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EUROSYSTEM

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Abbreviations used in the Price Stability Report

AJPES	Agency of the Republic of Slovenia for Public Legal Records and Related Services
bps	basis points
BRIC	Brazil, Russia, India and China
CNY	Chinese yuan renminbi
CPI	consumer price index
DF	deposit facility at the ECB
EA	euro area
ECB	European Central Bank
EFSF	European Financial Stability Facility
EIB	European Investment Bank
EMU	Economic and Monetary Union
Eonia	Euro OverNight Index Average
ESA 95	European System of Accounts (1995)
ESCB	European System of Central Banks
ESM	European Stability Mechanism
EU	European Union
EUR	euro
Euribor	Euro Interbank Offered Rate
Eurostat	Statistical Office of the European Communities
Fed	Federal Reserve
FRED	Federal Reserve Economic Data
GBP	pound sterling
GDP	gross domestic product
H	half of the year
HICP	harmonised index of consumer prices
hl	hectolitre
HRK	Croatian kuna
HSE	Holding Slovenske elektrarne
HUF	Hungarian forint
IMAD	Institute of Macroeconomic Analysis and Development of the Republic of Slovenia
IMF	International Monetary Fund
JPY	Japanese yen
LNRs	liabilities to non-euro-area residents denominated in euros
LTRO	longer-term refinancing operation
MFIs	monetary financial institutions
MIP	Macroeconomic Imbalance Procedure
MLF	marginal lending facility at the ECB
MRO	main refinancing operation
NACE	standard classification of economic activities
NFCs	non-financial corporations
NLB	Nova Ljubljanska banka d.d.
NPISH	non-profit institutions serving households
OECD	Organisation for Economic Cooperation and Development
p.p.	percentage points
PMI	purchasing managers' index

PPI	producer price index
Q	quarter
SMP	Securities Market Programme
SORS	Statistical Office of the Republic of Slovenia
TEŠ	Šoštanj Power Station
TRY	Turkish lira
ULC	unit labour costs
US	United States of America
USD	US dollar
WEO	World Economic Outlook
ZUJF	Fiscal Balance Act

Executive Summary

The decline in economic growth in the euro area and the worsened expectations for next year have significantly reduced growth in Slovenia's exports. At the same time, the government has gradually been losing credibility on the international financial markets since the middle of 2011, as a result of which it is increasingly difficult to obtain foreign financing. There can therefore be no further delay in fiscal consolidation and reforms to ensure the long-term sustainability of the public finances. In the short term, this will further depress demand, which has already been declining as a result of low confidence and high uncertainty, a decline in consumer purchasing power, and balance sheet adjustments of banks and corporates. Under these conditions, economic activity is expected to decline by almost 2% this year, and growth is not expected to resume until 2014. Although the deterioration in the economic situation is significantly smaller than in the first wave of the crisis, unemployment will rise further. By contrast, the baseline scenario of the projections envisages a significant improvement in certain key macroeconomic imbalances: a narrowing of the general government deficit from 6.4% of GDP last year to 1.5% in 2014, and an increase in the current account surplus to around 4% of GDP. In the second half of 2012, inflation has risen due to certain one-off effects and a rise in energy and food prices, while core inflation has remained low as a result of the decline in domestic consumption. Inflation is expected to fall to around 2%, partly as a result of the worsening macroeconomic situation.

* * *

In the first half of the year, global economic growth declined, inflationary pressures eased, while the uncertainty surrounding the fiscal position in certain euro area countries increased. In recent months, the economic outlook for 2013 has also deteriorated for the euro area in particular, as unemployment remains high and the confidence indicators remain unfavourable. The majority of central banks in the developed economies have therefore continued to pursue a stimulative monetary policy via low interest rates and the introduction of additional non-standard measures. In the summer, oil and food prices rose significantly again, which increased price pressures in the euro area in particular due to the depreciation of the euro.

In the second quarter of this year, economic situation in Slovenia deteriorated sharply. Final household consumption fell in the first half of the year as a result of a rapid decline in the real wage bill and social transfers, and a decline in confidence as the fiscal consolidation measures were announced. The latter also accelerated the decline in final government consumption. In an environment of weak demand and difficult access to financing, investment in capital expenditure and in inventories is continuing to decline. The value-added indicators reveal that the adverse developments have spread to all segments of the private sector; only in industry did quarterly growth remain positive, albeit low, in line with exports. The economic situation accelerated the fall in employment, while the number of vacancies also fell significantly. The almost unchanged registered unemployment rate is a reflection of increased outflows into inactivity, and of certain administrative measures. In June, the entry into force of the Fiscal Balance Act brought a decline in public sector wages. Real wages in the private sector are also declining, influenced by adverse developments on the labour market.

Having recorded a balanced position in 2011, the current account of the balance of payments recorded a surplus of 0.8% of GDP in the first seven months of this year. Due to falling domestic demand, real growth in imports of goods and services has been significantly outpaced by export growth since the second half of last year. Non-EU countries account for an increasing proportion of exports. With current transfers recording a balanced position, it is the deficit in factor income that is curbing an *increase in the current account surplus. The harmonised indicators suggest a gradual improvement in competitiveness, primarily as a result of the depreciation of the euro.*

In the first half of the year, the continuing decline in investment, partly as a result of deleveraging of corporates, and the increasingly significant limiting factors on the loan supply side brought a decline in the stock of corporate loans. Corporates partly replaced the decline in domestic financing with foreign resources, primarily FDI, while the export-oriented sectors also made use of loans from the rest of the world. In the first half of the year, growth in loans to households also declined significantly. The stock of loans to households has even declined in recent months, most notably consumer loans. The restructuring of bank funding proceeded in the direction of an increase of the deposits of households and OFIs and an increase in ECB funding. Borrowing at foreign banks, funding via debt securities and government deposits have been declining.

During the first nine months of the year, year-on-year inflation averaged 2.7%, higher than the euro area average, but there were differences in its structure. In the last two years, growth in energy and food prices in Slovenia has outpaced the corresponding growth in the euro area, but growth in prices of services and non-energy industrial goods has been much lower. Core inflation in Slovenia has thus been lower than the euro area average for three years now. Low core inflation is a reflection of lower demand, and the restrictions on wages as a result of the need to improve the competitiveness of the economy. In recent months, the rise in inflation is primarily a reflection of external and one-off factors: higher euro oil prices, prices of seasonal food, rises in prices of certain public services, most notably school meals, and rises in excise duties.

The projections indicate a decline in GDP of slightly less than 2% this year, with growth not expected to resume until 2014. The downward revision in the projections is primarily the result of a renewed deterioration in the international environment and the anticipated fiscal consolidation at home. Henceforth, weak domestic demand will not be merely a reflection of low investment activity, but also reduced household and government consumption. At the same time, growth in exports will be low, given the projected slowdown in the international environment. Nevertheless, the contribution made by net trade is expected to be higher than in previous projections, as a result of the projected additional decline in domestic demand, which will lead to a fall in imports. This is also evident from the current account projection, where the surplus is expected to increase to around 4% of GDP. After rising temporarily in 2012, inflation is expected to fall to around 2% in the coming years. The main factors in the higher projection for this year's inflation are high energy and food prices on global markets, and certain one-off effects related to fiscal consolidation, while core inflation will remain low as a result of the adverse macroeconomic situation.*

The risks in the GDP growth projections remain high and tilted to the downside. The risk in relation to foreign demand remains high, as a result of the uncertainty on the sovereign debt markets and the need for additional fiscal consolidation measures in the EU. There are also significant uncertainties surrounding domestic risk factors. The effects of a relatively extensive fiscal consolidation are difficult to predict, and some of the measures to achieve the planned reduction in the deficit have not yet been defined. At the same time, the funding situation remains considerably uncertain, primarily as a result of the difficulties in borrowing from the rest of the world. Deteriorating labour market situation would increase the chances of a further rise in structural unemployment and the related social problems, a loss of human capital and additional government expenditure. The risks surrounding inflation remain balanced, and similar to those in previous projections. The risks associated with higher energy and food prices have been assessed as slightly higher this time. The risks of higher inflation relate to possible additional measures in fiscal consolidation, and to price rises in sectors with a lower level of competition. A larger fall in domestic demand and larger adjustments in the economy via reductions in labour costs could lead to lower core inflation.

* * *

[*] Fiscal policy has not created adequate buffers in times of high growth when it acted in a pro-cyclical manner instead of being counter-cyclical.

The commitments in the Stability and Growth Pact are dictating a rapid reduction in the general government deficit. Despite the adverse consequences for demand and economic activity in the short term, fiscal consolidation is a vital prerequisite in preventing further sovereign downgradings and in enabling normal access to funding on the financial markets by the public and private sectors. The government's plan to cut the general government deficit by around 5% of GDP by 2014 has been taken into account in these projections. Given the political instability, achieving a basic consensus between the key political and social partners will be decisive in establishing a sustainable and thus credible fiscal consolidation. Adequate social security must also be ensured. Given the limited possibilities of economic growth in the medium term, high unemployment and a lack of confidence in the economy and among consumers, the use of measures with a smaller adverse impact on demand and economic growth could be applied to a greater extent. This entails at least the temporary use of measures on the revenue side of the budget, and less the reduction in government consumption, investment and public sector employment. Cutting the deficit should also be based on the continued adjustment of public sector wages and social transfers, where the situation permits. Reform of the pension system remains vital to ensuring the long-term sustainable financing of the public sector, while the same stands for health system reform, which must also contribute to increased efficiency in this part of the public sector.

The baseline scenario envisages rapid establishment of balanced public finances and a relatively large surplus in the external position, but rising unemployment will be an increasing problem. The increased uncertainty surrounding employment is also a major factor in the low level of domestic consumption, as unemployment is the largest risk to household income. Holding wage growth below productivity growth will be essential to reducing unemployment in the medium term. Here it will be necessary to improve the links between individuals' pay and their contributions to the performance of public sector businesses and institutions, and to allow wages to rise where this is necessary to ensure the requisite level of expertise and professionalism. The right wage policy would increase the competitiveness of the economy, and thus output and employment over the medium term. Increased competitiveness would also allow companies to reinforce their capital strength, generate their own resources for financing and to gain easier access to external financial resources.

In guiding bank recapitalisation activities and bank supervision, the Bank of Slovenia is attending to the gradual strengthening of the banking system, in line with the guidelines of the European Banking Authority. The ability to roll over or obtain new funding in the rest of the world – which in the form of loans from foreign banks and issued securities accounts for over a fifth of the banking system's total balance sheet – depends on the capital strength of the individual bank, but is also strongly dependent on the sovereign credit rating. Strengthening the banking system must also rely more heavily on the effective resolution of non-performing loans on bank balance sheets. It is therefore vital to address companies in difficulty and to speed up their financial restructuring, including the use of corporate debt-to-equity conversions. The aforementioned factors are partly hindering the functioning of the monetary policy transmission mechanism, and are a factor in interest rates on corporate loans being higher than the euro area average.

In addition to their contribution to medium-term fiscal consolidation, appropriately pitched structural reforms would also have a long-term impact on potential economic growth and labour productivity. Labour market reform and more active policies on the labour market should ensure the right balance between job and income security for workers and the requisite flexibility for companies in hiring and firing. This would improve the ability of companies to adapt to the changing situation on the market, while raising the employment rate in the long term. In the longer term, encouraging the development of human capital, market competition, particularly in the service sector, innovation and efficient corporate governance are of key importance. These factors widen the scope of commercial opportunities, increase the attractiveness of the economic environment for new investment, and thus promote economic development and facilitate the transition from cost competitiveness to innovation-led competitiveness.

								Projections					
								2012		2013		2014	
	2005	2006	2007	2008	2009	2010	2011	**Oct.**	Δ	**Oct.**	Δ	**Oct.**	Δ
Activity, employment and wages	*growth rates, %*												
GDP (real)	4.0	5.8	7.0	3.4	-7.8	1.2	0.6	**-1.8**	-0.6	**-0.7**	-1.3	**0.8**	-0.9
Employment	-0.5	1.6	3.3	2.6	-1.8	-2.2	-1.6	**-1.5**	-0.3	**-1.5**	-1.0	**-0.6**	-0.9
Compensation per employee	6.0	5.4	6.2	7.2	1.9	3.9	1.6	**0.3**	-1.1	**0.3**	-1.3	**0.6**	-1.6
Productivity	4.5	4.2	3.5	0.8	-6.1	3.5	2.2	**-0.3**	-0.3	**0.8**	-0.3	**1.4**	0.0
ULC (nominal)	1.5	1.1	2.6	6.4	8.5	0.4	-0.6	**0.6**	-0.8	**-0.5**	-1.0	**-0.8**	-1.6
Contribution to GDP growth	*percentage points*												
Domestic demand, excl. chg. in inventories	2.5	5.0	7.0	4.1	-6.1	-2.1	-1.4	**-3.1**	-1.6	**-1.7**	-1.4	**-0.4**	-1.5
Net exports	2.2	0.2	-2.0	0.1	2.4	1.5	1.3	**2.5**	1.5	**1.8**	0.9	**1.4**	0.7
Changes in inventories	-0.7	0.7	2.0	-0.9	-4.1	1.9	0.7	**-1.3**	-0.5	**-0.6**	-0.7	**-0.2**	-0.2
Domestic demand	*real growth rates, %*												
Domestic demand	1.8	5.6	9.0	3.2	-10.0	-0.2	-0.7	**-3.3**	-1.0	**-1.8**	-1.5	**-0.5**	-1.6
Private consumption	2.1	2.8	6.3	2.3	0.1	1.3	0.9	**-1.8**	-0.7	**-1.7**	-0.9	**0.4**	-0.2
Government spending	3.5	4.0	0.6	5.9	2.5	1.5	-1.2	**-3.0**	-1.2	**-2.0**	-1.2	**-1.6**	-1.6
Gross fixed capital formation	3.0	10.4	13.3	7.1	-23.2	-13.8	-8.1	**-8.7**	-6.3	**-3.3**	-4.8	**-1.8**	-5.7
Balance of payments	*growth rates, % (if not specified otherwise)*												
Exports of merchandise and services	10.6	12.5	13.7	4.0	-16.7	10.1	7.0	**1.0**	-1.3	**2.4**	-1.6	**4.3**	-0.7
Imports of merchandise and services	6.7	12.2	16.7	3.7	-19.5	7.9	5.2	**-2.5**	-3.5	**0.1**	-2.9	**2.8**	-1.6
Current account: EUR billion	-0.5	-0.8	-1.6	-2.3	-0.2	-0.2	0.0	**0.4**	0.4	**1.2**	0.7	**1.6**	0.9
as % GDP	-1.7	-2.5	-4.8	-6.2	-0.7	-0.6	0.0	**1.1**	1.2	**3.3**	2.0	**4.3**	2.5
Terms of trade*	-2.0	-0.5	0.9	-1.5	3.8	-3.9	-1.6	**-1.5**	-0.3	**-0.1**	-0.4	**0.0**	-0.1
Prices	*average annual growth rates, %*												
Consumer prices (HICP)	2.5	2.5	3.8	5.5	0.9	2.1	2.1	**2.9**	0.6	**2.3**	0.6	**1.3**	-0.5
HICP excluding energy	1.2	1.7	3.8	4.9	1.7	0.3	1.0	**1.7**	0.3	**1.9**	0.2	**1.5**	-0.4
HICP energy	11.9	8.5	3.4	9.4	-4.5	13.9	8.8	**9.8**	2.3	**4.3**	2.3	**0.6**	-0.5
International environment	*growth rates, % (if not specified otherwise)*							**Assumptions**					
Foreign demand**	8.2	11.6	11.3	5.9	-14.2	11.3	7.5	**1.2**	-0.6	**2.5**	-1.0	**4.0**	-0.5
Oil (USD per barrel)	54	65	73	98	62	80	111	**115**	-5.0	**110**	-5.0	**110**	-3.0
Non-oil commodities	12.0	29.1	17.4	10.1	-23.0	37.1	18.0	**-8.3**	-5.2	**1.6**	-2.3	**5.1**	-0.9
EMU inflation	2.2	2.2	2.1	3.3	0.3	1.6	2.7	**2.5**	0.5	**1.7**	0.0	**2.0**	0.0
PPI Germany	4.4	5.4	1.3	5.4	-4.0	1.5	5.6	**2.2**	0.1	**1.8**	-0.3	**1.4**	-0.3

* Based on national accounts deflators.

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

Δ: Difference between current projections and projections in April 2012 Price Stability Report.

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

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1 International Environment

In the first half of 2012, the main features of the global economy were slower economic growth, easing of inflationary pressures and increased uncertainty surrounding the fiscal position of certain euro area countries. In recent months, the economic outlook for 2013 has also deteriorated for the euro area in particular. The majority of central banks in the wealthiest economies have therefore continued to pursue a stimulative monetary policy via low interest rates and the introduction of additional non-standard measures, as unemployment remains high and the economic growth projections show no sign of a rapid recovery. Monetary policy also remains relatively stimulative in emerging countries. In the US and the euro area inflationary pressures gradually diminished in the first half of 2012 as a result of the fall in commodity prices on global markets. Oil prices and food prices again rose significantly in the summer, which increased price pressures in the euro area in particular as the euro fell.

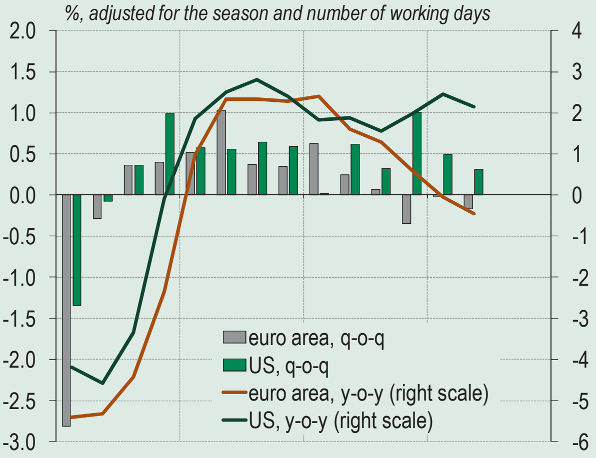
Economic developments

Global economic growth, which was still solid in the first quarter, declined again in the second quarter. One factor in this was a quarterly decline of 0.2% in GDP in the euro area, primarily as a result of the crisis in the periphery countries. During the first two quarters of the year, economic growth was relatively favourable in the US, but declined in the UK for the third consecutive quarter. In emerging Asian countries, economic activity slowed slightly in the second quarter. GDP in India was up 5.5% in year-on-year terms in the second quarter, while China recorded year-on-year growth of 7.6% in the second quarter, the lowest figure of the last three years.

Projections of global economic growth were revised downwards due to increased uncertainty surrounding the resolution of the fiscal crisis in the euro area. Growth is expected to remain relatively high in emerging economies. Given the increased uncertainty and declining economic growth in certain major developed economies, the IMF revised its forecasts of global economic growth for 2012 and 2013 downwards in July,

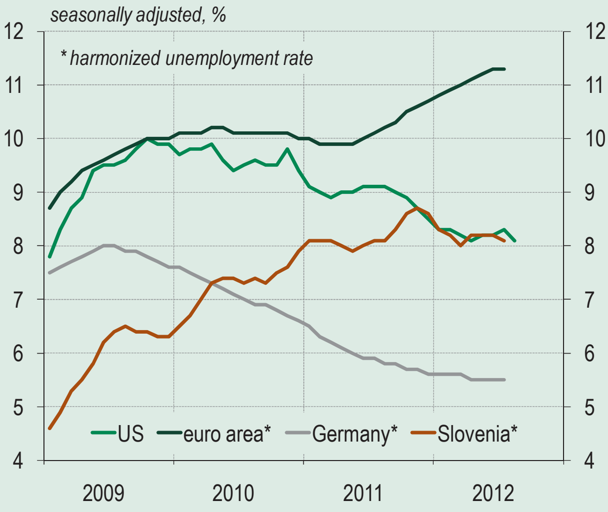
Figure 1.1: GDP growth in the euro area and the US

%, adjusted for the season and number of working days



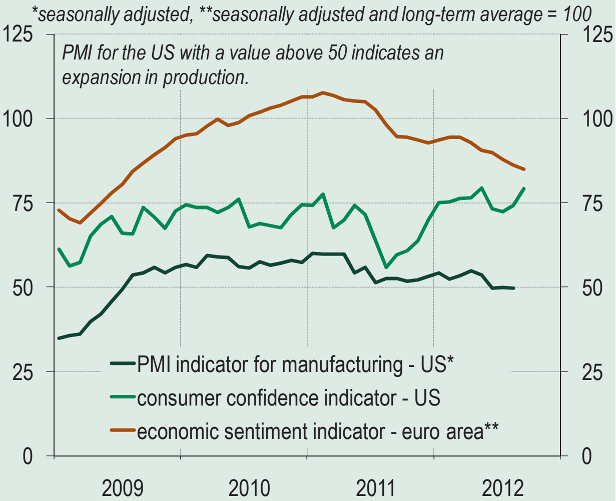
Sources: Eurostat, FRED.

Figure 1.2: International comparison of unemployment rates



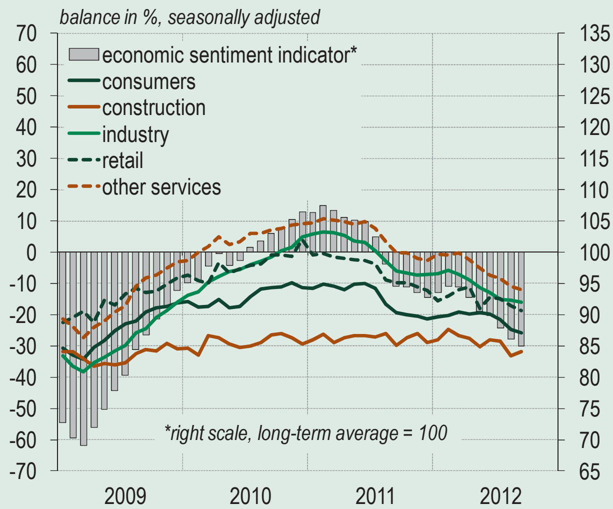
Sources: Eurostat, FRED.

Figure 1.3: Economic sentiment indicators for the euro area and the US



Sources: Eurostat, FRED.

Figure 1.4: Confidence indicators in the euro area



Source: European Commission.

by 0.1 percentage points and 0.2 percentage points to 3.5% and 3.9% respectively. According to its September forecasts, the ECB is expecting GDP in the euro area to decline by between 0.2% and 0.6% in 2012. Weak domestic demand is expected to be partly mitigated by relatively strong net exports. The outlook for economic growth in the US remains relatively favourable. According to Consensus's September forecasts, growth is expected to reach 2.2% this year and 2.1% next year. The forecasts for emerging countries were lowered slightly. According to the IMF's July forecast, the Chinese economy is expected to grow by 8.0% this year and by 8.5% next year, while the Indian economy is expected to grow by 6.1% and 6.5%.

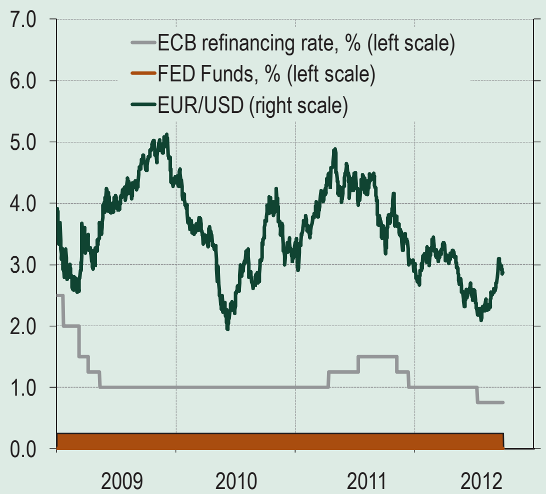
In the euro area, the adverse economic situation and the increasing differences between individual countries are also being reflected in the economic sentiment indicators. The unemployment rate also remains high. By July, it had risen to 11.3%, and the differences between individual countries are also increasing on the labour market. Youth unemployment remains high, reaching 22.6% in July, and is a particular cause for concern. The unemployment rate in the US remains above 8%. This is part of the reason why there has been no significant improvement in the consumer confidence indicator since the beginning of the year. In September, the economic sentiment indicator for the euro area issued by the European Commission declined for the sixth consecutive month, and all its components were below their long-term averages. The PMI for the euro area, which stood at 45.9 in September, suggests a further decline in economic activity in the third quarter.

As a result of the adverse economic situation, import demand in some of Slovenia's largest trading partners has fallen significantly. In the second quarter, economic activity in Germany was up 0.3% in quarterly terms, while growth in imports was still relatively favourable at 2.1%. The situation in Austria was similarly favourable. The French economy stagnated, while Spain and Italy remain in recession. In the second quarter, Italy's imports were down 8.2% in year-on-year terms. Economic activity is still declining in Croatia, where GDP in the second quarter was down 2.2% in year-on-year terms. The forecasts for the other republics of former Yugoslavia have also been revised downwards. Since April, the IMF has slightly cut its economic growth forecasts for Russia, where economic growth is expected to be around 4% this and next year.

Financial markets and commodity prices

The majority of central banks in developed countries have maintained a stimulative monetary policy of low interest rates, and are introducing or continuing additional non-standard measures.[1] The ECB cut its key interest rate in July to 0.75%, and then in the third quarter announced and began applying new non-standard measures. Immediately after the measures were introduced, the required yields on government bonds in the euro area periphery countries fell slightly. The Fed held its key interest rate in the interval between zero and 0.25%, where it is expected to remain at least until mid-2015. In September, a new round of securities purchases was announced. The Bank of England's key interest rate is at 0.50%, and in July it increased its purchases of government securities. The Japanese central bank has not changed its key interest rate since October 2010, and increased its securities purchases in September. Given the decline in economic growth and the fall in inflation, central banks in some emerging countries, among them China and Brazil, have cut their key interest rates this year.

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



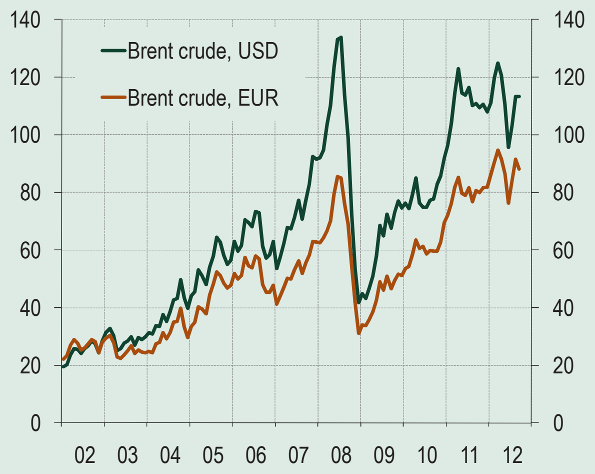
Sources: ECB, Federal Reserve.

In the second quarter, the euro fell against the US dollar, but ceased falling at the end of the third quarter. In the second quarter, the main factors in the euro's fall against the US dollar were the decline in economic activity in the euro area and the ongoing fiscal difficulties in the periphery countries. Uncertainty eased slightly in the third quarter, as a result of the introduction of additional non-standard measures by central banks, which led to a renewed rise in the euro. In the third quarter, the euro nevertheless averaged USD 1.25, down 2.4% relative to the second quarter.

In the third quarter, there was a rise in oil prices, primarily for geopolitical reasons, and also a significant rise in food prices as a result of drought. The oil price rose primarily as a result of uncertainty in Syria and Iran and speculation surrounding the additional stimulus measures by major central banks. The price of a barrel of Brent crude averaged USD 113 in September, up just over 2% in year-on-year terms. The euro's year-on-year depreciation against the US dollar meant that the rise in euro prices of oil was higher over the same period, at just under a tenth. In July, as a result of exceptional weather conditions in the major food producers and speculation about future prices, food prices also rose sharply on international markets. US dollar prices of food were neverthe-

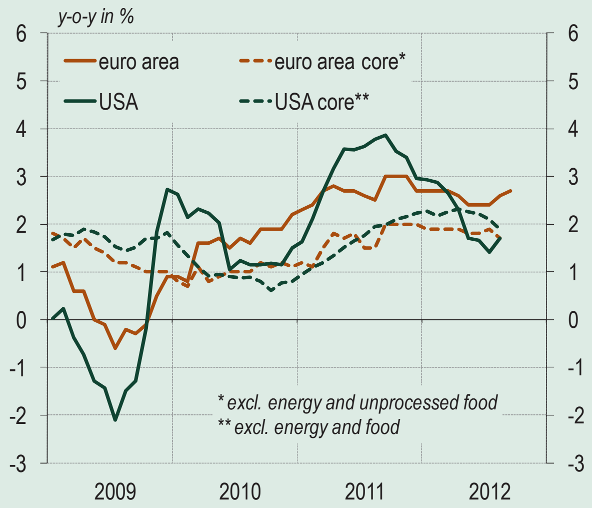
[1] For a more detailed description of the ECB measures see http://www.ecb.int/press/pr/date/2012/html/pr120906_1.en.html, for a more detailed description of the Fed measures see http://www.federalreserve.gov/newsevents/press/monetary/20120913a.htm., and for a more detailed description of the Bank of Japan measures see http://www.boj.or.jp/en/mopo/measures/mkt_ope/ope_m/index.htm/.

Figure 1.6: Oil prices per barrel



Sources: Bloomberg, ECB, Bank of Slovenia calculations.

Figure 1.7: Inflation in the euro area and the US



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

less down 3.7% in year-on-year terms in August according to ECB figures.

Inflation

During the first eight months of the year, the largest impact on this year's inflation in the euro area and the US came from energy prices, while core inflation remained stable. In September, inflation in the euro area stood at 2.7%. In August, year-on-year growth in energy prices reached 8.9%. In August, year-on-year growth in energy prices in the US stood at -0.6%, while inflation stood at 1.7%. As measured by the HICP excluding energy and unprocessed food, core inflation in the euro area stood at 1.7% in August, while core inflation in the US as measured by the CPI excluding energy and food stood at 1.9%.

2 Economic Trends and the Labour Market[2]

In the second quarter of this year, the economic situation in Slovenia deteriorated significantly, as domestic demand fell sharply and the situation in the euro area worsened. After increasing in 2011, final household consumption fell in the first half of this year as a result of a rapid decline in the real total wage bill and social transfers, and a decline in confidence as the fiscal consolidation measures were announced. The latter also accelerated decline in final government consumption. In an environment of weak demand and hampered access to finance, gross fixed capital investment is continuing to decline. Inventories also declined significantly. In the first half of this year, quarterly growth in exports remained positive, despite weak foreign demand, while the decline in imports was significant. As a result, the contribution made to GDP growth by net trade is increasing. The value-added figures for the second quarter suggest that the adverse developments have spread to all segments of the private sector, with the exception of industry where, due to exports, quarterly growth remained positive, albeit low.

In the second quarter, year-on-year fall in employment increased, while the number of vacancies fell sharply. At the same time, registered unemployment fell due to administrative measures, increase in the outflow of employees to inactivity and higher temporary employment. In June, the entry into force of the Fiscal Balance Act brought a decline in nominal public sector wages. Real wages in the private sector are also declining, under the influence of adverse developments on the labour market.

In comparison to the euro area, slower growth of Slovenia's GDP in 2011 and a larger decline this year has been primarily the result of a larger crisis in the investment component of domestic spending, while differences in the export sector are small. In the first half of the year, GDP in Slovenia declined by 1.6% in year-on-year terms, 1.3 percentage points more than the average decline in the euro area. The substantial decline in gross fixed capital investment, in which construction investment was the major factor, is the result of excessive investment in the years before the crisis, weak demand and difficult access to finance. Compared with the average for the euro area, household consumption was weaker in the second quarter of this year, while in the last

2 The customary revision was made for September's release of the national accounts, which this time featured significant changes to the quarterly and annual figures. According to the new estimate, the quarterly decline in GDP in the final quarter of last year stood at 1.1%, compared with the previous estimate of 0.6%. Quarterly GDP growth in the second quarter of 2011 was revised sharply upwards, by 0.7 percentage points to 0.6%. The current estimate is that GDP stagnated in the first quarter of this year, compared with the previous estimate of an increase of 0.2%. The revisions to the annual figures were also significant, particularly those for 2011. GDP recorded an increase of 0.6% last year, and not a decline of 0.2% as previously announced. The most visible changes to the main components of consumption were in final household consumption (+1.1%, previously -0.2%), while the decline in gross fixed capital formation was reduced from 10.7% to 8.1%. There was also a revision to the estimates for growth in value-added, particularly in the construction sector (-10.3%, previously -20.3%) and financial intermediation (-2.8%, previously +0.3%).

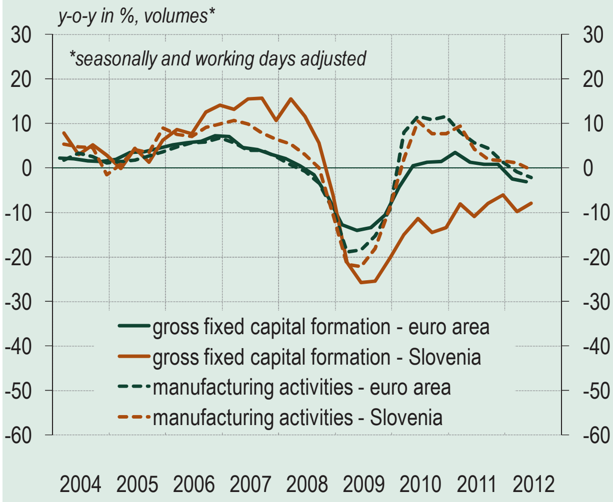
year and a half there has been a stronger contraction in government consumption as well. For most components of domestic consumption, the trends in Slovenia have recently been similar to those in Spain, Italy and Portugal. In contrast with most periphery EU Member States, growth in industrial production has remained solid, despite declining foreign demand indicators.

Aggregate demand

In 2011, domestic consumption was primarily reduced by construction investment, while in the second quarter of this year all components of aggregate consumption fell, including final household consumption. Total domestic consumption was down 6.8% in year-on-year terms, the largest fall since 2009. After increasing in 2011, final household consumption in the second quarter was down 3.0% in year-on-year terms. This was the first sharp response from households to the adverse economic situation since the outbreak of the crisis, and coincides with the announcement of a deeper-rooted fiscal consolidation and a simultaneous decline in household confidence. In addition to the ongoing decline in expenditure on durables, there was a sharp decline in spending on other goods. The increase in final household consumption in 2011 was surprising given the already present decline in purchasing power, and might be related to the use of savings. At the same time, after a gradual reduction in 2011 the government has more sharply adjusted its final consumption to the adverse fiscal situation. The quarterly decline in government consumption stood at 2.3% in the second quarter.

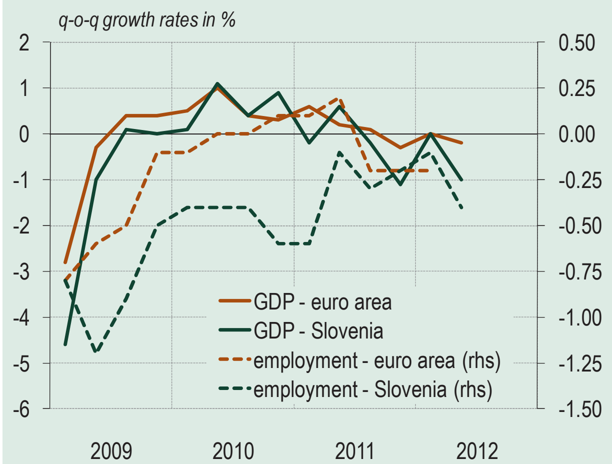
Between the final quarter of last year and the second quarter of this year, gross investment fell at its fastest pace since 2009. This was primarily the result of a decline in inventories, which declined further in the second quarter of this year as the retail sector responded to the fall in consumption. The decline in inventories has reduced year-on-year GDP growth in the last three quarters by around 2 percentage points. In the first half of the year, construction investment continued to decline, and was down almost 17% in year-on-year terms. After exceptionally large construction investment, particularly between 2006 and 2008, activity in the construction sector has continued to decline. This is the result of a decline in construction of infrastructure, large stocks of unsold housing, a lack of resources in the private sector and the fiscal problems. Investment in machinery and equipment increased significantly last year, but declined by 2.7% in the first half of this year. This was in line with a simultaneous year-on-year decline in output in the manufacturing

Figure 2.1: Selected national accounts items



Sources: Eurostat, Bank of Slovenia calculations.

Figure 2.2: GDP and employment

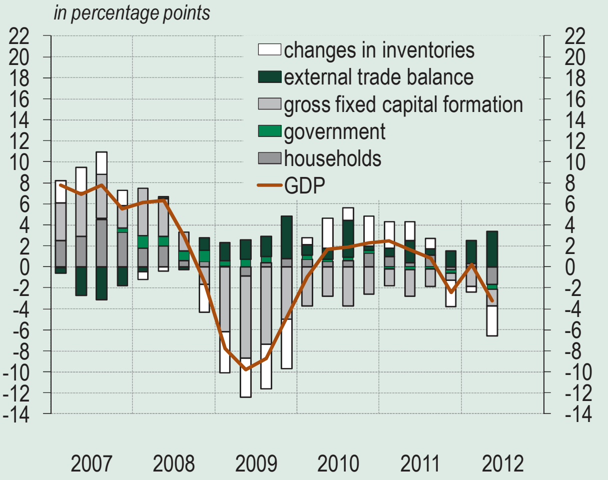


Source: Eurostat - national accounts, seasonally and working days adjusted data.

sector and the deteriorating situation in the international environment. Beside contraction in lending by domestic banks, the decline in investment is also related to the difficulties in corporate borrowing abroad.

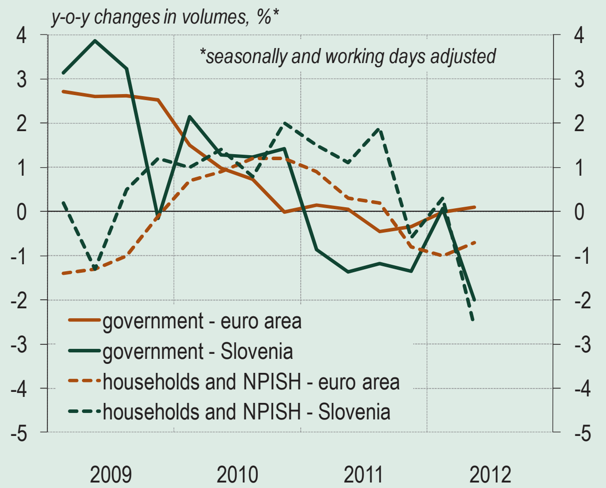
The contribution made to GDP growth by net exports is increasing, primarily as a result of a decline in imports. After last year's decline in quarterly growth, imports began falling rapidly this year. The main factors in this were weaker industrial production, lower investment in machinery and equipment and a fall in the consumption of durables and other goods by households. Imports of services, most notably travel and transport services, are also falling. As a result of the decline in economic activity in the EU, year-on-year growth in exports also declined, despite solid growth in exports to Germany, Austria and certain countries outside the EU. Total exports in the first half of the year were up almost 1% in year-on-year terms, while imports were down 3.3%. Since the final quarter of last year, the contribution made to GDP growth by net trade has been increasing, and reached 3.4 percentage points in the second quarter of this year.

Figure 2.3: Contributions to y-o-y GDP growth, expenditure side



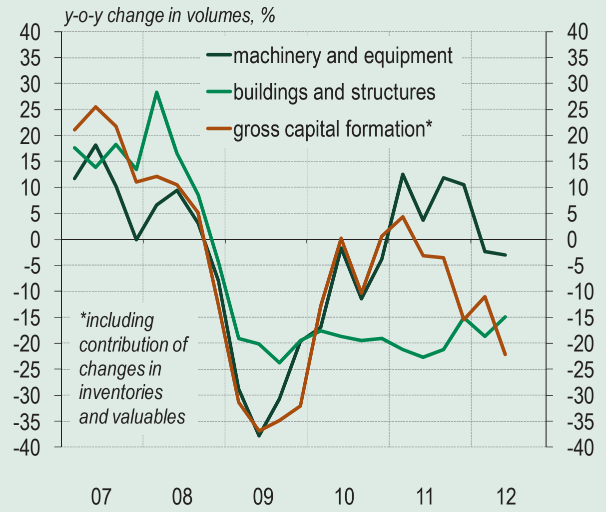
Source: SORS.

Figure 2.4: Final consumption of general government and households



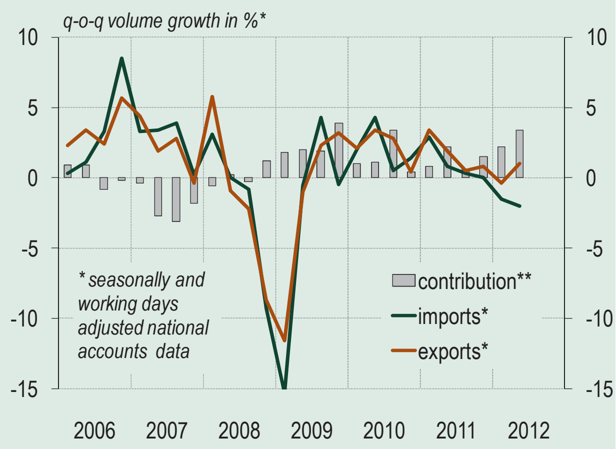
Sources: Eurostat, Bank of Slovenia calculations.

Figure 2.5: Investment



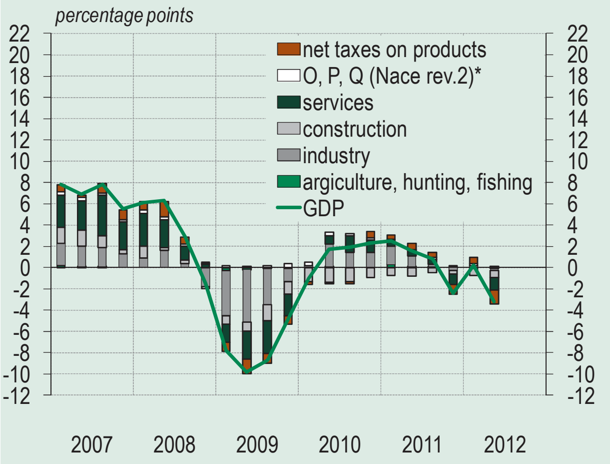
Source: SORS.

Figure 2.6: Exports and imports of goods and services



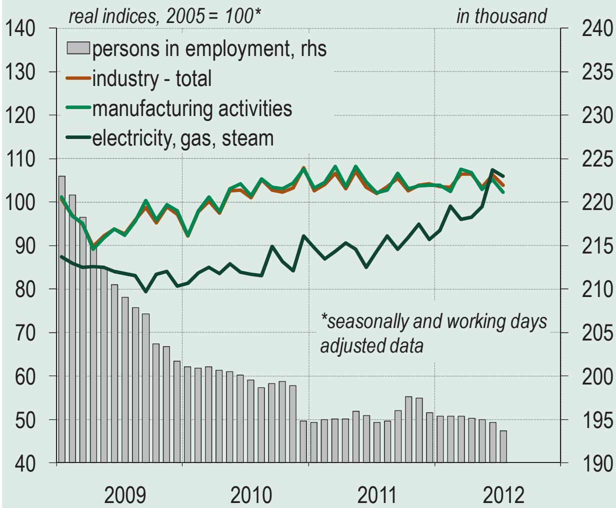
Source: SORS.
Note: **Contribution of external trade balance to y-o-y GDP growth in percentage points.

Figure 2.7: Contributions to y-o-y GDP growth, production side



Source: SORS.
Note: *Public administration, education, human health and social work.

Figure 2.9: Volume of production and employment in industry

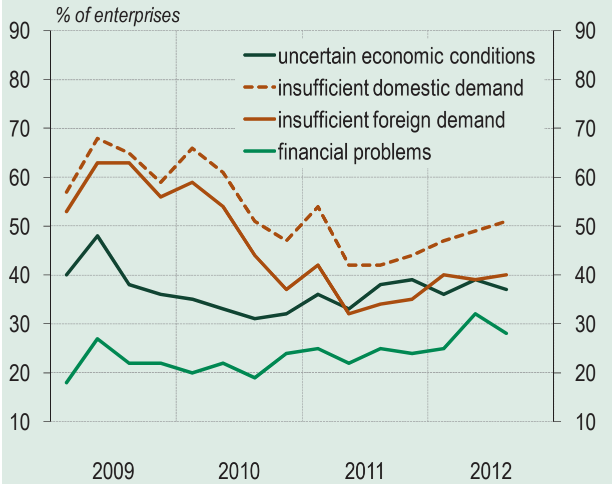


Source: SORS.

Figure 2.8: Business trends in manufacturing

Source: European Commission.

Figure 2.10: Limits to production in manufacturing activities



Source: SORS - Business tendency survey in manufacturing.

Supply side

In the first half of the year value-added in the vast majority of segments in the private sector declined in year-on-year terms. Value-added in public services was up 1%, primarily as a result of higher employment. Value-added in industry stagnated as a result of increased output in the energy sector, value-added in manufacturing having declined by more than 1% in year-on-year terms. The quarterly growth rates in the manufacturing sector have been low but positive since the third quarter of last year. The year-on-year decline was primarily the result of weaker foreign demand. The low level of investment remained the main reason for the decline of more than 10% in value-added in the construction sector. Net taxes on products in the second quarter were down a tenth in year-on-year terms, although this item has fluctuated sharply since the end of 2011. The low domestic consumption was reflected in a decline in value-added in trade and other services. The difficult financial situation is being reflected in a year-on-year decline in value-added in financial and insurance activities. Value-added in real estate activities stagnated in the first half of the year.

The contribution made to year-on-year GDP growth by manufacturing was negative in the first half of this year. Value-added was down 1.2% in year-on-year terms, and contributed 0.2 percentage points to the decline in GDP. This was the first negative contribution by manufacturing since 2009. The year-on-year rate of growth has been declining since the beginning of 2011, and turned negative in the final quarter. Value-added in manufacturing has recorded quarterly increases this year, by 0.3% in the first quarter and 0.6% in the second quarter. This is not in line with the simultaneous fall in employment and the quarterly decline in growth in output. As the situation in the international environment deteriorated further, exports in the second quarter were down in year-on-year terms for the first time since 2009. The situation on the domestic market also deteriorated, which is evident from the decline in domestic consumption, economic sentiment and imports. The proportion of firms citing insufficient domestic and foreign demand and the uncertain economic situation as the main limiting factors therefore increased in the first half of the year.

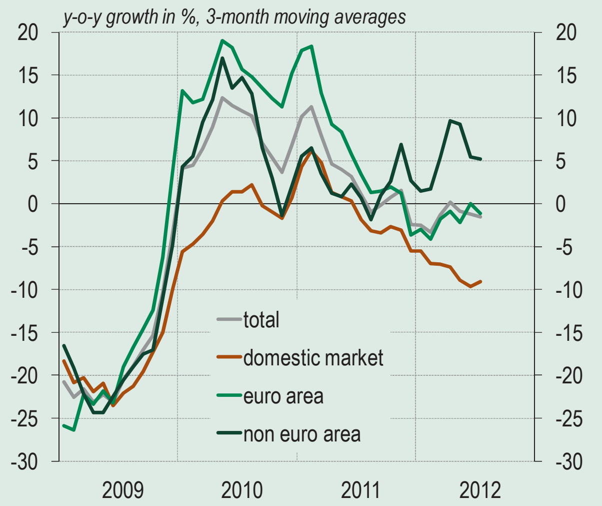
Value-added in industry stagnated, despite a year-on-year decline in value-added in manufacturing. Manufacturing accounts for around 83% of value-added in industry, for which reason these two time series usually move in line with each other. Because output in the electricity, gas and steam supply sector in the first half of the year increased by more than a tenth in year-on-year terms, the movement in overall value-added in industry was more favourable, even though the energy sector merely accounts for around 11% of total value-added in industry.

The indicators for orders and economic sentiment this year suggest a further deterioration in the situation in manufacturing. The survey indicators of the current and expected export and total orders have been falling since the first half of last year. In the first two quarters

Figure 2.11: Survey indicators of current and expected demand in manufacturing activities in Slovenia and the euro area economic sentiment indicator

Sources: SORS, Eurostat.

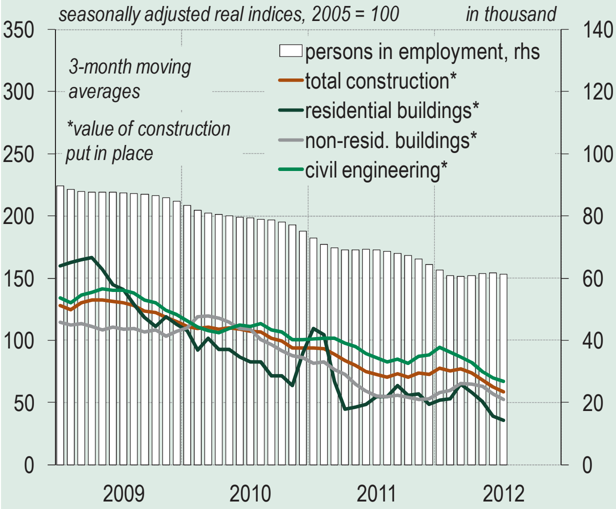
Figure 2.12: Real turnover in industry



Sources: SORS, Bank of Slovenia calculations.

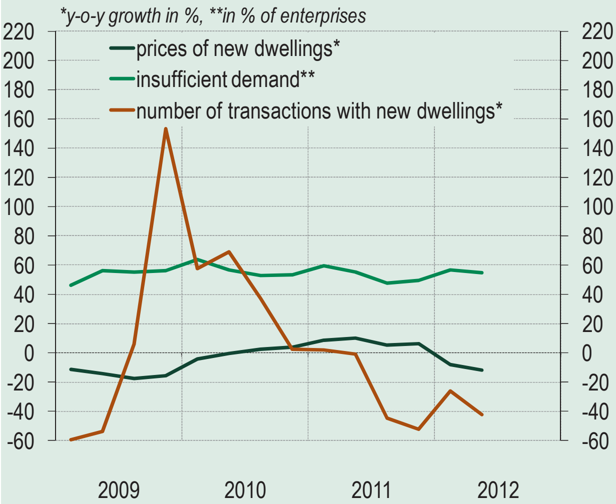
of this year the real value of new orders also declined quarter-on-quarter. Given the export orientation of manufacturing, the decline in orders is in line with the decline in the economic sentiment indicator in the euro area. Its value has been declining since the beginning of 2011, and in the second half of last year it fell below its long-term average. Because of weak demand exporters are refocusing on markets outside the euro area and the EU, where economic growth remains at a higher level for now. Slovenian industry's volume turnover in euro area part-

Figure 2.13: Construction



Sources: SORS, Bank of Slovenia calculations.

Figure 2.14: Construction - insufficient demand, transactions and prices of new dwellings



Sources: SORS, Bank of Slovenia calculations.

ners in the first half of the year was down almost 1% in year-on-year terms, while its volume turnover on markets outside the euro area was up more than 5%.

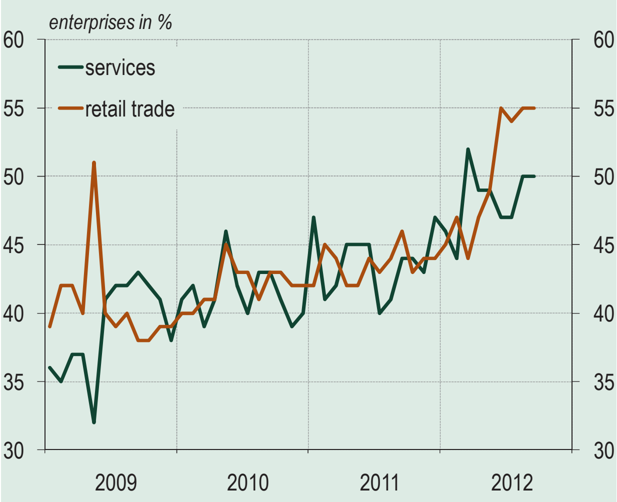
Value-added value in construction is continuing to decline, and contributed 0.6 percentage points to the decline in economic activity in the first half of the year. Value-added in the construction sector has been declining in year-on-year terms since the end of 2008, although the decline has slowed slightly since the second half of last year. Value-added in the first half of the year declined by 11.6% in year-on-year terms, while the amount of construction put in place declined by 17.1%. The quarterly decline in value-added has slowed this year, while the figures for the amount of construction put in place reveal an increase in the first quarter and a significant decline in the second quarter. All types of construction recorded a year-on-year decline in the amount put in place in the first half of the year. Activity in civil engineering work declined by just over a fifth, while construction of buildings was down just under a tenth.

The outlook in the construction sector remains poor. The number of construction firms with unsettled past-due liabilities[3] fell between the middle of last year and March of this year, then began rising again, reaching the high level seen in the first half of last year in July. In July construction again became the sector with the highest number of firms with unsettled past-due liabilities. The total amount of unsettled liabilities also remains highest in construction. The real value of new contracts in the first half of the year declined by more than a tenth, but the year-on-year decline has slowed in the last year. The value of new contracts for residential construction is continuing to record the fastest decline. The year-on-year decline in the number of building permits and the corresponding floor area of buildings in the first half of the year was still around 30%. In line with the fall in consumer purchasing power and the uncertainty on the labour market, the number of transactions in new-build housing in the first half of the year was down a third in year-on-year terms. According to SORS figures, prices of new-build housing fell by around a tenth over the same period. Demand in construction remains weak, in light of the survey indicators of total orders and expected orders, and insufficient demand remains the main limiting factor in the sector.

Value-added in financial and insurance activities declined in the first half of the year, and the estimate for

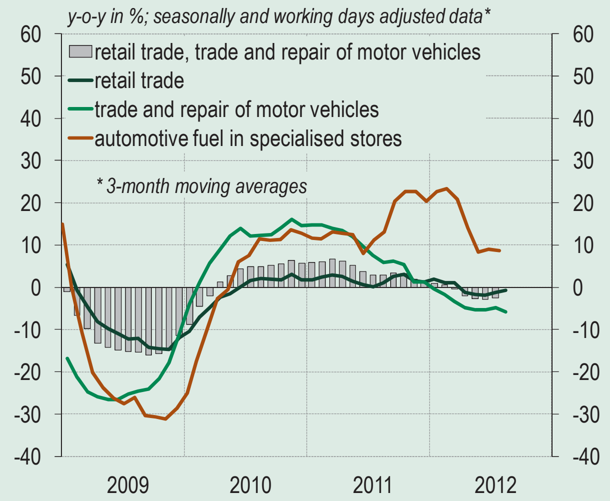
[3] Corporates with unsettled past-due liabilities from court enforcement orders and from tax debts of more than five days uninterrupted excluding other unsettled past-due liabilities from unpaid invoices between creditors and debtors. Source: AJPES.

Figure 2.15: Limits to activity - insufficient demand



Source: SORS.

Figure 2.16: Volume turnover in trade



Sources: SORS, Bank of Slovenia calculations.

last year was also revised downwards. Value-added declined by 2.2% in year-on-year terms, having declined by 2.8% last year according to revised SORS figures. With real wages falling, the year-on-year fall in employment has accelerated this year, reaching 2.8%. The banking system's performance remains weak. In June one of the banks made a prepayment of subordinated bonds at a discount, as a result of which the banking system recorded an overall profit in the first half of the year. However, this was a one-off event, the effect of which was nearly nullified by year-on-year growth of 43% in impairments and provisioning. The number of firms incapable of regularly servicing loans is continuing to rise, which is leading to a deterioration in the quality of banks` investments and, given the lack of capital, is restricting banks` lending activity.

Value-added in the sectors of wholesale and retail trade, transportation and storage, and accommodation and food service activities declined in the first half of the year. Value-added in these sectors declined by 1.3%, having increased by almost 2% last year. This year's decline was the result of weaker foreign demand and a further decline in domestic demand. The proportion of firms in wholesale and retail trade and other service sector activities for which insufficient demand is the main limiting factor has reached record levels this year. Value turnover in transportation and storage services, which are primarily dependent on foreign demand, was down in year-on-year terms in the second quarter of this year for the first time since 2009, by almost 1%. The year-on-year rate of growth has slowed in line with the decline in growth in manufacturing since 2010. Value turnover in the first half of the year also declined slightly in accommodation and food service activities. This year's year-on-year growth in the number of arrivals and overnight stays by foreign tourists is down significantly on 2011, while the number of arrivals and overnight stays by domestic tourists fell. Volume turnover in wholesale and retail trade also declined.

Total volume turnover in the retail sector and in trade in motor vehicles was down in year-on-year terms in the first half of the year for the first time since the beginning of 2010. According to original figures, volume turnover in the retail sector and in trade in motor vehicles fell by 2.0%, volume turnover in the retail sector (excluding motor vehicles and fuels) falling by almost 5% while volume turnover in trade and repair of motor vehicles fell by more than 5%. The latter's year-on-year decline was the first recorded since 2009. The year-on-year decline in total volume turnover was mitigated by year-on-year growth in volume turnover in trade in motor fuels, which stood at almost 15%, most likely as a result of purchases by non-residents.

Labour market

The sharp decline in economic activity in the second quarter of 2012 accelerated the year-on-year fall in employment. According to figures from the national accounts, the fall in employment reached 1%, significantly less than in the previous three years. The workforce in employment stood at 936,900 in the second quarter, down 6.7% on its peak in the final quarter of 2008.

Employment contracted in year-on-year terms in most segments of the private sector during the first half of the year, construction again recording the largest fall. In addition to the 7.3% fall in the construction sector, in the second quarter there was also a significant year-on-year fall of 5.7% in employment in real estate activities. The fall in employment in most other sectors did not exceed 2%, while there were rises in employment in information and communication activities and in professional, scientific and technical activities. After recording low year-on-year growth in the second half of 2011, employment in manufacturing has also begun falling this year. The year-on-year fall had reached 1% by the second quarter. This is a result of the deteriorating situation in the international environment. The fall in employment in manufacturing does not yet resemble that at the end of 2008, but could increase in the event of further negative shocks from the international environment.

Employment in the government sector in the second quarter was up 1.1% in year-on-year terms. The increase was the smallest since the end of 2007, but is nevertheless an indication of the failure of the government's plans to reduce public sector employment. According to the national accounts figures, at the end of the first half of the year employment in the activities of the public sector[4] was up 1.4% in year-on-year terms, even higher than the growth recorded last year. The monthly SORS figures, which are based on the register of the workforce in employment, also show a year-on-year rise of 1.1% in employment in the public sector in June. According to these figures, by the end of June only one part of the public sector, namely public administration and defence, had recorded a year-on-year fall in the workforce in employment (of 0.9%). Employment was up 1.6% in education, 2.5% in human health and social work, and 0.3% in arts, entertainment and recreation activities.

Table 2.1: Employment

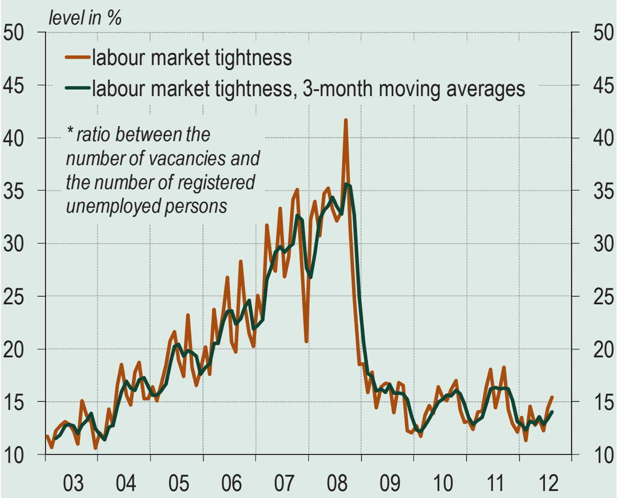
	2007	2008	2009	2010	2011	*2Q11*	*3Q11*	*4Q11*	*1Q12*	*2Q12*
	average annual growth in %					*y-o-y growth in %*				
A Agriculture, forestry and fishing	-2.4	-2.1	-1.7	-2.0	-2.5	*-2.6*	*-2.6*	*-2.2*	*-1.8*	*-1.6*
BCDE Industry	0.8	-0.3	-8.7	-5.7	-0.1	*-0.4*	*0.4*	*0.7*	*-0.4*	*-0.9*
F Construction	12.8	12.1	-0.9	-9.4	-11.4	*-11.7*	*-10.7*	*-10.4*	*-8.8*	*-7.3*
GHI Trade, accommodation, transport	3.9	3.9	0.1	-2.4	-2.4	*-2.5*	*-2.1*	*-1.5*	*-0.6*	*-1.2*
J Information and communication	7.5	5.8	4.0	0.8	0.3	*0.8*	*0.0*	*-0.4*	*1.2*	*1.6*
K Financial and insurance activities	3.6	4.5	1.8	-0.7	-1.0	*0.4*	*-3.1*	*-2.4*	*-2.8*	*-2.8*
L Real estate activities	11.4	11.8	4.3	0.0	-3.7	*-1.9*	*-5.5*	*-5.6*	*-3.8*	*-5.7*
MN Professional, technical and other business activities	9.4	2.5	-0.5	2.6	0.3	*1.1*	*-0.6*	*0.0*	*1.8*	*0.3*
OPQ Public administration and defence; education, health	0.7	1.9	2.2	2.3	0.9	*0.7*	*0.7*	*1.0*	*1.6*	*1.4*
RSTU Other activities	3.6	4.3	3.1	1.7	-1.9	*-2.1*	*-2.1*	*-1.8*	*-0.3*	*0.0*
TOTAL	3.3	2.6	-1.8	-2.2	-1.6	*-1.6*	*-1.6*	*-1.2*	*-0.6*	*-1.0*

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

[4] The public sector in this comparsion comprises the sectors of public administration and defence, compulsory social security, education, and human health.

The number of vacancies was down significantly in the first half of the year, but the number of new hires nevertheless increased. In the first two quarters of 2012 there was an average of 14,300 notified vacancies each month, down 12.5% in year-on-year terms. This was the result of a significant year-on-year fall in the number of vacancies in the second quarter. In July the number of vacancies returned to last year's level at around 15,500. Despite a fall in the number of vacancies in the first half of the year, the number of new hires rose to 9,700 on a monthly basis, up 6.5% in year-on-year terms. The number of new hires in May and June was also down in year-on-year terms, but the fall was not as large as that in the number of vacancies. The number of new hires again surpassed last year's level in July. Although the correspondence between the breakdown of vacancies and the breakdown of jobseekers increased in the first half of the year, labour market tightness[5] remains very low. This year did not see the usual increase in labour market tightness in the summer months.

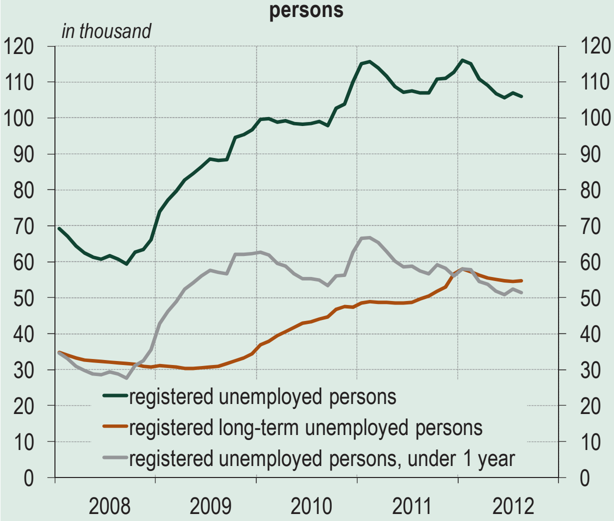
Figure 2.17: Labour market tightness*



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

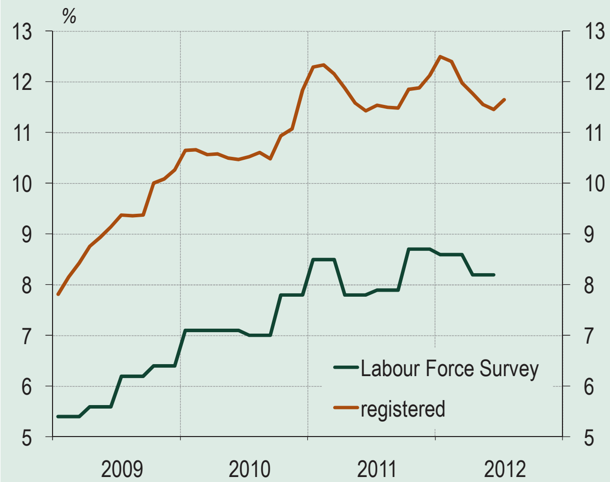
The vast majority of vacancies and new hires are for temporary employment, and the trend is worsening in comparison with previous years. In the first five months of the year 83.2% of the notified vacancies were for temporary employment, up 1.6 percentage points on the same period last year and up 10 percentage points on 2008. The increase in the number of vacancies for temporary employment and the number of workers in temporary employment is probably the result of a combination of the uncertain situation in the economy, and employers' fears of a further deterioration in the situation.

Figure 2.18: Number of unemployed and long-term unemployed persons



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

Figure 2.19: Unemployment rates



Source: SORS.

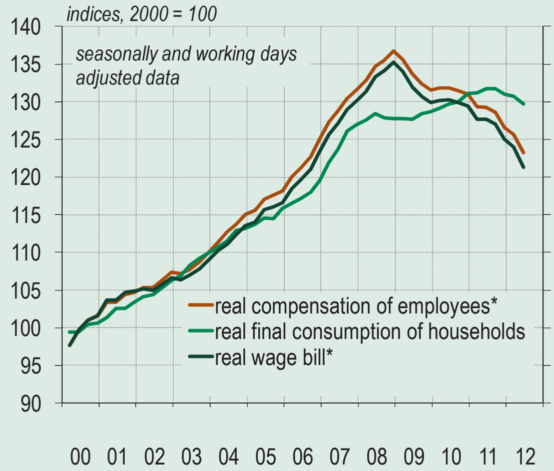
[5] Labour market tightness, calculated as the ratio of the number of job vacancies to the number of registered unemployed, is an indicator of the probability that the unemployed will find work.

The unemployment rate fell in the first half of the year, as the number of registered unemployed also fell. The number of registered unemployed fell from 116,000 in January to just under 106,000 in June. The registered unemployment rate fell accordingly, from 12.5% at the end of January to 11.5% at the end of June. This fall was partly the result of administrative measures in more stringent supervision by the Employment Service, and partly the result of the large outflow from unemployment into inactivity owing to retirement seen since the end of 2010. The number of retirements each month was about 400 higher than before the projected introduction of the pension reforms rejected in a referendum. Another factor in the fall in registered unemployment was the increase in temporary employment. Further evidence of the fall in unemployment comes from the figures for surveyed unemployment, which fell from 8.6% in the first quarter to 8.2% in the second quarter, partly as a result of seasonal fluctuations, although these have been smaller this year than last year.

In addition to the outflows from the unemployment, the fall in unemployment was also the result of smaller inflows. The number of people registering as unemployed in the first half of the year was down 5.1% on the same period last year. The number of workers who lost their jobs in bankruptcies was down more than a half, while the number of first-time jobseekers was down almost a fifth. In line with the increase in temporary employment, there was a rise in the number of people registering as unemployed because their temporary employment contracts have terminated. The inflow of workers made permanently redundant also increased, while the proportion of long-term unemployed has fallen since the beginning of the year, but still stands at 55.0%.

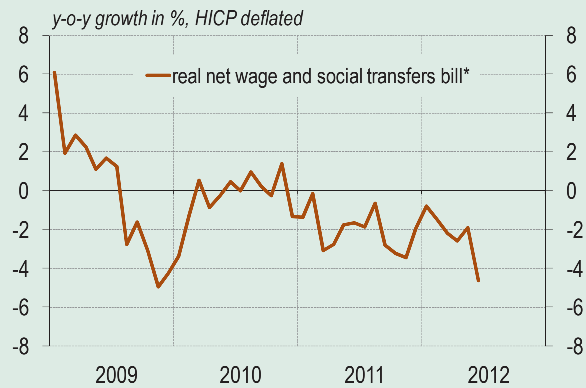
In addition to the adjustment of employment to the decline in economic activity, towards the end of the first half of the year there was also a significant adjustment in nominal gross wages for the first time. The average nominal gross wage per employee in the total economy in June was down 2.3% in current terms and down 1.3% in year-on-year terms. This was partly the result of the entry into force of the government's austerity measures in June, which reduced the average wage in the public sector by 3.4% in year-on-year terms. Alongside the adverse situation in the domestic environment, the signalling effect of the austerity measures was partly reflected in the private sector, where average gross wages in June were down in year-on-year terms in almost all sectors, most notably construction (by 6.6%). Despite June’s fall, the average gross wage in the total economy

Figure 2.20: Wage bill, compensation of employees and final consumption of households



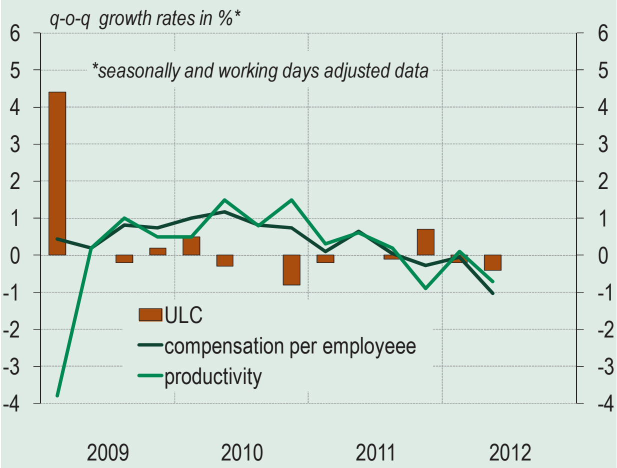
Sources: SORS - national accounts, ECB, Bank of Slovenia calculations.
*Note: *Deflated by seasonally adjusted HICP index.*

Figure 2.21: Real net wage and social transfers bill



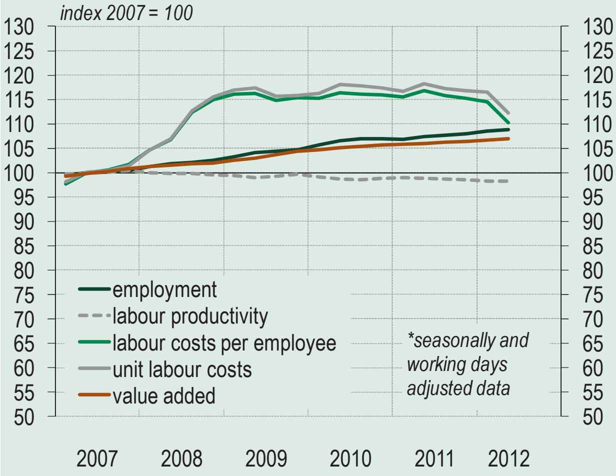
Sources: SORS, Ministry of Finance, Bank of Slovenia calculations.
*Note: *Net wage bill is calculated as the product of average gross monthly wages for employees of legal persons who received pay, and the total number of employees of legal persons minus income tax and social contributions. Social transfers are all transfers to individuals and households (pensions, scholarships...).*

Figure 2.22: Productivity, ULC and compensation per employee - total economy, Slovenia



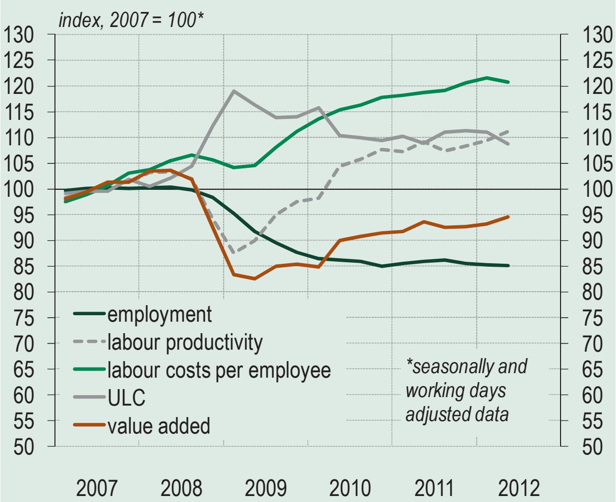
Sources: Eurostat, Bank of Slovenia calculations.

Figure 2.24: Labour cost adjustment - public sector*



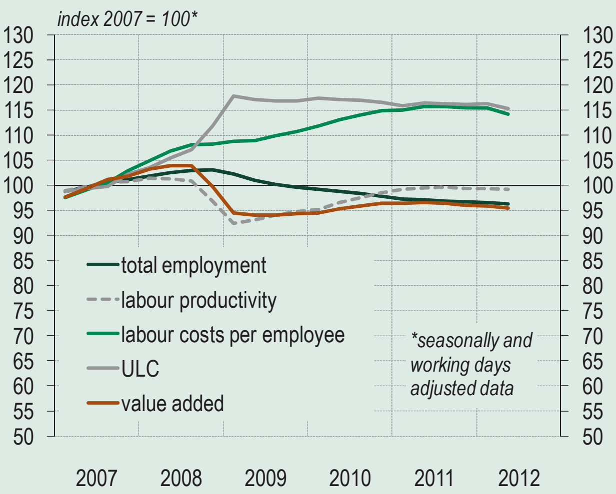
Sources: SORS, Bank of Slovenia calculations.
Note: *Includes activities classified under O, P, Q according to NACE rev. 2.

Figure 2.23: Labour cost adjustment - industry*



Sources: SORS, Bank of Slovenia calculations.
Note: *Includes activities classified under B, C, D, E according to NACE rev. 2.

Figure 2.25: Labour cost adjustment in total economy



Sources: Eurostat, Bank of Slovenia calculations.

in the first half of the year was nevertheless up 1% in year-on-year terms as a result of wage growth of 1.8% in the private sector, while the average wage in the public sector fell by 1%. June's fall in nominal wages in the private sector might signal that corporates have begun to make major cost adjustments via wages, and not solely via cuts in the workforce. A continuation of these trends could entail greater balance in the sharing of the burden of the adverse economic situation among the population.

The real wage bill has been declining since the end of 2008, and the decline accelerated in the first half of the year. In addition to the real wage bill, the real value of the sum of the net wage bill and social transfers has been declining since the end of 2010. This decline also accelerated in the first half of the year. The lengthy decline in the real wages and social transfers is also beginning to be seen in final household consumption.

Labour productivity in the second quarter was down in year-on-year terms, primarily as a result of a de-

cline in the public sector caused by austerity. The level of productivity is primarily dependent on the level of economic activity in the short term. Because output in the public sector is measured by spending in this sector, and the austerity measures have restricted spending, as employment has continued to rise productivity has declined in year-on-year terms by 0.5%. The austerity measures in the public sector have also brought a significant reduction of 5.6% in labour costs per employee, and a reduction of 5.1% in unit labour costs. In manufacturing, the segment of the private sector most exposed to international competition, labour costs per employee were up 1.7% in year-on-year terms, but this was accompanied by an increase of 1.9% in productivity. This was reflected in a fall of 0.2% in unit labour costs. Here only around a half of the overall increase in labour productivity in manufacturing is the result of a fall in employment, which is encouraging, as most of the increase in productivity since the beginning of 2010 was the result of a fall in employment. Total employment in the economy fell by 1% in year-on-year terms, while value-added declined by 1.3%. Unit labour costs as measured by value-added fell by 1%.

The fall in unit labour costs in the second quarter of this year was the first major fall since the end of 2010. The year-on-year fall of 1% in unit labour costs in the first half of the year was primarily the result of a decline in nominal wages. With regard to the relative developments in unit labour costs in individual sectors of the economy, for the first time there was a significant fall in labour costs in the public sector, where unit labour costs are still close to the levels seen in 2008 and 2009. The adjustment in public sector wages means that this sector has also assumed some of the burden of declining economic activity. Nevertheless, the adjustment in unit labour costs between the beginning of 2009 and mid-2012 was 8.9 index points in the private sector, compared with just 4.0 index points in the public sector.

3 Foreign Trade and Competitiveness Indicators

Having recorded a balanced position in 2011, the current account recorded a surplus of 0.8% of GDP during the first seven months of this year, as the situation in the global economy and the domestic situation deteriorated. This was primarily the result of changes in merchandise trade and trade in services. Real year-on-year growth in imports of merchandise and services has been significantly outpaced by export growth since the second half of last year, primarily as a result of the decline in domestic demand. On the export side, the importance of countries outside the EU has gradually increased. While current transfers were balanced, a widening deficit in factor income has acted to reduce the current account surplus.

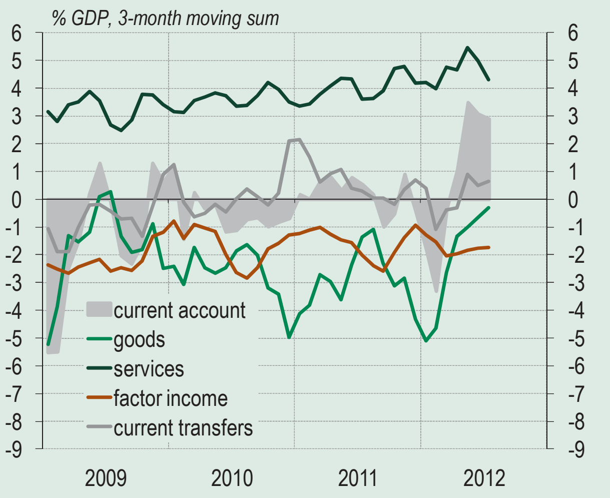
The harmonised competitiveness indicators partly improved during the first eight months of the year, primarily as a result of the depreciation of the euro. The fall in unit labour costs remained gradual, with the exception of the manufacturing sector, where the adjustment has been more deep-rooted.

Foreign trade

The current account position has moved from deficit to surplus this year, primarily as a result of the ongoing adjustment in domestic consumption and imports to the lower level of economic activity. The current account reached a balanced position in 2011, and during the first seven months of this year recorded a surplus of 0.8% of GDP. The current account surplus has arisen in an environment of deterioration in international business conditions, but it is primarily the result of a decline in imports. The increase in the surplus is the result of a narrower deficit in merchandise trade, which during the first seven months of the year diminished by 0.5 percentage points in year-on-year terms to 0.7% of GDP, and an increase in the surplus of trade in services to 2.6% of GDP. The widening deficit in factor income acted in the opposite direction. Current transfers were balanced.

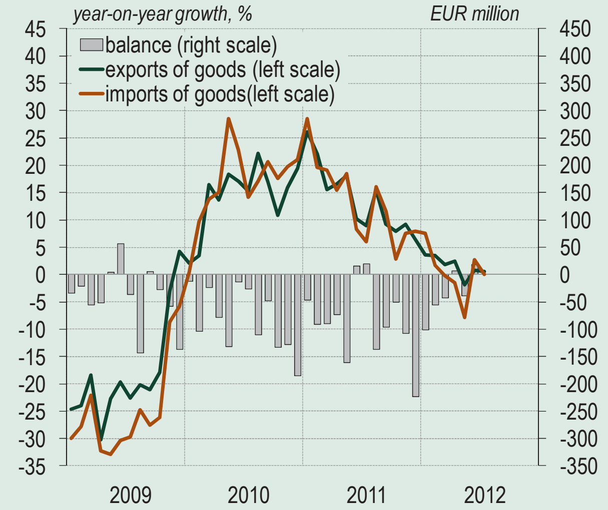
The merchandise trade deficit remained broadly unchanged last year, but has been diminishing rapidly since the beginning of this year. Growth in merchandise trade was already slowing last year as a result of the slowdown in economic growth in the EU. Growth in merchandise trade has continued to slow this year, as a result of the further deterioration in the economic situation. Alongside the decline in growth in export demand, the decline in domestic consumption was also a major factor in the decline in growth in merchandise imports. Year-on-year growth in merchandise trade has fallen sharply in the last year and a half. Merchandise exports during the final quarter of last year were up 20.7% in year-on-year terms, while growth in exports during the first seven months of this year declined to 1.5%. The decline in year-on-year growth was even sharper on the import side, the rate slowing from 22% in the first quarter of last year to zero this July. The overall merchandise trade deficit in the

Figure 3.1: Components of the current account



Sources: SORS, Bank of Slovenia.

Figure 3.2: Trade in goods



Source: Bank of Slovenia.

first seven months of the year amounted to EUR 256 million, EUR 170 million narrower in year-on-year terms.

The terms of merchandise trade calculated on the basis of the national accounts deteriorated again during the first half of this year, but less than in the same period last year. Import prices rose in year-on-year terms in the first quarter primarily as a result of higher energy prices and the euro's fall against the US dollar, and in the second quarter primarily as a result of the continuing fall in the euro. Year-on-year growth in merchandise import prices declined from 9.5% in the first quarter of last year to 2.4% in the second quarter of this year, while year-on-year growth in export prices declined from 6.6% to 1.3%. The deterioration in the terms of trade in the first half of the year was just over 1 percentage point less than in the same period of 2011 at 1.5%. This deterioration accounted for just over a quarter of the merchandise trade deficit, or 0.2% of GDP. The rapid growth in oil and food prices on the international commodity markets suggests a further deterioration in the terms of trade in the third quarter of this year.

Due to the continuing decline in foreign demand exports of intermediate goods and consumer goods in the second quarter declined in year-on-year terms. Growth in exports of capital goods nevertheless remained favourable. Year-on-year growth in exports of intermediate goods declined sharply in the second half of last year and this year. After recording year-on-year growth of 4.6% in the first quarter, exports of intermediate goods in the second were down 0.7% in year-on-year terms. The deterioration in the economic situation in the rest of the world was reflected most evidently in exports of consumer goods, which were down 3.2% in year-on-year terms in the first quarter and 1.1% in the second quarter. Growth in exports of capital goods slowed from 5.2% to 4.1%, but remained relatively high, primarily as a result of higher demand on markets outside the EU. These export trends continued in July.

The deterioration in the economic situation in the international environment, the increase in uncertainty and the decline in domestic consumption led to a significant decline in imports of all categories of goods in the second quarter. After increasing by 3.5% in the first quarter, imports of intermediate goods were down 1.5% in year-on-year terms in the second quarter as a result of a decline in manufacturing output. After recording high growth last year in line with growth in investment in machinery and equipment, imports of capital goods have declined this year, the rate accelerating from

1.3% in the first quarter to 5.9% in the second quarter. These developments are in line with the decline in orders, the financing difficulties and the growing lack of confidence in the export sector. As household consumption declined, imports of consumer goods in the second quarter were down 7.8% in year-on-year terms.

Had exports to non-EU countries not continued to increase, this year's decline in domestic economic activity would have been larger. The difference between the rates of growth in merchandise trade with EU Member States and non-EU countries was relatively small last year, but widened significantly this year, particularly on the export side. According to SORS figures, exports to EU Member States in the first seven months of the year were down 2.0% in year-on-year terms and exports to non-EU countries were up 7.3%, while merchandise imports from EU Member States were down 1.0% and imports from non-EU countries were up 1.4%.

The new focus on markets outside the EU is gradually altering the regional breakdown of merchandise trade. According to SORS figures, the proportion of total merchandise trade accounted for by EU Member States in the first seven months of the year was down 1.9 percentage points in year-on-year terms at 69.9% on the export side, and down 0.4 percentage points at 76.3% on the import side. A surplus of EUR 651 million was generated by trade with non-EU countries, up EUR 218 million in year-on-year terms. Overall coverage of merchandise imports by exports was up 1 percentage point in year-on-year terms at 95.0%.

Table 3.1: Components of the current account

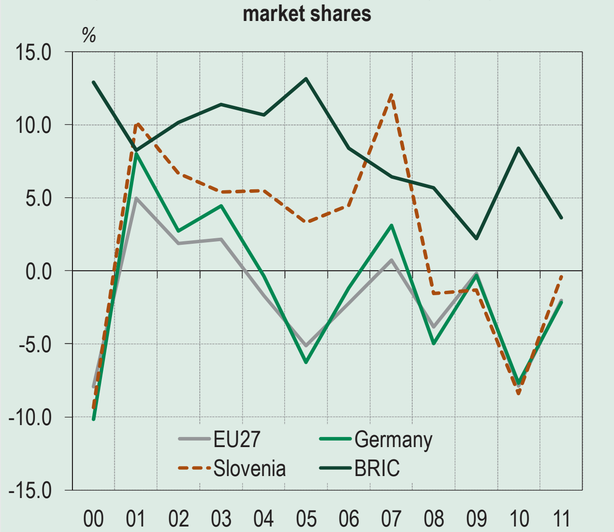
	2005	2006	2007	2008	2009	2010	2011	2011 1-7	2012 1-7
					mio EUR				
Current account balance	-498	-771	-1,646	-2,295	-246	-209	2	155	308
1. Goods	-1,026	-1,151	-1,666	-2,385	-498	-997	-1,043	-426	-256
2. Services	920	993	1,047	1,424	1,165	1,285	1,443	796	950
2.1. Transport	398	456	525	561	437	496	585	332	377
2.2. Tourism	743	783	834	904	891	1,002	1,135	619	690
- of which, exports	1,451	1,555	1,665	1,827	1,804	1,925	1,952	1,064	1,097
2.3. Other	-221	-247	-312	-42	-163	-213	-277	-156	-116
3. Factor income	-295	-440	-789	-1,030	-754	-599	-550	-322	-392
3.1. Labour income	128	107	50	8	81	143	218	103	130
3.2. Capital income	-424	-547	-839	-1,038	-835	-743	-768	-426	-523
4. Current transfers	-97	-173	-239	-303	-159	102	153	107	6
					as % GDP				
Current account balance	-1.7	-2.5	-4.8	-6.2	-0.7	-0.6	0.0	0.4	0.8
1. Goods	-3.6	-3.7	-4.8	-6.4	-1.4	-2.8	-2.9	-1.2	-0.7
2. Services	3.2	3.2	3.0	3.8	3.3	3.6	4.0	2.2	2.6
2.1. Transport	1.4	1.5	1.5	1.5	1.2	1.4	1.6	0.9	1.0
2.2. Tourism	2.6	2.5	2.4	2.4	2.5	2.8	3.1	1.7	1.9
- of which, exports	5.1	5.0	4.8	4.9	5.1	5.4	5.4	3.0	3.0
2.3. Other	-0.8	-0.8	-0.9	-0.1	-0.5	-0.6	-0.8	-0.4	-0.3
3. Factor income	-1.0	-1.4	-2.3	-2.8	-2.1	-1.7	-1.5	-0.9	-1.1
3.1. Labour income	0.4	0.3	0.1	0.0	0.2	0.4	0.6	0.3	0.4
3.2. Capital income	-1.5	-1.8	-2.4	-2.8	-2.3	-2.1	-2.1	-1.2	-1.4
4. Current transfers	-0.3	-0.6	-0.7	-0.8	-0.4	0.3	0.4	0.3	0.0

Sources: SORS, Bank of Slovenia.

Box 3.1: Market shares of Slovenia's merchandise exports to EU markets[1]

Slovenia's global market share is declining as a result of the boom in large emerging economies and the crisis in the EU. The cumulative loss of market share during the first four years of the crisis was nevertheless less than the EU average and than in Germany. At the same time, the EU's internal market remains homogeneous, members having conducted more than two-thirds of their international trade in 2011 with one another. The Slovenian economy's dependence on the EU is even greater: the EU accounts for around 70% of its total merchandise exports. Because demand on EU markets is weaker compared with global trade, and the debt crisis means that the economic recovery in the EU is expected to be weak, a high dependence on demand in the internal market represents a risk of further loss of global market share and export-driven economic growth.

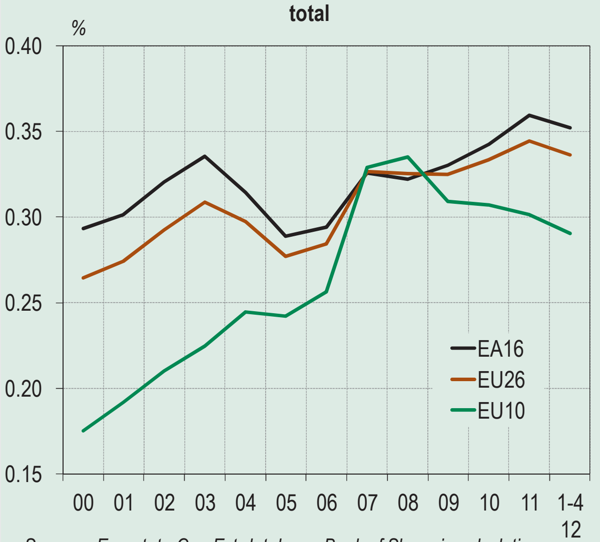
Figure 1: Goods exports - annual changes in global market shares



Sources: WTO, Bank of Slovenia calculations.

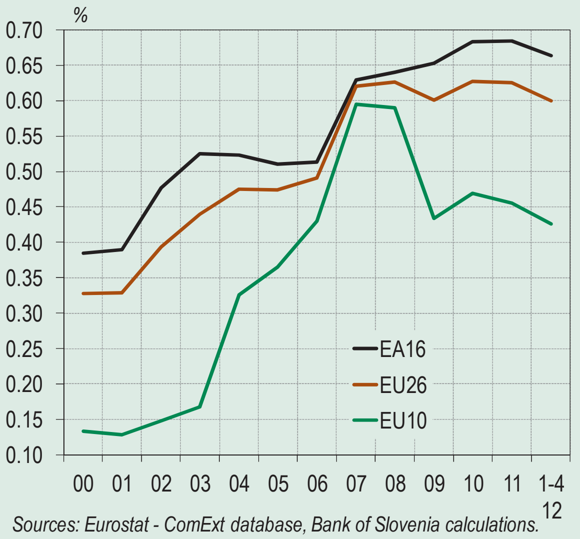
The development in the market shares of Slovenia's exports to other EU Member States (EU26) between 2000 and 2011 reveals an increase in the competitiveness of the export sector in these markets, the share having increased from 0.26% in 2000 to 0.34% in 2011. Growth in market share was faster in EU Member States outside the euro area (EU10), where it increased by 72% to 0.31%. Market share in the euro area (EA16) increased by just over a fifth to 0.36%. Before the outbreak of the crisis in 2008, market share primarily increased in the EU10. This could have been a result of the more favourable economic developments, the expansion of the internal market during the enlargement of the EU, and the refocusing of production chains to the new members. During the crisis up to 2011, Slovenia lost market share in the EU10 and increased it in the EA16. The former may be related to the appreciation of the euro, while the latter is primarily related to the recovery of the economies of Germany and Austria after 2009, which Slovenian exporters have successfully exploited. The largest market shares in the EA16 have been gained in Austria, Slovakia, Italy and Germany, while the largest in the EU10 have been gained in Hungary, Bulgaria, Romania, the Czech Republic and Poland.

Figure 2: Market share of Slovenia's goods exports in the EU - total



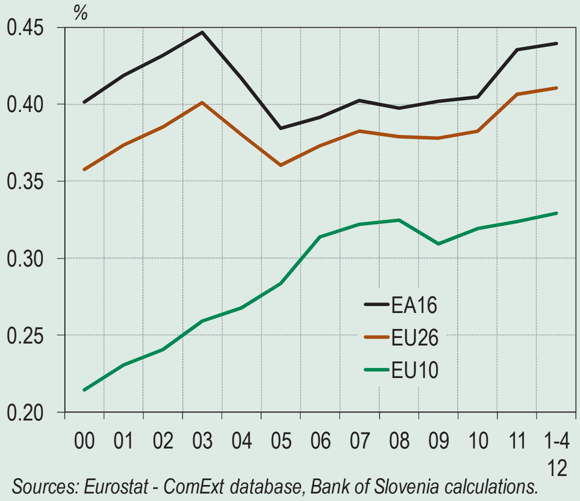
Sources: Eurostat - ComExt database, Bank of Slovenia calculations.

Figure 3: Market share of Slovenia's goods exports in the EU - transport equipment and parts and accessories



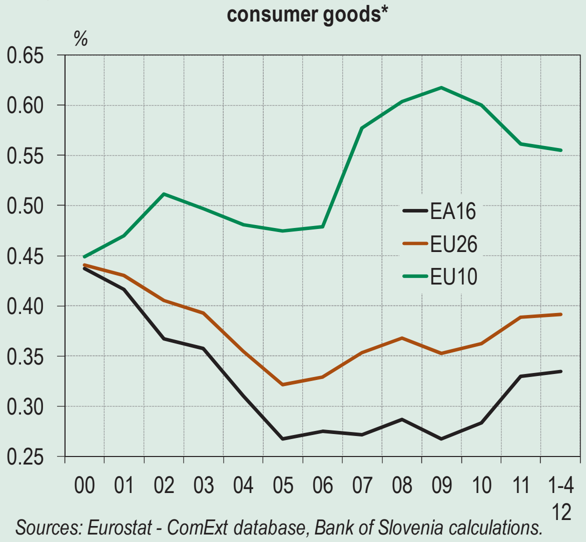
Sources: Eurostat - ComExt database, Bank of Slovenia calculations.

Figure 4: Market share of Slovenia's goods exports in the EU - industrial supplies*



Sources: Eurostat - ComExt database, Bank of Slovenia calculations.
*Note: *Primary and processed industrial supplies excluding fuels and lubricants.*

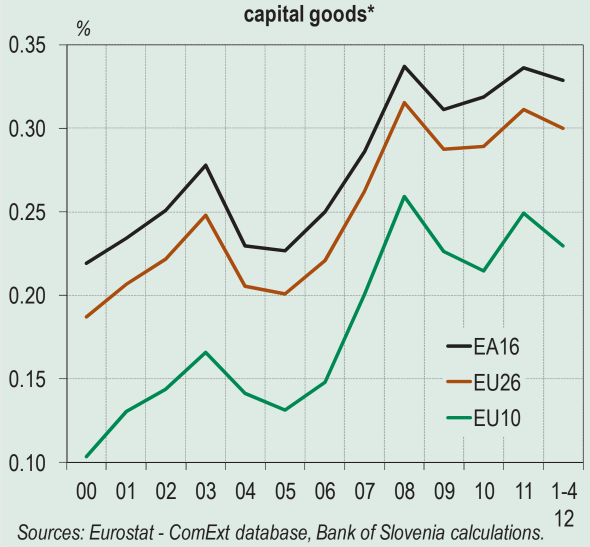
Figure 5: Market share of Slovenia's goods exports in the EU - consumer goods*



Sources: Eurostat - ComExt database, Bank of Slovenia calculations.
*Note: *Excluding food and beverages.*

Of the major categories of goods,[2] the largest market share in the EU26 is recorded by transport equipment, particularly in Hungary, Germany, Bulgaria, the Czech Republic and Austria. Growth in market share was high until the outbreak of the crisis, but has recently stagnated on average as a result of the reduced demand for vehicles manufactured in Slovenia. Before the outbreak of the crisis, there was a significant increase in the market share for capital goods, which is favourable from the point of view of the technological intensity of production. Slovenia's largest market shares for capital goods are in Germany, Bulgaria, Denmark, Romania, Austria and Slovakia. The market share for industrial supplies is largest in

Figure 6: Market share of Slovenia's goods exports in the EU - capital goods*



Sources: Eurostat - ComExt database, Bank of Slovenia calculations.
*Note: *Excluding transport equipment and parts and accessories.*

countries where manufacturing accounts for a high proportion of total value-added. Most notable market shares have been gained in Slovakia, Austria, Italy, Hungary, the Czech Republic and Germany. The highest growth in market share in the observation period was recorded for food and beverages, while only consumer goods recorded a loss of market share. The loss of market share for this category was related to the collapse of the textile, leather and furniture industry in the period between 2000 and 2005. The pharmaceutical industry

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1 To simplify the analysis, the euro area has been defined as the EA16 throughout the observation period, and therefore includes all euro area countries other than Slovenia as of 1 January 2010. The same holds for the EU26. The EU Member States not part of the euro area as at 1 January 2010 are designated the EU10. The market shares are calculated on the basis of nominal data from Eurostat's ComExt database as simple shares of individual countries' or groups' total merchandise imports accounted for by merchandise imports from Slovenia. The value of Slovenia's imports is deducted from the aggregate value of the imports of the EU27 and the EA17. The value of imports was taken into account because of the difference between the figures for Slovenia's exports to the EU, and the figures for the EU's imports from Slovenia, which according to Eurostat has exceeded EUR 2 billion annually since 2004, while the difference should be minimal. The market shares calculated on the basis of the export data would be overstated.

2 The categories of goods are taken from the broad economic categories (BEC) classification. The figures illustrate the categories of goods for which average market shares of more than 0.2% were recorded between 2000 and 2011 in the EU26. The fuels and lubricants category is not taken into account in the analysis, since Slovenia is not a producer of oil, refined petroleum products or gas, and growth in the market share for this category is primarily the result of the activities of brokerage firms.

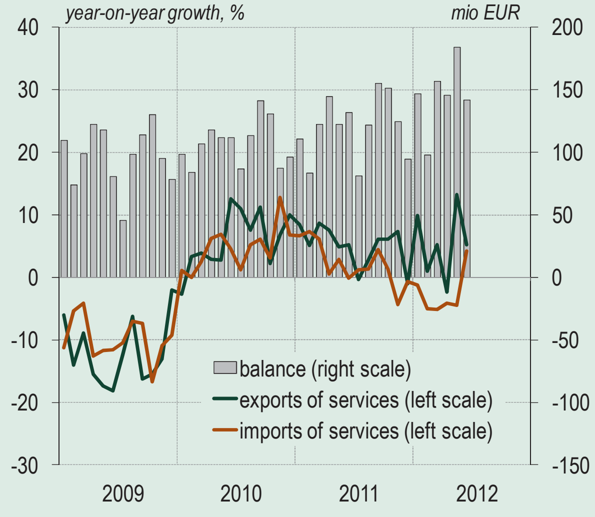
and the manufacture of electrical equipment later began to replace the market share of the aforementioned industries.

In the first four months of this year, the movement in market shares in the EU was not favourable. The total market share of merchandise exports to the EU26 was down 2.4% on the 2011 average (down 2.0% in the EA16 and 3.5% in the EU10). Of the main trading partners, the largest decline was in France (16%), and in Italy and Austria. Growth remained high in Germany, at over 5%. Of the major categories of goods, in the majority of EU countries there was an increase in the market shares for industrial supplies and consumer goods. The market share for transport equipment declined by 5%, primarily as a result of a 10% decline in the market share for vehicles. The market share for transport equipment in France declined by a quarter. The market share for capital goods declined in most countries, most notably by a quarter in Slovakia.

Of the major trading partners in the euro area, in the first seven months of the year there was a decline in exports to France and Italy, and an increase in exports to Austria and Germany. Exports to the former Yugoslav republics remained unchanged. Among the main euro area partners the largest increases were recorded by Austria (exports: 6.8%, imports: 2.9%) and, to a lesser extent, Germany (exports: 3.4%, imports: -2.0%). The results of trade with Italy were worse (exports: -3.6%, imports: 5.3%), because of decline in demand for cars the trade with France recorded the largest deterioration in merchandise trade (exports: -18.1%, imports: -14.2%). The total value of merchandise trade with the former Yugoslav republics remained unchanged. Imports fell by 6.6%, while exports rose by 0.7%. Of the other major trading partners, trade with Russia recorded a significant increase. Imports rose by more than 30%, while exports were up 16.0%. In trade with countries outside Europe, there was a significant increase of 16.0% in exports to the US. Trade with China is also increasing, but remains unbalanced: the value of merchandise imports is almost seven times larger than merchandise exports.[6]

The gap by which growth in imports of services trails growth in exports widened sharply in the final quarter of last year, and has continued to widen this year. Exports of services during the first seven months of the year stood at EUR 2.8 billion, up 4.8% in year-on-year terms, while imports were down 1.3% at EUR 1.9 billion.

Figure 3.3: Trade in sevices



Source: Bank of Slovenia.

The surplus of trade in services increased by EUR 154 million in year-on-year terms to EUR 950 million or 4.5% of GDP, the largest figure to date for the first seven months of the year. This year the largest contributions to the surplus of trade in services again came from transport services and travel services, which recorded a total surplus of EUR 1.1 billion. The main factors acting to reduce the surplus of trade in services were business and technical services and services based on intellectual property rights.

Despite a fall in the average spending by foreign visitors, growth in exports of travel services has remained favourable this year. Exports of travel services

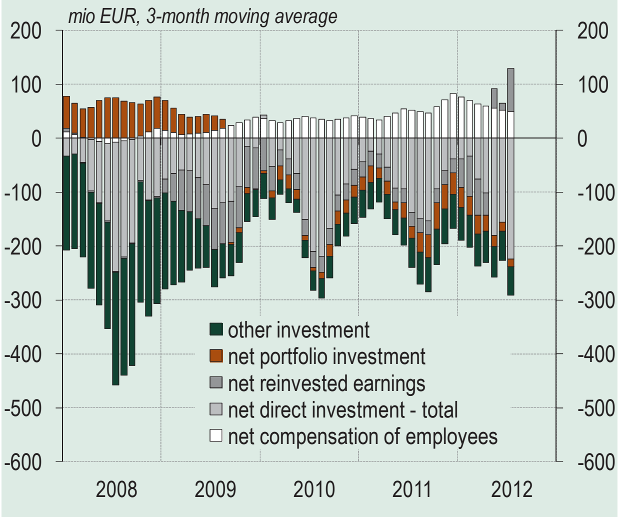
[6] According to Eurostat figures, China accounted for 4.1% of Slovenia's total merchandise imports in 2011. Of total merchandise imports from China, under the classification by broad economic categories (BEC) capital goods accounted for 47.5%, intermediate goods for use in industry for 27.7%, and consumer goods for 20.5%. Capital goods accounted for 16.2% of Slovenia's total merchandise imports in 2011, intermediate goods for industry for 36.2% and consumer goods for 12.3%.

during the first seven months of the year were up 3.1% in year-on-year terms. This was the result of a rise of 5.8% in the number of arrivals and a rise of 5.3% in the number of overnight stays by foreign visitors. The adverse socio-political situation in North Africa and Greece was a factor in the recent rise in foreign visitor numbers. Given the adverse situation on the labour market, residents' expenditure on travel in the rest of the world was down 8.3% in year-on-year terms. The surplus of trade in travel services over the first seven months of the year increased by EUR 70 million in year-on-year terms to EUR 690 million.

The largest increases in trade in services during the first seven months of the year were recorded by services based on intellectual property rights, and by computer and construction services, while growth in exports of transport services also remained favourable. Exports of intellectual property services (patents, licences, copyright) were up 35.3% in year-on-year terms and exports of computer services were up 31.0%, while exports of construction and assembly work and exports of communications services recorded slightly smaller increases. As a result of the collapse of the major construction firms, the largest increase on the import side was recorded by construction and assembly work in Slovenia, at 25.5%. Imports of computer and communications services also recorded a year-on-year increase of more than 20%, although the proportion of total imports of services that they account for remains small. As merchandise trade recorded weak growth, exports of transport services also increased in year-on-year terms, by 4.2%. With imports declining by 3.0%, the surplus in transport services increased by EUR 44 million to EUR 377 million.

The deficit in factor income during the first seven months of the year widened by EUR 70 million in year -on-year terms to EUR 392 million or 1.1% of GDP. There has been a surplus in net labour income since the onset of the economic crisis owing to a decline in the

Figure 3.4: Net factor income



Source: Bank of Slovenia.

employment of foreign workers, particularly in construction. This surplus is increasing from year to year. During the first seven months of the year it increased by EUR 27 million in year-on-year terms to EUR 130 million. The deficit in capital income simultaneously widened, by EUR 97 million to EUR 523 million.

The deficit in capital income during the first seven months of the year widened rapidly, receipts having declined significantly more in year-on-year terms than expenditure. Receipts of capital income were down 35.8% in year-on-year terms at EUR 230 million. The entire decline may be attributed to the effects of divestment and Slovenian firms' losses in outward FDI.[7] Divestment during the first seven months of the year was up EUR 63 million in year-on-year terms at EUR 89 million. Other capital income receipts have also declined as a result of the decline in investment in the rest of the world. The largest decline during the first seven months of the year was recorded by receipts from investments in securities, at 19.0%, mostly in the government and banking sectors. Only the Bank of Slovenia and other sectors recorded a slight increase in receipts. As a result of the decline in lending to the rest of the world since the out-

[7] Corporate earnings in Slovenia that belonged to foreign direct investors have been significantly smaller in the last two years, and were down a half on 2007. They amounted to EUR 303 million in 2011, while dividend payments amounted to EUR 365 million. Slovenian corporates in the rest of the world have made a loss since 2009. It amounted to EUR 94 million in 2011, while dividend payments amounted to EUR 85 million.

break of the crisis, receipts from interest on loans made to the rest of the world have declined by 12.6% this year.

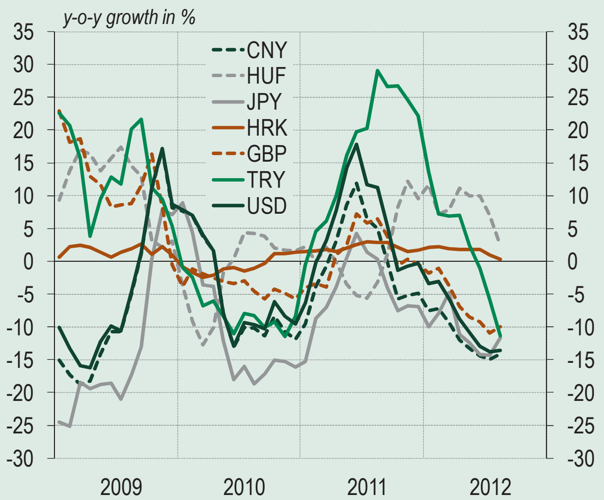
The year-on-year decline in expenditure from capital income during the first seven months of the year was relatively small. It stood at 4.0%. Expenditure on FDI increased by 7.6%, despite non-residents' divestment recording a year-on-year increase of EUR 107 million to EUR 150 million. Non-residents' investments in domestic securities declined by 15.6% in year-on-year terms, most notably subscriptions to government bonds and bills (down 10.2%) and bank bonds and notes (down more than a quarter). Interest payments on loans from the rest of the world were up 0.6%. After significant deleveraging by the banks and cuts in interest rates, the banks' interest payments were down 14.6% in year-on-year terms at EUR 111 million. Interest payments by corporates and households increased by 5.4% to EUR 91 million. The rise in financing costs as a result of Slovenia's downgrading has not yet been reflected in the growth in expenditure from capital income. This will only be reflected in new borrowing by the government and banks on international financial markets.

The surplus in current transfers during the first seven months of the year was significantly lower than in the same period last year. It amounted to EUR 6 million, down EUR 101 million in year-on-year terms. Current transfers into Slovenia during the first seven months of the year declined by 2.9% in year-on-year terms. There was a decline in both government transfers (by 1.9%) and private transfers (by 5.0%). In contrast to the inflows, both current government and private transfers to the rest of the world were up more than 10% in year-on-year terms. The deficit in private transfers was up EUR 44 million in year-on-year terms, while the surplus in government transfers was down just under a half at EUR 75 million. The majority of the net inflow of government transfers comprised funds from the EU budget for the implementation of the common agricultural and fisheries policies, and money from the structural funds and regional development funds.

Competitiveness indicators

The sharp depreciation in the euro against other major global currencies this year has also improved Slovenia's competitiveness as measured by the nominal harmonised indicator. The euro fell in year-on-year terms against most major currencies in the first eight months of the year: by 9.0% against the US dollar, by 11.6% against the Chinese yuan, by 10.8% against the Japanese yen and by 6.5% against the pound sterling. As a result of the fall in the euro, there was also an improvement in Slovenia's nominal harmonised competitiveness

Figure 3.5: Exchange rates of the euro

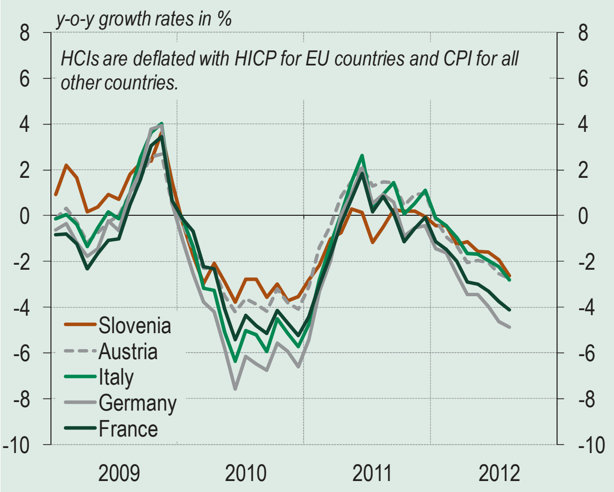


Sources: ECB, Bank of Slovenia calculations.

Figure 3.6: Nominal harmonised competitiveness indicator (40 countries and the rest of the euro area)

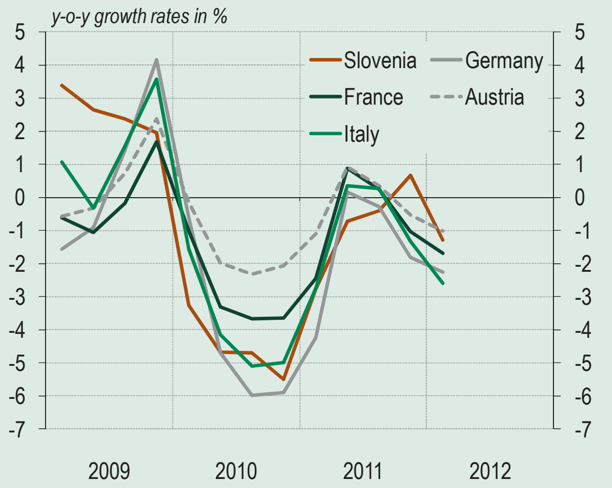
Source: ECB.

Figure 3.7: Harmonised price competitiveness indicator (40 countries and rest of the euro area)



Source: ECB.

Figure 3.8: Real harmonised competitiveness indicator - GDP deflator (20 countries and rest of the euro area)



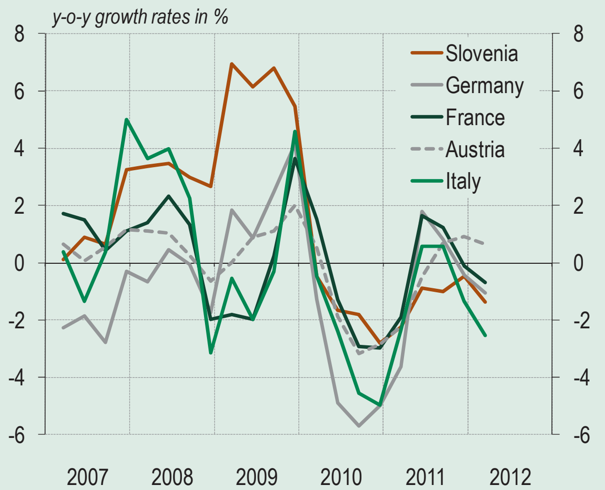
Source: ECB.

indicator, by an average of 0.9% over the first eight months of the year. This was less than the improvement in the indicator of the main euro area trading partners. This was the result of the euro's rise against the currencies of countries that have a higher weight in Slovenia's indicator. Slovenia trades less with the US, China and Japan than other euro area countries, and more with Croatia, Turkey and Hungary. The euro rose on average against the currencies of these three countries during the first eight months of the year: by 8.4% against the Hungarian forint, by 2.4% against the Turkish lira and by 1.6% against the Croatian kuna.

Slovenia's price competitiveness as measured by the harmonised indicators has slowly improved again this year, mostly as a result of the decline in the nominal effective exchange rate. The price competitiveness indicator deflated by the HICP fell by 1.4% on average in year-on-year terms during the first eight months of the year. This was 0.9 percentage points less than the average of the four main euro area trading partners, which was primarily the result of less favourable movements in the nominal competitiveness indicator. Higher year-on-year inflation has also contributed to the gap in recent months. Slovenia's price competitiveness indicator is close to the level of Italy's indicator, but is significantly behind the price competitiveness of France, Austria and Germany. Price competitiveness as measured by the indicator that takes account of the GDP deflator has gradually been improving since the beginning of 2009. Slovenia's indicator has reached a more favourable level than Italy's, but continues to trail the indicators of Austria, Germany and France.

The cost adjustment of the Slovenian economy remains relatively slow, with the exception of the export sector. The harmonised cost competitiveness indi-

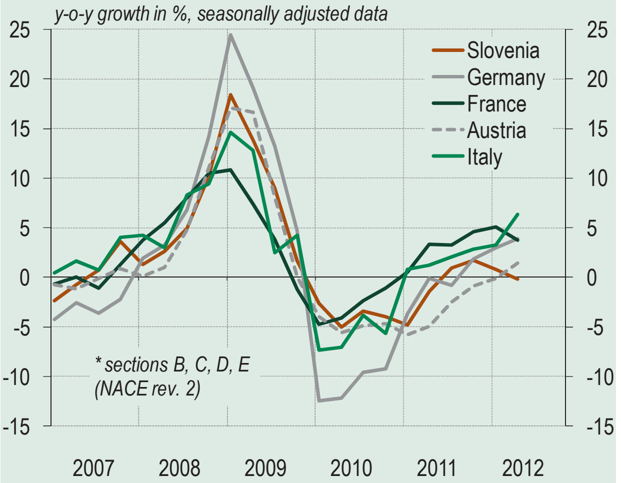
Figure 3.9: Real harmonised competitiveness indicator - ULC in total economy (20 countries and rest of the euro area)



Source: ECB.

cator as measured by unit labour costs in the total economy is slowly improving, after a significant deterioration in 2008 and 2009. Its level nevertheless remains relatively unfavourable compared with most of the main euro area trading partners. Given the depreciation in the nominal indicator and the weak economic activity, the improvement in the cost competitiveness of the total economy remains relatively slow. The exception is the cost adjustment in the tradable sector. Since the outbreak of the crisis in 2008 the tradable sector has made significant cost adjustments to the decline in economic activity. The competitiveness of the tradable sector thereby remains relatively unchanged compared with the pre-crisis period, and compared with competitors from the main euro area trading partners.

Figure 3.10: Unit labour costs - national accounts, industry excluding construction*



Sources: Eurostat, Bank of Slovenia calculations.

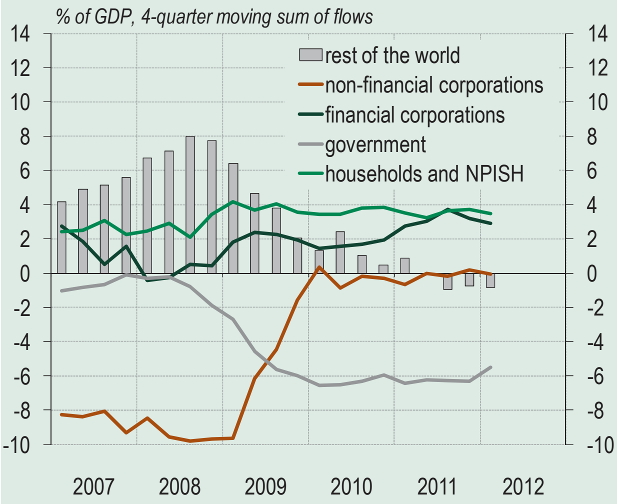
4 Financing

The adverse economic situation and political uncertainty, alongside the mounting debt crisis in certain euro area countries, are being reflected in the scale, types and costs of financing for the economy. The continuing decline in investment, partly as a result of the decline in borrowing by non-financial corporations and other domestic monetary financial institutions, and the increasingly significant limiting factors on the loan supply side brought a renewed decline in the stock of loans to non-financial corporations in the first half of the year. Non-financial corporations partly replaced the decline in domestic financing with foreign resources, primarily FDI, while the export-oriented sectors also made use of loans from the rest of the world. Growth in loans to households also declined significantly in the first half of the year. Other domestic monetary financial institutions continued to restructure their funding. There was an increase in deposits by households and other financial institutions, and funding from the ECB, while funding from foreign monetary financial institutions and funding via debt securities and government deposits declined. As a result of the deterioration in the quality of the loan portfolio for non-financial corporations and the associated higher impairment and provisioning costs, interest rates on new loans to non-financial corporations remained significantly above the euro area average in the first half of the year. Meanwhile interest rates on new loans to households remained comparable with the euro area average, and are being adjusted to interbank interest rates.

The adverse economic situation and uncertain political climate, alongside the mounting debt crisis in certain euro area countries, are being reflected in the financial accounts of individual sectors and the total economy. The annual savings-investment gap (hereinafter: financial deficit)[8] of non-financial corporations (NFCs)[9] has been close to a balanced position since the middle of 2011, primarily as a result of the extremely low level of investment and the deleveraging process. It stood at 0.1% of GDP in the first quarter of 2012. After the outbreak of the crisis, borrowing by NFCs declined sharply while borrowing by the government sector increased. Nevertheless, the government actually reduced its one-year financial deficit slightly in the first quarter. This was primarily the result of the decline in net government investment brought by the fiscal consolidation, but is also a reflection of the limited opportunity for additional borrowing because of downgradings and the financial markets' low confidence in the credibility of economic policy in Slovenia. In the year to the first quarter

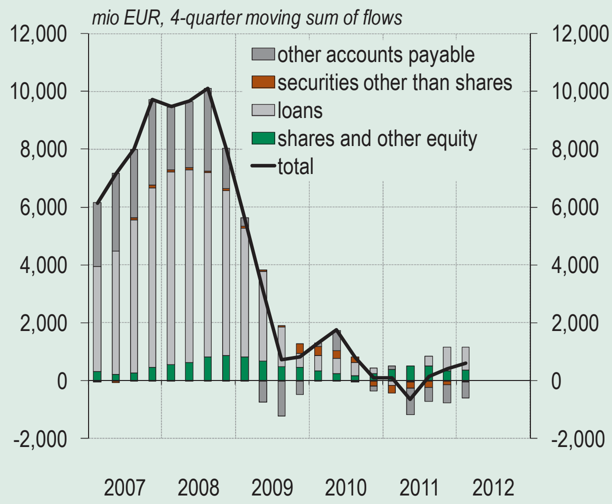
[8] The savings-investment gap is defined as the surplus of financial liabilities (investments) over financial assets (savings).
[9] According to the ESA 95 definition, non-financial corporations are legal entities that are market producers of goods and non-financial services.

Figure 4.1: Savings-investment gap



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

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



Source: Bank of Slovenia, unconsolidated data.

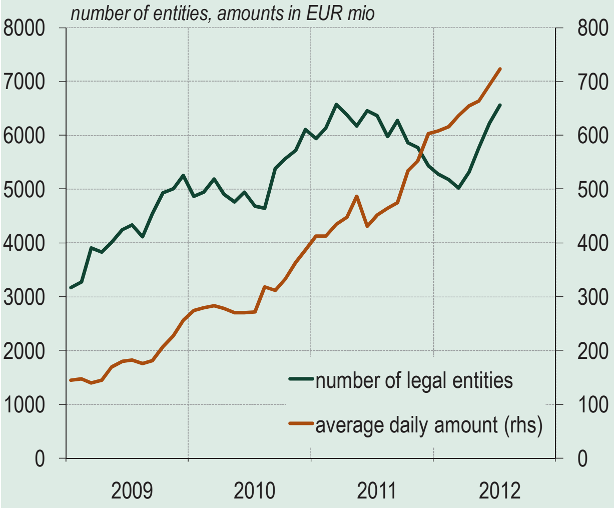
the financial deficit of the general government sector stood at 5.6% of GDP, 0.8 percentage points less than at the end of 2011. The one-year financial surplus of the household sector declined slightly in the first quarter as a result of a decline in financial assets, which could be a reflection of households' wish to maintain their real consumption in a situation of declining purchasing power. Net financing from the rest of the world, i.e. imports of net foreign savings, has been declining since the outbreak of the crisis, and had become net financing of the rest of the world by the third quarter of 2011. The one-year financial surplus against the rest of the world stood at 0.8% of GDP in the first quarter.

Financing and financial assets of non-financial corporations

Non-financial corporations' financial liabilities after the first quarter of this year amounted to EUR 87 billion, up EUR 167 million on the previous quarter. All sources of financing increased, with the exception of trade credits and advances. The largest increase was in NFCs' liabilities on the basis of issued shares and other equity instruments. They increased by EUR 60 million, primarily as a result of transactions, and remained the most important source of financing.. The stock of borrowing in the form of loans also increased slightly, by EUR 24 million, primarily as a result of an increase in loans received from the rest of the world. Domestic loans declined again in the first quarter. Financing via debt securities increased by EUR 28 million in the first quarter. The stock of trade credits and advances declined by EUR 161 million in the first quarter. In keeping with the payment indiscipline and the rise in the value of unsettled past-due liabilities, advances from other domestic corporates declined, while there was an increase of EUR 131 million in advances from the rest of the world.

The stock of loans to NFCs declined again in the first half of the year, as a result of the ongoing contraction in investment and the increasingly significant limiting factors on the supply side. Other domestic monetary financial institutions (MFIs) reduced their stock of loans to NFCs by 4.3% overall in year-on-year terms in the first six months of the year. The loan portfolios of other domestic MFIs are deteriorating as a result of excessive expectations of creditworthiness during the approval of loans in the past, the difficulties faced by NFCs in the crisis and their inability to settle liabilities, which is impacting the performance of MFIs and thus their capacity to approve new loans. In the medium term other domestic MFIs must

Figure 4.3: Outstanding matured liabilities



Source: AJPES.

also strengthen their capital base with regard to the stock of loans granted; this is also vital in terms of the possibilities of renewing and securing foreign funding. The mounting debt crisis means that the financial markets of the euro area have become even more segmented, which alongside uncertain domestic factors is significantly limiting other domestic MFIs' access to longer-term foreign funding. This is contributing to more stringent lending conditions, and thereby to the reduced supply of loans to NFCs. Weak demand for loans owing to the adverse economic situation and the ongoing deleveraging process at NFCs remain factors in the decline in loans to NFCs.

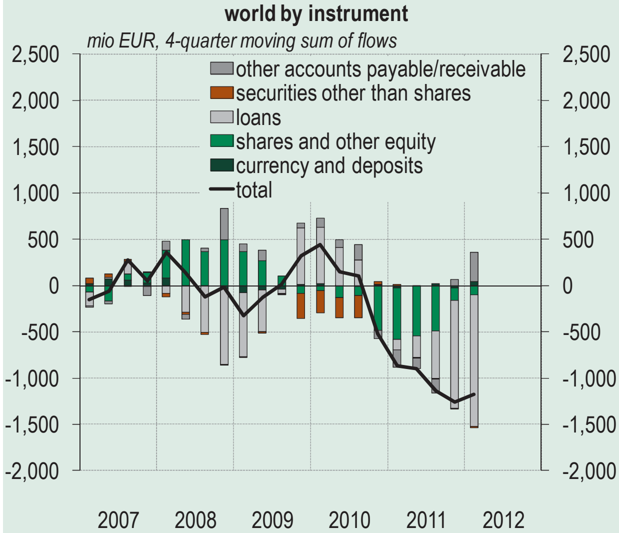
Having mainly approved long-term loans to NFCs last year, other domestic MFIs saw their stock of such loans decline sharply in the first half of this year. Given the decline in investment in equipment and machinery in the first half of 2012, the largest declines were recorded by loans with a maturity of between 1 and 5 five years, by almost EUR 210 million, and loans with a maturity of more than 5 years, by EUR 141 million. As in 2011, the stock of loans with a maturity of up to 1 year increased in the first half of the year, by almost EUR 100 million.[10] Nevertheless, growth in short-term loans was not sufficient to compensate for the loss of longer-term financing.

NFCs partly replaced the decline in domestic financing with foreign resources, primarily FDI and loans, particularly export-oriented NFCs. FDI increased by EUR 177 million in the first half of this year, only slightly less than in the same period last year. A large part of the increase in FDI was the result of an increase in capital by foreign owners of around EUR 140 million. While NFCs were still net lenders to the rest of the world in 2010, the trend has reversed in the last year. Since the middle of

Figure 4.4: Loans by domestic MFIs to domestic NFCs, by maturity

Source: Bank of Slovenia.

Figure 4.5: Net financial flows of NFCs (S.11) with rest of the world by instrument



Source: Bank of Slovenia, non-consolidated data.

[10] The shortening of average maturities is also partly the result of the restructuring of loans (Financial Stability Review, May 2012, p 26).

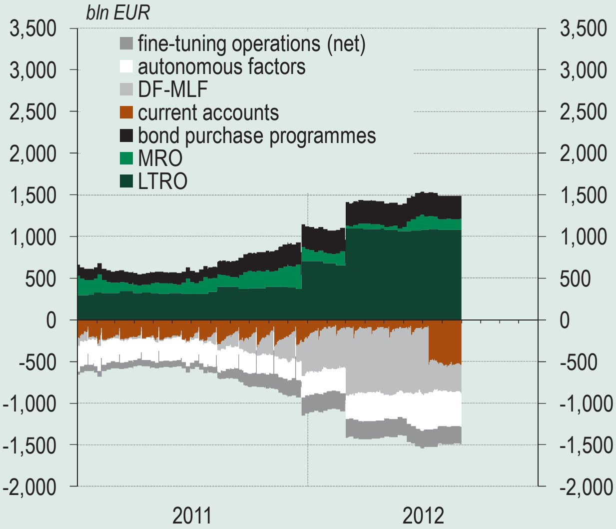
Box 4.1: Implementation of monetary policy since April 2012

As a result of the ongoing tensions in the sovereign debt market, between April and August banks in a number of euro area countries still hadn't had access to market-based funding, both short-term and long-term, and both unsecured and secured (repo). Furthermore, their eligible collateral for Eurosystem's credit operations narrowed due to sovereign debt and banks downgradings. In order to support crediting of households and non-financial corporations, and to preserve proper functioning of the monetary policy transmission mechanism throughout the euro area, the Governing Council of the ECB took additional measures to make Eurosystem's liquidity-providing operations more accessible to banks. It extended liquidity provision via fixed rate tender procedures with full allotment to 15 January 2013, as well as in late June and September it expanded the types of assets eligible to be used as collateral. The eligible collateral was broadened with (1) additional asset-backed securities, (2) securities and credit claims where the issuer/debtor or guarantor is central government whose credit rating does not meet the minimum rating threshold, provided that the country in question is under an EU/IMF programme and, in the view of the Governing Council of the ECB, is fulfilling the conditions of this programme, and (3) certain securities denominated in the US dollar, the pound sterling and the Japanese yen.

In addition, on 6 September the Governing Council of the ECB announced technical details of unlimited purchases of government bonds on the secondary market, the so-called Outright Monetary Transactions. The Eurosystem will purchase bonds with a residual maturity of one to three years of countries included in appropriate EFSF/ESM (European Financial Stability Facility / European Stability Mechanism) programmes, provided that these programmes include the possibility of EFSF/ESM purchases of the securities of concerned countries on the primary market. The start, continuation and termination of the purchases will depend on (1) the decision of the Governing Council of the ECB, (2) the necessity in terms of monetary policy and (3) whether the concerned country entirely fulfils the terms of the programme. The liquidity injected by the purchases will be sterilised. The Eurosystem will also continue to sterilise the liquidity created by the Securities Markets Programme (SMP), which the Governing Council of the ECB herewith ends.

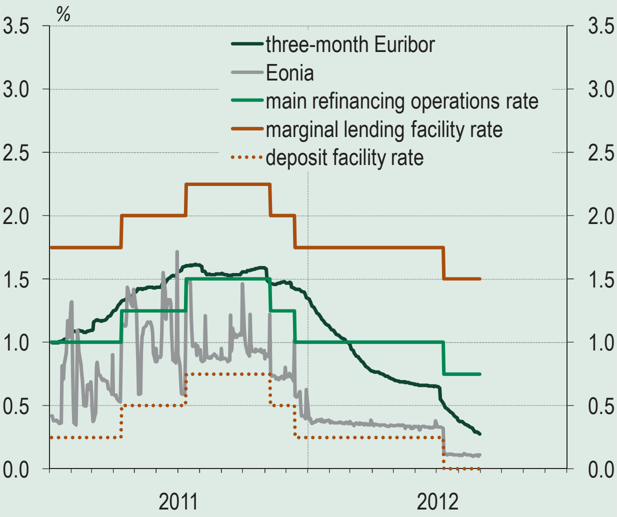
Eurosystem's liquidity-providing operations, i.e. the main refinancing operations (MROs) and longer-term refinancing operations (LTROs), increased by an average of EUR 72 billion to EUR 1,208 billion between April and August. They peaked at EUR 1,236 billion in June, primarily because of an increased participation in MROs, which rose to an average of EUR 161 billion in June. The LTROs borrowing did not change significantly over the observed period (Figure 1). The participation of Slovenian banks in the MROs and LTROs was almost unchanged between April and August. The outstanding amount of MROs in and LTROs averaged EUR 3,878 billion in August.

Figure 1: Banking system liquidity of the Eurosystem



Source: ECB.

Figure 2: ECB and unsecured money market interest rates



Sources: Bloomberg, ECB.

Such a large volume of Eurosystem's liquidity-providing operations is a result of two three-year LTROs, allotted on 21 December 2011 and 29 February 2012, which also affected the excess liquidity in the euro area. This is defined as the difference between the liquidity that the banks obtain from the Eurosystem and the banks' liquidity needs. After the second three-year LTRO, the excess liquidity in the euro area increased to a high EUR 800 billion. It remained high also between April and August; it averaged EUR 757 billion in August. By 10 July the banks had shifted almost all of their liquidity surpluses to the deposit facility (DF), while a smaller amount was left in current accounts at central banks, since the amount above the reserve requirements (excess reserves) is not remunerated, unlike the DF. The average daily excess reserves were almost unchanged at EUR 5 billion between April and June.

On 11 July the ECB decreased the interest rates by 25 basis points to: 0.75% for MROs, 0% for the DF and 1.25% for the marginal lending facility. This measure equalised the return on the DF and excess reserves, and the ratio between the usage of the DF and daily excess reserves altered. The usage of the DF averaged "just" EUR 325 billion in August, while the average daily excess reserves leapt to EUR 432 billion (Figure 1). Some banks, none of them Slovenian, still use the DF for regulatory reasons.

Due to the cut in the ECB's key interest rates, the unsecured and secured interbank money market interest rates fell to historic lows: on 31 August the Eonia stood at 0.11% and the three-month Euribor at 0.28% (Figure 2). Negative interest rates started to appear on the secured interbank money market across all maturities after 11 July. The excess liquidity kept unsecured and secured interbank money market interest rates low, with small intraday changes.

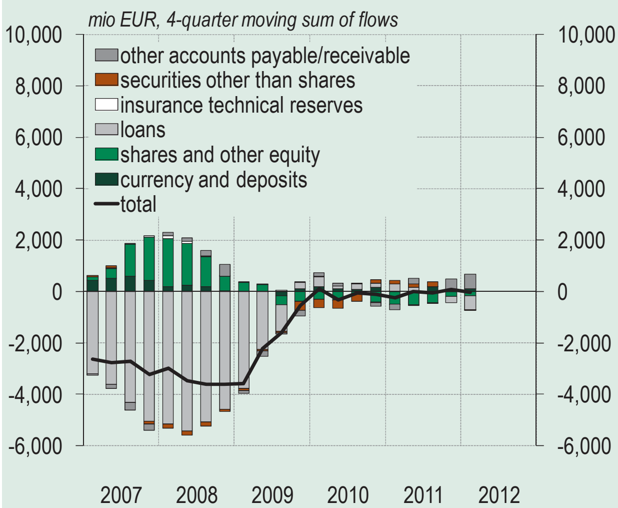
Negative interest rates on the bank deposits of institutional clients and on certain investments in the financial markets (repos, treasury bills of some countries) increased the liabilities to non-euro-area residents denominated in euro (LNR), as non-residents shifted their deposits to the Eurosystem, which remunerates them at a zero interest rate. Alongside the decline in government deposits at the Eurosystem and an increase in banknotes in circulation, growth in LNR contributed to the growth in autonomous factors[1] and was an additional (albeit small) source of the increase in the banks' liquidity needs.

[1] Autonomous factors are balance sheet items of the central bank which are not related to monetary policy, but nevertheless affect bank liquidity. These are for example banknotes in circulation, government deposits at the central bank, net assets of the central bank in euro and in foreign currency. Autonomous factors on the asset side of the central bank's balance sheet increase liquidity (e.g. investments in securities), while those on the liability side reduce liquidity (e.g. banknotes in circulation).

2011 NFCs have been net borrowers from the rest of the world.[11] In the first half of this year NFCs recorded net borrowing of EUR 48 million in the rest of the world, primarily as a result of a larger reduction in loans granted (EUR 132 million) than loans received (EUR 84 million). The narrowing of the merchandise trade deficit has also been reflected in trade credits, as NFCs recorded a net outflow of financial assets in the amount of EUR 70 million from this source in the first six months of the year.

NFCs increased their financial assets by EUR 323 million in the first quarter of this year, primarily via an increase in investments in shares and other equity. Investments in shares and other equity were up EUR 313 million on the end of 2011, driven partly by a positive revaluation of EUR 181 million. In contrast to previous quar-

Figure 4.6: Net financial flows of NFCs, by instruments (S.11)



Source: Bank of Slovenia, consolidated data.

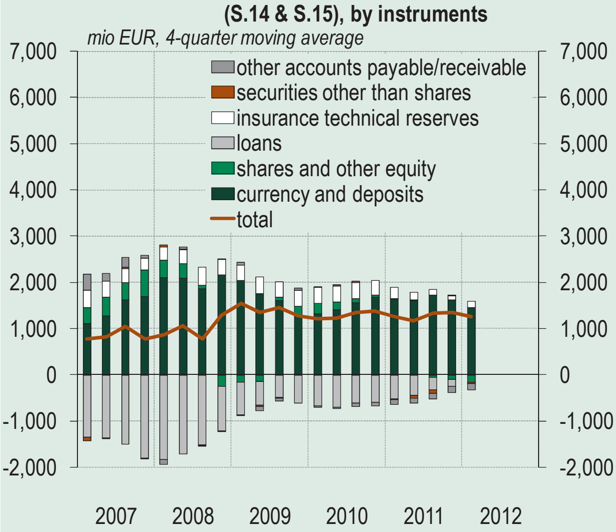
[11] The monthly figures suggest that borrowing from the rest of the world has fallen sharply in recent months, or that NFCs are even repaying loans to non-residents.

ters, outward trade credits and advances to the rest of the world increased in the first quarter of this year, by EUR 259 million, while trade credits and advances between domestic NFCs declined by EUR 265 million. The latter was also the result of write-offs of claims. The stock of loans granted by NFCs declined by EUR 215 million in the first quarter. The largest decline of EUR 160 million was recorded by loans to the rest of the world. Loans to other domestic NFCs also declined slightly. Investments in currency and deposits and investments in debt securities declined by EUR 98 million in the first quarter.

Household financing and savings[12]

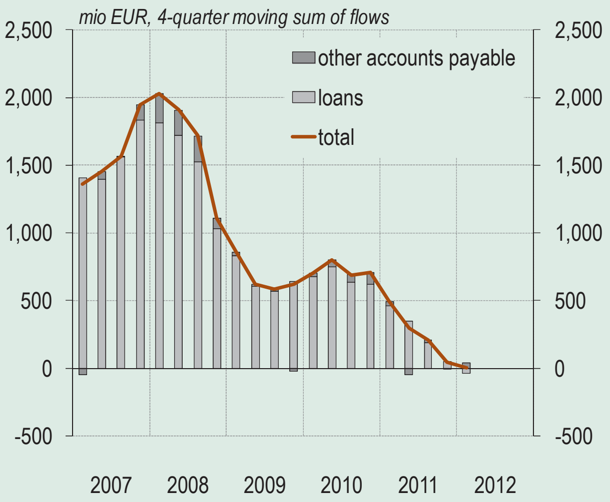
Households' financial liabilities at the end of the first quarter of this year amounted to EUR 12.5 billion, having remained at the level from the end of 2011. Liabilities from loans declined by EUR 98 million in the first quarter, primarily as a result of the continuing decline in consumer loans. The stock of consumer loans has been declining since the middle of 2010, as a result of the uncertain situation on the labour market, government austerity measures, and declining purchasing power. Consumer loans recorded an average decline of 5.3% in the first half of this year, compared with an average of 3%

Figure 4.7: Net financial flows of households and NPISH (S.14 & S.15), by instruments



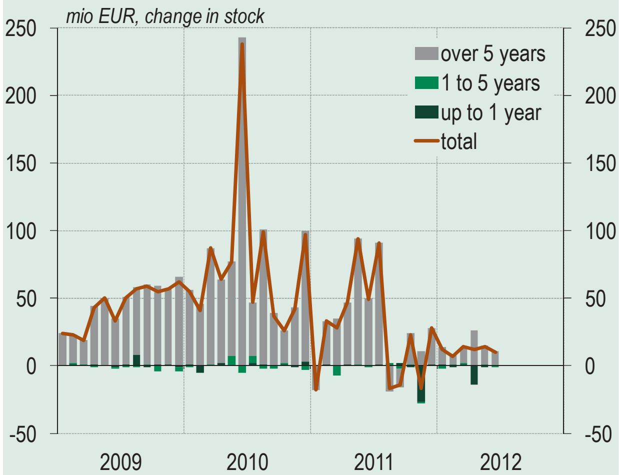
Source: Bank of Slovenia, consolidated data.

Figure 4.8: Financial liabilities of households and NPISH (S.14 & S.15), by instruments



Source: Bank of Slovenia, consolidated data.

Figure 4.9: Housing loans by domestic MFIs to domestic households, by maturity

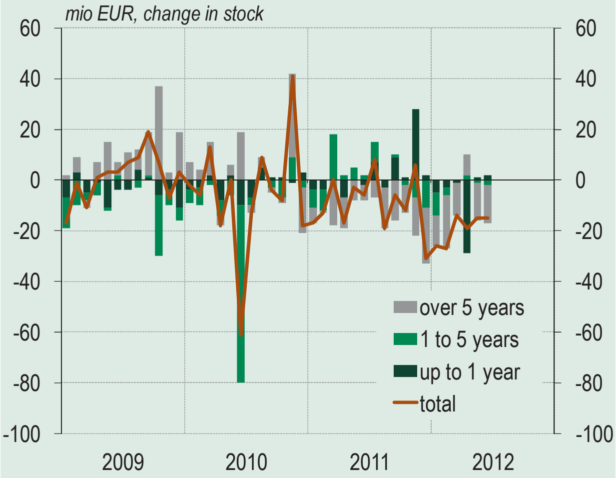


Source: Bank of Slovenia.

last year. Growth in housing loans also declined significantly, from more than 14% last year to an average of 5.6% in the first half of the year. The lower growth in housing loans is in line with the high real estate prices, particularly given the excess supply and declining purchasing power. This is also evident in the decline in the number of transactions on the real estate market. Real estate prices have recently fallen slightly, but in the current situation of high uncertainty households are postponing real estate purchases. Other household liabilities,

[12] Includes non-profit institutions serving households (S.15), in addition to households (S.14).

Figure 4.10: Consumer loans by domestic MFIs to domestic households, by maturity



Source: Bank of Slovenia.

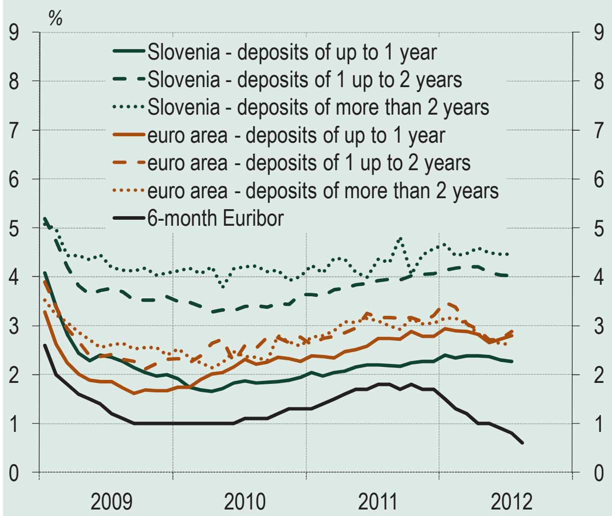
predominantly trade credits and advances, were up EUR 73 million in the first quarter.

The stock of households' financial assets amounted to EUR 40.8 billion at the end of the first quarter, down EUR 257 million on the end of 2011. This was primarily the result of a decline of EUR 382 million in the stock of other household deposits in the rest of the world in the first quarter. Deposits at other domestic MFIs increased by EUR 129 million over the same period. Households held 26% of their total financial assets invested in shares and other equity. The largest investments are in NFCs, mutual pension funds and investment funds. The stock of these investments increased by EUR 98 million in the first quarter, primarily as a result of positive revaluations. Financial investments in insurance technical reserves[13] accounted for 11% of total financial assets, having increased by EUR 123 million in the first quarter.

Bank funding and interest rates

The main influences over the future structure and cost of funding for other domestic MFIs will be the further deterioration in the quality of the credit portfolio and the related credit ratings of other domestic MFIs and the government. In the first half of 2012 there was an increase in deposits by households and other financial institutions and in funding at the ECB. Funding at foreign MFIs and funding via debt securities declined over the same period. Government deposits also declined. Other MFIs made renewed debt repayments of EUR 1,160 million to foreign banks in the first half of the year, the majority of which was repayments of loans with longer maturities. Liabilities from debt securities declined again, by almost EUR 500 million, as a result of prepayments of their own bonds by MFIs. The government sector also reduced its deposits at other domestic MFIs, by EUR 266 million, for the purpose of current operations. Other domestic MFIs compensated for this reduction with funding at the ECB, as a result of which their total assets remained broadly unchanged in the first half of the year. OFIs and households increased their deposits at other domestic MFIs by EUR 181 million in the first half of the year. Long-term household deposits, which represent a more desirable form of funding for other MFIs, have continued to record the largest increase. The interest rates on such deposits are therefore significantly above the euro area average. After December's 3-year LTRO, other domestic MFIs again participated in an LTRO at the ECB

Figure 4.11: Interest rates on household deposits, by maturity



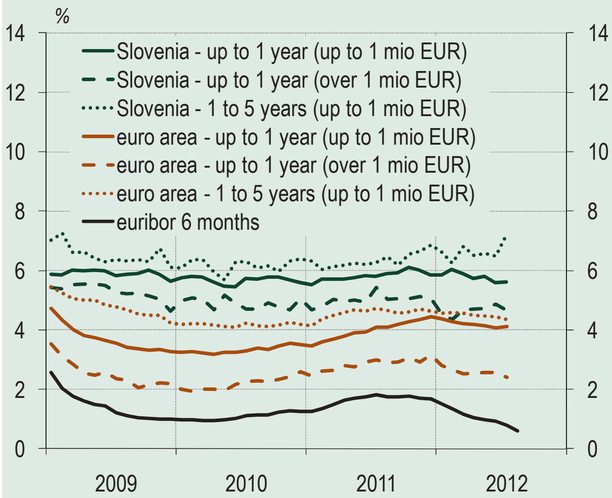
Sources: ECB, Bank of Slovenia.

[13] For the interpretation of insurance technical reserves in households' financial assets, see "Financial accounts methodology and the compilation process" at http://www.bsi.si/library/includes/datoteka.asp?DatotekaId=2198.

in February, which resulted in a further increase of EUR 2.2 billion in liabilities to the ECB. Other domestic MFIs thereby significantly reduced their short-term refinancing risk. An ongoing increase in write-downs and provisioning costs,[14] the maintenance of a high loan-to-deposit ratio, and a sovereign downgrading[15] could nevertheless additionally limit access to foreign funding in the future. This would further limit the supply of loans, which could further depress economic activity.

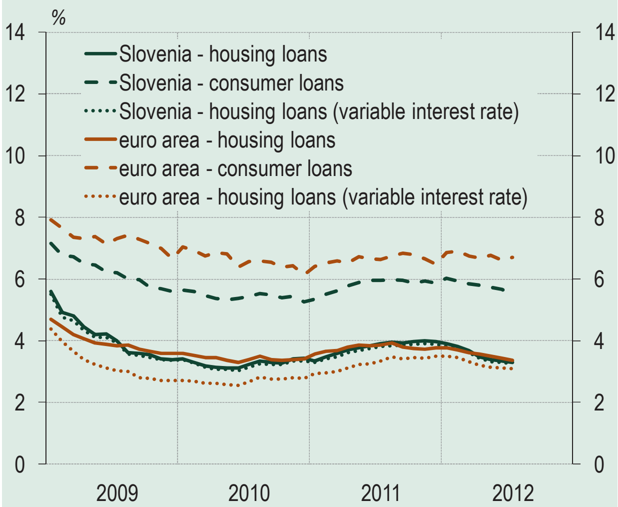
The increased difficulty in accessing funding for other MFIs, its higher cost, and the desire to maintain net interest income are being reflected in higher interest rates on loans, and thus in the supply of loans to the private sector, in particular to NFCs. The average interest rates on new loans to NFCs were again higher than the euro area average in the first half of the year. The higher interest rates were the result of several factors: (i) the greater uncertainty in Slovenian corporate performance relative to the euro area average, primarily as a result of the capital weakness in the Slovenian corporate sector; (ii) the relatively higher costs of bank funding; and (iii) other MFIs' need to maintain high net interest income to cover impairment costs.[16] Interest rates on longer-term loans in the first half of the year remained at their level from the end of 2011, significantly higher than the euro area average. The same is true of short-term loans, where the spread between interest rates in Slovenia and in the euro area overall has remained at around 2 percentage points.

Figure 4.12: Interest rates on loans to NFCs



Sources: ECB, Bank of Slovenia.

Figure 4.13: Interest rates on loans to households



Sources: ECB, Bank of Slovenia.

Interest rates on new loans to households are similar to interest rates in the euro area overall, and are being adjusted to the interbank interest rates. Interest rates on consumer and housing loans gradually increased until the middle of 2011, in line with the rise in the Euribor. As the Euribor fell in the final quarter of 2011, the trend reversed. Because almost 75% of housing loans in Slovenia are tied to interbank interest rates, the interest rates almost completely track the movement in the Euribor. Premiums over the 6-month Euribor on housing loans increased slightly in the first half of the year, but currently there is no indication that other MFIs are trying to limit the supply of these loans through an increase in interest rates. Interest rates on consumer loans in Slovenia remain lower than in the euro area, but the spread is narrowing.

[14] The erosion of the capital base is related to this. From this point of view, the recapitalisation of certain banks is vital to easing access to foreign funding.

[15] The sovereign credit rating is vital from the point of view of the refinancing of other domestic MFIs at the ECB. ECB loans are largely secured by means of Slovenian government bonds.

[16] As a result of the increased cost of write-downs and provisioning, and the unfavourable capital position, other MFIs have largely been forced to avoid reductions on the revenue side.

5 Public Finance Developments

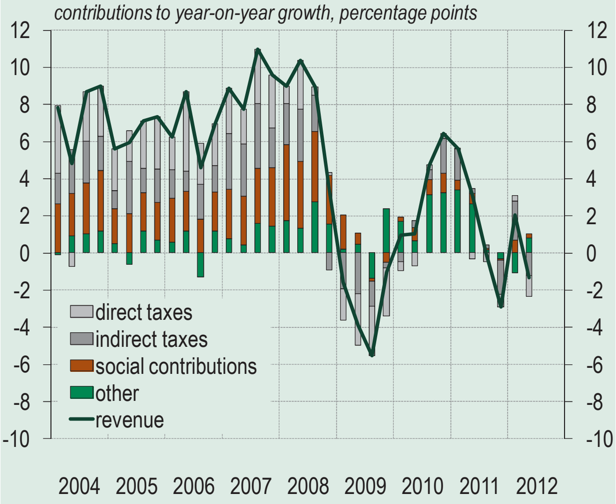
Having remained at a high level of around 6% of GDP for three years, the general government deficit is being reduced by measures adopted in the first half of this year. According to the Ministry of Finance's September forecasts, this year's general government deficit is expected to stand at 4.2% of GDP. The government remains committed to correcting the excessive deficit in the coming year in accordance with the provisions of the Stability and Growth Pact. Additional fiscal consolidation measures will therefore be required due to the deterioration in the macroeconomic situation. Government debt as a proportion of GDP rose further this year, despite the use of funds deposited at banks, but will remain below the threshold of 60% of GDP. Fiscal consolidation will remain an economic policy priority in the future, including in terms of ensuring access to the international financial markets. Structural reforms, the current focus of which is primarily pension reform, are also expected to contribute to the narrowing of the structural deficit in the coming years. Risks associated with public finances include the deteriorating macroeconomic situation, the possibilities of one-off expenditure, the possible redemption of guarantees, and the possible inadequacy of fiscal consolidation measures and their effects.

General government deficit

Having fluctuated at around 6% of GDP for three years, the general government deficit is expected to narrow to 4.2% of GDP this year according to Ministry of Finance forecasts. The general government deficit is being reduced in the context of the adverse economic situation, the reduction following the measures taken by other euro area countries with a delay. The general government deficit in the year to June 2012 amounted to EUR 1,668 million, or 4.6% of GDP. General government revenue was up slightly in year-on-year terms during the first half of the year, in the context of a nominal and real decline in economic activity, while expenditure was down sharply. At the end of September the Ministry of Finance forecast a general government deficit of 4.2% of GDP for this year, a decrease of more than 2 GDP percentage points on the previous year. In addition to consolidation measures on the expenditure side, expectations of a decline in one-off expenditure, which had a major impact on last year's deficit, are an important factor in the narrowing of the deficit. According to European Commission projections from May 2012, the general government deficit in the euro area is also expected to decline, from 4.1% of GDP last year to 3.2% of GDP this year, less than the decline in the previous year. The large differences between the deficits of euro area countries are expected to remain in the future. The general government debt in Slovenia was up slightly, to stand at 48.1% of GDP at the end of June.[17] The debt is expected

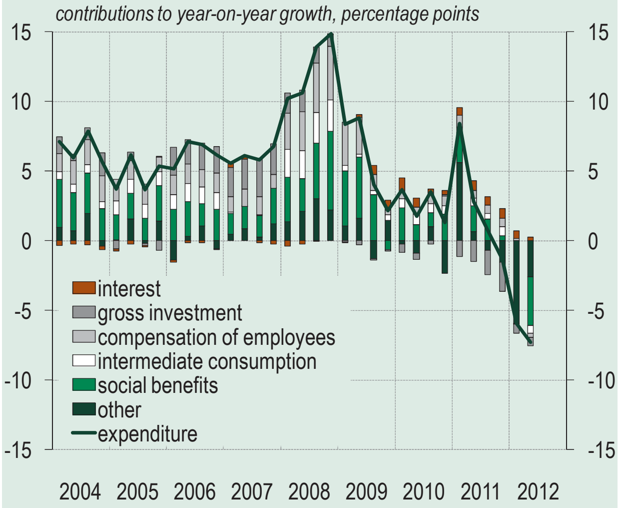
[17] Calculated as the stock of debt as at 30 June 2012 relative to annual GDP, up to and including the second quarter of 2012.

Figure 5.1: General government revenue



Sources: SORS, Bank of Slovenia calculations.

Figure 5.2: General government expenditure



Sources: SORS, Bank of Slovenia calculations.

to reach 53.8% of GDP by the end of the year according to Ministry of Finance forecasts from the end of September 2012. The euro area's general government debt is expected to increase from 88.0% of GDP in 2011 to 91.8% of GDP in 2012.

Low year-on-year growth in general government revenue during the first half of this year is a reflection of the renewed deterioration in the economic situation, particularly on the labour market. General government revenue was up 0.3% in year-on-year terms during the first half of 2012. The adverse situation on the labour market contributed to the low growth. Employment continues to contract, while growth in average compensation per employee is also low. Uncertainty regarding employment is an additional factor in consumers' willingness to spend, particularly on durables. Tax revenues were up slightly in the first half of this year relative to the same period last year. Higher excise duties on all types of products subject to the aforementioned tax have had a positive impact on revenue, while at the same time limiting the otherwise relatively inelastic demand for those goods. The most significant change to tax legislation introduced this year relates to corporate income tax. The corporate income tax rate was cut this year from 20% to 18%, to be followed by an annual cut of 1 percentage point to 15%.

Table 5.1: General government deficit and debt in Slovenia, 2008-2015

	SORS					Stability Programme					European Commission		
as % GDP	2008	2009	2010	2011	2012*	2011	2012	2013	2014	2015	2011	2012	2013
Revenue	42.4	43.1	44.5	44.3	44.6	44.5	44.7	44.1	43.8	43.7	44.5	44.4	44.0
Expenditure	44.3	49.1	50.3	50.7	49.2	50.9	48.2	46.7	45.3	44.1	50.9	48.7	47.9
of which: interest	1.1	1.3	1.6	1.9	2.0	2.0	2.5	2.6	2.5	2.5	2.0	2.5	2.6
Net lending (+) / borrowing (-)	-1.9	-6.0	-5.7	-6.4	-4.6	-6.4	-3.5	-2.5	-1.5	-0.4	-6.4	-4.3	-3.8
Structural balance	…	…	…	…	…	-3.8	-1.8	-1.1	-0.7	-0.1	-3.9	-2.2	-1.9
Debt	22.0	35.0	38.6	46.9	48.1	47.6	51.9	53.1	52.6	50.9	47.6	54.7	58.1
Real GDP *(growth, %)*	3.4	-7.8	1.2	0.6	-1.6	-0.2	-0.9	1.2	2.2	2.2	-0.2	-1.4	0.7

*Note: * Debt: calculated as outstanding debt on 30th June 2012 compared to one year GDP up to Q2/2012, other: one year up to June 2012.*
Sources: SORS (realisation), Ministry of Finance (April 2012), European Commission (May 2012).

Box 5.1: European Commission's Macroeconomic Imbalance Procedure and principal recommendations for Slovenia[1]

The European Commission has developed an early detection mechanism for the timely prevention of macroeconomic imbalances in Member States. The surveillance procedure to prevent and correct macroeconomic imbalances (the Macroeconomic Imbalance Procedure or MIP) was adopted on 13 December 2011 as part of the so-called "Six-Pack" of reforms in the area of EU economic governance.[2] The purpose of the MIP is to improve surveillance over the economic positions of Member States and to ensure appropriate economic policies that will prevent the occurrence of detrimental macroeconomic imbalances and facilitate the correction of existing excessive imbalances. In the scope of the MIP, the European Commission published its first Alert Mechanism Report in February this year, in which the condition of Member States' economies were presented with the help of indicators for detecting external and internal imbalances.[3] Threshold values were defined for each indicator. Member States already included in the financial assistance programmes of the EU and IMF (Ireland, Greece, Portugal and Romania) are not included in the MIP, as strict macroeconomic surveillance is already in place.

If the Commission identifies major deviations from permitted values in an Alert Mechanism Report for a specific Member State, an in-depth review of that country is triggered. If an in-depth review confirms the existence of excessive macroeconomic imbalances, then an Excessive Imbalance Procedure is triggered. During this procedure, the Member State must submit a plan for reducing imbalances, which must be agreed upon by the EU Council. If the Member State fails to act in accordance with the agreed measures, it is subject to a financial penalty in the amount of 0.1% of GDP, initially in the form of an interest-bearing deposit, and as an annual fine, if failure to fulfil measures persists. Financial sanctions will only apply to euro area countries.

The Commission identified 12 Member States based on the findings of the first Alert Mechanism Report. Significant imbalances were perceived for the following euro area countries: Belgium, Spain, France, Italy, Cyprus, Slovenia and Finland; and for the following EU Member States: Bulgaria, Denmark, Hungary, Sweden and the United Kingdom. Taking into account the Member States already included in the assistance programmes of the EU and IMF, some 60% of Member States are faced with macroeconomic imbalances.

In the detailed report on macroeconomic imbalances in Slovenia, the Commission finds that the imbalances identified are not excessive, but require close monitoring. During the period 2001-2010, Slovenia exceeded the threshold values of indicators for growth in unit labour costs, and in particular for growth in real estate prices and private sector credit flow during the period of rapid economic growth prior to the crisis. The threshold value of the indicator for the net international investment position was also exceeded slightly during the crisis, while the excessive current account deficit has been reduced. In its in-depth review, the Commission focused primarily on an analysis of the indebtedness of non-financial corporations and the vulnerability of the banking sector. The shortfall in external competitiveness is also unfavourable, but poses less of a problem. The Commission thus proposes three basic guidelines for the functioning of Slovenia's economic policy:

- *More effective supervision and improved corporate governance* to prevent a repeat of asset price bubbles and the unsustainable leveraging-up of corporates. More stringent stan-

[1] Sources: ECB Monthly Bulletin, June 2012; European Commission: Macroeconomic imbalances – Slovenia, Occasional Papers 109/July 2012; European Commission: Scoreboard for the surveillance of macroeconomic imbalances, Occasional Papers 92/February 2012; European Commission: Alert Mechanism Report, February 2012; and EU Regulation No. 1176/2011.

[2] The "Six-Pack" is a package of six legislative measures to improve economic governance in the EU. It represents the reform of the preventive and corrective arm of the Stability and Growth Pact, sets out new minimum requirements in the formulation of the national budgets and also includes the new Macroeconomic Imbalances Procedure.

[3] Indicators of external imbalances include the current account balance as a percentage of GDP, the net international investment position as a percentage of GDP, the percentage change in export market shares, the percentage change in nominal unit labour costs and the percentage change in the real effective exchange rate as measured by the HICP. Indicators of internal imbalances include growth in real estate prices expressed as a percentage, private sector credit flow as a percentage of GDP, private sector indebtedness as a percentage of GDP, the general government debt as a percentage of GDP, and the unemployment rate. For a detailed description see the Alert Mechanism Report, p 3. (http://ec.europa.eu/economy_finance/economic_governance/documents/alert_mechanism_report_2012_en.pdf).

dards for bank capitalisation and collateral valuations were proposed, together with a more active role on the part of the banking system's supervisor. Improving corporate governance would be achieved by reducing state ownership of banks and state intervention in management decisions. This would also promote FDI.

• *Improving conditions for FDI* would facilitate corporates' shift from debt to equity financing, which would increase the stability of private sector financing. Foreign investment would provide capital to the real sector and banking sector, where risk management should be improved. Payment indiscipline must be reduced and the effectiveness of bankruptcy proceedings improved to improve the investment climate.

• *Improving cost competitiveness* by containing wage growth could make a key difference in preventing the return of external imbalances. The Commission's recommendations in this area are standard and relate to moderating public sector wages and minimum wages, while simultaneously improving labour market flexibility. The latter relates to reduced protection for permanent employees and a reduction in labour market segmentation.

The investment allowance and allowance for spending on research and development were also increased. The statutory tax rate and corporate income tax as a proportion of GDP were already below the euro area average prior to the aforementioned cut.

General government expenditure was down sharply during the first half of the year, in part due to the government's austerity measures. Expenditure as a proportion of GDP, which rose sharply during the crisis, is also declining. Expenditure is being cut by the Fiscal Balance Act (ZUJF), not only this year, but also in the coming years. Total general government expenditure was down 6.6% during the first half of the year. A decline in one-off transactions, which increased the deficit by EUR 382 million or 1.1% of annual GDP during the first half of last year, contributed 3.3 percentage points to the fall in expenditure. The capital increase at NLB d.d. during the first quarter (EUR 243 million) and a transfer to Slovenian Railways (EUR 119 million) in the second quarter accounted for the majority of the aforementioned transactions last year, while there was a further capital increase at NLB d.d. in the amount of EUR 61 million this year. Moreover, nearly all categories of general government expenditure recorded a year-on-year decline. Only expenditure on interest recorded a sharp increase. Restrictions on employee compensation, which was down 0.3% in year-on-year terms during the first half of the year, continue. The provisions of the ZUJF will have an even more profound impact on the reduction of employee compensation during the second half of the year. Wages paid to public sector employees in June were lower due to an 8% linear cut in basic wages. However, the actual reduction of average wages was significantly lower owing to the final elimination of wage discrepancies. Expenditure on intermediate government consumption was down 2.4% during the first half of the year. Expenditure on social benefits was down in year-on-year terms for the first time since such figures have been available. No pension adjustments were made during the first half of this year, nor will any adjustments be made for the rest of the year, according to the provisions of ZUJF. Certain pensions were reduced in accordance with the provisions of the ZUJF. Changes introduced at the beginning of the year under the Public Funds Entitlement Act had a significant impact on other social transfers. Investment expenditure has declined for the third consecutive year. By contrast, interest payments, which reached 2.0% of GDP in the year to June, have continued to rise.

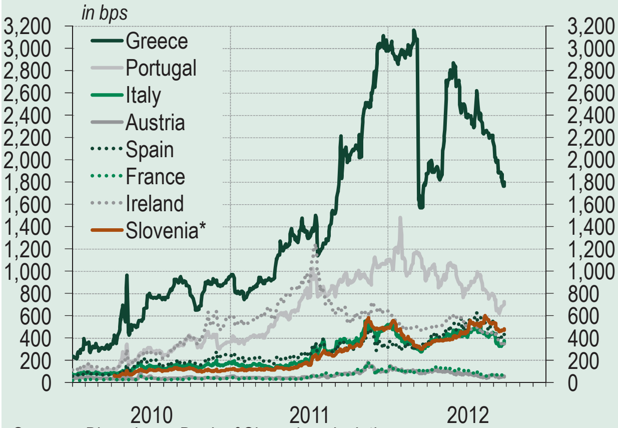
Government debt and guarantees

The general government debt was up slightly to stand at 48.1% of GDP at the end of June 2012. Borrowing during the first seven months of the year was primarily earmarked for the financing of the state budget and the repayment of maturing debt. The general government debt stood at EUR 17,334 million at the end of June, or 48.1% of GDP. The debt has risen by EUR 380 million since the end of last year. The government borrowed primarily by issuing treasury bills and by raising long-term loans at the domestic banks. According to figures from the consolidated general government budget,[18] borrowings raised over the first seven months of the year totalled EUR 1.3 billion, EUR 989 million less than required for financing in the same period as a result of the use of funds from previous borrowing. Debt repayments during the first seven months of the year totalled EUR 1.2 billion. Under the approved financing programme, the borrowing ceiling for the state budget is EUR 4.5 billion in 2012. The Ministry of Finance plans to issue long-term bonds in the amount of USD 1.5 billion by the end of the year, mostly likely on the US market, provided that market conditions are favourable. Otherwise, borrowing will continue (to a lesser amount) primarily on the domestic market.

The stock of government guarantees was up during the first half of the year primarily on account of guarantees issued with the aim of ensuring financial stability in the euro area. The stock of guarantees stood at EUR 7.6 billion or 21% of GDP at the end of June, up nearly 2 percentage points on the end of last year. More than EUR 5 billion, or around two-thirds, comprises standard guarantees. The remainder relate to addressing the economic crisis and are primarily from 2009, while a significant portion is earmarked for ensuring the financial stability of the euro area via guarantees to the temporary European Financial Stability Facility (EFSF). The stock of guarantees issued to address the economic crisis in Slovenia is gradually declining owing to a reduction in the stock of government-guaranteed bank bonds, while the stock of guarantees issued to address the euro area financial crisis is rising. According to Ministry of Finance figures, nearly EUR 1.1 billion in new guarantees for the EFSF were issued during the first half of this year, while the stock of guarantees issued to domestic corporates was virtually unchanged. Another major government guarantee in the amount of EUR 440 million is to be issued this year for the financing of Block 6 of the Šoštanj power station. According to state budget figures, guarantees in the amount of EUR 23 million were called during the first eight months of the year, while the revised budget earmarks EUR 25 million for that purpose this year. The government received EUR 7.4 million in commissions, primarily from the domestic banks, for guarantees issued during the first half of the year.

The required yield on long-term Slovenian government bonds continued to rise gradually from March on, and temporarily exceeded 7% in August. Problems in the banking system, political disagreements and the deteriorating macroeconomic situation contributed to downgrading of Slovenia's credit rating. The required yield on long-term Slovenian government bonds averaged 6.0% over the first eight months of the year, with the premium over the benchmark German bonds reaching 435 basis points. The required yield fell until March which, similar to other euro area countries, was also the result of non-standard measures by the ECB. The rise in the required yield after March was linked to the deepening of the debt crisis in certain euro area countries, in particular in Italy and Spain. The required yield on Slovenian government bonds rose further, occa-

Figure 5.3: Spreads on 10-year government bonds over German bond



Sources: Bloomberg, Bank of Slovenia calculations.
Notes: Spread is calculated as a difference between the yield of 10-year 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 01/21 is used after 11. January 2011.*

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

Box 5.2: Further improvement in economic governance in the euro area countries and the EU

EU Member States have responded to perceived deficiencies in the area of economic governance with the recent adoption of certain significant measures, and by planning several new measures. The objective of previously implemented and planned changes is to ensure the sustainability of public finances, the competitiveness of economies and the stability of the financial system, which are crucial for the functioning of the Economic and Monetary Union. Among the most important of previously implemented measures is the introduction of the European Semester, which ensures the improved coordination of EU Member States' economic policies. Implementation began at the beginning of last year. Five regulations and one directive, known as the "Six-Pack" entered into force in the middle of December 2011, introducing new rules for the entire EU, while the part relating to financial sanctions only applies to euro area countries. One new feature regarding the surveillance of economic policies is the Macroeconomic Imbalance Procedure, which was implemented for the first time during the first half of this year (see Box 5.1).

In March 2012 a total of 25 EU Member States (i.e. all Member States except the Czech Republic and United Kingdom) signed the Treaty on Stability, Coordination and Governance in the Economic and Monetary Union (hereinafter: the Treaty), part of which is the Fiscal Compact. The Treaty will enter into force on the first day of the month after instrument of ratification has been deposited by the 12th member of the euro area. Eight euro area countries, including Slovenia, and three other EU Member States had ratified the Treaty and deposited instruments of ratification by 27 September. The content of the Fiscal Compact must be transposed into national legislation within one year of the entry into force of the Treaty. In June 2012 the European Commission announced common principles for national fiscal correction mechanisms on the basis of the Treaty. The Commission defined the qualitative characteristics of the correction mechanism. The mechanism should (1) be transposed into national law, preferably at the constitutional level, (2) be consistent with the EU framework, (3) be activated in well-defined circumstances characterising a significant deviation from the medium-term fiscal objective or the adjustment path towards it, (4) take into account predetermined binding rules regarding the size of and the timeline of the correction of deviations, (5) give a prominent operational role to rules on public expenditure and discretionary tax measures, and include arrangements regarding the allocation of the fiscal adjustment burden across levels of the government, (6) define an escape clause that may only be activated in the exceptional circumstances set out in the Stability and Growth Pact, and on a strictly temporary basis with a commitment to make the appropriate structural adjustment, and (7) facilitate a significant role for independent monitoring institutions.

The reform of economic governance in the EU is increasing the role of the structural government deficit in the process of monitoring, supervising and assessing the fiscal policy of a specific country. An essential part of the Treaty is the commitment of signatory states to ensure budgets that are in balance or in surplus. The aforementioned rule is taken into account if a country achieves its medium-term fiscal objective of a structural deficit that does not exceed 0.5% of GDP.[1] On the basis of the Treaty, the Commission is also committed to drafting a proposed timetable for rapid convergence with the medium-term objective or with the target structural deficit of a specific country. The speed required to achieve the medium-term objective will have a significant impact on the conduct of economic policy in the euro area in the coming years.

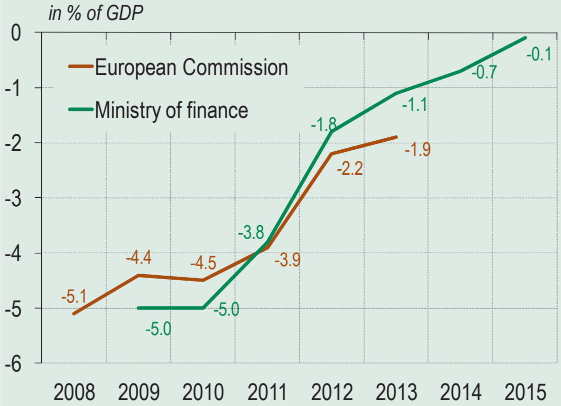
Slovenia's estimated structural deficit for 2011, calculated by the European Commission and the Ministry of Finance, is slightly less than 4% of GDP (see Figure 1). In the updated Stability Programme from April 2012, Slovenia confirmed a balanced structural position as a medium-term fiscal objective that it expects to achieve in 2015. The European Commission assessed that such a medium-term fiscal objective is insufficient for Slovenia, as pension reform was not carried out in 2011. After the excessive deficit is eliminated in 2013, in accordance with the requirements of the EDP, Slovenia is expected to continue reducing its structural deficit in 2014 and 2015, by a total of 1 GDP percentage point or an average of 0.5 GDP percentage points annually, in line with the plans set out in the latest Stability Programme. This corresponds to the minimum requirements of the Stability and Growth Pact.

At the end of last November the European Commission published two draft regulations, whose aim is to further strengthen fiscal discipline and monitoring mechanisms in euro area countries. The first regulation[2] relates to the establishment of a common timeline for the drafting of budget documents. An important new feature is the obligation of countries to draft budget documents for the next year by 15 October of the current year, and to publish and submit those documents to the European Commission and Eurogroup. The European Commission may request a revised draft budgetary plan, if it identifies non-compliance with budgetary policy obligations, and the monitoring of budget implementation during the current year for countries subject to the excessive deficit procedure. The regulation also establishes the requirement for independent macroeconomic forecasts, which serve as the basis for budgetary plans, and the requirement of an independent fiscal council to monitor the implementation of medium-term plans. The second regulation[3] governs the more stringent surveillance of Member States experiencing serious difficulties with respect to financial stability or that receive financial assistance on a precautionary basis. In certain cases, the aforementioned regulation provides for the drafting of a macroeconomic adjustment programme and the monitoring of a Member State, even after the programme concludes, if assistance is financed by the EU or Member States.

Current developments aimed at strengthening economic governance in the EU stem from the report of the President of the European Council from June this year, which proposes a comprehensive shift to a fiscal and banking union.[4] The report proposes strengthening the integration of Member States in four areas:

- An integrated financial framework, whose main elements are common European banking supervision, a common deposit insurance scheme and a common bank resolution scheme. The ESM could represent fiscal backstop for euro area countries. In mid-September the European Commission proposed the establishment of a common banking supervision mechanism in the euro area that will serve as the basis for a banking union, in which the ECB will play a key role.[5]

Figure 1: Structural deficit of the general government sector in Slovenia



The structural deficit as estimated by the Ministry of finance, reflects its targeted dynamics, while estimates of the European Commission reflect only implemented measures.
Sources: European Commission, Ministry of finance - Stability Programme, April 2012.

- An integrated budgetary framework, in which the possibility of issuing common euro bonds could be explored in the medium term.
- An integrated economic policy framework, e.g. in areas such as labour mobility or tax coordination.
- The strengthening of democratic legitimacy and accountability.

[1] When a country's debt is well below 60% of GDP and the risks associated with the long-term sustainability of public finances are low, that country's structural deficit may not exceed 1% of GDP.
[2] The proposal is accessible at: http://ec.europa.eu/europe2020/pdf/proposal_monito_assess_en.pdf
[3] The proposal is accessible at: http://ec.europa.eu/europe2020/pdf/proposal_strength_eco_en.pdf
[4] The proposal is accessible at: http://consilium.europa.eu/uedocs/cms_data/docs/pressdata/en/ec/131201.pdf
[5] A common supervision mechanism should be established by 1 January 2013. From that date forward, the ECB will be able to supervise credit institutions, in particular those that have received or requested public funds. Under the current proposal, the ECB would supervise systemic banks from July 2013 onwards, and all euro area banks from 1 January 2014.

sionally exceeding 7% in August following the downgrading of Slovenia's long-term debt in the same month by several ratings agencies. The main reasons given by the agencies for the downgrade are difficulties in the Slovenian banking system, political disagreements and the deteriorating macroeconomic situation. The outlook at all agencies remains negative. The recapitalisation of certain banks, fiscal consolidation and the implementation of structural reforms are crucial to lowering the required yield on Slovenian bonds.

Slovenia's participation in ensuring the financial stability of the euro area

Slovenia participates in programmes, primarily via the EFSF, aimed at providing assistance to Greece, Ireland, Portugal and Spain. Cyprus has also requested assistance. International assistance to resolve the fiscal problems of Ireland and Portugal amounts to EUR 68 billion and EUR 78 billion respectively. The first package of assistance approved for Greece totalled EUR 110 billion, while EUR 173 billion was approved in the second package, which includes around EUR 34 billion in unused funds from the first package. The assistance for Spain, which was requested in June, will amount up to EUR 100 billion at maximum, although the final amount has not been set yet. In contrast to other countries, which are receiving assistance to address their public debt problems, the assistance to Spain is earmarked solely for bailing out banks. Cyprus also requested assistance in June, but the amount is not yet agreed. A portion of the aforementioned assistance is being financed by the EFSF. The EFSF will provide funding to Ireland in the amount of EUR 17.7 billion, to Portugal in the amount of EUR 26 billion and to Greece in the amount of EUR 144.6 billion in the scope of the second package, which also includes contributions from the private sector in the amount of EUR 35.5 billion. Following the exclusion of Spain and Cyprus from the group of countries that contribute funds to the EFSF, Slovenia's share of guarantees will rise by 0.1 percentage points to 0.6%. According to Ministry of Finance figures, the stock of Slovenia's guarantees for securities issued by the EFSF stood at EUR 1,154 million at the end of June. The value of Slovenia's loans to countries receiving assistance in the scope of the aforementioned guarantees reached EUR 518 million, corresponding to the increase in the general government debt. Slovenia approved loans to Greece in the amount of EUR 263 million in the first package of assistance, which has already been completed. The aforementioned loans likewise resulted in an increase in the general government debt.

A permanent mechanism to ensure stability in the euro area will begin functioning later than previously planned. The ESM, which was originally planned to begin functioning this July, is now expected to begin functioning in October due to Germany's delay in ratifying the Treaty on Stability, Coordination and Governance in the Economic and Monetary Union. It will replace the EFSF, which functions as part of the temporary mechanism for ensuring financial stability. The ESM disposable funds will amount at EUR 500 billion, a portion of which will consist of paid-in capital from Member States. Slovenia's share of ESM capital will be EUR 342 million, EUR 137 million of which is expected to be paid during the first year of the mechanism's functioning. Only those countries that ratify the Treaty on Stability, Coordination and Governance in the Economic and Monetary Union will be eligible for financial assistance from the ESM (see Box 5.2). In addition to direct financial assistance for countries to address their debt problems and to ensure the financial stability of the euro area, the mechanism could also contribute funds for the recapitalisation of banks and the purchase of government securities on the primary and secondary markets.

Planned developments in the general government deficit

According to government plans, the actual and structural general government positions are expected to be nearly balanced in 2015. Additional measures will be required to achieve that objective. According to Ministry of Finance forecasts in the Reporting of Government Deficits and Debt Levels of 28 September 2012, the general government deficit is expected to fall to 4.2% of GDP this year. The deficit is expected to continue narrowing in the coming years according to projections from the latest Stability Programme from April 2012, to reach 0.4% of GDP by 2015. The Stability Programme states that the aforementioned target will be reached primarily by reducing general government expenditure, including employee compensation, intermediate consumption and social transfers. The revised state budget for 2012 and the ZUJF, which entered into force at the end of May, follow this policy. Although measures to balance public finances produce adverse effects on economic growth in the short term, their long-term effect is positive. Additional measures for the balancing of public finances are expected during the drafting of the state budgets for the next two years, together with structural reforms on the labour market and the pension legislation. In the context of the deteriorating economic situation, the short-term adverse effect on the economy must be taken into account when defining the types of measures to be implemented.

Slovenia has to bring down the general government deficit to below 3% of GDP by 2013 and then to maintain it below that level in line with the excessive deficit procedure. Slovenia has been undergoing the excessive deficit procedure since December 2009, which requires a reduction in the general government deficit to below 3% by 2013. The government confirmed its commitment to achieving this target in April's updated Stability Programme. The government must prepare draft budgets for the next two years, including measures for further reducing the deficit, by the end of September. This will also reduce the structural deficit, as required by the intergovernmental Treaty on Stability, Coordination and Governance in the Economic and Monetary Union. According to the European Council recommendations of December 2009, the structural deficit should be reduced by an average of 0.75 GDP percentage points annually until 2013. According to the latest Stability Programme from April 2012, the structural deficit is expected to reach 0.1% of GDP in 2015 (see Figure 1 in Box 5.2).

The planned deficit reduction is being hindered by the adverse macroeconomic situation, while risks are primarily linked to the possibility of expenditure of a one-off nature. The current economic situation and expectations are worse than envisaged in the updated Stability Programme from April 2012. Thus, the projections in the current Price Stability Report and those of the Institute of Macroeconomic Analysis and Development, (which form the basis for budgetary planning) indicate a more significant decline in GDP than was expected during the drafting of the consolidation plan. The possibility of expenditure of a one-off nature, due to possible additional assistance to certain banks and the increased call of issued guarantees, also represent a risk to the achievement of fiscal objectives.

Pension reform, which is expected to be adopted by the end of the year, is based on extending the pensionable age and retirement age for men and women, and the equalisation of the latter by the end of the transitional period. The implementation of reforms is crucial, as Slovenia is one of the countries with the highest population ageing costs. In the Ageing report[19] published by the European Commission in May 2012, the increase in strictly age-related general government expenditure is estimated at 10.3 GDP percentage points for Slovenia by 2060, according to the reference scenario, while the euro area average is 4.5 GDP percentage points. Strictly age-related expenditure includes pensions, healthcare, long-term care and education. Growth in these costs in Slovenia derives primarily from pensions. Pension reform that would contribute to the long-term sustainability of public finances is expected to be adopted by the end of this year, with its provisions entering into force in 2013. The fundamental changes in the government's proposal that bring the most significant fiscal effects relate to a change in conditions for old-age retirement which, for a full pension, dictate a retirement age of 65 and a 15-year insurance period for both sexes, or 60 years of age with 40 years of pensionable service without a buyout. The basis for calculating pensions would take into account the most favourable 28 consecutive years of employment, excluding the three least favourable years, with a regular annual adjustment of pensions that would take into account 60% of growth in the average wage and 40% of inflation.

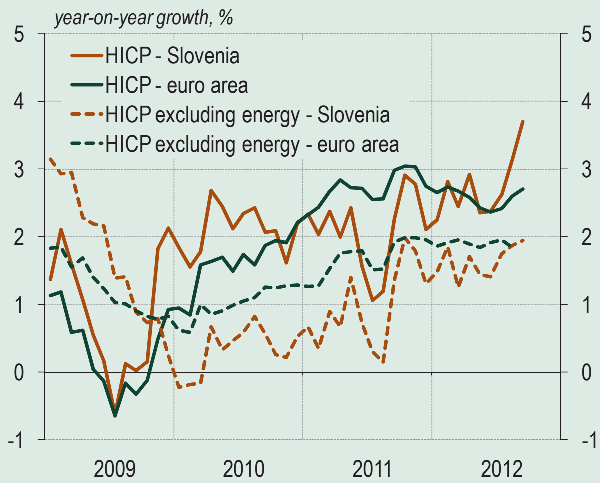
[19] The 2012 Ageing Report: Economic and budgetary projections for the EU27 Member States (2010-2060).

6 Price Developments

Year-on-year inflation averaged 2.7% during the first nine months of the year, 0.1 percentage points higher than the euro area average. There were differences, however, in the structure and causes of inflation. Growth in food prices in Slovenia in the last two years has outpaced the corresponding growth in the euro area, but growth in prices of services and non-energy industrial goods has been much lower. Core inflation in Slovenia has thus been lower than the euro area average for three years now. The difference is driven primarily by weaker household consumption and the limitations on cost pressures necessary for improving competitiveness. The rise in inflation in recent months is primarily a reflection of external and one-off factors: higher euro oil prices, prices of seasonal food, rises in prices of certain public services, most notably school meals, and rises in excise duties.

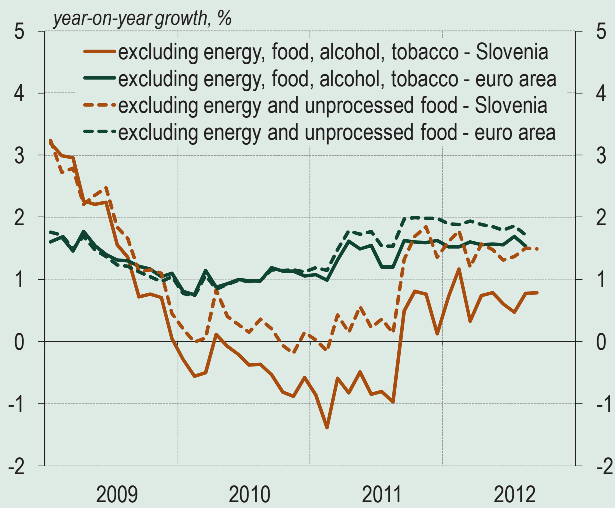
Year-on-year inflation has trended higher since the beginning of the year, to average 2.7% over the first nine months of the year, 0.1 percentage points higher than the euro area average. Inflation was up 0.8 percentage points on the same period last year. The year-on-year rate rose from 2.3% in January to 3.7% in September. The development of three main factors contributed to the aforementioned growth. The key factor in the rise in this year's inflation were energy prices. This component of inflation was heavily influenced by the euro exchange

Figure 6.1: Inflation



Sources: Eurostat, SORS, Bank of Slovenia calculations.

Figure 6.2: Core inflation



Sources: Eurostat, SORS, Bank of Slovenia calculations.

rate and prices of energy commodities, in particular oil prices. Energy prices contributed to nearly one half of price growth on average this year, which is significantly higher than their weight in the consumer basket (14.3%). Growth in food prices also remains high, which is likewise dependent on developments in the food prices on foreign markets. Also affecting food prices in Slovenia is the low level of competition on the market. Higher inflation is also a result of changes in the prices of certain public services and excise duties, which are primarily a reflection of the need for fiscal consolidation.

Macroeconomic factors and core inflation indicators

Developments in core inflation are primarily driven by weak domestic consumption. Core inflation indicators were again lower than euro area indicators over the first eight months of this year. The drop in domestic consumption is reflected in core inflation indicators, as it dissuades retailers from raising prices. Core inflation as measured by the HICP excluding energy and unprocessed food prices averaged 1.4% over the first nine months of the year, up 0.7 percentage points on the 2011 average. It should be noted that rises in excise duties on alcohol and tobacco are included in the aforementioned indicator. With the exception of February, core inflation as measured by the narrowest indicator, the HICP excluding energy, food, alcohol and tobacco, was below 1%. Such low core inflation is a reflection of weak domestic demand, with a corresponding effect on the prices of services and non-energy industrial goods. According to this indicator, prices rose by an average of 0.7% in year-on-year terms over the first nine months of the year. Growth in the narrowest core inflation indicator was 0.9 percentage points lower on average from January to August than the comparable euro area indicator. According to the broadest indicator, the HICP excluding energy, core inflation was 1.6% in year-on-year terms. All core inflation indicators have been lower than those in the euro area since the end of 2009. Low core inflation is in line with the negative output gap, as low aggregate demand holds economic growth to a level below economic potential.

Table 6.1 Breakdown of the HICP and price indicators

	weight	average year-on-year growth, %					year-on-year growth in quarter, %					
	2012	2008	2009	2010	2011	1H12	2Q11	3Q11	4Q11	1Q12	2Q12	3Q12
HICP	*100.0%*	5.5	0.9	2.1	2.1	2.5	2.0	1.5	2.6	2.5	2.5	3.2
Breakdown of HICP:												
Energy	*14.5%*	9.4	-4.5	13.9	8.8	8.5	8.3	6.9	8.0	8.3	8.7	10.8
Food	*22.7%*	8.1	1.8	2.5	4.8	3.7	5.7	3.5	4.8	3.7	3.8	5.1
processed	*15.4%*	9.9	2.7	2.9	5.0	4.6	4.7	4.8	6.0	4.7	4.4	4.6
unprocessed	*7.3%*	4.6	0.0	1.7	4.3	1.8	7.7	0.5	2.3	1.4	2.1	6.1
Other goods	*28.8%*	2.2	0.0	-2.2	-0.9	-0.2	-1.1	-1.4	0.0	-0.6	0.2	0.2
Services	*34.0%*	5.3	3.2	1.2	0.0	1.5	-0.4	0.2	1.1	1.9	1.1	1.1
Core inflation indicators												
HICP excl. energy	*85.5%*	4.9	1.7	0.3	1.0	1.5	0.9	0.6	1.7	1.5	1.5	1.9
HICP excl. energy and unprocessed food	*78.2%*	5.0	1.9	0.2	0.7	1.5	0.3	0.6	1.6	1.5	1.5	1.5
HICP excl. energy, food, alcohol and tobacco	*62.8%*	3.8	1.7	-0.4	-0.4	0.7	-0.7	-0.4	0.6	0.7	0.7	0.7
Other price indicators:												
Industrial producer prices on domestic market		5.6	-0.4	2.0	3.8	1.0	4.1	3.7	2.9	1.1	0.9	...
GDP deflator		4.1	3.6	-1.1	1.0	0.9	0.6	0.9	1.9	0.9	1.0	...
Import prices[1]		2.7	-4.6	6.4	5.9	2.6	5.9	5.0	4.2	3.0	2.3	...

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

The consumption of durables continued to decline, while expenditure on other categories of goods dropped considerably for the first time since the second quarter of 2009, as a result of a decline real household income, a downturn in consumer confidence and the increased prudence of households.

Low core inflation is in line with the recent decline in unit labour costs. Unit labour costs measured by value-added in the total economy were also down in year-on-year terms during the first half of this year. The fall in compensation per employee outstripped the fall in productivity, which does not indicate inflationary pressures. Upward pressure on prices derives from higher input costs tied to the euro prices of certain commodities.

Factors from the international environment once again exerted the most pressure on prices this year. Having recorded relatively high growth during the first quarter of this year, oil prices fell again in the second quarter, followed by a renewed rise. The average US dollar price for a barrel of Brent crude rose by slightly less than 1% in year-on-year terms over the first nine months of 2012 to stand at USD 112, while the euro price was up 11% year-on-year over the same period due to the aforementioned currency's depreciation. Droughts and floods in July resulted in a rise in food prices on the global markets. The prices of cereals and sugar rose considerably, while the prices of dairy products were unchanged and meat prices fell. By contrast, the prices of industrial commodities have been falling for almost a year. Thus year-on-year growth in primary commodity prices was negative until August.

Microeconomic factors and the structure of inflation

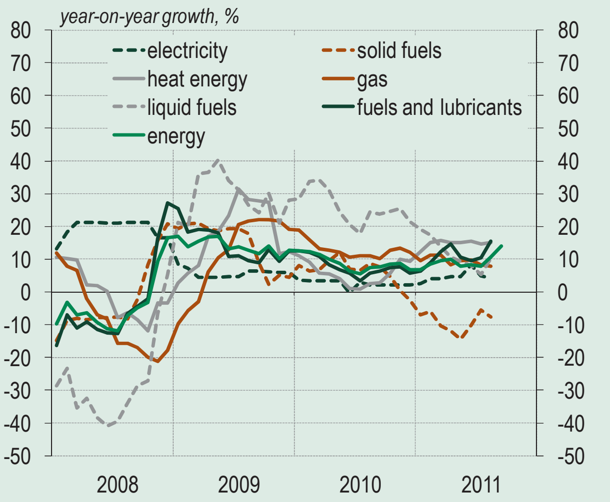
An analysis of individual price categories indicates that energy and processed food prices again contributed the most to inflation over the first nine months of 2012. Energy prices on average contributed 1.3 percentage points, while food prices contributed 0.7 percentage points. The contribution of other price categories has also risen slightly in recent months which, in addition to growth in motor fuel prices and July's rise in excise duties, resulted in a temporary rise in inflation well above 3%. Year-on-year growth in food prices in Slovenia has outpaced the average growth in the euro area over the last two years, while the opposite is generally true for the prices of services and non-energy industrial goods, in the latter category primarily due to the prices of durables. Higher growth in food prices in Slovenia is also partly a reflection of differences in the dynamic of changes in excise duties on tobacco products. Growth in food prices in 2010 and 2011 was down sharply on the growth recorded in 2007 and 2008, when price increases, following shocks on the commodities market, were also under the influence of inflationary pressures on the demand side and growth in labour costs in the context of a positive domestic economic climate.

Energy prices rose by an average of 9.3% in year-on-year terms over the first nine months of this year, as a result of developments in the euro exchange rate, global oil prices and rising duties. Year-on-year growth in energy prices in Slovenia in 2011 was lower than the average growth in the euro area, partly as a result of the reduction in excise duties on motor fuels at the beginning

Figure 6.3: Energy prices

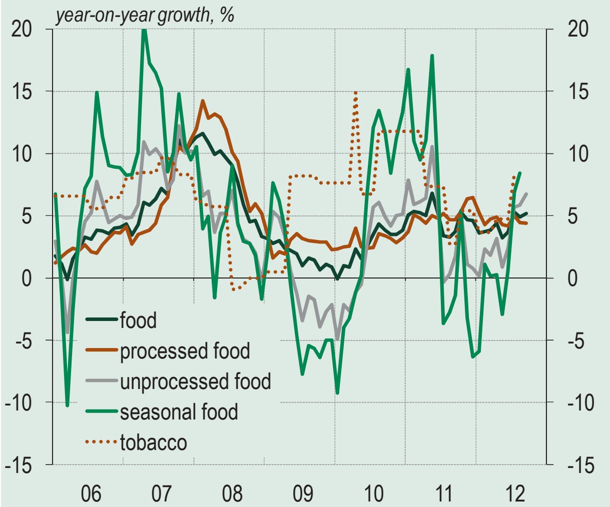
Sources: Eurostat, Bank of Slovenia calculations.

Figure 6.4: Individual energy price categories



Sources: Eurostat, Bank of Slovenia calculations.

Figure 6.5: Food prices



Sources: Eurostat, Bank of Slovenia calculations.

of the year, while average growth over the first eight months of this year has outpaced euro area growth. Contributing to the latter were the rise in excise duties at the end of last year and again in the context of this year's temporary fall in oil prices, and the introduction of an environmental levy on carbon dioxide emissions for motor fuels. Average year-on-year growth in the prices of district heating over the first eight months of the year also outpaced euro area growth, while growth in the prices of electricity and, in particular, solid fuels was lower.

Year-on-year growth in overall food prices averaged 4.2% over the first nine months of the year in the context of continuing significant fluctuations in the prices of seasonal food and rising excise duties on tobacco and alcohol. Year-on-year growth in processed food prices averaged 4.6% which, on the one hand, reflects last year's delayed pass-through of shocks on the commodity market to consumer prices, and is a result of rises in excise duties on tobacco and alcohol on the other.[20] Higher tobacco prices, closely linked to changes in excise duties, thus contributed 0.3 percentage points to inflation in August. Growth in prices of processed food

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

Sources: Eurostat, Bank of Slovenia calculations.

excluding tobacco slowed slightly in the first half of 2012 , as August prices were up 2.1% relative to last December. The rise in prices of food commodities, in particular corn, soy and wheat, on the international markets in the middle of the year is expected to have an impact on food prices in the coming months. Year-on-year growth in prices of unprocessed food averaged 3.2% over the first nine

[20] In July 2012, a raise in excise duty from 86 EUR to 90 EUR per thousand cigarettes was implemented. Thus excise duties reached the minimum level set in European Council Directive ahead of time as these changes were to be implemented by January 2014. Two additional increases were announced which will set the excise duty to 94 EUR per thousand cigarettes in October 2012 and to 97 EUR per thousand cigarettes in January 2013. In April 2012, higher excise duties on alcohol were also set at 11 EUR per hl/degree of alcohol for beer, 120 EUR per hl of intermediate products and 1200 EUR per hl of pure alcohol for ethyl alcohol.

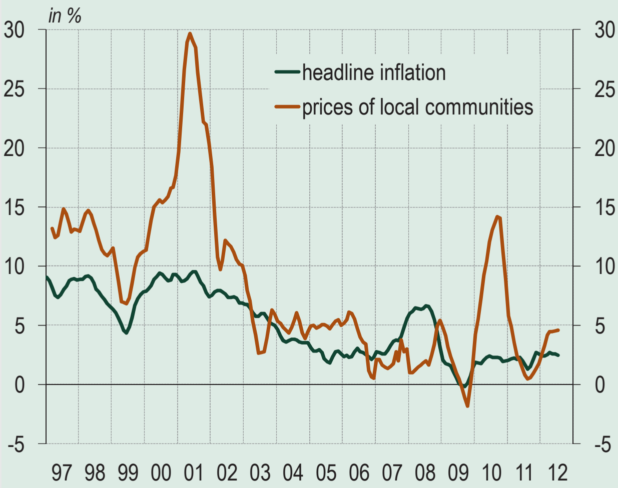
Box 6.1: Local community service providers' prices

Local community service providers' prices are set for the most part on monopolistic markets, and may therefore be a factor in price instability, if service providers do not control operating costs and other expenses. In this overview, prices of municipal services, heat energy and bus services are included in the aforementioned category. According to Eurostat, prices of municipal services comprise the prices of water and sewerage, refuse collection and other services (e.g. chimney sweeping and residential building management services). Bus transport services comprise urban and suburban transport. Detailed data are given from 2004 onwards, when inflation in Slovenia was largely aligned with the European average.

Prices of heat energy (and significantly less so prices of bus services) respond to oil prices. Thus a comparison of movements in Slovenian prices and euro area prices, or more precisely their difference, provides crucial additional information.

At less than 4% over the entire observation period, the proportion of the headline inflation basket of goods accounted for by prices of local communities is low and nearly the same in Slovenia and the euro area. In 2012 that proportion is 3.95% in Slovenia and 3.84% in the euro area, broken down as follows: prices of municipal services 2.34% and 2.69% respectively (prices of water and sewerage 1.22% and 1.25% respectively, while the prices of refuse disposal account for 0.55% in both Slovenia and the euro area), prices of heat energy 0.95% and 0.68% respectively and prices of bus services 0.67% and 0.48% respectively. Their direct contribution to headline inflation is therefore rather limited, as is the pass through to other prices via costs. A more pronounced effect

Figure 1: Y-o-y growth rates, 1997–2012



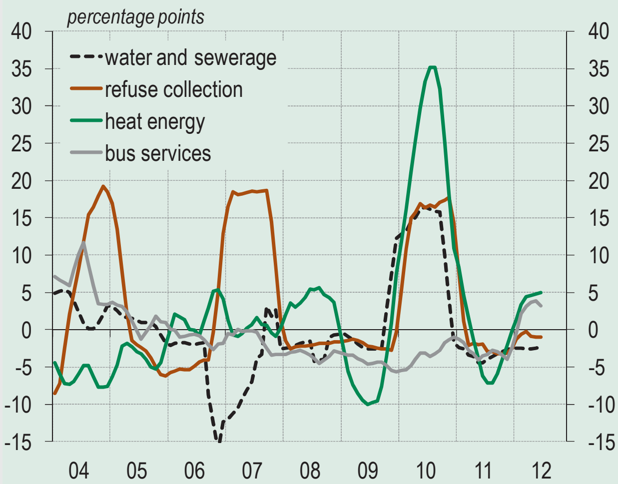
Sources: Eurostat, Bank of Slovenia calculations.

Table 1: Indicators of price growth of services of local communities (average annual rates)

	Slovenia				Euro area				Difference			
	average 2004-09	2010	2011	Jan.-July 2012	average 2004-09	2010	2011	Jan.-July 2012	average 2004-09	2010	2011	Jan.-July 2012
						y-o-y growth in percent						
Municipal services	2.4	11.8	1.0	0.1	3.1	2.8	2.7	2.2	-0.7	+9.0	-1.7	-2.1
Water and sewerage	1.4	15.3	0.0	0.0	2.9	3.0	3.3	2.5	-1.5	+12.3	-3.3	-2.5
Refuse collection	6.3	18.0	0.9	0.8	3.3	2.5	2.6	1.5	+3.0	+15.5	-1.7	-0.7
Heat energy	6.1	17.8	5.7	14.8	7.7	-6.9	7.8	10.6	-1.6	+24.7	-2.1	+4.2
Bus services	2.6	-1.0	-0.1	6.3	2.9	2.3	3.0	3.3	-0.3	-3.3	-3.1	+3.0
TOTAL	3.2	10.6	1.8	4.4	3.7	1.3	3.5	3.6	-0.5	+9.3	-1.7	+0.8
						contribution to inflation [1]						
Municipal services	-0.02	+0.20	-0.03	-0.06	+0.03	+0.03	0.00	-0.01	-0.05	+0.17	-0.03	-0.05
Water and sewerage	-0.02	+0.15	-0.03	-0.03	+0.01	+0.02	+0.01	0.00	-0.03	+0.13	-0.04	-0.03
Refuse collection	+0.01	+0.08	-0.01	-0.01	+0.01	0.00	0.00	-0.01	0.00	+0.08	-0.01	0.00
Heat energy	+0.02	+0.12	+0.03	+0.11	+0.03	-0.05	+0.03	+0.05	-0.01	+0.17	0.00	+0.06
Bus services	0.00	-0.02	-0.02	+0.03	0.00	0.00	0.00	0.00	0.00	-0.02	-0.02	+0.03
Total	0.00	+0.31	-0.01	+0.08	+0.06	-0.01	+0.03	+0.04	-0.06	+0.32	-0.04	+0.04

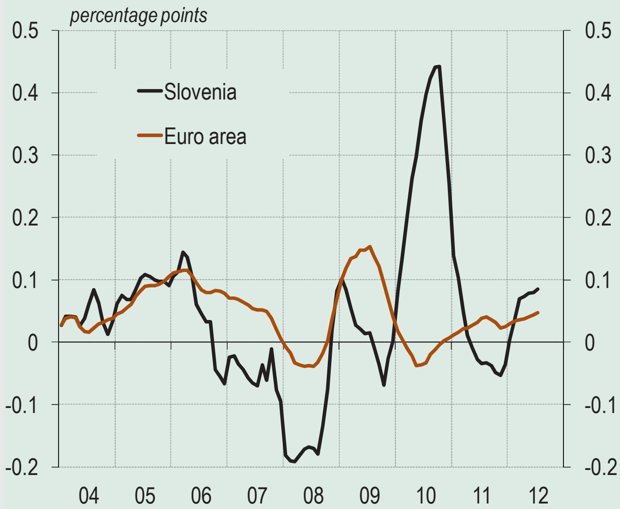
[1] *Contribution of selected aggregate in percentage points above or below total other inflation.*
Sources: Eurostat, Bank of Slovenia calculations.

Figure 2: Difference between y-o-y price growth in Slovenia and the euro area



Sources: Eurostat, Bank of Slovenia calculations.

Figure 3: Contribution to y-o-y headline inflation



Sources: Eurostat, Bank of Slovenia calculations.

may be seen in the context of significantly accelerated growth in the demonstration effect (directly or through the generation of wage growth).

Growth in prices of municipal services and bus services (but not in heat energy prices) in Slovenia significantly outpaced headline inflation in the early period of transition (Figure 1). A significant acceleration was recorded in all sub-categories in 2001, and in municipal services in 2002. Growth in prices of local communities contributed 0.7 percentage points to headline inflation in 2001. An oil shock must be taken into account in 2000 in particular, as well as the sharp increase in taxes for various government funds, so that the aforementioned wave of price rises was in fact only partly the result of local government policies. In any case, it resulted in the tightening of economic policies, as the majority of prices in question were classified as prices under a strict central control regime following the aforementioned events.

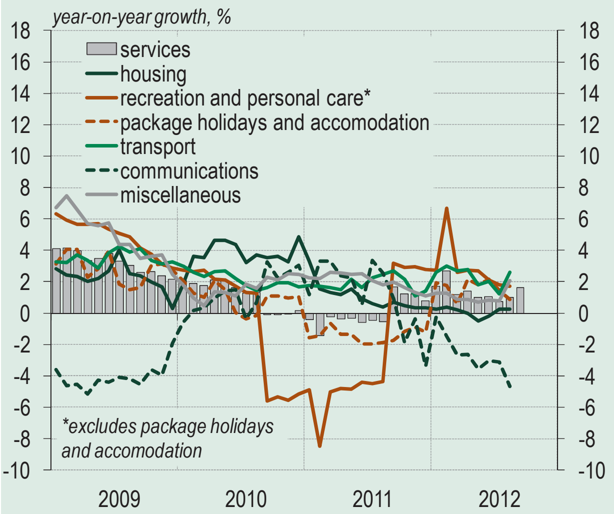
In the last 10 years, i.e. from 2003 onwards, the movement of prices of local communities has fully aligned with other components of inflation, while their growth has for the most part lagged behind the growth of comparable euro area prices (Figure 3). Worthy of note in all the aforementioned prices, except prices of bus services, is 2010, when the entire category again contributed 0.3 percentage points to average annual inflation. Old control ordinances expired, while new ordinances have not yet entered into force. A number of local communities raised their prices significantly at the end of 2009, including Ljubljana, which has the largest weight in the index of the aforementioned prices. Because the prices in this category typically lag behind other prices over the long term, their movement is characterised by occasional but significant one-off spikes (Figure 2).

Having recorded significantly below-average growth for an extended period in the past, only the spike in bus transport prices stands out in 2012 (in January in Ljubljana). The movement in prices in this sector has been generally very restrained over the last 10 years. But taking into account the accumulation of fiscal and financial pressures at the local government and national levels, risks are rising.

months of the year. Year-on-year growth in meat prices for the most part tracked processed food prices, while prices of seasonal food were typically much more volatile. Prices of seasonal foods were up 0.9% on average over the first eight months of the year, but up 8.4% in August.

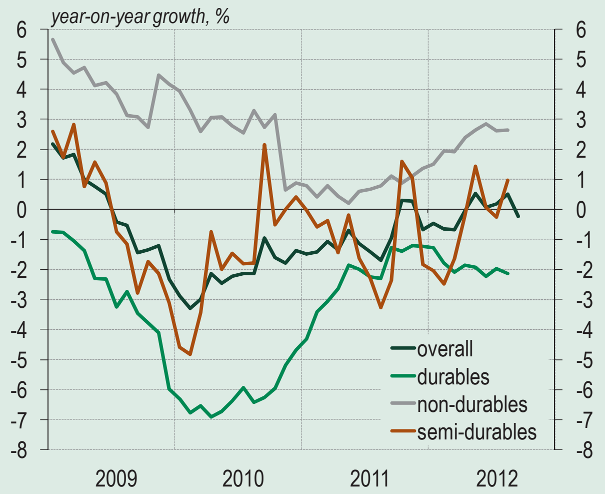
Prices of the majority of the services grew quite slowly over the first nine months of 2012 in the context of diminishing purchasing power. The exceptions were the prices of certain public services administered by local governments and services that are cov-

Figure 6.7: Services prices



Sources: Eurostat, Bank of Slovenia calculations.

Figure 6.8: Prices of non-energy industrial goods



Sources: Eurostat, Bank of Slovenia calculations.

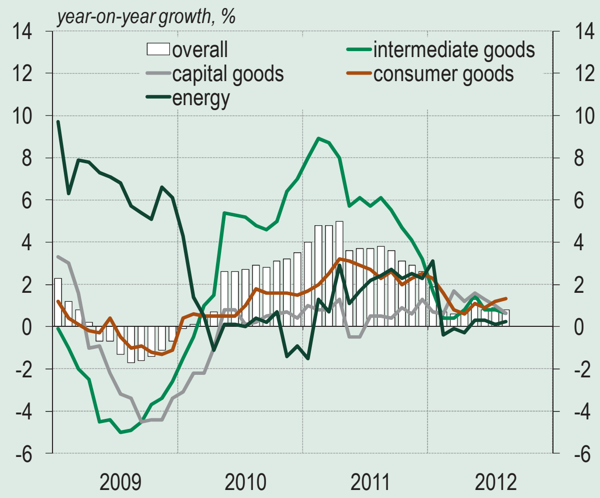
ered indirectly by the Fiscal Balance Act. Having fallen by 0.3% over the first nine months of last year, services prices were up 1.4% on average over the same period in 2012. Last year's decline was primarily the result of the changes in the calculation of school meals in autumn 2010. This year's more pronounced rises in the prices of individual services were linked exclusively to municipal and government measures. Prices of passenger road transport services rose in January, primarily due to a rise in the prices of Ljubljana public transport services by 6.4% and in the prices of cultural services, owing to a rise in the RTV licence fee by 3.2%. The costs of insurance services were up 3.3% in July due to a rise in the prices of health insurance, and by 3.1% and 3.3% respectively in August in the categories of education and social work, due to a rise in kindergarten prices. The total contribution of these categories to inflation was 0.3 percentage points in August. Among other services, prices of maintenance and repairs recorded the sharpest year-on-year growth (of 4%) over the first eight months of the year. Prices of hospital services recorded the sharpest drop (of 5.5%), in part due to the falling prices of healthcare services paid to the providers of the aforementioned services by the Health Insurance Institute, as defined in the annex to the general agreement for contractual year 2012. Due to changes in the calculation of school meal charges adopted in the Fiscal Balance Act, prices were up sharply in the canteen category in September, while prices of passenger road transport were down due to the introduction of a general transport subsidy for students and pupils.

Average prices of non-energy industrial goods were virtually unchanged in year-on-year terms over the first nine months of the year. Despite several consecutive months of year-on-year growth since April, the first such growth since the middle of 2009, prices of clothing and footwear, which account for nearly a quarter of non-energy industrial goods, were down 0.2% on average in year-on-year terms over the first nine months of the year, in the context of typical seasonal fluctuations. Car prices, which account for the second highest proportion of the aforementioned category, were also down year-on-year over the first eight months, by 3.7% on average. The average contribution of the remaining prices of non-energy industrial goods to inflation over the first eight months of the year was 0.1 percentage points.

Industrial producer prices

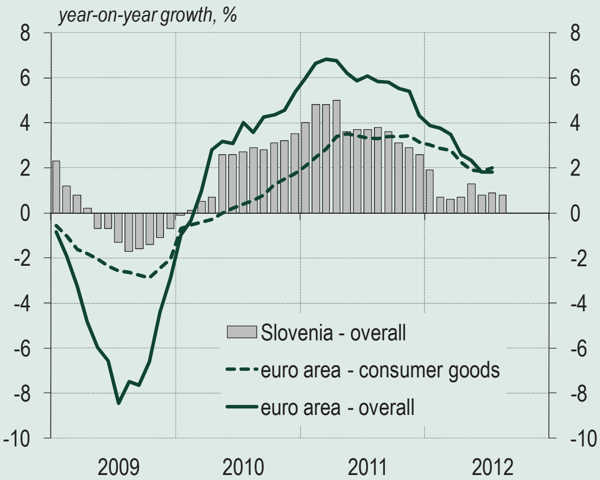
The decline in year-on-year growth in industrial producer prices on the domestic market has continued this year. Prices rose by an average of 1.0% in year-on-year terms over the first eight months of the year, down 3.2 percentage points on the same period last year. Year-on-year growth rates were down in all the categories of goods relative to 2011, except capital goods. Year-on-year growth in producer prices of intermediate goods was down 5.3 percentage points on last year's average over the first eight months of the year to stand at 0.9%. This was primarily the result of a year-on-year fall in prices in the manufacture of basic metals. Year-on-year growth in prices of consumer goods averaged 1.2% over the first eight months of the year. Energy prices, which fell sharply at the beginning of the year, have risen slightly in recent months, growth in the aforementioned prices having averaged 0.4% in year-on-year terms over the first eight months of the year. This is in line with the year-on-year growth in electricity, gas and steam supply prices. Year-on-year growth in euro area industrial producer prices on the domestic market averaged 2.8% over the first seven months of the year. The higher year-on-year growth compared with Slovenian producers primarily derives from energy prices, whose year-on-year growth in the euro area reached 7.3% over the first seven months of the year.

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.

7 Projections of Economic Trends and Inflation 2012–2014[21]

GDP is expected to decline by slightly less than 2% in 2012, with growth not expected to resume until 2014. The economic growth forecast has thus been revised down since the previous projections, by around 1 percentage point annually over the projection horizon. The downward revision is primarily the result of a renewed deterioration in the international environment and the anticipated implementation of fiscal consolidation measures. Due to the situation on the labour market, fiscal consolidation and pessimism among corporates and households, weak domestic demand will not be a reflection solely of low investment activity, but also of lower household consumption and government spending. At the same time export growth will also be low as a result of the projected slow growth in the international environment. The contribution made by net trade is nevertheless expected to be higher than in previous projections, as a result of assessments regarding an additional decline in domestic demand. Such developments are also evident from the current account projection, where the surplus is expected to increase to more than 4% of GDP. After rising temporarily in 2012, inflation is expected to fall to around 2% in the coming years. The main factors in this year's higher inflation are high energy prices and food prices on global markets, and certain one-off effects related to fiscal consolidation, while core inflation will remain low as a result of the adverse macroeconomic situation.

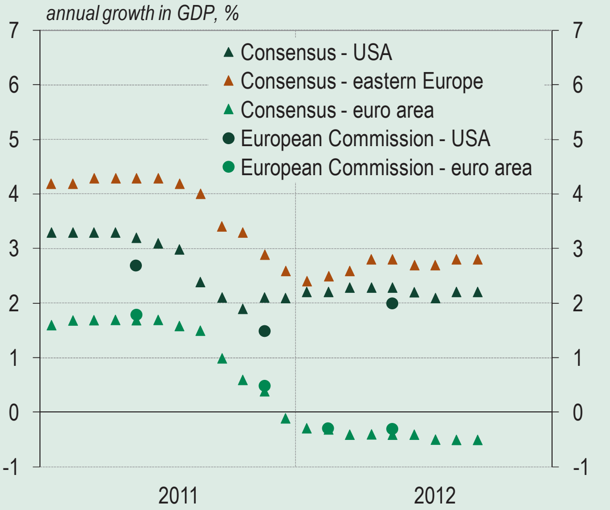
The risks in the GDP growth projections remain high and concentrated on the downside. The risk surrounding foreign demand remains present due to the persistent uncertainty on the sovereign debt markets and the need for additional fiscal consolidation measures in the EU. The uncertainties surrounding domestic risk factors also remain high. The effects of a relatively extensive fiscal consolidation are quite uncertain, while some measures for the planned reduction in the deficit have not yet been defined. At the same time the financing situation remains considerably uncertain, particularly with regard to access to sources of financing in the rest of the world. A deterioration in the situation on the labour market would increase the chances of a further rise in structural unemployment and the related social problems, a loss of human capital and additional government expenditure. The risks surrounding inflation remain balanced, and similar to those in previous projections. The risks associated with higher energy prices and food prices have been assessed as slightly higher this time. The risks of higher inflation relate to possible additional fiscal consolidation measures, and to price rises in sectors with a lower level of competition. A more significant contraction in domestic demand and sharper cost adjustment in the economy could reduce core inflation.

[21] The projections were made on the basis of the available data and the existing statistical methodologies as at 10 September 2012. The projections of macroeconomic factors presented in this report are based on assumptions for variables in the international environment and certain domestic factors dependent on economic policy decisions. The assumptions for the variables in the international environment are taken from Consensus Forecasts and Eastern Europe Consensus Forecasts (August 2012), JP Morgan (Global Data Watch, 7 September 2012), the OECD Outlook (June

International environment and external assumptions

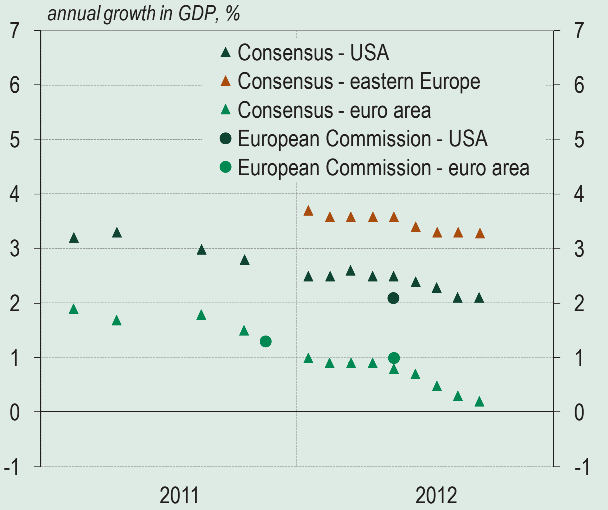
The outlook for economic growth in Slovenia's most important trading partners has deteriorated, as a result of the deepening fiscal crisis and the decline in confidence in a number of euro area countries. Owing to the increased need for fiscal consolidation in the euro area and the decline in economic activity in the middle of the year, the assumption for economic growth in Slovenia's most important trading partners was revised down. Other factors are the adverse situation on the labour market and the tightened financing conditions, which are reducing consumer and business confidence. The growth assumption for foreign demand in 2012 is down by a third on the previous projections. Foreign demand is expected to increase by merely 1.0% on average in 2012, although growth could begin to increase again by the end of the year according to current forecasts by international institutions. Average growth in 2013 is therefore expected to be higher at around 2.5%. The downward revision for 2013 is greater than the revision for 2012, in line with the

Figure 7.1: Projections of economic activity for 2012



Sources: Consensus Economics, European Commission.

Figure 7.2: Projections of economic activity for 2013



Sources: Consensus Economics, European Commission.

Table 7.1: Assumptions for the international environment

						Assumptions					
						2012		2013		2014	
	2007	2008	2009	2010	2011	**Oct**	Δ	**Oct**	Δ	**Oct**	Δ
	annual average growth (%) if not stated otherwise										
Foreign demand*	11.3	5.9	-14.2	11.3	7.5	**1.2**	-0.6	**2.5**	-1.0	**4.0**	-0.5
Oil (USD/barrel)	73	98	62	80	111	**115**	-5	**110**	-5	**110**	-3
Non-oil commodities	17.4	10.1	-23.0	37.1	18.0	**-8.3**	-5.2	**1.6**	-2.3	**5.1**	-0.9
EMU inflation	2.1	3.3	0.3	1.6	2.7	**2.5**	0.5	**1.7**	0.0	**2.0**	0.0
PPI Germany	1.3	5.4	-4.0	1.5	5.6	**2.2**	0.1	**1.8**	-0.3	**1.4**	-0.3

* *Volume of imports from the basket of foreign partners.*
Δ: *Difference between current projections and projections in April 2012 Price Stability Report.*
Sources: Bank of Slovenia, Eurostat, Consensus Economics, ECB, JP Morgan, OECD Outlook.

2012) and the IMF WEO Update (July 2012). Because additional fiscal consolidation measures were not known at the time the projections were made, they were included in the projections as a linear reduction in all categories of expenditures so that the budget targets set out in the latest Stability Programme for Slovenia from April 2012 would be achieved. The assumptions used in the projections are not the same as those used by the ESCB in its projections. For the relationship between the Bank of Slovenia projections and those of the ESCB, see the annex to the April 2008 Price Stability Report.

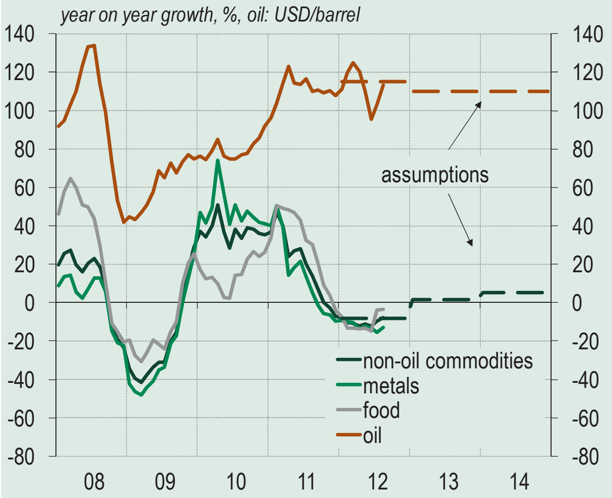
latest changes to forecasts for the euro area. The assumptions for growth in foreign demand are significantly below the long-term average of around 5.5%.

Despite unfavourable supply-side conditions, US dollar oil prices are expected to be lower than in the previous projections due to the cooling of global economic activity. The assumption regarding euro oil prices is somewhat higher owing to the euro's depreciation. The rapid rise in oil prices in 2012 was primarily the result of geopolitical tensions in the Middle East. Oil prices are expected to fluctuate between USD 110 and USD 115 per barrel in the future. This represents an average decrease of around 4% with regard to oil price assumptions from the previous projections, while euro oil prices are around 3% higher relative to the previous assumptions.

The prices of other commodities are expected to track the decline in global economic growth, although there are significant deviations within the aggregate. Slow global economic activity is expected to result in slower growth in primary commodity prices, particularly in 2012. The aforementioned prices are then expected to rise gradually in line with the expected global economic recovery. There have been differences recently between food prices, which are rising rapidly, and metals prices, which are falling in year-on-year terms. This may also have an effect on the inflation projections. The price elasticity of consumer demand for food is lower than the price elasticity of demand for industrial products, for which metal prices account for a large portion of input costs. It is therefore possible that the effect of growth in food prices on the international commodity markets on inflation will outweigh the effect of falling metal prices.

Inflation in the euro area is expected to stand at 2.5% in 2012, and to average slightly below 2% over the next two years. Rising energy and food prices and fiscal consolidation measures in the majority of euro area countries will contribute to maintaining this year's price growth above 2%. In the absence of further shocks on the international commodity markets, inflation is expected to average slightly less than 2% over the next two years. Given that no significant improvements can be expected in the situation on the labour market, core inflation will remain low as household consumption remains weak. Growth in producer prices in Germany should also fall gradually in the context of subdued economic activity and low growth in input costs.

Figure 7.3: Commodity prices

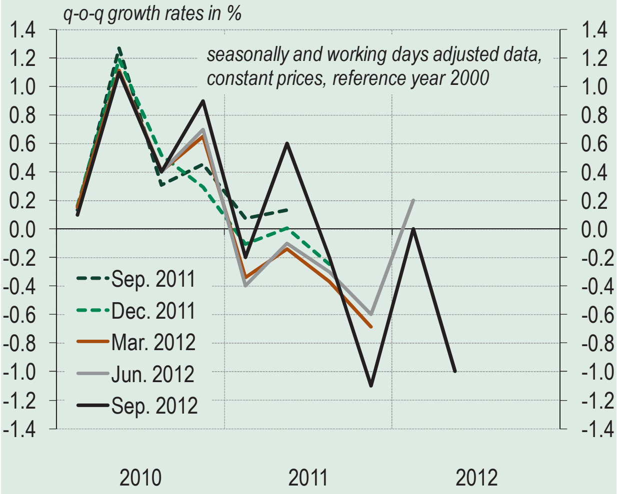


Sources: ECB, Bloomberg, Bank of Slovenia assumptions.

GDP growth

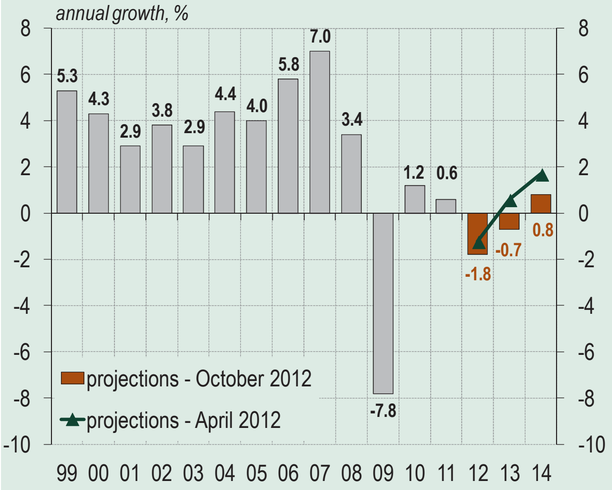
GDP is expected to decline by 1.8% in 2012, and by a further 0.7% in 2013, before rising by 0.8% in 2014. The GDP growth projection in 2012 is down around 0.5 percentage points on the previous projections, while the forecast for 2013 has also been revised down, by almost 1.5 percentage points. This is a significant downward revision compared with the previous projections, and is larger than in the majority of euro area countries. In addition to the revised data for past GDP, there was a sharp downward revision in the assumption for growth in foreign demand, while domestic demand will also continue to decline owing to fiscal consolidation. Currently available indicators point to a probable decline in aggregate economic activity again in the third quarter of this year, which

Figure 7.4: GDP at various national account data releases



Source: SORS.

Figure 7.5: GDP growth projections



Sources: SORS, Bank of Slovenia projections.

intensifies the carry-over of the negative dynamics in activity into 2013. Economic growth in Slovenia is expected to lag behind the average euro area growth by around 1 percentage point annually. The level of economic activity in 2014 will therefore be almost 10% lower than prior to the outbreak of the crisis at the end of 2008.

Aggregate demand

Domestic consumption is expected to decline over the entire projection horizon. The negative contribution made by construction investment will only gradually decline. Construction investment will continue to be restricted primarily by difficulties in financing, large stocks of unsold housing and fiscal consolidation measures. Given the high indebtedness of construction firms, and the lack of projects with an appropriate return and the right level of security against risks, the banks will remain cautious in their financing. Unsold new-built homes will continue to dissuade potential investors from constructing additional residential buildings. No major government investment can be expected owing to fiscal consolidation. Construction investment is thus expected to rely primarily on the building of facilities in the energy sector (See Box 7.1 for more details).

After recording relatively high growth in 2011, investment in machinery and equipment is expected to decline in 2012. The stagnation in production capacity utili-

Table 7.2: Components of domestic demand

						Projections					
						2012		2013		2014	
	2007	2008	2009	2010	2011	Oct.	Δ	Oct.	Δ	Oct.	Δ
	real growth rates, %										
Domestic demand	9.0	3.2	-10.0	-0.2	-0.7	**-3.3**	-1.0	**-1.8**	-1.5	**-0.5**	-1.6
Private consumption	6.3	2.3	0.1	1.3	0.9	**-1.8**	-0.7	**-1.7**	-0.9	**0.4**	-0.2
Government spending	0.6	5.9	2.5	1.5	-1.2	**-3.0**	-1.2	**-2.0**	-1.2	**-1.6**	-1.6
Gross fixed capital formation	13.3	7.1	-23.2	-13.8	-8.1	**-8.7**	-6.3	**-3.3**	-4.8	**-1.8**	-5.7

Δ: Difference between current projections and projections in April 2012 Price Stability Report.
Sources: SORS, Bank of Slovenia calculations.

Box 7.1: Investment in the energy sector

Certain major investments in the Slovenian energy infrastructure are expected to be started or concluded this year and in the coming years. This box presents selected indicators of the Slovenian energy sector and its past investment (including from the financing point of view), and an illustration and assessment of planned investment in this sector over the projection horizon.

The energy sector is important to the national economy for its role in ensuring the uninterrupted supply of energy.[1] NACE activities B (mining and quarrying) and D (electricity, gas, steam and air conditioning supply) are included in this sector. A high level of concentration in certain parts of Slovenia is one of the characteristics of these activities. Employees in the energy sector in the Posavje region, for example, account for approximately 15% of all employees, around 50% of value-added and profit, and fully 75% of the total capital of all companies in the region.

In contrast to the total economy, the situation in the Slovenian energy sector has not deteriorated during the crisis. The proportion of sales revenue and gross operating surplus accounted for by the energy sector relative to the economy overall increased between 2005 and 2010. The energy sector has also maintained a high level of investment during the crisis. Its investment has not decreased since 2008, but has remained at the pre-crisis level. Thus, the proportion of the Slovenian economy's total investment accounted for by the energy sector has nearly tripled in the last five years. Its proportion of investment in machinery and equipment, in particular, is on the rise.

Prior to the crisis, the proportion of own funds used to finance investment in the electricity[2] sector declined rapidly due to an increase in the proportion accounted for by loans, which has remained high, even after the outbreak of the crisis. The proportion of investment financing accounted for by own funds exceeded 80% in 2004, but had fallen to around 50% in 2010. By contrast, the proportion of investment financing accounted for by loans rose from less than 10% in 2004 to around 40% by 2010.

Annual investment of between EUR 400 million and EUR 800 million is expected in the energy sector in the period 2012-2014. This represents an average of just under 10% of total investment or between 1% and 2% of annual GDP in the

Table 1: Energy sector in Slovenia compared to total economy (shares in %)

	2005	2006	2007	2008	2009	2010
B+D Energy sector						
number of companies	0.5	0.5	0.5	0.5	0.5	0.7
number of employees	2.2	2.1	2.0	1.9	2.0	2.0
sales	3.4	3.6	3.4	4.5	5.4	5.7
gross operating surplus	6.0	5.5	5.2	5.9	8.5	7.5
gross fixed investment	5.8	5.5	6.7	7.4	9.5	14.1
gross fixed investment: building structures	…	…	…	8.1	9.1	12.7
gross fixed investment: machinery and equipment	…	…	…	8.1	11.0	17.1
D35 Electricity, gas, steam supply						
number of companies	0.4	0.4	0.4	0.4	0.4	0.6
number of employees	1.4	1.4	1.3	1.3	1.4	1.5
sales	3.0	3.2	3.0	4.2	5.0	5.3
gross operating surplus	5.7	5.1	4.8	5.6	8.0	6.8
gross fixed investment	4.6	5.0	6.0	6.6	8.6	12.8
gross fixed investment: building structures	…	…	…	7.6	8.5	11.7
gross fixed investment: machinery and equipment	…	…	…	7.0	9.9	15.5

Sources: SORS, Bank of Slovenia calculations.

Bank of Slovenia's baseline scenario. The energy sector's investment in 2013 and 2014 are expected to be double the average in the period 2007-2011, when they totalled around EUR 400 million annually. The framework plan for the implementation of investment in the energy infrastructure, set out in the National Energy Programme 2010-2030, states that investment until 2030 are expected to total around EUR 30 billion, or more than EUR 1 billion annually.

The total investment in Block 6 of the Šoštanj power station is expected to amount to around EUR 1.3 billion, with completion of the investment expected in 2014. In July this year the National Assembly approved a guarantee for the raising of a loan from the EIB in the amount of EUR 440 million, which is expected to facilitate the completion of the project. Taking into account previously completed works in the 2005-2011 period valued at around EUR 400 million, the remaining value of the project of around EUR 900 million is spread evenly over the 2012-2014 period in the estimate of planned investments given in Table 3.

A high level of investment activity in the construction of hydro-power stations is expected to continue in the future. Following the completion of construction of the Krško hydro-power station in the middle of 2012, two additional hydro-power stations in the chain of power stations on the lower Sava River are planned, with completion expected by 2017. Investment in the Brežice hydro-power station is estimated at EUR 120 million, while EUR 80 million is planned for the Mokrice hydro-power station. After securing the relevant spatial plan in June 2012, the start of construction of the Brežice hydro-power station is envisaged for 2013. The above estimate of planned investments takes into account an even distribution of the investment amount over four years, i.e. the average time required to build the three previous hydro-power stations on the lower Sava River. Start of construction of the Mokrice hydro-power station is planned for 2014. The average investment for the construction of each of nine or ten hydro-power stations on the middle Sava River is expected to be around EUR 130 million, with completion of the entire project expected around 2030. Construction of the first hydro-power station on the middle Sava River is expected to begin in 2014.

Following the signing of an agreement on the establishment of a joint venture between Plinovodi d.o.o. and the Russian Gazprom in June 2012, construction works on the South Stream gas pipeline project from Russia to Italy are expected to begin at the end of 2012. The value of the pipeline construction project in Slovenia is expected to be around EUR 1 billion, with completion expected at the beginning of 2015.

Table 2: Financing of investment in the electricity sector (shares in total financing in %)

	2004	2005	2006	2007	2008	2009	2010
Depreciation	67.8	60.6	51.1	40.6	36.9	28.4	34.7
Other own funds	16.6	25.2	32.2	27.0	27.1	42.4	20.3
Loans	8.9	6.0	14.5	30.9	33.4	26.0	42.1
Other funds	6.8	8.1	2.2	1.5	2.7	3.2	2.8

Sources: Ministry of Economic Development and Technology, Bank of Slovenia calculations.

Table 3: Estimates of expected investment in energy infrastructure in 2012–2014 (EUR mio)

	2012	2013	2014
TEŠ 6	300	300	300
Hydropower Plants at Lower Sava	30	30	50
Hydropower Plants at Middle Sava			32.5
South Stream	100	400	400
Total	**430**	**730**	**782.5**

Note: Estimates in the table are provisional, representing the lower bound of currently envisaged project values and are probably optimistic regarding the deadlines for starting or finishing the projects.
Sources: Internet pages of the companies (TEŠ, HSE, Plinovodi) and publications in the media, Bank of Slovenia calculations.

Currently the most distant, but largest investment in the Slovenian energy infrastructure in terms of value, is the construction of Block 2 of the Krško nuclear power plant. Current estimates of the value of the investment range from EUR 3.5 billion to EUR 4.5 billion. Block 2 of the Krško nuclear power plant is expected to begin operating after 2020, replacing the existing block, whose life cycle (of 40 years), in the absence of extensive investment, expires in 2023. Because concrete plans regarding the timetable for construction of Block 2 are not yet available, this investment is not included in the estimate over the projection horizon.

The effect of investment in the energy sector on economic activity is limited due to the large scope of imported component for this investment (e.g. machinery and equipment). Estimates by the Chamber of Commerce and Industry of Slovenia (2009) indicate that an investment of the scope of the construction of Block 2 of the Krško nuclear power plant could contribute to an increase in GDP in Slovenia of around 1% annually for the duration of the project.[3] Although the study conducted by Kryžanowski et al. (2006) states that Slovenian industry is capable of providing the majority of equipment associated with energy facilities, imported machinery and equipment are prevalent for Block 6 of the Šoštanj power station (Alstom) and Block 2 of the Krško nuclear power plant (agreements with Westinghouse). Domestic construction companies could contribute a greater share, although their participation is questionable owing to the fragmentation of this sector since the outbreak of the crisis.

[1] Energy balances indicate that Slovenia's dependence on energy imports (net imports of energy / energy used) has not changed significantly in the last 10 years, averaging around 50%. Relatively high energy dependency is primarily a result of imports of refined petroleum products and natural gas, which Slovenia does not produce. Excluding imports of refined petroleum products and natural gas, Slovenia would be a net exporter of energy.

[2] Figures are only available for electricity production and distribution companies.

[3] An investment of this scope would increase the outflow of labour income and profits of non-residents, i.e. total value-added generated by non-residents, which would push gross national income below gross domestic product. Interest on loans raised in the rest of the world by domestic corporates to finance investment must be added to outflows.

sation in manufacturing at a level below the long-term average is an indication of low need for investment. At the same time investment in machinery and equipment is also being curbed by lower growth forecasts for the main trading partners and increasingly limited possibilities of financing. The anticipated gradual improvement in foreign demand is expected to increase the need for additional investment in machinery and equipment.

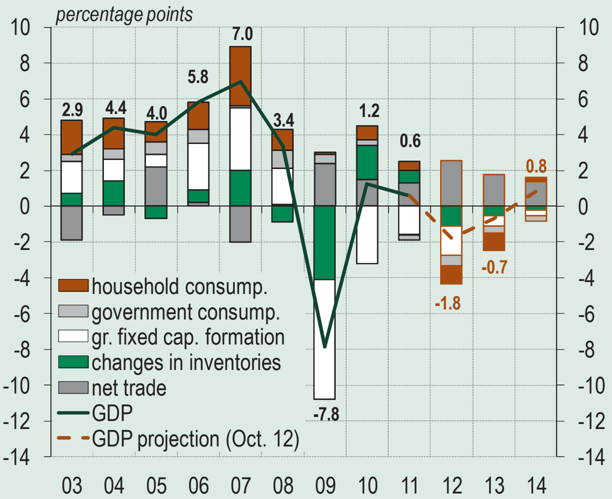
Household consumption is expected to decline this year and next year, primarily as a result of the situation on the labour market and fiscal consolidation measures. Household consumption is forecast to record

Table 7.3: Activity, employment and wages

						Projections					
						2012		2013		2014	
	2007	2008	2009	2010	2011	**Oct.**	Δ	**Oct.**	Δ	**Oct.**	Δ
	growth rates, %										
GDP (real)	7.0	3.4	-7.8	1.2	0.6	**-1.8**	-0.6	**-0.7**	-1.3	**0.8**	-0.9
Employment	3.3	2.6	-1.8	-2.2	-1.6	**-1.5**	-0.3	**-1.5**	-1.0	**-0.6**	-0.9
Compensation per employee	6.2	7.2	1.9	3.9	1.6	**0.3**	-1.1	**0.3**	-1.3	**0.6**	-1.6
Productivity	3.5	0.8	-6.1	3.5	2.2	**-0.3**	-0.3	**0.8**	-0.3	**1.4**	0.0
ULC (nominal)	2.6	6.4	8.5	0.4	-0.6	**0.6**	-0.8	**-0.5**	-1.0	**-0.8**	-1.6
Contribution to GDP growth	*percentage points*										
Domestic demand, excluding changes in inventories	7.0	4.1	-6.1	-2.1	-1.4	**-3.1**	-1.6	**-1.7**	-1.4	**-0.4**	-1.5
Net exports	-2.0	0.1	2.4	1.5	1.3	**2.5**	1.5	**1.8**	0.9	**1.4**	0.7
Changes in inventories	2.0	-0.9	-4.1	1.9	0.7	**-1.3**	-0.5	**-0.6**	-0.7	**-0.2**	-0.2

Δ: Difference between current projections and projections in April 2012 Price Stability Report.
Sources: SURS, Bank of Slovenia.

Figure 7.6: Projection of contributions to GDP growth by expenditure components



Sources: SORS, Bank of Slovenia projections.

a cumulative decline of just over 3%. Contributing to the aforementioned decline will be persistently high unemployment, which is being reflected in pessimism in the household sector, high domestic energy prices, the expected continued decline in real income in the private and public sectors, and the downsizing of government social policy. Household consumption is expected to decline in 2012 and 2013, but to stabilise in 2014 in line with an easing of the decline in real disposable income and increasing consumer confidence.

Government consumption will also decline, in line with the need for fiscal consolidation. A revision to the budget for 2013 and 2014 is currently being drafted, and is expected to be based on a significant reduction in expenditure. Because detailed measures to achieve fiscal consolidation are still unknown, they have been taken into account in the projections as a linear reduction in all categories of expenditure. The size of the consolidation taken into account is in line with the target pace for reducing the budget deficit envisaged in the Stability Programme from April 2012. The projections have therefore assumed a decline in the average nominal wage in the public sector, in the context of a fall in the workforce in employment, and a decline in expenditure on intermediate consumption. Given the planned reduction in expenditure in the revised state budget for 2012, final government consumption is expected to record a larger fall this year than last year. It is also projected to fall in 2013 and 2014. Growth in final government spending until 2014 has thus been cut by around 4 percentage points in cumulative terms, relative to the previous projections.

Despite the uncertain economic situation in the international environment, net trade will make a positive contribution to GDP growth, primarily as a result of low imports. The projections for import growth and export growth are lower due to the continuing slowdown in the pace of international trade in 2012, which is driven by the decline in economic activity in the major trading partners, and even more so by the decline in domestic demand. Because the revision to import growth is nearly two times the revision to export growth due to weak domestic demand, the contribution of net trade to GDP growth will be notably positive, up 1 percentage point annually compared with previous projections. The gap between import growth and export growth will narrow as a result of the gradual stabilisation of domestic demand.

Supply side

As a result of the deterioration in the international environment, activity in export-oriented sectors will decline in 2012, before increasing only slowly. An even slower recovery is expected in sectors dependent primarily on domestic demand. The situation in the export sector will be worse than forecast in the previous projections. Value-added in the export sector will decline further in the second half of this year, in line with deteriorating indicators of demand. At the same time there was a significant increase in the proportion of industrial firms citing the uncertain economic situation among the limiting factors in production. Growth in foreign demand, and thus the contribution made to GDP growth by export activities, is expected to increase later. Activity in sectors dependent primarily on domestic demand will be low due to the persistent adverse situation on the labour market and the government's consolidation measures. The situation is expected to deteriorate in wholesale and retail trade in particular, as a result of a further decline in purchasing power and low confidence of consumers.

Activity in the construction sector is expected to continue contracting this year and next year at least, albeit less sharply than in recent years. Although the ratio of value-added in construction to GDP is already very low, and below the euro area average, it is difficult to predict when activity in the construction sector will cease to contract. It is likely that the crisis will ease only gradually in this sector, as the number of building permits issued continues to fall, while survey indicators of demand remain low. The continuation of previously started infrastructure projects and the start of certain new projects are expected to contribute to the easing of the decline in value-added in construction, although it should be noted that imported goods and services will account for a large portion of the value of these projects.

Labour market

Employment will fall further in the coming years as a result of the slowdown in economic activity and fiscal consolidation. Despite relatively favourable developments on the labour market at the beginning of 2012, the labour market is expected to respond gradually in the future to the decline in economic activity. Employment is expected to fall by around 1.5% in 2012 and 2013. Even a very gradual recovery in economic activity in 2014 will not facilitate a recovery in employment. Employment will fall in the public sector and in the private sector in 2012. Weak domestic demand will prevent growth in employment in sectors primarily dependent on the domestic market. As investment declines, the workforce in employment in the construction sector will also fall further, albeit more slowly than in previous years. Structural unemployment can be expected to rise as a result of a decline in activity in sectors with low value-added. Given the assumed linear reduction in general government expenditure, a cumulative fall in employment in the public sector of around 1.5% is expected this year and over the next two years. The surveyed unemployment rate is expected to exceed 9% before the end of 2012, and to rise to around 10% by 2014. Despite the fall in employment, it is expected that a proportion of the unemployed will continue to become inactive, as a result of which the rise in unemployment is forecast to be smaller than would have been expected as a result of the ongoing fall in employment.

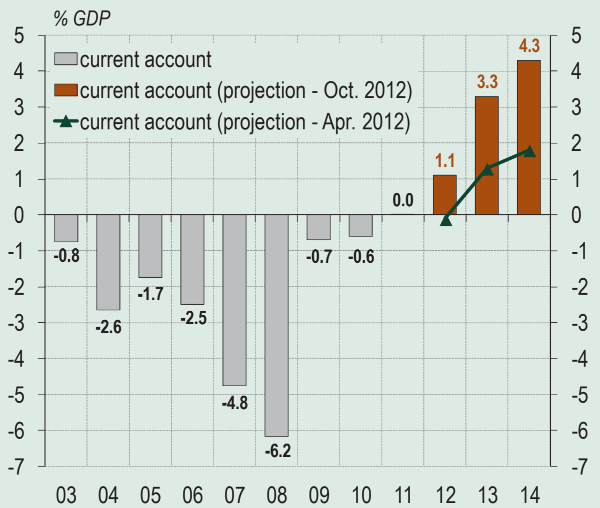
Nominal wage growth in the private sector will be limited as a result of the stagnation in economic activity and high unemployment. Year-on-year growth in the average nominal gross wage in the private sector slowed notably in the middle of 2012. These trends will continue for the remainder of 2012, when the average real wage is forecast to decline by more than 2%. Real wages are also expected to decline over the next two years. Wage growth will also depend on potential changes in the breakdown of new hires, as the hiring of workers in sectors with relatively low wages would have a negative statistical effect on wage growth, despite the economic recovery.

Public sector wage growth will depend on the focus of government austerity measures. Public sector wages have been stagnating since 2010, while a cumulative decline of more than 7% is expected this year and over the next two years in the context of the assumed linear reduction in general government expenditure. The main uncertainties surrounding the wage development in the public sector relate to the possibility and form of an agreement between the government and the public sector unions.

Foreign trade

Having been in balance last year, the current account is expected to record a surplus this year, which could rise to around 4% of GDP by 2014. The contributions to this year's surplus compared with 2011 will come primar-

Figure 7.7: Current account projections



Sources: SORS, Bank of Slovenia projections.

Figure 7.8: Terms of trade projections

Sources: SORS, Bank of Slovenia projections.

ily from an increase in the surplus of trade in services, and increasingly from the narrowing of the merchandise deficit in the coming years, in line with a gradual recovery in foreign demand. The terms of trade will contribute to the maintenance of the merchandise trade deficit in 2012 in particular, after which their impact is expected to be neutral. Projections of the current account position were revised up significantly, owing to the forecast of a sharper fall in domestic demand. The revisions average nearly 2 GDP percentage points.

The merchandise trade deficit is expected to narrow gradually, while the surplus of trade in services is expected to remain high after this year. The surplus in the balance of trade (merchandise trade and services) is forecast to rise from around 2% of GDP this year to around 4% of GDP in 2014. The maintenance of this year's merchandise trade deficit at last year's level is expected to be primarily the result of the adverse terms of trade. In addition to a gradual increase in foreign demand and an improvement in the terms of trade, a decline in all components of domestic consumption will act to reduce the merchandise trade deficit. The merchandise trade deficit is forecast to narrow from almost 3% of GDP in 2012 to around 1% of GDP by 2014. The surplus of trade in services related to merchandise trade, primarily transport services and business and technical services, will

Table 7.4: Current account

						Projections					
						2012		2013		2014	
	2007	2008	2009	2010	2011	**Oct.**	Δ	**Oct.**	Δ	**Oct.**	Δ
Exports of goods and services	13.7	4.0	-16.7	10.1	7.0	**1.0**	-1.3	**2.4**	-1.6	**4.3**	-0.7
Imports of goods and services	16.7	3.7	-19.5	7.9	5.2	**-2.5**	-3.5	**0.1**	-2.9	**2.8**	-1.6
Current account: EUR billion	-1.6	-2.3	-0.2	-0.2	0.0	**0.4**	0.4	**1.2**	0.7	**1.6**	0.9
as % GDP	-4.8	-6.2	-0.7	-0.6	0.0	**1.1**	1.2	**3.3**	2.0	**4.3**	2.5
Terms of trade*	0.9	-1.5	3.8	-3.9	-1.6	**-1.5**	-0.3	**-0.1**	-0.4	**0.0**	-0.1

** Based on national accounts deflators.*
Δ: Difference between current projections and projections in April 2012 Price Stability Report.
Sources: SORS, Bank of Slovenia.

gradually increase. Net exports of travel services are expected to remain relatively unchanged in the future, primarily as a result of an easing in the decline of imports of travel services, in addition to the gradual growth in exports of travel services. The surplus of trade in services is expected to stand at close to 5% of GDP.

The terms of trade will have a significant impact on the current account position. This should again be negative on average during 2012. Based on the current assumptions for import and export prices, the terms of trade could turn neutral in the coming years.

The deficit in factor income is expected to narrow from 1.8% of GDP this year to around 1% of GDP by 2014, while the surplus in transfers is expected to remain at around 0.5% of GDP. The main factor in the narrowing of the deficit in factor income is expected to be a diminishing deficit in capital income. Growth in outward interest payments is expected to be low, as a result of the anticipated maintenance of low interest rates. Government borrowing on the domestic market via treasury bill issues and a decline in government borrowing in the rest of the world could act in the same direction. The economic recovery could result in an increase in the flow of FDI, which should bring a gradual increase in receipts and expenditure for dividends and distributed earnings. The deficit in income from investments in securities is expected to widen, primarily as a result of an increase in the stock of securities held in non-residents' portfolios, in excess of the stock of foreign securities held in residents' portfolios. As a result of a decline in the employment of foreign workers, labour income is forecast to record net inflows of around 0.5% of GDP. Similar to last year, the surplus in transfers will primarily be the result of the disbursement of funds from the EU budget. A deficit is expected to be recorded in private transfers and other official transfers.

Inflation

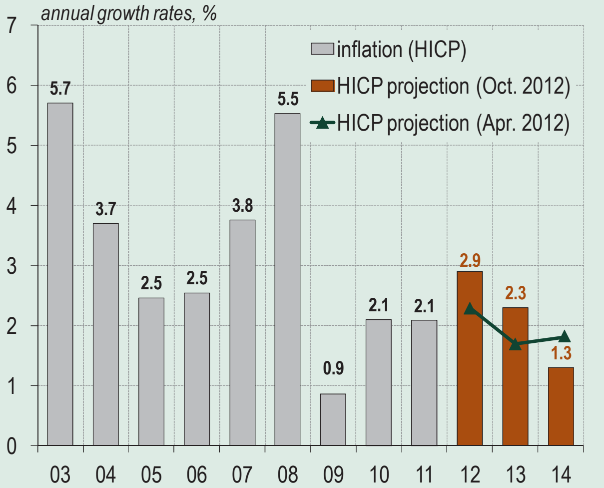
Inflation will reach nearly 3% in 2012. It is expected to fall in 2013 and 2014, primarily as a result of lower growth in energy and food prices, and the continuation of low core inflation. The current inflation forecast is higher than in the April projections, primarily as a result of higher growth in energy and food prices, and the effect of consolidation measures. Alongside commodity prices and the euro exchange rate, higher excise duties on tobacco and motor fuels have also affected food and energy prices. Thus, price growth as measured by the HICP is projected at 2.9% this year, before falling to just over

Table 7.5: Inflation projections

						Projections					
						2012		2013		2014	
	2007	2008	2009	2010	2011	**Oct.**	Δ	**Oct.**	Δ	**Oct.**	Δ
					average annual growth, %						
Consumer prices (HICP)	3.8	5.5	0.9	2.1	2.1	**2.9**	0.6	**2.3**	0.6	**1.3**	-0.5
food	7.1	8.1	1.8	2.5	4.8	**4.3**	1.7	**4.4**	2.3	**2.7**	0.5
energy	3.4	9.4	-4.5	13.9	8.8	**9.8**	2.3	**4.3**	2.3	**0.6**	-0.5
other goods	0.3	2.2	0.0	-2.2	-0.9	**0.0**	0.1	**0.2**	-0.4	**0.6**	-0.7
services	4.9	5.3	3.2	1.2	0.0	**1.5**	-0.2	**1.7**	-0.2	**1.4**	-0.6
Core inflation indicators (HICP)											
excluding energy	3.8	4.9	1.7	0.3	1.0	**1.7**	0.3	**1.9**	0.2	**1.5**	-0.4
excl. energy and unprocessed food	3.4	5.0	1.9	0.2	0.7	**1.6**	0.2	**1.7**	0.1	**1.4**	-0.5
excl. energy, food, alcohol and tobacco	2.7	3.8	1.7	-0.4	-0.4	**0.8**	-0.1	**1.0**	-0.5	**1.0**	-0.8

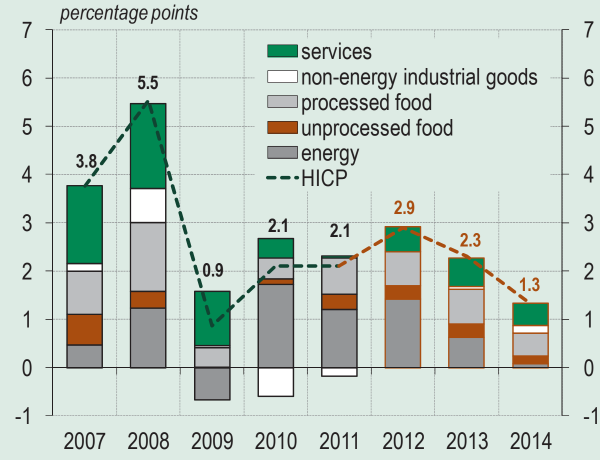
Δ: Difference between current projections and projections in April 2012 Price Stability Report.
Sources: SORS, Bank of Slovenia calculations.

Figure 7.9: Inflation projections



Sources: SORS, Bank of Slovenia projections.

Figure 7.10: Projections of contributions to inflation by components



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

2% in 2013 and below 2% in 2014. Core inflation will continue to be affected by weak private consumption.

Energy prices are again expected to make the largest contribution to inflation this year among all the price categories. In line with the expected euro oil prices, energy prices are projected to rise by nearly 10% this year, in the absence of rises in excise duties. Year-on-year growth in the aforementioned prices is expected to decline over the next two years. The main factors in the projection of domestic food prices are the relatively high assumption of growth in food prices on global markets and changes in excise duties on tobacco and alcohol. Year-on-year growth in food prices is expected to reach 4.3% in 2012, then slowing to just under 3% by 2014.

Low domestic consumption will continue to significantly limit the rise in core inflation. The decline in demand caused by the fall in consumer purchasing power and the uncertainty on the labour market are curbing growth in consumer prices. Core inflation is expected to remain low in line with the expected contraction in economic activity and private consumption. Average growth in the HICP excluding energy, food, alcohol and tobacco is projected at around 0.8% this year, and is expected to rise to 1% by the end of the projection horizon. Average growth in prices of non-energy industrial goods will stagnate this year, in part due to the fall in metals prices and the associated input costs, but is expected to rise gradually in the next two years. Growth in services prices, primarily as a result of a rise in the prices of certain public services and services linked to oil prices, is expected to contribute most to the rise in the narrowest core inflation indicator in 2012 and during the first part of 2013.

The overall direct impact on inflation from the announced government measures is expected to be larger this year, before declining thereafter. Two rises in excise duties on tobacco will be followed by two additional increases, the first in October this year and the second in January 2013. Rises in excise duties on tobacco products will contribute 0.3 percentage points to inflation this year and 0.1 percentage points in 2013. April's rise in excise duties on alcoholic beverages will contribute 0.05 percentage points to inflation in 2012. Should the government opt not to raise excise duties on refined petroleum products further this year, the contribution made to this year's growth in the HICP by previous rises will be 0.3 percentage points, owing to the pass-through effects from 2011 and this year's rises in excise duties in May, June and September. An additional environmental levy on carbon dioxide emissions, introduced in July this year, will contribute 0.1 percentage points to inflation in 2012 and 2013. According to the plan for managing administered prices in 2012 and 2013, the contribution made by administered prices is expected to be 0.1 percentage points this year and less than 0.05 percentage points in 2013.

The available monetary indicators and long-term inflation forecasts show that there is no expectation of higher price pressures in the medium term. The stock of loans to households has declined in recent months in year-on-year terms. Growth in housing loans is declining, while the stock of consumer loans is continuing to contract. Conditions for raising loans have also become tighter. This situation does not indicate the chances of a stronger reversal in domestic demand. Unit labour costs will decline in cumulative terms owing to adjustments in the private and public sectors. There is thus no expectation of domestic inflation leading to a deterioration in the price and cost competitiveness of the Slovenian economy. In its September forecasts for the period 2012 to 2017, Consensus projects inflation in Slovenia at just over 2%, with the highest rate of 2.6% expected in 2014.

Risks and uncertainties

The main external risk factor remains the possibility of a decline in economic activity in the rest of the world, and thus a decline in foreign demand and difficulties in financing. This risk is primarily associated with the uncertainty surrounding the resolution of the crisis on sovereign debt markets. There remain uncertainties surrounding the fiscal difficulties and their resolution in certain euro area countries. Domestic demand in the euro area, and thus demand for Slovenian products, could also be reduced by consumer pessimism in the EU, fiscal consolidation measures and higher commodity prices. The uncertainty surrounding the sustainability of public finances in certain developed economies outside the euro area is also increasing the risk to foreign demand. Another growing risk factor is the cooling of activity in emerging economies, owing to the possibility of weaker growth in demand in developed economies. On the other hand, increasing confidence due to additional monetary policy measures could have a positive impact on demand in the euro area.

The main domestic risks are the selection of additional fiscal consolidation measures, and the implementation and effects of structural reforms. The postponement of planned additional fiscal consolidation measures or the inability of the social partners to agree on urgent structural reforms could further increase the borrowing costs of the general government and private sector. This could have an adverse impact on the possibility of achieving fiscal sustainability and lessen opportunities for potential economic growth. Fiscal consolidation measures could also deviate from the linear reduction of

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

	Publication of new/previous forecast	GDP annual growth, %				Inflation annual average, %				Current account as % GDP			
		2012		2013		2012		2013		2012		2013	
		new	Δ	new	Δ	new	Δ	new	Δ	new	Δ	new	Δ
Bank of Slovenia	Oct. 12/Apr. 12	**-1.8**	-0.6	**-0.7**	-1.3	**2.9**	0.6	**2.3**	0.6	**1.1**	1.2	**3.3**	2.0
EIPF	Sep. 12/Mar. 12	**-1.6**	-0.7	**1.6**	-0.3	**2.3**	0.8	**1.3**	0.3	**1.5**	1.6	**2.1**	1.6
IMAD	Sep. 12/Mar. 12	**-2.0**	-1.1	**-1.4**	-2.6	**2.8**	0.8	**2.2**	0.4	**2.3**	1.7	**3.8**	2.6
Consensus Forecasts	Sep. 12/Mar. 12	**-1.4**	-1.2	**0.5**	-0.8	**2.2**	0.4	**2.3**	0.4	**…**	…	**…**	…
European Commission	May 12/Feb. 12	**-1.4**	-1.3	**0.7**	…	**2.2**	0.6	**1.7**	…	**-0.4**	…	**0.7**	…
OECD	May 12/Nov. 11	**-2.0**	-2.3	**-0.4**	-2.2	**2.4**	1.1	**1.4**	-0.3	**0.8**	1.3	**1.4**	2.2

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

expenditure assumed in the baseline scenario of projections. Because different measures have various effects on macroeconomic trends, deviations could also occur with regard to the baseline scenario.

With regard to financing, the risks of higher costs and thus access to sources are linked to the ability of corporates to increase their capital strength and to a further deterioration in the quality of the banks' balance sheets. The costs of funding banks and financing of corporates remain high as a result of rising premiums on borrowing in the rest of the world. Slovenian banks and long-term government debt were downgraded in the middle of this year. Ratings agencies also warned of the possibility of further downgrades, as a result of the uncertain economic outlook, the deterioration in the quality of the banks' balance sheets and the uncertainty regarding their recapitalisation, the lack of structural reforms, and crisis on the financial markets. Improving financing conditions is therefore crucial to corporates and banks in order to strengthen their capital base, where the latter is no longer sufficient in the current macroeconomic conditions.

The projections of gross investment remain particularly uncertain, owing to the uncertainty in the international environment, the deterioration in the fiscal position and the risks surrounding financing. The projected gradual easing of the decline in gross investment is based primarily on the assumption of an end to the contraction in investment in buildings, and on the start of major investments in the energy sector. Given the current unexploited production capacity in Slovenia, a standstill in global economic activity could additionally delay an expansion in capacity via investment in machinery and equipment in export-oriented sectors. Any slowdown in growth in investment in machinery and equipment could hinder productivity growth in the private sector, and opportunities for future potential growth. Further restrictions on government investment as part of fiscal consolidation could also result in a sharper decline in investment than projected under the baseline scenario. Here the financing of major investments (e.g. in the energy sector, where dependence on financing in the form of loans is increasing) via domestic banks, given their limited funding, could crowd-out other private sector investment.

The deteriorating situation on the labour market and the risk of a sustained rise in unemployment are an indication of the urgent need for further adjustment in labour costs to ensure the competitiveness of the economy. Unemployment could rise further as a result of the deepening of the crisis on the global markets and in the construction sector, and due to possible additional lay -offs in the public sector. The deepening of the crisis on the global markets would primarily affect employment in industry, while further fiscal consolidation would affect employment in both construction and the service sector. A further increase in structural unemployment would be particularly problematic. Long-term unemployment brings adverse social consequences and a loss of human capital, while eliminating it is usually a protracted process. Insufficient cost adjustments relative to productivity, in the event of new shocks that might affect economic activity, could also contribute to a more sustained rise in unemployment. Due to the additional deterioration in the situation on the labour market, household consumption could decline even further.

The risks surrounding inflation are balanced. A rise in energy prices and other commodity prices, a fall in the euro, potential increases in indirect taxation and administered prices as part of fiscal consolidation and a rise in prices in sectors with a low level of competition (e.g. municipal services, district heating, public transport and electricity companies) could result in inflation being higher than projected under the baseline scenario. Slower economic growth as a result of reduced foreign demand and reduced domestic demand caused by the situation on the labour market and fiscal consolidation is the most likely factor to reduce inflation. Lower economic activity would further delay the improvement in the situation on the labour market, thereby limiting labour costs. This would further reduce the possibility of passing higher input costs through into final consumer prices.