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Executive Summary

GDP increased by 2.6% in 2014, as the economic recovery continued in the final quarter, albeit at a more modest pace than in the middle of the year. Economic growth significantly outpaced that in the euro area average last year, albeit largely as a result of one-off factors. Foreign demand remained the main engine of economic growth, while a large contribution also came from government investment, partly financed by EU funds. GDP growth is forecast to reach 2.2% this year, before slowing to 1.8% next year. In both years it will largely be determined by the temporary nature of public investment. The current account surplus will remain at around 6% of GDP over the projection period, as a result of solid growth in exports, despite the gradual recovery in domestic demand and thus in imports. There has been a sharp fall in inflation, as a result of falling commodity prices on global markets and the persistence of relatively weak domestic demand. After temporarily dipping below zero, inflation will gradually rise to just over 1%.

* * *

The solid economic growth that began in the first half of 2013 continued in 2014. After a rapid growth in the middle of the year, the quarterly rate slowed to 0.3% by the end of the year, the same as in the euro area overall. Average annual growth was nevertheless significantly higher than in the euro area, where it stood at just 0.9%. Alongside favourable exports, the main factor in the faster growth in Slovenia was growth in investment in public infrastructure.

Last year exports were supported by solid foreign demand and improved cost competitiveness. Year-on-year growth in exports increased further at the end of the year. This was primarily attributable to the stabilisation of economic activity in the majority of the main trading partners, and to firms' effectiveness in seeking new sales markets. The more stable signals from the international environment are reflected in the confidence indicators, which improved again in the early part of this year.

Last year also saw heavy investment in infrastructure, particularly at local level, which was partly financed by EU funds. The high growth in investment was thus the product of factors that were mostly temporary in nature, which was reflected in the second half of last year, when government investment declined sharply. At the same time investment in machinery and equipment declined last year, which is not encouraging from the point of view of increasing the potential of the economy. After several years of decline, final government consumption increased slightly in the final quarter of last year.

Although the situation on the labour market was favourable, with rising employment and wages, there was no notable increase in private consumption. The main factor were new hires, where flexible forms of employment were prevalent. This is giving firms flexibility, but is also limiting growth in household consumption. The structure of unemployment is becoming increasingly skewed towards long-term unemployment. Outflows from registered unemployment increased sharply on account of new hires, while the increased inflows into unemployment owing to the expiry of temporary employment contracts at end of the year were an indication of the waning effect of the labour market reforms. Unemployment remained almost unchanged on average last year, but had fallen by around 7,000 in year-on-year terms to 123,000 by this February, as a result of favourable intra-year dynamics.

Falling commodity prices on global markets and the persistence of weak domestic demand brought a sharp fall in inflation. It averaged 0.4% last year, the same as in the euro area overall. Prices were down in year-on-year terms in the first quarter, although the fall is probably only temporary, as it is entirely attributable to developments in energy prices.

The current account surplus in 2014 amounted to 5.8% of GDP, slightly more than in 2013. The large surplus was the result of solid growth in merchandise exports. The deficit in primary income widened, primarily as a result of the increasing burden of interest payments on the public debt.

In a situation of favourable growth in the export sector, the current account surplus is being reflected in high net saving by the private sector, which is facilitating the deleveraging of the economy. Corporates have been net savers for three years now, amid weak nominal growth in investment and further reductions in indebtedness. The stock of corporate liabilities in the form of bank loans declined again last year. The decline in loans to the private sector despite strengthened economic growth was primarily the result of high corporate indebtedness, which remains concentrated in just a few sectors, and a lack of willingness on the part of the banks to take up risks when approving loans. Corporates are thus seeking alternative forms of financing within the available options, such as loans from the rest of the world and retained earnings. Households last year maintained their financial surplus close to its level of the end of 2013, and remained cautious in their consumer decisions despite higher income.

Confidence was gradually restored in the domestic banking system in 2014. This was reflected in an increase in deposits by the non-banking sector, to which almost all the sectors contributed. The increased confidence is the result of the successful process of the recovery, resolution and stabilisation of the banking sector. The contraction in the banking system's balance sheet total on the funding side was the result of a reduction in the banks' debt to the Eurosystem and to the rest of the world. Last year the contraction on the asset side was primarily the result of the further decline in loans to the private sector.

The government was again the sole sector to run a financial deficit last year. According to SORS estimates, it amounted to 4.9% of GDP in 2014. Excluding the assistance to financial institutions and other one-off effects, it was smaller than in the previous year at 3.5% of GDP. The general government debt had increased to 80.9% of GDP by the end of last year. The primary deficit excluding one-off effects narrowed significantly last year, while the primary deficit excluding interest amounted to just 0.3% of GDP.

The projections suggest only a gradual economic recovery. GDP growth is forecast to reach 2.2% this year, before slowing to 1.8% next year primarily as a result of a decline in government investment. The economic recovery will be based on a positive contribution from net trade, although the domestic demand components will also gradually strengthen.

In addition to the positive impact of the carry-over of growth from the previous year and the maintenance of solid growth in exports, the main factors in the economic growth forecast for 2015 are the expectations of heavy public investment partly financed by EU funds, as the disbursement of funds from the old 2007-2013 financial perspective finishes this year. Investment of this type will also have a decisive role over the remainder of the projection period in determining the dynamics of aggregate activity. An upward revision in GDP growth compared with the previous projection has therefore been made for this year alone. The GDP growth forecast for 2016 is the same as in the previous projection, despite the expected fall in public investment.

Net trade will make a positive contribution to GDP growth over the entire projection period. Increased impetus in private-sector investment will be limited in particular by persistently high corporate indebtedness. Household consumption will only increase gradually, given the still uncertain situation on the labour market, while government consumption will be constrained by the need for fiscal consolidation. The maintenance of solid growth in exports will hold the current account surplus around 6% of GDP, despite a slight increase in domestic consumption. In light of the weakness of domestic demand, and the absence of price pressures from the international environment, inflation is forecast to gradually rise to around 1% over the projection period.

The risks to the economic growth projections are slightly tilted to the downside. The largest risk to economic growth is growth in investment and the export sector. Growth in government investment is uncertain, as the current financing period from the European cohesion funds ends this year, while there are significant unknowns surrounding the disbursement of funds in the new period. The scheme for financing government investment within the framework of the Juncker investment plan is also unclear. The risks related to growth in foreign demand are balanced. The main risk to export growth is the fall in the number of manufacturing sectors that were contributing to growth in industrial production at the end of last year, which is diminishing export potential, at least temporarily. Growth in private-sector investment is also uncertain, although in this case the risks are *tilted to the upside in light of high capacity utilisation, access to financing for successful firms, and the significant amount of retained earnings. Given that growth in private consumption lagged behind the recovery in purchasing power of households in 2014, the likelihood of stronger growth in household consumption is also relatively high.*

The risks to inflation over the projection period are on the upside. Faster-than-expected rises in oil prices, higher wage growth and an impact of expansionary monetary policy that is larger than forecast under the baseline scenario could all result in price growth that is faster than expected in the baseline.

* * *

In July 2014 the Bank of Slovenia outlined its view of the future strategic challenges for the functioning of economic policy in Slovenia.[1] *In the opinion of the Bank of Slovenia, economic policy measures should focus primarily on the strengthening of banking sector balance sheets, the establishment of the foundations for financial stability, corporate deleveraging and restructuring, and the strengthening of the long-term sustainability of public finances. The measures taken should have as low as possible short-term adverse impact, particularly on exports, but also on domestic demand. The measures should also focus as far as possible on encouraging long-term economic potential and on ensuring sustainable long-term growth. Only thus will the conditions for the gradual elimination of high unemployment be put in place.*

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[1] http://www.bsi.si/library/includes/datoteka.asp?DatotekaId=5849

								Projections					
								2015		2016		2017	
	2008	2009	2010	2011	2012	2013	2014	Apr.	Δ	Apr.	Δ	Apr.	Δ
Activity, employment and wages	*growth rates, %*												
GDP (real)	3.3	-7.8	1.2	0.6	-2.6	-1.0	2.6	**2.2**	0.9	**1.8**	0.0	**2.0**	…
Employment	2.6	-1.8	-2.2	-1.6	-0.8	-1.5	0.7	**0.6**	0.4	**0.4**	-0.2	**0.4**	…
Compensation per employee	7.2	1.8	4.0	1.6	-1.2	1.9	-0.2	**1.1**	-0.3	**1.3**	-0.3	**1.4**	…
Productivity	0.7	-6.1	3.5	2.3	-1.8	0.5	2.0	**1.6**	0.4	**1.3**	-0.2	**1.6**	…
ULC (nominal)	6.4	8.5	0.5	-0.7	0.6	1.4	-2.1	**-0.5**	-0.7	**0.0**	-0.1	**-0.2**	…
Contribution to GDP growth	*percentage points*												
Domestic demand, excl. chg. in inventories	4.0	-5.7	-2.8	-1.3	-3.7	-2.1	1.0	**0.7**	0.2	**0.7**	-0.5	**1.2**	…
Net exports	0.2	1.9	2.1	1.4	2.9	1.0	1.9	**1.1**	0.4	**1.0**	0.5	**0.7**	…
Changes in inventories	-0.9	-4.0	1.9	0.6	-1.8	0.1	-0.2	**0.4**	0.4	**0.0**	0.0	**0.0**	…
Domestic demand	*real growth rates, %*												
Domestic consumption	3.1	-9.5	-0.9	-0.8	-5.6	-2.1	0.8	**0.8**	0.3	**0.8**	-0.4	**1.3**	…
Private consumption	2.4	0.9	1.0	-0.1	-3.0	-3.9	0.3	**0.5**	0.0	**1.2**	0.2	**1.3**	…
Government spending	4.9	2.4	0.1	-1.3	-1.5	-1.1	-0.5	**0.4**	0.8	**0.5**	0.9	**0.5**	…
Gross fixed capital formation	7.0	-22.0	-13.7	-4.6	-8.9	1.9	4.8	**1.9**	0.1	**-0.1**	-4.0	**2.3**	…
Balance of payments	*growth rates, % (if not specified otherwise)*												
Exports of merchandise and services	4.2	-16.6	10.1	7.0	0.3	2.6	6.3	**4.7**	1.0	**4.9**	-0.1	**5.1**	…
Imports of merchandise and services	3.8	-18.8	6.6	5.0	-3.9	1.4	4.1	**3.6**	0.5	**4.1**	-0.9	**4.7**	…
Current account: EUR billion	-2.1	-0.2	0.0	0.1	1.0	2.0	2.2	**2.2**	0.5	**2.3**	0.6	**2.5**	…
as % GDP	-5.4	-0.6	-0.1	0.2	2.7	5.6	5.8	**5.8**	1.0	**5.9**	1.3	**6.2**	…
Terms of trade*	-1.3	3.5	-4.0	-1.4	-1.0	1.0	0.8	**0.4**	0.8	**-0.7**	-0.8	**-0.7**	…
Prices	*average annual growth rates, %*												
Consumer prices (HICP)	5.5	0.9	2.1	2.1	2.8	1.9	0.4	**-0.1**	-0.8	**1.1**	-0.1	**1.4**	…
HICP excluding energy	4.9	1.7	0.3	1.0	1.8	1.9	0.7	**0.9**	0.1	**1.2**	-0.2	**1.5**	…
HICP energy	9.4	-4.5	13.9	8.8	9.0	1.8	-1.4	**-6.0**	-6.0	**1.0**	1.0	**0.8**	…
International environment	*growth rates, % (if not specified otherwise)*							Assumptions					
Foreign demand**	2.7	-13.7	10.1	6.9	0.5	1.5	1.9	**2.4**	0.0	**3.2**	0.1	**3.4**	…
Oil (USD per barrel)	98	62	80	111	112	109	99	**62**	-45	**68**	-39	**72**	…
Non-oil commodities	10.5	-23.3	36.5	21.9	-12.5	-5.0	-6.4	**-11.0**	-11.1	**2.6**	-1.8	**4.8**	…
EMU inflation	3.3	0.3	1.6	2.7	2.5	1.4	0.4	**0.3**	-0.8	**1.1**	-0.3	**1.7**	…
PPI Germany	5.4	-4.0	1.5	5.1	1.7	0.0	-0.9	**-0.5**	-1.1	**1.5**	-0.1	**1.8**	…

* Based on national accounts deflators.

** Volume of imports from the basket of foreign partners.

Δ : Difference between current projections and projections in Macroeconomic Developments and Projections, September 2014.

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

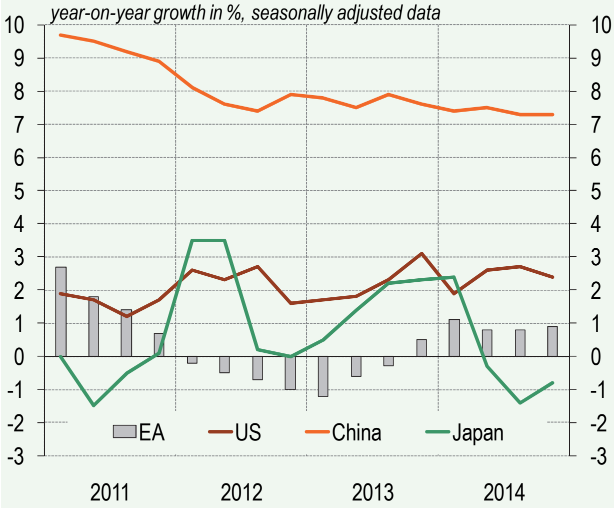
1 International Environment

The global economy displayed diverging trends in economic activity in the second half of last year and the early part of this year, in the wake of large falls in US dollar oil prices and inflation and the continuing easing of monetary policy by most of the major central banks, most notably the ECB. Economic activity in the euro area remains relatively weak, while inflation moved into the negative zone in December and remained there in the first quarter of this year. Consumer confidence and economic sentiment nevertheless remained above their long-term average at the end of last year and at the beginning of this year. Economic developments were relatively favourable in the majority of Slovenia's main trading partners outside the euro area. Oil prices reached their low of the last six years in January, but have gradually risen since the end of that month, while other commodity prices are still falling. The euro has also been falling against major global currencies since mid-2014.

Economic developments

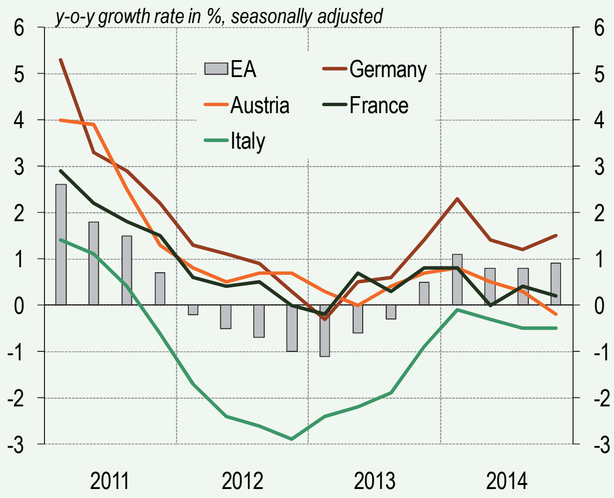
Amongst major global economies, economic growth remained relatively high in China and the US, and low in the euro area, while Japan saw a significant decline in activity in the second half of the year. The economic recovery in the euro area continued in the second half of 2014, but growth remained relatively low. Low growth means that the unemployment rate is only falling gradually: it stood at a still-high 11.2% in January. Consumer confidence and economic sentiment nevertheless remained above their long-term average at the end of last year and at the beginning of this year. GDP in the US was up 2.4% last year. One of the factors in the growth

Figure 1.1: GDP in the major global economies



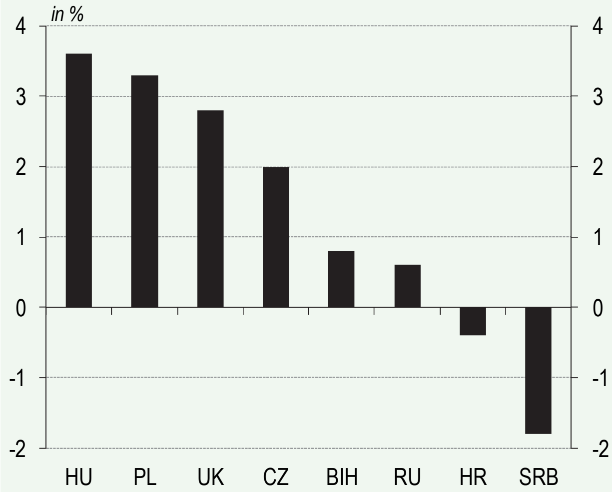
Source: Eurostat, Tradingeconomics.

Figure 1.2: GDP growth in main EA trading partners



Source: Eurostat.

Figure 1.3: GDP growth in major trading partners outside the euro area in 2014



Source: Consensus Economics, Eurostat, nacional statistic offices.

was private consumption, which strengthened as unemployment fell. The growth rate fell to 5.6% in December, the lowest level of the last six years. Economic activity in the second half of last year fell by just over 1% in year-on-year terms in Japan, but rose by 7.3% in China, slightly below the average of the last three years.

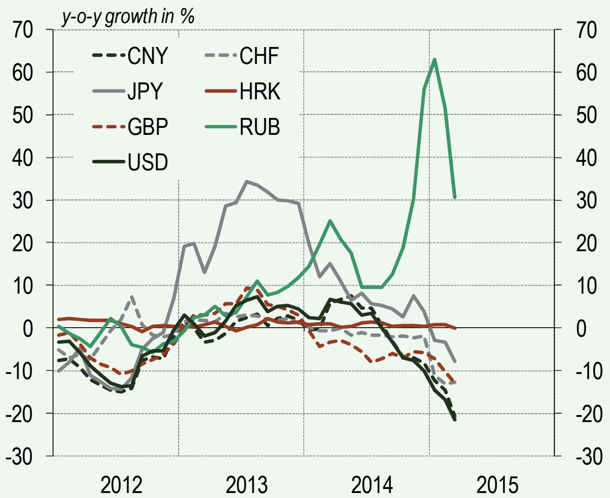
Economic activity in Slovenia's most important trading partners in the euro area was weak last year. The largest rise in GDP among these countries was recorded by Germany, where it amounted to 1.6%. After slowing sharply in the third quarter, economic activity in Germany strengthened again in the final quarter, when GDP was up 1.5% in year-on-year terms. Economic growth in France was less favourable, but positive: GDP in the final quarter was up 0.2% in year-on-year terms, and was up 0.4% over the whole year. GDP recorded the same increase in Austria, albeit with a deterioration in the situation at the end of the year. Economic activity in Italy declined for the third consecutive year, although the decline was smaller than in previous years.

Economic developments were relatively favourable in the majority of Slovenia's main trading partners outside the euro area last year. Amongst EU Member States, particularly high economic growth was recorded by Poland and Hungary, where GDP in the second half of the year was up more than 3% in year-on-year terms, and growth stood at 3.3% and 3.6% respectively over the whole year. Also in the UK the high growth in the first half of last year was maintained in the second half of the year, with growth averaging 2.8% over the whole year. GDP rose by 2.0% last year in the Czech Republic, and by just under 1% in Bosnia and Herzegovina. Economic growth slowed sharply last year in Russia to just 0.6%. GDP in Croatia increased in the final quarter after 12 consecutive quarters of decline, but was down 0.4% over the whole year, the smallest decline of the last three years. Economic activity declined sharply in Serbia, particularly in the second half of the year: GDP was down 1.8% last year.

Financial markets and commodity prices

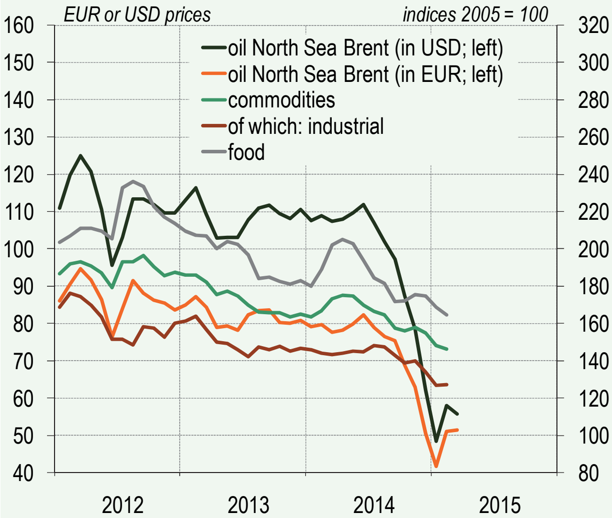
Monetary policy at the majority of the central banks in the advanced economies remained expansionary in 2014 and early 2015. As a result of strengthening economic activity and the falling unemployment rate, the Fed ended its purchases of long-term securities in October 2014, but left its key interest rate unchanged in the interval between zero and 0.25%. The ECB cut its key interest rate twice last year, the second time to 0.05% in Septem-

Figure 1.4: Exchange rates



Source: ECB, Bank of Slovenia calculations.

Figure 1.5: Commodities



Source: The Economist, Bloomberg, Bank of Slovenia calcuations.

ber. It also expanded its toolkit of non-standard measures, which was strengthened further at the beginning of this year.[2] Most other major central banks are also maintaining an expansionary policy, including the Bank of England and the Bank of Japan. The central banks of Canada, Sweden, Australia, India, China, Indonesia, Poland, Russia and Turkey all eased their monetary policy in the late part of last year and early part of this year.

The euro fell against major global currencies in the second half of 2014, the fall continuing in the early months of this year. The euro fell sharply against the US dollar in the final quarter of last year in particular, and continued to fall over the first three months of this year. It lost 21.6% against the US dollar in the 12 months to the end of March. The euro also fell against the majority of other currencies. In February it was down 13.0% in year-on-year terms against the pound sterling and 7.8% against the Japanese yen.

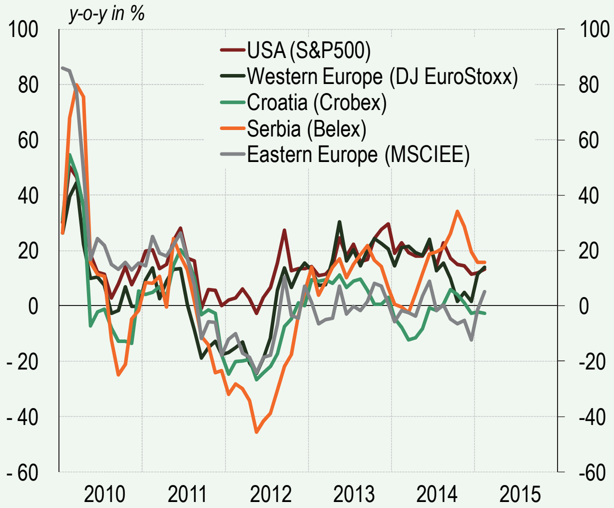
The sharp fall in oil prices seen in the second half of last year came to an end at the end of January, but other commodity prices continued to fall in the early months of this year. The price of a barrel of Brent crude was still in excess of USD 100 even at the beginning of last September, but by this January it had fallen to just USD 48, the lowest figure of the last six years. The fall came to an end at the end of January, and by early March the price had risen again to USD 60, before fluctuating around USD 54 in the second half of March. US dollar prices of all primary commodities fell by 4.7% last year, and continued falling in the early part of this year. The year-on-year fall stood at just over 12% in February.

International capital markets

Most capital markets performed well in 2014. The most notable negative yield was recorded in Russia, which suffered the largest losses on account of the conflict with Ukraine and the fall in oil prices. Russia's RTS share index lost 45% in 2014. This was followed by the 15% fall in Austria's ATX, as a result of Austrian banks' sensitivity to the Russia-Ukraine conflict and the exposure of numerous Austrian firms to the oil industry. The main stock market indices in the US, China and India recorded annual gains of between 10% and 54%. The SXXE index for eastern Europe recorded a rise of 1.7% in 2014.

[2] A detailed description of the ECB's non-standard measures is given at http://www.ecb.europa.eu/press/pressconf/2014/html/is140605.en.html, http://www.ecb.europa.eu/press/pressconf/2014/html/is140904.en.html and http://www.ecb.europa.eu/press/pressconf/2014/html/is141204.en.html.

Figure 1.6: Foreign stock exchange indices



Source: Bloomberg.

The positive trend continued in early 2015. After slight uncertainty in January, when the stock market indices recorded average monthly growth of 2%, the majority of indices recorded average monthly growth of 6% in February, thus approaching the record rises of the previous year. The markets' appetite for risk was increased by the non-standard measures being applied by central banks with the aim of preventing deflationary pressures and strengthening economic activity. The required yield on bonds was thus further depressed, forcing investors into purchasing higher-risk shares.

2 Economic Trends and the Labour Market

Despite a slowdown in the final quarter, economic growth was relatively high in 2014, and its structure was favourable from the perspective of export orientation, bur less so from the perspective of the temporary nature of public investment. Growth in exports and thus in industrial production strongly out-performed growth in foreign demand, and the contribution made by net trade to annual GDP growth of 2.6% amounted to almost 2 percentage points. Growth in gross fixed capital formation approached 5%, entirely as a result of a significant increase in public investment, as investment in machinery and equipment declined. Public investment was the sole source of growth in construction, which was thus entirely dependent on central and local government, which was reflected in quarterly declines in value-added in the sector in the wake of weaker public investment in the second half of the year. Growth in private consumption was weak compared with the developments on the labour market, partly because these developments were strongly associated with an increase in uncertain forms of employment. Aggregate activity in private-sector services declined at the end of the year, which was the main factor in the slowdown in quarterly GDP growth to the level of the euro area average. According to the figures available by the end of March, economic growth strengthened again in the first quarter of this year.

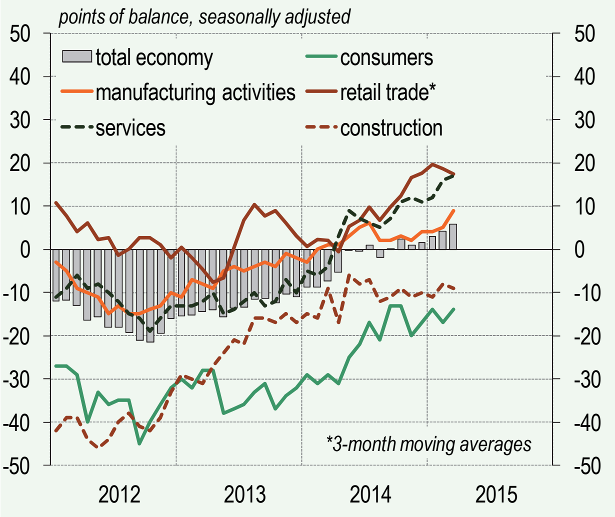
The situation on the labour market improved in 2014, although uncertain forms of employment were prevalent among new hires. The total number of employees increased, primarily as a result of a boom in employment agency work, while temporary employment accounted for the prevailing proportion of new hires. Employment increased in most of the major economic sectors. The number of unemployed has been falling in year-on-year terms since last July, but unemployment nevertheless remains high and is becoming increasingly structural. Inflows into unemployment as a result of the termination of temporary employment increased in the final quarter, which could indicate the ebbing-away of the effects of the labour market reforms adopted in April 2013. Wages have been gradually rising, including in the public sector since the middle of last year. The weak deflation also made a significant contribution to real growth in wages in the recent period.[3]

[3] Developments in consumer purchasing power are measured via changes in the real wage bill on the basis of monthly figures. One-off developments have had a major impact on disposable income over the last two years according to SORS figures. The following factors acted to increase disposable income in the final quarter of 2013: a) settlements from the ruling in connection with the elimination of the third quarter of wage disparities were included under wages and social security contributions (the total payment in connection with the third quarter of wage disparities amounted to EUR 192 million), b) the ruling in connection with the erased residents (approximately EUR 130 million) was included under current transfers. This entails a large decline in disposable income in the final quarter of 2014, which has most likely not been reflected in the actual developments in disposable income during that period, and is at odds with the rise in the wage bill. In the autumn revision the SORS will rebook these transactions under capital transfers, and they will thereby no longer have any impact on disposable income disclosed in this manner. The actual payments of the aforementioned transactions will have an impact on disposable income in a period other than that in which they were recorded: the payments in connection with the third quarter of wage disparities were made in the first quarter of 2014 and in the first quarter of 2015, while the payments to the erased residents began to be made in 2014 and will continue in the following years (this reflects the differences between the accounting approach and the paid realisation approach).

Confidence indicators

The economic sentiment improved sharply in the first quarter of this year. Manufacturing confidence reached its highest level since the first quarter of 2011 as firms assessed the level of current and expected demand more favourably, while their employment assessments were also positive. Confidence also improved slightly in the construction sector, with a pronounced increase in order books. Confidence in the retail sector remained high overall in the first quarter in comparison to turnover developments. Confidence in other private-sector services increased towards the end of the quarter to reach its highest level since 2008, with firms expecting high growth in demand in the next three months. Consumer confidence also improved, although judging by turnover in the retail sector this was only partly reflected in increased consumption.

Figure 2.1: Confidence indicators

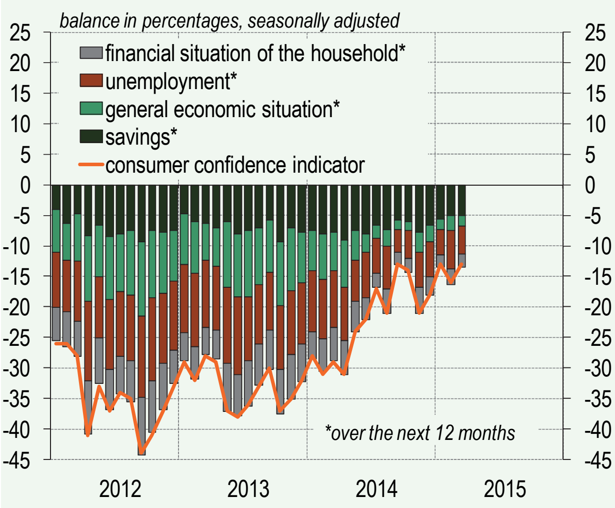


Source: SORS, Bank of Slovenia calculations.

Gross domestic product

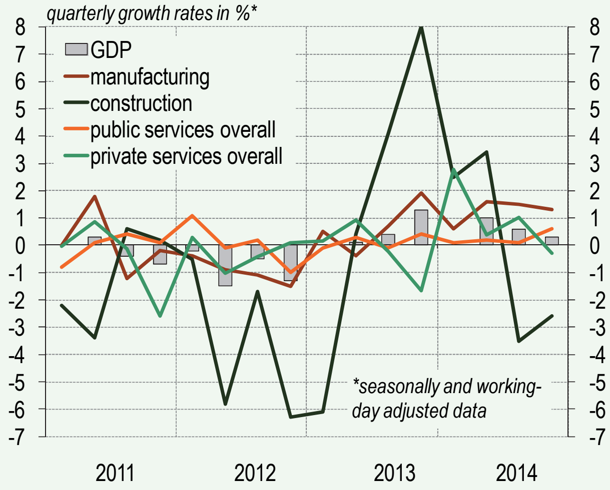
Quarterly economic growth slowed in the final quarter of last year to the same level as the euro area average as a result of weaker activity in private-sector services. GDP was up 0.3% in quarterly terms, more than was expected on the basis of the available monthly indicators. After growing relatively rapidly over the first nine months of the year, total value-added in private-sector services declined by 0.3%, the majority of sectors contributing to the decline according to the monthly figures. This was related to the slowdown in the recovery in domestic final consumption and the fall in construction investment; the latter had a particularly sharp impact on activity in technical services. Construction activity was down in quarterly terms for the second consecutive quarter, which in the absence of private-sector construction

Figure 2.2: Decomposition of consumer confidence indicator



Source: SORS, Bank of Slovenia calculations.

Figure 2.3: GDP components, production side



Source: SORS, Bank of Slovenia estimates of private sector services' growth rates.

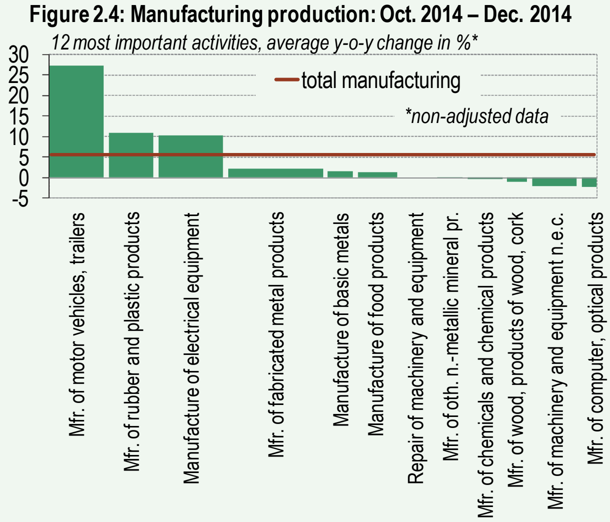
investment is almost entirely connected to the dynamics in public investment, depending on the disbursement of European funds. Economic growth was thus primarily based on increased output in manufacturing, most notably the car, chemical and electrical industries.

The vast majority of sectors contributed positively to the relatively rapid economic growth in 2014. GDP was up 2.6% on 2013, as manufacturing and private-sector services made the prevalent contributions of approximately 1 percentage point. Rapid growth in the first half of the year meant that the contribution made by construction was significant, at 0.5 percentage points. Economic growth exceeded the euro area average by 1.7 percentage points last year, but GDP in 2014 nevertheless merely reached its level of 2006.

Aggregate demand

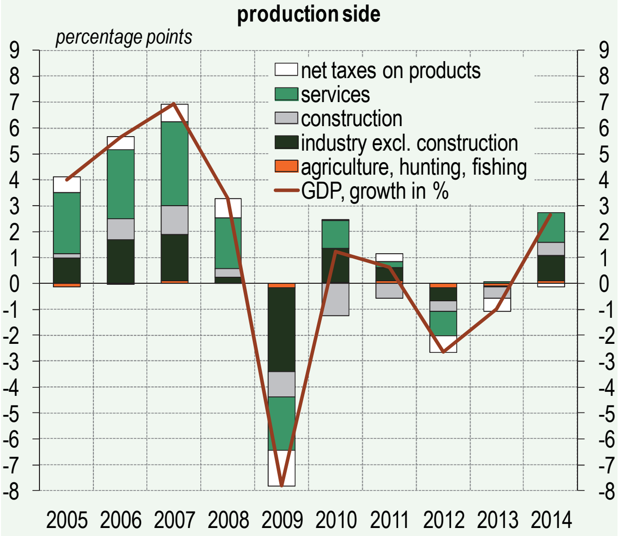
Quarterly economic growth in the final quarter of last year was entirely dependent on foreign demand for the second consecutive quarter. Real growth in exports remained high and geographically diversified, which, as imports stagnated, brought a large contribution to GDP growth by net trade. In contrast to exports, the quarterly dynamic in domestic consumption was weak. In addition to weak household consumption, gross fixed capital formation declined after five quarters of growth. The quarterly decline at the end of the year was significant, at 3.6%. Investment in residential construction continued to decline, in keeping with the freeze in the market and the large numbers of unsold new-build housing. At the same time there was a significant decline in infrastructure investment, which was entirely dependent on public financing. In contrast to the growth in exports and industrial production, and the increasing capacity utilisation, there

Figure 2.4: Manufacturing production: Oct. 2014 – Dec. 2014



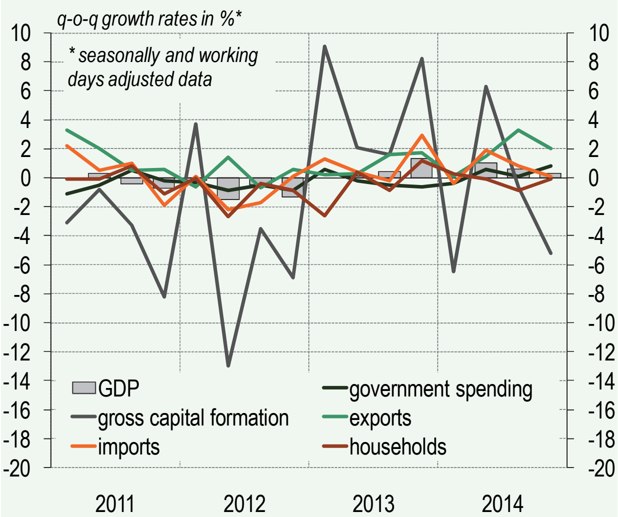
Notes: Width of each column represents a share of activity in total value added in manufacturing in 2013. Pharmaceuticals are not included due to data confidentiality.
Source: SORS, Bank of Slovenia calculations.

Figure 2.5: Contribution of components to annual GDP growth, production side



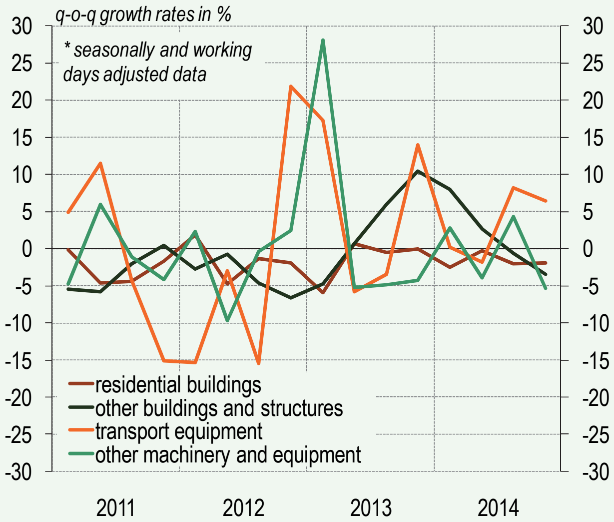
Source: SORS.

Figure 2.6: GDP components, expenditure side



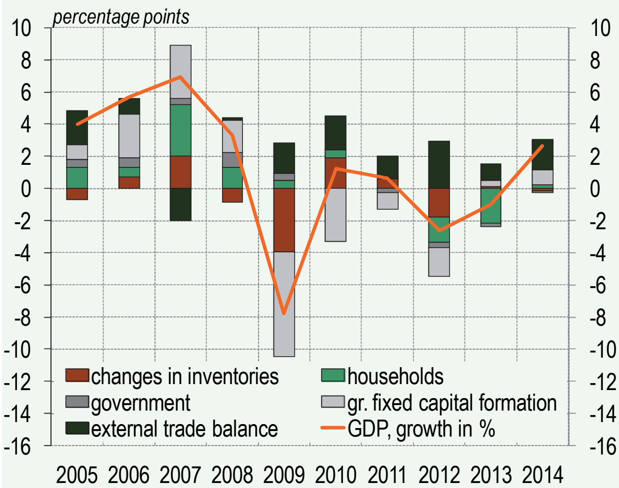
Source :SORS, Bank of Slovenia calculations.

Figure 2.7: Gross fixed capital formation



Source: SORS, Bank of Slovenia calculations.

Figure 2.9: Contributions to annual GDP growth, expenditure side

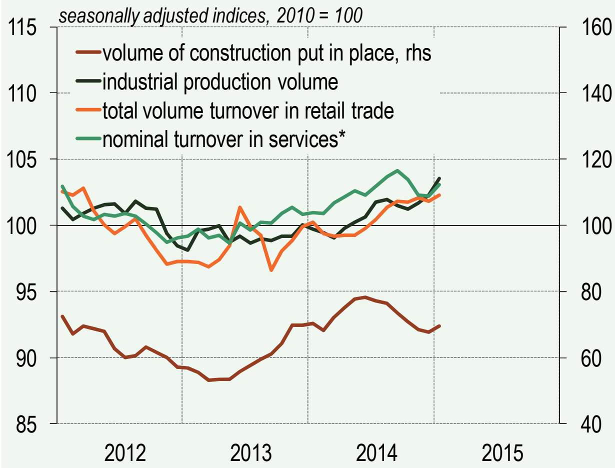


Source: SORS, Bank of Slovenia calculations.

Figure 2.8: Capacity utilization in industry

Source: Eurostat, quarterly survey.

Figure 2.10: Monthly economic activity indicators



Source: SORS.
Notes: * Private sector services excluding trade and financial services.

was a significant decline of more than 5% in investment in other machinery and equipment. It is very low relative to GDP, and in real terms it stands at its level of mid-2005. Investment in transport equipment continued to grow, supported by growth in turnover in transport services, an indication of fleet overhauls in the sector.

Growth in domestic consumption was weak overall in 2014, despite the pronounced increase in public investment. It merely stood at just under 1%, despite the low basis from 2013. Growth in household consumption was low, and was merely the result of increased purchase of durables, most notably cars. Final government consumption also declined, albeit by considerably less than in 2013. The direct negative contribution made to GDP growth by austerity measures also declined correspondingly: it was just 0.1 percentage points, compared with 0.3 percentage points in 2013. Gross investment contributed 0.5 percentage points to overall growth, entirely through public infrastructure projects. Investment in machinery and equipment was down by just over 3%; investment in production capacity recorded the most adverse developments from the point of view of economic potential. The latter could have a major adverse impact on the ability to ensure further rapid growth in exports, which in 2014 were again the main engine of economic growth. The contribution made to GDP growth by net trade amounted to almost 2 percentage points.

Economic developments in the first quarter of 2015

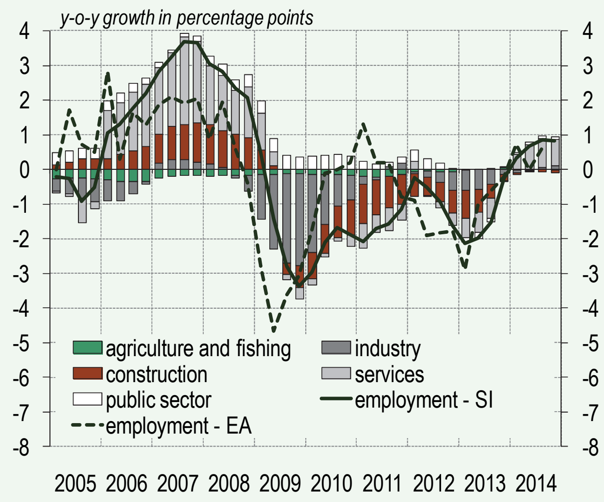
According to the figures released at the end of March, economic growth strengthened in the first quarter. Monthly growth in industrial production reached 4% in January. After several months of decline, construction activity was up just over a tenth on December. The amount of construction put in place increased in all segments, most notably in civil engineering work, an indication of a new phase of the execution of public investment co-financed by European funds. Turnover in private-sector services also strengthened. Turnover in January was up just over 1% in monthly terms in the retail sector, and by 2% overall in other services.

Employment

The improvement in the economic situation has been reflected positively in total employment. After falling for almost five years, it began rising in 2014. It was up 0.8% in year-on-year terms in the final quarter of 2014, and by 0.7% on average over the year. The number of employees in the final quarter was up 1% in year-on-year terms, while growth in the number of self-employed slowed, reaching zero in the final quarter. The proportion of total employment accounted for by the self-employed is a fifth, which is around 5 percentage points higher than the euro area average.

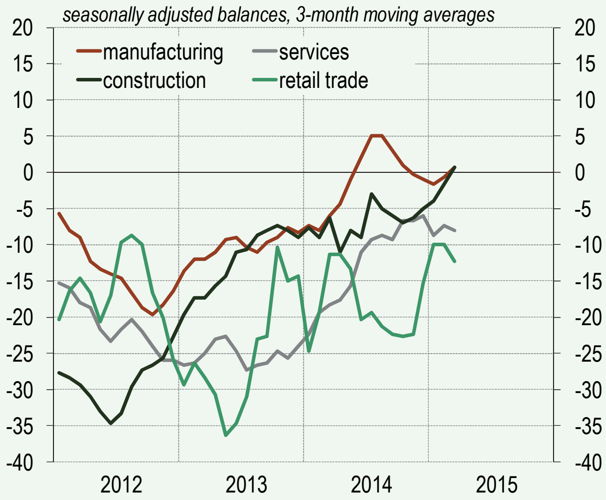
Total employment in the private sector was up in year-on-year terms throughout last year. Year-on-year growth reached almost 1% by the end of the year. Employment is increasing at non-financial corporations,

Figure 2.11: Contributions to employment growth



Source: SORS - national accounts, Bank of Slovenia calculations.

Figure 2.12: Expected employment



Source: SORS, Bank of Slovenia calculations.

which is largely attributable to private-sector services. The rise in the number of employees in professional, scientific and technical activities and in administrative and support service activities reached 4.6% last year, primarily as a result of employment agencies, which is clouding the picture of the sectoral breakdown of actual employment in other sectors, particularly in industry and construction. Employment in other personal service activities also increased, by almost 3%. After several years of decline, the number of employees in wholesale and retail trade, transport, and accommodation and food service activities began rising in the middle of the year, while the number of employees in manufacturing began rising in the second quarter after falling for just over two years. The fall in employment in construction slowed sharply from more than 7% in 2013 to just under 1% last year. Employment in financial and insurance activities is continuing to fall as a result of the restructuring of the banking sector: it was down 2.1% last year.

Employment in predominantly public services[4] also increased last year, albeit to a lesser extent. The total number of employees in the final quarter was up 0.3% in year-on-year terms in predominantly public services, and up 0.2% in the general government sector. The number of employees in sectors not under direct government control, where private supply is also present, is continuing to rise. This is confirmed by the monthly SORS figures, which are not entirely comparable to the national ac-

Table 2.1: Unemployment and employment

	2010	2011	2012	2013	2014	13Q4	14Q1	14Q2	14Q3	14Q4
					in 1,000					
Registered unemployed persons	100.5	*110.7*	110.2	119.8	120.1	120.7	128.8	120.2	114.5	116.9
Unemployment rate					*in %*					
- LFS	7.3	8.2	8.9	10.1	9.8	9.6	10.8	9.3	9.3	9.6
- registered	10.7	11.8	12.0	13.1	13.1	13.2	14.1	13.1	12.5	12.7
Probability of transition between employ. and unemployment					*in %*					
- probability to find a job[1]	14.2	13.8	13.2	13.6	15.4	11.6	16.1	17.8	14.5	13.1
- probability to lose a job[2]	2.8	2.6	2.8	2.8	2.6	3.0	3.3	2.2	2.2	2.9
					in 1,000					
Total employment[3]	961.7	946.0	938.2	924.3	930.5	927.1	918.5	927.4	941.5	934.7
					year-on-year growth in %					
Persons in paid employment	-2.7	-2.1	-1.1	-3.0	0.4	-1.9	-0.3	0.2	0.6	1.0
Self-employed	0.3	0.5	0.5	5.1	1.8	6.8	3.0	2.5	1.8	0.0
By sectors										
A Agriculture, forestry and fishing	-2.0	-2.5	-1.0	0.0	-0.2	0.4	-0.3	-0.3	-0.1	-0.3
BCDE Manufacturing, mining and quarrying and other industry	-5.7	-0.1	-1.1	-1.9	0.0	-0.7	-0.4	-0.1	0.1	0.4
F Construction	-9.4	-11.4	-7.8	-7.1	-0.9	-2.6	-0.8	-0.5	-1.1	-1.3
GHI Trade, accommodation, transport	-2.4	-2.4	-1.2	-1.2	0.2	-0.5	-0.9	-0.2	0.8	1.0
J Information and communication services	0.8	0.3	2.1	2.3	1.2	2.7	1.9	1.9	1.9	-0.8
K Financial and insurance activities	-0.7	-2.8	-1.7	-2.7	-2.1	-2.5	-2.1	-2.1	-2.1	-2.1
L Real estate activities	0.0	-2.7	-1.4	0.9	0.5	0.0	-1.9	0.0	1.9	1.9
MN Professional, technical and other business activities	2.6	0.7	1.4	-3.0	4.6	-1.1	4.7	5.2	4.3	4.2
RST Other activities	1.7	-1.9	0.2	6.1	2.9	7.7	2.3	3.2	3.5	2.6
- mainly private sector (without O..Q)[3]	-3.1	-2.2	-1.3	-1.7	0.7	-0.3	0.3	0.8	1.0	0.9
- mainly public services (O..Q)[3]	2.3	0.9	1.1	-0.6	0.3	-0.1	0.2	0.4	0.4	0.3
Total employment[4]	-2.2	-1.6	-0.8	-1.5	0.7	-0.3	0.3	0.7	0.9	0.8

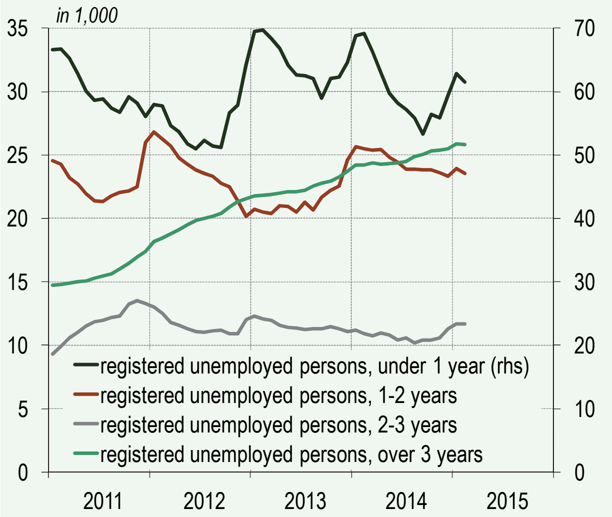
[1] Newly employed as a share of registered unemployed persons according to Employment Service of Slovenia. The higher the indicator's value, the better chance of finding a job.
[2] Newly registered unemployed due to a job loss as a share of total employment. Calculation is based on Employment Service of Slovenia's data and registered data of total employment. The higher the indicator's value, the higher chance of losing a job.
[3] Public administration, education, human health and social work services according to NACE rev. 2.
[4] Employed and self-employed persons.
Source: SORS, Bank of Slovenia calculations.

[4] Public administration and defence, education, human health and social work activities (Sectors O, P and Q under the NACE Rev. 2).

Figure 2.13: Unemployment

*Note: * Number of registered unemployed persons, y-o-y change.*
Source: Employment Service of Slovenia, SORS, Bank of Slovenia calculations.

Figure 2.14: Long-term unemployed persons



Source: Employment Service of Slovenia, Bank of Slovenia calculations.

counts figures, but reveal that the workforce in employment in human health and social work and in education has been increasing in year-on-year terms since mid-2013.

Labour market flows and unemployment

The number of new hires rose significantly last year, partly as a result of a rise in the number of first-time hires. The number of unemployed deregistering for reason of employment was up just under a tenth in year-on-year terms in the final quarter, and by almost 14% at the annual level. The increase in these outflows relative to registered unemployment was the largest since 2008. The new hires were the result of major demand for labour, but also of youth employment incentives under the emergency law adopted in November 2013. At the same time the number of people included in active employment measures was down almost a tenth on 2013. The year-on-year increase in outflows from registered unemployment for reason of first-time employment was also encouraging. Outflows of this type were up more than 40% in the final quarter, and by 45% over the whole year. This was the highest growth in outflows due to first-time employment since 2007. The positive developments continued in the early part of this year, and the employment expectations indicators are improving in the majority of sectors. According to the Employment Survey,[5] employment was forecast to grow by 0.5% in the first half of this year, albeit primarily via employment agencies. Temporary employment contracts remain prevalent among new hires. Despite the labour market reform,[6] almost three-quarters of all new hires were in the form of temporary contracts, while among young people (aged 15 to 29) the figure was almost 80%.

The number of registered unemployed began falling in year-on-year terms in July, and the trend has continued this year. The year-on-year fall reached 5.6% in February, the largest of the last six years. Unemployment nevertheless remains high, and is one of the main macroeconomic issues. Registered unemployment stood at 122,552 in February, up around 85% since the outbreak

[5] The *Employment Survey 2014/II* is the Employment Service's field research, the purpose of which is to provide short-term forecasts of developments on the labour market in the country. The sample is representative of firms with ten or more employees.
[6] The labour market reform passed on 5 March 2013 incentivised against temporary employment by limiting the chaining of contracts for the same job to a maximum of two years, introducing severance pay in the event of termination of temporary employment at a level comparable to severance pay for permanent employment, increasing the employers' contributions to unemployment insurance on temporary contracts, and exempting employers from paying the contribution for the first two years after hiring an employee permanently.

Box 2.1: Successful firms are having problems in recruiting qualified personnel

The Bank of Slovenia conducted a survey of Slovenian firms in spring 2014 with a focus on the situation and problems on the labour market.[1] Part of the survey related to factors limiting the permanent employment of workers, and the impact of legislation changes on corporate HR policy. The purpose of the questions was to formulate guidelines for further measures to stimulate employment and to improve the situation on the labour market. It is interesting to analyse the responses of the firms whose performance was above-average both before and after the crisis. It was found that the best-performing firms cite recruiting qualified personnel as one of their main problems, although at first sight this is not a significant problem overall across the surveyed firms.

Firms were classified on the basis of their overall factor productivity in two years, 2007 and 2013.[2] The firms that were either above-average or below-average in terms of productivity in their sector in both 2007 and 2013 were classified as "highly successful" and "highly unsuccessful" respectively. According to this classification, 29.3% of the surveyed firms belong to the first group, and 43.5% to the second. In addition to above-average productivity, firms in the first group are distinguished by their job creation and higher wages: in contrast to the highly unsuccessful firms, the majority of highly successful firms had more employees in 2013 than in 2007, while in both years wages at the highly successful firms were around 22% higher than at the highly unsuccessful firms.

Although the firms' opinions of the most important factors hindering the employment of workers on a permanent basis were similar, factor insufficient availability of labour with required skills was significant at the best-performing firms. As

Table 1: Factors that hindering employment of permanent workers (ranked by importance factor for very successful companies)

Factors	Highly successful firms		Highly unsuccessful firms		All firms	
	Rang	Percentage indicating factor was "relevant" or "very relevant"	Rang	Percentage indicating factor was "relevant" or "very relevant"	Rang	Percentage indicating factor was "relevant" or "very relevant"
High payroll taxes	1	27.3%	1	19.5%	1	23.6%
Uncertainty about economic conditions	2	29.2%	2	21.3%	2	25.3%
Insufficient availability of labour with the required skills	3	52.4%	9	51.7%	8	51.6%
Possibility to unilaterally and temporarily lower wages in case of adverse shocks	4	55.4%	4	42.8%	6	49.4%
Firing costs	5	55.4%	6	44.3%	4	48.5%
Hiring costs	6	55.7%	7	45.4%	7	50.0%
Risks that labour laws are changed	7	55.7%	5	43.2%	3	48.3%
Access to finance	8	58.4%	3	41.3%	5	48.5%
High wages	9	64.1%	8	50.3%	9	56.0%
Costs of other inputs complementary to labour	10	68.6%	10	55.0%	10	60.5%

Source: WDN survey for 2014, conducted by the Bank of Slovenia, Annual reports of business entities, various years (AJPES).
Notes: Firm success is measured by total factor productivity (TFP) in 2007 and 2013; highly successful (unsuccessful) firms are defined as those whose productivity is above-average (below-average) in both years. The TFP calculations control for the endogeneity of inputs using the methodology proposed by Wooldridge (2009); the model coefficients and residuals are calculated for each 2-digit NACE 2.1 sector individually. A total of 370 responses are from firms in the 'Highly successful' category; 549 responses are from firms in the 'Highly unsuccessful' category; with a total of 1263 responses amongst all firms.

Table 1 illustrates, high payroll taxes and the uncertainty about economic condition were the two most important factors cited by all groups of firms: around 72% of the highly successful firms and around 80% of the highly unsuccessful firms cited these factors as important or very important. There was a significant gap in the relative importance of the third most important factor for highly successful firms: insufficient availability of labour with the required skills. This factor was in second-to-last position at the highly unsuccessful firms, and in eighth position across all the firms. Judging by the overall survey results alone, it could be wrongly concluded that this factor is unimportant, but it is actually one of the most important factors at the highly successful firms, who also employ the most workers.

The importance of the other answers to questions regarding employment do not differ significantly between successful firms and unsuccessful firms, with the exception of access to financing. Institutional rigidities that limit the adjustment of labour costs in the event of an adverse shock (e.g. the hiring cost and the impossibility of reducing wages) are cited as the next most important factor. High wages defined by collective agreements are almost the least important factor, which is also the case for the highly unsuccessful firms. This finding could to a great extent be attributable to the low number of collective agreements concluded since the outbreak of the crisis.

[1] The survey was conducted within the framework of collaboration with other EU central banks on the Wage Dynamics Network (WDN) project. See Box 2.1 in the Macroeconomic Developments and Projections of September 2014 for certain basic results of the survey.

[2] Total factor productivity is a comprehensive productivity indicator that takes account of how efficiently a firm uses various types of production factors (labour, capital, intermediate goods). The calculation of this indicator in individual sectors took account of the different impact that the economic crisis has had in individual sectors.

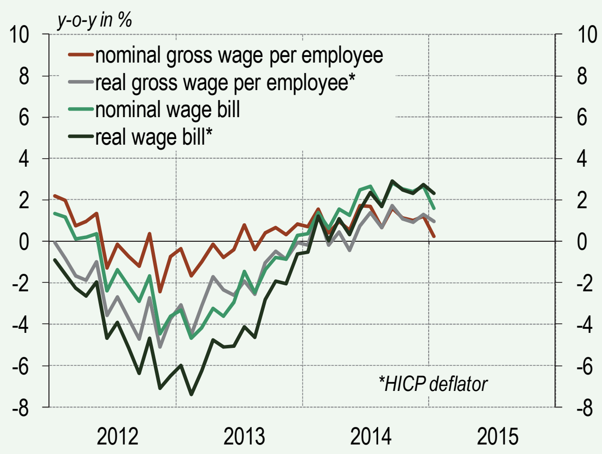
of the crisis at the end of 2008. The registered unemployment rate fell last year, but was still high at 13% in December. There has also been a notable rise in long-term unemployment, which in 2014 was up 8.1% on the 2013 average, as the proportion of total unemployment that it accounts for increased to a half. A particular concern is the sustained rise in the number of long-term unemployed who have been registered with the Employment Service for more than three years.

Of those newly registering as unemployed, the number whose temporary employment had expired was again rising at end of last year. The total number of those newly registering as unemployed was down approximately 5% last year. The largest factor in this decline was fall of almost 14% in inflows of people made redundant. Inflows as a result of loss of temporary employment also declined last year, by approximately 4%, although they were up 1% in the final quarter of the year. This could be an indication that the effects of the labour market reforms are ebbing away. The trends were reversed in inflows of first-time jobseekers: they increased in the first half of the year, and then fell by just over a tenth in the final quarter, leaving them down approximately 3% over the year as a whole.

Wage developments

Wages have been slowly rising in line with the growth in economic activity since mid-2013, but this came to a halt in January of this year. The average nominal

Figure 2.15: Total wage bill and average gross wage per employee



Note: Wage bill is calculated as the product of average gross monthly wages for employees of legal persons who received pay and the total number of employees of legal persons.
Source: SORS, Bank of Slovenia calculations.

Box 2.2: Understatement of the surveyed unemployment rate

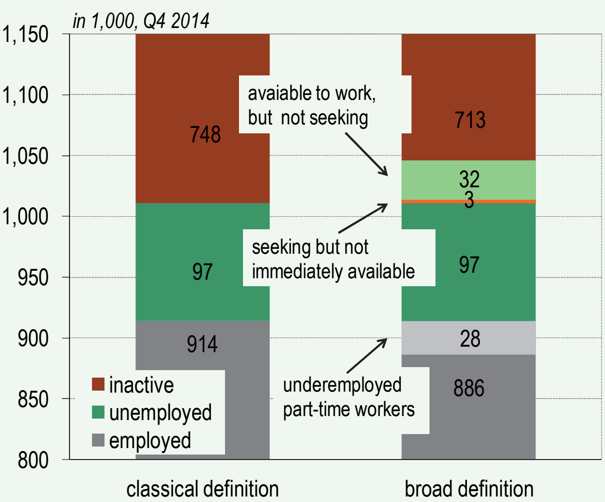
The ILO unemployment rate increased by 5.3 percentage points between the final quarter of 2008 and the final quarter of 2014 to reach 9.6%, although the increase would have amounted to 8.2 percentage points had the supplementary indicators described below been included.[1] One of the main factors used in the monitoring of the labour market, the ILO unemployment rate, is deficient, as it neglects a specific section of the population and thus underestimates the actual deterioration in the situation on the labour market in Slovenia since the outbreak of the crisis.[2] However, the recognition of this potential labour force is important. In the event of more favourable economic developments these people could activate themselves as jobseekers, thereby increasing the base of unemployed persons. This would raise the unemployment rate or leave it unchanged, which would neutralise the appearance of an improvement in the situation on the labour market according to the standard unemployment indicator.

Eurostat has developed three indicators to explain this grey area of ILO unemployment (Figure 1). The first indicator covers people who are recorded as employed but have insufficient volume of work and want to work more. They are classified as underemployed *part-time workers*. The second indicators focuses on *jobless persons seeking a job but not immediately available for work*. The third indicator covers *jobless persons available for work but not seeking it*. This includes the discouraged unemployed, who are ready to work immediately but are not actively seeking work as they believe they have no chance of being hired. The first indicator thus captures people who under the traditional definition are classed as employed, and whose level of connection with the labour market is significantly higher than people captured by the other two indicators, who would be classed as inactive under the traditional definition.

A review of the supplementary indicators shows a high representation of women and inactive older people who have been discouraged from seeking work. A more detailed review of socio-demographic attributes reveals that women are prominent in all the supplementary indicators, particularly *jobless persons seeking a job but not immediately available for work*. Health problems are the main reason cited. The indicator of *jobless persons available for work but not seeking it* includes the discouraged unemployed, whose proportion has increased by over a half in the last five years. They are predominantly aged over 50, with low skills.

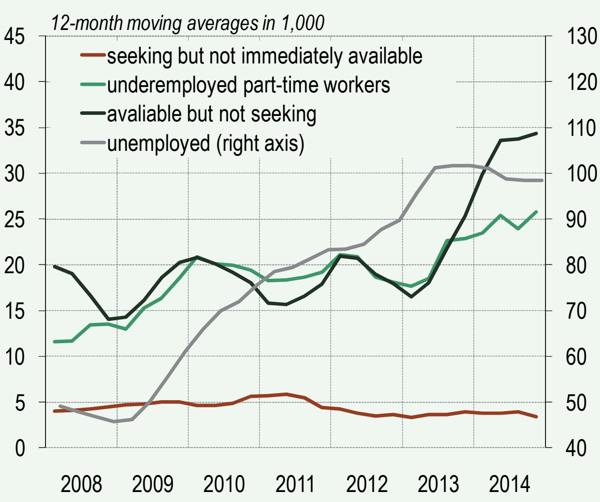
The supplementary indicators also clearly reveal the problems faced by young people in obtaining full-time employment. Young people (aged 15 to 29) account for the largest proportion of the ILO unemployed, and an even larger proportion of those covered by the supplementary unemployment indicators. The *underemployed part-time workers* indicator mostly comprises employed persons aged under 40. Young

Figure 1: ILO labour statuses and new supplementary indicators



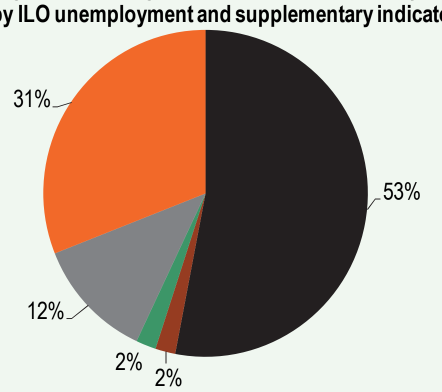
Source: Eurostat, SORS, Bank of Slovenia calculations.

Figure 2: ILO unemployment and new supplementary indicators



Source: Eurostat.

Figure 3: Coverage of self-perceived unemployment by ILO unemployment and supplementary indicators



Source: SORS, Bank of Slovenia calculations.

people aged under 30 account for just under a half, mostly working via the student service, with secondary-level qualifications. The main reason that they do not work full-time are their studying/training obligations and a lack of work. A quarter of *underemployed part-time workers* comprise people aged 30 to 39 with tertiary qualifications, mostly employed at a firm or an organisation. The main reasons cited for their reduced working hours are that they cannot get a full-time job, and the smaller amount of work at the organisation. Young people aged under 30 account for just over a half of *jobless persons seeking a job but not immediately available for work*. The main reason that they cannot accept a job immediately is the need to finish their studies. This is also reflected in a higher representation of people with secondary-level qualifications. Young people aged under 30 with secondary-level qualifications are also prevalent among *jobless persons available for work but not seeking it*, and cite studies as the main reason that they are not actively seeking work.

[1] Adding the people captured by the supplementary indicators to the ILO unemployed.

[2] The internationally accepted definition used by the International Labour Organisation defines an unemployed person as someone who is actively seeking work and is available to start work within the next fortnight and who did not undertake at least one hour of paid work in the week before being surveyed. People who do not satisfy all of the aforementioned conditions simultaneously are not defined as unemployed under the ILO methodology, even though they have certain attributes of being unemployed.

gross wage in the total economy rose by 1.1% in 2014, but the rate slowed to 0.2% in January, the lowest figure since August 2013. Gross wages in the private sector were unchanged in January. They fell in accommodation and food service activities in particular, but rose significantly in insurance and brokerage as a result of high bonus payments. In 2014, wages in the private sector rose by 1.4%. The rise in wages was primarily the result of a rise of 3.3% in wages in primarily export-oriented manufacturing. The end of a base effect meant that wages in predominantly public services began increasing in year-on-year terms in June. The rate of growth reached just under 1% in January, and 1.3% in the government sector. After rising by 0.7% in the final quarter, wages in predominantly public services recorded their first positive growth over the whole year since 2009, albeit at just 0.2%. Last year the average wage was up 1% in year-on-year terms in public administration and defence, but was unchanged in education, and in human health and social work. Growth in employment and wages has also been reflected in a rise in the nominal wage bill, which was up

Figure 2.16: Total wage bill and average monthly gross wage per employee

*Note: *The wage bill is calculated as the product of the average gross wage for employees of legal persons who received pay and the total number of employees of legal persons.*
Source: SORS, Bank of Slovenia calculations.

Table 2.2: Labour costs indicators

	2010	2011	2012	2013	2014	13Q4	14Q1	14Q2	14Q3	14Q4
					in EUR					
Average gross wage	1495	*1525*	1526	1523	1540	1564	1527	1528	1524	1581
					nominal year-on-year growth, %					
Average net wage	3.9	2.1	0.4	0.6	0.8	1.0	0.8	0.8	0.9	0.9
Average gross wage	3.9	2.0	0.1	-0.1	1.1	0.6	0.9	1.1	1.3	1.1
- mainly private sector (excl. O..Q)[1]	5.0	2.6	0.9	0.7	1.4	1.2	1.6	1.3	1.4	1.4
- mainly public services (O..Q)[1]	-0.1	0.0	-2.2	-2.3	0.2	-1.0	-1.1	0.2	1.1	0.7
Average gross wage in manufacturing	8.9	3.9	2.5	2.8	3.3	3.6	3.9	2.8	3.1	3.2
Average real net wage[2]	1.8	0.1	-2.3	-1.3	0.5	-0.1	0.2	0.0	0.8	0.9
Labour costs per hour worked[3]	1.2	2.0	-0.2	-2.1	1.9	2.1	2.3	2.3	2.2	0.9
Labour costs per hour worked in manufacturing[3]	3.2	1.9	2.9	0.6	3.7	4.5	3.1	2.6	5.9	3.1
Gross wage per unit of output[4]	0.4	-0.3	1.9	-0.6	-0.8	-1.8	-0.8	-1.1	-0.9	-0.5
Gross wage per unit of output in manufacturing[4]	-4.9	0.8	4.0	1.2	-1.4	-1.8	0.0	-1.2	-1.8	-2.6
Unit labour costs[4,5]	0.5	-0.7	0.6	1.4	-2.1	2.7	-1.2	-1.8	-1.1	-4.2
Labour costs per employee[5]	4.0	1.6	-1.2	1.9	-0.2	5.2	0.5	0.3	1.1	-2.6
Output per employee	3.5	2.3	-1.8	0.5	2.0	2.4	1.7	2.2	2.3	1.6
Output per employee - manufacturing	14.4	3.0	-1.4	1.6	4.7	5.4	3.8	4.1	5.0	5.9
HICP	2.1	2.1	2.8	1.9	0.4	1.1	0.6	0.8	0.1	0.0
GDP deflator	-1.1	1.2	0.3	1.4	0.4	2.1	1.5	0.5	0.4	-0.7

[1] Public administration, education, human health and social work services according to NACE rev. 2.
[2] HICP deflator.
[3] Labour costs according to SORS calculations.
[4] Unit of output for the total economy is defined as real GDP per person employed, and in manufacturing as real value added per person employed (both based on national accounts).
[5] Labour costs calculated on the basis of employee compensation (national accounts).
Source: SORS, Bank of Slovenia calculations.

almost 2% last year, by 2.5% in the private sector and by approximately 0.5% in mostly public services. Growth in the real wage bill has exceeded 2% in recent months, in line with inflation developments.

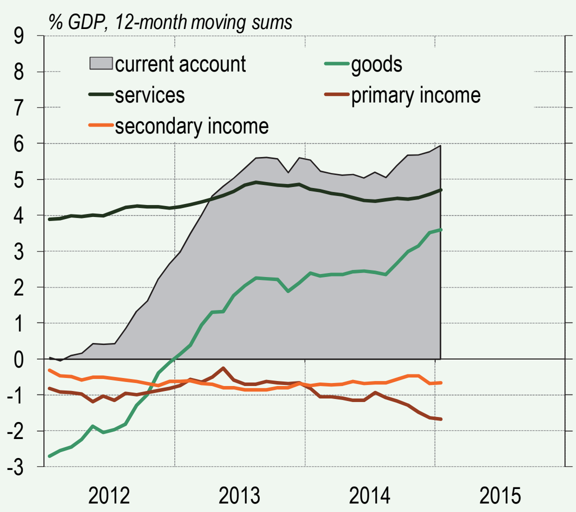
3 Current Account and Competitiveness Indicators

The current account surplus amounted to EUR 2.2 billion or 5.8% of GDP in 2014, slightly more than in the previous year. Growth in merchandise exports increased in the early part of the year in line with growth in foreign demand, particular from EU Member States, and strengthened sharply as of July primarily on the basis of rapid growth in exports of motor vehicles. The year-long decline in the surplus of trade in services came to an end in the autumn. The widening deficit in primary income, primarily as a result of the sharp growth in interest payments on the government sector-s rising external debt, acted to reduce the current account surplus. The large current account surplus is also a reflection of the improved competitiveness of Slovenia's export sector and the constraints on costs in the non-tradable sector of the economy.

Current account position

Slovenia recorded a large current account surplus for the second consecutive year. It amounted to EUR 2.2 billion or 5.8% of GDP in 2014. The increase was largely the result of an increase in the merchandise trade surplus, which widened from 2.1% of GDP in 2013 to 3.6% of GDP in 2014. Coverage of imports by exports increased from 103.6% to 106.0%. The surplus of trade in services narrowed from 4.9% of GDP to 4.6% of GDP, as a result of the widening deficit in management consultancy services. The deficit in primary income widened from 0.7% of GDP to 1.6% of GDP, as a result of a wider deficit in income on FDI and the costs of financing the general government debt. The deficit in secondary income remained at 0.7% of GDP, unchanged from 2013.

Figure 3.1: Current account components

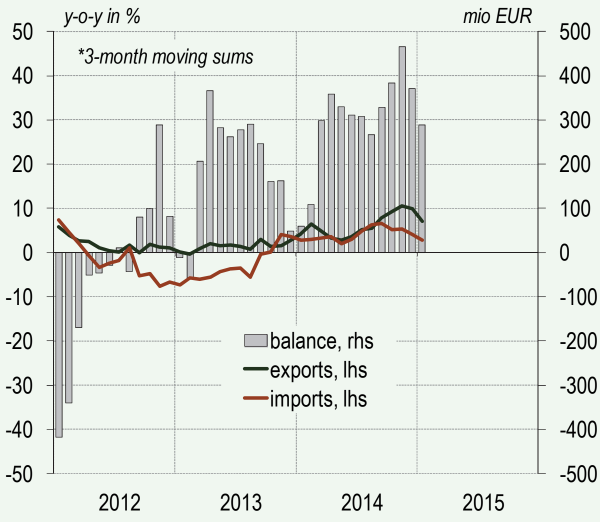


Source: Bank of Slovenia.

Merchandise trade

Year-on-year growth in merchandise exports has been outpacing growth in imports since the beginning of 2012. Favourable demand, particularly from EU Member States, saw year-on-year growth in exports exceed 10% in the second half of last year, and stand at 6.5% over the year as a whole. Year-on-year growth in merchandise imports was 2.5 percentage points less. In the wake of these developments, the merchandise trade surplus amounted to EUR 1.3 billion last year.

Figure 3.2: Goods trade*



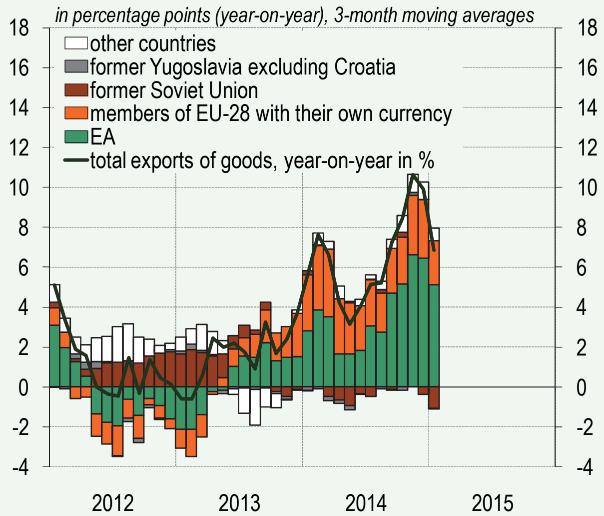
Source: Bank of Slovenia.

Year-on-year growth in merchandise exports has been driven exclusively by exports to EU Member States since mid-2013. According to SORS figures, merchandise exports to EU Member States increased by 9.1% in 2014, while exports to non-EU countries increased by just 0.5%. Slovenian exporters compensated for the deterioration in the situation, most notably in Serbia and Russia, by exporting to other markets outside the EU.

The main factor in the increase in merchandise exports in the second half of last year was exports of consumer goods. Consumer goods accounted for merely just over 20% of total growth in merchandise exports in the first quarter, but for almost 60% in the final quarter. The rapid growth was related to the strengthening of production and exports of cars since July. Exports of capital goods increased over the year, and accounted for 12% of total growth in the first quarter but for just over 16% in the final quarter. The contribution made to export growth by intermediate goods declined until the third quarter, when it fell behind the contribution made by consumer goods.

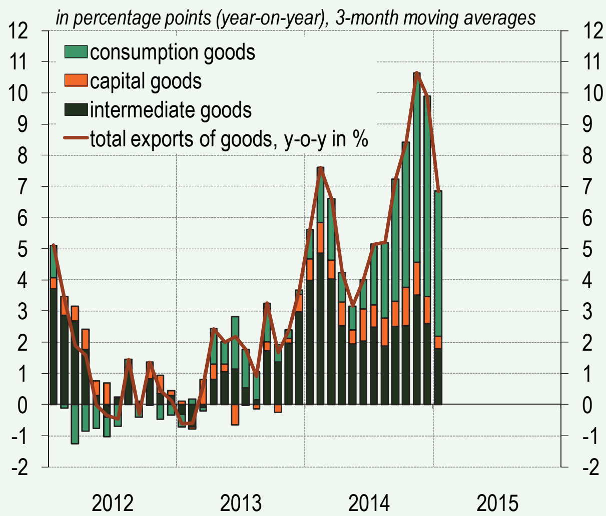
Merchandise imports strengthened in nominal terms in the second half of the year, despite the continuing fall in import prices. In the wake of increased industrial

Figure 3.3: Contributions to export growth by country groups



Source: SORS, Bank of Slovenia calculations.

Figure 3.4: Contributions of main BEC groups to export growth

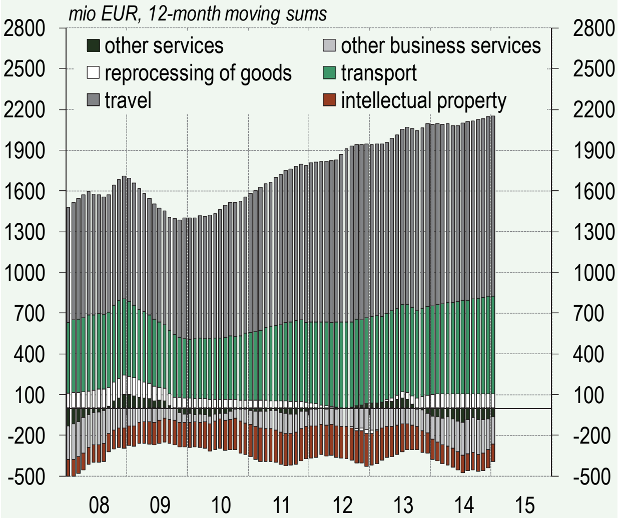


Source: SORS, Bank of Slovenia calculations.

Figure 3.5: External trade unit value indices

Source: SORS.

Figure 3.6: Trade in services balance



Source: Bank of Slovenia.

production and exports, growth in imports of intermediate goods strengthened slightly in the second half of last year, but were nevertheless down just under 1% in nominal terms in 2014. The nominal decline was largely attributable to the decline in prices of primary industrial and agricultural commodities, most notably falling oil prices. Growth in imports of capital goods strengthened sharply as of the second quarter, and stood at just over 6% across the whole of 2014, although this has not yet been reflected in growth in investment itself. The largest increase in merchandise imports was recorded by consumer goods, at just over 8%, rather at odds with the minimal increase in private consumption.

Trade in services

The surplus of trade in services again made the largest contribution to the current account surplus, even though it narrowed slightly relative to 2013. Despite an improvement in the second half of the year, growth in exports of services was significantly outpaced by growth in imports last year. Imports of services were up just over 7%, while exports were up just 3.9%, which narrowed the surplus of trade in services by EUR 48 million to EUR 1.7 billion.

The surplus in transport services and merchandise handling, i.e. in services closely linked to merchandise trade, widened in 2014. Imports and exports of transport services closely track developments in merchandise trade, but growth in exports over the year was slightly higher than growth in imports at 9.2%. The most notable increases were in freight rail transport and sea and coastal freight water transport, and on the export side of freight transport by air.

Developments in trade in travel services were less favourable. The number of arrivals by foreign visitors was up 6.1% in 2014, although growth in the number of overnight stays was low, at just over 1%. This discrepancy is an indication of the increase in the proportion of transit tourism and the reduction in the foreign visitors' average time of stay, which has also been reflected in exports of travel services. In value terms, exports of travel services were up just 0.3% while imports were up just over 4%, partly as a result of an increase of more than 10% in business travel abroad. The surplus of trade in travel services was virtually unchanged in year-on-year terms at EUR 1.3 billion.

The deficit in services other than transport and travel is widening rapidly. It widened by just under a third last year to EUR 330 million. The largest increase of

EUR 85 million was recorded by the deficit in other business services, which amounted to EUR 233 million. Although it is narrowing, the deficit in intellectual property services remains relatively wide at EUR 130 million. Of other services, only construction services recorded a surplus, of EUR 41 million, while the deficit in financial services widened to EUR 51 million, and the deficit in telecommunications and computer services also widened slightly.

Table 3.1: Components of the current account

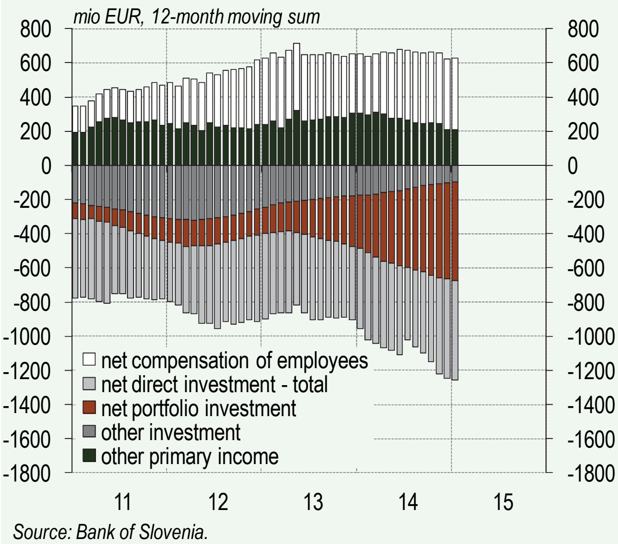
	2012	2013	2014	in 12 months to Jan.14	in 12 months to Jan.15	13Q3	13Q4	14Q3	14Q4	Jan.14	Jan.15
					in EUR million						
Current account balance	954	2,027	2,150	2,009	2,218	477	480	620	634	68	136
1. Goods	-36	763	1,307	865	1,340	247	48	328	370	80	113
2. Services	1,509	1,755	1,707	1,711	1,753	532	339	565	389	94	140
2.1. Transport	633	654	719	653	721	177	151	197	174	50	52
2.2. Travel	1,278	1,345	1,322	1,338	1,326	433	309	447	319	95	98
2.3. Other	-401	-243	-334	-280	-294	-78	-121	-79	-103	-51	-10
3. Primary income	-292	-243	-612	-300	-624	-192	-2	-203	-179	-63	-75
3.1. Labour income	376	348	416	346	416	85	94	96	96	31	31
3.2. Investment income	-911	-899	-1,238	-953	-1,251	-317	-170	-306	-315	-91	-103
4. Secondary income	-227	-249	-252	-267	-251	-110	95	-71	53	-44	-43
					in % of BDP						
Current account balance	2.7	5.6	5.8	5.5	5.9	5.1	5.2	6.4	6.7	2.4	4.6
1. Goods	-0.1	2.1	3.5	2.4	3.6	2.7	0.5	3.4	3.9	2.8	3.9
2. Services	4.2	4.9	4.6	4.7	4.7	5.7	3.7	5.9	4.1	3.3	4.8
2.1. Transport	1.8	1.8	1.9	1.8	1.9	1.9	1.6	2.0	1.8	1.7	1.8
2.2. Travel	3.5	3.7	3.5	3.7	3.6	4.7	3.3	4.6	3.4	3.3	3.4
2.3. Other	-1.1	-0.7	-0.9	-0.8	-0.8	-0.8	-1.3	-0.8	-1.1	-1.8	-0.3
3. Primary income	-0.8	-0.7	-1.6	-0.8	-1.7	-2.1	0.0	-2.1	-1.9	-2.2	-2.6
3.1. Labour income	1.0	1.0	1.1	1.0	1.1	0.9	1.0	1.0	1.0	1.1	1.1
3.2. Investment income	-2.5	-2.5	-3.3	-2.6	-3.4	-3.4	-1.8	-3.2	-3.3	-3.1	-3.5
4. Secondary income	-0.6	-0.7	-0.7	-0.7	-0.7	-1.2	1.0	-0.7	0.6	-1.5	-1.5
					nominal year-on-year growth rates in %						
Export of goods and services	1.6	2.4	6.1	2.6	5.7	3.3	2.7	6.6	9.2	6.1	1.2
Export of goods	1.0	2.1	6.6	2.2	6.1	2.9	2.9	7.9	9.9	6.6	1.2
Export of services	4.1	3.9	4.1	4.2	3.8	4.6	1.8	2.2	5.9	4.0	0.9
Transport	2.9	3.4	9.5	3.9	8.6	3.9	4.4	10.0	11.1	10.8	-0.4
Travel	1.7	1.5	0.4	2.5	0.2	3.7	3.7	-2.2	1.3	3.9	1.9
Other	8.0	7.1	4.1	6.4	4.2	6.8	-1.5	3.3	6.2	-1.0	0.9
Import of goods and services	-2.3	-1.6	4.7	-1.3	4.2	-0.5	3.3	5.6	3.9	3.5	-2.6
Import of goods	-3.1	-1.7	4.2	-1.6	4.1	-0.3	3.5	6.7	4.1	0.6	-0.6
Import of services	2.8	-1.2	7.4	0.6	4.5	-1.5	1.7	0.1	2.8	25.1	-14.4
Transport	-1.6	3.4	9.1	5.4	7.1	-1.1	6.5	9.0	8.3	23.1	-3.4
Travel	-10.6	-4.9	4.3	-3.2	2.5	-4.1	-7.1	-9.9	-3.2	36.0	-1.9
Other	10.0	-1.6	7.9	0.4	4.3	0.0	2.3	3.0	2.3	23.5	-21.1

Source: Bank of Slovenia.
Note: Shares in GDP are calculated on the basis of monthly estimates of GDP.

Primary and secondary income

The deficit in primary income more than doubled last year, reaching almost EUR 600 million. The deficit in capital income widened by EUR 326 million to EUR 1,225 million. The largest factor in the widening deficit was growth in net payments of income on investments in securities, where the deficit widened by EUR 241 million to EUR 536 million. Within this framework, expenditure for financing the external general government debt increased by EUR 249 million to EUR 799 million. Losses[7] on Slovenian firms' outward FDI were down just under a third in year-on-year terms, but remained high at EUR 346 million. The deficit in income on FDI is also widening as a result of sales of domestic firms to non-residents. It widened by EUR 153 million to EUR 583 million, and the trend can be expected to continue in the future. The surplus in labour income widened by EUR 69 million in year-on-year terms to EUR 416 million as a result of slightly slower growth in outflows. The surplus in other primary income narrowed by EUR 100 million in year-on-year terms to just under EUR 210 million, largely as a result of a decline in inflows from government rents, taxes on production and imports, and subsidies. The overall deficit in primary income widened by EUR 356 million in 2014 to EUR 598 million, or 1.6% of GDP.

Figure 3.7: Net primary income



Source: Bank of Slovenia.

After recording a large deficit in the first quarter, secondary income stagnated in the second and third quarters before moving into surplus in the final quarter. The deficit widened very slightly in 2014 to EUR 252 million. The government deficit narrowed by EUR 13 million (primarily on account of EU own resources from VAT and GNI), while the deficit of other sectors, where social security contributions and taxes on income and assets are prevalent, widened by EUR 16 million.

Current account developments in January 2015

The current account surplus continued to widen in January. It was EUR 68 million wider in year-on-year terms, taking the cumulative deficit over 12 months to 5.9% of GDP. Growth in merchandise exports slowed in January to just over 1%, and imports actually declined, which widened the merchandise trade surplus by EUR 33 million. The surplus of trade in services in January was up EUR 46 million in year-on-year terms, almost exclusively as a result of a contraction in imports. The latter was most pronounced in business and other consultancy services, as a result of a high basis in connection with payments for services in the recovery and resolution of the domestic banking system. An increase in government expenditure for financing the external debt contributed more than EUR 12 million to the widening of the deficit in primary income. The deficit in secondary income was unchanged in year-on-year terms.

[7] The coverage of losses in the current account is disclosed as firms' negative reinvested earnings on outward FDI.

Selected competitiveness indicators[8]

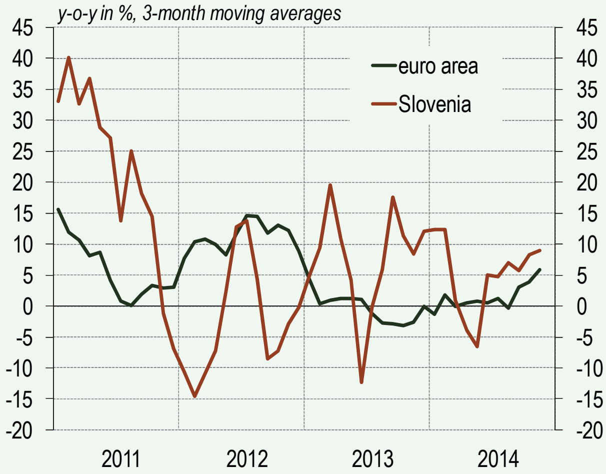
Slovenia's price competitiveness improved as a result of low domestic inflation and the fall in the euro. Year-on-year growth in prices in Slovenia as measured by the HICP in the final quarter of last year was at its lowest level since 2009. Domestic inflation was also lower than price growth in the majority of the main trading partners. The fall in the euro was also a major factor in the strengthening of competitiveness against partners outside the euro area in the final quarter.

There was an extremely sharp fall in unit labour costs (ULCs) last year compared with the euro area average. This was largely attributable to the increase in value-added, which was significant in all major sectors, most notably the tradable sector, i.e. manufacturing. Growth in ULCs across the euro area strengthened in the second

Figure 3.8: Harmonised price competitiveness indicators (based on HICP/CPI deflators)

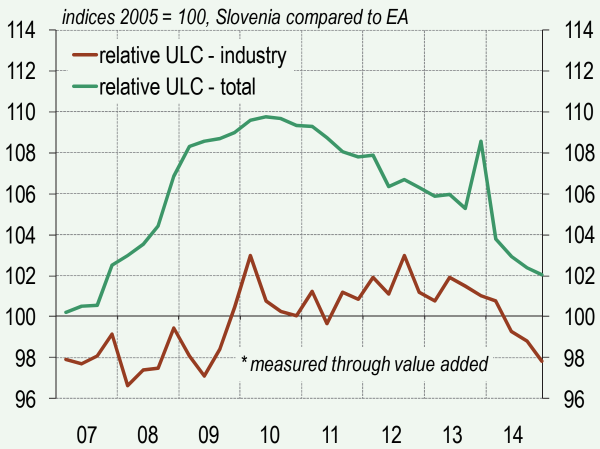
Source: ECB.

Figure 3.10: High-tech exports



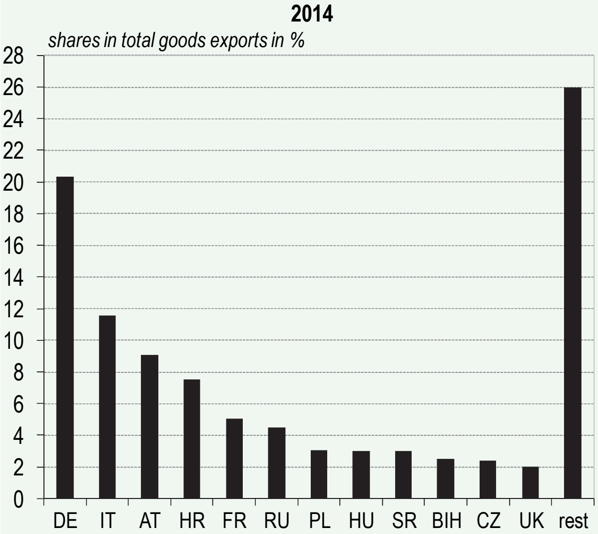
Source: Eurostat, Bank of Slovenia calculations according to the OECD methodology.

Figure 3.9: Nominal unit labour costs* in relative terms



Source: Eurostat, Bank of Slovenia calculations.
Note: In the case of Slovenia, the temporary increase in the ULC for the total economy in the last quarter of 2013 is due to the impact of the settlement of wage disparities in the general government sector in the amount of almost 200 mio EUR.

Figure 3.11: Geographical diversification of goods exports in 2014



Source: Bank of Slovenia.

[8] A rise in the value of the harmonised competitiveness indicators (appreciation) entails a deterioration in competitiveness, while a fall (depreciation) entails an improvement in competitiveness in comparison with the selected countries.

half of the year, primarily as a result of the continuing growth in employee compensation.

The increased competitiveness of domestic firms has been reflected in rapid growth in exports. Year-on-year growth in exports in the final quarter strongly exceeded the average over the first three quarters of the year, and was higher than growth in exports across the euro area. Growth in exports of capital goods, which are generally more intensive in technological terms, and account for approximately 10% of total merchandise exports, was far above the average growth in 2013. Growth in exports of high-tech products also remained above the euro area average. At the same time merchandise exports are relatively diversified in geographical terms, which mitigates the differences in economic activity between markets.

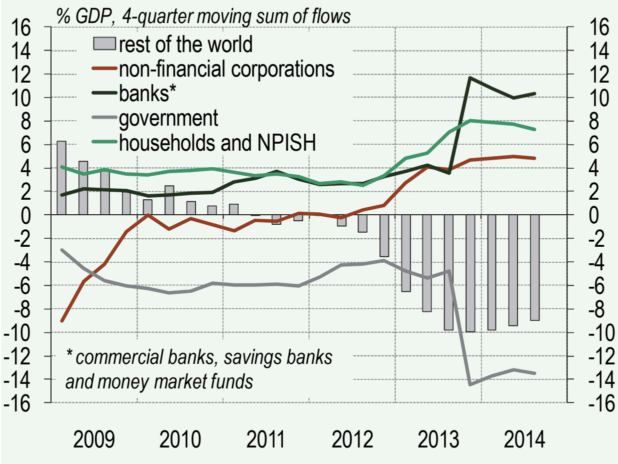
4 Financing

The more favourable macroeconomic situation in Slovenia and the measures to stabilise the banking system were reflected in the financial accounts of individual institutional sectors. Corporates have increased their retained earnings, while their financial surplus is stabilising in the wake of weak current growth in investment. Part of the surplus was invested in bank deposits, and part in business-to-business loans and in loans to the rest of the world. Corporates are continuing to deleverage, but their indebtedness remains high. Households have also maintained a high financial surplus, having remained cautious in consumption, and are increasing their saving, primarily in bank deposits. The banks are continuing to make debt repayments and are reducing loans to the private sector. The corporates that were successful in adjusting to this process compensated for the loss of domestic bank financing by issuing debt securities and by raising loans from the rest of the world.

Savings-investment gap by sector

The improved domestic economic situation in 2014 has already been reflected in the private sector's financial accounts, and is being evidenced in the stabilisation of the 12-month surplus[9] in domestic saving over domestic investment. The surplus, which is evidenced as a financial surplus against the rest of the world, stood at 9% of GDP in the third quarter, down slightly from the end of 2013. Corporates[10] have increased their retained earnings, while their financial surplus stabilised as a result of weak current nominal growth in investment. The corporate sector's financial surplus stood at 4.8% of GDP in the third quarter of 2014. The household sector sharply increased its net financial surplus in 2013, and maintained it at a high level in 2014.

Figure 4.1: Savings-investment gap



Note: Figures for Q4 2013 were influenced by the transfer of bank assets to BAMC after AQR/ST.
Source: Bank of Slovenia - nonconsolidated financial accounts, SORS.

[9] The savings-investment surplus is defined as the surplus of financial assets (savings) over financial liabilities (investments).
[10] Corporates or non-financial corporations (S.11) are market producers whose core business activity is the production of marketable goods and non-financial services.

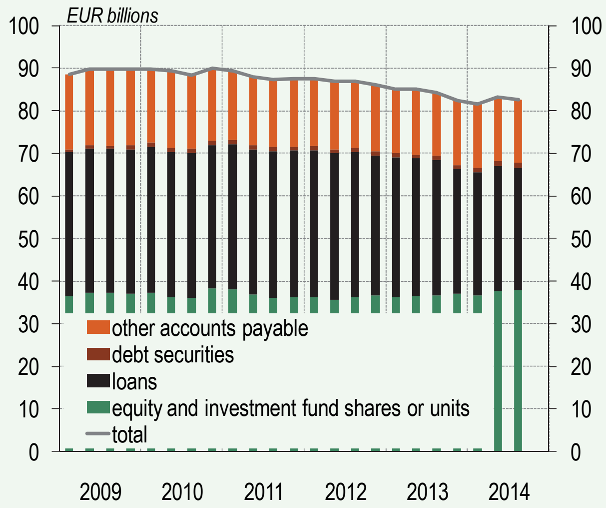
Given the weak growth in consumption over the first three quarters of the year, the latter was primarily a reflection of the gradual increase in the wage bill as a result of the improvement in the situation on the labour market. The household sector's financial surplus stood at 7.3% of GDP in the third quarter of 2014. The banking sector's financial surplus remained extremely high as a result of the banks' reluctance to lend to the private sector.

Corporate financing and financial assets

Corporate financial liabilities amounted to EUR 42.6 billion at the end of the third quarter of 2014, unchanged from the end of 2013, although the structure did change. Negative revaluations of shares and other equity in particular reduced the value of assets by EUR 1 billion, while new investments brought an increase of the same amount. In the wake of a gradual increase in retained earnings, corporates further increased their financial surplus, having increased their investments in transferable deposits at domestic banks by EUR 0.4 billion over the first three quarters of 2014.[11] The stock of loans granted also increased: domestic business-to-business loans by EUR 0.2 billion and loans to the rest of the world by EUR 0.1 billion. Domestic business-to-business lending in the form of trade credits has continued to decline: it was down EUR 0.1 billion over the first three quarters of 2014, while trade credits granted to the rest of the world increased by EUR 0.4 billion. Other claims against the government sector also increased by EUR 0.4 billion, which was partly attributable to increased investment by local government and prepayments for mobile networks. The sole transaction decline was recorded by investments in shares and other equity, at EUR 0.3 billion, but they still account for the largest proportion of corporate assets, at EUR 15 billion.

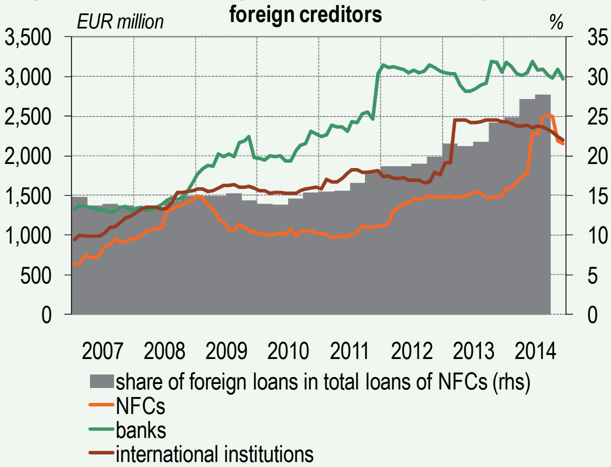
Corporate financial liabilities increased by EUR 0.3 billion over the first three quarters of 2014 to EUR 82.6 billion. Corporates primarily increased their liabilities via successful issues of debt securities in the amount of EUR 0.3 billion,[12] while positive revaluations of equity[13] accounted for a significant increase in liabilities, in the amount of EUR 0.7 billion. There were further de-

Figure 4.2: Financial liabilities of NFCs (S.11)



Source: Bank of Slovenia, non-consolidated data.

Figure 4.3: Stock of foreign loans to NFCs according to sector of foreign creditors



Note: 2011 - large transaction between foreign owner and Slovenian real estate companies; 2013 - large loan of two international institutions for TEŠ6; 2014 - two large transactions with two foreign companies.
Source: Bank of Slovenia.

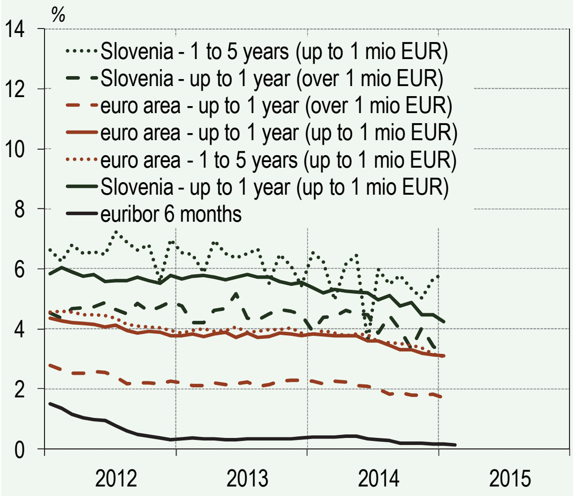
[11] The increase was in part attributable to a Petrol bond issue in the amount of EUR 265 million, the proceeds of which were partly deposited with banks, and partly used to repay bank loans.
[12] The most successful borrowing was the Petrol bond issued in the rest of the world in the amount of EUR 265 million, with a coupon rate of 3.25%. Corporates issued just over EUR 200 million of debt securities on the domestic market in the first three quarters of the year.
[13] Equity comprises shares and other equity, and investment fund units.

clines in domestic bank financing, in the amount of EUR 0.8 billion, and in financing via domestic and foreign trade credits, in the total amount of EUR 0.4 billion. As domestic resources have dried up and lending rates remain high, lending from the rest of the world is accounting for an increasing proportion of financing. Corporate loans raised in the rest of the world accounted for 28% of total corporate loans at the end of the third quarter of 2014, up just over 3 percentage points on the end of 2013. The majority (85%) of loans raised in the rest of the world are long-term loans.

The fall in the banks' liability interest rates and the measures to stabilise the banking system have already been reflected in a fall in interest rates on new corporate loans, although they remain significantly above the euro area average. Short-term interest rates on new corporate loans of less than EUR 1 million were 1.5 percentage points higher than the euro area average in 2014, while short-term interest rates on loans of more than EUR 1 million were just over 2 percentage points higher than the euro area average. The situation is similar for long-term loans, where the spread between the interest rates in Slovenia and those across the euro area remains at 2 percentage points.

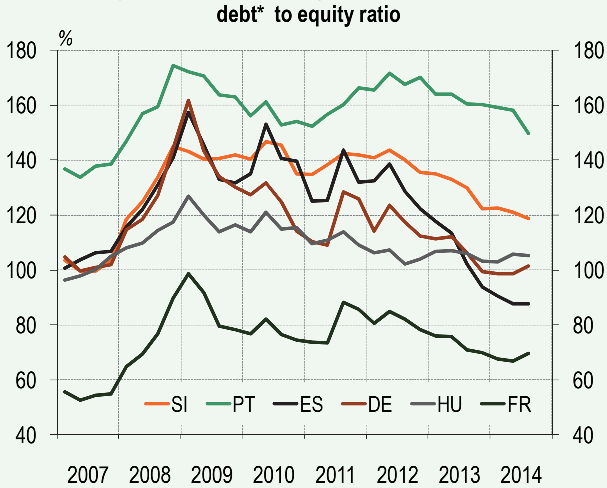
Slovenian corporate indebtedness as measured by the debt-to-equity financing ratio remains high, although significantly lower than in the two previous years. It stood at 119% in the third quarter of 2014, down 21 percentage points on the same period two years earlier.[14] The main factor in this decline was the reduction in debt, while equity financing has remained weak. The corporate indebtedness indicator as measured by the ratio of debt to GDP stood at just over 80%, 20 percentage points less than the euro area average. The actual level of indebtedness of the Slovenian economy is not problematic; only the financing structure is inappropriate, as it lacks equity. The actual indebtedness of the corporate sector is also sharply concentrated. Almost half of the excess debt[15] is carried by the hundred firms with the largest excess debt.[16]

Figure 4.4: Interest rates on loans to NFCs



Source: ECB, Bank of Slovenia.

Figure 4.5: Cross country comparison of NFCs debt* to equity ratio



*Note: * Securities other than shares, loans and other accounts payable.*
Source: ECB, BoS calculations.

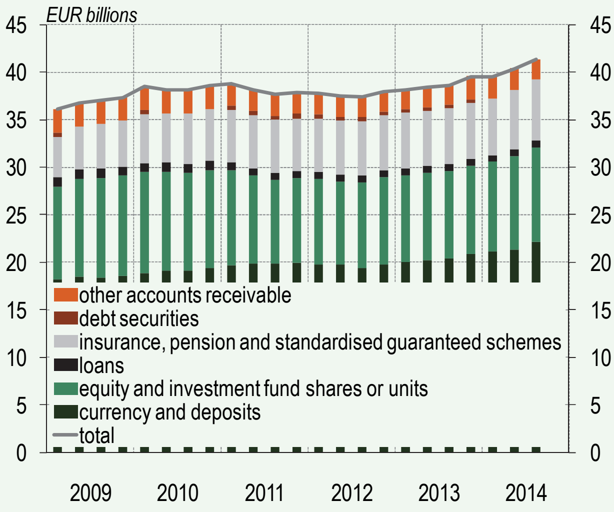
[14] The largest decline was recorded in the final quarter of 2013, as a result of the revaluation of non-performing loans and their transfer to the BAMC.
[15] Excess debt is defined as the excess net financial debt (NFD) for firms where NFD/EBITDA >= 5 or NFD/EBITDA = 0 or is negative.
[16] For more detailed analysis, see Stability of the Slovenian Banking System, December 2014, p 54.

Household financing and savings

Households increased their investments by EUR 2.1 billion over the first three quarters of 2014 to EUR 41.7 billion. The increase in the stock of assets is the result of the gradual rise in the wage bill. Another major factor in the increase in assets were positive revaluations in investments in shares and in insurance and pensions,[17] which amounted to EUR 0.9 billion over the first three quarters of 2014. Because uncertain forms of work are prevalent among new hires, households only increased their consumption to a lesser extent in 2014, while remaining cautious and increasing their gross saving, primarily investing the increase in assets in bank deposits. Confidence has been restored in the domestic banking system, households having invested EUR 0.6 billion in domestic deposits and just EUR 0.2 billion in the rest of the world.[18] Households nevertheless remain cautious in committing assets for fixed terms: the majority of the deposits are sight deposits. This was largely the result of the sharp fall in interest rates on deposits of all maturities in Slovenia and in the rest of the world. Interest rates on long-term household deposits began to fall after the adoption of a measure to limit deposit rates in 2012, and have gradually approached average interest rates in the euro area. At the same time interest rates on short-term deposits remain below the euro area average, which could in the future cause the gradual outflow of deposits to the rest of the world or a search for alternative higher-yielding but higher-risk investments.

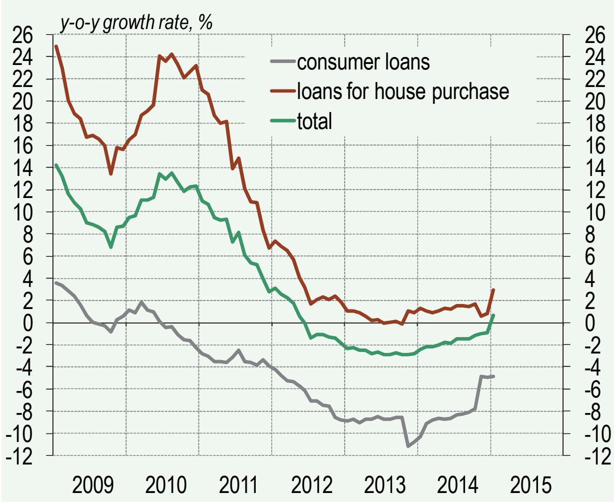
Household financial liabilities amounted to EUR 12.3 billion at the end of the third quarter of 2014, broadly unchanged from the end of 2013. Liabilities from bank loans declined by EUR 0.1 billion, but other accounts payable[19] increased by the same amount. Bank loans to households have continued to decline in year-on-year terms, primarily on account of consumer loans, albeit at diminishing rates. The decline stood at 1% at the end of 2014, compared with 3% a year earlier. Interest rates on new consumer loans remain just under 1 percentage point below the euro area average. At the

Figure 4.6: Financial assets of households (S.14 and S.15)



Source: Bank of Slovenia, non-consolidated data.

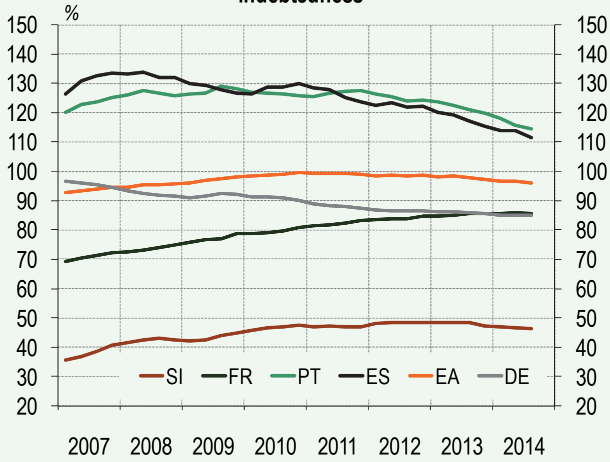
Figure 4.7: Loans to households



Source: Bank of Slovenia.

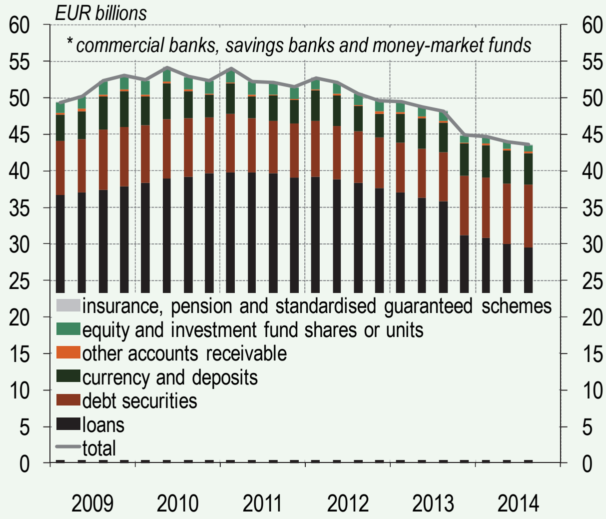
[17] Investments in insurance and pensions comprise life insurance and annuity entitlements, non-life insurance technical reserves, pension entitlements, entitlements to non-pension benefits and claims of pension funds on pension managers.
[18] The developments in Cyprus, the initiation of an orderly wind-down process at two banks and the uncertainty surrounding the results of the comprehensive assessment of the banking system had a profound impact on household confidence in the domestic banking system in 2013. This was reflected in a decline of EUR 0.4 billion in deposits at domestic banks and an increase of EUR 0.6 billion in deposits in the rest of the world.
[19] This category includes trade credits and advances, and other accounts receivable/payable, which arise on the basis of time differences between accounted transactions and payments.

Figure 4.8: Cross country comparison of household indebtedness*



Source: ECB.
*Note: * Indebtedness is calculated as debt (loans+debt securities) over gross disposable income.*

Figure 4.9: Financial assets of banks* (S.122 and S.123)



Source: Bank of Slovenia, non-consolidated data.

same time interest rates on new housing loans rose above the euro area average in the second half of 2013. They had risen by a further 0.4 percentage points by the end of 2014.

Slovenian households remain among the least indebted: their debt is half of the average household debt in the euro area. The average debt of Slovenian households amounted to 46% of annual disposable income or 32% of GDP at the end of the third quarter of 2014. Slovenian households are also the lowest-risk class of bank customer: less than 5% of claims against them are non-performing.

Bank funding

The banking sector's financial assets amounted to EUR 43.6 billion at the end of the third quarter of 2014, down EUR 1.3 billion on the end of 2013. This was the result of net repayments of corporate loans in the amount of EUR 0.8 billion, loans to non-residents in the amount of EUR 0.2 billion and household loans in the amount of EUR 0.1 billion. Domestic interbank lending contracted by EUR 0.4 billion over the same period. Write-offs of bank loans amounted to EUR 0.2 billion over the first three quarters of 2014. Bank deposits remained unchanged, although this was primarily a structural effect: the banks reduced their balance at the central bank by EUR 0.9 billion, and invested the money in deposits at foreign banks. The only bank assets to increase were investments in debt securities, which were up EUR 350 million as a result of the successful issue of 3-year Nova Ljubljanska banka bonds in the amount of EUR 300 million with a coupon rate of 2.9%. The main purchasers of these bonds were non-residents, and the banks earmarked the proceeds of the sale for general funding needs and the repayment of more expensive funding.

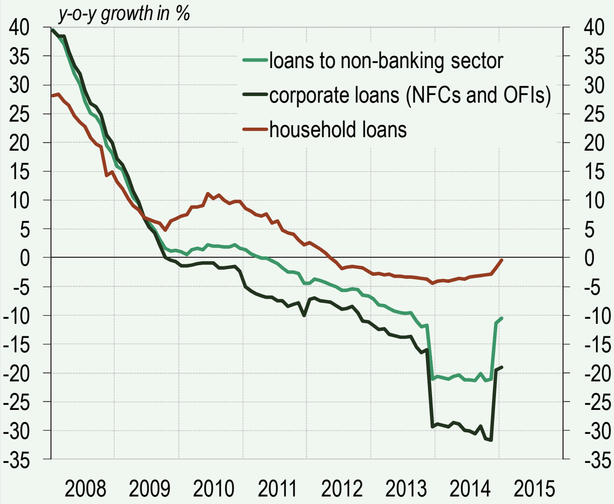
Bank financial liabilities declined by EUR 1.4 billion over the first three quarters to stand at EUR 38.8 billion at the end of the third quarter. The largest factor was the early repayment of the ECB's 3-year LTRO, which was reflected in a decline of EUR 2.4 billion in liabilities from loans raised at the central bank. There were further debt repayments to foreign banks in the amount of EUR 0.9 billion and to domestic banks in the amount of EUR 0.4 billion. The banks continued the process of repaying debt to banks in the rest of the world, albeit at a slower pace than in the previous six years. Liabilities to foreign banks accounted for a third of total bank liabilities at the end of 2008, but just 11% at the end of September

Box 4.1: Bank performance in 2014 and the first quarter of 2015

The situation in the banking system gradually stabilised as the bank recovery process continued. The transfer of certain non-performing claims of two more banks to the Bank Assets Management Company (BAMC) and their recapitalisation in October and December of last year brought an a further improvement in the quality of the banks' credit portfolio, their capital adequacy and their liquidity. Credit institution risk nevertheless remains one of the major risks in the banking system, alongside high income risk, the long period of contracting turnover in an environment of low interest rates having reduced the banks' ability to generate income. The bank were also risk-adverse last year, and corporates raised a significant proportion of their financing in the rest of the world, which further reduced the banks' potential income.

V Loans to the non-banking sector declined by EUR 2.8 billion last year, most notably loans to non-financial corporations (NFCs), which were down EUR 2.3 billion. Impairments and the transfer of claims to the BAMC at Abanka and Banka Celje were another factor in the contraction in loans to the non-banking sector in the final quarter of last year. The year-on-year contraction in loans to the non-banking sector declined by 10 percentage points to 11.4% in December as a result of base effect. There was also a pronounced base effect in loans to NFCs and OFIs, the sectors from which the largest proportion of claims were transferred to the BAMC. Loans to the non-banking sector recorded a net increase in all

Figure 1: Loans to non-banking sector



Source: Bank of Slovenia.

segments in January 2015. Most notable was the significant positive increase of EUR 104 million in loans to NFCs after a long absence of growth, although the year-on-year contraction remained large at 18.3% despite the improvement.

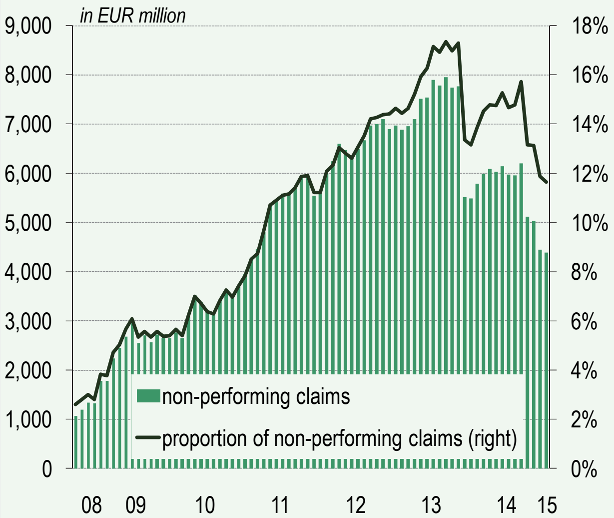
The dynamics in household loans are also improving. The stock of loans at the end of January approached its level of a year earlier, which was largely attributable to an increase in the stock of housing loans as a result of the appreciation of the Swiss franc.

Survey figures (BLS) reveal that net corporate demand for loans at Slovenian banks increased in 2014, after several years of decline. The growth in net demand is primarily the result of the improvement in the economic situation. Another positive factor is the fall in asset interest rates, which tracked the significant fall in liability interest rates with a lag and to a lesser extent. In early 2015 certain banks also held positive expectations of future corporate demand for loans.

The banks have remained conservative in corporate lending, and have maintained high credit standards. By contrast, banks across the euro area have reported relaxing credit standards since the second quarter of 2014 (for the first time since the outbreak of the economic and financial crisis).

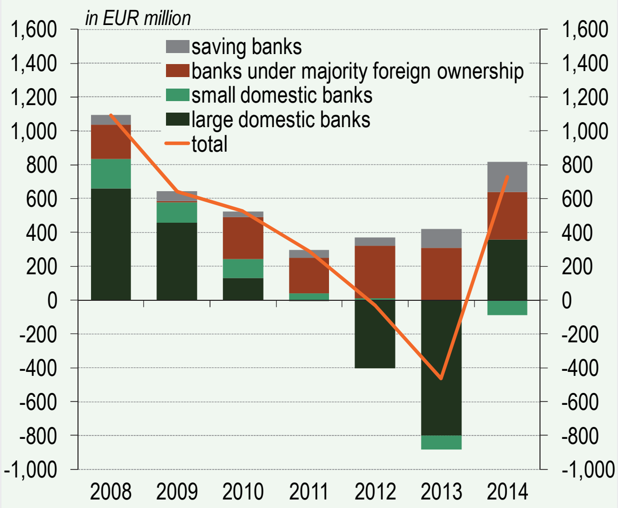
Credit risk remains the most significant systemic risk in the banking system, but has been stabilising throughout the bank resolution process. Following the initial transfer to the BAMC at the end of 2013, non-performing claims (classified claims more than 90 days in arrears) recoded renewed growth until last May, when they stabilised at 14.8% of the total for several months, and then increased again in September. The final quarter of 2014 saw the transfer of non-performing claims from Abanka and Banka Celje to the BAMC, which reduced the proportion of non-performing claims by 2.5 percentage points in October to 13.2% and by a further 1.2 percentage points in December to 11.9%. The reduction was reflected primarily in the sectors of corporates and OFIs, which were the subject of the transfer. However, even ignoring the effect of the transfer of the non-performing claims, the proportion continued to decline as of October. It declined by a further 0.3 percentage points in January to 11.6%. In the non-resident sector, which was not subject to transfer to the BAMC, growth in non-performing claims continued throughout

Figure 2: Non-performing claims



Source: Bank of Slovenia.

Figure 3: Change in stock of household deposits



Source: Bank of Slovenia.

the first nine months of the year, but the stock of non-performing claims declined in the final quarter. Households remain the lowest-risk part of the credit portfolio.

Despite the transfer of non-performing claims to the BAMC, construction remains the sector with the largest proportion of non-performing claims, although the figure declined throughout the year. Non-performing claims also declined in the sectors of accommodation and food service activities and of transportation and storage last year. There was also a notable trend of decline in the proportion of non-performing claims in the sectors of wholesale and retail trade and of manufacturing, which were subject to transfer to the BAMC.

The stock of securities held on bank balance sheets increased by EUR 1.1 billion in 2014. The majority of the increase was the result of transactions related to the two bank recapitalisations. The two banks received a total of EUR 551 million in BAMC bonds and EUR 338 million in Slovenian government securities. The proportion of the banking system's balance sheet assets accounted for by securities stood at close to 25% at the end of 2014.

Slovenian banks increased their liabilities to the Eurosystem in December 2014. By participating in the new targeted longer -term refinancing operations at the Eurosystem they borrowed EUR 631 million, primarily on account of the favourable pricing of the funding. Throughout 2014 the banks made intensive early repayments of funding from the 3-year LTRO that matured in the first quarter of 2015, in the total amount of EUR 2.6 billion. The proportion of total funding accounted for by these liabilities had declined to 2.7% by the end of January 2015, a third of the figure a year earlier.

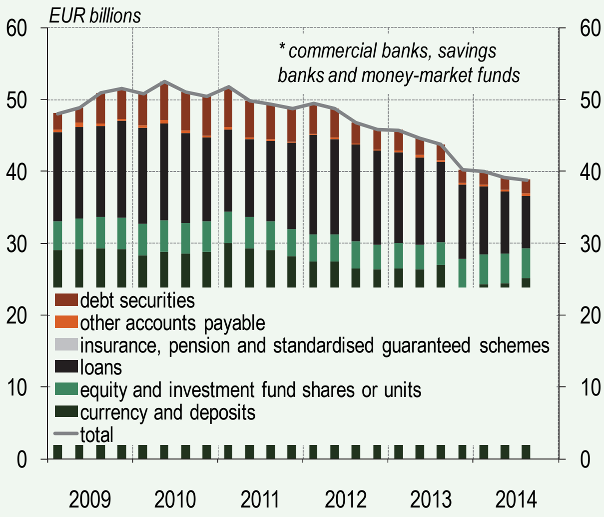
Debt repayments to foreign banks in 2014 were significantly slower than in the previous years. The banks repaid EUR 0.8 billion of these liabilities, of which the banks under majority foreign ownership accounted for two-thirds. In 2015 the banks will face their largest repayments to foreign banks in the first half of the year, when EUR 1.3 billion or 22% of this debt matures.

Deposits by the non-banking sector, which remain the most important source of bank funding, increased by EUR 1.9 billion or 8.3% in 2014. Although all sectors other than non-residents recorded an increase in deposits, the most notable positive increase in 2014 was recorded by the household sector. After intensive withdrawals of household deposits from the banking system in 2013, the deposits returned to the banks last year despite a halving of rates, and growth in deposits at savings banks also picked up pace. Inflows of household deposits continued in January 2015, taking the year-on-year rate of growth to 4.9%.

The banks recorded a pre-tax loss in 2014. Having remained in balance until the end of October, the banking system's operating result moved into the red in November and December. The loss amounted to EUR 67.5 million at the end of the year. The banking system's gross income recoded a solid increase of 18%. As interest income declined by 11.5% as a result of the decline in in lending activity, the main factor in last year's growth in net interest income was the sharp decline off 37.5% in interest expenses, as a result of the fall in deposit rates and the ongoing debt repayments to the rest of the world. Growth in non-interest income was positive last year. Impairment and provisioning costs amounted to EUR 614 million last year, down significantly on the previous year's high figure (caused by the AQR and stress tests). Impairment and provisioning costs in the banking system did not increase in the final quarter of last year as sharply as they did in previous years, but nevertheless still accounted for over a half of the disposal of the banks' gross income. The banks also continued improving their cost-efficiency last year. Operating costs were down close to 5% last year. The Slovenian banking system recorded a pre-tax profit of EUR 33 million in January.

2014. The calling of the government guarantee for Probanka and Factor banka meant that the sole increase was in loans raised with the government sector, at EUR 0.5 billion. Deposits are still the most important source of bank funding. The proportion of total balance sheet liabilities that they account for increased to just over 63%, as inflows of EUR 1.2 billion were recorded over the first three quarters of 2014. The private sector remains cautious, and is increasing its deposits at domestic banks, particularly sight deposits: households increased their deposits by EUR 0.6 billion over the first three quarters of 2014, and corporates by EUR 0.4 billion. An increase in bank deposits was also recorded by OFIs (EUR 0.2 billion) and by the government sector (EUR 0.5 billion). The latter was primarily related to the introduction of a negative interest rate[20] on new government time deposits at the central bank. As a result the government is opting not to place money in time deposits at the central bank, but instead to place it in overnight deposits at banks. The banks' equity amounted to EUR 4.2 billion at the end of the third quarter of 2014, up EUR 0.3 billion on the end of 2013 as a result of positive revaluations.

Figure 4.10: Financial liabilities of banks* (S.122 and S.123)



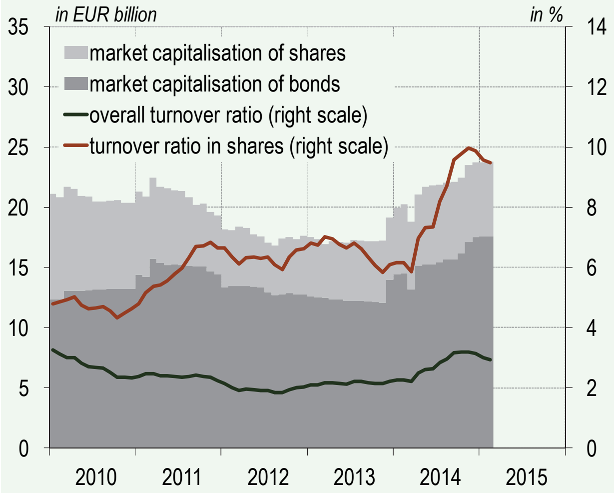
Source: Bank of Slovenia, non-consolidated data.

Domestic capital market

The SBI TOP ended February at 796.41 points. It was up 9.2% in year-on-year terms, and 0.7% in monthly terms. After a negative conclusion in the last year, returns on the domestic stock exchange corrected slightly. The market capitalisation of shares and bonds remained at EUR 6.2 billion and EUR 17.56 billion respectively, the turnover ratios of both shares and bonds having declined for the second consecutive month as volume contracted. Moody's upgraded Slovenia by one notch in January from BA1 to BAA3. The ECB's decision to activate a quantitative easing programme had a positive impact on foreign

[20] The ECB introduced a negative interest rate on the deposit facility in June 2014. This applies to: (i) banks' average reserve holdings in excess of the minimum reserve requirements, (ii) government deposits held with the Eurosystem that exceed certain thresholds, (iii) Eurosystem reserve management services accounts if not currently remunerated, (iv) participants' account balances in TARGET2, (v) non-Eurosystem NCB balances (overnight deposits) held in TARGET2, and (vi) other accounts held by third parties with Eurosystem central banks when stipulated that they are not currently remunerated or are remunerated at the deposit facility rate.

Figure 4.11: Market capitalisation on the LJSE in EUR billion and annual turnover ratios (TR)



Source: Ljubljana Stock Exchange.

markets and on the Slovenian market. The response of the domestic stock exchange was positive, but not to the same extent as the global stock markets. Uncertainty on the domestic stock exchange was again exacerbated by the debate and petition against privatisation.

5 Public Finances

The general government deficit amounted to 4.9% of GDP in 2014, significantly less than in the previous year, but primarily on account of the smaller size of the bank recapitalisations. The latter accounted for 0.9 GDP percentage points of the deficit, while the ruling by the ECHR on the foreign currency deposits of savers at Ljubljanska banka accounted for a further 0.7 GDP percentage points. Excluding the recapitalisations and other one-off effects, the general government deficit narrowed compared with the previous year. There was a sharp increase in interest expenditure in 2014, to 3.3% of GDP. This means that the primary general government deficit (after the exclusion of the aforementioned transactions) narrowed significantly last year, to 0.3% of GDP.

The government is forecasting a general government deficit of 2.9% of GDP in 2015, whereby Slovenia will have eliminated the excessive deficit in accordance with the requirements of the excessive deficit procedure. The realisation of the plans is subject to risks, which are primarily related to macroeconomic developments potentially being less favourable than forecast during the preparation of the revision to the state budget for 2015 and to the effect of the measures potentially being smaller than planned.

The general government debt stood at 80.9% of GDP at the end of 2014. The large increase in recent years is primarily a reflection of the measures to stabilise the banking system. The pre-financing of future debt repayments contributed significantly to the rise in debt last year. This year's issues of treasury bills were undertaken at low or even zero interest rates. The yield on long-term Slovenian bonds fell further in March in connection with the launch of the securities purchase programme by the ECB. The general government debt is forecast to reach 81.6% of GDP by the end of 2015.

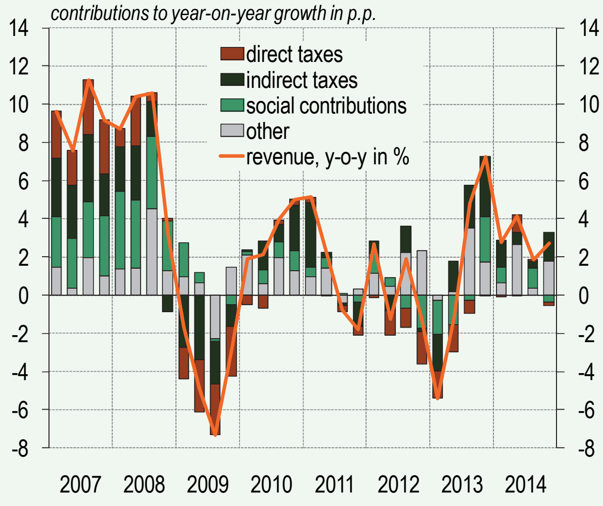
General government deficit

The general government deficit amounted to 4.9% of GDP in 2014. The narrowing relative to the previous year was primarily a reflection of the smaller scale of the measures to stabilise the banking system. They accounted for 0.9% of GDP of the deficit (compared with 10.1% of GDP in 2013), and were related to the recapitalisation of Abanka and Banka Celje.[21] The deficit was larger than forecast in the Stability Programme (4.1% of GDP), largely as a result of the recognition of liabilities to Ljubljanska banka savers on the basis of a ruling by the European Court of Human Rights (ECHR) in the amount of 0.7% of GDP. Last year an auction was held for mobile telephony radio frequencies, which had a positive impact

[21] For any such future interventions the Bank Resolution Authority and Fund Act (Official Gazette of the Republic of Slovenia, No. 97/14) was adopted in December 2014: in case of need, bank recapitalisations are to be executed from the aforementioned fund.

on public finances in the amount of 0.2% of GDP. After excluding the aforementioned measures, the general government deficit amounted to 3.5% of GDP, 0.7 GDP percentage points less than in 2013, if the bank recapitalisations, payments to erased residents and payments to civil servants on account of wage disparities are excluded. If interest payments are also excluded from the deficit in 2014, the primary deficit would have amounted to 0.3% of GDP, significantly less than the primary deficit of 1.7% of GDP in 2013. The general government deficit in Slovenia was larger than the average deficit across the euro area in 2014 (which amounted to 2.6% of GDP according to the European Commission's estimates of February 2015).

Figure 5.1: General government revenue



Source: SORS, Bank of Slovenia calculations.

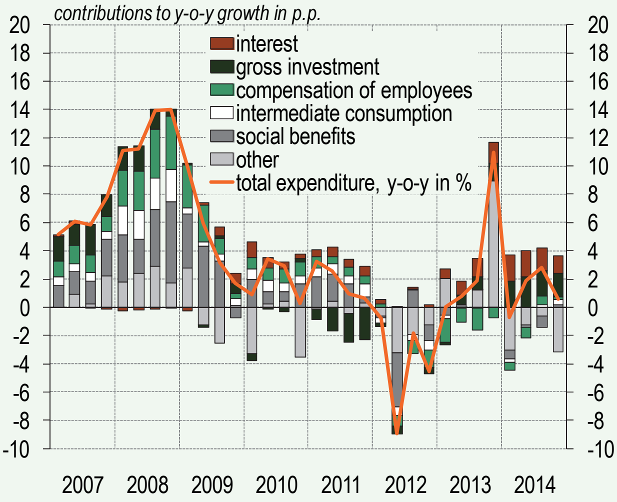
General government revenues increased in 2014 as a result of the more favourable economic situation and higher tax rates. General government revenues were up 2.9%. The largest increase among taxes was in inflows of indirect taxes, which were up 2.9%. Alongside weak growth in consumption, this was attributable to the rise in the VAT rates in mid-2013. Despite a rise in all categories of excise duty, inflows of excise duties remained approximately at the level of the previous year. The increase in revenues from direct taxes was attributable to the abolition of the automatic indexation of tax allowances and the net taxable base in the scale of personal income tax brackets, and the abolition of personal income tax allowances for those aged over 65. The improved situation on the labour market was evident in increased revenues from personal income tax (up 1.1%) and net social security contributions (up 1.0%). The increase in the latter was also attributable to the increased taxation of certain groups of taxpayers of health insurance contribution. The highest growth on the revenue side was recorded by capital transfers (up 68.8%), in connection with flows of EU funds.

Table 5.1: General government deficit and debt in Slovenia 2011–2018*

	SORS			Draft Budgetary Plan		Stability Programme					EC		
as % BDP	2012	2013	2014	2014	2015	2014	2015	2016	2017	2018	2014	2015	2016
Revenue	44.6	45.0	45.0	45.3	44.4	46.4	45.5	44.6	43.8	43.4	44.9	44.3	43.7
Expenditure	48.6	59.9	49.9	49.7	47.2	50.5	47.9	46.1	44.5	43.1	50.3	47.2	46.4
of which: interest	2.0	2.5	3.3	3.3	3.2	3.4	3.3	3.3	3.1	3.0	3.3	3.2	3.0
Net lending (+) / borrowing (-)	-4.0	-14.9	-4.9	-4.4	-2.8	-4.1	-2.4	-1.5	-0.7	0.3	-5.4	-2.9	-2.8
excl. support to fin. Institution	-3.8	-4.8	-4.0	-3.5	-2.8	-3.2	-2.4	-1.5	-0.7	0.3	-4.5	-2.9	-2.8
Structural balance	…	…	…	-2.8	-2.4	-2.0	-1.5	-1.0	-0.7	-0.1	-2.5	-2.2	-2.9
Debt	53.7	70.3	80.9	82.2	83.2	80.9	81.1	76.0	72.5	70.4	82.2	83.0	81.8
Real GDP (growth, %)	-2.6	-1.0	2.6	2.0	1.6	0.5	0.7	1.3	1.7	1.7	2.6	1.8	2.3

Source: SORS (realisation), Ministry of Finance (April 2014), European Commission (EC, February 2015).
*Note: * All data according to ESA 2010, except for the data from Stability Programme, which is according to ESA 1995.*

Figure 5.2: General government expenditure (excluding support to financial institutions)



Source: SORS, Bank of Slovenia calculations.

The increase in general government expenditure (after the exclusion of support for financial institutions) in 2014 was a reflection of government investment activity and the rise in debt. The utilisation of EU funds increased as the end of the financial perspective is approaching, and at the same time in 2014 local elections took place. Government investment thus increased by just over a fifth. The high growth in interest payments is a reflection of the previous large increase in debt. Employee compensation was down 0.5% on 2013. Expenditure on intermediate consumption was up 0.7%. Expenditure on social security benefits and support fell for the third consecutive year, this time by 0.9%. The number of pensioners rose by just 1.1% last year, significantly less than the rates of growth seen before the pension reform, and pensions were also not adjusted in line with wages and inflation. Unemployment benefits declined significantly, as a result of the improved situation on the labour market and losses of entitlements (only a fifth of the unemployed were entitled to benefits at the end of last year). By contrast, payments to ensure social security increased.

General government debt and government guarantee

The general government debt had risen to 80.9% of GDP by the end of the year, partly as a result of the pre-financing of debt repayments in the coming years and bank resolution measures. The general government debt was up EUR 4.7 billion on the end of 2013 thus reaching EUR 30,133 million. As a ratio to GDP it is still below the euro area average, which stood at 94.3% according to the European Commission's estimates of February 2015. The increase in debt last year was partly earmarked for financing the primary deficit, but the debt was primarily raised by other factors, which are disclosed under "deficit-debt adjustments" in Table 5.2. These relate primarily to the pre-financing of debt repayments maturing in the coming years, and to two BAMC bond issues in connection with the transfer of non-performing claims from Abanka and Banka Celje. Another factor in the increase in the ratio of debt to GDP is the snowball effect, which reflects the overall effect of interest expenditure and economic growth on debt expressed as a percentage of GDP.

Table 5.2: Contributions of components to change in general government debt

% GDP	2009	2010	2011	2012	2013	2014
Debt	34.4	38.2	46.5	53.7	70.3	80.9
Change in debt	**12.8**	**3.8**	**8.3**	**7.2**	**16.6**	**10.6**
of which: primary balance	4.8	4.0	4.8	2.0	12.3	1.7
difference interest rate-growth rate ("snow-ball effect")	2.3	1.6	1.2	3.1	2.3	1.2
deficit debt adjustment	5.6	-1.9	2.3	2.1	2.0	7.7

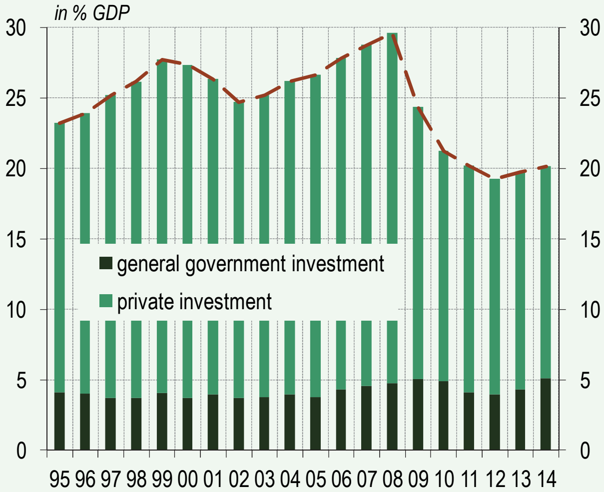
Source: SORS, Bank of Slovenia calculations.

Box 5.1: Government investment and its impact on economic activity

The ratio of government investment to GDP in Slovenia has surpassed the euro area average. While the ratio of total government expenditure to GDP over the 2010 to 2013 period in Slovenia did not differ significantly (after the exclusion of bank recapitalisations) from the euro area average, which was just under a half, the ratio of investment[1] expenditure to GDP was higher. It averaged 4.3% between 2010 and 2013, while the overall ratio of government investment to GDP in the euro area was 3.0%. After increasing in the last two years, government investment in Slovenia amounted to 5.1% of GDP in 2014.

In Slovenia too government investment accounts for a minority of total investment in the economy, but in recent years it has been the key factor in investment growth. Government investment has accounted for more than a fifth of total investment since 2009, and in 2014 it accounted for more than a quarter.[2] It is evident from Figure 1 that since the outbreak of the economic and financial crisis the ratio of private-sector investment to GDP has declined significantly, by more than a third in nominal terms over the first two years of the crisis. After an additional nominal decline in 2012, private-sector investment increased just slightly in 2013 and 2014. Figure 2 shows that changes in government investment in the last two years were the main factor in the growth in total investment in the economy, and therefore had a significant impact on economic growth.

Figure 1: Share of government and private investment in GDP



Source: SORS.

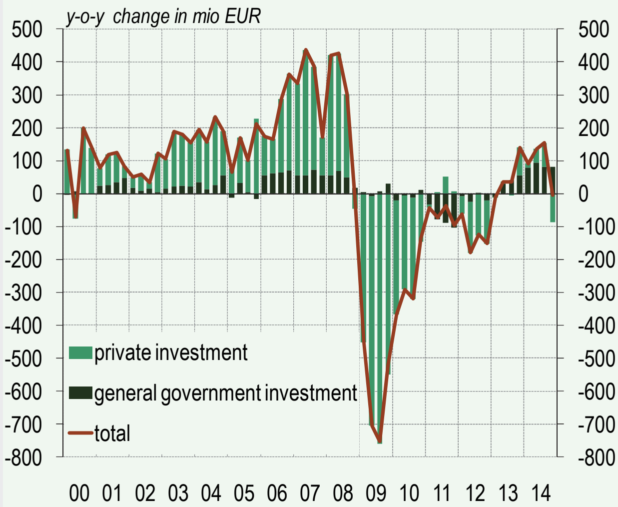
The largest proportion of government investment was earmarked for transport. According to the COFOG, the largest investment was earmarked for economic affairs[3] (almost 30% in 2013), and within this category for transport (approximately a fifth of total government investment). The following areas also account for a large proportion of government investment: education (all levels), general public services (most notably basic research), housing and community amenities (most notably water supply) and environmental protection (most notably wastewater management).

Growth in government investment was encouraged over the last two years by the increased utilisation of European funds. The same is planned for 2015. The possibility of utilising funds from the 2007-2013 financial perspective ends this year. Slovenia strengthened its spending of European funds in the final quarter of 2013, and particularly in last year. With regard to the budget plans, further growth in government investment can be expected in 2015, thereby continuing to contribute to GDP growth. However, it is uncertain to what degree the government will succeed in utilising the available funds. The experience of previous years suggests that the realisation of the disbursement of EU funds is less than originally planned in the budget.

Disbursement of EU funds is expected to be less in 2016 than in the recent period, resulting in a decline in government investment. Disbursement of EU funds from the 2014-2020 financial framework will begin in 2016. The latter brings Slovenia around EUR 1 billion less funding from the cohesion funds than was available in the 2007-2013 financial perspective. The new financial framework also changes the objectives and the priorities for which EU financial assets are earmarked. Infrastructure projects, which were strongly represented in the previous perspective, have lost significance, while governments are to focus more on increasing employment, improving competitiveness, and improving the related innovation and research.

The impact on GDP of the increase in government investment is primarily seen during the execution of the investment. In the long term the estimated increase in GDP as a result of government investment is relatively small, although its impact lasts for a very long period. Analysis conducted for Slovenia

Figure 2: Change in investment spending



Source: SORS, Bank of Slovenia calculations.

on the basis of the Eagle, a calibrated DSGE model, reveals the multiplier of government investment to be 0.6 in the very short term, and 0.2 in the very long term. This means that an increase in government investment spending of 1% of GDP in the quarter in which the investment is executed increases GDP by around 0.6%. The model's estimate of the size of the impact is dependent on what proportion of the government investment is imported: the assumption in the model is 25%. If the proportion of imports is smaller, the impact on GDP is greater. The impact of government investment diminishes over time: GDP is just 0.3% higher one year after the execution of the investment, and around 0.2% higher ten years after the execution of investment. The estimate relates to a one-off increase in government investment at a time when the economy is in a balanced position in the economic cycle (Clancy, Jacquinot, Lozej, 2014).[4]

Literature:

- Batini Nicoletta, Eyraud Luc, Weber Anke: A Simple Method to Compute Fiscal Multipliers. (2014) IMF Working Paper No. 14/93, 33 pages.
- Clancy Daragh, Jacquinot Pascal, Lozej Matija: The Effects of Government Spending in a Small Open Economy Within a Monetary Union. (2014) ECB Working Paper No. 1727, 71 pages.
- Coenen Gunter, Erceg Christopher, Freedman Charles et al.: Effects of Fiscal Stimulus in Structural Models. (2010) IMF Working Paper No. 10/73, 123 pages.
- European Commission: Public Finances in EMU, Chapter III Fiscal Policy, Debt Reduction and Growth after the Crisis. (2010), pp 185-192.
- International Monetary Fund: World Economic Outlook, Chapter 3: Is It Time For an Infrastructure Push? The Macroeconomic Effects of Public Investment, October 2014, pp 75-114.

[1] Government investment is defined according to the ESA methodology, i.e. the general government sector S.13. This consists of central government, local government and social security funds. In accordance with this definition, it does not include firms such as DARS d.d., Telekom Slovenije and the electricity companies that are under majority government ownership but cover the majority of their costs with sales on the market. The term investment used throughout this text refers to gross fixed capital formation.

[2] For comparison: in the decade before 2009 government investment accounted for approximately 15% of total investment.

[3] Includes general economic, commercial and labour affairs, agriculture, forestry, fishing and hunting, fuel and energy, mining, manufacturing and construction, transport, communication, R&D in economics, and other economic affairs n.e.c.

[4] The average short-term multiplier of government investment is higher across EU Member States, standing at 0.9 on average, whereby the DSGE model was also slightly different (European Commission, 2010). Similarly, certain other models for euro area countries suggest that the short-term multiplier is around 1, while the long-term figure is a little above zero (Coenen et al., 2010). The size of fiscal multipliers depends on the econometric model selected, the phase of the economic cycle in which country finds itself, the persistence of the fiscal shock (measure), the adjustment of monetary policy to fiscal policy, the openness of the economy, the way of financing the investment, etc. The actual effect of investment also depends on the choice of investment projects, the preparation, execution and control of the project, etc. (Batini, Eyraud, Weber, 2014 and IMF, 2014).

Government guarantees and sureties amounted to 22.2% of GDP at end of the year, having increased since the middle of the year as a result of the measures to stabilise the banking system. Approximately half of the stock of guarantees relates to DARS d.d. and the EFSF, which issues bonds to assist European countries in financial difficulties. The increase in the stock of guarantees in the second half of last year was related to the issue of BAMC bonds. In the final quarter Probanka and Factor banka began repaying the guarantee called in mid-2014, which increased state budget revenues (with no impact on the general government deficit, as it was a financial transaction). EUR 432 million of guarantees were called last year, while repayments of called guarantees amounted to EUR 27 million. Both were mostly related to the orderly wind-down of Probanka and Factor banka.

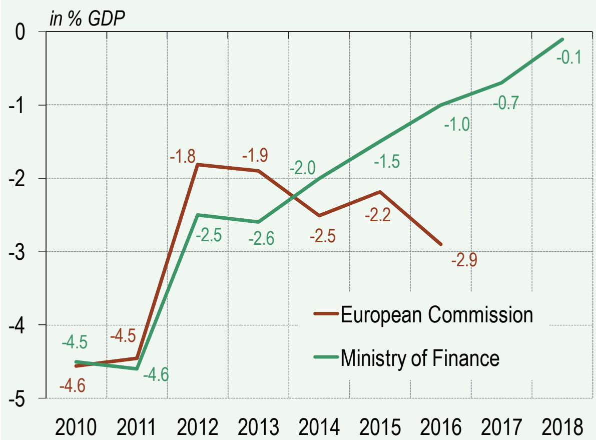
The required yield and the cost of borrowing reached record lows in the first quarter of this year. The required yield on 10-year Slovenian government bonds has been falling for more than a year, and fell below 1.0% in early March, before averaging 1.0% across the month. A 20-year bond with a total nominal value of EUR 1 billion and a coupon rate of 1.5% was issued in March. In February and March there were further treasury bills issues at extremely low interest rates, and even at zero interest rate on shorter maturities (since last November). The fall in yields began at the end of 2013, after the measures to stabilise the banking system had been taken, while this year's fall was primarily the result of the introduction of additional non-standard monetary policy measures by the ECB. The data showing an improvement in the economic situation and outlook in Slovenia also had a beneficial impact on required yields.

Forecasts for general government deficit

Slovenia's key fiscal target is to eliminate the excessive deficit in 2015. Slovenia has been in the excessive deficit procedure since 2009, and according to plans is set to eliminate it by the stipulated deadline of 2015. Under the revision to the state budget for 2015 adopted in February of this year, a deficit of 2.9% of GDP was forecast. April's report on the general government deficit and debt also leaves this target unchanged. The risks to the realisation of the forecast deficit encompass a potential deterioration in the macroeconomic situation, a smaller-than-planned impact from the measures, and uncertainty related to calculation of the deficit under the ESA 2010.[22]

In the Stability Programme Slovenia is planning the gradual reduction of the general government deficit and the attainment of structural balance. After reducing the general government deficit to below 3% of GDP, Slovenia will have to further reduce it. The Fiscal Compact (the Treaty on Stability, Coordination and Governance in the Economic and Monetary Union) requires a balanced position in the structural sense, and further reduction will also be necessary on account of the debt, which exceeds 60% of GDP. The structural deficit in 2014 stood at 2.5% of GDP according to the European Commission's estimates of February 2015, 0.6 GDP percentage points more than in 2013. The government's new plans will be revealed in this year's update to the Stability Programme, which is expected to be published at the end of April.

Figure 5.3: Public finance structural balance



Note: Structural balance estimate by the MoF reflects targeted dynamics, while the EC estimate only includes adopted measures.
Source: EC, Ministry of Finance - Stability Programme, April 2014.

The measures to reduce the deficit in previous years were often temporary in nature, therefore more systemic measures are required. Thus measures in the area of employee compensation were again applied only until the end of 2015. This means that a new agreement will soon be required, otherwise employee compensation will increase significantly next year. Many temporary measures were also included in the Fiscal Balance Act, including the abolition of child benefit for the seventh and eighth brackets, a reduction in cash social assistance, and a reduction in the pensioners' allowance (which is determined each year by the budget implementation act). These were tied to economic growth of more than 2.5%.

[22] The uncertainty surrounding the calculation under the ESA 2010 is partly related to information (e.g. annual returns of personal income tax and corporate income tax, final accounts) that will only be available after the end of the budgetary year.

According to initial figures growth in 2014 was higher, which means that these transfers could be increased as of 2016. Other measures include the 50% marginal rate of personal income tax that only applies until the end of this year, while the higher VAT rates are also temporary.

The government is preparing a review of the health sector, and a demographic reserve fund is expected to be established by the middle of the year. In conjunction with the WHO, the Ministry of Health will draw up analysis of the healthcare system to serve as the basis for preparing a healthcare reform. The analysis, including proposals, should be completed by the end of the year. A demographic reserve fund is expected to be established by the middle of this year on the basis of the pension law enacted in 2013. The purpose of the fund is to ensure the long-term stability of the pension system, and its functioning and funding will be regulated by means of a separate law.

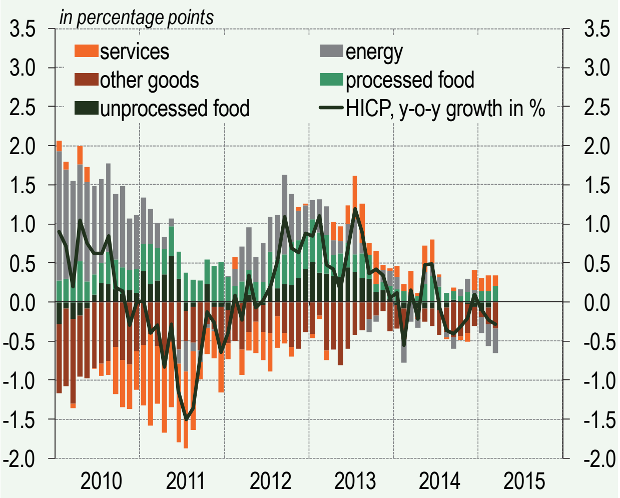
6 Price Developments

Price dynamics in the first three months of this year remained primarily under the influence of low commodity prices on global markets, the fall in the euro and certain base effects. Average growth in the harmonised index of consumer prices over the first three months of 2015 was down in year-on-year terms at 0.5%, slightly above the euro area average. However, core inflation rose over this period, having fallen in the euro area. The divergence in price developments might also be the result of positive macroeconomic shifts in Slovenia, although the increase in the real wage bill has not fully passed through into final consumption as a result of cautious behaviour by households in the wake of increasing uncertainty in employment forms and as a result of changes in purchasing habits.

Structure of price developments

There was no significant change in the structure of price developments in the first quarter of this year compared with the previous quarter, with the exception of energy prices. The decline in the contribution made by energy prices was the result of the persistence of low oil prices on global markets. Although prices of crude oil rose slightly from the end of January, and the euro has continued to fall, the year-on-year fall in energy prices was very sharp at 6.1%. By contrast, the negative contribution made by prices of non-energy industrial goods declined, in line with the increase in the real wage bill and the fall in the euro. These factors have also been reflected in services prices: growth in services prices increased in the early part of this year compared with the final quarter of last year. This was primarily attributable to certain market services, as a result of the ending of campaigns by certain providers on one hand, and a rise in prices of certain providers on the other. The contribution made by food prices remained unchanged, as the dy-

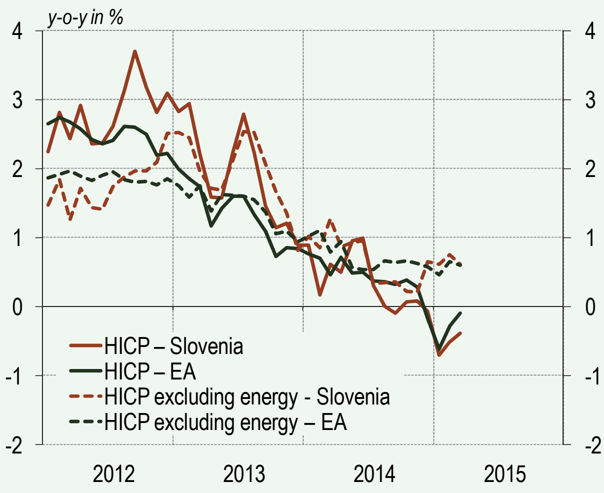
Figure 6.1: Difference in inflation between Slovenia and euro area



Source: Eurostat, Bank of Slovenia calculations.

namics of the sub-components remained similar. The contributions made by all components across the euro area also declined over the same period, most notably the contributions made by energy prices and services prices.

Figure 6.2: Inflation in Slovenia and euro area



Source: Eurostat.

Price developments in Slovenia again approached the overall dynamics of the euro area. There has been a sharp convergence of inflation in Slovenia with inflation across the euro area in the last year. This convergence was seen in all sub-components. It was sharpest of all in the components primarily dependent on imported products, such as food prices and energy prices. The differences in growth in core inflation components also narrowed.

Macroeconomic factors and core inflation indicators

Average core inflation was low in 2014, and below the euro area average. In the first three months of this year it rose to above the euro area average, where core inflation has continued to fall. Core inflation as measured by the HICP excluding energy, food, alcohol and tobacco averaged 0.6% in 2014, down 0.2 percent-

Table 6.1: Breakdown of the HICP and price indicators

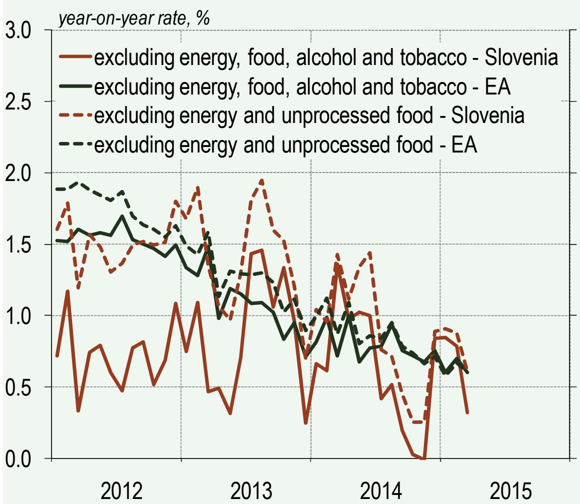
	weight	average year-on-year growth, %					year-on-year growth in quarter, %					
	2014	2010	2011	2012	2013	2014	4Q13	1Q14	2Q14	3Q14	4Q14	1Q15
HICP	100.0%	2.1	2.1	2.8	1.9	0.4	1.1	0.6	0.8	0.1	0.0	-0.5
Breakdown of HICP:												
Energy	14.7%	13.9	8.8	9.0	1.8	-1.4	-0.1	-2.3	0.2	-1.5	-2.0	-7.5
Food	23.6%	2.5	4.8	4.7	4.9	0.8	2.4	1.5	0.7	0.3	0.6	0.7
processed	16.1%	2.9	5.0	4.7	3.6	1.8	2.3	2.2	2.4	1.7	1.1	1.4
unprocessed	7.5%	1.7	4.3	4.5	7.6	-1.5	2.7	0.1	-2.8	-2.6	-0.7	-0.6
Other goods	26.4%	-2.2	-0.9	-0.2	-0.9	-1.0	-0.5	-0.5	-0.6	-1.3	-1.4	-0.8
Services	35.2%	1.2	0.0	1.5	2.2	1.8	2.0	1.9	2.3	1.5	1.5	1.7
Core inflation indicators:												
HICP excl. Energy	85.3%	0.3	1.0	1.8	1.9	0.7	1.3	1.1	0.9	0.3	0.4	0.7
HICP excl. energy and unprocessed food	77.8%	0.2	0.7	1.5	1.4	0.9	1.1	1.1	1.3	0.6	0.5	0.8
HICP excl. energy, food, alcohol and tobacco	61.7%	-0.4	-0.4	0.7	0.9	0.6	0.8	0.9	1.0	0.4	0.3	0.6
Other price indicators:												
Industrial producer prices on domestic market		2.0	3.8	1.0	0.3	-1.1	-0.3	-1.0	-1.4	-1.1	-0.8	...
GDP deflator		-1.1	1.2	0.3	1.4	0.4	2.1	1.5	0.5	0.4	-0.7	...
Import prices[1]		6.5	5.6	2.3	-1.2	-1.0	-1.8	-1.8	-1.4	-0.5	-0.4	...

Note: [1] National accounts figure.
Source: SORS, Eurostat, Bank of Slovenia calculations.

age points on the previous year, and also down 0.2 percentage points on the euro area average. Services prices were the main factor raising its year-on-year rate in Slovenia, while prices of non-energy industrial goods acted to reduce it. Average year-on-year growth in the two other core inflation indicators was the same as in the euro area overall. All three core inflation indicators exceeded the euro area indicators over the first quarter of this year. Year-on-year growth in services prices is higher in Slovenia, while the fall in prices of non-energy industrial goods is larger than in the euro area overall.

The weak growth in household consumption is perhaps already slowly raising core inflation, although the signals are still relatively unreliable. The increase in the real wage bill has not yet passed through into final consumption to any great extent. The stock of consumer loans is still declining, albeit less than in previous years. Instead of increasing consumption households are increasing saving, most likely because of the prevalence of uncertain forms of new employment. At the same time gradual shifts in domestic demand are reflecting changes in household purchasing habits. Wage growth has recently been outpaced by productivity growth, for which reason there are no major price pressures on the supply side as prices of input commodities remain low.

Figure 6.3: Core inflation in Slovenia and euro area

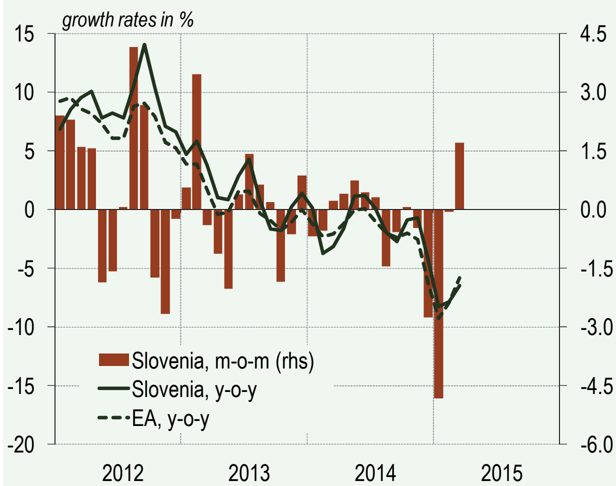


Source: Eurostat, Bank of Slovenia calculations.

Microeconomic factors and the structure of inflation

The sharp fall in oil prices on global markets increased the year-on-year fall in energy prices in 2014, despite the fall in the euro. As a result of a base effect, the year-on-year fall in prices of refined petroleum products has remained pronounced in the early part of this year. After rising by 1.9% in 2013, energy prices fell 1.4% last year, 0.5 percentage points less than in the euro area overall. The main factor in the fall was prices of motor fuels, which fell by 2.2% last year after rising by 1.3% in 2013. Increases in excise duties on refined petroleum products prevented an even larger fall in these prices. At the same time growth in electricity prices slowed sharply from 11.3% to -1.4%, as the rise in the electricity network charge dropped out of the inflation calculation in early 2014. By contrast, year-on-year growth in gas prices increased sharply, as a result of a base effect, providers having sharply reduced prices in the summer of 2013. Year-on-year growth in prices of heating oil also increased, as a result of a pronounced rise in excise duties. Although oil prices have been slowly rising since this January, the average year-on-year fall in energy prices over the first quarter of this year was still larger than that over the final quarter of last year at 7.5%.

Figure 6.4: Energy prices



Source: Eurostat, Bank of Slovenia calculations.

Box 6.1: Impact on inflation of low oil prices and the euro exchange rate

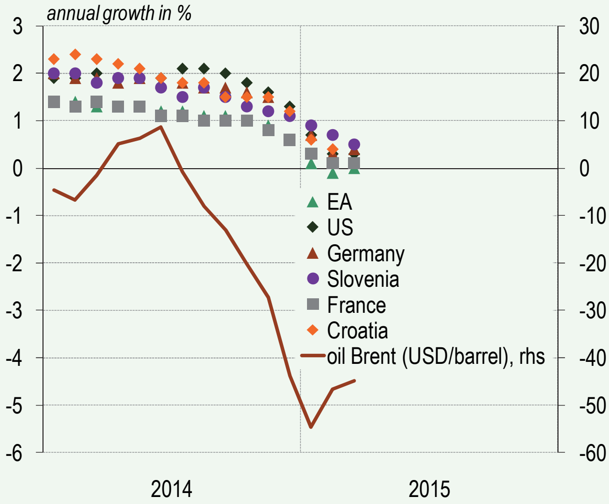
Oil prices fell sharply in the second half of 2014, having previously been stable at around USD 105 per barrel for four years. The price was down 55% in year-on-year terms in January 2015 at USD 55, then began to rise again to average USD 56 in March. The euro fell by just under a fifth against the US dollar over the same period. This slowed the fall in euro oil prices, but did not stop a sharp fall in inflation.

Falling oil prices reduces global inflation. The short-term inflation forecasts began falling in July 2014 in line with the beginning of the fall in oil prices. The Consensus forecast for US inflation in 2015 was reduced from just over 2% in August 2014 to merely 0.3% in February 2015. Meanwhile the Consensus forecast for inflation in the euro area in 2015 stood at 0.9% last November, while in February of this year a deflation of 0.1% was being forecast. Inflation is forecast at 0.3% for the EU in 2015. The trend of falling inflation forecasts is in line with the results of global econometric models (Global Economic Prospects, January 2015). On the basis of data for the G20 countries, it is estimated that a 30% fall in oil prices would reduce inflation in 2015 by between 0.4 and 0.9 percentage points.

As elsewhere, refined petroleum products are one of the fundamental sources of energy in production and consumption in Slovenia, for which reason the recent developments in oil prices will continue to bring a fall in prices of consumer essentials. Direct effects will prevail, where developments in oil prices will pass through in full into the selling prices of refined petroleum products with a lag of two weeks. Towards the end of 2014, the government increased excise duties several times, in line with declining oil prices. It has done so in October and November, while in the latter period the excise duties have been lowered in order to keep fuel prices competitive in comparison to the neighbouring countries.

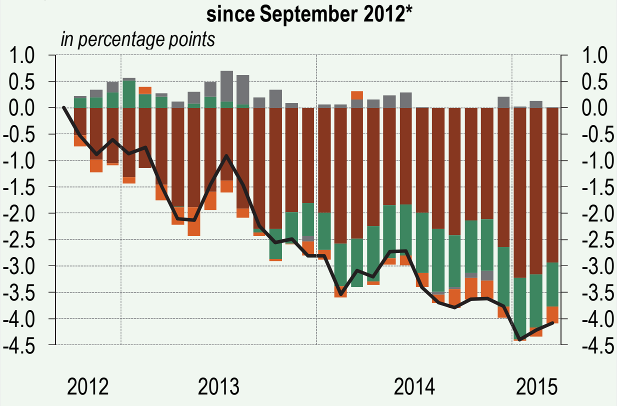
The impact that the shock of falling oil prices will have on inflation and on economic activity is primarily dependent on the proportion of oil in production and consumption. The fall in oil prices will thus be reflected directly in consumer purchasing power and firms' profit margins. Lower prices of refined petroleum products also act as a stimulus for the Slovenian economy: the expectation is that they will bring benefits primarily in the sense of greater consumer purchasing power and lower production costs. Consumers will earmark at least part of their increased income for consumption of other goods, and will save part. Because oil is an important production factor, lower prices can allow firms to generate higher profits. Although the positive effects are prevalent, the potential negative effects of lower oil prices on economic activity also need to be considered. As a result of declining activity in countries that are dependent on oil exports and are major trading partners of Slovenia (e.g. Russia), they could directly and indirectly reduce demand for Slovenian exports.

Figure 1: Consensus HICP forecast for selected countries in 2015



Source: Consensus Economics.

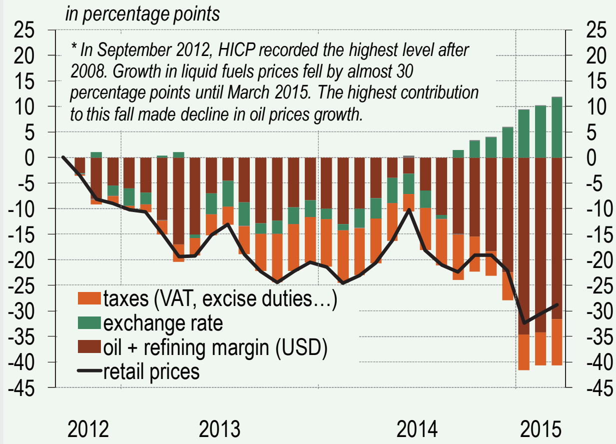
Figure 2: Contributions to the decline in headline HICP inflation since September 2012*



** In September 2012, HICP recorded the highest level after 2008. HICP growth fell by around 4 percentage points until March 2015. The decline in energy prices growth contributed to this fall almost 3 percentage points.*

Source: ECB, Bank of Slovenia calculations.

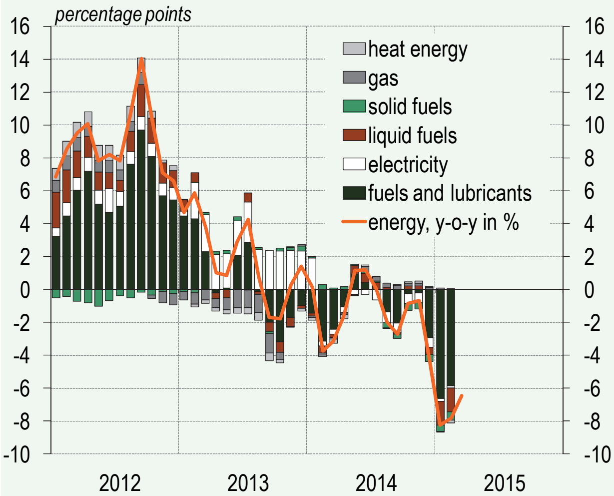
Figure 3: Contributions to the decline in price inflation in liquid fuels since September 2012*



Source: Ministry of Economy, Decree setting prices for petroleum products, Decree on the definition and methods of calculating a special fee for carrying out the public service obligation to form compulsory stocks of crude oil and petroleum products, Bank of Slovenia calculations.

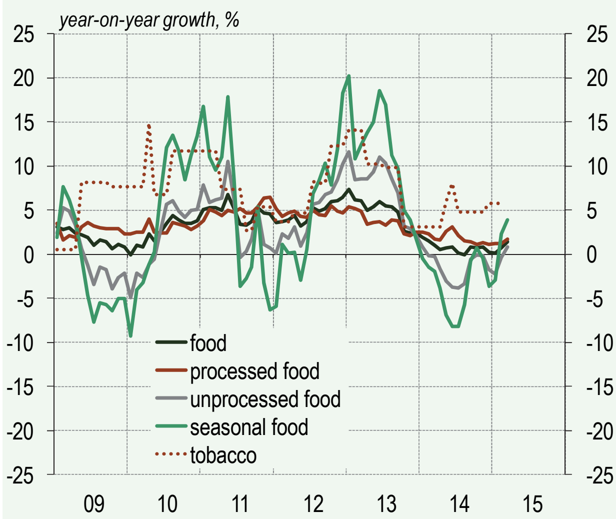
The latest forecast for inflation in 2015 is 0.8 percentage points lower than the Bank of Slovenia's October 2014 projections. This downward revision primarily originates in changes in the projection of energy prices, which are now forecast to fall by 6%, zero growth having been forecast in October. A base effect means that the projection for growth in energy prices in 2016 is 1 percentage point higher, at 1.0%. The projections are based on futures prices, according to which prices will slowly rise this year to average USD 62 per barrel over the year, rising to USD 68 and USD 72 over the next two years. This does not take account of indirect and secondary effects that could additionally reduce inflation via production costs and the impact on wage growth.

Figure 6.5: Contributions to energy inflation



Source: ECB.

Figure 6.6: Food prices



Sources: Eurostat, Bank of Slovenia calculations.

The year-on-year fall in prices of motor fuels was even sharper than in the previous quarter, while prices of heating oil also fell.

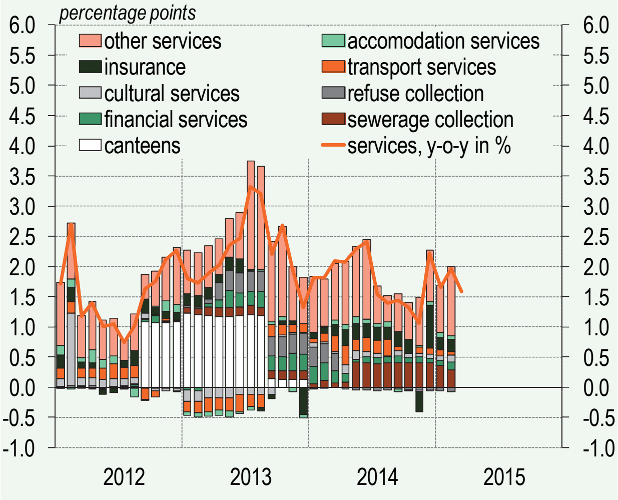
Year-on-year growth in food prices in 2014 was down sharply on the previous year, and thus made the largest contribution to the fall in headline inflation. Its average over the first three months of this year was unchanged from 2014. Growth in food prices averaged 0.8% last year, 4.1 percentage points less than in the previous year and 0.3 percentage points more than the euro area average. The main factor in this fall was prices of unprocessed food, which after recording high year-on-year growth in 2013 began falling at the beginning of last year. Despite the bad weather conditions in the summer, vegetable prices fell sharply, by 8.1% overall in 2014, having risen by 16% in 2013. Year-on-year growth in prices of fruit and vegetables also slowed. Growth in prices of processed food also slowed in line with food prices on global markets, which to a certain extent was also the result of price cuts by certain retailers owing to increased competition in this part of the domestic market. Year-on-year growth in food prices averaged 0.7% over the first quarter of this year, up slightly on the final quarter of 2014. This was primarily attributable to increased growth in prices of processed food in March as a result of a base effect, while the fall in prices of unprocessed food also slowed slightly at the same time.

Despite the effect of the rise in VAT dropping out of the inflation calculation in the second half of the year, growth in services prices remained relatively high in 2014, and increased further in the last months. Growth in services prices averaged 1.8% last year, 0.5 percentage points less than in the previous year and 0.6 percentage points more than the euro area average. The decline in growth was attributable to the smaller scale of fiscal and administrative measures in 2014, and in particular to the rise in prices of food at canteens dropping out of the inflation calculation, which accounted for 0.8 percentage points of the decline in year-on-year growth in services prices. The rise in VAT in mid-2013 was nevertheless still contributing to the high growth, as was the renewed rise in sewerage prices, which since the liberation of prices in 2013 have continued to rise sharply.

In addition, there was also a slight increase in year-on-year growth in prices of certain market services, such as transport services and insurance connected with transport. Another upward-acting factor was the base effect from the December 2013 reductions in health insurance, premiums for which again fell temporarily in November 2014. Growth in services prices averaged 1.7% over the first quarter of this year, 0.2 percentage points more than in the previous quarter. This was mainly attributable to the slowdown in the year-on-year fall in prices of telephone and internet services, and the continuing increase in year-on-year growth in prices of package holidays. Year-on-year growth in prices of insurance connected with transport also increased further.

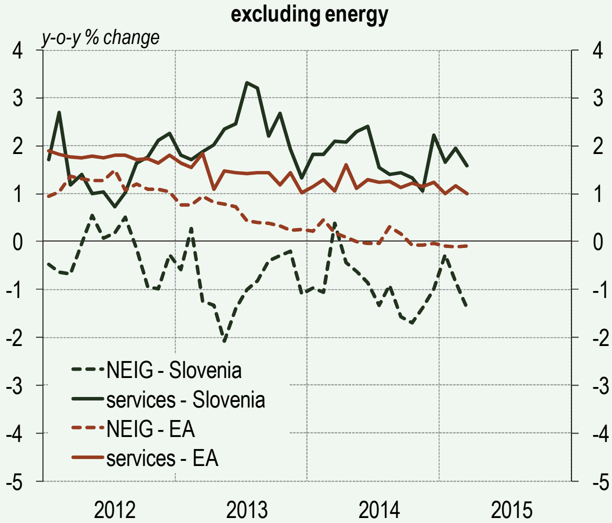
The fall in prices of non-energy industrial goods deepened slightly in 2014, and is still yet to show any sign of a positive shift in the early part of this year. Prices of non-energy industrial goods fell by 1.0% overall in 2014, 0.1 percentage points more than in the previous year, while prices across the euro area rose by 0.1%. The fall in Slovenia was primarily the result of a year-on-year fall in prices of clothing and footwear and prices of sports equipment. By contrast, the fall in car prices slowed temporarily. The year-on-year fall in these prices averaged 0.8% over the first quarter, 0.5 percentage points less

Figure 6.7: Contributions to growth in services prices



Source: ECB.

Figure 6.8: Prices of services and industrial goods excluding energy



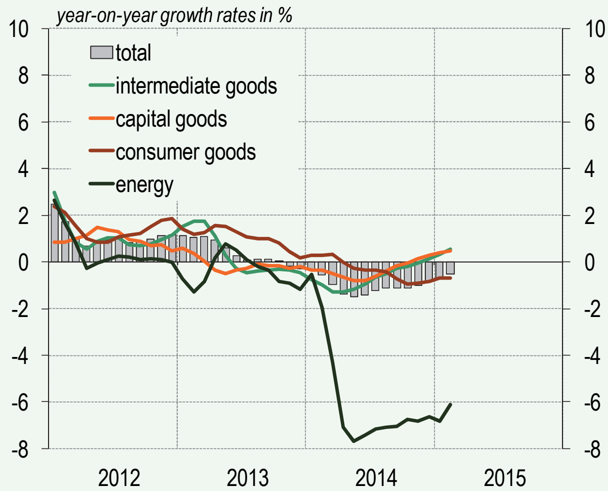
Source: Eurostat, SORS, Bank of Slovenia calculations.

than in the final quarter of last year. After falling for most of last year, prices of sports equipment rose, while year-on-year growth in prices of clothing and footwear and car prices was also less negative. By contrast, prices of household equipment fell slightly more sharply than in the previous quarter, which was primarily attributable to a sharper fall in prices of household appliances.

Industrial producer prices

Industrial producer prices on the domestic market fell sharply in 2014, primarily as a result of the fall in energy prices, although the fall in prices gradually slowed over the final months. Aggregate prices fell by 1.1% over the year, 0.3 percentage points more than in the euro area overall. The main factor was energy prices, whose fall deepened by 5.9 percentage points to 6.4%. As a result of the fall in electricity prices on the European market in recent years and the fall in oil prices, the year-on-year fall in prices in the production of electricity, gas and steam increased sharply, to prevail over the extremely high growth in water supply prices. Producer prices of commodities fell significantly in the first half of the year. After a long break, prices in the manufacture of

Figure 6.9: Producer prices on domestic market



Source: SORS, Bank of Slovenia calculations.

metals began rising again in the final quarter, and aggregate growth in commodity prices had turned positive by the beginning of this year owing to the fall in the euro. A reversal in prices in the second half of the year was also seen in capital goods, prices of which gradually rose in the early part of this year. In contrast to commodity prices, prices of consumer goods fell significantly in the second half of last year, particularly prices of non-durables as a result of lower input costs.

7 Projections of Economic Trends and Inflation 2015–2017[23]

The recovery in the domestic economy is projected to be more modest this year and in the next two years than in 2014. Annual economic growth will average 2% over the projection period. Exports will remain the main engine of growth, while domestic demand is expected to strengthen only gradually.

Within domestic demand components, gross fixed capital formation is again forecast to record the fastest growth this year, as a result of the execution of public infrastructure projects, while growth in government final consumption and private final consumption will remain relatively weak. In line with the expectation of further fiscal consolidation, government consumption will remain moderate over the next two years, while the gradual improvement in the situation on the labour market and the restoration of consumer confidence will gradually strengthen private consumption. Fast corporate deleveraging is expected to continue, which is creating the conditions for growth in private-sector investment. This will be gradual, and will not succeed in fully compensating for the anticipated decline in public investment in 2016.

Consumer prices will fall slightly overall this year, as a result of the sharp fall in energy prices at the turn of the year. Core inflation will also remain low. The latter will begin to gradually rise over the next two years, in line with the increase in economic activity and the gradual closure of the output gap, which is expected to remain slightly negative throughout the projection period.

The risks to the economic growth projections are moderately on the downside for this year and next year. Realising the planned public investment and ensuring the further good performance of the export sector entail the largest risks. The risk to public investment after 2015 relates primarily to the new period of the European financial framework, while the scheme for financing the investments of the Juncker Investment Plan is also unclear. The main risk to export growth is the fall in the number of manufacturing sectors that were contributing to growth in industrial production at the end of last year, which has diminished export potential, at least temporar-

[23] The projections were made on the basis of the applicable statistical methodologies and data available on 2 March 2015. The projections of macroeconomic factors presented in this report are based on assumptions of the movement in variables from the international environment and on certain domestic factors dependent on economic policy decisions. The assumptions of the movement in variables from the international environment are taken from the Consensus Forecasts and Eastern Europe Consensus Forecasts (February 2015), the European Economic Forecasts (European Commission, winter 2015), the OECD Economic Outlook (November 2014), and the IMF WEO Update (January 2015). The assumptions used in the projections are not necessarily the same as those used by the ESCB in its projections. For the relationship between the Bank of Slovenia projections and those of the ESCB, see the appendix in the April 2008 Price Stability Report.

ily. Growth in private-sector investment is also uncertain, although in this case the risks are on the upside in light of high capacity utilisation, access to financing for successful firms, and the significant stock of retained earnings.

The risks to inflation over the projection period are on the upside. Higher commodity and labour costs could in particular result in higher-than-forecast price growth, the former in connection with faster growth in oil prices, and the latter as a result of wage pressures in the wake of the further recovery of the economy. A situation of loose monetary policy, excess liquidity on the part of the banks and households, and increased confidence is creating the conditions for better growth in domestic demand and additional upward pressure on prices.

International environment and external assumptions

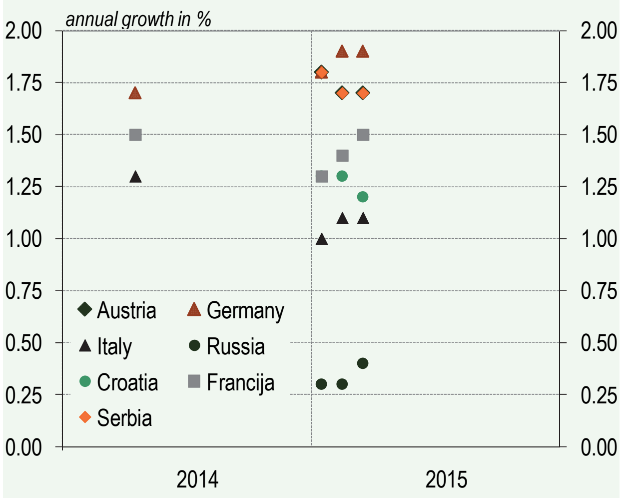
After declining in the second half of last year, expectations surrounding growth in the major trading partners stabilised. Weak economic growth in the euro area in the second half of last year and the deterioration in relations between Russia and the EU lowered the forecasts. Despite the current easing of the situation, the economic growth forecasts for Russia are still declining, while the economic situation is expected to remain modest in Serbia and Croatia. By contrast, the figures for Germany and France have improved recently, while the ECB's quantitative easing is expected to have a beneficial impact on growth in foreign demand. The latter remains in line with the previous projections. It is projected to increase by 2.4% this year, and by 3.2% and 3.4% in the next two years.

The assumptions for prices of oil and primary commodities have declined sharply since the previous projections. The sharper fall in oil prices between last October and this January brought a pronounced reduction in the technical assumption for US dollar oil prices. They are expected to gradually increase over the projection period, from USD 62 per barrel in 2015 to USD 68 and USD 72 respectively in the next two years. Other commodity prices will fall slightly this year, and will then gradually rise over the next years in line with the dynamics in oil prices.

Figure 7.1: Projections of GDP growth in Slovenia's main trading partners for the year 2015

Source: Consensus Economics.

Figure 7.2: Projections of GDP growth in Slovenia's main trading partners for the year 2016



Source: Consensus Economics.

Table 7.1: Assumptions for the international environment

	2010	2011	2012	2013	2014	Assumptions 2015 Apr.	2015 Δ	2016 Apr.	2016 Δ	2017 Apr.	2017 Δ
	growth rates, % (if not specified otherwise)										
Foreign demand*	10.1	6.9	0.5	1.5	1.9	**2.4**	0.0	**3.2**	0.1	**3.4**	...
Oil (USD per barrel)	80	111	112	109	99	**62**	-45	**68**	-39	**72**	...
Non-oil commodities	36.5	21.9	-12.5	-5.0	-6.4	**-11.0**	-11.1	**2.6**	-1.8	**4.8**	...
EMU inflation	1.6	2.7	2.5	1.4	0.4	**0.3**	-0.8	**1.1**	-0.3	**1.7**	...
PPI Germany	1.5	5.1	1.7	0.0	-0.9	**-0.5**	-1.1	**1.5**	-0.1	**1.8**	...

** Volume of imports from the basket of foreign partners.*
Δ: Difference between current assumptions and assumptions in September 2014 Macroeconomic Developments and Projections.
Source: Bank of Slovenia, Eurostat, Consensus Economics, ECB, JP Morgan, OECD Economic Outlook.

Inflation in the euro area will merely be slightly above zero this year, as a result of falling energy prices. As a result of the fall in energy prices, which was sharper than anticipated, the inflation forecasts have been revised downwards since the previous projections, and low inflation remains a significant risk throughout the projection period. Producer prices in Germany are expected to continue falling this year, and are then expected to record gradual growth of less than 2% over the next two years.

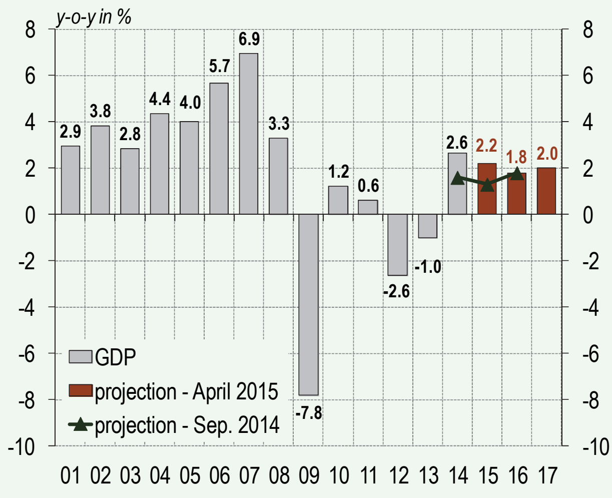
GDP growth

Economic growth is forecast at 2.2% this year, and is expected to be slightly lower over the next two years, but still solid. A relatively strong carry-over effect, growth in public investment that will be higher than previously projected and slightly higher growth in exports will all have a positive impact on this year's growth. The upward revision for this year amounts to 0.9 percentage points, which is partly attributable to higher-than-forecast growth in the final quarter of last year. The main factor in the slightly lower economic growth in the next two years

Figure 7.3: Commodity prices

Source: ECB, Bloomberg, Bank of Slovenia assumptions.

Figure 7.4: GDP growth projections



Source: SORS, Bank of Slovenia projections.

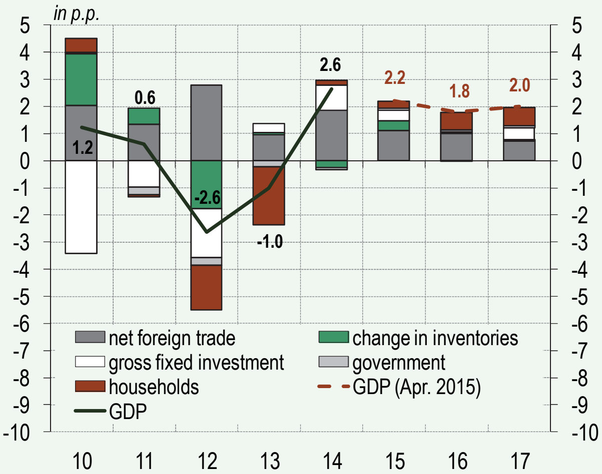
will be a fall in government investment in accordance with the beginning of the new European financial framework. The projected increase in private-sector investment will still be too weak in 2016 for aggregate growth in gross fixed capital formation. The domestic consumption projection is slightly higher, government consumption in particular, as a result of a turn to a more growth-friendly fiscal policy, while the projection for growth in private consumption has been revised upwards only marginally.

Aggregate demand

Exports will remain the main engine of economic growth in the coming years. The contribution to growth made by net exports will weaken, but will remain positive over the entire projection period. The forecast for growth in foreign demand having remained unchanged, the higher forecast growth in exports in 2015 is attributable to a carry-over effect, which amounts to 3.5 percentage points. The pronounced gap by which export growth outpaced growth in foreign demand last year will narrow slightly as a result of a base effect, the anticipated slowdown in the improvement in cost competitiveness and the relatively low growth in investment in production capacities. This year's import growth forecast has also been revised upwards, primarily as a result of high public investment and the slightly higher projections for export growth, while the import growth forecast for 2016 is lower than in the previous projections as a result of the fall in public investment. Towards the end of the projection period import growth will be strengthened by increased private consumption and investment.

The recovery in domestic consumption will strongly depend on public investment plans and impetus in private-sector investments in production capacities. The forecast for this year's growth in domestic consumption is moderately higher than in the previous projections as a result of continuing growth in public investment and the slight increase in final government consumption, while the forecast for 2016 is lower, as private-sector investment will still be too weak to compensate for the expected decline in public investment. Final household consumption will only recover gradually, although purchasing

Figure 7.5: Projection of expenditure contributions to GDP growth rate



Note: Due to rounding, sums of components may differ from aggregate values.
Source: SORS, Bank of Slovenia projections.

Table 7.2: Components of domestic demand

	2010	2011	2012	2013	2014	Projections 2015 Apr.	2015 Δ	2016 Apr.	2016 Δ	2017 Apr.	2017 Δ
	real growth rates, %										
Domestic consumption	-0.9	-0.8	-5.6	-2.1	0.8	**0.8**	0.3	**0.8**	-0.4	**1.3**	...
Private consumption	1.0	-0.1	-3.0	-3.9	0.3	**0.5**	0.0	**1.2**	0.2	**1.3**	...
Government spending	0.1	-1.3	-1.5	-1.1	-0.5	**0.4**	0.8	**0.5**	0.9	**0.5**	...
Gross fixed capital formation	-13.7	-4.6	-8.9	1.9	4.8	**1.9**	0.1	**-0.1**	-4.0	**2.3**	...

Δ: Difference between current projections and projections in September 2014 Macroeconomic Developments and Projections.
Source: SORS, Bank of Slovenia.

power will increase over the projection period in the wake of wage growth and low inflation. The forecast for growth in private consumption has been revised slightly upwards relative to the previous projections for 2016 alone, as a result of a lag in the impact of slightly higher growth in employment, partly related to public investment, and the impact of the fall in prices of refined petroleum products in 2015 on consumer purchasing power.

Growth in investment will continue this year, primarily on account of public projects, while growth in private-sector investment in machinery and equipment is expected to only begin strengthening in the following years. Growth in public investment co-financed from the European financial perspective, which is ending in 2015, will be the sole factor in this year's growth in gross fixed capital formation. A sharper fall in public investment is expected in 2016, in line with the beginning of the new financial framework. Private-sector investment in machinery and equipment is expected to decline further in 2015 as a result of the continuing restructuring and deleveraging of the corporate sector and a further contraction in domestic bank lending. However, the ongoing process of reaching master restructuring agreements for individual large firms is improving the outlook in the following years, while a need for investment in production capacity is indicated by the high capacity utilisation in manufacturing.

Government consumption will remain low over the projection period, on account of the urgency of structural adjustment in the fiscal area. The forecast for this year's government consumption is based on the measures taken to date, while expected inflationary developments will also have an impact on real growth. This year's average nominal wage in the government sector will remain at a similar level to last year. This is attributable to the extension of the measures from previous years, the enforcement of the April 2014 promotions and the adoption of certain additional measures to reduce wage growth. The average wage in the government sector is expected to rise by slightly less than 2% each year in the next two years, partly as a result of promotions at the end of December 2015 and 2016. Employment in the government sector is forecast to remain more or less unchanged over the projection period. Low growth is expected in intermediate consumption. Government consumption is forecast to increase by around 0.4% to 0.5% each year over the projection period.

Supply side

Economic growth will remain primarily dependent on the dynamics in industrial production. Growth in industrial production and exports in 2014 strongly outperformed growth in foreign demand, which is a reflection of the increased competitiveness of the export sector, and simultaneously the basis for growth in industrial production to continue at close to last year's level. As a result of the gradual recovery in domestic demand, including investment, towards the end of the projection period greater contribution to growth in industrial production is also expected from developments on the domestic market, where industry still generates about 30% of its revenue, despite a strong focus on exports.

Growth in value-added in construction will remain conditioned by the effectiveness of the disbursement of EU funds. After a quarterly decline in activity in the second half of 2014, which was attributable to the completion of a number of projects before local elections, renewed growth in construction activity is anticipated this year in line with government investment plans, albeit at a less pronounced rate, primarily as a result of a base effect. Given current order books, the number of building permits issued and the adverse situation on the new-build housing market, private-sector construction investment will remain weak. As a result of the end of the current European financial perspective this year, and the reduction in funding and change in the purpose of funding in the new financial framework, a significant decline in the amount of construction put in place is expected in 2016.

After poorer results in private-sector services at the end of 2014, activity is forecast to gradually increase over the projection period in line with the recovery in domestic demand and further growth in exports. Growth in transport services is expected to increase slightly, as the strengthening of domestic business-to-business operations begins to contribute more strongly alongside growth based on foreign demand. After very weak growth last year, exports of travel services are forecast to strengthen as a result of changes in the promotion of tourism, while the recovery of domestic guests' purchasing power will also contribute to growth in value-added in accommodation and food service activities. The anticipated gradual recovery in purchasing power will also contribute to an increase in activity in other services, most notably trade. The implementation of more growth-friendly fiscal consolidation is expected to bring weak growth in value-added in public services.

Labour market

The surveyed unemployment rate will fall over the projection period, but will remain above 9%. Further moderate growth in employment is forecast, although uncertain forms of employment will continue to prevail, with an adverse impact on growth in private consumption. The prevalence of agency work, which was pronounced last year, is clouding the current employment picture, which is hindering projections of employment in individual sectors, industry and construction in particular. Growth in employment has been revised downwards from previous projections for 2016, primarily as a result of a sharper fall in labour-intensive public investment, which will slow growth in employment via agencies. Employment in the government sector is forecast to remain more or less unchanged over the projection period, while moderate growth is forecast in employment in other services, in line with the gradual recovery in private consumption.

Wage growth in the private sector will remain moderate over the projection period, while the government sector is also expected to contribute to aggregate

Table 7.3: Activity, employment and wages

						Projections					
						2015		2016		2017	
	2010	2011	2012	2013	2014	Apr.	∆	Apr.	∆	Apr.	∆
	growth rates, %										
GDP (real)	1.2	0.6	-2.6	-1.0	2.6	**2.2**	0.9	**1.8**	0.0	**2.0**	…
Employment	-2.2	-1.6	-0.8	-1.5	0.7	**0.6**	0.4	**0.4**	-0.2	**0.4**	…
Compensation per employee	4.0	1.6	-1.2	1.9	-0.2	**1.1**	-0.3	**1.3**	-0.3	**1.4**	…
Productivity	3.5	2.3	-1.8	0.5	2.0	**1.6**	0.4	**1.3**	-0.2	**1.6**	…
ULC (nominal)	0.5	-0.7	0.6	1.4	-2.1	**-0.5**	-0.7	**0.0**	-0.1	**-0.2**	…
Contribution to GDP growth	*percentage points*										
Domestic demand, excl. chg. in inventories	-2.8	-1.3	-3.7	-2.1	1.0	**0.7**	0.2	**0.7**	-0.5	**1.2**	…
Net exports	2.1	1.4	2.9	1.0	1.9	**1.1**	0.4	**1.0**	0.5	**0.7**	…
Changes in inventories	1.9	0.6	-1.8	0.1	-0.2	**0.4**	0.4	**0.0**	0.0	**0.0**	…

∆: Difference between current projections and projections in September 2014 Macroeconomic Developments and Projections.
Source: SORS, Bank of Slovenia.

[24] During the crisis the number of sole traders increased by approximately 10,000 to 81,000 according to AJPES figures. Because their revenues are not included in wage statistics, the credibility of the impact of wage developments on consumer purchasing power declined. At the same time increased employment via agencies is clouding the actual picture of wage developments in each sector. The two factors make it difficult to accurately formulate a projection of wage developments.

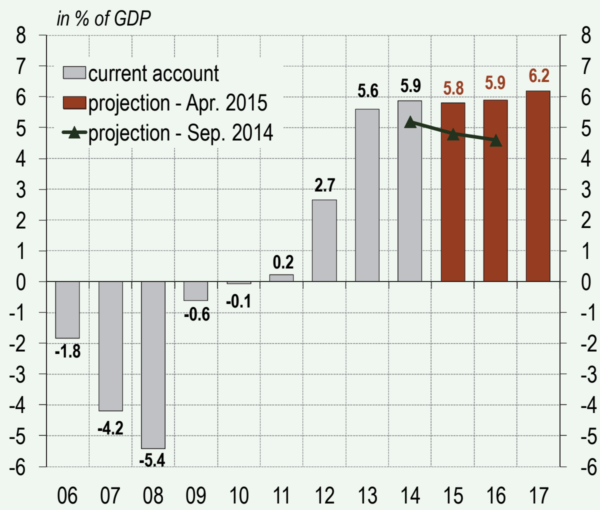
wage growth. The forecast for wage growth[24] is slightly lower than in the previous projections, as a result of the weak recovery in private-sector services. The slightly lower wage growth is also attributable to the prevalence of lower-quality forms of employment via agencies and temporary employment, while low inflation means that the upward pressure on wages will also be smaller. Export-oriented sectors will be the main factors in wage growth in the private sector. However, the average wage in the government sector is forecast to rise by slightly less than 2% each year, partly as a result of the relaxation of civil service promotions.

Foreign trade

The current account surplus will remain around 6% of GDP over the projection period, more than was forecast in the previous projections. The very gradual growth in private investment will be a factor in the large surplus throughout the projection period. In the context of a slow recovery in private consumption and weak growth in investment, consolidation processes mean that growth in government consumption will also be weak. Export growth will continue to outpace import growth.

The favourable developments in the balance of trade in the next few years will allow for the financing of the projected growth in the deficit in primary income. The surplus of trade in merchandise and services is forecast to widen from 8.2% of GDP last year to 9.8% of GDP in 2017. A positive contribution to this year's growth will come from the terms of trade, which are expected to deteriorate moderately over the next two years, primarily as a result of slightly higher growth in import prices. The deficit in primary income is forecast to widen from 1.6% of GDP in 2014 to just under 3% of GDP by the end of the projection period, although growth in the gross external debt will slow in the next two years as a result of austerity measures. In the context of relatively low interest rates,

Figure 7.6: Current account projection



Source: SORS, Bank of Slovenia projections.

Table 7.4: Current account projections

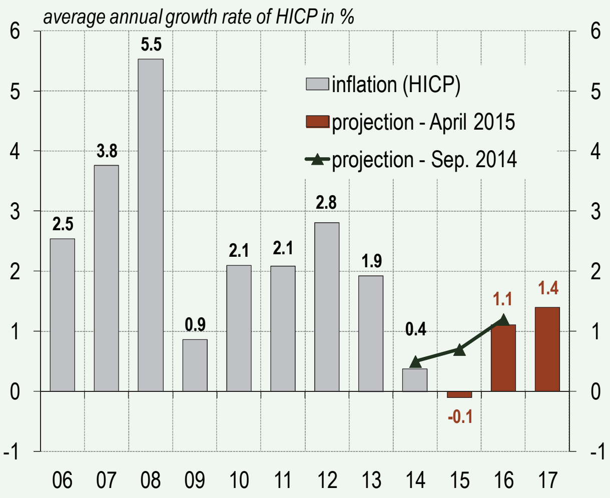
						Projections					
						2015		2016		2017	
	2010	2011	2012	2013	2014	Apr.	Δ	Apr.	Δ	Apr.	Δ
	growth rates, % (if not specified otherwise)										
Exports of merchandise and services	10.1	7.0	0.3	2.6	6.3	**4.7**	1.0	**4.9**	-0.1	**5.1**	...
Imports of merchandise and services	6.6	5.0	-3.9	1.4	4.1	**3.6**	0.5	**4.1**	-0.9	**4.7**	...
Current account: EUR billion	0.0	0.1	1.0	2.0	2.2	**2.2**	0.5	**2.3**	0.6	**2.5**	...
as % GDP	-0.1	0.2	2.7	5.6	5.8	**5.8**	1.0	**5.9**	1.3	**6.2**	...
Terms of trade*	-4.0	-1.4	-1.0	1.0	0.8	**0.4**	0.8	**-0.7**	-0.8	**-0.7**	...

** Based on national accounts deflators.*
Δ: Difference between current projections and projections in September 2014 Macroeconomic Developments and Projections.
Source: SORS, Bank of Slovenia.

Figure 7.7: Terms of trade projections

Source: SORS, Bank of Slovenia projections.

Figure 7.8: Inflation projection



Source: SORS, Bank of Slovenia projections.

this will slightly curb growth in interest expenditure. At the same time the increased outflow of profits to the rest of the world as a result of privatisation will contribute to growth in the deficit in primary income.

Inflation

Average growth in prices is forecast at -0.1% in 2015, but will rise over the next two years. The inflation projection for 2015 has been revised sharply downwards from the previous projections, primarily as a result of the negative contribution made by energy prices (see Box 6.1 on page 56). Despite the fall in the euro, inflation developments this year will remain under the prevailing influence of the fall in energy prices, while inflation is forecast to gradually increase over the next two years, in line with developments in economic activity and the gradual closure of the output gap. Average inflation is forecast at 1.1% in 2016, and 1.4% in 2017.

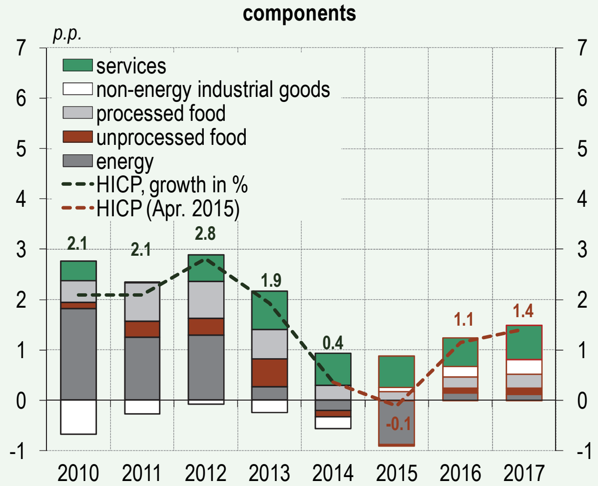
Energy prices on global markets are the main factor in the downward revision of this year's inflation forecast. Year-on-year growth in energy prices has been revised downwards by 6.0 percentage points from the most recent forecast, as a result of the sharp fall in oil prices between October 2014 and January 2015. Given the current assumptions of moderate growth in oil prices on global markets and the current euro exchange rate against the US dollar, the negative growth in energy prices will progressively diminish this year, particularly towards the end of the year when the base effect drops out. Growth in energy prices will thus average -6.0% this year, but is then forecast to increase over the next two years in line with the assumptions for euro oil prices. The global excess supply of certain food products and the Russian ban on imports have acted to lower food prices in Slovenia. The impact of these factors is expected to dissipate this year, and the contribution made by food prices is expected to be mildly positive this year, then to gradually increase in line with the assumptions for food prices in the rest of the world.

The main components of core inflation will be subject to the exchange rate and domestic demand over the projection period. The impact of lower oil prices on prices of non-energy industrial goods is expected to be short-term only, directly via production and retail sales chains. Pass-through will be limited because of the fall in the euro, and the corresponding weaker fall in import prices, the fall in which has slowed in recent months. After declining for five years, growth in prices of non-energy industrial goods is forecast to turn positive again, and later to increase in line with domestic consumption. Growth in services prices is forecast to stay close to 2% throughout the projection period, while their contribution to inflation will be the largest of all price categories. Higher growth in prices of market services is expected in particular, having been significantly below its long-term average since the outbreak of the crisis, in contrast to public services. Prices of market services are influenced by the fall in the euro, which according to this year's initial figures has a larger impact than the indirect fall in oil prices, which is reflected in high growth in prices of package holidays.

The gradual increase in private consumption will strengthen growth in core inflation. Alongside the decline in the negative impact of factors from the international environment, the main factors in core inflation developments will be moderate growth in domestic economic activity and the narrowing of the negative output gap. In keeping with the increase in economic activity and the gradual improvement of the situation on the labour market, consumer confidence is expected to strengthen, and with it private consumption. At the same time the output gap will narrow, although it is expected to remain negative until the end of the projection period. The forecast growth in commodity prices on global markets and the simultaneous fall in the euro will strengthen import prices, thereby increasing the pressure on core inflation. Core inflation as measured by the HICP excluding energy, food, alcohol and tobacco is forecast at around 0.8% this year, before rising to 1.1% in 2016 and to 1.4% in 2017.

The overall direct impact of government measures on inflation will be low. The rise in excise duties on alcohol

Figure 7.9: Projections of contributions to inflation by components



Note: Due to rounding, sums of components may differ from aggregate values.
Source: SORS, Bank of Slovenia projections.

Table 7.5: Inflation projections

						Projections					
						2015		2016		2017	
	2010	2011	2012	2013	2014	Apr.	Δ	Apr.	Δ	Apr.	Δ
						average annual growth, %					
Consumer prices (HICP)	2.1	2.1	2.8	1.9	0.4	**-0.1**	-0.8	**1.1**	-0.1	**1.4**	...
food	2.5	4.8	4.7	4.9	0.8	**0.6**	-0.7	**1.4**	-0.4	**1.7**	...
energy	13.9	8.8	9.0	1.8	-1.4	**-6.0**	-6.0	**1.0**	1.0	**0.8**	...
other goods	-2.2	-0.9	-0.2	-0.9	-1.0	**0.1**	0.1	**0.5**	-0.3	**0.8**	...
services	1.2	0.0	1.5	2.2	1.8	**1.7**	0.5	**1.6**	0.0	**1.9**	...
Core inflation indicators (HICP)											
excluding energy	0.3	1.0	1.8	1.9	0.7	**0.9**	0.1	**1.2**	-0.2	**1.5**	...
excl. energy and unprocessed food	0.2	0.7	1.5	1.4	0.9	**1.0**	0.2	**1.2**	-0.2	**1.5**	...
excl. energy, food, alcohol and tobacco	-0.4	-0.4	0.7	0.9	0.6	**1.0**	0.3	**1.1**	-0.2	**1.4**	...

Δ: Difference between current projections and projections in September 2014 Macroeconomic Developments and Projections.
Source: SORS, Bank of Slovenia.

and tobacco in the spring of last year will contribute 0.05 percentage points to inflation this year. January's rise in taxes on CO_2 will account for 0.07 percentage points of this year's inflation. The rise in the rate of tax on financial transactions and insurance services contributed 0.05 percentage points to price growth in the first quarter. Should the government leave excise duties on refined petroleum products unchanged for the remainder of this year, their contribution to inflation will be -0.05 percentage points. The overall contribution of government measures to the inflation rate is thus projected at 0.1 percentage points this year, and around -0.1 percentage points in 2016.

Risks and uncertainties

The main risks to economic growth for this year and next year are slightly on the downside, as a result of the uncertainty surrounding the implementation of public investment and the ongoing robust performance of the export sector. Last year's recovery in economic activity was otherwise encouraging, but a large part of growth was the result of enhanced public investment in the wake of the ending of the financing of projects by the EU funds. The economic growth forecast is therefore subject to considerable risk in light of one-off developments. Less uncertain is the generation of a surplus in net trade with the rest of the world, which is largely dependent on foreign demand, which on one hand is being promoted by the ECB's expansionary monetary policy, but on the other is being hindered by weak economic activity in certain partners outside the euro area, most notably Russia, Serbia and Croatia. The main risk to growth in external demand is thus the tightening of economic sanctions between the EU and Russia, while the main domestic risk factor in exports is the significant fall in the number of manufacturing sectors that were contributing to growth in industrial production in the final quarter of last year.

The speed of the recovery in domestic demand will primarily depend on the ability of private-sector firms to compensate for the decline in government investment. Growth in investment was relatively high last year solely as a result of the increase in public investment, while private-sector investment declined in real terms. The uncertainty surrounding growth in investment for this year and next year is related primarily to the ability of central and local government to carry out all open projects in full, and to begin effectively disbursing funds from the new European financial framework. With regard to

Table 7.6: Comparison of forecasts for Slovenia and change from previous forecasts

	Publication of new/previous forecast	GDP growth rate, %				Inflation annual average, %				Current account % of GDP			
		2015		2016		2015		2016		2015		2016	
		new	Δ	new	Δ	new	Δ	new	Δ	new	Δ	new	Δ
Bank of Slovenia	Apr. 15/Sep. 14	**2.2**	0.9	**1.8**	0.0	**-0.1**	-0.8	**1.1**	-0.1	**5.8**	1.0	**5.9**	1.3
IMAD	Mar. 15/Sep. 14	**2.4**	0.8	**2.0**	0.4	**-0.2**	-0.8	**1.0**	-0.2	**5.9**	0.3	**6.0**	0.3
Consensus Forecasts	Mar. 15/Feb. 15	**1.8**	0.0	**2.0**	0.0	**0.5**	-0.2	**1.4**	-0.1	**…**	…	**…**	…
European Commission	Feb. 15/Nov. 14	**1.8**	0.1	**2.3**	-0.2	**-0.3**	-1.3	**0.9**	-0.6	**5.7**	-0.4	**5.4**	-0.5
OECD	Nov. 14/May 14	**1.4**	0.2	**2.2**	…	**0.6**	-0.3	**1.0**	…	**6.0**	-1.4	**6.5**	…
IMF	Oct. 14/Apr. 14	**1.4**	0.5	**1.5**	0.0	**1.0**	-0.6	**1.7**	-0.4	**5.8**	0.0	**5.5**	0.4

Δ: Difference between current and previous forecasts.
Source: Bank of Slovenia, IMAD, European Commission, Consensus Economics, IMF, OECD, Bank of Slovenia calculations.

additional funding for public investment, the scheme within the framework of the Juncker Investment Plan also remains unclear. Although certain firms remain excessively indebted, investment in machinery and equipment could be stronger than forecast under the baseline scenario of the projections, given that capacity utilisation is high, successful firms have access to financing, and the stock of retained earnings is also large.

As a result of growth in real wages outperforming private consumption in 2014, and given the increase in household saving, growth in private consumption could be higher than expected. Growth in employment and wages is merely expected to remain moderate over the projection period, accompanied by prevailing uncertain forms of employment. Real household income is nevertheless increasing more quickly than private consumption. With household savings already high, low passive interest rates mean that additional saving in safer forms is becoming less and less attractive. In the absence of shocks from the external environment, and in particular from domestic fiscal measures, growth in private consumption could be higher than forecast.

Pressure from interest groups to raise pensions and wages in the public sector represent a risk of higher-than-planned government consumption. In 2015 Slovenia must eliminate the excessive deficit in accordance with the requirements of the excessive deficit procedure that it has been undergoing since 2009. The largest risk is therefore presented by the government's ability to hold government consumption within the stated boundaries in a situation of economic recovery, in light of the several years of constraints on wage growth. If the risks to the growth forecast for employment in the public sector are balanced, major deviations are possible in wage growth, particularly in 2016, should an appropriate agreement between the government and the public sector unions not be reached this year.

The risks surrounding the inflation projections are on the upside. Price growth could be higher than projected because of higher costs of commodities, some oil producers having warned already that the extraction of oil at today's prices is becoming increasingly unprofitable for certain techniques. Tensions in the Persian Gulf increased further. The potential for faster-than-expected growth in wages entails an additional risk of higher costs. With the economic recovery, partly as a result of stimulative macroeconomic policies, and the strengthening of the labour market, pressures on wages are expected to increase towards the end of the projection period in the private and public sector. A situation of loose monetary policy, excess liquidity (on the part of the banks and households), and increased confidence is creating the conditions for higher growth in domestic demand and additional upward pressure on prices.