BANKA SLOVENIJE

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Abbreviations used in the Price Stability Report

AJPES	Agency of the Republic of Slovenia for Public Legal Records and Related Services
AT	Austria
BE	Belgium
bps	basis points
BRIC	Brazil, Russia, India, China
CPI	consumer price index
CZ	Czech Republic
DARS	Motorway Company in the Republic of Slovenia
DE	Germany
EA	euro area
ECB	European Central Bank
EE	Estonia
EFSF	European Financial Stability Facility
EMU	Economic and Monetary Union
ERM II	Exchange Rate Mechanism
ES	Spain
ESA 95	European System of Accounts (1995)
ESCB	European System of Central Banks
ESM	European Stability Mechanism
EU	European Union
EUR	euro
EURIBOR	euro interbank offered rate
Eurostat	Statistical Office of the European Communities
Fed	Federal Reserve
FI	Finland
FDI	foreign direct investment
FR	France
FRED	Federal Reserve Economic Data
GDP	gross domestic product
GR	Greece
H	half-year
HICP	harmonised index of consumer prices
HU	Hungary
IE	Ireland
IMAD	Institute of Macroeconomic Analysis and Development of the Republic of Slovenia
IMF	International Monetary Fund
IT	Italy
lhs	left-hand scale
MFIs	monetary financial institutions
NACE	Statistical Classification of Economic Activities in the European Community
NFCs	non-financial corporations
NL	Netherlands
NLB	Nova Ljubljanska Banka d.d.
OECD	Organisation for Economic Cooperation and Development
p.p.	percentage points
PL	Poland

PMI	purchasing managers' index
PPI	producer price index
PSR	Price Stability Report
PT	Portugal
Q	quarter
rhs	right-hand scale
SI	Slovenia
SK	Slovakia
SORS	Statistical Office of the Republic of Slovenia
ULC	unit labour costs
US	United States of America
USD	US dollar
VAT	value added tax
WEO	World Economic Outlook

Summary

A renewed and extremely sharp decline in construction investment and activity in the construction sector resulted in very low GDP growth during the first half of the year, despite the relatively favourable growth in exports. Economic growth in the rest of the world was also down significantly in the second quarter. That growth could come under increasing pressure from problems with the credibility of debt servicing in certain euro area countries. Both of the aforementioned factors resulted in the materialisation of the risks presented in April's price stability report. This means much poorer prospects for a rapid economic recovery. Forecast economic growth was thus revised downwards to 1.3% for this year, and to 1.7% for next year. Such low growth will not be sufficient to reduce the high level of unemployment and the large general government deficit. Additional measures are necessary. Inflation is expected to rise temporarily at the end of this year due to several one-off effects, and then fall below 2% in line with the decline in the contribution to inflation made by energy prices and worsened macroeconomic situation.

* * *

The main features of the global economy in the first half of 2011 were slowing economic growth in the second quarter, rising inflationary pressures, particularly in emerging economies, and increasing uncertainty over the fiscal position of certain developed economies. August saw a sharp increase in uncertainty regarding the global economic recovery, the main factor, alongside lower economic activity, being uncertainty about fiscal consolidation in euro area countries and the US. More rapid growth is also being hindered by the fiscal consolidation required in the majority of countries. At the same time, the monetary policy of the majority of central banks in developed countries remains accommodative, as reflected in relatively low interest rates and non-standard measures, while it is less accommodative or even restrictive in emerging countries owing to the risk of high inflation. Inflationary pressures remain significant in the US and euro area, as oil and other commodity prices remain high, despite a moderation in recent months.

Economic growth slowed down in Slovenia during the first half of the year, and stood at less than 1% in year-on-year terms in the second quarter. The deteriorating economic situation in the first half of the year was primarily the result of a decline in domestic demand. Particularly noteworthy was the decline in construction investment and the resulting decline in construction activity. This remains the main factor hindering economic growth in Slovenia. Following relatively high quarterly growth rates last year, investment in machinery and equipment has also begun to decline this year, despite relatively high capacity utilisation in manufacturing and growth in merchandise exports. The dependence of economic growth on the situation in the rest of the world increased in the first half of the year, as a result of the decline in domestic demand. The number of job vacancies and new hires has risen in recent months, slowing the year-on-year decline in employment in the private sector during the first two quarters of 2011. The exception was construction, where the decline in employment remains very pronounced. The unemployment rate is high compared with the previous year. In the second quarter, the registered unemployment rate and the survey unemployment rate stood at 11.6% and 7.8% respectively. In the context of moderate growth in wages and a further con-

traction in employment, the competitiveness of the Slovenian economy continues to gradually improve. Nevertheless, the adjustment of Slovenia's cost competitiveness continues to lag behind the majority of the main euro area trading partners.

The current account deficit has narrowed rapidly since 2008, to stand at just 0.1% of GDP for the 12-month period ending in July this year. Merchandise trade with the rest of the world rose until the end of the first quarter due to high growth in foreign demand and the accompanying high growth in imports of intermediate goods. Merchandise imports grew slightly faster than exports in nominal terms, primarily as a result of price factors. Growth in foreign trade slowed significantly as a result of declining growth in foreign demand in the second quarter of this year. The slowing growth in imports was more pronounced than in exports due to weaker domestic demand which, despite the deteriorating terms of trade during the first half of this year, resulted in the narrowing of the merchandise trade deficit. The largest contribution to the narrowing of the current account deficit came from current transfers, primarily as a result of continuing high inflows of general government transfers.

Loans to non-financial corporations were down in the first half of 2011, primarily owing to loan demand, which is based on the low level of economic and investment activity, and partly due to gradually more pronounced supply-side factors. When renewing and approving new corporate loans, banks must take into account corporates' relatively high debt-to-equity ratio, increased uncertainty regarding access to foreign sources of funding and operational risk, particularly in sectors, hit hardest by the crisis. The restructuring of bank funding continues, while impairment and provisioning costs remain high, and interest rates on loans are higher than the euro area average. This is particularly true for corporate loans. The proportion of short-term loans was up in the first quarter, while the proportion of long-term loans was up in the second quarter. Non-financial corporations partly compensated for the loss of domestic financing with foreign sources, primarily via FDI, and partly via foreign loans. Growth in loans to households was down in the first half of the year, due to slightly lower growth in housing loans. Consumer loans were also down in the first half of the year.

Inflation fluctuated considerably over the first nine months of the year, primarily owing to base effects and certain major one-off changes. Growth in the harmonised index of consumer prices averaged 1.9% in year-on-year terms over the first nine months of the year, 0.7 percentage points lower than the euro area. In addition to the last year's considerable drop in school meal prices, the main factor in the aforementioned deviation was relatively low growth in prices of non-energy industrial goods. Core inflation is well below the euro area average. This primarily reflects the low level of demand and economic activity, and the gradual reduction in unit labour costs, necessary to improve the price and cost competitiveness of the Slovenian economy.

Projections of economic activity and inflation have been revised downwards. Following very low growth in economic activity during the first half of the year, the forecast for GDP growth in 2011 was revised downwards by half a percentage point to 1.3%. An even more pronounced downward revision in economic growth for next year, to 1.7%, was made owing to a lower assumption of growth in foreign demand and the slow recovery in domestic spending. A low growth in all components of domestic demand is expected over the entire projection horizon. Thus foreign trade is expected to contribute most to economic growth. The current account deficit will become a surplus of around 1% of GDP, as a result of the narrowing of the merchandise deficit and a sustained surplus in transfers, while the deficit in capital income is widening. Core inflation is expected to rise slightly, primarily as a result of certain one-off effects, but will remain low owing to the merely gradual recovery in domestic demand and slow growth in labour costs. Thus, headline inflation, with the exception of a temporary rise at the end of the year, is expected to be less than 2% over the remainder of the projection horizon.

Uncertainty regarding GDP growth is on the rise, and indicates that growth will very likely be lower than forecast in the baseline projection. The risk relating to growth in foreign demand is rising as a result of growing uncertainty on the sovereign debt markets, declining confidence, the need for fiscal consolidation and persistently high unemployment in the most important trading partners. At the same time, uncertainty regarding certain domestic factors is also growing. The necessary structural reforms and fiscal consolidation have been delayed, which might give rise to distrust in fiscal policy, increased uncertainty regarding the economy and a rise in the financing costs of the general government and the private sector. Another contributing *factor could be the downgrading of Slovenian government bonds in September. Access to refinancing in the rest of the world could also be hindered. This would affect investment activity in particular. There is also an increasing likelihood of a sustained rise in unemployment, and the related social consequences, the loss of human capital and an increase in general government expenditure. Inflationary risks remain balanced, similar to previous projections.*

* * *

The provisions of the Stability and Growth Pact are dictating the pace of fiscal consolidation, which can no longer be delayed. Credible consolidation would help to reduce uncertainty and improve confidence in the private sector, which would also have a positive effect on economic activity and employment in the medium term. Credible consolidation is also crucial to maintaining the still-relatively-favourable country rating, which also has an impact on the private sector's access to sources of financing. The Ministry of Finance is projecting a general government deficit of 5.5% of GDP for this year, while general government debt is expected to rise to 45.1% of GDP. Slovenia's fiscal priority must remain reducing the general government deficit to below the reference value of 3% of GDP by the end of 2013 at the latest. With regard to fiscal consolidation, it is imperative to focus on structural measures that will improve the public finance situation. Unsustainable measures based on reducing tax revenue should be avoided. Public sector wage policy must be restrictive, as wage bill in the public sector have risen from around 11% of GDP to nearly 13% of GDP since 2008, which contributes significantly to the deficit in public finances.

Special attention must be given in the current conditions of low economic growth to reducing the extremely high level of unemployment, which could continue to rise in the absence of the appropriate measures. Although the level of labour costs relative to productivity in export-oriented sectors has adjusted to the reduced level of economic activity, this has not occurred to a sufficient extent in the majority of other sectors. Stimulating domestic demand through fiscal policy is subject to limitations, dictated by fiscal consolidation. Under such conditions, growth in productivity must lag behind wage growth in order to improve the competitiveness of the economy, stimulate employment and reduce unemployment. Because in the short-term growth in production is crucial to maintaining favourable growth in exports, it is essential to ensure the appropriate competitive position of the Slovenian economy.

In addition to their contribution to the medium-term consolidation of public finances, appropriately focused structural reforms would also have a long-term impact on potential economic growth and labour productivity. Reform of the labour market must ensure the right balance between job and income security for workers and the necessary flexibility for companies in hiring and firing workers. This would make it easier for companies to adapt to the changing situation on the market, while raising the employment rate in the long term. Reform of the pension system remains necessary to ensure the long-term sustainable financing of the public sector, similar to health reform, which must also contribute to increasing the efficiency of this part of the public sector. In the longer term, it is crucial to encourage the development of human capital, efficient corporate governance, market competition, particularly in the service sector, and innovation. These factors widen the scope of commercial opportunities, increase the attractiveness of the economic environment for new investment, and thus promote economic development.

Stalled efforts to secure the long-term sustainability of public finances, the basis of which are structural reforms, is not merely an economic problem; it is also a social problem. During a period that may be crucial for maintaining a sustainable social model, key political and social partners must reach a fundamental consensus on measures to overcome the crisis. During the adverse economic conditions, the opportunities at the disposal of those responsible for economic policy are limited, while available measures could have some adverse trade-off effects.

								Projections					
								2011		2012		2013	
	2004	2005	2006	2007	2008	2009	2010	**Oct**	Δ	**Oct**	Δ	**Oct**	Δ
Activity, employment and wages	*growth rates, %*												
GDP (real)	4.4	4.0	5.8	6.9	3.6	-8.0	1.4	**1.3**	-0.5	**1.7**	-1.0	**2.5**	-0.6
Employment	0.4	-0.5	1.5	3.3	2.6	-1.8	-2.5	**-1.7**	-0.3	**-0.6**	-0.6	**0.1**	-0.4
Compensation per employee	7.7	6.0	5.4	6.2	7.2	1.8	4.3	**2.4**	-1.4	**2.6**	-1.4	**2.8**	-1.4
Productivity	4.0	4.5	4.2	3.4	1.0	-6.3	4.0	**3.1**	-0.1	**2.3**	-0.4	**2.7**	0.0
ULC (nominal)	3.5	1.5	1.0	2.7	6.2	8.7	0.4	**-0.6**	-1.2	**0.4**	-0.8	**0.3**	-1.2
Contribution to GDP growth	*percentage points*												
Domestic demand, excl. chg. in inventories	3.5	2.5	5.0	6.9	5.1	-6.3	-2.0	**-2.0**	-2.2	**0.3**	-1.6	**1.7**	-0.8
Net exports	-0.5	2.2	0.2	-2.0	-0.6	2.3	1.5	**1.8**	0.6	**0.9**	0.1	**0.8**	0.2
Changes in inventories	1.4	-0.7	0.7	2.0	-0.9	-4.0	1.9	**1.4**	1.0	**0.4**	0.4	**0.0**	0.0
Domestic demand	*real growth rates, %*												
Domestic demand	4.9	1.8	5.6	8.9	4.1	-10.0	-0.1	**-0.6**	-1.2	**0.8**	-1.1	**1.8**	-0.8
Private consumption	3.0	2.1	2.8	6.1	3.7	-0.2	-0.7	**0.1**	-0.7	**0.6**	-1.1	**1.2**	-0.8
Government spending	3.3	3.5	4.0	0.6	6.1	2.9	1.5	**0.2**	0.6	**0.2**	-0.9	**0.4**	-1.2
Gross fixed capital formation	5.0	3.0	10.4	13.3	7.8	-23.3	-8.3	**-9.3**	-8.3	**-0.4**	-3.4	**4.6**	-0.4
Balance of payments	*growth rates, % (if not specified otherwise)*												
Exports of merchandise and services	12.4	10.6	12.5	13.7	2.9	-17.2	9.5	**7.6**	0.4	**4.9**	-1.8	**6.5**	-0.1
Imports of merchandise and services	13.3	6.7	12.2	16.7	3.7	-19.6	7.2	**5.1**	-0.4	**3.8**	-1.8	**5.7**	-0.3
Current account: EUR billion	-0.7	-0.5	-0.8	-1.6	-2.6	-0.5	-0.3	**-0.2**	0.4	**0.1**	0.5	**0.3**	0.7
as % GDP	-2.6	-1.7	-2.5	-4.8	-6.9	-1.3	-0.8	**-0.5**	1.1	**0.4**	1.5	**0.8**	1.7
Terms of trade*	-1.0	-2.0	-0.5	0.9	-1.5	4.3	-3.8	**-1.4**	1.0	**0.6**	0.4	**0.2**	0.2
Prices	*average annual growth rates, %*												
Consumer prices (HICP)	3.7	2.5	2.5	3.8	5.5	0.9	2.1	**2.0**	-0.7	**1.6**	-0.7	**1.6**	-0.3
HICP excluding energy	3.2	1.2	1.7	3.8	4.9	1.7	0.3	**0.9**	-0.6	**1.5**	-0.7	**1.7**	-0.3
HICP energy	7.0	11.9	8.5	3.4	9.4	-4.5	13.9	**8.3**	-1.3	**2.2**	-0.8	**0.4**	-0.8
International environment	*growth rates, % (if not specified otherwise)*							**Assumptions**					
Foreign demand**	10.3	8.2	11.6	11.3	5.9	-14.2	11.3	**7.0**	0.2	**4.5**	-1.8	**6.0**	0.0
Oil (USD per barrel)	38	54	65	73	98	62	80	**110**	0	**107**	-1	**104**	-4
Non-oil commodities	22.1	12.0	29.1	17.4	10.1	-23.0	37.1	**21.0**	-6.5	**-2.0**	-3.0	**5.0**	0.0
EMU inflation	2.1	2.2	2.2	2.1	3.3	0.3	1.6	**2.6**	0.3	**1.9**	0.2	**1.8**	0.0
PPI Germany	1.6	4.4	5.4	1.3	5.4	-4.0	1.5	**5.1**	2.3	**2.3**	0.1	**1.8**	0.0

* Based on national accounts deflators

** Volume of imports from the basket of foreign partners

Δ: Difference between current projections and projections in April 2011 Price Stability Report

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

1 International Environment

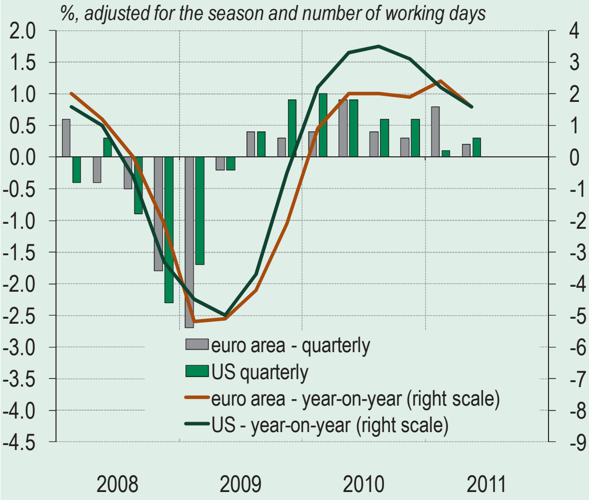
The main features of the global economy in the first half of 2011 were slowing economic growth in the second quarter, rising inflationary pressures, particularly in emerging economies, and increasing uncertainty over the fiscal position of certain developed countries. August saw a sharp increase in uncertainty regarding the global economic recovery, the main factor, alongside lower economic activity, being uncertainty about fiscal consolidation in euro area countries and the US. At the same time, the monetary policy stance of the majority of central banks in developed countries remains accommodative, as reflected in relatively low interest rates and non-standard measures, while it is less stimulative or even restrictive in emerging countries owing to the risk of high inflation. Inflationary pressures remain significant in the US and euro area, as oil and other commodity prices remain high, despite an easing in recent months.

Economic developments

Global economic growth, which rose sharply in the first quarter, was lower again in the second quarter. Growth was particularly low in the US and the euro area, and in certain other developed economies. Low growth in economic activity in the euro area, where quarter-on-quarter GDP growth was 0.2% in the second quarter, contributed significantly to declining global economic growth. Contributing alongside France to the slowdown in growth relative to the first quarter was Germany, where growth of merely 0.1% was recorded, as a result of a decline in private consumption and activity in the construction sector. GDP growth was also relatively low in the US during the first half of the year. GDP rose by 0.3% relative to the first quarter in the US during the second quarter, primarily as a result of growth in investment in non-residential assets, expenditure at the federal level and exports, and lower growth in imports. There was also an increase in household consumption, albeit less than in the first quarter. Extraordinary events had a significant impact on the decline in Japanese exports, resulting in a

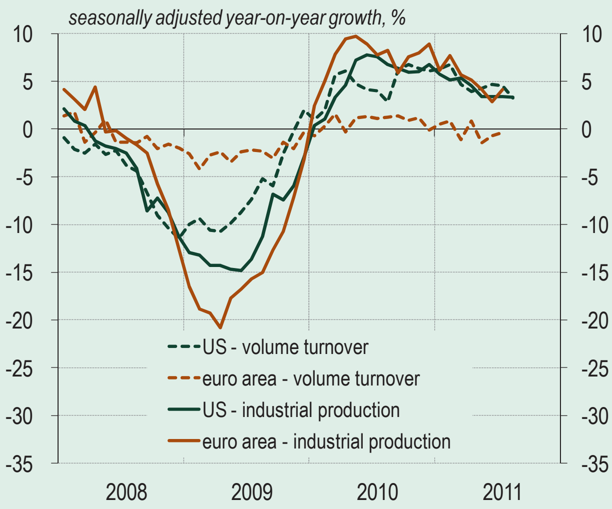
Figure 1.1: GDP growth

%, adjusted for the season and number of working days



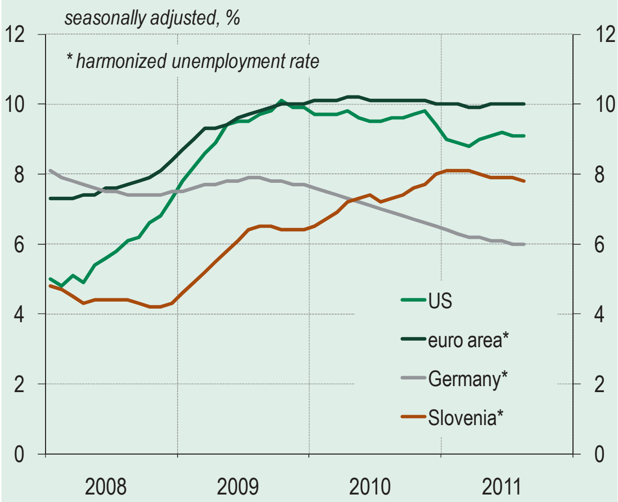
Sources: Eurostat, FRED.

Figure 1.2: Retail trade and industrial production



Sources: Eurostat, FRED, Bank of Slovenia calculations

Figure 1.3: Unemployment rate



Sources: Eurostat, FRED

quarterly decline in Japanese GDP of 0.9% in the first quarter and 0.5% in the second quarter.

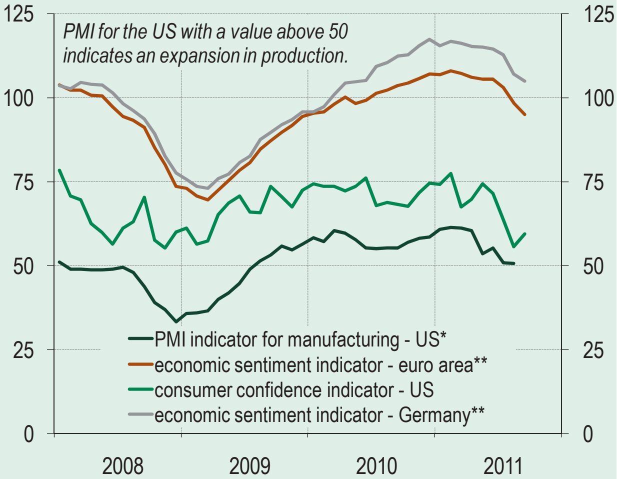
Projections of global economic growth were revised downwards owing to low growth in the US and the euro area. Growth in economic activity remains relatively high in emerging economies. Due to increased uncertainty and declining economic growth in certain major developed economies, the IMF revised its forecast of global economic growth for 2011 downwards in September, by 0.3 percentage points to 4.0%. Growth in economic activity remains relatively high in emerging economies, particularly in Asia. GDP in India was up 7.7% in year-on-year terms in the second quarter of this year (by 7.8% in the first quarter), while China achieved 9.6% growth in the second quarter following year-on-year growth of 9.7% in the first quarter.

Low household consumption in the US and the euro area is a result of persistently high unemployment, the relatively high level of household indebtedness, lower disposable income, declining household assets and a deepening of the debt crisis in recent months. US and euro area households, which borrowed considerably in the period of high growth, are now cautious in their spending. Also contributing to low private consumption are low wage growth and the declining value of assets owing to the fall in real estate prices and a decrease in financial assets. Increased caution in spending is also a result of the high unemployment rate, which has fluctuated at around 10% in the euro area over the last two years. The euro area unemployment rate has not changed significantly since the end of 2009, partly as a result of measures to protect and preserve jobs. The unemployment rate has risen sharply since the outbreak of the crisis, particularly in the US, where the rate has persisted at around 9% for close to two years. Consumer confidence has fallen sharply in recent months due to increased uncertainty regarding the debt crisis. According to the IFO survey, confidence has fallen sharply in Germany, while in August the US Consumer Confidence Index fell to its lowest level in the last two years.

Growth in foreign import demand is in line with developments in economic activity in the most important trading partners. According to estimates, growth in foreign demand will slow this year relative to last year, as a result of slower global economic growth this year. Real GDP growth in Germany is forecast at around 3% for this year, which is less than last year, when growth was exceptional and reached 3.7%. With the exception of Croatia, real GDP rose in the first half of the year in all other major trading partners, Russia having achieved the high-

Figure 1.4: Economic sentiment indicators

**seasonally adjusted, **seasonally adjusted and long-term average = 100*



Sources: Eurostat, FRED

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

Sources: ECB, Federal Reserve

est growth of 3.6% in year-on-year terms. Real GDP was down 0.8% in year-on-year terms in Croatia during the first quarter, while a similar year-on-year increase was recorded in the second quarter.

Financial markets and commodity prices

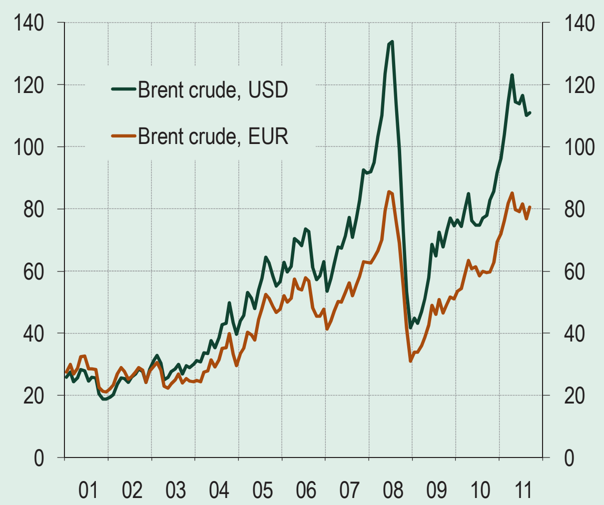
The majority of central banks in the developed world continued to implement an accommodative monetary policy stance in the third quarter, which is reflected in relatively low interest rates and non-standard measures. The interest rates of central banks in countries with somewhat higher inflation are gradually rising. The ECB raised its key interest rate, which stood at 1.50% in September, in April and July, both times by 0.25 percentage points. To ensure the proper functioning of the sovereign debt markets, which is necessary for the effective functioning of monetary policy, the ECB intervened with the additional purchase of bonds of countries that have committed to credible fiscal consolidation measures. The US Federal Reserve (the Fed) is expected to maintain its key interest rate in the interval between 0% and 0.25% at least until the second half of 2013. The Fed completed a second round of quantitative easing in June. The Bank of England is continuing its non-standard measures, while its base rate has remained at 0.50% since March 2009. The Bank of Japan's key interest rate has remained unchanged at 0.05% since October 2010. It intervened on the foreign-exchange market in March 2011 due to natural catastrophe. It intervened again in August to prevent the appreciation of the yen. The Swiss central bank also intervened on the currency market, as the Swiss franc appreciated sharply in the third quarter of this year against all major currencies, thereby reducing the competitiveness of the Swiss economy. To that end, it set a minimum exchange rate of 1.2 francs per euro in September. In contrast, a number of central banks in emerging countries have raised their key interest rates.

The euro rose against the US dollar, primarily in the second quarter, while its appreciation stalled in the third quarter. The euro's rise against the US dollar in the second quarter was mainly a result of relatively high economic growth in the euro area in the first quarter and a temporary easing of the public finance problems in euro area peripheral countries. The public finance problems of those countries rose again in the third quarter, bringing an end to further appreciation of the euro. The euro averaged USD 1.4137 in the third quarter, down 1.8% relative to the second quarter.

The situation on the sovereign debt markets has deteriorated this year. The required yields on the bonds of euro area peripheral countries remain high. After easing temporarily in the first quarter of this year, the renewed increase in uncertainty in the second quarter was reflected in a rise in premiums in euro area periphery countries above the required yields on the lowest-risk bonds. The required yields on the bonds of certain countries fell after the ECB's intervention on the sovereign debt market. In June EU leaders agreed to increase the volume of guarantees in the scope of the EFSF from EUR 440 billion to EUR 780 billion to stabilise financial conditions. Uncertainty due to a rise in the US borrowing limit also increased, resulting in the downgrading of the US credit rating by one of the main rating agencies in August.

The prices of oil and other commodities were down slightly in the third quarter, primarily as a result of lower economic growth in major economies. Year-on-year growth in the prices of commodities and precious metals remains high. The price of oil fell in the third quarter, owing to a slight slowdown in global economic growth, to stand at USD 112.5, down 4.0% on the second quarter. A similar trend was also seen in commodity prices, which were down in the third quarter relative to the first half of the year, while year-on-year growth in September remained high. Precious metal prices reached record levels in the third quarter. The average price of gold climbed to USD 1,787.4 per ounce in September due to increased uncertainty regarding public finance issues, particularly in euro area peripheral countries.

Figure 1.6: Oil prices per barrel



Sources: Bloomberg, ECB, Bank of Slovenia calculations

Inflation

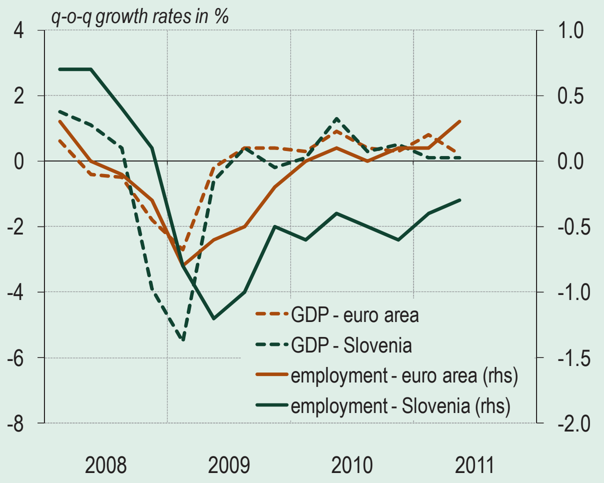
High commodity and energy prices continue to have the largest impact on the relatively high growth in prices in the euro area and US. **Core inflation has also risen since the beginning of the year in both economies.** Growth in the HICP reached 3.0% in the euro area in September, up 0.5 percentage points on August. Energy prices remain high, having recorded year-on-year growth of 11.8% in August. Growth in the CPI reached 3.8% in the US in August, up 0.2 percentage points on July. The highest growth in the US was also recorded in energy prices, which were up 18.4% in year-on-year terms in August. Core inflation in the euro area as measured by growth in the HICP excluding energy and unprocessed food prices stood at 1.5% in year-on-year terms in August, unchanged from July. Core inflation in the US as measured by growth in the CPI excluding energy and food rose in August to stand at 2.0%, up 0.2 percentage points on July. The high growth in prices in the third quarter in certain developed economies and the BRIC countries continues to exceed the reference values of central banks.

2 Economic Trends and the Labour Market

Economic growth fell in Slovenia during the first half of the year, to stand at less than 1% in year-on-year terms in the second quarter. The deteriorating economic situation in the first half of the year was primarily the result of a decline in domestic demand, where declining construction investment, and thus construction activity, continue to stand out. This remains the main factor hindering economic growth in Slovenia. Following relatively high quarterly growth last year, investment in machinery and equipment has also begun to decline in current terms this year, despite the relatively high level of production capacity utilisation and growth in merchandise exports. The dependence of economic growth on the situation in the rest of the world rose in the first half of the year, as a result of weak domestic demand. This is confirmed by the structure of GDP growth in a period marked by significant contributions from manufacturing and net exports. The number of job vacancies and new hires has risen in recent months, slowing the year-on-year decline in employment in the private sector during the first two quarters of this year. The exception was construction, where the decline in employment remains very pronounced. Contrary to government plans, employment in the public sector has risen further, although the rate of growth is slowing. The unemployment rate is high compared with the previous year. In the second quarter, the registered unemployment rate and the survey unemployment rate stood at 11.6% and 7.8% respectively. In the context of moderate growth in wages and a further contraction in employment, the competitiveness of the Slovenian economy continues to improve gradually.

Economic growth in Slovenia lags behind average euro area growth, reflecting the continuing decline in domestic demand, which is primarily driven by a decline in construction investment. According to revised figures from the national accounts, GDP grew by 1.4% in Slovenia last year, 0.4 percentage points less than in the euro area. The gap in growth widened slightly in the first half of the year. While the euro area economy achieved high quarterly growth of 0.8% in the first quarter on the back of accelerated growth in foreign trade, that figure was extremely low in Slovenia owing to declining domestic consumption. Quarterly GDP growth in the euro area fell to 0.2% in the second quarter owing to the global economic downturn and the decline in domestic consumption, while barely perceptible growth continued in Slovenia. The decline in domestic consumption in Slovenia picked up pace in the second quarter, mainly due to accelerated drop in construction investment. Growth was again driven by relatively high growth in exports and the continuing renewal of inventories. Year-on-year GDP growth in the second quarter fell to just under 1%, primarily as a result of the sharp contraction in construction in-

Figure 2.1: GDP and employment



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

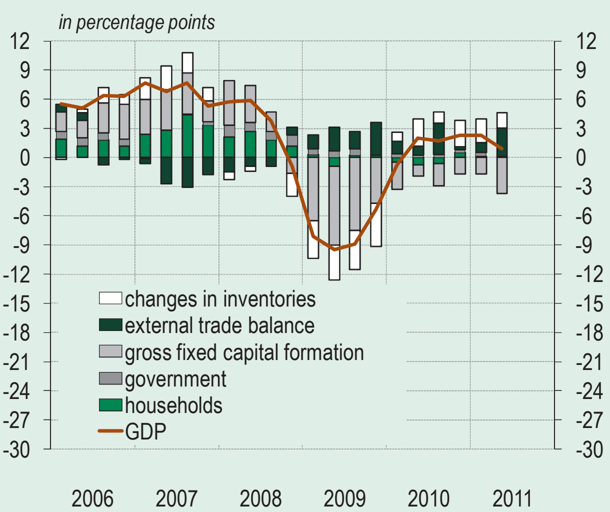
vestment. The contraction in construction activity from previously unsustainable levels remains the main factor hindering Slovenian economic growth.

Aggregate demand

After stagnating in 2010, the contribution of domestic consumption to year-on-year GDP growth turned negative again in the first half of the year, primarily as a result of the deteriorating situation in the second quarter. Domestic consumption was down 0.5% during the first half of the year owing to the accelerating decline in construction investment, stalled investment in equipment and machinery, lower consumer purchasing power and government austerity measures, lowering GDP growth by 0.4 percentage points. Year-on-year changes in consumption were positive in the first quarter, with the exception of gross fixed capital formation. The second quarter saw a deterioration in most components of consumption. The decline in investment has accelerated further. The decline in domestic consumption in the second quarter was also seen in imports, which were down 0.3% on the first quarter.

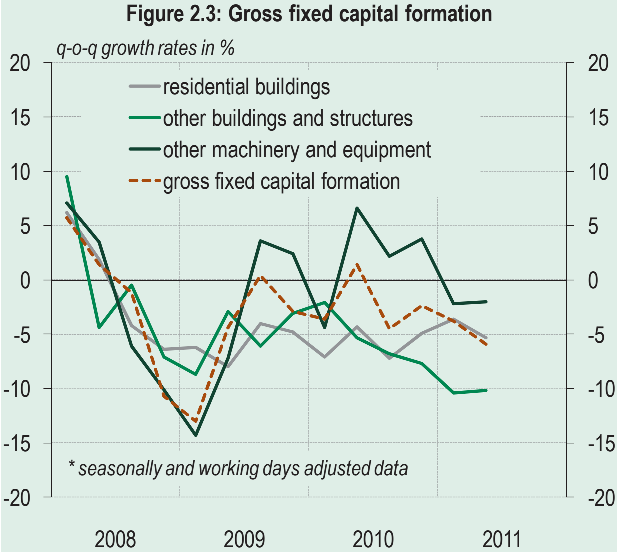
After some positive signs in the last year, quarterly trends in the first half of the year were negative for the majority of investment components. The sharp decline in construction investment continued last year. In the context of growth in export orders, investment in equipment and machinery which, according to survey figures was primarily aimed at renewing production capacity, has risen relatively rapidly since the second quarter. These trends did not continue in the first half of this year, as uncertainty rose again on foreign markets, most notably in the second quarter. High, 15.5% year-on-year growth in investment in equipment and machinery in the

Figure 2.2: Contributions to y-o-y GDP growth, expenditure side



Source: SORS

Figure 2.3: Gross fixed capital formation

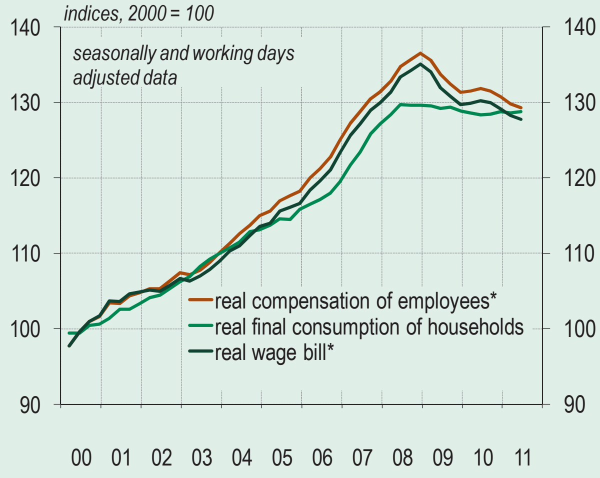


Source: SORS, Bank of Slovenia calculations first quarter of this year was primarily the result of a low basis, as such investment was down relative to the previous quarter. The quarterly decline in investment in equipment and machinery continued in the second quarter, and was also down 3.2% in year-on-year terms owing to the high basis. Because the simultaneous year-on-year decline in construction investment exceeded 28%, the renewal of inventories was unable to prevent a decline in total gross investment, which was down more than 9% in the second quarter, lowering GDP growth by 2.1 percentage points. Construction investment as a proportion of GDP fell to 9.0%, the lowest level in the last ten years.

Following last year's decline, final household consumption stagnated in the first half of this year. The real gross wage bill has declined since the second quarter of 2009 owing to the deteriorating situation on the labour market. Consumer purchasing power is declining, despite a sharp increase in government expenditure on social transfers, while the unemployment rate is elevated. This is reflected in final household consumption, which fell by slightly less than 1% last year. An even greater fall in aggregate final household consumption was prevented by increased spending on durables, in particular on car purchases. At the same time, sharp declines in revenue (as high as 6% or more) were recorded in some segments of durables last year, as households reduced the volume of purchases of goods with higher income elasticity of demand owing to the uncertain economic climate. Final household consumption was unchanged during the first half of this year. There was a significant decline in the consumption of durables, while the consumption of other products recorded moderate growth. The consumption of durables was down more than 4% in year-on-year terms, in line with a lower number of new vehicle registrations and an additional decline in revenue in some segments of durables.

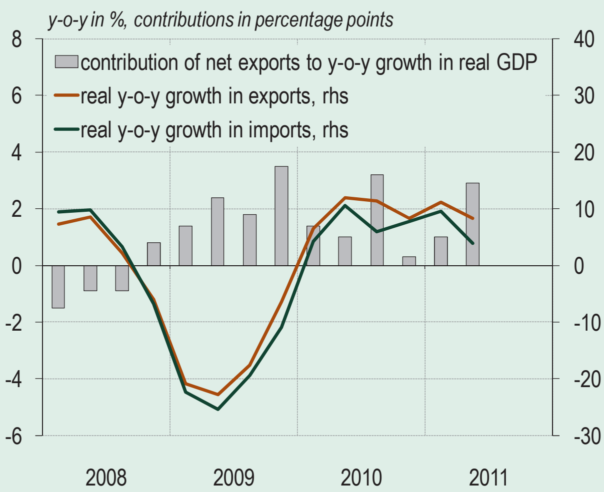
Having contributed positively to GDP growth last year and in the first quarter of this year, the contribution of final government consumption turned neutral in the second quarter. Following high growth in 2008, growth in final government consumption declined in the two subsequent years. Final government consumption was down 1.2% in the second quarter of this year relative to the first quarter, but remained unchanged in year-on-year terms. Declining growth in total government expenditure is a result of the implementation of fiscal consolidation measures that have been in force since last February. These measures are aimed primarily at savings related to expenditure on goods and services, reducing investment and the lower indexation of wages and pen-

Figure 2.4: Wage bill, compensation of employees and final consumption of households



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

Figure 2.5: Foreign trade



Source: SORS - national accounts

Box 2.1: Technology intensity of production in the manufacturing sector

With manufacturing accounting for one fifth of total value-added and total employment, the Slovenian economy is one of the most industrialised in the euro area. The manufacturing sector remains a key source of economic growth, despite declining employment and lower value-added as a proportion of GDP than a decade ago. The manufacturing sector generates more than 60% of its revenue on foreign markets. Owing to the sharp decline in international trade, manufacturing was in a deep crisis at the end of 2008 and in the first half of 2009. The decline in value-added in manufacturing was also the main factor in falling GDP during the same period. Later, in conjunction with a recovery in international trade and integration in international supply chains, growth in production also revived which, in the context of the crisis in domestic demand, has become a key driver of economic growth.

Differences in growth between sectors, which were already evident during the period of high economic growth, have increased further during the crisis. The crisis has accelerated the decline of the majority of low-technology industries. With some exceptions, industries with higher technology intensity have responded relatively well to the recovery in international trade, and have begun to increase production.[1] Of particular note among industries subject to a greater degree to cyclical developments in international trade are the manufacture of motor vehicles and electrical appliances, the only industries to have exceeded pre-crisis output during the first half of 2011. In terms of value-added and employment, the importance of medium-high-technology industries, which include the two aforementioned sectors, has been increasing.

The importance of low-technology industries began to diminish prior to the crisis owing to increased competition from countries with low labour costs. The crisis has further accelerated the decline of such industries. Value-added declined in eight out of ten low-technology industries from the manufacturing sector already in 2008, when the economic situation was still relatively favourable during the first half of the year. Value-added for the entire group of low-technology industries fell by more than 7% in 2008. After a sharp drop in 2009, the value-added for the aforementioned group declined by 1.3% in 2010, while value-added rose by 8.0% on average in the manufacturing sector overall. Output also contracted during the first half of 2011 in the manufacture of furniture, textiles and garments, and in other manufacturing industries. These are the same industries that lag most behind pre-crisis output levels. The proportion of total value-added in manufacturing accounted for by the group of low-technology industries fell by 13 percentage points to 23% in the ten years to 2010. In 2000 the companies from this group employed 43% of the workforce in employment in manufacturing. That proportion had fallen to 31% by the first half of 2011. The average wage in this group, which also reflects the structure of the employees, is around 14% lower than the manufacturing sector average.

After relatively low growth during the period of high economic growth, value-added in medium-low technology industries declined already in 2008, and contracted by nearly one fifth in 2009. An above-average rebound was seen in 2010 in the manufacture of basic metals and rubber and plastic products on account of increased demand for intermediate goods. Growth in value-added in other industries was below the average of the manufacturing sector overall. Year-on-year growth in the manufacture of basic metals and fabricated metal products was up during the first half of 2011 primarily due to high growth in demand in the first quarter. The manufacture of non-metallic mineral products stagnated in the context of the deepening crisis in the construction sector, while the manufacture of rubber and plastic products fell sharply. The level of output in the first half of 2011 was well below the level seen in the first half of 2008 in all medium-low-technology industries. At 30%, the proportion of total value-added in manufacturing accounted for by this group remained at the 2000 level, while the proportion of the total workforce in employment in manufacturing accounted for by the same group was up, from 30% in 2000 to 35% by the second half of 2011. The wages of this group are at the average of the manufacturing sector overall.

The majority of medium-high-technology industries recorded high growth in value-added prior to the outbreak of the crisis at the end of 2008. Since the majority of this group's revenue is generated on foreign markets, its activity fell sharply with the decline in international trade at the end of 2008. The value-added of these industries was down one fifth in 2009. The manufacture of motor vehicles recorded the smallest decline in value-added in this group on account of government subsidies for new vehicle purchases on a number of important markets. The sharp decline in the manufacture of other machinery and equipment was the result of a significant drop in investment. The chemical, electric machinery and apparatus and automotive industries recorded high growth in value-added in 2010 owing to the recovery in international trade. At the same time, the situation in the manufacture of other machinery and equipment, and other transportation equipment has not improved significantly owing to uncertainty in the international environment, the low utilisation of production capacity and the deteriorating situation on the labour market. Output in the group of medium-high-technology industries was also up in the first half of 2011, again with significant differences between individual industries. The manufacture of other transportation equipment and the manufacture of other machinery and equipment recorded strong growth

Table: Groups of manufacturing industries according to technological intensity of their production

	Real value added				Volume of production		Persons in employment		Wages
	Annual changes, %				growth, %		%	growth, %	%
	2007	2008	2009	2010	H1 2011/ H1 2010	H1 2011/ H1 2008	share in C H1 2011	H1 2011/ H1 2008	H1 2011; C avg. = 100
C Manufacturing - total	**8.5**	**0.3**	**-16.6**	**8.0**	**7.6**	**-12.2**	**100.0**	**-17.7**	**100**
Industries with low technological intensity	**5.9**	**-7.2**	**-14.4**	**-1.3**	*	*	**30.6**	**-24.9**	**86**
10 Manufacture of food products	7.7	-12.6	-10.8	2.3	7.8	0.6	7.0	-10.5	88
11 Manufacture of beverages	0.3	0.1	14.0	-17.8	2.3	-7.7	1.0	-10.6	121
13 Manufacture of textiles	6.0	-6.6	-24.8	-6.2	-0.8	-58.1	2.3	-45.8	85
14 Manufacture of wearing apparel	2.2	-4.5	-27.5	-11.4	-1.3	-48.2	2.8	-49.7	66
15 Manufacture of leather and related products	-8.7	-5.7	-15.7	15.4	30.1	-5.5	2.0	-15.7	70
16 Manufacture of wood, products of wood, cork	10.0	-16.7	-19.6	10.6	6.5	-20.2	4.8	-22.9	83
17 Manufacture of paper and paper products	7.3	-11.3	0.3	1.2	6.3	-8.2	2.3	-12.0	105
18 Printing and reproduction of recorded media	10.5	4.0	-10.3	-5.0	1.5	-15.7	2.4	-24.5	99
31 Manufacture of furniture	4.0	-1.0	-28.2	-8.2	-2.4	-43.6	4.4	-24.4	78
32 Other manufacturing	7.9	-2.7	-27.9	4.5	-3.6	-34.3	1.6	-12.7	94
Industries with medium-low technological intensity	**4.3**	**-1.3**	**-18.2**	**11.3**	*	*	**34.8**	**-13.1**	**100**
22 Manufacture of rubber and plastic products	-2.7	-2.7	-18.1	13.3	-10.5	-21.7	7.3	-7.1	101
23 Manufacture of non-metallic mineral products	4.9	-4.0	-28.7	8.0	0.1	-33.7	4.3	-20.2	103
24 Manufacture of basic metals	1.0	1.9	-22.1	26.1	18.6	-15.2	4.1	-24.9	105
25 Manufacture of fabricated metal products	7.9	-1.6	-13.7	6.9	15.6	-15.2	15.9	-12.4	94
33 Repair of machinery and equipment	5.5	3.5	-16.7	7.9	-0.2	-27.8	3.3	-0.3	109
Industries with medium-high technological intensity	**12.1**	**2.5**	**-20.0**	**12.6**	*	*	**28.1**	**-15.3**	**101**
20 Manufacture of chemicals and chemical products	7.4	-3.9	-15.7	17.4	3.7	-7.9	3.5	-12.6	119
27 Manufacture of electrical equipment	11.9	-0.7	-23.1	18.2	8.5	7.1	10.0	-11.2	93
28 Manufacture of machinery and equipment n.e.c.	12.4	12.0	-24.2	0.0	14.2	-21.3	7.3	-21.2	103
29 Manufacture of motor vehicles, trailers	18.1	1.8	-11.0	15.0	3.7	5.9	7.0	-10.6	102
30 Manufacture of other transport equipment	3.7	12.6	-41.2	2.2	14.1	-17.2	0.3	-64.9	117
Industries with high technological intensity	**17.7**	**14.9**	**-15.5**	**9.5**	*	*	**6.6**	**-12.9**	**153**
21 Manufacture of basic pharmaceutical products and prep.	12.5	12.8	-6.7	4.0	17.6**	27.3**	2.9	11.0	213
26 Manufacture of computer, optical products	23.3	16.9	-23.9	16.0	33.4	-13.9	3.6	-25.7	104

Source: SORS, Eurostat, Bank of Slovenia calculations
Notes: Detailed data for value added in manufacturing is available up to 2010.
**With data published in SORS databases, reliable estimates of aggregate production of groups of industries according to their technological intensity of production can't be calculated.*
***Due to confidentiality, SORS doesn't publish production indices for manufacturing of basic pharmaceutical products and preparations. As an estimate to production figures for manufacturing of basic pharmaceutical products and preparations, nominal growth of pharmaceutical products and preparations' export is used, based on figures from Eurostat's ComExt database.*

driven by a high level of investment in some important foreign markets, while growth in other industries from this group was down sharply. The proportion of total value-added and employment in the manufacturing sector accounted for by medium-high-technology industries is on the rise. Value-added reached 29% in 2010, up 7 percentage points on 2000. The proportion of the workforce in employment in manufacturing accounted for by this group reached 28% in the first half of 2011, up 7 percentage points on a decade earlier. Wages in this group are approximately 2% above the manufacturing sector average.

Due to low dependency of the pharmaceutical industry on cyclical developments in demand, the value-added of the group of high-technology industries declined by less than the average of the manufacturing sector overall in 2009. The 16% decline was thus primarily the result of a 25% drop in the manufacture of computers, and electronic and optical equipment, which nevertheless recorded renewed growth in 2010. The nominal value of exports of pharmaceutical products and pharmaceutical preparations, and the year-on-year growth in the output of computers, and electronic and optical equipment in the first half of 2011 indicate the continuation of favourable trends in the group of high-technology industries. The workforce in employment is contracting in this group, as employment growth in the pharmaceutical industry is slower than the decline in employment in the manufacture of computer, and electronic and optical devices. The proportion of the total workforce in employment in the manufacturing sector accounted for by this group has stagnated in the last decade at 7%. At the same time, the proportion of total value-added in manufacturing accounted for by the group of high-technology industries was up by merely 2 percentage points to 14% in the ten years to 2010. The average wage in this group is approximately 50% above the manufacturing sector average, but solely on account of the level of wages in the pharmaceutical industry.

[1] Classification of industries by technology intensity is summarised according to the OECD (http://www.oecd.org/dataoecd/43/41/48350231.pdf).

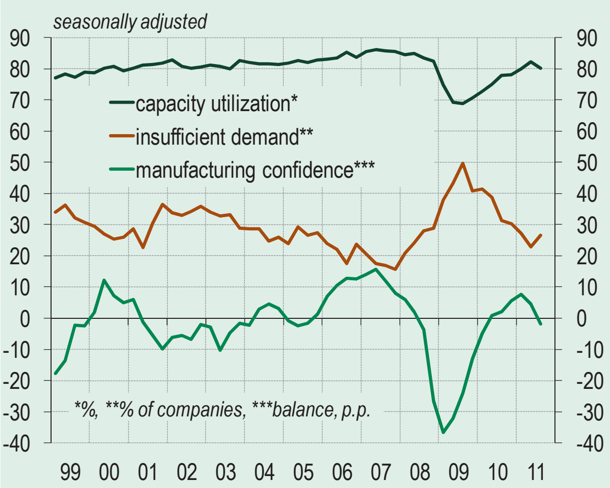
sions to inflation. At the same time, the number of public sector employees has risen relatively rapidly this year.

In the context of the deepening crisis in domestic demand, the contribution of foreign trade to GDP growth rose further during the first half of this year. Net foreign trade contributed 1.5 percentage points to GDP growth last year, and 2 percentage points during the first half of this year. Its contribution was high particularly in the second quarter, when imports of merchandise and services were down in quarterly terms, while growth in exports remained relatively high. The quarter-on-quarter stagnation in merchandise imports during the second quarter was primarily the result of a further decline in gross fixed capital formation, which drove down imports of capital goods. At the same time, imports of intermediate goods were down slightly in the context of lower growth in industrial production. Quarterly growth in exports fell, primarily as a result of lower exports of services. Growth in merchandise exports remained high at 3.4%, despite signs of declining growth in foreign demand.

Supply side

The manufacturing sector again made the largest contribution to year-on-year GDP growth in the first half of this year. With a year-on-year increase in value-added of 7.8%, manufacturing contributed 1.4 percentage points to GDP growth. After modest quarterly growth in

Figure 2.6: Business trends in manufacturing



Source: European Commission

the first quarter, growth in value-added in the manufacturing sector rose to 3.5% in the second quarter, but fell from 9.7% to 6.2% in year-on-year terms as a result of a base effect. The quarterly movement in value-added was not in line with the declining growth in output in the manufacturing sector, as illustrated by monthly data. Based on these data, growth in industrial production in the manufacturing sector declined from 1.2% in the first quarter to 0.6% in the second quarter. Production was down 3.0% in July and was over the first seven months of this year more in line with the movement in indicators of foreign demand and industrial production in Slovenia's main trading partners. Indicators illustrating the utilisation of production capacity, confidence in the manufacturing sector, and a lack of demand in the second and third quarter of this year have also begun to deteriorate.

Indicators of orders and economic sentiment point to a deteriorating situation in the manufacturing sector. The survey indicator of export orders and total orders declined in September for the fifth consecutive month. The real value of new orders declined already in the second quarter, by nearly 2% relative to the previous quarter. Lower demand for intermediate and capital goods has contributed to the aforementioned decline. Year-on-year growth in new orders was thus down significantly in the second quarter, from around 10% in the first quarter to slightly less than 2%. A fall in the value of orders was also seen in July. At the same time, the indicator of economic sentiment in the euro area points to a deteriorating situation on the most important markets, its value having declined since February, while falling below the long-term average in August and September. Also linked to the deteriorating situation in the international environment was a fall in the survey indicator of production capacity utilisation in the manufacturing sector in the third quarter.

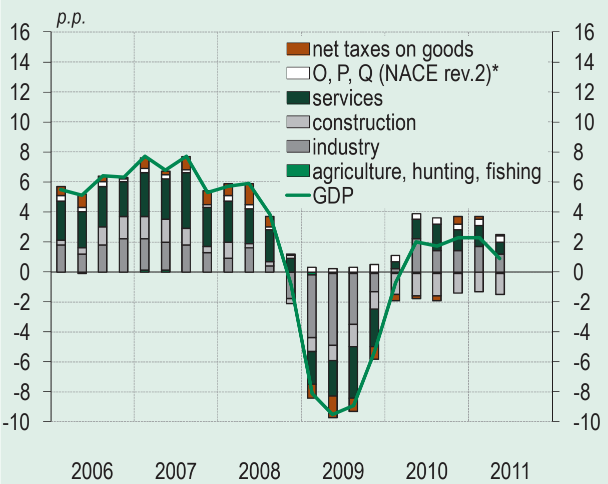
The continuing sharp fall in value-added in the construction sector contributed 1.4 percentage points to the decline in overall economic growth in the first half of the year. Despite the fact that value-added in the construction sector has been declining since the second

Figure 2.7: Survey indicators of current and expected demand in manufacturing

Source: SORS

quarter of 2008, the rate of decline accelerated further in the first two quarters of this year. Value-added was down 22.7% in year-on-year terms in the first half of the year, while the value of construction put in place was down 28.7%, the decline in the second quarter having accelerated further relative to the first quarter. All types of construction recorded a sharp decline in quarterly terms. Here the most noteworthy quarterly change was in civil engineering work, where a 1% increase in activity in the

Figure 2.8: Contributions to y-o-y GDP growth, production side

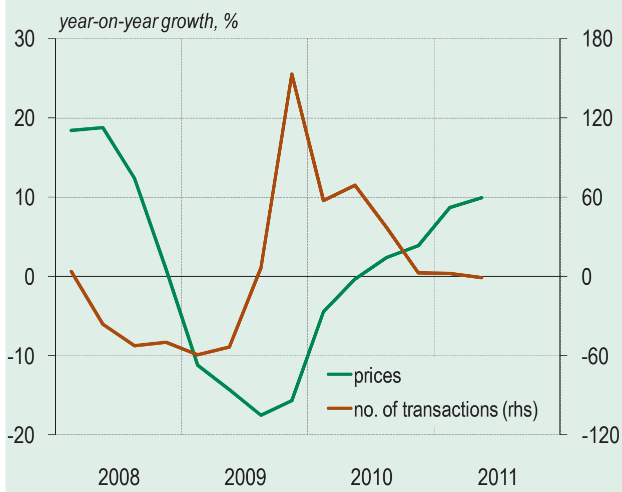


*public administration, education, human health and social work
Source: SORS

Figure 2.9: Construction: activity and confidence

Sources: SORS, Bank of Slovenia calculations

Figure 2.10: New dwellings



Sources: SORS, Bank of Slovenia calculations

first quarter was followed by a 17% contraction in the second quarter. The sharp year-on-year contraction in construction activity continued in July. The deepening of negative developments in construction was partly the result of a crisis at another two major construction companies, one of which went into bankruptcy in the middle of June, and the other of which is facing liquidity problems. The failure of major construction companies is also having an adverse impact on their subcontractors.

A number of indicators point to the continuation of the adverse situation in the construction sector. The proportion of corporates in the construction sector with unsettled past-due liabilities was up sharply over the first eight months of the year to stand at just under 23% in August. A similar trend was seen in the proportion of total unsettled past-due liabilities accounted for by construction companies, which exceeded 32% in August.[1] This is the highest figure among all sectors in both cases. The number of building permits was down in year-on-year terms during the first half of the year, as a result of a year -on-year fall in the first quarter. The floor space associated with approved building permits also declined in the first two quarters, by slightly less than one fifth on average. According to SORS figures, the prices of new residential properties have continued to rise in contrast to construction activity and consumer purchasing power. They were up nearly one tenth on the second half of last year during the first half of this year. Persistently high prices are in the interests of the creditors of construction companies, among which are also banks. The number of transactions was down nearly one quarter over the same period. As a result, inventories of unsold new dwellings remain high, owing to the high growth in residential construction in the years prior to the crisis.

Growth in value-added in financial and insurance activities is unexpectedly high. According to revised figures from the national accounts, value-added in the financial intermediation sector was up 5% last year, almost entirely as a result of growth in the insurance sector, where value-added was up nearly one fifth, primarily as a result of an increase in the number of underwritten insurance policies. Value-added in financial and insurance activities was up again in the first half of this year, by nearly 8%.

Year-on-year growth in value-added in the sectors of trade, transportation and storage, and accommodation and food services sectors remained relatively

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

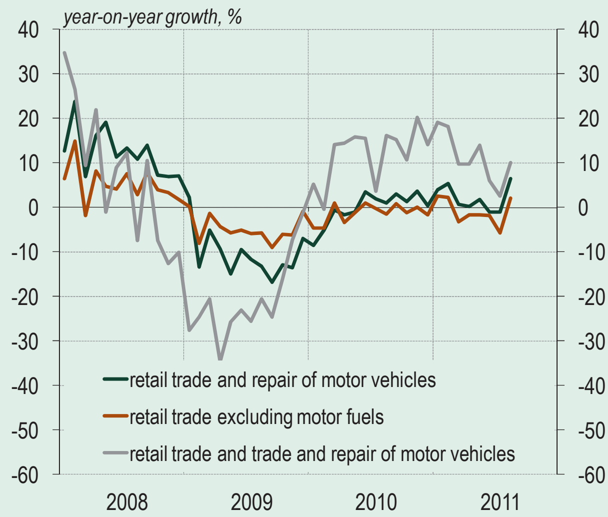
low in the first half of the year. It stood at 2.4%, similar to the average growth recorded last year. The main factor in the relatively low growth in value-added in this group of activities are low sales in certain retail segments owing to declining consumer purchasing power. This also affects the low growth in nominal revenues in the accommodation and food services sector. Growth in nominal revenues in the transportation and storage sector was also down sharply in the second quarter due to lower growth in international trade.

Total volume turnover in the retail sector and trade in motor vehicles during the first half of the year was up on the same period last year, although growth in turnover fell sharply in the second quarter. Volume turnover in the retail sector and trade of motor vehicles was up 5.2% in year-on-year terms in the first half of the year, but only as a result of an increase in turnover in trade in motor vehicles and motor fuels. Despite the adverse economic situation, volume turnover in trade and repair of motor vehicles in the second quarter was up more than one eighth in year-on-year terms during the first half of the year. Growth, however, slowed in the second quarter. Volume turnover in retail trade excluding motor vehicles and fuels has been in decline in year-on-year terms since the first quarter of 2009, with the exception of the first quarter of this year. A decline in turnover was present in the second quarter in several retail segments, most notably in sales of durables for the home, construction and leisure. Year-on-year growth in total volume turnover in the retail sector and trade of motor vehicles fell from 7.2% in the first quarter of this year to 3.5% in the second quarter, and was down nearly one tenth from the peak recorded in the third quarter of 2008. The low level of turnover in the retail sector continued in July, significant growth having been achieved in August, which was temporary in nature, at least in trade in foodstuffs, as turnover was likely affected by a sharp increase in the number of foreign visitors.

Labour market

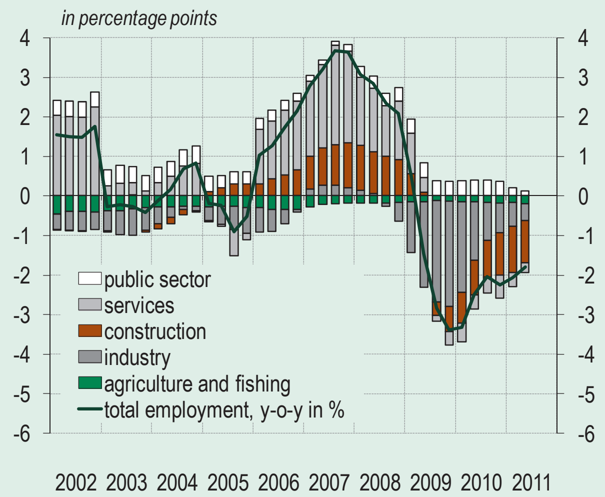
Employment continues to contract in the context of low economic growth, but at a slower pace than previously recorded. The year-on-year contraction in employment peaked at the end of 2009, when it stood at 3.4%. The contraction began slowing at the beginning of 2010, when it averaged 2.5% for the year, and slowed further in the first two quarters of this year. The year-on-year fall stood at 2.1% in the first quarter and 1.8% in the second quarter. According to figures from the national

Figure 2.11: Volume turnover in trade



Sources: SORS, Bank of Slovenia calculations

Figure 2.12: Contributions to employment growth



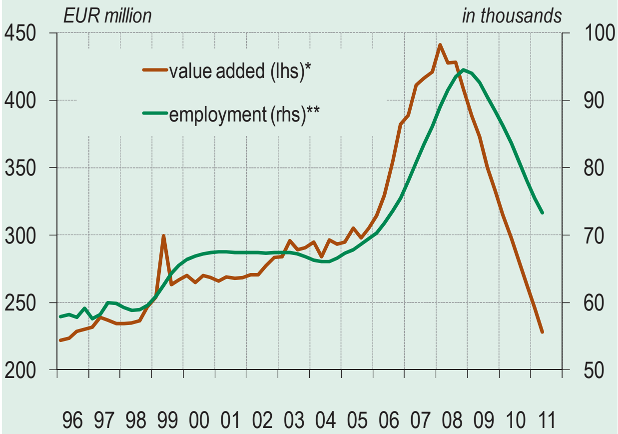
Sources: SORS - national accounts, Bank of Slovenia calculations accounts, there were more than 940,000 people employed in the second quarter of this year.

Employment continued to fall in the private sector in the first half of 2011, most notably in construction, while employment has already recorded growth in certain sectors. Employment in construction declined rapidly from the middle of 2009 until the first quarter of this year, when the year-on-year contraction reached 13.2%. The contraction in the second quarter of this year was smaller, at 12.4%. The year-on-year contraction in employment in this sector in the first half of this year was thus around four percentage points higher than the same period last year. The contraction is also slowing in other sectors where employment continues to fall. Having declined by 6.3% in 2010, employment in manufacturing fell by 2.1% in the second quarter of this year. The year-on-year contraction in employment in the sectors of wholesale and retail trade, accommodation and food service activities, and transportation slowed from the 2010 average of 2.9% to 2.1% in the second quarter of this year. In contrast, employment increased in certain private sector activities. Employment in information and communication activities has risen in year-on-year terms since the end of 2010, although by only 0.4% in the second quarter of this year. Employment in financial and insurance activities has risen since the first quarter of this year. Growth of 1.4% was recorded in the second quarter of this year, most likely at insurance companies, given operating results. Even more encouraging is the employment trend in professional, scientific, technical and other business activities, where employment has risen in year-on-year terms since the beginning of 2010. Year-on-year growth in the second quarter of this year stood at 2.1%.

Employment in the public sector was up 0.7% in year-on-year terms in the first quarter and up 0.2% in the second quarter. Although the growth in public sector employment has fallen relative to the previous year, when growth stood at 1.7%, it remains in contrast to government plans to reduce public sector employment. Monthly figures from the SORS, which are not fully comparable with figures from the national accounts, indicate that employment in public administration and culture was down during the first half of the year, but up in health and education.

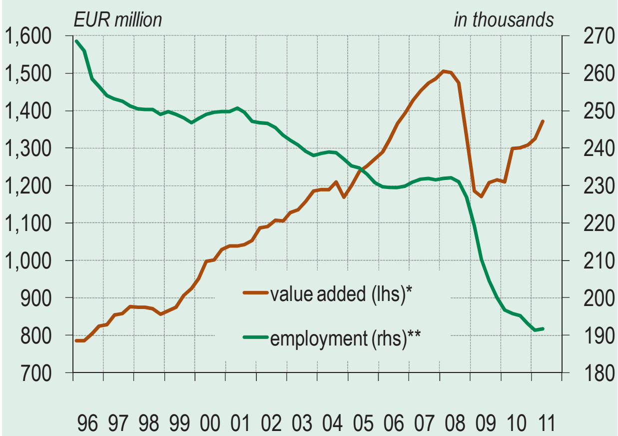
The trend in the number of actual hours worked in the private sector, which better reflects current changes in demand for labour and employment, points to somewhat more encouraging developments than the employment figures. The indicator of actual hours worked is more appropriate, because employers are more flexible in adapting the number of working

Figure 2.13: Value added and employment - construction



*Seasonally and working days adjusted data, constant prices, reference year 2000
**Seasonally and working days adjusted data
Source: SORS

Figure 2.14: Value added and employment - manufacturing



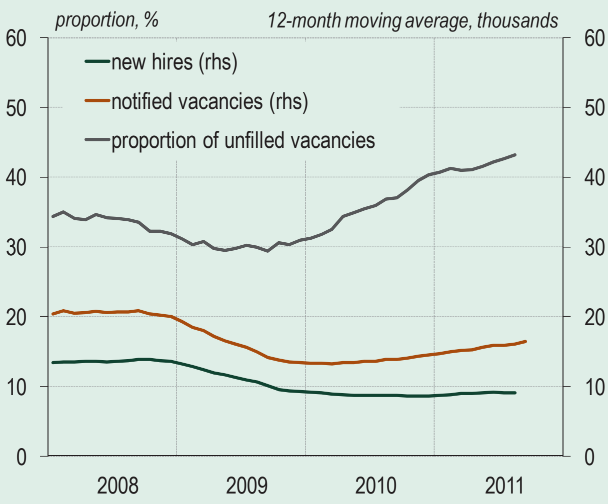
*Seasonally and working day adjusted data, constant prices, reference year 2000
**Seasonally and working day adjusted data
Source: SORS

hours, for example by ordering overtime or by cutting working hours, than with regard to firing or hiring workers. The number of hours worked in the private sector peaked in the second half of 2008, when year-on-year growth stood at around 4%, but has declined since that time.[2] The year-on-year decline in the number of hours worked peaked in the first quarter of 2010, when it reached 5.6%. Since then the decline has slowed, and stood at 1.8% in the first quarter of this year. The number of hours worked in the second quarter was at the level recorded at the beginning of 2005.

In the majority of private sector activities, the decline in the number of hours worked has continued, particularly in construction, where the rate of decline is still accelerating. The number of hours worked in manufacturing was down 1.1% in year-on-year terms in the first quarter of this year, indicating a gradual end to the negative trend seen since the first quarter of 2010. The number of hours worked in construction was down 11.8% in year-on-year terms in the first quarter of this year, the rate of year-on-year decline increasing. The decline in the number of hours worked in construction follows a period of very high growth in previous years. The number of hours worked in construction increased by around 30% from the beginning of 2006 to the end of 2008, and by more than 60% from the beginning of 2002. The number of hours worked in construction reached the level seen at the end of 2006 during the first quarter of this year. Because value-added in construction is at the 1996 level, it can be concluded that the number of hours worked in construction will continue to decline.

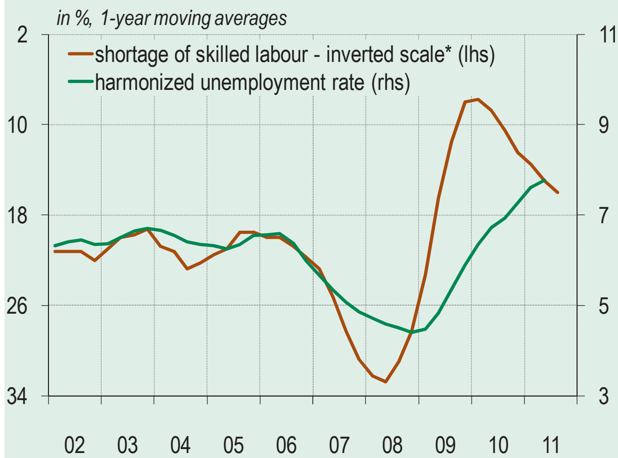
The imbalance between supply and demand on the labour market is increasing. Despite high unemployment, the number of job vacancies and the number of new hires are increasing in parallel with an increasing proportion of unfilled vacancies. Having declined significantly in 2009, the number of notified vacancies was up 8.3% in 2010, with growth having continued in the first half of this year. The number of vacancies was up 19.7% in year-on-year terms during the first half of this year. The number of vacancies for temporary jobs is increasing in particular, although the level remains down by around one fifth on the pre-crisis period. Meanwhile, the number of notified vacancies for permanent employment has risen only slightly in recent months, and is down one third on the pre-crisis period. The number of new hires is increasing, with year-on-year growth averaging 8.0% over the first eight months of the year. The proportion of unfilled vacancies is nevertheless increasing, as the number

Figure 2.15: Vacancies, new hires and proportion of unfilled vacancies



Sources: Employment Service, Bank of Slovenia calculations

Figure 2.16: Shortages of labour, unemployment rate



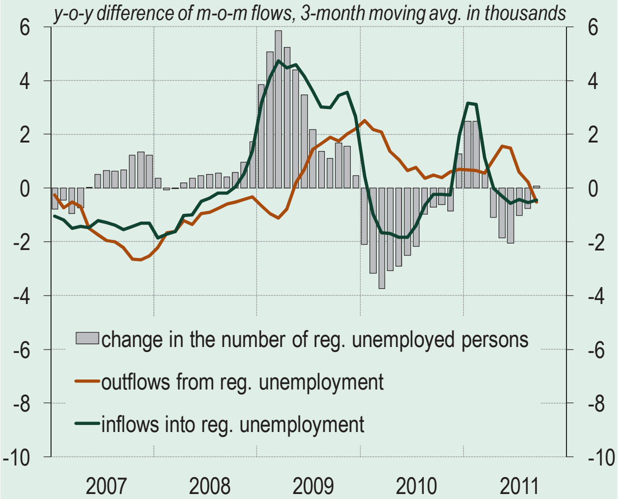
*Percentage of firms specifying that a shortage of skilled labour was a limiting factor in the quarterly Survey on Business Tendency in manufacturing
Sources: SORS, Eurostat, Bank of Slovenia calculations

[2] As work hours have a very large seasonal component, for the purpose of analysis they are taken into account as a moving average, calculated on the basis of the last four quarters.

of vacancies is increasing faster than the number of new hires. The proportion of unfilled vacancies was around 43% in August, compared to around 30% in the five years prior to the crisis. The changing structure of employment and the demand for labour is also illustrated by survey indicators regarding the lack of trained workers in manufacturing. These indicators usually move in the opposite direction of unemployment trends. Despite rising unemployment, however, corporates have stated a lack of trained workers as a limiting factor since the middle of 2009.

After a sharp rise in the number of registered unemployed at the end of 2010, that number fell until the middle of this year in the context of seasonal factors, although the registered unemployment rate remains high at 11.5%. Taking into account the usual seasonal movements, the number of unemployed was lowest in September, before the Employment Service registered persons whose student status has expired, and highest in January, prior to the start of seasonal work. Alongside the usual seasonal movements, the other major factors in the increase at the end of last year were one-off effects related to pension reform. The number of unemployed fell by 7.1% between January and August this year, from 115,100 to 107,000. The Employment Service registered

Figure 2.17: Inflows, outflows and changes in the number of unemployed persons



Source: Employment Service of Slovenia

48,000 newly unemployed and deregistered 56,200 persons during the same period. Around one half of inflows into unemployment was the result of expiring temporary employment term contracts, 16.9% due to the termination of permanent employment contracts and 9.5% as the result of bankruptcies. There were more new unemployed due to bankruptcies than in the same period last year, while there were slightly fewer due to the termination of permanent employment contracts. Outflows from unemployment (into employment, non-activity or other records) over the previous six months of this year were high in absolute numbers, but only slightly higher than the long-term average relative to the number of unemployed. Against this background, the seasonally adjusted registered unemployment rate fell slightly, from 11.8% in January to 11.7% in July.

The fall in the workforce in employment since the outbreak of the crisis has been larger than the rise in the number of unemployed, which is partly the result of a fall in the number of foreign workers. The number of foreign workers peaked in the third quarter of 2008, when 70,300 were employed, accounting for 8% of the workforce in employment. The fall in the number of foreign workers between the peak of the economic cycle and the second quarter of this year was significantly sharper than the drop in the overall workforce in employment: the number of foreign workers was down 19.4% or 13,660 persons, while the overall workforce in employment fell by 6.0%.

In addition to the fall in employment, the private sector is adjusting to the decline in activity through other means of reducing labour costs, as wage growth was moderate again in the second quarter of this year. After recording an extremely high figure in 2008, year-on-year growth in the average nominal gross wage slowed significantly in 2009 with the outbreak of the crisis. Growth accelerated at the beginning of 2010, but had slowed again by the second quarter of this year, to stand at 2.9% in year-on-year terms. Wage increases in 2010 were primarily the result of three temporary factors:

(i) the statistical effect of a rise in the average wage in the private sector due to extensive lay-offs among the low-paid; (ii) a rise in the minimum wage in March of nearly one quarter; and (iii) a rise in the wages of workers whose wages were temporarily reduced during their inclusion in the government measure to subsidise temporary lay-offs. As of the second quarter of this year, the last two factors, which raised the basis for the calculation of year-on-year growth in wages, no longer have an impact on the year-on-year comparison. In the context of a more moderate fall in employment, the statistical increase in the average wage will also diminish owing to changes in the structure of employees. Worker lay-offs and the curbing of wage growth are also reflected in the very moderate growth in the nominal wage bill, which best reflects corporate cost adjustments. After a relatively sharp fall of 2.8% in 2009, the wage bill in the private sector rose by 1.1% in 2010 owing to the aforementioned effects, while year-on-year growth stood at 0.4% in the second quarter of this year.

Figure 2.18: Total wage bill and average monthly gross wage

**Wage bills are calculated as the product of average gross monthly wages for employees of legal persons who received pay and the total number of employees of legal persons*
Sources: SORS, Bank of Slovenia calculations

Table 2.1: Labour cost indicators

	2006	2007	2008	2009	2010	Q210	Q310	Q410	Q111	Q211
	nominal year-on-year growth, %									
Gross wage	4.8	5.9	8.3	3.5	3.9	4.3	4.2	3.3	3.1	2.0
Gross wage in the private sector	5.5	6.8	7.9	1.8	5.1	5.7	5.4	4.4	3.9	2.9
Gross wage in the public sector[1]	3.4	4.0	9.8	6.6	0.0	-0.3	0.6	0.1	0.4	-0.1
Gross wage in manufacturing	5.6	6.9	7.6	0.9	8.9	10.0	8.7	6.8	5.4	3.6
Labour costs per hour worked[2]	4.4	4.5	9.1	3.6	1.1	-0.6	-1.2	2.8	2.2	2.8
Labour costs per hour worked in manufacturing[2]	3.7	5.2	10.5	5.8	3.1	-0.3	2.9	4.3	2.1	3.3
Gross wage per unit of output[3]	0.6	2.4	7.3	10.4	-0.1	-0.3	0.4	-1.3	-1.3	-0.7
Gross wage in manufacturing per unit of output[3]	-3.3	-0.6	6.8	9.5	-5.6	-9.2	-4.0	-3.9	-6.6	-4.5
Unit labour costs[3, 4]	1.1	2.6	6.2	8.7	0.3	0.6	0.9	-0.7	-1.2	-0.3
Labour costs per employee[4]	5.4	6.1	7.2	1.9	4.3	5.2	4.8	3.9	3.2	2.4
Output per employee	4.2	3.4	1.0	-6.3	4.0	4.6	3.8	4.7	4.5	2.7
Output per employee (manufacturing)	9.2	7.6	0.7	-7.8	15.3	21.1	13.2	11.2	12.9	8.5
HICP	2.5	3.8	5.5	0.9	2.1	2.4	2.3	2.0	2.2	2.0
GDP deflator	2.1	4.2	4.1	3.0	-1.1	-0.6	-0.6	-1.7	0.5	0.4

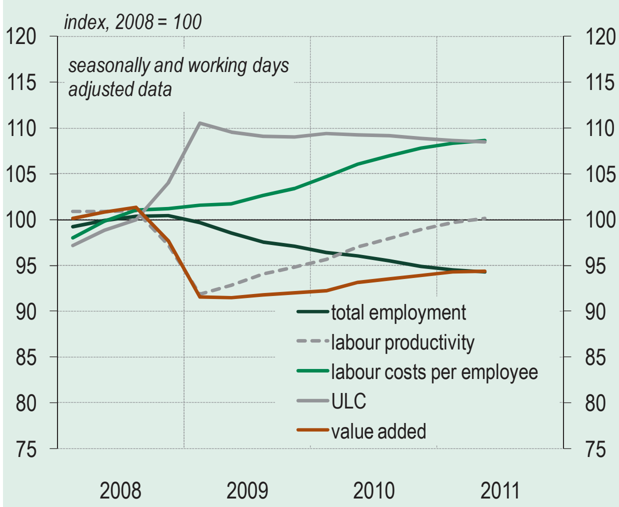
[1] Public administration, education, health and culture according to NACE rev. 2
[2] Labour costs according to SORS calculations
[3] Output is defined as real GDP based on national accounts data for economy-wide figures and real value added for manufacturing
[4] Labour costs calculated on the basis of employee compensation (national accounts)
Sources: SORS, Bank of Slovenia calculations

Growth in the average nominal gross wage in the public sector has stagnated. Public sector wage growth was high in 2008 and early 2009 owing to the introduction of the wage reforms. Public sector wage growth declined at the outset of the crisis primarily as a result of government austerity measures, which include the elimination of performance bonuses, the freezing of regular promotions and lower indexation to inflation. According to the standard classification, average wages in the public sector rose by just 0.1% in year-on-year terms in the first half of 2011,[3] and by 0.2% in the institutional sector of the government.[4] Owing to a moderate rise in employment, the wage bill has risen slightly faster in the public sector, by just under one percentage point on average during the first half of this year.

Labour productivity fell sharply at the turn of the year between 2008 and 2009, but is rising again on account of economic growth and a further fall in employment. GDP per employee in the first quarter of 2009 was down 9.0% in year-on-year terms, as there was a significant fall in output and the number of employees had not yet adjusted to the new situation. With the gradual increase in output while employment continued to fall, productivity gradually rose, and in the second quarter of this year reached its level of 2008. The fluctuation in productivity was particularly pronounced in manufacturing. As a result of the sharp decline in output, productivity in the first quarter of 2009 was down 15.9% in year-on-year terms. This, however, was followed by a sharper adjustment in the number of employees, which meant that productivity in the second quarter of this year had already exceeded its pre-crisis level by more than 10%.

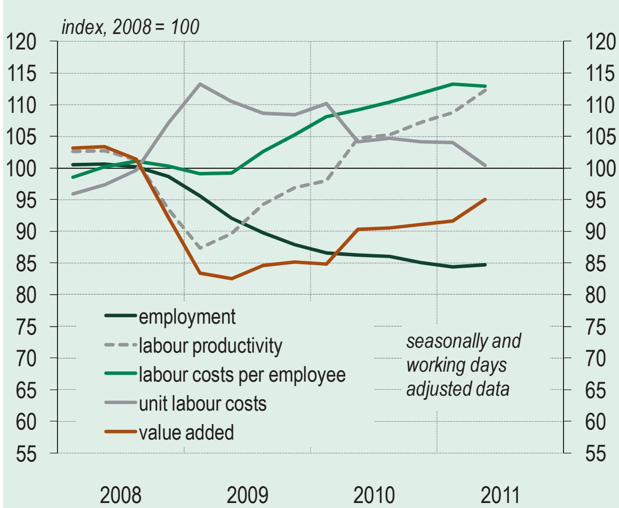
After extremely high growth in early 2009, year-on-year growth in nominal unit labour costs stalled, manufacturing recording the largest decline in unit labour costs. As a result of the rapid decline in economic activity, unit labour costs in the first quarter of 2009 were up 13.7%, almost 9 percentage points above the average year-on-year growth of the previous ten years. Year-on-year growth began to slow towards the end of 2009. Unit labour costs have declined gradually in year-on-year terms since the final quarter of 2010. In manufacturing the gross unit wage in the first quarter of 2009 was up

Figure 2.19: Cost adjustment in total economy



Sources: Eurostat, Bank of Slovenia calculations

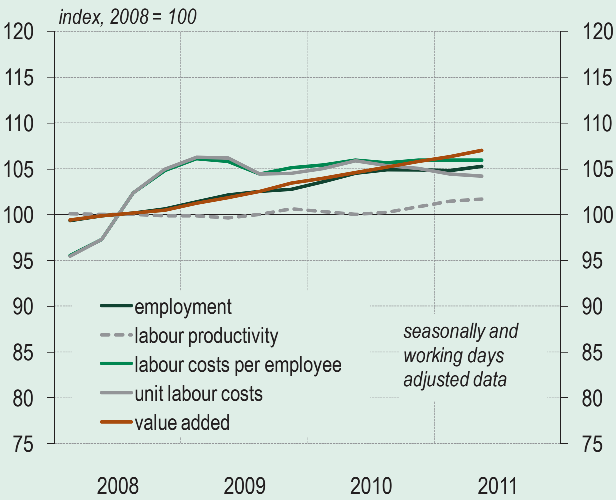
Figure 2.20: Labour cost adjustment - industry*



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

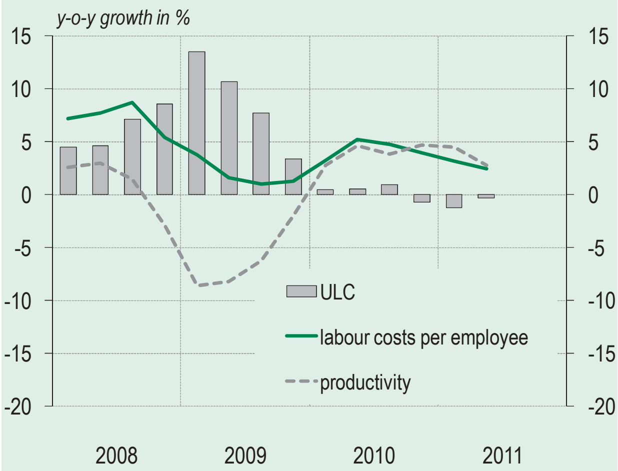
[3] Under this indicator, the public sector consists of public administration, education, health and culture according to NACE rev. 2. Its weakness is that it also includes legal entities that do not belong to the public sector, while its advantage is that the data time series are available over a longer period.
[4] The institutional sector of the general government is defined under the ESA 95, and includes Central government (S.1311), Regional government (S.1312), Local government (S.1313) and Social security funds (S.1314). The figures are available only for the last few years.

Figure 2.21: Labour cost adjustment - public sector*



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

Figure 2.22: Productivity, ULC, labour costs per employee - total economy, Slovenia



Sources: Eurostat, Bank of Slovenia calculations

18.2% in year-on-year terms, while the year-on-year rate has been declining since the final quarter of 2009. The gross unit wage was thus down 4.5% in year-on-year terms in the second quarter of this year. The decline in unit labour costs is the result of a significant fall in employment in this sector, of nearly one fifth since the outbreak of the crisis, and the gradual recovery in economic activity. Unit labour costs in manufacturing in the second quarter of this year were less than one percentage point lower than in the second quarter of 2008.

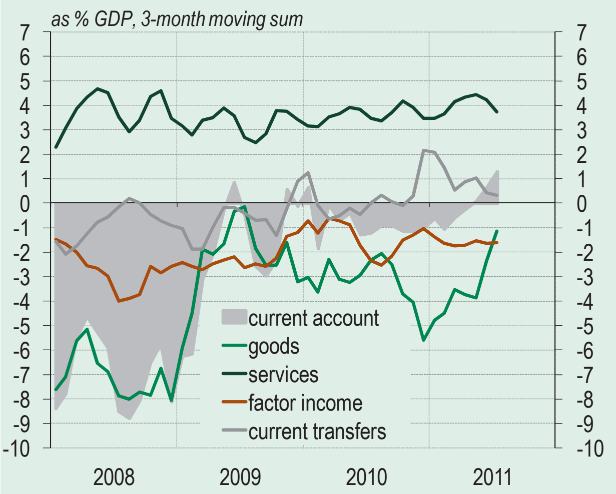
3 Foreign Trade and Competitiveness

The current account deficit has narrowed rapidly since 2008, to stand at 0.1% of GDP for the 12 months ending July this year. Foreign trade rose until the end of the first quarter of this year as a result of high growth in foreign demand and the associated high growth in imports of intermediate goods. Merchandise imports grew slightly faster than exports in nominal terms, primarily as a result of price factors. As a result of declining growth in foreign demand, growth in foreign trade slowed significantly in the second quarter of this year. The drop in growth in imports was more severe than that of exports owing to weak domestic demand. As a result, the trade deficit narrowed, despite deteriorating terms of trade. The surplus in services, in particular tourism services, widened in year-on-year terms over the first seven months of the year. The largest contribution to the narrowing of the current account deficit came from current transfers, primarily as a result of continuing high inflows of general government transfers. The gap by which Slovenia's price competitiveness lags behind that of the main euro area trading partners narrowed slightly during the first eight months of this year. At the same time, improvement in competitiveness indicators, as measured by the GDP deflator and unit labour costs, continued in the first quarter. Nevertheless, Slovenia's competitiveness according to all three indicators continues to lag behind the majority of main euro area trading partners.

Foreign trade

The current account deficit has narrowed rapidly since reaching its peak of 6.9% of GDP in 2008. The deficit swung to a surplus during the first seven months of this year. After the outbreak of the financial and economic crisis, foreign demand and domestic consumption fell sharply in 2009, resulting in a steeper decline in imports than exports. The current account deficit thus narrowed to 1.3% of GDP. The deficit narrowed at a slower pace in 2010, reaching 0.8% of GDP. Driven by the recovery in economic activity in Slovenia's most important trading partners, Germany in particular, primarily exports and imports of intermediate goods have increased since the second quarter of last year. In the second half of last year there was an increase in domestic demand alongside foreign demand, and thus in merchandise imports for final domestic consumption. As a result, the merchandise trade deficit widened in the context of adverse price factors. Growth in foreign trade declined in the second quarter of this year. Because growth in imports declined faster than growth in exports, the current account deficit recorded over the first five months became a surplus of 0.5% of GDP in July this year. Alongside a larger surplus in services, the main factor in the narrowing of the current account deficit was net current transfers. In the context of a contraction in the second quarter of this year, which continued in July, the current

Figure 3.1: Components of the current account



Sources: SORS, Bank of Slovenia

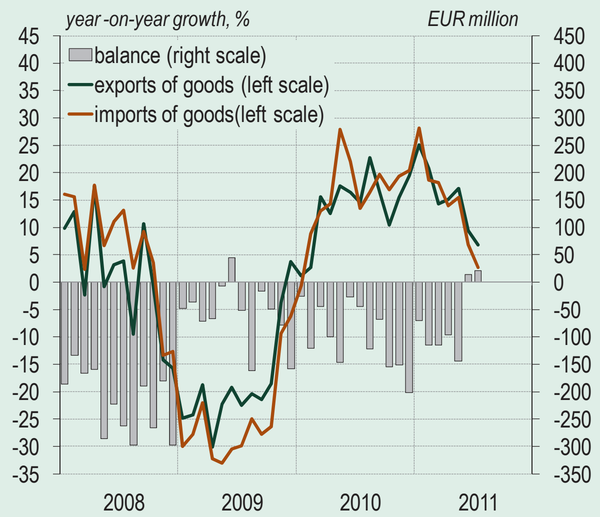
account deficit fell significantly in year-on-year terms over the last 12 months, to stand at EUR 52 million or 0.1% of GDP in July, compared with 0.9% of GDP a year earlier.

The merchandise trade deficit has narrowed rapidly since the beginning of this year. The trend and pace of year-on-year growth in merchandise trade rose until the first quarter of this year as a result of the favourable economic activity in the most important EU trading partners. Except for the third quarter of last year, growth in nominal merchandise imports has outpaced growth in exports, primarily as a result of deteriorating terms of trade. Growth in global economic activity has slowed this year, particularly in some of Slovenia's main EU trading partners, which also points to a trend of declining growth in foreign trade. Merchandise exports were up 19.5% in year-on-year terms in the first quarter, and by 13.4% in the second quarter. The decline in year-on-year growth in imports was even more significant, from 21.2% to 10.7%. A similar trend continued in July, when year-on-year growth in exports stood at 6.8%, and growth in imports stood at 2.7%. The cumulative merchandise trade deficit in the 12 months to July stood at EUR 1,202 million or 3.4% of GDP, compared with 2.8% of GDP last July.

The deterioration in the terms of trade continued in the first half of this year, but less intensively than last year. The indices of prices of goods have risen sharply since the second quarter of last year, more so on the import side than on the export side. Year-on-year growth in export prices accelerated slightly in the first half of this year relative to the second half of last year. Growth in import prices fell, despite the still high year-on-year growth in prices of industrial commodities, food and energy, but continued to outpace growth in export prices. Export prices were up 3.7% on average in year-on-year terms during the first half of the year, while import prices were up 5.7%. The deterioration in the terms of trade more than halved relative to 2010, to stand at 2.0%. The slightly higher growth in import prices last year was in partly due to the euro's fall against the US dollar by 4.8%, while this year's lower growth in import prices was a result of euro's appreciation of 5.6% over the first six months of the year. The deterioration in the terms of trade contributed around EUR 200 million or 1.1% of GDP to the merchandise trade deficit.

Growth in merchandise exports was down in the second quarter as a result of declining growth in foreign demand. This decline was largest in intermediate goods, where year-on-year growth was down 8 percentage points relative to the first quarter to stand at 19.2%. Growth in exports of consumer goods was also down

Figure 3.2: Trade in goods



Source: Bank of Slovenia

5.9 percentage points to stand at 5.1%. In contrast, growth in exports of capital goods continued to rise, from 9.0% in the first quarter to 11.5% in the second quarter. Year-on-year growth in components of exports in terms of economic purpose of use fell again in July, exports of capital goods, where growth was relatively high at 8.0%, having recorded the smallest decline. This can be contributed to at least two factors: the effect of a relatively low base and the nature of the capital goods manufacturing process. The increase in exports of capital goods was followed last year by a one-month lag in the increase in exports of intermediate goods and consumer goods. Such a lag is to be expected due to the nature of the business and production process, which is relatively longer in the manufacture of capital goods than for the other two groups of goods. Slowing growth is also expected to have delayed effects on the year-on-year growth in exports of capital goods. At 23.6%, above-average growth in exports of intermediate goods to EU Member States was recorded over the first seven months of this year, while within exports of capital goods and consumer goods above-average growth rates were recorded with countries outside EU, at 13.8% and 11.8% respectively.

Movements in the components of merchandise imports were similar to exports. Because of the high import component in merchandise exports, year-on-year growth was highest in imports of intermediate goods. The peak in year-on-year growth was recorded in the second quarter of last year at 31.2%, growth then remaining at around 25% until the first quarter of this year. Lower economic growth in the second quarter of

Table 3.1: Components of the current account

	2004	2005	2006	2007	2008	2009	2010	2010 1-7	2011 1-7
					EUR million				
Current account balance	-720	-498	-771	-1,646	-2,574	-456	-297	-143	102
1. Goods	-1,009	-1,026	-1,151	-1,666	-2,648	-703	-1,205	-507	-505
2. Services	688	920	993	1,047	1,424	1,165	1,308	735	861
2.1. Transport	324	398	456	525	561	437	496	264	332
2.2. Tourism	608	743	783	834	904	891	1,012	536	671
- of which, exports	1,312	1,451	1,555	1,665	1,827	1,804	1,935	1,072	1,162
2.3. Other	-245	-221	-247	-312	-42	-163	-200	-64	-142
3. Factor income	-322	-295	-440	-789	-1,062	-766	-507	-300	-361
3.1. Labour income	138	128	107	50	-25	69	139	78	86
3.2. Capital income	-460	-424	-547	-839	-1,038	-835	-646	-378	-447
4. Current transfers	-76	-97	-173	-239	-287	-152	106	-71	107
					as % GDP				
Current account balance	-2.6	-1.7	-2.5	-4.8	-6.9	-1.3	-0.8	-0.7	0.5
1. Goods	-3.7	-3.6	-3.7	-4.8	-7.1	-2.0	-3.4	-2.5	-2.4
2. Services	2.5	3.2	3.2	3.0	3.8	3.3	3.7	3.6	4.2
2.1. Transport	1.2	1.4	1.5	1.5	1.5	1.2	1.4	1.3	1.6
2.2. Tourism	2.2	2.6	2.5	2.4	2.4	2.5	2.9	2.6	3.2
- of which, exports	4.8	5.1	5.0	4.8	4.9	5.1	5.5	5.3	5.6
2.3. Other	-0.9	-0.8	-0.8	-0.9	-0.1	-0.5	-0.6	-0.3	-0.7
3. Factor income	-1.2	-1.0	-1.4	-2.3	-2.8	-2.2	-1.4	-1.5	-1.7
3.1. Labour income	0.5	0.4	0.3	0.1	-0.1	0.2	0.4	0.4	0.4
3.2. Capital income	-1.7	-1.5	-1.8	-2.4	-2.8	-2.4	-1.8	-1.9	-2.2
4. Current transfers	-0.3	-0.3	-0.6	-0.7	-0.8	-0.4	0.3	-0.4	0.5

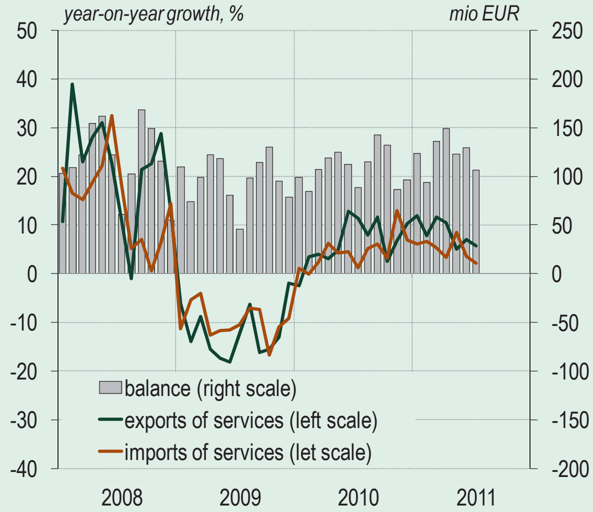
Sources: SORS, Bank of Slovenia

this year had a significant impact on imports of intermediate goods, year-on-year growth having nearly halved to stand at 13.7% in the second quarter. Following initial growth in the second quarter of last year, imports of capital goods have risen gradually, peaking in the first quarter of this year when 23.3% year-on-year growth was recorded. Despite the quarterly growth, imports of capital goods were down 2.3% in year-on-year terms in the second quarter. Only imports of consumer goods recorded growth in the second quarter relative to the first quarter, from 6.7% to 11.1%, despite weak household demand. The acceleration was short-lived, as year-on-year growth in imports of consumer goods declined to 1.6% in July.

According to SORS figures, merchandise trade with EU Member States has risen faster than trade with non-EU countries since the start of the economic recovery. These trends continued in the first seven months of the year, year-on-year growth in merchandise exports to the EU and to non-EU countries having stood at 16.1% and 11.4% respectively. The regional differences in merchandise imports have narrowed recently, primarily as a result of growth in imports of capital goods and consumer goods from non-EU countries. Growth in merchandise imports from EU Member States reached 14.1% over the first seven months of the year, compared with growth in imports from non-EU countries of 12.2%. Among the most important markets outside the EU, growth in merchandise exports to the former Yugoslav republics was relatively slow, while growth in imports was above average. Merchandise exports were up 10.8% in year-on-year terms, while imports rose by 22.8%. Merchandise trade with Russia was down over the first seven months of the year, with exports down 1% and imports down 4.6%. The merchandise trade deficit with EU Member States contributed EUR 1,120 million to the overall merchandise trade deficit, while the surplus with non-EU countries stood at EUR 405 million.

Growth in trade with services was down slightly more on the import side than on the export side in the second quarter of this year. Year-on-year growth in exports

Figure 3.3: Trade in sevices



Source: Bank of Slovenia

of services fell from 10.6% in the first quarter to 6.6% in the second quarter, while year-on-year growth in imports fell from 6.0% to 3.0%. These trends continued in July. The cumulative surplus of trade in services in the 12 months to July stood at EUR 1.4 billion or 4.0% of GDP, compared with 3.6% of GDP in the same month last year. During the first seven months of this year, above-average year-on-year increases were recorded in revenues from communications services (26.7%) and revenues from insurance (14.0%), while the lowest increases were recorded in revenues from construction and assembly work in the rest of the world and revenues from intellectual property services. As a result of favourable growth in merchandise exports and imports, particularly in the first quarter, there was also a significant increase in revenues from transportation services, of 13.3%. The largest increase on the expenditure side, of 29.0%, was recorded by communications services. Above-average year-on-year increases were also recorded in expenditure on financial services and trade intermediation services, although the proportion of total services imports that they account for remains low. In line with weak construction investment, expenditure on construction and assembly work has also stagnated at a low level.

Growth in revenues from tourism was relatively high over the first seven months of this year, while expenditure on tourism was down sharply. Revenues from tourism were up 8.3% in year-on-year terms over the first seven months of this year which, in light of the increase of 9.1% in the number of foreign visitors and the increase of 9.3% in the number of overnight stays, could indicate slightly lower average spending than in previous years. In contrast to revenues, expenditure on tourism was down 8.6% in year-on-year terms. That decline accelerated further in the second quarter in the context of the adverse situation on the labour market. The result of these movements was a year-on-year increase of EUR 126 million in the surplus in tourism trade to EUR 861 million.

The deficit in factor income widened in year-on-year terms over the first seven months of the year. Outflows of labour income were down owing to a decline in the employment of foreign workers. The net surplus in labour income stood at EUR 86 million over the first seven months of this year. Although year-on-year growth in capital income outpaced expenditure, the deficit in capital income widened by nearly EUR 70 million to EUR 447 million. The main factor in the deficit in capital income was the net outflow of income from FDI, which included the net payments of dividends and earnings, and net interest payments to associates. Slightly less than one half of the deficit in income from FDI was accounted for by reinvested and undistributed earnings, which are included in capital transactions as an increase in assets in the form of direct investments by non-residents. Alongside FDI, the main factors in the year-on-year widening of the deficit in capital income were an increase in net interest payments to the rest of the world and net payments from investments in securities. The cumulative deficit in factor income over the 12 months to July stood at EUR 568 million or 1.6% of GDP, the same proportion recorded last July.

Current transfers were the main factor in this year's narrowing of the current account deficit. The improvement in current transfers began at the end of last year, and has continued this year. Net inflows of current transfers totalled EUR 107 million over the first seven months of the year, while a net outflow of EUR 71 million was recorded in the same period last year. The main factor in the surplus was the net inflow of general government transfers. The majority of the net inflow of general government transfers were funds from the EU budget for the implementation of common agricultural and fisheries policies, which totalled EUR 161 million over the first eight months of the year, and money from structural funds and regional development funds in the amount of EUR 252 million. For all of 2010, the inflow of funds from the EU budget for the implementation of common agricultural and fisheries policies totalled EUR 218 million, while inflows of structural funds and regional development funds amounted to EUR 364 million.

Competitiveness

Having fallen last year, the nominal harmonised competitiveness indicator[5] has risen in year-on-year terms since April of this year. The indicator appreciated by 0.2% over the first eight months of the year. During the same period, the euro fell by 12.3% in year-on-year term against the Swiss franc and by 3.8% against the Japanese yen. The euro rose by 7.2% against the US dollar, and 1.4% against the pound sterling.

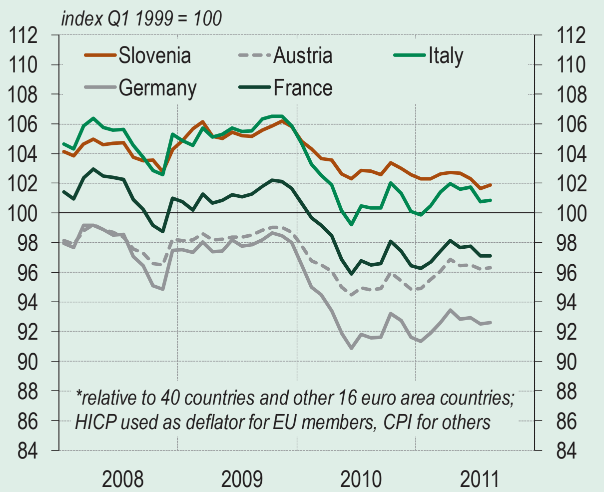
The main factor in the year-on-year improvement in the harmonised indicator of Slovenia's price competitiveness over the first eight months of this year was

[5] In terms of competitiveness, an increase (decrease) or a high level (low level) in the indicator is unfavourable (favourable). The PSR discusses the harmonised competitiveness indicators published by the ECB (http://www.ecb.int/stats/exchange/hci/html/index.en.html). The nominal competitiveness indicator and the real competitiveness indicator deflated by the consumer price index are measured for 40 different countries and the other 16 members of the euro area, while the indicators that use the GDP deflator and unit labour costs in the total economy are measured for 20 countries and the other 16 members of the euro area. The European Commission also publishes price and cost competitiveness indicators (http://ec.europa.eu/economy_finance/db_indicators/competitiveness/index_en.htm). These differ from those of the ECB because of methodological differences resulting from the countries covered, the different sources for the deflators and the data conversion methods.

Figure 3.4: Harmonised indicators of national competitiveness*

Source: ECB

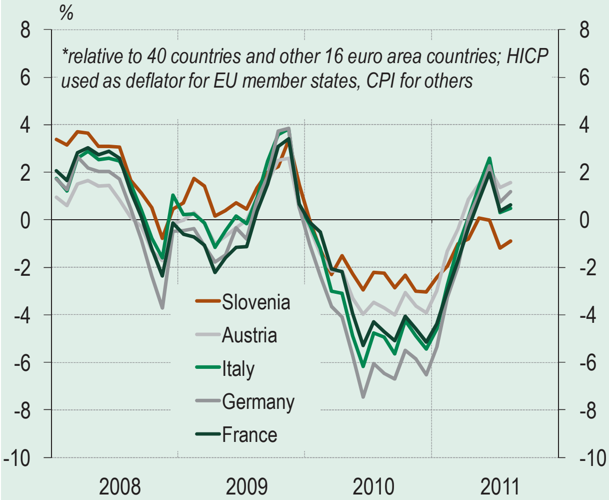
Figure 3.5: Harmonised price competitiveness indicator*



Source: ECB

slower growth in domestic prices than in foreign prices. The real effective exchange rate indicator depreciated by more than 1% in year-on-year terms over the first eight months of the year. Growth in domestic consumer prices has been lower than the growth in foreign prices this year, most notably in July and August. Despite a sharp year-on-year appreciation in the nominal effective exchange rate, the real effective exchange rate depreciated slightly in June, with year-on-year depreciation in July and August fluctuating at around 1%.

Figure 3.6: Harmonised price competitiveness indicator* (year-on-year growth)

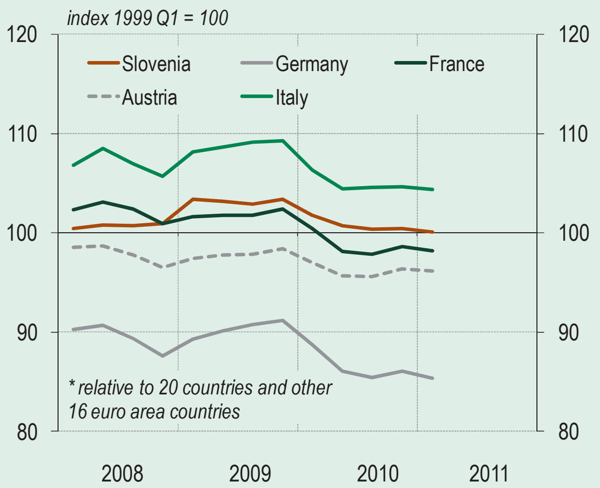


Source: ECB

The gap by which Slovenia's price competitiveness lags behind that of the main euro area trading partners narrowed over the first eight months of this year. Over the first eight months of the year, the improvement in Slovenia's price competitiveness as measured by the HICP outstripped the average improvement in the price competitiveness in the main trading partners by 0.7 percentage points. In August alone, Slovenia's price competitiveness improved by 0.9%, while the average price competitiveness of the main trading partners deteriorated by slightly less than 1%. According to this indicator, Germany remains the most price-competitive among countries in comparison.

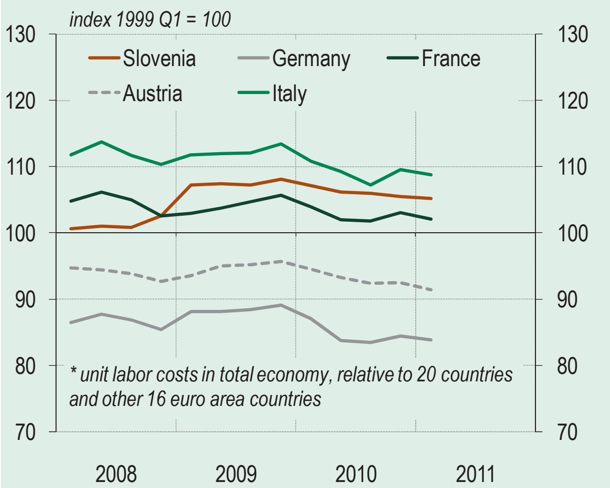
The harmonised competitiveness indicator as measured by the GDP deflator has improved slowly since the end of 2009. Improvement in the first quarter of this year lagged slightly behind that recorded by the main trading partners. This indicator improved again in the first quarter of this year relative to the previous quarter and in year-on-year terms. It recorded a quarterly decline of 0.4% in the first quarter, approximately the same as the average decline in the main euro area trading partners. This competitiveness indicator was down by 1.7% in Slovenia in year-on-year terms, compared with an average of 2.2% in the euro area trading partners. Having

Figure 3.7: Harmonised competitiveness indicator (GDP deflator)*



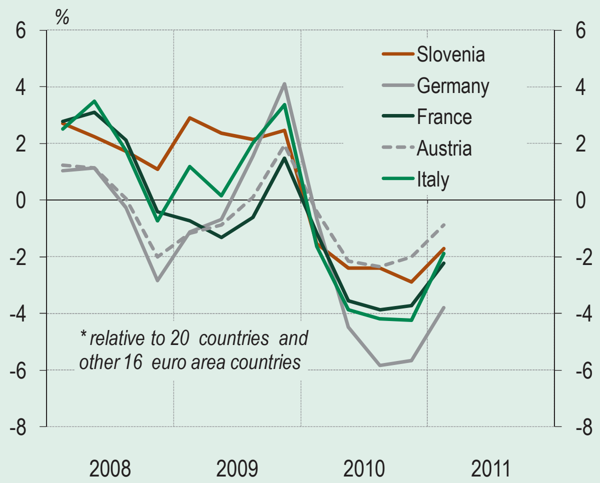
Source: ECB

Figure 3.9: Harmonised cost competitiveness indicator*



Source: ECB

Figure 3.8: Harmonised competitiveness indicator (GDP deflator* - year-on-year growth)



Source: ECB

Figure 3.10: Harmonised cost competitiveness indicator* (year-on-year growth)

Source: ECB

stood at 1 percentage point in the final quarter of last year, the gap between the year-on-year rates of depreciation in this indicator narrowed to 0.5 percentage points in the first quarter of this year.

The harmonised cost competitiveness indicator as measured by unit labour costs in the total economy has also improved since the end of 2009. This indicator improved again in the first quarter of this year relative to the previous quarter and in year-on-year terms, although the pace of improvement has slowed relative to last year. The index recorded a quarterly depreciation of 0.3% in the first quarter of this year, and a year-on-year decline of 1.9%. This was less than in the final quarter of last year, when the quarterly depreciation stood at 0.5% and the year-on-year depreciation at 2.4%.

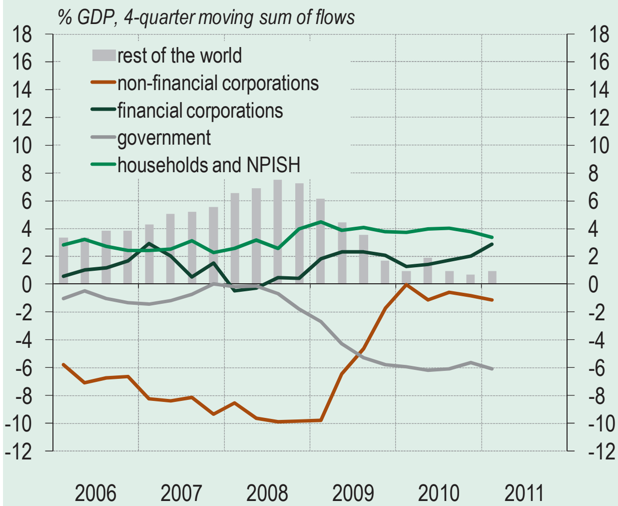
Although the trend in Slovenia's cost competitiveness indicator has been improving gradually since the end of 2009, the gap by which it lags behind the same indicator for the main euro area trading partners is widening. The improvement in Slovenia's cost competitiveness in the first quarter of this year was 0.6 percentage points less in quarterly terms than the average increase in the trading partners, and 0.7 percentage points less in year-on-year terms. Slower improvement in cost competitiveness in Slovenia reflects the slower adjustment of unit labour costs in the total economy. This indicator is therefore higher than the majority of the main euro area trading partners since the outbreak of the economic crisis.

4 Financing

Loans to non-financial corporations were down in the first half of 2011, primarily owing to loan demand, which is based on the low level of economic and investment activity, and partly due to gradually lower supply of loans. When renewing and approving new corporate loans, banks must take into account relatively high debt-to-equity ratio of corporates, increased uncertainty regarding access to foreign sources of funding and operational risk, particularly in sectors, hit hardest by the crisis. Together with the restructuring of bank funding and with the impairment and provisioning costs remaining high, they are reflected in interest rates on loans being higher than the euro area average. This is particularly true for corporate loans. The proportion of short-term loans was up in the first quarter, while the proportion of long-term loans increased in the second quarter. Non-financial corporations partly compensated the lower domestic financing with foreign sources, primarily via FDI, and partly via foreign loans. Growth in loans to households was down in the first half of the year, due to slightly lower growth in housing loans. Consumer loans were also down in the first half of the year.

The net savings of the private sector have been almost equal to the general government deficit for the last five quarters. The effects of the financial crisis and the slow economic recovery are also reflected in the financial flows of individual sectors and the economy as a whole. The rapid growth in investments by non-financial corporations (NFCs)[6] in the period prior to the crisis has slowed sharply in the last two years, which was reflected in a narrowing of the financial deficit[7] in the sector of NFCs. NFCs have reduced their net financial deficit by around 9% of GDP since the beginning of 2009, while the need for general government financing has increased, as the general government deficit has widened significantly on account of anti-crisis measures aimed at stimulating the economy and due to the functioning of automatic sta-

Figure 4.1: Savings-investment gap



Sources: Bank of Slovenia - consolidated financial accounts, SORS

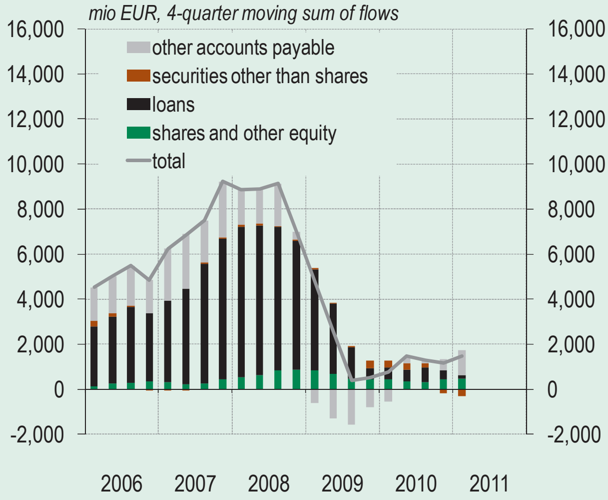
[6] According to the ESA 95 definition, non-financial corporations (NFCs) are legal entities that are market producers of goods and non-financial services.
[7] A net financial deficit is defined as the surplus in flows from financial liabilities over flows from financial assets, and is by definition equal to the surplus of investments over savings.

bilisers. The one-year financial deficit of the general government stood at 6% of GDP in the first quarter of this year. Household savings have risen slightly since the outbreak of the crisis, and have remained at around 4% of GDP. Net financing from the rest of the world, or the need for net imports of foreign savings, was low compared with the period prior to the crisis, and stood at around 1% of GDP in the first quarter. These trends are also being reflected in the external debt. The net external debt decreased during the first half of the year, to EUR 10.88 billion. This amounts to 30.4% of GDP, down 0.6 percentage points on the end of 2010. The gross external debt increased by EUR 1.66 billion in the first half of 2011 to stand at EUR 42.4 billion in June. Gross external claims amounted to EUR 31.5 billion in June 2011, up EUR 1.78 billion on the end of 2010.

Financing and investments of non-financial corporations

The largest increase among the sources of financing of NFCs was recorded by liabilities from shares and other equity, while other liabilities declined. The financial liabilities of NFCs amounted to EUR 88.5 billion in the first quarter, up nearly EUR 2 billion on the end of 2010. Financial liabilities from shares and other equity rose by EUR 2.4 billion in the first quarter to stand at EUR 37.8 billion. The increase in the financial liabilities of NFCs from shares and other equity in the first quarter of this year was almost entirely the result of an increase in the value of shares and other equity.[8] NFCs' financial liabilities from loans were also up in the first quarter, by EUR 218 million. The growth in loans in the first quarter was primarily driven by domestic short-term financing (in particular at other monetary financial institutions – other MFIs)[9] and long-term financing secured in the rest of the world, while long-term loans raised in Slovenia were

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



Source: Bank of Slovenia, unconsolidated data

down in the first quarter. The financing of NFCs via other liabilities declined by EUR 557 million in the first quarter of this year. This was primarily the result of a decline in the value of trade credits and advances due to unpaid liabilities. Predominant among the aforementioned other sources are liabilities to other NFCs and households, which is in line with increased lack of payment discipline and the rise in unsettled past-due liabilities.

Loans to NFCs declined on average in year-on-year terms during the first half of 2011, primarily due to weak demand. The importance of factors on the supply side of loans has risen in the last year. Loans to NFCs fell by 0.7% over the first six months of this year. The decline in these loans has continued primarily as a result of weak demand for loans due to low investment activity, uncertainty in the economy and net debt repayments by NFCs owing to their excessive relative indebtedness. Unfavourable economic results in some sectors have a significant impact on the operations of other MFIs and result in high impairment and provisioning costs.[10] Loan approval and collateral terms have tightened relative to the pre-crisis period, in particular for NFCs in

[8] Positive revaluation accounted for more than 90% of the increase in the stock of financial liabilities from shares and other equity.
[9] According to ESA 95 definition, other monetary financial institutions comprise banks, savings banks and money market funds.
[10] In the medium term, other MFIs must also increase their capital relative to loans granted, and in accordance with Basel III guidelines. This is also necessary in terms of opportunities for renewing and securing foreign sources of funding. Access to foreign sources may become even more difficult owing to the volatility on the international financial markets, which is again present and has risen since the second quarter of 2010.

Box 4.1: Savings and investment prior to and during the crisis

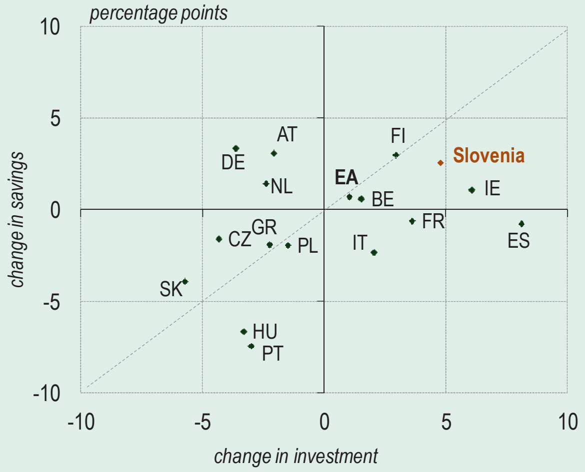
Macroeconomic imbalances are also reflected in imbalances at both the aggregate and sectoral level between savings and investment, and are an indicator of the competitive position of an individual country. In its report, Surveillance of Intra-Euro Area Competitiveness and Imbalances, and in planned new economic governance procedures in the EU, the European Commission attempts to identify imbalances by analysing the savings-investment gap.

A deficit in savings relative to investment is not a problem in itself, as inequality between the two variables is normal for certain sectors. Households are typically net savers. Their net savings are defined as the difference between disposable income and consumption. Corporates typically invest more than they save, the majority of their savings taking the form of undistributed earnings and capital utilisation (depreciation). The ratio between savings and investment by the general government sector depends primarily on the cyclical position of the economy, the economic and political stance of every government having a decisive impact on the aforementioned ratio.

At the global level, accumulated and long-term unsustainable imbalances have undoubtedly contributed to the financial and economic crisis. These imbalances have been reflected in high current account deficits or surpluses. These were the result of surplus savings prior to the crisis, particularly in the oil-producing countries and in emerging Asian economies, and due to rising deficits and excessive spending in developed countries, particularly in the US. The financial and economic crisis has brought a halt to the widening of imbalances. Forecasts, however, suggest that imbalances could widen again without the appropriate economic policy measures. This would further increase the instability of the global economic and financial system.

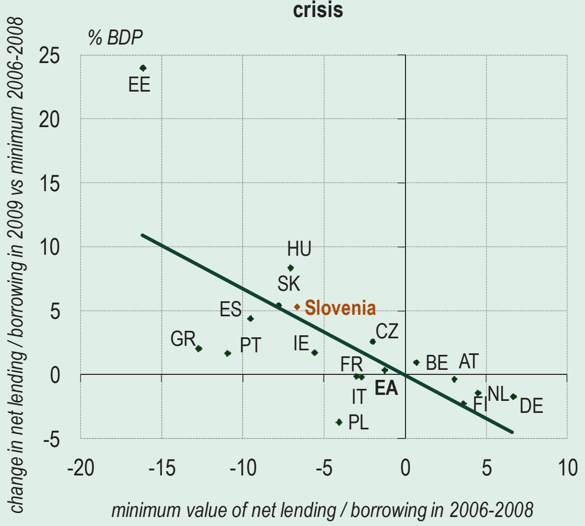
Changes in savings and investment in Slovenia prior to and after the outbreak of the crisis were more significant than in the euro area overall. As a result of the relatively stronger adjustments in countries with the greatest imbalances,[1] the differences in the gaps between savings and investment have narrowed in the euro area during the crisis. Savings as a share of GDP ranged from 20% to 22% in the euro area prior to the crisis, while savings in Slovenia rose from around 23% of GDP in 1995 to around 27% of GDP in 2007. The increase

Figure 1: Changes of shares of savings and investment in GDP (2005-2007 vs 1998-2000)



Sources: Eurostat, Bank of Slovenia calculations

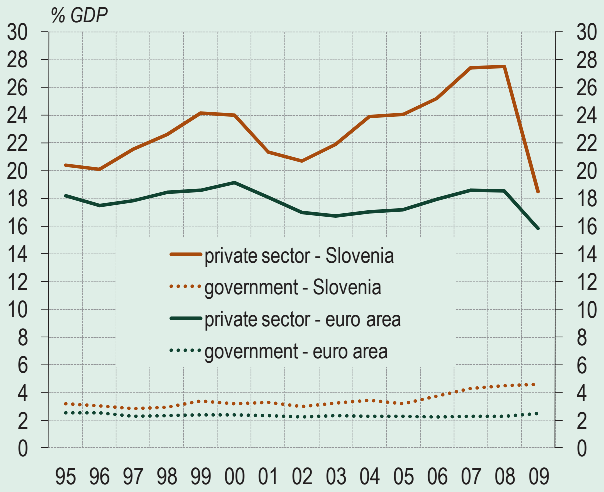
Figure 2: Adjustment of saving-investment gap[2] in the crisis



Sources: Eurostat, Bank of Slovenia calculations

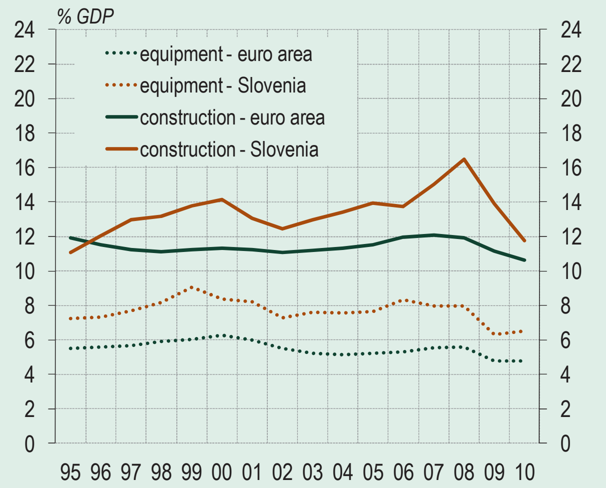
in investment as a proportion of GDP was even sharper, having risen by close to 8 percentage points in Slovenia between 1995 and 2008 to almost 32% of GDP, while that proportion rose by merely 2 percentage points in the euro area during the same period. The falls in the shares of savings and investment in Slovenia relative to the euro area following the outbreak of the crisis were proportionate to the difference in the growth of both shares prior to the crisis. The share of both fell in Slovenia and in the euro area to their lowest levels in the observation period. Nevertheless, the share of investment

Figure 3: Investment in Slovenia and in euro area



Sources: Eurostat, Bank of Slovenia calculations

Figure 4: Investment by type in Slovenia and in euro area



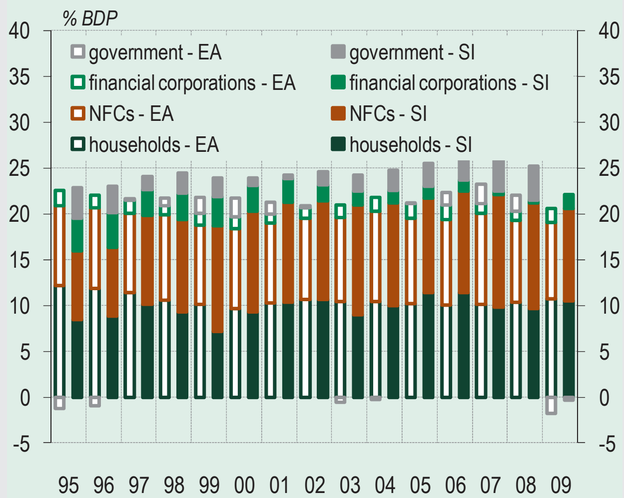
Sources: Eurostat, Bank of Slovenia calculations

Slovenia was still above historical highs, while the share of savings was at the level comparable to highest levels achieved in the euro area as a whole.

Private sector investment contributed most to the increase in investment as shate of GDP in Slovenia prior to the crisis.[3] The share of total investment accounted for by private sector investment has fallen from slightly less than 90% to around 80% in Slovenia, and to around 85% in the euro area. The share of private sector investment fell in Slovenia primarily as the result of a sharp decline in corporate investment, and fell below the level just prior to the crisis and below the long-term average prior to the crisis. The previously positive contribution of general government investment to total investment fell sharply in Slovenia relative to the euro area.[4] The decline in investment in the euro area during the crisis has been sharpest in those countries where investment as share of GDP was above average prior to the crisis. The share of private sector investment has not changed considerably in the euro area.

Changes in investment in equipment and construction investment in Slovenia were more significant than in the euro area. The share of construction investment rose by around 5 percentage points of GDP in Slovenia prior to crisis, but was virtually unchanged in the euro area. The share of construction investment in GDP fell below the pre-crisis level in Slovenia and the euro area following the outbreak of the crisis. By contrast, changes in investment in equipment in Slovenia prior to the crisis tracked economic activity more closely, similar to the euro area. In 2009 the share of GDP accounted for by investment in equipment was only slightly below the long-term average.

Figure 5: Sector savings in Slovenia and in euro area



Sources: Eurostat, Bank of Slovenia calculations

Higher share of savings in GDP in Slovenia relative to the euro area prior to the crisis was the result of higher corporate and general government savings. The general government sector was the main factor in the fall in the share of savings during the crisis, as the share of private sector savings was virtually unchanged. General government savings declined primarily due to the counter-cyclical nature of fiscal policy and the functioning of automatic stabilisers. Following the outbreak of the crisis, Slovenian and euro area corporates simultaneously reduced their investment and savings, while financial corporations and households increased their savings. The increase in household savings was primarily the result of uncertainty at the outset of the financial crisis and the uncertain situation on the labour market, and in part also due to rising general government deficits.

Empirical analyses of savings and investment are frequent (e.g. World Economic Outlook, IMF, 2004 and the literature stated therein or OECD Economic Outlook, 2001). In most cases, they find that it is more reliable to define variables that explain savings than in the case of finding variables that define investment trends. It should be also be noted that decisions regarding savings and investment are, to a great extent, conditional on long-term factors that are hard to quantify, such as the institutional framework in which an economy functions (the Anglo-Saxon versus the continental financial system, or business ethics based on different beliefs), the technological cycle, which determines the need for investment, and structural reforms that determine the flexibility of the economy.

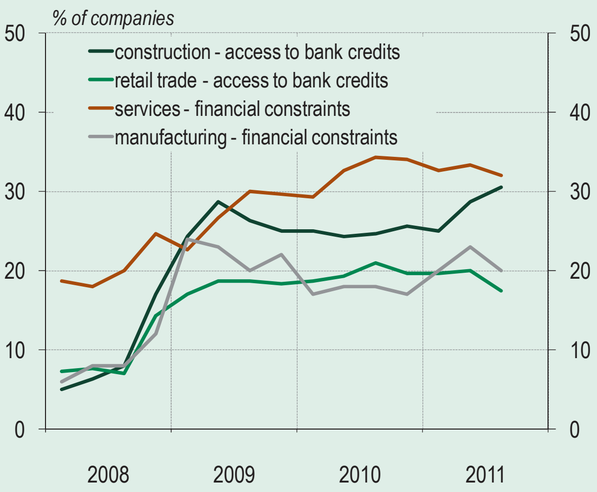
[1] The findings are similar to those of the IMF for a broader set of countries. The opposite finding is true for countries or groups of countries (e.g. China and oil-producing countries) with higher surpluses in the period prior to the crisis (IMF WP 11/197).

[2] Net lending/borrowing is roughly defined as the difference between savings and investment. A more precise definition from the statistics of institutional sectors is: gross savings plus net capital transfers (from which gross capital formation and acquisitions less disposals of non-produced non-financial assets are deducted.

[3] The private sector includes non-financial corporations, financial corporations and households. DARS is thus included in the private sector.

[4] See also the comparison of investment trends in euro area countries in the Monthly Bulletin of the ECB, July 2011.

Figure 4.3: Limiting factors - financing



Source: SORS

highly indebted sectors and in the sectors hit hardest by the crisis. Indicators of limiting factors relating to financing were for the most part unchanged last year, with the exception of the services sector. The indicators have deteriorated this year in construction, and temporarily in manufacturing. At the same time, other MFIs have focused more on the household sector to mitigate risks associated with the credit portfolio.

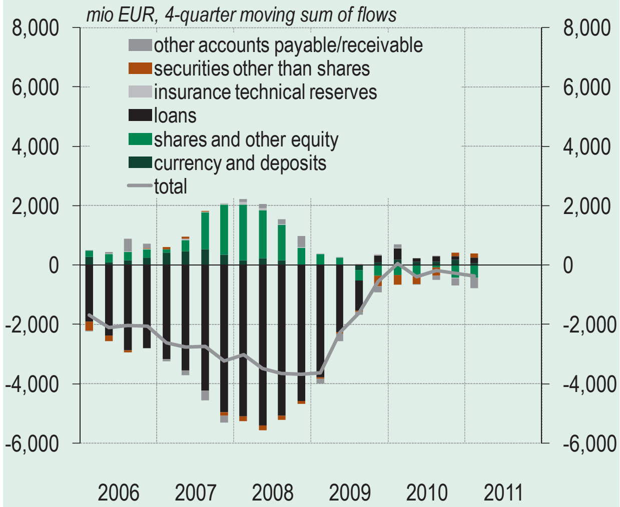
Other MFIs approved primarily short-term loans to NFCs in the first quarter of this year. Short-term loans were partially offset by longer-term loans in the second quarter, but not to an extent that would prevent a decline in lending activity. The first quarter saw a sharp increase in loans of up to 1 one year. The stock of loans of 1 to 5 years and loans of more than 5 years declined in the same period. The stock of long-term loans rose in the second quarter of this year, but not sufficiently to compensate for the decline in short-term financing. The gradual decline in the stock of short-term loans thus continued in the first half of the year, which is partly a result of the tighter loan approval conditions of other MFIs than before the crisis. Short-term loans were down 8.5% in the first half of the year. A major factor in the aforementioned decline is the high cost of short-term financing, which is relatively more expensive compared with long-term loans. This is also being reflected in the interest rate spread, which has widened significantly since the outbreak of the crisis. After last year's relatively high year-on-year growth in long-term loans to NFCs, which averaged 14% in the first half of 2010, growth fell to 4% in the same period this year.

In the first half of 2011, NFCs partly compensated for the loss of domestic financing with foreign sources, primarily via FDI and partly via foreign loans. FDI rose

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

Source: Bank of Slovenia

Figure 4.5: Net financial flows of NFCs, by instruments (S.11)



Source: Bank of Slovenia, unconsolidated data

by nearly EUR 300 million during this period, primarily as the result of a sharp increase in financing from foreign owners, which exceeded EUR 200 million over the first six months of the year. Having made net debt repayments to the rest of the world last year, NFCs began borrowing again in the first half of the year, in the amount of EUR 71 million. Both long-term and short-term borrowing were contributing factors. Non-residents' investments in the securities of domestic NFCs rose by EUR 65 million, while NFCs invested more in foreign securities, resulting in a net financial outflow of EUR 170 million. The same is true for trade credits, via which domestic corporates secured EUR 200 million in financing from the rest of the world during the first half of the year. As NFCs were heavily financed by the rest of the world during the same period, a net financial outflow of EUR 211 million was recorded in the first half of the year.

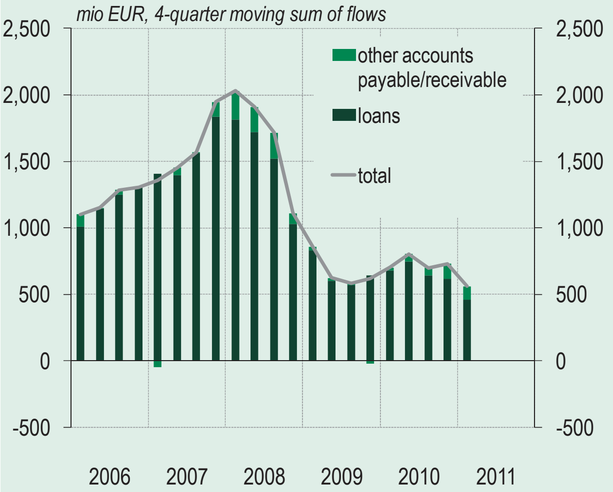
NFCs increased their stock of investments by EUR 142 million in quarterly terms during the first quarter of this year, primarily in the form of loans granted, and investments in shares and other equity. The majority of loans, or EUR 180 million, flowed to the rest of the world. Loans accounted for 14% of all investments by NFCs in the first quarter. The stock of investments in shares and other equity was also up, having risen by EUR 161 million in the first quarter, primarily on account of larger transactions. Other claims, mainly from trade credits and advances, accounted for 36% of investment by NFCs. Trade credits and advances were down by EUR 192 million in the first quarter. The decline in investments was primarily the result of a decline in trade credits and advances, and a negative valuation due to the write-off of claims, in particular against other NFCs. Trade credits and advances from NFCs to the rest of the world have increased in line with growth in exports.

Household financing and savings

Households' financial liabilities[11] decreased by EUR 86 million in quarterly terms in the first quarter of this year, in particular short-term loans. The largest proportion of these loans are accounted for by consumer loans, which have been declining in year-on-year terms since the middle of 2010 in line with the uncertain conditions on the labour market and low household consumption. The average year-on-year decline in consumer loans stood at 3% in the first half of the year. Nevertheless, average year-on-year growth in total loans to households was

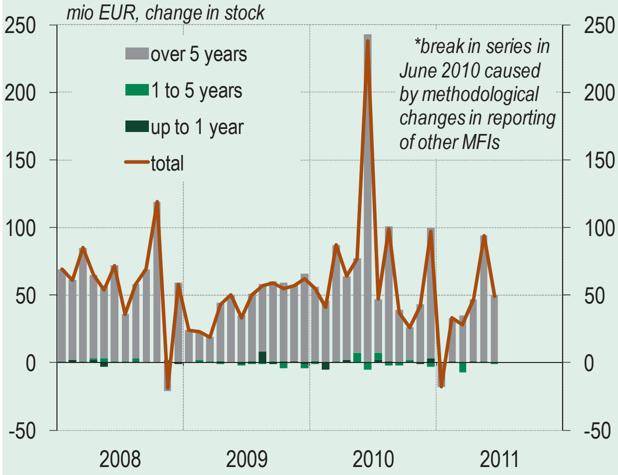
[11] Includes non-profit institutions serving households (S.15), in addition to households (S.14).

Figure 4.6: Financial liabilities of households and NPISH (S.14 & S.15), by instruments



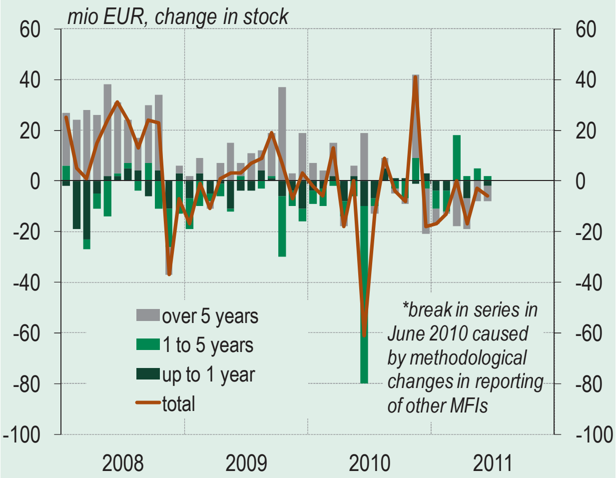
Source: Bank of Slovenia, consolidated data

Figure 4.8: Housing loans by domestic MFIs to domestic households, by maturity*



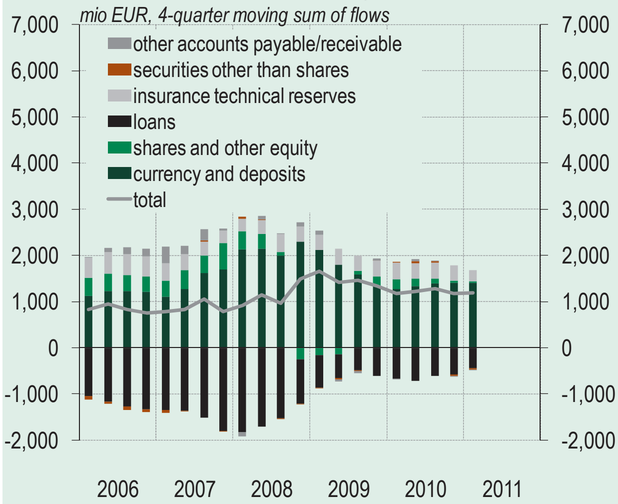
Source: Bank of Slovenia

Figure 4.7: Consumer loans by domestic MFIs to domestic households, by maturity*



Source: Bank of Slovenia

Figure 4.9: Net financial flows of households and NPISH (S.14 & S.15), by instruments



Source: Bank of Slovenia, consolidated data

nearly 8% during the first half of 2011, as the result of an increase in the stock of long-term loans, which are predominantly housing loans. After last year's relatively high year-on-year growth in housing loans, which account for the majority of total loans to households, the growth rate fell sharply during the first six months of this year. After standing at more than 20% early in the year, year-on-year growth had fallen to 13% by June. The recent lower growth in housing loans reflects the decline in the number of transactions on the real estate market and a gradual rise in interest rates. Other household liabilities, predominantly trade credits and advances, were down by EUR 31 million in the first quarter.

The stock of household investments declined by EUR 48 million in the first quarter of this year relative to the end of 2010, to stand at EUR 41.7 billion.[12] Household deposits accounted for 37% of the sector's investments at the end of the first quarter, with 96% of all de-

[12] Financial Accounts of Slovenia, quarterly figures, August 2011.

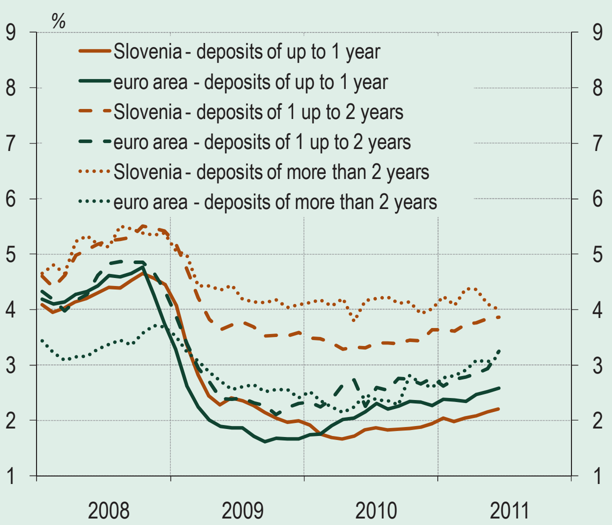
posits placed at domestic banks and 4% at banks in the rest of the world. Household deposits were EUR 59 million on the stock at the end of 2010 during the first quarter of this year, deposits at the domestic banks having risen by EUR 115 million. The second most important form of household investments are shares and other equity, which account for 27% of the sector's total investments. The majority of the aforementioned investments were in NFCs (72%), followed by investment funds (11%) and mutual pension funds (11%). The stock of investments in shares fell by EUR 89 million due to the effects of revaluation, while the stock of investments in other equity was up EUR 118 million. Investments in currency,[13] which accounted for 16% of households' financial assets at the end of the first quarter, were up again in the first quarter, by EUR 297 million. Investments in life insurance reserves were virtually unchanged.

Sources of bank funding and interest rates

The rising cost of financing will impact the restructuring of funding of other MFIs in the future. Other MFIs continued to restructure their sources of funding in the first half of this year. The proportion of household and government deposits rose, while the proportion of funding accounted for by foreign MFIs, and debt securities declined. Because other MFIs only partially compensated for their net debt repayments on the foreign interbank markets and at the Eurosystem, and for the reduction in their liabilities from debt securities with household and government deposits, their total assets contracted by EUR 510 million in the first half of the year. Government deposits at other MFIs were up EUR 670 million during the first half of the year, while household deposits rose by more than EUR 220 million. Long-term deposits, the most required form of funding for other MFIs, recorded the largest increase among household deposits. The interest rates on deposits of longer maturity have thus remained above the euro area average. An increase in write-downs and provisioning costs, a lack of longer-term funding and the uncertainty associated with the debt crisis in the euro area could increase the cost of and limit access to foreign sources of funding for other MFIs in the future. This would lead to a reduction in the supply of loans. The same applies should the country rating be downgraded further.

The shift by other MFIs to more expensive sources of funding is reflected in higher interest rates on loans, including on loans to the private sector, in particular to NFCs. The average premium over the EURIBOR on loans raised by other domestic MFIs in the rest of the world, which represents an approximation of the average cost of funding for other MFIs, stood at 2.0% in the first half of 2011, up 0.4 percentage points on the average in 2010. Interest rates on newly approved loans to NFCs were also relatively high in the first half of 2011, and higher than euro area interest rates. In addition to more expensive sources of funding for other MFIs, this is also a result of the high indebtedness and uncertainty regarding the operations of NFCs. These factors, and high impairment and provisioning costs owing to the deterioration in loans to other MFIs, do not provide the conditions for a fall in interest rates on loans. Interest rates on long-term

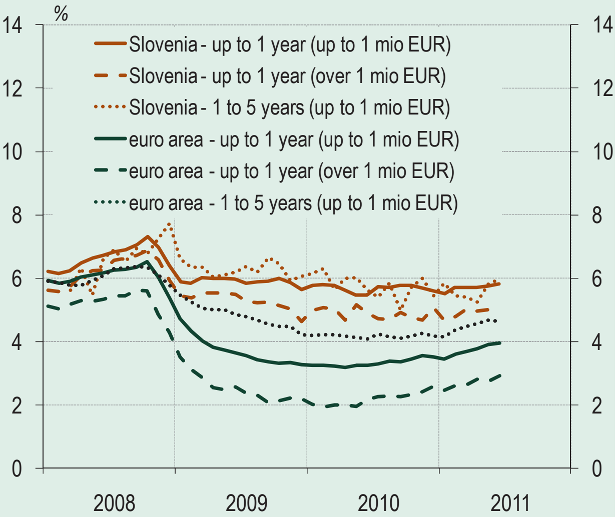
Figure 4.10: Interest rates on household deposits, by maturity



Sources: ECB, Bank of Slovenia

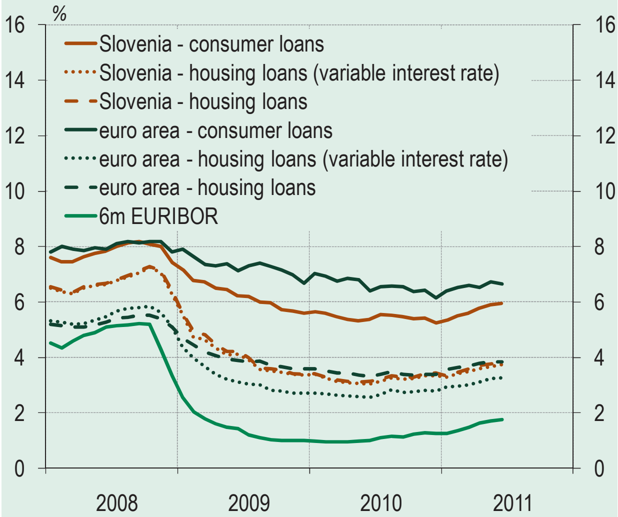
[13] Household currency is estimated as the difference between cash inflows and outflows from tourism and cash inflows and outflows from labour income. See the Methodological Notes in the Bank of Slovenia Bulletin for additional information.

Figure 4.11: Interest rates on loans to NFCs



Sources: ECB, Bank of Slovenia

Figure 4.12: Interest rates on loans to households



Sources: ECB, Bank of Slovenia

loans rose in the first half of the year, in line with rising ECB interest rates, and remain significantly higher than in the euro area. The same is true for short-term loans, where the gap between interest rates in Slovenia and in the euro area is only gradually narrowing. Interest rates on short-term and long-term loans were thus 2 percentage points above the euro area average during the first half of this year.

Interest rates on new loans to households are moving in line with comparable interest rates in the euro area, and are adjusting to a great extent to interbank interest rates. Interest rates on consumer and housing loans have been rising slowly since the end of last year, driven by a rise in the ECB interest rate and increased uncertainty on the international financial markets. Interest rates on consumer loans in Slovenia remain lower than euro area rates, although the gap is gradually narrowing. Having stood at 1.3 percentage points in the first half of 2010, the average gap has fallen to 0.9 percentage points this year. Interest rates on housing loans rose during the first half of the year, similar to euro area interest rates, primarily as the result of a rise in interbank interest rates. Interest rates on housing loans have averaged 3.5% this year, which is comparable with the level of euro area interest rates. Premiums over the EURIBOR for housing loans have remained virtually unchanged since the beginning of 2010. This gives no indication that other MFIs plan to raise interest rates, and thus limit the supply of these types of loans.

5 Public Finance Developments

The Ministry of Finance is projecting a general government deficit of 5.5% of GDP for this year, while general government debt is expected to rise to 45.1% of GDP. The general government deficit remains high for the third successive year, while the general government debt continues to rise. This year's movement in general government revenue is in line with the low economic activity, while one-off expenditure items have had a significant impact on growth in general government expenditure. Slovenia's fiscal priority remains reducing the general government deficit to below the reference value of 3% of GDP by 2013 at the latest in accordance with excessive deficit procedure. A more pronounced narrowing of the general government deficit is planned for 2012 in the Stability Programme, once again on the basis of limiting growth in expenditure. Drafting and implementing the appropriate structural reforms remain important economic policy tasks.

General government deficit

Available figures indicate that the general government deficit remains high for the third successive year, and will reach 5.5% of GDP in 2011 according to forecasts by the Ministry of Finance. Contributing significantly to this in the context of low economic growth are one-off government expenditure items. In the autumn report on this year's general government deficit and debt, the general government deficit is estimated at 5.5% of GDP, while the debt is estimated at 45.1% of GDP. One-off government expenditure items have contributed fully 1.2% of GDP to the deficit. These include the March recapitalisation of NLB (EUR 243 million or

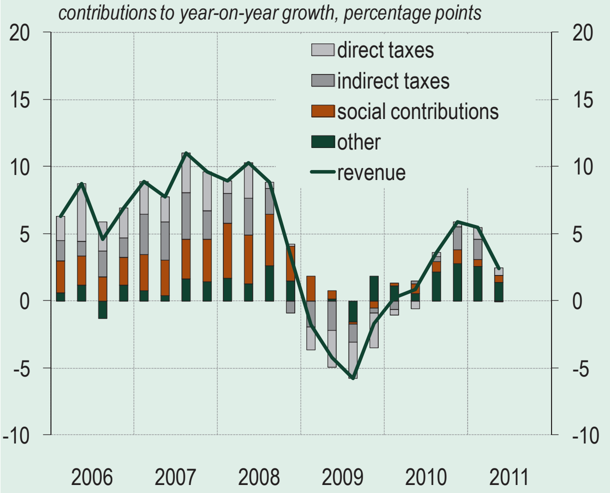
Table 5.1: General government deficit and debt in Slovenia, 2008-2013

	SORS				Stability Programme				European Commission		
as % BDP	2008	2009	2010	2011*	2010	2011	2012	2013	2010	2011	2012
Revenue	42.4	43.2	44.3	44.6	43.5	44.2	43.5	43.0	43.4	43.3	43.1
Expenditure	44.2	49.3	50.1	51.1	49.0	49.7	47.4	45.9	49.0	49.1	48.1
of which: interest	1.1	1.4	1.6	1.8	1.6	1.8	2.0	1.9	1.6	1.8	2.0
Net lending (+) / borrowing (-)	-1.9	-6.1	-5.8	-6.4	-5.5	-5.5	-3.9	-2.9	-5.6	-5.8	-5.0
Structural balance	…	…	...	...	-4.3	-3.8	-3.0	-2.3	-3.0	-2.9	-3.3
Debt	21.9	35.3	38.8	44.4	38.0	43.3	45.3	46.2	38.0	42.8	46.0
Real GDP *(growth, %)*	3.6	-8.0	1.4	1.8	1.2	1.8	2.2	2.3	1.2	1.9	2.5

*Note: *Debt: outstanding at 30th June 2011, other: one year up to June 2011*
Sources: SORS (realisation), Ministry of Finance (April 2011), European Commission (May 2011)

Figure 5.1: General government revenue

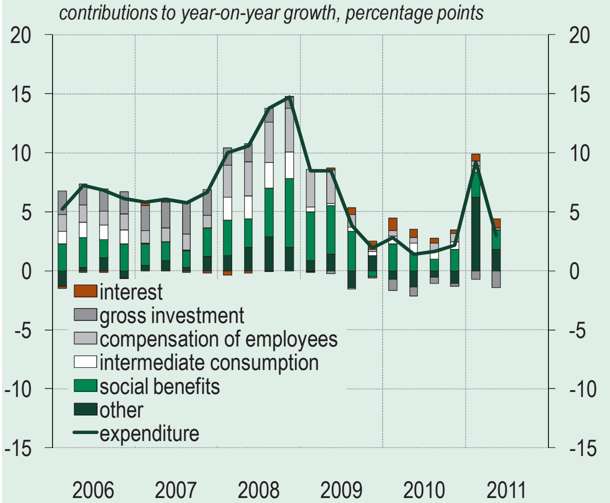
contributions to year-on-year growth, percentage points



Sources: SORS, Bank of Slovenia calculations

Figure 5.2: General government expenditure

contributions to year-on-year growth, percentage points



Sources: SORS, Bank of Slovenia calculations

0.7% of GDP), April's agreed transfer to the Slovenian Railways (EUR 134 million or 0.4% of GDP) and the recapitalisation of Adria Airways (EUR 50 million or 0.1% of GDP).[14] Following its regular revision, the SORS estimated the general government deficit for 2010 at 5.8% of GDP, which is 0.2 percentage points higher than the previous estimate. The general government deficit rose to 6.4% of GDP in the year to June 2011. The average deficit for euro area countries was 6.0% of GDP in 2010. According to its May forecasts, the European Commission is projecting a decline in the deficit to 4.3% of GDP this year. Certain countries have adopted additional measures in recent months to consolidate public finances owing to the crisis on the sovereign debt markets.

General government revenue is growing in line with the low economic growth. Discretionary measures are not having a significant impact on the level of revenue. General government revenue rose by 3.8% in the first half of 2011. Revenue from direct taxes rose by 3.7%, corporate income tax having recorded higher growth than personal income tax. Corporate income tax declined by around 40% in nominal terms in the previous three years due to the economic and financial crisis and cuts in the tax rate. Corporate income tax has risen again this year from this low basis. Social security contributions were up 1.4% during the first half of the year, their low growth is a reflection of the adverse situation on the labour market. Revenue from indirect taxes was up 2.1% in year-on-year terms from January to June, of which VAT by 3.5%, while revenue from excise duties was also higher. Two-thirds of excise duties are accounted for by duties on energy products, which were down in year-on-year terms. In case of presuming that the excise duties on energy products are maintained at the level from the first half of September until the end of the year, total excise duties on 95-octane gasoline and diesel fuel would be one tenth lower than last year, while excise duties on heating oil would be higher by approximately the same amount. Excise duties on tobacco were raised twice this year, in April and October. The government's discretionary decisions have not had a major impact on revenue this year, as changes to all categories of excise duties have reduced revenue by merely 0.1% of GDP.

Growth in general government expenditure excluding one-off measures was down slightly in the first half of the year relative to last year, and down sharply on previous years. The low growth rate reflects the measures set out in an intervention act and a reduc-

[14] The recapitalisation of NLB was included in general government expenditure in the first quarter of this year, while a transfer to the Slovenian Railways increased general government expenditure in the second quarter. The general government has also supported the recapitalisation of Adria Airways, for which state assistance was approved by the European Commission.

Box 5.1: Improving the coordination of economic policies within the EU[1]

The financial and economic crisis has exposed significant weaknesses in economic governance in the EU, particularly with regard to the Stability and Growth Pact as a mechanism for ensuring the fiscal stability of the Member States. The need for improved coordination of economic policies has been highlighted. For the smooth functioning of EMU, national governments must ensure the sustainability of their public finances, the competitiveness of national economies and the stability of the financial system.[2] The main objectives of planned changes are thus to increase fiscal discipline and to control macroeconomic imbalances.[3] Sanctions have also been introduced for offenders.

A decision was made to establish the Task Force on Economic Governance in March 2010 at the meeting of the European Council chaired by its president, Herman van Rompuy. The task force was charged with drafting proposals for improving budgetary and macroeconomic control, and with establishing a crisis management framework. The numerous changes in the area of economic governance comprise six legislative proposals, published by the European Commission at the end of September 2010. Mr van Rompuy's task force also published recommendations in October. Of the six directives, four proposals relate to fiscal area, and represent a wide range of reforms to the Stability and Growth Pact. The purpose of the other two directives is to identify and effectively resolve macroeconomic imbalances within the EU and the euro area. The package was approved by the European Parliament at the end of September 2011. The aim is to implement the proposed changes as soon as possible. The most contentious point in the negotiations between the European Parliament and Member States is how to make decisions regarding envisaged sanctions against countries guilty of breaching the Stability and Growth Pact and against countries that contribute to the deepening of macroeconomic imbalances in the EU.[4] The main changes aimed at strengthening fiscal and macroeconomic control are presented below. Mention is also made of certain other important elements of the updated framework, such as the Euro Plus Pact and the European Stability Mechanism (ESM).

The reference values for the general government deficit of 3% of GDP and the general government debt of 60% of GDP have been maintained as reference values in the Stability and Growth Pact. However, more attention than before will be given to government expenditure when assessing the implementation of fiscal policy. Growth in general government expenditure, with the exclusion of some expenses,[5] should not exceed a predetermined value that is linked to the trend of potential output. Growth in expenditure should be cut further during periods in which medium-term fiscal objectives are not met, and fiscal consolidation is required. One of the most important fiscal changes relates to the increased importance of general government debt in the context of the excessive deficit procedure. Governments with excessive debt will have to reduce their debt to the reference limits at an appropriately planned pace.

The strengthening of national budgetary framework of individual EU Member States is also planned. The directive on national fiscal frameworks will set minimum standards. These relate to the availability of up-to-date fiscal data, procedures for adopting multi-year fiscal plans and the introduction of appropriate fiscal rules. Further improvements are also needed with regard to the quality and independence of fiscal and economic analysis and the preparation of fiscal statistics.

The planned monitoring of macroeconomic imbalances to ensure the conditions for growth and competitiveness is a new element of economic governance in the EU. Numerous imbalances, which have made adjustments during the crisis more difficult, accumulated in the period prior to the crisis. Stricter control over macroeconomic imbalances, such as loss of competitiveness, external trade imbalances, and high public or private debt, is envisaged after the adoption of the package of measures. The development of indicators to identify unwanted macroeconomic imbalances is planned. The legislative package envisages the introduction of an excessive imbalance procedure to prevent and mitigate such imbalances.

Sanctions are envisaged for euro area countries if a specific country does not implement stabilisation measures quickly enough. These are imposed in the event of an excessively high general government deficit and/or debt and for macroeconomic imbalances. A penalty follows, when the European Commission determines and the European Council confirms that the country did not implement appropriate measures quickly enough. The maximum penalty for excessive debt is expected to be 0.5% of GDP, 0.2% of GDP for an excessive deficit, and 0.1% of GDP for imbalances. A penalty initially takes the form of an interest-bearing deposit, followed by a non-interest-bearing deposit, followed by a fine in extreme cases. The key to the success of the new economic governance mechanism is the consistent implementation of the new rules and the more automatic enforcement of sanctions in the case of breaches. Non-monetary sanctions are also envisaged, such as new requirements regarding reporting or the mission of the European Commission in connection with ECB in euro area countries and ERM II participants.

Part of the changes, already being implemented, is the so-called **European semester**, which includes efforts for the closer advanced coordination of budgetary and macroeconomic policies, and the structural reforms of EU Member States. This means a complete and effective framework for coordinating economic policies. The first coordination within this framework took place this year. In January 2011 the European Commission published its Annual Growth Survey, in which it defined fiscal consolidation for macroeconomic stability, structural reforms to increase employment and measures to promote growth as the main challenges of economic policy in the EU and the euro area. Member States then drafted national development programmes until the end of April, in which they identified bottlenecks for growth and national stability programmes. Pursuant to the recommendations of the Commission, in June the Council published recommendations to Member States regarding their reform programmes and stability programmes.

The **Euro Plus Pact** was adopted in March 2011. Alongside euro area countries, the aforementioned pact includes six EU Member States outside the euro area (Bulgaria, Denmark, Latvia, Lithuania, Poland and Romania). Elements of the pact include improving competitiveness, increasing employment, and increased fiscal and financial stability. The Euro Plus Pact is expected to provide the impetus to implement structural reforms and support the objectives of the Europe 2020 strategy. Member States adopt annual commitments in the scope of the aforementioned pact.

Also of importance in terms of crisis management is the agreement signed in July 2011 to establish a permanent crisis mechanism, known as the **European Stability Mechanism**[6] **(ESM),** with EUR 700 billion in capital, which in mid-2013 will replace the existing temporary system aimed at ensuring the stability of the euro. Paid-up capital will amount to EUR 80 billion. Slovenia will pay up EUR 342 million in five annual instalments from 2013 onwards. The mechanism will function as a lender of the last resort. The responsibilities of the ESM will include financial assistance for countries in distress, conditional on a macroeconomic programme, and bonds purchases on the primary market.

[1] For more information, see: Monthly Bulletin of the ECB, March 2011: The reform of economic governance in the euro area – essential elements; and Monthly Bulletin of the ECB, July 2011: The new EU framework for financial crisis management and resolution.

[2] Monthly Bulletin of the ECB, July 2011, p. 71.

[3] Involves external and internal imbalances. The former are expected to be monitored using external position indicators (e.g. the current account and net external financial assets) and competitiveness indicators (e.g. the real effective exchange rates, unit labour costs, and inflation as measured by the harmonised index of consumer prices). Indicators of internal imbalances are expected to include housing market indicators (e.g. value-added in construction and housing prices) and debt indicators (e.g. debt of the public and private sectors).

[4] The European Parliament favoured voting on sanctions with a reverse qualified majority. This means that Member States must vote not to impose sanctions (as proposed by the European Commission) by a qualified majority. Member States were in favour of implementing a decision on sanctions, if it is supported by a qualified majority. It was agreed that a normal qualified majority shall apply in the preventive phase, and that a reverse qualified majority for the adoption of sanctions shall apply in the corrective phase. This means that it will be much easier to enforce sanctions against offenders.

[5] For example, expenditure on interest, and expenditure financed from EU sources.

[6] See the April 2011 Price Stability Report with regard to mechanisms for ensuring financial stability in the EU.

tion in government investment. General government expenditure rose by 5.9% in the first half of 2011, or by 1.6% when one-off measures are excluded (e.g. the recapitalisation of NLB and a transfer to the Slovenian Railways), which is lower than the growth in nominal GDP during the same period. The government adopted several measures to restrict spending. Agreement was reached with the public sector unions to delay the implementation of wage reforms and on other wage-related measures. The average wage in the public sector was therefore virtually unchanged in year-on-year terms. Compensation of employees in the public sector increased by 1.1% in the first half of the year, while the number of employees in the government sector (S.13 under the ESA 95) rose by 0.5%, which is less than in previous years. An intervention act also limited this year's growth in pensions and other social transfers to one quarter of the legally prescribed growth. This acted to limit growth in expenditure on pensions to the previous year's level, despite an increase in the number of retirements at the end of 2010 and early 2011. Expenditure on interest payments continues to rise in line with the rising debt.

Social benefits continue to grow, reflecting the increased number of retirements and the adverse situation on the labour market. A great deal of this expenditure was on pensions, which were up 3.6% during the first half of 2011 relative to the same period last year. The number of old age pensioners was up 4.9% in year-on-year terms over the first seven months of the year, while the total number of pensioners was up 2.8%. Unemployment benefits have risen sharply as a result of the adverse situation on the labour market. Higher unemployment benefits are the result of a rise in the number of unemployed and an increase in the average benefit. The Labour Market Regulation Act entered into force on 1 January 2011. It expanded the pool of those entitled to unemployment benefits, increased the money benefits during the first three months of receipt, and set a minimum gross benefit of EUR 350. The Exercise of Rights to Public Funds Act and the Financial Social Assistance Act, which were to have entered into force on 1 June 2011 and some parts on 1 September 2011, will enter into force at the beginning of next year. The aim of the amended social benefits regime is to create a more equitable and longer-term sustainable social state. The criteria for individual rights have been amended, while all rights will now be exercised with a single application.

Government debt and guarantees

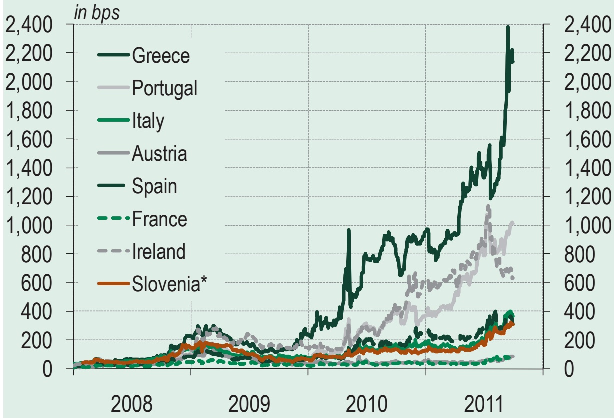
The general government debt rose to 44.4% of GDP in the first half of the year, the government having borrowed primarily to finance this year's deficit and to repay maturing debt. The general government debt stood at EUR 15,890 million at the end of June, up EUR 2,153 million on the end of last year. The central government debt accounted for 96% of the total debt at the end of June, and derives primarily from the debt generated by the state budget, which borrows in line with the financing programme for 2011. This year's maximum borrowing under the aforementioned programme was set at EUR 4.2 billion. According to Ministry of Finance estimates, borrowing is expect to amount to EUR 3 billion, two thirds of which is earmarked to finance this year's budget deficit, while one third is earmarked for the repayment of debt principal maturing this year. The state budget borrowed EUR 3.027 billion over the first eight months of the year. Two bonds, each in the amount of EUR 1.5 billion, were issued in this period: a 10-year bond in January and a 15-year bond in March. The coupon rate on the 10-year bond is 4.375%, with a yield at issue 156 basis points over the comparable German bonds. The coupon rate on the 15-year bond is 5.125%, with a premium over the comparable German bonds of 188 basis points at issuance. Both issues were syndicated, with 92% of the amount of long-term bonds issued this year held by non-residents at the end of June. All principal arising from long-term bonds matured and was paid in the first half of the year. A small portion of this year's borrowing was also earmarked for the pre-financing of debt principal maturing over the next two years. According to Ministry of Finance estimates, the general government debt is expected to reach EUR 16,213 million or 45.1% of GDP by the end of this year.

The government is striving to improve fiscal discipline in the draft version of the new Public Finance Act. The draft Public Finance Act, which is currently in parliamentary procedure, contains an article on fiscal rues and fiscal discipline. Contextually, this means defining maximum limits on public expenditure, the general government debt, guarantees and the levels of general government structural and primary balance. The maximum limit on debt is set at 48% of GDP (excluding EFSF debt). The draft act stipulates general government to reach structural balance for the duration of one economic cycle. Balanced general government structural deficit is also Slovenia's medium-term fiscal objective since this March. It will not, however, be achieved by 2013 according to projections from the Stability Programme.

Guarantees issued in the first half of this year primarily related to the functioning of a temporary mechanism for ensuring financial stability in the euro area. The government issued new guarantees in the amount of EUR 181 million in the first half of the year, of which EUR 21 million was earmarked for domestic corporates,[15] and EUR 160 million for the temporary mechanism for ensuring financial stability in the euro area (the EFSF).[16] Slovenia provides aid to Ireland and Portugal in the scope of the EFSF. The stock of government guarantees stood at EUR 7.4 billion or 20.8% of GDP at the end of June this year. According to state budget figures, guarantees in the amount of EUR 14 million were redeemed by the end of this August.

The premiums on Slovenian 10-year government bonds over the yields on comparable German bonds of equal maturity have risen gradually since May. The premiums on Slovenian bonds stood at around 130 basis points until May. The premiums on Portuguese government bonds began to rise sharply at the end of March as a result of the deepening debt crisis in that country. Greece was downgraded in May and again in July, which drove up the premiums on Greek bonds during this period. Premiums in Italy and Spain rose in July due to escalating public finance problems. At the same time, the premiums on the bonds of certain other euro area countries began to rise. Premiums remain high on bonds from

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



Sources: Bloomberg, Bank of Slovenia calculations
*Note: Spread is calculated as a difference between the yield of 10-year government bond and the yield of reference German bond on a daily basis and is used as a measure of country's credit risk. *In the picture SLOREP 01/21 is used after 11. January 2011*

Greece, Ireland and Portugal, i.e. countries included in international financial assistance programmes, on account of their debt crises. The premiums on Slovenian 10 -year bonds have risen gradually since May, and stood at around 250 basis points at the end of August and at nearly 300 basis points in September over the comparable German bonds. The ratings agencies Moody's and Fitch downgraded[17] Slovenian government bonds one notch in September, with the possibility of a further downgrade in the future.

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

Slovenia's role in ensuring financial stability in the euro area is in providing assistance to Greece, Ireland and Portugal. International assistance in the amount of EUR 68 billion to resolve Ireland's public finance problems was approved last November, while EUR 78 billion in assistance to Portugal was approved in May this year. An agreement on additional assistance to Greece, expected to amount to EUR 109 billion, is currently in the process of ratification. Part of the aforemen-

[15] This year's maximum amount of guarantees granted under the Budget Implementation Act was set at EUR 2,450 million.
[16] For more information, see Box 5.1 Mechanisms for ensuring financial stability in the EU in the April 2011 Price Stability Report.
[17] The main reasons given for the downgrading were risks associated with the banking sector, a deteriorating outlook for economic growth, increasing political uncertainty in the country and the inability of the government to implement the necessary structural reforms.

tioned assistance is financed from the EFSF, EUR 17.7 billion to Ireland and EUR 26 billion to Portugal. Slovenia's share of guarantees under the EFSF is 0.5%. This means that Slovenia's contribution to assistance earmarked for Ireland will be approximately EUR 89 million, and around EUR 130 million of the assistance earmarked for Portugal. Greece has received assistance to finance its debt since last May in the form of IMF loans and bilateral loans from the euro area countries, including Slovenia. Loans to Greece totalling EUR 131 million were approved from the Slovenian state budget over the first seven months of this year, bringing the total amount of loans received by Greece from the Slovenian state budget since 2010 to EUR 234 million. In accordance with July's agreement between euro area heads of state, the payment of a sixth tranche of loans to Greece is planned for autumn, provided that the conditions for payment are met. Greece is then expected to receive assistance from the EFSF. The agreement must still be ratified by the parliaments of euro area countries.

Agreement was reached in July to raise the level of funds in the scope of the temporary mechanism to ensure the financial stability of the euro area, and on the changes that would improve its effectiveness. At the July meeting, euro area heads of state agreed to increase EFSF funds from EUR 440 billion to EUR 780 billion, thus increasing Slovenia's share of guarantees from EUR 2,073 million to EUR 3,664 million. Changes are also envisaged that will improve the efficiency and flexibility of the EFSF. These primarily relate to the possibility of the preventive approval of assistance and the possibility to use EFSF funds to recapitalise financial institutions. The EFSF will also be able to transact on the secondary market of euro area debt instruments. Similar to the agreement on EFSF assistance to Greece, the agreement on changes to the EFSF mechanism must be ratified by the parliaments of euro area countries. The EFSF, which functions in the scope of the temporary mechanism for ensuring financial stability, will operate until the middle of the year 2013, when it will be replaced by the European Stability Mechanism (ESM), a permanent mechanism for ensuring stability in the euro area.

Planned developments in the general government deficit

Under the excessive deficit procedure, Slovenia must cut its general government deficit to below 3% of GDP by no later than 2013. Slovenia has been undergoing the excessive deficit procedure since December 2009, and consolidation of public finances is one of the government's top priorities. The goal is to gradually reduce the general government deficit to below 3% of GDP, and to stabilise the public debt. The deadline for eliminating the excessive deficit for Slovenia is 2013.

The government is planning a restrictive fiscal policy in 2012 and 2013, and the elimination of the excessive deficit in accordance with the commitments set out in the Stability Programme. The government adopted the latest update to the Stability Programme in April 2011. The current Stability Programme envisages adjustments primarily on the expenditure side. Given that expenditure on interest throughout the period will increase further because of the continued financing of deficits via borrowing, the cuts in primary expenditure will have to be even deeper. After coordinating with social partners, the government intends to send a proposal to parliament to extend intervention measures to 2012, with the aim of cutting general government expenditure. The measures relate primarily to transfers to individuals and households, pensions and the wages of public employees.

Structural reforms are needed to achieve a sustained reduction in the general government deficit and to improve long-term fiscal sustainability. Slovenia's general government deficit is to a great extent structural in nature. Available estimates (see Table 5.1) show that the structural general government deficit remains high,[18]

[18] In the current situation, estimates of the structural deficit are less reliable, and the subject of frequent revisions.

and at around 3% of GDP according to European Commission estimates. Government measures last year and this year were primarily aimed at limiting expenditure through intervention act measures, particularly in the areas of public sector wages, social transfers and pensions, and at reducing expenditure on investment. Particularly with regard to expenditure on wages, these measures entail delaying the elimination of discrepancies until a later period. More systematic measures on the expenditure side are crucial for the sustained reduction of the deficit, for stabilising the debt, and for maintaining confidence on the international financial markets. In this context, urgent pension reform failed to receive support at a referendum.

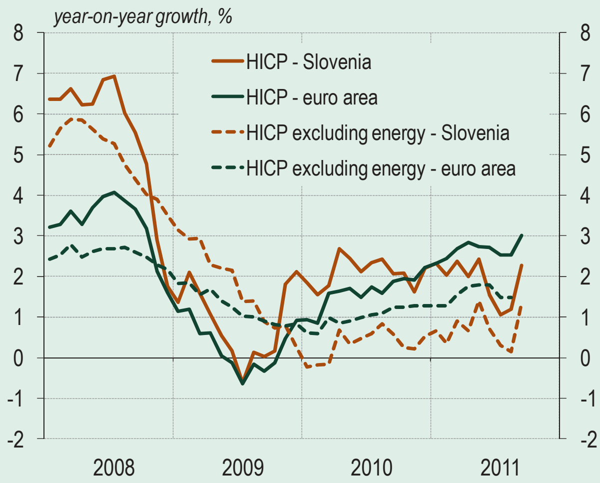
6 Price Developments

Inflation in Slovenia fluctuated considerably over the first nine months of the year, primarily owing to base effects and certain major one-off changes. Growth in the harmonised index of consumer prices averaged 1.9% in year-on-year terms over the first nine months of the year, 0.7 percentage points less than in the euro area. In addition to the last year's considerable drop in school meal prices, the main factor in the aforementioned deviation was relatively low growth in prices of non-energy industrial goods. Core inflation is significantly lower than the euro area average. This primarily reflects the low level of demand and economic activity, and low growth in unit labour costs, which is necessary to improve the price and cost competitiveness of the Slovenian economy.

Macroeconomic factors and core inflation indicators

Core inflation rose during the spring months, but reversed its course in the following months. Core inflation indicators continue to point to slower price growth in Slovenia than in the euro area. Core inflation as measured by the HICP excluding energy and unprocessed food prices averaged 0.3% over the first nine months, up 0.1 percentage points on the 2010 average. A fall in this measure of core inflation was hindered by the rise in food prices, passed through to domestic food products from the global markets. Core inflation as measured by the narrowest indicator, the HICP excluding energy, food, alcohol and tobacco, was negative in year-on-year terms in all months prior to August. According to this indicator, prices fell by an average of 0.7% in year-on-year terms over the first nine months of the year. According to the broadest indicator, the HICP excluding energy, price growth was 0.7% in year-on-year terms. All core inflation indicators have been lower than those in the euro area since the end of 2009, reflecting weaker domestic demand than the euro area average. From January to August, growth in the narrowest core inflation indicator was 2.1 percentage points lower on average than the comparable euro area indicator.

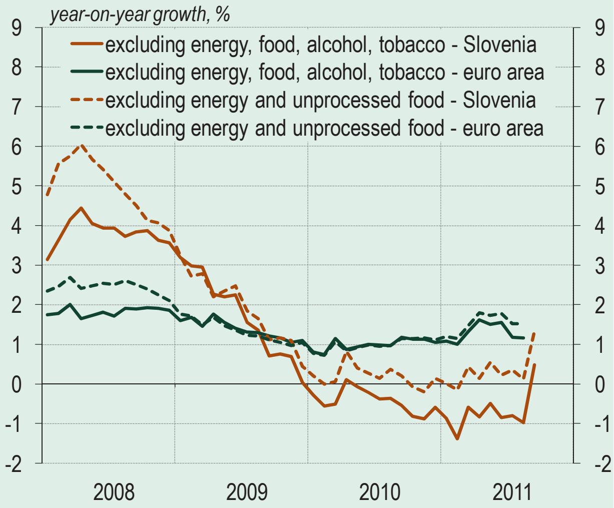
Figure 6.1: Inflation



Sources: Eurostat, SORS, Bank of Slovenia calculations

Low core inflation includes the effect of last year's considerable drop in school meals prices, but is primarily a result of the still-low level of demand and economic activity. Continuation of the adverse situation on the labour market and the decline in consumer purchasing power as measured by real growth in the gross wage bill contributed to the stagnation in final household consumption. Declining growth in labour costs has continued this year in line with falling employment and the necessary re-establishment of the price competitiveness of the economy. Year-on-year growth in real revenue was negative in many retail segments. In the context of unused production capacity in the economy, suppliers of goods and services are extremely limited in terms of raising prices, at least on competitive markets. Growth in prices of oil and other commodities on the global markets has increased corporate operating costs, despite the euro's appreciation against the US dollar. The pass-through to retail prices, however, was small. Slovenian import prices were up 7.4% on average over the first nine months of the year owing to higher commodity prices.

Figure 6.2: Core inflation



Sources: Eurostat, SORS, Bank of Slovenia calculations

Microeconomic factors and the structure of inflation

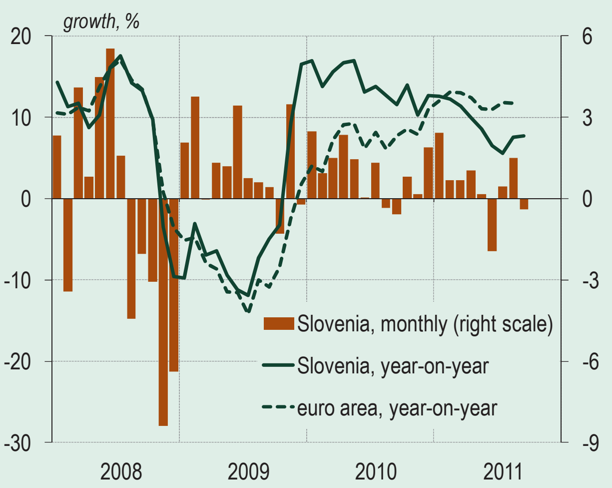
In the context of rising prices on the global markets, energy prices in Slovenia rose by an average of 9.2%

Table 6.1: Breakdown of the HICP and price indicators

	weight 2011	average year-on-year growth, % 2007	2008	2009	2010	1H11	year-on-year growth in quarter, % 2Q10	3Q10	4Q10	1Q11	2Q11	3Q11
HICP	*100.0 %*	3.8	5.5	0.9	2.1	2.1	2.4	2.3	2.0	2.2	2.0	1.5
Breakdown of HICP:												
Energy	*14.3 %*	3.4	9.4	-4.5	13.9	10.2	15.6	12.7	12.3	12.1	8.3	6.9
Food	*22.6 %*	7.1	8.1	1.8	2.5	5.4	2.1	3.9	3.6	5.2	5.7	3.5
processed	*15.3 %*	6.3	9.9	2.7	2.9	4.6	2.9	3.1	3.1	4.5	4.7	4.9
unprocessed	*7.3 %*	8.7	4.6	0.0	1.7	7.1	0.3	5.5	4.7	6.6	7.7	0.5
Other goods	*29.0 %*	0.3	2.2	0.0	-2.2	-1.2	-2.3	-1.7	-1.6	-1.3	-1.1	-1.4
Services	*34.1 %*	4.9	5.3	3.2	1.2	-0.6	1.9	0.8	0.0	-0.7	-0.4	0.2
Core inflation indicators												
HICP excluding energy	*85.7 %*	3.8	4.9	1.7	0.3	0.8	0.5	0.7	0.3	0.6	0.9	0.6
HICP excluding energy and unprocessed food	*78.4 %*	3.4	5.0	1.9	0.2	0.2	0.5	0.2	0.0	0.1	0.3	0.6
HICP excluding energy, food, alcohol and tobacco	*63.1 %*	2.7	3.8	1.7	-0.4	-0.8	-0.1	-0.4	-0.8	-0.9	-0.7	-0.4
Other price indicators:												
Industrial producer prices on domestic market		5.5	5.6	-0.4	2.0	4.3	2.0	2.8	3.2	4.5	4.1	...
GDP deflator		4.2	4.1	3.0	-1.1	0.4	-0.6	-0.6	-1.7	0.5	0.4	...
Import prices[1]		1.4	2.7	-4.6	6.6	6.9	7.5	7.8	8.6	8.6	5.4	...

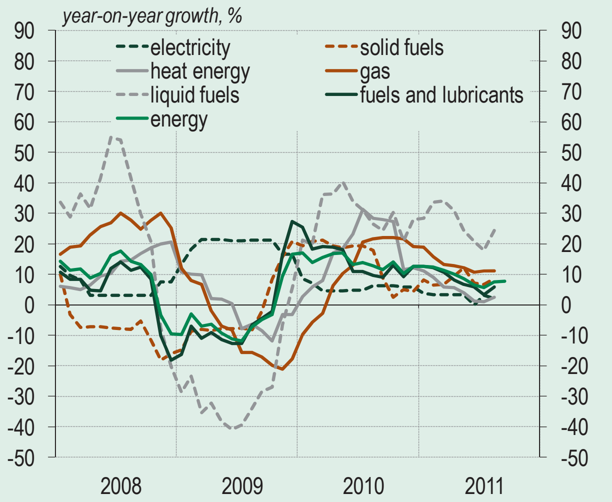
Note: [1] National accounts figures
Sources: SORS, Eurostat, Bank of Slovenia calculations

Figure 6.3: Energy prices



Sources: Eurostat, Bank of Slovenia calaculations

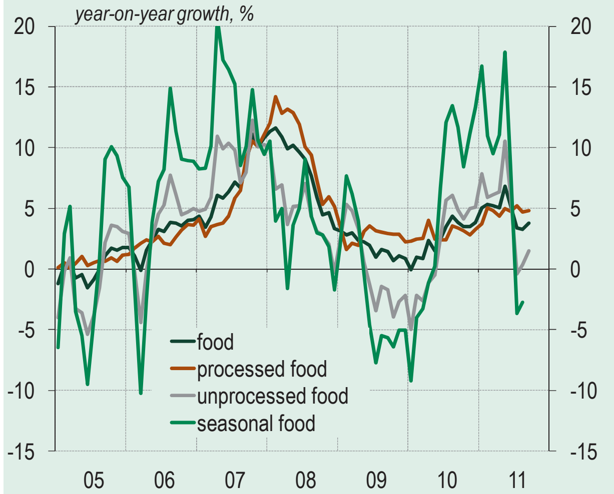
Figure 6.4: Individual energy price categories



Sources: Eurostat, Bank of Slovenia calculations

in year-on-year terms over the first eight months of the year, 2.8 percentage points less than in the euro area. At the beginning of the year the Slovenian government mitigated the pass-through of rising oil prices to the final prices of motor fuels and lubricants by lowering excise duties on petrol products. In the context of easing global oil prices in the middle of the year, the government raised excise duties slightly again. Nevertheless, at 8.1% on average over the first eight months of the year, year-on-year growth in the prices of motor fuels and lubricants

Figure 6.5: Food prices

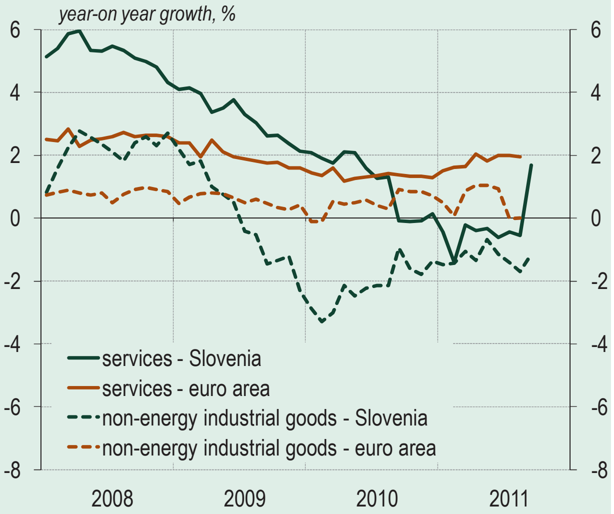


Sources: Eurostat, Bank of Slovenia calculations

was 5.9 percentage points lower than in the euro area. Considerably more pronounced was the rise in the price of heating oil by 26.5% in year-on-year terms over the first eight months of the year, driven by an increase in excise duties, in addition to global prices. This growth was roughly equal to average euro area growth. In contrast to previous years, growth in electricity and district heating prices has been considerably lower than the euro area average this year. Year-on-year growth in energy prices stood at 7.7% in September.

The pass-through of last year's sharp growth in food prices on the global markets to Slovenian retail prices was significantly lower than in 2007 and 2008. Nevertheless, food prices on the domestic market were up 4.9% in year-on-year terms over the first eight months of the year, 2.4 percentage points more than in the euro area. Prices of processed food, the largest group among food prices, rose by 4.7% on average in year-on-year terms over the first eight months of the year. This was due to higher growth in all subcategories, while primarily the prices of tobacco and alcohol rose last year due to the raising of excise duties. The prices of unprocessed food have fluctuated considerably this year, with a sudden jump in the prices of seasonal food (fruits and vegetables) in May, followed by an even

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

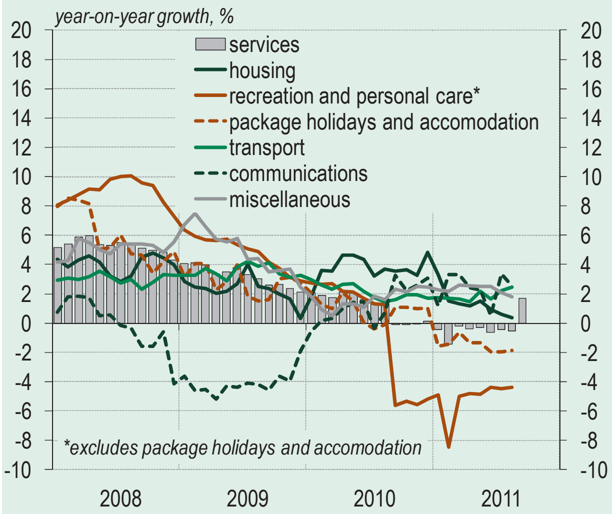


Sources: Eurostat, Bank of Slovenia calculations

sharper drop in July. Year-on-year growth in the aforementioned prices was negative in July, but still stood at 5.3% on average over the first eight months of the year, which is 3.4 percentage points higher than in the euro area. Year-on-year growth in food prices stood at 3.8% in September.

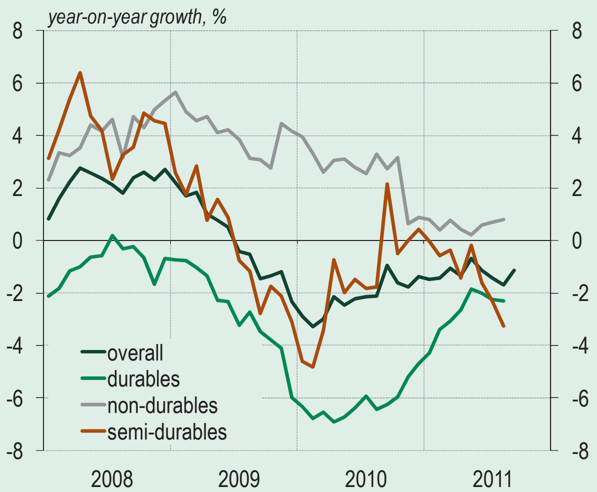
Year-on-year growth in services prices was negative until August and below the growth recorded in the euro area. Services prices were down 0.5% in year-on-year terms over the first eight months of the year. In addition to the macroeconomic situation, this was also a result of the effects of the change in the calculation of prices of school meals (in the subcategory "canteens") in September last year, and the effect of a temporary one-month drop in the prices of services due to a lower TV subscription this February. Excluding these two segments from the calculation, average year-on-year growth in the first eight months in services prices would have been around 1.6%, which is 0.2 percentage points lower than growth in euro area services prices. The majority of service price sub-groups is characterised by subdued growth, the highest year-on-year growth in recent months having been achieved by the prices of communications services, where the lowest growth has typically been recorded over the past several years. The effect of last year's reduction

Figure 6.7: Services prices



Sources: Eurostat, Bank of Slovenia calculations

Figure 6.8: Prices of non-energy industrial goods



Sources: Eurostat, Bank of Slovenia calculations

in school meal prices dropped out of the calculation in September. This was the main reason for the increase in year-on-year growth of services prices from -0.5% in August to 1.7%.

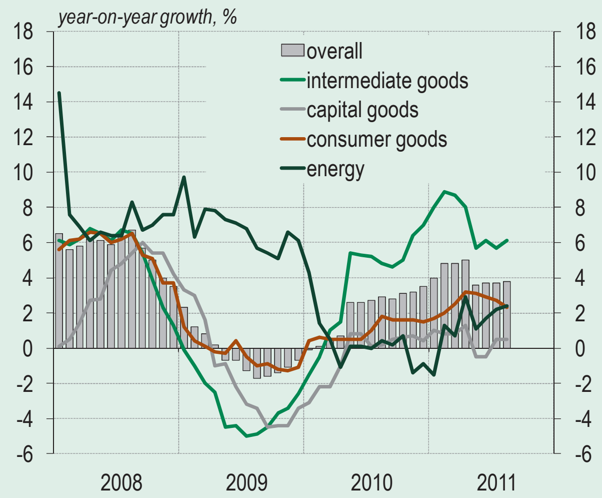
Prices of non-energy industrial goods have continued to fall this year in year-on-year terms, but at a slower pace than at the end of 2009 and early 2010. Prices of non-energy industrial goods fell by an average of 1.3% in year-on-year terms over the first eight months of the year, compared with a rise in the euro area of

0.6%. The most notable decline continues to be in the prices of durables (a decline of 2.7%), although the year-on-year decline has slowed. The main factor in this development was car prices, which saw a more significant increase in February, ending the previous long-term declining trend. Car prices remained above the January level until August. The prices of semi-durables have also declined this year in year-on-year terms (by 1.2% on average over the first eight months of the year), primarily as a result of clothing and footwear prices, which have declined in year-on-year terms, with sharp above-average seasonal fluctuations. Year-on-year growth in the prices of non-durables remains low.

Industrial producer prices

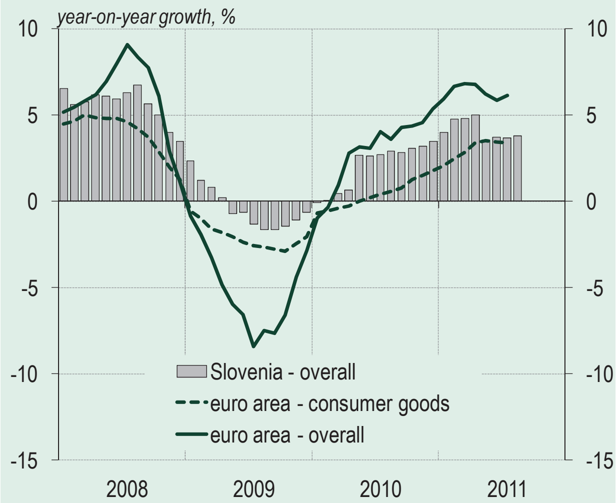
Year-on-year growth in industrial producer prices on the domestic market has risen since the middle of 2009, reaching its peak in April this year, followed by slowing growth. Prices rose by an average of 4.1% in year-on-year terms over the first eight months of this year, up 2.6 percentage points on the same period last year. Among commodities prices, which were up 7.1% on average over the first eight months of the year, prices in the manufacture of basic metals recorded the highest growth, at 16.1%. Since the movement of commodity prices used in the production chain is under the significant influence of trends in commodity prices on the global markets, changes to the former are rapidly reflected in industrial producer prices on the domestic market. Year-on-year growth in the prices of consumer goods averaged 2.5% over the first eight months of this year, the prices of durables having recorded the highest average growth. Energy prices, which declined further at the beginning of the year, have risen in recent months, primarily due to price increases in the electricity, gas and steam supply. In the euro area, the highest average year-on-year growth (of 12.1%) over the first seven months among all industrial producer prices was recorded by energy prices. During the same period, euro area industrial producer prices on the domestic market rose by an average of 6.4% in year-on-year terms, driven in part by high year-on-year growth in commodity prices.

Figure 6.9: Industrial producer prices on the domestic market



Sources: SORS, Bank of Slovenia calculations

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



Sources: Eurostat, Bank of Slovenia calculations

7 Projections of Economic Trends and Inflation 2011-2013[19]

Projections of economic activity and inflation have been revised down. Following the stagnation in economic activity in the first half of the year, the projection of GDP growth for this year was revised down by half a percentage point to 1.3%. An even sharper downward revision in economic growth for next year, to 1.7%, was made owing to a lower forecast of growth in foreign demand and the slow recovery in domestic spending. A low growth in all components of domestic demand is expected over the entire projection horizon. The contribution of foreign trade to economic growth is expected to remain positive. The current account deficit will become a surplus of around 1% of GDP, as a result of the narrowing merchandise deficit and the widening surplus in transfers, although the deficit in capital income is widening. Core inflation is expected to rise slightly, primarily as a result of certain one-off effects, but will remain low owing to the gradual recovery in domestic demand and slow growth in labour costs. Thus, headline inflation, with the exception of a temporary rise at the end of the year, is expected to be less than 2% over the remainder of the projection horizon.

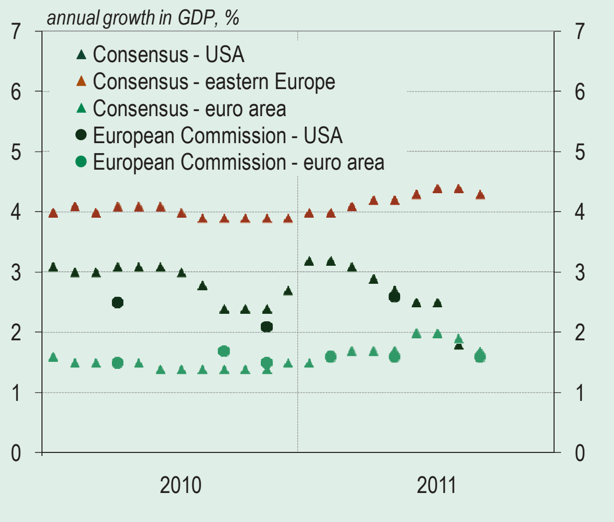
Uncertainty regarding GDP growth is on the rise, and indicates that growth will very likely be lower than forecast in the baseline projection. The risk relating to foreign demand is rising as a result of growing uncertainty on the sovereign debt markets, declining corporate confidence, the need for fiscal consolidation and persistently high unemployment in the most important trading partners. At the same time, uncertainty regarding certain domestic factors is also growing. The implementation of the necessary structural reforms and fiscal consolidation has been delayed, which might give rise to distrust in fiscal policy, increased uncertainty regarding the economy and, in the context of a further downgrading, a rise in the costs of financing of the general government and private sectors. Access to refinancing in the rest of the world could also be hindered. This would affect investment activity in particular. There is also an increasing likelihood of a sustained rise in unemployment, and the related social consequences, the loss of human capital and an increase in general government expenditure. Inflationary risks remain balanced, and similar to previous projections.

[19] The projections were made on the basis of the data available and the statistical methodologies applicable on 2 September 2011. The projections of macroeconomic factors presented in this report are based on assumptions for the variables in the international environment and certain domestic factors dependent on economic policy decisions. The assumptions for the variables in the international environment are taken from Consensus Forecasts and Eastern Europe Consensus Forecasts (August 2011), JP Morgan (Global Data Watch, 3 September 2011), OECD Outlook (June 2011) and the IMF WEO Update (June 2011). The domestic factors under the influence of economic policy and exogenously included in the forecasting process are public sector spending and investment, public sector wages, the movement of administered prices and certain other variables of a fiscal nature. The assumptions used in the projections are not the same as those used by the ESCB in its projections. For the relationship between the Bank of Slovenia projections and those of the ESCB, see the annex in the price stability report, April 2008.

International environment and external assumptions

Relatively high economic growth in some of Slovenia's most important trading partners in the first quarter has led to an improvement in expectations regarding this year's foreign demand. Growth in foreign demand is expected to slow sharply in the second half of 2011 and next year. The global economy began to slow down in the second quarter, particularly in developed countries. Public finance problems arose again at the beginning of the second half of the year in certain euro area countries and in the US, while unemployment rates have not decreased. Nevertheless, as a result of the relatively high growth in the first quarter, and still-solid international trade in the second quarter, the assumption for this year's growth in foreign demand is slightly higher at 7%. Owing to the slowdown in the global economy in the second half of this year, and projections of economic growth in the most important trading partners for the coming year that are lower than in the previous projections, the assumption regarding growth in foreign demand in 2012 has been revised down by nearly one third. This assumption is particularly subject to risk since, at the time projections were prepared, the majority of international institutions had not yet published projections that reflected economic growth in the second quarter, which was lower than expected.

Figure 7.1: Projections of economic activity for 2011



Sources: Consensus Economics, European Commission

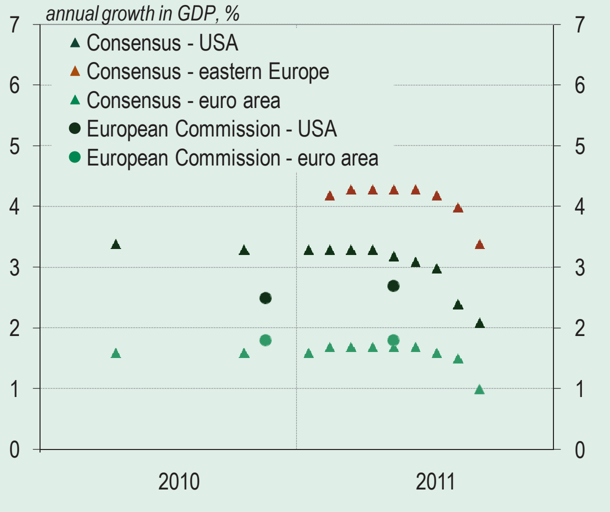
The assumption regarding growth in commodity prices is somewhat lower compared to earlier projections, while assumptions regarding US dollar oil prices are slightly higher. High growth in crude oil and commodity prices continued at the beginning of the year, under the influence of favourable data on global economic growth and due to the political crisis in the Middle East and North Africa, while commodity and oil prices fell in the second and third quarters due to the low economic growth in developed economies. Taking into account the forecasts of market participants, oil prices are expected to average around USD 110 USD per barrel, close to this year's average until September, while commodity prices are expected to rise by more than 20% this year. Owing

Table 7.1: Assumptions regarding factors from the international environment

						Assumptions					
						2011		2012		2013	
	2006	2007	2008	2009	2010	**Oct.**	**Δ**	**Oct.**	**Δ**	**Oct.**	**Δ**
	annual growth, %, unless stated										
Foreign demand*	11.6	11.3	5.9	-14.2	11.3	**7.0**	0.2	**4.5**	-1.8	**6.0**	0.0
Oil (USD/barrel)	65	73	98	62	80	**110**	0	**107**	-1	**104**	-4
Non-oil commodities	29.1	17.4	10.1	-23.0	37.1	**21.0**	-6.5	**-2.0**	-3.0	**5.0**	0.0
EMU inflation	2.2	2.1	3.3	0.3	1.6	**2.6**	0.3	**1.9**	0.2	**1.8**	0.0
PPI Germany	5.4	1.3	5.4	-4.0	1.5	**5.1**	2.3	**2.3**	0.1	**1.8**	0.0

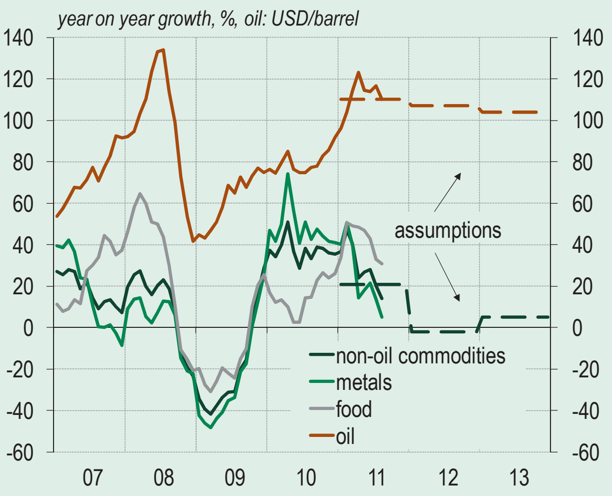
*** Volume of imports from the basket of foreign partners*
Δ: Difference between current projections and projections in April 2011 Price Stability Report
Sources: Bank of Slovenia, Eurostat, Consensus Economics, ECB, JP Morgan, OECD Outlook

Figure 7.2: Projections of economic activity for 2012



Sources: Consensus Economics, European Commission

Figure 7.3: Commodity prices



Sources: ECB, Bloomberg, Bank of Slovenia assumptions

to a slowing global economy in 2012 and a higher basis from this year, commodity prices are expected to fall slightly in 2012, while the price of Brent crude is also expected to be down slightly.

According to international institutions, inflation in the euro area and US is expected to be somewhat higher this year due to high growth in energy prices, but is expected to ease next year. Slightly higher growth in energy prices has resulted in an upward revision to the assumption for this year's inflation in the euro area and US, and to assumed growth in producer prices in Germany. Inflation of 2.6% and 3.0% is projected for this year in the euro area and US respectively, while producer prices in Germany are expected to rise by more than 5%. As a result of slowing growth in energy prices and somewhat lower expectations of global economic growth in 2012, inflation is also expected to ease next year, while growth in producer prices in Germany will gradually approach the long-term average.

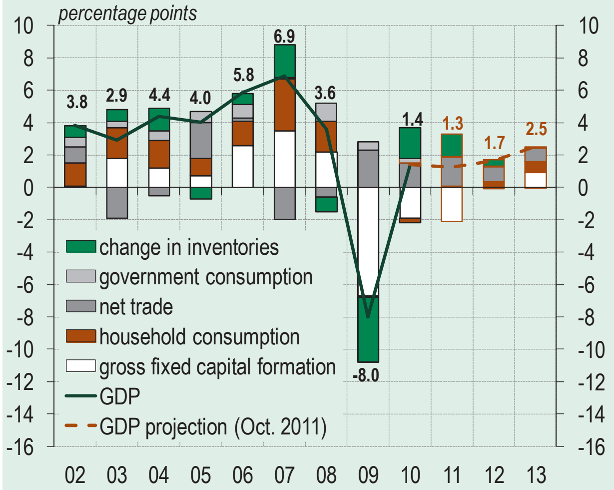
Domestic demand

Household consumption will remain low until the end of the projection horizon in the context of a continued fall in employment and the real wage bill. The recent stagnation in final household consumption reflects low consumer purchasing power, which is dictated by a continuing fall in employment and a decline in the real gross wage bill. Household consumption is also strongly characterised by uncertainty regarding current and future developments on the labour market. Relatively pessimistic expectations regarding developments in real disposable incomes do not indicate any possibility of a substantial increase in household consumption, which is expected to rise only gradually, at an average of around 0.7% annually over the projection horizon.

Despite the already exceptionally low level of investment, its growth will be limited by several factors, the most noteworthy being high corporate indebtedness, the refinancing of maturing bank debt in 2012, subdued growth in demand from the rest of the world and the implementation of fiscal consolidation. Investment is expected to decline significantly this year, and begin a gradual recovery next year. Expected additional deleveraging of corporates will limit the ability of companies to finance investment, particularly in an environment in which banks may limit loan approvals because of the need to achieve the necessary level of capital adequacy. A halt in the increase in production capacity utilisation will, together with expected subdued demand from the rest of the world, contribute to a merely slow increase in investment in machinery and equipment. Given the sharp drop in investment in construction since the outbreak of the crisis, construction investment can be expected to once again contribute positively to aggregate investment in the coming years. In the context of difficult conditions on the financial markets, the level of public debt does not facilitate an increase in domestic spending with the help of fiscal measures. There is a notable increase in expenditure on the road and railway infrastructure in the government's Development Programmes Plan for the period 2010 to 2013. However, the implementation of such investment is uncertain due to public finance limitations. Major investment in the production of electricity is becoming increasingly likely.

The contribution of net exports to economic growth will be high this year, and then gradually diminish. Despite the projected lower growth in foreign demand in the second half of the year, the contribution of foreign trade to GDP growth will be higher this year than last year, and one half higher than forecast in previous projections, because of persistently low domestic demand. The contribution of foreign trade to GDP growth over the next two years is expected to halve to slightly less than one percentage point. This means that it is expected to remain at a level similar to the previous projections. This is a result of the simultaneous decline in projected demand from the rest of the world and still low domestic

Figure 7.4: Projection of contributions to GDP growth by expenditure components



Sources: SORS, Bank of Slovenia projections

demand. For this reason growth in both imports and exports is expected to slow in 2012.

Government spending will be subject to the necessary fiscal consolidation and will remain low. Thus, government spending will not contribute significantly to aggregate demand. Growth in real government spending is expected to be less than 1% over the entire projection horizon, a downward revision of approximately 1.5 percentage points compared to previous projections. Average annual growth in real government spending of just over 0.2% is likewise significantly below the long-term average. Increased government saving is based on the continuation of a restrictive policy of employment, which

Table 7.2: Components of domestic demand

						Projections					
						2011		2012		2013	
	2006	2007	2008	2009	2010	**Oct.**	Δ	**Oct.**	Δ	**Oct.**	Δ
	real growth rates, %										
Domestic demand	5.6	8.9	4.1	-10.0	-0.1	**-0.6**	-1.2	**0.8**	-1.1	**1.8**	-0.8
Private consumption	2.8	6.1	3.7	-0.2	-0.7	**0.1**	-0.7	**0.6**	-1.1	**1.2**	-0.8
Government spending	4.0	0.6	6.1	2.9	1.5	**0.2**	0.6	**0.2**	-0.9	**0.4**	-1.2
Gross fixed capital formation	10.4	13.3	7.8	-23.3	-8.3	**-9.3**	-8.3	**-0.4**	-3.4	**4.6**	-0.4

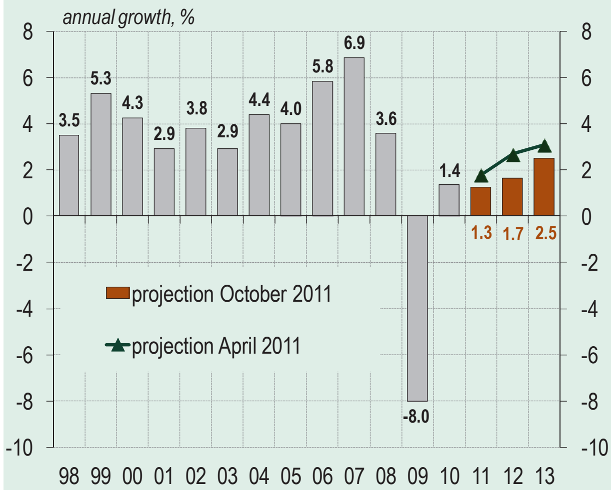
Δ: Difference between current projections and projections in April 2011 Price Stability Report
Sources: SORS, Bank of Slovenia

is expected to grow by around 0.2% this year and then decline by 0.5% each subsequent year, and on savings in material costs. The nominal average wage in the government sector is expected to increase by around 0.3% this year, and by just over 2% over the next two years owing to currently valid agreements on public sector wage adjustments.

GDP growth and developments on the labour market

GDP growth this year is projected at just below 1.5%, and is expected to gradually approach 2.5% by 2013. The recovery in economic activity is considerably slower compared to the April projections. After stalling in the first half of the year, the projection for this year's economic growth assumes slightly higher quarterly growth in the second half of the year. Downward revisions to projections of economic growth relative to the previous projections are most notable for 2012 (downward revision of one percentage point). Lower GDP growth in that year will be affected by both slower growth in foreign demand and persistently low domestic spending. Growth in the Slovenian economy is expected to be export-driven over the entire projection horizon. Domestic spending will not contribute significantly to GDP growth until the end of the projection horizon, primarily as a result of stalled investment and thus construction. Average GDP growth in the period 2011 to 2013 is projected to be lower by around 0.7 percentage points annually. This year's economic growth in Slovenia will be approximately half a percentage point lower than average euro area growth. Growth in Slovenia is expected to exceed that of the euro area by the end of the projection horizon, but significantly less than in the years prior to the crisis.

Figure 7.5: GDP growth projection



Sources: SORS, Bank of Slovenia projections

Table 7.3: Activity, employment and wages

	2006	2007	2008	2009	2010	Projections 2011 Oct.	2011 Δ	2012 Oct.	2012 Δ	2013 Oct.	2013 Δ
	growth rates, %										
GDP (real)	5.8	6.9	3.6	-8.0	1.4	**1.3**	-0.5	**1.7**	-1.0	**2.5**	-0.6
Employment	1.5	3.3	2.6	-1.8	-2.5	**-1.7**	-0.3	**-0.6**	-0.6	**0.1**	-0.4
Compensation per employee	5.4	6.2	7.2	1.8	4.3	**2.4**	-1.4	**2.6**	-1.4	**2.8**	-1.4
Productivity	4.2	3.4	1.0	-6.3	4.0	**3.1**	-0.1	**2.3**	-0.4	**2.7**	0.0
ULC (nominal)	1.0	2.7	6.2	8.7	0.4	**-0.6**	-1.2	**0.4**	-0.8	**0.3**	-1.2
Contribution to GDP growth	*percentage points*										
Domestic demand, excluding changes in inventories	5.0	6.9	5.1	-6.3	-2.0	**-2.0**	-2.2	**0.3**	-1.6	**1.7**	-0.8
Net exports	0.2	-2.0	-0.6	2.3	1.5	**1.8**	0.6	**0.9**	0.1	**0.8**	0.2
Changes in inventories	0.7	2.0	-0.9	-4.0	1.9	**1.4**	1.0	**0.4**	0.4	**0.0**	0.0

Δ: Difference between current projections and projections in April 2011 Price Stability Report
Sources: SORS, Bank of Slovenia

Export-oriented sectors will continue to be the main factors in value-added growth in the short term. The contribution of value-added in the manufacturing activities, most dependent on exports, will be slightly lower in the next two years than this year. Export-oriented services, in particular the transport sector, will continue to contribute to growth in value-added over the projection horizon, while the contribution of the construction sector will remain negative, at least this year and next year. The negative contribution of the construction sector is primarily the result of a sharp drop in value-added this year, while the contribution of construction is expected to become positive over the next two years.

Due to slow economic growth and the continuing adjustment of the labour market to changes in the structure of the economy, employment growth will also be very slow. Employment growth was revised downwards in all years included in the projections, most notably in 2012, similar to economic activity. The cumulative downward revision to employment growth over the three years included in the projections is more than one percentage points relative to the April projections. Employment is expected to fall by more than 2% by 2013. Employment growth in the manufacturing sector will be lower in line with lower growth in foreign demand and slower growth in value-added, while the decline in employment in the construction sector has probably not ended yet. Employment in the private sector will thus continue to contract. As a result of slow economic growth, changes in the structure of the economy and the unadjusted supply of labour, rapid employment growth is not expected, while unemployment is expected to remain at a relatively high level over the longer term. The current surveyed unemployment rate of 8.4% is expected to rise further and reach its peak in the middle of 2012. The rate is expected to fluctuate between 8.5% and 9% over the projection horizon. A slow decline in unemployment, not expected until 2013, reflects the increase in structural unemployment during the recent crisis.

Low wage growth in the private sector will primarily be a reflection of the slow economic recovery, and partly of changes in the structure of the workforce. Although private sector wage growth is expected to outstrip public sector wage growth over the entire projection horizon, it will remain low and facilitate the cost adjustment of the economy. Corporates are adapting to the adverse economic conditions not only by reducing the number of employees, but also via lower growth in average wages. A gradual economic recovery will facilitate faster wage growth. This, however, will be to a certain extent dampened by the statistical effect of the reemployment of workers, who lost their jobs during the crisis, at lower wages. Nevertheless, the effect of probably relatively heterogeneous new employments in the future will not be as large as the effect of the heterogeneous structure of layoffs during the crisis. Annual wage growth in the private sector is expected to be between 2.5% and 3% over the entire projection horizon.

Last year's agreement between the government and certain public sector unions restricted wage growth in the public sector, but only temporarily, as it is again primarily a case of deferring wage reforms. The agreement restricts wage growth in the public sector under the baseline scenario, primarily in 2011 and 2012. It involves partial wage indexation, limits on wage increases for certain public sector professions, an unchanged annual leave allowance, the non-payment of performance-related bonuses and restrictions on promotions. Wage increases as part of the elimination of wage discrepancies are currently scheduled for the first two years following the year in which GDP growth exceeds 2.5%. Given that GDP growth will not exceed 2.5% during the projection horizon under the baseline scenario, further implementation of wage reforms is not expected until after 2013. Growth in average public sector wages is forecast at 0.3% in 2011, 1.5% in 2012 and 2.9% in 2013.

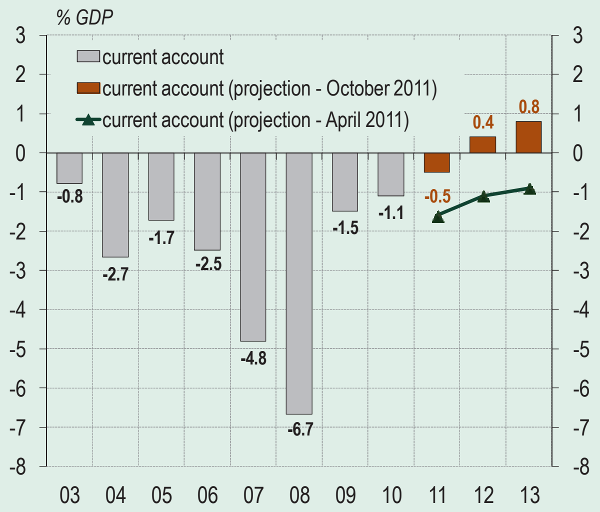
Foreign trade

The current account deficit is expected to become a surplus of around 1% of GDP by the end of the projection horizon. The current account deficit is expected to narrow from 0.8% of GDP in 2010 to 0.5% of GDP this year, before becoming a surplus of 1% of GDP in 2013.

The merchandise trade deficit is expected to narrow rapidly this year and in future years. It is expected to reach around 4% of GDP in 2011, and narrow to just over 2% of GDP by the end of the projection horizon. Growth in exports in volume terms will outpace growth in imports of merchandise and services, primarily as a result of weak domestic demand. The gap between growth in imports and exports is expected to gradually narrow. Higher growth in real exports than imports by 2.5 percentage points this year will be more than compensated by the estimated deterioration in the terms of trade of 1.5%. Improved terms of trade are also expected to contribute to the current account surplus over the next two years.

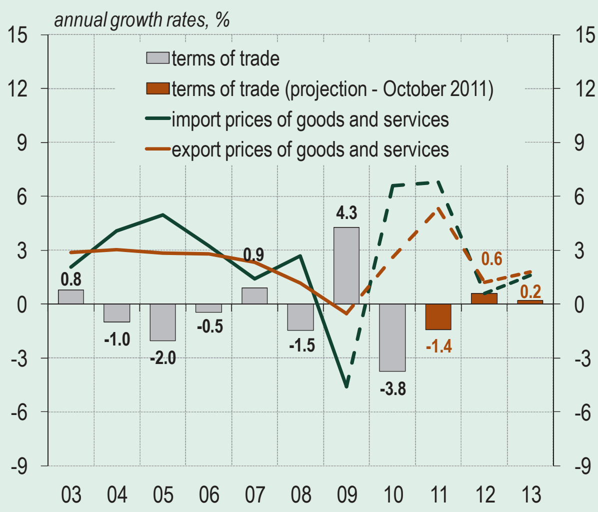
The surplus in services is expected to remain unchanged at around 5% of GDP. Growth in transport services and business and technical services is expected to be similar to that of merchandise exports and imports. Due to the expected further decline in domestic construction activity, expenditure on domestic investment works is

Figure 7.6: Current account projection



Sources: SORS, Bank of Slovenia projections

Figure 7.7: Terms of trade projection



Sources: SORS, Bank of Slovenia projections

Table 7.4: Current account

						Projections					
						2011		2012		2013	
	2006	2007	2008	2009	2010	**Oct.**	Δ	**Oct.**	Δ	**Oct.**	Δ
	growth rates, % (if not specified otherwise)										
Exports of goods and services	12.5	13.7	2.9	-17.2	9.5	**7.6**	0.4	**4.9**	-1.8	**6.5**	-0.1
Imports of goods and services	12.2	16.7	3.7	-19.6	7.2	**5.1**	-0.4	**3.8**	-1.8	**5.7**	-0.3
Current account: EUR billion	-0.8	-1.6	-2.6	-0.5	-0.3	**-0.2**	0.4	**0.1**	0.5	**0.3**	0.7
as % GDP	-2.5	-4.8	-6.9	-1.3	-0.8	**-0.5**	1.1	**0.4**	1.5	**0.8**	1.7
Terms of trade*	-0.5	0.9	-1.5	4.3	-3.8	**-1.4**	1.0	**0.6**	0.4	**0.2**	0.2

** Based on national accounts deflators*
Δ: Difference between current projections and projections in April 2011 Price Stability Report
Sources: SORS, Bank of Slovenia

expected to decline at a faster pace than revenues from works in the rest of the world. The result would be a slight increase in net revenues from construction services in the coming years. In addition to a gradual increase in revenues, growth in net tourism revenues is expected to be driven by declining expenditure on travel abroad, which was down nearly one tenth over the first seven months of 2011 owing to the deteriorating domestic situation.

The deficit in factor income is expected to widen over the projection horizon as a result of the expansion of the deficit in capital income. The surplus of transfers is expected to widen this year, and remain unchanged at around 0.7% of GDP. The deficit in factor income is expected to reach nearly 2% of GDP this year, and gradually widen over the next two years to 2.5% of GDP by the end of the projection. In the context of expected stable interest rates after 2011, the current relatively high level of gross external debt could result in a slight increase in net interest payments to the rest of the world. The recovery in economic activity should also bring an increase in non-residents' FDI in Slovenia, resulting in a gradual increase in expenditure on dividends and distributed earnings. Another factor in the future widening of the deficit in factor income will be net income from investments in debt securities. Falling employment of foreign workers means that the net inflow of labour income this year and in the next two years is projected at around 0.4% of GDP. Similar to last year, the surplus related to the disbursement of EU budget funds is expected to be the main factor in maintaining the surplus in transfers over the projection horizon. The surplus in transfers is expected to widen to 0.7% in 2011, and remain close to this level in the coming years.

Inflation

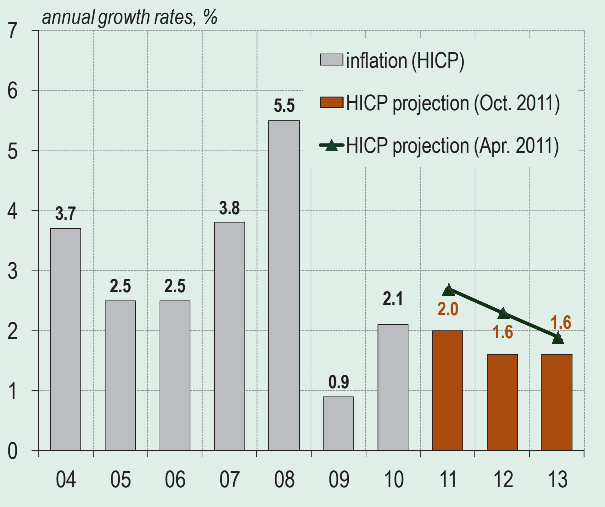
Inflation is expected to stand at 2% this year. Despite the gradual rise in core inflation, headline inflation is expected to average around 1.6% over the next two years in the context of easing energy and food prices on the global market. Year-on-year inflation is expected to rise to more than 2% in the third quarter as a result of one-off effects, and then gradually fall until the end of the projection horizon. The current projection of inflation for this year is lower than the April projections owing to the slower growth in domestic energy prices and on account of the slower growth in core inflation. Also contributing to the downward revision of the inflation forecast is a less pronounced pass-through of rises in food prices on the global markets to final domestic prices. The adverse

Table 7.5: Inflation

						Projections					
						2011		2012		2013	
	2006	2007	2008	2009	2010	**Oct**	Δ	**Oct**	Δ	**Oct**	Δ
						average annual growth, %					
Consumer prices (HICP)	2.5	3.8	5.5	0.9	2.1	**2.0**	-0.7	**1.6**	-0.7	**1.6**	-0.3
food	2.7	7.1	8.1	1.8	2.5	**4.6**	-1.2	**2.5**	-1.8	**2.3**	0.3
energy	8.5	3.4	9.4	-4.5	13.9	**8.3**	-1.3	**2.2**	-0.8	**0.4**	-0.8
other goods	-0.9	0.3	2.2	0.0	-2.2	**-1.1**	-0.5	**0.1**	-0.4	**0.8**	-0.5
services	3.5	4.9	5.3	3.2	1.2	**0.0**	-0.2	**1.8**	-0.2	**1.9**	-0.4
Core inflation indicators (HICP)											
excluding energy	1.7	3.8	4.9	1.7	0.3	**0.9**	-0.6	**1.5**	-0.7	**1.7**	-0.3
excl. energy and unprocessed food	1.5	3.4	5.0	1.9	0.2	**0.6**	-0.4	**1.6**	-0.4	**1.6**	-0.4
excl. energy, food, alcohol and tobacco	1.3	2.7	3.8	1.7	-0.4	**-0.4**	-0.3	**1.1**	-0.3	**1.5**	-0.4

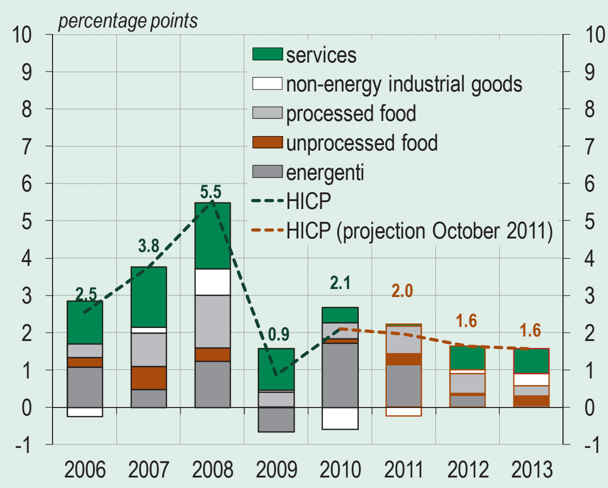
Δ: Difference between current projections and projections in April 2011 Price Stability Report
Sources: SORS, Bank of Slovenia

Figure 7.8: Inflation projections



Sources: SORS, Bank of Slovenia projections

Figure 7.9: Projection of contributions to inflation by components



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

situation on the labour market continues to result in low household consumption, curbing core inflation. Average growth in the HICP excluding energy, food, alcohol and tobacco is expected to be negative this year. This indicator of core inflation is projected to rise to 1.1% in 2012, in line with a very gradual recovery in domestic demand, and to 1.5% in 2013.

In the structure of inflation, the contributions made by energy and food prices are expected to be prominent this year, while the contribution of services prices is expected to increase in the coming years. Growth in energy prices is projected at 8.3% this year, in line with assumptions regarding oil prices and the US dollar exchange rate, and previous adjustments to excise duties. The Slovenian government has mitigated the pass-through of higher oil prices on the global markets by reducing excise duties on motor fuels. Growth is expected to decline to 2.2% in 2012 and 0.4% in 2013, in the context of an assumed easing of energy prices. Domestic energy prices are expected to rise during the aforementioned years, despite the projected stabilisation of oil prices, primarily as a result of an expected rise in electricity prices and rising prices of district heating and natural gas, on which higher oil prices have a delayed impact. Domestic food prices will be affected over the projection horizon primarily by the expected rise in food prices on the global market and changes in excise duties on tobacco. Average growth in food prices is projected at 4.6% this year, falling to 2.3% by the end of the projection horizon. Growth in services prices will rise to around 2% by the end of this year, due to last year's one-off effects of subsidies for school meals, and is expected to remain at this level until the end of the projection horizon.

The rise in core inflation will be a result of certain one-off effects, but will remain low due to the adverse macroeconomic situation. Most of the rise in core inflation will be the result of higher growth in services prices due to the one-off effect of the lower basis from last year. The decline in prices of non-energy industrial goods will come to a halt in the middle of the 2012, with these prices expected to begin rising in the second half of the year. Average growth in the prices of non-energy industrial goods is expected to be very low in 2012, and around 1% in 2013. Growth in final consumer prices is limited by low growth in total household income, which in addition to the uncertain conditions on the labour market, limits final household consumption. Nominal unit labour costs are not expected to change over the projection horizon. Cost pressures on prices will therefore be relatively low.

The aggregate direct impact of announced government measures on inflation is expected to be relatively small over the projection horizon. The contribution of administered prices is expected to be 0.1 percentage points this year, rising to 0.2 percentage points in 2012, and falling again to 0.1 percentage points in 2013. Prices of railway tickets rose by 6.0% this March, while tobacco prices rose by 3.9% in April. The aggregate contribution to this year's inflation will be around 0.1 percentage points. In line with the European Directive on the increase of excise duties on tobacco products, tobacco prices will rise again this year and twice in 2012, contributing an additional 0.1 percentage points to inflation in both years. The TV subscription fee will be raised again by 6.25% in January 2012, followed in February by another temporary increase in year-on-year growth in administered prices due to February 2011 one-off reduction in the aforementioned subscription. The government exerts significant influence over motor fuel prices by adjusting excise duties. The estimated effect of previous changes on inflation is -0.4 percentage points in 2011 and -0.1 percentage points in 2012.

The available monetary indicators, and indicators of relative prices and costs and inflationary expectations show that no significant price pressures are expected in the medium term. Year-on-year growth in loans to households is declining, and stood at around 8% in the first half of this year, primarily due to the relatively high growth in housing loans, while consumer loans have been declining. Loans will not lead to any major changes in domestic demand over the projection horizon. Likewise, no price pressures in terms of the cost competitiveness or price competitiveness of the Slovenian economy are expected over the projection horizon. The level of unit labour costs and the level of the real effective exchange rate still indicate a deterioration in price and cost competitiveness in recent years relative to the majority of main euro area trading partners. Such conditions limit growth in prices in the medium term. In September, Consensus forecast average annual inflation of between 2.0% and 2.2%for the period 2012 to 2016, while the IMF forecast stands between 2.1% and 2.3%.

Risks and uncertainties

The main external risk factor remains the possibility of lower growth in foreign demand and economic activity, primarily due to uncertainty regarding the sustainability of public finances in certain countries. This uncertainty has risen relative to the risks highlighted in the previous projections. In addition to high spreads on the debt securities of periphery countries, the possible pass-through of uncertainty to other euro area countries and disagreement over the resolution of the debt crisis also constitute increased risk. This could reduce corporate and consumer confidence, and accelerate the implementation of fiscal consolidation measures. This would restrict domestic demand in the euro area and thus demand for Slovenian products, and have an adverse impact on employment. Increased uncertainty regarding the sustainability of public finances in certain developed economies outside the euro area also represents risk. An additional risk factor is the cooling of activity in emerging economies due to possible weaker growth in demand. Higher commodity prices on the global markets could impact private spending in Slovenia and the rest of the

Table 7.6: Comparison of inflation forecasts for Slovenia for 2012-2016

%	2012	2013	2014	2015	2016
Consensus Economics (March 2011)	2.5	2.5	2.3	2.2	2.0
IMF (April 2011)	3.1	2.3	2.3	2.4	2.4
Consensus Economics (September 2011)	2.1	2.2	2.1	2.2	2.0
IMF (September 2011)	2.1	2.3	2.2	2.2	2.1

Sources: IMF WEO database, Consensus Economics

Table 7.7: Comparison of forecasts for Slovenia and change from the previous forecasts

	Publication of new/previous forecast	GDP annual growth, %				Inflation annual average, %				Current account as % GDP			
		2011		2012		2011		2012		2011		2012	
		new	Δ	new	Δ	new	Δ	new	Δ	new	Δ	new	Δ
Bank of Slovenia	Oct 11/Apr 11	**1.3**	-0.5	**1.7**	-1.0	**2.0**	-0.7	**1.6**	-0.7	**-0.5**	1.1	**0.4**	1.5
EIPF	Sep 11/Mar 11	**1.8**	-0.9	**2.0**	-0.9	**1.8**	-1.1	**1.2**	-1,1	**-0.4**	1.3	**0.5**	1.6
IMAD	Sep 11/Mar 11	**1.5**	-0.7	**2.0**	-0.5	**1.6**	-0.6	**1.8**	-1.2	**-1.0**	1.3	**-0.5**	1.9
IMF	Sep 11/Mar 11	**1.9**	-0.1	**2.0**	-0.4	**1.8**	-0.4	**2.1**	-1.0	**-1.7**	0.3	**-2.1**	0.0
Consensus Forecasts	Sep 11/Mar 11	**1.7**	-0.4	**1.9**	-0.6	**1.9**	-0.7	**2.1**	-0.4	**-1.0**	0.4	**-1.3**	-0.2
European Commission	May 11/Nov 10	**1.9**	0.0	**2.5**	-0.1	**2.6**	0.6	**2.1**	-0.1	**-1.4**	-0.8	**-1.9**	-1.1
OECD	May 11/Nov 10	**1.8**	-0.2	**2.6**	-0.1	**2.5**	0.6	**2.2**	0.0	**-1.3**	2.6	**-1.4**	3.2

Δ: Difference between current and previous forecasts
Sources: Bank of Slovenia, EIPF, UMAR, IMF, European Commission, Consensus Economics, OECD, Bank of Slovenia calculations

world via a contraction in disposal income, and could have an impact on the level of investment via higher input costs and lower profits.

Uncertainty regarding the implementation of emergency measures in the areas of public finance and structural reforms has become more pronounced among domestic risks. The risks of rising spreads on government bonds and the associated higher costs of financing the government have thus partly materialised. At the same time, delaying structural reforms could also lead to further deteriorations in ability to achieve medium- and long-term public finance sustainability and the outlook for potential economic growth. The rejection of pension reforms at June's referendum and the current political crisis have already been reflected in a deteriorating foreign perception regarding the stability of the economic situation in Slovenia. Such risk relates primarily to the perception regarding the ability of the political body to carry out the necessary structural changes and the consolidation of public finances in a timely manner. The rejection of pension reforms and the opposition of certain interest groups are also increasing uncertainty regarding the implementation of other reforms, such as those relating to the healthcare system, social security and labour market legislation. Any additional sovereign debt downgrading could be reflected in rising financing costs for the government and private sector.

Financing risks are associated with the ability of corporate sector, faced with relatively high leverage, to raise capital. Risks are also associated with banks' opportunities to secure long-term sources of funding. The costs of funding banks and financing corporates could increase mainly as a result of rising spreads on borrowing in the rest of the world by residents. Rating agencies have downgraded certain Slovenian banks, while in September Moody's and Fitch downgraded Slovenian sovereign bonds, putting them on negative watch. Rising financing costs would be an additional burden for relatively highly indebted corporates, and reduce their ability to borrow. It could also limit access to sources of financing in the rest of the world. The crisis in the construction sector, which is reflected in illiquidity and payment indiscipline, deteriorates the quality of banks' balance sheets. Commercial banks are therefore forced to look for new, less risky business opportunities, in addition to ensuring an appropriate level of capital. Banks sought to achieve this in the past by focusing on loans to households. Despite demand for their products, banks are generally not willing to lend to corporates whose transaction accounts have been garnished or who settle their obligations in arrears or have unpaid financial liabilities from past operations (e.g. delays in the repayment of loans, unpaid contributions from wages, unpaid wages, etc.). A systematic basis and effective mechanisms for precursory commercial and financial rehabilitation must be established so that banks can finance the operations of corporates in distress. This would facilitate at least the partial continuation of operations and thus the repayment of at least part of the debt on the basis of operations, and not merely on the sale of assets, in the context of the appropriate sanctions against owners and rights for creditors and/or new owners.

Projections of gross investment remain particularly risky owing to the uncertainty in the international environment, the deteriorating public finance position and risks regarding financing. Because the expected easing of the decline in gross investment is based primarily on the assumption of a reversal of the decline in construction investment, the opposite could lead to the further deepening of the crisis in the construction sector. A halt in global economic growth could delay an expansion in production capacity via investment in machinery and equipment in export-oriented sectors. Rising financing costs could also contribute to the aforementioned. Possible slower growth in investment in machinery and equipment could hinder growth in productivity in the private sector. Slower growth in aggregate investment than projected in the baseline scenario could also be further limited by government investment in the scope of fiscal consolidation.

The deteriorating situation on the labour market and the risk of a sustained rise in unemployment indicate the need for an appropriate adjustment of labour costs to ensure the competitiveness of the economy. Unemployment could rise further if the crisis in the construction sector and certain other less-competitive sectors deepens. A further increase in structural unemployment would be particularly problematic. Long-term unemployment brings negative social consequences and the loss of human capital, while eliminating it is usually a slow process. The cost adjustment of the economy continues to lag behind that of the main euro area trading partners, as the level of unit labour costs remains higher than in the pre-crisis period. Insufficient cost adjustments relative to productivity could contribute to a more sustained increase in unemployment. The social partners have not yet reached a general agreement on future wage policy. The adverse trends on the labour market could hinder or delay the expected recovery in household consumption.

Inflationary risks are balanced. Higher inflation than projected in the baseline scenario could primarily result from higher commodity prices, and possible increases in indirect taxes and administered prices in the scope of fiscal consolidation. On the other hand, lower inflation could be primarily a result of slower economic growth, which would delay the revival of the labour market. This would further reduce the possibility of passing higher input costs through to final consumer prices.