BANKA SLOVENIJE

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# MONETARY POLICY REPORT

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# 1 SUMMARY AND BANK OF SLOVENIA GOVERNING BOARD POSITION

At the end of 2005 Slovenia met the convergence criterion on price stability, the falling inflation trend having been achieved while maintaining the main macroeconomic equilibria. A central role in establishing and maintaining the disinflation trend was played by the Bank of Slovenia's moderately restrictive monetary policy and good coordination of monetary policy with fiscal and other macroeconomic policies. Since joining the ERM II, the Bank of Slovenia has maintained its interest rates at an appropriate level, within the restrictions tied to ensuring exchange rate stability, thus limiting the possibility of an excessive aggregate demand and consequent inflationary pressures. In line with the markets' expectations regarding the introduction of the euro, this year the Bank of Slovenia has adjusted interest rates in the direction of the ECB's interest rates.

The fall in inflation to 2.5% in 2005 was achieved in the context of a favourable macroeconomic environment in Slovenia. Economic growth was 3.9%, which coincides with the equilibrium increase in the economy's supply capacity. Growth in household spending remains behind GDP growth, despite the faster pace of borrowing. Growth in labour costs has long been moderate in comparison with productivity growth, which is limiting the possibility of cost-based inflationary pressures, and is at the same time acting to stimulate an increase in employment and the maintenance of price competitiveness in the real sector. With the coordinated exercise of a wide range of economic policies, the sources of inflation last year were primarily on the supply side. Thus the rapid growth in commodities prices and prices of refined petroleum products on international commodities exchanges made a significant contribution to inflation, while core inflation was merely 0.8%. The low level of core inflation is also the result of certain microeconomic and structural factors associated with competition on international markets that reduced growth in prices of food products, clothing and footwear, and used cars.

The macroeconomic developments projected for the 2006 to 2008 period in Slovenia remain favourable. According to Bank of Slovenia forecasts, economic growth in the coming years will fluctuate around a level in line with the available estimations of growth in potential GDP. Economic growth should amount to 4.2% this year and next year, and to 3.9% in 2008. In the structure of economic growth there is expected to be a shift towards slightly higher growth in domestic demand, while the contribution made by net trade will be smaller, although still positive. Growth in private consumption will remain behind projected economic growth, primarily as a result of the continuing trend of moderate growth in disposable income. After its low rate last year, growth in investment activity should again surpass GDP growth, in particular because of investment spending by the government on the construction of road infrastructure and a faster pace of investment in house-building. The current account deficit could rise slightly in the coming years because of deteriorating terms of trade, which can be attributed to the growth in commodities prices. These negative effects will be partly mitigated by relatively strong growth in real exports, and the current account position could thus hold at a deficit of 2% of GDP over the forecasting period.

The macroeconomic projections for the next medium-term period, insofar as there is no significant change in some of the fundamental assumptions, do not indicate any major risks to price stability. Despite the faster growth in prices of refined petroleum products on international markets, inflation was relatively subdued in the early part of the year, in the context of certain seasonal influences. Given the projected movement in inflation factors, consumer prices should rise by 2.2% this year. In the medium term, inflation projections point to slightly faster growth in free prices. The forecast for headline inflation in 2008 is 2.6%, assuming that energy prices are stable. Among macroeconomic factors, the forecast of slow price movements in the coming three-year period is based on the expected continuation of moderate growth in labour costs and relatively balanced growth in aggregate supply and demand. Despite the significant direct impact of rises in energy prices on inflation in Slovenia, price stability is not threatened, which is indicated by the low level of core inflation and the absence of higher energy prices feeding through into other prices.

The favourable projections of economic trends are exposed to certain macroeconomic risks in the short and medium term. In the international environment the rapid growth in commodities prices is continuing, and these could exceed the current projections used in the forecasts. The very rapid growth in prices of refined petroleum products has recently been particularly prominent. The remaining of the oil price at the current level of around USD 75 per barrel could in the short term raise inflation by approximately 1 percentage point over the baseline scenario. While a rise in prices of refined petroleum products represents the most significant short-term risk, in the medium term the possibility of excess spending and the overheating of the economy will demand the greatest vigilance from economic policymakers. This could also encourage wage growth that is not justified by a corresponding rise in productivity. The overall effects of these factors could trigger a new inflation cycle, and consequently worsen the price competitiveness of the Slovenian economy, slowing economic growth.

Since Slovenia joined the ERM II, the framework for exercising macroeconomic policy has been defined in the Programme for ERM II Entry and Adoption of the Euro adopted by the Bank of Slovenia and the Slovenian government, and the commitments given to the European partners in the communiqué when Slovenia joined. Should the medium-term risk of the overheating of the economy come into effect, a fiscal policy response with an appropriate measure of restrictiveness has been envisaged in this framework. The programme also envisages the maintenance of an appropriate administered prices policy. Growth in administered prices cannot be allowed to outstrip growth in free prices without justification, and thus, given the possibility to exploit monopoly positions, defer the elimination of internal inefficiencies. A lax administered prices policy could also have significant demonstrative effects on other sectors of the economy. In accordance with the programme the social partners are committed to ensuring that increases in wages and other labour costs do not exceed productivity growth in the medium term, thus allowing the positive trends in job creation to be maintained. Given the growing structural imbalances in the labour market, it makes sense to increase labour market flexibility and to take action to train the workforce with regard to needs in fast-growing companies and sectors. Adjustments in markets for products and services should be accelerated, these being aimed at ensuring competition and contributing to greater flexibility in the event of asymmetric shocks in the Slovenian economy.

The coming period brings additional challenges for fiscal policy. The latter has to ensure stability in public finances, which will be based on a clearly defined strategy for the tax system and the avoidance of one-off measures. Given the favourable economic climate, it is extremely important that public finance consolidation be accelerated, thus providing for an adequate safety reserve in the public finance position in order to comply with the rules of public finance discipline in the Stability and Growth Pact. At the same time this would create a sufficient margin of manoeuvre for a counter-cyclical fiscal policy in line with the programme. Directing the projected revenues from EU funds towards further increases in the production capacity of the economy, and not, either directly or indirectly, towards short-term government spending will also be of key importance. The adverse long-term effects of the ageing population will also demand specific adjustments in the financing and disbursement of pensions and health services, thus ensuring long-term sustainability in public finances.

* * *

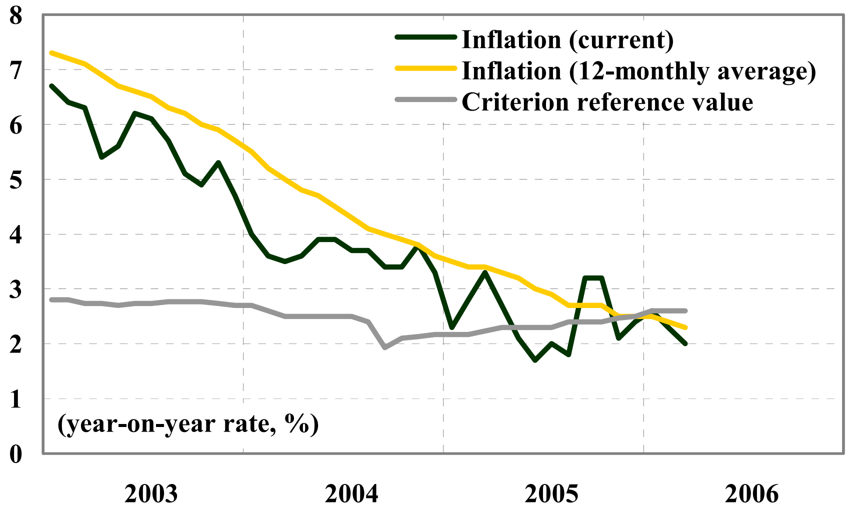
The Governing Board of the Bank of Slovenia assesses that the exercise of economic policy in the coming medium-term period will be the key to establishing the credibility of the framework for exercising macroeconomic policy in the environment of the monetary union as approved in the programme. The fulfilment of the convergence criteria, the favourable forecasts and the positive expectations of European institutions all indicate that Slovenia is ready to introduce the euro. Nevertheless, 2007 brings a high concentration of factors that entail short-term risks to the forecast moderate inflation rate. The actual introduction of the euro is not expected to have a discernable impact on prices, but the possible price effects of a rise in VAT rates, up to 0.7 percentage points, should be noted, as should the price effects of adjustments in excise duties, while signs of a relaxation of administered prices policy can be seen, particularly in the energy sector. All these risks are under the direct control of economic policy, and their realisation would undermine the credibility of this policy. At the same time this could also threaten price stability by feeding through into growth of other prices or labour costs, particularly in the context of inflation risks on the side of excessive growth in aggregate demand and rising prices of refined petroleum products. The period for introducing the euro therefore represents a significant upgrade to macroeconomic policy, which in the future will be constantly exposed to proving its ability to manage macroeconomic risks. Under the current conditions the latter above all requires more pronounced consolidation and greater flexibility in fiscal policy. If the macroeconomic policy responses are right, the long-term benefits of introducing the euro can be relied upon.

# 2 ECONOMIC TRENDS AND INFLATION

**Inflation fell sustainably in 2005 to the level of the price stability criterion**

The level of price stability attained in 2005 guarantees that the conditions for further economic and monetary integration with other members of the eurozone are being met. The fall in inflation in 2005 to 2.5% was achieved in the context of the coordinated application of a broad package of economic policies and favourable trends in the economic environment. Monetary policy ensured that interest rates were at an appropriate level, in line with the objective of exchange rate stability. The neutral fiscal policy position, which under conditions of an upturn in the economic cycle has succeeded in reducing the general government deficit, did not provide any additional stimulus to aggregate demand that could have an inflationary effect. Moderate inflation in administered prices and, in part, the counter-cyclical adjustment of excise duties on refined petroleum products prevented price movements with no justification on a cost basis and slightly reduced the volatility of inflation rates. The relatively slow increase in labour costs allowed companies to maintain stability of their operation and to remain competitive under the conditions of an unchanged exchange rate. In addition to the aforementioned factors, price pressures from the international environment, in particular rises in prices of refined petroleum products, were restricted by microeconomic factors on the markets for food products, clothing and footwear and used cars.

**Figure 2.1: Achievement of price stability**




Sources: SORS, Eurostat, ARC calculation

## 2.1 Macroeconomic Trends

**Macroeconomic trends are mostly in line with expectations**

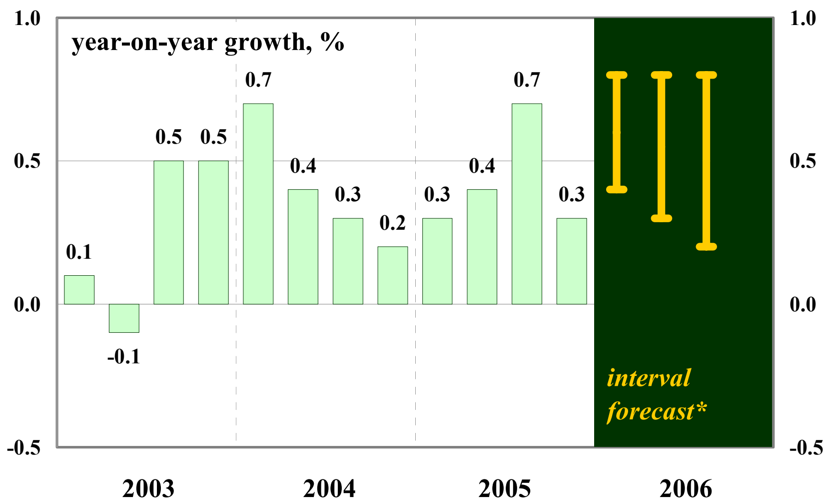
Economic developments over the last six months have taken place without any major shocks and mostly in line with expectations. After a pause at the end of last year, the rise in energy prices continued in the first months of this year, and this was tracked to an increasing extent by prices of other commodities. The economic picture in the eurozone is clearly improving gradually, while inflation trends have remained under control since the ECB began to tighten monetary policy. In the context of a slight cyclical upturn, macroeconomic trends in Slovenia remain in line with expectations, and the increase in aggregate demand has for the moment not deviated significantly from the increase in potential supply. Favourable developments in foreign trade as a result of the successful exploitation of niches on world markets were the main engine of economic growth last year. Employment and wages moved in line with the favourable economic climate, with the components of labour costs continuing to move diversely. A cause for concern is the rise in unemployment, which points to structural imbalances on the labour market.

## International Environment

**Low economic growth in the eurozone at the end of last year and favourable signs at the start of this year**

Economic trends in the eurozone were rather diverse in the final two quarters of last year, but the current indicators and forecasts remain good. After high growth in the third quarter, when GDP in the eurozone rose by 0.7% in real terms from the previous quarter, economic growth was below expectations in the final quarter at just 0.3%. The slowdown in economic activity was linked to slightly lower growth in consumption and a negative contribution from net exports. However, given the favourable conditions of financing, high corporate profits and the projected growth in foreign demand, investment spending remains strong, which indicates that the downturn in the economic climate at the end of last year was probably merely temporary. Further evidence for this comes from the current indicators at the beginning of this year and signs of an improvement in the situation on the labour market. According to European Commission forecasts, economic growth in the first quarter should amount to between 0.4% and 0.8% on a quarterly basis. Under the influence of favourable macroeconomic trends in recent months, in March the ECB also raised its forecast for economic growth this year from last September's figure of between 1.3% and 2.3% to between 1.7% and 2.5%.

**Figure 2.2: Economic growth in the eurozone, including European Commission projections**




Source: European Commission, projections for next three quarters, April 2006

**Rapid growth in commodities prices is continuing on international markets**

Energy prices and prices of other commodities continue to rise rapidly on exchanges. At the end of last year the price of crude oil fell slightly from the highs that it recorded after the hurricanes in the Gulf of Mexico at the end of the summer. With the Iranian nuclear question still unresolved, unrest in Nigeria and the continuing strengthening of global demand, oil prices began to rise again at the beginning of this year, reaching a record high of USD 70 per barrel in the middle of April. The rise in prices of refined petroleum products has been additionally exacerbated by the bottleneck in the processing of crude, with repairs to the refineries damaged during the hurricanes in the Gulf of Mexico being delayed slightly. Prices of other commodities have also been accelerating in the recent period, in particular metals prices, which have gained more than 30% on average in the last half a year.

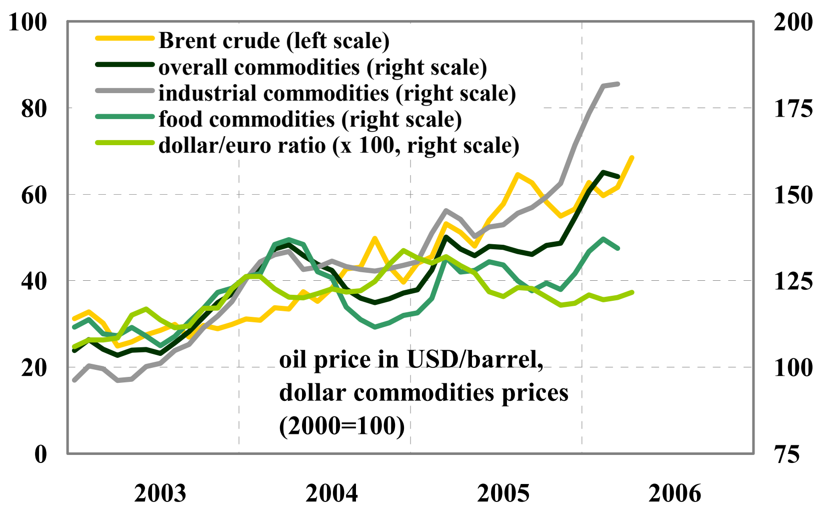
**Inflation trends in the international environment remain under the control of central banks**

Despite the significant rise in commodities prices, inflation trends in the international environment remain relatively settled for the moment. At 2.2%, last year's inflation in the eurozone exceeded the ECB's medium-term target for the sixth consecutive year, but core inflation excluding food and oil prices remains low, having fluctuated around 1.4% in the last year. The inflation trends are similar in the USA, where headline inflation rose to 3.4% last year, while core inflation has been fluctuating around 2.1% in the last 12 months. The most evident threat to price stability remains the aforementioned rise in oil prices, which has also been joined in the last half a year by the increased pace of rises in prices of other commodities. These risks, underpinned with the long-standing high liquidity in the eurozone, were also the reason for the ECB beginning to tighten its monetary policy, the bank raising its key interest rates by 25 basis points first in December of last year, and then again this March. Monetary tightening has already been underway in the USA for almost two years, with the authorities continually but gradually raising interest rates since June 2004, by 25 basis points each time. The Fed's greater activity was partly facilitated by the better macroeconomic picture, while the real estate market in the USA has for some time shown signs of overheating, thereby providing an additional risk to both price stability and general macroeconomic stability.

**The interest rate spread affected the movement of the euro/dllar exchange rate**

The faster tightening of monetary policy in the USA gave rise to a significant interest rate spread with the eurozone, and this was also reflected in the movement of the euro/dollar exchange rate. Three years of dollar depreciation (between the beginning of 2002 and the beginning of 2005 the dollar lost almost 50% of its value against the euro) thus came to a temporary end, with the dollar returning to a level of 1.20 against the euro from 1.35 in the first half of 2005, and it has remained relatively stable around this level for the last ten months. While dollar depreciation in the past was an important mitigating factor in high dollar commodities prices feeding through into inflation in the eurozone and also Slovenia, these positive effects of exchange rate movements have been absent in the last year.

**Figure 2.3: Oil prices, commodities prices and euro/dollar exchange rate**



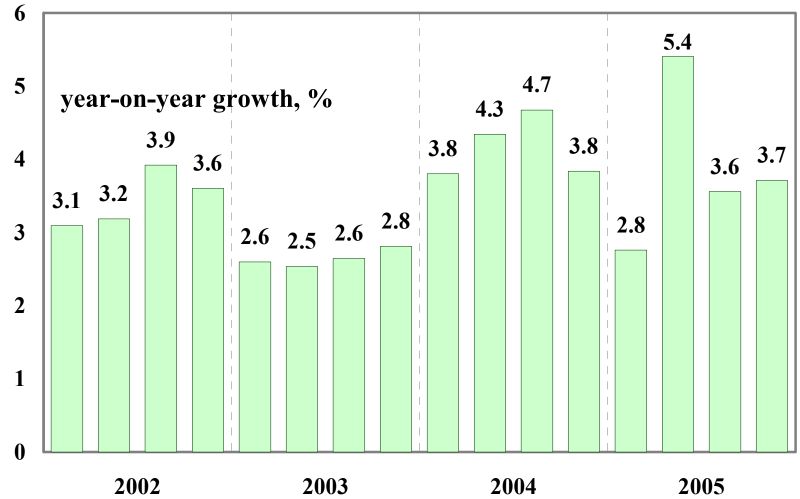

Sources: Reuters, The Economist; ARC calculations

## Economic Activity

**Economic growth was 3.9% last year according to current estimates**

Current estimates of aggregate economic activity for the second half of last year are slightly lower than the previous estimates, but not significantly. GDP grew by 3.9% in real terms on average last year, 0.2 percentage points less than the figure in the Bank of Slovenia's autumn forecast, and 0.3 percentage points less than in the previous year. Nevertheless, last year's economic growth was relatively high, and was approximately in line with the estimated growth in potential GDP. In the quarterly breakdown, there was significantly uneven growth in the first half of the year, and growth was slightly below expectations in the final quarter, current indicators having pointed to the possibility of slightly greater impetus at the end of the year. The output gap had practically closed last year (see Figure 2.8), but in the context of the relatively slow dynamic in the second half of the year aggregate demand is not causing any inflationary pressures for the moment.

**Figure 2.4: GDP growth by quarter**

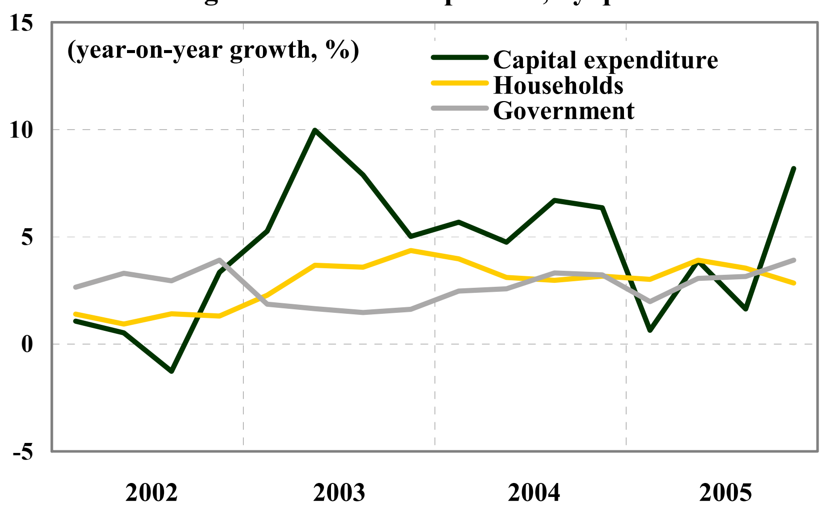



Sources: SORS, ARC calculation

**A high contribution by net trade in the context of moderate domestic consumption…**

The largest contributor to economic growth last year, accounting for 2.3 percentage points, was net trade, the gap between growth in exports of goods and services and growth in imports of goods and services expanding. Despite low

**Figure 2.5: GDP components, by quarter**




Sources: SORS, ARC calculation

domestic consumption in the main trading partners, some Slovenian companies, particularly in the automotive and steel sectors, succeeded in significantly improving their export performance, while movements on the import side were slightly slower, in part because of low investment spending and a decrease in inventories. The positive effect of the gap between export growth and import growth gradually declined towards the end of the year, while domestic consumption picked up slightly. Among the components of the latter, on average over the year the fastest growth, though still sustainable, was recorded by household spending, which rose by 3.3%, while similar growth of 3.0% was recorded by government spending, which strengthened slightly further at the end of the year; gross capital formation declined by 3.0%, primarily because of a decline in inventories.

**…and weak investment activity, which strengthened again in the final quarter**

Of all the components of GDP, the negative growth in gross capital formation was the most out of step with the previous forecasts. Capital expenditure recorded positive growth of 3.7% on average over the year, entirely comparable to the average in the previous five years, while after three years of accumulation the decline in inventories reduced economic growth by 1.7 percentage points. The significant increase in the current rate of growth in capital expenditure in the final quarter, which was partly a consequence of the abolition of relief for certain investments, indicates that investment activities remain strong, in line with the currently favourable terms of financing, while the signs also remain favourable for higher economic growth.

## Box 2.1: Investments in 2005

After several years of solid growth, gross capital formation in 2005 was down from the previous year. The main factor in the decrease in gross capital formation was the decline in inventories, which had grown for the three preceding years. There was significant diversity in the movement of individual components of capital expenditure, and they reflected changes in the institutional environment for companies and government decisions more than the favourable trends in the macroeconomic environment.

The fastest-growing component of gross capital formation in 2005 was investments in housing, which were driven by the release of funds from the National Housing Savings Scheme (NHSS) and the favourable terms of financing offered by commercial banks. Sales of land by municipalities in 2005 and the large number of building permits issued in the last few quarters indicate that the high rate of growth in housebuilding could continue in 2006. Investments in other buildings and structures, which include civil engineering structures and thus reflect the investment focus of the government, grew significantly more slowly than the overall growth in investments in 2005.

**Table: Changes in capital expenditure, 1998 to 2005**

| | 1998 | 1999 | 2000 | 2001 | 2002 | 2003 | 2004 | 2005 | 2005 |
|---|---|---|---|---|---|---|---|---|---|
| | | | | *real growth, %* | | | | | share (%) |
| **Capital expenditure** | **9.3** | **18.2** | **1.8** | **0.4** | **0.9** | **7.1** | **5.9** | **3.7** | **100.0** |
| **Buildings and structures** | **5.2** | **11.6** | **1.9** | **-5.5** | **4.1** | **5.3** | **2.7** | **4.1** | **54.0** |
| Housing | 4.8 | 7.8 | -10.2 | 0.6 | 2.8 | -13.2 | 5.5 | 13.7 | 13.8 |
| Other buildings and structures | 5.4 | 13.3 | 7.0 | -7.7 | 4.6 | 12.3 | 1.9 | 1.1 | 40.2 |
| **Plant and equipment** | **15.6** | **24.1** | **3.5** | **6.4** | **-2.7** | **11.4** | **9.4** | **2.9** | **42.1** |
| Transport equipment | 25.7 | 9.5 | 19.6 | 0.8 | -3.4 | 9.5 | 12.2 | -1.9 | 9.1 |
| Other plant and equipment | 13.4 | 27.8 | -0.1 | 8.0 | -2.5 | 12.0 | 8.6 | 4.3 | 33.0 |
| **Basic livestock and perennial plantations** | **-33.1** | **30.6** | **-58.3** | **43.3** | **31.4** | **-21.8** | **2.2** | **1.0** | **0.4** |
| **Other products** | **8.2** | **42.9** | **-6.0** | **7.6** | **-1.8** | **-11.5** | **10.1** | **8.6** | **3.4** |

Sources: SORS, ARC calculation

Among the more important components of capital expenditure, the largest decline in 2005 was recorded by investments in means of transport, in contrast with 2004, when this was the fastest-growing component. The rapid growth recorded in 2004 by investments in means of transport, which is one of the most variable components of investment, was linked above all to the opening of the market for used cars when Slovenia joined the EU.

## The Labour Market

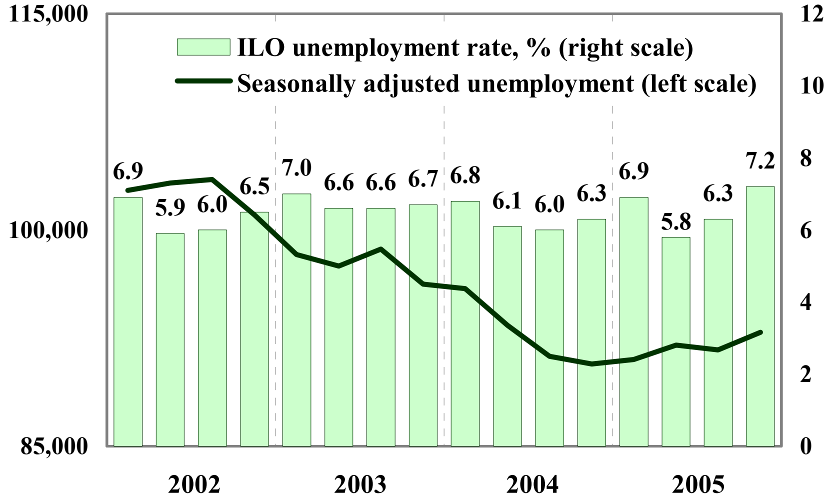
**There were divergent trends on the labour market in 2005**

Developments on the labour market in 2005 began to show signs of divergent movement in employment and unemployment. While employment increased in line with the favourable economic activity, recording average annual growth of 0.7% according to the national accounts figures, there was no corresponding fall in unemployment. The overall rise in employment originated in the increase in the workforce. Employment increased most in commercial services, and new jobs continued to be created in the government sector, while employment fell in basic industries, particularly in labour-intensive sectors.

**The fall in unemployment stopped last year**

Last year brought an end to the long period of falling unemployment that began in 1998, with the exception of a brief cyclical interruption at the end of 2001. The number of people registered as unemployed with the Employment Service at the end of the year was 2.0% higher than at the end of the previous year, while the surveyed level of unemployment also leapt at the end of the year, reaching a relatively high 7.2% in the final quarter. The principal reason for the rise in unemployment last year was the large number of bankruptcies, particularly in labour-intensive sectors such as the textile industry. Rising unemployment under relatively favourable conditions in the cycle could point to the presence of structural problems on the labour market.

**Figure 2.6: Unemployment**




Sources: SORS, ARC calculation

**Growth in labour costs remains moderate…**

Growth in labour costs remained moderate last year, which became particularly clear after the revised wage figures were published (see Box 2.2). The average gross wage grew by 2.2% in real terms over the whole of last year. However, with GDP growing by 3.9% in real terms and employment growing by 0.7%, the estimated growth in labour productivity was 3.1%. As a result, the provision of the social agreement that envisages a gap of 1 percentage point between growth in real gross wages per employee and labour productivity growth was practically fulfilled.

### Box 2.2: Labour costs in 2005

Various indicators are used to analyse the movement of labour costs. Among the most common labour cost indicators available in Slovenia are internationally comparable figures on compensation of employees from the national accounts, figures on labour costs per hour worked, figures on the movement of gross wages, which are usually the most up-to-date, and the derived indicator of unit labour costs, which is the most commonly used indicator in analysis of the competitiveness of the economy.

The movement of components of labour costs is also usually of interest. The Bank of Slovenia monitors the movement of components of labour costs using a compound indicator that allows for the change in average gross wages (SORS), other employment earnings (APLRRS) and other taxes not included in gross wages (MoF). By contrast, labour costs per hour worked, which are published by the SORS, are divided into a wage component and other labour costs. The figures for 2005 show highly contradictory movements in individual components, which is primarily the result of developments in the context of changes in tax legislation in 2004.[1] While growth in gross wages was reasonably steady, other employment earnings were nominally down on the previous year.

There were several revisions made to indicators of labour costs in 2005 and the early part of 2006. The largest revisions were made to the figures for wages and labour costs per hour worked. There were methodological changes made in the statistical monitoring of wages in 2005, with private sector legal entities with one or two employees being included in the figures. Because of this change in methodology, the published wage figures originally recorded wage growth in 2005 that was excessive.[2] In December 2005 the SORS revised the wage figures for January 2004 to September 2005. The revision reduced the average monthly gross wage for the first ten months of 2005 by approximately 450 tolars, and raised the average figure for 2004 by approximately 3,200 tolars. Average growth in the average gross wage over the first nine months of the year thus fell by 1.7 percentage points. When publishing the figures for labour costs per hour worked for the final quarter of 2005 in March 2006, in line with the aforementioned revision of the wage figures and in accordance with improved methodology the SORS also revised these figures. The average growth in labour costs per hour worked in the first three quarters of 2005 was thus revised downwards by approximately 1.0 percentage points.

On the basis of a review of the indicators of labour costs, they could be said to have been relatively favourable in 2005. Judging by the Bank of Slovenia's two estimates for the movement of unit labour costs, which in previous years represented the lower and upper limits for unit labour costs according to the national accounts, their growth in 2005 adjusted by the GDP deflator ranged from -0.3% to 0.7%, or 1.5 percentage points less than this if price effects are eliminated by adjusting for the consumer price index.

[1] For more, see Box 2.2: Methodological, tax and structural changes, and wages and labour costs in 2005, Monetary Policy Report, November 2005

[2] This "excessive" wage growth was also used in the European Commission autumn 2005 projections that Eurostat used to forecast total labour costs and unit labour costs for 2005, which were among the fastest-growing in the EU25. Allowing for the revision to wage movements, the unit labour costs calculated in this manner would be entirely comparable to those of other countries

**Table: Indicators of labour costs**

| year-on-year growth, % | average 96-00 | average 01-05 | 2000 | 2001 | 2002 | 2003 | 2004 | 2005 |
|---|---|---|---|---|---|---|---|---|
| **Unit labour costs (real)** | | | | | | | | |
| Eurostat (national accounts)*/** | -1.5 | -0.3 | 3.3 | 0.4 | -1.3 | -1.0 | 0.6 | na |
| ARC (average gross wage)** | -1.3 | -0.2 | 1.6 | 0.8 | -0.2 | -1.2 | -1.3 | 0.7 |
| ARC (APLRRS figures)**/*** | -0.7 | -0.1 | 2.3 | 0.4 | -1.7 | -1.0 | 2.2 | -0.3 |
| ARC (manufacturing)** | -2.0 | -1.5 | -2.2 | -1.9 | -2.8 | -0.9 | -2.4 | 0.9 |
| **Total labour costs (nominal)** | | | | | | | | |
| SORS (per hour worked)**** | 11.0 | 8.0 | 12.8 | 13.8 | 4.8 | 8.2 | 7.0 | 6.3 |
| - wages | 11.0 | 7.7 | 13.3 | 13.2 | 4.5 | 7.9 | 6.8 | 5.8 |
| - labour costs other than wages | 11.1 | 9.6 | 10.5 | 16.8 | 5.8 | 9.3 | 8.0 | 7.9 |
| SORS (compensation of employees - nat. acc.)** | 10.8 | 9.7 | 14.1 | 12.7 | 10.1 | 7.8 | 8.2 | na |
| Bank of Slovenia estimate (ARC) | 10.6 | 8.2 | 11.0 | 11.7 | 9.5 | 7.5 | 6.4 | 3.1 |
| - gross wages*** | 10.7 | 8.2 | 10.6 | 11.9 | 9.8 | 7.5 | 4.6 | 4.9 |
| - other employment earnings | 8.5 | 6.1 | 11.5 | 6.2 | 6.4 | 4.5 | 14.6 | -6.9 |
| - other taxes | 12.4 | 10.4 | 11.9 | 16.8 | 11.4 | 10.3 | 7.1 | 5.2 |
| Memo: - consumer price index | 8.0 | 5.5 | 8.9 | 8.5 | 7.5 | 5.6 | 3.6 | 2.5 |
| - GDP deflator | 6.9 | 5.3 | 5.6 | 8.7 | 8.0 | 5.9 | 2.9 | 1.0 |

*Only annual figures for 1995/2004 available
**Adjusted for GDP deflator
***Change in methodology in 2004
****Eurostat methodology; figures available from Q1 of 1997
Sources: SORS, APRRLS, ARC calculations

**…particularly allowing for tax changes and other employment earnings**

Numerous tax changes also had a significant impact on labour costs last year. First, the cost of labour for companies was reduced by a cut in the taxation of labour in the form of payroll tax, which entered into force in September 2004. Second, the increase in the general income tax relief in January 2005 and certain other changes resulted in net wages growing 1.3 percentage points faster than gross wages, meaning that employees' earnings, and consequently their purchasing power, grew relative to the labour costs incurred by companies. Third, changes in the income tax levied on intellectual contract-based work resulted in a shift in the structure of earnings away from intellectual contract-based payments to wage payments. This means that the figures for growth in average gross wages still slightly overestimate the actual increase in labour costs, as consideration needs to be made of the decline in other earnings from employment, which was 6.9% on average last year. The slow growth in labour costs is thus still not causing any inflationary pressures of a cost nature, while at the same time the competitiveness of companies is increasing, giving them greater opportunities to create jobs.

## Balance of Payments

**The current account deficit in 2005 was lower than in 2004…**

According to current estimates, the current account deficit last year was down just under one-half from the previous year, and was slightly lower than had been previously forecast. In the context of a significant deterioration in the terms of trade and a record surplus in trade in services, the current account deficit reached just over EUR 300 million last year, or 1.1% of GDP.

**…despite a significant deterioration in the terms of trade, thanks to a larger surplus in trade in services,…**

Despite a deterioration of 2.6% in the terms of trade, the deficit in merchandise trade remained practically at the level recorded in 2004. In the context of low foreign demand, the main factors in this were good export results in the automotive and steel industries, while owing to low domestic consumption, a decline in inventories and slow investment activity growth in imports was slightly lower than previously forecast. Another factor in low year-on-year growth in imports in 2005 was the lower volume of major one-off import deals that in the period leading up to Slovenia joining the EU had been associated with the expected changes in the foreign trade regime. On the export side, the largest increase was recorded by trade with France, the year-on-year growth of 42.2% in these exports taking it to fourth place among Slovenia's most important export markets. There was also rapid growth in exports to Austria, while below-average growth was recorded by exports to Italy, and in particular Germany and the USA, exports to the latter actually declining by more than one-quarter. The main contributors to the surplus in trade in services, which stood at just under EUR 900 million last year, were tourism and transport.

**…lower outflows in labour and capital income, and higher current transfers**

The negative position in labour and capital income contracted slightly last year, while the positive contribution by current transfers rose slightly. The surplus in labour income has been falling for some time now, and did so again last year, when it decreased by EUR 11 million. The deficit in capital income was EUR 35 million smaller than in 2004, while the surplus in current transfers rose by EUR 32 million.

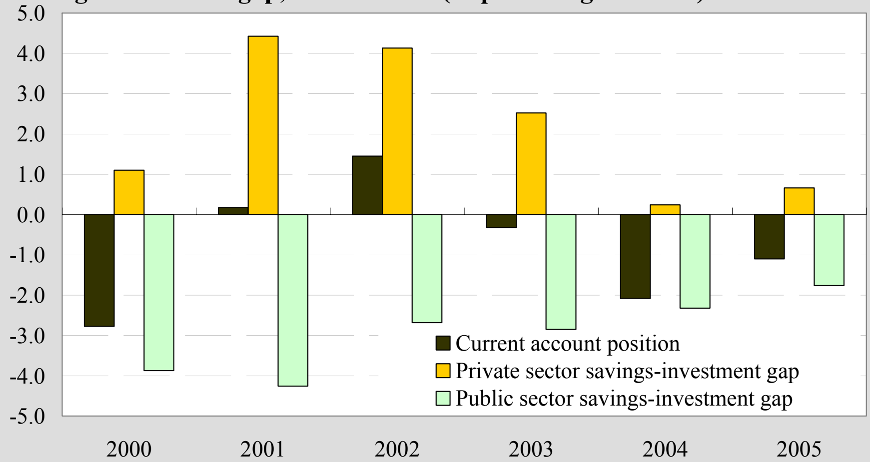
### Box 2.3: Structuring of the savings-investment gaps in 2005

Both an increase in the positive savings-investment gap in the private sector and a decrease in the negative gap between savings and investment in the public sector contributed to the contraction in the current account deficit from just over 2% of GDP in 2004 to approximately 1% of GDP in 2005.

The public sector accounted for approximately 60% of the closure of the aggregate gap in 2005, and the private sector for 40%. The main factor in the closure of the gap in the private sector was increased saving, while the public sector recorded a slight increase in saving, and also a decrease in investments.

These developments in 2005 were a considerable improvement, and in terms of the behaviour of the private sector represented a turnaround from the preceding two years, when the current account deficit increased primarily as a result of the decline in the private sector's surplus. This came to pass primarily in the context of an increase in private sector investment, in particular before Slovenia joined the EU, and lower saving under the conditions of the nominal convergence of interest rates. The impact of the public sector between 2002 and 2004 was fairly neutral, and in cumulative terms it even contributed to the closure of the aggregate savings-investment gap with an increase in saving and a restrictive investment policy.

**Figure: Savings-investment gap, 2000 to 2005 (as percentage of GDP)**




Sources: SORS, Ministry of Finance, ARC calculations

## Terms of Financing

**Economic activity supported by high financial inflows…**

Relatively strong economic activity and increased flows with the rest of the world were the main features of the economic trends that last year affected the terms of financing for the national economy. The net financial inflow in 2005 was a relatively high EUR 1.5 billion or 5.5% of GDP, which is considerably more than had been previously forecast. The largest proportion of the increase on 2004 in the net financial flow was brought by higher private sector borrowing, in particular by banks, which recorded net borrowing of EUR 2.1 billion abroad last year in their search for sources of financing. Last year financial outflows via outward FDI were almost exactly equal to the financial inflows from inward FDI. Also among the more important items on the outward side of the balance of payments are portfolio investments in foreign securities, which accounted for an outflow of EUR 1.2 billion, while the early part of this year has also seen increasing interest in the Slovenian capital market on the part of foreign investors after demand fell away in the second half of 2005.

**…and high domestic lending activity**

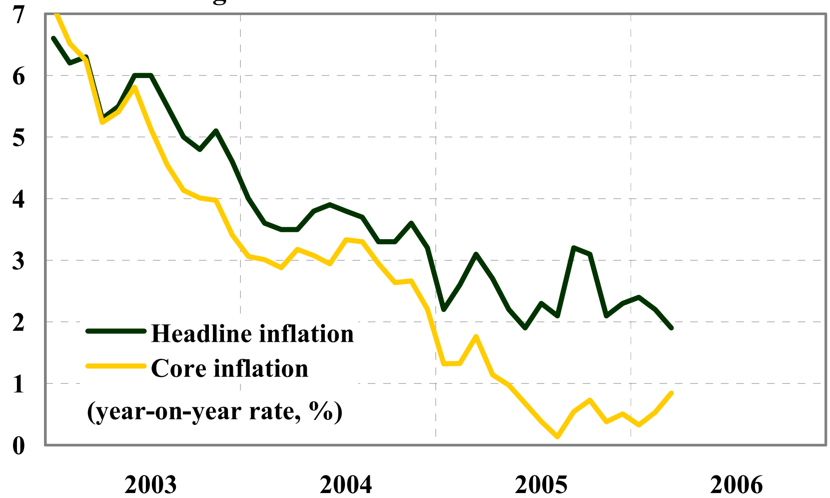
Domestic lending also grew relatively rapidly last year, at year-on-year growth rates of just over 20%, while borrowing abroad also increased. In comparison with 2004, there was a shift away from companies financing themselves directly via loans from abroad to financing based mostly on foreign currency loans approved at domestic commercial banks.

## 2.2 Inflation Factors

**Inflation continued to fall last year**

Inflation trends were favourable last year, and the fall in inflation continued in the first quarter of this year. Consumer prices rose by 2.5% on average last year, 1.1 percentage points less than in 2004. Thus inflation fell again last year, but at a significantly slower rate, which was primarily restricted by the rapid growth in energy prices The only way to maintain a reduction in headline inflation was therefore the decline in core inflation,[1] which averaged just 0.8% last year. This decline more than compensated for the 12.2% growth in energy prices. The fall in inflation also continued in the early part of this year, but was primarily the result of slower growth in prices of seasonal products, while growth in energy prices remained high. From its very low rates there was also a slight increase in core inflation, which stood at 0.8% year-on-year in March, thus reaching its average level from last year.

**Figure 2.7: Headline and core inflation**




Sources: SORS, ARC calculations

**Low wage growth, limited domestic consumption and the negative output gap acted to curb inflation**

The majority of the indicators of the macroeconomic environment show that developments in the economy last year favoured a further fall in core inflation. The movement of labour costs was favourable last year, and growth remained moderate. Real growth in average gross wages, which are estimated to account for between 70% and 80% of total labour costs, amounted to just 2.2%. Growth in labour costs again remained just under 1 percentage point behind productivity growth last year, and thus did not give rise to any inflationary pressures. The low wage growth was supported mainly by tougher conditions on the labour market, with employment only rising on account of an increase in the workforce. The absence of inflationary pressures was not merely on the side of cost factors, but was also seen in demand factors. The increase in economic growth did not originate from faster domestic consumption, but mostly from the increase in the contribution by net trade. Growth in domestic consumption last year was moderate in terms of both households and the government sector, while growth in investment spending was also low. The faster economic growth recorded in the last two years has already almost closed the negative output gap, which last year was still negative, and thus acted to reduce inflation. According to our estimates, the output gap in 2005 should have averaged approximately -0.2% of potential GDP, although European Commission estimates[2] put it larger still at

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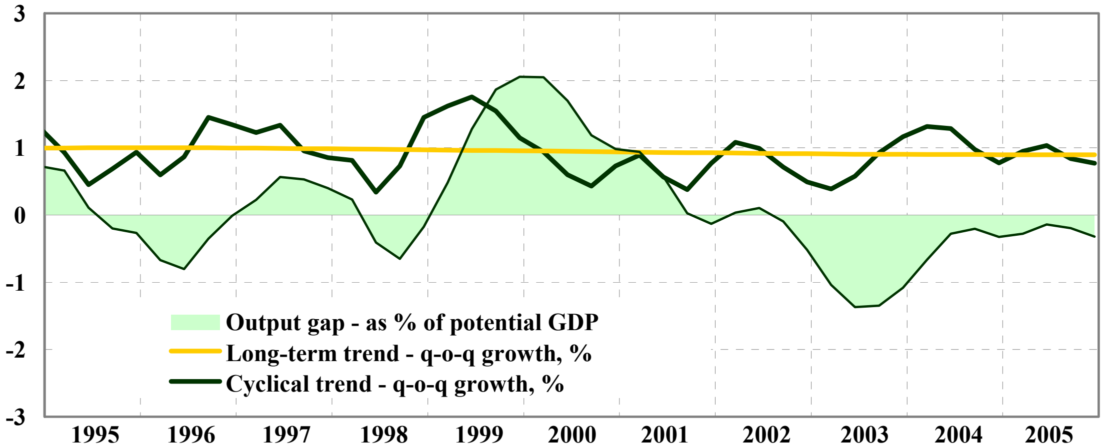
[1] Core inflation measures changes in consumer prices excluding changes in energy prices, prices of seasonal products and the influence of tax changes

[2] The European Commission estimates are based on information in the December 2005 convergence programme: http://europa.eu.int/comm/economy_finance/about/activities/sgp/country/commass/sl/ass_sl20052006.pdf

approximately -1.2% of potential GDP, and forecast the gap to remain negative until 2008.

**Figure 2.8: Output gap developments between 1995 and 2005**




Source: ARC estimates

**Unfavourable developments in the international environment caused most inflationary pressures**

Factors in the international environment mostly acted to increase inflation last year. The gradual recovery of the world economy over the last two years resulted in unexpectedly high growth in demand for oil, for which producers were unprepared. The high demand for oil exceeded the short-term limits on pumping and refining capacity, causing a sharp rise in prices. Supply was further restricted by unpredictable natural disasters, attacks on oil pipelines and political tensions in the Middle East. Dollar oil prices rose on average by approximately 75% in the last two years and by approximately 90% in the last three years, and there was no let-up in the pace of growth in the early part of this year. Import prices were pushed even further up by the slow appreciation of the dollar against the tolar last year caused by interest rate rises in the USA and the widening of the spread between American and European interest rates. In addition, with the ECB's interest rates unchanged, there was rising liquidity in the eurozone, which was partly reflected on the Slovenian market owing to the process of nominal interest rate convergence. However the import of part of the surplus liquidity did not cause a demand shock, and therefore did not have a significant impact on domestic inflation movements.

**Coordinated and credible economic policies limited inflationary expectations**

Inflationary expectations also eased last year in line with the fall in inflation. Action coordinated between the Bank of Slovenia and the Slovenian government also restricted inflationary pressures last year. With the policy of gradual nominal interest rate convergence the Bank of Slovenia held its interest rates above those of the ECB, but still in line with the maintenance of stability in the nominal tolar exchange rate against the euro. The interest rate spread on long-term securities thus remained at a level between 0.0 and 0.5 percentage points, which indicates the financial markets' confidence in the success of the previous disinflation process and sustainable inflation in the future. An additional brake on inflation was provided last year by the stable exchange rate, which has remained close to the central rate ever since Slovenia joined the ERM II.

**Administrative government measures were fairly neutral from the inflation point of view**

The government tried to mitigate the transmission of high oil prices on world markets into domestic prices by making counter-cyclical adjustments to excise duties on refined petroleum products, and also adjusted other excise duties in accordance with EU legislation. Despite the counter-cyclical adjustments in excise duties, prices of refined petroleum products rose by 9.5% last year to December, accounting for approximately 0.9 percentage points of the year-on-year inflation rate of 2.3%. The policy of adjusting excise duties merely diminishes the fluctuation in prices, and cannot prevent the rising trend.

Estimates show that had excise duties not been adjusted last year, remaining instead at the average level in 2004, inflation would only be less than 0.1 percentage points higher. Longer-term analysis also indicates that over the long term there are no major effects on inflation, while the amplitude of the fluctuation in counter-cyclical adjustment can be one-third smaller.[3] In addition, the government was restricted by an EU directive on the minimum allowable excise duties on refined petroleum products, this level having already been reached in the first half of last year. The government also raised excise duties on tobacco products last year in line with European legislation. Because the tolar exchange rate against the euro has been stable since the middle of 2004, the adjustment of excise duties on tobacco in January 2005 was smaller than in previous years. The effect on inflation of the rise in tobacco duties therefore amounted merely to just over 0.3 percentage points last year, while this year the figure is likely to be around 0.2 percentage points. The Excise Duty Act envisages three further adjustments in the period to 2008, in July of this year, July 2007 and January 2008, which should be the final adjustment. The total contribution to inflation of these increases could amount to between 0.4 and 0.5 percentage points.

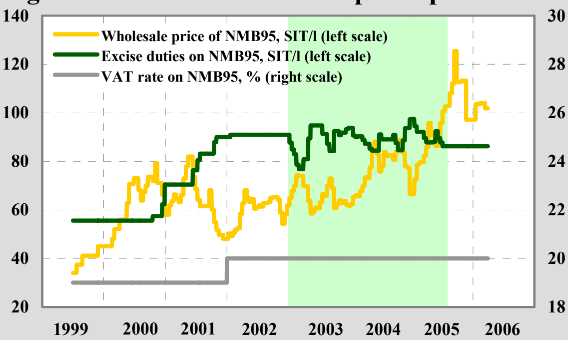
## Box 2.4: Price setting for refined petroleum products and the effect of excise duty policy on inflation

Price setting for refined petroleum products is rather specific in Slovenia, as it is partly market-based, and partly under the influence of policymakers. The adjustment of a portion of the retail prices to the movement of prices in world exchanges is market-based, while retailers do not have a free choice in setting their own price policy, which is the same for all retailers. Prices of refined petroleum products in Slovenia thus depend on the level of prices of refined petroleum products on the Mediterranean exchange ($P^*$), the movement of the exchange rate of the dollar against the tolar ($e_{usd}$), the margin of domestic retailers ($M$), the contribution to oil-stock reserves ($r$), and indirect taxes, excise duties ($TR$) and VAT, while heating oil is also subject to a carbon emission tax.

$$P = \overline{P^* e_{usd}} + r + M + TR + VAT \qquad (1)$$

This price formation allows domestic oil retailers to trade at almost no risk, and ensures that there is sufficient coverage of infrastructure depreciation to maintain the supply of refined petroleum products undisrupted in Slovenia. Excise duties and VAT provide additional sources of general government revenue, and in the event of sound public finances represent a lever for supporting other economic policies in attaining their objectives. The excise duty policy can thus on one hand pursue the objectives of sustainable public finances and act as a fiscal stabiliser, or on the other can mitigate retail prices by counter-cyclical adjustments to oil shocks, reducing risks and the costs associated with them.

**Figure 1: Structure of NMB95 petrol price**




Source: Petrol, ARC calculations

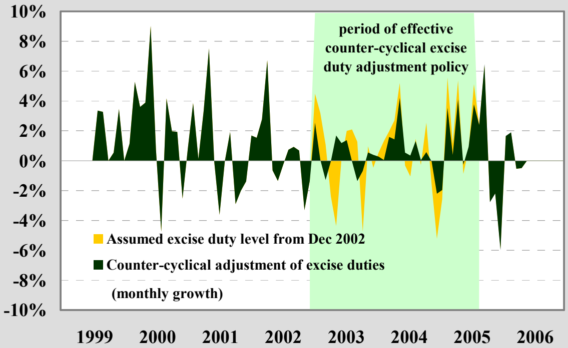
Alongside an appropriate monetary policy, a policy of counter-cyclical management of excise duties can contribute to a reduction in inflationary expectations, thus limiting the indirect transmission of oil shocks into other prices.

From the middle of 1999, when excise duties were introduced, until the end of 2002, excise duty policy in Slovenia pursued the objective of consolidation of the general government budget, but after 2002 it aimed to mitigate the transmission of high oil price fluctuations on world markets into the domestic economy (see Figure 1). During the poorer economic climate in 2001 and 2002 the government raised excise duties on petrol in order to partly make up for a loss of fiscal revenues, which was additionally facilitated by the fall in oil prices during that period. The rise in excise duties therefore did not cause any additional pressures on inflation. The figures even show that the rise in energy prices during this period contributed to a fall in inflation (Figure 2.9), which could not be

[3] More information about the price setting for refined petroleum products and the effectiveness of the policy of counter-cyclical adjustment of excise duties is given in Box 2.4

said of the last three years. The optimistic forecasts regarding the future climate and the relatively high level of excise duties at the end of 2002 allowed for a policy in the next three years of counter-cyclical excise duty adjustments, which mainly limited the fluctuation of retail prices of refined petroleum products, but did not restrict the growth trend.

**Figure 2: Monthly growth in NMB95 petrol price**




Source: Petrol, ARC calculations

The figures show that during the period of effective counter-cyclical adjustment of excise duties (January 2003 to July 2005), the fluctuation in the monthly growth of the retail price of the best-selling petrol NMB95 was one-third less than it would have been had the excise duties not been adjusted and been left at their level of the end of 2002. The figures for the average monthly growth in the NMB95 retail price also indicate the success of this policy. This averaged 0.74%, just 0.05 percentage points less than the average monthly growth would have been in the event of excise duties being left unchanged. The direct effect of the counter-cyclical adjustment of excise duties on inflation was therefore relatively small, approximately 0.07 percentage points on average each year. The impact of the counter-cyclical excise duty policy on inflation in the period for measuring the Maastricht price stability criterion was even more negligible, excise duty levels having remained unchanged for two-thirds of the period in question.

**Table 1: Excise duty policy (NMB95)**

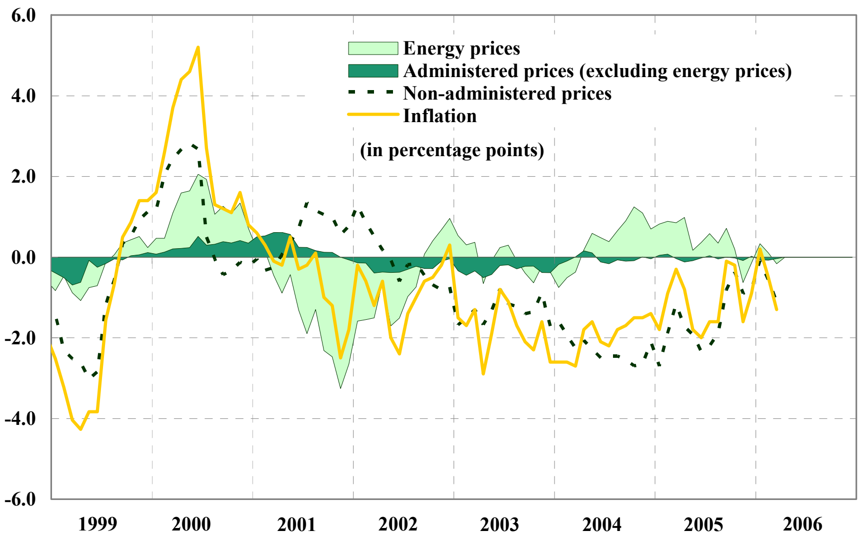
| | period | counter-cyclical adjustment | without adjustment |
|---|---|---|---|
| Average monthly growth | Jan 99 - Dec 02 | 1.24% | |
| | Jan 03 - Jul 05 | 0.74% | 0.81% |
| | Aug 05 - Apr 06 | 0.04% | 0.05% |
| Standard deviation | Jan 99 - Dec 02 | 0.03 pp | |
| | Jan 03 - Jul 05 | 0.02 pp | 0.03 pp |
| | Aug 05 - Apr 06 | 0.04 pp | 0.04 pp |

Sources: Petrol, ARC calculations

**Growth in some administered prices again strongly outstripped growth in free prices last year**

The administered prices policy was not the most consistent last year, with growth in administered prices excluding energy prices again outpacing growth in free prices. Year-on-year growth in administered prices excluding energy prices amounted to 4.3% last December, with growth in residential heating prices (17.5%), road tolls (9.1%) and prices of textbooks (5.4%) particularly prominent. Growth in prices of municipal services excluding residential heating was below-average last year, and in certain instances was even negative. Although growth in

**Figure 2.9: Contributions of individual price categories to headline inflation**



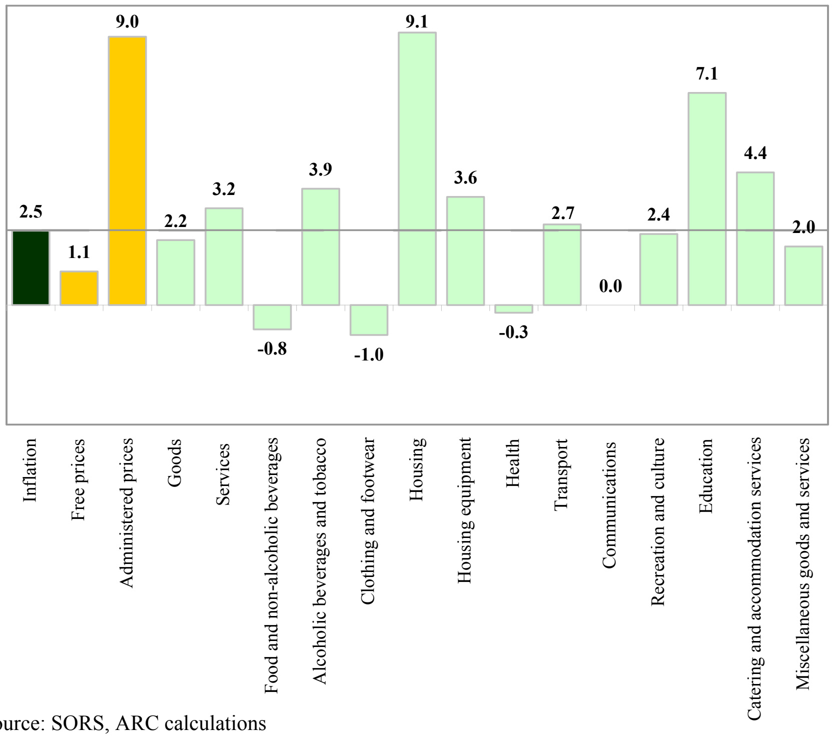

Source: ARC

administered prices excluding energy prices outpaced growth in free prices, this did not have a significant impact on year-on-year inflation. Figure 2.9 shows the effects of changes in individual categories of prices on year-on-year inflation, implying inflation pressures caused by individual categories can be estimated. The figures show that the movement of administered prices other than energy prices acted to speed up inflation in 2000 and 2001, while the gradual slowdown in growth in these prices in 2002 and 2003 supported the disinflation process. The administered prices policy only became more or less neutral from the point of view of the impact on inflation in the last two years, when growth in administered prices (excluding energy prices) eased to 4%. Inflation developments in the last two years were thus primarily the result of faster growth in energy prices on one hand, and the gradual slowdown of growth in free prices on the other. Because the impact of the latter was stronger, the trend of falling inflation continued over the last two years. The disinflation process was thus strongest in 2001 and 2003, but has begun to gradually slow down in the last two years.

**Diverse movements in the structure of inflation**

The movement of prices of individual categories of products and services within the structure of inflation was considerably more diverse last year than in previous years, with growth in prices deviating significantly from the average. Growth in some categories of prices was well below average, while growth in others was well above average. Prices of clothing and footwear fell on average by 1.0% last year, food prices by 0.8% and prices of health services by 0.3%. The average level of prices of communications services remained unchanged last year. Housing costs, prices of household equipment, alcoholic beverages and tobacco, prices of education services and prices of catering and accommodation services all recorded above-average increases, while growth in prices of transport services and services of recreation and culture was close to the 2.5% level of average inflation.

**Figure 2.10: Structure of inflation in 2005**




Source: SORS, ARC calculations

**Global competition from China and the excess supply of used cars more than neutralised the high growth in prices of refined petroleum products**

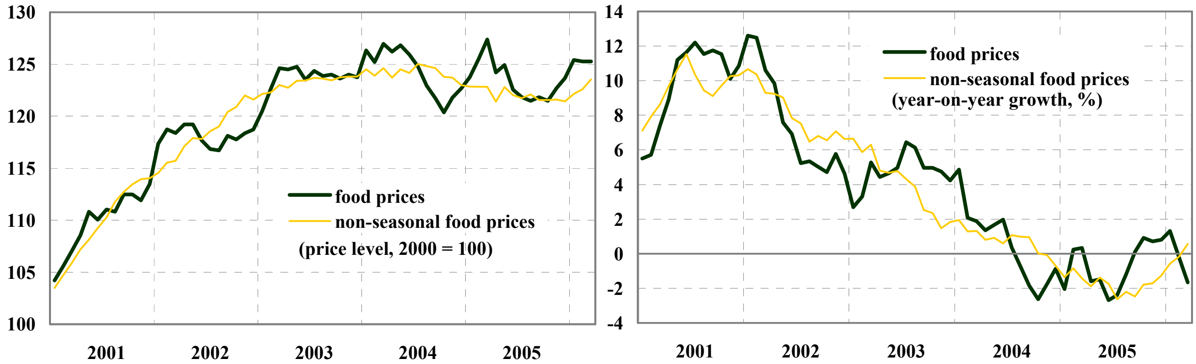
These movements indicate that last year there were other microeconomic factors, probably temporary, in addition to the oil shock. These can be linked primarily with increased global competition from China and the excess supply of used cars, for which the market in Slovenia has rapidly expanded in the last two years.

According to estimates, increased competition from China led to a decrease of 0.2 percentage points in core inflation, while price decreases of more than one-fifth for used cars led to a decrease of 0.5 percentage points in core inflation. Given that the majority of these effects were temporary in nature, the opposite effect can be expected this year and next year. This can already be seen in this March's zero year-on-year inflation in prices of clothing and footwear, while year-on-year growth in prices of used cars remains negative.

**Beginning of the gradual normalisation of food price movements**

After a year of decline and adaptation to the equilibrium level of prices in the single European market, food prices have begun to gradually rise this year. Although the price aggregate is not yet showing it, this is already clear for prices of non-seasonal food, while the movement of prices of seasonal food remains dynamic and uncertain, thus shading the actual picture of developments. There were two effects in the year after Slovenia joined the European Union. The first, the direct effect, was a fall in prices owing to the abolition of customs duties. The second, indirect effect applied downward pressure to prices via the additional supply of food products from the expanded European market, which had become competitive in price terms with those of domestic producers. Given the large number of countries that joined the single market together, and the differing levels of prior development in their markets for foodstuffs, the adjustment of relative prices took longer than originally anticipated, and the direction of the adjustments varied from country to country. In the majority of the new members there was a rise in food prices after enlargement, with only Slovenia and Malta recording a fall in food prices. In addition to the aforementioned factors, food prices in Slovenia last year were also restrained by uncertainty over the pricing policy of major European chains of discount retailers, which last year expanded into the Slovenian market. Given the adjustment of food prices to the lowest level last year and the previous year, temporary faster growth can be expected this year, while in the long term prices will settle at the EU average. The faster growth in non-seasonal food prices in the early part of the year was therefore expected, and indicates a process of the normalisation of these prices.

**Figure 2.11: Food prices in the last five years**

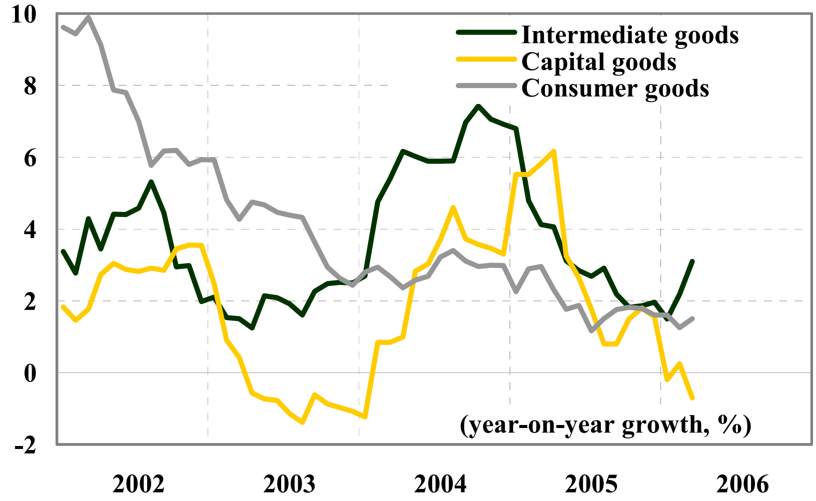



Sources: SORS, ARC calculations

**Growth in producer prices settled at 2%**

Slower growth in producer prices of manufactured goods also restricted inflationary expectations last year. After a one-off adjustment in the level of some prices of manufactured goods at the beginning of 2004, metals in particular, overall growth in producer prices rose as a consequence, before slowing again at the end of last year. Average growth in producer prices fell by 1.6 percentage points last year to 2.7%, with the year-on-year rate falling as far as 1.8% in the final quarter. The trend of slower growth in producer prices continued in the first quarter of this year, when the year-on-year rate reached just 1.6%. The slower growth in the price aggregate was the result of slower growth in all the price groups. The largest slowdown in growth was recorded by prices

Figure 2.12: Producer prices of manufactured goods



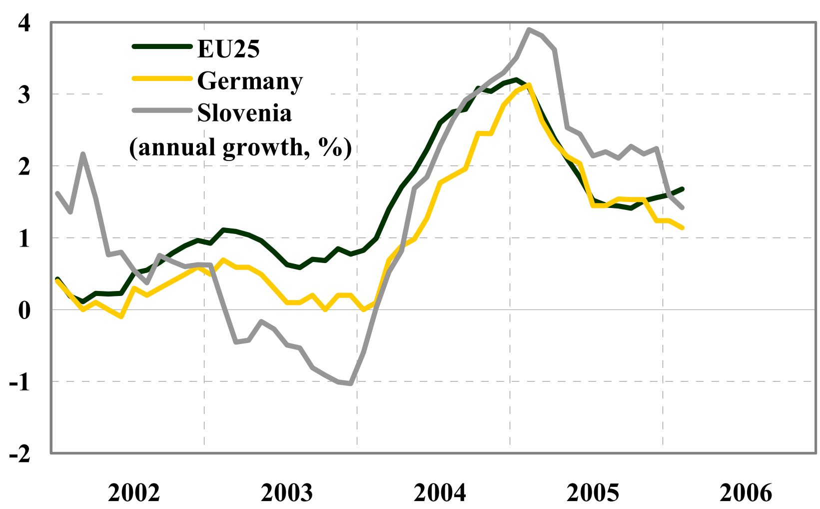

Sources: SORS, ARC calculations

of intermediate goods (4.9 percentage points year-on-year) and prices of capital goods (1.8 percentage points year-on-year). The latter continued to follow a trend of declining growth this year, while growth in prices of intermediate goods began to rise again. After a year and a half at a moderate rate between 2% and 3%, growth in prices of consumer goods slowed further in the second half of last year, the year-on-year rate falling to approximately 1.5%, where it remained in the first quarter of this year. Growth in producer prices thus remains favourable, and is not applying any pressure on inflation.

**The low growth in producer prices in comparison with other countries was the result of the lower importance of energy production in Slovenia**

In comparison with certain other EU countries, growth in producer prices in Slovenia is relatively low, and is to a large degree the result of significantly slower growth in energy prices. The later is probably the result of the lower importance of energy production in Slovenia. Nevertheless, growth in producer prices excluding energy prices in Slovenia this year remains in line with price movements in Germany, Slovenia's largest trading partner, and the European Union as a whole, which indicates the high level of relative adjustment in these prices between Slovenia and the other countries of the European Union.

Figure 2.13: Comparison of producer prices of manufactured goods




Source: Eurostat, producer prices of manufactured goods other than energy prices

# 3 MONETARY POLICY

**The focus of the Bank of Slovenia and the Slovenian government is introducing the euro at the beginning of 2007**

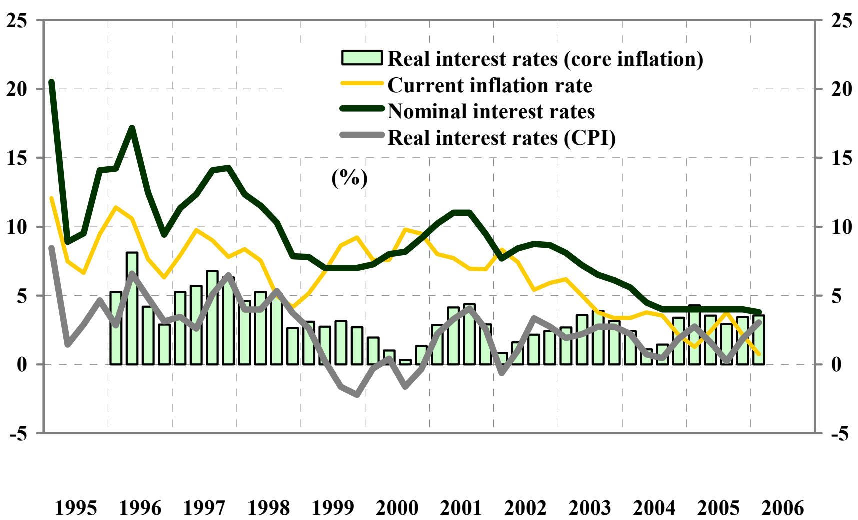
Monetary policy has been conducted in accordance with the joint Bank of Slovenia and government programme for ERM II entry and adoption of the euro.[4] Within the framework of the limitations imposed on it by participation in the ERM II, the Bank of Slovenia uses its monetary policy and exchange rate policy to create the conditions for adopting the euro at the earliest opportunity. With inflation stable and low, and monetary and macroeconomic movements in line with forecasts, in the early part of 2006 the Bank of Slovenia continued with the convergence of interest rates towards the ECB's interest rates.

## 3.1 Monetary Policy and Macroeconomic Trends

**No change in the Bank of Slovenia's real interest rates**

The Bank of Slovenia's real interest rates and the real interest rates on long-term tolar loans have remained almost unchanged in the last year. The interest rate on 60-day tolar bills had stood at 4.0% since Slovenia joined the ERM II, but was then cut by a total of 0.5 percentage points in February and March to 3.5%. The trend of rapidly falling interest rates on long-term tolar loans ended at the end of 2004 in line with the stabilisation of the main Bank of Slovenia interest rate. Since then the aforementioned interest rate has fallen by just 0.2 percentage points, and stood at 7.7% in March 2006.

**Figure 3.1: Bank of Slovenia interest rates**




Sources: Bank of Slovenia, ARC calculations

**Limited inflationary pressures from the side of aggregate demand**

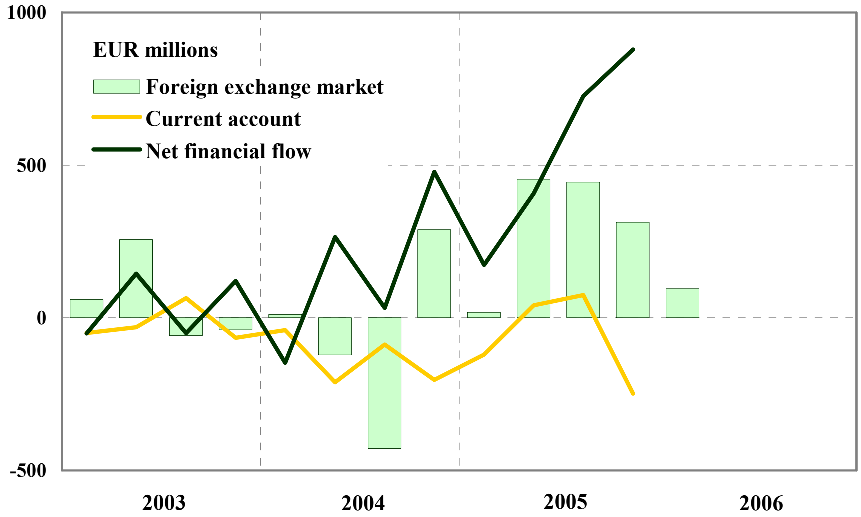
Moderate domestic consumption, the slow closure of the output gap and low inflation indicate that inflationary pressures on the side of aggregate demand are limited. Real growth in household spending amounted to 3.3% in 2005, 0.6 percentage points less than real GDP growth. The output gap measured as the difference between actual GDP and potential GDP has been gradually closing since 2004, but is still negative. Inflation and inflation projections remain relatively low.

[4] See the Programme for ERM II Entry and Adoption of the Euro (November 2003), http://www.bsi.si/library/includes/datoteka.asp?DatotekaID=1243

**Financial inflows as a result of increased lending activity**

Financial inflows in 2005 primarily reflected the demand for increased lending activity. The private sector's financial inflows gradually increased during 2005, and amounted to EUR 0.9 billion in the final quarter, and to EUR 2.2 billion or 8% of annual GDP over the whole year. Inflows in 2005 mostly reflected the increase in loans to banks from abroad, with the banks requiring these sources in order to fill the gap between demand for lending and the slower increase in bank deposits. Banks are also seeking longer-term and thus more stable sources of financing. The relatively strong financial inflows are seen in the increased excess supply of foreign exchange on the foreign exchange market, while another factor in this increased supply was foreign currency loans growing faster than foreign currency deposits at domestic banks.

**Figure 3.2: Foreign exchange market and balance of payments flows**




Source: Bank of Slovenia

**Adjustment to the Bank of Slovenia's nominal interest rates**

In light of the market expectations of the introduction of the euro, the Bank of Slovenia adjusted its interest rates in the direction of nominal convergence in the early part of 2006. The market expectations are also seen in the composition of the financial account. The private sector's financial flows increased further in the early part of 2006: the net financial inflow was EUR 92 million in January, but increased further in February according to provisional figures and indicators. The largest increase was recorded by non-residents' investments in domestic securities. The excess supply of foreign exchange in January 2006 was the highest since Slovenia joined the ERM II. With the reduction in the Bank of Slovenia's interest rates the excess supply of foreign exchange on the foreign exchange market fell sharply, and was just EUR 95 million in the first quarter of 2006, the lowest since the first quarter of 2005. The rise in the ECB's interest rates meant that the spread between the key interest rates of the Bank of Slovenia and the ECB was reduced to 100 basis points.

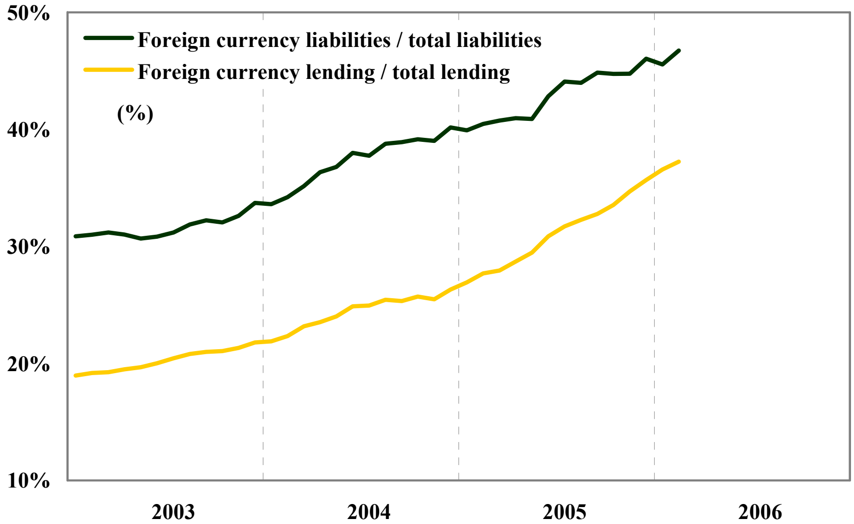
**The Bank of Slovenia's interest rates continue to converge with the ECB's interest rates**

With the reduction in the Bank of Slovenia's interest rates and the rise in the ECB's interest rates, the interest rate convergence prior to Slovenia joining the eurozone continued. On 10 February and 3 March 2006, the Bank of Slovenia cut the lombard loan rate by a total of 0.5 percentage points to 4.5%, the interest rate on 60-day tolar bills by 0.5 percentage points to 3.5%, the forward foreign exchange swap rate by 0.75 percentage points to 0.75%, and the reverse foreign exchange swap rate by 0.75 percentage points to 0.25%. On 6 December 2005 and 8 March 2006, the ECB raised its refinancing rate by a total of 0.5 percentage points to 2.5%. The refinancing rate at the Bank of Slovenia, which is equal to the sum of the ECB refinancing rate and the Bank of Slovenia forward foreign exchange swap rate, has thus fallen from 3.5% to 3.25% since the end of last year. With the reduction in the Bank of Slovenia's interest rates and the rise in the ECB's interest rates, the spread between the 60-day tolar bill rate and the ECB refinancing rate fell from 200 basis points to 100 basis during this period.

**Euroisation is only partly diminishing the impact of monetary policy**

The market expectations of the introduction of the euro speeded up the euroisation of assets and liabilities, and in some segments this limited the influence of the Bank of Slovenia's monetary policy. As Figure 3.3 reveals, the amount of banks' foreign currency operations is constantly increasing, while the amount of tolar operations is diminishing. The proportion of total loans accounted for by foreign currency loans has risen fairly rapidly in recent years: having stood at approximately 15% at the beginning of 2002, it had passed 35% by the beginning of 2006. Foreign currency is also of increasing importance to banks on the liability side: the proportion of total liabilities accounted for by foreign currency rose from approximately 30% at the beginning of 2002 to more than 45% at the beginning of 2006. The proportion of foreign currency deposits has remained unchanged, while bank borrowing abroad is increasing. The stable, predictable exchange rate is also a factor in this euroisation. The faster pace of euroisation of both assets and liabilities is not increasing currency risk at banks, but is reducing the room for tolar interest rate policy to act. Despite the euroisation process, tolar interest rates are prevalent in segments where lending can act in the most rapid inflationary manner, which is justification for the Bank of Slovenia maintaining higher interest rates than in the eurozone. Tolar lending is particularly prevalent in consumer lending, and accounts for almost 90% of newly approved lending. The Bank of Slovenia's interest rates also have an impact on deposits, and thus act to limit excessive consumption. Conversion costs, payments and euro interest rates that are often higher in Slovenia than abroad are making it possible to limit lending in euros in the aforementioned market segments and to maintain an influence on aggregate activities by tolar interest rates.

**Figure 3.3: Euroisation of bank assets and liabilities**




Source: Bank of Slovenia

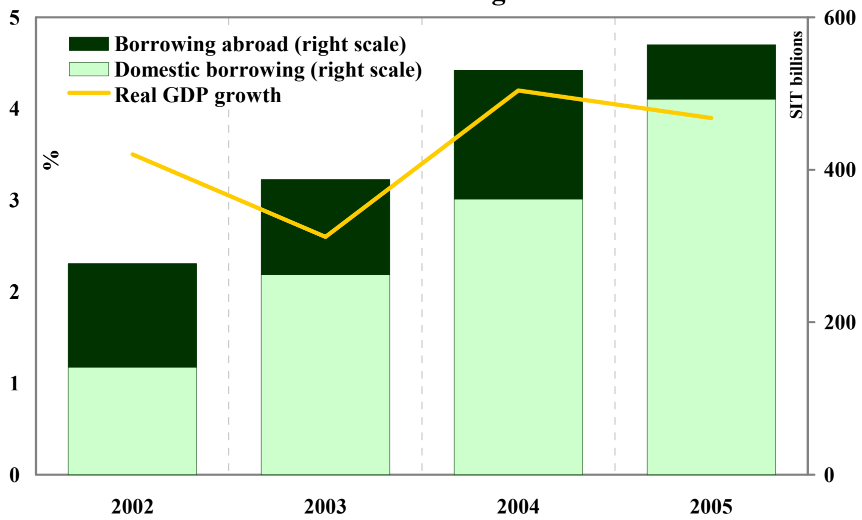
**High lending activity is the result of deepening financial intermediation**

The relatively high lending activity is to a great extent the result of deeper financial intermediation. The depth of financial intermediation as measured by the ratio of lending to the private sector to GDP is relatively low in Slovenia: having stood at 45% at the end of 2004, it was 60% at the end of 2005. Given that the depth of financial intermediation is to a great extent dependent on economic wealth, in the older EU member-states it is significant greater than in Slovenia, surpassing 100% in the majority of cases, and even 150% in some. The deepening of financial intermediation thus depends to a great extent on Slovenia's ability to catch up with the wealthier members of the EU. Should Slovenia record real GDP growth of 4% and 20% nominal growth in lending to the private sector, the ratio of private sector lending to GDP would increase by approximately 10 percentage points per year.

**Corporates are switching from foreign to domestic sources of financing**

An important factor in the increase in corporate borrowing at domestic banks is the shift away from foreign sources to domestic sources of financing owing to the decline in the spread between domestic and foreign interest rates. The increase in corporate borrowing abroad amounted to SIT 169 billion in 2004, but just SIT 71 billion in 2005. The increase in domestic corporate borrowing amounted to SIT 362 billion in 2004, and to SIT 493 billion in 2005. Total corporate lending thus amounted to SIT 564 billion in 2005, and was almost similar to the figure in 2004 (SIT 530 billion), but the structure changed significantly: the proportion accounted for by foreign lending fell from 32% in 2004 to 13% in 2005. Other factors in the increase in lending to the private sector, households in particular, were the increase in housing lending, the increased competition on the lending market, and the reduction in the costs of taking loans.

**Figure 3.4: Corporate shift from foreign sources to domestic sources of financing**




Source: Bank of Slovenia

**Growth in M1 is slowing…**

Since the end of 2004 the movement of M1 has been gradually slowing, and is line with economic activity and the movement of household income. The rapid growth in M1 after the beginning of 2004 can to a great extent be attributed to the increase in economic activity, which was just 2.8% year-on-year in the second half of 2003, but 4.3% year-on-year in the second half of 2004. Another factor in the growth in M1 at the end of 2004 was the current rate of growth in household income, which resulted from the change in the taxation of some earnings, most notably intellectual contract-based payments. Growth in M1 has been declining since the beginning of 2005, and is in line with the normalisation of household income and moderate economic growth. Year-on-year growth in M1 still stood at 27.8% in December 2004, but was just 10.0% in February 2006.

**…while growth in the broad monetary aggregates remains low**

Growth in the broad monetary aggregates remains low, as a result of alternative forms of saving becoming more widespread. Growth in M2 and M3 averaged 5.9% and 6.3% respectively in the last year, and remains reasonably stable. The low growth in these aggregates can be attributed to the increase in portfolio investments. These are more often migrating abroad as a result of both interest rate convergence and changes in legislation that are allowing investment funds to increase their investments abroad. The net outflow of private sector investments amounted to SIT 65 billion in 2003, SIT 90 billion in 2004 and SIT 222 billion in 2005. In conditions of reasonably strong demand for lending, banks are compensating for the slow growth in deposits with borrowing abroad, which amounted to SIT 629 billion in 2005, approximately 85% of the increase in lending to the private sector.

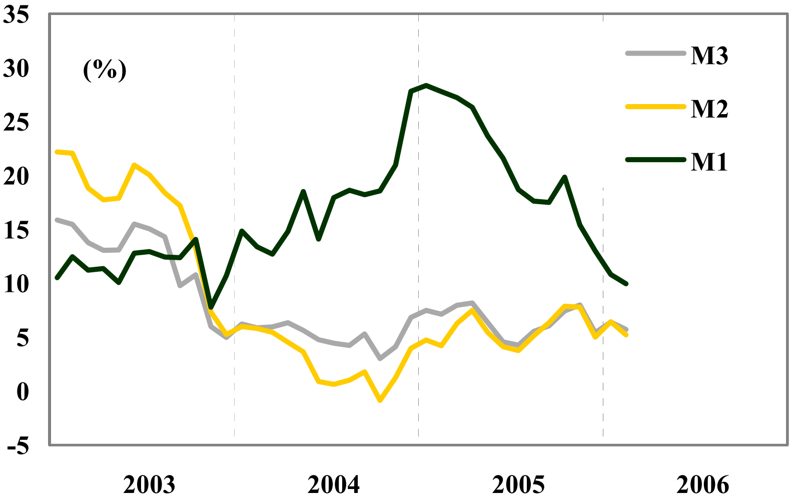
**Growth in tolar time deposits is increasing, while that of foreign currency deposits is decreasing**

The increase in tolar time deposits and the decrease in foreign currency deposits is the result of tolar interest rates still being higher than foreign currency interest rates under the conditions of a stable exchange rate. Since the beginning of 2005 tolar time deposits have increased by SIT 182 billion, and foreign currency deposits by SIT 107 billion. Over the same period year-on-year growth in tolar time deposits rose from -7.3% to 10.0%, while that of foreign currency deposits fell from 14.2% to 6.9%. During this period the interest rate on deposits of one to three months fluctuated at just over 3%, while that on foreign currency deposits was around 1.5%, or around 1.8% after the most recent rise in interest rates by the ECB.

**Shortening of the average maturity of tolar deposits**

Tolar interest rates on longer maturities are falling faster than those on shorter maturities, and this is being reflected in a shortening of the average maturity period of tolar time deposits. The proportion of total tolar time deposits accounted for by deposits of one to three months rose by 3.1 percentage points between the beginning of 2005 and February 2006 to 43.5%. The proportion accounted for by long-term tolar deposits fell by 4.3 percentage points over the same period to 15.8%, while the proportion accounted for by other maturities remained unchanged. During the same period the interest rate on deposits of one to three months remained unchanged, while that on long-term deposits fell by almost 1.5 percentage points. This interest rate movement is also to a great extent the result of interest rate convergence as the moment for joining the eurozone approaches.

**Figure 3.5: Year-on-year growth in monetary aggregates**




Source: Bank of Slovenia

**Other macroeconomic indicators are in line with expectations**

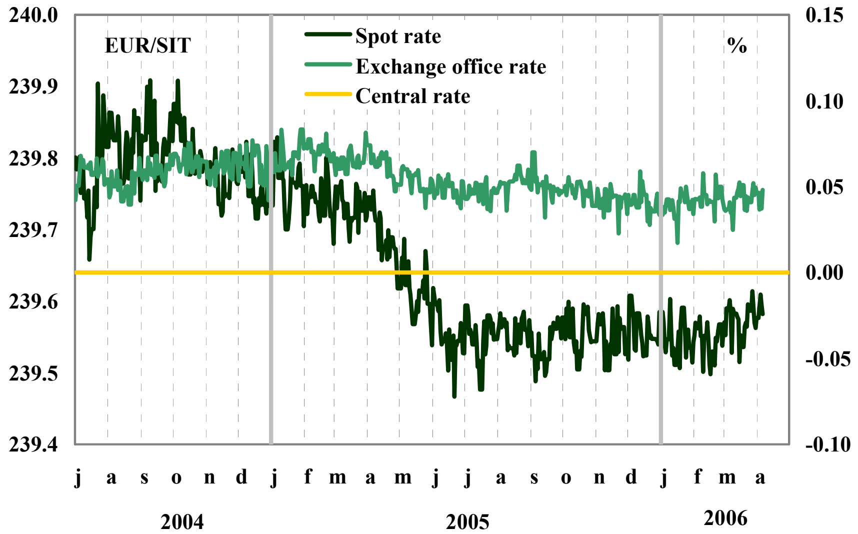
Other macroeconomic indicators (aggregate demand, the current account, the general government deficit and labour costs) were in line with expectations. The current account deficit in 2005 improved by 1% of GDP to stand at 1.1% of GDP, while the general government deficit fell by 0.5% of GDP over the same period to stand at 1.8% of GDP. Household income in 2005 was up 4.2% on average from the previous year, while labour costs per employee rose by 3.1% over the same period.

## 3.2 Monetary Policy Instruments in the ERM II

**Negligible deviation in market exchange rates from the central rate**

Since entry into the ERM II, the Bank of Slovenia's monetary policy has focused on the stability of the exchange rate. The differentials between the central rate and the market exchange rate during the participation to date in the ERM II have been negligible. In the period between Slovenia joining the ERM II and March 2005 the average differential between the exchange rate on the spot market[5] and the central rate was 0.06%, in the direction of depreciation, with a standard deviation of just 0.02%. The tolar gradually appreciated in April and May 2005 owing to the excess supply of the foreign exchange markets. Between June 2005 and the beginning of April 2006 the exchange rate was on the appreciation side of the central rate: the average differential was 0.04%, with a standard deviation of 0.02%. Excess demand means that the rate on the exchange office market has fluctuated slightly above the central rate since Slovenia joined the ERM II. Between the entry date and the beginning of April, the average differential in the exchange office rate was 0.05% from the central rate, with a standard deviation of 0.02%.

**Figure 3.6: Market exchange rates and deviations from central rate**



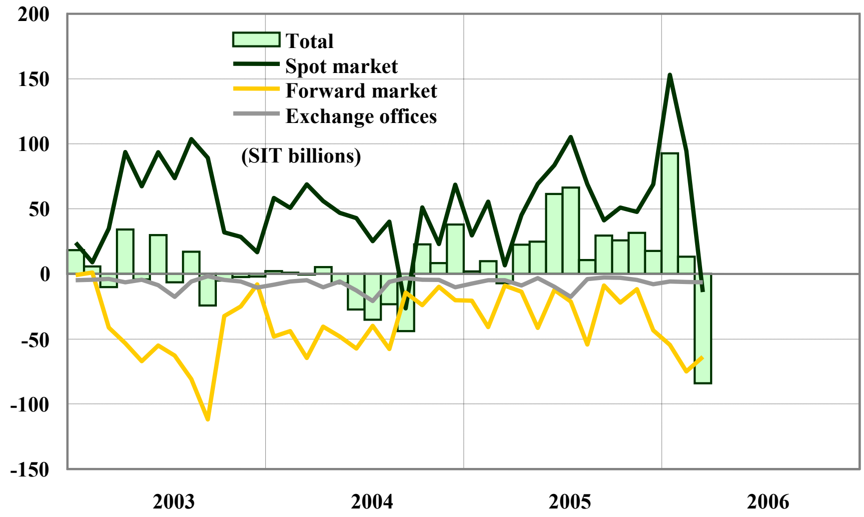

Source: Bank of Slovenia

**The foreign exchange markets are in balance in the long term**

There has been no major excess supply of or demand for foreign exchange on the markets since Slovenia joined the ERM II, which indicates that the central rate is sustainable in the long term. Despite short-term fluctuations in the supply of and demand for foreign exchange, the total excess supply on the foreign exchange markets amounted to SIT 282.9 billion between July 2005 and March 2006, an average of 2.5% of GDP. This period can be broken down into three smaller periods: excess demand from July 2004 to September 2004 (monthly average of SIT 102.7 billion), balance between October 2004 and March 2005 (average monthly excess supply of SIT 12.2 billion), and excess supply from April 2005 to February 2006 (monthly average of SIT 36.0 billion). Demand was always in excess of supply on the forward market and the exchange office market, while on the spot market the supply of foreign exchange was greater than demand. The relatively high excess demand for foreign exchange in March 2006 was to a great extent the result of a single major transaction, and partly also to the cut in the Bank of Slovenia's interest rates.

[5] The spot market is intended for concluding transactions to be settled within two working days of the contract being concluded. All bank transactions with companies, households and non-residents and all euro transactions between banks are considered when the rate is calculated

**Figure 3.7: Excess supply/demand on foreign exchange markets**




Source: Bank of Slovenia

Minor short-term imbalances on the foreign exchange markets were otherwise reflected in the movement of the tolar exchange rate, but because the deviations from the central rate were very small, there was no need for intervention by the Bank of Slovenia. The Bank of Slovenia last exerted an active influence on the exchange rate in July 2004, when immediately after ERM II entry it intervened indirectly on the foreign exchange markets for three days by setting the base exchange rate, and then intervened directly on the interbank foreign exchange market by selling foreign exchange outright to banks. This signalled the Bank of Slovenia's intention of maintaining the nominal tolar exchange rate in the vicinity of the central rate to the foreign exchange markets.

**Given the minor deviations from the central rate shown by the market exchange rates, there was no need for exchange rate interventions**

## 3.3 Structural Adjustments to Ease the Transition to the Eurosystem

With the planned adoption of the euro in mind, the Bank of Slovenia continued to make certain structural adjustments to monetary policy instruments aimed at easing the transition to the conditions of operations in the eurosystem. These adjustments relate to the replacement of 270-day tolar bills with long-term deposits, the gradual relaxation of minimum foreign currency liquidity, restrictions in the liquidity ladder, the level of swapped foreign exchange, and the system of required reserves.

In 2005 the Bank of Slovenia again offered long-term tolar deposits with the aim of sterilising the excess liquidity from the maturity of the 270-day tolar bills issued during the takeover of Lek at the end of 2002. The interest rate offered on the long-term tolar deposits was 0.2 percentage points higher than the interest rates on 60-day tolar bills, while the maturity date stretches past the time planned for the adoption of the euro. SIT 203.5 billion of reserve money was withdrawn by the Bank of Slovenia via this instrument between July 2004, when the first offer was made, and July 2005. Over the same period the stock of 270-day tolar bills fell by SIT 199.7 billion, meaning that the operation of replacing 270-day tolar bills with the long-term deposit did not have a significant impact on the amount of reserve money in circulation.

**The long-term deposit as an instrument for sterilising past foreign currency inflows**

**Relaxation of minimum foreign currency liquidity requirements and replacement of swaps with outright foreign exchange purchases**

In order to increase banks' flexibility in transacting on foreign exchange markets, the Bank of Slovenia gradually relaxed the minimum prescribed foreign currency liquidity, and offered to replace foreign exchange swaps with outright purchases. In 2004 the Bank of Slovenia reduced the minimum requirement for liquid assets in foreign currency from 80% to 70%. In April 2006 it cut this further to 50% of short-term liabilities in foreign currency. The level of compulsory subscription to foreign currency bills was reduced from 45% of liquid foreign currency assets to 35% in 2004, and then to 25% in 2005. Compulsory subscription to foreign currency bills was finally abolished in July 2005. The stock of foreign currency bills has therefore been gradually diminishing since then. The stock of foreign currency bills peaked in April 2004 at SIT 584.5 billion, but had declined to just SIT 266.5 billion by the end of February 2006. In 2005 and the early part of 2006 the Bank of Slovenia again offered banks the opportunity of the outright sale of foreign exchange from the cumulative stock of Bank of Slovenia foreign exchange swaps. It purchased SIT 331.8 billion of foreign exchange from banks via this offer in 2004, SIT 414.9 billion in 2005, and SIT 118.7 billion in the first three months of 2006.

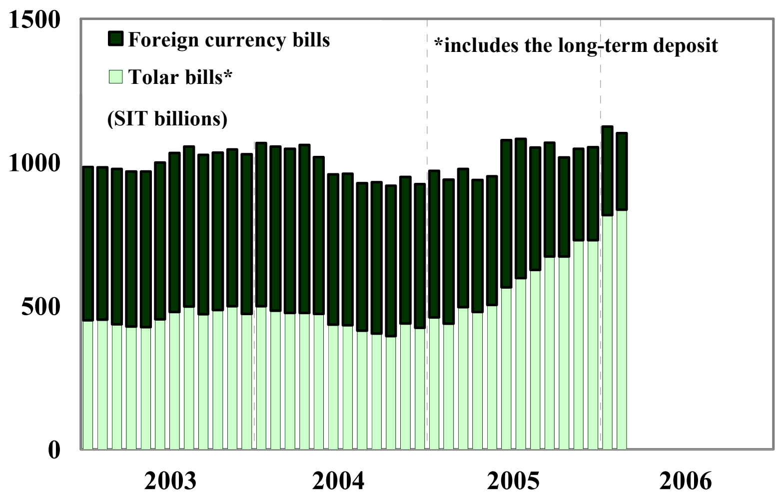
**Adjustment of the required reserve instrument to the arrangements in the eurozone**

The Bank of Slovenia continued to adjust the required reserve instrument to the ECB standards. In March 2005 it lowered the level of required reserves for tolar liabilities falling due in up to 90 days from 4.5% to 2%. Thus the level of required reserves for all liabilities falling due in up to two years is now 2%, in line with the arrangements in the eurosystem. The level for liabilities falling due in more than two years remains at 0%. The Bank of Slovenia aimed to delay the liquidity effect of the change until after the euro has been adopted. Banks and savings banks were therefore obliged to place the excess liquidity arising from the lowering of required reserves in the amount of SIT 37 billion in long-term deposits with the Bank of Slovenia maturing at the end of March 2007.

**An increase in tolar bills as a result of structural adjustments**

These structural changes in Bank of Slovenia instruments should be taken into consideration when analysing changes in the stock of tolar bills. The change in the stock of tolar bills and the long-term deposit does not only indicate the quantity of sterilised foreign exchange interventions, but also part of the liquidity released from the decrease in foreign currency bills and the reduction of required reserve liabilities. It is evident from Figure 3.8 that the stock of foreign currency bills and tolar bills has amounted to approximately SIT 1,000 billion over the last three years. The ratio between the two has changed significantly, with the proportion accounted for by tolar bills rising from approximately 45% in 2004 to more than 75% in February 2006.

**Figure 3.8: Increase in tolar bills and decrease in foreign currency bills**




Source: Bank of Slovenia

**Adjustment of the prudential instrument in the liquidity ladder**

The Bank of Slovenia is gradually adjusting the liquidity ladder instrument to the regulations in the eurosystem. The possibility of including tolar lending with an A credit rating and a maturity of more than 180 days when meeting the liquidity coefficients in the first category (maturing in up to 30 days) was abolished, and a weighting for household and corporate sector sight deposits of 85% in the first category and 60% in the second category (maturing in up to 180 days) was established. Banks have been able to operate under the new system since July 2005, and were obliged to switch to the new system by 1 January 2006.

## Box 3.1: Diary of Bank of Slovenia measures since ERM II entry

28 June 2004

- The Bank of Slovenia enters the ERM II. The central exchange rate is set at SIT 239.640 to the euro, with a lower intervention point of SIT 203.694 and an upper point of SIT 275.586 to the euro (15% above or below the central rate).
- The Bank of Slovenia cuts the foreign exchange swap rate from 1.5% to 1.0%.
- The Bank of Slovenia intervenes on the foreign exchange market by setting the base exchange rate. The signalled exchange rate is SIT 239.64 to the euro. The intervention lasts until 1 July 2004.

2. julij 20042 July 2004

The Bank of Slovenia raises the price of the reverse foreign exchange swap from 0.25% to 1.0%, thus allowing banks cheaper access to foreign currency liquidity. This eases the deprecation pressure on the tolar.

20 July 2004

The Bank of Slovenia cuts the interest rate on 270-day tolar bills from 4.25% to 4.20%

27 July 2004

The Bank of Slovenia intervenes directly on the interbank foreign exchange market by selling foreign currency.

30 July 2004

The Bank of Slovenia first offers banks the chance to subscribe to the long-term tolar deposit as a replacement for 270-day tolar bills. The interest rate is 0.2 percentage points higher than that on 60-day tolar bills. Banks subscribe to SIT 160.8 billion of long-term tolar deposits by the end of February 2005.

27 October 2004

The Bank of Slovenia continues to adjust the required reserve system to the ECB standards. In so doing it:

- includes companies issuing electronic money among those obliged to maintain required reserves
- abolishes the mandatory 50% daily maintenance of required reserves
- regulates the obligation to maintain required reserves in the event of bankruptcy
- sets a 0% level of required reserves for repo transactions

24 and 25 November 2004

As part of the replacement of foreign exchange swaps with outright purchases, the Bank of Slovenia purchases SIT 75.3 billion of foreign currency from banks.

3 to 10 December 2004

As part of the replacement of foreign exchange swaps with outright purchases, the Bank of Slovenia purchases SIT 22.6 billion of foreign currency from banks.

23 December 2004

The Bank of Slovenia raises the foreign exchange swap rate from 1.0% to 1.25%, and thus the refinancing rate from 3.0% to 3.25%. The aim of the structural adjustment is to ensure continuing stability on the money market.

1 February 2005

The Bank of Slovenia revokes the provision pursuant to which credit institutions that had failed to repay intraday liquidity loans by the closing of the payments window had to take a lombard loan at the lombard loan rate plus 4 percentage points. Henceforth they can take loans at the lombard loan rate without paying the premium.

27 March 2005

The Bank of Slovenia continues to adjust the required reserve system to the ECB standards. The level of required reserves for tolar deposits up to 90 days is cut from 4.5% to 2.0%. Those obliged to maintain required reserves must take up the amount of liquidity released (SIT 36.9 billion) by 29 March 2005 in long-term deposits with the Bank of Slovenia, maturing on 30 March 2007.

13 to 19 April 2005
As part of the replacement of foreign exchange swaps with outright purchases, the Bank of Slovenia purchases SIT 70.6 billion of foreign currency from banks.

8 April 2005
The Bank of Slovenia raises the foreign exchange swap rate from 1.25% to 1.5%.

10 to 16 June 2005
As part of the replacement of foreign exchange swaps with outright purchases, the Bank of Slovenia purchases SIT 46.9 billion of foreign currency from banks.

20 to 26 July 2005
As part of the replacement of foreign exchange swaps with outright purchases, the Bank of Slovenia purchases SIT 83.9 billion of foreign currency from banks.

19 to 23 September 2005
As part of the replacement of foreign exchange swaps with outright purchases, the Bank of Slovenia purchases SIT 117.7 billion of foreign currency from banks.

5 to 12 December 2005
As part of the replacement of foreign exchange swaps with outright purchases, the Bank of Slovenia purchases SIT 95.7 billion of foreign currency from banks.

6 December 2005
The ECB having raised its refinancing rate from 2.0% to 2.25%, the refinancing rate of Bank of Slovenia is raised from 3.5% to 3.75%.

10 February 2006
The Bank of Slovenia lowers the following interest rates:

- the Bank of Slovenia refinancing rate from 3.75%% to 3.5%
- the lombard loan rate from 5.0% to 4.75%
- the 60-day tolar bill rate from 4.0% to 3.75%
- the foreign exchange swap rate from 1.5% to 1.25%
- the reverse foreign exchange swap rate from 1.0% to 0.75%

14 to 20 February 2006
As part of the replacement of foreign exchange swaps with outright purchases, the Bank of Slovenia purchases SIT 118.7 billion of foreign currency from banks.

3 March 2006
The Bank of Slovenia lowers the following interest rates:

- the Bank of Slovenia refinancing rate from 3.5% to 3.25% (the rise in the ECB refinancing rate from 2.25% to 2.5% on 8 March being taken into consideration)
- the lombard loan rate from 4.75% to 4.5%
- the 60-day tolar bill rate from 3.75% to 3.5%
- the foreign exchange swap rate from 1.25% to 0.75%
- the reverse foreign exchange swap rate from 0.75% to 0.25%

# 4 ECONOMIC OUTLOOK[6]

With an improvement in the world economic activity and an increase in domestic demand, GDP growth in the period to 2008 will remain high at approximately 4%. The forecasts are that prices will have risen by approximately 2.0% by the end of this year, and then price growth will stabilise at approximately 2.5% during the next two years, given the absence of new oil shocks. In the context of the gradual convergence of import and export growth, the current account position will worsen by approximately 1 GDP percentage point owing to unfavourable terms of trade.

The first section of this chapter presents the anticipated trends in selected variables in the international environment. This is followed by an account of the projections of economic activity, employment and wages. The third section shows the trend in domestic demand broken down by components of consumption. The external balance and terms of financing are analysed in the fourth and fifth sections. The final section presents forecast price movements. A summary of the forecasts and a comparison with the estimates from November 2005 are given in Table 4.8 at the end of the section.

## 4.1 The International Environment

**Despite supply-side price pressures, the strengthening of domestic demand in the rest of the world will contribute to solid growth in Slovenia**

Economic growth in Slovenia's most important trading partners will be higher this year than last year. In addition to net trade contribution remaining favourable, another factor in this should be the recovery of domestic demand in eurozone countries. This has been very modest in recent years owing to a slowdown in investment activity and weak household spending, but in the future household spending should rise alongside increased investment expenditure. Given the strengthening of domestic demand and the associated inflationary pressures, monetary policy in the eurozone is expected to continue tightening. Together with rapid rises in commodities prices, price pressures from the supply side abroad are expected to be relatively strong, at least this year. Supply-side

**Table 4.1: Assumptions for international environment**

| | | | | | 2006 | | 2007 | | 2008 | |
|---|---|---|---|---|---|---|---|---|---|---|
| | | | | | Forecast | | Forecast | | Forecast | |
| | 2002 | 2003 | 2004 | 2005 | May | Δ | May | Δ | May | Δ |
| | *annual growth, %, unless stated* | | | | | | | | | |
| Foreign demand* | 1.9 | 3.7 | 5.3 | 4.7 | 6.0 | 0.0 | 6.0 | 0.0 | 6.0 | … |
| USD/EUR | 0.94 | 1.13 | 1.24 | 1.25 | 1.21 | 0.0 | 1.21 | 0.0 | 1.21 | … |
| Oil (USD/barrel) | 25 | 29 | 38 | 54 | 65 | 0.0 | 65 | 0.0 | 65 | … |
| Commodities | 4.6 | 11.3 | 16.0 | 6.0 | 15.0 | 12.0 | 3.0 | 0.0 | 3.0 | … |
| Inflation in EMU | 2.2 | 2.1 | 2.1 | 2.2 | 2.2 | 0.3 | 2.2 | 0.3 | 2.0 | … |
| PPI Germany | -0.6 | 1.7 | 1.6 | 4.6 | 2.9 | 0.8 | 1.7 | -0.4 | 1.7 | … |
| 3-m Euribor (%) | 3.3 | 2.3 | 2.3 | 2.3 | 3.0 | 0.7 | 3.5 | 1.0 | 3.5 | … |

* Volume of imports by basket of foreign partners
Sources: JP Morgan, Consensus Forecast, OECD Economic Outlook, IMF World Economic Outlook

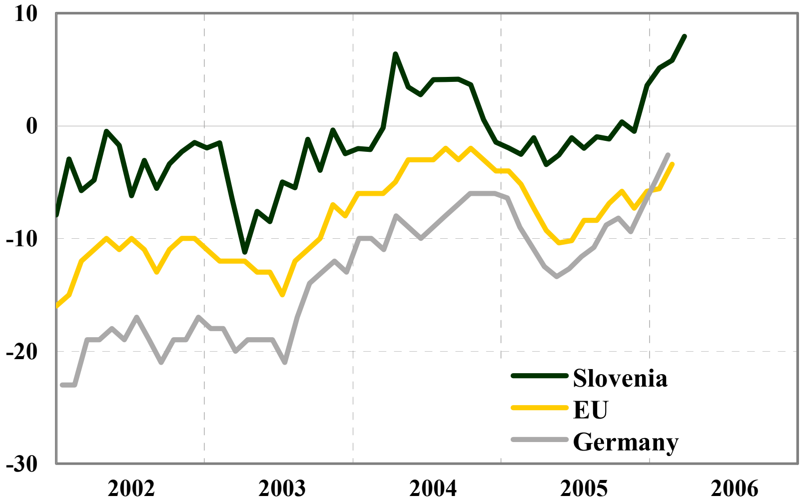
[6] The forecasts were made on the basis of information available and the statistical methodology applicable on 31 March 2006. The projection of macroeconomic factors in this section rests on assumptions for movements in variables in the international environment and certain domestic factors conditioned by economic policy decisions. The domestic factors under the influence of economic policy and exogenously included in the forecasting process are the movements of the tolar exchange rate, public sector spending and investment, public sector wages, the movement of administered prices and certain other variables of a fiscal nature

factors will remain the most significant risk factor that could bring about significant inflationary pressures from abroad.

**Both final consumption and investment spending in the rest of the world can be expected to strengthen**

Despite the temporary slowdown at the end of last year, foreign demand should begin to rise in the first half of this year, and more sharply in the second half. Both indicators of sentiment in the most important trading partners and the figures for growth in industrial production, investment and retail sales point to increased economic activity abroad. The retail sales should be specifically encouraged by the VAT rise envisaged in Germany. Investment activity should begin to rise thanks to strongly increased corporate profits in the eurozone, despite the continuing outflow of investment abroad. An important factor in the higher profits were the tougher conditions on the labour market in the last few years, which have also limited the recovery in household spending. The reasonably restricted wage growth in the past led to a significant improvement in competitiveness in Germany in particular, and will remain a significant factor of a solid export growth. Labour costs can be expected to contribute towards competitiveness, despite the slight increase in wage growth brought by improved profits, in line with trade union demands. The pace of exports should be further encouraged by reasonably solid activity in the world economy and a slight fall in the euro. Demand from the countries of eastern and south-eastern Europe will remain relatively high, although growth will not be as pronounced as in previous years. Russia will remain an exception as investment demand and household spending will remain strong as oil prices remain high.

**Figure 4.1: Business confidence in Slovenia and abroad**




Sources: SORS, ARC calculations

**The dollar's rise against the euro ended at the end of 2005**

The dollar's rise against the euro caused by the better performance of the American economy than the European economy, the political uncertainty before the elections in Germany and by the increase in the spread between interest rates in the USA and the eurozone came to an end at the end of 2005. The onset of interest rate rises by the ECB and the first signs of economic recovery in the eurozone were factors in this. Our forecasts employ a technical assumption of a constant value of USD 1.21 to the euro throughout the forecasting period, which corresponds to the current average exchange rate in the last month and is also very close to the forecasts of foreign institutions.

**Oil prices remain high…**

Oil prices should ease in the future, but will remain high. After a brief respite following the rapid rise in oil prices caused by the bad weather conditions in September 2005, oil prices rose slightly again at the end of last year and the early part of this year. The high level of oil prices is partly being caused by high oil consumption, which after rising by 1.2% in 2005 should rise by a further 1.8% in 2006 thanks to sustained demand from China and North America. The main factors on the supply side in the sustained high oil prices are the low level of excess production capacity and refining capacity, and the worsening of political and geopolitical conditions in certain oil-producing countries. The majority of analysts thus expect oil prices to remain high, with forward contracts pointing to a price of around USD 65 per barrel. This is the assumption used in the forecasts.

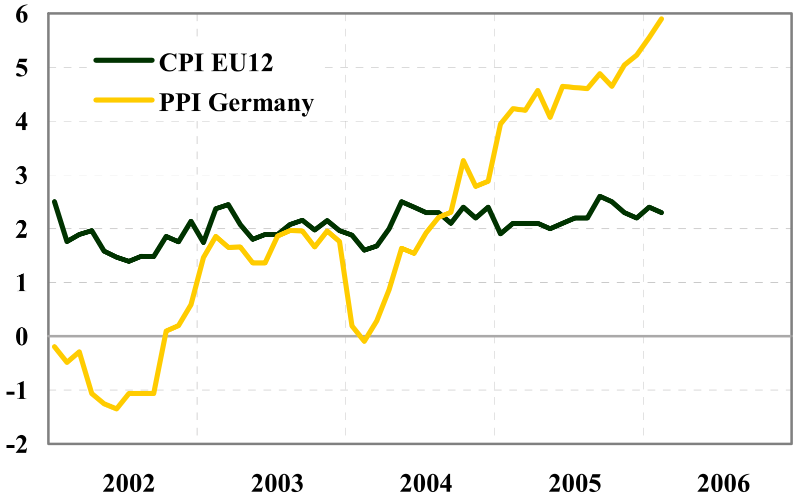
**…as do other commodities prices,…**

Commodities prices rose extremely sharply at the end of last year and the early part of this year, with all components contributing to this rise. The rapid rise reflects the continuing high demand from China and South-East Asia, and the increase in demand from wealthier countries, but is also the result of speculation in certain commodities, such as steel, not traded directly on the market. The price level at the end of 2005 thus surpassed the record level recorded at the end of the 1980s. The current rate of growth in dollar prices of all the components in the basket of commodities prices is more than 1.5% per month, with metals prices recording the fastest growth of more than 4% and non-comestible agricultural produce the slowest of 1.5%. Given that the current rates of growth show no sign yet of slowing, the assumed movements in commodities prices have been revised significantly upwards from the previous forecast.

**…thus contributing significantly to higher prices abroad**

The rise to 2.2% in the inflation forecast for 2006 in the eurozone, up from the previous forecast, is mostly the result of the unexpectedly high growth in energy prices, particularly refined petroleum products. Core inflation in the eurozone fell throughout last year, with the inflation rate excluding energy prices and prices of unprocessed food falling below 1.5%, having stood at more than 2.0% at the end of 2004. The projection that inflation will remain above the ECB's target level in 2006 is mostly the result of high oil prices and the effects of rises in certain administered prices, while the relatively high rise in prices in 2007 will be under the influence of changes in indirect taxation, in particular the VAT rise in Germany. Rapid growth in prices in the energy sector has also exerted a strong influence recently on the growth in producer prices of manufactured goods in Germany. Prices in other sectors are rising slightly more slowly, and for the moment there is no sign of high energy prices feeding through into prices of manufactured consumer goods, which partly reflects the increase in competition, and partly the moderate growth in unit labour costs. Producers' expectations also indicate that energy prices will not feed through into other prices in the future, and overall producer prices are therefore expected to gradually slow.

**Figure 4.2: CPI in eurozone and PPI in Germany**




Source: Eurostat

**Monetary policy begins to be tightened in the eurozone**

After leaving them unchanged for more than two years, the ECB raised the interest rates on its key instruments at the end of 2005 and in March 2006. The assumption for interest rate movements is based on the market expectations of further gradual rises in interest rates in the eurozone. Interest rates are expected to continue gradually rising over the forecasting period, which is in line with the inflationary pressures originating from the renewed growth in domestic demand, reasonably high lending growth and the risks associated in particular with high energy prices potentially feeding through into other prices.

## 4.2 Activity, Employment and Wages

**Economic growth remains around 4%**

Economic growth forecasts for the coming years were revised slightly upwards from the autumn forecasts, but remain around 4%. GDP growth will remain higher than the estimated growth of between 3.5% and 4% in potential output throughout the forecasting period. This growth will continue to facilitate the process of real convergence with the wealthier EU countries, with economic growth faster than the EU average, although with growth faster than the growth in potential output a positive output gap will open during the forecasting period.

**Table 4.2: Activity, employment and wages**

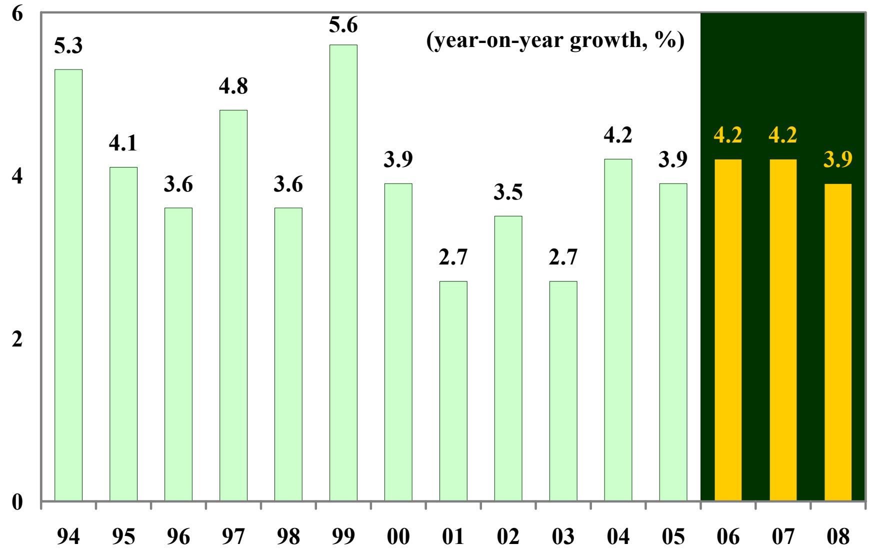
| | | | | | 2006 Forecast | | 2007 Forecast | | 2008 Forecast | |
|---|---|---|---|---|---|---|---|---|---|---|
| | 2002 | 2003 | 2004 | 2005 | May | Δ | May | Δ | May | Δ |
| | *real growth, %, unless stated* | | | | | | | | | |
| Real GDP | 3.5 | 2.7 | 4.2 | 3.9 | 4.2 | 0.4 | 4.2 | 0.4 | 3.9 | ... |
| Per capita GDP (EUR) | 11,866 | 12,461 | 13,103 | 13,677 | 14,477 | -667 | 15,448 | -946 | 16,440 | ... |
| Employment | 1.5 | -0.2 | 0.4 | 0.7 | 0.4 | 0.1 | 0.3 | -0.2 | 0.3 | ... |
| Net wages | 2.1 | 1.8 | 0.8 | 3.6 | 2.9 | 0.2 | 2.9 | 0.2 | 2.6 | ... |
| Gross wages | 2.1 | 1.9 | 1.0 | 2.3 | 2.9 | 0.2 | 2.9 | 0.2 | 2.6 | ... |
| Productivity | 2.0 | 2.9 | 3.8 | 3.2 | 3.9 | 0.4 | 3.9 | 0.6 | 3.6 | ... |

Source: ARC

**The problem of employment structure is becoming increasingly evident**

Despite the reasonably favourable economic climate, the pace of employment growth will slow slightly. The continuation of the positive current rate of growth in employment will primarily be the result of employment in the public sector, while trends in the private sector will be somewhat less favourable.

**Figure 4.3: GDP projections**




Source: ARC

In 2005 the relatively dynamic economic activity was still being positively reflected in the developments on the labour market, employment rising by 0.7% according to figures in the national accounts, with a rise of 1.8% in the government sector and 0.5% in the remainder of the economy. A feature of 2005 was a rise in unemployment during a good economic climate, which begs the conclusion of a rise in structural unemployment. Problems with employment structure could also continue during the forecasting period. In the context of structural shifts in the economy and the resulting contraction of employment in traditional labour-intensive industries, employment growth will therefore be limited.

**Sustainable wage growth expected**

The rapid growth in net wages in 2005 was primarily the result of tax reforms and methodological changes in the statistical monitoring of wages. It is estimated that the diverse movement in components of labour costs seen in 2005 will become more equalised in the future. The wage increases for the next two years have not yet been agreed for either the public sector or the private sector, but the social partners have agreed in negotiations that real wage growth must continue to remain behind productivity growth in the future. After low growth in average real wages in the public sector of 0.9% in 2005, on the basis of budget documents for the coming years an increase in real wages can be expected. Public sector wages are set to rise by 1.8% in real terms in 2006, and by 2.0% in 2007. Given the favourable economic climate, wage growth in the private sector should outstrip that in the public sector by 1.0 to 1.5 percentage points. According to these estimates the movement of total labour costs in the coming years will be in line with the expected movement in productivity, and will therefore not give rise to inflationary pressures of a cost nature. Should this not happen, rapid growth in the element representing the majority of costs at companies could be reflected in inflationary pressures, a decline in competitiveness and a slowdown in employment.

## 4.3 Components of Consumption

**Prevailing contribution by domestic demand, with the contribution of net trade also positive**

The contribution made to economic growth by domestic demand will increase during the forecasting period, while the contribution made by net trade will be lower than in 2005, although remaining positive. The increase in the contribution by domestic consumption is almost exclusively the result of increased investment spending after a decline in total investments in 2005.

**Table 4.3: Components of consumption**

| | 2002 | 2003 | 2004 | 2005 | 2006 Forecast May | 2006 Δ | 2007 Forecast May | 2007 Δ | 2008 Forecast May | 2008 Δ |
|---|---|---|---|---|---|---|---|---|---|---|
| | *real growth, %* | | | | | | | | | |
| Domestic demand | 2.4 | 4.7 | 4.6 | 1.6 | 3.7 | -0.4 | 3.9 | 0.3 | 3.5 | … |
| Private consumption | 1.3 | 3.5 | 3.3 | 3.3 | 3.2 | -0.2 | 3.1 | -0.1 | 3.1 | … |
| Government spending | 3.2 | 1.6 | 2.9 | 3.0 | 2.7 | 0.2 | 2.8 | 0.3 | 2.7 | … |
| Gross capital formation | 4.0 | 10.1 | 9.2 | -3.0 | 5.4 | -1.6 | 6.0 | 0.7 | 4.9 | … |

Source: ARC

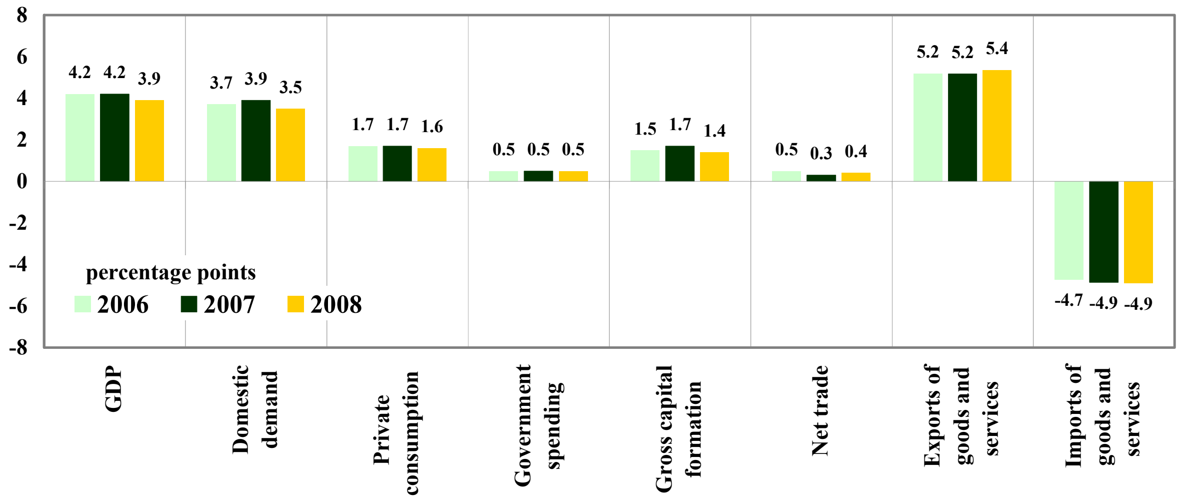
**The risks to the economic growth forecast are mostly on the export side**

Exports of goods and services will be a strong factor in economic growth throughout the forecasting period. The contribution of net trade will decline in 2006 because of a slight slowdown in export growth and also a rise in growth in import demand in line with the increase in domestic consumption. Given the projected increase in foreign demand, the cooling of export growth is to a great extent expected to be the result of stalled growth in exports by the car industry, which was the main engine of high export growth in 2005. Domestic demand will continue to account for the majority of economic growth on average in 2007 and 2008, approximately 90%, while the contribution of net trade will remain positive, in contrast to previous projections. A further delay in the revival of activity in the most important trading partners and a sharper fall-off in export activity by the car industry could in particular lead to economic growth in Slovenia being lower than currently forecast in the forecasting period.

**Household spending at a high but sustainable level,…**

Household spending will remain high, but at a sustainable level behind GDP growth. The contribution made to economic growth by household spending will be almost unchanged from 2005. The main factors in the maintenance of fairly high but sustainable household spending will be the relatively high disposable income, which is expected to be restricted by an agreement on wage policy, and the continuing relatively good terms of financing, which are likely to tighten slightly in the future. In particular, in 2007 the envisaged ending of the transition period in which the low rate of VAT could be applied to housing will contribute to household spending remaining at a high level. However, the poorer employment outlook and the changes either already introduced or anticipated in the realm of taxation will prevent excessive household spending. Households will continue to be encouraged to use long-term forms of saving by the institutional changes already introduced in pension insurance. Among the factors having the greatest impact on household spending, the largest risk is the failure to date by the social partners to reach an agreement on wage increase for the period from 2006 inclusive. Because pension rises have been tied to wages since the middle of 2005, disposable income from pensions also represents a risk to the realisation of the household spending forecast.

**Figure 4.4: Projection for components of consumption**




Source: ARC

**…while investment activity will strengthen after weakness in 2005;…**

After recording low rates last year, the current rate of growth in investment activity will pick up in the coming years, and its contribution to economic growth will increase to the level corresponding to the long-term average. The low investment activity in 2005 was primarily the result of a decline in inventories and low government investment. By contrast, housebuilding was the fastest-growing component of capital expenditure, and should remain so in the future. The acceleration of investment growth in 2007 or the second half of 2006 is a result of the anticipated expansion of housebuilding before the envisaged end of the transition period for the application of the low VAT rate, which is expected to happen at the end of 2007 .During the transition period Slovenia was allowed to apply a lower VAT rate on the construction and repair of housing and other structures designed for residential purposes. Given slightly stronger investments in plant and equipment and increased investment spending by the government on road infrastructure, growth in investment in housing can be expected to remain strong. The anticipated investment in the car industry will make a significant contribution to high investments this year and next year.

**…government spending will remain reasonably stable**

Throughout the forecasting period the contribution to economic growth made by the government will remain similar to that in previous years. Government spending was relatively strong in 2005, primarily as a result of slightly higher expenditure on collective government spending over the whole year, and in the second half of the year in particular, when government expenditure on administration, defence, and research and development rose by 4.4% overall. Growth in government spending is projected to remain at a level around 2.8% in the coming years. This is slightly higher than in the previous forecasts, the rise resulting mostly from moderate growth in public sector wages after the slow growth in 2005, although the restrictive policy of expenditure on goods and services will continue.

## 4.4 Balance of Payments

**Minor changes in the current forecasts from the previous forecasts**

The estimated current account deficit will increase by approximately 1 percentage point from the level of 1.1% of GDP recorded in 2005. Despite the higher forecast for export growth, the increase in the deficit is slightly larger than in the previous forecasts owing to a deterioration in the terms of trade, i.e. prices of imported goods growing faster than prices of exported goods in 2006. The rates of growth in imports and exports in 2007 do not differ significantly from the previous forecasts, but they do differ slightly for 2006 with export growth forecast to outpace import growth. The reasons for the differences in the forecast are the faster improvement in foreign demand on the side of increased export growth, and the slightly lower growth in the projected domestic demand in 2006 on the side of decreased import growth.

**Table 4.4: Current account**

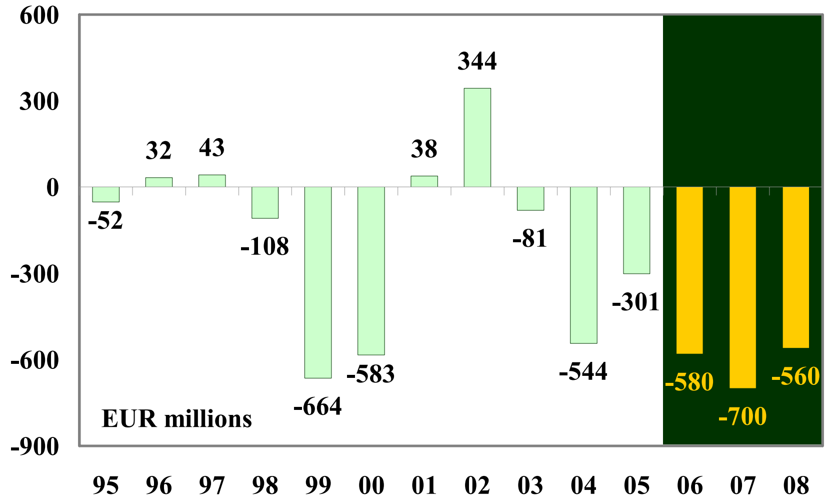
| | 2002 | 2003 | 2004 | 2005 | 2006 Forecast May | 2006 Δ | 2007 Forecast May | 2007 Δ | 2008 Forecast May | 2008 Δ |
|---|---|---|---|---|---|---|---|---|---|---|
| | *real growth, %* | | | | | | | | | |
| Exports of goods and services | 6.7 | 3.1 | 12.5 | 9.2 | 7.4 | 1.0 | 7.1 | 0.4 | 7.2 | … |
| Imports of goods and services | 4.8 | 6.7 | 13.2 | 5.3 | 6.7 | -0.3 | 6.6 | 0.3 | 6.7 | … |
| Current account (EUR millions) | 344 | -81 | -544 | -301 | -580 | -80.0 | -700 | -270 | -560 | … |
| as % of GDP | 1.5 | -0.4 | -2.1 | -1.1 | -2.0 | -0.3 | -2.3 | -1.0 | -1.7 | … |
| Terms of trade | 0.5 | 1.3 | -1.0 | -2.7 | -1.6 | -1.5 | -0.1 | -0.2 | 0.4 | … |

Source: ARC

**The current account deficit will be approximately 2% of GDP…**

The estimated current account deficit will worsen from EUR 301 million in 2005 to EUR 580 million in 2006 and EUR 700 million in 2007. This deterioration is almost entirely due to a worsening of the balance of trade in goods because of unfavourable movement in the terms of trade in 2006. A rise in the interest paid on loans and deposits from abroad and rising expenditure on dividends and reinvested earnings will also account for a minor proportion of the increase in the estimated deficit. The estimated current account deficit will improve to EUR 560 million in 2008, despite the continuation of the highly negative position in the trade balance in goods from 2007 and a minor deterioration in the net flow of capital income. The improvement can be attributed to an increase in the positive balance of trade in services, which shows a stable trend of growth in the projections.

**Figure 4.5: Projection of current account**




Source: ARC

**…primarily as a result of unfavourable movements in the terms of trade in 2006…**

The unfavourable movement in the terms of trade seen in 2005 is expected to continue in 2006 because of rapid growth in commodities prices, but with a slowdown in commodities prices in the next two years the terms of trade are expected to have a neutral effect on the current account position. Growth in import prices will outstrip growth in export prices by 1.6 percentage points in 2006. This will contribute significantly to the increase in the current account deficit this year, and the continuation of the deficit at a relatively high level in the coming years. The exclusion of unfavourable growth trends in import and export prices (unfavourable terms of trade) would significantly improve the current account position. The current account deficit excluding unfavourable terms of trade would fall to approximately EUR 260 million in 2006 and 2008 and to approximately EUR 350 million in 2007. The total negative contribution made to the current account deficit by the terms of trade will range from 0.9% to 1.2% of GDP in the coming years.

**…which will be reflected in a wider deficit in merchandise trade**

Growth in merchandise exports is expected to outstrip growth in merchandise imports by 0.5 to 0.7 percentage points in the coming years. The high growth in exports of merchandise in 2004 and 2005 associated with the final abolition of customs duties when Slovenia joined the EU trade area and the high growth in exports by the car industry should settle at a level slightly above 7% in the future. These projections are slightly higher than the previous forecasts, primarily because of the improvement in economic activity in Slovenia's most important trading partners already in 2006. The current projections for merchandise exports assume an unchanged rate of growth in the car industry exports. Given the large proportion of exports that they account for, any fluctuation in these could have a significant impact on the actual volume of merchandise exports. Growth in merchandise imports is linked to both growth in merchandise exports and growth in domestic consumption. The largest contribution to the increase in the latter comes from growth in gross capital formation, followed by growth in spending on consumer goods and growth in spending on intermediate goods. Growth in imports is projected to be 1.4 percentage points higher in the coming years than in 2005, primarily as a result of the projected increase in growth in domestic demand from 2005. Growth in merchandise imports in 2006 is down 0.3 percentage points from the previous forecast, while that in 2007 is up 0.3 percentage points. In both years the slightly lower growth in imports is a reflection of gap by which increased growth in domestic demand trails GDP growth, but import growth is slightly higher in 2007 because of the projected increase in gross capital formation in that year.

**The greatest risks are in the realisation of the terms of trade**

The current projections for the current account position are a reflection of current assumptions, the main risks being changes in the assumptions for estimating growth in imports and exports of goods and services and the terms of trade. The risks in forecasting growth in imports and exports of goods and services relate to a great extent to the level of economic activity in Slovenia's trading partners and the level of growth in domestic demand, which is still behind GDP growth. The terms of trade assumed in the current projections for the current account represent the majority of the deterioration in the position from the previous year. Given that Slovenia is a small country, a change in domestic demand cannot bring any pressure on prices of foreign goods, while strong competition also implies that a change in foreign demand for domestic goods cannot lead to significant changes in the prices of these goods. This means that Slovenia's terms of trade, i.e. the prices of imported and exported goods, are determined by global supply and demand and shocks on world markets, with the latter, e.g. oil prices and commodities prices, continuing to have a significant impact on the realisation of balance of trade in goods projections and also on the current account position.

**Stable growth in the positive services position and the negative income position**

The balance of trade in services will be positive in all the coming years, and should improve by approximately EUR 150 million each year. The main factors in this trend will be favourable foreign demand and slightly higher growth in export prices of services than in import prices in 2007 and 2008. The income position will worsen by approximately EUR 105 million in 2006 and 2007, and by EUR 80 million in 2008. The main factors in this worsening will be the rise in interest paid, and increasing expenditure on dividends and reinvested earnings. A rise in interest payments is projected because of ongoing increase in the stock of loans and deposits from abroad and also the projected rise in interest rates. High and increasing expenditure on dividends and reinvested earnings are partly a reflection of the volume of inward FDI realised in Slovenia in the past, and partly a reflection of the increase in inward FDI projected in the future, particularly in 2007 and 2008. Rising income from investments in foreign debt securities, which should significantly exceed expenditure on foreign investments in domestic debt securities, will contribute to a decline in the deficit in the income position. With growth in labour expenditure slightly exceeding labour revenues, the positive labour income position will decline slightly.

**Transfers are projected to be almost in balance**

Net transfers will be almost in balance in the coming years, with private transfers positive and official transfers negative. Since Slovenia joined the EU, both revenue from the EU budget and expenditure for the EU budget have risen. The balance of this revenue and expenditure will be slightly positive, and will slightly offset the negative balance in official transfers.

## 4.5 Terms of Financing

**Slovenia's increasing financial integration will contribute to...**

High growth in financial inflows and outflows is expected in the next three years, as a reflection of Slovenia's growing integration into the single European market, the unrestricted flow of capital, and the small size of the domestic market. The adoption of the single currency will see the elimination of exchange-rate risk for transactions in euros, which will additionally strengthen capital flows in the direction of risk diversification and portfolio restructuring.

**…the continuation of a strong surplus in financial inflows from the rest of the world…**

Despite the rise in both financial inflows and outflows, the strong surplus in net financial inflows seen in 2005 is expected to continue over the next three years, particularly in 2007 and 2008, when it should stand at 8.2% and 7.6% of GDP respectively. Bank borrowing via loans from the rest of the world will again to a great extent contribute to financial inflows, while strong growth in inward FDI is envisaged in 2007 and 2008. Higher portfolio investments in Slovenia's private sector and the government sector will also contribute to high financial inflows in the future. A continuation of the increasing financial outflows recorded in recent years is projected for investments in foreign securities, outward FDI and loans made to the rest of the world.

**Table 4.5: Financial account**

| | | | | | 2006 Forecast | | 2007 Forecast | | 2008 Forecast | |
|---|---|---|---|---|---|---|---|---|---|---|
| | 2002 | 2003 | 2004 | 2005 | May | Δ | May | Δ | May | Δ |
| Financial account (as % of GDP) | 4.9 | 0.6 | -0.1 | 5.3 | 4.8 | 2.4 | 8.2 | 5.1 | 7.6 | … |
| of which: FDI | 6.6 | -0.5 | 0.9 | -0.2 | 0.5 | 0.2 | 1.9 | 2.1 | 1.4 | … |
| Foreign exchange reserves (EUR millions) | 7,842 | 7,881 | 7,891 | 8,832 | 9,642 | 1,421 | 11,492 | 2,681 | 13,452 | … |
| - as % of GDP | 34.1 | 32.7 | 31.1 | 32.2 | 33.5 | 6.4 | 37.2 | 10.3 | 40.5 | … |
| External debt (EUR millions) | 11,483 | 13,051 | 15,397 | 19,565 | 22,665 | 2,469 | 26,245 | 3,629 | 30,025 | … |
| - as % of GDP | 49.9 | 54.1 | 59.5 | 71.3 | 78.5 | 11.8 | 85.0 | 16.0 | 91.0 | … |

Source: ARC

**…primarily because of the inflow of loans made to the banking sector…**

The largest financial inflow will again be loans from the rest of the world. The majority of these loans will be taken by banks. Given the decline in interest rates since 2001, the need for banks to obtain financial assets has increased for two reasons. First, during this period of declining interest rates banks have seen a certain loss in residents' deposits in favour of alternative investments with greater returns. Second, the decline in interest rates in the context of high economic activity has brought an increase in demand for lending. Thus once interest rates have settled at the level of the ECB's interest rates, banks will be able to obtain the assets required for financing domestic lending activity via loans from the rest of the world in the range from EUR 1.9 billion to EUR 2.4 billion, and via deposits by non-residents in the amount of EUR 500 million. Estimated loans to companies from the rest of the world will settle at a level between EUR 280 million and EUR 320 million, this estimate continuing to assume a shift from borrowing abroad to borrowing by companies at domestic banks. Loans made to the rest of the world also show a stable growth trend, with the majority being directed towards the former Yugoslavia. The volume of these loans is a reflection of the relatively favourable lending terms in Slovenia, and of Slovenia's trading with these countries.

**…and strong growth in inward FDI,…**

The net financial inflow via inward FDI should rise from EUR 150 million in 2006 to EUR 600 million in 2007 and EUR 450 million in 2008. This increase in the net financial inflow will come from the projected increase in inward FDI, in particular in equity, via the privatisation of certain large companies in the telecommunications sector, the banking sector and the gambling industry. The forecast for the increase in inward FDI assumes dispersion over the entire period of the forecast, but with the largest increase of EUR 1.2 billion projected as coming in 2007. A stable growth trend for outward FDI is projected for the same period, with the majority of investments, as in previous years, being made in equity and directed towards the Balkans and countries in transition.

**…despite the increase in portfolio investments in foreign capital markets**

With investment expected to increase on the both the Slovenian capital market and the foreign capital market, portfolio investments are projected to settle at a net financial outflow in the range from EUR 250 million to EUR 300 million. The increase in the financial outflow assumes a restructuring in the portfolio of the non-monetary financial sector in the direction of risk diversification, and is a reflection of the decline in market indices on the domestic capital market in 2005 and the relaxation of institutional barriers regarding the proportion of foreign securities in the structure of investments by mutual funds. The forecasts envisage an end to the restructuring of these portfolios and thus a slowdown in the financial outflow in 2007 and 2008. An increase in financial inflows from foreign portfolio investments is expected during the forecasting period, these having been significantly lower in 2004 and 2005 because of debt repayments by the government or the repayment of maturing eurobonds. Given that the next tranche of eurobonds does not mature until 2009 and 2010, the main factors in the projected financial inflow will be higher investments in companies, bank bonds and Slovenian government bonds. The forecast increase in investments in the private sector originates in the increasing interest shown by non-residents in the Slovenian capital market, part of which can be attributed to the synergy of portfolio investments with higher inward FDI. The net financial flow of trade credits and capital transfers is expected to remain a relatively small net outflow. In addition to previous trends, the projections for trade credits granted and received and for capital transfers take projections for the volume of trading in the current account into consideration.

**Expectations of an increase in lending to the private sector at a declining pace…**

Total lending at domestic banks and abroad will probably be slightly higher than in previous forecasts, although the current rate of growth in new borrowing should begin to decline during the forecasting period. These trends are in line with the projected improvement in economic activity and the moderate level of domestic consumption. Further interest rate convergence and more favourable terms of lending at domestic banks during the forecasting period mean that the proportion of company financing accounted for by foreign loans will continue to decline slightly, and will fall below 10%. In line with the ongoing restructuring of debt, government borrowing on the domestic market will increase further, with borrowing abroad diminishing. With banks borrowing heavily from the rest of the world, the highest growth in domestic lending in 2006 will be recorded by foreign currency lending, which is in line with the currency coordination of the asset and liability sides of banks' balance sheets.

**…in the direction of deepening of financial intermediation**

The depth of financial intermediation as measured by lending to the private sector as a proportion of GDP will increase from 55% in 2005 to approximately 80% in 2008. The current rate of growth in the depth of financial intermediation will begin to decline during the forecasting period. Year-on-year growth in lending to the corporate sector and to households is projected to fall to approximately 20% and 15% respectively in 2008. This increase in lending is in line with interest rate convergence and the process of catching up economically with wealthier EU member-states, where lending exceeds 100% of GDP. The increase in corporate borrowing from the previous forecasts can be attributed to the improvement in economic activity. With forecasts of household spending unchanged, the volume of household lending in the coming years will not differ significantly from the previous forecasts. Demand for lending from households will be relatively high, because of slightly higher wage growth and slightly higher projected demand for housing loans in 2006 and 2007. Government borrowing in the upcoming period reflects the need to finance the projected budget deficit and the repayment of government debt to the rest of the world. The trend of a shift from short-term borrowing to long-term borrowing will continue in the coming years, in particular because of the projected improvement in investment activity.

**A growing positive contribution by net financial flows to broad money growth…**

Domestic lending activity will be the main contributor to broad money in the coming years. The negative contribution to broad money by balance of payments flows will gradually diminish, with the net financial flow increasing significantly from previous forecasts in line with balance of payments projections.

**…and a decline in the current rate of growth in narrow money**

Growth in the broad monetary aggregates will be correspondingly higher than in the previous forecasts because of higher net inflows from the rest of the world and higher borrowing. Average annual growth rate in broad money is projected to increase from approximately 11% in 2006 to 16% in 2008. Growth in narrow money has been adjusted in the other direction from the previous forecasts. Owing to bonus payments and high one-off contract-based payments at the end of 2004, this rose sharply, meaning that average annual growth in narrow money rose strongly in 2005.

**Table 4.6: Monetary system**

| | | | | | 2006 Forecast | | 2007 Forecast | | 2008 Forecast | |
|---|---|---|---|---|---|---|---|---|---|---|
| | 2002 | 2003 | 2004 | 2005 | May | Δ | May | Δ | May | Δ |
| **Monetary system** | *average annual growth, %* | | | | | | | | | |
| M1 | 18.2 | 11.6 | 17.5 | 21.4 | 11.0 | -3.4 | 10.5 | -2.7 | 10.0 | … |
| M3 | 22.5 | 12.3 | 5.2 | 6.5 | 11.4 | 1.6 | 15.5 | 3.7 | 16.0 | … |
| Total lending | 15.8 | 12.5 | 17.9 | 20.6 | 20.7 | 3.4 | 19.4 | 4.2 | 17.4 | … |

Source: ARC

However, the current rate of growth in narrow money slowed significantly in 2005, and average annual growth is thus forecast to be lower, between 10% and 11%.

**Changes in the maturity structure of tolar deposits**

The average maturity period of tolar deposits will probably lengthen in the period leading up to the adoption of the euro. The current shift in tolar deposits towards short-term maturities is to a great extent connected with the declining slope of the interest rate yield curve.

## 4.6 Inflation

**Inflation to remain low**

The trend of falling inflation ended last year, as last year's average level of around 2.5% is already in the vicinity of the long-term balance that can be expected in an economy still undergoing the process of real convergence. Taking exogenous variables and economic policy assumptions into consideration, inflation will fall further this year and next year to an average of 2.2%, but can be expected to average approximately 2.6% in 2008. The 12-monthly average of

**Table 4.7: Inflation**

| | | | | | 2006 Forecast | | 2007 Forecast | | 2008 Forecast | |
|---|---|---|---|---|---|---|---|---|---|---|
| | 2002 | 2003 | 2004 | 2005 | May | Δ | May | Δ | May | Δ |
| | *annual growth (final quarter), %* | | | | | | | | | |
| Consumer prices | 7.2 | 4.8 | 3.4 | 2.5 | 1.9 | -0.4 | 2.3 | -0.1 | 2.7 | … |
| Free prices | 6.9 | 5.1 | 2.1 | 1.3 | 1.8 | -0.8 | 2.5 | -0.2 | 2.9 | … |
| Administered prices | 8.8 | 3.7 | 9.5 | 8.0 | 2.5 | 1.4 | 1.4 | 0.3 | 1.6 | … |
| | *average annual growth, %* | | | | | | | | | |
| Consumer prices | 7.5 | 5.6 | 3.6 | 2.5 | 2.2 | -0.4 | 2.2 | -0.2 | 2.6 | … |
| Free prices | 7.61 | 5.9 | 3.0 | 1.1 | 1.4 | -1.0 | 2.3 | -0.4 | 2.8 | … |
| Administered prices | 7.5 | 4.8 | 6.6 | 9.0 | 4.9 | 1.3 | 1.5 | 0.4 | 1.6 | … |

Source: ARC

year-on-year inflation as measured by the harmonised index of consumer prices will remain below the Maastricht criterion reference value throughout the forecasting period, which indicates the long-term sustainability of the price stability attained.

**Downward revisions of price growth are the result of free prices growing more slowly than expected**

The downward revisions for 2006 and 2007 from the November projections are mainly connected with the exceptionally low growth in free prices last year and with expectations of slower, more gradual transmission of the effects of temporary factors from last year and the previous year. Growth in free prices is therefore expected to be lower, and consequently growth in administered prices excluding energy prices will also be slower.

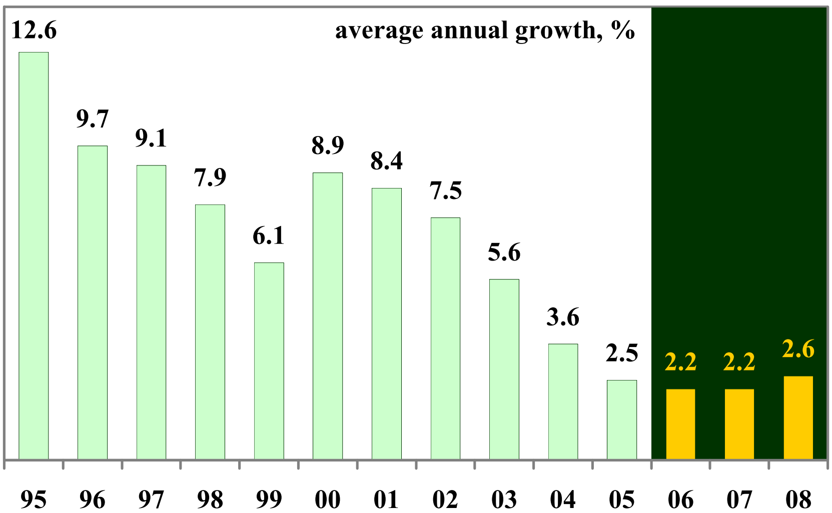
**Growth in free prices is gradually reaching the projected long-term path**

Projections of domestic macroeconomic environment point to the possibility of a gradual rise in inflation of free prices towards the projected long-term balance. After the extremely low rates recorded last year, growth in free prices will therefore gradually increase. Our forecasts are for year-on-year growth in free prices of 1.8% in the final quarter of 2006, and then higher growth of 2.5% in the final quarter of 2007 and 2.9% in the final quarter of 2008. The continuation of good economic activity will probably see the output gap close completely this year, which will neutralise the downward pressure on inflation present in recent years. Nevertheless, after temporarily high wage growth this year and next year, this is expected to ease to 2.6% in 2008, and will thus remain below productivity growth throughout the forecasting period. The main reason for slower growth in labour costs is the tougher conditions on the labour market. The main risk regarding excessive wage growth is the failure to reach a wage agreement for the whole of the forecasting period in either the private sector or the public sector. Given the projections of domestic and foreign price movements, the real effective exchange rate will remain in balance and will not have any noticeable effect on prices or competitiveness. For the moment the risk of the high growth in energy prices seen in recent years gradually feeding through into free prices in the coming years seems limited.

**Projected easing of price pressures from abroad**

The exogenous assumptions from the international environment point to a gradual easing in price pressures from abroad. After last year's faster growth rate of 2.2%, growth in consumer prices in the eurozone should slow again to 2.0% in the period to 2008. Growth in producer prices in Germany, Slovenia's biggest trading partner, should also slow. Despite the assumptions of recovery in world economic growth after 2005, with monetary policy increasingly restrictive abroad this should not entail any significant price pressures.

**Figure 4.6: Inflation projections**




Source: ARC

**Projected slower growth in administered prices**

With free prices growing faster, the projected slowdown in the growth in administered prices, which is an implicit consequence of the assumption that energy prices will remain unchanged, should contribute to lower inflation. The movement of administered prices assumes that the oil price will be unchanged on world markets, and that prices of refined petroleum products on the domestic market will consequently be unchanged. At the same time all other administered prices should move in line with free prices, in accordance with the macroeconomic framework adopted. Thus growth in administered prices overall will continue to exceed growth in free prices in 2006, while in 2007 and 2008 administered prices will be behind growth in free prices on average owing to the zero growth in prices of refined petroleum products. Another significant risk in these projections is the movement of oil prices, which in the event of significant deviation from our assumptions could prevent the projected fall in growth in administered prices.

**Fiscal policy and administered prices policy are decisive in maintaining price stability**

In the coming years fiscal policy and administered prices policy will assume the decisive role in maintaining price stability. By maintaining sound public finances, the former will also have to ensure sustainability in the other macroeconomic equilibria to facilitate long-term stability in inflationary expectations. The administered prices policy will have to pursue its objectives more consistently and prevent rises in prices under administration that are not justified in cost terms. In the event of oil prices remaining unchanged on world markets, as proceeds from our assumptions, the forecasts are made under the assumption that prices of refined petroleum products will remain unchanged, i.e. that the government will leave excise duties unchanged. The projections also assume that apart from the increases in excise duties on tobacco already announced the government will not significantly contribute to price rises through discretionary changes in indirect taxation. A rise in indirect taxation could raise inflation by between 0.4 and 0.5 percentage points over the entire forecasting period. An additional risk is a possible rise in VAT rates next year, which could contribute approximately 0.7 percentage points to average inflation according to our forecasts.

**Inflationary pressures caused by price rounding will be limited during the introduction of the euro**

Inflationary pressures brought by rounding when the euro is introduced are expected to be limited and similar to those in other eurozone countries. These effects are likely to appear solely in sectors with a low level of competition, and will probably only be temporarily (see Box 4.1). In order to further limit the aforementioned risks of the consumers' misperception of euro prices and to prevent price rises during the introduction of the euro that are not justified in cost terms, the Bank of Slovenia supported a law that has prescribed mandatory informative dual pricing from 1 March of this year until the actual introduction of the euro, and mandatory dual pricing for six months after introduction. The Bank of Slovenia also supports a joint campaign by the Statistical Office of the Republic of Slovenia and the Slovene Consumers' Association on supplementary price supervision, which the two institutions aim to carry out this year and next year.

## Box 4.1: The effect of the introduction of the euro on inflation

According to opinion surveys conducted in the eurozone countries in November 2004, almost three years after the introduction of the euro, 95% of consumers felt that prices were converted into euros to their detriment,[1] which is completely at odds to the expert view, which does not recognise any unusual major shifts in inflation during this period. Eurostat calculations show that the euro cash changeover brought a rise in year-on-year inflation of no more than 0.2 percentage points.[2] Studies conducted for individual countries similarly found that: the effect was estimated at 0.3 percentage points in Germany, 0.2 percentage points in Belgium, 0.4 percentage points in Spain and between 0.1 and 0.6 percentage points in

**Table: Inflation during the euro cash changeover**

| (%) | EUROZONE | | | | | | | | | | | | | Comparison | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | average | BL | D | GR | E | F | IRL | I | LUX | NL | A | P | FI | DK | S | GB |
| **2001** | 2.4 | 2.4 | 1.9 | 3.7 | 2.8 | 1.8 | 4 | 2.3 | 2.4 | 5.1 | 2.3 | 4.4 | 2.7 | 2.3 | 2.7 | 1.2 |
| **2002** | 2.3 | 1.6 | 1.4 | 3.9 | 3.6 | 1.9 | 4.7 | 2.6 | 2.1 | 3.9 | 1.7 | 3.7 | 2 | 2.4 | 1.9 | 1.3 |

Source: Eurostat

Italy.[3] Why is there such a discrepancy between the human perception of inflation and the statistics?

The reasons are primarily psychological, and are described by several concepts. First, the concept of "rational ignorance" explains the matter in question by arguing that consumers better remember changes in the prices of the goods that they purchase more often.[4] ECB research showed that certain types of products, in particular service activities such as restaurants, cinemas, dry cleaners and hairdressers, did in fact record unusual price rises in the first months of 2002.[5] Although some of these rises were the result of seasonal factors owing to bad weather conditions, the public attributed the inflationary pressure solely to the introduction of the euro.

Second, the changeover from the legacy currencies to the euro brought an unusual number of price changes (rounding up and down), which probably raised consumers' awareness of these changes. According to the concept of the "selective corrective effect", consumers should more strongly identify changes that confirm their previous expectations, which were pessimistic.[6]

Third, a "monetary illusion" factor, which clouds consumers' picture of their purchasing power, is also likely to contribute to an erroneous perception of inflation. Compared with the previous currencies, the larger unit of the euro may have weakened consumers' focus, and brought increased spending. For the same reason, the sharp decline in the number of psychologically appealing prices, usually ending in a "9", could also have led to the erroneous perception of price rises during the changeover to euro cash. In the majority of countries it took more than a year for the proportion of such prices to rise again to the previous level.[7]

[1] European Commission (2004). Flash Eurobarometer. The Euro, Three Years Later.
[2] Eurostat (2002) Euro changeover effects.
[3] See references in Giovane, P, F Lippi and R Sabbatini (2005), L'euro e l'inflazione, Percezione, fatti e analisi, Il Mulino
[4] See for example Marques JF and S Dehaene (2004), Developing Intuition for Prices in Euros: Rescaling or Relearning Prices? Journal of Experimental Psychology 10(3)
[5] European Central Bank (2002). Evaluation of the 2002 Cash Changeover
[6] See for example Traut-Mattausch E, S Schulz-Hardt, T Greitemeyer and D Frey (2004), Expectancy Confirmation in Spite of Disconfirming Evidence: The Case of Price Increases Due to the Introduction of the Euro, European Journal of Social Psychology 34
[7] See del Giovane and Sabbatini (2005), and references cited therein

## 4.7 Comparison with Forecasts of Other Institutions

**A comparison of the forecasts of various institutions…**

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

**…reveals considerable similarity…**

The forecasts by various institutions for economic trends in Slovenia are becoming increasingly similar. With regard to economic activity, there is a consensus that GDP growth in 2006 will be even higher than in 2005, and will remain high in 2007.The figures for GDP growth have been revised upwards overall. Opinions of an increased contribution to economic growth by domestic demand are also unanimous, with differences only arising with regard to the current account position. Here there is an interesting difference between domestic institutions, which are generally forecasting a larger deficit, and foreign institutions, which are forecasting a deficit 1 GDP percentage point narrower. Neither is there any consensus about the contraction or expansion of the current account deficit in 2007.

**Table 4.8: Comparison of forecasts for Slovenia and change since previous forecast**

| | Publication date of new / previous forecast | GDP annual growth, % | | | | Inflation annual average, % | | | | Current account as % of GDP | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | | 2006 | | 2007 | | 2006 | | 2007 | | 2006 | | 2007 | |
| | | new | Δ | new | Δ | new | Δ | new | Δ | new | Δ | new | Δ |
| **Bank of Slovenia** | May 06 / Nov 05 | **4.2** | 0.4 | **4.2** | 0.4 | **2.2** | -0.4 | **2.2** | -0.2 | **-2.0** | -0.3 | **-2.3** | -1.0 |
| **EIPF** | Jan 06 / Sep 05 | **4.5** | -0.3 | **…** | … | **2.2** | 0.2 | **…** | … | **-1.3** | 0.3 | **…** | …. |
| **UMAR** | Apr 06 / Oct 05 | **4.2** | 0.2 | **4.0** | 0.0 | **2.1** | -0.2 | **2.1** | -0.3 | **-1.7** | -1.0 | **-1.3** | -1.5 |
| **European Commission** | May 06 / Nov 05 | **4.3** | 0.3 | **4.1** | -0.1 | **2.4** | -0.1 | **2.5** | 0.0 | **-1.6** | 0.2 | **-1.8** | 0.2 |
| **IMF** | Apr 06 / Oct 05 | **4.0** | 0.1 | **4.0** | … | **2.4** | -0.1 | **2.4** | … | **-0.3** | 0.5 | **0.1** | … |
| **Consensus Forecasts** | Mar 06 / Sep 05 | **3.8** | -0.1 | **4.0** | … | **2.3** | -0.1 | **2.1** | … | **-0.1** | 0.0 | **-0.1** | … |

Sources: Bank of Slovenia, UMAR, EIPF, IMF World Economic Outlook, Consensus Economic Forecasts, European Commission

**…in inflation forecasts**

This time the variation in the inflation forecasts is rather small. The forecasts for average annual inflation range from 2.1% to 2.4% for 2006, and the same for 2007. Thus the differences between the forecasts of domestic and foreign institutions have significantly narrowed in the last year.

## Table 4.9: Selected main indicators

| | 2002 | 2003 | 2004 | 2005 | 2006 Forecast May | 2006 Forecast Δ | 2007 Forecast May | 2007 Forecast Δ | 2008 Forecast May | 2008 Forecast Δ |
|---|---|---|---|---|---|---|---|---|---|---|
| **Activity, employment, wages** | *real growth, %, unless stated* | | | | | | | | | |
| Real GDP | 3.5 | 2.7 | 4.2 | 3.9 | 4.2 | 0.4 | 4.2 | 0.4 | 3.9 | ... |
| Per capita GDP (EUR) | 11,866 | 12,461 | 13,103 | 13,677 | 14,477 | -667 | 15,448 | -946 | 16,440 | ... |
| Employment | 1.5 | -0.2 | 0.4 | 0.7 | 0.4 | 0.1 | 0.3 | -0.2 | 0.3 | ... |
| Net wages | 2.1 | 1.8 | 0.8 | 3.6 | 2.9 | 0.2 | 2.9 | 0.2 | 2.6 | ... |
| Gross wages | 2.1 | 1.9 | 1.0 | 2.2 | 2.9 | 0.2 | 2.9 | 0.2 | 2.6 | ... |
| Productivity | 2.0 | 2.9 | 3.8 | 3.2 | 3.9 | 0.4 | 3.9 | 0.6 | 3.6 | ... |
| **Domestic demand** | *real growth, %* | | | | | | | | | |
| Domestic demand | 2.4 | 4.7 | 4.6 | 1.6 | 3.7 | -0.4 | 3.9 | 0.3 | 3.5 | ... |
| Private consumption | 1.3 | 3.5 | 3.3 | 3.3 | 3.2 | -0.2 | 3.1 | -0.1 | 3.1 | ... |
| Government spending | 3.2 | 1.6 | 2.9 | 3.0 | 2.7 | 0.2 | 2.8 | 0.3 | 2.7 | ... |
| Gross capital formation | 4.0 | 10.1 | 9.2 | -3.0 | 5.4 | -1.6 | 6.0 | 0.7 | 4.9 | ... |
| **Balance of payments** | *real growth, %, unless stated* | | | | | | | | | |
| Exports of goods and services | 6.7 | 3.1 | 12.5 | 9.2 | 7.4 | 1.0 | 7.1 | 0.4 | 7.2 | ... |
| Imports of goods and services | 4.8 | 6.7 | 13.2 | 5.3 | 6.7 | -0.3 | 6.6 | 0.3 | 6.7 | ... |
| Current account (EUR millions) | 344 | -81 | -544 | -301 | -580 | -80.0 | -700 | -270 | -560 | ... |
| as % of GDP | 1.5 | -0.4 | -2.1 | -1.1 | -2.0 | -0.3 | -2.3 | -1.0 | -1.7 | ... |
| Terms of trade | 0.5 | 1.3 | -1.0 | -2.7 | -1.6 | -1.5 | -0.1 | -0.2 | 0.4 | ... |
| Financial account (as % of GDP) | 4.9 | 0.6 | -0.1 | 5.3 | 4.8 | 2.4 | 8.2 | 5.1 | 7.6 | ... |
| of which: FDI | 6.6 | -0.5 | 0.9 | -0.2 | 0.5 | 0.2 | 1.9 | 2.1 | 1.4 | ... |
| Foreign exchange reserves (EUR millions) | 7,842 | 7,881 | 7,891 | 8,832 | 9,642 | 1421 | 11,492 | 2681 | 13,452 | ... |
| - as % of GDP | 34.1 | 32.7 | 31.1 | 32.2 | 33.5 | 6.4 | 37.2 | 10.3 | 40.5 | ... |
| External debt (EUR millions) | 11,483 | 13,051 | 15,397 | 19,565 | 22,665 | 2,469 | 26,245 | 3,629 | 30,025 | ... |
| - as % of GDP | 49.9 | 54.1 | 59.5 | 71.3 | 78.5 | 11.8 | 85.0 | 16.0 | 91.0 | ... |
| **Monetary system** | *average annual growth, %* | | | | | | | | | |
| M1 | 18.2 | 11.6 | 17.5 | 21.4 | 11.0 | -3.4 | 10.5 | -2.7 | 10.0 | ... |
| M3 | 22.5 | 12.3 | 5.2 | 6.5 | 11.4 | 1.6 | 15.5 | 3.7 | 16.0 | ... |
| Total lending | 15.8 | 12.5 | 17.9 | 20.6 | 20.7 | 3.4 | 19.4 | 4.2 | 17.4 | ... |
| **Prices** | *annual growth (final quarter), %* | | | | | | | | | |
| Consumer prices | 7.2 | 4.8 | 3.4 | 2.5 | 1.9 | -0.4 | 2.3 | -0.1 | 2.7 | ... |
| Free prices | 6.9 | 5.1 | 2.1 | 1.3 | 1.8 | -0.8 | 2.5 | -0.2 | 2.9 | ... |
| Administered prices | 8.8 | 3.7 | 9.5 | 8.0 | 2.5 | 1.4 | 1.4 | 0.3 | 1.6 | ... |
| | *average annual growth, %* | | | | | | | | | |
| Consumer prices | 7.5 | 5.6 | 3.6 | 2.5 | 2.2 | -0.4 | 2.2 | -0.2 | 2.6 | ... |
| Free prices | 7.6 | 5.9 | 3.0 | 1.1 | 1.4 | -1.0 | 2.3 | -0.4 | 2.8 | ... |
| Administered prices | 7.5 | 4.8 | 6.6 | 9.0 | 4.9 | 1.3 | 1.5 | 0.4 | 1.6 | ... |
| **International environmental factors** | *annual growth, %, unless stated* | | | | | | | | | |
| Foreign demand* | 1.9 | 3.7 | 5.3 | 4.7 | 6.0 | 0.0 | 6.0 | 0.0 | 6.0 | ... |
| USD/EUR | 0.94 | 1.13 | 1.24 | 1.25 | 1.21 | 0.0 | 1.21 | 0.0 | 1.21 | ... |
| Oil (USD/barrel) | 25 | 29 | 38 | 54 | 65 | 0.0 | 65 | 0.0 | 65 | ... |
| Commodities | 4.6 | 11.3 | 16.0 | 6.0 | 15.0 | 12.0 | 3.0 | 0.0 | 3.0 | ... |
| Inflation in EMU | 2.2 | 2.1 | 2.1 | 2.2 | 2.2 | 0.3 | 2.2 | 0.3 | 2.0 | ... |
| PPI Germany | -0.6 | 1.7 | 1.6 | 4.6 | 2.9 | 0.8 | 1.7 | -0.4 | 1.7 | ... |
| 3-m Euribor (%) | 3.3 | 2.3 | 2.3 | 2.3 | 3.0 | 0.7 | 3.5 | 1.0 | 3.5 | ... |

* Volume of imports by basket of foreign partners
Source: ARC, Consensus Forecasts, JP Morgan, OECD Outlook, IMF World Economic Outlook, SORS

# 5 ECONOMIC POLICY IN LIGHT OF EURO ADOPTION

**The introduction of the euro is a turning point in the exercise of economic policy in Slovenia**

Slovenia's macroeconomic environment is likely to experience a significant turning point on 1 January 2007. The current macroeconomic environment will become part of the macroeconomic environment of the eurozone, and vice-versa, the monetary environment of the eurozone will become part of Slovenia's domestic monetary environment. This will complete the shift in the macroeconomic policy begun when Slovenia joined the ERM II. In order for the economy to function successfully within the monetary union, the basic guidelines for economic policy outlined in the Programme for ERM II Entry and Adoption of the Euro adopted in November 2003 by the Bank of Slovenia and Slovenia's government must continue to be upheld.[7]

## 5.1 Achieving Nominal Convergence

**Meeting the convergence criteria is a prerequisite for introducing the euro**

Achieving sustainable nominal convergence is a pre-requisite for introducing the euro. In accordance with Article 122 of the Treaty, this is assessed by the European Commission and the ECB, which verify whether the convergence criteria have been met and draw up separate convergence reports. The two institutions made their most recent review of the criteria of price stability, government finances, exchange rates and interest rates in October 2004 for the ten new member-states and Sweden. In addition to meeting the aforementioned economic criteria, before introducing the euro a member-state must also ensure compatibility between its national legislation and the Treaty and the Statute of the European System of Central Banks (ESCB). The individual economic convergence criteria are examined in detail below, with a focus on whether they are met by Slovenia.

### Price Stability Criterion

**The disinflation process was renewed in 2001…**

After the inflation shocks of 1999, the disinflation process resumed in Slovenia in 2000, and the inflation rate has fallen since then from just under 10% to around 2.5%. This process was the result of adjustments in economic policy, including the introduction of a new framework for monetary policy,[8] the objective of which was to ensure a gradual, sustained fall in inflation. Year-on-year growth of the harmonised index of consumer prices (HICP) first fell below 3% in January 2005, and has since then fluctuated around 2.5%. Here the slightly larger fluctuation compared with other European Union countries primarily reflects the change in seasonal factors and the movement of energy prices on international commodities exchanges, which have a relatively higher impact on inflation in Slovenia. Since November 2005, the 12-month average inflation as measured by the HICP has not exceeded the reference value, which means that Slovenia has met the price stability criterion starting with that month.

**…and progressed under conditions of a general macroeconomic equilibrium**

The fall in inflation in particular took place over the last two years in the context of numerous macroeconomic processes and coordinated economic policies. Thanks to a significant fiscal consolidation that resulted in a fall in the general

[7] http://www.bsi.si/library/includes/datoteka.asp?DatotekaID=1243
[8] http://www.bsi.si/library/includes/datoteka.asp?DatotekaID=1131

government deficit of 2.5 GDP percentage points during the last four years, there was no need for extensive increases in tax rates that could have given rise to inflationary pressures. Meanwhile the fiscal policy position prevented the occurrence of excess aggregate demand, while the counter-cyclical policy of adjusting excise duties on refined petroleum products smoothed the considerable fluctuations in energy prices on international commodities exchanges. The administered prices policy was reasonably successful in ensuring a gradual rise in the prices that were either behind their cost level or did not include indirect taxation in line with EU legislation, while also preventing price rises not justified in cost terms. The incomes policy, which was based on the rule of a one percentage point gap between the growth in real wages and productivity growth, restricted cost-based inflationary pressures, while raising corporate competitiveness and facilitating easier restructuring conditions and job creation. The increased competition on markets for products and services after Slovenia joined the EU had additional positive effects on price stability.

**Sustainability is the key to meeting the price stability criterion, and price stability was achieved sustainably in Slovenia**

In addition to the fall in the average inflation rate below the reference value, the sustainability of price movements is also of importance to the review of the price stability criterion. The sustainability of the inflation level reached is assessed in principle from the point of view of various indicators of price movements and developments in the macroeconomic environment. Table 5.1 shows that the level of other price indices, such as the national consumer price index (CPI), the GDP deflator, the index of producer prices of manufactured goods (PPI) and the private consumption deflator, have all recorded a sustainable decline since 2000, so as reaching a level in line with general price stability by 2005. Only the year-on-year rise in import prices somewhat stood out, though this is mostly the exogenous effect of the rise in oil prices and commodities prices on world markets. A similarly favourable picture is presented by macroeconomic movements, with the difference between actual output and potential output being practically negligible in 2005, while growth in labour costs was relatively low compared with productivity growth. The balance of payments and public finance positions were testimony to the sustained nature of the disinflation throughout the process and evidence that no inflation rebound shocks can be expected. The forecasts of both domestic and international institutions indicate that inflation in Slovenia will range from 2.1% to 2.4% in the next two years (see Table 4.9).

**Table 5.1: Inflation criteria and indicators of inflation trends**

| | 2000 | 2001 | 2002 | 2003 | 2004 | 2005 |
|---|---|---|---|---|---|---|
| HICP | 8.9 | 8.6 | 7.5 | 5.7 | 3.7 | 2.5 |
| CPI | 8.9 | 8.4 | 7.5 | 5.6 | 3.6 | 2.5 |
| PPI | 7.7 | 8.9 | 5.1 | 2.5 | 4.9 | 2.7 |
| GDP deflator | 5.4 | 8.7 | 7.9 | 5.8 | 3.2 | 1.0 |
| Private consumption deflator | 7.8 | 7.6 | 7.9 | 5.4 | 3.5 | 1.6 |
| Import deflator | 13.9 | 6.3 | 2.5 | 2.0 | 4.2 | 5.7 |
| Growth in average gross wage | 10.6 | 11.9 | 9.8 | 7.5 | 5.7 | 4.9 |
| Real unit labour costs | 3.3 | 0.4 | -1.3 | -1.0 | 0.6 | … |
| Output gap | 1.5 | 0.4 | -0.1 | -1.2 | -0.4 | -0.2 |

Notes: (year-on-year growth as %, or % of GDP for output gap)
Sources: SORS, Bank of Slovenia, ARC calculations

**The processes of real convergence mean that the equilibrium inflation rate in Slovenia is slightly higher than in the eurozone**

Forecasts of the structural level of inflation in Slovenia indicate that in the medium term inflation will fluctuate around the level reached last year. The catching-up process with wealthier countries entails a higher equilibrium inflation rate in Slovenia. The Balassa-Samuelson effect means that owing to real convergence the natural equilibrium inflation rate in Slovenia is approximately 1 to 1.5 percentage points higher than in the wealthier countries of the eurozone.[9] It should be noted that this is a typical equilibrium process within

[9] See D Kozamernik: Doseganje stabilnosti cen v ERM II in po prevzemu evra (Achieving price stability in the ERM II and after the adoption of the euro), Bančni vestnik, July-August 2005, and references therein

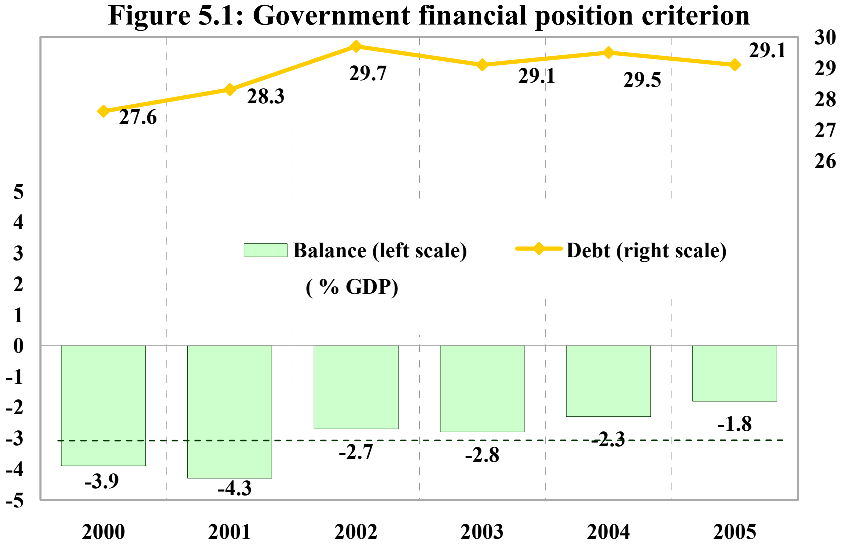
the framework of a well-functioning monetary union, and has no bearing on the competitiveness of the economy. The Balassa-Samuelson effect reflects the convergence in prices that takes place in parallel with the convergence in the general level of prosperity, as the general level of prices in Slovenia is by about one quarter lower than the general level in the eurozone.

## Government Financial Position Criterion

**Slovenia meets the Maastricht criterion for government finances**

Slovenia has long met the government financial position criterion. Since 2002 the general government deficit has been below the reference value of 3% of GDP, while the general government debt has been well below the reference value of 60% of GDP. The most recent audited figures in line with the ESA 95 methodology reveal a gradual decline in the budget deficit by 0.5 GDP percentage points in 2004 and 2005, while the general government debt as a proportion of GDP has remained almost unchanged for the last two years.

**Figure 5.1: Government financial position criterion**




Source: SORS

**A gradual reduction of the budget deficit is forecast to 1.0% of GDP by 2008**

The most recent forecasts by the Ministry of Finance, published in the 2005 Update of the Convergence Programme, show that Slovenia will continue to meet the two government financial position criteria in the future.[10] The general government deficit should amount to 1.7% of GDP in 2006, and should then decline gradually to 1.4% of GDP in 2007 and 1.0% in 2008. The general government debt should amount to 29.6% of GDP at the end of 2006 and 29.8% at the end of 2007, and should then contract to 29.4% of GDP.

**The structure of the deficit has changed slightly**

The composition of the general government deficit in 2005 was slightly different from what it had been in previous years. The social security account finished the year with a surplus of 0.8% of GDP, the reason for the surplus being the takeover of the debt of the Health Insurance Institute and the Pension and Disability Institute by central government. The latter recorded a deficit of 2.8% of GDP, but excluding the debt-takeover the figure would have been 2.1%, almost unchanged from the 2004 figure of 2.2%. Local government recorded a surplus of 0.2% of GDP, mainly as a result of sales of estate for construction purposes.[11]

**Slovenia will continue to meet the government financial position criterion in 2006**

For 2006 no major differences compared to 2005 can be expected in the deficit, and the favourable macroeconomic situation and size of the planned deficit will ensure that Slovenia continues to meet the government financial position criterion.

[10] Convergence Programme, update, December 2005; see http://www.gov.si/mf/angl/tekgib/conv_programme_2005.pdf
[11] http://www.stat.si/doc/03-PO-149-0601.doc

## Box 5.1: Short-term and medium-term risks to public finances

On the revenue side there are certain measures envisaged that could lead to uncertainties. The gradual pace of the reduction of the general government deficit can to a great extent be attributed to a simultaneous decrease in tax and non-tax revenues, which should fall by approximately 1.8 GDP percentage points between 2006 and 2008. The main impact on tax sources of revenue is the gradual abolition of the payroll tax by 2009, which currently accounts for revenue worth 1.9% of GDP, yet its abolition will reduce the government's revenue, due to its expenditure as an employer, by just 1.4 percentage points of GDP. Another public finance and inflation risk is the current proposal for a rise in the upper VAT rate from 20% to 21% and a rise in the lower VAT rate from 8.5% to 9% in 2007. The key factor in these and the other changes mentioned will be to carefully monitor actual revenues, ensuring that they are at the right level. It is also essential to make a detailed calculation of any revenue consequences of the major tax reforms that the government is currently studying.[1] These proposals, such as the introduction of a flat personal income tax, a sharp rise in VAT rates and the introduction of a property tax, could have a significant impact on tax revenues.

On the expenditure side the government committed itself in the Update of the Convergence Programme to a relatively strong reduction in expenditure of 2.5 GDP percentage points. The way that expenditure is to be reduced is particularly welcome: in addition to savings in interest payments it is built on a reduction in expenditure on public administration and subsidies, while social security expenditure is to be reduced via more effective entitlement verification. Among the key assumptions here are a cut in administration of 1% annually, wage growth in the public sector trailing the one in the private sector by 1.3 percentage points, cuts in material costs for goods and services, a restrictive employment policy, and a social policy that should not introduce new transfers during the period of the programme. While reducing the aforementioned costs, the government is likely to increase defence spending, spending to promote competitiveness, R&D spending and education spending, although the general level of public investments should remain almost unchanged between 2006 and 2008 at 3.1% to 3.4% of GDP.

Certain risks can arise in cost reduction, insofar as cost-based needs exceed the capacity to make the planned savings. The government aims to reduce employment in the public sector, but to simultaneously strengthen the armed forces and the police as demanded by NATO membership and the protection of the Schengen border. Extra costs associated with Slovenia's presidency of the European Union can be expected in 2008. In addition the government is endeavouring to reduce total social transfers, which should fall by 0.5 GDP percentage points. Here it is assumed that solid economic growth and a suitably active policy will encourage job creation. The problems in some labour-intensive sectors present the risk of an increase in structural unemployment, despite the favourable economic cycle, which could demand solutions that entail additional unplanned costs. The same should be emphasised as a danger in the implementation of any further reforms and the uncertainties associated with them, in particular as far as the labour market is concerned. The Update of the Convergence Programme and the budget memorandum correctly cite calculations based solely on existing legislation. However, in mentioning the introduction of long-term structural reforms currently under discussion during the period of the programme, they only draw attention to the possibility of raising economic growth and employment, without mentioning hypothetical adverse short-term effects that could have an impact on both budget revenues and expenditures.

In addition it is vital to monitor shifts in items that do not represent direct expenditures by the government, but for which a government guarantee is assumed. Thus DARS, Slovenia's motorways corporation, will receive significantly less funding from the state budget in 2006 and 2007 than envisaged in the Resolution on the National Motorways Construction Programme,[2] although there will be no reduction in the amount that it invests, as it will be able to borrow more with the help of a government guarantee.[3] Leaving the amount of public investment unchanged, the government would probably have a positive influence on the total amount of investment and on long-term development, but at the same time would tend to indirectly stimulate aggregate demand.

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[1] The frameowrk for economic and social reforms to increase prosperity in Slovenia, see http://www.svr.gov.si/index.php?id=908&L=1

[2] The *Resolution on the National Motorways Construction Programme* of 27 February 2004 is available at http://www.uradni-list.si/1/objava.jsp?urlid=200450&stevilka=2300

[3] See for example *Ministry Work Programme for 2006*, available at http://www.mzp.gov.si/fileadmin/mzp.gov.si/pageuploads/program_dela_min_2006.pdf

## Exchange Rate Criterion

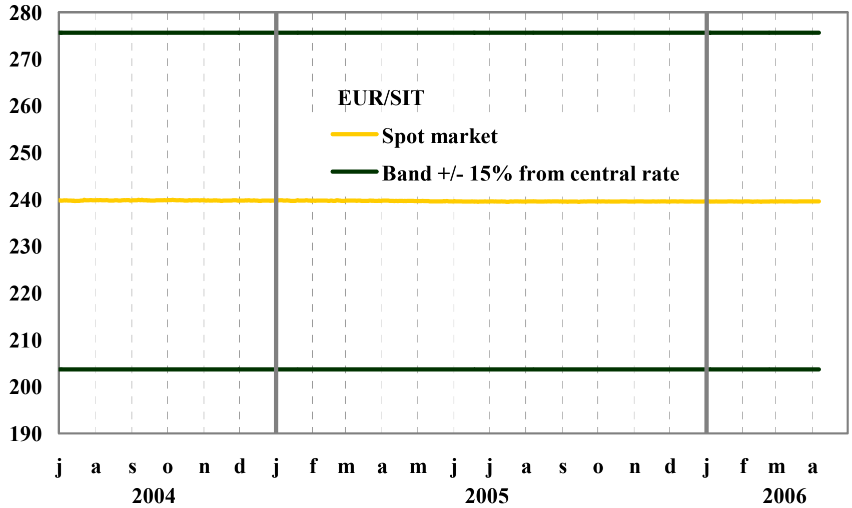
**The exchange rate is very stable, and shows almost no deviation from the central rate…**

The tolar exchange rate against the euro has been extremely stable since Slovenia joined the ERM II. Slovenia joined the ERM II on 28 June 2004, with the central rate being set at SIT 239.640 to the euro, with a standard band of fluctuation of 15% either side of this. No significant deviation has occurred during this period, with the spot market showing negligible deviation from the central rate.

**…which is reflected in the internal and external macroeconomic equilibria**

Evidence that the central rate is well set comes not only from the stability of the exchange rate, but also from the internal and external equilibria. Price stability points to the absence of inflationary pressures that could originate in an undervalued domestic currency, while the practically balanced current account position is a reflection of the domestic currency not being overvalued. The current account position is not one of the essential criteria of nominal convergence, but a sharp increase in the current account deficit within the ERM II would in all likelihood trigger doubts about the right level of the exchange rate, the testing of which is after all the main reason for participation in the ERM II.

**Figure 5.2: Movement of the exchange rate within the upper and lower bands of the criterion**




Source: Bank of Slovenia

**Given the stability of the exchange rate, there was no need for the Bank of Slovenia to intervene to influence it**

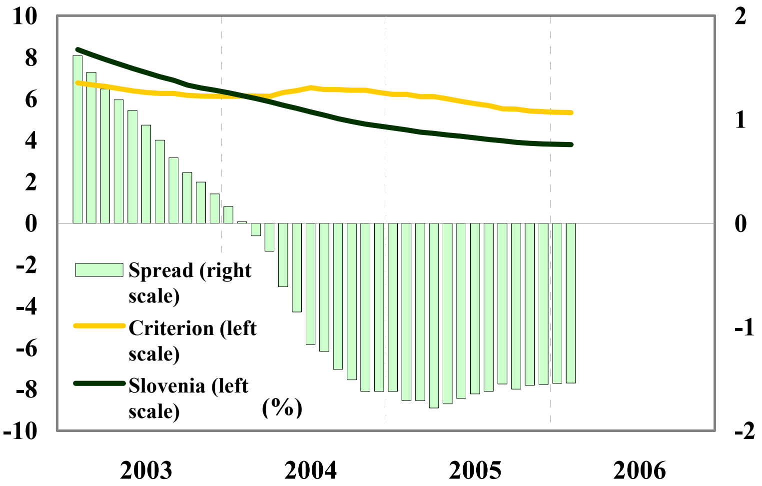
With the exception of the initial phase after Slovenia joined the ERM II, the Bank of Slovenia has not needed to intervene to influence the exchange rate. In order to stem inflationary pressures it has endeavoured to maintain interest rates at a level appropriate to exchange rate stability. In recent months the Bank of Slovenia has begun to reduce the spread between its refinancing rates and the ECB's interest rates. In so doing the Bank of Slovenia acted in accordance with the financial markets' expectations of the approaching introduction of the euro.

## Long-Term Interest Rates Criterion

**Slovenia has long met the long-term interest rates criterion**

Slovenia has long met the long-term interest rates criterion. This requires long-term interest rates in a country aiming to join the euro to be no more than 2 percentage points higher than the unweighted average of long-term interest rates in the three EU countries with the best price stability results, with the yield on long-term government securities taken as the reference. The spread between the reference rate and Slovenia's long-term interest rates recorded a sharp, sustainable fall in the period to the beginning of 2005, and since then have remained relatively low.

**Figure 5.3: Long-term interest rates criterion**




Sources: Bank of Slovenia, Eurostat

**Long-term interest rates are an indicator of confidence in the credibility of economic policy**

Long-term interest rates reflect financial markets' confidence in the credibility of economic policy in the maintenance of macroeconomic equilibria and price stability. To a great extent the spread in long-term interest rates represents the differential between the risk premiums that investors ascribe to different securities. Given that in addition to the credit risk the risk premium also includes the inflation risk and the exchange-rate risk, this spread is a good indicator of general nominal convergence. The fall in long-term interest rates and the small interest rate spread are also a reflection of the conviction of businesses and institutions that the fulfilment of the criteria is sustainable and is expected to remain so in the future.

## 5.2 Risks in the Forecasts

**Posible risks in macroeconomic trends**

Economic policy must be fully ready for any deviations from the forecast macroeconomic trends. It is therefore vital to simulate possible scenarios for economic growth in the event of certain macroeconomic shocks. In line with this the Bank of Slovenia calculates alternative scenarios for which economic policy must be ready to take prompt measures in the future. This does not merely refer to readiness for adverse shocks, but more to ensuring in advance that they are averted.

**The greatest inflation risks are high oil prices,…**

The most prominent risk among the foreign variables is a rise in oil prices. A sustained rise of USD 5 per barrel would raise inflation by 0.5 percentage points in 2006, 0.2 percentage points in 2007 and 0.1 percentage points in 2008. Should oil prices remain at the current level of around USD 75 per barrel, inflation could rise to approximately 3% in the short term. An oil shock is especially unwelcome, as economic policy is unable to directly exert any significant influence on it in the short run. Economic policy should therefore ensure that there is no expansion of adverse inflationary pressures to other macroeconomic factors.

**…rapid growth in administered prices, …**

In the domestic environment it is the growth in administered prices that has the most direct impact on inflation, noting that the effect of growth in regulated prices by 2 percentage points higher than the growth in free prices would be particularly strong in 2007 and 2008. For economic policy, restricting inflation in administered prices primarily entails restricting growth in costs in regulated sectors with a monopoly market structure.

**…and excessive domestic demand,…**

The simulations also reveal the danger of economic overheating caused by faster growth in wages or domestic demand. Wage growth has a positive effect on economic growth in the medium term via higher household spending. However one must take into consideration the negative effect of overheating on inflation, which in the event of wage growth outstripping the forecast by 1 percentage point would rise by 0.4 percentage points in 2007. The current account would also worsen in the event of higher wage growth, as a portion of the higher wages would be spent on imports. A rise of 1 percentage point in household spending would have similar or even stronger effects than higher wage growth. Stronger household spending would exacerbate the adverse effects on inflation and the current account, lower the level of competitiveness, which in the longer term could trigger a reverse in the cycle, a slower economic growth and rising unemployment.

**Table 5.2: Response of macroeconomic variables to simulated shocks**

| | Simulation | Shock (change) | Period of shock |
|---|---|---|---|
| | **a) Foreign environment** | | |
| 1. | Oil price | price up USD 5 per barrel compared to baseline forecast | Q106-Q406 |
| 2. | Commodities prices | price up 10% compared to baseline forecast | Q106-Q406 |
| 3. | Foreign demand | up 1% compared to baseline forecast | Q106-Q406 |
| | **b) Domestic environment** | | |
| 4. | Wage growth | up 1 pp compared to baseline forecast | Q106-Q406 |
| 5. | Household spending | growth up by 1 pp compared to baseline forecast | Q106-Q406 |
| 6. | Government spending | growth up by 1 pp compared to baseline forecast | Q106-Q406 |
| 7. | Growth in administered prices | 2 pp more than growth in free prices from baseline forecast | Q106-Q406 |

| | Simulation | GDP | | | Inflation | | | Current account | | |
|---|---|---|---|---|---|---|---|---|---|---|
| | | 2006 | 2007 | 2008 | 2006 | 2007 | 2008 | 2006 | 2007 | 2008 |
| | **Forecasts (baseline scenario)** | 4.2 | 4.2 | 3.9 | 2.2 | 2.2 | 2.6 | -2.0 | -2.3 | -1.7 |
| | **a) Foreign environment** | | | | | | | | | |
| **1.** | Oil | 4.1 | 4.1 | 3.8 | 2.7 | 2.4 | 2.7 | -2.1 | -2.5 | -2.0 |
| **2.** | Commodities | 4.1 | 4.2 | 3.9 | 2.3 | 2.4 | 2.7 | -2.1 | -2.4 | -1.8 |
| **3.** | Foreign demand | 4.3 | 4.4 | 4.0 | 2.2 | 2.3 | 2.6 | -1.9 | -2.0 | -1.6 |
| | **b) Domestic environment** | | | | | | | | | |
| **4.** | Wages | 4.3 | 4.4 | 4.0 | 2.3 | 2.6 | 2.8 | -2.1 | -2.6 | -1.9 |
| **5.** | Household spending | 4.4 | 4.5 | 4.3 | 2.3 | 2.5 | 3.0 | -2.3 | -2.7 | -2.1 |
| **6.** | Government spending | 4.3 | 4.3 | 4.1 | 2.2 | 2.3 | 2.7 | -2.1 | -2.4 | -1.8 |
| **7.** | Administered prices | 4.1 | 4.1 | 3.9 | 2.2 | 2.4 | 2.9 | -2.1 | -2.4 | -1.7 |

Notes: Year-on-year growth in %. The simulations were made using the model used by the Bank of Slovenia for the forecasts. In some simulations (1, 2, 3 and 6), exogenous variables were altered, while in the remaining simulations (4, 5 and 7) a change defining the simulation was added to the variables in the baseline scenario. All the other assumptions in the simulations are the same as those in the baseline scenario.
Sources: SORS, Bank of Slovenia, ARC calculations

**…including government spending**

Higher government spending would have very similar effects, although to a lesser extent, given the lesser importance of government spending within aggregate demand. Government spending should therefore be treated in the reverse manner to household spending. In the event of any danger of overheating, fiscal policy must curb government spending, thus stopping inflationary pressures.

**A correct response by fiscal policy is important**

Here it should be noted that the emphasis in fiscal policy should be on managing government spending. The optimal response of fiscal policy to the overheating of the economy cannot be tax hikes, as this mainly creates additional inflationary pressures. Taking into consideration the transmission of costs into prices, the potential rise in VAT rates from 8.5% and 20% to 9% and 21%, respectively, in 2007 would cause additional inflationary pressure in the amount of 0.7 percentage points. The forecasts indicate that rises in excise duties would apply the same pressure on prices.

## 5.3 Medium-Term Macroeconomic Policy

**The macroeconomic environment in Slovenia has changed since it joined the ERM II**

Ever since Slovenia joined the ERM II, the macroeconomic environment in the country has been undergoing a major structural change. Monetary policy is increasingly leaving the role of stabilising aggregate demand and inflation to other economic policies. During 2006 the existing interest rate spread between the ECB and the Bank of Slovenia will close, and Slovenia will then finally assume the common monetary policy of the ECB. Given the increasing coordination of the Slovenian economy with the circumstances in the eurozone, the common monetary policy can be expected to become relevant to macroeconomic trends in Slovenia after it joins the eurozone. In the event of any imbalances or potential asymmetric shocks, other macroeconomic policies will have to respond.

### The Role of Macroeconomic Policy Under the Conditions of the Nominal Anchor

**Fiscal policy plays the main role in stabilising aggregate demand**

The role of stabilising demand and smoothing cyclical fluctuations now belongs primarily to fiscal policy. An optimal fiscal policy eases domestic demand during the boom phase of the business cycle, and supports it during the down phase. During favourable economic times the taxable base and the amount of tax collected usually increase, while the need for transfers decreases, which has a positive impact on the cyclical deficit, and vice-versa. The public finance position in a suitable fiscal policy therefore automatically moves cyclically, and in a broad range. For a successful counter-cyclical fiscal policy it is often necessary to adjust public expenditure by more than the automatic cyclical component. Such adjustment could require the creation of a structural public finance surplus, and not merely a neutral position during times of a favourable economic climate.

**Incomes policy can prevent inflationary pressures and affect external competitiveness**

The incomes policy must also play a key role in preventing cost-induced inflationary pressures. Controlling labour costs is of central importance to ensuring competitiveness and price stability within the framework of monetary union. There was a decline in unit labour costs in the last three years in the eurozone, where the cumulative fall between 2002 and 2004 was 1.5%, and even more so among the new EU members, where the cumulative fall was 5.3% over the same period.[12] The possible abandonment of the moderate incomes policy in Slovenia, given the continuing decline in real unit labour costs abroad, could have considerable repercussions for the competitiveness of Slovenian companies, and could result in a reversal in the employment trend. Further restricting wage growth in the public sector could have a signalling effect on wage growth in the economy as a whole. In the wage agreement for the upcoming period the social partners must therefore also take account of the rule under which wage growth remains behind productivity growth.

**The inflationary effects of supply-side shocks, such as oil shocks, cannot be allowed to spur wage growth**

Labour costs growing in line with productivity means that nominal labour costs cannot adapt to the price rises that could be triggered by adverse supply shocks.

[12] Labour market and wage developments in 2004, European Commission, Special Report No.3, 2005

Adverse supply shocks, such as a rise in prices of refined petroleum products, also appear as an additional cost factor for companies and reduce their output capacities. The latter is reflected in lower demand for labour. Although companies transmit part of the shock into prices, which can impact on inflation, labour income cannot be allowed to adapt to such price rises, as the resulting lower demand for labour would entail a rise in unemployment, with economic activity falling further and the competitiveness of the economy declining. Because labour costs are the most important costs for companies, they could strengthen inflationary pressures and the persistence of inflation at a higher level. Because of these very effects, it is sensible to act in the direction of a gradual elimination of wage indexation to the inflation rate and the assurance of greater flexibility in labour costs. Economic policymakers must therefore prevent the possible transmission of oil prices into other prices or wages, which would threaten price stability, at least temporarily.

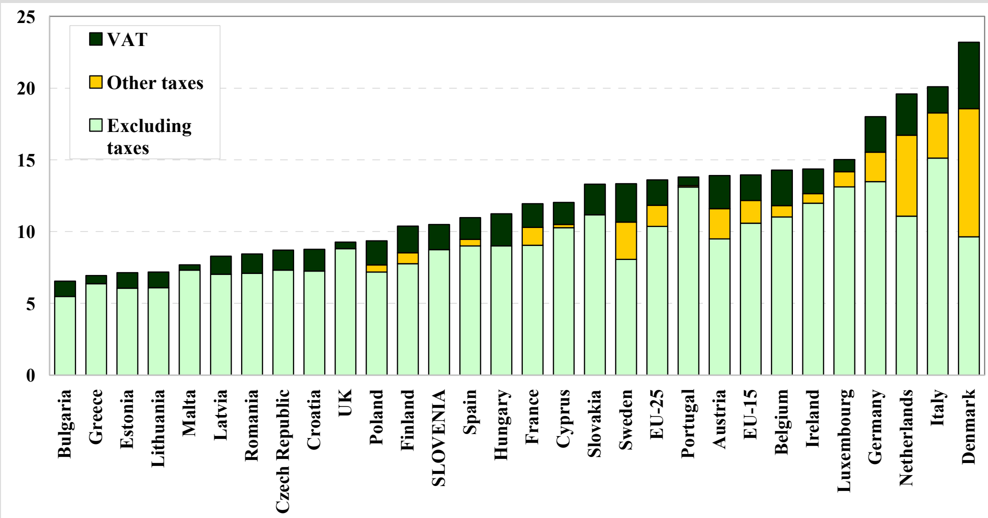
**Administered prices must encourage structural adjustments and cost control**

Administered prices policy must prevent inflationary pressures and simultaneously encourage structural adjustments in regulated sectors. In principle, the rule applying to administered prices is that their overall growth rate should not exceed the projected growth in free prices. However, at the same time regulated prices cannot in the long term lag behind the growth in costs, which is in line with productivity growth, thus causing losses for public companies and other companies whose prices are partly or fully predetermined. Therefore these companies must strive to control the costs that they can influence themselves. For this reason the optimal administered prices policy is closely linked to the incomes policy, as excessive growth in costs often originates in unjustifiably rapid wage growth (see Box 5.2). Administered prices must of course also be in accordance with domestic and European legislation, which presupposes other restrictions. This year the government drew up a plan for managing regulated prices for 2006 and 2007, which takes heed of all the aforementioned principles.[13]

## Box 5.2: Administered prices policy in light of cost control by companies

The electricity price is one of the most important components of administered prices, and with a weight of 2.8% in the average basket of consumer prices in Slovenia it represents an important household expense. The graph below shows that electricity prices vary considerably from country to country. Ignoring any natural advantages in electricity generation, the price level roughly depends on two closely linked factors: the general level of prices or household purchasing power, and the level of labour costs.

**Figure: Electricity prices for households***




Source: Eurostat; *as at 1 July 2005 (in euros for 100 kWh, household consumption for 90 m$^2$ of residential space)

[13] http://cns.gov.si/dato3.nsf/OC/060226164959C/$file/62v6.doc

**Table: Average gross wage trends by institutional sector**

| | Cumulative real growth in average gross wage (2000–2005) | Average gross wage in 2005 (SIT) | Proportion of workforce with university qualification (31/12/2004, %) |
|---|---|---|---|
| A Agriculture, hunting and forestry | 0.0 | 224,388 | 7.3 |
| B Fishing and fishing services | 0.7 | 218,518 | 7.9 |
| C Mining | 20.7 | 344,843 | 5.7 |
| D Manufacturing | 13.4 | 239,026 | 6.9 |
| E Electricity, gas and water supply | 23.6 | 353,926 | 13.5 |
| E40.11 Electricity production | 40.4 | 379,354 | na |
| E40.12 Electricity transmission | 58.7 | 470,880 | na |
| E40.13 Electricity distribution and trading | 14.9 | 340,868 | na |
| F Construction | 7.8 | 224,612 | 3.8 |
| G Trade and repair of motor vehicles and consumer goods | 8.2 | 244,806 | 8.0 |
| H Hotels and catering | 3.2 | 202,878 | 4.1 |
| I Transport, storage and communications | 9.9 | 299,238 | 8.3 |
| J Financial intermediation | 13.4 | 413,508 | 26.1 |
| K Real estate, leasing and business services | 7.8 | 292,576 | 25.8 |
| L Public administration, defence and social insurance | 4.3 | 333,298 | 33.8 |
| M Education | 18.3 | 340,972 | 40.9 |
| N Health and social care | 8.0 | 316,814 | 23.7 |
| O Other public, communal and personal services | 1.3 | 325,086 | 21.8 |
| **TOTAL** | **10.7** | **277,235** | **15.7** |

Sources: SORS, ARC calculations

The figures reveal that, allowing for these two factors, electricity prices for households in Slovenia do not differ significantly from prices in other countries, which means that the control of electricity price movements to date in Slovenia has been achieved in a sustainable manner. Euro electricity prices (excluding taxes) actually differ from the EU25 average by approximately 15%, which is entirely in line with the level of prices and the level of labour costs in Slovenia.

Because the purpose of using the instrument of administered prices is to prevent unjustified price rises on account of internal inefficiencies at companies and the exploitation of a monopoly position, it is sensible to analyse the movement of wages in administered sectors, as wage growth, particularly in relation to productivity growth, can be one of the indicators of companies' internal efficiency. The SORS figures show that wage growth in the energy sector has significantly outstripped growth in average gross wages in Slovenia for the fifth consecutive year, while productivity growth in the energy sector was practically equal to overall productivity growth. The average gross wage in Slovenia in 2005 was 10.7% higher in real terms than in 2000, compared with a figure of 23.6% in real terms in the electricity, gas and water supply sector. The high level of wages in the energy sector (only financial intermediation has higher wages, which can partly be attributed to it having twice the proportion of employees with university qualifications) also indicates that companies in these sectors probably still have significant internal reserves for increasing efficiency.

**Financial supervision must supervise financial stability, particularly in light of reversals in the business cycle**

In a period of rapid lending and deepening financial intermediation, the role of financial supervision is growing in importance. In addition to maintaining financial stability and preventing risks that could trigger imbalances on financial markets, the supervision of the financial system participates indirectly in the exercise of macroeconomic policy. Slovenia's joining of the eurozone will reduce the risk of a financial crisis with consequences for the exchange rate, the balance of payments, the banking system, government debt, etc. However, the combination of rapid growth in lending, an overheating economy and a stock market or housing bubble could nevertheless trigger a rapid reversal and a recession as a result of an unjustified speed in the process of deepening financial intermediation. Financial crises are mostly connected with a cyclical reversal, which means that smoothing macroeconomic fluctuations is also in the interest of financial stability. Financial supervision generally does not have a sufficiently wide range of instruments to curb credit expansion. It can however set guidelines via the monitoring of specific indicators of risk and partly via requirements for minimum values in certain indicators, and warn other policy areas of the danger of overheating.

## Medium- and Long-Term Challenges for Macroeconomic Policy

**Currenly the main risk is overheating, which would demand a strong counter-cyclical fiscal response…**

With the output gap closing and strong growth in household and corporate lending, one of the main risks is the overheating of the economy, which would demand a strong counter-cyclical reaction from fiscal policy. In such conditions fiscal policy can act as a lever to restrict excessive growth in aggregate demand via a faster reduction of the deficit, but it must be supported by income policy, which must curb excessive growth in labour costs, thus contributing to price stability. Therefore in the medium and long term it will be important to limit the amount of fixed expenditure, thus increasing the responsiveness of fiscal policy. Because the amount of fixed expenditure in the general government budget is relatively high, there is not yet sufficient room for manoeuvre for an optimal fiscal policy. From this point of view it would be sensible to define in advance the amounts and programmes in the budget that could be eliminated should the risk of overheating arise. The prior experience of countries that introduced the euro, particularly those that underwent real convergence and a sharp decline in nominal interest rates, reveals the danger of the economy overheating during and after entry into the eurozone, and emphasises the importance of correctly pitched economic policies.

**…which in the long term will only be possible if the structural deficit is suitably low**

In addition to the flexibility of fiscal policy, whether fiscal policy is appropriate will in the future depend primarily on the appropriate level of the structural public finance position. This would provide for deficit flexibility within the limits allowed by the Reformed Stability and Growth Pact, and ensure medium-term sustainability in public finances. The rules of the Pact, adopted in June 2005, are clear. EU member-states are committed to achieving a public finance position ranging from a deficit of 1% of GDP to balance or surplus over the medium term. To this end they must endeavour to reduce the structural deficit in the average year by 0.5% of GDP, with one-off measures being ignored. The reduction of the structural deficit should accelerate during a period of favourable economic trends, thus raising the possibility of releasing provisions up to the allowed deficit limit of 3% of GDP in less favourable economic circumstances. The Update of the Convergence Programme shows that the cyclically adjusted general government deficit fell in 2005 from 1.9% to 1.7% of GDP, and that according to forecasts it should gradually fall further to 1.0% of GDP in 2008. The contraction of the structural deficit is welcome, while its pace, given the assumptions of solid economic growth in the Convergence Programme (4.0% in 2006 and 2007, 3.8% in 2008), hovers around the lower limit prescribed in the Reformed Stability and Growth Pact. For the needs of a counter-cyclical policy, in future it would be sensible to ensure that there is a surplus in the public finance position during a favourable economic climate. Thus the assessment of the Convergence Programme drawn up by the European Commission[14] and the preliminary report on the 2006 Article IV consultation with Slovenia by the IMF[15] conclude that Slovenia should plan for a slightly faster reduction of the general government deficit in the coming years.

[14] Commission's assessment of the December 2005 update of the convergence programme of Slovenia, see: http://europa.eu.int/comm/economy_finance/about/activities/sgp/country/commass/sl/ass_sl2005 2006.pdf
[15] 2006 Article IV Consultation with Slovenia Preliminary Conclusions of the IMF Mission, available at http://www.imf.org/external/np/ms/2006/032806.htm

**Revenues from EU funds must be managed prudently, preventing the promotion of excessive aggregate spending**

An additional challenge for fiscal policy will be to adjust the general government budget to new revenues, and EU funds in particular. As far as possible it is primarily investment projects that should be financed using EU funds. This could release funding that should be earmarked either for financing additional (reasonable) investment projects or for reducing the structural deficit. The funds should be used to increase economic potential, and never to increase current government spending. The net positive budgetary revenue from EU funds was negligible in 2005, but it is likely to increase significantly in the coming years. The budget memorandum envisages that during the 2007 to 2013 financial perspective the net government position will amount to approximately 0.68% of GDP each year.[16] An unchanged deficit in the context of a higher disbursement of EU funds would undoubtedly represent an expansionist fiscal policy, triggering additional inflationary pressures. In addition, the general government deficit needs to respond to a permanent reduction in costs on the expenditure side.[17] Thus, for example, the cost of interest payments in last year's budget had fallen to 1.8% of GDP from 2.3% in 2002, and should fall further to just 1.4% by 2008. The decline in this cost is connected to the permanent structural adjustment in long-term interest rates in Slovenia as a result of it achieving sustainable price stability and joining the eurozone. The cyclically adjusted deficit should fall by 0.4 GDP percentage points in the three years to 2008 merely because of lower interest payments.

**Given the adverse demographic trends, public finances are currently not sustainable in the long term**

The general government budget must also be sustainable over the longer term. With regard to demographic changes and the ageing population, budget sustainability will to a great extent be connected to further pension reforms. Last year's change in pension indexation to wages caused an additional deterioration in the long-term sustainability of public finances. This is also indicated by the latest European Commission research into this subject, which rates the sustainability of the general government budget in Slovenia as one of the most threatened in the EU.[18] Even though Slovenia has one of the lowest levels of public debt in the EU, there can be no excuse for failing to improve the structural public finance position at sufficient speed. Structural adjustments will be required in the pension system in the medium term, the aim being to re-establish the long-term sustainability of public finances.

**Greater flexibility in the economy will create the conditions for ECB monetary policy to be optimal**

In the long term, the success of membership of the eurozone will depend on several structural reforms to increase the flexibility of the economy. The common monetary policy will pay no heed to asymmetric shocks present solely in Slovenia, their strength being inversely correlated with the flexibility of the economy. The government-backed framework of economic and social reforms for increasing prosperity in Slovenia proposes some sensible measures in this direction, these also being in line with the implementation of the Lisbon Strategy.[19] These proposals include the deregulation of product markets and the promotion of competition. This could contribute to the lowering of prices and the prevention of inflationary pressures, thus preventing the occurrence of asymmetric shocks. Slovenia will therefore need to speed up the liberalisation of certain markets, and competition regulators at home and at the EU level will have an important role to play in this. In addition the positive effects of greater labour market flexibility should be noted. These include efforts to improve the regional, professional and educational mobility of the public, a greater adjustment of wages in individual sectors or companies to specific shocks, and in

[16] Budget memorandum for 2006 to 2007, 3 November 2005, see http://www.vlada.si//util/bin.php?id=2005101011134974
[17] The economic literature speaks of "windfall gains", see for example Servaas Deroose: Euro adoption and macroeconomic policy challenges in Slovenia, available at http://europa.eu.int/comm/economy_finance/events/2006/conference170306/deroose_speech_en.pdf
[18] The sustainability of public finances based on the 2005/06 updates of stability and convergence programmes
[19] See also the *Development Strategy of Slovenia*, available at http://www.gov.si/umar/aprojekt/asrs/ssd-new.pdf

certain areas a greater flexibility of the employment protection legislation as well as more flexible forms of employment. All of these could contribute to greater macroeconomic stability and ensure higher economic growth..

**The problem of a concentration of short-term risks to price stability**

Some inflation risks are particularly pronounced over the next short-term period, and require economic policy to be ready to respond appropriately. As discussed in Section 4.7, there is a greater concentration of risks in the direction of higher price growth in the period envisaged for the introduction of the euro. In addition to the aforementioned risk from the effect of introducing the euro (See Box 4.1), consideration should also be given to the fiscal risks associated with the rise in the VAT, the rise in excise duties and certain signs of relaxation in administered prices policy, in particular in the energy sector. To these should be added the current extremely high risk associated with higher oil prices. The concentration of these effects in a very short period could lead, in the event of any risk being realised, to a sharp rise in inflation above the forecast in the baseline scenario in this report. Such price growth could additionally accelerate wage growth, triggering a new inflation cycle and threatening the price stability achieved to date. As a major portion of these risks originates in levers under the control of economic policy, the role of the latter is to prevent these risks from happening. Correctly exercising economic policy in the period ahead will be of key importance to establishing the credibility of the macroeconomic environment designed in the Programme for ERM II Entry and Adoption of the Euro, and to meeting the commitments given in the joint communiqué when Slovenia joined the ERM II.

## Box 5.3: Communiqué marking Slovenia's entry into the ERM II

At the request of the Slovenian authorities, the ministers of the euro area Member States of the European Union, the President of the European Central Bank and the ministers and the central bank governors of Denmark and Slovenia have decided, by mutual agreement, following a common procedure involving the European Commission and after consultation of the Economic and Financial Committee, to include the Slovenian tolar in the Exchange Rate Mechanism II (ERM II). The central rate of the Slovenian tolar is set at 1 euro = 239.640 tolars. The standard fluctuation band of plus or minus 15% will be observed around the central rate of the tolar. The agreement on the participation of the tolar in ERM II is based on a firm commitment by the Slovenian authorities to continue to take the necessary measures to lower inflation in a sustainable way: these include most notably measures aimed at further liberalising administered prices and advancing further with deindexation, in particular of the wage and certain social transfer setting mechanisms. Continued vigilance will be needed so that domestic cost developments, in particular wages, are in line with productivity growth. The authorities, together with the responsible EU bodies, will closely monitor macroeconomic developments. Fiscal policy will have to play a central role in controlling demand-induced inflationary pressures, and financial supervision will assist in containing domestic credit growth. Structural reforms aimed at further enhancing the economy's flexibility and adaptability will be implemented in a timely fashion so as to strengthen domestic adjustment mechanisms and to maintain the overall competitiveness of the economy. The compulsory intervention points in the mechanism will be communicated by the ECB and the Bank of Slovenia, in time for the opening of the foreign exchange markets on 28 June 2004.