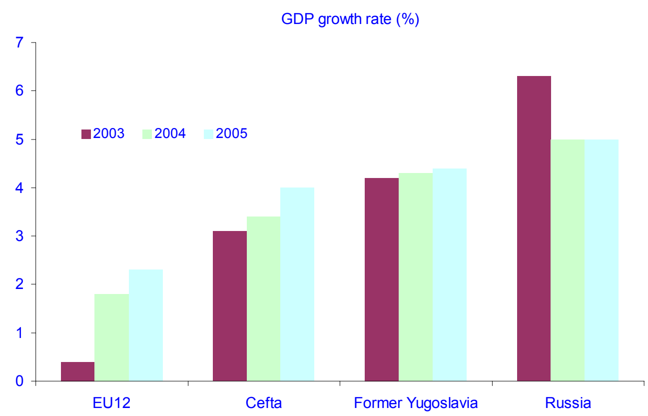
The deficit in current account transactions will grow to around 2% of GDP in 2005. The basic difference compared to the previous forecast stems from the increased imports of goods and the reduction in the volume of transfers received. Increased imports stem from the revised estimate of domestic demand, while lower transfers from abroad result from a less optimistic assumption concerning inflows from the EU. The equilibrium in the current account recorded in 2003 will become a deficit of around EUR 250 million this year. We anticipate a further deterioration in the current account balance in 2005, when the deficit will reach a little over EUR 500 million, or 2% of GDP. An improvement is not expected until 2006, when the current account deficit will fall to around 1.8% of GDP as export growth outpaces import growth.

Figure 4.5: Balance of payments current account (EUR m)



Source: Analysis and Research Department

The biggest contribution to the deterioration in the current account balance compared to last year will come from the increased deficit in trade in goods. Goods exports will pick up in line with increased foreign demand, while increased imports will be associated with the strengthening of domestic consumption. Growth in goods exports will be higher than previously forecast despite a lowering of the assumption regarding growth in foreign demand. The biggest contributions to this came from the increased rate of growth in the volume of goods exports at the end of last year and the slightly improved, although still fairly uncertain, expectations regarding exports, or export orders. Aside from this uncertainty, the most important risks relating to the movement in export volumes are associated with:



- the rate of recovery in Slovenia's most important trading partners;
- the scale of the deterioration in competitiveness of Slovenian exporters resulting from the introduction of customs duties and the cancellation of existing favourable free trade agreements with countries of the former Yugoslavia;
- the real appreciation of the tolar, which will have an unfavourable impact on the competitiveness of exporters.

The main contribution to the deficit in trade in goods will come from increased imports of capital goods and consumption goods. Growth in import volumes will be somewhat smaller than in 2003 owing mainly to the expected absence of certain one-off shocks that occurred last year. Nevertheless, all components of goods imports will rise compared to the previous forecasts. The rise in imports of intermediate goods is related to the increase in exports, while imports of capital goods and consumption goods will grow in line with the expected increase in domestic consumption. This will be helped not only by the cutting of interest rates and the changes envisaged in the tax reforms but also by a real appreciation of the tolar, which will increase Slovenian consumers' purchasing power abroad. The basic uncertainty regarding the forecast import volume trend relates to the size of the increase in domestic consumption, which given the anticipated changes in price factors (interest rates and the exchange rate), is linked to the decision by economic agents as to whether to substitute saving with consumption or to change the structure of their financial portfolio.

Although subject to a host of uncertainties, the terms of trade will have a positive impact on the current account balance. In 2004 export price growth will exceed import price growth by 0.6%, and in 2005 by 1%. The favourable terms of trade will contribute around 0.2% of GDP to the current account balance in 2004, and around 0.4% of GDP in 2005. Import prices growing more slowly than export prices results mainly from the strengthening of the euro and the assumption that commodity and oil prices will gradually come down. This latter aspect represents the biggest source of risk as far as projected movements in terms of trade are concerned. In the event of unfavourable exchange rate movements, supply-side or demand-side shocks on the commodities market could prevent the terms of trade contributing positively to the current account balance.

We do not anticipate any substantial changes in other components of foreign trade. The balance of trade in services will move in line with increased domestic demand and the recovery in economic activity abroad. Consequently, we expect it to deteriorate a little in 2004 and then begin to rise. The balance of labour compensation will remain unchanged. The balance of income from capital will deteriorate as a result of low interest rates and unfavourable trends in foreign exchange reserves and the external debt on the one hand, and on the other hand because of distributed and reinvested profits from foreign direct investment in Slovenia. We expect membership of the EU to result in a slight increase in transfer receipts. Actual transfer receipts depend largely on the ability to cofinance domestic projects using domestic sources, which have not yet been secured and therefore our transfer projections are open to question.

4.5 Conditions of financing and saving

The conditions and means of financing the economy will depend on trends in the real sector and in the balance of payments current account. In the next two years foreign financial outflows will exceed financial inflows, but according to our estimates the net financial outflow will not be more than 0.5% of GDP. The principal reason for the downward revision of net financial inflows compared to the earlier projections is the smaller net inflow from direct investments. The net outflow will result largely from the anticipated maturing of government Eurobonds in 2004 and 2005. The volume of foreign financial transactions will increase in both directions under the influence of Slovenia's increasing integration in the single European market. This will result in a smaller risk for foreign investors. On the other hand, the smallness of the domestic market and the complete freedom of capital flows, will encourage residents to seek additional sources of finance or investment abroad.

Table 4.5: External financial flows

				Forecast			2004			2005			2006		
							Forecast			Forecast			Forecast		
	2001	2002	2003	2004	2005	2006	previous	new	chg.	previous	new	chg.	previous	new	chg.
	as % of GDP														
Net financial flows	7.9	4.9	0.4	-0.1	-0.5	1.4	-0.2	-0.1	0.1	0.1	-0.5	-0.6	…	1.4	…
foreign direct investment	1.3	7.4	-0.4	0.2	0.3	0.4	0.9	0.2	-0.7	1.5	0.3	-1.2	…	0.4	…
	balance at year's end														
Forex reserves (EURm)	6,514	7,842	7,881	7,678	6,994	6,877	7,909	7,678	-231	7,871	6,994	-877	…	6,877	…
- as % of GDP	30.2	34.1	32.7	30.7	26.3	24.2	30.9	30.7	-0.2	28.8	26.3	-2.5	…	24.2	…
External debt (EURm)*	10,403	11,483	13,051	14,349	15,283	16,621	10,097	14,349	4,252	10,759	15,283	4,524	…	16,621	…
- as % of GDP	48.2	49.9	54.1	57.4	57.4	58.5	39.4	57.4	18.0	39.4	57.4	18.0	…	58.5	…

* The external debt is calculated according to new methodology and therefore forecasts are not directly comparable (see Box 4.2).

Source: Analysis and Research Department

The conditions of financing will remain relatively favourable. The current low level of foreign interest rates, which are not expected to begin rising until the start of next year, and the low risk premium, which will fall even further with Slovenia's entry into the EU, make access to sources of financing favourable in price terms.

Trade credits will continue to be an important outflow item in the balance of payments capital account. Although the current account balance will deteriorate, trade credits will remain at a similar level to last year in 2004 and then gradually rise. This reflects a continuing need to finance importers in the former Yugoslavia and central Europe as these economies face balance of payments and public finance difficulties. Low interest rates abroad and easy access to sources of financing will help make this possible. But at the same time it increases the risk exposure of Slovenian companies that finance their customers in this way.

Net direct investments and net portfolio investments will decline in the next few years. The volume of both inward direct investment in Slovenia and outward direct investment by Slovenian residents will increase. Membership of the EU means direct investment in Slovenia is less risky, and therefore more attractive, although we are not anticipating any major acquisitions of Slovenian companies by foreign investors. Neither is the Government planning any major disposals of assets in the next few years. On the outward investment side, Slovenian companies will invest in the former Yugoslavia in an attempt to avoid the poorer operating conditions resulting from higher customs duties and the abolition of preferential trade agreements accompanying Slovenia's entry into the EU. After Slovenia joins the EU we will see a slight rise in net outflows in the form of private sector portfolio investments. In the context of increased interest among residents in alternative sources of investment and due to a lack of suitable instruments in the domestic financial market, we expect quite strong outflows of portfolio investments.

Foreign exchange reserves will fall slightly over the next few years as a consequence of the deterioration in the current account balance and the net outflow in foreign financial transactions. Primarily on account of increased private sector borrowing, the **external debt** will rise in absolute terms while remaining more or less unchanged as a percentage of both GDP and exports of goods and services.

Box 4.2: **Changed methodology for calculating external debt**

The methodology used to calculate the external debt was altered in September 2003. The new methodology is based on the standards laid down by the International Monetary Fund in its publication External Debt Statistics: Guide for Compilers and Users, IMF, 2003: http://www.imf.org/external/pubs/ft/eds/Eng/Guide/index.htm.)

Compared to the old guide, the new IMF guide introduces a wider category "Gross External Debt". The new external debt definition is based on a general obligation or debtor-creditor relationship and requires a more detailed follow up of the private sector. The new standard actually introduces a wider range of data from sectoral as well as from the instrumental point of view, in terms of external debt in the private sector, but also in the range of instruments included. This methodology of external debt is based on the gross principle and includes a number of other liabilities (e.g. short-term trade credits, deposits and loans) that were previously not included in its calculation. As a result, the debt (so-called gross external debt) is greater under the new methodology than under the old methodology.

Gross external debt, at any given time, is the outstanding amount of liabilities that require payment of principal and/or interest by the debtor at some point in the future and that are owed to nonresidents by residents of an economy. The financial instruments of gross external debt are: debt securities (money market instruments, bonds and notes), trade credits (short-term and long-term), loans (short-term and long-term), currency and deposits, and other debt liabilities. The maturity of a debt is determined according to the principle of original maturity. In order to maintain consistency with other macroeconomic statistics the debt is reported at the nominal value without accrued interest. At the end of the period the balance of gross external debt is converted into EUR at current exchange rates.

The volume of foreign loans received and loans granted abroad will increase but the balance will remain unchanged. The volume of loans from abroad will rise on account of the increased consumption and the related need for financing. Because of the high level of foreign lending in 2003, and despite the expected poorer economic conditions in the other countries of the former Yugoslavia, we have revised the foreign lending item upwards by around EUR 100 million a year.

The total volume of domestic and foreign financing will rise in the next few years. These trends are in line with the anticipated increase in economic activity and domestic consumption. Foreign loans will continue to account for approximately one-third of the total financing of enterprises. In line with the ongoing debt restructuring and the increased deficit, government borrowing in the domestic market will also grow rapidly. Given the high levels of borrowing from abroad, foreign currency lending will continue to be the fastest growing component of domestic credit in the future.

The Government will not raise finance through the issuance of securities abroad. Eurobond obligations of EUR 200 million will fall due for payment in mid-2004, and a further EUR 500 million in mid-2005. A large majority of the holders of the maturing Eurobonds are nonresidents, with domestic banks and insurance companies accounting for only around 5% of the total sum of the two maturing issues. Given the information currently available we have assumed that the Government will not borrow abroad to pay these obligations. In this relation, there is uncertainty over possible new issues of domestic government securities and the volume of funds that foreign investors would be prepared to invest in them. This would neutralise the outflows resulting from the maturing of the earlier Eurobond issues.

In the context of relatively high consumption levels, borrowing by households and enterprises will increase in the coming years, continuing the trend from last year, when loans to enterprises, particularly foreign currency lending, recorded quite high growth rates. Therefore the net borrowing of enterprises, measured as the ratio of loans to deposits, will begin to rise appreciably again. According to our projections it will return to the 1999 level in 2006. With the increase in loans and lower growth of deposits the falling trend in household borrowing will also come to an end.

In the coming years we expect an equalising of long-term and short-term deposit growth, reflecting the lowering of interest rates and the increased demand for money as consumption rises. At the same time the realignment from short-term borrowing to long-term borrowing will continue.

As a result of net outflows in the current account and financial account of the balance of payments, domestic loans will contribute the majority of an increase in broad money. Continuing the trend from the second half of 2003, the contribution of foreign flows to the formation of broad money will be negative. And because of the increase in consumption we are anticipating somewhat higher growth in domestic lending.

The growth in monetary aggregates will decline but at different rates for different aggregates. As in 2003, the reduction in the growth rate will be somewhat more pronounced for the broad monetary aggregates, although not as fast as last year because foreign financial flows will be in equilibrium or even record a net outflow. As economic activity recovers, the reduction in the growth rates of narrow monetary aggregates will be somewhat less pronounced.

Table 4.6: Monetary system

				Forecast			2004			2005			2006		
							Forecast			Forecast			Forecast		
	2001	2002	2003	2004	2005	2006	previous	new	change	previous	new	change	previous	new	change
	annual average														
M1	9.7	16.9	12.3	12.9	11.9	10.9	11.4	12.9	1.5	8.8	11.9	3.1	…	10.9	…
M3	22.7	23.5	14.1	11.3	10.4	9.2	10.7	11.3	0.6	9.5	10.4	0.9	…	9.2	…
Total credits	18.7	17.3	11.8	17.0	16.2	15.4	13.1	17.0	3.9	13.2	16.2	3.0	…	15.4	…

The forecasts are not directly comparable because of changes in the definitions of monetary aggregates.

Source: Analysis and Research Department

The growth of foreign currency deposits will have a bigger influence on the **M3** growth projection than in previous years, while in the future tolar and foreign currency deposits will make a more equal contribution. We expect foreign currency deposits to grow faster than tolar deposits as the yield on foreign currency deposits matches the yield on tolar deposits. At the same time the increase in foreign currency deposits will also reflect uncertainty among residents regarding the central parity to the euro on entry into ERM II and the final irrevocable parity ahead of the euro changeover when Slovenia joins EMU.

M1 growth at a level above 10% in the coming years will be in line with the recovery in domestic economic activity and lower inflation. This growth rate will reflect a shift out of long-term and short-term deposits into demand deposits as a result of increased demand for transaction money. The commencement of lending from the National Housing Saving Scheme will also have an important influence on M1 growth. However, the planned tax reforms represent an important risk factor in determining the rate of M1 growth. The main reform is the inclusion of interest income in income tax calculations. This will further reduce the returns on tolar time deposits, which will already be falling on account of the continuing reduction in tolar interest rates.

In terms of the ratio between long-term and short-term deposits the **maturity composition** of tolar deposits will remain more or less unchanged. An accelerated decline in relative returns on long-term deposits and increased economic activity and demand for transaction money, i.e. money at shorter maturities, will encourage growth in short-term deposits at the expense of long-term deposits over the entire period of these projections. The diversification of residents' portfolios associated with the search for alternative investments in the context of a withdrawal from bank deposits will play an important role in changing the maturity composition of tolar deposits.

4.7 Inflation

We expect the process of a sustained reduction in inflation to continue in the coming years and a stabilisation of the inflation rate below 3% to be achieved. Taking into account the exogenous variables and the various components of economic policy, we expect inflation in the final quarter of 2004 to be 3.2%, and to fall to 2.8% in the expected period for calculating fulfilment of the Maastricht criteria (the second half of 2005 and the first half of 2006).

Table 4.7: Price developments

				Forecast			2004			2005			2006		
							Forecast			Forecast			Forecast		
	2001	2002	2003	2004	2005	2006	previous	new	chg.	previous	new	chg.	previous	new	chg.
	average annual percentage change														
Consumer prices	8.5	7.6	5.6	3.4	3.0	2.8	4.0	3.4	-0.6	3.0	3.0	0.0	…	2.8	…
Free prices	7.7	7.6	5.9	3.4	3.0	2.8	3.9	3.4	-0.5	3.0	3.0	0.0	…	2.8	…
Administered prices	12.5	7.5	4.8	3.0	3.2	2.9	4.1	3.0	-1.1	3.2	3.2	0.0	…	2.9	…
	annual percentage change (last quarter)														
Consumer prices	7.3	7.2	4.8	3.2	2.8	2.8	3.5	3.2	-0.3	2.9	2.8	-0.1	…	2.8	…
Free prices	7.9	6.9	5.1	3.2	2.8	2.8	3.5	3.2	-0.3	2.9	2.8	-0.1	…	2.8	…
Administered prices	5.0	8.8	3.7	3.2	2.9	2.9	3.5	3.2	-0.3	3.0	2.9	-0.1	…	2.9	…

Source: Analysis and Research Department

Low growth in free and administered prices will contribute to the reduction in overall inflation. Administered prices will not rise appreciably faster than free prices and will be in line with the price growth plan of the Ministry of the Economy. On average they will rise in 2004 by 3.0%, and in 2005 by 3.2%. Free prices will be affected not only by weak inflationary pressures from abroad and the favourable impact of economic policies but also, to a significant extent, by the increase in competition following Slovenia's entry into the European Union. We project year-on-year growth in free prices of 3.2% in the last quarter of 2004, and 2.8% at the end of 2005.

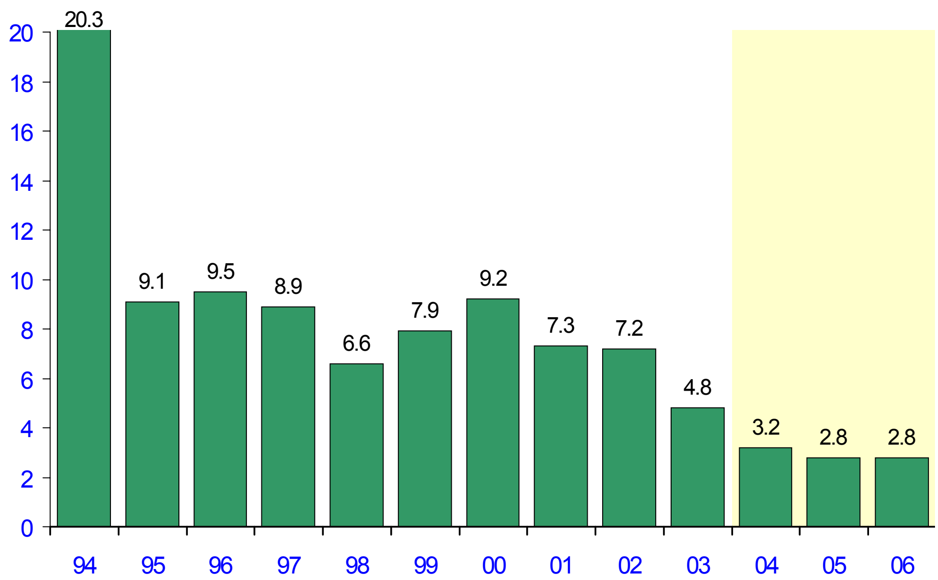
We are not anticipating significant price pressures from abroad. Consumer price growth abroad remains low owing to weak economic activity. We expect this trend to continue in the coming years. High oil prices and strong commodity price growth will continue to be compensated for by the strength of the euro against the dollar, thus preventing any significant transmission of import prices to domestic price trends. However, the possibility of a significant rise in oil or commodity prices represents an important risk factor in the inflation forecasts.

We are expecting economic policies to create the conditions, which will support the process of reducing inflation or prevent shocks that could jeopardise this process. Current economic activity is still well below the estimated potential level and so demand-side shocks in the short run cannot significantly influence price movements. In the period until ERM II entry, monetary policy will still also have a part to play in preventing the emergence of demand-side pressures by ensuring suitably high real interest rates. Gradual stabilisation of the exchange rate in the run-up to ERM II entry will also help to steady prices by reducing inflationary expectations among economic agents. However, the reduction in the tax burden on lower income groups announced in the tax reforms and the taxation of capital could trigger increased consumption and put pressure on prices.

We have assumed a continuation of the Government's policy of adjusting excise duties on refined petroleum products to prevent oil price volatility being passed on to domestic prices. At the start of this year the Government lowered excise duties in response to high oil prices but it was not able to fully prevent an increase in prices of refined petroleum products. In the projections we have applied the assumption that the Government will not substantially contribute to an increase in prices through discretionary changes in indirect taxation over and above the adjustments to the excise duties on tobacco that have already been announced. We expect the contribution to inflation caused by increases in indirect taxes to range from 0.3 percentage points in 2004 to 0.1 percentage points in 2006. The Government's capacity to take action in these areas in the future will continue to be strongly influenced by the size of the budget deficit.

Household incomes will not put pressure on price trends, either on the demand side or the supply side. The need to maintain competitiveness means that the slowness of the economic recovery will prevent excessive wage growth in the private sector, which is expected to lag behind productivity growth. A sustainable agreement between employers and unions over the mechanism for adjusting basic wages in the private sector, which has yet to be concluded, will play an important role in preventing substantial inflationary pressures. The basis for such an agreement will have to be the agreement already achieved in the public sector, which will ensure that real wage growth in the public sector does not significantly exceed 1%.

Figure 4.7: Year-on-year inflation to final quarter, per cent



Source: Analysis and Research Department

Table 4.8: Selected main indicators

				Forecast			2004			2005			2006		
							Forecast			Forecast			Forecast		
	2001	2002	2003	2004	2005	2006	previous	new	chg.	previous	new	chg.	previous	new	chg.
Activity, employment, wages	*real percentage change*														
Real GDP	2.8	2.9	2.3	3.1	3.6	3.9	3.2	3.1	-0.1	3.6	3.6	0.0	…	3.9	…
Per capita GDP (EUR)	10,801	11,508	12,052	12,491	13,304	14,215	12,765	12,491	-274	13,595	13,304	-291	…	14,215	…
Employment	1.0	0.4	-0.4	0.4	0.5	0.8	0.1	0.4	0.3	0.1	0.5	0.4	…	0.8	…
Net wages	3.1	2.1	2.2	1.8	2.3	2.1	2.3	1.8	-0.5	2.3	2.3	0.0	…	2.1	…
Productivity	1.8	2.5	2.7	2.7	3.1	3.1	3.1	2.7	-0.4	3.4	3.1	-0.3	…	3.1	…
Domestic demand	*real percentage change*														
Domestic demand	0.9	2.1	3.9	4.4	4.4	3.9	3.8	4.4	0.6	3.6	4.4	0.8	…	3.9	…
Private consumption	2.3	1.2	3.0	3.7	3.8	3.6	3.1	3.7	0.6	2.9	3.8	0.9	…	3.6	…
Government consumption	4.0	2.5	2.8	3.4	2.4	2.2	2.8	3.4	0.6	2.7	2.4	-0.3	…	2.2	…
Gross fixed capital formation	-4.6	4.1	7.0	6.3	7.3	5.5	6.1	6.3	0.2	5.7	7.3	1.6	…	5.5	…
Balance of payments	*real percentage change*														
Exports of goods and services	6.5	6.5	3.4	4.9	6.0	6.7	4.1	4.9	0.8	4.2	6.0	1.8	…	6.7	…
Imports of goods and services	3.0	4.9	6.3	6.7	7.2	6.5	5.1	6.7	1.6	4.2	7.2	3.0	…	6.5	…
Current account: EURm	38	330	17	-238	-534	-522	-185	-238	-53	-267	-534	-267	…	-522	…
as % of GDP	0.2	1.5	0.1	-1.0	-2.0	-1.8	-0.7	-1.0	-0.3	-1.0	-2.0	-1.0	…	-1.8	…
Terms of trade	2.7	2.4	0.2	0.6	1.0	0.0	0.3	0.6	0.3	0.1	1.0	0.9	…	0.0	…
													…		…
Net financial flows (as % of GDP)	7.9	4.9	0.4	-0.1	-0.5	1.4	-0.2	-0.1	0.1	0.1	-0.5	-0.6	…	1.4	…
of which: foreign direct investment	1.3	7.4	-0.4	0.2	0.3	0.4	0.9	0.2	-0.7	1.5	0.3	-1.2	…	0.4	…
Forex reserves (EURm)	6,514	7,842	7,881	7,678	6,994	6,877	7,909	7,678	-231.0	7,871	6,994	-877	…	6,877	…
- as % of GDP	30.2	34.1	32.7	30.7	26.3	24.2	30.9	30.7	-0.2	28.8	26.3	-2.5	…	24.2	…
External debt (EURm)*	10,403	11,483	13,051	14,349	15,283	16,621	10,097	14,349	4,252	10,759	15,283	4,524	…	16,621	…
- as % of GDP	48.2	49.9	54.1	57.4	57.4	58.5	39.4	57.4	18.0	39.4	57.4	18.0	…	58.5	…
Monetary system**	*average annual percentage change*														
M1	9.7	16.9	12.3	12.9	11.9	10.9	11.4	12.9	1.5	8.8	11.9	3.1	…	10.9	…
M3	22.7	23.5	14.1	11.3	10.4	9.2	10.7	11.3	0.6	9.5	10.4	0.9	…	9.2	…
Total credits	18.7	17.3	11.8	17.0	16.2	15.4	13.1	17.0	3.9	13.2	16.2	3.0	…	15.4	…
Prices	*annual percentage change (last quarter)*														
Consumer prices	7.3	7.2	4.8	3.2	2.8	2.8	3.5	3.2	-0.3	2.9	2.8	-0.1	…	2.8	…
Free prices	7.9	6.9	5.1	3.2	2.8	2.8	3.5	3.2	-0.3	2.9	2.8	-0.1	…	2.8	…
Administered prices	5.0	8.8	3.7	3.2	2.9	2.9	3.5	3.2	-0.3	3.0	2.9	-0.1	…	2.9	…
	average annual percentage change														
Consumer prices	8.5	7.6	5.6	3.4	3.0	2.8	4.0	3.4	-0.6	3.0	3.0	0.0	…	2.8	…
Free prices	7.7	7.6	5.9	3.4	3.0	2.8	3.9	3.4	-0.5	3.0	3.0	0.0	…	2.8	…
Administered prices	12.5	7.5	4.8	3.0	3.2	2.9	4.1	3.0	-1.1	3.2	3.2	0.0	…	2.9	…
International factors	*annnual percentage change*														
Foreign demand***	4.5	2.7	2.6	4.7	5.6	5.6	6.0	4.7	-1.3	6.0	5.6	-0.4	…	5.6	…
USD/EUR	0.895	0.944	1.130	1.260	1.260	1.260	1.100	1.260	0.160	1.100	1.260	0.160	…	1.260	…
Oil price (USD/barrel)	24.4	25.0	28.8	29.0	27.0	26.0	27.0	29.0	2.0	27.0	27.0	0.0	…	26.0	…
Commodities	-6.5	4.6	11.3	10.0	3.0	3.0	3.0	10.0	7.0	3.0	3.0	0.0	…	3.0	…
Inflation in EMU	2.6	2.2	2.1	1.8	1.7	1.7	2.0	1.8	-0.2	2.0	1.7	-0.3	…	1.7	…
PPI Germany	3.0	-0.6	1.7	0.6	1.2	1.2	0.6	0.6	0.0	0.6	1.2	0.6	…	1.2	…
EURIBOR 3m (%)	4.3	3.3	2.3	2.4	2.6	2.9	2.4	2.4	0.0	3.0	2.6	-0.4	…	2.9	…

* The external debt is calculated according to new methodology and therefore forecasts are not directly comparable (see Box 4.2).
** The forecasts are not directly comparable because of changes in the definitions of monetary aggregates.
*** Volume of imports of a basket of goods from foreign partners.
Source: Analysis and Research Department, Consensus Forecasts, JP Morgan, OECD Outlook, IMF World Economic Outlook, SURS

Box 4.3: **Forecasts of other institutions**

Forecasts for Slovenia are compiled not only by domestic institutions but also by international and private organisations. It is useful to compare forecasts because they highlight differences in understanding future economic trends. However, the forecasts are not directly comparable because they cover different periods and therefore do not take into account the same data. Furthermore, the forecasts rest on different assumptions with regard both to exogenous variables in the international environment and to economic policy action.

Notwithstanding these differences, there is a consensus that economic activity in Slovenia will begin to pick up in 2004, with growth forecasts ranging from 3.1% to 3.6%, and that the increase in economic growth will continue in 2005, when the forecasts range from 3.6% to 3.8%. For both years the lowest of the economic growth forecasts are those of the Bank of Slovenia. There are difference, therefore, between the institutions as to the pace and sources of the recovery, which are reflected mainly in varying forecasts for the current account deficit. A deficit of between 0.2% and 1% of GDP is expected in the current account in 2004. And all the institutions forecast a widening of the deficit in 2005 to a level between 0.4% and 2% of GDP.

The inflation forecasts also differ. These range from 3.3% to 4.5% in 2004 and from 3.0% to 3.8% in 2005. There is a high degree of similarity among the forecasts of domestic institutions and a more appreciable deviation among foreign institutions, which are considerably more pessimistic in relation to the lowering of prices. A possible reason for this is that the foreign institutions have not taken sufficient account of the economic policy orientations or have ignored current inflation trends.

Table: Comparison of forecasts for Slovenia and change since previous forecast

	Date new forecasts / previous forecasts	GDP (% annual growth) 2004		GDP 2005		Inflation (annual average in %) 2004		Inflation 2005		Current account (as % of GDP) 2004		Current account 2005	
		new	A	new	A	new	A	new	A	new	A	new	A
Bank of Slovenia	Apr 04 / Oct 03	3.1	-0.1	3.6	0.0	3.4	-0.6	3.0	0.0	-1.0	-0.3	-2.0	-1.0
EIPF*	Mar 04	3.3	…	3.8	…	3.5	…	3.7	…	-1.1	…	-1.3	…
IMAD	Apr 04 / Oct 03	3.6	0.0	3.7	0.0	3.3	-1.6	3.0	-1.0	-0.2	-0.7	-0.4	-0.6
European Comisison	Apr 04 / Nov 03	3.2	-0.1	3.6	-0.1	3.6	-1.6	3.2	-1.1	-0.5	-0.8	-0.6	-0.7
Consensus Forecasts	Feb 04 / Sep 03	3.6	-0.3	3.8	…	4.4	-0.1	3.8	…	-0.3	-0.8	-0.6	…

* The current account balance does not include factor incomes and transfers.
Source: Economic Trends, March 2004; Institute for Macroeconomic Analysis and Development (UMAR); European Commission Economic Forecasts Spring 2004; Consensus Economic Forecasts

5. MONETARY POLICY CONDUCT AND SHORT-TERM ORIENTATION

Until Slovenia enters ERM II monetary policy will be conducted in line with the need to maintain the counter-inflationary trend and to adapt to the conditions for operating within the ERM II. Once inside ERM II monetary policy will be subordinated to the task of maintaining the nominal exchange rate of the tolar close to its central parity with the euro. Fiscal and incomes policy will take on the burden of managing macroeconomic activity and inflation. Excessive consumption and accelerated growth of labour costs are the shocks, which are the most difficult to control and are therefore the most dangerous of the potential shocks that could affect the domestic economy, while Slovenia is in ERM II. Shocks of this nature could push the inflation rate back upwards, extend the not without risk period in ERM II, and via imports and poorer competitiveness substantially worsen the external equilibrium. Preventive action and active intervention in the event of such shocks using available macroeconomic policies will be key to success in the ERM II period and to adoption of the euro.

5.1. Creating the conditions for entering ERM II

The reduction in inflation is the result of appropriate counter-inflationary policy action. In the most recent period inflation has been falling strongly, even slightly faster than we projected in the autumn forecasts. The normal disinflationary trend resulting from a moderately restrictive monetary policy has been accelerated by low economic activity. Indirectly the low level of economic activity has also been reflected on the labour market, where falling employment levels have constrained wage growth, while smaller growth in labour costs in turn has further contributed to lower inflation. Moreover, accelerated disinflation has also been made possible by an inflation-neutral fiscal policy that has restricted tax pressures on prices, while administered prices growth was also quite moderate.

The substantial reduction in inflation is sustainable. A rapid reduction in inflation could be unsustainable if it caused macroeconomic imbalances in the economy. An unsustainable reduction in inflation would probably be reflected in the current account if it was based on an excessive real appreciation of the tolar, or in an inappropriate fiscal balance if it resulted from delaying the introduction of necessary tax measures. And such imbalances would require macroeconomic policy action, a depreciation of the tolar or an increase in tax pressures, which would accelerate inflation again. This is the type of effect that could be produced by reducing inflation through a freeze on administered prices, because the short-term reduction in inflation would be followed by administered price corrections and renewed pressure on inflation. Therefore the overall goal of the counter-inflationary programme of the monetary and fiscal authorities envisages harmonising the growth of administered prices with the anticipated growth in free prices. This ensures that administered prices are inflation neutral because relative prices remain unchanged. We understand inflation neutrality of fiscal policy as meaning the absence of inflationary pressures, resulting from fiscal policy measures, both upward and downward.

Monetary policy is still contributing its share to maintaining the falling inflation trend. The Bank of Slovenia maintains a satisfactory level of real interest rates for necessary restrictive measures and for stabilising inflation below the level required to fulfil the Maastricht inflation criterion. At the same time the past and anticipated intensity of the disinflation process is sufficient for the lowering of nominal interest rates and the gradual stabilisation of exchange rate dynamics to be in line with a gentle transition to the conditions of ERM II. Monetary policy orientation has therefore been a success thus far and will remain unchanged until ERM II entry.

5.2. Coordination of macroeconomic policies in ERM II

In the joint programme for ERM II entry and adoption of the euro the Bank of Slovenia and the Slovenian Government set out the tasks of macroeconomic policy after entry into ERM II. The new distribution of tasks is dictated primarily by a determination of central parity of tolar against euro. The focus of the Bank of Slovenia will become a stabilisation of the exchange rate around the central parity. Given that monetary policy cannot achieve several goals simultaneously, its role in ensuring price stability and managing economic activity will be taken over by fiscal policy.

Monetary policy will ensure stabilisation of the nominal exchange rate of the tolar around a central parity, which is a precondition for adoption of the euro. The central parity between the tolar and the euro will be determined on entry into ERM II. It will be set on the basis of the coordinated views of the Bank of Slovenia, the Slovenian Government, the European Central Bank, the central banks of the euro system and the European Commission on the long-term equilibrium real value of the tolar. Setting an equilibrium value means determining the parity with a view to both the potential impact on inflation and the effect on the competitiveness of the economy. Taking the long-term equilibrium value of the tolar into account should have the effect of preventing the need to change the central parity in the future. For successfully carrying out its tasks in ERM II the Bank of Slovenia already disposes of suitable instruments and has gained adequate experience in managing the exchange rate of the tolar. Appropriate exchange rate stability has already been achieved if we consider the movements around the depreciating trend of the tolar necessary for independent monetary policy implementation. On entry into ERM II we do not therefore anticipate changes in the use of exchange rate or monetary policy instruments. But monetary policy orientation will change, as it will focus on the stability of the tolar exchange rate, given the existing macroeconomic equilibria.

With the priority orientation of monetary policy being to maintain the stability of the exchange rate, it will no longer be able to respond appropriately in the event of macroeconomic shocks occurring while the domestic currency is in the ERM II. Monetary policy can be used as an instrument of responding to macroeconomic shocks and as an instrument of stabilising inflation by means of managing aggregate demand on one hand, or as an instrument for stabilising the exchange rate at the desired level on the other hand. Using monetary policy to stabilise the nominal exchange rate will thus preclude its use for maintaining low inflation or managing aggregate demand and aggregate activity. Although a stable exchange rate can itself be an effective anchor for inflationary expectations and long-term price trends, it is a very weak instrument for managing domestic demand. Given that in the event of an excessive consumption shock the central bank is unable to respond with a more restrictive interest rate, and the real interest rate can even fall in the context of an (anticipated) increase in inflation, monetary policy *de facto* becomes pro-cyclical. Any increase in demand will exacerbate the shock because of low real interest rates, while if demand is insufficient higher real interest rates will be reflected in an even more pronounced economic slowdown than would otherwise be the case. This means greater fluctuation in the economic cycles and consequently more variable inflation. Inflation generally rises excessively when an economy is overheating, causing a strong real appreciation and a decline in competitiveness. Ultimately, a low level of competitiveness causes the slowdown in economic growth to persist until price growth slows and competitiveness recovers.[5] The anti-cyclical action of macroeconomic policies under Government control will be vitally important for preventing inflationary cycles of this nature on the demand side.

[5] We sometimes refer to these cyclical movements as the "euro business cycle". Euro area countries that do not respond sufficiently restrictively to the inflation cycle will have a longer period of slow economic activity when the cycle turns round. Such costs in terms of growth and employment are frequent in the case of a price stabilisation policy based on the fixing of a nominal exchange rate. The Bank of Slovenia has therefore given preference to an active monetary policy ahead of the alternative of fixing the exchange rate until inflation stabilises at a low level.

The task of managing macroeconomic activity, and hence indirectly also inflation, will therefore be assumed by fiscal policy after ERM II entry. Fiscal policy has a range of instruments at its disposal. One of the main instruments of fiscal policy will be the planning of non-investment public expenditure so that it will be used as an anti-cyclical stabiliser of the economy with the aim of restraining the shock of domestic consumption and preventing the emergence of inflationary cycles. The necessary anti-cyclical action will require sufficient budget reserves in order that the Maastricht fiscal criteria (and subsequently the Stability and Growth Pact following adoption of the euro) are not jeopardised. The second category of instruments under Government control will have to prevent the emergence of fiscal shocks of a cost-push nature in the economy and the consequent direct upward pressure on inflation. This relates mainly to restricting increases in tax levels and excise duties above the level required by harmonisation with European Union regulations. Equally important is restricting the growth in administered prices (on an aggregate level) above the inflation limit for fulfilling the Maastricht inflation criterion. This means that administered prices must be at least inflation neutral, while appropriate relative prices remain unchanged. At the same time these price restrictions encourage structural reforms and better cost control in enterprises that are not forced to improve their competitiveness because of the monopolistic structure of the market. As far as incomes policy is concerned, public sector wages and social transfers will need to be restrained so that they do not cause a deterioration in the budget balance and at the same time not accelerate wage dynamics in the private sector due to signalling effect.

5.3. Risks associated with participation in ERM II

Major risks to a successful transition from ERM II into the euro system stem from an asymmetric shock of domestic consumption and from an accelerated rate of growth in nominal wage costs. This assessment is based on current and expected macroeconomic trends and the degree to which various shocks can be controlled using economic policies. The economic recovery envisaged in the forecasts will reduce the pace at which inflation is brought down, but the forecast reduction in inflation nevertheless remains on target to fulfil the inflation criterion during the ERM II period. In Box 5.1 we show that without an immediate and appropriate response on the part of macroeconomic policies even a small shock with inflationary effects would jeopardise fulfilment of this criterion. The fact that the majority of other shocks can be curbed, or are caused by economic policies, shows that the biggest risk is associated with private demand or pressures on labour costs. Thus we expect that appropriate fiscal policy action will prevent shocks from administered prices and a rise in tax rates and absorb supply-side shocks, such as an oil shock, in the same way as in the most recent period. In the event of an asymmetric demand-side shock, i.e. where demand is not aligned with demand conditions in the euro area, there is an additional risk because the restrictive stance of the ECB, which will determine the stance of domestic economic policy, will not be adequate to the domestic conditions. In other words, in the event of simultaneous strong demand in the euro area the ECB will raise interest rates and the Bank of Slovenia will have to do the same. In the case of a symmetric shock therefore monetary policy would become more restrictive, but with an asymmetric shock a monetary policy reaction will not be possible and the key role will have to be played by other macroeconomic policies.

Box 5.1: **Risk to fulfilment of Maastricht inflation criterion: excessive growth of wages and domestic consumption**

After ERM II entry, the biggest risks to fulfilment of the Maastricht inflation criterion and to the general stability of the economy will come from pressures caused by aggregate demand and the dynamics of labour costs. We highlight these risks, because monetary policy will be committed to maintaining a stable exchange rate within standard band around an agreed central parity in ERM II. This will consequently limit its ability to respond to demand-side shocks. Fiscal and incomes policy will need to take on the task of controlling the risks associated with excessive demand or excessive wage growth.

In the table below we compare the values of selected macroeconomic indicators in the forecasts (baseline scenario) with an increased household consumption scenario and an accelerated nominal wage growth scenario. For reasons of transparency we have limited the comparison to GDP growth, year-on-year inflation rates, current account balance as a percentage of GDP and employment growth. The estimates given for both shock scenarios are modelled, and therefore subject to the particularities of econometric models in general (including the one used), but they are nevertheless quite illustrative both in qualitative and quantitative terms.

Table: Response of macroeconomic variables to shocks

	GDP			Inflation			Current account			Employment		
	2004	2005	2006	2004	2005	2006	2004	2005	2006	2004	2005	2006
Baseline scenario	3.1	3.6	3.9	3.5	3.0	2.8	-1.0	-2.0	-1.8	0.4	0.5	0.8
Consumption shock[1]	0.6	0.7	-0.4	0.0	0.3	0.6	0.0	-0.2	-0.6	0.0	0.4	0.1
Wage shock[2]	0.1	0.0	-0.3	0.0	0.4	0.3	0.0	-0.2	-0.2	0.0	-0.4	-0.6

Figures in rows 2 and 3 indicate deviation from the baseline scenario in percentage points.
1 Annual consumption growth two percentage points higher following second quarter of 2004.
2 Wage growth two percentage points higher following second quarter of 2004.

In the event of increased domestic consumption economic growth will increase temporarily, and so too will employment growth, but it will be at the expense of higher inflation and a worsening current account. This shock scenario is based on an increase in private consumption growth from the third quarter of 2004 by two percentage points in one year compared to the baseline scenario. Part of the increased consumption is triggered by economic growth and part is reflected through increased imports in an increased current account deficit. Inflation rises, and partly because of its internal dynamics it remains above the basic scenario even when aggregate demand pressures subside. Increased consumption will also lead to a rise in employment, although with a time lag. Shortly, an additional percentage point growth in real GDP, triggered by domestic demand, will add 0.4 percentage points on inflation, increase employment growth by 0.6 percentage points and worsen current account deficit by 0.3 percentage points of GDP within one year period.

Accelerated wage growth not only boosts domestic consumption but is also reflected as a cost factor and additionally increases inflation. In this scenario an increase of two percentage points in nominal wage growth compared to the baseline scenario in the year from the third quarter of 2004 was assumed. The acceleration in nominal wage growth is transmitted to inflation only gradually. Initially there will be a temporary increase in real disposable income, which via aggregate demand accelerates somewhat the rate of production growth and simultaneously inflation. In addition to the demand-side effect described above, a wage shock additionally contributes to inflation through increased labour costs. Together with the appreciable impact on inflation, the excessive nominal wage growth scenario also causes a fall in employment growth or even a reduction in employment. This is reflected in a decline in the competitiveness of the economy as a result of increased labour costs and hence a reduction in demand for labour. The estimates indicate that an acceleration in nominal wage growth of one percentage point in one year will contribute 0.2 percentage points to inflation and initially have a neutral impact on economic growth, but will lower employment growth by 0.2 percentage points and increase the current account deficit by 0.1 percentage points of GDP. An even stronger deterioration in the current account balance and in the employment trend will result in the second year after the shock, i.e. in 2006.

Excessive consumption and excessive wage growth represent a risk factor in fulfilling the inflation criterion. The results of the simulation show that achievement of the Maastricht inflation criterion could be jeopardised even by relatively small shocks that economic policy was unable to prevent or constrain in time. Successful participation in ERM II and adoption of the euro will therefore require extremely cautious economic policy conduct and coordination as set out in the joint programme for ERM II entry and adoption of the euro.

In the absence of an appropriate economic policy response, unfavourable shocks would prolong the stay in ERM II and carry the possibility of a stagnation in economic activity. It is clear that with an inadequate economic policy response the Maastricht inflation criterion would not be met in the event of excessive growth in domestic consumption, and in particular an accelerated growth in labour costs. Failure to meet any of the Maastricht criteria would mean extending the period within ERM II until all the criteria are met simultaneously. In itself, remaining longer in ERM II will not necessarily entail increased costs. But as stated earlier, an inflation shock would cause an excessive real appreciation and a decline in the competitiveness of the economy. This effect would directly impair the current account, or the external equilibrium, and slow down economic activity. But indirectly it would also be reflected in a deterioration of the public finance position as a result of a drop in revenues linked to economic activity and an increase in expenditures (higher unemployment transfers, anti-cyclical measures, and so on). Such a deterioration in the macroeconomic equilibria would further delay the possibility of meeting the criteria for adoption of the euro, and consequently prolong the period in ERM II. A deterioration in the macroeconomic equilibria could even threaten the sustainability of the central parity and lead to an attack on the currency if the financial markets believed there was a possibility of a devaluation. If the central bank were unable to withstand a speculative attack on the currency, serious damage would be caused to the financial system and to the real economy. Eventually, a devaluation would once again encourage inflationary pressures. Maintenance of the macroeconomic equilibria, particularly the current account and the public finance position, at a sustainable level is key to ensuring the credibility of economic policies and the central parity, and is a precondition for a successful stay in ERM II.

5.4. Positions of the Governing Board of the Bank of Slovenia

The Governing Board of the Bank of Slovenia believes that because of the risks associated with ERM II the adoption of the euro at the earliest possible opportunity is in the interests of the Slovenian economy. ERM II is often presented as a framework for preparing macroeconomic policies for the monetary union environment and for testing the sustainability of the central parity.[6] Because of the risk of an inadequate response to shocks from the available macroeconomic policies, ERM II is actually a constraint on rigorous fiscal policy action. However, from an economic viewpoint ERM II presents a much greater risk than monetary union. In ERM II, the exchange rate risk is still present, together with the risk

[6] So-called “training room”.

of a speculative attack on the currency. This could result from inappropriate economic policy conduct and a deterioration in the macroeconomic equilibria, but it could also occur even if the economic policies are appropriate; for example, where a financial crisis spreads from other countries. Or it could be linked to inaccurate expectations of economic policy measures or of future economic trends. At the moment we believe the likelihood of such cases is small, but the very grave consequences for the real economy were they to occur need to be taken into account. Therefore we believe that all macroeconomic policies must act towards the goal of transiting through ERM II and adopting the euro as quickly as possible.