BANKA SLOVENIJE

BANK OF SLOVENIA

EUROSYSTEM

MACROECONOMIC DEVELOPMENTS AND PROJECTIONS

OCTOBER 2013

BANKA SLOVENIJE

BANK OF SLOVENIA

EUROSYSTEM

Published by:

BANKA SLOVENIJE
Slovenska 35
1505 Ljubljana
Tel.: +386 1 471 9000
Fax.: +386 1 251 5516

This publication is also available in Slovene.

ISSN 2335-3643

Table of contents

Figures, tables and boxes:

Figures:

Tables:

Boxes:

Abbreviations used in Macroeconomic Developments and Projections*

AJPES	Agency for Public Legal Records and Related Services
AT	Austria
BAMC	Bank Assets Management Company
BE	Belgium
BIH	Bosnia and Herzegovina
bps	Basic point
BRIC	Brazil, Russia, India, China
CB	Central bank
CEFTA	Central European Free Trade Agreement
CPI	Consumer price index
CY	Cyprus
DARS	Motorway Company in the Republic of Slovenia
DE	Germany
EA	Euro area
EA-17	Euro area
EC	European Commission
ECB	European Central Bank
EE	Estonia
EFSF	European Financial Stability Facility
EMU	Economic and Monetary Union
ES	Spain
ESA95	European System of Accounts (1995)
ESCB	European System of Central Banks
ESM	European Stability Mechanism
EU	European Union
EU-27	European Union - 27 members (excluding Croatia)
EU-28	European Union - 28 members (including Croatia)
EUR	Euro
Euribor	Euro Interbank Offered Rate
Eurostat	Statistical Office of the European Communities
FDI	Foreign direct investment
Eed	Federal Reserve
FI	Finland
FR	France
FRED	Federal Reserve Economic Data
GDP	Gross domestic product
GR	Greece
HICP	Harmonised Index of Consumer Prices
IE	Ireland
ILO	International Labour Organization
IMAD	Institute of Macroeconomic Analysis and Development of the Republic of Slovenia
IMF	International Monetary Fund
IT	Italy

LTD ratio	Loan to deposit ratio
LTRO	Longer-term refinancing operation
LU	Luxembourg
MDAP	Macroeconomic Developments and Projections
MoF	Ministry of finance
MT	Malta
NACE	Standard classification of economic activities
NFCs	Non-financial corporations
NGOs	Non-governmental organizations
NKBM	Nova Kreditna Banka Maribor d.d.
NL	Netherlands
NLB	Nova Ljubljanska Banka d.d.
NPISH	Non-profit institutions serving households
OECD	Organisation for Economic Co-operation and Development
p. p.	Percentage point
PMI	Purchasing managers' index
PPI	Producer price index
PT	Portugal
Q	Quarter
SI	Slovenia
SK	Slovakia
SKD	Standard Classification of Activities
SMEs	Small and medium enterprises
SORS	Statistical Office of the Republic of Slovenia
TEŠ 6	Block 6 of Šoštanj power station
UK	United Kingdom
ULC	Unit labour costs
US	United States of America
USD	US dollar
VAT	Value added tax
WEO	World Economic Outlook
ZUJF	Fiscal Balance Act

* The Macroeconomic Developments and Projections report is the successor to the Price Stability Report.

Executive Summary

Economic activity declined further in the first half of 2013. The contraction slowed, but primarily as a result of one-off factors in domestic demand. There has been no sign yet of any effect from the more favourable developments in the narrow external environment, exports not having increased despite the euro area recovery. The domestic environment has been marked by uncertainty, high unemployment, constraints on financing, declining consumer confidence and diminished purchasing power, which was caused by the cost adjustment of the economy and fiscal consolidation measures. The medium-term consolidation of the public finances and the restructuring of bank and corporate balance sheets are unavoidable, but they are also reducing the room for manoeuvre in mitigating the consequences of the crisis, which are being exacerbated by feedback from the fiscal consolidation measures. The delays in the solving of the problems of the banking system that resulted from the need for the closer involvement of external institutions have limited access to financing on the international financial markets. GDP is expected to contract by 2.6% this year, and by more than 0.5% next year. Employment is expected to fall by more than 5% over the projection horizon. A gradual increase in exports and a stall in imports in line with domestic demand could increase the current account surplus to more than 7% of GDP. Weak domestic demand will also contribute to a fall in core inflation, after the temporary rise caused by fiscal consolidation measures. In the absence of demand-side pressures and supply shocks, inflation is projected at less than 2% in the coming years. The additional fiscal consolidation measures proposed in the draft budgets for 2014 and 2015 are an indication of the government's determination to reduce the deficit to below 3% of GDP in 2015, which will require additional measures on the expenditure side.

* * *

Euro area GDP recorded a quarterly increase in the second quarter for the first time in a year and a half. All the main components of domestic demand increased, while the confidence indicators are improving despite high unemployment. While the recovery in the majority of developed countries has been very gradual, economic growth in emerging markets is slowing. Monetary policy remains accommodative.

In Slovenia GDP recorded quarterly declines of around 1% in the final part of last year and the early part of this year, while the main factors in the slowdown in the contraction to 0.3% in the second quarter were a slight increase in investment and the increase in household consumption before the rise in VAT rates. The ongoing austerity measures are continuing to reduce government consumption. Although the export sector is the only part of the economy whose growth is preventing an even larger decline in activity, it has not yet fully exploited the weak recovery in the majority of the most important euro area partners despite the improvement in cost competitiveness. Therefore, the contribution to GDP by industry remains negative, despite the gradual improvement in the situation in the international environment. Increased domestic consumption was a major factor in the growth in the majority of service sectors in the second quarter, but the improvement is likely to have merely been temporary. Despite the difficult financing conditions, activity in the construction sector has gradually been stabilising at a low level. Total employment rose in the first half of the year, but was nevertheless down more than 2% in year-on-year terms. Employment is falling in the private sector as a result of urgent cost adjustment, while in the public sector the adjustment is for the moment primarily being made through wage reductions. Despite falling in the second quarter, the surveyed unemployment rate remains above 10%.

Weak imports and relatively solid exports are rapidly widening the current account surplus. After recording a surplus of 3.3% of GDP in 2012, the current account recorded a surplus of more than 6% of GDP in the first half of this year as a result of wider merchandise trade surplus. Cost competitiveness in the tradable sector has continued to improve compared with the euro area average.

The banks again reduced their stock of loans to the private sector in the first half of 2013. Corporates responded to the limits on the supply side from domestic banks by increasing their borrowing in the rest of the world. The stock of consumer loans to households declined, while the stock of housing loans has remained unchanged. Alongside weak demand, the main factors in the decline in *loans have been the restructuring of bank investments as a result of the reduction in indebtedness to the rest of the world, constraints on funding and the deterioration in credit register quality. The latter causes an increase in impairments and provisions, which is being reflected in the stock of loans and in interest rates on corporate loans. These are significantly above the euro area average, given that corporates are over-leveraged and have an adverse financing structure. Interest rates on loans to households are however comparable to overall rates in the euro area.*

During the first nine months of 2013, average growth in the harmonised index of consumer prices slowed to 2.2%. The slowing trend was interrupted in the middle of the year by the rise in VAT rates, whose impact was in line with expectations. Fiscal consolidation measures also brought a temporary rise in core inflation, which now exceeds the euro area average. There are currently no demand-side pressures on prices, while the impact on inflation from the supply side is also limited, with the exception of the effects of fiscal consolidation.

GDP is projected to decline by 2.6% this year, and to decline again in 2014. The downward revisions in both years are a reflection of weaker foreign demand, fiscal consolidation measures, worsening labour market conditions, private sector deleveraging and the ongoing problems with access to financing. All components of domestic demand are expected to decline over the projection horizon. The anticipated continuing recovery in the international environment, cost adjustment in the economy and further increase in economic sentiment could contribute to an improvement in the economic situation. The current account surplus is projected to exceed 6% of GDP this year, and to reach around 7.5% of GDP by the end of the projection horizon. Such surplus will be the result of very weak domestic consumption and the rapid deleveraging of the private sector. Inflation is expected to fall to an average of 2.2% this year, and to below 2% in the next two years. Core inflation will be low due to continuing adverse macroeconomic situation.

The risks to the GDP growth projection remain high, with a higher probability of growth being lower than the baseline projection. The recovery in the international environment is uncertain due to the slowdown in growth in emerging economies and the unresolved problems in the euro area. The uncertainties surrounding domestic factors have increased with regard to the risk assessments in the previous round of projections. They relate primarily to the scope of the additional fiscal consolidation measures and to the scope and timing of the measures to ensure stability in the banking system. These two factors and the implementation of structural reforms are crucial to the very uncertain situation in funding, particularly borrowing in the rest of the world, which is determined by the credit rating of Slovenia's sovereign debt. In the given situation, the effects of new labour market legislation are also rather uncertain. Given the lengthy fall in employment and the persistently high unemployment, the likelihood of high long-term structural unemployment is also increasing. The risks to the inflation projections remain balanced. The risk of higher price growth is related primarily to additional fiscal consolidation measures, to price rises in sectors with low competition, and to rises in energy and food prices brought by developments on international commodity markets. A faster decline in domestic demand and a sharper cost adjustment in the economy could result in lower core inflation.

* * *

The Bank of Slovenia is conducting stress tests and asset quality reviews in conjunction with foreign institutions with the aim of stabilising the situation in the banking sector. The additional reviews comply with European rules on the use of public funds. They will determine the amount of additional capital to ensure the capital adequacy of individual banks. In addition to the sovereign credit rating and the restructuring of the over-leveraged real sector, capital adequacy of banks will largely determine the ability to roll over maturing foreign loans and to undertake new borrowing in the rest of the world. The reinforcement of the banking system will depend primarily on the effective resolution of non-performing loans; the initial transfer of these from bank balance sheets to the BAMC is expected to begin before the end of the year. The financing of the economy via bank loans made primarily on the basis of bank borrowing in the rest of the world, which was prevalent before the crisis, proved to be unsustainable in the long term, and is currently declining, partly as a result of banks' debt repayments to the rest of the world. The economy needs financial restructuring and deleveraging. The aforementioned factors are hindering monetary policy transmission mechanism and are contributing to interest rates on corporate loans being higher than in the euro area overall. Cuts in the key interest rate have not contributed to lending growth, an indication of the constraints on both supply and demand.

The European Council has set 2015 as Slovenia's new target for eliminating the excessive deficit. Fiscal consolidation, improvement of the situation in the financial sector, and the implementation of structural reforms are the prerequisites for preventing further sovereign downgradings and maintaining access to financing on the international markets for the private and public sectors. Already implemented structural reforms to ensure the long-term sustainability of the public finances and to increase the long-term potential of the economy have not yet been reflected in financing conditions. These remain tight, also as a result of the delays in the restructuring of the banking system and the corporate sector caused by the need for closer cooperation with European institutions and the involvement of external evaluators of the quality of the Slovenian banking system.

In October's report on the general government deficit and debt, the general government deficit in 2013 is estimated at 5.7% of GDP, or 4.0% of GDP excluding the funds required for bank recapitalisation. According to the last estimates, the funds for bank recapitalisation in 2013 amount to 1.8% of GDP. This amount is likely at a lower end of the requisite funding for bank recapitalisation in 2013 and 2014; the final amount will be known after the stress testing exercise of the Slovenian banking system has been completed. The general government deficit in the 12 months to the end of June 2013 amounted to 5.3% of GDP. Additional measures will be required to meet the target of a deficit of less than 3% of GDP in 2015.

Fiscal consolidation measures should be designed to minimise the loss of employment and the contraction in demand, and above all should be as neutral as possible with regard to the export sector, which should remain the main engine of economic growth. The Bank of Slovenia thus supports the latest package of fiscal consolidation measures, as they largely comply with the aforementioned criteria. However it notes that it will be necessary in the future to stabilise the fiscal environment, as its frequent changes hinder business planning and reduce Slovenia's attractiveness to foreign investors. Measures on the expenditure side must be implemented consistently. Other options for rationalisation lie in the merger of smaller municipalities and in quasi-governmental companies, where labour costs have not adjusted to the crisis situation and where overall costs can also be reduced by corporate streamlining. In addition to the deterioration in the macroeconomic situation, the effect of recent consolidation measures is being limited by the rising interest expenditure caused by the increase in government debt, while a rise in implicit interest rates is likely to further increase such expenditure.

Unemployment is a growing problem, which together with increased uncertainty surrounding employment is contributing to low consumption. Alongside economic recovery, reducing unemployment will require a sustainable ratio of wages to productivity, and the creation of a favourable environment for new businesses. Curbs on costs in monopoly sectors will also contribute to an improvement in cost competitiveness. Increased cost competitiveness would allow for the reinforcement of capital strength and the creation of corporates' own financing funds. Active labour market policy should ensure the adequate level of training and requalification for the unemployed to increase their employment opportunities and to switch the labour force from sectors in difficulty to sectors with good prospects. This will ensure the efficient use of human capital. Another vital factor will be the creation of conditions that prevent the emigration of young, highly qualified workers.

In addition to enacting referendum legislation and reforms of the labour market and pension system, the government also approved the National Reform Programme in May 2013. The programme gives guidelines for numerous structural reforms, and implementation of these reforms is now being assessed by the European Commission. It will issue its opinion of the implementation of the country specific recommendations drawn up in the early summer as part of the European semester. Alongside Slovenia's credibility in the financial markets, the effective implementation of properly pitched structural reforms will have a long-term impact on economic growth and labour productivity, thereby contributing to medium-term fiscal consolidation. Promoting more effective governance in the corporate and public sector, the development of human capital and innovation, and a well-ordered and effective institutional framework for the functioning of the economy in the environment based on the strong rule of law, remain of vital importance to meeting these objectives in Slovenia.

								Projections					
								2013		2014		2015	
	2006	2007	2008	2009	2010	2011	2012	**Oct.**	Δ	**Oct.**	Δ	**Oct.**	Δ
Activity, employment and wages	*growth rates, %*												
GDP (real)	5.8	7.0	3.4	-7.9	1.3	0.7	-2.5	**-2.6**	-0.7	**-0.7**	-1.2	**1.4**	0.0
Employment	1.5	3.3	2.6	-1.8	-2.2	-1.6	-0.8	**-2.6**	-0.2	**-2.4**	-1.5	**-0.4**	-0.3
Compensation per employee	5.4	6.2	7.2	1.8	3.9	1.6	-1.0	**-0.7**	-0.2	**-0.3**	-0.9	**0.3**	-0.3
Productivity	4.2	3.5	0.8	-6.2	3.5	2.4	-1.7	**0.0**	-0.5	**1.8**	0.4	**1.7**	0.2
ULC (nominal)	1.1	2.6	6.4	8.6	0.4	-0.7	0.8	**-0.7**	0.3	**-2.0**	-1.2	**-1.4**	-0.6
Contribution to GDP growth	*percentage points*												
Domestic demand, excl. chg. in inventories	5.0	7.0	4.1	-6.4	-2.4	-0.9	-4.5	**-3.2**	-0.2	**-2.7**	-1.4	**-0.6**	-0.9
Net exports	0.2	-2.0	0.1	2.6	1.8	1.0	3.8	**1.8**	0.3	**2.0**	0.9	**2.0**	1.0
Changes in inventories	0.7	2.0	-0.9	-4.1	1.9	0.6	-1.8	**-1.3**	-0.8	**0.0**	-0.8	**0.0**	0.0
Domestic demand	*real growth rates, %*												
Domestic demand	5.6	9.0	3.2	-10.3	-0.5	-0.3	-6.4	**-4.8**	-1.1	**-3.0**	-2.4	**-0.7**	-1.1
Private consumption	2.8	6.2	2.4	-0.2	1.5	0.8	-4.8	**-3.8**	-0.7	**-3.3**	-2.1	**-0.6**	-0.8
Government spending	4.0	0.6	5.9	2.5	1.3	-1.6	-1.3	**-2.5**	-0.2	**-1.8**	-1.3	**-2.0**	-1.6
Gross fixed capital formation	10.4	13.3	7.1	-23.8	-15.3	-5.5	-8.2	**-3.3**	1.6	**-2.7**	0.3	**0.8**	-0.8
Balance of payments	*growth rates, % (if not specified otherwise)*												
Exports of merchandise and services	12.5	13.7	4.0	-16.1	10.2	7.0	0.6	**1.3**	0.9	**2.1**	-0.5	**3.4**	-1.1
Imports of merchandise and services	12.2	16.7	3.7	-19.2	7.4	5.6	-4.7	**-1.1**	0.6	**-0.6**	-2.1	**1.1**	-2.7
Current account: EUR billion	-0.5	-1.4	-2.0	-0.2	0.0	0.1	1.2	**2.1**	0.7	**2.4**	0.9	**2.7**	1.1
as % GDP	-1.8	-4.2	-5.4	-0.5	-0.1	0.4	3.3	**6.1**	2.1	**6.8**	2.5	**7.7**	3.1
Terms of trade*	-0.5	0.9	-1.5	3.7	-3.9	-1.4	-1.0	**0.3**	0.9	**-1.1**	-0.1	**-1.1**	-0.1
Prices	*average annual growth rates, %*												
Consumer prices (HICP)	2.5	3.8	5.5	0.9	2.1	2.1	2.8	**2.2**	-0.1	**1.7**	0.3	**1.5**	-0.1
HICP excluding energy	1.7	3.8	4.9	1.7	0.3	1.0	1.8	**2.2**	0.2	**1.8**	0.3	**1.6**	-0.1
HICP energy	8.5	3.4	9.4	-4.5	13.9	8.8	9.0	**2.6**	-1.7	**0.9**	0.0	**0.6**	-0.2
International environment	*growth rates, % (if not specified otherwise)*							**Assumptions**					
Foreign demand**	11.3	10.0	3.8	-14.3	11.8	8.0	1.9	**1.3**	-0.3	**2.5**	-0.7	**3.8**	-0.7
Oil (USD per barrel)	65	73	98	62	80	111	112	**110**	-5.0	**110**	-5.0	**110**	-5.0
Non-oil commodities	29.1	17.4	10.1	-23.0	37.1	17.9	-7.2	**-5.4**	-6.6	**-0.6**	-2.6	**2.0**	-3.0
EMU inflation	2.2	2.1	3.3	0.3	1.6	2.7	2.5	**1.5**	-0.3	**1.3**	-0.5	**1.4**	-0.6
PPI Germany	5.4	1.3	5.4	-4.0	1.5	5.6	2.1	**0.7**	-1.0	**1.6**	-0.8	**1.6**	-0.6

Notes: * 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, April 2013.

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

1 International Environment

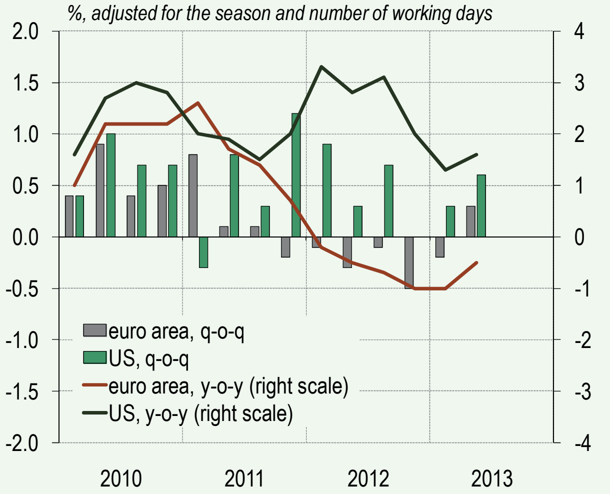
Euro area GDP rose in the second quarter of this year for the first time in a year and a half, while confidence in the economy also improved, which was a factor in the rise in the euro against other major currencies. The economic recovery will nevertheless be very gradual, as the labour market still contains major imbalances, and numerous euro area countries are facing fiscal difficulties and limited access to financial markets. Furthermore, the outlook in emerging economies is cooling. Monetary policy remains stimulative. The decline in commodity prices continued in the early part of the third quarter, but oil prices rose until September, primarily as a result of political tensions in Syria and Egypt.

Economic developments

According to the IMF's July forecasts, this year's global economic growth is expected to be the same as last year, although the risks are still on the downside. According to the IMF's July forecast, global economic growth is expected to stand at 3.1% this year, the same as last year. The lowering of this year's forecast is the result of lower growth in international trade and weak domestic demand, particularly in developed countries. Economic activity in the US strengthened in the second quarter of this year as a result of increases in exports, investment and household consumption. GDP growth in the BRIC countries remains high compared with developed countries, but is slowing. It ranged from 1.2% in Russia to 7.5% in China in the second quarter of this year.

Figure 1.1: GDP growth in the euro area and the US

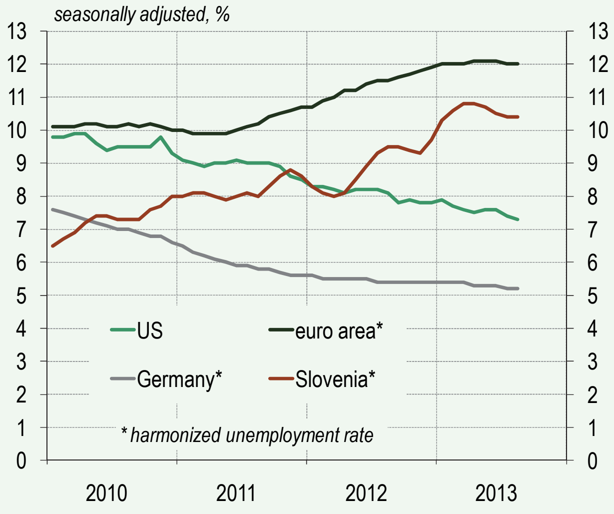
%, adjusted for the season and number of working days



Source: Eurostat.

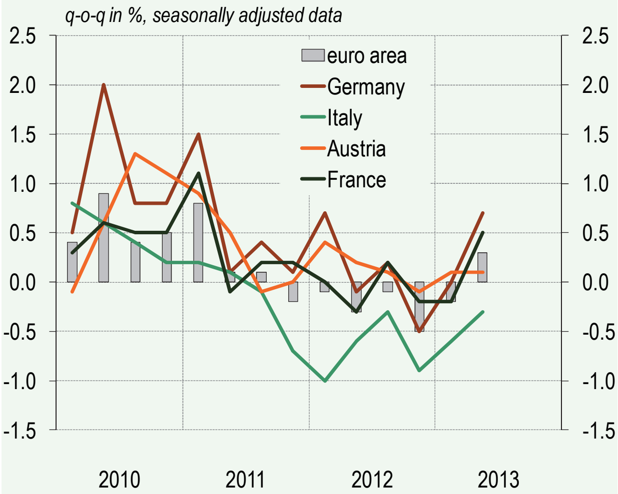
Quarterly growth in GDP in the euro area in the second quarter of this year was positive for the first time in one and a half years, and the economic sentiment improved significantly. Economic activity in the second quarter was up 0.3% in quarterly terms, as all the main components of GDP recorded growth. Investment in equipment and machinery, final household consumption and imports all remained down in year-on-year terms but government consumption was up. The positive quarterly growth was largely the result of relatively high growth in Germany and France, while the contraction in activity in

Figure 1.2: International comparison of unemployment rates



Sources: Eurostat, FRED.

Figure 1.3: GDP growth in the euro area and in Slovenia's main trading partners

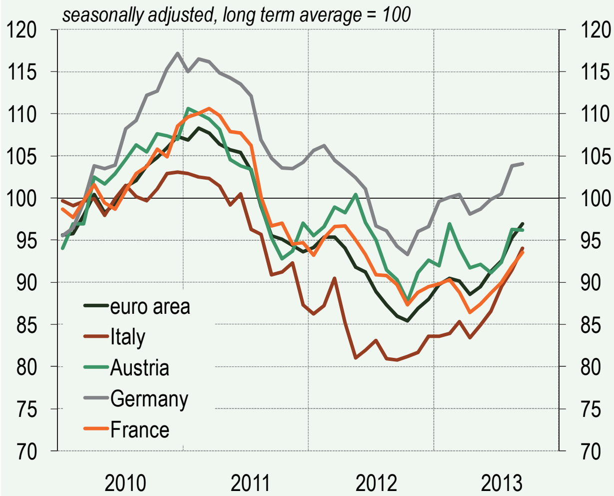


Source: Eurostat.

Italy and Spain also slowed. The unemployment rate in the euro area remains at record levels at around 12%, but has not changed significantly since the beginning of the year. The economic sentiment and the PMIs have been gradually improving since the end of the first quarter. Despite the growth, the economic sentiment indicators remain below the long-term average, while the PMIs suggest weak but positive growth in the third quarter.

Economic activity in Slovenia's most important trading partners increased in the second quarter. GDP grew by 0.7% in the second quarter in Germany, by 0.2% in Austria and by 0.5% in France. In Italy GDP contracted by 0.2%, less than in the previous quarter. Growth in the second quarter was more favourable in major partners outside the euro area, with the exception of Croatia, where GDP in the second quarter was down in year-on-year terms (see Box 1.1), and in Russia, where forecasts for this year's economic growth were lowered significantly as a result.

Figure 1.4: Economic sentiment indicators for the euro area and Slovenia's main trading partners



Source: Eurostat.

Financial markets and commodity prices

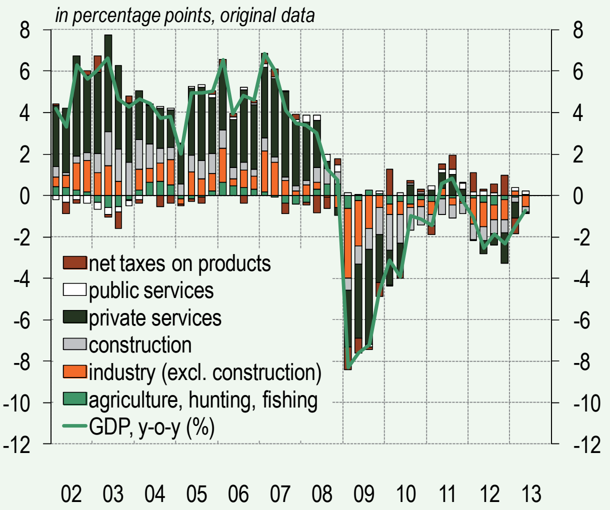
The ECB and the Bank of England have communicated their intentions with regard to future monetary policy guidelines (i.e.'forward guidance'), while the Federal Reserve and the Bank of Japan are continuing with non-standard measures. In May the ECB cut its key interest rate to 0.5%, while the interest rate on the deposit facility remained at zero and the interest rate on the marginal lending facility was cut to 1.00%. In July it announced 'forward guidance', followed by the Bank of England.[1] Its key interest rate has been unchanged at 0.5% since March 2009. In September the Bank of Japan announced its intention to further expand the amount of

[1] http://www.ecb.europa.eu/press/pressconf/2013/html/is130704.en.html for the ECB and http://www.bankofengland.co.uk/monetarypolicy/Pages/forwardguidance.aspx for the BOE.

Box 1.1: Macroeconomic situation in Croatia on its accession to the EU

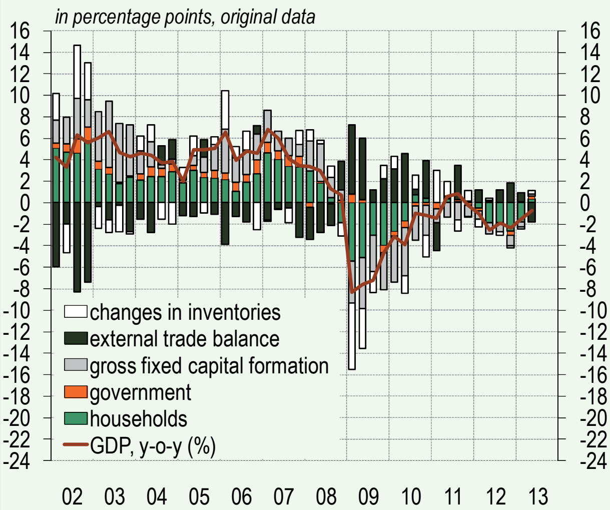
Croatia presented an adverse economic picture at its accession to the EU, and the anticipated recovery is weak. GDP has fallen by just over a tenth since the outbreak of the crisis in 2008, and by 2% last year alone. Value-added is declining in almost all of the private sector, but in contrast to the EU overall there was no recovery in industry in 2010 and 2011. Industry accounts for more than 20% of total value-added in Croatia, and the reduction in trade barriers when joining the EU means that the domestic market will face increased competition. Growth in value-added in public services is low, and the proportion of total value-added that they account for is 17%, less than the EU average. The crisis has also been marked by a contraction in all aggregates of domestic demand. The decline in investment is slowing, but the contraction in private consumption has increased in the last year. Major factors were one of the highest unemployment rates in the EU and a sharp decline in purchasing power.[1] The contribution made to GDP growth by final government consumption remains negative, while the public debt has risen by approximately 25 percentage points since the outbreak of the crisis

Figure 1: Contributions to y-o-y GDP growth, production side



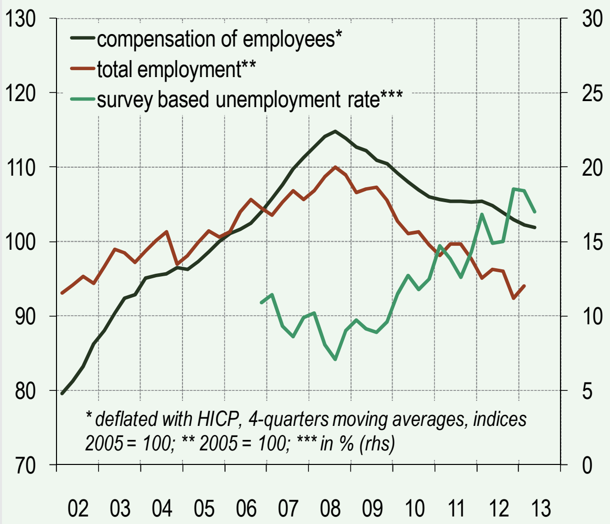
Sources: ECB, Bank of Slovenia calculations of net taxes on products.

Figure 2: Contributions to y-o-y GDP growth, expenditure side



Source: ECB.

Figure 3: Labour market indicators

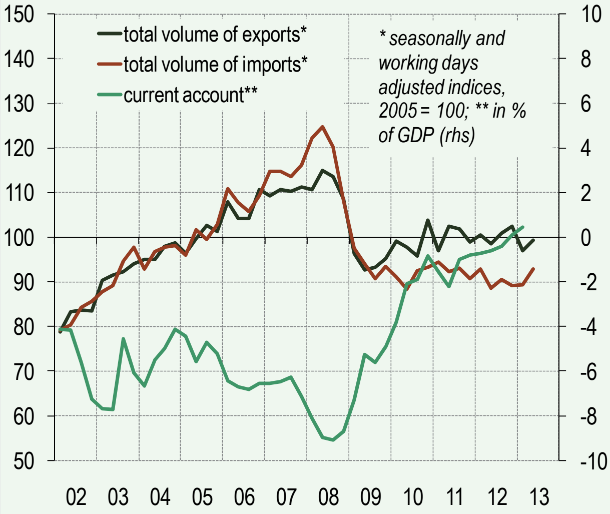


Sources: Eurostat, Bank of Slovenia calculations.

Figure 4: Real unit labor costs, whole economy

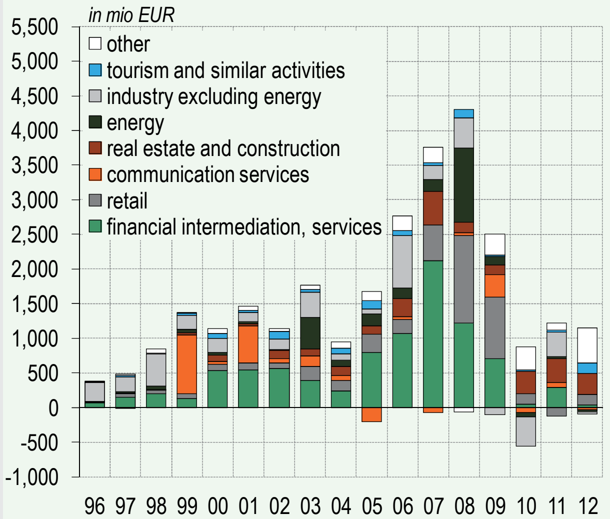
Sources: Eurostat, Bank of Slovenia calculations.

Figure 5: Indicators of international trade



Sources: Eurostat, Bank of Slovenia calculations.

Figure 6: Foreign direct investments in Croatia



Sources: National Bank of Croatia, Bank of Slovenia calculations.

to 53.7% of GDP. In recent years net trade has been the sole positive contribution to GDP growth, but largely because of the sharp decline in imports, which has swung the previous large current account deficits into a surplus. The decline in economic activity has slowed this year, as private consumption has stabilised. Consensus is forecasting a decline of 0.7% in GDP, and positive growth in 2014, albeit of less than 1%. It is expected to be based on a gradual increase in investment, industrial production and private consumption.

The weak export growth reflects the competitiveness problems of the Croatian economy. After low growth in 2011, total real exports were unchanged overall last year, and developments in the first half of 2013 were also unfavourable. The level remains down more than a tenth on the pre-crisis level. The recovery in exports of services, which account for almost 50% of total exports, was weak, partly as a result of the relatively slow growth in exports of travel services, which account for 35% of total exports. The movement in real unit labour costs relative to the EU average has been favourable for Croatia in the last few years. The competitiveness problems derive in part from rigidities in the labour market, the inefficiency of the public sector and the poor business environment. Improvements in these areas are the objective of structural reforms, which should be accelerated by EU accession.[2] The EU accounts for almost 60% of Croatia's merchandise exports. Slovenia accounts for 9%, while the highest figure in the region is that of Bosnia and Herzegovina, at more than 12%. Because Croatia's accession to the EU means that it has adopted the acquis communautaire in the area of trade, it can no longer be a member of separate trade or regional agreements, such as CEFTA (Bosnia and Herzegovina, Serbia, Macedonia, Albania, Moldova, Montenegro, Kosovo). The CEFTA countries account for just under a fifth of Croatia's total exports.

In addition to structural reforms, the disbursement of European funds could also contribute to Croatia's economic recovery. Joining the EU is also expected to have a positive impact on foreign investment. After joining the EU, Croatia is expected to receive revenues from the EU budget in the amount of EUR 655 million for 2013 (i.e. the second half of the year). The majority of this money will come from the Structural Funds and Cohesion Fund (around EUR 450 million). The impact of EU funds on economic growth will only be discernible if disbursement is efficient, which is questionable given the inefficiency of public administration, to which the European Commission has drawn attention. As a result of the adoption of European legislation, EU accession may also increase the inflow of foreign investment, which has declined significantly since the outbreak of the crisis.[3] EU Member States have traditionally been the largest investors in Croatia, most notably Austria, the Netherlands, Germany and Hungary. Their investment between 1996 and 2012 amounted to just under EUR 17 billion. Total investment amounted to EUR 26.6 billion, of which 75% was invested in the service sector, primarily in financial and insurance activities, wholesale and retail trade, telecommunications and real estate activities. The investment rate in industry excluding the energy sector was only around 12%, or just EUR 190 million per year, which did not significantly increase the export capacity of the economy.

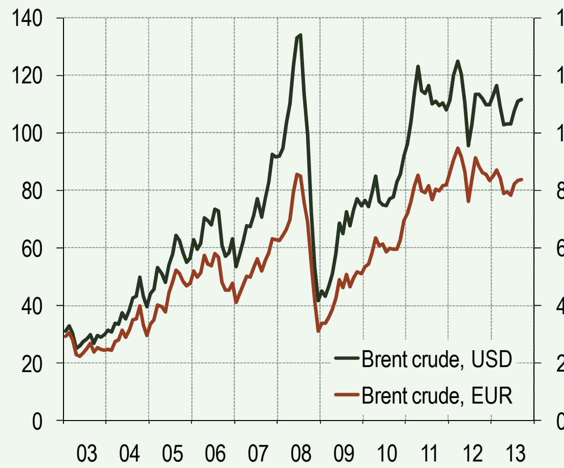
[1] Purchasing power as estimated by employee compensation deflated by the HICP has declined by more than 12% since the outbreak of the crisis. Croatia's GDP per capita at purchasing power parity in 2012 was 61% of the EU28 average, comparable to that of Latvia.
[2, 3] For more, see:
http://ec.europa.eu/economy_finance/eu/forecasts/2013_spring/cc_croatia_en.pdf and
http://ec.europa.eu/europe2020/pdf/nd/swd2013_croatia_en.pdf.

base money. The Federal Reserve decided to maintain its expansionary monetary policy, the key interest rate having remained at the interval from zero to 0.25% since December 2008.

The euro has mostly risen since March as a result of improved economic data for the second quarter and the mood on the financial markets. The euro / US dollar exchange rate was also affected by the Fed's rhetoric and changes to ECB monetary policy. The euro averaged USD 1.3348 in September, up 3.8% on September 2012. The euro also rose against other currencies in year-on-year terms: by 2.1% against the Swiss franc, by 5.4% against the pound sterling and by 31.8% against the Japanese yen.

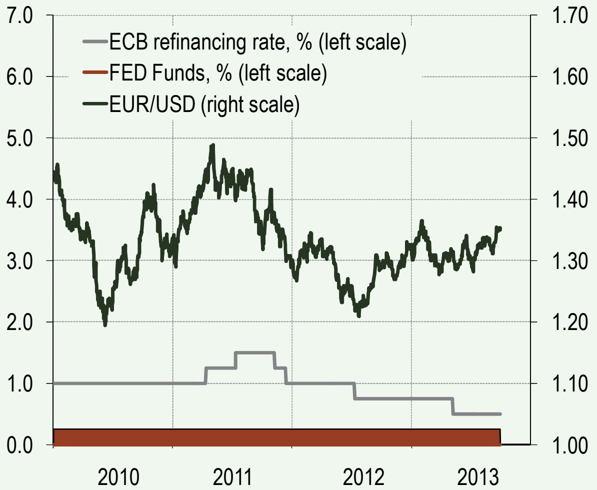
The US dollar price of Brent crude gradually rose in monthly terms from March as a result of the political unrest in Syria and Egypt. It fell sharply in April alone, in line with the movement in prices of other commodities, but has risen since June as a result of geopolitical factors and slightly better economic data for the euro area and

Figure 1.6: Oil prices per barrel



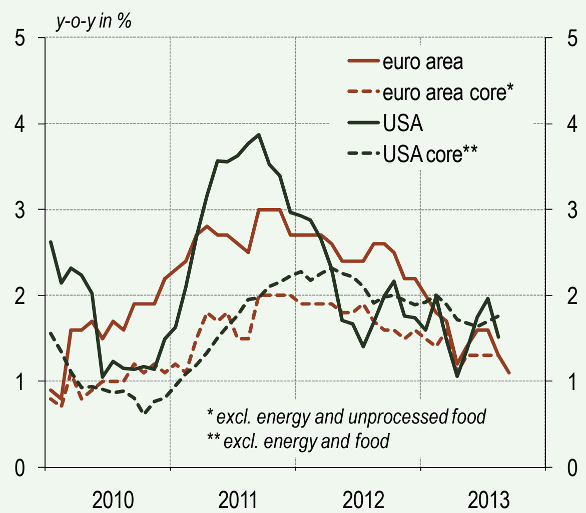
Sources: Bloomberg, ECB, Bank of Slovenia calculations.

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



Sources: ECB, Federal Reserve.

Figure 1.7: Inflation in the euro area and the US



Sources: Eurostat, U.S. Department of Labor.

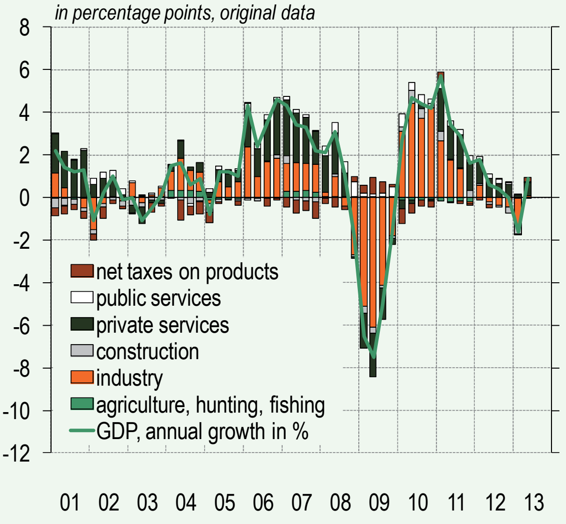
Box 1.2: Differences in the economic performance of Germany and Slovenia, 2001-2013

Following the collapse of the construction sector and the contraction in private sector services in Slovenia, the breakdowns of value-added in Germany and Slovenia are very similar. In both the proportion accounted for by industry is traditionally among the highest in the EU, and the differences between the proportions of total value-added accounted for by public services and private sector services are small.

Both economies saw large fluctuations in GDP growth between 2001 and 2013. Economic growth in Germany was weak up to 2005 inclusive. The construction sector contracted, while growth in industry and services was low. Real wages fell at the same time, unemployment was high, and there was a large general government deficit. In Germany this was a period of reforms (e.g. the Hartz labour market reforms within the Agenda 2010 framework), which occurred amid a relatively favourable international environment. Export growth and curbs on domestic consumption widened the current account surplus. In Slovenia economic growth was solid until 2005, and was based on even growth in industry and services. Between 2004 and 2007 both economies took advantage of the international climate and strengthened exports, while in Slovenia from 2006 there was a sharp increase in growth in private sector services and construction on the basis of rapid growth in external borrowing and wages. Average annual growth in investment in Slovenia exceeded 10%.

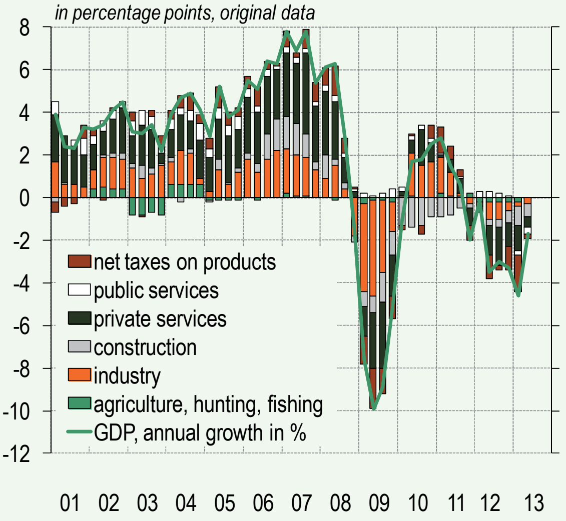
The impacts of the foreign demand shock at the end of 2008 were initially comparable. Exports and industrial activity fell sharply, the latter by even more in Germany than in Slovenia in 2009. GDP nevertheless declined by almost 3 percentage points more in Slovenia than in Germany in 2009. The difference was the result of the bursting of construction bubble, with adverse consequences for parts of trade and industry, and a sharper decline in private sector services as the labour market responded more intensively. Public spending in both countries was strengthened at the outbreak of the crisis, but

Figure 1: Contributions to the GDP annual growth - Germany



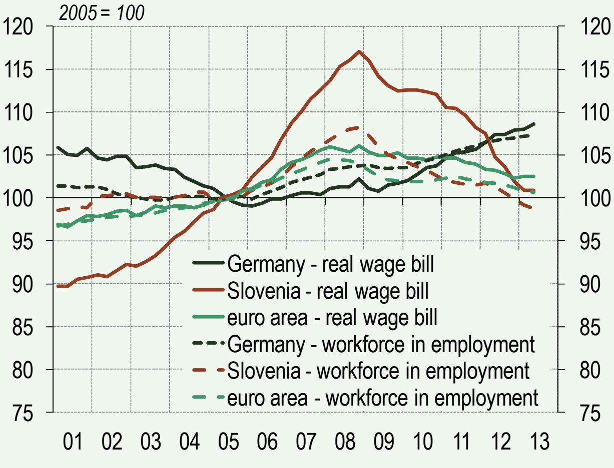
Sources: ECB, Bank of Slovenia calculations.

Figure 2: Contributions to GDP annual growth - Slovenia



Source: SORS.

Figure 3: Worforce in employment* and real wage bill**



*Notes: *Seasonally and working-day adjusted data. **Seasonally and working-day adjusted real indices (HICP deflator).*
Sources: Eurostat, ECB, Bank of Slovenia calculations.

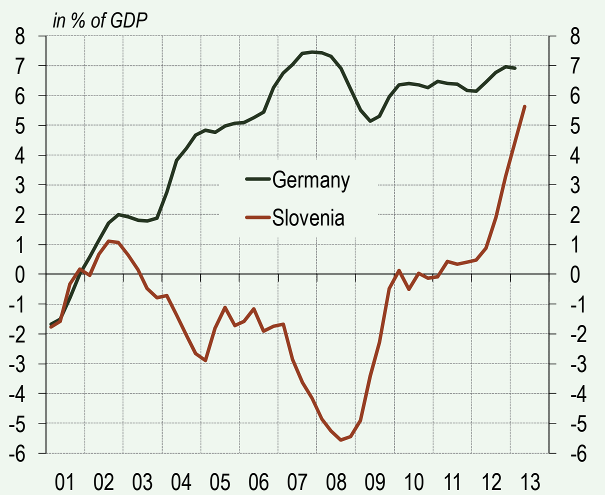
the increase in the deficit was more pronounced in Slovenia as a result of the larger decline in revenues, and also as a result of the previous pro-cyclical tax policy and wage reforms in the public sector just before the outbreak of the crisis.

The German economy recovered rapidly after the initial shock. Year-on-year GDP growth had returned to around 2.5% by the first quarter of 2010, the bulk of growth until the end of 2011 coming from industry as exports were rapidly redirected to markets outside the EU.[1] Services also recovered quickly. Export growth later slowed as the euro area crisis deepened, and reached zero in year-on-year terms in the first half of 2013. Value-added in industry began to decline in the second quarter of 2012, an indication that growth in domestic demand was not geared towards industrial products. By 2012 only services were driving economic growth, while net trade offset the decline in investment. GDP declined temporarily in year-on-year terms in the first quarter of 2013, before growth returned in the second quarter, primarily as a result of increased household consumption and the resulting higher growth in the service sector. Employment rose consistently, as did the real wage bill, although it was not until 2011 that it reached its level of 2001. Unit labour costs increased. At the same time the government closed the fiscal gap via rapid growth in revenues and a neutral expenditure policy.

The pattern in Slovenia was almost the reverse, as the consequences of the overheating economy in the pre-crisis period became more and more evident. In 2010 and the first half of 2011 the economic recovery had approximately the pace of the euro area average. Export-oriented growth in industry offset the decline in construction, while the recovery in private sector services was also solid. This was at least partly the result of an expansionary fiscal policy, but there was also a rapid increase in debt and a deterioration in the financing conditions. The first serious fiscal consolidation measures followed in late 2011 and in the second quarter of 2012, which significantly reduced purchasing power and confidence. Services were hit particularly hard. There was a decline in imports and the current account surplus began to widen. The recession deepened further, driven in part by the slowdown in foreign demand and thus in industry. The fall in employment accelerated, as did the fall in real wages. The cost-efficiency of the economy improved, but with adverse consequences for sectors focusing on the domestic market. The decline in GDP slowed in the first half of this year, but mostly as a result of one-off factors in domestic demand. The fiscal squeeze is taking place in a less-favourable economic situation in the international environment, at least for the moment, which means that it is difficult to compensate for weak domestic consumption by means of increased exports.

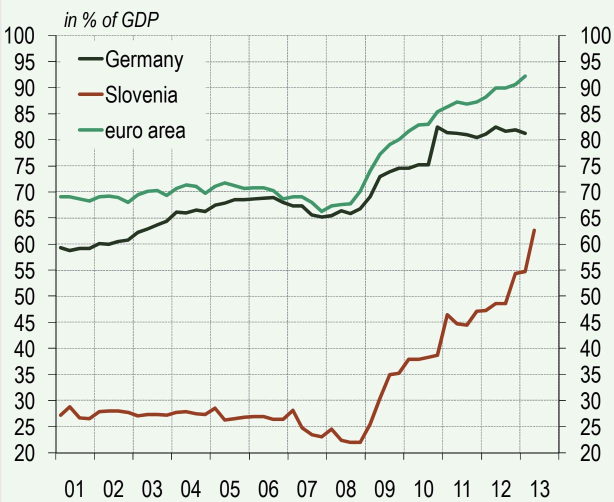
[1] In the context of weak demand from the EU, German exports were intensively redirected elsewhere. The proportion of German exports accounted for by markets outside the EU stood at 35% in 2007, and 44% in the first half of 2013. In Slovenia this figure increased by just 2 percentage points to 33%.

Figure 4: Current account balance



Sources: Eurostat, SORS, Bank of Slovenia.

Figure 5: General government debt



Sources: SORS, Eurostat, ESA95.

the US. A barrel of Brent crude averaged USD 111.60 in September, down 1.6% in year-on-year terms. The euro price of Brent crude was down 5.2% in year-on-year terms as a result of the appreciation of the euro. There has been a different trend in US dollar prices of other commodities, the price of which has gradually fallen continuously since March. Prices were down 6.9% in August, most notably food prices, which were down 15.1% in year-on-year terms as a result of this year's good cereal harvest and last year's basis.

The spreads on government bond yields of most euro area periphery countries have fallen slightly since the last projections, but remain high. The main factors affecting the spreads from March were the agreements on assistance for Cyprus and the political uncertainty in Italy and Portugal, which limited the fall in the required yields in these countries. Ireland's spreads are already lower than those of Italy and Spain as a result of the improvement in the state of its public finances and assessment of the ongoing successful restructuring of the banking sector.

2 Economic Trends and the Labour Market

The decline in economic activity slowed in the first half of this year, primarily as a result of certain one-off effects. Investment and final domestic consumption increased as a result of the purchase of machinery and equipment, and as a result of increased demand before the rise in VAT. The rundown in inventories was therefore weaker, while the high import component in segments of increased domestic consumption reduced the net trade contribution to economic growth. The current rate of growth in value-added in private sector services improved compared with last year, while the contraction in construction also slowed sharply in the second quarter. Government consumption continued to decline, which resulted in lower activity in public services. Output in the manufacturing sector also continued to decline, despite an improvement in cost competitiveness and a slightly better economic situation across the EU. The available monthly indicators suggest weaker domestic final consumption in the third quarter, whereas confidence in the economy remained stable also in September.

The situation on the labour market eased in the first half of the year. Employment recorded a seasonal increase, and unemployment fell despite greater inflows of first-time job-seekers. The fall in employment in the private sector slowed notably, although the year-on-year fall in employment remains largest in this sector. The largest flows from unemployment into employment and vice-versa still comprise chains of temporary forms of employment. The nominal wage bill is falling in the private sector as a result of lay-offs, and in the public sector as a result of reductions in nominal wages.

GDP[2]

The slowdown in the current decline in GDP in the first half of this year was the result of more favourable developments in value-added in sectors primarily dependent on domestic demand. The quarterly decline in GDP stood at 1% in the final quarter of last year, but had slowed to 0.3% by the second quarter of this

[2] The regular revision was carried out when the national accounts were published in September, in which there were significant changes in the quarterly figures and even larger changes in the annual figures. As a result of the change in the quarterly rates, the pass-through of the negative dynamic in GDP from 2012 into 2013 is now estimated to have been slightly smaller. The changes in the annual figures were more significant for 2012 in particular. GDP declined by 2.5% last year, and not 2.3% as previously announced. Among the main components of aggregate demand, there were notable changes in final household consumption (which declined by 4.8% compared with the previous figure of 2.9%), while the decline in gross fixed capital formation was revised downwards from 9.3% to 8.2%. At the same time there were significant revisions in the estimates of growth in value-added in the majority of sectors. The largest revisions were for construction (-6.8%, previously -11.6%), information and communication (-0.4%, previously -2.7%) and manufacturing (-2.9%, previously -0.9%). For 2011, the largest revision in any items of aggregate demand was gross fixed capital formation (-5.5%, previously -8.1%), while the largest revision in value-added was in the financial and insurance activities sector (-4.7%, previously -2.8%).

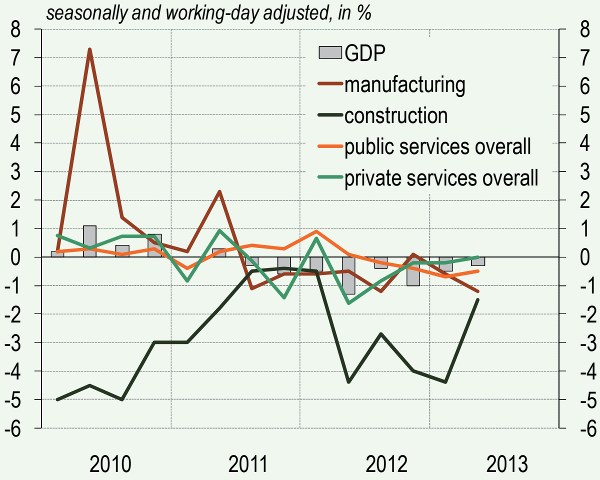
year. During this period the decline in value-added in private sector services came to an end, primarily as a result of stabilisation in wholesale and retail trade, transportation and storage, and accommodation and food service activities, and increased growth in the information and communication sector. A slowdown in adverse developments was also seen in the majority of other services. While private sector services generate around 20% of turnover on foreign markets, they are becoming increasingly dependent on foreign demand. Exports of services declined in current terms in the second quarter, which diluted the impact of the improvement in domestic demand during this period. At the same time, the quarterly decline in value-added in the construction sector slowed to 1.5% in the second quarter, the lowest level in the last year, and turnover generated by the sector abroad has been increasing rapidly. In contrast to the developments in the majority of service sectors, the contraction in activity in the manufacturing sector accelerated, and quarterly declines have been recorded almost uninterrupted for two years now.

The year-on-year decline in GDP also slowed in the second quarter. GDP in the first quarter was down 4.6% in year-on-year terms, but the decline slowed to 1.7% in the second quarter as a result of a base effect. The information and communication sector is notable for its year-on-year growth in value-added increasing to more than 3% in connection with growth in a major firm's earnings. The decline in value-added slowed in other segments of the private sector. The exception was industry, as a result of adverse developments in the energy sector. At the same time the decline in value-added in public services increased to 2%.

The gap by which economic growth trails the euro area average narrowed. With the exception of a few quarters, year-on-year growth in value-added in Slovenia has been weaker than in the euro area overall in industry and in private sector services since the outbreak of the crisis. Although industry is primarily export-oriented, it still generates around 30% of its turnover on the domestic

Figure 2.1: GDP quarterly growth rates in Slovenia

seasonally and working-day adjusted, in %



Sources: SORS, Bank of Slovenia estimates of private services' value added growth rates.

Figure 2.2: Differences in y-o-y growth rates of GDP and its components between Slovenia and the EA - production side*

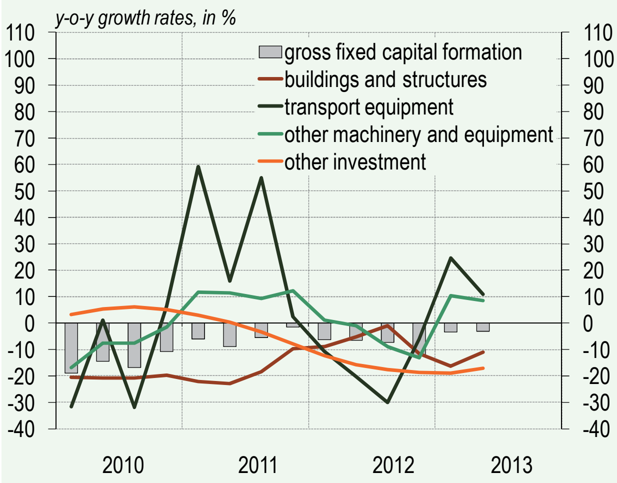
Sources: Eurostat, Bank of Slovenia calculations.

market. Given the persistence of weak domestic consumption, the recovery in the immediate international environment has thus far not been reflected in total activity in industry this year. Another factor has been the cooling of certain markets outside the EU where exporters redirected sales in previous years because of the recession in the euro area. The narrowing gap in private sector services in the second quarter was likely to be merely temporary in nature, as a result of increased household consumption before the rise in VAT. Developments in public services have deteriorated significantly this year relative to the euro area overall as a result of the impact of fiscal consolidation.

Aggregate demand

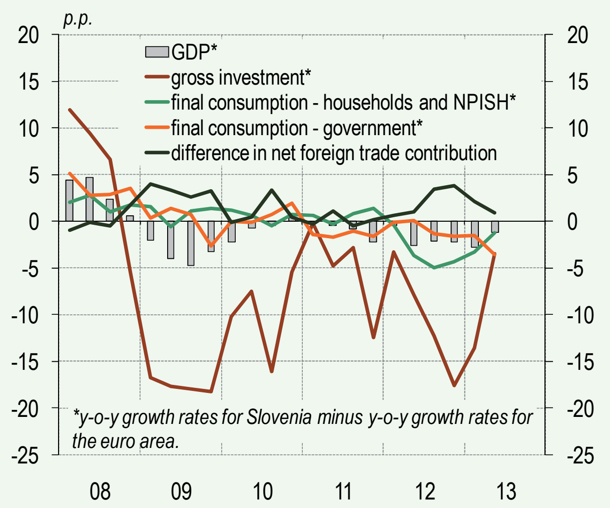
The slowdown in the decline in domestic consumption in the first half of this year was probably merely temporary. The year-on-year decline in the total domestic consumption exceeded 8% in the second half of last year, but slowed to 3.4% in the second quarter of this year. The contraction in gross fixed capital formation slowed, primarily as a result of increased investment in machinery and equipment, which varied greatly. The contraction in household consumption also slowed, but probably merely temporarily as a result of increased purchases of durables before the rise in VAT. As the difficulties with financing in the private sector have continued, and in light of another decline in consumer purchasing power in the first half of this year given the movement in the real wage bill, the slowdown in the contraction in do-

Figure 2.3: Gross fixed capital formation



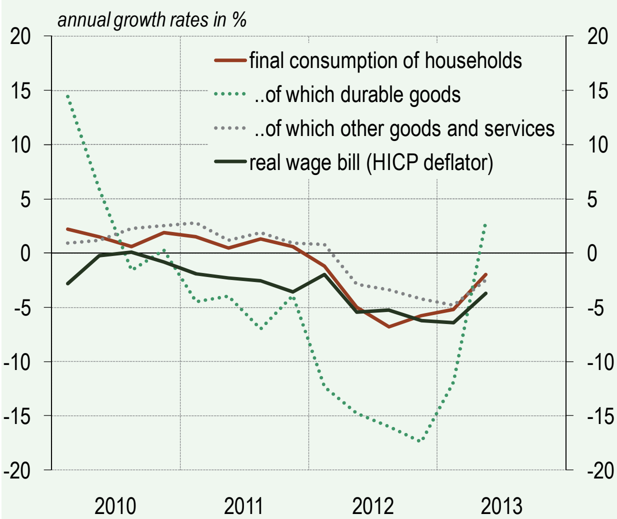
Source: SORS.

Figure 2.5: Differences in y-o-y growth rates of GDP and its components between Slovenia and the EA - expenditure side*



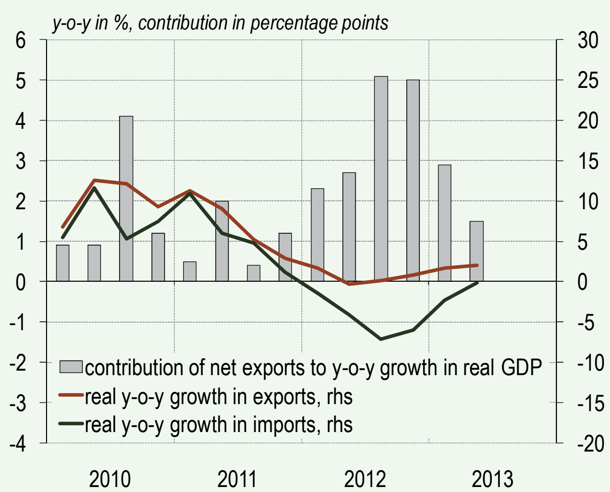
Sources: Eurostat, ECB, Bank of Slovenia calculations.

Figure 2.4: Final consumption of households and wage bill



Sources: SORS, Bank of Slovenia calculations.

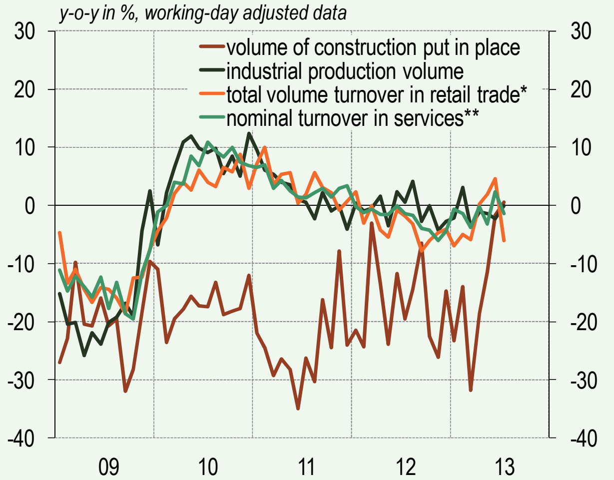
Figure 2.6: Foreign trade



Source: SORS - national accounts.

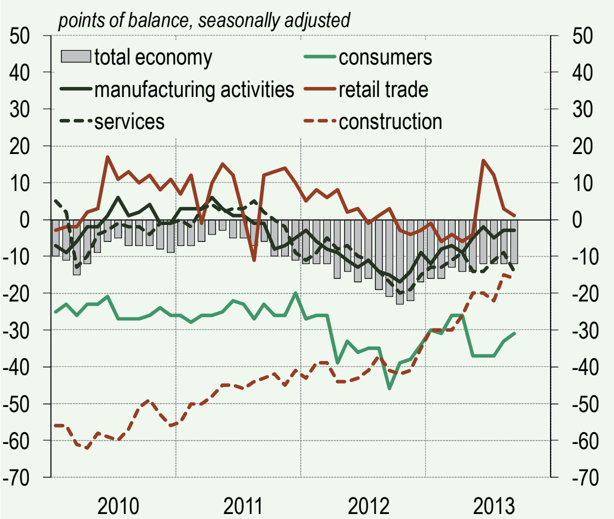
mestic consumption was probably merely temporary. Growth in domestic consumption aggregates remains behind the euro area average, the gap in government consumption having widened this year as a result of the implementation of tougher austerity measures. As a result of growth in certain segments of domestic demand, the rundown in inventories slowed, their contribution to the year-on-year fall in GDP diminishing to less than 1 percentage point in the second quarter.

Figure 2.7: Monthly economic activity indicators



*Notes: * Retail trade, and trade and repair of motor vehicles. ** Private sector services excluding trade and financial services.*
Sources: SORS, Bank of Slovenia calculations.

Figure 2.8: Confidence indicators



Source: SORS.

The contribution to the change in GDP made by net trade declined in the first half of the year. The contribution to the change in GDP made by net trade in the second half of last year increased to 5 percentage points as a result of the decline in domestic demand and the resulting decline in imports. The contraction in imports slowed in the first quarter of this year, while in the second quarter total imports were unchanged in year-on-year terms, as imports of services declined and merchandise imports increased. Imports of various types of capital goods increased in the first half of the year, motorised machinery and equipment recording the most notable growth. Imports of other transport equipment increased sharply in the final quarter of last year and the first quarter of this year, while imports of road vehicles were significant in the second quarter. At the same time year-on-year growth in exports increased to 2%, but only as a result of a base effect, total exports having declined in quarterly terms as a result of a decline in exports of services while merchandise exports were unchanged. Merchandise exports to markets outside the EU declined in current terms, but exports to EU Member States increased in the second quarter as the economic situation improved slightly.

Economic developments in the third quarter

The available monthly activity and confidence indicators do not suggest a sharper deterioration in the economic situation in the third quarter. Industrial production remained stable as merchandise exports increased in July, while turnover in private sector services other than wholesale and retail trade declined significantly. After declining sharply, most notably in consumer durables, in July following the rise in VAT, turnover in wholesale and retail trade increased in current terms in August. Signs of recovery were again seen in construction in July, when the total amount of construction put in place was up in year-on-year terms for the first time since the outbreak of the crisis, partly as a result of increased activity in civil engineering. Confidence in the economy

Box 2.1: Analysis of the productivity and indebtedness of Slovenian firms on the basis of micro data

Corporate productivity and indebtedness are subject to numerous microeconomic analyses. Despite the differences in data availability, the studies suggest some common findings. First, there are distinct differences in productivity between firms and between sectors, which are statistically reflected in the wide distribution of the relevant financial indicators. Second, the distribution of productivity indicators changes asymmetrically over time, with the smallest changes seen at firms with higher productivity.[1] Third, productivity is positively correlated with corporate size, particularly in more advanced economies, while there are pronounced differences between firms of different size even within a particular sector.[2] Fourth, there are also considerable differences in indebtedness between firms in related sector, and indebtedness is usually lower at smaller firms.[3] Fifth, corporate borrowing between 2005 and 2007 in the euro area was faster than the average of the last 20 years, but indebtedness has declined since 2008.

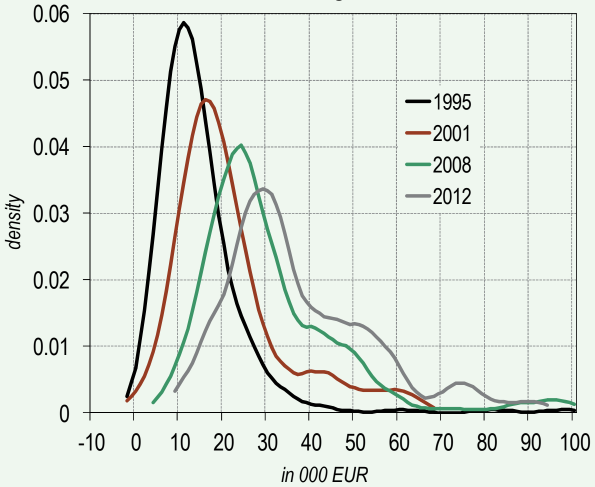
The aforementioned findings of microeconomic studies draw attention to at least two statistical facts that need to be taken into account when developments in indicators at the level of firms and at the level of economies are being interpreted: first, the significant variations between firms mean that the idea of a representative firm is misleading, and second, the asymmetric distributions of the indicators reduce the informational value of averages, thus creating bias in aggregate estimates.

Analysis of Slovenian corporate performance[4] indicates that the developments in productivity and indebtedness are in line with the key findings of these studies. Productivity and debt are very widely distributed across firms in Slovenia, which is true also within sectors and within corporate size categories. Throughout the analysis period labour productivity[5] grew fastest at large enterprises in the manufacturing sector, at an average of 5.8% per year as measured by median value-added per employee.

A key factor in the rapid growth in average productivity at large manufacturing firms before the crisis was the collapse of firms with low productivity. From the point of view of productivity the economic crisis did not have a significant impact on this sector: between 2008 and 2012 growth in median value-added per employee was only slightly lower than the average over the entire period. Large retail firms were hit much harder by the crisis. The productivity of these firms grew by an average of 2.5% per year until 2007, and then subsequently declined by approximately the same amount.

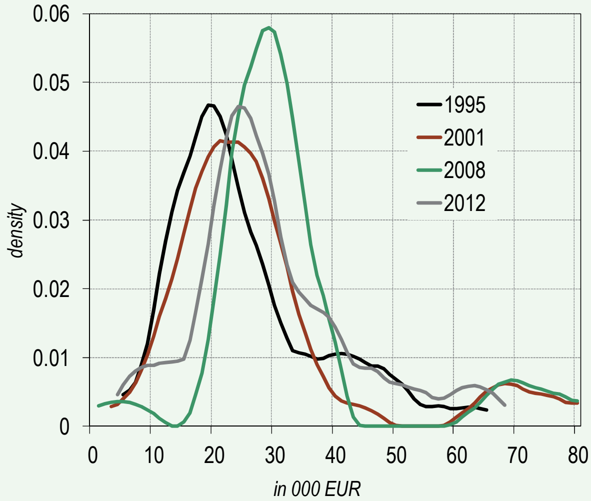
The long transition period meant that the functioning of economies of scale in the part of the economy under analysis was only uniformly reflected after 2009, when large enterprises recorded the highest productivity among all the corporate size categories in all sectors for the first time. Large enterprises have ever since recorded the highest value-added

Figure 1: Distribution of value added per person in large manufacturing firms



Sources: Agency of the RS for Public Legal Record and Related Services (AJPES), Bank of Slovenia calculations.

Figure 2: Distribution of value added per person in large firms from wholesale and retail trade



Sources: Agency of the RS for Public Legal Records and Related Services (AJPES), Bank of Slovenia calculations.

per employee and the lowest unit labour costs (ULCs). Over the entire period of the analysis ULCs at large enterprises declined on average by a fifth, most notably in the sectors of construction and manufacturing. The decline was smaller in the other corporate size categories, with the exception of micro enterprises. Micro enterprises' ULCs increased by more than a quarter over the entire period: the fastest growth was prior to 2009, when these firms recorded the lowest growth in value-added per employee.

The distribution of the debt-to-equity ratio also reveals significant differences between firms. Corporate indebtedness measured by this indicator increased fastest between 2001 and 2007 in line with developments in the euro area, particularly at medium-sized enterprises, where the median indicator increased by 78.6%. At the same time the indebtedness of micro enterprises increased by less than a tenth, and fell over the entire period of the analysis, in contrast to the other corporate size categories. After 2008 indebtedness fell in all the corporate size categories as measured by the median, by just under a third at SMEs and by just 4% at large enterprises. At the latter the arithmetic mean of indebtedness fell by 16% over the same period, an indication of the substantial differences in developments in various measures of average. The gaps between the median and the mean were most pronounced at large construction firms, a key factor in which was the collapse of highly indebted firms.

[1] Bartelsman, E. J., Doms, M.: Understanding Productivity: Lessons from Longitudinal Microdata, Journal of Economic Literature, 38 (2000), pp 569-94.
[2] Bartelsman et al: Cross-Country Differences in Productivity: The Role of Allocation and Selection, American Economic Review, 103(1), 2013, pp 305-34.
[3] Corporate Indebtedness in the Euro Area, ECB Monthly Bulletin, February 2012.
[4] Vodopivec, M., Čede, U.: Productivity, Unit Labor Costs and Leverage in Slovenia: A Descriptive Analysis of Longitudinal Firm-Level Data, Surveys and Analyses, 2/2013. The study is based on analysis of corporate performance between 1995 and 2012. The analysis includes firms from five sectors: manufacturing, construction, wholesale and retail trade, accommodation and food service activities, and transportation and storage. For the purpose of the analysis firms are classified into four corporate size categories according to the number of full-time employees, namely micro, small, medium-sized and large enterprises. The analysis does not cover sole proprietorships, legal entities under public law, monetary financial institutions, NGOs or associations. The corporate figures were obtained from the business register of the Agency for Public Legal Records and Related Services (AJPES).
[5] Measured by value-added per employee.

remained unchanged in September for the fourth consecutive month. Expectations regarding future demand improved in manufacturing and construction, but deteriorated in services.

Labour market

Employment recorded a seasonal increase in the second quarter, while the contraction in seasonally adjusted employment slowed. Seasonally unadjusted survey figures, registered figures and national accounts

Table 2.1: Employment

	2008	2009	2010	2011	2012	*2Q12*	*3Q12*	*4Q12*	*1Q13*	*2Q13*
	average annual growth in %					*y-o-y growth in %*				
A Agriculture, forestry and fishing	-2.1	-1.7	-2.0	-2.5	-0.9	-0.8	-0.6	-1.1	-1.4	-1.5
BCDE Industry	-0.3	-8.7	-5.7	0.0	-1.2	-0.7	-1.5	-2.3	-3.2	-3.1
F Construction	12.1	-0.9	-9.4	-11.4	-7.8	-6.8	-7.2	-8.9	-11.2	-9.6
GHI Trade, accommodation, transport	3.9	0.1	-2.4	-2.4	-1.2	-1.0	-1.5	-1.9	-2.6	-2.7
J Information and communication	5.8	4.0	0.8	0.3	2.1	2.0	2.4	2.4	1.2	0.8
K Financial and insurance activities	4.5	1.8	-0.7	-3.1	-1.6	-1.6	-1.2	-2.4	-2.9	-2.9
L Real estate activities	11.8	4.3	0.0	-3.7	-1.0	-1.9	0.0	2.0	0.0	-1.9
MN Professional, technical and other business activities	2.5	-0.5	2.6	0.7	1.4	1.4	1.1	0.3	-1.4	-0.4
OPQ Public administration and defence; education, health	1.9	2.2	2.3	0.9	1.1	1.5	0.9	0.1	-1.0	-1.2
RST Other activities	4.3	3.1	1.7	-1.9	0.2	0.6	0.0	0.0	-1.8	-1.8
TOTAL	2.6	-1.8	-2.2	-1.6	-0.8	-0.5	-0.9	-1.6	-2.7	-2.5

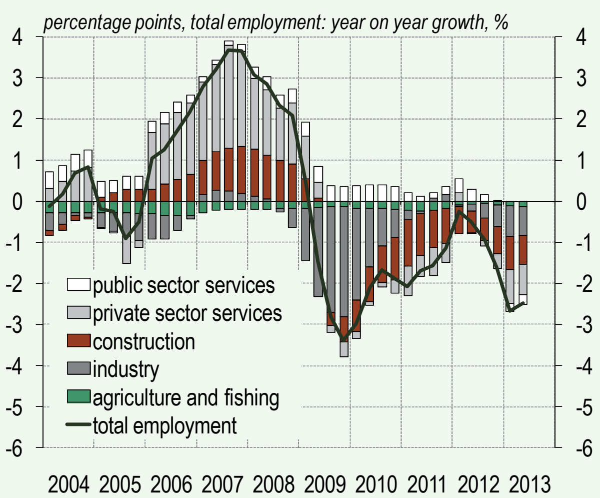
Sources: SORS - national accounts, Bank of Slovenia calculations.

figures reveal a current increase in the number of employees in the first half of the year. Developments in the number of employees in the first half of the year and, in particular, in the second quarter were considerably better than in previous years. The seasonally adjusted number of employees according to the national accounts was down 2.5% in year-on-year terms at 919,400 in the second quarter, the lowest employment figure since the second quarter of 2001. The majority of the year-on-year decrease was the result of drops in employment of 0.7% in the final quarter of last year and 0.8% in the first quarter of this year, while the current decrease in the second quarter stood at just under 0.4%.

The largest year-on-year decrease in employment was in the private sector, although the current decrease in employment slowed. The year-on-year decrease was again largest in the construction sector, at 9.6%, but the situation here is also easing, as current developments suggest a stronger seasonal increase in employment than in previous years. In terms of year-on-year decreases, construction was followed by manufacturing (3.3%), financial and insurance activities (2.9%) and wholesale and retail trade (2.7%). The year-on-year decrease in the manufacturing sector was almost exclusively the result of a drop at the end of last year and the beginning of this year, while the recent developments are more favourable.

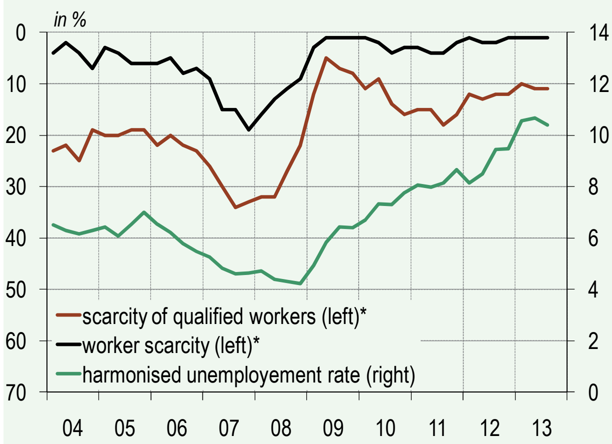
Employment in the government sector fell by 2% in year-on-year terms. The decrease in employment also slowed in this sector in current terms in the second quarter. The registered figures for public services show that by the end of June the workforce in employment was down 1.1% overall.[3] The largest decrease was in employment in the public administration sector, at 3.5%, while the workforce in employment in the health sector was unchanged in year-on-year terms at the end of June. Total employment in public services according to registered figures increased in current terms in the second quarter,

Figure 2.9: Contribution of sectors to changes in total employment



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

Figure 2.10: Worker scarcity, unemployment rate



*Note: * Precentage of companies that stated worker scarcity as a limitation factor in the quarterly Business tendency survey in manufacturing. Left axis is inverted.*
Sources: SORS, Eurostat, Bank of Slovenia calculations.

which is a seasonal development, but the increase was merely 0.3%, the lowest in recent years.

The number of new hires in the first half of the year was up significantly on last year, and was comparable to the figure in the first half of 2011. The number of people deregistering as unemployed because they found a job was up almost 30% in year-on-year terms in the second quarter, and up 12.4% in the first half of the year overall. This was primarily the result of a very low basis

[3] Public services include public administration and defence, compulsory social security, education and health (Sectors O, P and Q according to the SKD 2008).

Box 2.2: Youth unemployment

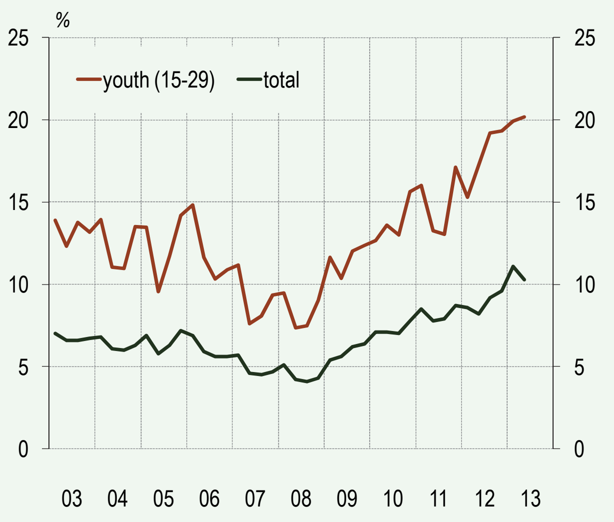
Youth unemployment has begun to rise rapidly in recent years. Unemployment, particularly longer-term unemployment, can lead to economic and social exclusion of young people, and the gradual loss of human capital. Given that young people in Slovenia are rather late in entering the labour market, all those aged from 15 to 29 are classed as youth.[1] In international comparisons the term "youth" normally means aged 15 to 24.

The overall unemployment rate and the youth unemployment rate[2] displayed a falling trend until the outbreak of the crisis, but have increased since 2008 as employers have strictly curbed new hires. Young people have been hit harder by the crisis, and the youth unemployment rate has risen faster than the overall unemployment rate. Young people are most exposed to lay-offs, as they are more likely to be employed via flexible forms of work, most notably temporary employment and student work. Another factor in the faster rise in the youth unemployment rate was the fall in the youth workforce in employment, as some have begun to move into inactivity. The average youth unemployment rate over the entire measurement period is almost double the overall rate. It also fluctuates more sharply, as the school and academic years have a major impact on its movement. The monthly figures for registered youth unemployment reveal the rate to rise sharply in the autumn months, generally in October, when the number of first-time jobseekers rises. Afterwards the rate usually begins to fall, but this did not happen in late 2012 as a result of a general deterioration in the situation on the labour market. The situation is also deteriorating this year in terms of the Labour Force Survey unemployment rate.

Since the outbreak of the crisis youth unemployment has increased in the majority of other European countries.[3] The average Labour Force Survey youth unemployment rate in the EU rose from just under 13% in the final quarter of 2008 to 18.5% in the final quarter of 2012. The rate in Slovenia rose from 9% to just over 19% over the same period. Growth in youth unemployment was especially high in Greece, Spain, Portugal and Italy, where the rate ranges from 25% to almost 50%. The lowest youth unemployment rates are in Austria and Germany, although the figures were nevertheless higher than the overall unemployment rate.

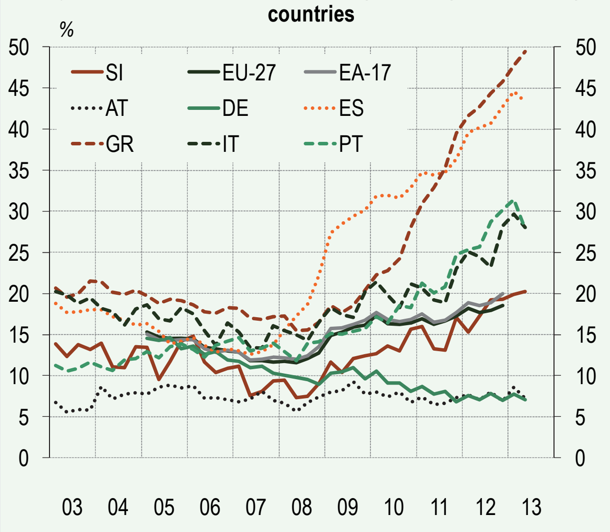
The youth unemployment rate would be even higher in Slovenia if the inclusion of young people in secondary and tertiary education was not so high. The proportion of young people included in formal education stood at just under 58% in Slovenia in 2012, slightly more than at the outbreak of the crisis, and almost 12 percentage points higher than the EU average. The high inclusion of young people in formal education also results in a lower labour market participation rate for young people in Slovenia. This averaged 54% in 2012, 3 percentage points less than the EU average. The difference between the

Figure 1: Labour Force Survey unemployment rates in Slovenia



Sources: Eurostat, Bank of Slovenia calculations.

Figure 2: Youth Labour Force Survey unemplyment rates by countries



Sources: Eurostat, Bank of Slovenia calculations.

labour market participation rates is narrower than the difference between the rates of inclusion in formal education because in Slovenia more young people pursue education and work simultaneously, including via the student work. More problematic is the trend in the youth participation rate in Slovenia during the crisis, the rate having declined by 6 percentage points between 2008 and 2012, while the EU average declined by just 1 percentage point. The main reason for the decline in the participation rate in Slovenia was the fall in the youth workforce in employment, which amounted to more than a third over the period in question, compared with less than 15% in the EU overall.[4]

In light of the slight increase in young people's inclusion in formal education, the decline in the participation rate in Slovenia means that an increasing number of young people are inactive and not enrolled in education. These accounted for just under half of young people classed as NEETs (not in employment, education or training) in 2011. The remainder of the NEETs comprise unemployed youth.[5] Just under 12% of young people were classed as NEETs in Slovenia in 2012, up just over 4 percentage points on 2008. Primarily as a result of young people's high inclusion in education, this is still less than the EU average of just under 16%, the figure having risen by just under 3 percentage points over the same period.

The deterioration in the situation on the labour market has also encouraged young people to emigrate. A total of 1,570 young citizens emigrated from Slovenia in 2012, the highest figure since independence.[6] The proportion of those emigrating in 2011 who had tertiary qualifications was higher than that among the youth population overall, at 17% compared with 12%. The most common destinations for Slovenian citizens in 2011 were Germany and Austria.

The government has introduced several measures because of rising youth unemployment. An employer that hires an unemployed person younger than 26 for a permanent position can claim the reduction in tax base of 45% for a period of two years under the Corporate Income Tax Act. With regard to the Pension and Disability Insurance Act, employers who hire such a person for a permanent position and retain him/her for at least two years may claim a partial refund of the employer's contributions for the first two years as of 1 January 2013. The aforementioned act notwithstanding, under the Act Regulating Emergency Measures in the Labour Market and Parental Care an employer that hires an unemployed person aged under 30 for a permanent position between 1 November 2013 and 31 December 2014 will be fully exempt from the payment of job-related contributions for a period of two years.

As part of its active youth employment policy the Employment Service of Slovenia is providing indirect co-financing for corporate scholarships and the First Challenge programme which involves employment subsidies for unemployed people aged under 30. Within the framework of general active employment policy programmes, young people account for a significant proportion of the education and training programme and the programme promoting self-employment. Furthermore, unemployed young people have become the number one priority group in European employment policy. The Youth Guarantee programme, for which European funding is available, is expected to begin by 2014, and aims to provide those aged 25 and under with employment or education via measures drawn up by the Ministry of Labour, Family, Social Affairs and Equal Opportunities.[7]

---

[1] The same definition is used by the Office of the Republic of Slovenia for Youth and by the Employment Service of Slovenia.

[2] The analysis uses Labour Force Survey unemployment rates, which are internationally comparable, unless it is explicitly stated that the registered unemployment rate is being used.

[3] Only Germany and Luxembourg recorded declines.

[4] The smaller decline in the participation rate than in the workforce in employment can be explained by the rise in youth unemployment in both areas.

[5] Employment Service of Slovenia in cooperation with the Ministry of Labour, Family, Social Affairs and Equal Opportunities, Young People and the Labour Market, May 2013. Those not working but actively seeking and available for work are classed under the Labour Force Survey youth unemployment rate according to the ILO definition.

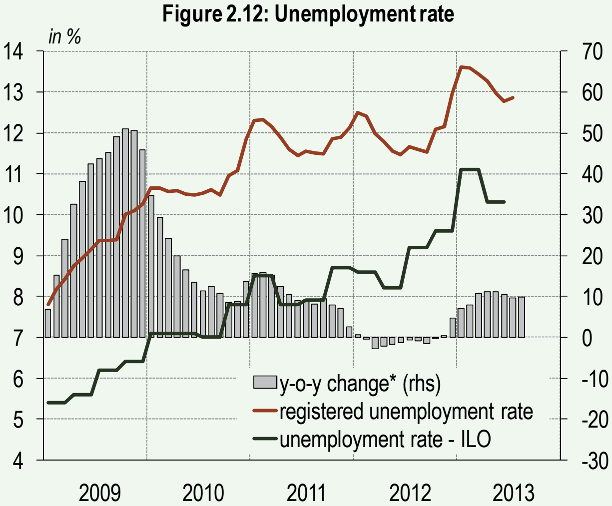
[6] There were just under 3,400 youth emigrants in 2012 (Slovenian citizens and others), just under 1% of the total population in this age group. The figure in Slovenia was 1.3% in 2011, slightly less than the unweighted EU average of approximately 1.5% at that time. For more on international migrations in Slovenia, see Box 2.1 of Macroeconomic Trends and Projections, April 2013.

[7] Employment Service of Slovenia in cooperation with Ministry of Labour, Family, Social Affairs and Equal Opportunities: Young People and the Labour Market, May 2013; Slovenija doma v Evropi website: European Commission measures to tackle youth unemployment, 19 June 2013, and website of the Ministry of Labour, Family, Social Affairs and Equal Opportunities: Young people are the key in designing schemes and measures for the young, 10 September 2013.

Figure 2.11: Long-term unemployed persons

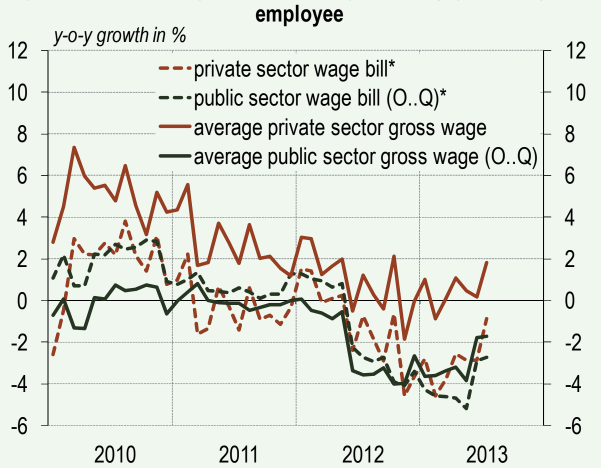
Sources: Employment Service of Slovenia, Bank of Slovenia calculations.

Figure 2.12: Unemployment rate



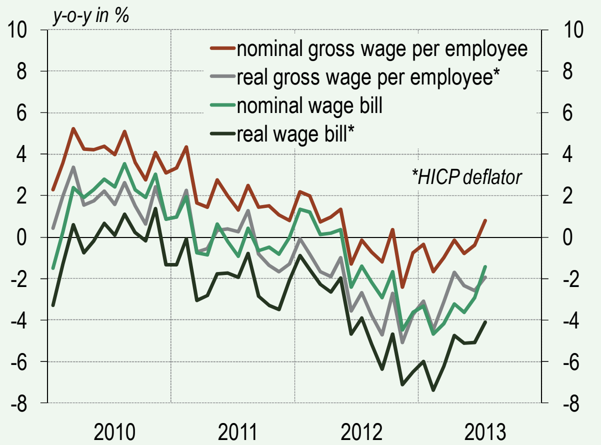
Note: * Y-o-y change in the number of registered unemployed persons, in %
Sources: Employment Office of the Republic of Slovenia, SORS, Bank of Slovenia calculations.

Figure 2.13: 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.
Sources: SORS, Bank of Slovenia calculations.

Figure 2.14: 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.
Sources: SORS, Bank of Slovenia calculations.

from last year, when the uncertainty and fear surrounding the entry into force of the ZUJF meant that there were significantly fewer new hires than in previous years. The number of unemployed entering employment during the first seven months of this year was nevertheless up just under 5% on the same period of 2011, a year of greater stability. Indicators of demand for workers in manufacturing reveal that firms are primarily seeking skilled workers, an indication of structural mismatch on the labour market.[4] Furthermore, the demand for all types of workers is

[4] The figures for the number of vacancies reveal an increase in the proportion of vacancies for permanent positions, which accounted for just under a quarter of all notified vacancies at the end of July, compared with less than a fifth in previous years. The abolition of compulsory notification of vacancies with the Employment Service means that as of April the Employment Service's figures are no longer representative of the whole economy. They only cover vacancies in the public sector and those vacancies that companies themselves decide to notify with the Employment Service. It is likely that the change in the ratio is partly the result of the change in data capture, as there is generally a higher proportion of vacancies for permanent positions in the public sector. If the change is not just the result of a change in data capture, it could be a sign that the introduction of severance payments for temporary employment under the Employment Relationships Act of this April had some effect in curbing such employment. Another consequence of this would be that at the end of the year there will not be such a sharp increase in the number of people newly registering as unemployed for reason of the termination of temporary employment.

Box 2.3: Analysis of employment dynamics using job flows in Slovenia, 1996-2012[1]

Detailed figures at the level of the firm allow for in-depth empirical research into job flows, which is of relevance in understanding the economic cycle, productivity growth, the dynamics of the lifecycle and variation from firm, to firm, and in identifying the need for structural changes. Patterns of job flow (creation and destruction) can also provide useful information in the interpretation of unemployment trends. By contrast, employment dynamics at level of the firm are often used as an indicator of labour market flexibility, which is one of the prerequisites for the efficient allocation of resources and for economic growth.

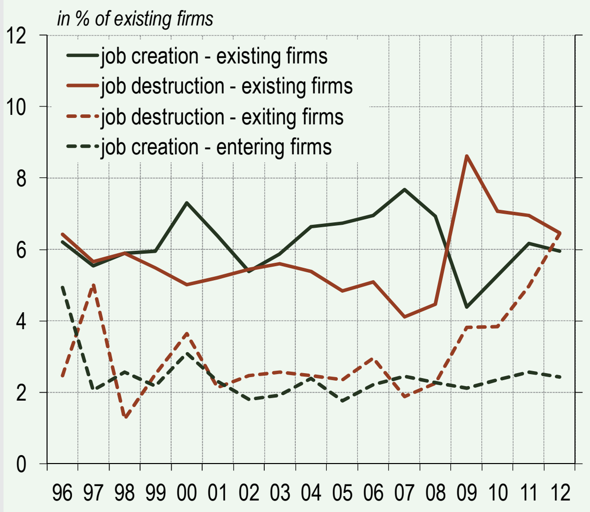
The changes in employment at the level of the firm in Slovenia during the period in question were related to the simultaneously high rates of job creation, destruction and reallocation.[2] Job reallocation, even within individual sectors, was significantly larger than changes in net employment growth. Between 1996 and 2003, when employment stagnated, the average annual rate of job creation and job destruction was approximately 8%. During this period one in every six jobs was created or destroyed on average. During the expansionary period, the job creation rate reached 10% while the job destruction rate declined to 6%. With the outbreak of the financial crisis the job creation rate reached its lowest average level in 2009 at 6.5%, while the job destruction rate leaped to 12.5% before slowing slightly over the next two years and then rising again to 12.9% in 2012. In terms of the job reallocation rate, Slovenia is comparable to the majority of continental Europe, while job reallocation rates of up to double this are seen in Brazil, the UK, Mexico, the US and Hungary. Some studies have linked different job reallocation rates to regulations on firing workers and different levels of temporary employment.

Analysis of the figures for Slovenia revealed that the job reallocation rate during the expansionary period was similar to that before expansion. By contrast, the job reallocation rate increased sharply during the crisis (2009 to 2012) as a result of a significantly larger increase in the job destruction rate relative to the job creation rate. Empirical studies have also found that job reallocation in the US is counter-cyclical (primarily as a result of the strong counter-cyclical component in job destruction), while job reallocation in Europe is acyclical or moderately pro-cyclical. In Slovenia too the counter-cyclical component of job destruction during the expansionary period was relatively weak.

The entry and exit of firms onto and from the market also play an important role in the job creation and destruction process. Firms entering the market accounted for an average of around 27% of total new jobs created in Slovenia during the period in question, while firms exiting the market accounted for around 33% of all job destruction. This is comparable to the findings in other countries,[3] where existing firms account for a majority (around two-thirds) of job creation and destruction. There are nevertheless significant differences between the movement of job creation and job destruction at firms entering or exiting the market and that at existing companies. Job creation as a result of entry onto the market was relatively stable over the entire period, even during the expansionary period, while job destruction was significantly more variable. During the crisis the job destruction rate as a result of firms exiting the market increased even when the contraction in employment at existing firms had begun to slow. The proportion of job destruction accounted for by firms exiting the market began to increase after 2009, reaching 50% of the total in 2012.

Job creation and job destruction during the observation period were the result of permanent changes in employment. The level of job permanence was high, and the variations were

Figure 1: Job flows rates



Sources: SORS, Bank of Slovenia calculations.

primarily cyclical in nature. During the period of stagnation in employment (1996 to 2003), the permanence of job creation and job destruction was similar, with 82% of jobs created (lost) remaining so after a period of one year, compared with around 76% after two years and 73% after three years. During the expansionary period (2004 to 2008), the one-year permanence of job creation did not change significantly relative to the previous period, while the permanence of job creation measured after two or three years increased slightly. At the same time the permanence of job destruction declined. During the crisis (2009 to 2012), the permanence of job creation declined sharply (by 10 to 14 percentage points), which could be the result of an increase in temporary employment. The permanence of job destruction increased, albeit to a lesser extent (by approximately 6 percentage points).

Net flows of jobs varied greatly within sectors. As in other countries, before the crisis employment contracted in the primary and manufacturing sectors (Sectors B, C, D and E under the SKD 2008), and expanded in the service sectors (Sectors G to T). During the expansionary period the net job flows were particularly high in the construction sector (11%), more than double the net rate in the service sectors. During the crisis, net job flows declined markedly in the construction and manufacturing sectors, while the decline in the service sectors was significantly smaller.

The sectors also differed in respect of the job creation and destruction rates. The average job creation rate ranged from just under 2% in the electricity supply sector to just over 12% in the administrative and support service activities sector. The average job destruction rate ranged from just over 2% in the water supply sector to just over 13% in the real estate activities sector. The positive and statistically significant correlation between job creation and destruction at the sectoral level is evidence that the job creation and destruction rates are part of the same economic process. Sectors that create more jobs also see more jobs destroyed. This phenomenon has also been found in other studies, and can be explained theoretically by changes in demand and technological shocks in individual sectors, differences in the lifecycles of individual sectors, and corporate size and age. In Slovenia net job flows diminish as a function of corporate size. Controlling the age, net employment growth in most corporate age groups is higher at smaller firms, but becomes independent of size at larger firms. Younger firms typically have higher job creation and job destruction rates than older firms, while only firms less than three years old saw net employment growth overall. Corporate age and size therefore need to be taken into account when policy to promote job creation in the private sector is being designed. It can be concluded that the liberalisation of regulations related to the costs of new businesses is likely to contribute to net employment growth.

---

[1] For detailed analysis, see Banerjee, B, Jesenko, M, Dynamics of Firm-Level Job Flows in Slovenia, 1996–2011, Bank of Slovenia Working Papers, 2/2013.

[2] The job creation and job destruction rates are defined as flows in jobs relative to employment levels in a group of firms (the sector, the size category, etc.). Job reallocation represents the sum of the flows of job creation and job destruction, and can be interpreted as the turnover of jobs in the economy.

[3] In the UK it was found that firms entering the market accounted for 30% of all job creation while firms exiting the market accounted for 45% of job destruction between 1997 and 2008, while the corresponding figures in the US for the 1972 to 1986 period were 20% and 25%.

approximately the same as at the end of 2012, which does not give an indication that higher employment in manufacturing can be expected in the future.

After peaking in January of this year, unemployment was decreasing until June, and remained broadly unchanged in July and August. Between January and June 2013 the number of registered unemployed fell from just over 124,000 to just under 117,000. The decrease in the first half of the year was seasonal in nature. Further evidence of the decrease in unemployment came from the survey figures, according to which the unemployment rate fell from 11.1% in the first quarter to 10.3% in the second quarter. The year-on-year increase in the number of registered unemployed averaged just under a tenth in the first half of the year, the registered unemployment rate standing at 12.8% at the end of June. This was mostly the result of a significantly larger number of people newly registering as unemployed in the final quarter of last year and the first four months of this year. There was no deterioration in the situation on the labour market in

Table 2.2: Labour cost indicators

	2008	2009	2010	2011	2012	Q212	Q312	Q412	Q113	Q213
	nominal y-o-y growth, %									
Gross wage	8.3	3.5	3.9	2.0	0.1	0.3	-0.7	-1.0	-1.0	-0.5
Gross wage in the private sector	7.8	1.9	5.0	2.6	0.9	1.0	0.4	0.0	0.1	0.6
Gross wage in the public sector[1]	10.1	6.8	-0.1	0.0	-2.2	-1.6	-3.5	-3.5	-3.5	-3.0
Gross wage in manufacturing	7.6	0.9	8.9	3.9	2.5	2.5	2.0	2.3	1.6	2.9
Labour costs per hour worked[2]	9.1	3.6	1.1	2.0	-0.3	3.2	-0.6	-2.0	-3.3	-5.9
Labour costs per hour worked in manufacturing[2]	10.5	5.7	3.2	2.0	2.9	9.7	2.8	1.6	4.5	-5.6
Gross wage per unit of output[3]	7.5	10.3	0.4	-0.4	1.8	3.4	1.5	0.8	1.0	-1.2
Gross wage per unit in manufacturing[3]	6.9	10.0	-5.1	0.3	3.9	5.8	4.7	1.6	1.2	1.6
Unit labour costs[3, 4]	6.4	8.6	0.4	-0.7	0.8	0.9	0.9	0.3	1.2	-0.1
Compensation per employee[4]	7.2	1.9	3.9	1.6	-1.0	-2.1	-1.2	-1.4	-0.8	0.7
Output per employee	0.8	-6.2	3.5	2.4	-1.7	-3.0	-2.1	-1.7	-2.0	0.8
Output per employee (manufacturing)	0.7	-8.3	14.7	3.6	-1.3	-3.1	-2.6	0.7	0.4	1.2
HICP	5.5	0.9	2.1	2.1	2.8	2.5	3.2	3.0	2.7	1.8
GDP deflator	4.1	3.3	-1.1	1.2	0.2	0.1	0.2	0.2	0.0	1.7

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

July and August: the level of registered unemployment at the end of August was unchanged from June.

The largest number of people newly registering as unemployed in the first half of the year was due to the expiry of temporary contract. The figure was up just over a fifth in year-on-year terms. The number of first-time job-seekers was up almost a half at the same time. This was also reflected in the structure of unemployment, year-on-year growth in the number of first-time job seekers exceeding 20%. It appears that last year's adverse economic situation caused some young people to defer their entry into the labour market, which resulted in a fall in the number of first-time job-seekers last year and a sharp rise this year. At the same time the number of people deregistering as unemployed in the first half of the year was significantly higher than the average of previous years. A major factor was the heavy outflows into employment, while outflows from unemployment for reasons other than employment in the first half of the year were down a sixth in year-on-year terms. The proportion of these accounted for by retirements is declining. The end of 2013 will see the end of the period when under the old legislation the Employment Service pays pension and disability insurance contributions for unemployed workers filing an application before the end of 2010 who were less than three years away from retirement. The decline in the number of people newly registering as unemployed in the first half of the year meant that the proportion of long-term unemployed increased, from 44% to just over 46%.

As a result of the economic slowdown and fiscal consolidation measures, the average nominal gross wage is declining alongside the decrease in employ-

ment. In the total economy it was down just under 1% in the first half of the year. The year-on-year decline was largely a result of the reduction in wages in public services brought by the June 2012 austerity measures. The decline of 0.4% in the average nominal wage in June of this year is an indication that the labour market is continuing to undergo a wage adjustment even after the base effect has ceased. The average wage declined by 3.2% in the first half of the year in public services (Sectors O, P and Q), but remained unchanged in the private sector. The sector that recorded the largest year-on-year increase in wages in the first half of the year was the electricity, gas and steam supply sector, at 4.5%, while the largest fall of almost 5% was recorded by the education sector. Because wage growth in the energy sector is to a great extent determined by the government as the owner, these developments are not in line with the fiscal consolidation processes, and in addition have an adverse signalling effect. The average real gross wage in the total economy in the first half of the year was down just under 3% in year-on-year terms, while the real gross wage bill was down just over 5%.

3 Current Account and Competitiveness Indicators

The current account surplus has been widening rapidly since the second half of last year, and stood at EUR 2.1 billion or 6.2% of GDP in the 12 months to July. In the context of weak foreign demand, nominal growth in exports of merchandise and services was low, but imports declined sharply as a result of the contraction in domestic consumption. Alongside the merchandise trade surplus, another factor in the widening current account surplus was the narrowing of the deficit in factor income as a result of an increased surplus in labour income and a narrower deficit in capital income. Only the widening deficit in current transfers prevented an even larger increase in the current account surplus.

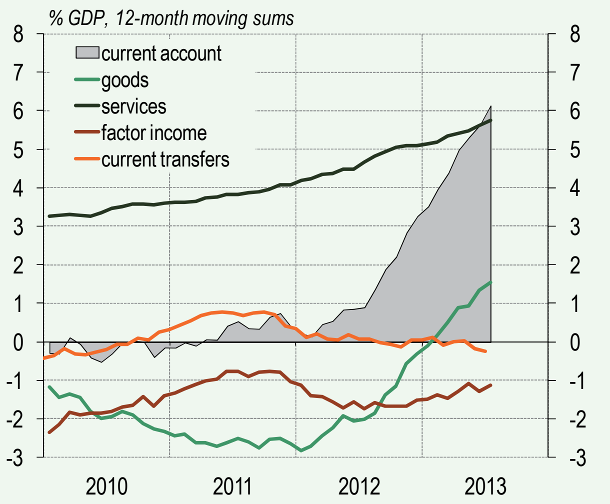
Slovenia's competitiveness has deteriorated this year as a result of a rise in the euro and relatively high inflation. Slovenia's cost competitiveness has improved at the same time, as unit labour costs in the total economy increased by less in the first half of the year than in the euro area overall. Labour cost adjustment remains stronger in the tradable sector, but has largely been conditioned by a contraction in employment.

Current account[5]

The current account surplus is widening for the third consecutive year, and the accumulation of the surplus accelerated further in the second quarter as export growth outpaced import growth. After recording a relatively balanced position between 2009 and 2011, the current account saw an accelerated increase in the surplus last year. The surplus over the first seven months of this year amounted to EUR 1.4 billion, more than in the whole of 2012. The main factor in the growth in the surplus over the last two years as growth in foreign demand has slowed was the deterioration in the domestic economic situation. The adverse situation on the labour market and the tightening of government austerity measures have significantly reduced domestic consumption, which together with weak growth in exports has contributed to a faster decline in imports of merchandise and services. The merchandise trade surplus accounted for just over a third of the current account surplus over the first seven months of the year.

[5] The balance of payments figures for the 2006 to 2013 period were revised in July 2013. The revision reduced the current account deficit and increased the current account surplus over the entire period; the surplus in 2012 was thus EUR 340 million or around 1% of GDP larger. The changes in other years were smaller. The vast majority of the revision was attributable to changes in the merchandise trade balance. In addition to regular updates of data sources, the following major changes were made: (1) The Statistical Office of the Republic of Slovenia revised the methodology for capturing foreign firms engaging in merchandise trade in Slovenia for the 2006 to 2012 period. Merchandise exports during the observation period were revised upwards by 0.9% to 1.5%, while merchandise imports were revised upwards by up to 0.7%. For more, see http://www.stat.si/novica_prikazi.aspx?id=5543. (2) On the basis of bilateral cooperation with individual countries, the figures for outflows of immigrants' remittances (most notably to Serbia) were updated, while figures for inflows of emigrants' remittances (from Germany, Italy, Austria, Switzerland) were obtained for the first time. (3) Transactions in emission allowances have been included under the capital account (acquisition/disposal of non-produced, non-financial assets) as of 2008 instead of under services.

Figure 3.1: Components of the current account



Source: Bank of Slovenia.

Figure 3.2: Trade in goods*

Source: Bank of Slovenia.

Table 3.1: Components of the current account

	2005	2006	2007	2008	2009	2010	2011	2012	1 year to July 13	1-7 2013
					mio EUR					
Current account balance	-498	-545	-1,441	-2,028	-173	-50	146	1,159	2,138	1,395
1. Goods	-1,026	-919	-1,456	-2,144	-440	-830	-957	-110	532	496
2. Services	920	993	1,047	1,428	1,165	1,281	1,476	1,803	2,001	1,206
2.1. Transport	398	456	525	561	437	496	585	630	605	353
2.2. Tourism	743	783	834	904	891	1,002	1,158	1,356	1,353	750
- of which, exports	1,451	1,555	1,665	1,827	1,804	1,925	1,975	2,090	2,075	1,135
2.3. Other	-221	-247	-312	-38	-163	-218	-267	-183	43	104
3. Factor income	-295	-440	-789	-1,030	-724	-588	-524	-552	-313	-183
3.1. Labour income	128	107	50	8	96	150	234	377	447	260
3.2. Capital income	-424	-547	-839	-1,038	-820	-739	-758	-929	-760	-443
4. Current transfers	-97	-178	-243	-282	-174	88	151	18	-83	-124
					as % GDP					
Current account balance	-1.7	-1.8	-4.2	-5.4	-0.5	-0.1	0.4	3.3	6.1	
1. Goods	-3.6	-3.0	-4.2	-5.8	-1.2	-2.3	-2.6	-0.3	1.5	
2. Services	3.2	3.2	3.0	3.8	3.3	3.6	4.1	5.2	5.8	
2.1. Transport	1.4	1.5	1.5	1.5	1.2	1.4	1.6	1.8	1.7	
2.2. Tourism	2.6	2.5	2.4	2.4	2.5	2.8	3.2	3.9	3.9	
- of which, exports	5.1	5.0	4.8	4.9	5.1	5.4	5.5	6.0	6.0	
2.3. Other	-0.8	-0.8	-0.9	-0.1	-0.5	-0.6	-0.7	-0.5	0.1	
3. Factor income	-1.0	-1.4	-2.3	-2.8	-2.0	-1.7	-1.4	-1.6	-0.9	
3.1. Labour income	0.4	0.3	0.1	0.0	0.3	0.4	0.6	1.1	1.3	
3.2. Capital income	-1.5	-1.8	-2.4	-2.8	-2.3	-2.1	-2.1	-2.7	-2.2	
4. Current transfers	-0.3	-0.6	-0.7	-0.8	-0.5	0.2	0.4	0.1	-0.2	

Sources: SORS, Bank of Slovenia.

Merchandise trade

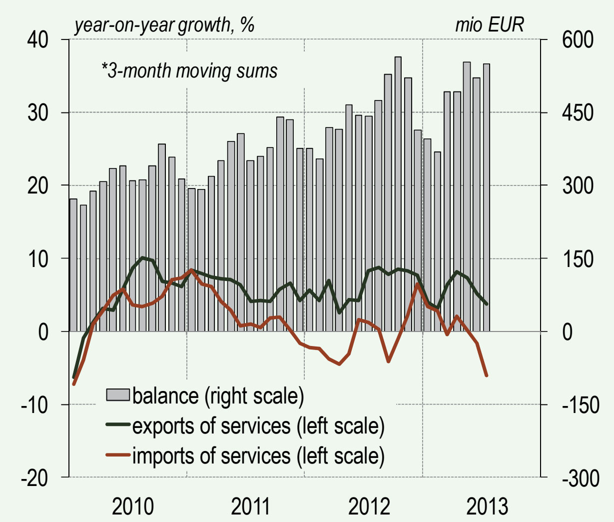
The merchandise trade deficit turned into a surplus in the second half of last year, which has widened dramatically this year. Nominal year-on-year growth in exports stood at 2.7% in the first quarter of last year, but the crisis in the EU meant that the average rate had slowed to less than 0.5% by the first quarter of this year. A decline in total merchandise exports was prevented by the relatively rapid growth in exports to markets outside the EU. Nominal growth in merchandise exports increased to 1.5% in the second quarter of this year, but there was a change in the dynamics between EU markets and other markets. Year-on-year growth in exports to markets outside the EU slowed sharply as a result of lower exports to Serbia and to Bosnia and Herzegovina and slower growth in exports to the BRIC countries. In the context of a slightly more favourable economic situation, exports to the EU, most notably France, Austria, Slovakia, Hungary, the Czech Republic and Italy, were up in year-on-year terms. Nominal merchandise exports during the first seven months of the year were up 1.8% in year-on-year terms, while merchandise imports were down 3.2% despite an increase in investment in certain segments and consumption of durables. Merchandise trade was still in deficit over the first seven months of last year, at EUR 146 million, but recorded a surplus of EUR 496 million during the first seven months of this year. Coverage of merchandise imports by exports over the same period increased from 99% last year to 104% this year.

Another factor in the growth in the merchandise trade surplus this year has been positive terms of trade. The terms of trade measured on the basis of national accounts figures were negative in the amount of 1% last year. The figure diminished to 0.5% in the first quarter of this year, as export prices were down 0.7% in year-on-year terms and import prices were down 0.2%. Export prices were unchanged in the second quarter, while the decline in import prices increased to 1.9%. The main factor in the year-on-year fall in import prices was the fall in euro oil prices, as a result of the euro's rise against the US dollar. Industrial commodity prices and food prices also fell. In the first half of the year export prices fell by 0.6% overall, and import prices by 0.9%. The terms of trade thus became positive in the amount of 0.3%.

The decline in nominal merchandise imports would have been even greater without increased investment in machinery and equipment and increased purchases of durables before the rise in VAT. This year the fastest growth has been in imports of capital goods, which were up just under 15% in year-on-year terms in the first quarter and just over 13% in the second quarter. Alongside high imports of transport and general industrial equipment, another factor was high imports of equipment for the TEŠ 6 project (Block 6 of Šoštanj power station), which accounted for 7.4% of total imports of capital goods during the first seven months of the year. Excluding imports of equipment for TEŠ 6, imports of capital goods would have remained at the level of last year. The announcement of the VAT rise brought a sharp increase in year-on-year growth in imports of consumer goods in the second quarter to of 6.5%, the rate increasing to almost 13% in July. Imports of cars increased in particular, by 30% in year-on-year terms in the second quarter and by 64% in July, although July's increase was likely the result of imports of vehicles paid for before the VAT rise, while the basis was also low. Without the increased imports of vehicles and equipment for TEŠ 6, merchandise imports would have been around EUR 220 million lower, and the current account surplus in the 12 months to July would have approached 7% of GDP.

Trade in services

Year-on-year growth in exports of services has slowed sharply since the middle of the second quarter, while the decline in imports has increased, which has further widened the surplus of trade in services. Year-on-year growth in exports of services in June and July was much slower than in the early part of the year, while the year-on-year contraction in imports exceeded



Source: Bank of Slovenia.

7.5%. Exports of services during the first seven months of the year were up just over 5% in year-on-year terms, while imports were down 2.5%. The surplus of trade in services widened by just under EUR 200 million in year-on-year terms to EUR 1.2 billion.

Exports of travel services were down in year-on-year terms during the first four months of the year, but the situation later improved. Export of travel services during the first seven months of the year were nevertheless down 1.3% in year-on-year terms. In light of the rise of just under 3% in the number of arrivals by foreign visitors and the rise of just under 2% in the number of overnight stays, the decline in revenues from exports of travel services is an indication of a fall in the average spending of foreign visitors to Slovenia. Imports of travel services have continued to decline in line with the fall in purchasing power. They were down more than 3% in year-on-year terms during the first seven months of the year. The surplus of trade in travel services did not narrow significantly, and stood at EUR 750 million.

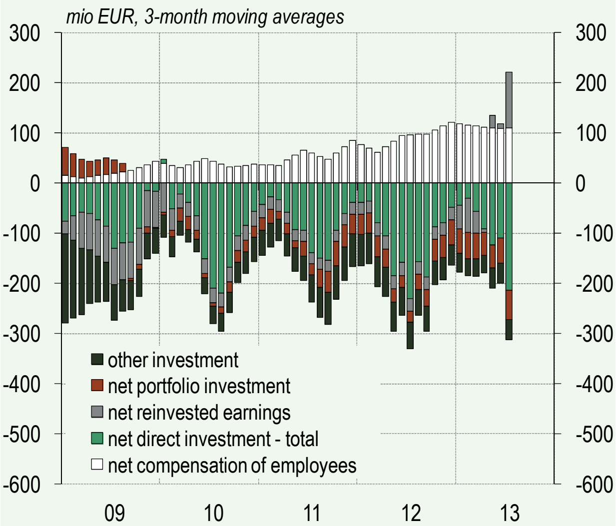
Trade in transport services has been declining rapidly this year. Exports of transport services during the first seven months of the year were down just over 4% in year-on-year terms, while imports were down just under 2%. This year's largest decline was in exports of passenger air and rail transport services and exports of oil and gas transportation services. The surplus of trade in transport services narrowed by EUR 26 million in year-on-year terms to EUR 353 million.

Travel and transport services still account for the largest proportion of the surplus of trade in services, but exports of other services are becoming increasingly important. Growth in exports of foreign trade intermediation services has increased sharply since the second half of last year. It stood at almost 90% during the first seven months of the year. With imports having increased by 6% over this period, the surplus widened to EUR 220 million, up a quarter on the surplus in these services over the whole of last year. Trade in construction services has also increased rapidly since the second half of last year. Imports of construction services have increased rapidly following the collapse of the major domestic construction firms. Exports of construction services have also increased rapidly, construction firms having generated a tenth of their total turnover last year in the rest of the world. The surplus of trade in construction services during the first seven months of the year widened by a fifth in year-on-year terms to EUR 72 million. There was a deficit in trade in other services, intellectual property services recording the largest deficit of EUR 93 million.

Factor income and transfers

The deficit in net factor income has narrowed again this year. The deficit in factor income over the 12 months to July narrowed to EUR 313 million or 0.9% of GDP, compared with 1.8% of GDP a year earlier. Since the outbreak of the crisis the number of Slovenian citizens in the rest of the world has increased, while the number of foreign citizens working in Slovenia has declined. The surplus in labour income has therefore widened rapidly. Over the first seven months of the year it increased by EUR 70 million in year-on-year terms to EUR 260 million. An even larger factor in the narrower deficit in factor in-

Figure 3.4: Net factor income



Source: Bank of Slovenia.

come was the year-on-year decline of EUR 170 million in net capital income to EUR 443 million.

The largest factor in the deficit in capital income was the net outflow of income from FDI, which declined significantly. The deficit in net income from FDI contributed EUR 234 million to the overall deficit in capital income. Most notable were paid dividends and distributed earnings in the amount of EUR 284 million, down slightly in year-on-year terms. The decline in the value of FDI indicated by reinvested and undistributed earnings slowed sharply during the first seven months of the year, most notably from Slovenian outward investments, from EUR 248 million to EUR 102 million.[6] Another significant factor in the year-on-year narrowing of the deficit in capital income, in light of the private sector's debt repayments, was the year-on-year decline in net interest payments on loans to the rest of the world. The decline in these liabilities was compensated for by issues of debt securities, particularly government securities. The stock of government debt securities owned by non-residents amounted to EUR 4.6 billion in 2008, but had risen to EUR 11.8 billion by the end of the first quarter of this year.

The increased cost of borrowing during the crisis means that there has been a deficit in income on investments in debt securities since 2010. The net outflow of income from securities during the first seven months of the year was up EUR 45 million in year-on-year terms at EUR 121 million.

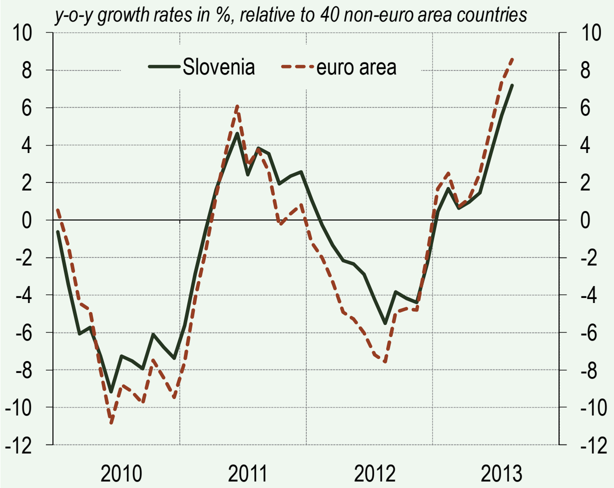
The deficit in current transfers increased sharply during the first seven months of the year. It amounted to EUR 124 million. The surplus in government transfers was down significantly on the same period last year. Other government transfers alone recorded a surplus; the net position of the state budget against the EU budget was balanced. There was an increase of more than 15% in payments into the EU budget from gross national income and the adjustment in favour of the UK. The deficit in private transfers widened by EUR 54 million to EUR 142 million as a result of increased outflows of tax on property income, social security contributions and taxes on products.

Selected competitiveness indicators

This year's rise in the euro against most major global currencies has reduced Slovenia's competitiveness as measured by the nominal effective exchange rate. The euro rose significantly in year-on-year terms against the majority of major currencies over the first eight months of the year: by 2.7% against the US dollar, by 4.9% against the pound sterling and by 24.6% against the Japanese yen. The year-on-year rise in the nominal effective exchange rate averaged 2.7% over the first eight months of this year, and August's year-on-year rise of 7.2% was the highest in the last four years. This was nevertheless approximately 1 percentage point less than the appreciation in the comparable indicator for the euro area over the same period. The smaller appreciation in Slove-

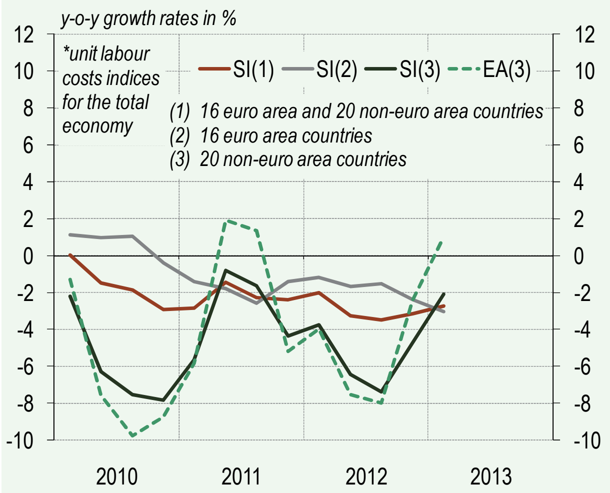
[6] Reinvested earnings of Slovenian firms in the rest of the world declined by EUR 1.4 billion in total during the crisis, while non-residents' reinvested earnings in Slovenia declined by EUR 0.8 billion, although the loss of reinvested earnings was compensated for by new FDI. The stock of Slovenian firms' outward FDI increased by EUR 0.2 billion between 2009 and the end of the first quarter of this year, while non-residents' inward FDI in Slovenia increased by EUR 0.9 billion.

Figure 3.5: Nominal harmonised competitiveness indicator



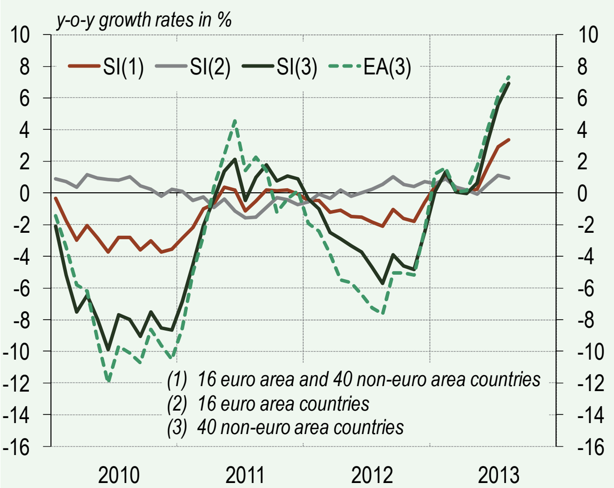
Source: ECB.

Figure 3.7: Harmonised competitiveness indicator* (based on ULC)



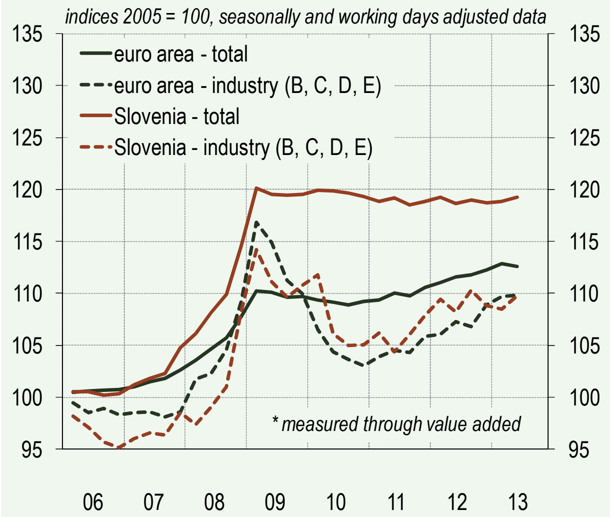
Source: ECB.

Figure 3.6: Harmonised price competitiveness indicator (HICP / CPI deflator)



Source: ECB.

Figure 3.8: Nominal unit labour costs*



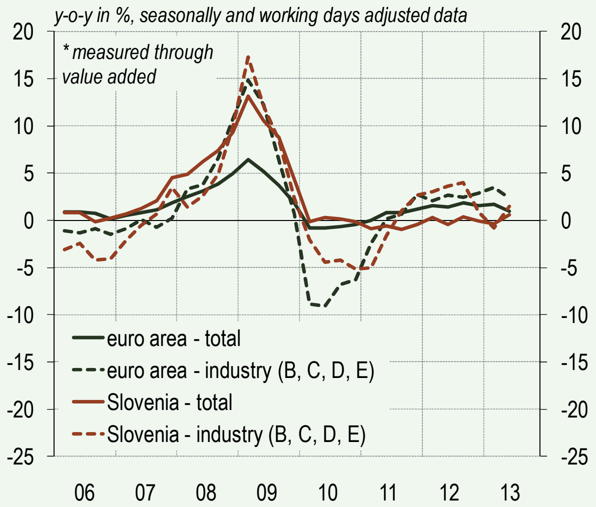
Sources: Eurostat, Bank of Slovenia calculations.

nia's indicator was the result of the euro's smaller rise against the currencies of countries that have a higher weight in Slovenia's indicator. Slovenia trades less with the US, Japan and the UK than does the euro area overall, and more with Croatia and Poland. The euro was up just 0.4% in year-on-year terms against the Croatian kuna during the first eight months of the year, and actually fell by 0.5% against the Polish zloty.

Slovenia's price competitiveness relative to countries outside the euro area and euro area countries has deteriorated this year. The deterioration in price competitiveness relative to countries outside the euro area was primarily the result of an increase in the nominal indicator. By contrast, Slovenia's price competitiveness relative to euro area countries deteriorated because domestic inflation was higher than the euro area average, as a result of fiscal consolidation measures.

The cost adjustment of the Slovenian economy is continuing, which is improving cost competitiveness. After deteriorating significantly in 2008 and 2009, Slovenia's competitiveness as measured by unit labour costs (ULCs) in the total economy has improved for the third consecutive year. ULCs in the first half of the year increased by 0.2%, approximately 1.5 percentage point less than in the euro area overall. The slower growth in ULCs in the context of reasonably similar developments in labour productivity was the result of reductions in labour costs in individual segments of the private sector and government measures addressing wages in the public sector. The fastest adjustment in ULCs was in industry, which is largely exposed to international competition, although the adverse situation in the domestic environment is also having an impact. In comparison with the euro area overall, the adjustment in this sector is to a much larger extent happening via a fall in employment and increased labour productivity than via average labour costs.

Figure 3.9: Nominal unit labour costs*



Sources: Eurostat, Bank of Slovenia calculations.

4 Financing

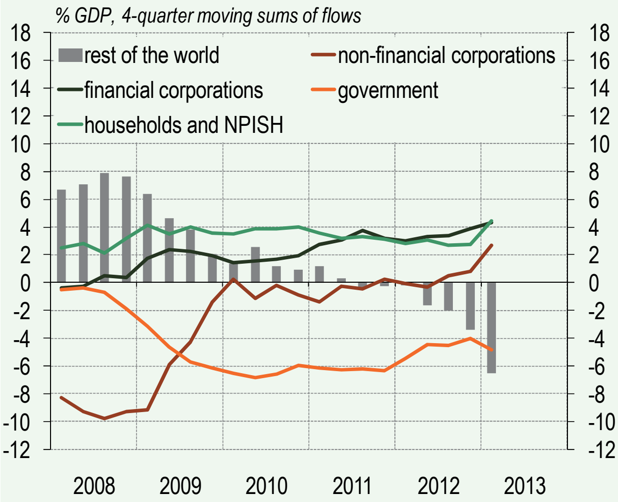
The adverse macroeconomic situation in Slovenia and the adoption of additional fiscal consolidation measures have been reflected in the financial accounts of individual institutional sectors. The decline in domestic consumption brought a sharp increase in the surplus with the rest of the world. The maturing of foreign liabilities and the uncertainty in accessing new funding is forcing the banks to restructure their funding and investments. This has been reflected in lending activity, the banks having again reduced the stock of lending to corporates and households in the first half of 2013. Other major factors in the contraction in loans were the deterioration of the credit portfolio and high impairment and provisioning costs. Corporates partly succeeded in compensating for the loss of domestic funding by borrowing in the rest of the world. Households slightly increased their investments in currency and deposits in the first quarter, but the stock of deposits declined in the second quarter under the influence of the Cypriot financial crisis and the resulting increased uncertainty surrounding the domestic banking system. The outflow of household deposits in the second quarter was partly offset by corporates, which increased their deposits in the first half of the year. The government deposited a portion of the proceeds of the US dollar bond issue at domestic banks.

Savings-investment gap by sector

The adverse domestic economic situation, which was partly the result of additional fiscal consolidation measures, has been reflected in the financial accounts of individual institutional sectors. The one-year savings-investment (financial) surplus[7] against the rest of the world increased sharply in the first quarter of 2013, to end the period at 6.6% of GDP. The high surplus was primarily the result of the decline in domestic demand, and partly the result of the continuing process of fiscal consolidation. Non-financial corporations[8] (hereinafter referred to as corporates) have continued to reduce investment, which has been reflected in an increase in their financial surplus as they have simultaneously deleveraged. It stood at 2.7% of GDP in the first quarter, up almost 2 percentage points on the end of 2012. Households' financial surplus also increased sharply in the first quarter to end the period at 4.6% of GDP. This increase was primarily the result of a decline in household consumption in the period of great uncertainty and declining purchasing power. By contrast, the government sector slightly increased its one-year financial deficit in the first quarter of 2013. It amounted to 4.9% of GDP in

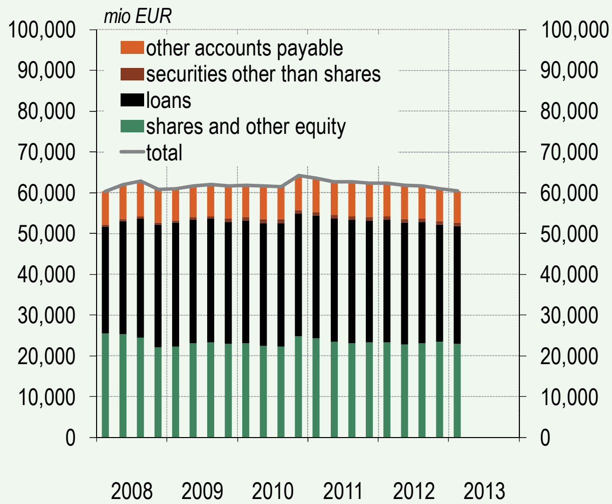
[7] The savings-investment surplus is defined as the surplus of financial assets (savings) over financial liabilities (investments).
[8] According to the ESA95 definition, non-financial corporations (corporates) are legal persons that are market producers of goods and non-financial services.

Figure 4.1: Savings-investment gap



Sources: Bank of Slovenia - consolidated financial accounts, SORS.

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



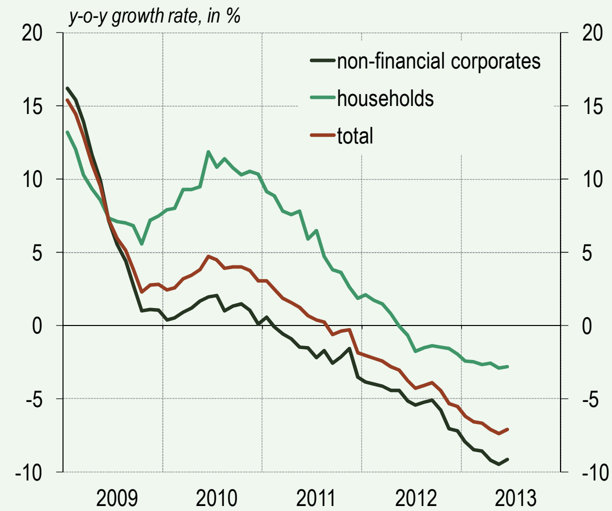
Source: Bank of Slovenia, consolidated data.

the first quarter, 1 percentage point more than at the end of 2012. The increase was primarily the result of a one-off measure aimed at stabilising the banking system.

Financing and financial assets of corporate sector

Corporate financial liabilities declined by EUR 1 billion in the first quarter of 2013, primarily as a result of a decline in liabilities from shares and other equity. These liabilities declined by EUR 695 million, mostly as a result of negative revaluations. Liabilities from trade credits and advances also declined, by EUR 616 million. Intra-sectoral trade credits and advances declined (EUR 290 million), as did trade credits and advances to the rest of the world (EUR 326 million). While the latter was primarily the result of the decline in imports, the decline in intra-sectoral trade credits was in line with the uncertainty surrounding the economic recovery in conditions of high payment indiscipline.[9]

Figure 4.3: Loans to households and non-financial corporates



Source: Bank of Slovenia.

Corporates increased their liabilities from loans in the first quarter, solely as a result of an increase in foreign loans. The stock of domestic loans contracted again. Corporates reduced their stock of domestic bank loans by EUR 875 million in the first half of the year, double the reduction in the same period last year. The reduction was the result of a further contraction in investment, which is reducing demand for loans, and also

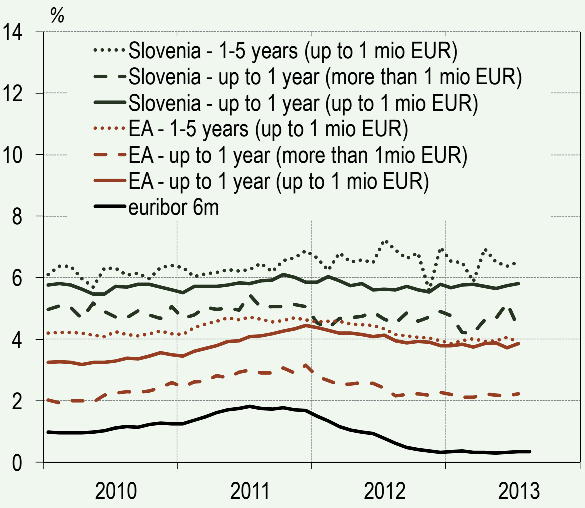
[9] The number of bankruptcy proceedings during the first eight months of this year almost reached the number in the whole of 2012, while the number of liquidation proceedings was actually higher. The largest increase in bankruptcy proceedings was because of a change in legislation in July of this year. The change provides for easier and faster bankruptcy proceedings, where a bankruptcy debtor that initiates bankruptcy proceedings can be exempted from advances.

the result of increasingly prevalent limiting factors on the supply side. High impairment and provisioning costs are additional factor. Bank loans to corporates before impairments and provisioning were down 8.8% in year-on-year terms at the end of the first half of the year, and down 13.1% after the creation of impairments. The maturity breakdown of loans is also changing. The stock of long-term loans is declining faster than the stock of short-term loans,[10] although investments in machinery and equipment have increased. Some corporates have succeeded in partly compensating for the loss of domestic financing by borrowing in the rest of the world. They borrowed EUR 660 million in the rest of the world in the first quarter of this year, although a large part of this inflow was the disbursement of loans intended for construction of an energy facility (TEŠ 6).

The impaired access to and high cost of bank funding, high impairment costs and the related need to maintain net interest income are being reflected in high interest rates on corporate loans. Interest rates on new corporate loans in the first half of the year were still significantly higher than the euro area average. This was the result of several factors: (i) the higher costs of bank funding, (ii) the need to maintain the banks' net interest income, and to cover impairment costs, and (iii) the higher indebtedness and resulting higher risk weight of Slovenian corporates compared with the euro area average. Interest rates on corporate loans of up to EUR 1 million in the first half of the year were almost 2 percentage points higher than the euro area average, while the interest rate on loans of more than EUR 1 million were 2.3 percentage points higher. There was no significant increase in the interest rate spread on corporate loans compared with the end of last year.

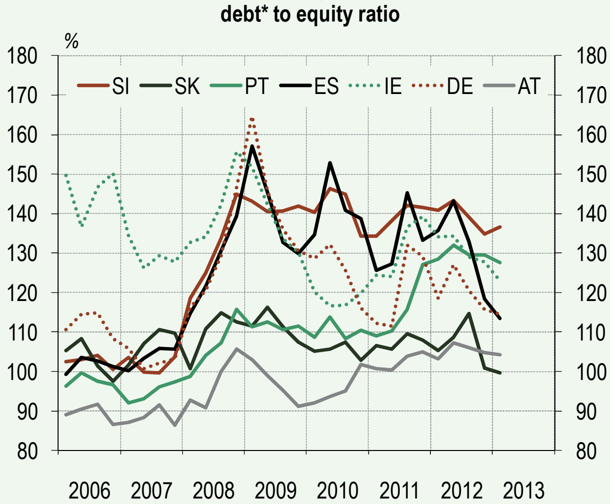
High corporate indebtedness is limiting access to financing, and is thus further curbing investment activity. Corporate indebtedness in Slovenia as measured by the debt-to-equity ratio at the end of the first quarter of 2013 was up slightly on the end of 2012 at 137%.[11] Additional factor in persistence of high leverage in Slovenia is the deepening economic crisis, which has had a significant impact on corporate earnings and market value, in which the lack of liquidity in the Slovenian capital market is also a factor. High leverage is a limiting factor for many

Figure 4.4: Interest rates on loans to NFCs



Sources: 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.*
Sources: ECB, Bank of Slovenia calculations.

[10] The proportion of new loans that are short-term is increasing, while a large proportion of new long-term loans are merely rollovers.
[11] The ratio of corporate debt to GDP stood at 106% at the end of the first quarter, below the euro area average. The difference between the two indebtedness indicators suggests that Slovenian corporates have inappropriate financing structure (i.e. a lack of equity).

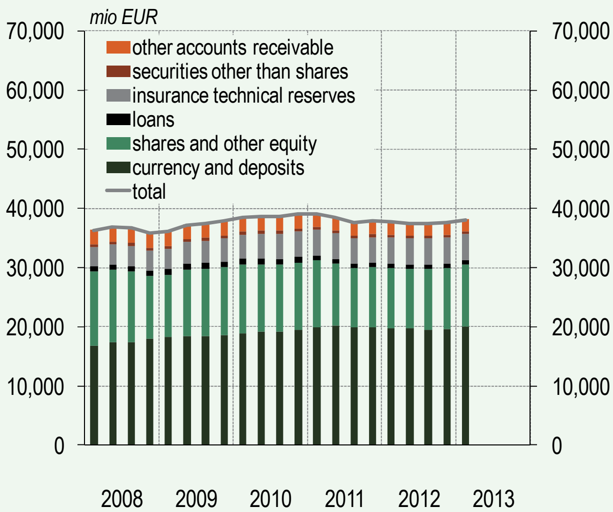
corporates in obtaining new financing, as they do not have sufficient assets for loan collateral. This is also preventing any impetus in new investment.[12]

Corporates' financial assets increased by EUR 186 million in the first quarter of 2013, primarily as a result of an increase in domestic deposits and trade credits to the rest of the world. Corporates increased their deposits by EUR 330 million in the first quarter, the largest quarterly increase since 2004. Export growth brought an increase of almost EUR 430 million in trade credits to the rest of the world, while intra-sectoral trade credits declined by EUR 300 million. Corporates reduced their investments in shares and other equity by EUR 169 million, and loans granted, primarily to the rest of the world, by EUR 121 million.

Household financing and savings

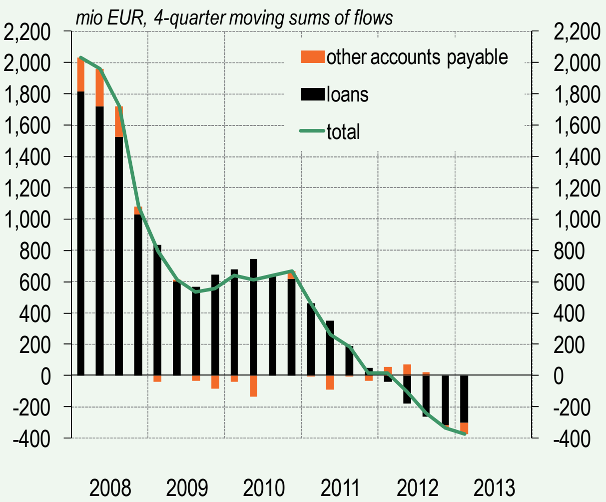
Households increased their investments by EUR 516 million in the first quarter, primarily as a result of an increase in investments in currency and deposits and a rise in the value of investments in shares and other equity. The stock of currency and deposits, which is the most important component of Slovenian households' assets, increased by EUR 437 million in the first quarter, of which EUR 245 million was held in the rest of the world. There was an increase in holdings of currency and time deposits in Slovenia and in the rest of the world. As a

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



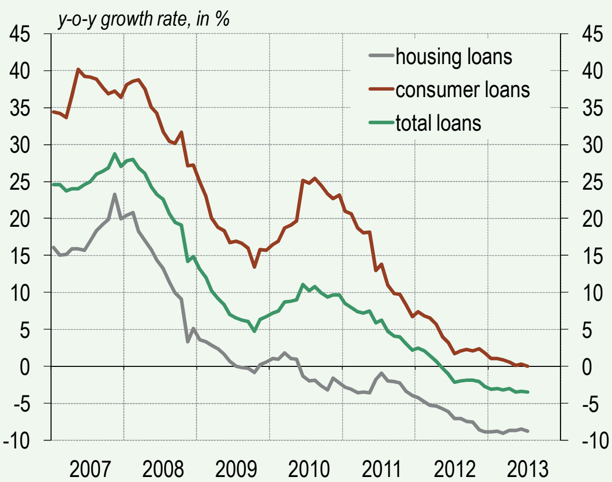
Source: Bank of Slovenia, unconsolidated data.

Figure 4.7: Financial liabilities of households and NPISH (S.14 and S.15), by instruments



Source: Bank of Slovenia, consolidated data.

Figure 4.8: Loans to households



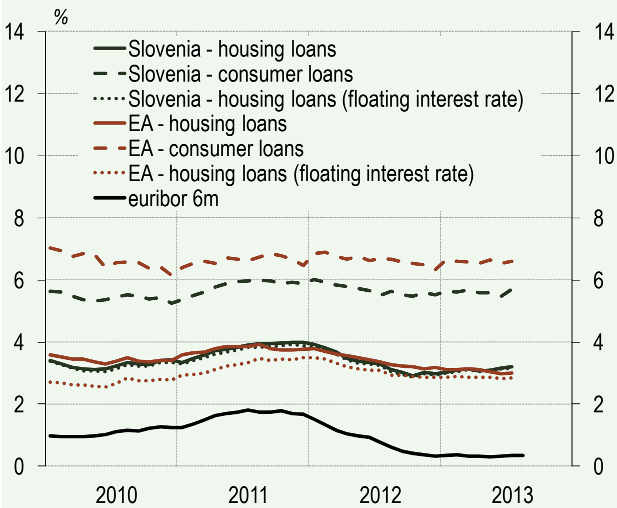
Source: Bank of Slovenia.

[12] A systemic debt relief bill is under preparation. Systemic debt relief for the real sector would improve financial stability and would change the structure of corporate financing, improving corporates' ability to generate their own resources as corporate revenue grew. Support for corporates was previously seen in non-standard measures such as financing for SMEs, for which institutional solutions are already being sought within the euro area. In Slovenia a prominent role is played in this area by SID banka, which will directly finance working capital in the amount of EUR 375 million, and will earmark EUR 125 million for financing investments and for research and development.

result of the adverse situation on the labour market, fiscal consolidation measures, and the Cypriot financial crisis and the resulting increased uncertainty surrounding the domestic banking system, the stock of deposits in the domestic banking sector declined by EUR 269 million in the second quarter.[13] Another factor in the decline was increased purchases of consumer durables before the VAT rise. Investment in shares and other equity increased by EUR 117 million in the first quarter, primarily as a result of positive revaluations.

In the context of falling disposable income, high unemployment and uncertainty surrounding the future financial situation, households are behaving very cautiously, and again reduced their debt. It amounted to EUR 12.2 billion at the end of the first quarter. The stock of bank loans to households has been declining since the middle of 2012, primarily as a result of a contraction in consumer loans. The latter were down 8.5% in year-on-year terms in June. Housing loans were unchanged in the first half of the year. Given the adverse situation on the labour market and the expectations of

Figure 4.9: Interest rates on loans to households



Sources: ECB, Bank of Slovenia.

further falls in real estate prices, even though prices are already lower than their pre-crisis levels, there is no expectation of higher growth in the remainder of the year.

Slovenian households are significantly less indebted than the euro area average. Their debt at the end of the first quarter amounted to 53% of disposable income, only half of the euro area average. Despite the adverse situation on the labour market and the government consolidation measures, households remain low-risk clients, less than 4% of whose claims are non-performing (more than 90 days in arrears).

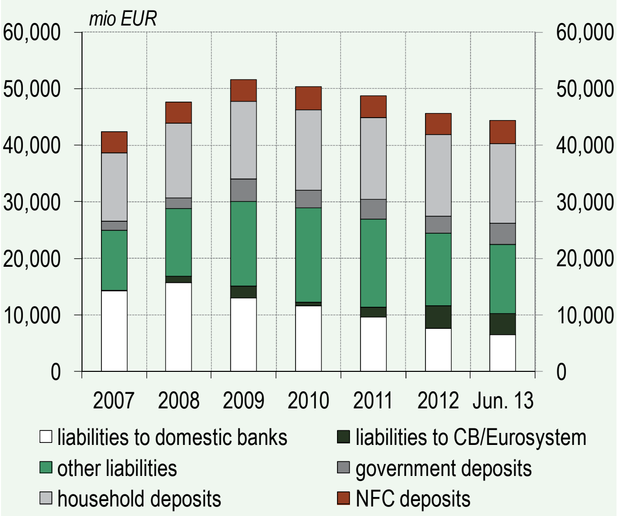
Interest rates on new housing loans rose above the euro area average in the second quarter, while interest rates on consumer loans remained slightly lower. Interest rates on housing loans have been gradually rising since the end of 2012, and surpassed the euro area average in the second quarter. Premiums over the 6-month EURIBOR on housing loans increased slightly in the first half of the year, probably a reflection of the banks' slight increase in caution in approving such loans because of the need to maintain interest income. Interest rates on consumer loans remain lower than the euro area average, the spread not having changed significantly.

Bank funding

The banks continue to face high levels of uncertainty in accessing funding, which has been reflected in low lending activity and high interest rates. The situation is being exacerbated by the deterioration in the loan portfolio and the need to deleverage. Liabilities to foreign banks declined by EUR 1.1 billion in the first half of the year, comparable to the same period last year.[14] Liabilities from debt securities also declined in the first half of the year, by EUR 248 million. This was primarily the

[13] There was a notable switch of deposits from the domestic banks to the banks under majority foreign ownership in 2012 and the first half of 2013, which was not conditioned by differences in deposit interest rates.
[14] The domestic banks' maturing liabilities to the rest of the world next year are expected to be lower than this year's figure, while the largest debt repayments to the rest of the world - if the domestic banks do not make debt prepayments - are expected to occur in 2015. The domestic banks will then see EUR 4.9 billion of bank loans from the rest of the world, EUR 1.5 billion of liabilities from issued debt securities and EUR 3.8 billion liabilities from LTROs at the ECB mature.

Figure 4.10: Selected liabilities of domestic banks



Source: Bank of Slovenia.

result of a partial bond prepayment by SID banka. Deposits by the non-banking sector increased by just over EUR 1 billion in the first half of the year, largely as a result of government deposits. The government deposited some of the proceeds of its US dollar bond issue in domestic banks. Corporate deposits also increased, by EUR 372 million. As a result of the adverse situation on the labour market, fiscal consolidation measures, the Cypriot financial crisis and the resulting increased uncertainty, household deposits declined by EUR 305 million in the first half of the year. Maturing foreign funding and the uncertain access to foreign financial markets has compelled the banks to restructure their funding and investments, which in the future will be profoundly affected by the deterioration in the quality of the credit portfolio[15] and high impairment and provisioning costs.[16] Growth in deposits, particularly long-term deposits, would contribute to greater stability in the banking system, and would also have a beneficial impact on the LTD ratio,[17] which is of key importance to access to the wholesale markets.

[15] The proportion of non-performing claims more than 90 days in arrears stood at 16.3% in June.
[16] The banking sector ended the first half of 2013 with pre-tax loss of EUR 243 million, compared with a profit of EUR 19 million in the same period last year.
[17] The ratio was down 10 percentage points on the end of 2012 at 119% in June 2013.

5 Public Finances

The decline in economic activity in 2013 is hindering the reduction of the general government deficit, on which the support measures for financial institutions have also had a temporary impact. According to the latest assessments of the Ministry of Finance, bank recapitalisations this year are forecast to amount to EUR 620 million or 1.8% of GDP. The final forecasts will be known after the asset quality review and stress testing of the banking system have been concluded. The European Council has extended Slovenia's deadline for eliminating the excessive government deficit by two years to 2015. The elimination of the excessive deficit will be carried out under conditions of weak economic activity. The general government debt exceeded 60% of GDP in the second quarter of 2013. Alongside factors in the international environment and the low liquidity of government bonds, the high growth in the debt, the large deficit in recent years and the adverse macroeconomic situation have brought a rise in the required yields on Slovenian government bonds and increased difficulties in borrowing on international financial markets.

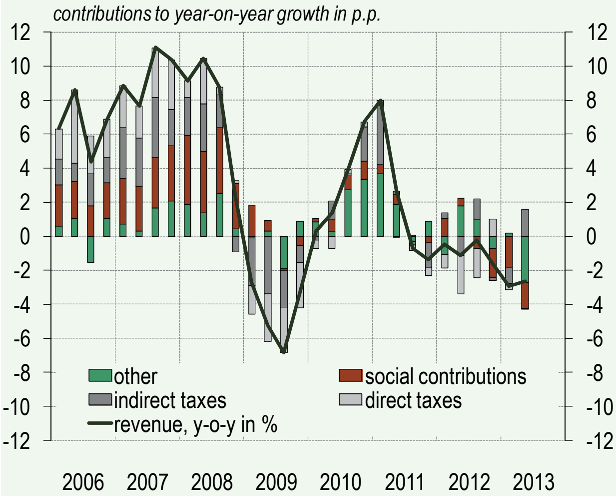
General government deficit

The general government deficit excluding the support to financial institutions[18] is forecast to increase to 4.0% of GDP this year. The debt has continued to increase, and reached 62.6% of GDP by the end of June. The general government deficit excluding the support to financial institutions amounted to 3.8% of GDP over the 12 months to June, similar to that at the end of last year. The most recent update to the Stability Programme forecast a temporary increase in the government deficit, primarily as a result of an increased amount of support to financial institutions. This support was forecast at 3.7% of GDP in May's Stability Programme for this year and reduced to 1.8% of GDP in October's report on the general government deficit and debt. In the report this year's general government deficit excluding the support to financial institutions was forecast at 4% of GDP, while the overall deficit was forecast at 5.7% of GDP. The euro area deficit, which last year stood at 3.7% of GDP, is expected to decline slightly again this year, to 2.9% of GDP according to the latest forecasts by the European Commission. Despite rapid growth, Slovenia's general government debt remains significantly lower than euro area average, which according to Eurostat figures reached 90.6% of GDP last year.

General government revenues are continuing to decline, as a result of the decline in economic activity. The largest contributing factor is the adverse situation on the labour market. Revenues in the first half of the year were down 2.8% in year-on-year terms. The year

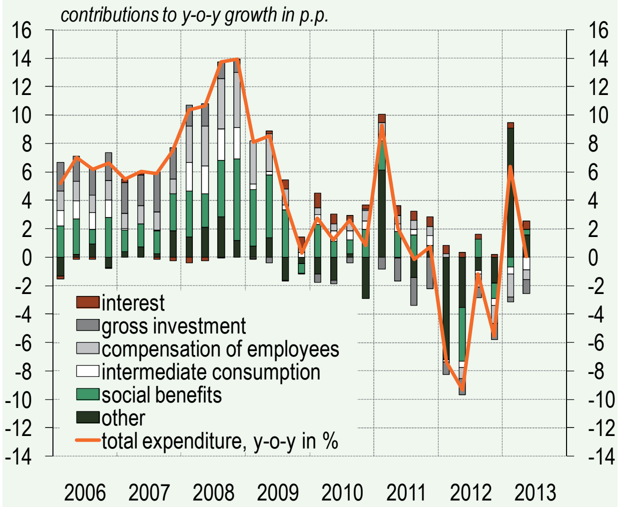
[18] Support to financial institutions amounted to EUR 61 million in the third quarter of 2012, EUR 320 million in the first quarter of 2013 and EUR 121 million in the second quarter of 2013.

Figure 5.1: General government revenue



Sources: SORS, Bank of Slovenia calculations.

Figure 5.2: General government expenditure



Sources: SORS, Bank of Slovenia calculations.

-on-year contraction in employment and wages is resulting in lower revenue from personal income tax and social security contributions and also from indirect taxes via the impact on household consumption. VAT revenues in the first half of the year were down 4.1% in year-on-year terms. Excise duty revenues were down, despite the year-on-year rise in excise duties on petrol, alcohol and tobacco. Taxes on corporate income remain low. Last year saw the introduction of additional legislative changes in the direction of expanded allowances and cuts in tax rates. Corporate income tax amounted to 1.3% of GDP last year, approximately 2 GDP percentage points less than five years ago, when these revenues peaked. The tax rate was cut to 17% this year, and will remain at this level. In addition to rises in excise duties, the VAT rates were raised in July (the standard rate by 2 percentage points to 22% and the reduced rate by 1 percentage point to 9.5%).

General government expenditure excluding the support to financial institutions has continued to decline, although interest expenditure again increased. Gov-

Table 5.1: General government deficit and debt in Slovenia, 2009-2016

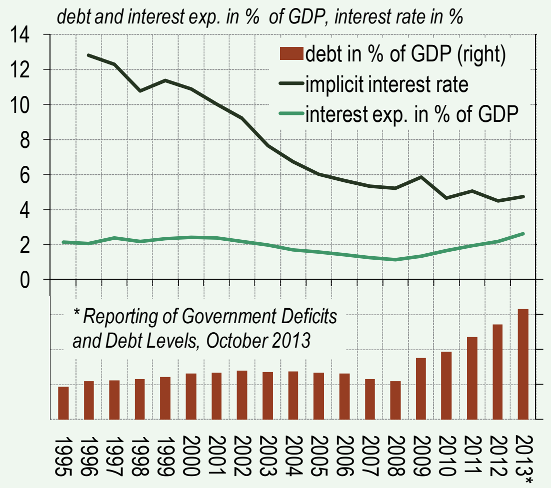
	SORS					Stability Programme					EC		
as % GDP	2009	2010	2011	2012	2013*	2012	2013	2014	2015	2016	2012	2013	2014
Revenue	42.3	43.6	43.6	44.2	44.1	44.8	45.5	46.8	45.8	45.3	45.0	45.0	44.2
Expenditure	48.7	49.4	49.9	48.1	49.4	48.8	53.4	49.4	47.9	46.7	49.0	50.3	49.1
of which: interest	1.4	1.6	1.9	2.2	2.3	2.1	2.7	2.9	2.8	3.0	2.1	2.3	2.8
Net lending (+) / borrowing (-)	-6.3	-5.9	-6.3	-3.8	-5.3	-4.0	-7.9	-2.6	-2.1	-1.4	-4.0	-5.3	-4.9
excl. support to fin. institutions	-6.3	-5.9	-5.7	-3.7	-3.8	-3.8	-4.2	-2.6	-2.1	-1.4	-3.8	-4.1	-4.9
Structural balance	…	…	…	…	…	-2.2	-1.8	-0.7	-0.8	-0.8	-2.7	-2.4	-3.3
Debt	35.2	38.7	47.1	54.4	62.6	54.1	61.8	63.2	63.2	61.8	54.1	61.0	66.5
Real GDP (growth, %)	-7.9	1.3	0.7	-2.5	-3.2	-2.3	-1.9	0.2	1.2	1.6	-2.3	-2.0	-0.1

*Note: * Debt: calculated as outstanding debt on 30th June 2013 compared to one year GDP up to Q2 2013, other: one year up to June 2013.*
Sources: SORS (realisation), Ministry of Finance (May 2013), European Commission (EC, May 2013), Bank of Slovenia calculations.

Box 5.1: Rising interest expenditure is hindering fiscal consolidation

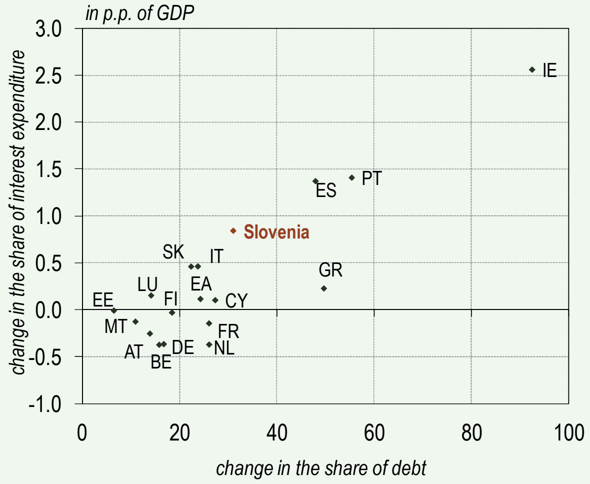
The deterioration in the economic situation in recent years, which has been particularly pronounced in Slovenia, has led to a higher deficit and growth in government debt. Although debt increased in all euro area countries, not all saw an increase in the ratio of interest payments to GDP. The interest burden increased most in some of the more vulnerable euro area countries, generally those countries simultaneously facing the highest growth in debt and the largest decline in GDP. The ratio of interest expenditure to GDP increased by around 2.5 percentage points in Ireland and by almost 1.5 percentage points in Portugal and Spain between 2007 and 2012. Debt and interest expenditure also increased sharply in Slovenia. The government sector's interest payments amounted to EUR 763 million or 2.2% of GDP in 2012, up just under 1 GDP percentage point on the final year before the crisis, but comparable to the ratio a decade earlier because of the higher interest rates at that time. Interest payments averaged 3.1% of GDP in euro area countries last year, up minimally on the pre-crisis period.

Figure 1: Government debt, interest expenditure and implicit interest rate in Slovenia



Sources: SORS, Ministry of finance, Bank of Slovenia calculations.

Figure 2: Change in the share of debt and interest payments in the GDP in euro area countries (2007–2012)



Sources: Eurostat, Bank of Slovenia calculations.

Table 1: Indicators of interest burden for the general government sector

	1996	2000	2005	2007	2008	2009	2010	2011	2012	2013 **
Slovenia										
interest expenditure as % of GDP	2.1	2.4	1.6	1.3	1.1	1.4	1.6	1.9	2.2	2.6
interest expenditure as % of govn. expenditure	4.7	5.1	3.5	3.0	2.5	2.8	3.3	3.9	4.5	...
implicit interest rate *	12.8	10.9	6.0	5.3	5.2	5.8	4.7	5.1	4.5	4.7
government debt as % of GDP	21.9	26.3	26.7	23.1	22.0	35.2	38.7	47.1	54.4	63.1
Euro area										
interest expenditure as % of GDP	5.5	3.9	3.0	3.0	3.0	2.9	2.8	3.0	3.1	
interest expenditure as % of govn. expenditure	10.9	8.4	6.3	6.5	6.5	5.6	5.5	6.1	6.2	
implicit interest rate *	7.9	5.7	4.5	4.6	4.7	3.9	3.6	3.7	3.6	
government debt as % of GDP	73.8	69.2	70.3	66.4	70.2	80.0	85.4	87.3	90.6	

*Notes: * Implicit interest rate is calculated as a share of current year interest payments in debt at the end of the previous year. ** Data for Slovenia are from Reporting of Government Deficits and Debt Levels (Oct. 2013).*
Sources: SORS, Eurostat, Ministry of finance, Bank of Slovenia calculations.

Interest expenditure in Slovenia has increased in recent years as a result of the rapid growth in government debt, and not as a result of the rise in the implicit[1] interest rates on the debt. The general government debt has more than doubled since 2007, while the implicit interest rate on the debt - calculated as the ratio of interest payments in the current year to the stock of debt at the end of the previous year - has declined, and stood at 4.5% last year. Another factor in the fall in the implicit interest rate was last year's increase in (cheaper) short-term borrowing, which slightly reduced the average residual maturity of the debt, which nevertheless remained at more than six years.

In comparison with many euro area countries, Slovenia has relatively low funding needs. These are temporarily increasing, as a result of the measures to support financial institutions. The impact of further borrowing on expenditure, the deficit and government debt is not negligible, as the required yields are currently high, and the concentration of maturing instruments is also higher because of the increase in short-term debt. The funding requirement in 2014 relates to the projected state budget deficit of 2.9% of GDP and the refinancing of maturing debt (primarily RS65 bonds with a nominal value of EUR 1.5 billion and a coupon rate of 4.375%, and 18-month treasury bills with a nominal value of EUR 1.1 billion and a yield of 4.15%) in the amount of about 9% of GDP. A difference in the interest rate in the amount of 100 basis points represents a difference in annual funding costs of more than EUR 40 million or 0.12% of GDP, whereby the calculation does not take account of any additional borrowing for measures to support the financial system and/or changes in the amount of pre-financing of debt repayment.

Slovenia's financing conditions have recently been unfavourable. The required yield on Slovenian long-term bonds is high.[2] Borrowing at interest rates higher than the interest rate of the maturing instruments (for refinancing) or the implicit interest rate (for new borrowing) entails a rise in the implicit interest rate. The implicit interest rate has been higher than (nominal) economic growth for four years, and the difference between them is raising the ratio of debt to GDP, which is reflected in the snowball effect.

Rising interest expenditure is supplanting other expenditure, and hindering fiscal consolidation. This is particularly undesirable when it necessitates reductions in components of consumption that have a favourable impact on economic growth and social stability.

[1] The latter reflects a number of factors such as the month of borrowing and the maturity breakdown of the debt. More expensive or cheaper borrowing is only gradually reflected in the implicit interest rate.
[2] Slovenia borrowed USD 3.5 billion on the US dollar market in May, of which USD 2.5 billion were raised by 10-year government bond with a coupon rate of 5.85%.

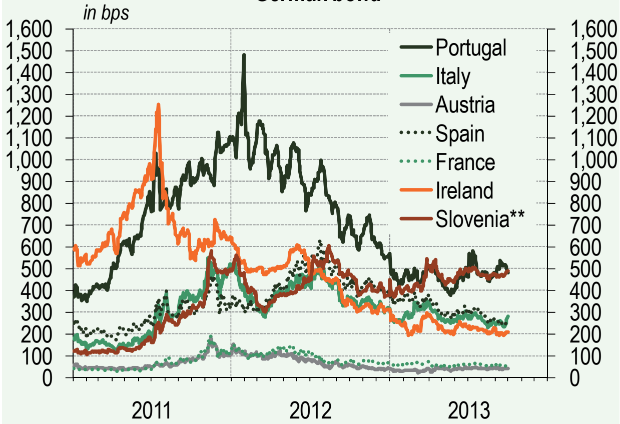
ernment expenditure, which declined last year for the first time since the outbreak of the crisis, was down 2.1% in year-on-year terms in the first half of the year, if the support for financial institutions is excluded. The key measures were taken by the ZUJF and the two public sector wage agreements, while the government is continuing to curb its discretionary expenditure. Compensation of employees was down 4.2% in the first half of the year in year -on-year terms. Average compensation per employee was down (by 2.4%), as was the number of employees in the general government sector (by 1.8%). The main measure in this year's wage agreement is a further reduction in individual wages (by 0.5% to 4.86%), which like the reduction in supplementary pension insurance premiums will be in force until the end of 2014. Expenditure on intermediate consumption and on government investment declined. Social benefits in the first half of the year were down 0.4% in year-on-year terms, despite the continued increase in expenditure on pensions mainly as a result of a rise in the number of pensioners, pensions having been only marginally adjusted this year. The higher debt is contributing to increased interest expenditure, which in the 12 months to June 2013 amounted to 2.3% of GDP (see Box 5.1).

The support provided to financial institutions in the first half of the year widened the general government deficit by 1.2% of GDP at an annual level. Additional measures are planned for the months ahead. The deficit was increased by a further EUR 320 million in the first quarter by the conversion of NLB CoCo bonds into equity, and by EUR 121 million in the second quarter via the conversion of NKBM CoCo bonds and the conversion of interest on CoCo bonds into equity. These transactions represent around 5% of general government expenditure in the first half of the year. In the October report on the general government deficit and debt, the Ministry of Finance includes bank recapitalisation in the amount of EUR 620 million in its forecast for the general government deficit for this year. The requisite scale and the duration of any further measures in support of financial institutions will be known after the asset quality review and stress testing of the banking system have been concluded.

General government debt and guarantees

The general government debt rose to 62.6% of GDP in the first half of the year. The government borrowed most via long-term bonds. The debt has risen by EUR 2.7 billion since the end of last year. Borrowing increased most in May, with the issue of two bonds on the foreign market with a total nominal value of USD 3.5 billion or EUR 2.7 billion. The nominal value of the issue of five-year bond was USD 1 billion, while the coupon rate was 4.75%. The ten-year bond was issued at a nominal value of USD 2.5 billion, with a coupon rate of 5.85%. The majority of the two issues (more than 95%) was bought by foreign investors. Treasury bills in the amount of EUR 1.5 billion were issued in the first half of the year, and were mostly sold to domestic investors (at the end of June non-residents held 20% of the stock of treasury bills issued this year). According to the consolidated general government data,[19] total borrowing in the first half of the year amounted to EUR 4.3 billion. The money was earmarked for repaying debt in the amount of EUR 1.8 billion, and for financing the deficit in revenues and expenditure and the deficit in the lending and repayments account in the amount of EUR 1.4 billion. The surplus of borrowing over the financing needs in the first half of the year in the amount of EUR 1.1 billion was placed at domestic banks. In accordance with September state budget financing programme update, the borrowing ceiling for 2013 is raised to EUR 8 billion, although the Ministry of Finance expects that actual borrowing will amount to EUR 4.6 billion.

Figure 5.3: Spreads* on long term government bonds over German bond



*Notes: * Spread is calculated as a difference between the yield of long term government bond and the yield of reference German bond on a daily basis and is used as a measure of country's credit risk. ** SLOREP 09/24 is used after 1. January 2013.*
Sources: Bloomberg, Bank of Slovenia calculations.

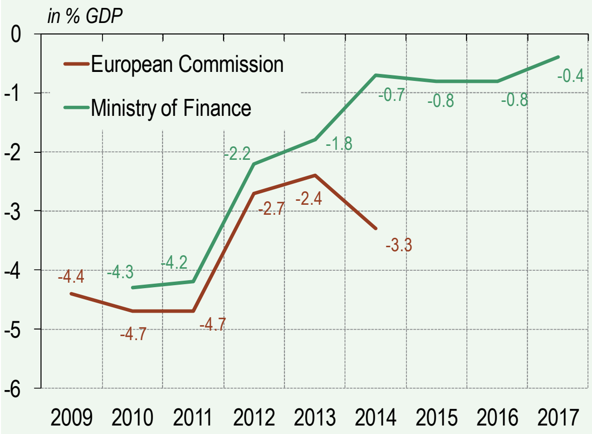
The stock of government guarantees increased in the first half of the year, primarily as a result of the approval of a guarantee for the TEŠ 6 project. The stock of government guarantees stood at EUR 6.9 billion or 19.8% of GDP at the end of June, up around EUR 0.4 billion on the end of last year. The increase was primarily the result of the approval of a guarantee for the loan for the construction of TEŠ 6 in the amount of EUR 440 million. Guarantees for DARS d.d. still account for the largest proportion of the stock of guarantees, standing at EUR 2.8 billion or 40% of the total. The stock of guarantees will increase significantly in the third quarter due to guarantees provided to ensure the liquidity and solvency of Probanka d.d. and Factor banka d.d. in connection with the process for the supervised winding down of the two banks. The government's guarantee liability is just over EUR 1 billion. According to state budget figures, EUR 20 million of guarantees were called during the first eight months of the year, while in the revised budget a total of EUR 73 million is earmarked for this purpose in 2013.

[19] The consolidated general government includes the state budget, local government budgets, the Health Insurance Institute and the Pension and Disability Insurance Institute.

The required yield on Slovenian long-term government bonds rose by around 150 basis points during the first eight months of the year. In September the required yield on 11-year government bond fluctuated around 6.6%, a premium of nearly 470 basis points over the German benchmark. The rise in the yield in March was primarily related to the resolution of the debt problems of Cyprus. After the situation had eased the required yield declined slightly, and stood at 5.8% prior to the issue of Slovenian government bonds at the end of April. During the bond issue Moody's unexpectedly downgraded Slovenia's long-term sovereign debt by two notches. The yield to maturity on the issued bonds (after a currency swap into euro) stood at 4.59% for the five-year and 5.45% for the ten-year bond, which is lower than estimated yield of euro denominated bonds. The required yield remained stable at 5.8% in May, despite the tightening of referendum legislation and the adoptionof the fiscal rule into the constitution. After the release of figures showing a further decline in GDP in the first quarter, the yield gradually rose in June and remained close to 6.5% in the absence of any major uncertainty on the financial markets in the summer. The persistently low liquidity of Slovenian bonds is hindering bond issues and is also one of the main factors behind the high required yield. Further fiscal consolidation and the implementation of the planned bank restructuring remain crucial for yield reduction.

The national debt is also increasing as a result of Slovenia's participation in assistance to euro area countries. Slovenia has participated in assistance to euro area countries via three aid mechanisms: the European Financial Stability Facility (EFSF), the European Stability Mechanism (ESM) and bilateral loans to Greece. The EFSF will eventually be replaced by the ESM, while the programme of bilateral loans to Greece concluded last year. The bilateral loans to Greece and the assistance via the EFSF is included in the debt of the creditor country. In the case of the ESM assistance, only the capital contributed to the fund is included in the debt. The

Figure 5.4: Public finance structural balance



Note: Structural balance estimate by the MoF reflects targeted dynamics, while the EC estimate only includes adopted measures.
Sources: EC, Ministry of Finance - Stability Programme, May 2013.

EFSF is currently providing financial assistance to Greece, Ireland and Portugal, while the ESM is currently assisting Spain and Cyprus. By the middle of this year Slovenia had paid 60% of its planned capital contribution of EUR 342 million into the ESM, with two instalment payments of EUR 68 million to follow this year and next year. Slovenia's assistance to euro area countries via all three mechanisms amounted to 3.8% of GDP at the end of June 2013, which was also the amount by which the general government debt increased for this reason.

Planned developments in the general government deficit

Slovenia's deficit this year will be excessive for the fifth consecutive year. Its reduction and elimination over the next two years is one of the priority tasks of economic policy. In June 2013 the European Council extended Slovenia's deadline for eliminating the excessive government deficit by two years to 2015. The extension is based on the finding that Slovenia took effective action between 2010 and 2013 to reduce the deficit, but there were unexpected economic developments with major adverse fiscal consequences. The European Council recommendation of June set the interim nominal deficit targets at 3.7% of GDP in 2013 (or 4.9% including one-off expenditure for recapitalisation of the two largest banks), 3.3% of GDP in 2014 and 2.5% of GDP in 2015. The improvement in the structural balance is thereby estimated at 0.7% of GDP in 2013 and 0.5% of GDP in 2014 and 2015.

The key measures in the gradual reduction of the deficit are planned in the budgets for 2014 and 2015, which are in the process of being adopted. The government is forecasting budget deficits of 2.9% of GDP in 2014 and 2.4% of GDP in 2015. On the revenue side, the introduction of a real estate tax is being prepared, as was announced in the May update of the Stability Programme. Changes in personal income tax, measures for more effective tax collection and action against the shadow economy are also planned. On the expenditure side, measures have been agreed to reduce wage expenditure in 2014, while the government is planning further reductions in employee compensation in 2015. The deindexation of pensions and social transfers and greater efficiency in the use of current funding are also envisaged. Under new European legislation, the European Commission will also give its opinion of the proposed amendments to the budget for 2014.

The medium-term objective remains balanced structural position, which is expected to be achieved gradually. In the May 2013 update of the Stability Programme, Slovenia planned a reduction of the deficit to below the reference value in 2014 and confirmed a balanced structural position as the medium-term objective.[20] According to these plans, the actual position and the structural position are forecast to be almost in balance by 2017, i.e. two years later than forecast in the previous update of the Stability Programme. Measures of a permanent nature are required for a sustained reduction of the deficit.

The reduction of the general government deficit and the stabilisation of the debt are being hindered by the worse-than-expected macroeconomic situation and the restructuring of the banking system. Further fiscal consolidation and the implementation of planned measures in connection with the resolution of banks' impaired assets are nevertheless vital to regaining investor confidence and keeping access to the financial markets. This year's decline in economic activity is proving larger than initially forecast, and is projected to continue into next year. The adverse economic situation is hindering the fiscal consolidation, which in return creates additional difficulties in the economic recovery in the short term. Consolidation is also being hindered by the high cost of government borrowing.

Despite the implementation of certain reforms, many challenges remain ahead in the area of structural reforms. The pension reform came into force at the beginning of this year, which has slightly improved the medium-term sustainability of the pension system by tightening certain parameters. Since pension expenditure is projected to increase again after 2020, the government has begun drawing up guidelines and calculations for coordination with the social partners in the preparation of further changes. The regulation of long-term care is again being forecast. Given the critical situation in the health sector, changes to legislation in this area are also being drafted.

[20] According to the European Commission's assessment (assessment of the 2013 national reform programme and stability programme for Slovenia, May 2013), the medium-term target set is not appropriate.

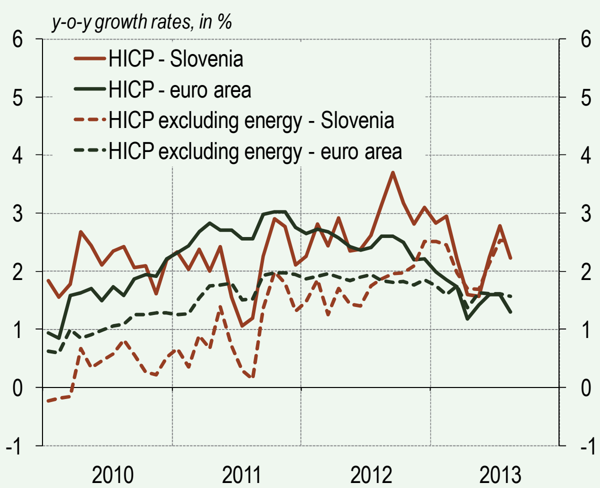
6 Inflation

Growth in the harmonised index of consumer prices in the first nine months of the year averaged 2.2%, 0.7 percentage points more than the euro area average. Inflation was down 0.5 percentage points in year-on-year terms. The main factors of the decrease were the absence of demand-side pressures as a result of the continuing decline in household disposable income, and lower cost pressures as a result of a fall in commodity prices on global markets. Year-on-year inflation thus declined during the first nine months of the year, despite the rise in seasonal food prices and the fiscal consolidation and administrative measures. After being very low in the first half of the year, core inflation rose slightly as the VAT rates were increased, but remains relatively low. The rise in VAT has only partly passed through into final consumer prices.

Structure of inflation

The structure of inflation in the first nine months of the year changed compared with the same period last year. The services prices contribution increased gradually as a result of price rises related to administrative changes and fiscal consolidation. The contribution of food prices also increased, and accounted for more than a half of headline inflation. By contrast, the contribution made to headline inflation by energy prices was lower than last year, as year-on-year growth in energy prices declined as a result of lower oil prices on global markets and a fall in the gas prices of some providers. In line with weak demand, prices of non-energy industrial goods and their contribution to headline inflation continued to decline in year-on-year terms. A major contrast to the developments in the euro area during the first nine months of the year was the increase in the contribution made to headline inflation by services prices, which in the euro area was down slightly compared to the same period last year. Another major difference in the structure of inflation was the contribution made by prices of industrial goods, which was negative in Slovenia but positive in the euro area.

Figure 6.1: Inflation

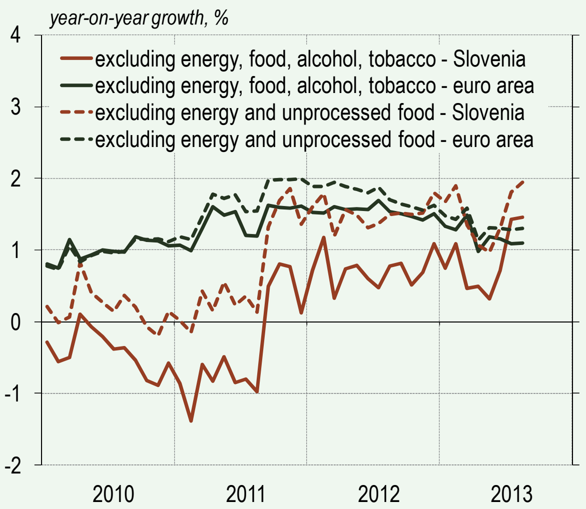


Sources: Eurostat, SORS, calculations Bank of Slovenia.

Macroeconomic factors and core inflation indicators

Core inflation remains relatively low, despite an increase caused by price rises related to fiscal consolidation. Core inflation as measured by the HICP excluding energy, food, alcohol and tobacco averaged 0.9% during the first nine months of the year, up 0.2 percentage points in year-on-year terms. It was low in the first half of the year, but rose by 0.7 percentage points to 1.4% in July as the VAT rates increased. The narrowest core inflation indicator slightly exceeded the euro area average, which averaged 1.2% during the first nine months of the year, down from 1.6% in the same period last year. In addition to the rise in VAT (see also Box 6.1), core inflation as measured by the narrowest indicator was affected also by other administrative price rises, most notably the introduction of the tax on financial services and the transfer of responsibility for setting prices of public utilities to local authorities. By contrast, prices of non-energy industrial goods, which depend more on the demand shocks, fell in year-on-year terms, reducing core inflation. The VAT rise also led to an increase in the other two core inflation indicators in July. Before the rise, the growth in the HICP excluding energy and unprocessed food has been declining slowly as the impact of excise duties on alcohol and tobacco started to drop out of the calculation. It averaged 1.5% over the first nine months of the year. The broadest core inflation indicator, the HICP

Figure 6.2: Core inflation



Sources: Eurostat, Bank of Slovenia calculations.

Table 6.1: Breakdown of the HICP and price indicators

	weight	average year-on-year growth, %					year-on-year growth in quarter, %					
	2013	2009	2010	2011	2012	1H13	2Q12	3Q12	4Q12	1Q13	2Q13	3Q13
HICP	*100.0%*	0.9	2.1	2.1	2.8	2.2	2.5	3.2	3.0	2.7	1.8	2.2
Breakdown of HICP:												
Energy	*14.4%*	-4.5	13.9	8.8	9.0	3.2	8.7	10.8	8.0	4.8	1.6	1.0
Food	*23.5%*	1.8	2.5	4.8	4.7	6.0	3.8	5.1	6.2	6.5	5.5	5.2
processed	*16.1%*	2.7	2.9	5.0	4.7	4.3	4.4	4.6	5.0	5.1	3.6	3.6
unprocessed	*7.4%*	0.0	1.7	4.3	4.5	9.5	2.1	6.1	8.5	9.5	9.6	8.6
Other goods	*27.9%*	0.0	-2.2	-0.9	-0.2	-1.1	0.2	0.2	-0.7	-0.5	-1.6	-0.8
Services	*34.3%*	3.2	1.2	0.0	1.5	2.0	1.1	1.1	2.0	1.8	2.3	2.9
Core inflation indicators												
HICP excl. energy	*85.6%*	1.7	0.3	1.0	1.8	2.1	1.5	1.9	2.2	2.3	1.8	2.4
HICP excl. energy and unprocessed food	*78.2%*	1.9	0.2	0.7	1.5	1.4	1.5	1.5	1.6	1.6	1.1	1.8
HICP excl. energy, food, alcohol and tobacco	*62.2%*	1.7	-0.4	-0.4	0.7	0.6	0.7	0.7	0.8	0.8	0.5	1.3
Other price indicators:												
Industrial producer prices on domestic market		-0.4	2.0	3.8	1.0	0.7	0.9	0.9	1.2	1.1	0.3	...
GDP deflator		3.3	-1.1	1.2	0.3	0.9	0.1	0.2	0.2	0.0	1.7	...
Import prices[1]		-4.5	6.5	5.6	2.2	-0.4	2.6	2.8	1.4	0.6	-1.4	...

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

excluding energy, recorded a higher average in the first half of the year than last year as a result of high growth in prices of unprocessed food. It averaged 2.2% over the first nine months of the year, 0.5 percentage points higher than the euro area average.

Core inflation remains subject to the absence of demand-side pressures, while supply-side pressures have also diminished as a result of lower commodity prices on international markets and the ongoing adjustment of labour costs in the private sector. Due to the decline in real wages, higher taxes and lower social transfers, real household disposable income has declined again this year. This, along with high levels of uncertainty, has reduced private consumption, particularly purchases of durables, although the latter recorded a sharp temporary increase in the months before the VAT rise. Lower demand is also in line with the continuing fall in the stock of consumer loans. Given the fall in labour costs and the year-on-year fall in input commodity prices, there were no pronounced price pressures on the supply side in the first nine months of the year.

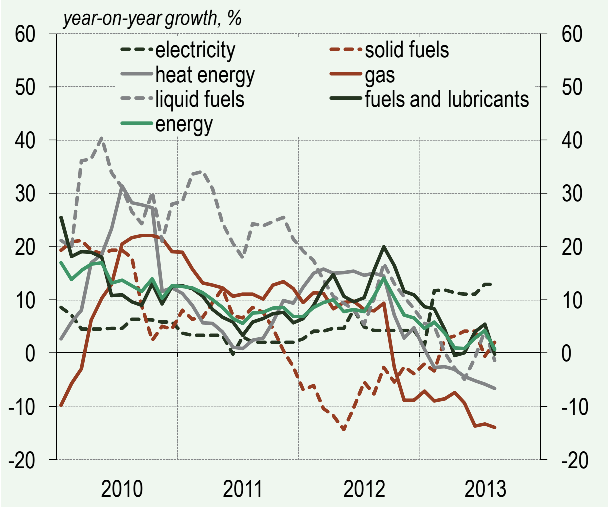
Microeconomic factors and the structure of inflation

Year-on-year growth in energy prices declined significantly in the first nine months of the year as a result of the year-on-year fall in US dollar oil prices, the movement in the euro exchange rate, and falls in gas prices. Electricity prices rose sharply. Year-on-year growth in energy prices averaged 2.5% over the first nine months of the year, down 6.8 percentage points in year-on-year terms, but 1.3 percentage points higher than the euro area average. The main factors in the lower growth in energy prices were the fall in gas prices due to the entry of a new supplier at the end of last year and the temporary price reductions by that supplier in the summer. Average gas prices over the first eight months of the year were down 10.3% in year-on-year terms, and was followed by a fall in district heating prices. A major factor

Figure 6.3: Energy prices

Sources: Eurostat, Bank of Slovenia calculations.

Figure 6.4: Individual energy price categories



Sources: Eurostat, Bank of Slovenia calculations.

in the lower growth in energy prices was the decline in year-on-year growth in prices of refined petroleum products as a result of a year-on-year fall in euro oil prices on global markets. Despite the carbon tax increase in January and the VAT rise in July, average prices of motor fuels were up by just 3.8% over the first eight months of the year, while heating oil prices were up 0.6%. The contribution of the excise duties to headline inflation in the first eight months of the year declined significantly. At the same time there was a significant rise of 10.6% in elec-

Box 6.1: Impact of the rise in VAT rates on inflation

In the May Stability Programme, the government announced a rise in VAT rates on 1 July 2013, with the standard VAT rate being raised from 20% to 22% and the reduced rate from 8.5% to 9.5%. This measure is forecast to have an overall impact of around EUR 250 million on general government revenues on an annual basis. In the event of a complete and immediate pass-through into prices, the VAT rise would contribute 1.2 percentage points to headline inflation.

In line with previous domestic and international experience, changes in VAT rates were not immediately and completely passed through into final consumer prices. This was especially unexpected at a time of low economic activity, as low domestic demand restricts retailers from raising prices. The impact of the rise in VAT on inflation is reflected in the difference between the actual change in prices and the change in prices that would probably have occurred without the rise in VAT.

According to our estimates, July's rise in VAT raised inflation as measured by the HICP by 0.8 percentage points, whereby a large part of the pass-through occurred in July, and a smaller part in August and September. The estimated impact of the rise indicates a pass-through into final consumer prices of around 70% for the whole basket of goods and 65% for the narrowest core inflation indicator. The size of the pass-through is in line with the middle scenario of April's alternative projections, where a rise of 2 percentage points in the standard VAT rate alone was taken into account (see MDAP April 2013, Box 7.1), and the estimated pass-through was 70%. The size of the pass-through is also in line with the experience of other countries, where it has usually been between 60% and 100%.

The total pass-through in the first month after the VAT rise was, as estimated by the Bank of Slovenia, at 0.6 percentage points which is about 50% of the total potential pass-through. The pass-through was the highest in energy prices and accounted for 0.2 percentage points of the rise in headline inflation. The pass-through in services prices contributed additional 0.2 percentage points to inflation, which was slightly above expectations. The pass-through was reflected particularly in prices of telephone and internet services and prices of package holidays. The pass-through of the rise in VAT into food prices contributed around 0.1 percentage points to headline inflation in July according to our estimates, and was moderate in the first month. The main rises were in prices of tobacco products and alcoholic beverages, which are price inelastic products and are the only food products subject to the standard VAT rate, and in prices of fruit. In line with the domestic demand situation, the pass-through into headline inflation was lower for non-energy industrial goods at approximately 0.1 percentage points.

The additional pass-through in August was estimated at 0.2 percentage points. The pass-through was most evident in

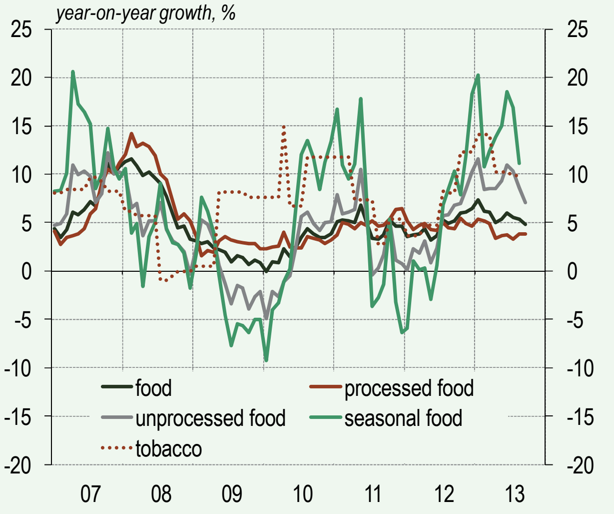
Table 1: Pass-through of the VAT increase in July 2013 into individual inflation groups

in percentage points for each group	July	August	September	Total	Pass-through
Consumer prices (HICP)	2.8	2.2	1.5		
food	0.40	0.31	0.06	0.77	69%
processed	0.48	0.24	0.09	0.81	68%
unprocessed	0.22	0.46	0.00	0.68	74%
energy	1.50	0.07	0.00	1.57	94%
other goods	0.39	0.12	0.10	0.61	41%
services	0.60	0.10	0.02	0.72	84%
HICP	0.62	0.15	0.04	0.82	70%
Core inflation indicators (HICP)					
excluding energy	0.48	0.16	0.06	0.70	66%
excluding energy and unprocessed food	0.50	0.14	0.06	0.70	65%
excluding energy, food, alc. and tobbaco	0.51	0.11	0.06	0.67	65%

Sources: SORS, Bank of Slovenia calculations.

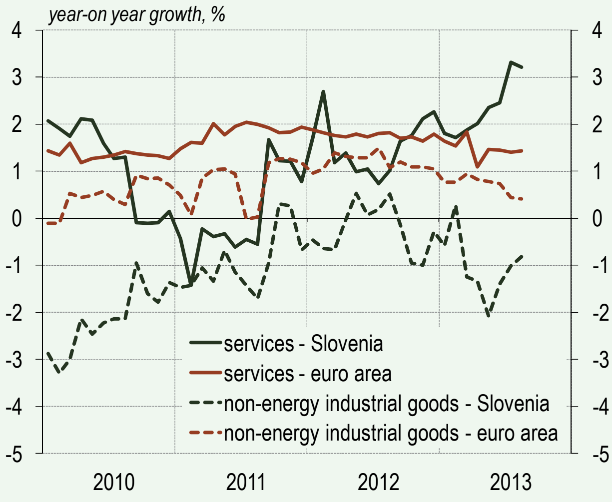
other energy prices, meat, certain processed food products and non-energy industrial goods. In line with the start of the new school year and the end of summer sales, the pass-through continued to a lesser extent also in September. It was primarily reflected in prices of certain industrial goods, processed food and services.

Figure 6.5: Food prices



Sources: Eurostat, Bank of Slovenia calculations.

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

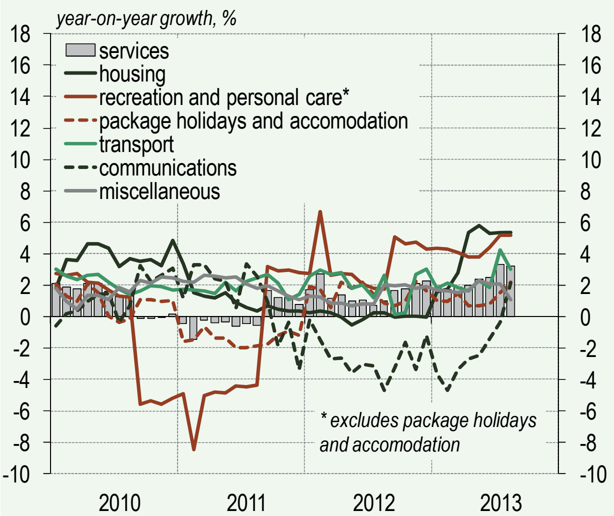


Sources: Eurostat, Bank of Slovenia calculations.

tricity prices, as a result of a rise in the charge for sustainable electricity production.

Year-on-year growth in food prices in the first nine months of this year remained high, primarily as a result of prices of fruit and vegetables. Growth in prices of processed food declined slightly, due to the impact of past rises in excise duties on tobacco and alcohol dropping out of the calculation. Growth in food prices averaged 5.7% over the first nine months of the year, up 1.5 percentage points in year-on-year terms, and 2.7 percentage points higher than the euro area average. The movements in prices of fruit and vegetables and the persistence of relatively high growth in meat prices led to high year-on-year growth in prices of unprocessed food. It averaged 9.3% over the first nine months of the year, up 6.0 percentage points in year-on-year terms, whereby prices of seasonal food rose by 14.3%. Growth in prices of processed food declined slightly to 4.1% on average over this period. This was a result of the aforementioned decline in the contribution of excise duties on alcohol and tobacco along with a decline in growth in prices of bread

Figure 6.7: Services prices

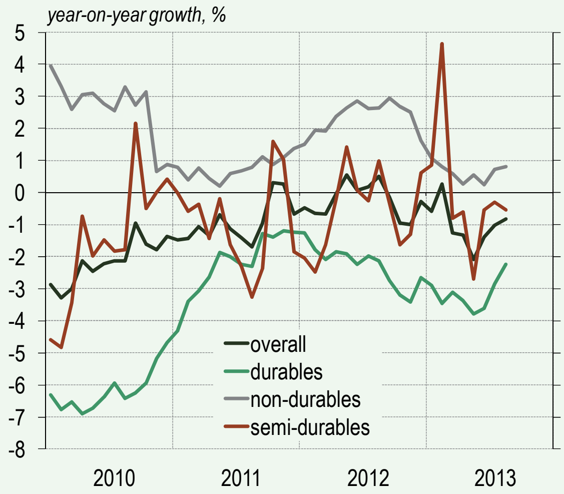


Sources: Eurostat, Bank of Slovenia calculations.

and cereal, milk, dairy products and eggs, and non-alcoholic beverages. The pass-through of the rise in VAT into final consumer prices was gradual and incomplete.

The main factors in the movement in services prices in the first nine months of the year were measures related to fiscal consolidation, and the transfer of the

Figure 6.8: Prices of non-energy industrial goods



Sources: Eurostat, Bank of Slovenia calculations.

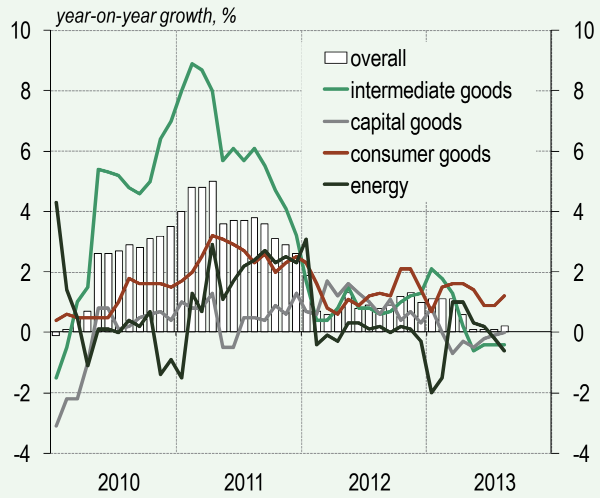
responsibility for setting prices of municipal services to local authorities. Year-on-year growth in services prices averaged 2.3% over the first nine months of the year, up 1 percentage point in year-on-year terms and 0.8 percentage points higher than in the euro area average. The impact of the price increases linked to the fiscal consolidation in the second half of last year, including the impact of the change in school meal subsidies, remained pronounced. This year, growth in services prices has risen as a result of the rise in VAT, rises in prices of municipal services and the introduction of a tax on financial services. Year-on-year growth in prices of municipal services averaged 6.2% over the first eight months of the year, up from 0.2% in the same period last year, while growth in prices of financial services increased from 0.1% to 3.7%. Year-on-year growth in prices of package holidays was also higher than in the same period last year. By contrast, growth in prices in restaurants and cafes was lower than last year. In addition, prices of accommodation services and cultural services fell, the latter as a result of a reduction in the RTV subscription fee. Prices of telephone and internet services were also falling in year-on-year terms until the rise in VAT. Growth in prices of other services remains very low, as a result of the decline in domestic demand.

Prices of non-energy industrial goods fell in year-on-year terms during the first nine months of the year, in line with declining consumer purchasing power. Prices fell by 1.0% year-on-year on average, 0.9 percentage points down on more than in the same period last year. The average year-on-year decrease in prices of cars and furniture during the first eight months of the year were larger than in the same period last year, at 4.2% and 2.7% respectively. Year-on-year growth in prices of clothing and footwear was positive and averaged 0.3% over the first eight months of the year, up 0.5 percentage points in year-on-year terms. Prices of clothing and footwear rose in year-on-year terms, after several years of negative growth, partly as a result of the rise in VAT. At the same time prices of sports equipment have risen this year after a sharp decrease last year, with the rate averaging 1.2% over the first eight months of the year. In contrast to Slovenia, a trend of weak but positive growth in prices of non-energy industrial goods has continued in the euro area average.

Industrial producer prices

Year-on-year growth in industrial producer prices on the domestic market remains very low. It averaged 0.5% over the first eight months of the year, down 0.4 percentage points in year-on-year terms. During this period, year-on-year growth in producer prices of consumer durables declined most, by 2.5 percentage points to 0.0%. In March these prices decreased in year-on-year terms for the first time so far. This was partly a result of lower year-on-year growth in prices in the manufacture of furniture, and a year-on-year fall in producer prices of computer, electronic and optical equipment. The latter and the year-on-year fall in prices in the manufacture of fabricated metal products had an impact on prices of capital goods, which have been falling in year-on-year terms since March. The year-on-year fall in prices in energy production averaged 0.2% over the first eight months of the year, primarily as a result of a fall in prices

Figure 6.9: Industrial producer prices on the domestic market



Sources: SORS, Bank of Slovenia calculations.

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

Sources: Eurostat, Bank of Slovenia calculations.

of electricity, gas and steam supply in the early part of the year and in the summer. Year-on-year growth in prices in the production of commodities has been declining since the beginning of the year, and turned negative in the middle of the year. The main factor in this was a more intensive year-on-year fall in producer prices of basic metals.

Only the producer prices of consumer non-durables recorded an increase in average year-on-year growth over the first eight months of the year, by 0.5 percentage points to 1.5%. This was primarily a result of higher growth in prices in the manufacture of food products in the early part of the year.

7 Projections of Economic Trends and Inflation 2013–2015[21]

This year's decline in economic activity will be similar to that in 2012, and growth will only return very gradually in 2015. Cumulative growth over the projection period has been revised downwards from the previous projections by almost 2 percentage points, of which more than 1 percentage point is in 2014. The downward revision is partly the consequence of weaker growth in foreign demand, but also the result of the realisation of risks identified in the April projections. The revisions are a reflection of major constraints in financing, additional fiscal consolidation measures, larger fall in employment, and high uncertainty in the economy. The latter will be reflected in lower investment, which will only recover at the end of the projection period. Household and government consumption are also projected to decline over the projection period. In the coming years, growth will therefore be based exclusively on exports, which will widen the current account surplus as imports fall. The current account surplus is to surpass 6% this year, and 7.5% of GDP by the end of the projection horizon. Inflation is projected to fall to 2.2% this year, and then to below 2% over the next two years due to falling energy prices and the impact of the VAT rise dropping out of the calculation.

The risks to the this year's GDP projections are balanced, but are on the downside for the coming years. In addition to the uncertainty surrounding the gradual recovery in the main trading partners, domestic risk factors have also intensified. These relate in particular to credible fiscal consolidation, the restructuring and recapitalisation of the banks, and deleveraging in certain sectors. Negative feedback between the banking sector and other sectors could become even more pronounced in the event of increased uncertainty surrounding the acquisition of foreign funding and any further possible downgradings of sovereign debt. Employment will also fall during the projection period, which could, in the event of an increase in structural unemployment, particularly among young educated population, reduce long-term potential growth.

The inflation risks remain mostly unchanged and balanced. The risks of higher inflation relate to additional austerity measures, price rises in sectors with limited competition, and rises in oil and other energy prices. By contrast, an even larger contraction in domestic demand and stronger cost adjustment in the economy could result in lower inflation than anticipated.

[21] *The projections were made on the basis of the applicable statistical methodologies and data available on 13 September 2013. The projections of macroeconomic factors presented in this report are based on assumptions of the movement in variables from the international environment and 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 (August 2013), the European Economic Forecast (European Commission, spring 2013), the OECD Economic Outlook (May 2013), and the IMF WEO update (July 2013). The assumptions used in the projections are not the same as those used by the ESCB in its projections. For the relationship between the Bank of Slovenia projections and those of the ESCB, see the appendix in the April 2008 Price Stability Report.*

International environment and external assumptions

The outlook for growth in the most important trading partners has deteriorated slightly since the last projections, and faster growth is being limited above all by the adverse situation on the labour market. Foreign institutions have decreased their economic growth forecasts for the projection period for Slovenia's most important trading partners in the euro area and outside, most notably Russia. The reduction is largely the result of weaker performance in the first quarter of this year, as growth in the second quarter was more encouraging and in line with the increase in confidence indicators. Foreign demand is assumed to increase by an average of just 1.3% in 2013, and its growth over the remainder of the projection horizon will not approach the long-term average. Foreign demand is assumed to increase by 2.5% in 2014, despite weaker growth in the euro area. Domestic demand in particular will be weak in the euro area, as it will be constrained by high unemployment, while demand from other countries will also be only modest.

The assumptions for the US dollar prices of oil and other commodities have been revised slightly downwards from the previous projections over the entire projection horizon. This will be the result of slower global economic growth and the anticipated gradual easing of the geopolitical situation in the Middle East. The price of Brent crude is assumed to average USD 110 per barrel in 2013, and to remain at this level until the end of the projection period. Euro oil prices are assumed to fall by around 5% this year. Prices of other commodities also fell in the first half of the year, and are forecast to fall by more than 5% this year, before rising at an increasing rate in line with the expected gradual recovery in the global economy.

Inflation in the euro area will be low during the projection period at less than 2%. The main factors behind this will be lower energy prices and the anticipated milder fiscal consolidation measures on the revenue side in the peripheral countries. The adverse situation on the labour market and the ongoing weak domestic demand indicate that pressures on core inflation will be limited. Low growth in input costs suggest that growth in producer prices in Germany is assumed to increase only very gradually, and will remain below its long-term average even at the end of the projection period.

GDP growth

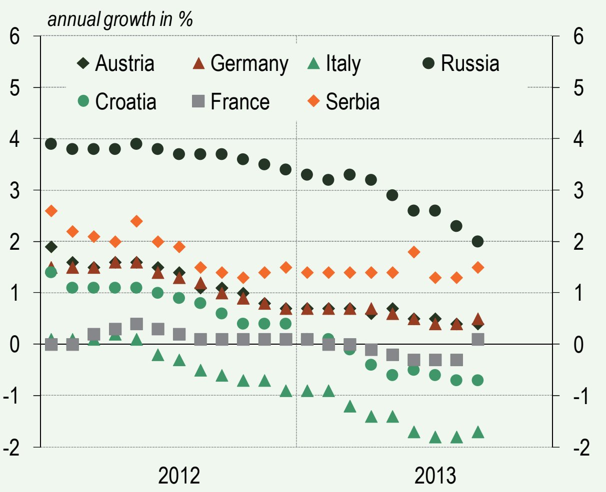
This year's decline in GDP is projected to be comparable to that in 2012, while activity is expected to decline further by 0.7% in 2014. A gradual economic recovery is expected only in 2015, when GDP is projected to increase by 1.4%. The downward revisions in

Table 7.1: Assumptions for the international environment

						Assumptions					
						2013		2014		2015	
	2008	2009	2010	2011	2012	**Oct.**	**Δ**	**Oct.**	**Δ**	**Oct.**	**Δ**
	annual average growth (%) if not stated otherwise										
Foreign demand*	3.8	-14.3	11.8	8.0	1.9	**1.3**	-0.3	**2.5**	-0.7	**3.8**	-0.7
Oil (USD/barrel)	98	62	80	111	112	**110**	-5	**110**	-5	**110**	-5
Non-oil commodities	10.1	-23.0	37.1	17.9	-7.2	**-5.4**	-6.6	**-0.6**	-2.6	**2.0**	-3.0
EMU inflation	3.3	0.3	1.6	2.7	2.5	**1.5**	-0.3	**1.3**	-0.5	**1.4**	-0.6
PPI Germany	5.4	-4.0	1.5	5.6	2.1	**0.7**	-1.0	**1.6**	-0.8	**1.6**	-0.6

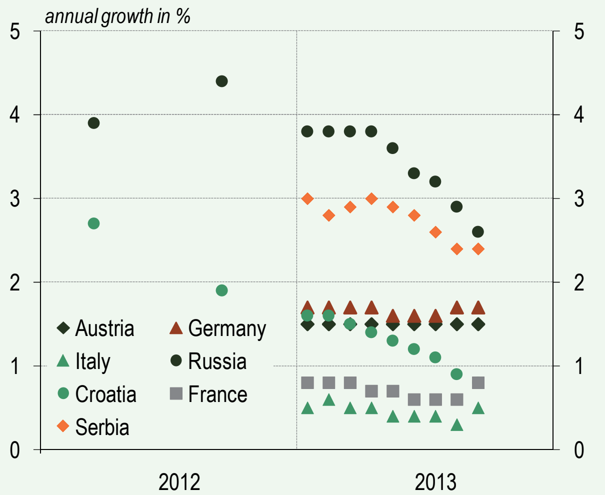
*Note: * Volume of imports from the basket of foreign partners.*
Δ: Difference between current projections and projections in April 2013 Price Stability Report.
Sources: Bank of Slovenia, Eurostat, Consensus Economics, ECB, JP Morgan, OECD Outlook.

Figure 7.1: Projections of GDP growth in Slovenia's main trading partners for the year 2013



Source: Consensus Economics.

Figure 7.2: Projections of GDP growth in Slovenia's main trading partners for the year 2014

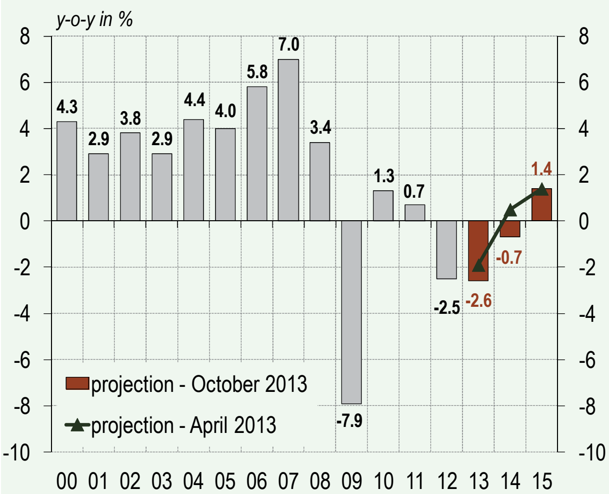


Source: Consensus Economics.

Figure 7.3: Commodity prices

Sources: ECB, Bloomberg, Bank of Slovenia assumptions.

Figure 7.4: GDP growth projection



Sources: SORS, projection Bank of Slovenia.

growth from the previous projections amount to 0.7 percentage points for this year and 1.2 percentage points for 2014. Alongside the lower assumption for foreign demand, a further deterioration in the domestic environment is projected. The situation on the labour market deteriorated, while additional fiscal consolidation measures have further reduced disposable income and household confidence. The majority of the economic sentiment indicators do not suggest a stronger deterioration in the economic situation in the third quarter, but fall in GDP could be stronger in the fourth quarter due to additional fiscal consolidation measures. The Slovenian economy is one of the few in the euro area forecast to remain in recession in 2014, while activity in 2015 will be around 10% lower than its pre-crisis level.

Aggregate demand

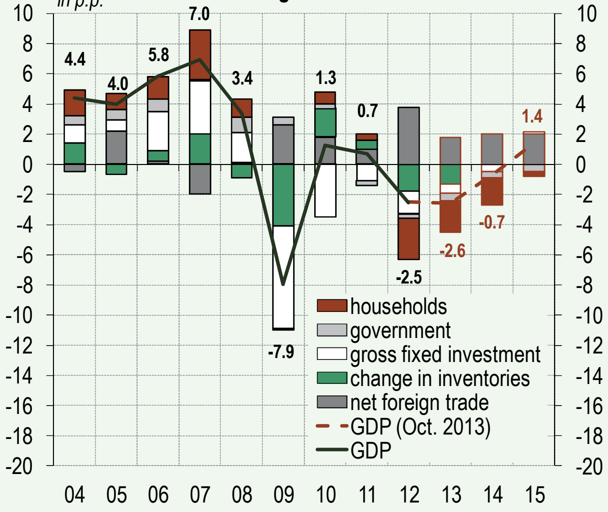
Domestic demand will contract throughout the projection horizon, and a particularly large decline in

household consumption and investment is projected for this year and next year. The decline in household disposable income as a result of the adverse situation on the labour market and fiscal consolidation, the persistently high level of uncertainty and the temporary slight rise in inflation will sharply reduce household final consumption. It is projected to decline by 3.8% this year, and by a further 3.3% in 2014 and 0.6% in 2015.

Government consumption will pursue the requisite fiscal consolidation. The projections for government consumption are taken from the revised budget for 2013 and the May update of the Stability Programme. Average nominal wages in the public sector are assumed to decline this year and next year, but to remain more or less unchanged in 2015. Employment and spending on intermediate consumption in the public sector will gradually decline at the same time. Government consumption will be down 2.5% this year, and by a further 1.8% in 2014 and 2.0% in 2015.

Investment will decline this year and next year, and is projected to return to gradual growth only in 2015. Construction investment will continue to decline as a result of stocks of unsold dwellings, lower household disposable income, and the constraints on financing and demand at construction firms, despite a slight improvement in survey indicators in recent months. High corporate indebtedness in this sector and the risks surrounding returns of some construction projects suggest that the banks will exercise caution. A factor that could bring

Figure 7.5: Projection of expenditure contributions to GDP growth rate



Sources: SORS, projection Bank of Slovenia.

growth in certain areas, most notably infrastructure and energy improvements to buildings, is the planned increase in disbursements of EU funds. Investment in machinery and equipment will remain limited because of low capacity utilisation, weaker financing conditions and the muted growth outlook in the most important trading partners. The sole positive contribution to investment this year and probably next year will come from increased investment in the energy sector, which has large import content.

Net exports will be the sole engine of growth in the projection horizon, even though export growth will be relatively weak. The downward revision in the projection for import and export growth reflects lower assumption for

Table 7.2: Domestic demand components

						Projection					
						2013		2014		2015	
	2008	2009	2010	2011	2012	**Oct.**	Δ	**Oct.**	Δ	**Oct.**	Δ
	real growth rates in %										
Domestic demand	3.2	-10.3	-0.5	-0.3	-6.4	**-4.8**	-1.1	**-3.0**	-2.4	**-0.7**	-1.1
Private consumption	2.4	-0.2	1.5	0.8	-4.8	**-3.8**	-0.7	**-3.3**	-2.1	**-0.6**	-0.8
Government spending	5.9	2.5	1.3	-1.6	-1.3	**-2.5**	-0.2	**-1.8**	-1.3	**-2.0**	-1.6
Gross fixed capital formation	7.1	-23.8	-15.3	-5.5	-8.2	**-3.3**	1.6	**-2.7**	0.3	**0.8**	-0.8

Δ: Difference between current projections and projections in Macroeconomic Developments and Projections, April 2013.
Sources: SORS, Bank of Slovenia.

growth in foreign demand and the further decline in domestic demand. Compared with the previous projections, import growth is cumulatively down almost 5 percentage points in 2014 and 2015, while export growth is down 1.6 percentage points. The gap between growth in imports and exports will slowly close, which is consistent with a gradual decline in the negative contribution from domestic demand. Weak domestic demand and thus imports will be the main factors in the strongly positive contribution to GDP growth made by net export throughout the projection period.

Supply side

The recovery will be very limited in all sectors. Export -oriented sectors are subject to deteriorating trends in the international environment, while domestic-oriented sectors are subject to declining domestic demand. The situation in the tradable sector deteriorated again. Given the recession in the euro area, exporters refocused on other markets, where the growth forecasts were lowered, while the forecasts for economic growth in the most important euro area trading partners have also deteriorated since the last projections. This is worsening the outlook for growth in the manufacturing sector, and in numerous private sector services, which given the crisis on the domestic market are increasingly focusing on the rest of the world. The overall uncertainty in the economy and the constraints on financing also remain at elevated levels. In line with the growth in foreign demand, the contribution to GDP made by export-oriented sectors is projected to increase over the projection period, but growth will remain low. Indicators that reflect the situation in sectors primarily dependent on the domestic market have also failed to improve or have only shown a temporary improvement. The indicator of insufficient demand in the wholesale and retail trade sector and the indicator of financing constraints in services also deteriorated further. The confidence indicators, the number of building permits issued and the value of new contracts suggest a stabilisation in the construction sector, but the upturn is likely to be very gradual. For this reason these sectors will continue to contract this year, and their recovery will be very limited for the remainder of the projection period. Value-added in the financial sector will also decline further.

Labour market

The unemployment rate is expected to increase throughout the projection period. As a result of lower growth in foreign demand, a further decline in domestic demand, and restructuring in the direction of less labour-intensive production, manufacturing will not be a factor in reducing unemployment. The outlook for employment in services also remains poor. Private sector services will face a decline in domestic demand throughout the projection horizon, which will have a negative impact on hiring, while employment in public services will be reduced by consolidation measures. The fall in employment in the construction sector will slow, but the absence of major construction investment and over-leveraging suggest that the structure will continue to shift towards small firms. As a result of the contraction in activity in sectors with low value-added, structural unemployment is to increase further, and the lack of jobs for young people with tertiary qualifications will play an increasing role in this respect. Given the projected consolidation measures, employment will fall cumulatively by almost 4% in the public sector, and by more than 5% in the private sector over the projection period. The ILO unemployment rate will thus rise to more than 13%.

Wages in the public sector are projected to decline further, while wage growth in the private sector will remain low. Average wages in the public sector are forecast to decline by just over 3% this year. The decline is primarily the result of a pass-through from consolidation measures in 2012, when wage bonuses were cut while wages underwent a linear reduction. Next year wages in the public sector are forecast to fall by a further 1.3% under agreements to defer promotions, reduce wages

Table 7.3: Activity, employment and wages

						Projection					
						2013		2014		2015	
	2008	2009	2010	2011	2012	**Oct.**	Δ	**Oct.**	Δ	**Oct.**	Δ
	growth rates, %										
GDP (real)	3.4	-7.9	1.3	0.7	-2.5	**-2.6**	-0.7	**-0.7**	-1.2	**1.4**	0.0
Employment	2.6	-1.8	-2.2	-1.6	-0.8	**-2.6**	-0.2	**-2.4**	-1.5	**-0.4**	-0.3
Compensation per employee	7.2	1.8	3.9	1.6	-1.0	**-0.7**	-0.2	**-0.3**	-0.9	**0.3**	-0.3
Productivity	0.8	-6.2	3.5	2.4	-1.7	**0.0**	-0.5	**1.8**	0.4	**1.7**	0.2
ULC (nominal)	6.4	8.6	0.4	-0.7	0.8	**-0.7**	0.3	**-2.0**	-1.2	**-1.4**	-0.6
Contribution to GDP growth	*percentage points*										
Domestic demand, excluding changes in inventories	4.1	-6.4	-2.4	-0.9	-4.5	**-3.2**	-0.2	**-2.7**	-1.4	**-0.6**	-0.9
Net exports	0.1	2.6	1.8	1.0	3.8	**1.8**	0.3	**2.0**	0.9	**2.0**	1.0
Changes in inventories	-0.9	-4.1	1.9	0.6	-1.8	**-1.3**	-0.8	**0.0**	-0.8	**0.0**	0.0

Δ: Difference between current projections and projections in Macroeconomic Developments and Projections, April 2013.
Sources: SORS, Bank of Slovenia.

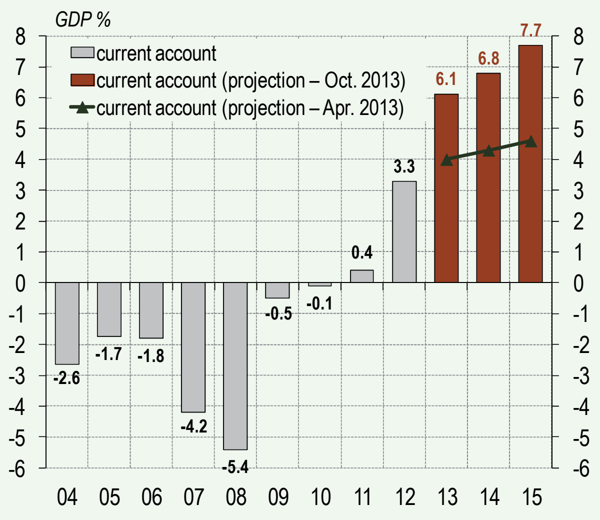
and temporarily compress the wage scale. Average wages in the public sector are forecast to remain unchanged in 2015 as the macroeconomic situation remains unfavourable, while wage growth will also be limited by the requirements to reduce the budget deficit in accordance with the commitments of the Stability Programme. In the absence of agreements between unions and employers, slow nominal wage growth is projected in the private sector, which will be significantly lower than the projected inflation.

Foreign trade

The current account surplus will widen more rapidly over the projection horizon than was projected in the previous projections, primarily as a result of lower domestic demand. The surplus will widen from 3.3% of GDP last year to approximately 6% of GDP this year. The current account surplus will widen to almost 7% of GDP in 2014 and to more than 7.5% of GDP in 2015 as a result of a further contraction in domestic demand and gradual pick up in exports. Negative terms of trade will prevent an even larger increase in the surplus in the next two year.

The largest factor in the widening of the current account surplus will be merchandise trade, while the balance of trade in services will remain unchanged and the deficit in factor income is projected to increase. The surplus of trade in merchandise and services is forecast to reach 6.9% of GDP this year and to widen to around 9% by 2015. The merchandise trade surplus will widen from 1.2% of GDP this year to around 3.0% of GDP in 2015, while the surplus of trade in services will remain around 6% of GDP for the remainder of the pro-

Figure 7.6: Current account projection



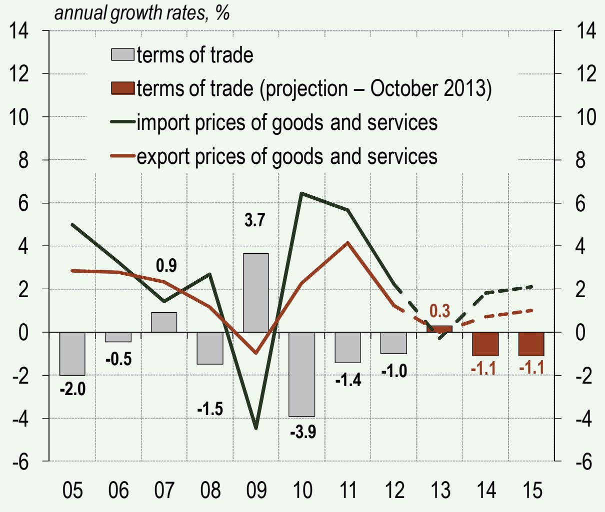
Sources: SORS, projection Bank of Slovenia.

Table 7.4: Current account

	2008	2009	2010	2011	2012	Projection 2013 Oct.	2013 Δ	2014 Oct.	2014 Δ	2015 Oct.	2015 Δ
Exports of goods and services	4.0	-16.1	10.2	7.0	0.6	**1.3**	0.9	**2.1**	-0.5	**3.4**	-1.1
Imports of goods and services	3.7	-19.2	7.4	5.6	-4.7	**-1.1**	0.6	**-0.6**	-2.1	**1.1**	-2.7
Current account: EUR billion	-2.0	-0.2	0.0	0.1	1.2	**2.1**	0.7	**2.4**	0.9	**2.7**	1.1
as % GDP	-5.4	-0.5	-0.1	0.4	3.3	**6.1**	2.1	**6.8**	2.5	**7.7**	3.1
Terms of trade*	-1.5	3.7	-3.9	-1.4	-1.0	**0.3**	0.9	**-1.1**	-0.1	**-1.1**	-0.1

*Note: * Based on national accounts deflators.*
Δ: Difference between current projections and projections in Macroeconomic Developments and Projections, April 2013.
Sources: SORS, Bank of Slovenia.

Figure 7.7: Terms of trade projections



Sources: SORS, Bank of Slovenia projections.

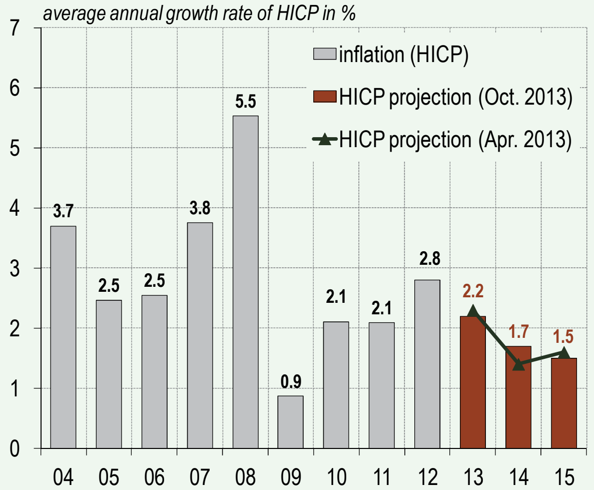
jection period. The deficit in factor income will widen to 1.6% of GDP, primarily as a result of growth in interest payments, while the surplus in transfers is forecast to be negligible.

Inflation

Average inflation will again exceed 2% this year, but is forecast to fall in 2014 and 2015. The current inflation projection does not differ significantly from the previous projections, although with a slightly higher forecast for 2014 and partial revision of the structure. Inflation as measured by the HICP is projected at 2.2% this year, and is then projected to fall to 1.7% in 2014 and 1.5% in 2015. The effect of external factors is expected to diminish over the projection period in line with expected decreases in commodity prices on global markets. On the domestic market, inflation will remain curbed by weak domestic demand, while additional consolidation measures on the revenue side of the budget will act in the opposite direction.

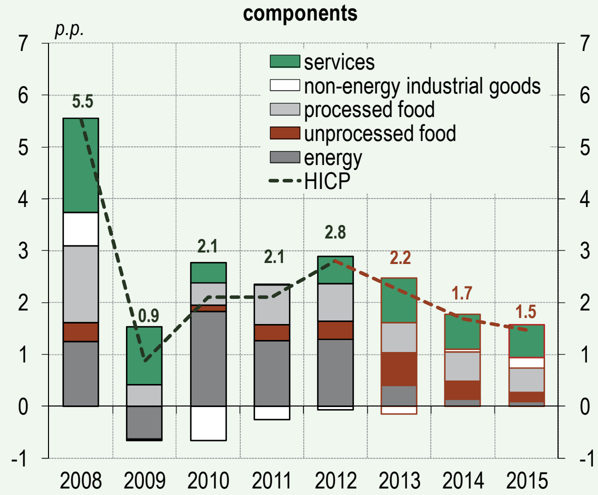
In the structure of inflation, the contributions of food and services prices are expected to be markedly high, while the contribution made by energy prices is forecast to be lower this year. Higher food prices will account for more than half of inflation this year, with their contribution projected to decline slightly till the end of the projection period. This development is in line with the projected growth in food prices on global markets and changes in duties already implemented. Average growth in food prices is forecast at 5.3% this year, and at around 3.9% and 2.7% in the next two years. Year-on-year growth in services prices is forecast to be higher than in the previous projections, primarily as a result of this year's rise in VAT, the impact of which will pass through into 2014 before gradually dropping out of the inflation calculation. Year-on-year growth in services prices is projected at 2.5% this year, and will then slow to 2.0% in 2014 and 1.8% in 2015. Growth in energy prices will be

Figure 7.8: Inflation projection



Sources: SORS, projection Bank of Slovenia.

Figure 7.9: Projections of contributions to inflation by components



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

slower compared to the April projections due to the year-on-year fall in oil prices on global markets in the first nine months of this year, and cuts in natural gas prices by some Slovenian providers in the summer months. Energy prices are forecast to rise by 2.6% this year. Growth is then projected to decline, reaching 0.6% by the end of the projection period. Prices of non-energy industrial goods will decrease this year by more than previously projected, while the decrease is expected to moderate in 2014.

Despite a rise in duties, core inflation will remain low as a result of weak domestic consumption. Given the need for fiscal consolidation, the government has adopted a number of measures that are raising core inflation, particularly in the category of services prices. At the same time, the adverse situation on the labour market is reducing real household disposable income. Additionally, no major pressures from commodity prices that could primarily affect non-energy industrial goods prices are expected. Core inflation is accordingly projected to remain low. Average growth in the HICP excluding energy,

Table 7.5: Inflation

						Projection					
						2013		2014		2015	
	2008	2009	2010	2011	2012	**Oct.**	Δ	**Oct.**	Δ	**Oct.**	Δ
						average annual growth, %					
Consumer prices (HICP)	5.5	0.9	2.1	2.1	2.8	**2.2**	-0.1	**1.7**	0.3	**1.5**	-0.1
food	8.1	1.8	2.5	4.8	4.7	**5.3**	1.0	**3.9**	1.0	**2.7**	-0.4
energy	9.4	-4.5	13.9	8.8	9.0	**2.6**	-1.7	**0.9**	0.0	**0.6**	-0.2
other goods	2.2	0.0	-2.2	-0.9	-0.2	**-0.8**	-0.8	**-0.1**	-0.4	**0.5**	0.0
services	5.3	3.2	1.2	0.0	1.5	**2.5**	0.4	**2.0**	0.4	**1.8**	0.1
Core inflation indicators (HICP)											
excluding energy	4.9	1.7	0.3	1.0	1.8	**2.2**	0.2	**1.8**	0.3	**1.6**	-0.1
excl. energy and unprocessed food	5.0	1.9	0.2	0.7	1.5	**1.6**	-0.1	**1.6**	0.2	**1.6**	-0.1
excl. energy, food, alcohol and tobacco	3.8	1.7	-0.4	-0.4	0.7	**1.0**	-0.1	**1.1**	-0.1	**1.2**	0.0

Δ: Difference between current projections and projections in Macroeconomic Developments and Projections, April 2013.
Sources: SORS, Bank of Slovenia.

food, alcohol and tobacco is projected at 1.0% this year, and will remain at that level until the end of the projection period.

The overall direct impact of government measures on inflation has been high this year. July's VAT rise will contribute approximately 0.4 percentage points to average inflation this year and in 2014. January's rise in excise duties on tobacco and the pass-through of last year's rises in excise duties on tobacco will contribute 0.3 percentage points to inflation this year. Should the government leave excise duties on refined petroleum products unchanged for the remainder of this year, their contribution to inflation will amount to 0.1 percentage points as a result of the pass-through from last year. The introduction of the tax on financial services in March, coupled with a pass-through of the last year's introduction of the carbon tax and its increase in January will together contribute 0.2 percentage points to inflation. The total contribution of duties to this year's inflation rate is thus projected at 1.1 percentage points. Government measures are projected to contribute around 0.4 percentage points to inflation in 2014.

The available indicators of monetary developments, labour costs and inflation expectations for Slovenia suggest that no major price pressures can be expected in the medium term. The stock of loans to households at the end of the first half of the year was down 2.6% in year-on-year terms, primarily as a result of a decline in consumer loans. Loans will not lead to any major changes in domestic demand over the projection period. There can also be no expectation of cost pressures on prices, as unit labour costs will continue to fall. This situation is curbing inflation in the medium term. The September Consensus projections of average annual inflation in Slovenia stand between 2.0% and 2.3% for the 2012 to 2016 period.

Risks and uncertainties

The risks to GDP developments are balanced this year, and are very much on the downside in the years ahead. The risks are increasingly related to the implementation of the commitments to consolidate the budget and to the projected costs and progress of the restructuring of the banking system. The European Commission's autumn assessment of the speed and the scope of the implementation of consolidation measures will have a significant impact on Slovenia's international credibility at the time when it will have to return to the international financial markets for funding. The high spreads are also having a profoundly adverse impact on the financing of the private sector and the banks, and in the event of further sovereign downgradings the financing conditions for all sectors will deteriorate

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			
		2013		2014		2013		2014		2013		2014	
		new	Δ	**new**	Δ	**new**	Δ	**new**	Δ	**new**	Δ	**new**	Δ
Bank of Slovenia	Oct. 13/Apr. 13	**-2.6**	-0.7	**-0.7**	-1.2	**2.2**	-0.1	**1.7**	0.3	**6.1**	2.1	**6.8**	2.5
IMAD	Sep. 13/Aug. 13	**-2.4**	0.0	**-0.8**	-0.6	**2.0**	0.1	**1.9**	0.2	**5.0**	0.8	**5.0**	0.8
Consensus Forecasts	Sep. 13/Aug. 13	**-2.4**	0.0	**0.0**	0.0	**2.2**	0.0	**2.0**	0.1	**…**	…	**…**	…
European Commission	May 13/Feb. 13	**-2.0**	0.0	**-0.1**	-0.8	**2.2**	0.0	**1.4**	-0.1	**4.8**	1.0	**4.7**	1.4
OECD	May 13/Nov. 12	**-2.3**	-0.2	**0.1**	-1.0	**2.1**	-0.2	**1.2**	-0.6	**4.1**	-1.0	**4.8**	-1.6
IMF	Apr. 13/Oct. 12	**-2.0**	-1.6	**1.5**	-0.2	**1.8**	0.3	**1.9**	0.0	**2.7**	1.7	**2.5**	1.6

Δ: Difference between the current and the previous forecast.
Sources: Bank of Slovenia, IMAD, European Commission, Consensus Economic Forecasts, OECD.

further. Given the relatively high indebtedness of certain parts of the economy, this would have negative feedback on the possibility of recovery, and would further exacerbate corporate business conditions. This would again increase the need for bank recapitalisation and would have an adverse impact on the general government debt and deficit.

Foreign demand remains one of the main risks in the recovery of the Slovenian economy. The projected recovery in the key euro area trading partners will remain relatively weak until 2015, while growth in emerging economies also slowed in the early part of this year. Risks related to the ongoing sovereign debt crisis in the euro area periphery countries remain present, although they diminished slightly in the second quarter and early part of the third quarter. Growth in markets where Slovenian exporters refocused in light of the euro area crisis could also slow further.

The risk of a loss of human capital because of permanently high unemployment is strongly increasing. Unemployment is projected to rise further during the projection period, and could remain high even when the economic situation gradually improves. Most problematic is structural unemployment, as it leads to losses of human capital and can become a long-lasting social problem.

The inflationary risks are balanced in the projection period. Higher energy prices, further rises in indirect taxes for budget consolidation purposes, price rises in sectors with limited competition (e.g. municipal services, district heating, public transport, electricity companies) and a fall in the euro could all lead to higher-than-forecast inflation. An even sharper contraction in economic activity could lead to lower inflation. Lower economic activity would worsen the situation on the labour market and would curb labour costs and price pressures from the supply side, which would reduce the possibility of input costs passing through into inflation.