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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
BS	Bank of Slovenia
DARS	Motorway Company in the Republic of Slovenia
ECB	European Central Bank
EIPF	Faculty of Law Economic Institute
EMU	Economic and Monetary Union
ERM II	Exchange Rate Mechanism
ESA95	European System of Accounts (1995)
ESCB	European System of Central Banks
EU	European Union
EU27	European Union (of 27 Member States)
EUR	euro
GDP	gross domestic product
HICP	harmonised index of consumer prices
IFS	International Financial Statistics (International Monetary Fund database)
ILO	International Labour Organisation
IMAD	Institute of Macroeconomic Analysis and Development of the Republic of Slovenia
IMF	International Monetary Fund
m.a.	moving average
MoF	Ministry of Finance of the Republic of Slovenia
NCB	national central banks (of euro area countries)
OECD	Organisation for Economic Cooperation and Development
OPEC	Organisation of Petroleum-Exporting Countries
p.p.	percentage point
PSR	Price Stability Report
RS	Republic of Slovenia
SORS	Statistical Office of the Republic of Slovenia
TARS	Tax Administration of the Republic of Slovenia
ULC	unit labour costs
US	United States of America
USD	US dollar
VAT	value added tax

Summary

Projections of economic trends and inflation are accompanied by unusually high uncertainties in the international environment. The cooling of the economy in the international environment derives not only from a reversal in the cycle, but is increasingly affected by structural factors that are shaped by both energy and other commodity prices and volatility on international financial markets, which is leading to tensions between debtors and creditors. These uncertainties are accompanied by upside inflationary risks and downside risks in terms of economic growth. These conditions require a common understanding of the problems and coordinated measures. A significant slowdown in economic activity in the international environment represents the biggest risk to domestic economic growth in the medium term, and at the same time could further exacerbate external imbalance, particularly in the context of the Slovenian economy's deteriorating price competitiveness. This could also be more sharply reflected in the labour market.

Since the publication of the Price Stability Report (PSR), macroeconomic imbalances in Slovenia have deepened somewhat. Economic activity over the projection horizon could be more moderate and could contribute to a gradual slowing of core inflation. Inflation during the first half of 2008 exceeded the spring projections, partly as a result of higher commodity prices, and partly due to the slower decrease in domestic demand. Economic activity picked up again in the first quarter on account of high investment activity, while the current account deficit in the last 12 months exceeded 6% of GDP. Following a period in which the main macroeconomic indicators pointed to the overheating of the economy, the baseline projection of economic trends indicates more moderate economic growth over the next medium-term period, at a level just below 4%. More moderate growth in demand could contribute to the re-establishment of price stability over the projection horizon. In addition to the risks in the international environment, this dynamic is conditioned primarily by a slowdown in the growth in domestic labour costs, which could have a key impact on the economy's competitiveness, improving external imbalance and on employment trends.

* * *

Economic trends in the international environment indicate increased inflationary pressures in the first half of 2008, while expectations point to lower economic activity and slowing growth in commodity prices on average in the next medium-term period. Despite the slowdown in economic activity in the euro area, expectations regarding the total import demand of major trading partners have not changed significantly, due to steady demand from the markets of central and southern Europe and Russia. The most significant change in the international environment is the rise in inflation, which is primarily a reflection of the sharp rise in commodity prices during the first half of the year. In July the price of a barrel of crude oil (159 litres) on world markets surpassed USD 140, but had fallen back to a level just over USD 100 by September. Given trends on futures markets, the assumption regarding the price of oil is USD 120 for 2009 and 2010, while the assumption regarding growth in US dollar prices of other commodities has been revised upwards, primarily in 2008, from 12.5% to 20.0% year-on-year.

Year-on-year economic growth in Slovenia during the first half of 2008 stood at 5.5%. Domestic demand is falling more slowly than expected, primarily on account of high investment growth. At 18.7% year-on-year, investments in other buildings and structures recorded the fastest growth, primarily a reflection of accelerated road construction. Growth in investments in residential construction remains high, despite the slowdown in the second quarter, while growth in investments in machinery and equipment is becoming more moderate, at a level of 8% year-on-year. According to available figures for the first half of the *year, growth in household consumption and government spending lags behind GDP growth, but is above the long-term average. Growth in government spending in the first half of the year was approximately the same as last year's average, and was primarily the result of growth in intermediate consumption and employment, partly linked to the EU presidency. Higher growth in economic activity and aggregate demand compared to the international environment contributed to higher growth in imports than in exports in the first half of the year, which was reflected in a negative contribution by net trade to GDP growth. At the beginning of the third quarter, growth in industrial production was negative, while the first signs of a reversal in economic activity were also reflected in the labour market. Year-on-year employment growth remains high, while high employment growth in the context of a slowdown in economic activity is yielding declining real growth in output per employee. Given the sharp acceleration in growth in gross wages to over 8% in the first half of the year, growth in unit labour costs is significantly higher than growth rates that facilitate the competitive functioning of the economy without price pressures.*

The savings-investment gap has been widening since the middle of 2006, while the current account deficit already exceeds 6% of GDP. In addition to deteriorating terms of trade, the higher rate of growth in the volume of imports than exports is contributing an increasing share to the widening current account deficit. Following the rapid growth in imports of consumer goods recorded last year, it is more moderate this year, while capital goods are the fastest-growing component of imports. The widening of the current account deficit points to insufficient domestic savings with regard to investment. Because the economy meets excess demand for financing via banks by borrowing in the rest of the world, the net external debt is rising, that of the private sector in particular. Interest payments on the net external debt, resulting from a current account deficit since 2004, have already contributed 1.9% of GDP to the current account deficit in the last year in the context of tightened financing conditions. The current account deficit could be particularly problematic in light of the slowdown in economic activity in the international environment, unfavourable trends in price competitiveness indicators in Slovenia and tightened access to sources of financing due to the uncertainties on international financial markets.

Year-on-year inflation fluctuated above 6% from January to August, exceeding euro area inflation by approximately 3 percentage points, before settling at 5.5% in September. This indicates the materialisation of certain risks outlined by the Bank of Slovenia in previous Price Stability Reports regarding price pressures from the international environment and domestic inflationary factors. Rising oil prices have increased the contribution of energy prices to year-on-year inflation to more than 2 percentage points. Growth in foods prices fell from 11.6% in February to 6.1% in September in the context of a gradual slowdown in the growth of food commodity prices on world markets. With the adoption of wage agreements in the public and private sectors, the most significant risk among domestic factors, namely second-round effects on growth in labour costs due to the considerable indexation of wages to current inflationary trends, has largely materialised. This is combining with the effects of public sector wage reform. Taking into account continued high economic activity, aggregate demand that exceeds the supply potential and favourable labour market conditions in the first half of the year, the domestic macroeconomic environment contributed to persistently high core inflation. Year-on-year inflation excluding food, energy, alcohol and tobacco reached its highest level in April at 4.4%, and has gradually fallen, settling at 3.8% in September when it exceeded euro area core inflation by approximately 2 percentage points. Headline inflation in the euro area fell from 4.0% in June and July to 3.6% in September. The most significant contributions to this high growth were made by high oil and food prices, as core inflation indicators were virtually unchanged at just under 2%.

The projection of economic growth in 2008 was revised upwards to 4.5% on account of high growth in the first half of the year, while a simultaneous slowing of growth in foreign and domestic demand in 2009 and a gradual recovery in 2010 could result in a drop in average economic growth to below 4% in 2009 and 2010. More subdued economic growth primarily reflects more moderate growth in domestic demand, which should, in the context of a gradual recovery in foreign demand after 2009, contribute to the renewed positive contribution of foreign trade to economic growth. Private consumption should be somewhat higher than the April projection in the second half of 2008 and in 2009, primarily on account of agreed wage increases, while annual real growth is not expected to exceed 3.5%. In terms of substance, the new projections entail a temporary acceleration *in economic growth in 2008, linked primarily to developments from the first half of the year, followed by a decrease in activity to the previously expected level, meaning a slowdown in growth in 2009. If the current employment growth proves to be sustained and not mainly cyclical, as currently indicated by concentration in sectors such as construction, growth could exceed 4% in 2009 as well.*

The downturn in the pace of economic activity in the rest of the world and the exceptionally low growth in exports in the first half of the year represent the main reason for the widening of the current account deficit to around 6.3% of GDP this year, while the deficit is expected to gradually close over the next two years. Growth in exports of goods and services is expected to outstrip growth in imports by approximately 0.3 percentage points in 2009 and 2010, representing the main source behind the gradual closing of the deficit. It is therefore crucial that price competitiveness indicators, which have recently revealed considerable real appreciation, partly linked to the appreciation of the euro, do not cause growth in exports to significantly lag behind growth in imports. The negative factor income position will contribute significantly to the current account deficit over the projection horizon, primarily due to net interest expenditure on the current net external debt.

The easing of inflation will be largely linked to the base effects of past external price pressures, while the decline in core inflation will be more gradual given realised and expected developments in the domestic macroeconomic environment. In line with current and expected developments in assumptions, inflation projections have been revised slightly upwards to 6.1%, 3.5% and 2.8% for 2008, 2009 and 2010, respectively. A sharp decrease in the contribution made to inflation by energy products and food commodities, linked to the supply-side price shocks from last year and the first half of this year, is expected to take place at the end of 2008 and during 2009. On the other hand, the effect on prices from aggregate demand and domestic costs factors, particularly labour costs, will not ease as quickly as indicated by projections in the April Price Stability Report. Core inflation is not expected to return to a more sustainable level, one more comparable to the euro area, until 2010.

Upside risks prevail in terms of inflation, while downside risks prevail in terms of economic growth. With regard to economic growth, the greatest risk remains the possibility of a sharper and more sustained downturn in economic growth in the international environment. A significant decline in foreign demand similar to that experienced in 2001, when growth in the imports of major trading partners fell by 5 percentage points, could slow economic growth by 1.5 percentage points on average over the next two years. The credit squeeze that could occur if uncertainties on world financial markets deepen further could act to slow spending and investment in Slovenia and the rest of the world. Among domestic demand factors, the greatest uncertainty is represented by investment growth, which could slow considerably due to recent high growth. Among inflation factors, uncertainties are linked primarily to developments regarding commodity prices and wages. It is still difficult to assess the effects of this year's wage adjustments on the easing of core inflation. Simulations indicate that, in the context of full indexation of wages to past inflation over the projection horizon, inflation would be on average approximately 1 percentage point above the baseline projection for years 2008 to 2010. Sustained deterioration in the economy's cost and price competitiveness due to excessively high inflation and growth in labour costs could also hinder a gradual decrease in external imbalance.

The Maastricht convergence criteria and the rules set out in the Stability and Growth Pact serve as the framework for managing national economic policy since Slovenia joined the euro area. In recent months inflation has exceeded the Maastricht price stability criterion by approximately 2 percentage points. According to the last notification the general government position is expected to be balanced in 2008, following a surplus in 2007. However, public finance ratios could deteriorate very quickly in the event of a sharper slowdown in economic growth, since the reserves generated in the context of very favourable growth in revenues in recent years are relatively small.

Given the expected economic developments, domestic economic policies must provide for a gradual transition to the area of a more moderate economic activity in line with price stability and external balance. As long as there are no signs that economic growth could slow excessively, promoting economic activity through macroeconomic policies would be inappropriate, as it could hamper the lowering of inflation and increase the external deficit. Stimulating investment activity limits the investment *activity of the private sector, particularly in an environment of tightened conditions for raising loans. Attention must be focused on establishing more moderate trends with regard to growth in labour costs and deindexation, and to establishing an appropriate market structure and flexibly functioning markets. Moderate growth in nominal labour costs, which is largely driven by the productivity growth trend, is crucial for sustained price stability, the economy's price competitiveness and sustainable long-term economic growth.*

						Projections					
						2008		2009		2010	
	2003	2004	2005	2006	2007	**Oct.**	∆	**Oct.**	∆	**Oct.**	∆
Activity, employment, wages	*real growth, %*										
Real GDP	2.8	4.3	4.3	5.9	6.8	**4.5**	0.3	**3.5**	-0.4	**4.1**	0.0
Employment	-0.4	0.3	-0.1	1.6	3.0	**2.1**	1.2	**0.3**	-0.3	**0.5**	0.0
Average net wages (nominal)	7.5	4.4	6.2	5.1	7.9	**8.5**	0.7	**7.0**	0.1	**6.1**	0.6
Disposable income*	1.7	4.2	1.7	5.2	6.6	**4.4**	1.4	**3.7**	-0.2	**3.7**	0.4
Average gross wages (nominal)	7.6	4.6	4.9	4.8	5.9	**8.7**	1.3	**7.1**	0.1	**6.2**	0.6
Productivity	3.2	4.0	4.5	4.2	3.7	**2.4**	-0.9	**3.2**	-0.1	**3.6**	0.0
ULC (nominal)	4.2	0.6	0.4	0.5	2.1	**6.2**	2.2	**3.8**	0.2	**2.5**	0.6
Domestic demand	*real growth, %*										
Domestic demand	4.8	4.8	2.1	5.7	8.0	**5.0**	0.8	**3.3**	-0.2	**4.0**	0.3
Household expenditure	3.3	2.7	2.6	2.9	5.0	**3.3**	0.1	**3.4**	0.4	**3.4**	0.1
Government spending	2.2	3.4	3.3	4.1	2.5	**3.1**	0.5	**1.9**	0.0	**1.8**	0.0
Gross investment	10.3	10.4	0.4	12.5	17.2	**9.1**	1.9	**4.0**	-1.4	**6.0**	0.4
Balance of payments	*real growth, %*										
Exports of goods and services	3.1	12.4	10.6	12.5	13.8	**7.1**	-2.4	**7.4**	-0.8	**8.4**	0.1
Imports of goods and services	6.7	13.3	6.6	12.2	15.7	**7.8**	-1.5	**7.1**	-0.6	**8.1**	0.3
Current account (EUR billion)	-0.2	-0.9	-0.7	-1.0	-2.0	**-2.4**	-0.2	**-2.5**	-0.3	**-2.5**	-0.4
as % of GDP	-0.8	-2.7	-2.1	-2.5	-4.3	**-6.3**	-0.2	**-6.2**	-0.7	**-5.8**	-0.8
Terms of trade**	0.8	-1.0	-2.0	-0.6	0.0	**-2.0**	0.2	**0.1**	-0.3	**0.5**	0.1
Prices	*average annual growth, %*										
Consumer prices (HICP)	5.7	3.7	2.5	2.5	3.7	**6.1**	0.5	**3.5**	0.0	**2.8**	0.2
Non-administered prices	5.9	3.0	1.2	1.9	4.1	**5.5**	0.0	**3.6**	0.0	**2.9**	-0.1
Administered prices	4.4	6.1	7.4	4.9	2.2	**7.7**	1.8	**3.3**	0.1	**2.6**	1.7
International environment	*average annual growth, %*										
Foreign demand***	6.2	8.5	5.0	9.6	7.7	**5.3**	-0.2	**6.2**	-0.1	**6.8**	0.4
Oil (USD per barrel)	28.8	38.3	54.2	64.9	72.7	**115**	15	**120**	22	**120**	23.0
Non-oil commodities	11.3	16.0	6.0	27.7	17.5	**19.5**	7.0	**0.0**	-5.0	**5.0**	0.0
EMU inflation	2.1	2.1	2.2	2.2	2.1	**3.6**	0.7	**2.5**	0.4	**2.0**	0.1
PPI Germany	1.7	1.6	4.6	5.5	2.0	**5.3**	3.0	**3.0**	1.2	**1.8**	0.0

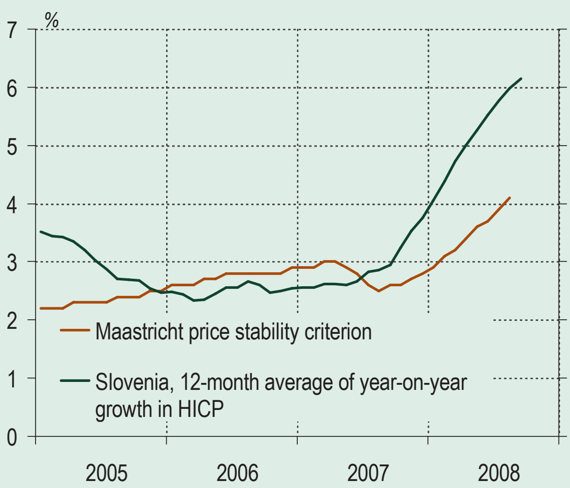
* Net wages, other earnings from employment and social benefits; HICP deflated
** Based on national accounts deflators.
*** Basket of foreign partners import volumes.
∆ : The difference between April 2008 and October 2008 projections.
Source: SORS, Bank of Slovenia, Eurostat, Consensus Forecasts, JP Morgan, OECD Outlook, IMF World Economic Outlook.

1 Recent Price Developments

Following high average price growth last year, inflation has risen further this year due to both domestic and external factors. The average annual growth in consumer prices, measured by the HICP, stood at 6.4% in the first nine months of this year, an increase of 2.7 percentage points compared with the 2007 average. Among external factors which had the most significant impact on higher growth of prices, are higher commodity prices, particularly energy and food prices. Among domestic factors, the most notable impact came from growth in labour costs, still relatively high economic growth and growth in aggregate demand, Inflationary pressures linked to the domestic macroeconomic environment were primarily seen in the rapid growth in core inflation indicators at the beginning of the year. However, this growth has been easing in recent months.

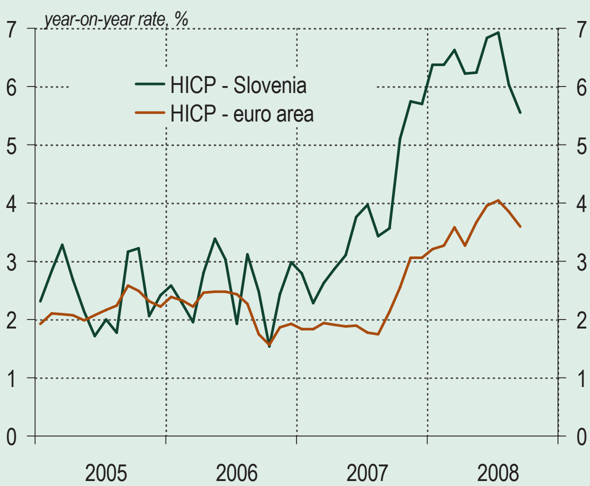
In the first eight months of the year, inflation exceeded the level consistent with sustainable real convergence, and has increasingly deviated from the Maastricht price stability criterion since the summer of 2007. In July that criterion stood at 3.9%, 2.1 percentage points lower than the 12-month average HICP growth rate in Slovenia. The gap between the average inflation rates in Slovenia and the euro area rose from 1.7 percentage points on average in 2007 to 2.8 percentage points in the first eight months of this year. The increase in inflation relative to the euro area is a reflection of the different response to factors from the international environment, and also a reflection of internal factors from the domestic macroeconomic environment that are less noticeable in the euro area.

Figure 1.1: Maastricht price stability criterion



Source: Eurostat, SORS; Bank of Slovenia calculations

Figure 1.2: Headline inflation



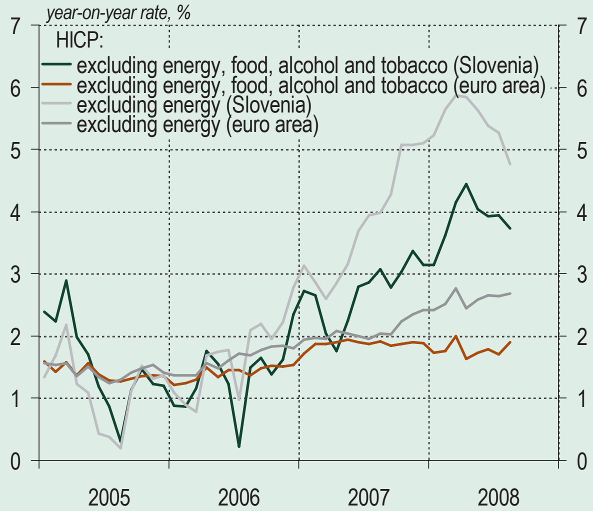
Source: Eurostat, SORS, Bank of Slovenia calculations

Macroeconomic factors and core inflation indicators

Price developments in recent months reflect a gradual slowing of domestic economic activity. Core inflation indicators in Slovenia have gradually fallen in the last four months. Following strong economic growth last year, the pace of economic activity slowed somewhat in the first half of this year. The majority of indicators signal that the slowdown in growth could continue in the second half of the year. Suppliers of goods and services are limited in their ability to raise prices in such an economic climate. Growth in the HICP excluding energy and unprocessed food has decreased by more than 1 percentage point since March to stand at 4.5% in September. Since price developments at the beginning of the year were still being strongly affected by rising processed food prices, core inflation indicators excluding both processed and unprocessed food should also be compared. Growth in the harmonised price index excluding energy, food, alcohol and tobacco stood at 3.8% in September, representing a gradual decrease since April, when the rate stood at 4.4%. Nevertheless, the difference in price growth relative to the euro area remains at a high level.

High aggregate demand means that inflationary pressures are only diminishing slowly. Compared with the record growth recorded last year, economic activity is decreasing gradually, but is still above the estimated potential growth. The output gap remains positive, but the latest figures and indicators regarding economic activity trends signal that the closing of the output gap could perhaps accelerate in the future (see Box 1.1.). The main driver of domestic demand remains growth in investments, which are predominantly being directed into construction. Thus growth in the supply capacity is somewhat limited and continues to be driven primarily by higher employment, on account of investments in a sector with relatively low value added. Strong demand for labour also reflects the rather low growth in productivity, which has lagged behind the long-term average by more than 1 percentage point over the last year. According to the actual

Figure 1.3: Core inflation



Source: Eurostat, Bank of Slovenia calculations

national accounts figures growth in household consumption remains relatively slow, despite the relatively high growth in disposable income. Year-on-year growth in government spending has risen slightly since the final quarter of last year, but remains well below GDP growth.

Given the strong economic activity in Slovenia and inflation trends, financing conditions are overly favourable. Although the fall in real interest rates has halted in recent months, interest rates are still too low to efficiently limit demand-side inflationary pressures. Nominal lending rates for both non-financial corporations and households have risen in the last year and are currently fluctuating between 7% and 8% due to the tightening of ECB monetary policy and increased instabilities on financial markets. In the context of increased corporate indebtedness and higher interest rates, the costs of corporate financing are rising. This, alongside high costs in the form of commodity prices and higher nominal wages, gradually already affects corporate profits and investment decisions, and thus indirectly lending to non-financial corporations. Expectations of a slowdown in economic growth, which can already be seen to some extent in certain indicators, are further reducing growth in lending to non-financial corporations. In the context of tighter financing conditions, lower growth in private consumption, increased pessimism among consumers and an easing of real estate prices, growth in lending to households has also decreased, falling 10 percentage points in the first seven months of this year.

Since the beginning of the year growth in labour costs has fluctuated at a level well above the level consistent with achieving price stability. Developments on the labour market in the second quarter of this year indicate that the slowdown in economic activity is already having a partial effect of gradually lower employment growth compared with last year and the beginning of this year. High employment growth is still being driven primarily by employment in construction. However, employment growth is slowing in conjunction with slowing activity in this sector. Nevertheless, the gradual slowing in employment growth has not yet been reflected in a rising unemployment rate, which declined further in the second quarter to just over 4%. Agreements reached on a one-off wage adjustment due to the high inflation in 2007 have led to the rising growth in labour costs this year. Private sector labour costs, measured by the average gross wage, rose by nearly 9% on average in the first half of the year, or approximately 2.5 percentage points more than in the same period last year. In the context of an expected long-term productivity trend of between 3% and 4%, recent growth in nominal unit labour costs has reached nearly 5%. If growth in labour costs were to continue at this pace, particularly when economic conditions are deteriorating in both the domestic and international environment, one could expect pressures on inflation to

Table 1.1: Structure of HICP and price indicators

		average annual growth, %					year-on-year growth in quarter, %				
	weight	2004	2005	2006	2007	H108	07Q2	07Q3	07Q4	08Q1	08Q2
HICP	*100.0%*	3.7	2.5	2.5	3.8	6.4	3.2	3.7	5.5	6.5	6.4
Breakdown of HICP:											
Energy	*13.4%*	7.0	11.9	8.5	3.4	12.1	3.3	1.1	8.6	12.5	11.7
Food	*22.5%*	1.3	0.2	2.7	7.1	10.6	6.1	7.5	10.7	11.3	9.9
processed	*14.9%*	2.7	0.6	2.5	6.3	12.8	3.9	7.1	10.6	13.0	12.7
unprocessed	*7.5%*	-1.4	-0.8	3.1	8.7	6.2	10.4	8.3	10.8	7.8	4.7
Other goods	*29.8%*	1.8	-0.3	-0.9	0.3	2.1	0.0	0.4	0.9	1.6	2.6
Services	*34.3%*	5.8	3.3	3.5	4.9	5.5	4.4	5.2	5.3	5.5	5.5
Core inflation indicators											
HICP excluding energy	*86.6%*	3.2	1.2	1.7	3.8	5.6	3.2	4.1	5.1	5.6	5.6
HICP excluding energy and unprocessed food	*79.1%*	3.7	1.3	1.5	3.4	5.5	2.6	3.7	4.5	5.4	5.7
HICP excluding energy, food, alcohol and tobacco	*64.2%*	3.9	1.5	1.3	2.7	3.9	2.3	2.9	3.2	3.6	4.1
Administered prices and non-administered prices:[1]											
Administered prices	*23.1%*	6.1	7.4	4.8	2.1	7.4	2.0	0.7	5.4	7.6	7.2
Non-administered prices	*76.9%*	3.0	1.2	1.9	4.1	6.1	3.5	4.4	5.5	6.1	6.1
Other price indicators:											
Industrial producer prices on the domestic market		4.3	2.7	2.3	5.4	6.1	5.1	5.4	6.5	5.9	6.3
GDP deflator		3.3	1.7	2.0	3.9	4.5	3.5	4.2	3.8	5.3	3.9
Import prices[2]		4.1	5.0	3.3	3.3	3.3	4.6	2.0	3.1	3.2	3.4
Selected macroeconomic factors:											
Output gap (HP trend)		-0.7	-1.2	-0.3	1.0	1.4	1.0	1.1	1.2	1.4	1.5
Unit labour costs[3]		0.5	0.9	0.3	2.5	5.8	2.3	2.1	5.0	5.5	6.0
Labour costs per employee[3]		4.6	4.9	4.8	5.9	8.2	5.6	5.8	6.8	7.8	8.6
Productivity[3]		4.1	4.0	4.5	3.3	2.3	3.3	3.6	1.7	2.2	2.4
Profit indicator[4]		2.9	0.8	1.7	1.4	-1.1	1.2	2.0	-1.2	-0.2	-2.1

Notes: [1] ECB methodology, [2] National accounts figures, [3] Gross wages only, [4] Calculated as the difference between the GDP deflator and unit labour costs
Source: SORS, Eurostat, Bank of Slovenia calculations

be formed on one hand, and a drop in employment to occur on the other. The latter could happen particularly if companies are unable to pass higher operating costs on to prices due to deteriorating economic conditions.

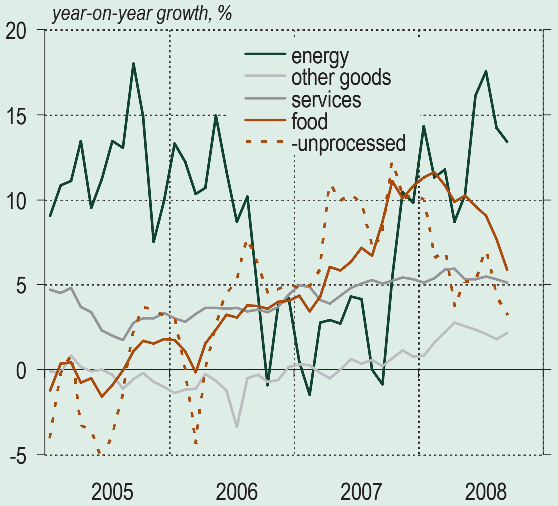
An important factor that in part limited inflation is the appreciation of the nominal effective exchange rate, which continues to mitigate supply-side inflation shocks from the international environment. The appreciation of the euro has partially contributed to the reduced pass-through of US dollar oil prices to the costs of euro area companies. The euro's appreciation against the US dollar in the first seven months of the year, compared with last year's average, stood at 11%, while US dollar oil prices rose by more than 20%. Furthermore, the appreciation of the euro also reduces the price competitiveness of the domestic economy, which could act to limit inflation and inflation expectations in the medium term.

Microeconomic factors and the structure of inflation

Food and oil prices remain the fastest growing components of inflation. Among the sub-categories, energy prices have risen the most this year. Average annual growth in energy prices in the first eight months of this year stood at 13.1%,9.7 percentage points higher than last year's average. Thus the contribution of energy prices to headline inflation has risen from an average of 0.5 percentage points in 2007 to 1.7 percentage points in the first nine months of this year. The higher growth in energy prices is a result of growth in oil prices in world markets, which stood at 72% in year-on-year terms in the first eight months of the year. The rise in oil prices on international markets has also been seen this year in the euro area, where year-on-year growth in energy prices in the first eight months stood at 13.1%, while growth was just 2.6% last year, similar to that in Slovenia.

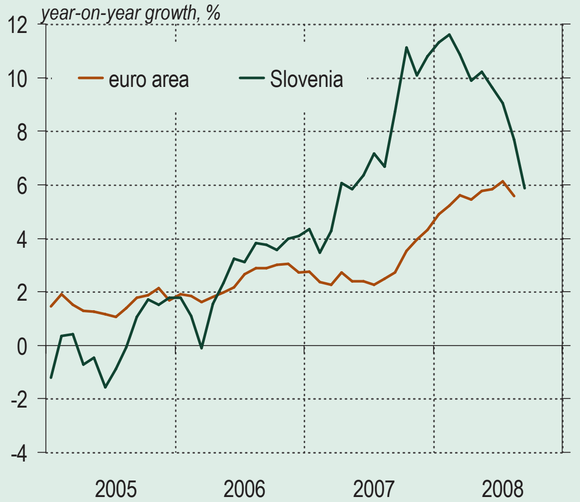
Developments in food prices have been more moderate this year compared with last year, as year-on-year growth began slowing in the second half of the year. Year-on-year growth in food prices in the first nine months of the year stood at 9.6% on average, an increase of 2.5 percentage points on last year. The higher year-on-year growth in the first four months of the year was primarily the result of lower growth in food prices during the same period last year. The fastest growing food prices this year are prices of processed food, which have grown 11.5% year-on-year in the first nine months, while growth in unprocessed food prices is gradually

Figure 1.4: Individual price categories



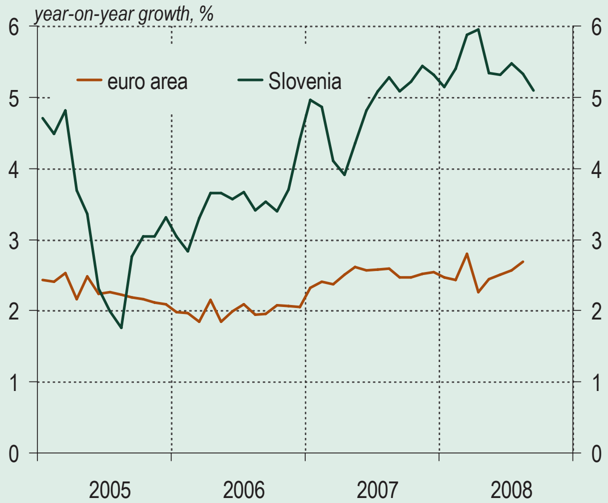
Source: Eurostat, SORS, Bank of Slovenia calculations

Figure 1.5: Food prices in Slovenia and the euro area



Source: Eurostat, SORS, Bank of Slovenia calculations

Figure 1.6: Prices of services in Slovenia and the euro area



Source: Eurostat, SORS, Bank of Slovenia calculations

slowing. In September year-on-year growth in unprocessed food prices was just slightly higher than 3%, while it was significantly higher at the end of last year at 10%. Similar to last year the continued high growth in food prices can be attributed primarily to higher food prices in the international environment, where this year's average year-on-year growth in US dollar food prices stood at 58%. Average year-on-year growth in euro area food prices in the first eight months of this year stood at 5.6%, which is 2.8 percentage points up on last year, but still well below the average growth of food prices in Slovenia.

Figure 1.7: Prices of non-energy industrial goods

Source: Eurostat, SORS, Bank of Slovenia calculations

At the beginning of the third quarter, growth in services prices stabilised at the level seen at the end of last year, following a slight increase during the first half of the year. Average annual growth in services prices in the first nine months of the year stood at 5.5%, an increase of 0.6 percentage points on last year. In the euro area growth in services prices in the first eight months of this year stood at 2.5%, or 3 percentage points lower than in Slovenia. Among services, the most notable growth was recorded by prices of recreational and personal care services, which rose by approximately 9%, an increase of 1.5 percentage points compared with the previous year, and the prices of package holidays, which also recorded growth of 9%. The prices of transport services have also risen this year by approximately 2%. Following last year's drop, the prices of municipal services have remained largely unchanged this year.

Developments in the prices of non-energy industrial goods have been in line with macroeconomic trends. Average annual growth in the prices of non-energy industrial goods in the first nine months of 2008 stood at 2.0%, an increase of 1.6 percentage points on last year. This category's contribution to headline inflation has risen from 0.2 percentage points last year to 0.7 percentage points this year. The largest contribution to the higher growth in prices came from prices of clothing and footwear, which rose by 3.5% on average in the first nine months of this year. For the first time in three years, growth in the prices of non-energy industrial goods has exceeded the euro area average, where growth of 0.7% has been recorded this year. Nevertheless, it is evident from developments in prices of non-energy industrial goods that their growth is slowing in line with an easing of macroeconomic factors.

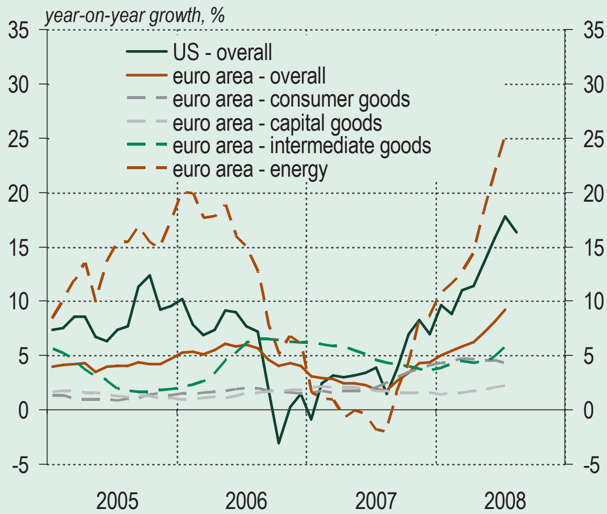
Producer prices

In the first seven months of this year, industrial producer prices on the domestic market rose by an average of 6.2%, an increase of 0.8 percentage points on

Figure 1.8: Industrial producer prices on the domestic market

Source: SORS, Bank of Slovenia calculations

Figure 1.9: Industrial producer prices on the domestic market for the US and the euro area



Source: Eurostat, Federal Reserve Bank of St Louis, Bank of Slovenia calculations

last year's average. This type of trend suggests that additional pressures on growth in the prices of consumer goods are possible in the future. Prices of intermediate goods recorded the highest growth (7.2%), as a result of high growth in energy and commodity prices on world markets. On average, US dollar prices of commodities on world markets rose by 29% year-on-year in the first eight months of 2008, an increase of 10 percentage points on last year's average. Prices of consumer goods rose by an average of 6% over the first seven months of the year, while prices of capital goods rose by 2.7%. Higher average growth in energy prices, which was up 14.4 percentage points on 2007 at 16.2% in the first seven months of this year, contributed most to the higher growth in euro area producer prices compared with last year. In addition to energy prices, prices of intermediate and consumer goods also rose, but to a lesser extent. In contrast to the euro area, this year's growth in US industrial producer prices was down 3.1 percentage points on last year, at 0.7%.

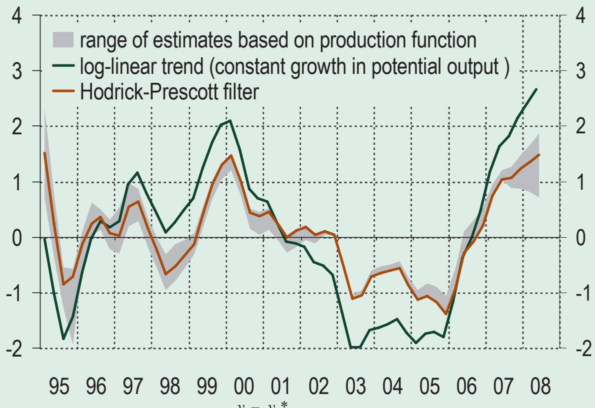
Box 1.1: Potential output and output gap indicators for Slovenia

The output gap measures the ratio of aggregate demand to the economy's supply capacities, and is one of the main indicators of underlying inflationary pressures in the short to medium-term. If demand exceeds supply capacities, the result is pressures on rising prices. To define the output gap, it is necessary to estimate the level of supply capacities, namely potential output. Potential output is generally defined as the level of supply in an economy, determined by the structure of production, technological capacity and production factors. When aggregate demand exceeds the level of supply capacities of the economy, it signals inflationary pressures.

The various methods of estimating potential output provide a similar picture of the output gap trend in Slovenia. According to estimates, the output gap has remained strongly positive over the last two years, indicating aggregate demand in excess of supply potential and thus clearly reflecting underlying inflationary pressures. The European Commission's estimates also indicate the existence of a similar positive output gap.[1] At the same time, projections indicate that the output gap could close entirely over the projection horizon in the context of slowing economic activity, which could result in a reduction of inflationary pressures in the future.

The methods most frequently used to calculate potential output can be classified into two larger groups: (i) the production function and (ii) statistical methods. In the first case, potential output is determined on the basis of a supply-side model of the economy. Statistical models include single variant and multi-variant approaches, namely distinguishing between trend and cyclical components of a time series of GDP. All the methods used to calculate potential output have advantages and disadvantages. Thus it is helpful to use a variety of output gap indicators.[2] Frequently, assessments of output gap indicators are extremely dubious due to revisions of figures and the unreliability of statistical assessments at the tail of an available sample of data.[3] Since no official time series of capital is available in Slovenia, the value of this series must be estimated, using one of several methods available, and the values of the parameters that will be used for this purpose must be defined. In addition to defining the type of investments based on which the extent of capital is determined, the coefficients of elasticity of output to a change in production factors have to be determined.

Figure: Range of estimates of output gap in Slovenia*



** The output gap is defined as $\frac{y - y^*}{y^*} \times 100$, where y is actual GDP, and y* is the potential output*
Source: SORS, Bank of Slovenia calculations

Despite the unreliability of individual assessments, it is possible to determine the major tendencies of the output gap using different methods, if the results of the various assessments are similar. The range of assessed values of the output gap shown in the figure is based on various methods and parameter values, which are included in calculations of the production function (e.g. the Hodrick-Prescott filter with a smoothing parameter of 1,600) and a log-linear trend, which assumes that growth in potential output is unchanged over the assessment period. In the production function, the time series of capital is determined based on the perpetual inventory method, where various initial values of capital are used (based on an optimality condition by which the price of capital is equal to the marginal capital output, and based on the SORS's estimate of the value of capital for the fourth quarter of 1999), as well as depreciation rates (annual depreciation rates of 5%, 7.5% and 10% are used), various definitions of investments (total investments and investments excluding investments in built structures) and various methods for smoothing elementary time series (the Hodrick-Prescott filter and a trend assessment based on the X12 method).

[1] http://circa.europa.eu/Public/irc/ecfin/outgaps/library?l=/1_spring_2008/spring_2008_results&vm=compact&sb=Title

[2] Evidence of the importance of accurately estimating the output gap when implementing economic policy comes from the case of the US from the mid-1960s to the 1980s, when inflation in the US rose, despite the estimates of the Council of Economic Advisers at that time indicating the existence of a negative output gap (Orphanides and van Norden, 1999).

[3] Camba-Mendez et al. (2005) arrived at similar conclusions for the euro area.

Box 1.2: Contribution of the Balassa-Samuelson effect to the inflation differential between Slovenia and euro area [1]

The Balassa-Samuelson (B-S) effect is one of the sources of inflation and inflation differentials between countries in the euro area. The B-S effect reflects the difference in inflation rates between countries, arsing exclusively from the differences in the growth in relative productivity of the tradable and non-tradable sectors by countries. It thus reflects an equilibrium process that does not influence the external competitiveness of a country, as only the prices of the non-tradable sector are affected. Using the B–S effect it is possible to partially explain higher inflation in relatively less developed and rapidly growing countries, as rapid economic growth is typically driven by rapid growth in the tradable sector (e.g. due to higher exposure to competition, FDI and international integration). The B-S effect assumes that wages in the tradable sector reflect the sector's productivity growth, while wages in the non-tradable sector adapt to more or less the same extent due to the assumed mobility of labour and the institutional wage-setting framework, although productivity in this sector is lower. To finance wage growth that is not in line with productivity growth, the non-tradable sector increases prices in relative terms more than the tradable sector, thus contributing to growth in the general price index. Such developments were also present over the last decade in Slovenia. Average wage growth in the non-tradable sector was only slightly slower than in the tradable sector, despite productivity growth being significantly slower, while at the same time prices in the non-tradable sector were increasing faster (Table 1).[2]

New estimates indicate that the B-S effect over the last decade (1998-2007) in Slovenia was 0.6 percentage points with regard to the euro area.[3] This means that it is possible to attribute an average of up to 0.6 percentage point of inflation differential between Slovenia and the euro area to the faster growth in relative productivity in the tradable sector compared to the non-tradable sector in Slovenia or to the catch-up effect. The updated estimate is in line with the previous estimate (0.7 percentage point in the 1993-2001 period), and with other available estimates that typically range from 0.5 to 1.5 percentage points.[4]

With the convergence of Slovenian productivity with that of the euro area, the B-S effect can be expected to gradually diminish in the future. Since the size of the B-S effect is affected by the difference in relative productivity growth between the tradable and non-tradable sectors, improved growth in productivity in the non-tradable sector would contribute most to reducing the B-S effect and thus inflation differential with regard to the euro area. Measures and structural reforms that will contribute to increased competition in the non-tradable sector will be crucial in this respect.[5]

Inflation Differentials between euro area countries are a normal phenomenon and, to some extent, represent an adjustment mechanism in the process of economic convergence. At the same time, differences in inflation could also be the result of inappropriate domestic policies or factors, such as fiscal policy, wage trends and structural factors. In this case, differ-

Table: Balassa-Samuelson effect in Slovenia compared with the euro area, and selected indicators for Slovenia

	1998-2007 (average)	1998-2002 (average)	2003-2007 (average)
B-S effect (percentage points)	**0.6**	**0.6**	**0.7**
Indicators for Slovenia (growth %):			
Wages in the tradable sector (nominal)	8.4	10.2	6.5
Wages in the non-tradable sector (nominal)	7.6	8.8	6.4
Productivity in the tradable sector	6.1	5.2	7
Productivity in the non-tradable sector	2.1	1.4	2.8
Prices in the tradable sector*	3.9	6.4	1.3
Prices in the non-tradable sector*	5.7	6.9	4.4

** Value added deflator as measure for producer prices*
Source: Eurostat, Bank of Slovenia calculations

ences in inflation should be addressed by national policies, as monetary policy is responsible for maintaining price stability in the euro area as a whole. In addition to the B-S effect, there are other factors linked to the process of convergence, including the catching-up of prices and income and differences in the structure of the economy (preferences of consumers and the composition of the consumer basket, the production structure,[6] the openness of the economy, the share of imported goods, dependence on commodities and the functioning of markets). Furthermore, a temporary factor contributing to the inflation differentials among the euro area countries is the introduction of the euro, which brings a new institutional environment, increased integration in euro area capital markets and lower interest rates in countries with higher inflation rates in the past, which could result in an increase in domestic demand and inflationary pressures, particularly in the non-tradable sector.[7] The impact of specific effects is difficult to assess and isolate, and interpretations therefore require caution. When formulating economic policies it is important to consider how differences in inflation affect the competitiveness of an economy and thus longer-term outlook for economic growth and employment. The analysis indicates that the B-S effect, which represents an equilibrium process and thus does not affect the price competitiveness of a country, can only explain a small portion of the difference between Slovenian and euro area inflation, which stood at nearly 3 percentage points, on average, in the first eight months of 2008.

[1] This box is a summary of the update of the article by T Žumer, "Estimation of the Balassa-Samuelson effect in Slovenia", published in Surveys and Analyses X/1 (September 2002), Bank of Slovenia, and the contribution to the working paper, "On the estimated size of the Balassa-Samuelson effect in five Central and Eastern European countries", National Hungarian Bank WP, 2002/5.

[2] The tradable sector includes sectors C, D and E, while the non-tradable sector includes sectors G, H, I, J and K. The agriculture and public administration sectors (representing approximately 20% of total value added) are excluded because of administrative price setting. Productivity is defined as output per employee, while labour costs per employee are defined as the average gross wage.

[3] The B-S effect is calculated as the ratio of growth in relative productivity (of the tradable sector relative to the non-tradable sector) in Slovenia to that of the euro area in a selected period, weighted by the share of non-tradable goods (services) in the HICP basket (which rose gradually from 24% in 1998 to 34% in 2007). The estimation methodology is explained in detail in the aforementioned paper.

[4] To review available estimates of the B-S effect, including a comparison with other countries, see B Égert, L Halpern and R MacDonald (2006): "Equilibrium Exchange Rates in Transition Economies: Taking Stock of the Issues", Journal of Economic Surveys, vol. 20(2), pp 257-324. Most studies find that the B-S effect is only able to explain a small portion of the inflation differential, or the appreciation of the real exchange rate.

[5] On the other hand, a rising share of services in the HICP basket (which currently stands at 41% in the euro area and 34% in Slovenia) will result in an increase in the B-S effect. However, the calculations indicate that this effect is relatively small compared with the catch-up effect in productivity.

[6] B Égert and J Podpiera have identified a change in quality (a "quality bias") as the main factor of higher inflation in Visegrad countries, as higher quality brings higher consumer prices and producer prices (CEPR Policy insight No. 20, April 2008).

[7] See for example the article "Monetary policy and inflation differentials in a heterogeneous currency area", ECB Monthly Bulletin, May 2005.

2 International Environment and Projection Assumptions [1]

Slowing economic growth and high inflation remain the main characteristics of the economic environment in most countries at the beginning of the third quarter of 2008. Alongside uncertainties in financial markets and a slowdown on real estate markets, it is high commodity and oil prices that are acting primarily to reduce global economic growth. Statistical releases indicating the deteriorating situation in the euro area in the second quarter of this year and persistent instability on global financial markets point to continuing uncertainties with regard to economic developments in the second half of this year and in the first half of 2009. A sharp slowdown in economic growth in the second quarter followed growth that exceeded expectations at the beginning of the year in the euro area. Particularly worrying are the figures from the euro area's three largest economies (Germany, France and Italy), which recorded negative economic growth in the second quarter. The latest releases of economic activity indicators for Japan indicate that the economy could slide into recession this

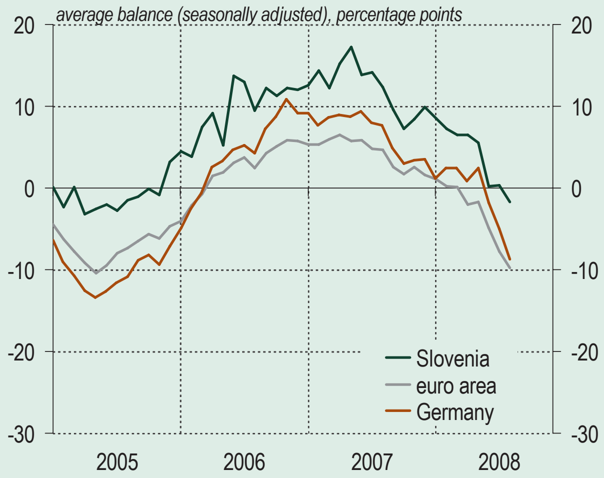
Table 2.1: Assumptions regarding factors from the international environment

						Projections					
						2008		2009		2010	
	2003	2004	2005	2006	2007	**Oct**	Δ	**Oct**	Δ	**Oct**	Δ
	annual growth, %, unless stated										
Foreign demand*	6.2	8.5	5.0	9.6	7.7	**5.3**	-0.2	**6.2**	-0.1	**6.8**	0.4
Oil (USD/barrel)	28.8	38.3	54.2	64.9	72.7	**115**	15	**120**	22	**120**	23
Non-oil commodities	11.3	16.0	6.0	27.7	17.5	**19.5**	7.0	**0.0**	-5.0	**5.0**	0.0
EMU inflation	2.1	2.1	2.2	2.2	2.1	**3.6**	0.7	**2.5**	0.4	**2.0**	0.1
PPI Germany	1.7	1.6	4.6	5.5	2.0	**5.3**	3.0	**3.0**	1.2	**1.8**	0.0

** Volume of imports of basket of foreign partners*
Δ: The difference between current projections and projections in April 2008 Price Stability Report.
Source: Bank of Slovenia, Eurostat, Consensus Forecasts, JP Morgan, OECD Outlook, IMF World Economic Outlook

[1] The forecasts were made on the basis of data available and the statistical methodology applicable on 10 September 2008. The projections of macroeconomic factors in the Price Stability Report are based on assumptions regarding the movement of variables from the international environment and certain domestic factors conditioned by economic policy decisions. Assumptions regarding the variables in the international environment are summarised from Consensus Forecasts (August, 2008), JP Morgan (Global Data Watch, 30 August), OECD Outlook (July 2008), IMF World Economic Outlook Update (July 2008) and from the value of futures contracts as at 29 August 2008. The domestic factors under the influence of economic policy and exogenously included in the forecasting process are public sector spending and investment, public sector wages, the movement of administered prices and certain other variables of a fiscal nature. The assumed values used in the projections are not the same as those used by the ESCB in its projections. For more on the relation between Bank of Slovenia and ESCB projections, see the annex in the April 2008 Price Stability Report.

Figure 2.1: Business confidence in Slovenia and abroad



Source: Eurostat

year. More encouraging are the figures for the US, where the latest releases indicate an improvement in economic growth. High quarterly growth during the second quarter in the US was partly the result of one-off fiscal measures that stimulated household consumption, and a result of the depreciation of the US dollar, which increased exports. The first half of 2008 was characterised by continuing high growth in commodity prices, particularly oil prices, which contributed significantly to the rising costs of producers, who only succeeded in passing through a portion of these costs to consumers. Thus inflation in both the euro area and US rose sharply in the first half of this year. Growth in commodity and oil prices is expected to slow during the second half of this year, driven by slowing global economic growth and last year's high base.

Economic growth this year in the most important trading partners is expected to be lower than in 2007. An additional downward deviation is possible, primarily due to shocks in financial markets and higher commodity prices. By mid-year consumer confidence indicators and the general economic sentiment indicator had deteriorated in the euro area. Estimates of euro area growth in the second quarter, which were significantly lower than expected, corroborated the downward revision of the economic growth forecast for this year. Economic growth in the euro area's three largest economies was negative in the second quarter. Germany, Slovenia's largest trading partner, recorded a 0.5% quarterly drop in economic activity. Final household consumption recorded a quarterly fall of 0.7%, while gross investments declined by 3.4%, with investments in construction down 3.5%. Exports, which were up 2.1% in year-on-year terms in the first quarter, also slowed, falling by 0.2% in the second quarter. In line with deteriorating indicators for the second quarter, forecasts of euro area economic growth for 2008 and 2009 have been revised downwards. Consensus's August forecast for euro area economic growth is 1.5% for 2008 and 1.1% in 2009, compared with forecasts from six months ago of 1.6% for 2008 and 1.9% for 2009. The European Commission's September interim euro area growth forecast for this year was somewhat lower than Consensus's forecast, at 1.3%. Indicators of economic activity are somewhat better for the US. In the second quarter of 2008 GDP rose by 0.8% from the preceding quarter partly as the result of a one-off fiscal measure and export growth. Consensus's August forecast for economic growth in the US is 1.6% for this year and 1.4% for 2009. Six months ago the forecast of US GDP growth for 2008 was also 1.6%, but the forecast for 2009 was significantly higher at 2.6%. A slowdown in growth is also

Figure 2.2: Euro area economic growth and European Commission projections

Source: European Commission interim forecasts, September 2008; projections for all quarters of 2008

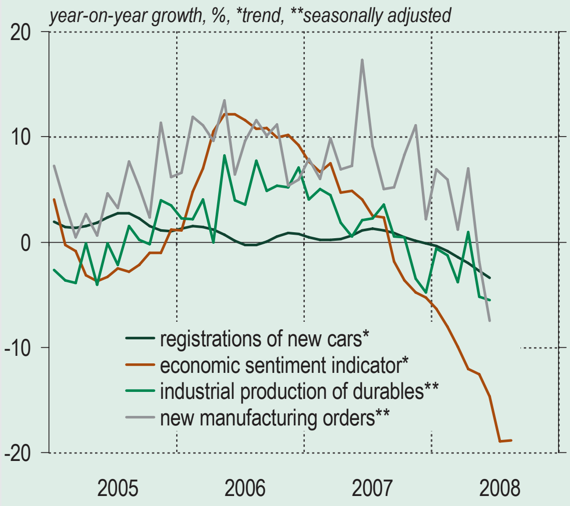
Box 2.1: Euro area economic sentiment indicators point to a deteriorating economic outlook

Just over a year ago, confidence indicators in the euro area were hovering close to historically high levels, but in the past six months their values have fallen significantly in nearly every sector. The European Commission's euro area economic sentiment indicator[1] is based on surveys that assess the current economic situation and expectations regarding the future economic situation. The European Commission's indicator comprises five sub-categories (manufacturing industry, services, retail trade, construction and consumer indicators), which form the overall economic sentiment indicator. The most important components are manufacturing industry and services with weights of 40% and 30% respectively. The euro area expectations indicator, which is one of the components of the general economic sentiment indicator and measures the expectations of market participants with regard to the upcoming economic situation, has been deteriorating for several months this year. Some studies carried out in recent years indicate that the expectations indicator actually reflects the short-term economic situation quite well.[2]

Despite a slight improvement from July to August, the euro area's overall economic sentiment indicator remains well below the long-term average. In terms of components, euro area confidence indicators suggest a significant drop in practically all important sub-categories of the overall economic sentiment index. The lowest balance, calculated as the difference between positive and negative responses, was recorded in August by the economic sentiment indicator in the construction and retail sectors. The highest value was recorded by the services indicator, which however is also at a very low level.

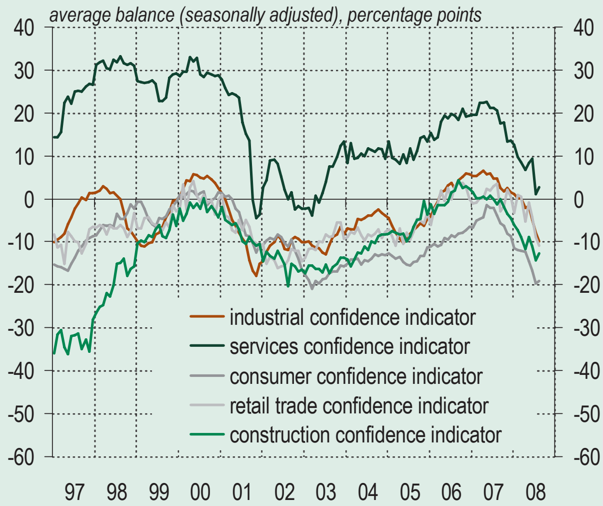
Further evidence of the poor economic situation comes from the latest figures regarding new orders, the number of new car registrations and the industrial production of durables. The trend of the number of new car registrations has been negative since the middle of 2007, while the number of new car registrations in June was the lowest in the last four years. Figures regarding new orders in the euro area (down more than 7% year-on-year in June) are also relatively weak. Industrial production was down 5.5% in the same period.

Figure 1: Economic activity indicators



Source: Eurostat

Figure 2: Confidence indicators in the euro area



Source: European Commission

[1] The economic sentiment indicator, which the European Commission estimates on the basis of survey results, is remarkably representative of economic developments, as it is based on a sample of 125,000 companies and 40,000 consumers from EU Member States.

[2] See Hüfner, Schröder (2002): Forecasting Economic Activity in Germany – How useful are sentiment indicators. Zew Discussion Paper No. 02-56

expected in Slovenia's other trading partners. The sharpest slowdown is expected in France and Italy, while the slowdown in growth in trading partners from central and eastern Europe will be less perceptible.

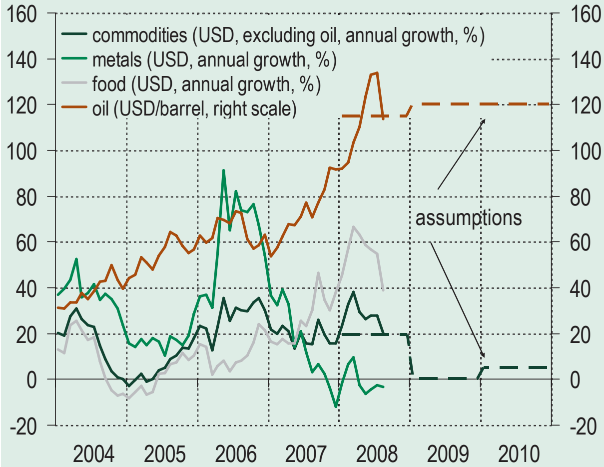
The relatively favourable demand from the countries of central and eastern Europe is expected to only partially offset the effect of weak economic growth in the euro area. Therefore the forecast of growth in foreign demand for Slovenian imports is slightly lower than the April forecast. Releases of figures on low euro area growth in the second quarter, particularly with regard to domestic spending and exports, despite relatively favourable demand from central and eastern European countries, have led to a downward revision of the April assumption of growth in foreign demand by 0.2 percentage points in 2008 and 0.1 percentage points in 2009. Growth in foreign demand for Slovenian exports is expected to be 5.3% in 2008 and 6.2% in 2009. According to forecasts, weak euro area economic activity is expected to continue in the second half of 2008 and at the beginning of 2009. The forecasts were additionally hampered by uncertainties in the financial markets, which have spread from the US to the euro area, and high commodity and oil prices. By contrast, Consensus has revised its forecasts of economic growth for Russia upwards in the last three months. Economic growth in Russia is expected to be 7.7% in 2008 and 7.0% in 2009, compared to Consensus's forecast six months ago of 6.8% in 2008 and 6.5% in 2009. Consensus's forecasts for Serbia and central European countries also remain relatively favourable. The forecast of future US growth remains uncertain primarily due to doubts as to whether emerging economies in Asia will successfully assume the role of the driving force in the global economic environment. In contrast to previous years, US growth is expected to be based to a greater extent on exports, and less on domestic spending. Conditions on global financial markets are expected to improve gradually in 2009, which could stimulate growth in spending in Slovenia's trading partners. Given the rapidly changing conditions on global financial markets and the highly probable consequences of these developments for the real economy, such expectations could prove to be overly optimistic. Slowing growth in commodity and oil prices could also contribute to increased spending in trading partners. Growth in foreign demand is expected to return to the long-term level in 2010.

Following high growth in oil prices in 2007 and during the first half of 2008, oil prices have eased since the middle of this year. The high growth in oil prices seen in 2007 was also characteristic of the first half of 2008. In 2007 the average price for a barrel of Brent crude (159 litres) was USD 73 and EUR 53. The average price for a barrel of oil in the first three months of 2008, when growth in oil prices accelerated further, was USD 96, an increase of 33% on the 2007 average. Growth in the euro price for a barrel of oil was somewhat lower on account of the euro's appreciation against the US dollar. The price of oil continued to rise in the second quarter of this year, and reached its peak in July when the price climbed to USD 135 per barrel. In addition to high demand (OPEC has continually taken the position that supply is sufficiently high) and supply-side disruptions, speculation on commodity exchanges also contributed to the high price of oil. The easing of growth in oil prices began at the end of July and continued in August, when the average price for a barrel of oil stood at just under USD 114. Slowing global economic growth was the main factor in lower oil prices. According to our assumptions, the price of oil at year-end should remain at a level similar to the average price over the first seven months of this year. The price of oil is expected to rise by 58% in US dollar terms and 43% in euros from the average 2007 price. The reason for the upward revision of the oil price assumption from the April forecast is the high oil prices achieved in the first eight months of 2008. Futures contracts indicate an easing in growth to a level of around USD 120 per barrel in 2009 and 2010.

Taking into account current developments and expectations, the April assumption regarding commod-

ity prices other than oil was also revised upwards for this year. While notably more moderate growth in metal prices was recorded in the first seven months of this year, when metal prices rose by just 2% on average from 2007, food prices, particularly wheat, soy and milk prices, have risen sharply. US dollar food prices rose by 45% in the first seven months of 2008 from the same period in 2007. At the beginning of 2008 year-on-year growth in the price of wheat on world markets exceeded 100%, while the price of corn rose by 40% in year-on-year terms during the first half of this year. The sharp growth in food prices was primarily due to increasing demand from emerging markets, unfavourable weather conditions, the use of grains and agricultural land in the production of bio-fuels, and agriculture policies aimed at reducing surpluses. Growth in commodity prices, including food prices, is expected to slow over the next two years. The presence of supply-side shocks and the high base from last year and this year are expected to contribute to the easing of commodity prices in the coming years.

Figure 2.3: Prices on world commodity markets



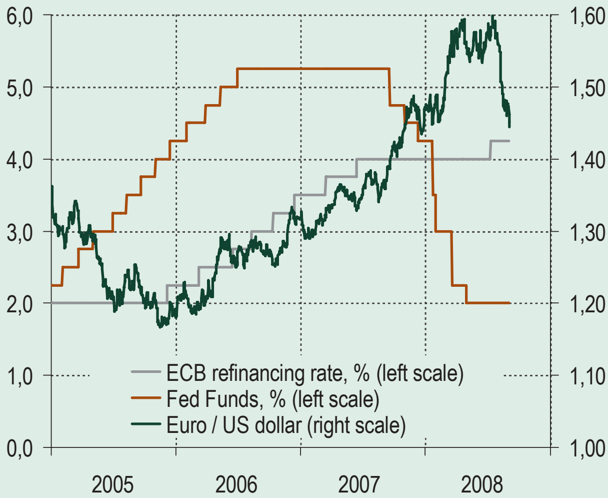
Source: The Economist, Bloomberg, Bank of Slovenia calculations and assumptions

Inflation in the euro area and the US has risen sharply this year primarily on account of high oil and food prices. Prices as measured by the harmonised index of consumer prices rose by 2.1% on average in the euro area in 2007, with a notable acceleration in price growth in the final quarter. Consumer prices rose by 3.6% in the first eight months of 2008 compared with the same period last year. Higher food and oil prices contributed most to the growth, while other factors contributed somewhat less. Nevertheless, core inflation measured as growth in prices excluding energy and unprocessed food stood at 2.5% in year-on-year terms in June and July in the euro area, while the 2007 average was 2.0%. In July the price of transport fuels rose by 18.9% in year-on-year terms, while the price of fuel oil was up 51.5% in the same period. The growth rates of euro area industrial producer prices have also risen since the end of 2007. In July year-on-year growth in the index of industrial producer prices stood at 9% in the euro area, while year-on-year growth rates were even higher in some countries, such as the Netherlands (14.5%) and Belgium (13.8%). High growth in industrial producer prices was also seen in Germany, where prices were up 8.9% year-on-year in July, while the average growth in industrial producer prices in Germany was just 2% last year. The reasons for the sharp increase in industrial producer prices can be found in record high commodity and energy prices, which have accelerated growth in the prices of intermediate goods and consumer non-durables. Higher labour costs have also contributed to the rise in industrial producer prices. The movement of consumer prices in the US this year has been very similar to that in the euro area, except that price growth has been higher over the entire period. The rise in inflation at the beginning of 2008 was sharper, as price growth rose to 4.0% year-on-year in March despite lower domestic demand, following average growth of 2.9% in 2007. By July year-on-year inflation had reached 5.6%. Core inflation, defined as the price index excluding energy and food, also rose; it stood at 2.5% in July in year-on.-year terms, while the 2007 average was 1.9%. Similar to the euro area, this trend in core inflation suggests the pass-through of a specific portion of high energy and food prices to other prices, which should ease in the future in the context of an expected slowdown in demand.

Assumptions regarding growth in consumer prices in the euro area and the US and growth in German producer prices have been revised upwards. The upwards revision of the assumption regarding euro area inflation to 3.6% for 2008 is primarily the result of higher energy prices and sustained growth in food prices on world markets. In addition to pressures from commodity and food prices, increased pressures on inflation from labour costs, in the context of slower growth in productivity, are expected in the future. Risks regarding higher labour costs originate from the demands of unions for compensation of a portion of lost purchasing power in the context of high food and energy prices and for employee participation in favourable economic results from past years. Price pressures from high labour costs should be mitigated somewhat by lower profit margins. The assumption regarding the inflation rate in the US has been revised upwards, while the upward revision of the assumption regarding growth in German producer prices is even greater. Both revisions are driven primarily by the record commodity and energy prices. In the absence of shocks in commodity markets and in the circumstances of higher productivity growth, all three indicators of price growth should ease over the next two years.

Since the last projections the ECB has raised its key interest rate, while the Federal Reserve has lowered its rate. In July the ECB raised its key interest rate to 4.25%, while the Federal Reserve lowered the Federal Funds rate to 2.00% in April. The cut in the Federal Funds rate was driven by uncertainties in financial markets, which remain high this year. By contrast, the ECB's decision to raise its interest rate was primarily "…to prevent broadly based second-round effects and to counteract the increasing upside risks to price stability over the

Figure 2.4: Euro / US dollar exchange rate and central bank interest rates



Source : ECB, Federal Reserve

medium term…."[2] The standard assumption that euro area interest rates will be aligned with the expectations of financial markets has been applied in the projections.

The euro appreciated significantly against the US dollar in the early part of this year as a result of deepening uncertainty in financial markets and the bad news regarding US economic indicators, while the US dollar has recovered somewhat against the euro since the end of July. The euro's appreciation against the US dollar continued in the first half of 2008, and reached its peak in July when the euro averaged USD 1.577. Following the release of weaker euro area figures for the second quarter, the US dollar began to appreciate. In August the euro averaged USD 1.4975. The value of the euro against the US dollar in the future is based on the technical assumption that the euro-US dollar exchange rate is equal to the average for the month prior to the preparation of the forecasts.

[2] http://www.ecb.int/press/pressconf/2008/html/is080703.en.html

3 Economic Trends and the Labour Market

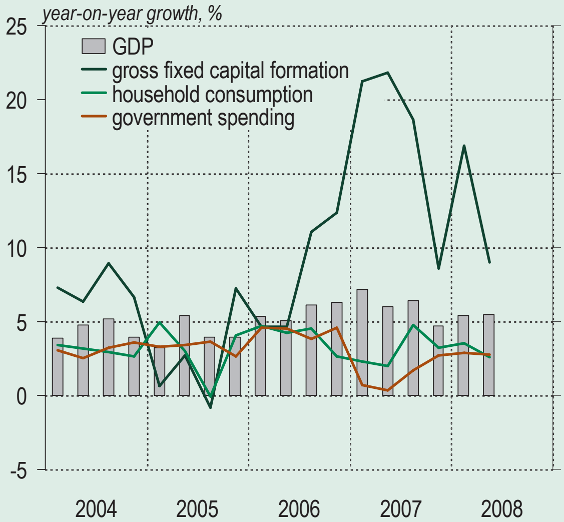
Slovenia's real GDP growth was lower in the first half of 2008 compared with the high growth recorded in 2007, but still averaged 5.5% in year-on-year terms. Projections indicate a gradual decrease in economic activity to the level of the long-term trend. The provisional estimate of GDP growth for 2007 was revised upwards from 6.1% to 6.8%. According to seasonally and working days adjusted figures, GDP rose by 0.9% in the second quarter, or by nearly half of the 2% growth recorded in the first quarter. Nevertheless, economic growth in Slovenia was somewhat higher than expected in the first half of 2008, although it is expected to continue slowing in the second half of the year. The upward revision of economic growth projections is primarily the result of high growth in domestic investment spending. The slowing of growth in investment spending is expected to contribute to a cyclical slowdown in economic growth in the future. Weaker foreign demand, driven by a slowdown in economic activity abroad, a strong euro and high commodity prices on world markets are also expected to contribute to more moderate growth. The rate of growth in exports slowed in the first half of the year to a level similar to that recorded in the second half of last year, falling by nearly half compared to the rate of growth recorded at the beginning of last year. Projections indicate that GDP growth will slow over the next two years, which is consistent with previous projections. The expected average economic growth of less than 4% over the next two years will be slightly lower than the estimated long-term growth trend. This growth should continue to facilitate the process of real convergence with more developed EU countries, with Slovenia expected to record higher GDP growth than old EU Member States.

Table 3.1: Activity, employment and wages

						Projections					
						2008		2009		2010	
	2003	2004	2005	2006	2007	**Oct**	Δ	**Oct**	Δ	**Oct**	Δ
	real growth, %										
GDP	2.8	4.3	4.3	5.9	6.8	**4.5**	0.3	**3.5**	-0.4	**4.1**	0.0
Employment	-0.2	0.4	0.7	1.2	2.7	**2.1**	1.2	**0.3**	-0.3	**0.5**	0.0
Average net wage (nominal)	7.5	4.4	6.2	5.1	7.9	**8.5**	0.7	**7.0**	0.1	**6.1**	0.6
Disposable income*	1.7	4.2	1.7	5.2	6.6	**4.4**	1.4	**3.7**	-0.2	**3.7**	0.4
Average gross wage (nominal)	7.6	4.6	4.9	4.8	5.9	**8.7**	1.3	**7.1**	0.1	**6.2**	0.6
Productivity	3.0	3.9	3.6	4.6	4.0	**2.4**	-0.9	**3.2**	-0.1	**3.6**	0.0
ULC (nominal)	4.4	0.7	1.2	0.1	1.9	**6.2**	2.2	**3.8**	0.2	**2.5**	0.6

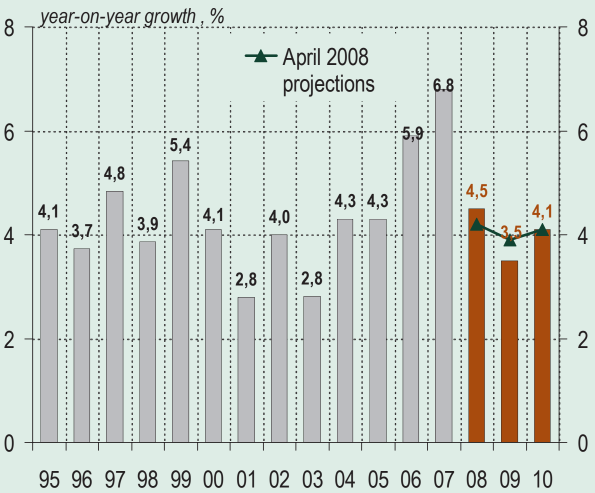
* Net wages, other earnings from employment and social benefits; adjusted for HICP deflator.
Δ: The difference between current projections and projections in the April 2008 Price Stability Report.
Source: SORS, Bank of Slovenia.

Figure 3.1: Domestic demand and GDP



Source: SORS; Bank of Slovenia calculations

Figure 3.2: GDP growth projections



Source: SORS, Bank of Slovenia projections

The structure of growth in value added remained almost unchanged during the first half of 2008 with regard to last year, while no significant changes are expected until the end of year. As in 2007, the greatest contribution to growth in value added in the first half of this year came from construction, while the retail and financial intermediation sectors also recorded high value added growth. Value added in the construction sector rose by an average of 20.5% year-on-year during the first six months of 2008, where the 13.9% growth in value added recorded in the second quarter was significantly lower than the 27.4% year-on-year growth achieved in the first quarter. Growth in value added in manufacturing was slower: the 2.4% year-on-year growth during the first half of the year was significantly lower than the long-term average of 5.4% over the last ten years. Industrial production was down in July from June, in part reflecting developments in EU and euro area economic activity. GDP in the euro area was down 0.2% in the second quarter compared with the first quarter, and was down 0.1% in the EU overall. In addition to a decline in manufacturing orders from the rest of the world, deteriorating economic and consumer confidence indicators in Slovenia, the euro area and EU (see Box 2.1) also suggest pessimistic expectations until the end of the year.

Domestic demand is expected to remain the main factor in the economic cycle this year. In real terms,

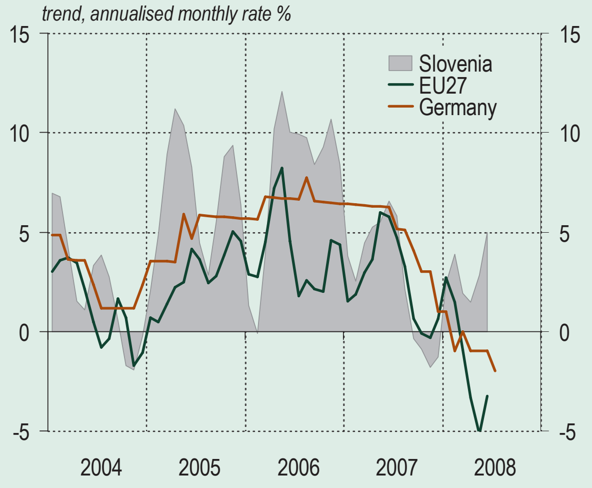
Table 3.2: GDP and components of demand in Slovenia and the rest of the world

	GDP				Private consumption				Government spending				Gross investment				Exports				Imports			
	2007		2008		2007		2008		2007		2008		2007		2008		2007		2008		2007		2008	
	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2
	year-on-year change, % (seasonally adjusted)																							
Euro area*	2.6	2.1	2.1	1.4	1.8	1.2	1.2	0.4	2.5	2.1	1.3	1.7	3.7	3.2	3.7	2.4	7.3	4.1	5.4	3.6	6.5	4.0	4.7	3.4
European Union**	2.9	2.5	2.3	1.6	2.4	1.8	1.7	1.0	2.4	2.1	1.4	1.6	4.5	4.1	3.6	2.0	6.9	4.3	5.4	3.9	7.1	4.7	4.7	3.6
US	2.8	2.3	2.5	2.2	2.9	2.2	1.5	1.4	2.3	2.1	2.6	2.4	-1.3	-1.1	-1.7	-2.7	11.7	8.9	10.1	11.2	2.2	1.1	-1.0	-2.0
Japan	1.8	1.4	1.2	1.0	1.8	1.2	1.3	0.5	0.2	1.4	0.7	0.5	-1.4	-3.8	-3.6	-2.6	8.5	10.4	11.0	6.5	1.5	2.3	2.9	-1.2
Slovenia	6.3	4.9	5.6	5.1	4.8	3.2	3.5	2.6	1.7	2.7	2.9	2.7	19.6	7.6	17.3	10.9	15.1	9.3	6.8	7.8	18.2	8.6	9.7	7.3

**15 countries, **27 countries.*
Source: Eurostat, SORS, 2008.

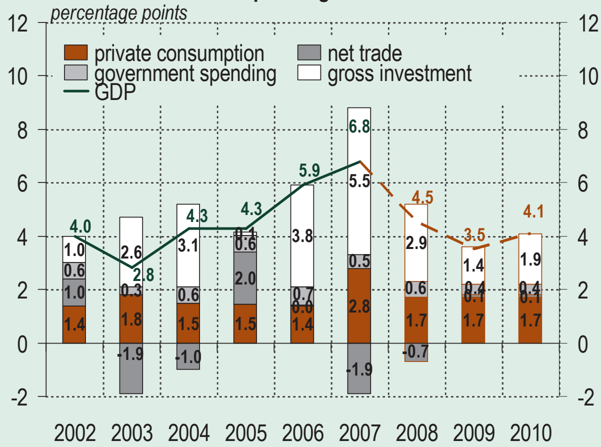
domestic consumption rose by 5.1% year-on-year in the second quarter of 2008. The significant contribution of domestic demand to economic growth in 2008 will again be driven by relatively high investment growth. High investment growth in the first half of the year was in part the result of continued relatively favourable financing conditions, which are now tightening with rising interest rates. High growth in domestic investment coupled with expected solid employment growth continues to contribute to an increase in the economy's supply capacities. Nevertheless, it is necessary to take into account that a significant portion of employment growth and accelerated investment is cyclical in nature, which only deepens the economic cycle. At the same time, there is a gradual reversal in current investment and employment growth, and economic activity will gradually fall to the level of supply potential, in line with expectations. In 2008 the contribution of net trade will be slightly negative, as growth of exports, in the context of lower foreign demand, will be lower than last year while, on average, growth in imports will outstrip growth in exports due to high domestic consumption, namely strong investment activity. Domestic demand is expected to account for the majority of aggregate demand throughout the period from 2008 to 2010, while the average contribution of net trade will be slightly negative. The decreasing contribution of domestic consumption will primarily be the result of a cooling in investment spending after the sharp increase in total investment in 2007 and 2008. According to current estimates, growth in both private consumption and government

Figure 3.3: Total industrial production excluding construction



Source: Eurostat

Figure 3.4: Contributions to GDP growth by components of spending



Source: SORS, Bank of Slovenia projections
Note: The sum of components may differ from aggregate values due to rounding and use of chain indices.

Table 3.3: Components of domestic demand

						Projections					
						2008		2009		2010	
	2003	2004	2005	2006	2007	**Oct**	Δ	**Oct**	Δ	**Oct**	Δ
	real growth, %										
Domestic demand	4.8	4.8	2.1	5.7	8.0	**5.0**	0.8	**3.3**	-0.2	**4.0**	0.3
Private consumption	3.3	2.7	2.6	2.9	5.0	**3.3**	0.1	**3.4**	0.4	**3.4**	0.1
Government spending	2.2	3.4	3.3	4.1	2.5	**3.1**	0.5	**1.9**	0.0	**1.8**	0.0
Gross investment	10.3	10.4	0.4	12.5	17.2	**9.1**	1.9	**4.0**	-1.4	**6.0**	0.4

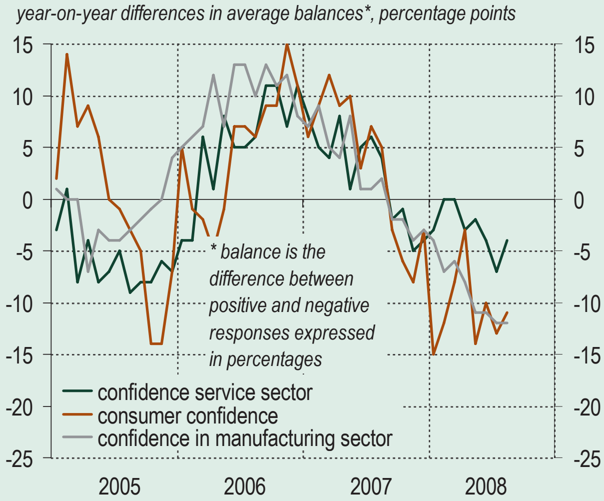
Δ: The difference between current projections and projections in the April 2008 Price Stability Report.
Source: SORS, Bank of Slovenia.

spending is expected to remain moderate over the entire projection horizon.

In real terms, household consumption rose by 3.1% year-on-year in the first half of 2008. Household consumption is expected to remain close to this level until the end of the year. Higher wage growth and continued favourable conditions on the labour market will be important factors in household consumption this year. However, consumer confidence indicators fell in the first half of the year, most notably those indicators that reflect the willingness of consumers to make major purchases. Consumers' expectations regarding future economic developments also deteriorated slightly. Similar developments can be seen in other EU Member States where, due to higher inflation and the deteriorating economic climate, households are changing their behaviour by spending less and opting for cheaper purchases. A gradual tightening of financing conditions, through rising interest rates, is also having a dampening effect on the level of household consumption. Growth in household consumption is being further restricted by faster-than-projected growth in prices, which is slowing growth in real disposable income, and by slightly lower employment growth compared with last year. Previously implemented institutional changes in pension insurance and new alternative forms of savings will encourage households to opt for longer-term forms of savings in the future.

In the last year, growth in household consumption has lagged behind the growth in disposable income, which is expected to remain at a relatively high level. Despite the significant upward revision to growth in household consumption for 2007 from 3.1% to 5.0%, growth in household consumption has lagged behind the growth in real disposable income last year. According to assessments, the revised estimate of growth in household consumption is more in line with macroeconomic developments last year than the previous estimate. The level of disposable income has been rising this year due to growth in average earnings and rapid employment growth. Although net wages, which represent the majority

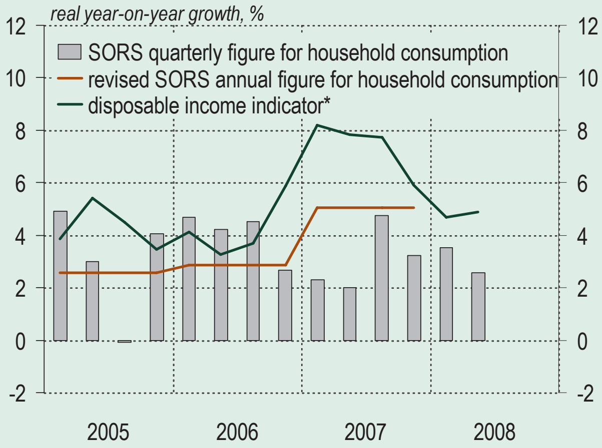
Figure 3.5: Seasonally adjusted confidence indicators



Source: SORS, Bank of Slovenia calculations

of disposable income, rose by 14.6% in the first half of the year, some other components of disposable income, particularly social transfers, did not grow at a significantly slower pace. Since net wages have risen the most in higher income brackets with a generally lower marginal propensity to spend, this increase has not had any considerable impact on household consumption. In addition to higher employment growth, growth in the number of social transfer recipients has also contributed to the increase in the number of income earners in households. The number of pension recipients rose by 1.4% in year-on-year terms during the first six months of this year, while total employment was up 3.1% year-on-year in the same period, and has been rising at approximately the same pace for nearly a year. Since this year's largest increase in employment was in the construction sector, where figures show that a large number of foreign workers are employed, the increase in disposable income is not entirely reflected in household consumption. Growth in real disposable income in 2008 is estimated at 4.4% in year-on-year terms, while growth is expected to slow to between 3.5% and 4.0% over the next two years. Rapid growth of wages in the public and private sector in addition to the rapid employment growth, particularly in 2008, are expected to have the greatest impact on growth in

Figure 3.6: Household consumption and disposable income



** Net wages, other earnings from employment and social benefits. Adjusted by HICP deflator.*
Source: SORS, AJPES; Bank of Slovenia calculations

disposable income over the projection horizon compared with previous projections.

According to the baseline projection, household consumption is expected to lag behind GDP growth in the future as well. Growth in household consumption is expected to slow in the future, following exceptionally high growth in 2007. A decline in employment growth is expected to contribute most to the relatively slow growth in household consumption, high growth in prices additionally limiting growth in real disposable income. High growth in the prices of food and energy, which make up a large portion of the consumer basket, will have a considerable impact on consumers' unwillingness to spend. Negative wealth effects, particularly those resulting from a slowdown or even negative growth in real estate prices, and those that are the result of a significant slowdown in growth in securities prices, could also have some effect on the future behaviour of consumers. Such expectations regarding household consumption are in line with the significant deterioration in consumer confidence indicators that primarily point to pessimism with respect to the willingness of consumers to make major purchases.

According to estimates, the contribution made by government spending to aggregate demand over the entire projection horizon is expected to be lower than the average from the last few years. Final government spending rose by 2.8% in the first half of the year. The government spending forecast for this year was revised to 3.0%, upwards by 0.4 percentage points from the previous forecast, largely as the result of employment growth in the government sector, which was 1.3% year-on-year in the first half of 2008. Annual growth in government spending is expected to remain below 2.0% in 2009 and 2010. In line with agreements reached as part of public sector wage negotiations, nominal growth in government spending is quite high over the entire horizon.

Gross investments rose significantly in the first half of 2008, while quarterly growth has slowed to the level seen at the end of last year. Average growth in gross investments in the first half of the year stood at 14.1% year-on-year, with 17.3% and 10.9% being recorded in the first and second quarter respectively. Following a slight slowdown in the final quarter of last year, investment growth accelerated again at the beginning of 2008, before slowing again in the second quarter. Gross investments are expected to rise by approximately 9% year-on-year in 2008, the upward revision primarily the result of rapid growth in the first and second quarter. Investments in machinery and equipment posted relatively solid growth, rising by 8.2% on average in the first half of the year. The fastest growing components of investment were non-residential and housing construction, as investments in built structures rose by 17.2% year-on-year, housing construction by 13.2% and the construction of non-residential structures by 18.7%. High growth in investment in non-residential construction at the beginning of the year was partly the result of favourable weather conditions, which sped up the previously planned high level of motorway construction. The high growth in investments in housing construction was also partly the result of shifts in timing due to favourable weather conditions at the beginning of the year and partly the result of high demand for housing.

According to expectations, the fastest growing component of fixed capital formation over the projection

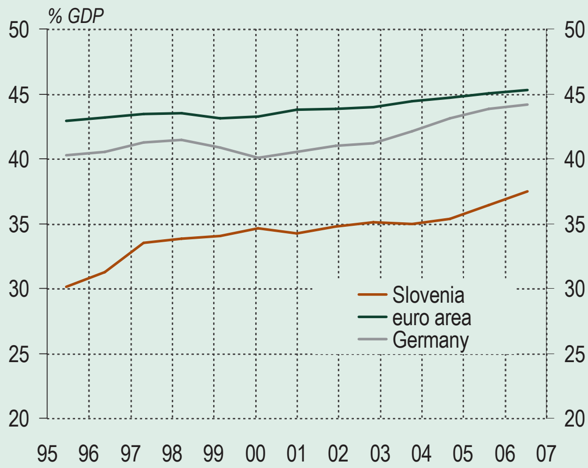
Box 3.1: Corporate profit indicators in Slovenia

The analysis of corporate profit trends plays an important role in assessing underlying inflationary pressures, while profits have a significant impact on corporate decisions regarding future investment activities and employment. A favourable level of past profits could act to partly mitigate the negative effects of deteriorating economic conditions. Instead of an immediate reduction in employment, accumulated profits from a period of favourable economic growth could be reduced, at least for a certain period.

Changes in profits can reflect both cyclical and structural changes. Due to the relatively slow adjustment of employment and the level of capital, the profit trends are generally procyclical, meaning that profits rise in a period of high economic growth and fall when the economy cools. Significant changes in terms of trade, triggered for example by high commodity prices and exchange rate fluctuations, also affect profit trends. Structural factors that affect corporate productivity and costs, where a rise in productivity or decreasing costs contribute to rising profits, also play an important role in the generation of profits. Among structural factors, the efficiency of the labour market, namely the speed at which the labour market adapts in terms of both the response of employment and wage adjustments, plays a particularly important role. The level of competition also has an impact on the level of profits. Increasing competition in the market typically lowers profit margins, which corporates are only able to increase when their relative efficiency improves on account of increasing competition.[1] High profits, namely the difference between output prices and (marginal) costs, could be the reflection of a lack of competition, the relatively efficient operations of corporates or cyclically driven demand. [2]

Profit indicators are evident from corporate balance sheets, while for the purpose of international comparability, figures from national accounts statistics are frequently used.[3] In addition to a direct comparison of profits with value-added (profit margin), these are primarily indicators that are based on a definition of profit as the difference between revenues (or the price component) and expenses (or the cost component). A simplified profit indicator therefore defines profit as the difference between the GDP deflator and unit labour costs. In terms of the difference between price and marginal costs, the inverse ratio of the costs of labour input to GDP is also used as a profit indicator (margin, mark-up) in analysis.[4]

Figure 1: Gross operating surplus and gross mixed income

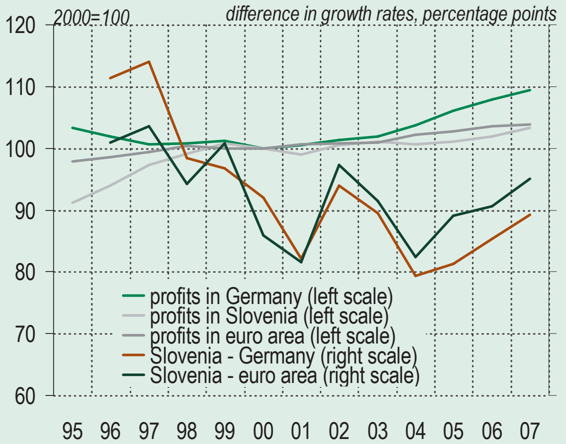


Source: Eurostat, Bank of Slovenia calculations

The majority of profit indicators show that recent growth in profits in Slovenia was only higher than the euro area average in 2007. At the same time, growth in profits has lagged behind growth in profits in Germany, Slovenia's main trading partner, in recent years, primarily due to slow growth in German labour costs. The comparison also indicates that the ratio of profit to GDP in Slovenia is slightly more than 5 percentage points lower than the euro area average, which could also reflect certain structural factors, such as the relative taxation of labour and capital. In the last two years the relative level of profit in Slovenia has declined compared with Germany, and has converged slightly with the level of the euro area. This indicates that profits could serve to mitigate the negative effects of the forecast slowdown in economic growth to a similar extent as in the euro area but to a lesser extent than in Germany, for example. This could be reflected in corporates responding slightly more slowly to deteriorating economic conditions by cutting employment. Furthermore, the expected decline in profit growth in the future could have the favourable result of lower growth in prices.

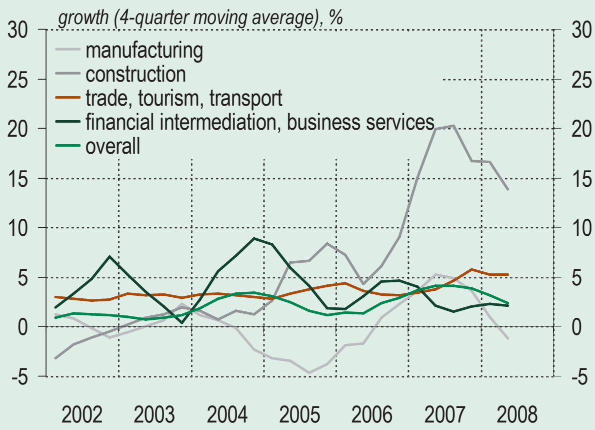
In the last year profits grew fastest in the construction sector where, similar to manufacturing, growth has slowed markedly compared to one year ago, while growth in profits in the service sector was nearly the same as average growth in profits.[5] Growth in profits in the financial intermediation and business services sector was below average, while growth in profit in the retail, hotels and restaurants and transport sectors in the last year once again outstripped the average growth in profits for

Figure 2: Profit indicators



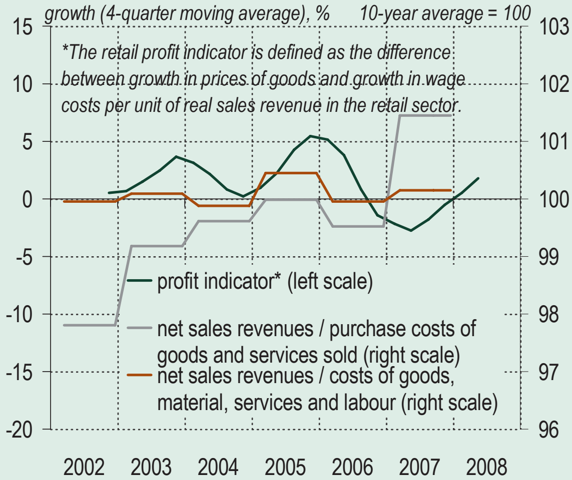
The profit indicator is defined as the difference between growth in the GDP deflator and growth in ULC.
Source: Eurostat, Bank of Slovenia calculations

Figure 3: Profit indicator in Slovenia by sector



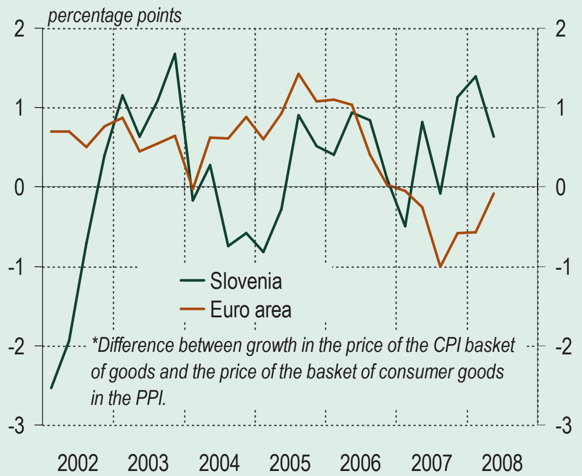
The profit indicator is defined as the difference between growth in the value added deflator and growth in ULC.
Source: SORS, Bank of Slovenia calculations

Figure 4: Retail sector profit indicators



Source: SORS, AJPES, Bank of Slovenia calculations

Figure 5: Retail margin indicator*



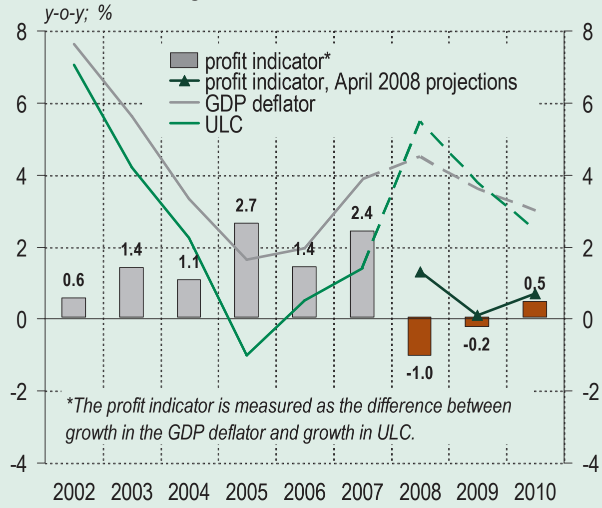
Source: Eurostat, Bank of Slovenia calculations

the overall economy. Particularly noteworthy are the improved growth in profits in the construction sector since the middle of 2005, which is in line with the exceptionally high growth in value added in this sector, and the decline in growth in profits in the manufacturing sector since the middle of 2007. The use of proxies for growth in profits in the retail sector indicates that profits have grown at a similar pace as the average growth in profits in Slovenia, with some noticeable differences in the dynamic, which is improving slightly in the retail sector in contrast to total profits. Annual figures from corporate balance sheets indicate that the ratio of sales revenues to purchase costs increased significantly in 2007 compared with the long-term average, while the ratio of sales revenues to total costs rose by slightly less, a reflection of the larger increase in other costs relative to the increase in the purchased cost of merchandise.

---

[1] Profitability in the EU, for example, fell between 1989 and 1992 during the introduction of the single EU market. Only after this period did profitability begin to rise again (Sauner-Leroy, 1993).
[2] Nevertheless, the majority of analyses find that there is a negative correlation between the level of competition and inflation. See Cavelaars (2002) for OECD countries, and Przybyla and Roma (2005) for the euro area.
[3] For an overview of alternative measures of profit see the Quarterly Report on the Euro Area (2004, Vol. 3, No.3) EU Commission: DG EC-FIN.
[4] For more on the how this profit indicator is derived, see Cavelaars (2002).
[5] The sectoral breakdown of activities is in line with figures on nominal value added published by the SORS.

Figure 3.7: Profit indicator

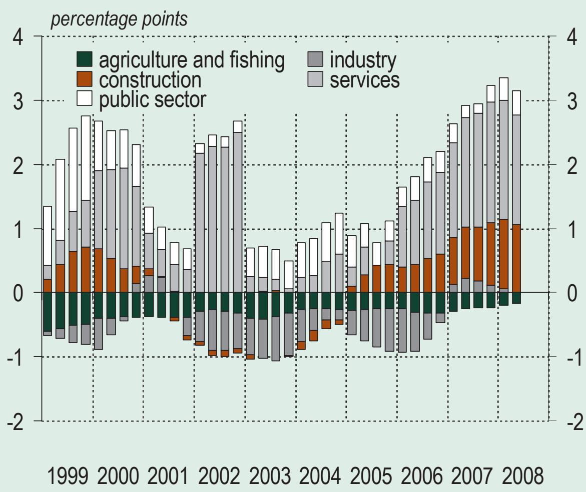


Source: SORS, Bank of Slovenia calculations

horizon will be investments in non-residential structures, while government investments and investments by public-sector companies are expected to slow most. Growth in investments in buildings and structures in the future is expected to be slightly slower than in the first half of this year, as indicated by the results from surveys of business trends in construction, and by figures for building permits issued. There have also been signs of an easing of the high growth in real estate prices. Permits issued for the construction of buildings were down 11% in the second quarter of 2008 from the same period last year, while building permits issued for housing construction were down 34%. In the context of a deteriorating domestic and foreign economic climate, slower growth in investments in machinery and equipment can also be expected in line with a decrease in the value of the indicator of excess production capacity. Growth in government investments and the investments of government-controlled companies, particularly DARS, is expected to slow gradually in the coming years. According to the Stability Programme from December 2007, government investments expressed as a proportion of GDP are expected to slow gradually to the level achieved in the previous period. Following a share of government investments in 2006 and 2007 of 3.7% of GDP, that proportion is expected to decline to 3.3% of GDP in 2010, similar to the level from the 2000 to 2005 period. A modest nominal rise in government investments of 3.2% was forecast for this year in the Report of Government Deficits and Debt Levels from April 2008, following an increase of 8.0% in the first quarter. Private sector investments will be stimulated primarily by the gradual cut in the corporate income tax rate, which will reach 20% in 2010, down from 25% in 2006. This facilitates higher corporate profits, and thus more available funds for investing. However, high commodity prices, relatively high growth in labour costs and higher costs of financing will restrict growth in profits and thus corporate investment spending. The higher costs of financing are the result of higher interest rates and tightened financing conditions, which are the result of higher risk premiums in the context of recent developments on financial markets, but also originate in the cumulative level of debt. Estimates for 2008 and 2009 indicate that the price component of income, measured by GDP deflator growth, will lag behind the price component of costs, measured by growth in unit labour costs, meaning that growth in profits in these two years will slow. In line with the expected easing of labour costs and more subdued growth in import prices, this ratio will not return to a positive level until 2010 (see Figure 3.7), which will facilitate renewed growth in profits and thus available own corporate resources for investing.

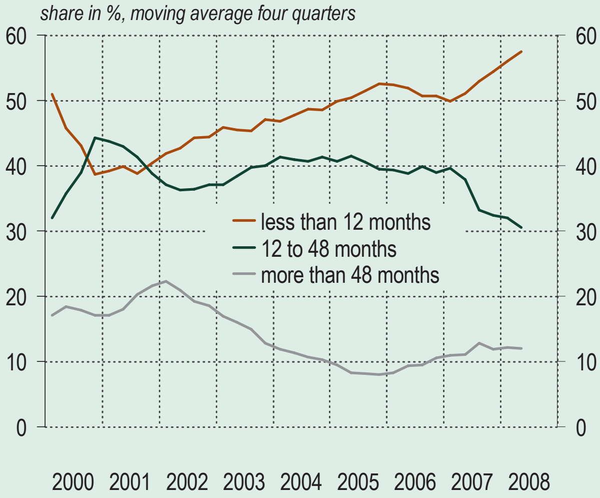
The labour market has also gradually seen a perceptible reversal in the current rate of employment growth, which is now slowing slightly. The latter is particularly evident in manufacturing, where the number of employees began falling again in the second quarter of 2008. That number had risen since the first quarter of last year, driven primarily by the favourable cycle, following five consecutive years of decline. The forecast contraction of production in the automotive industry will have a significant effect on future developments in the Slovenian labour market in the coming period. Renault, for example, plans to cut production, which is expected to involve employee layoffs. Nevertheless, employment in most sectors

Figure 3.8: Contributions to employment growth by sector



Source: SORS (national accounts); Bank of Slovenia calculations

Figure 3.9: Structure of unemployment by duration



Source: Eurostat - labour force survey; Bank of Slovenia calculations

continues to rise. Employment growth stood at 3.1% and 3.0% in the first and second quarters respectively. Growth was particularly strong in the construction sector, where it reached 13.1% year-on-year in the first half of 2008, contributing 1.1 percentage points to total employment growth. In addition to construction, employment also grew rapidly in real estate, leasing and business services (by 6.2%) in the first half of the year, and in transport, storage and communications, where 5.9% year-on-year growth was recorded.

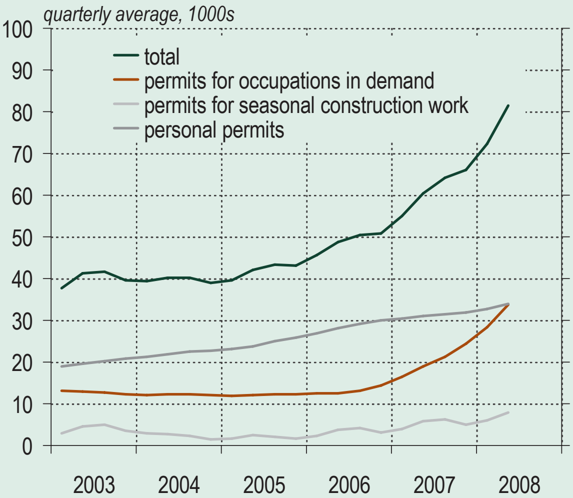
In line with high economic growth and rising employment, the trend of falling unemployment continued in the first half of the year. The registered unemployment rate stood at 6.8% in the first half of the year, down 1.2 percentage points on the same period last year. In line with the current growth of recent years, the unemployment rate measured by the Labour Force Survey rose slightly in the first quarter, followed by a renewed drop. Unemployment stood at 5.1% and 4.2% in the first and second quarters, respectively. The surveyed unemployment rate is also low by international standards, as it was more than 2 percentage points below the euro area average of 6.8%in the second quarter of this year. The unemployment rate is also more than 1 percentage point below the average for the group of 12 new EU Member States (5.6%), with whom Slovenia is more comparable in the current economic climate. The structure of unemployment continues to change in the context of a significant drop in unemployment. The trend of a rising proportion of long-term unemployed (those unemployed for more than 48 months) from 2005 continues. That their actual number remains largely unchanged indicates the presence of structural barriers that could preclude a further fall in unemployment. In recent quarters the proportion of short-term unemployed (those unemployed for less than 12 months) has also risen, which could be a reflection of an increase in frictional unemployment associated with greater labour market flexibility.

Indicators of worker flows and figures regarding the number of job vacancies indicate a continuing increase in the imbalance between supply and demand in the labour market. In the context of high economic growth, the proportion of those newly employed in the last year, whether from other jobs, from unemployment or from outside the labour force, has risen rapidly since the middle of 2005. In the third quarter of 2005 these workers accounted for 6.7% of employees, compared with 7.9% in the first quarter of this year. The departure rate measured by flows of workers out of employment to other jobs, to unemployment and to outside the labour force stood at approximately 6.5% in the same period. The number of vacant jobs measured as the difference between new employees and the number of newly registered vacancies has risen in recent years. The relative figure has risen by approximately 2 percentage points on average in the last four years, reaching 11% this year.

The imbalance between supply and demand on the Slovenian labour market would be even higher were it not for the significant increase in the number of foreign citizens employed in Slovenia in recent years. From January 2005 to July 2008, the number of valid work permits for non-residents more than doubled from 38,800 to 83,800. Of these, approximately 34,000 or 41% are personal permits, and are not tied to labour market conditions or limited by an annual quota set by the government. Approximately 8,000 or 10% are work permits relating to seasonal work, the majority of seasonal workers being employed in the construction sector. The majority of remaining permits (36,000 or 43%) are work permits tied to a specific job and employer. On this basis it is possible to determine that more than half, or 50,000 permits, could be terminated in the context of less favourable labour market conditions. These non-residents represent approximately 5% of employment, meaning that the risk of a significant increase in the number of registered unemployed among Slovenian citizens in the context of weaker economic growth is relatively low. It should be noted that EU citizens, including citizens of new EU Member States, have not been included in the aforementioned figure as May 2004, as they do not require a work permit for employment in Slovenia. Nevertheless, their number has remained relatively small since Slovenia's accession to the EU. The termination of jobs held by non-residents represents significantly greater risk with regard to the number of employed.

In line with the slowdown in the economic cycle, employment growth is expected to become more moderate over the projection horizon. The greatest slowdown is expected in the construction sector where employment rose most under the influence of the current economic cycle. The drop in employment is expected to be driven primarily by a decrease in the number of employees with fixed-term contracts, where non-residents represent a relatively high proportion of workers. These employees represent the segment of the labour market in which employment is most dependent on cyclical changes in economic activity. Since the introduction of the new Employment Relationship Act in 2003, the proportion of employees with fixed-term contracts has risen by approximately one-third, reaching 17.0% in the first quarter of 2008.

Figure 3.10: Valid work permits for non-residents



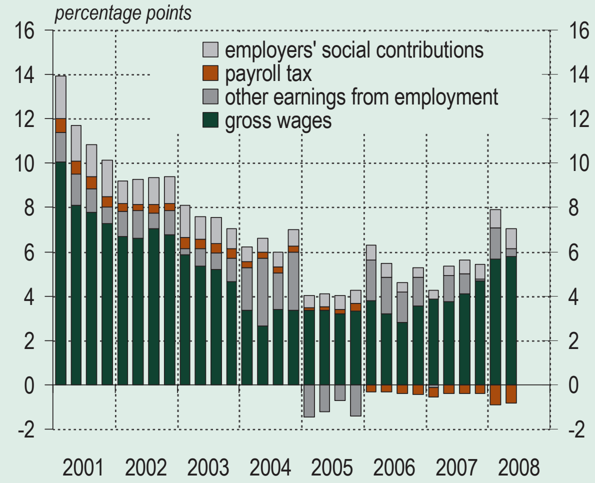
Source: Employment Service of Slovenia

Figure 3.11: Unemployment, participation rate* and vacancy rate

** labour force as a proportion of working age population*
Source: SORS, labour force survey, Employment Service of Slovenia

The high growth in labour costs in the first half of the year indicates the realisation of risks outlined in the spring Price Stability Report. Growth in average gross wages in the private sector, which best reflects cyclical developments in the labour market, was 9.4% in nominal terms in the second quarter of 2008, while growth in the manufacturing sector stood at 9.6%. Growth in gross wages per unit output, which reached 6.0% in the second quarter, is also rising, the rate having stood at less than 1% between 2004 and 2006, and 2.1% on average in 2007. The gradual phasing-out of payroll tax has partially limited growth in labour costs, which has lagged behind the accelerated growth in gross wages. Since 2006 growth in unit labour costs has fallen by approximately 0.4 percentage points annually due to the phasing-out of this tax. At the same time, the labour cost indicator is somewhat misleading when analysing trends, primarily due to the high volatility of other earnings from employment: in the second quarter of 2006 other earnings from

Figure 3.12: Contributions to growth in labour costs per employee



Source: SORS; AJPES; MoF, Bank of Slovenia calculations

Table 3.4: Labour cost indicators

	2003	2004	2005	2006	2007	Q207	Q307	Q407	Q108	Q208
	nominal year-on-year growth, %									
Gross wages	7.6	4.6	4.9	4.8	5.9	5.6	5.8	6.8	7.8	8.6
Gross wages in the private sector	7.8	5.3	5.4	5.4	6.8	6.3	6.7	8.0	8.2	9.4
Gross wages in the public sector	6.7	2.7	3.3	3.4	4.1	4.6	4.4	3.8	7.1	7.0
Gross wages in manufacturing	7.6	6.6	5.9	5.5	6.8	6.0	6.8	8.4	8.2	9.6
Labour costs per employee[1]	7.6	6.4	2.9	5.0	4.7	5.0	5.2	5.0	7.0	6.2
Other earnings from employment per employee	4.3	14.3	-7.0	10.1	2.9	6.0	5.9	0.5	10.4	1.9
Gross wages per unit of output[2]	4.2	0.6	0.4	0.6	2.1	2.3	2.1	5.0	5.5	6.0
Gross wages per unit of output (trend)[2,3]	4.1	1.1	1.4	1.3	2.4	2.1	2.3	3.3	4.3	5.1
Gross wages per unit of output in manufacturing[2]	-0.3	1.2	0.1	-3.4	-0.2	-1.7	-0.1	2.7	6.8	6.4
Gross wages per unit of output in manufacturing (trend)[2]	1.3	0.4	-0.4	-0.8	0.5	-0.3	0.5	2.2	2.0	3.4
Unit labour costs[1,2]	4.2	2.4	-1.5	0.8	1.0	1.6	1.6	3.3	4.7	3.7
Unit labour costs (trend)[1,2,3]	4.1	3.0	-0.6	1.5	1.3	1.5	1.8	1.5	3.5	2.7
Compensation of employees per unit of output[2]	5.2	3.9	1.2	1.2	2.8					
Output per employee[2]	3.2	4.0	4.5	4.2	3.7	3.3	3.6	1.7	2.2	2.4
Output per employee (manufacturing)[2]	7.9	5.4	5.8	9.2	6.9	7.8	6.9	5.6	1.3	3.0
HICP	5.7	3.7	2.5	2.5	3.7	3.2	3.7	5.5	6.5	6.4
GDP deflator[2]	5.6	3.4	1.6	2.0	4.1	3.5	4.2	3.8	5.3	3.9

[1] Labour costs includes gross wages (SORS), other earnings from employment (AJPES), and social contributions and payroll tax (MoF).
[2] The annual national accounts figures have been reconciled with the methodological revision of the 2000 to 2007 GDP figures conducted in September 2008.
[3] Output per employee, average over last 10 years: 3.5%
Output per employee in manufacturing, average over last 10 years: 6.2%
Source: SORS, AJPES, Ministry of Finance, Bank of Slovenia calculations.

employment contributed 3.6 percentage points to the growth in unit labour costs, compared with -0.1 percentage points in the final quarter of 2005. Slowing growth in productivity has also contributed to higher growth in unit labour costs. In the first half of this year average year-on-year growth in output per employee stood at 2.3%, while the average growth recorded in the period from 2003 to 2007 was 3.9%.

A comparison of growth in unit labour costs with the GDP deflator indicates that labour costs have also had an impact on the high growth in prices in the last year. Growth in unit labour costs in the first half of 2008 lagged behind growth in the GDP deflator by just 0.4 percentage points, compared with an average of 2.5 percentage points in the period from 2005 to 2007. Sharp growth in gross wages and a trend of falling productivity growth point to factors that could cause inflationary pressures and hinder a drop in inflation in the future. A comparison of growth in nominal labour costs with growth in average ten-year productivity in Table 3.4 is shown for the purpose of stripping out the effects of the economic cycle on the productivity estimate and the effects of fluctuations in deflators. This indicator points to the inflationary effect of labour costs if economic growth were close to its potential. The gap between growth in nominal labour costs per employee and growth in long-term productivity deteriorated considerably in the first half of this year, reaching 3.1 percentage points on average, an increase of 2.4 percentage points from the average of the previous three years. Taking into account the growth rate of gross wages, this suggests a significant deterioration in this indicator at the level of the overall economy. At the moment it is not clear to what extent this is a one-off or more sustained trend. If wages and productivity continue to grow at the same pace in the future, labour costs could significantly hinder the process of re-establishing price stability.

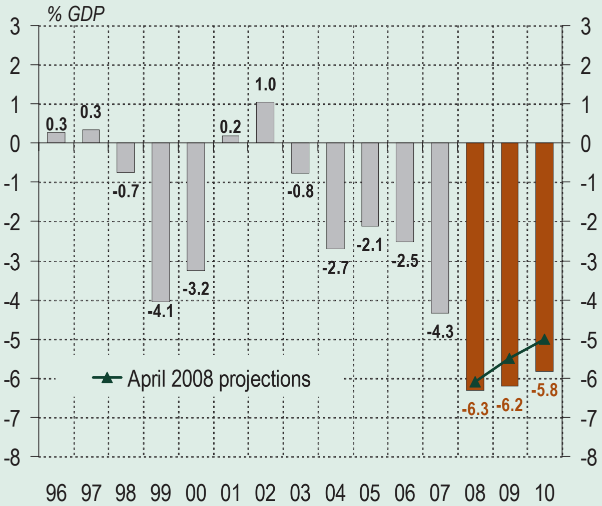
In contrast to recent years, public sector wage growth will outstrip private sector wage growth by an average of 1.8 percentage points over the projection horizon. The assumption in the projections is for public sector wage growth of approximately 8.8% until 2010. In June 2008 the government and the majority of the public sector unions signed a new collective agreement on public sector wage adjustments for this year. The parties also agreed to implement the changeover to the new wage system in September with the payment of August wages. At the end of August they also agreed to a partial wage settlement backdated to May 2008. Despite the signing of the agreement considerable risks remain with regard to public sector wages. The changeover to the new wage system with the aim of eliminating wage discrepancies actually means creating new (im)balances that are not supported by all employees. In addition some unions, such as judges, have not yet agreed to the new wage system. The public sector collective agreement also sets out a general wage adjustment for inflation, as of 1 July 2008, equal to half of the expected year-on-year inflation as at December 2008. A similar adjustment is envisaged for July 2009. The assumption regarding growth in the nominal average gross wage in the public sector for 2009 and 2010 takes into account further regular wage adjustments, and the elimination of wage discrepancies by the envisaged deadlines.

The private sector collective agreement signed in May 2008 envisages a basic wage increase of 5.2% on account of high inflation in 2007. Given that an increase of this extent was already envisaged during negotiations in January 2008 when no agreement was reached, the relatively high wage growth in the first months of this year was at least in part the result of advance wage adjustments by employers. This is supported by the fact that private sector wages rose by just 0.15% on a monthly basis in June, despite employers' obligation to pay a wage settlement covering the period from January to April at that time. Although the signing of the agreement in the private sector has mitigated the risk of excessive wage growth, certain risks still exist. The new collective agreement envisages a partial indexation of wages, as basic gross wages are expected to rise automatically with respect to inflation in 2008, by the difference between actual inflation and 4.55% Given the inflation projections, this would mean a 1.55% increase at the beginning of next year. In addition, the social partners agreed to a further 4% increase in the minimum wage on 1 August 2008. The baseline scenario includes an assumption regarding private sector wage growth in 2008 that takes into account economic and productivity trends, and an adjustment for price growth as agreed among the social partners. Private sector wages are expected to rise by approximately 8.7% in 2008. This takes into account the assumption that the dissipation of supply-side shocks in commodity markets will give corporates somewhat more flexibility in the next two years until the end of the projection horizon for private sector employee expenditures, which are expected to rise by close to 6.5% in 2009, growth then slowing to approximately 5.5% in 2010.

4 External Balance and Competitiveness

Slovenia's current account deficit widened sharply in 2007 compared with the average of the previous three years, reaching 4.3% of GDP. Projections indicate that the deficit could increase further this year to exceed 6% of GDP. The current account deficit is expected to widen from EUR 1.5 billion in 2007 to EUR 2.4 billion this year, and to remain at or near this level for the next two years. Thus the current account deficit is expected to increase from 4.3% of GDP in 2007 to 6.3% of GDP in 2008, and then begin to close gradually, reaching just below 6% of GDP by the end of the projection horizon. In 2008 the widening of the deficit compared with last year and previous projections is expected in the context of lower growth in exports than imports in volume terms, unfavourable terms of trade and continuing negative trends in the factor income and transfer account. According to assessments, trends in merchandise trade and in factor income, the latter largely due to increased borrowing in the rest of the world, will have the greatest impact on the deterioration of the current account. Growth in import and export volumes for 2008 and 2009 has been

Figure 4.1: Current account projections



Source: Bank of Slovenia

Table 4.1: Current account

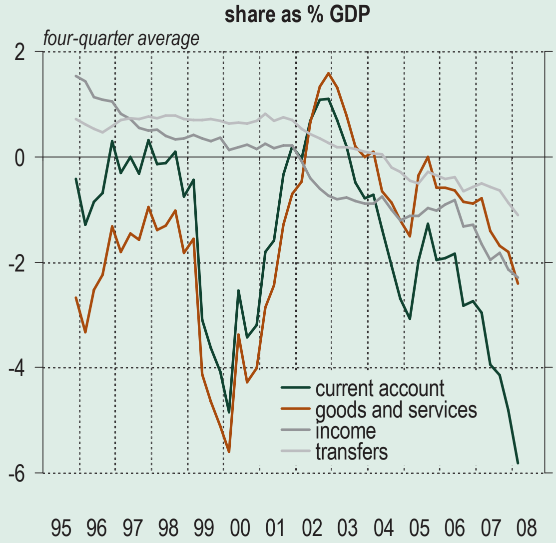
						Projections					
						2008		2009		2010	
	2003	2004	2005	2006	2007	**Oct**	Δ	**Oct**	Δ	**Oct**	Δ
	real growth, %, unless stated										
Exports of goods and services	3.1	12.4	10.6	12.5	13.8	**7.1**	-2.4	**7.4**	-0.8	**8.4**	0.1
Imports of goods and services	6.7	13.3	6.6	12.2	15.7	**7.8**	-1.5	**7.1**	-0.6	**8.1**	0.3
Current account: EUR billion	-0.2	-0.9	-0.7	-1.0	-2.0	**-2.4**	-0.2	**-2.5**	-0.3	**-2.5**	-0.4
as % GDP	-0.8	-2.7	-2.1	-2.5	-4.3	**-6.3**	-0.2	**-6.2**	-0.7	**-5.8**	-0.8
Terms of trade*	0.8	-1.0	-2.0	-0.6	0.0	**-2.0**	0.2	**0.1**	-0.3	**0.5**	0.1

* *Based on national accounts deflators.*
Δ: The difference between current projections and projections in the April 2008 Price Stability Report.
Source: SORS, Bank of Slovenia.

Box 4.1: Determinants of the rising current account deficit

In the last few years Slovenia has faced a widening current account deficit, the deficit over the 12 months to this June exceeding 6% of GDP. The length of the period of widening current account deficit and the size of the deficit have exceeded the previous widening between 1998 and 2000. There has been fluctuation in the current account position in the past, as a result of certain transitional effects and the business cycle, and it is a phenomenon to be expected in small, open economies. This box compares the factors that have contributed to a widening current account deficit in three periods since 1998, and gives some guidelines for assessing the sustainability of the deficit that has arisen.

Figure: Current account components, share as % GDP



Source: Eurostat, Bank of Slovenia calculations

A large increase in imports of goods brought an expansion of the deficit in 1998 to 2000. At the end of 1998 and in the first half of 1999 the high growth in imports of goods was the result of the replacement of the previous system of sales tax with a VAT system, and also of the aggregate demand cycle, which was similar to the demand cycle after 2006. During this period factor income and transfers were in net surplus, and helped to narrow the deficit.

In the period before Slovenia joined the EU and the ERM II, the current account deficit began to widen again. Major factors alongside the trade deficit in goods and services were net factor income, in particular the increase in net outflows of capital income, and the widening deficit in transfers. The main factor in the expanding deficit in capital income was the removal of capital restrictions at the end of 1999. Borrowing in the rest of the world by domestic entities also increased as a result, in addition to inward FDI by non-residents. The result of these trends was an increase in the net outflow of income from FDI and interest payments for servicing external debt. In addition, with private transfers relatively balanced over the

Table: Contributions of current account components to overall balance

	2001	2002	2003	2004	2005	2006	2007
			as % GDP				
Current account	0.2	1.0	-0.8	-2.7	-2.1	-2.5	-4.3
Goods and services	-0.7	1.5	0.0	-1.2	-0.4	-0.5	-1.4
Volume	-1.7	-0.5	-2.1	-2.8	-1.0	-0.8	-1.6
Prices	1.0	2.0	2.1	1.6	0.7	0.3	0.2
Goods	-3.4	-1.1	-2.1	-3.8	-3.6	-3.8	-5.0
Volume	-4.2	-2.8	-3.8	-4.7	-3.4	-3.3	-4.0
Prices	0.9	1.7	1.7	1.0	-0.2	-0.5	-1.0
Services	2.6	2.6	2.1	2.6	3.3	3.3	3.6
Volume	2.5	2.3	1.7	2.0	2.4	2.4	2.4
Prices	0.1	0.3	0.4	0.6	0.8	0.8	1.1
Income	0.2	-0.7	-0.9	-1.2	-1.4	-1.4	-2.1
Labour	0.8	0.7	0.5	0.5	0.5	0.4	0.2
Capital	-0.6	-1.4	-1.4	-1.7	-1.9	-1.8	-2.3
Transfers	0.7	0.3	0.1	-0.3	-0.3	-0.6	-0.8

Source: SORS, Bank of Slovenia calculations.

observation period, a net outflow arose in official transfers.

Further momentum in the deepening of the deficit was provided by the reversal in the economic cycle in Slovenia after 2006. Expressed in proportionate terms, the current account deficit in 2007 and the early part of this year has already exceeded the previous high recorded in 1999, and is being reflected in a rapid increase in foreign borrowing, and the associated costs. The increased contribution made by the deficit in goods and services trade, which is the result of both quantitative and price factors, is being accompanied by high net outflows of capital income, which is the result of increasing borrowing in the rest of the world and higher interest rates. These developments are particularly unfavourable because the deficit in capital income has already exceeded 2% of GDP, and this deficit has been widening since 2003 (see table). The largest contribution to the current account deficit comes from the goods trade position. The deficit of goods trade rose to 3.8% of GDP in 2004, and remained around that level until 2007, when it rose to 5% of GDP. The main factor in the increase in the negative quantitative effect over the observation period was rapid growth in imports of capital goods and consumer goods. In addition to the changes in the volume of goods trade that occurred when Slovenia joined the EU, another major contribution to the widening deficit since 2004 has come from price factors,[1] which are reflected in prices of goods' imports growing faster than those of exports. The balance of trade in services was strongly positive throughout the observation period, the positive terms of trade in services mainly neutralising the unfavourable trends and negative terms of trade in goods.

In principle, the sustainability of the deficit depends on whether the increase in imports of goods and services is connected with an expansion of the base for future output and increased exports with which the past deficit can be financed. In such an event the expansion of the current account deficit would not be of excessive concern. It would only become problematic if the increase in imports were connected to rising domestic final consumption, such as final household consumption, or to investment in construction that is not directly aimed at increasing output. In such an event the cumulative net borrowing in the rest of the world and the increase in the debt servicing burden would be unsustainable over the medium and long term. Given the debt created, balancing the current account requires exports to exceed imports in value terms. Much greater attention should therefore be given to economic policies that can bring an improvement in the competitiveness of the Slovenian economy. If the economy is incapable of creating a surplus of net exports because of insufficient (price) competitiveness, the current account can only be balanced by reducing imports or encouraging domestic saving.

The vulnerability of the economy because of the current account deficit is also linked to exposure to external financial conditions, which is of particular importance in the current conditions on international financial markets. Domestic banks that have raised loans in the rest of the world to fund domestic lending, and thus corporates too, are exposed inter alia to risks related to refinancing resources, which could lead to limits on financing and consequently on investment. Furthermore high borrowing costs in the rest of the world also entail higher costs for financing the deficit, and thus an additional financial burden on domestic corporates and households.

[1] The contribution made by the terms of trade, which is calculated as the first differential of the effect of prices (see table) on the merchandise trade position, has been negative since 2004. The largest deteriorations in the terms of trade came in 2005 (-1.2%) and 2007 (-0.5%) .

revised downwards compared with previous projections, while export volumes for 2010 remain virtually unchanged in the context of a smaller increase on the import side. According to estimates, the most significant revisions with regard to the last projection in April 2008 is made for this year, as exports and imports are expected to record slower growth by 2.5 and 1.5 percentage points respectively. Changes for the coming years are expected to be relatively small (between 0.2 and 0.6 percentage points).

Price factors are expected to have a greater impact on this year’s deficit in merchandise trade and the current account than the decrease in the volume of merchandise trade. Due to rising energy and other commodity prices, the terms of trade, which were neutral in 2007, will deteriorate by approximately 2 percentage points this year, but are expected to gradually improve from next year on. In the context of uncertainty on world markets, particularly with regard to energy prices, this forecast for the terms of trade is subject to a high level of risk, as is the forecast for net factor income, which will be affected to a great extent by developments on world markets.

Growth in trade in goods and services is expected to slow slightly more than forecast in previous projections. Growth in exports is expected to slightly outstrip growth in imports over the next two years, and will contribute to a gradual improvement in the external balance. The favourable outlook in Europe, particularly in new EU Member States, led to higher demand for exports of Slovenian goods and services in 2007. This was expected given the foreign demand forecast used in previous projections. A portion of the above-average increase in the volume of trade with EU Member States following Slovenia's entry into the EU can be attributed to the favourable effects of the Slovenian economy's greater integration with other EU and euro area Member States. These favourable effects can primarily be seen in a decrease in operating costs related to merchandise trade arising from the abolition of customs duties in the European internal market and other reductions in costs related to merchandise trade within the single economic area. However, other factors not directly linked to the Slovenian economy could contribute to high growth in Slovenia's merchandise trade. In previous projections regarding merchandise trade, it was assessed that the so-called "Rotterdam effect"[3] will continue this year, and to a lesser extent over the next few years. This effect is expected to contribute an additional 1 percentage point to growth in export and import volumes of goods this year, while the effect on growth in merchandise trade will gradually dissipate in the coming years. Current trends in merchandise trade indicate that previous expectations of an additional acceleration of growth in merchandise trade on account of intermediation in re-exports of goods will not materialise. The downturn in the economic activity in the euro area, particularly in Slovenia's most important trading partners, will also have an impact on the declining growth in merchandise trade this year. This will primarily be seen in lower demand and exports of goods to euro area countries. In the next two years, particularly in 2010, exports will again pick up in the context of rising growth in foreign demand, while growth in imports will be lower than growth in exports in both years on account of lower growth in domestic demand, investment demand in particular.

Increased production and exports by the domestic automotive industry which, like the majority of exports, are closely linked to imports of equipment and material, and will thus contribute to maintaining high growth in imports, will contribute to high growth in exports this year. According to estimates, additional exports from the automotive industry are expected to contribute 0.9 percentage points to total growth in exports of goods and services in 2008. As a result, higher imports of intermediate goods will contribute 0.6 percentage points to growth in total imports of goods and services this year. By achieving the planned utilisation of production capacities and exports, these effects on growth in merchandise trade are expected to be negligible. A possible deterioration in the political and institutional situation in certain countries in south-eastern and eastern Europe could have negative consequences this year and in the coming years, not only on the volume of merchandise trade, but also on the position and further development of investments in the region by the Slovenian companies. This could result in further deterioration in the current account.

Given the projections of macroeconomic trends, the deficit in merchandise trade will widen further this year, followed by a gradual closing. The deficit in merchandise trade is expected to increase to EUR 2.6 billion or 6.8% of GDP in 2008. This deterioration will primarily be the result of negative terms of trade and, to a lesser extent, faster growth in imports with regard to exports of goods in real terms. According to estimates, growth in merchandise trade will gradually fall in the coming years compared with the average of the last few years, and will

[3] For more information see Box 4.1 in the April 2008 Price Stability Report.
http://www.bsi.si/en/publications.asp?MapaId=786

move in line with growth in foreign demand on the export side. In addition to lower growth in exports of goods, driven by the high import dependence of export industry, the slowdown in domestic spending, particularly investment spending (the most dynamic domestic component of GDP growth in 2007), will have a significant impact on the slower growth in imports of goods. The negative terms of trade, which are primarily a reflection of high growth in oil and other commodity prices on world markets, are expected to have a significant impact on the estimated current account deficit of EUR 2.4 billion in 2008. Euro oil prices are expected to rise by 42% in 2008 compared with last year. Based on this assumption and assumptions regarding growth in commodity prices and inflation in the euro area, import prices are expected to rise faster than export prices by approximately 2 percentage points. The estimated negative effect of the terms of trade in goods and services on the current account position in 2008 is EUR 0.6 billion, which explains three-quarters of the widening of the current account deficit compared with 2007. The nominal current account deficit will widen slightly in 2009 and 2010, remaining at a level of approximately EUR 2.5 billion. Nevertheless, the terms of trade are expected to improve gradually in these two years, and contribute an average of approximately EUR 100 million to closing the current account deficit. Growth in imports and exports of goods in the next two years is expected to be between 7% and 8%.

The surplus in trade in services with the rest of the world remains the most important factor in closing the current account deficit. The factors that influence growth in exports and imports of services are similar to those that affect merchandise trade. Over the projection horizon, lower economic activity and a drop in foreign demand will have the greatest indirect impact on services that are closely linked to merchandise trade. These primarily include transport services and business and technical services. The most noteworthy of the latter services are foreign trade intermediation, services linked to the handling of goods (receipt, shipping and warehousing) and other services associated with the promotion of goods. Due to a significant slowdown of growth in construction investments, particularly in civil engineering work, income and, in particular, expenditure from investment work in Slovenia are also expected to fall slightly in the coming years. The expected drop in household purchasing power in Slovenia's most important trading partners will probably result in decreased revenues from tourism. Taking into account all of the aforementioned factors, the rate of growth in exports and imports of services is expected to outstrip the rate of growth in merchandise trade, as it did last year. However, this gap is projected to gradually narrow in the future. Compared with the last projections, growth in trade in services is expected to be slightly more than 1 percentage point lower on both the export and import sides. Growth in imports of services in 2009 and 2010 is expected to be just below 1 percentage point lower than export growth, due to lower growth in imports of goods and more moderate growth in domestic investment. The expected faster growth in export prices than import prices should have a favourable effect on the surplus in trade in services. In the context of the realisation of such trends, the surplus in services, which stood at 3.6% of GDP in 2007, is expected to gradually increase in the coming years to just over 4% of GDP by 2010.

The deficit in net factor income has widened rapidly in recent years, and this trend is expected to continue over the projection horizon. In 2005 the deficit stood at EUR 300 million, and more than doubled to EUR 709 million, or 2.1% of GDP, by 2007. The deficit in net factor income is expected to widen to approximately 2.5% of GDP by the end of the projection horizon. In the context of a rising number of foreign workers in Slovenia,[4] net inflows of labour income have been falling for a number of years. Last year net inflows of labour income were down one-third on the previous year, and stood at just EUR 78 million. Due to faster growth in expenditure than

[4] In the year to July the number of valid work permits issued to non-residents rose by more than one-third.

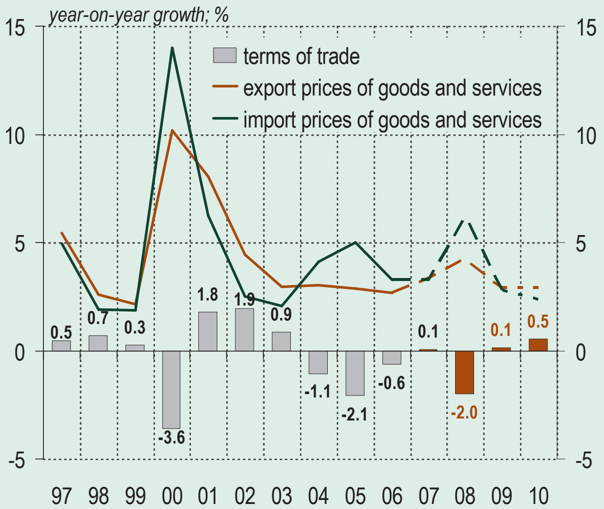
income, the deficit in capital income widened by EUR 239 million last year compared with 2006 to EUR 786 million. Interest payments to the rest of the world increased the most on the expenditure side. In the context of an increase in the gross external debt in the past four years by approximately EUR 4 billion annually and the rise in interest rates on world markets, interest payments on loans taken abroad rose by 62% year-on-year in 2007. The transfer of profits to parent companies abroad has also risen since 2005. According to balance of payment figures, last year foreign-owned companies reinvested just EUR 52 million of the EUR 478 million in profit generated, transferring the remainder abroad. Among capital income, only income from investments in securities recorded a net inflow, increasing by more than EUR 40 million year-on-year to EUR 222 million in 2007. On the income side, the largest increase was recorded by banks' income from investments in foreign bonds and notes.

In the context of a falling labour income surplus, the net deficit in income from equity and interest payments will contribute most to the negative factor income position over the projection horizon. The main factors in the widening of the deficit in capital income, which is expected to rise from 2.3% of GDP in 2007 to just below 3% of GDP by the end of the projection horizon in 2010, are increasing interest payments and rising expenditure on dividends and reinvested earnings. The increase in interest payments is expected due to rising gross debt in the form of loans from the rest of the world in comparison with gross claims in the form of loans to the rest of the world, whereby this assessment is subject to uncertainty with regard to the future movement of interest rates on world financial markets. High and rising expenditures on dividends and reinvested earnings are, in terms of volume, a reflection of FDI realised in the past in Slovenia and, in terms of growth, a reflection of expected FDI in Slovenia in the future. According to assessments, alongside labour income, another factor in the closing of the factor income deficit in the future will be income from investments in foreign debt securities, which according to the stock at the end of the first quarter of 2008 was two times higher than the stock of foreign investments in Slovenian debt securities.

The deficit of EUR 274 million in current transfers widened by slightly less than two-thirds in 2007 compared with the previous year, and has become a major factor in the deterioration in the current account. Last year net outflows of private transfers fell by EUR 12 million year-on-year to EUR 52 million. On the income side, official transfers were down in 2007, which saw the deficit in official transfers double in year-on-year terms to EUR 222 million. The majority of official transfers relate to payments of taxes and contributions to the rest of the world and insurance premiums. Receipts from the EU budget amounted to 59.8% of the forecast value, while expenditure reached 112.2% of the forecast value. An above-average increase in liabilities from traditional funds (customs duties) and expenditure arising from VAT was recorded on the expenditure side last year. The net position of Slovenia's state budget against the EU budget was nearly balanced in 2007. In the first half of this year, the deficit in current transfers reached EUR 263 million or 0.7% of GDP, whereby the net position of Slovenia's state budget against the EU budget showed a deficit in the amount of EUR 62 million or 0.2% of GDP. Given previous trends, an increase in the volume of transfers, particularly official transfers, is expected this year and in the future. However, following an increase in 2008 to 0.8% of GDP, the negative transfer position is expected to fall slightly next year and remain at this level until the end of the projection horizon. In the planning of the net position with the EU budget, data from the budget memorandum for 2007 and 2008 was taken into account. This memorandum forecasted receipts of 1.56% of GDP and expenditure of 1.13% of GDP, thereby resulting in an annual surplus of approximately EUR 150 million in terms of estimated GDP. This surplus, given the previous realisation, particularly on the receipt side, was sufficiently reduced so that, according to estimates, the position of receipts and expenditure related to the EU budget will be nearly balanced in the next two years. The deficit in transfers is expected to remain unchanged compared with last year at 0.8% of GDP in 2008, before falling slightly to fluctuate at approximately 0.7% of GDP in the coming years.

Given assumed import and export price factors, the terms of trade are expected to deteriorate significantly this year and to contribute most to the deteriorating current account position. The overall terms of trade were neutral in 2007. Annual growth in both import and export prices stood at 3.3%. This trend in import and export prices was significantly more favourable than in 2006, when the terms of trade deteriorated by 0.6 percentage points, and above all were more favourable than the forecast for this year. The terms of trade deteriorated by 1.3 percentage points in the first half of the year, with an average deterioration of 2 percentage points forecast for 2008 due to high oil prices and persistently high prices of other commodities. A gradual improvement in the terms of trade is expected over the next two years in the context of assumptions regarding the movement of commodity and oil prices on world markets. According to estimates, the terms of trade in services were positive in 2007, as export and import prices of services rose by 4.1% and 1.7% respectively in year-on-year terms.

Figure 4.2: Terms of trade

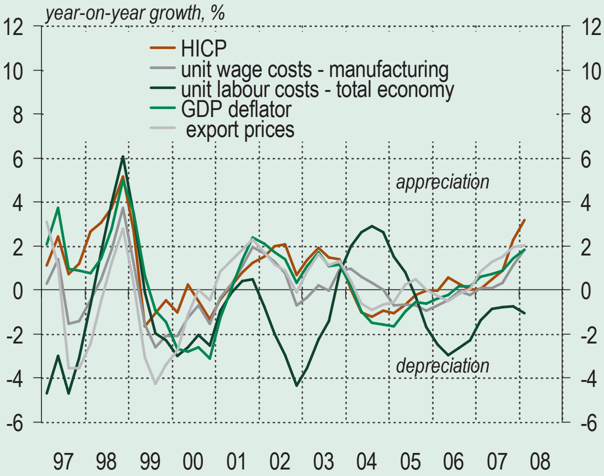


Source: SORS National Accounts; Bank of Slovenia calculations

Growth stood at 1.8% on the export side and 4.0% on the import side during the first half of this year. Nevertheless, a positive contribution by the terms of trade to trade in services is expected over the projection period, as service export prices are forecast to grow from 1.0 to 1.5 percentage points faster than import prices. Given the aforementioned assumptions, the contribution of the terms of trade to the current account position would be negative in 2008 in the amount of 1.3% of estimated GDP, while improving terms of trade over the next two years will help reduce the current account deficit by 0.3 percentage points by 2010.

Most indicators of the real effective exchange rate point to an appreciation during the first quarter of 2008, following a sharp appreciation last year. The exception is the real effective exchange rate as measured by labour costs in the manufacturing sector, which depreciated, as it did last year. The real effective exchange rate as measured by the HICP appreciated by an average of 1% against the EU in 2007. The price competitiveness indicator points to a continuing appreciation this year, primarily due to domestic prices growing faster than the basket of foreign prices. The real effective exchange rate as measured by the HICP appreciated by 3.2% in year-on-terms in the first quarter of this year. The real effective exchange rate as measured by unit labour costs in the whole economy appreciated by 0.8% against the EU in the first quarter of 2008, and by 1.8% in year-on-year terms, the highest appreciation since Slovenia joined the EU. By contrast, the real effective exchange rate as measured by unit labour costs in the manufacturing sector depreciated by 0.3% against the EU in the first quarter of this year, and by 1% in year-on-year terms. Like last year, this is the only indicator this year that points to an improved competitive position of the Slovenian economy and manufacturing sector. High growth in output and productivity in recent years have more than offset growth in labour costs in the manufacturing sector. Nevertheless, the latest figures indicate that growth in output and productivity has also slowed. The real effec-

Figure 4.3: Real effective exchange rates*

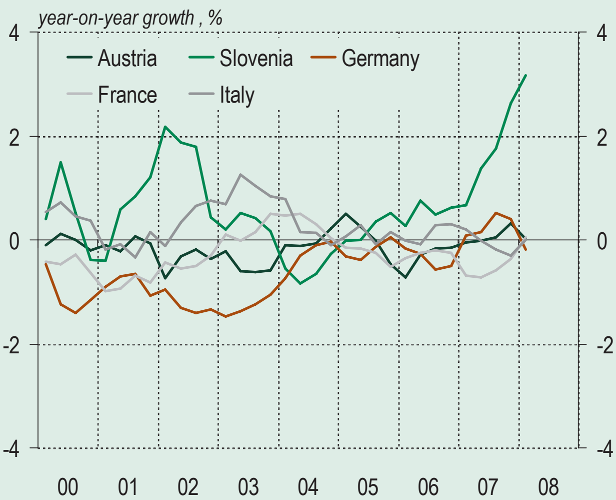


* against EU27
Source: European Commission

tive exchange rate as measured by the GDP deflator also indicates a decline in the competitiveness of the Slovenian economy against the EU, the indicator demonstrating a rising trend since 2005, Appreciation based on this indicator, which averaged 0.9% in 2007, has continued this year, reaching 1.9% in year-on-year terms in the first quarter. The movement of this indicator, similar to the movement of the indicator of unit labour costs in the whole economy, reflects faster growth in costs of the non-tradable sector compared with the tradable sector, partly as a result of the Balassa-Samuelson effect (see Box 1.2). The real effective exchange rate as measured by the deflator of export prices of goods and services against the EU, which appreciated by an average of 1.4% in 2007, appreciated by 2.0% year-on-year during the first quarter this year. Appreciation does not necessarily mean a deterioration in the competitiveness of Slovenian economy, but in part reflects changes in the structure of Slovenian exports. Last year exports from the automotive industry rose sharply, as did products with higher value added, which affected the level and movement of export prices.

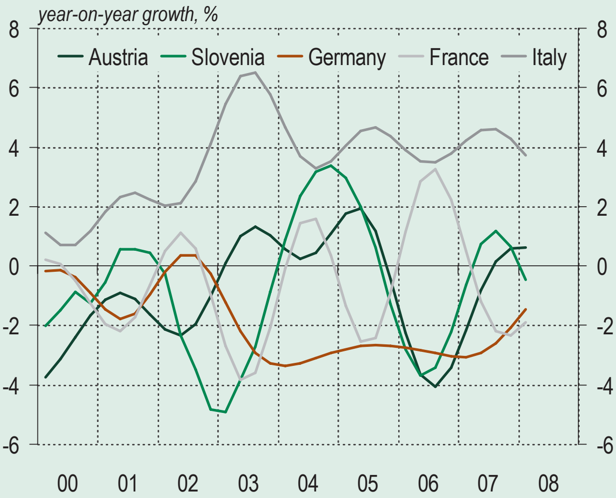
Following the depreciation of the effective euro exchange rate in the euro area against the basket of EU currencies in recent years, this trend has reversed this year, while the year-on-year appreciation of the euro against the basket of currencies of 41 countries stood at 3%. The nominal effective euro exchange rate has depreciated in the past four years against the basket of domestic currencies of other EU Member States, the rate of depreciation slowing and completely reversing in the second half of last year. The nominal effective euro exchange rate against EU Member States outside the euro area depreciated by approximately 4% in the four years until the third quarter of 2007 inclusive, since when the total appreciation has reached 7.6% Taking into account the euro exchange rate against currencies outside the EU, the nominal effective euro exchange rate in the euro area against the basket of 41 currencies appreciated by an average of 3.6% in year-on-year terms during the last year. In the last year the euro has appreciated most against the pound sterling (17.0%) and against the US dollar (9.9%). By the end of February 2008, the euro had surpassed USD 1.50 and was approaching USD 1.60. This trend then reversed, with the euro depreciating to below USD 1.50. The euro has risen more than 40% against the US dollar in the last five years, directly affecting the competitive position of euro area countries in the US market. Since the movement of the US dollar is linked to several currencies of emerging competitor countries

Figure 4.4: Real effective exchange rate against the euro area HICP deflator



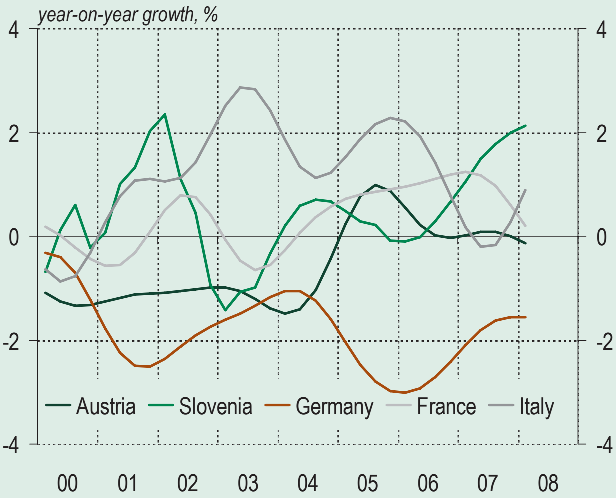
Source: European Commission, Bank of Slovenia calculations

Figure 4.5: Real effective exchange rate against the euro area unit wage costs (manufacturing)



Source: European Commission, Bank of Slovenia calculations

Figure 4.6: Real effective exchange rate against the euro area unit labour costs (whole economy)



Source: European Commission, Bank of Slovenia calculations

from Asia, the appreciation of the euro against the US dollar represents additional pressures on the competitiveness of the euro area and Slovenian economies. The weakness of certain currencies against the euro also reflects the difficulties in the economies of these countries, particularly in light of the uncertainties on financial markets.

Slovenia's competitiveness compared with its most important trading partners within the euro area as measured by the HICP has deteriorated since the second quarter of last year. The price competitiveness indicator against euro area countries has appreciated sharply in the last year due to the high level of inflation in Slovenia, placing Slovenia on the tail of all Member States in terms of price competitiveness. In one year domestic prices growing faster than the basket of foreign prices contributed 60% to growth in the price index, while the appreciation of the nominal effective exchange rate accounted for the remainder. Due to the expected drop in inflation in Slovenia, which will outstrip the expected drop in euro area inflation in relative terms, competitiveness measured by this indicator should deteriorate less in the coming years than in the previous period.

Slovenia's cost competitiveness indicator in the manufacturing sector against euro area countries[5] indicates that Slovenia's competitive position relative to its important euro area trading partners is improving this year. The real effective exchange rate measured by unit labour costs in Slovenia's manufacturing sector appreciated by an average of 0.5% last year, then depreciated by 0.5% year-on-year in the first quarter of 2008. This type of trend and the high fluctuation in this indicator point to what is probably a cyclical and not a lasting improvement in competitiveness.

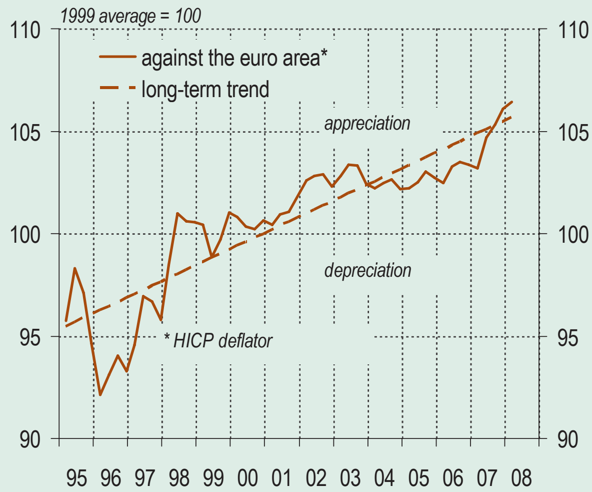
The trend of the competitiveness indicator with regard to unit labour costs in the economy as a whole against euro area countries is less favourable for Slovenia. Last year this indicator appreciated sharply compared with the average of the last five years. This trend is primarily the result of a faster increase in the costs per unit output of the Slovenian non-tradable sector compared with other euro area countries. Growth in the unit labour cost indices for the whole economy in Slovenia and Germany differs considerably throughout the period for which data is available, the gap widening further in recent years. This type of trend indicates a deteriora-

[5] Since the adoption of the euro at the beginning of 2007, the real effective exchange rate index against euro area countries only shows the ratio of the domestic price index to the basket of prices of euro area countries.

tion in Slovenia's competitiveness compared with Germany, in terms of labour costs for the whole economy.

The effects of long-term real convergence, which are neutral with regard to decreasing competitiveness, could also be reflected in the movement of price competitiveness indicators. Since 1995 these effects, taking into account the long-term trend of appreciation of the real effective exchange rate, have been quite moderate (see Box 1.2). Such sharp appreciation in the real exchange rate against the euro area in the last year cannot be explained solely by the process of long-term real convergence (see Figure 4.7 and Box 1.2). The trend of the real effective exchange rate indicates there was a reversal for the worse in 2007. The previous relatively long period of stable movement in the real effective exchange rate has ended. Close monitoring of further changes in this indicator will be necessary in the future.

Figure 4.7: Real effective exchange rate



Source: European Commission, Bank of Slovenia calculations

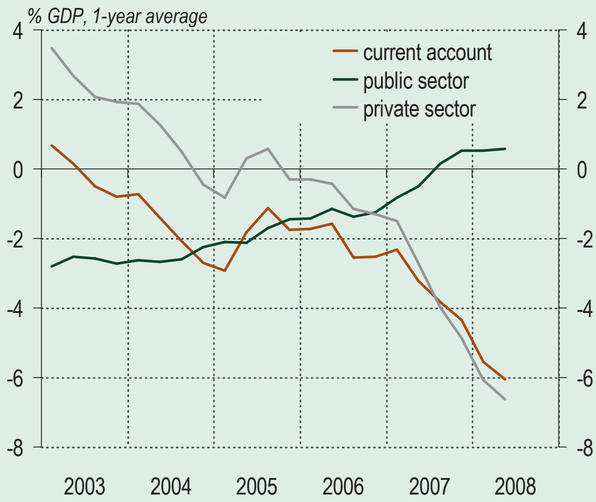
5 Financing Conditions

The expansion of the savings-investment gap in Slovenia in recent years has coincided with relatively strong borrowing in the rest of the world and an increase in the net external debt. The main intermediaries in financing from the rest of the world are the banks, which borrow in the rest of the world in order to finance other domestic sectors. After rising rapidly last year, lending to the domestic private sector has slowed this year, which is connected to the slowdown in economic activity, the tighter financing conditions and the downturn in real estate prices.[6]

Financial flows with rest of world and external debt

The private sector savings-investment gap has been expanding rapidly since the middle of 2006. Because there is insufficient net saving in the public sector, the deficit in domestic saving is being financed by borrowing in the rest of the world. National saving increased by 1.8 percentage points over the preceding two years to 27.2% of GDP in 2007, while growth in gross investment increased by 4.3 percentage points over the same period to 31.4% of GDP. The savings-investment gap, i.e. the difference between domestic saving and investment, thereby increased by 2.5 percentage points to 4.2% of GDP in 2007, and has continued to increased this year, as Figure 5.1 reveals. By June 2008 the savings-investment gap had reached 6% of GDP. The public

Figure 5.1: Savings-investment gap*



Source: SORS, Bank of Slovenia, own calculations

** The public sector savings-investment gap is defined as a deficit of general government according to ESA95 methodology. The private sector savings-investment gap is the difference between public sector savings-investment gap and the balance of payments current account.*

sector savings-investment gap continues to decrease, and has actually been slightly positive in the last year. The private sector savings-investment gap has been gradually widening since 2003, and after a temporary reversal has been expanding continuously and rapidly since the middle of 2005. Given that the current account deficit has been widening by an average of 2 percentage points per year over the last two years, balancing these trends would require a significant increase in the general government surplus.

[6] The domestic private sector includes non-financial corporations, households and non-monetary financial institutions.

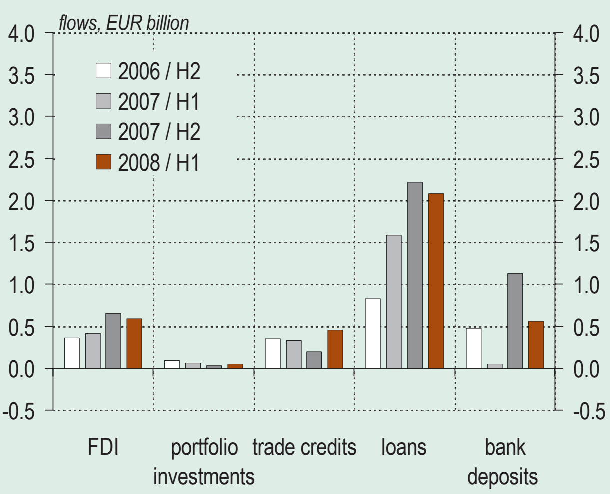
The increase in the net financial inflow in the balance of payments[7] is the result of the increase in the savings-investment gap. The net financial inflow increased from EUR 1.1 billion in 2006 to EUR 1.7 billion in 2007. It amounted to EUR 2.4 billion between last July and this June, equivalent to about 7% of GDP, two-thirds of the inflow going into the private sector, and the remaining third into the government sector. The net financial inflow into the government sector was primarily the result of February's release of government bonds in the amount of EUR 1.0 billion.

Both financial inflows and outflows remain strong, an indication of Slovenia's high level of integration into international financial flows. This increased significantly when Slovenia introduced the euro, thereby eliminating foreign-exchange risk and reducing the risks of financing in the rest of the world, but recently it has been partly restricted by the uncertainties on international financial markets. The private sector's financial inflows amounted to just over 15% of GDP in 2006, and to almost 25% of GDP in the year to June 2008. Financial outflows increased from 15% of GDP to just under 20% of GDP over the same period.

Loans from abroad to banks and bank deposits by non-residents were again prevalent among the financial inflows into the private sector in the first half of this year. Of the total financial inflow into the private sector of EUR 3.8 billion in the first half this year, loans to banks from the rest of the world accounted for EUR 1.9 billion, while bank deposits by non-residents accounted for EUR 0.6 billion. The aforementioned inflows were not up compared to the second half of 2007, which is probably connected to the decline in credit demand from domestic sectors, and the consequent lesser need for banks to finance themselves from the rest of the world. The uncertainties on financial markets and the associated high cost of borrowing in the rest of the world have also contributed to this.[8]

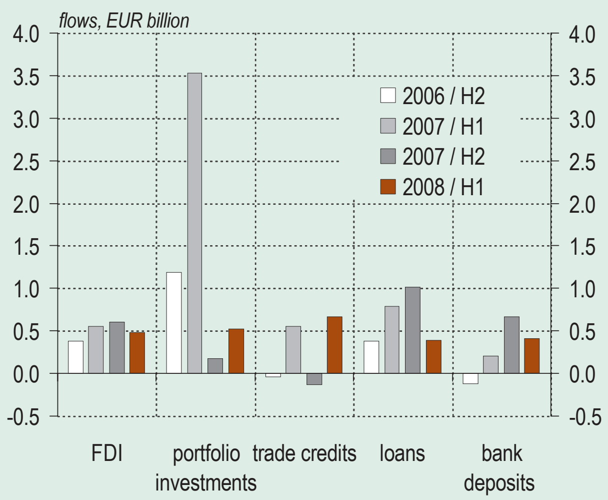
Of the other financial inflows into the private sector, inward FDI remains at last year's level, while corporate borrowing in the rest of the world and portfolio investments are negligible. Inward FDI in 2007 was double that in the previous year, and remained at around 3.5% of GDP in 2008. Corporate borrowing in the rest of the world remains low, at around 1% of GDP. The proportion of total corporate borrowing raised in the rest of the

Figure 5.2: Financial inflows from the rest of the world



Source: Bank of Slovenia

Figure 5.3: Financial outflows to the rest of the world



Source: Bank of Slovenia

[7] The net financial flow represents the position of the financial account, excluding statistical errors.
[8] With the exception of FDI, both financial inflows and financial outflows have actually been declining in the euro area since the second half of last year, primarily as a result of the uncertainties on the financial markets. For more, see ECB Monthly Bulletin, August 2008, Box 7, p 67. http://www.ecb.int/pub/pdf/mobu/mb200808en.pdf

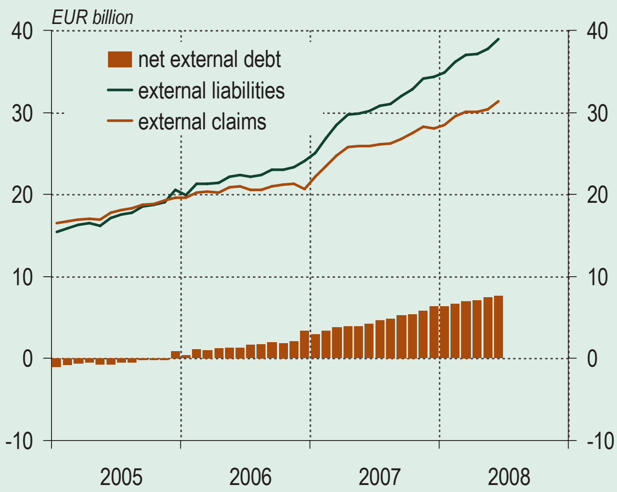
world thus declined from almost a fifth in 2006 to less than a tenth in 2007, and was merely around 7% in the first half of this year.

The largest increases in financial outflows in the first half of 2008 relative to the second half of 2007 were recorded by portfolio investments and trade credits, while loans to the rest of the world declined. The decline in loans to the rest of the world and the end of the increase in deposits in the rest of the world are probably associated with the higher risk brought by the uncertainties on the financial markets.[9] At the same time it is surprising that outward portfolio investments are increasing, despite the financial uncertainties: they amounted to EUR 0.2 billion in the second half of last year, and to EUR 0.5 billion in the first half of this year.[10] The increase in trade credits is partly the result of the poorer economic climate in the rest of the world, but is also partly seasonal in nature. Outward FDI has been relatively stable in recent years, at around 3.5% of GDP, similar to inward FDI.

This year's financial flows with the rest of the world could remain at last year's level, as a result of which growth in the gross external debt and gross external claims would be slightly slower than previously. Inflows of loans from the rest of the world are expected to slow, as a result of the slightly lower economic growth forecasts, the uncertainties on the financial markets, and the high level of lending already achieved. Inflows from FDI are also expected to remain at a level similar to previous years, these depending to a great extent on the realisation of government plans to sell off state-held assets. On the outflow side, loans and FDI are expected to remain at the level of the previous year. Inflows and outflows of portfolio investments are expected to remain negligible in the future. Slovenia's gross external debt increased by EUR 10.4 billion in 2007, and by a further EUR 4.6 billion in the first half of this year, while external claims increased by EUR 7.4 billion and EUR 3.2 billion over the same period. The rate of growth in both the gross external debt and gross external claims is gradually slowing. The gross external debt stood at EUR 39.0 billion at the end of June, while gross external claims stood at EUR 31.3 billion.

With debt instruments prevalent among net financing from the rest of the world, the net external debt is increasing, while the increase in net interest payments is also widening the current account deficit. The net external debt increased by EUR 2.4 billion in 2006, by EUR 2.9 billion in 2007, and by EUR 1.4 billion in the first half of 2008, which means that the pace of the increase has remained unchanged in the last year. The net external debt stood at EUR 7.7 billion at the end of June 2008. The rise in the net external debt is being accompanied by an increase in the burden of financing, which is adding to the deterioration in the current account. Net outflows of investment income increased from EUR 0.5 billion in 2006, to EUR 0.8 billion in 2007, and amounted to EUR 0.5 billion in the first half of 2008.

Figure 5.4: External debt

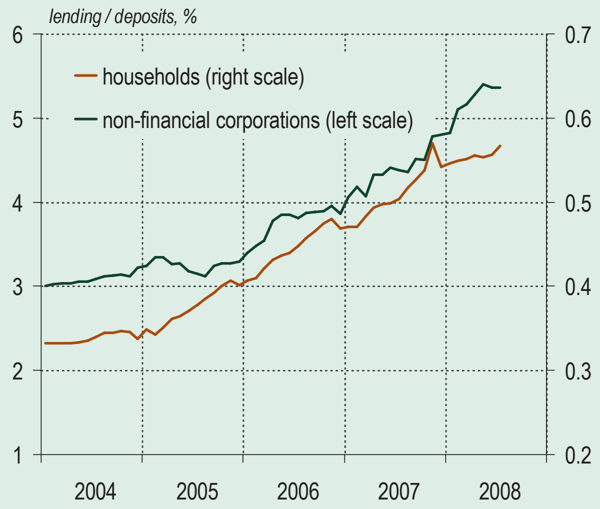


Source: Bank of Slovenia

[9] See previous note.

[10] The increased financial inflow into the Bank of Slovenia and outflow of private sector portfolio investments in the first half of 2007 was primarily the result of the repayment of Bank of Slovenia bills and the placement of this money by domestic banks into foreign securities at the beginning of 2007. For more details, see the Price Stability Report, October 2007, p 48, Box: Adjustment of certain balance of payments categories following the introduction of the euro.
http://www.bsi.si/en/publications.asp?MapaId=786

Figure 5.5: Net indebtedness at banks



Source: ECB, Bank of Slovenia

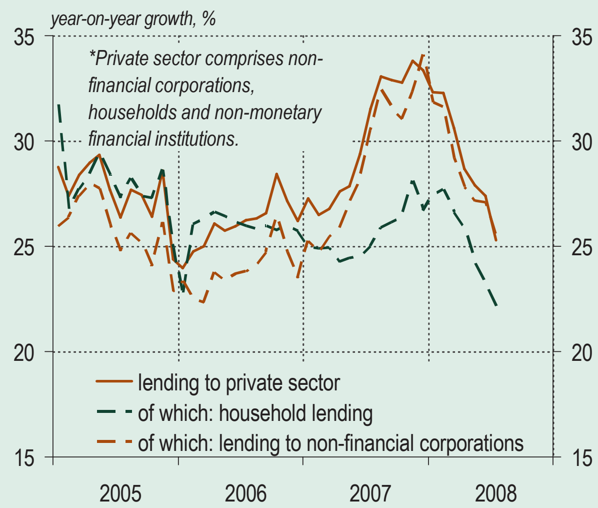
Given that the current account deficit is not expected to significantly expand over the projection horizon, but is merely expected to remain relatively high, the increase in the net external debt and the costs of financing this debt should continue to increase at a slightly slower pace than in the recent period. The current account deficit is expected to continue to be financed via debt instruments.

Lending activity and financing conditions

Given a lack of domestic resources, banks are financing the domestic private sector's credit demand by borrowing in the rest of the world, thereby intermediating in financing from the rest of the world. The flow of loans to banks from the rest of the world and the flow of deposits by non-residents amounted to EUR 4.5 billion in 2007, and to EUR 2.5 billion in the first half of 2008. The flow of lending to domestic sectors amounted to EUR 6.8 billion in 2007, and EUR 2.9 billion in the first half of 2008. This means that banks are financing an increasing proportion of lending by borrowing in the rest of the world. The increasing level of intermediation by banks in financing from the rest of the world is also seen in the increase in the net indebtedness of the domestic private sector at banks. The net indebtedness of the non-financial corporations and households, defined as the ratio of the stock of lending to deposits for each sector, began to significantly increase in 2005, when the ratio stood at just over 3 for non-financial corporations and just over 0.35 for households. The ratio for non-financial corporations had increased to around 5.5 by the middle of this year, while the ratio for households has remained at around 0.55 since the end of last year.

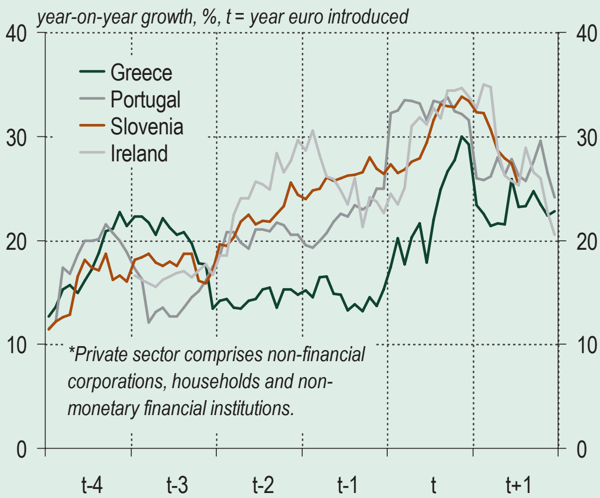
Growth in bank lending to the private sector, which reached almost 35% in year-on-year terms at the end of the year, slowed in the first half of this year, and

Figure 5.6: Lending to the domestic private sector



Source: Bank of Slovenia

Figure 5.7: Growth in lending to the private sector and the introduction of the euro*



Source: IFS

currently stands at just over 25%. Growth in lending to the private sector increased by almost 10 percentage points last year. As is clear from Figure 5.6, lending to both non-financial corporations and households began to significantly increase in the second quarter of last year, peaking at the end of the year, and since then has slowed relatively rapidly. Growth in lending to non-financial corporations has significantly outpaced growth in household lending in the last year-and-a-half.

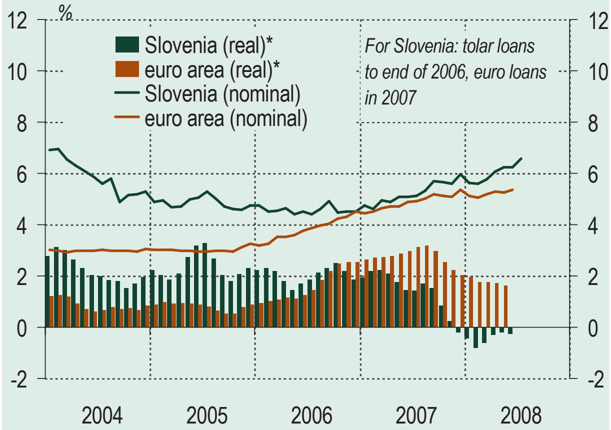
The relatively high growth in borrowing from banks by the domestic private sector is also connected to the process of real convergence with more developed EU Member States. The high levels of borrowing are therefore in part an expected component of the process of real convergence, i.e. catching up with the most developed EU Member States. The depth of financial intermediation as measured by lending to the private sector expressed as a proportion of GDP has in recent years increased by around 10 percentage points each year, and now exceeds 70%. The gap between the measured depth of financial intermediation for the euro area as a whole and that for Slovenia thus narrowed from about 55 percentage points of GDP in 2004 to just over 40 percentage points of GDP in the middle of this year. As Figure 5.7 reveals, other less developed Member States saw similar growth in lending after joining the euro area. They also recorded a sharp increase in lending growth in the first year after introducing the euro, which then slowed relatively rapidly in the following year, as in Slovenia.

This year's gradual slowdown in borrowing by non-financial corporations is partly cyclical in nature, and is connected to the slowdown in economic growth.[11] The strong borrowing by non-financial corporations in the second and third quarters of last year in particular was to a great extent connected to the rapid economic growth, investment in particular, the high demand for financing for corporate M&A activities, and the reinforcement and expansion of positions in foreign markets, the western Balkans in particular. Real year-on-year growth in GDP and investment has been slightly lower since the third quarter of 2007, which has coincided with a slowdown in lending to non-financial corporations.

Despite the gradual rise in nominal interest rates since the end of 2006, real financing conditions for non-financial corporations are still favourable. As Figure 5.8 reveals, since 2006 the movement and level of nominal interest rates on loans to non-financial corporations in Slovenia have been comparable to those in the euro area, an indication of the Slovenian financial system's significant level of integration with the euro area. Since the middle of last year real interest rates have been lower in Slovenia than in the euro area, primarily because of slightly higher inflation. Real interest rates in Slovenia have been gradually rising since the end of 2007, which is probably already bringing about a slowdown in lending to non-financial corporations.

The projected continuing slowdown in economic activity and investment and the current trends point to a gradual decline in year-on-year growth in lending to

Figure 5.8: Interest rates on loans of more than EUR 1 million to non-financial corporations



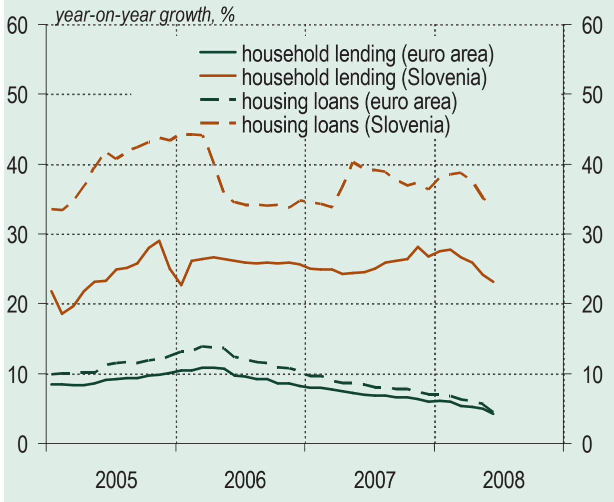
** Real interest rates, allowing for past inflation (3-month moving average).*
Source: ECB, Bank of Slovenia

[11] Growth in lending to non-financial corporations in the euro area has been gradually slowing in recent months, and stood at 13.6% in year-on-year terms in June 2008. The ECB attributes the slowdown in lending to non-financial corporations in the euro area to higher interest rates, tighter financing conditions and the slowdown in economic activity (ECB, Monthly Bulletin, August 2008).
http://www.ecb.int/pub/pdf/mobu/mb200808en.pdf

non-financial corporations. Projections of economic trends indicate a gradual slowdown in economic growth to around 4% on average over the projection horizon, accompanied by a continued slowdown in investment. Year-on-year growth in lending to non-financial corporations can therefore be expected to decline from the current figure of around 25% to about 15% by the end of the projection horizon in 2010. Growth in lending will continue to outpace growth in lending in the euro area because of the process of real convergence.

This year's slowdown in household lending is the result of both a gradual decline in housing lending and a decline in consumer lending. The breakdown of household lending shows that housing loans to households have recorded year-on-year growth of approximately 40% in recent years, significantly outpacing overall growth in household lending. Here it should be noted that the high growth in housing lending is also a result of the relatively low proportion of total lending accounted for by these loans. The proportion of total household lending

Figure 5.9: Breakdown of household lending



Source: ECB, Bank of Slovenia

accounted for by housing loans has increased over the last three years from about 25% to more than 40% in the middle of 2008. Year-on-year growth in consumer lending increased gradually last year, to stand at more than 20% at the end of the year. Growth in both housing lending and consumer lending has gradually slowed this year. Year-on-year growth in housing lending stood at 31.7% in July, compared with a rate of 13.3% for consumer lending.[12]

Growth in housing lending has been gradually slowing together with slower growth in real estate prices, but remains relatively high. Growth in real estate prices has been gradually slowing since the beginning of last year, the rate of growth in advertised prices for flats of most types in Ljubljana having declined from around 20% at the beginning of 2007 to just over 5% in the first quarter of this year.[13] As growth in real estate prices continues to decline, the trend of slower growth in housing lending can be expected to continue.

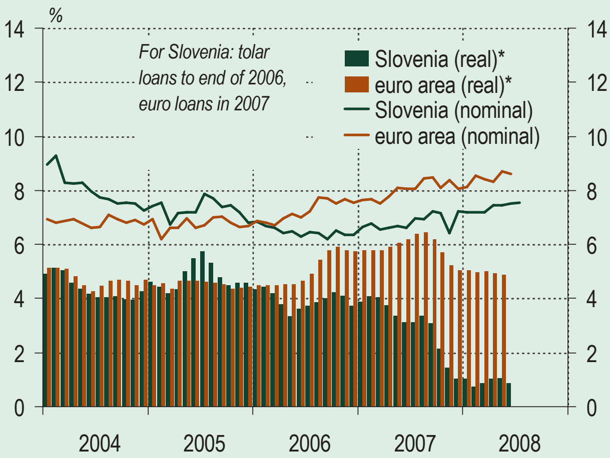
The slowdown in consumer lending is in line with the movement of private consumption. The increase in year-on-year growth in consumer lending, particularly in the second half of last year, was in line with the movement of domestic private consumption, which grew by 5.0% in real terms last year. The slowdown in private consumption, which recorded real year-on-year growth of 3.0% in the first half of the this year, is bringing a decline in growth in consumer lending.

Since the middle of 2006, the financing conditions for household consumption have been more favourable in Slovenia than in the euro area. Figure 5.10 clearly shows that since the beginning of 2006 nominal interest rates and, even more so, real interest rates on consumer loans have been lower in Slovenia than in the euro area. The gradual increase in nominal and real interest rates is

[12] Household lending in the euro area has been slowing since the middle of 2006. The ECB primarily attributes the gradual decline in household lending in the euro area to the slowdown in real estate prices and the gradual rise in lending rates (ECB, Monthly Bulletin, August 2008). http://www.ecb.int/pub/pdf/mobu/mb200808en.pdf

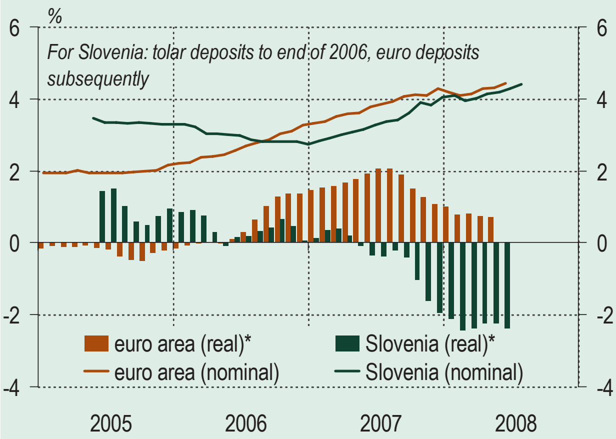
[13] Source: SLONEP. Growth in transaction prices of housing slowed in 2007 in the Ljubljana region, but increased in the rest of Slovenia (Source: TARS). The trends on the real estate market were comprehensively discussed in the Financial Stability Review, May 2008. http://www.bsi.si/en/publications.asp?MapaId=784

Figure 5.10: Interest rates on consumer loans to households



* Real interest rates, allowing for past inflation (3-month moving average).
Source: ECB, Bank of Slovenia

Figure 5.11: Interest rates on household deposits of up to 1 year



* Real interest rates, allowing for past inflation (3-month moving average).
Source: ECB, Bank of Slovenia

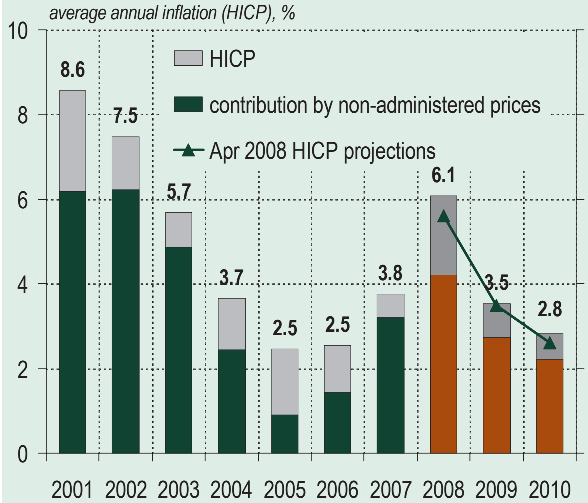
probably one of the reasons for the gradual slowdown in consumer lending this year, as well as the lower borrowing capacity of households.

The decline in real interest rates on household deposits has ceased this year, but they nevertheless remain negative. The movement of nominal interest rates on household deposits since the end of 2006 is an indication of the high level of integration with the euro area; nominal interest rates and, even more so, real interest rates on household deposits of up to 1 year are lower in Slovenia than in the euro area. Real interest rates have actually been negative in the last year. The past migration from bank deposits to high-risk investments led to an increase in households' sensitivity to potential fluctuations on the financial markets. Low interest rates can act to stimulate domestic consumption, and can thereby be a source of inflationary pressure. The continuing gradual increase in nominal and real interest rates should mitigate the aforementioned risks. Growth in deposits has been gradually increasing in the last year because of the uncertainties on the financial markets and the rise in interest rates.

6 Price Projections and Risks

The inflation projection has been revised upwards from the projections made in April. Average annual inflation as measured by the HICP is forecast at 6.1% for 2008, up 2.4 percentage points on last year's growth rate. Inflation is expected to decline to 3.5% in 2009, and to 2.8% in 2010. Given the assumptions, and the expected macroeconomic trends, inflation is only likely to return to the price stability levels at the end of the projection horizon. Compared with the projections of April 2008, this entails upward revisions of 0.5 percentage points in 2008 and 0.2 percentage points in 2010, the inflation forecast for 2009 remaining unchanged. The higher forecast for this year is already an indication of the materialisation of the majority of the risks to which the Bank of Slovenia drew attention in the previous Price Stability Report,

Figure 6.1: Inflation projections



Source: SORS, Bank of Slovenia projections

Table 6.1: Inflation

						Projections					
						2008		2009		2010	
	2003	2004	2005	2006	2007	**Oct**	Δ	**Oct**	Δ	**Oct**	Δ
	average annual growth, %										
Consumer prices (HICP)	5.7	3.7	2.5	2.5	3.8	**6.1**	0.5	**3.5**	0.0	**2.8**	0.2
food	6.1	1.3	0.2	2.7	7.1	**8.7**	-0.9	**4.6**	-0.9	**3.7**	…
energy	3.4	7.0	11.9	8.5	3.4	**12.4**	4.3	**3.2**	0.4	**2.3**	…
other goods	4.8	1.8	-0.3	-0.9	0.3	**2.0**	0.5	**1.3**	-0.2	**1.4**	…
services	7.1	5.8	3.3	3.5	4.9	**5.4**	0.0	**4.7**	0.5	**3.6**	…
Core inflation indicators (HICP)											
excluding energy prices	6.0	3.2	1.2	1.7	3.8	**5.1**	-0.1	**3.5**	-0.1	**2.9**	0.9
excluding energy and unprocessed food prices	6.3	3.7	1.3	1.5	3.4	**5.1**	-0.2	**3.4**	-0.3	**2.8**	…
excluding energy, food, alcohol and tobacco prices	6.0	3.9	1.5	1.3	2.7	**3.8**	0.2	**3.2**	0.2	**2.6**	…
Non-administered prices	5.9	3.0	1.2	1.9	4.1	**5.5**	0.0	**3.6**	0.0	**2.9**	-0.1
Administered prices	4.4	6.1	7.4	4.8	2.1	**7.7**	1.8	**3.3**	0.1	**2.6**	1.7

Δ: The difference between current projections and projections in the April 2008 Price Stability Report.
Source: Bank of Slovenia.

namely those relating to the movement of energy prices, the rise in labour costs and high economic activity.

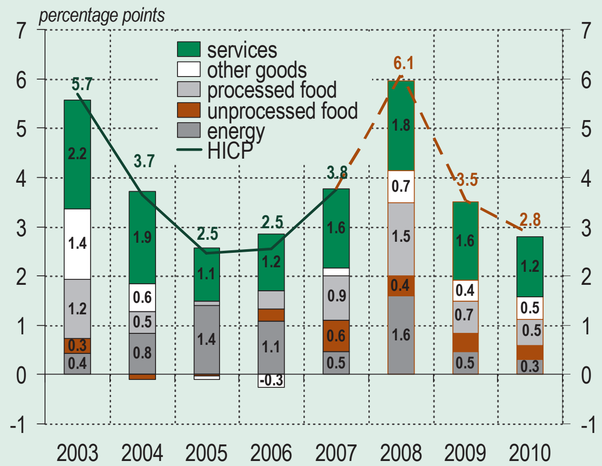
The expected slowdown in economic activity at home and abroad, a decline in real growth in disposable income and tighter financing conditions should facilitate a fall in inflation in the future. The latest figures show that domestic economic activity has begun to slow. Although year-on-year growth in GDP was still relatively favourable in the second quarter, the quarterly growth rate is already showing signs of a slowdown. Similar trends are being seen in other countries in the euro area, where GDP growth in the second quarter was actually negative. In the context of lower growth in household purchasing power as a result of past high inflation, and the expected decline in foreign demand, the pressure for domestic prices to rise will most probably have to be reduced. The easing of price pressures can first be expected in sectors where competition is greatest, followed by the service sector, and finally in the food trade sector, where the price elasticity of demand for products is lowest. Given these trends, it will probably be relatively difficult to pass the entire high growth in labour costs into prices; this is already reducing growth in profits, and is set to intensify in the future. In the tightened macroeconomic conditions, a continuation of the high wage growth seen in the first half of the year could to a greater extent lead to a reduction in profits, and only to a lesser extent to higher price growth. As a result there could be a temporary fall in employment or a rise in unemployment. The macroeconomic imbalances currently seen could thus be balanced via a deterioration in conditions on the labour market. In the opposite case there is a risk of a deepening inflation spiral, a longer recession and a long-term loss of competitiveness. In addition, the financing conditions are also tightening, with interest rates on loans rising and other lending terms (collateral, credit ratings) becoming stricter. This is consequently being reflected in a decline in growth in corporate and household lending. Growth in household lending has been declining since the beginning of the year, in both the consumer and housing segments. The deterioration of conditions on the securities market and the real estate market, where the

Table 6.2: Assumed direct effects on inflation of government measures in 2008 and 2009

Measure	expected change	expected effects on HICP (percentage points)	actual change Jan to Aug 2008	actual effect on HICP (percentage points)
Changes in administered prices in 2008:				
– Changes in prices of certain textbooks	average price increase of 2.8%	0.007	price increase of 2.7%	0.006
– Changes in price of railway tickets	average price increase of 3.5%	0.007	price increase of 3.2%	0.006
– Planned increase in contribution to mandatory reserves of refined petroleum products	increase in contribution of 10%	0.000	no increase	0.000
– Changes in network charge and supplements to network charge for electricity transmission	increase in final electricity price of 1.4%	0.032	no increase	0.000
Total effect on inflation		**0.046**		**0.012**
Changes in administered prices in 2009:				
– Changes in prices of certain textbooks	average price increase of 2.6%	0.007		
– Changes in price of railway tickets	average price increase of 2.8%	0.007		
– Planned increase in contribution to mandatory reserves of refined petroleum products	increase in contribution of 10%	0.000		
Total effect on inflation		**0.014**		

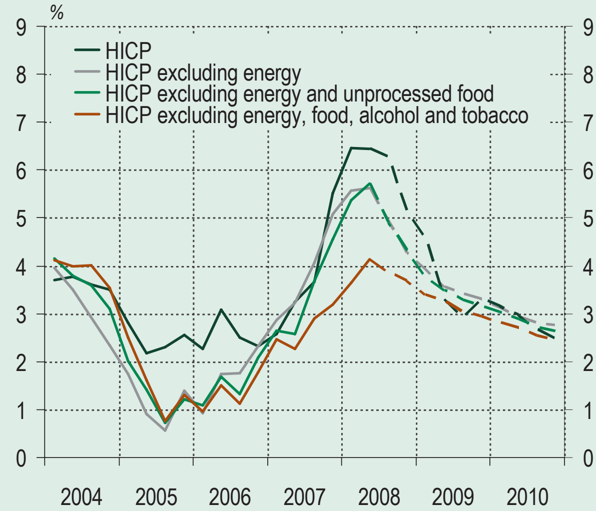
Source: Plan for managing regulated prices in 2008 and 2009.

Figure 6.2: Contributions of components to inflation



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

Figure 6.3: HICP and core inflation



Source: Eurostat, Bank of Slovenia projections

vast majority of households are seeing their asset values decline, could also bring about a decline in demand. The manner in which the process of re-establishing price stability and the other macroeconomic equilibria unfolds in the future will be crucial in ensuring that the competitiveness of the Slovenian economy does not suffer excessively.

In line with the trends in the domestic macroeconomic environment, core inflation is also expected to continue falling gradually. The core inflation indicators suggest that its growth rate should fall to between 2.5% and 3% by the end of the projection horizon. Year-on-year growth in the HICP excluding prices of energy, food, alcohol and tobacco probably peaked in April, at 4.4%, and by August had fallen by 0.7 percentage points to 3.7%. The average annual growth in this index should stand at about 3.8% this year, and is expected to gradually fall to 3.2% in 2009 and 2.6% in 2010, in line with the processes of achieving price stability.

The trends in the international environment should not give rise to further inflationary pressures over the projection horizon. Oil prices should stabilise at around USD 120 per barrel, while growth in other commodity prices, unprocessed food in particular, should also slow. Inflation in the euro area is expected to rise this year, primarily as a result of supply-side shocks and high commodity prices, but is projected to follow a renewed slowdown over the next two years to a level of just over 2%. Growth in prices of manufactured goods in Germany is forecast to be only slightly higher over the projection horizon, having been significantly higher in recent years. The external environment is also expected to have a limiting effect on inflation as a result of the slowdown in foreign demand relative to previous years.

Growth in the majority of indices of individual price categories has been revised upwards in line with the aggregate index. The revision of the forecasts for this year is primarily the result of the realisation of certain risks, in particular those relating to energy prices, and of growth in aggregate demand and labour costs being higher than expected. Average annual growth in energy prices has been revised upwards by over 4 percentage points, and is forecast at just over 12% for this year, but should decline to around 3% in 2009, and close to 2% in 2010. Next year's significant decline in growth is primarily the result of a base effect, as the projected future current rate of growth in energy prices is significantly lower than this year's rate. In contrast to the previous projections, the slightly higher growth forecast for electricity prices is now included. Three large electricity price rises of about

10% each at intervals of six months have been assumed for the period to the end of 2009. The growth projections for this year's prices of industrial goods other than food and next year's services prices have also been revised slightly upwards. The revisions are primarily the result of higher growth in aggregate demand, together with the agreements reached and past developments relating to growth in labour costs, which currently represent the largest risk from the domestic environment to the re-establishment of price stability. In contrast to the aforementioned sub-categories, the growth forecasts for food prices have been revised downwards for this year and next year. Year-on-year growth in prices of unprocessed food on global markets has been gradually slowing since the beginning of the year, while domestic growth in prices of processed food is also slowing in line with the forecasts of food retailers. The latter is a notable additional risk, should retailers' pricing policies fail to reflect market conditions. In such an event, a large one-off rise in food prices could again be seen in the final quarter of this year, which could exacerbate the consequences of the projected economic slowdown.

After growing rapidly this year, administered prices are forecast to grow more slowly in the next two years, being outpaced by growth in non-administered prices. This year's faster growth in administered prices will probably be primarily the result of the strong growth in energy prices from the end of last year and the beginning of this year. The projection of growth in energy prices is in line with assumptions regarding the movement of oil prices on global markets and the US dollar/euro exchange rate, which do not change significantly from their initial values over the projection horizon. Current growth in energy prices over the projection horizon therefore remains low, and is consequently reducing year-on-year growth in both energy prices and administered prices. Growth in other administered prices is forecast to be in line with growth in non-administered prices as envisaged in the plan for managing regulated prices in 2008 and 2009.[14] According to the plan, the direct effects of changes in prices under direct government control are expected to be considerably lower than in previous years. The effect is forecast to be about 0.05 percentage points this year, and just one-fifth of this next year. The majority of the necessary adjustments and reconciliation of excise duties with European directives have already been carried out. This year the effect of last year's rise in excise duties on tobacco products reduced year-on-year inflation in July by 0.3 percentage points.

The projections of economic trends and inflation remain subject to considerable uncertainties. The uncertainties are primarily connected to the movement of commodity prices, the dimension of the financial turmoil, and their consequences for economic growth at home and abroad. The high level of commodity prices reached is an indication that changes in commodity prices are also the result of structural factors, which usually have a longer-term impact on prices and can be extremely difficult to predict. The turmoil on the financial markets is deepening in structural terms, and could have a profound impact on economic trends in the macroeconomic environment. The ECB and the European Commission have already lowered their economic growth forecasts for the euro area as a result of the unfavourable conditions. The decline in confidence indicators and the adverse trends on the real estate markets in the US and in certain European countries indicate that global economic activity and economic activity in some of Slovenia's trading partners could be lower than forecast in 2008.

Investment represents the largest uncertainty among the domestic factors. After declining gradually last year, growth in investment accelerated sharply in the first quarter of 2008, thus raising the question of how long the strong investment cycle can last, and how deep the decline in investment growth will be when the cycle comes to an end. This question is raised in particular with regard to investment activity tied to government projects, most

[14] Source: Načrt uravnavanja reguliranih cen za leti 2008 in 2009 (Plan for managing regulated prices in 2008 and 2009) http://193.2.236.95/dato3.nsf/OC/080103210540A/$file/152v1_11.doc

notably DARS, but is also likely to relate in the future to the construction of railway infrastructure. The structure of investment is relatively unfavourable from the point of view of future economic growth, as growth is coming primarily from construction, while growth in investment in equipment, which contributes to more sustainable growth by expanding output potential, is slowing. The extremely high growth in employment in the construction sector is also mostly cyclical in nature, which means that the rapid employment growth in this sector could be followed by an equally rapid contraction in employment.

Given the uncertainties related to the realisation of the assumptions, alternative scenarios for the projections and simulations have also been drawn up to give an indication of possible deviations from the baseline scenario. The alternative scenarios of the projections are based on the modified assumptions given in Table 6.3. By comparing the scenarios, it is possible to assess the impact of deviations in the assumptions on the projections.

The prevailing risks over the projection horizon are those relating to slowing economic activity and rising inflation. As in the previous Price Stability Report from April, the principal risks involving external factors are

Table 6.3: Model simulations of selected macroeconomic shocks

	Simulation	Shock (change)
	a) Foreign environment	
1.	Oil price	USD 10 per barrel higher than forecast
2.	Commodity prices	10% higher than forecast
3.	Foreign demand	1 percentage point lower than forecast
	b) Domestic environment	
4.	Wage growth	1 percentage point higher than forecast
5.	Household consumption	1 percentage point higher than forecast
6.	Investment	1 percentage point lower than forecast
7.	Government spending	1 percentage point higher than forecast
8.	Growth in administered prices	1 percentage point higher than forecast

	Simulation	GDP			Inflation		
		2008	2009	2010	2008	2009	2010
Projections (baseline scenario), %		4.5	3.5	4.1	6.1	3.5	2.8
Response of projections to shocks:		*deviations from baseline scenario, percentage points*					
	a) Foreign environment						
1.	Oil price	0.0	-0.1	-0.1	0.3	0.3	0.1
2.	Commodity prices	0.0	0.0	0.0	0.2	0.2	0.1
3.	Foreign demand	-0.1	-0.3	-0.1	0.0	-0.1	0.0
	b) Domestic environment						
4.	Wages	0.1	0.2	0.1	0.1	0.4	0.5
5.	Household consumption	0.2	0.3	0.4	0.1	0.3	0.4
6.	Investment	-0.2	-0.4	-0.5	-0.1	-0.2	-0.2
7.	Government spending	0.1	0.2	0.2	0.0	0.2	0.2
8.	Administered prices	0.0	-0.1	0.0	0.1	0.2	0.2

Notes: Year-on-year growth, %. The simulations were conducted using the model used by the Bank of Slovenia for its forecasting. Simulations 1, 2, 3 and 7 are based on changes in exogenous variables, while in simulations 4, 5, 6 and 8 the changes defining the actual simulation are added to the variables from the baseline scenario. All other assumptions in the simulations were the same as those in the baseline scenario. The duration of the shocks was the third quarter of 2008 to the final quarter of 2010.
Sources: SORS, Bank of Slovenia, Bank of Slovenia calculations

again those relating to commodity prices, developments on the financial markets and global activity, which deepened further in September. Most notable among the domestic factors are the risks of high wage growth and pass-through into prices, and lower investment demand.

The tensions on global financial markets, high commodity prices and the resulting slowdown in economic activity in the international environment represent the main downside risk to economic growth. Restricted liquidity and credit availability and tightened financing conditions represent a risk of growth in consumption and investment falling more than expected both at home and abroad. The still-high commodity prices, which have contributed to a deterioration in confidence indicators in the majority of the most important trading partners, could also add to the slowdown in the economic climate. The baseline scenario assumes that the deterioration in economic activity in the rest of the world will only have a temporary impact: after a temporary slowdown in 2008, the baseline scenario assumes that growth in foreign demand will gradually pick up again towards the end of the projection horizon.

Given the major uncertainties over developments in the international environment, a scenario of lower growth in foreign demand, which would additionally slow economic activity in Slovenia, has also been estimated. The alternative scenario, presented in Table 6.4, assumes growth in foreign demand of 5 percentage points less than that in the baseline scenario in the first year of the simulation horizon, which corresponds to the decline in foreign demand in 2001. The realisation of such a scenario would have a profound impact in reducing economic growth and employment in Slovenia, which would consequently lead to a fall in inflation. In the event of such a shock economic growth would be about 0.5 percentage points lower in 2008, and 1.5 percentage points lower in 2009 and 2010, while inflation would be 0.1 percentage points lower in 2009 and 0.5 percentage points lower in 2010. In addition to lower export growth, growth in domestic demand would also decline significantly, particular investment growth, which according to the model forecast could decline on average by more than 2 percentage points during the 2008 to 2010 period. The export response would lead the current account deficit to cumulatively expand by about 1 GDP percentage point in 2009 and 2010. The response by domestic corporates to the cooling of demand in trading partners would depend primarily on their readiness for adverse developments. Corporates could temporarily overcome

Table 6.4: Alternative projection scenario: lower economic growth in the rest of the world

	scenario of lower economic growth in the rest of the world			deviations from baseline scenario		
	2008	2009	2010	2008	2009	2010
	year-on-year growth, %			percentage points		
GDP	**4.1**	**2.1**	**2.6**	-0.4	-1.4	-1.5
Employment	**1.8**	**-0.4**	**-0.3**	-0.3	-0.7	-0.8
Net wages	**8.5**	**6.9**	**5.7**	0.0	-0.1	-0.4
Gross wages	**8.7**	**7.0**	**5.8**	0.0	-0.1	-0.4
Domestic demand	**4.2**	**2.4**	**3.2**	-0.8	-0.9	-0.8
Households	**3.2**	**3.0**	**2.8**	-0.1	-0.4	-0.6
Investments	**6.5**	**1.7**	**4.3**	-2.6	-2.3	-1.7
Exports	**4.9**	**4.2**	**4.1**	-2.3	-3.2	-4.2
Imports	**5.0**	**4.5**	**4.6**	-2.7	-2.6	-3.5
Current account (as % GDP)	**-6.0**	**-6.7**	**-6.4**	0.3	-0.5	-0.6
HICP	**6.1**	**3.4**	**2.3**	0.0	-0.1	-0.5

Note: This scenario assumes that economic growth in the rest of the world in the second half of 2008 and the first half of 2009 will be 5 percentage points lower than in the baseline scenario.
Source: Bank of Slovenia.

the deterioration in economic conditions on the basis of reserves created by earnings retained during favourable times. However a longer-term decline in output would force corporates into additional cost controls, which in the context of the high wage growth agreed for this year and next year could trigger a decline in employment.

The risks to economic growth arising in the domestic environment are more balanced. Higher-than-expected wage growth and low (real) interest rates (as a result of higher inflation relative to the euro area) could encourage growth in private consumption above that forecast in the baseline scenario. However, there is the possibility that the tightening of financing conditions, the slowdown on the real estate and securities markets, and high commodity prices, which in principle reduce real disposable income and consumer confidence, could have an impact on consumption, as is happening in certain other countries. There is also a risk that after two years of extremely rapid growth, investment growth will be lower than forecast in the baseline scenario, as a result of less favourable foreign demand, difficult access to financial resources, a deterioration in the competitive position and the contraction of corporate profits.

The main risks to inflation arising from the rest of the world are the movements of oil prices and other commodity prices, and their pass-through into domestic prices and medium-term inflation expectations. Should growth in commodity prices remain high, inflation will be higher than expected. In addition, it is uncertain to what extent past rises in commodity prices on global markets have actually been reflected in domestic inflation. In addition to the direct effects, in the pass-through into domestic prices there are also indirect effects (when price rises are built into input prices in the production chain) and second-round effects (when price rises pass through into wage increases). This type of risk is so much greater in conditions of strong domestic demand, which allows for the significant pass-through of external shocks into domestic prices, by virtue of which corporates are able to preserve their profit margins. Alongside prices on global markets, exchange rate movements are another factor in domestic prices of imported commodities, whereby a fall in the euro could add to inflationary pressures. Inflation risks also arise in the movement of electricity prices, and other energy prices such as natural gas. In the case of these two products, the suppliers state that price rises are unavoidable. The baseline scenario therefore already incorporates a gradual rise in electricity prices by a total of 60% during 2008 and 2009, while the forecast for the price of natural gas has been drawn up on the basis of the forecast for oil price movements. Given the forecasts by electricity and natural gas distributors, it is highly likely that the assumed rates of growth will be too low.

The wage agreements reached in the summer mean that the risks that the Bank of Slovenia warned of in its previous Price Stability Reports have been realised, although it is uncertain how the projected high wage growth will be reflected in domestic prices. Second-round effects have thus arisen in Slovenia, as the agreements envisage the (almost) complete indexation of wages to headline inflation, which the Bank of Slovenia and the ECB both warned of. The baseline scenario assumes that in the conditions of slower productivity growth corporates will partly compensate for the envisaged wage increases by cutting margins, as a result of which the higher wage growth will not be reflected in higher inflation in its entirety. However, it is uncertain as to what extent corporates will actually be able and ready to compensate for higher wage growth by cutting margins. The movement of profit indicators shows that in recent years growth in profit in Slovenia has been similar to that in the euro area (see Box 3.1). However, there is a risk that corporates will pass cost increases through into prices to a larger-than-expected extent, thus making domestic inflation higher. According to the most unfavourable scenario, the second-round effects could lead to a continuation of the wage-inflation spiral, which could entail inflation in Slovenia remaining high over the medium term. The model forecasts indicate that full wage indexation to growth in prices and output per employee could lead to inflation remaining at around 5% in 2009 and 2010.

Should economic growth in Slovenia or the rest of the world be weaker than expected, the fall in inflation could accelerate. Lower economic growth triggered by a further slowdown in the climate at home or abroad could lead to an accelerated decline in price growth. Estimates of output gap indicators, as yet incomplete, reveal aggregate demand in Slovenia as exceeding output potential by around 1% to 2% (see Box 1.1). The baseline scenario envisages the gradual closing of the positive output gap by the end of the projection horizon, as GDP growth in 2009 and 2010 is forecast to be lower than the current growth forecast for output potential. Should growth in foreign demand or growth in individual components of domestic consumption slow by an additional percentage point, inflation could additionally fall by between 0.1 and 0.3 percentage points each year.

The movements in items in the general government accounts are currently exposed to major risks. The projected deterioration in macroeconomic conditions and fall in employment entail a heavier burden on the budget, primarily as a result of an increase in social transfers, but also entail a decline in revenue from direct and indirect taxes (VAT, income taxes, payroll taxes). The key to the impact on social transfers will be how corporates adapt to the deterioration in the climate (by reducing wages, profits or employment), and to what extent employment will be cut by laying off non-residents, which will have a smaller impact on budgetary expenditure.

The projections are also subject to uncertainties as a result of the revision of the national accounts figures. When releasing the national accounts figures for the second quarter of 2008, the Statistical Office also released its latest revisions to the annual figures for 2000 to 2007, to which the quarterly figures are yet to be adjusted, in keeping with customary practice. The formulation of projections in the context of such significant revisions to GDP and some of its components is rendered particularly difficult, as it hinders the interpretation of economic trends. The revised and adjusted quarterly figures are expected to be available by the time of the release of the next Price Stability Report in the spring.

Box 6.1: Comparison of 2008 and 2009 forecasts with those of other institutions

Forecasts for Slovenia are compiled by domestic and international institutions. It is useful to compare forecasts because they highlight differences in thinking concerning future economic trends, despite the forecasts not being directly comparable as they cover different periods and therefore do not take into account the same information. Furthermore, the forecasts are based on different assumptions with regard to both exogenous variables in the international environment and economic policy actions.

The economic growth forecasts for 2008 have generally been revised downwards from the previous round of forecasts, the institutions remaining united in the opinion that growth will be between 4% and 5%. The majority of the institutions are forecasting a relatively sharp economic slowdown in 2009.

Nearly all the institutions are forecasting a widening of the current account deficit in both years, but as in the last round of forecasts the prevailing opinion is that the current account deficit in 2009 will be slightly smaller than this year's deficit.

For inflation, again all the institutions raised their forecasts for both years compared with the previous round, the figures suggesting that inflation in 2008 will be close to 6%, while all the institutions forecast that there will be a significant fall in inflation in 2009, but that the rate will remain relatively high at between 3.5% and 4.5%.

Table: Comparison of forecasts for Slovenia and changes from previous forecasts

	Release of new/previous forecast	GDP annual growth, %				Inflation annual average, %				Current account as % GDP			
		2008		2009		2008		2009		2008		2009	
		new	Δ	**new**	Δ	**new**	Δ	**new**	Δ	**new**	Δ	**new**	Δ
Bank of Slovenia	Oct. 08 / Apr. 08	**4.5**	0.3	**3.5**	-0.4	**6.1**	0.5	**3.5**	0.0	**-6.3**	-0.2	**-6.2**	-0.7
EIPF	Sep. 08 / Mar. 08	**5.0**	0.5	**4.4**	-0.1	**6.1**	1.0	**4.6**	2.4	**-7.1**	-2.4	**-4.6**	-1.6
IMAD	Oct. 08 / Apr. 08	**4.8**	0.4	**3.1**	-1.0	**6.2**	1.0	**3.9**	0.7	**-5.8**	-1.2	**-4.7**	-1.9
Consensus Forecasts	Sep. 08 / Mar. 08	**4.7**	0.0	**4.2**	-0.2	**6.1**	1.6	**4.2**	0.9	**-5.2**	-2.2	**-4.3**	-1.7
UniCredit	Sep. 08 / Mar. 08	**4.4**	0.3	**4.2**	0.2	**6.4***	1.6	**4.6***	1.8	**-5.1**	-0.4	**-5.0**	-0.2

Δ: The difference between current and previous projections.
** End of period.*
Source: Bank of Slovenia, EIPF, IMAD, Consensus Economic Forecasts, Unicredit Group CEE Research Network; Bank of Slovenia calculations.