BANK OF SLOVENIA

MONETARY POLICY REPORT

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Slovenska 35
1505 Ljubljana
Tel: +386 1 4719000
Fax: +386 1 2515516

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1 EXECUTIVE SUMMARY

The Bank of Slovenia and the Slovenian government are successfully implementing the Programme for ERM II Entry and Adoption of the Euro. After Slovenia had been in the ERM II for two years, the European Council established on the basis of the convergence reports by the ECB and European Commission that Slovenia has met the conditions for adopting the euro. The two reports state that Slovenia has sustainably met the Maastricht criteria for price stability, interest rates, the general government deficit and debt, and exchange rate stability. The reports' evaluation is that the framework for monetary policy framework made a significant contribution to stepping up the disinflation process after 2000 and to meeting the criterion. Based on the reports, the European Commission proposed to the European Council that the ERM II central exchange rate of 239.64 tolars to the euro be set as the conversion rate. The unanimous approval of the conversion rate is confirmation that the decision taken then was right, as was the assessment that the exchange rate is in line with the maintenance of internal and external balances. It will thus be possible to adopt the euro on 1 January 2007.

Economic trends in the international environment in the first half of the year were mostly very favourable, although prices of raw materials are high. Economic growth was higher than had been forecast in the eurozone, where it should exceed 2% this year. Economic activity is also high in the new EU member-states, Russia, the former Yugoslav republics, China and Japan, but is slowing in the US. The good economic climate and certain geopolitical frictions were factors in the continuing growth in prices of oil and other commodities. Although there are no signs of these causing a slowdown in economic activity, upward pressures on prices were more in evidence up until September, when oil prices fell sharply. Inflation is around 4% in the US, and is ranging between 2% and 2.5% in the eurozone. Producer prices are still recording even higher growth. Central banks are responding to inflation and to economic activity by gradually tightening monetary policy.

Domestic economic trends are favourable, and are displaying a large degree of cyclical coordination with the eurozone. High growth in the first half of 2006 meant that economic growth forecasts for this year were revised upwards to 4.5%, but they remain unchanged at around 4% for the next two years. Projections indicate that growth in household spending will remain approximately 1 percentage point behind economic growth, primarily because of moderate wage growth, even allowing for the one-off effects of the tax reform in 2007. Investment spending will grow faster than economic growth, and is being additionally encouraged by the decline in inventories and increasing investment in housing and transport infrastructure. The moderate growth in labour costs and the favourable economic climate are enabling significant growth in employment, of approximately 2% in cumulative terms over the projection, with the public sector being assumed to account for approximately one-third of the projected increase.

The slight deterioration in the projected current account position to a deficit of between 2.5% and 3% of GDP primarily reflects methodological changes that weakened the current account by just under 1 GDP percentage point. Other factors in the forecast for a deterioration in the current account were the major upward revision of the pace of imports versus exports, and the deterioration in the investment income position, which occurred because of faster rises in interest rates. However, the terms of trade deteriorated less than had been previously forecast, the price effects of which brought an improvement in the balance.

The forecast economic trends remain in line with the maintenance of price stability. Inflation forecasts range from 2.5% to 3%, having been revised slightly upwards for the period of the forecast. This year's upward revision can be attributed to the high prices of refined petroleum products in the second quarter, the effect of which is expected to weaken in the future. Looking more to the medium term, growth in non-administered prices should gradually increase from its low recent level to close to 3%. The principal reason for this is the positive output gap, where growth in aggregate demand has partly outstripped growth in potential output. This is not expected to bring any major inflationary pressures, provided that labour costs, the main cost factor in price formation, grow moderately as forecast.

The short-term risks to inflation that were examined in the previous forecasts have receded slightly. Market expectations point to a lower probability of major rises in oil prices. The administered prices policy is being implemented adequately, while the government's intentions point to little likelihood of any need to raise VAT. Estimates show that a 1 percentage point rise in the reduced and basic VAT rates could have a direct inflationary impact of 0.7 percentage points, or even more if there is feed-through into wage dynamics. Should any of the other risks come to pass, there could be a significant rise in inflation at the very time of the adoption of the euro. Were inflation to get out of control, inflationary pressures could begin to build themselves into the growth in labour costs, causing inflation to remain at a higher level. Such a rise in inflation would harm the price competitiveness of the economy, and would lower the price stability credibility of macroeconomic policies, which is the key to successfully anchoring inflationary pressures at a low level.

The medium-term risk of a significant inflationary cycle of the overheating of the economy is limited. This forecast takes account of the SORS's estimate that the current rate of GDP growth in the first two quarters was sharply above the long-term trend and the previous forecasts. Because this increase can to a great extent be attributed to certain one-off factors, there is no expectation that growth in aggregate demand will outstrip growth in potential output over the long term, thus causing the economy to overheat. The chance of overheating is being additionally limited by the moderate growth in household income, a more-rapid-than-expected tightening of monetary policy in the eurozone, and the strengthening of the supply side of the economy via increased investment and employment.

Recently the Bank of Slovenia has maintained its interest rates slightly above those of the ECB. In so doing it aimed to prevent monetary policy acting as a stimulus during a period of relatively high growth in aggregate demand. This also allowed for close convergence between domestic interest rates and interest rates in the eurozone. Given the gradual increase in the ECB's interest rates, this also prevented unnecessary fluctuation in interest rates that could have had an adverse impact on the stability of the financial system. The projected convergence in interest rates will thus be at a level that suits the domestic economic cycle.

2 ECONOMIC TRENDS AND INFLATION

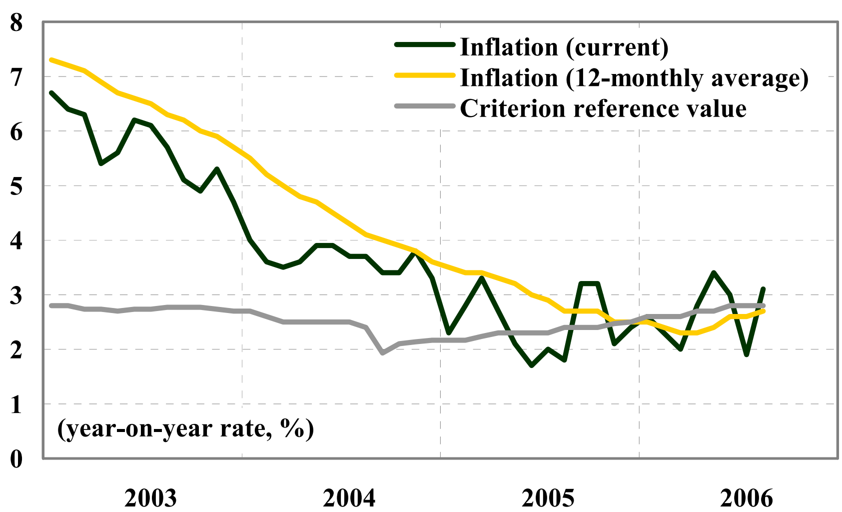
2.1 Macroeconomic Trends

Price trends have remained favourable in 2006, HICP inflation having fluctuated around 2.5% since the middle of 2005, it averaged 2.6% over the last nine months. This indicates that in the gradual disinflation process begun in 2001 price stability has been achieved in sustainable manner, and that in the future inflation will be able to remain at the long-term equilibrium level now reached.

The sustainable level of inflation this year is again the result of the right mix of economic policies in the context of relatively favourable conditions in the domestic environment, and partly adverse trends in the international economic environment. Despite the gradual nominal convergence in interest rates, monetary policy continues to ensure that interest rates are at a level consistent with the achievement of exchange rate stability, while preventing excessive final consumption. Fiscal policy also succeeded in favourable economic conditions in reducing the general government deficit, and thus did not promote aggregate demand, while its pitch meant that there was no need for any measures that would raise costs to the economy. This was particularly evident in light of the moderate inflation in administered prices excluding energy prices. Despite slightly improved conditions on the labour market, labour costs grew relatively slowly, allowing competitiveness to be maintained under the conditions of a stable exchange rate.

Price factors in the international environment, in particular oil prices and other commodity prices, had an adverse impact on movements in inflation this year, while a variety of domestic microeconomic factors acted in a less disinflationary manner than last year. The forecasts are that the latter merely represent the end of the period of extremely low growth in the prices of certain products seen in recent years, which occurred because of the adjustment in relative prices inside the EU following enlargement in 2004 and the increased competition from China.

Figure 2.1: Achievement of price stability



Sources: SORS, Eurostat, ARC calculation.

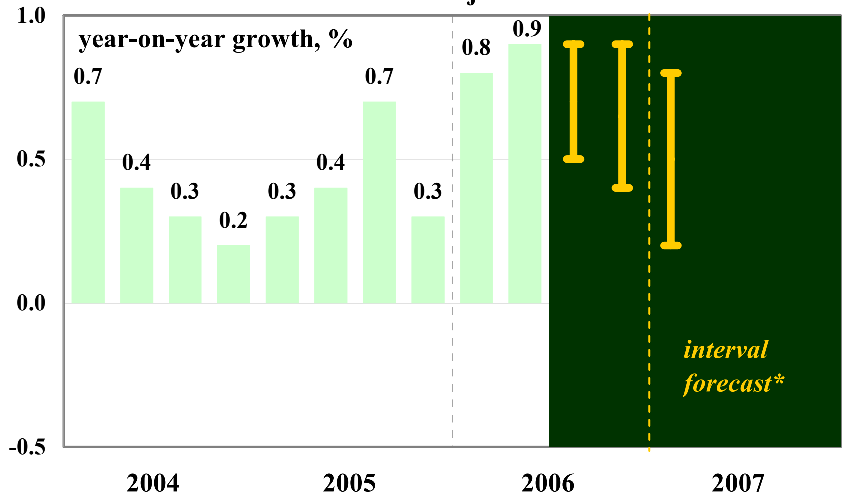
International environment

The current rate of economic growth in eurozone accelerated in the first and second quarters of 2006, reaching 0.8% and 0.9% according to the initial Eurostat estimates.[1] The increase in economic growth, which is higher than potential growth in the eurozone, is the highest since 2000, despite the sharp increase in oil prices. A feature of this economic recovery is that it is based primarily on domestic demand, and not merely on favourable export flows. Investment spending increased sharply, primarily thanks to the favourable terms of financing, high corporate profits, the expected growth in domestic private sector demand and the growth in foreign demand. Thanks to an improvement in conditions on the labour market (the eurozone unemployment rate stood at 7.8% in July 2006, down 0.8 percentage points from a year earlier), there was also an improvement in consumer confidence, although growth in private consumption remains relatively low for the moment. Based on the economic impetus achieved in the first half of 2006, the European Commission, the ECB and the IMF revised their forecasts for economic growth in the eurozone in 2006 upwards by 0.4 percentage points to 2.4% or 2.5%. Some short-term indicators that peaked in the summer are already showing a weakening in economic growth for the second half of the year. The likely reasons for the expected cooling in the economy are the deferred effects of high oil prices and the euro's rise against the dollar, while higher spending in Germany prior to the VAT increase in 2007 will have a beneficial effect on economic growth. As expected, the strong economic growth in the US of 1.4% in the first quarter slowed to 0.7% in the second quarter. The effect of high oil prices and rises in interest rates began to be reflected in the pace of the economy in the US in the second quarter of 2006 via the cooling of the real estate market and the weakening of domestic spending, both investment spending and private consumption.

Commodity prices continue to grow rapidly on international markets, in particular prices of metals

On the international commodity markets, energy prices and other commodity prices continued to grow rapidly this year. The main factors in the rise in the price of oil this year were the political tensions in Nigeria and Iran, the fluctuations in oil stocks in the US and speculative oil buying. The price of oil temporarily rose sharply in the middle of the summer to USD 78 per barrel, this year's high, as a result of the conflict between Israel and Lebanon and

Figure 2.2: Economic growth in the eurozone, including European Comission Projections



Source: European Commission, August 2006 projections for next three quarters.

[1]http://epp.eurostat.ec.europa.eu/pls/portal/docs/PAGE/PGP_PRD_CAT_PREREL/PGE_CAT_PREREL_YEAR_2006/PGE_CAT_PREREL_YEAR_2006_MONTH_09/2-01092006-EN-AP.PDF

Table 2.1: Current and year-on-year growth in GDP and expenditure components

	GDP				Households				Government			
	2005		2006		2005		2006		2005		2006	
	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2
quarterly growth, %												
Eurozone	0.6	0.3	0.8	0.9	0.7	0.1	0.7	0.3	0.7	0.2	0.8	0.4
EU25	0.6	0.5	0.8	0.9	0.6	0.2	0.7	0.5	0.7	0.2	0.6	0.5
US	1.0	0.4	1.4	0.7	1.0	0.2	1.2	0.6	1.0	-0.5	1.1	-0.1
year-on-year growth, %												
Eurozone	1.7	1.8	2.1	2.6	1.8	1.1	1.8	1.7	1.5	1.7	2.3	2.0
EU25	1.9	2.0	2.4	2.8	1.8	1.3	1.9	2.0	1.9	1.8	2.2	2.0
US	3.4	3.1	3.7	3.6	3.8	2.9	3.4	3.0	1.1	0.9	1.6	1.5

	Gross fixed capital formation				Exports				Imports			
	2005		2006		2005		2006		2005		2006	
	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2
quarterly growth, %												
Eurozone	1.2	0.4	0.9	2.1	2.6	0.9	3.9	1.3	2.5	1.6	2.9	1.2
EU25	1.6	0.7	1.1	1.9	2.6	1.4	4.0	1.9	2.5	1.9	3.4	1.9
US	1.3	0.8	2.0	0.1	0.8	2.3	3.3	1.2	0.6	3.1	2.2	0.1
year-on-year growth, %												
Eurozone	3.4	3.3	3.7	4.6	5.4	5.0	9.6	9.0	5.8	5.6	9.9	8.3
EU25	3.8	4.2	4.6	5.4	6.2	6.3	10.8	10.2	6.1	6.3	11.0	10.0
US	6.3	6.2	6.5	4.1	6.8	6.7	9.0	7.9	4.9	5.2	6.4	6.2

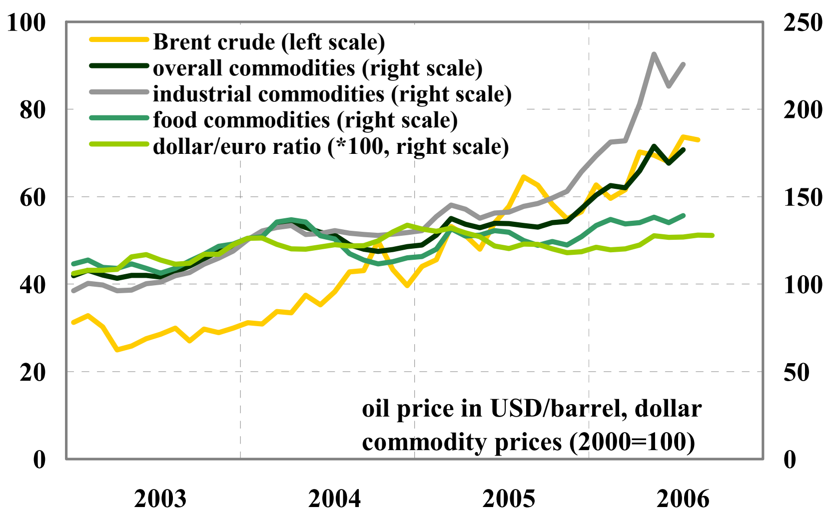
Source: Eurostat.

disruptions to supply from Alaska. Commodity prices are also growing rapidly, in particular prices of metals, the growth in which averaged 57% over the first seven months of the year.

Gradual increase in core inflation in the eurozone, and rise in core inflation in the US

The high growth in oil prices and commodity prices in the first eight months of 2006 remains the principal reason for inflation persisting at a relatively high level in the US and above the ECB's medium-term target in the eurozone. Inflation in the eurozone fluctuated around 2.4% in the first eight months of 2006, while core inflation stood at around 1.5%. The maintenance of the gap between inflation and core inflation indicates that the feed-through of energy prices into other prices in the eurozone is limited for the moment. Nevertheless,

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



Sources: Reuters, The Economist; ARC calculation.

there was a gradual increase in core inflation in the first eight months of 2006, brought also by strong domestic demand. Inflationary expectations also picked up slightly, but remain sustainable. Price pressures have increased in recent months on the side of producer prices of manufactured goods, but the strong competition faced by producers is currently preventing high oil prices and commodity prices from feeding through more into prices of final products. So far the secondary feed-through of the growth in oil prices and commodity prices into wages has been limited, and in addition the stable growth in productivity is helping to maintain unit labour costs at a low level, which is thus not giving rise to inflationary pressures. Core inflation began to rise rapidly in the US in the first eight months of 2006, owing to which the gap between headline inflation and core inflation began to diminish. Inflationary expectations have also begun to rise. Inflation averaged approximately 3.9% over the first eight months of 2006, while core inflation averaged 2.4%. While the inflation gap stood at 1.9 percentage points in January, by August it had shrunk to 1 percentage point, primarily owing to the rise in core inflation. In light of the slowdown in domestic demand in the US, which was already being reflected on the real estate market in the first half of 2006, the pressures on core inflation are expected to ease during the rest of the year.

Inflation movements in the international environment remain under the control of central banks

High oil prices and commodity prices have an impact on monetary policy to curb inflationary pressures. With inflation trends somewhat above the target, and a high level of availability liquidity in the eurozone, in December 2005 the ECB began to normalise the interest rate level for the first time since October 2000, and by August 2006 had gradually raised the main refinancing rate by 1 percentage point to 3%. By contrast, for the first time since June 2004 the Federal Reserve did not raise its interest rate in August and September 2006, keeping it at 5.25%. The increase of 4.25 percentage points in the Fed's interest rate after June 2004 was already beginning to be reflected in a slowdown in economic growth in the second quarter of 2006.

The interest rate spread affects the movement of the euro/dollar exchange rate

The financial markets' expectations of the movement in interest rates and the actual movement of the interest rate spread between the ECB and the Federal Reserve affected the movement of the euro's exchange rate against the dollar. While the continual rises in Federal Reserve interest rates and the unchanged ECB interest rates saw a trend of the euro falling against the dollar last year, in 2006 this movement in the exchange rate reversed, and the euro appreciated. The euro gained 8.4% against the dollar between December 2005 and August 2006, as a result of expectations of an end to interest rate rises in the US and the tightening of monetary policy in the eurozone.

Economic activity

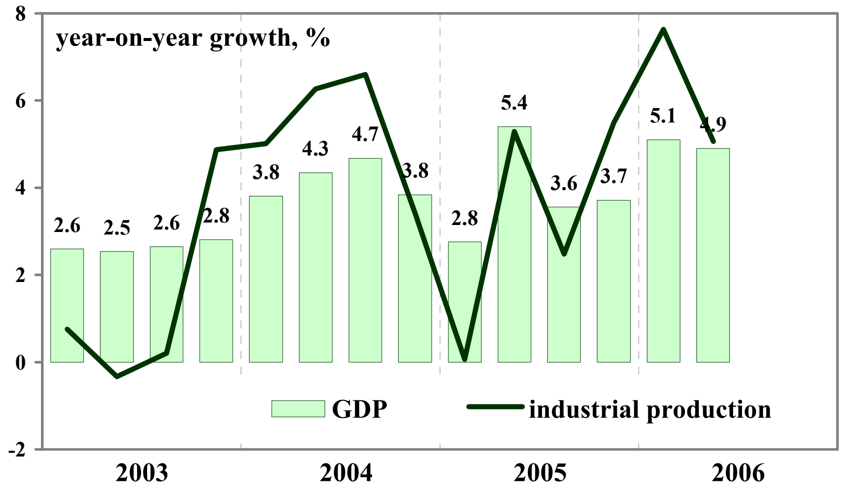
Economic activity picked up in the first half of 2006…

Economic growth in Slovenia accelerated significantly in the first half of 2006, to a level of 5% year-on-year. GDP grew by 5.1% in the first quarter and by 4.9% in the second quarter in real terms, while the overall rate adjusted for season and for the number of working days was 5.6% in the second quarter. The growth rates achieved slightly exceed the estimated potential growth of the economy. In contrast to last year, the focus of economic activity is shifting towards domestic demand, the contribution made by net trade having declined.

…in the context of an increase in the contribution made to economic growth by domestic spending…

From the point of view of aggregate demand, the contribution made to economic growth by domestic spending was 4.1 percentage points in the first quarter of 2006, or approximately 80% of total growth, while in the second quarter it expanded to 4.5 percentage points, or 90% of total growth. To a great extent it was gross investment that was responsible for this contribution, in particular gross fixed capital formation, which picked up in the final quarter of 2005 and grew by 8.9% year-on-year in the first half of 2006. The negative contribution to economic growth made by inventories declined slightly, from an average of 0.6 percentage points during 2005 to 0.5 percentage points in the first half of 2006. Year-on-year growth in final consumption remained relatively high in the first half of the year at approximately 3.5%, while growth in government spending was up 1.5 percentage points on its average in 2005 at 3.7%.[2]

Figure 2.4: GDP growth by quarter

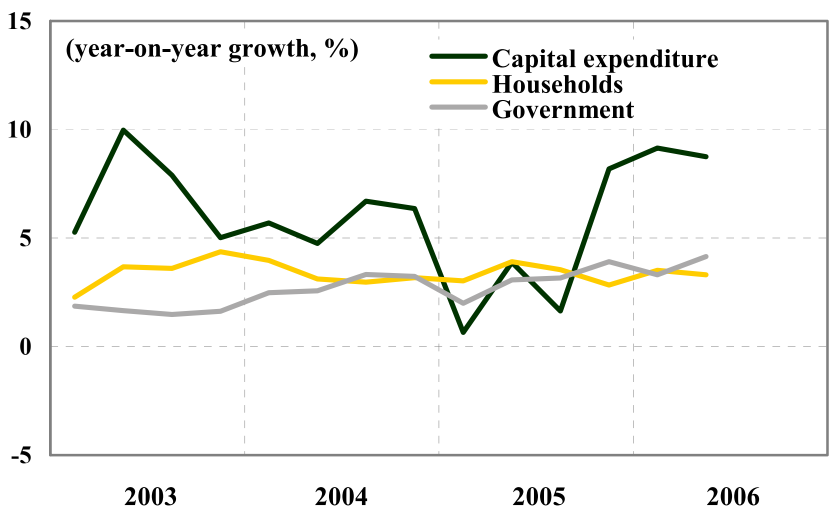


Sources: SORS, ARC calculation.

…brought in particular by an increase in gross fixed capital formation…

Construction of buildings and structures and investment in equipment and machinery has been the engine behind the increase in gross fixed capital formation and economic growth since the final quarter of 2005. The largest increase in the first two quarters of 2006, at an average of 16.8%, was recorded by investment in transport equipment, primarily because of the expected deterioration in the pricing terms of certain types of transport equipment from 2007, and last year's low basis. Investment in other equipment also increased by 16% in the first quarter, but the growth rate then slowed to 9.6% in the second

Figure 2.5: GDP expenditure components, by quarter



Sources: SORS, ARC calculation.

[2] The annual figures for GDP and expenditure components for the 2001 to 2005 period published in the middle of September have not yet been brought into line with the quarterly figures available. In our calculations for GDP and expenditure components for 2005 the annual figures are used.

quarter. The sustained investment drive is most evident in residential buildings, where investment has recorded above-average year-on-year growth since the middle of 2004, the rate having exceeded 10% for seven consecutive quarters now.

…and despite the decline in the contribution made by net trade

Net trade was an important engine of economic growth overall last year, but has declined in importance since the final quarter of 2005. The contribution made to GDP growth by net trade averaged 2.3 percentage points in 2005, but fell to 0.9 percentage points in the final quarter, remained at 1 percentage point in the first quarter of 2006, and then fell to just 0.4 percentage points in the second quarter. The shift away from net trade is in line with the slowdown of growth in export-oriented industries, the car industry and the chemical industry in particular, the strengthening of investment and the increase in consumer optimism.

Growth in imports and exports of goods and services fluctuated in the first half of 2006

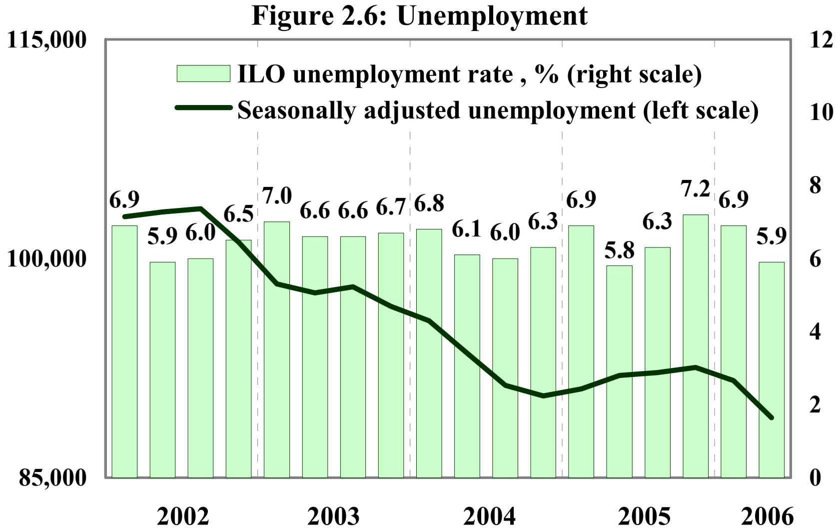
There was considerable fluctuation in import and export growth in the first half of 2006. After a one-off increase in the first quarter of 2006, when they reached rates of between 13% and 16%, growth in imports and exports of goods and in imports of services returned to between 7% and 9% in the second quarter, close to the level seen last year. The pace of the increase in imports and exports matches the current rate of growth in export-oriented sectors, in particular manufacturing, where the year-on-year growth of 8% in industrial production recorded in the first quarter declined to 4.8% in the second quarter. High growth in value-added was also recorded in the first quarter by the transport, hotels and catering, and retail sectors, but their decline in growth in the second quarter was significantly smaller. Because there was a sharp decline in exports of services in the second quarter, and because the decline in growth was larger on the merchandise export side than on the import side, the contribution made to economic growth by net trade also declined over this period.

Labour market

Favourable trends on the labour market and a fall in the registered and surveyed levels of unemployment

Trends on the labour market in the first seven months of 2006 were favourable compared with the end of 2005. The labour force expanded by 0.5% during this period, while the persons in employment expanded by 1.4%, and the number of registered unemployed fell by 7.5%. Employment expanded both at companies and in the small business. Both the current and year-on-year rates of growth strengthened in the small business sector, while the slow pace of growth seen at companies in the early part of the year began to increase in March. Over the first six months of the year, the largest increases in employment at companies were recorded in the construction sector and in certain marketable service

Figure 2.6: Unemployment



Sources: SORS, ARC calculation.

activities, while labour-intensive sectors recorded the largest decreases. Further evidence of the favourable trends on the labour market comes from the employment figures in the national accounts, with employment having risen year-on-year by 0.8% in the first quarter and by 1.0% in the second quarter. However, the figures show (see Box 2.1) that the disappearance of those registered as unemployed from the Employment Service's records in the first eight months of 2006 compared with the same period last year was partly the result of job creation during the good economic performance in the first half of the year, but came mainly as a result of stricter handling of those registered as unemployed.

Box 2.1: Unemployment records and labour market

Given the significant increase in the number of people leaving the Employment Service's records in the first eight months of 2006, it is interesting to estimate the extent to which the decline in the number of registered unemployed is the result of the stricter records introduced at the end of 2005. This is particularly interesting because the breakdown and amount of people registering as unemployed in the first eight months of the year is practically identical to the same period last year, while there were 9,596 more people who left the Employment Service's records in the first eight months of 2006 than in the same period last year.

The stricter records meant there was also a change in the breakdown of those deregistering. The graphs show that the share of unemployed who found a job in the first eight months of 2006 was down 6.8 percentage points on the same period last year, while the share of those deregistering who were classed as unavailable for work or who refused a job offer[1] increased by 3.4 percentage points. This indicates that this year's decline in the number of registered unemployed could partly be the result of institutional changes in the handling of the unemployed.

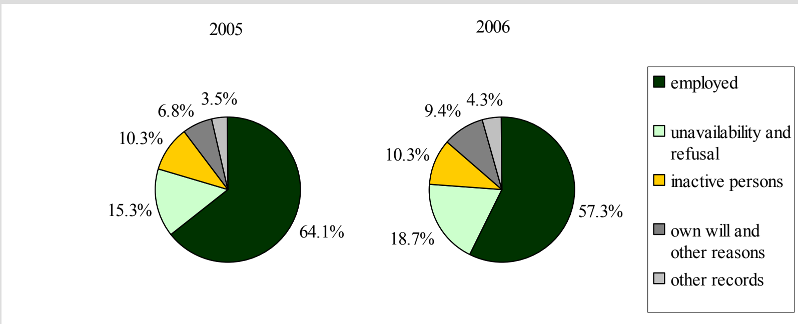
An even more telling year-on-year difference is illustrated by the net deregistration (the difference between the total number registering and the total number deregistering) at the Employment Service. Of the increase in those deregistering in the first eight months of 2006 compared with the same period last year, 39% was because of unavailability for work or refusal of a job offer, which is probably an indication of the stricter rules for the recording of unemployment, while 17% comprised those who found a job, which is most probably the result of the favourable economic climate. The remaining 45% of the increase in those deregistering consisted of transferrals to other records, and represents those now classed as no longer in the labour force (education and retirement) or having left by their own will or for other reasons.[2]

Allowing for its limitations, this analysis shows that approximately 40% of the decline in the number of registered unemployed in the first half of 2006 can be attributed to institutional changes and the changes in labour market legislation at the end of 2005. This does not necessarily mean that those deregistering in such a way did not actually take up employment.

[1] The Employment Service's precise definition covers those deregistering as unemployed owing to unavailability for work, a refusal of a job offer, a failure to actively seek employment, a refusal to participate in employment schemes, a failure to uphold the obligations of such schemes, unregistered work, or provision of false information

[2] A comparison can be made between the two periods thanks to the breakdown and amount of those newly registering as unemployed being practically identical in both periods and an assumption that the increase in deregistration was the result of the increase in the net deregistration of unemployed people this year

Figure 1: Breakdown of the deregistered unemployed at the Employment Service



Source: Employment Service of Slovenia

The good economic performance nevertheless had an impact on the unemployment measured by survey, which fell from 7.2% in the final quarter of 2005 to 5.9% in the second quarter of 2006.

Growth in labour costs remains moderate

In the first half of 2006 labour costs continued to grow modestly compared with last year. Cost structure figures published in the middle of September show that labour compensation increased by 6% in 2005, but by 3.2% per employee on average in real terms. The largest increases in labour compensation were recorded by the electricity, gas and water supply sector (10.1% in nominal terms, 6.7% per employee on average in real terms), and by the transport, storage and communications sector (8.9% in nominal terms, 5% per employee on average in real terms). The increase in labour compensation in the manufacturing sector was below-average at 4.4%, or 3.8% per employee on average in real terms. Year-on-year growth in average gross wage stood at 5.1% in the first six months of 2006, or 2.4% in real terms. At 3.6%, year-on-year growth in average gross wage in the public sector was outstripped by the year-on-year growth in average gross wage of 5.6% in the private sector, a reflection of the favourable employment conditions in the private sector, the restrictive wage policy in the public sector and the statistical effect of the decline in low-paid jobs in the private sector. With real GDP growth at 5% and employment growth at 0.9%, labour productivity growth in the first half of 2006 was estimated at 4%. Productivity growth thus outstripped real gross wage growth by 1.6 percentage points. Longer-term growth trends for real gross wages and productivity show the medium term productivity outstripping growth in real gross wages by 0.9 percentage points. Further evidence of the absence of cost-based inflationary pressures comes from the quarterly figures for labour costs per hour worked, which rose on average by just 3.4% year-on-year in the first six months of the year, primarily as a result of low growth in labour costs per hour worked in the public sector, 2.2 percentage points less than last year’s average. There are various reasons for the decline in labour costs, including the gradual abolition of payroll tax.

Balance of payments

An increase in the current account deficit in the first half of 2006 compared with the same period last year…

According to current estimates the balance of payments deficit in the first seven months of the year doubled from the same period last year to EUR 279.8 million. The main reason for the deterioration in the balance of payments, despite the increase in the surplus in services, is the expansion of the deficit in factor income and transfers.

…owing slightly to a wider deficit in merchandise trade…

The current rate of growth in merchandise trade slowed over the first seven months of the year, more on the import side than on the export side, but the year-on-year rates of growth nevertheless remain relatively high. Imports of goods in the first seven months of 2006 were primarily under the influence of price effects, namely higher oil prices and prices of metals, while exports of goods were primarily under the influence of increased foreign demand, which has been a powerful factor in the faster pace of growth in Slovenian industry since the second quarter of the last year. Expectations of greater foreign demand brought an increase in companies’ gross fixed capital formation and higher imports of investment goods, while there was also a year-on-year increase of 20% in exports of intermediate goods and an increase of 16% in exports of investment goods. The seasonally adjusted figures show that export orders also rose during the second quarter, by 6 percentage points, and were up 19 percentage points on the same period last year. The gap by which import growth trails export growth, despite the high import component of Slovenian exports, can mainly be attributed to the decline in inventories of final products in manufacturing. Merchandise trade with non-EU countries expanded faster than merchandise trade with EU member-states; Slovenia has a surplus in merchandise trade with non-EU countries, despite strong growth in imports, but a deficit in merchandise trade with EU member-states. The services surplus in the first seven months of 2006 was higher than in the same period last year, despite exports growing more slowly than imports. The largest revenues from services were generated by services associated with merchandise trade, such as transport services, while tourism revenues and revenues from other business and technical services also increased.

…but mainly owing to greater deficits in investment income and current transfers

The deficits in investment income and current transfers were wider than the same period last year, the surplus in labour income having declined slightly. In addition to increased outflows as a result of non-residents' investments in domestic securities and higher interest payments on loans approved from the rest of the world, particularly by banks, which have strongly increased their borrowing abroad in recent years, there were certain one-off factors in the increase in the deficit in investment income. The increased deficit in current transfers was caused by a deficit in official transfers, as a result of increased payments into the EU budget and lower disbursement of EU funds, and a deficit in private transfers.

Last year's surplus in the financial account has become a deficit this year…

The relatively strong economic activity and increased outward financial investment by the private sector had an impact on the financial account during 2006. There was a net financial inflow of EUR 557 million in the first seven months of 2005, but this became a net financial outflow of EUR 273 million in the same period this year. Outward investments by the private sector were responsible for the financial outflows, while the government sector recorded a net inflow from the rest of the world on account of portfolio investments by non-residents.

…owing to an increase in outward financial investments by the private sector

Portfolio and direct investments were prominent among private sector investments, while the financing of exports via loans and trade credits also continued to grow. Investments in first-class securities were prevalent among banks' portfolio investments, while mutual funds continued to restructure their portfolios in the early part of the year, the proportion accounted for by foreign investments steadying at around 50%. In recent years investment in corporate equity has prevailed among outward FDI, but this year just over one-half of investments have been made in the form of loans and trade credits. The amount of bank lending to the rest of the world has been increasing since 2004, in particular to foreign companies in the former Yugoslavia. The increase in trade credits this year is primarily a reflection of the good pace of exports.

Portfolio investments by non-residents are prominent among financial inflows

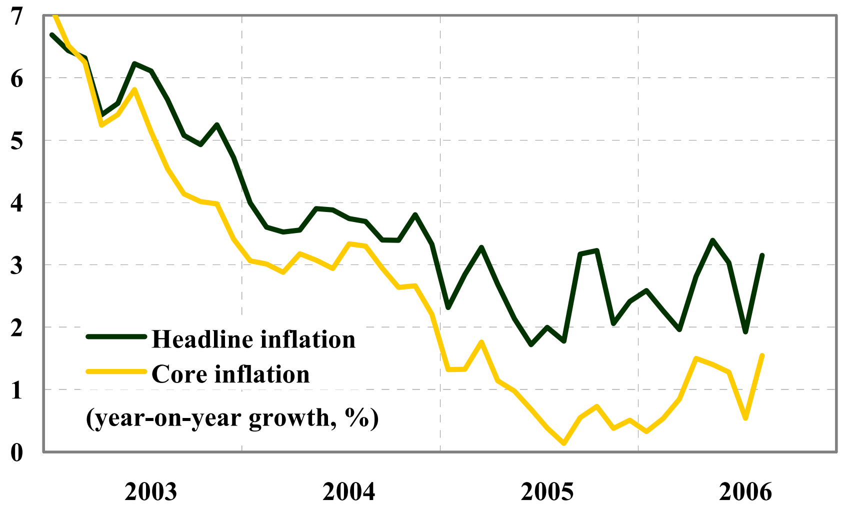
Deposits by non-residents were most prominent among financial inflows at the beginning of the year, but portfolio investments by non-residents have been prominent this year compared to last year. In contrast to previous years, when it made net repayments of debt, the government sector has recorded net inflows this year, partly as a result of reinvestment by non-residents following last year's repayment of eurobonds. Bank borrowing from the rest of the world in the first seven months of the year was close to that in the same period last year, the low stock of borrowing in the first four months of the year rising sharply in May. There was also a sharp increase in inward FDI in May and June, but only in the form of borrowing between affiliated companies.

2.2 Inflation Factors

Inflation is favourable this year, despite high monthly fluctuations

Inflation trends remain favourable this year, despite high monthly fluctuations in the year-on-year rate. The average annual increase in prices as measured by the harmonised index of consumer prices had eased to 2.6% by the third quarter of this year, just 0.1 percentage points above last year's figure. The slight increase in annual inflation is primarily the result of faster growth in prices in the second quarter, while average quarterly growth remains at around 0.6%. The faster growth in prices in the second quarter was primarily the result of both a rise in core inflation[3] and further growth in energy prices. After a year of extremely low rates, core inflation rose to approximately 1.5% in the second quarter of this year.

Figure 2.7: Headline and core inflation

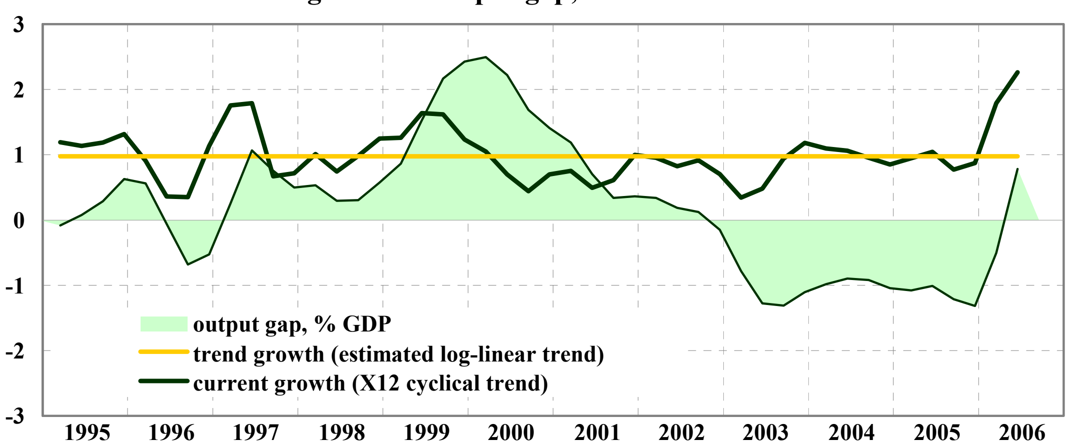


Sources: SORS, ARC calculation.

The impact of domestic factors on inflation is relatively uncertain

In contrast to previous years, indicators in the domestic macroeconomic environment show a more mixed picture with regard to inflationary pressures. With the economy growing significantly faster than potential output, the negative output gap that had lasted fore several years came to an end, and a positive output gap appeared in the second quarter. Because the majority of the impetus behind economic growth is coming from gross investment in housing, office buildings, and plant and equipment, the positive output gap does not yet entail a major risk of more significant inflationary pressures, which could arise were the economic growth primarily the result of increased government spending or final private consumption. The rapid growth in gross investment also entails an expansion in output capacity, and thus higher growth in potential domestic output in the future. During this favourable economic growth there was also a rise in employment, which indicates that conditions on the labour market are gradually improving. Growth in labour costs nevertheless remains moderate, and

Figure 2.8: Output gap, 1995 to 2006



Source: ARC estimate.

[3] Core inflation resembles developments in prices of consumer goods excluding energy prices, prices of seasonal products and the changes in taxation.

is less than productivity growth. Year-on-year growth in the average gross wage stood at just 2.4% in real terms over the first six months of the year, compared with 3.5% in the same period last year. With productivity growth estimated at 4%, real growth in wages is 1.6 percentage points behind growth in output per employee. Labour costs are also being reduced this year by the gradual abolition of payroll tax, while risks of faster growth have been limited by the adoption of wage agreements in both the public and the private sectors.The effect of domestic inflation factors is therefore still relatively uncertain, but in the event of the strong economic growth continuing there could undoubtedly be a build-up of inflationary pressures from the domestic environment too.

Factors from the international environment are again putting pressure on prices

The main pressures on prices continue to come from factors in the international environment. The sharp rise in oil prices seen in the last two years continued in the first half of this year. The dollar price of Brent crude rose by approximately 30% over this period, which was also the average annual growth rate during this period. The latter has been gradually declining in the last year, but remains high. A significant fall in oil prices only occurred in the last two months of August and September, after tensions over the Iranian nuclear issue eased and the hurricane season did not cause any major damage to the oil industry, while the end of the holiday season in the US also eased demand for oil. In addition to rise in oil prices, prices of certain other commodities, zinc, copper and gold in particular, continued to rise this year. After 2004 the growth in dollar prices of metals was again the fastest among commodities, averaging 57% in the first seven months of 2006 and standing at approximately 82% year-on-year in July. Among the reasons cited by analysts for the renewed rapid growth in commodity prices are the optimistic forecasts for global economic activity, the continuing strong demand from China, and speculation by certain market dealers. The latter is thought by some to have been responsible for up to 50% of the growth in the first four months of this year.[4] The effect of high growth in commodity prices on domestic prices has partly been compensated for this year by the appreciation of the euro (and hence the tolar) against the US dollar, as a result of the beginning of gradual reduction of the interest rate spread between the eurozone and the US. Growth in import prices was therefore approximately 7.5 percentage points lower.

Economic policies remains coherent this year

In keeping with the objective of adopting the euro, domestic economic policies acted in a coordinated manner to limit inflationary pressures. With its policy of gradual interest rate convergence, the Bank of Slovenia maintained interest rates at a level above that of the ECB, but still in accordance with the maintenance of the stability of the nominal exchange rate. Stable inflationary expectations have been further underpinned this year by the positive assessments from the European Commission and the ECB of the stability of the Slovenian economy and the sustainability of the macroeconomic equilibria given in the spring convergence reports.

Growth in energy prices led administered prices to grow faster than non-administered prices

In line with the plan for managing regulated prices, the Slovenian government was more consistent in exercising administered prices policy this year. Year-on-year growth in administered prices excluding energy prices approached growth in non-administered prices in the first half of the year, and stood at 1.8% in August. Overall growth in administered prices nevertheless remains faster than growth in non-admininistered prices, as growth in energy prices is again high. Year-on-year growth in energy prices averaged 12.2% in the first half of the year, while the government had not had the possibility of adjusting excise duties since last July, as they had been at the minimum level allowed. It was only at the end of this August, when oil prices fell significantly, that the government was able to raise excise duties to create a reserve for any subsequent increases in oil prices. This entails the continuation of the policy of counter-cyclical adjustment of excise duties by which the government reduced the fluctuation in domestic retail prices of refined petroleum products in 2004 and 2005.

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[4] http://www.unctad.org/templates/Page.asp?intItemID=3824&lang=1

Excise duty policy remains under the influence of EU directives this year

The government continued to raise excise duties on tobacco products in line with EU directives and the Excise Duties Act. The effect of excise duties on tobacco on this year's inflation rate is likely to be 0.1 percentage points less than last year, as no adjustment was required this January owing to the stability of the tolar exchange rate against the euro last year. The effect on inflation could have been even smaller, had producers not decided to raise their prices even further in October. The level of the increase can be interpreted as a case of price rounding prior to the final currency changeover, as the retail prices of the best-selling cigarettes are now EUR 2.00 and not EUR 1.98 in tolar counter-value.

Box 2.2: Monetary policy conditions and the disinflation trend

Monetary policy can exert an influence on inflation via interest rate transmission, via exchange-rate transmission, or via a combination of the two instruments. Monetary policy exerts an influence on inflation via the interest rate transmission mechanism by acting on aggregate demand or the output gap in the medium term, or by controlling the amount of money in circulation in the long term. Exchange-rate transmission into inflation occurs over the short term via the impact on import prices or prices in the tradable sector, or over the medium term via the action of these prices on other prices or via a direct impact on aggregate activity. The pitch of the two principal Bank of Slovenia monetary policy instruments and their effect on the disinflation trend in the most recent medium-term period is examined in this box.

After the inflation shocks in 1999, the Bank of Slovenia sharply tightened monetary policy. The gradual but extensive increase in interest rates up to the middle of 2001 was aimed at curbing the strong excess aggregate demand (the positive output gap) during this period. Higher nominal interest rates were reflected in higher real interest rates, which rose from negative values in 1999 to 2000 to around 4% by the middle of 2001, and remained around 2% in the following years. With a moderately restrictive monetary policy stance the Bank of Slovenia maintained the disinflation trend from 2001. Given the relatively strong inflationary pressures on the supply side during this period, it is reasonable to express real interest rates with regard to the level of core inflation, which does not take such effects into account. The Bank of Slovenia's monetary policy was even tighter according to this indicator.

In Figure 2, the lower level of the real effective exchange rate (depreciated exchange rate) entails upward pressure on inflation, and the higher level entails downward pressure on inflation (appreciated exchange rate). The movement of the real effective exchange rate with regard to the average for the last ten years and with regard to the (log-linear) trend since 1990 shows that a period of a mainly appreciated real effective exchange rate up to 2000 was followed by a period of a mainly depreciated real effective exchange rate up to the beginning of 2003. Although the exchange rate instrument during the latter period was probably in the area of upward pressure on inflation, it did not prevent the re-establishment of the disinflation trend after 2000. The predominant factors in the re-establishment of the disinflation trend after 2000 were those with a stronger impact on inflation, under the direct or indirect influence of monetary policy. Although the level of the real exchange rate did not contribute to the reduction of inflation after 2000, which probably slowed the process slightly, the movement of the exchange rate allowed the external balance to be maintained and the tradable and non-tradable sectors to share the burden in the disinflation process more equally.

Figure 1: Bank of Slovenia interest rates

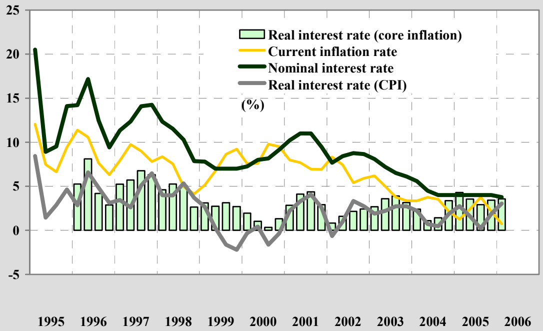


Figure 2: Real effective exchange rate

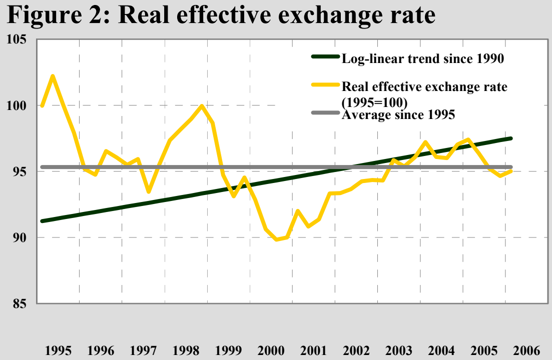
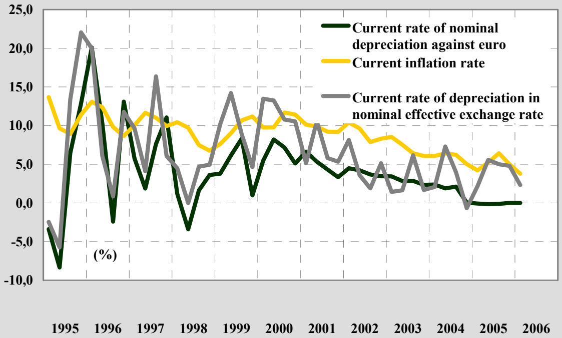


Figure 3: Inflation and exchange rate dynamics



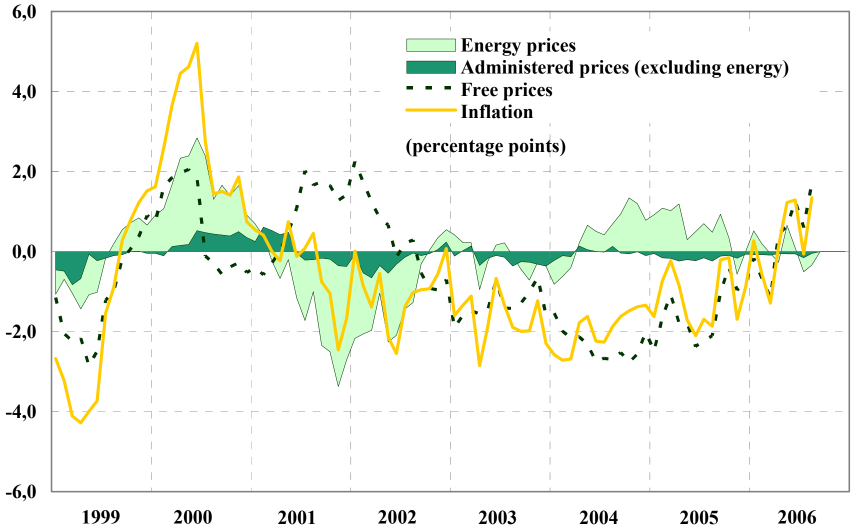
The reduction of inflation while external and internal equilibria are maintained is a reflection of the design of the Bank of Slovenia's monetary policy.[1] In order for the Bank of Slovenia to be able exercise a monetary policy tailored to domestic macroeconomic needs, it had to steer the exchange rate dynamic in the zone in keeping with the uncovered interest parity; domestic interest rates had to be equal to foreign interest rates plus the projected nominal depreciation in the exchange rate and various premiums (risk, liquidity, the Bank of Slovenia's reverse foreign exchange swap, etc.). By preventing interest-elastic inflows of foreign liquidity, this action allowed interest rate transmission to act independently. The Bank of Slovenia exploited its manoeuvring room in managing the nominal exchange rate so that this management was inflation-neutral in the medium term, and in keeping with the maintenance of the external equilibrium. Because in principle the depreciation trend coincided with the disinflation trend, the dynamics of those prices tied to foreign currencies also followed the trend in other prices in the medium term. As a result, the expected dynamics of the depreciation did not in principle have any systematic effect to reduce or raise inflationary expectations.[2] The Bank of Slovenia adjusted interest rates and the depreciation of the tolar against the euro in keeping with the reduction of inflation and inflationary expectations. By the time Slovenia entered the ERM II, when the Bank of Slovenia had stabilised the nominal exchange rate against the euro, the disinflation process was practically complete, and the projections of inflation were in line with meeting the Maastricht price stability criterion.

[1] Bank of Slovenia monetary policy guidelines (2001)

[2] By accommodating the inertia of inflation, the exchange rate dynamic duplicated or created the conditions for monetary policy acting in a closed economy, and allowed transmission via interest rates to have effect

Most likely in this case it is a matter primarily of the limitations of technical solutions for sales of products in vending machines, and also the fact that producers had already raised their prices at the same time as the increase in excise duties this July. In addition, EU member-states are also adopting an increasingly restrictive policy towards the tobacco industry, which is widening the gap between excess supply and lower demand for cigarettes, which should in theory limit the upward movement of cigarette prices.

Figure 2.9: Pressure on inflation from individual categories of prices

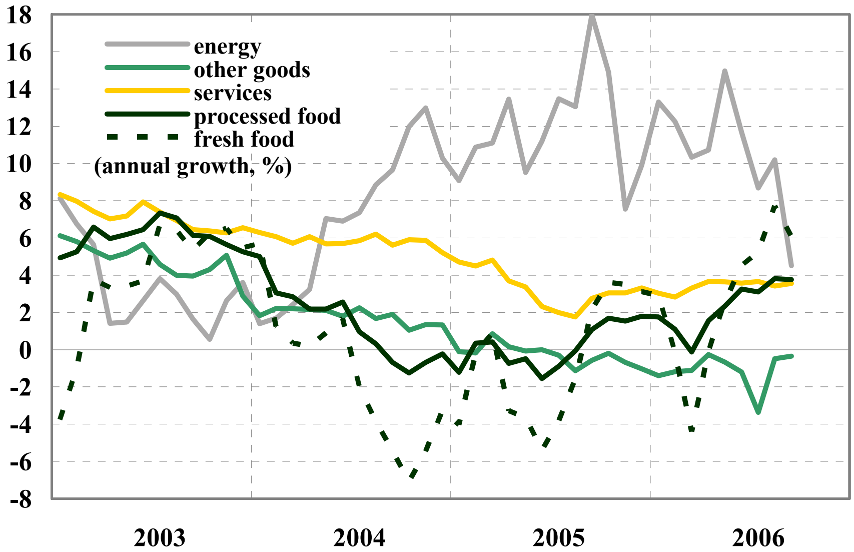


Source: ARC.

Developments in non-administered prices are building up inflationary pressures

After more than three years of disinflationary trend, non-administered prices are gradually rising this year, in line with expectations. This is partly connected to the gradual feed-through of higher transport costs and other costs of input products into retail prices, and partly to the extremely low growth in certain product prices last year. These trends are not specific to Slovenia, as the rise in energy prices has begun to gradually feed through into consumer prices in other EU member-states, with eurozone countries being no exception. Nevertheless, analysis of the direct effects of the rise in energy prices on inflation in Slovenia shows that this year they have not had a significant impact on inflation rates, having raised year-on-year inflation merely by an average of just under 0.04 percentage points over the first eight months of the year compared with last December. Even lower, indeed negative, were the contributions made by administered prices other than energy prices, which lowered inflation by just under 0.08 percentage points on average over the same period.

Figure 2.10: Movement of individual categories of prices



Sources: SORS, ARC calculation.

An end to the period of relative price adjustment after EU enlargement and increased competition from China

Further evidence of there being specific inflationary pressures from non-administered prices comes from detailed analysis of the movement of prices in individual sub-categories. In the context of rapid growth in energy prices ranging from 8% to 15% year-on-year, year-on-year growth in prices of other goods, which showed a falling trend in previous years, has also begun to increase. The period of negative year-on-year growth rates in prices of other goods[5] has been coming to an end, also bringing an end to the period of adjustment in the prices of certain products (clothing and footwear in particular) that in recent years were under stronger pressure from competition and relative price adjustments within the European Union.

Growth in prices of services remains stable

After last year's slowdown, growth in prices of services has settled this year at last year's average of around 3.3%, and does not additionally increase contribution to overall inflation. The gradual increase in year-on-year growth in prices of services, which has been noticeable since the middle of last year, is merely a correction in the year-on-year rates from last year's one-off changes in prices of package holidays and hospital services.

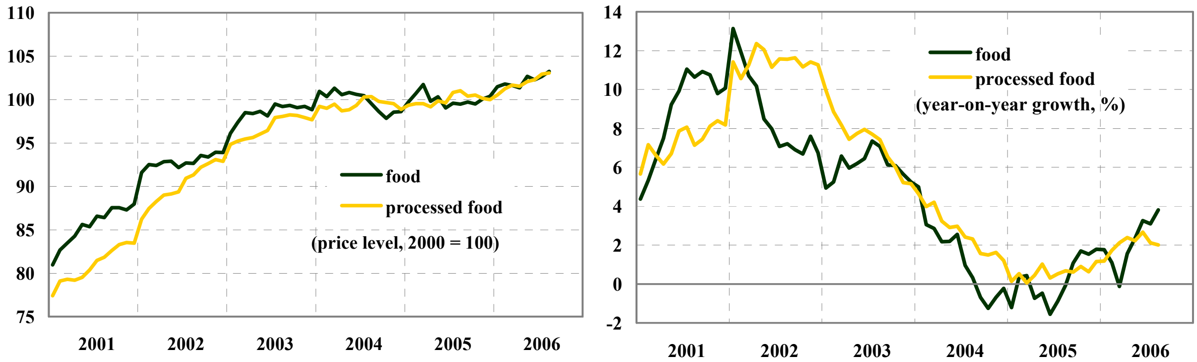
Food prices under pressure from higher transport and production costs

Food prices began to gradually rise this year, primarily as a result of the gradual feed-through of higher transport costs and prices of artificial fertiliser, in which

[5] Other goods comprise all goods that do not belong to the categories of energy, food and beverages, or tobacco products

oil accounts for a major portion of the input costs. Prices of processed food were the first to begin to rise, and were followed by prices of unprocessed food. Year-on-year growth in prices of processed food was increasing from the middle of last year, and only began to gradually ease to around 2% at the end of the second quarter of this year. Prices of unprocessed food show a similar rising trend, but unlike those of processed food they have fluctuated more, year-on-year growth reaching 8% in August. This was primarily the result of bad weather conditions in the second and third quarters of this year, and also higher production costs.

Figure 2.11: Movement of food prices in the last five years

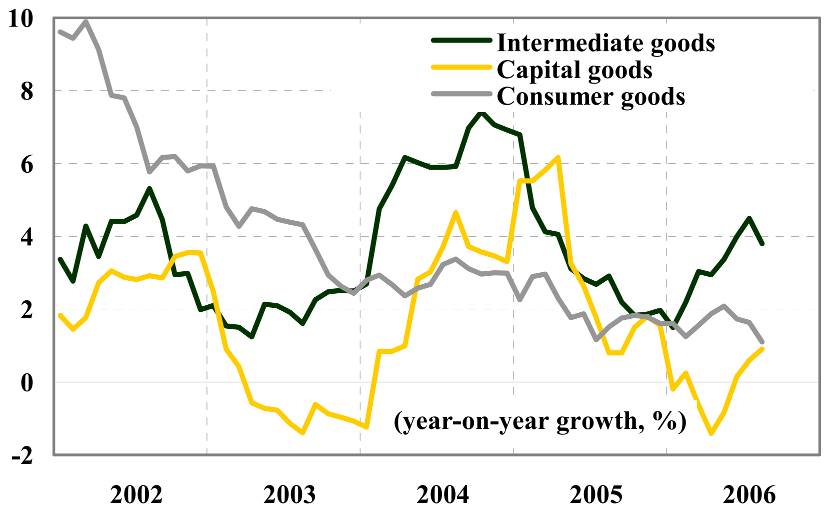


Source: ARC.

No sign yet of inflationary pressures from domestic producers

After a period of slower growth in producer prices of manufactured goods, year-on-year growth picked up at the end of last year. This faster growth is exclusively the result of faster growth in prices of intermediate goods, which rose by just over 2 percentage points in the first half of the year to approximately 4% year-on-year. Most prominent of all was the faster growth in energy producer prices, which was the result of a one-off rise in prices at the beginning of the year, which was not compensated for by the price falling in later months than it had last year. However the monthly rate of growth in energy producer prices remains low, and has even been negative in recent months, pointing to a gradual slowdown in these prices. In contrast to energy producer prices, the monthly rate of growth in other commodity prices remained relatively strong in both the second and third quarters, and has averaged around 5% annualised since the beginning of the year. Despite the faster growth in prices of intermediate goods, growth in producer prices of consumer goods and growth in prices of capital goods remain slower. Year-on-year growth in producer prices of consumer goods

Figure 2.12: Producer prices of manufactured goods



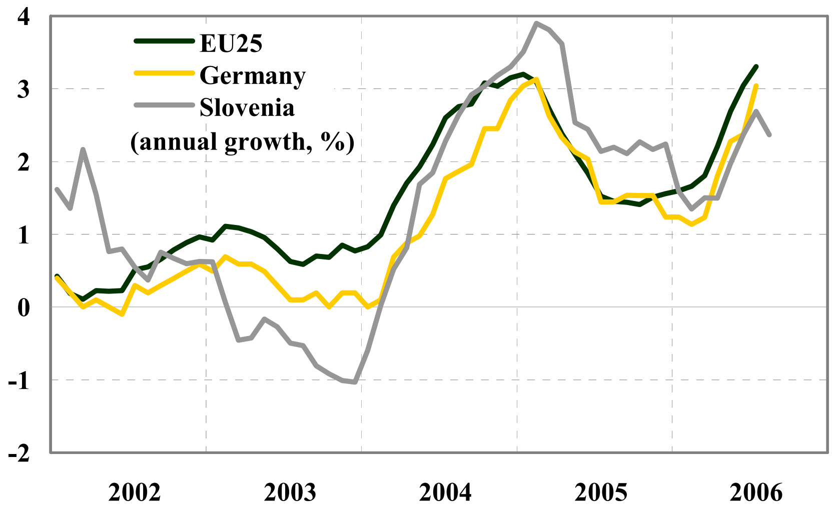
Sources: SORS, ARC calculation.

has ranged between 1% and 2% in the last year, while year-on-year growth in prices of capital goods saw a sharp decline in the first half of the year, and was even negative. The gradual increase in year-on-year growth in prices of capital goods in recent months merely consists of a balancing of the level effects, the monthly rate remaining relatively slow, having averaged 0.3% annualised in the last eight months. Such developments show that domestic producer prices, with the exception of the fractionally faster growth in commodity prices, metals in particular, do not indicate any particular pressures on inflation.

Higher energy prices are feeding through into other domestic producer prices of manufactured goods with a delay

The current movements in producer prices, which point to the absence of significant inflationary pressures, must be taken with caution. Higher energy prices and commodity prices can be expected to gradually feed through into other producer prices in the future, and via these into inflation. According to foreign institutions,[6] there should already be signs abroad of gradual pressures on producer prices of consumer goods, in particular because of the rising cost of input products, under the conditions of high commodity prices, and stronger domestic spending. At the same time a comparison of growth in producer prices with the EU average shows that growth in producer prices other than energy prices is below-average in Slovenia, which could mean that the pressures are yet to arrive and will be reflected with a slight delay. It is very unlikely that this will not occur, as the past growth in these price was was very similar to one another, and the convergence in price levels in this segment of the market is likely to be particularly strong.

Figure 2.13: Comparison of producer prices of manufactured goods (excluding energy prices)



Source: Eurostat.

[6] ECB – Monthly Bulletin, September 2006

3 MONETARY POLICY

The Bank of Slovenia's primary objective is price stability. The Bank of Slovenia monetary policy has been conducted in accordance with the Bank of Slovenia Act, Bank of Slovenia Monetary Policy Guidelines adopted in November 2001, and the Programme for ERM II Entry and Adoption of the Euro. The last of these was adopted by the Bank of Slovenia and the Slovenian government in November 2003, and in it they committed themselves to joining the ERM II by the end of 2004 and to creating the conditions to allow the adoption of the euro at the beginning of 2007.

Slovenia will adopt the euro on 1 January 2007

In line with the Programme for ERM II Entry and Adoption of the Euro, Slovenia joined the ERM II on 28 June 2004, one of the prerequisites for adopting the euro. With Slovenia having met all of the conditions for adopting the euro by the middle of 2006, the European Council decided that it should join the eurozone on 1 January 2007, adopting the euro as the domestic legal tender (see Box 3.1).

Box 3.1: The positive assessment for Slovenia in the ECB and European Commission Convergence Reports

The ECB and the European Commission released their convergence reports for Slovenia on 16 May 2006. In the reports the two institutions confirmed that Slovenia has met the conditions for adopting the euro. In accordance with this, on 11 July 2006 the European Council decided that Slovenia should adopt the euro on 1 January 2007, thereby joining the eurozone.

The European Council confirmed the conversion rate for the changeover from the tolar to the euro, the rate being the same as the central exchange rate when Slovenia joined the ERM II on 28 June 2006. Slovenia has not devalued the central rate since it joined the ERM II, and the tolar/euro market exchange rate has not deviated significantly from the central rate. The conversion rate is thus SIT 239.640 to the euro. In accordance with the ERM II agreement, the ECB and the Bank of Slovenia will continue to monitor the movement of the tolar/euro market exchange rate.

The decision to expand the eurozone is a significant landmark both for the eurozone and for Slovenia. Slovenia will be the first of the ten new EU member-states to join the eurozone. The benefits to Slovenia in joining the eurozone are lower exchange-rate risks, price and cost transparency, lower transaction and information costs, and greater resilience to economic and financial shocks. For Slovenia the eurozone thus represents a more stable environment, with a credible monetary policy, price stability and low long-term interest rates. The European Council also called on Slovenia to continue to pursue sound economic policies, particularly in the area of fiscal policy, structural reforms and the maintenance of competitiveness. Slovenia will be able to exploit all the benefits of the large currency zone, provided that it fully integrates into the zone, which entails eliminating the remaining barriers in labour mobility in particular. Open, competitive and flexible labour markets are particularly important to the functioning of the eurozone and to the effective pursuit of a single monetary policy.

Source: Monthly Bulletin (ECB, August 2006)

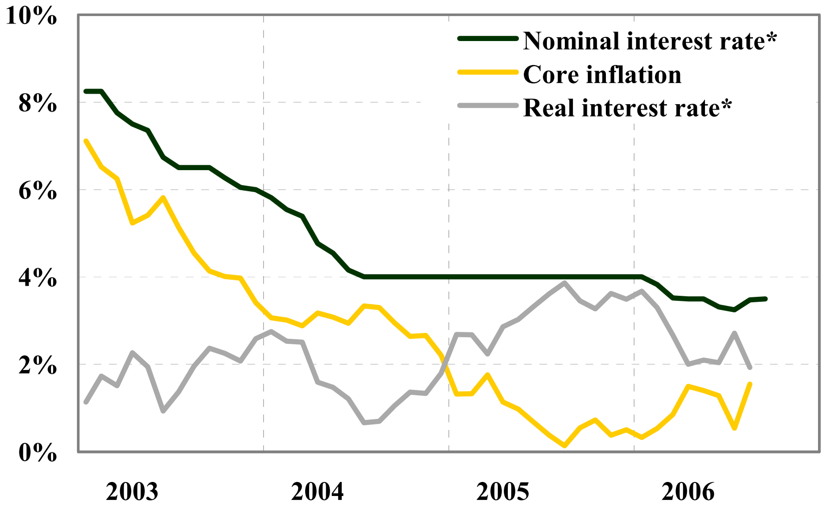
3.1 Monetary Policy and Macroeconomic Trends

Keeping appropriate Bank of Slovenia's real interest rates

Within the limits imposed by membership of the ERM II and the imminent adoption of the euro, the Bank of Slovenia has adjusted its interest rates with regard to the needs of domestic economic activity and gradual nominal convergence. It therefore maintained interest rates at a level above those of the

ECB. The interest rate on 60-day tolar bills between the time that Slovenia joined the ERM II and February 2006 was 4.0%, but was then gradually cut to 3.25% by July. In August the Bank of Slovenia raised this interest rate to 3.5%. The real interest rate on 60-day tolar bills, calculated as the difference between the nominal interest rate and the current rate of core inflation, averaged just over 3% between the middle of 2005 and the beginning of 2006. In recent months it has been around 2%, partly as a result of slightly higher core inflation, and the gradual convergence of the Bank of Slovenia's nominal interest rates with those of the ECB.

Figure 3.1: Bank of Slovenia interest rates



* 60-day tolar bills
Source: Bank of Slovenia, ARC calculation.

Interest rate convergence continued at the beginning of 2006

At the beginning of 2006 the Bank of Slovenia adjusted the interest rates on its monetary policy instruments in the direction of nominal convergence. Between the end of 2005 and March 2006 it cut the interest rate on 60-day tolar bills by 0.5 percentage points to 3.5%. With the ECB gradually raising its interest rates by a total of 0.5 percentage points, this reduced the spread between the 60-day tolar bill rate and the ECB's main refinancing rate from 2 percentage points to 1 percentage point.

A structural adjustment to interest rates in June

The cuts in the interest rates on 60-day tolar bills and the long-term deposit at the beginning of June were primarily structural adjustments. The interest rate on 60-day tolar bills stood at 3.25% between June and August, while that on the long-term deposit stood at 3.45%, slightly less than the Bank of Slovenia's refinancing rate (the sum of the foreign exchange swap rate and the ECB's main refinancing rate). This rose to 3.5% when the ECB raised its refinancing rate by 0.25 percentage points.

The rise in interest rates signals the end of the period of falling interest rates

At the beginning of August the Bank of Slovenia raised its interest rates by 0.25 percentage points, thus signalling an end to the period of falling interest rates. Since then the interest rate on 60-day tolar bills has stood at 3.5%, the interest rate on the long-term deposit at 3.7%, the overnight deposit rate at 2.5%, the lombard loan rate at 4.75%, and the Bank of Slovenia refinancing rate at 3.75%. The simultaneous rise of 0.25 percentage points in the ECB's interest rates meant that the spread between the interest rate on 60-day tolar bills and the ECB's main refinancing rate remains 0.5 percentage points.

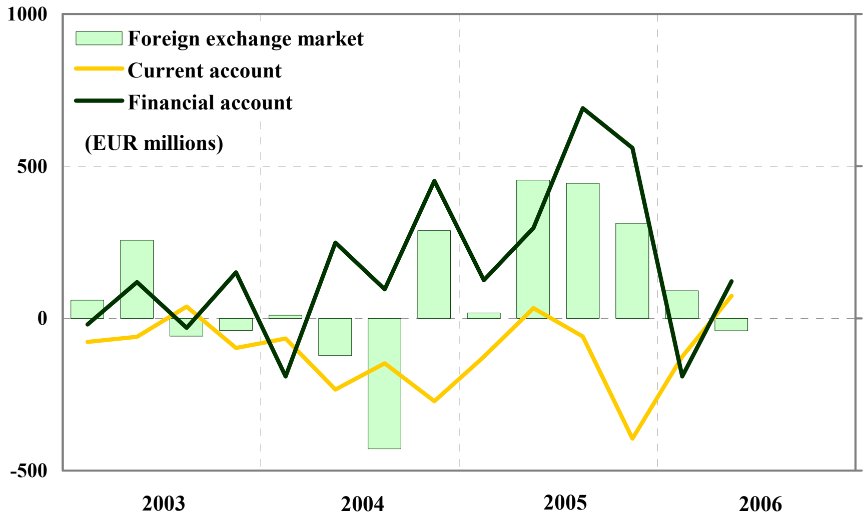
Increased inward and outward financial flows

The net financial inflow into the private sector, which was the principal source of the excess supply of foreign exchange on the markets in 2005, declined in 2006. The net financial inflow into the private sector amounted to more than 6% of GDP in 2005, but was actually slightly negative in the first half of 2006. The main reason for the decline in the net inflow is an increase in outflows, outward portfolio investments in particular, with the high inflows from the rest of the world almost unchanged at just under 10% of GDP. These large inward and outward financial flows indicate Slovenia's growing integration into international financial flows. The European Council's final decision that Slovenia can adopt the euro on 1 January 2007 brought a further reduction in its currency risk and country risk.

A decline in the excess supply of foreign exchange on the markets

With the decline in the net financial inflow, which to a great extent determines supply and demand on the foreign exchange markets, the excess supply of foreign exchange also fell in 2006, and with it the pressure on the exchange rate. The excess supply of foreign exchange amounted to EUR 1.2 billion in 2005, but just EUR 91 million in the first quarter of 2006. The demand for foreign exchange actually outweighed supply in the second quarter of 2006 (by EUR 41 million).

Figure 3.2: Foreign exchange market and balance of payments flows



Source: Bank of Slovenia.

Growth in M1 is in line with economic activity

The movement of M1 has primarily reflected the relative fast pace of economic activity. Another factor in the growth in M1 at the end of 2004 and the beginning of 2005 was the current rate of growth in household income, which was the result of changes in the taxation of certain income, contract-based earnings in particular. Growth in M1 eased in the second half of 2005, but it picked up again in the first half of 2006 under the influence of fast economic growth. Year-on-year growth in M1 averaged 21.9% in 2005, and 16.3% in the first half of 2006. The slightly higher growth in M1 recorded in the last two years can be attributed to the gradual reduction in interest rates and the increase in transactions in alternative forms of investment, primarily investments in mutual funds and investments abroad.

Growth in the broad monetary aggregates remains low as a result of the expansion of alternative investments

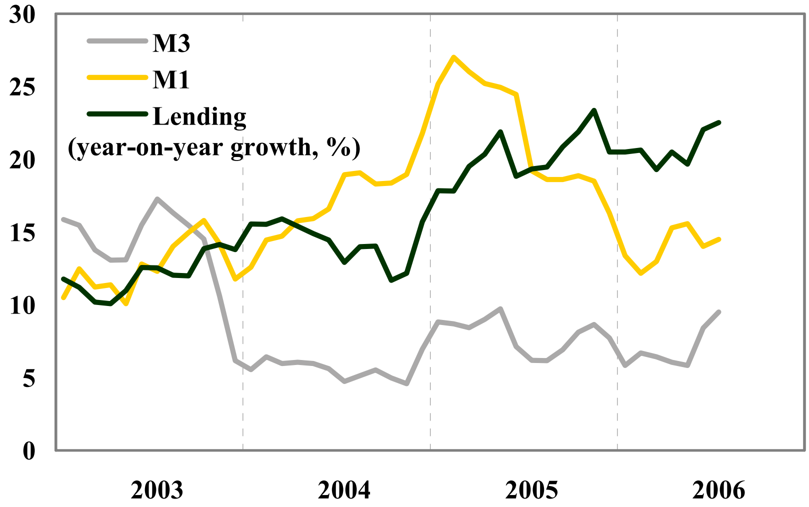
Growth in the broad monetary aggregates remains low, as a result of the expansion of alternative forms of saving. Year-on-year growth in M2 and M3 averaged 7.3% and 8.0% respectively in 2005, and 7.2% and 7.0% in the first seven months of 2006. The low growth in these aggregates is also partly the result of the increase in outward portfolio investments. These are more frequently being moved to the rest of the world as a result of both interest rate convergence and changes in legislation, allowing investment funds to increase their investments abroad. The net outflow of portfolio investments amounted to EUR 0.7 billion in 2004, EUR 1.7 billion in 2005, and EUR 1.0 billion in the first seven months of 2006. The expansion of alternative forms of saving is also very prominent at households, which in 2005 recorded the largest increases in investments in mutual funds (EUR 504 million), life insurance funds (EUR 208 million) and supplementary pension insurance funds (EUR 192 million).

Household deposits at banks increased during this period by just one-third of the increase in deposits at mutual funds.

Increasing growth in foreign currency deposits, decreasing growth in tolar deposits

The trend of increasing tolar time deposits and decreasing foreign currency deposits continued at the beginning of 2006, but foreign currency deposits have been increasing since the second quarter, while tolar time deposits have been decreasing. Year-on-year growth in tolar time deposits remained around 10% in the first quarter, while that of foreign currency deposits was around 5%, but growth in both foreign currency deposits and tolar time deposits is now around 8%. The increase in foreign currency deposits and the decrease in tolar time deposits is to a great extent the result of the gradual increase in interest rates on euro deposits and the decline in interest rates on tolar time deposits. The interest rates on tolar deposits maturing in 1 to 3 months fell from 2.9% in March to 2.7% in July, while the interest rates on euro deposits rose from 1.8% to 2.1% over the same period.

Figure 3.3: Money and credit



Source: Bank of Slovenia.

High lending activity as a result of financial deepening and the economy's switch from foreign to domestic sources of financing

Relatively high lending activity by banks is speeding up the process of financial deepening, and reorienting the economy from foreign to domestic sources of financing. The depth of financial intermediation, as measured by the ratio of lending to the private sector to GDP, is relatively low in Slovenia, having stood at approximately 45% at the end of 2004, 60% at the end of 2005, and almost 65% at the end of 2006. Because the depth of financial intermediation is to a great extent related to the level of development in the economy, it is considerably higher in the old EU member-states than in Slovenia, exceeding 100% in the majority of them, and even 150% in a few. The process of financial deepening is thus to a great extent the result of the process of catching up with the wealthier EU member-states. Given real GDP growth of 4% and nominal growth of 20% in lending to the private sector, the ratio of lending to the private sector to GDP in Slovenia would increase by approximately 10 percentage points per year. A significant factor in the increase in lending was the reorientation of the economy away from foreign sources and toward domestic sources of financing as a result of the diminishing spread between domestic and foreign interest rates. Foreign financing accounted for almost one-third of the economy's total financing in 2004, but merely 15% approximately since 2005. Other factors in the increase in private sector lending, particularly to households, were the increase in housing lending, the increase in competition on the lending market, and the fall in borrowing costs. In addition, under the conditions of the free flow of capital and in the process of convergence with the eurozone, banks have increasingly easy and cheap access to sources of financing from abroad, which is allowing them to lend to domestic sectors.

Limited inflationary pressures from aggregate demand

The Bank of Slovenia's moderately positive real interest rates are preventing monetary policy from acting in an expansionary manner on economic activity. Economic activity is relatively strong, but the fact that domestic spending remains moderate illustrates that inflationary pressures from the side of aggregate demand are limited. Real GDP increased by 5.0% year-on-year in the first half of the year, the highest since 1999 and exceeded growth in potential GDP. The largest contribution to GDP growth came from gross investment, which grew at 5.7% year-on-year. Real growth in household spending amounted to 3.4% during this period, 1.6 percentage points behind growth in real GDP. Inflation is rather volatile, primarily under the influence of oil prices on world markets and shifts in seasonal effects. Core inflation nevertheless remains reasonably low, fluctuating at just over 1% in recent months.

Other macroeconomic indicators are in line with expectations

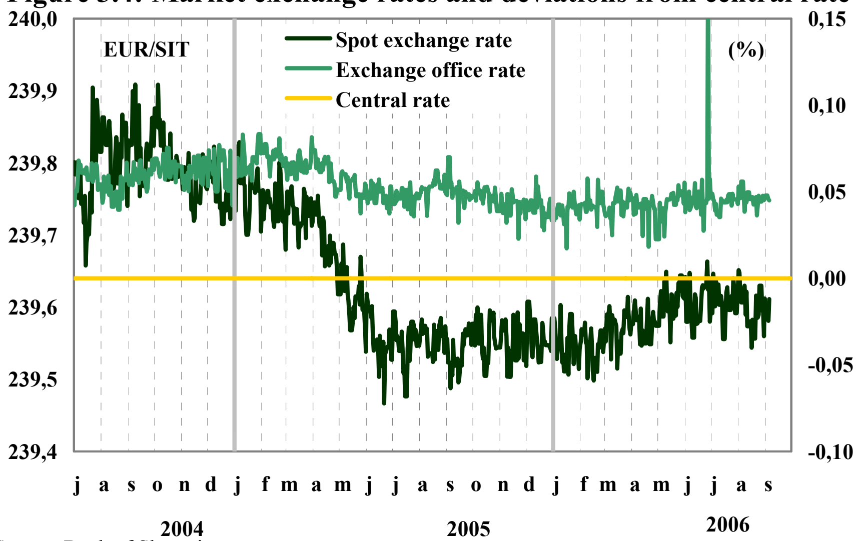
Other macroeconomic indicators – the current account, the general government deficit and labour costs – were in line with expectations. The current account deficit improved by 0.7 GDP percentage points over the previous year to 2.0% of GDP in 2005, but had amounted to 1.7% of estimated GDP in the first seven months of 2006. The general government deficit fell by 0.9 GDP percentage points in 2005 to 1.4% of GDP, while the figures to July indicate that it will remain at a similar level this year. The average gross wage has been rising by approximately 5% year-on-year in the last year, or approximately 2% in real terms, but growth remains behind productivity growth.

3.2 Monetary Policy Instruments in the ERM II

The deviations in the market exchange rates from the central rate have again been negligible in 2006

Since Slovenia joined the ERM II, the Bank of Slovenia has been conducting its monetary policy in line with the maintenance of the stability of the nominal tolar exchange rate against the euro. The market rates' deviations from the central rate during the participation to date in the ERM II have been negligible. Between 28 June 2004, when Slovenia joined the ERM II, and the beginning of September 2006, the exchange rate on the spot foreign exchange market[7] had an average deviation of 0.04% from the central rate, while that of the exchange office rate was 0.05%. The spot exchange rate fluctuated on the depreciation side of the

Figure 3.4: Market exchange rates and deviations from central rate



Source: Bank of Slovenia.

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

central rate between ERM II entry and the middle of 2005, but since then it has been on the appreciation side. The exchange office rate has always fluctuated on the depreciation side of the central rate, as a result of excess demand.

The spot exchange rate has mainly moved on the appreciation side of the central rate in 2006. Its deviation from the central rate averaged 0.04% in the first quarter, but just 0.02% between April and September. The exchange office rate has recorded an average deviation of 0.04% on the depreciation side of the central rate in 2006.

The foreign exchange markets are in balance in the long term

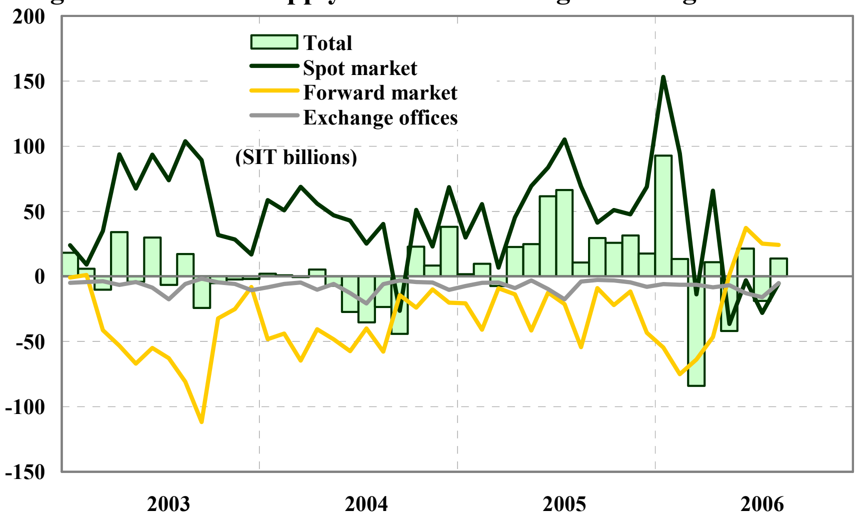
Since Slovenia joined the ERM II there has been no major excess of supply of or demand for foreign exchange on the foreign exchange markets, which indicates that the central rate is at a level sustainable in the long term. Despite short-term fluctuations in supply and demand in the first eight months of 2006, the total excess supply of foreign exchange on the markets amounted to just SIT 7.1 billion, an average of 0.1% of GDP. The only slightly larger imbalances were an excess supply of SIT 92.8 billion in January and an excess demand of SIT 84.2 billion in March.

On the spot market supply of foreign exchange exceeded demand during the first four months of the year, but since May demand has exceeded supply, while the position on the forward market was the reverse, i.e. excess demand until April, and excess supply since May. Between January and April there was an excess supply of foreign exchange of SIT 299.6 billion on the spot market and an excess demand of SIT 240.0 billion on the forward market, while between May and August there was an excess demand of SIT 72.8 billion on the spot market and an excess supply of SIT 87.9 billion on the forward market. The transition from excess supply to excess demand on the spot market was primarily the result of a decline in tolar investments by non-residents as foreign interest rates rose and domestic interest rates remained at the same level. The excess supply on the forward market since May has to a great extent been the result of forward sales of foreign exchange by certain domestic companies that were concluded at the end of 2005 and the beginning of 2006.

The small deviations in the market exchange rates from the central rate meant there was no need for exchange rate interventions

The smaller, short-term discrepancies between supply and demand on the foreign exchange markets were reflected in the movement of the tolar's market exchange rate, but because the deviations from the central rate were very minor, there was no need for the Bank of Slovenia to intervene. The Bank of Slovenia thus last actively intervened to shape the exchange rate in the first month after Slovenia joined the ERM II, when it wished to signal to the market its intention to hold the tolar stable against the euro.

Figure 3.5: Excess supply/demand on foreign exchange markets



Source: Bank of Slovenia.

3.3 Structural Adjustments to Ease the Transition to the Eurosystem

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

The long-term deposit as a sterilisation instrument

In the first seven months of 2005 the Bank of Slovenia again offered a long-term tolar deposit with the aim of sterilising excess liquidity from the maturity of 270-day tolar bills issued during the takeover of Lek at the end of 2002. The interest rate offered on the long-term tolar deposit was 0.2 percentage points higher than the interest rate on 60-day tolar bills, while the time that the deposit matures extends into the period after the planned adoption of the euro. Between July 2004, when the first offer was made, and July 2005, the Bank of Slovenia withdrew SIT 203.5 billion of primary money via this instrument. During the same period the stock of 270-day tolar bills fell by SIT 199.7 billion, which means that the operation of replacing 270-day tolar bills with the long-term deposit did not have a significant impact on the amount of reserve money in circulation.

Final abolition of the minimum foreign currency liquidity requirement and replacement of swaps with outright purchases of foreign exchange

In order to increase banks' flexibility in transacting on foreign exchange markets, the Bank of Slovenia gradually relaxed the minimum foreign currency liquidity, and offered to replace foreign exchange swaps with outright purchases. In 2004 the Bank of Slovenia cut the minimum requirement for the liquid assets that banks must hold in foreign currency from 80% to 70%. This requirement was cut further in April 2006 to 50% of their short-term liabilities in foreign currency. The requirement was cut again when the irrevocable conversion rate for the changeover from tolars to euros was set, and is being abolished altogether on 1 October. The requirement for mandatory subscription to foreign currency bills was cut from 45% to 35% in 2004, and in 2005 was cut further to 25% of liquid assets in foreign currency. The mandatory subscription to foreign currency bills was completely abolished in July 2005. The Bank of Slovenia abolished dollar-denominated foreign currency bills in June 2006, and all 120-day foreign currency bills in August 2006. The stock of foreign currency bills has therefore been gradually diminishing. The stock foreign currency bills peaked at SIT 584.5 billion in April 2004, but had fallen to just SIT 151.7 billion by the end of August 2006. In 2005 and 2006 the Bank of Slovenia again offered banks the opportunity to make an outright sale of foreign exchange from accumulated Bank of Slovenia foreign exchange swaps. Via this offer it made outright purchases from banks of SIT 331.8 billion of foreign exchange in 2004, SIT 414.9 billion in 2005, and SIT 149.9 billion in the first eight months of 2006. This resulted in a decline in the stock of foreign exchange swaps with the Bank of Slovenia, which stood at SIT 225.7 billion at the end of 2004 and SIT 164.8 billion at the end of 2005, and was negligible at the end of September 2006.

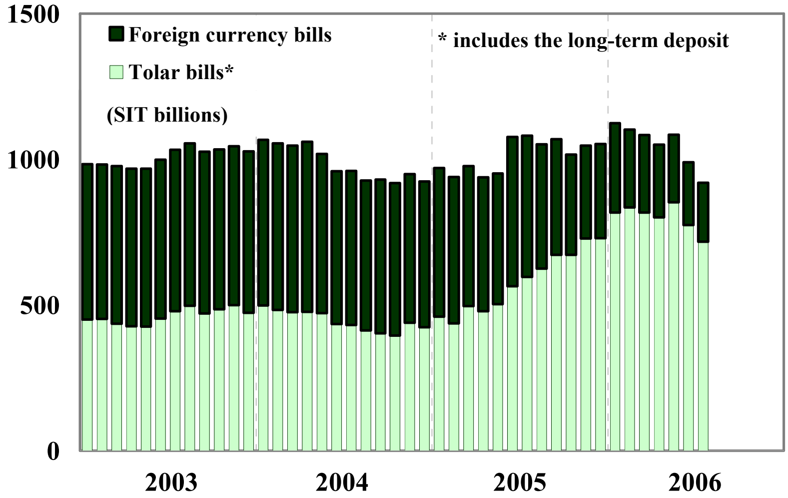
Adjustment of the reserve requirement instrument to the arrangements in the eurozone

The Bank of Slovenia continued to adjust the reserve requirement instrument to ECB standards. In March 2005 the Bank of Slovenia lowered the reserve requirement for tolar liabilities maturing in up to 90 days from 4.5% to 2%. Thus the reserve requirement for all liabilities maturing in up to two years is now 2%, in line with the arrangements in the eurosystem. The requirement for liabilities maturing in more than two years remains at 0%. The Bank of Slovenia aimed to delay the liquidity effect of the change until after the adoption of the euro. Banks and savings banks were therefore obliged to place the excess liquidity arising from the lowering of the reserve requirement in the amount of SIT 37 billion in a long-term deposit with the Bank of Slovenia maturing at the end of March 2007. Since the end of September 2006 the reserve requirement has been calculated from the position as at the final day of the month and no longer from the average, and the maintenance period for the reserve requirement has been adjusted to the calendar of the Eurosystem's reserve requirements, while the treatment of the period of notice for time deposits with the contractual possibility of early withdrawal and the treatment of saving by instalments have also been adjusted to the arrangements in the Eurosystem. By the end of the year the reserve requirement instrument will be fully adjusted to ECB standards.

An increase in tolar bills as a result of structural adjustments

It is important to consider these structural changes in the Bank of Slovenia's instruments when analysing the movement in the stock of tolar bills. The change in the stock of tolar bills and the long-term deposit is not merely an indication of the quantity of foreign exchange sterilisation by intervention, but also of the liquidity released from the decline in foreign currency bills and the decrease in liabilities from the reserve requirement. It is clear from Figure 3.6 that the stock of foreign currency bills and tolar bills has been between SIT 900 billion and SIT 1,100 billion in the last three years. The ratio of tolar bills to foreign currency bills has changed significantly, with the proportion of the total accounted for by tolar bills rising gradually from approximately 45% in 2004 to reach almost 80% in August 2006.

Figure 3.6: Increase in tolar bills as a result of decline in foreign currency bills



Source: Bank of Slovenia.

Adjustment of the liquidity ladder credit instrument

The Bank of Slovenia is also gradually adjusting the liquidity ladder instrument to the arrangements in the Eurosystem. The possibility of using A-rated tolar lending maturing in more than 180 days to meet the liquidity ratios in the first category (remaining maturity of up to 30 days) was thus abolished, and a weighting was established for household sight deposits and corporate sight deposits of 85% in the first category and 60% in the second category (remaining maturity of up to 180 days). Banks had the possibility of operating under the new system since July 2005, but were obliged to switch to the new system on 1 January 2006. Since September it has been allowed to include lending to direct state budget spending units and lending covered by Republic of Slovenia guarantee in the two liquidity ladder categories. As of 1 January 2007 this lending will have to meet the eligibility criteria in order to be included in the liquidity ladder.

At the end of 2006 the Bank of Slovenia will issue a short-term deposit for the purpose of providing collateral for euro cash. The deposit will be issued as 60-day tolar bills mature, and will mature in February and March 2007.

Box 3.2: Diary of Bank of Slovenia measures since ERM II entry

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

2 July 2004
The Bank of Slovenia raises the reverse foreign exchange swap rate from 0.25% to 1.0%, thus allowing banks cheaper access to foreign currency liquidity. This eases the deprecation pressure on the tolar.

20 July 2004
The Bank of Slovenia cuts the interest rate on 270-day tolar bills from 4.25% to 4.20%.

27 July 2004
The Bank of Slovenia intervenes directly on the interbank foreign exchange market by selling foreign currency.

30 July 2004
The Bank of Slovenia first offers banks the chance to subscribe to a long-term tolar deposit as a replacement for 270-day tolar bills. The interest rate is 0.2 percentage points higher than that on 60-day tolar bills. Banks subscribe to SIT 203.5 billion of long-term tolar deposits by July 2005.

27 October 2004
The Bank of Slovenia continues to adjust the reserve requirement system to ECB standards. In so doing it:
- includes companies issuing electronic money among the institutions subject to the reserve requirement
- abolishes the mandatory 50% daily maintenance of the reserve requirement
- regulates the obligation to meet the reserve requirement in the event of bankruptcy
- sets a 0% reserve requirement for repurchase agreements

24 and 25 November 2004
As part of the replacement of foreign exchange swaps with outright purchases, the Bank of Slovenia purchases SIT 75.3 billion of foreign currency from banks.

3 to 10 December 2004
As part of the replacement of foreign exchange swaps with outright purchases, the Bank of Slovenia purchases SIT 22.6 billion of foreign currency from banks.

23 December 2004
The Bank of Slovenia raises the foreign exchange swap rate from 1.0% to 1.25%, and thus the refinancing rate from 3.0% to 3.25%. The aim of this structural adjustment is to ensure continuing stability on the money market.

1 February 2005
The Bank of Slovenia revokes the provision pursuant to which credit institutions that had failed to repay one-day liquidity loans by the end of payment transactions had to take a lombard loan at the lombard loan interest rate plus 4 percentage points. Now they can take loans at the lombard loan rate without paying the premium.

11 February 2005
The Bank of Slovenia cuts the requirement for the mandatory subscription to foreign currency bills from 35% to 30% of liquid assets in foreign currency.

27 March 2005
The Bank of Slovenia continues to adjust the reserve requirement system to ECB standards. The reserve requirement for tolar deposits of up to 90 days is cut from 4.5% to 2.0%. Institutions subject to the reserve requirement must subscribe to a long-term deposit with the Bank of Slovenia in the amount of the liquidity released (SIT 36.9 billion) by 29 March 2005, the deposit maturing on 30 March 2007.

8 April 2005
The Bank of Slovenia raises the foreign exchange swap rate from 1.25% to 1.5%. It cuts the requirement for the mandatory subscription to foreign currency bills from 30% to 25% of liquid assets in foreign currency.

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

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

14 July 2005
The Bank of Slovenia abolishes mandatory subscription to foreign currency bills.

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

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

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

6 December 2005
The rise in the ECB's refinancing rate from 2.0% to 2.25% raises the Bank of Slovenia's refinancing rate from 3.5% to 3.75%.

10 February 2006
The Bank of Slovenia cuts its interest rates as follows:
- the refinancing rate from 3.75% to 3.5%
- the lombard loan rate from 5.0% to 4.75%
- the interest rate on 60-day tolar bills from 4.0% to 3.75%
- the foreign exchange swap rate from 1.5% to 1.25%
- the reverse foreign exchange swap rate from 1.0% to 0.75%

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

3 March 2006
The Bank of Slovenia cuts its interest rates as follows:
- the refinancing rate from 3.5% to 3.25% (including the rise in the ECB's refinancing rate from 2.25% to 2.5% on 8 March)
- the lombard loan rate from 4.75% to 4.5%
- the interest rate on 60-day tolar bills from 3.75% to 3.5%
- the foreign exchange swap rate from 1.25% to 0.75%
- the reverse foreign exchange swap rate from 0.75% to 0.25%

1 April 2006
The Bank of Slovenia cuts the minimum requirement for liquid assets in foreign currency from 70% to 50% of short-term foreign currency liabilities.

1 June 2006
The Bank of Slovenia abolishes subscription to dollar-denominated foreign currency bills.

9 June 2006
The Bank of Slovenia cuts its interest rates as follows:
- the interest rate on 60-day tolar bills from 3.5% to 3.25%
- the interest rate on the long-term deposit from 3.7% to 3.45%

The rise in the ECB's refinancing rate from 2.5% to 2.75% raises the Bank of Slovenia's refinancing rate from 3.25% to 3.5%.

26 to 29 June 2006
As part of the replacement of foreign exchange swaps with outright purchases, the Bank of Slovenia purchases SIT 31.2 billion of foreign currency from banks.

11 July 2006
The Bank of Slovenia cuts the minimum requirement for liquid assets in foreign currency from 50% to 30% of short-term foreign currency liabilities.

19 July 2006
The Bank of Slovenia continues to adjust the reserve requirement system to ECB standards. Thus, from September:
- the reserve requirement is calculated from the position as at the final day of the month, rather than from the average
- the data source for the calculation is changed
- the maintenance period is adjusted to the calendar for the Eurosystem's reserve requirement
- the treatment of the period of notice for time deposits with the contractual possibility of early withdrawal and the treatment of saving by instalments are adjusted

4 August 2006
The Bank of Slovenia raises its interest rates as follows:
- the interest rate on 60-day tolar bills from 3.25% to 3.5%
- the interest rate on the long-term deposit from 3.45% to 3.7%
- the overnight deposit rate from 2.25% to 2.5%
- the lombard loan rate from 4.5% to 4.75%

The rise in the ECB's refinancing rate from 2.75% to 3.0% raises the Bank of Slovenia's refinancing rate from 3.5% to 3.75%.

29 August 2006
The Bank of Slovenia abolishes subscription to foreign currency bills maturing in 120 days.

13 September 2006
The Bank of Slovenia allows lending to direct state budget spending units and lending covered by Republic of Slovenia guarantee to be included in the two categories of the liquidity ladder.

1 October 2006
The Bank of Slovenia completely abolishes the minimum requirement for liquid assets in foreign currency.

4 ECONOMIC PROJECTIONS[8]

In the context of a favourable global economic climate and an increase in domestic demand, GDP growth will remain relatively high in the period to 2008, at a level over 4%. Price inflation is forecast to stand at approximately 2.6% at the end of this year, and to remain at this level for the next two years, assuming there are no new oil shocks. With the high rates of import and export growth slowing gradually, the unfavourable terms of trade and negative trends in factor income will see the current account deteriorate to approximately 2.5% of GDP.

The first part of this section examines the projected movements in selected factors from the international environment. This is followed by a description of projections of economic activity, employment and wages. The third part shows the trend in domestic demand in terms of individual components of spending. The external balance and terms of financing are analysed in the fourth and fifth parts. The final part presents forecasts for price movements. A summary of the forecasts and a comparison with the forecasts from May 2006 are given in Table 4.9 at the end of the section.

4.1 International Environment

The strengthening of domestic demand in the rest of the world will contribute to solid growth in Slovenia, while risk factors are building on the demand side in addition to the supply side

Economic growth in Slovenia's most important trading partners will be higher this year than last year. Alongside the continuing contribution made by trade, the recovery of domestic demand in the eurozone is another factor in this. Demand was rather modest in recent years as a result of both slow investment activity and weak household spending, but in the future, this year in particular, household spending should also begin to increase alongside increased investment. Owing to stronger domestic demand and the associated inflationary pressures, monetary policy in the eurozone is expected to be further tightened. Rapid growth in commodity prices means that supply-side price pressures from the rest of the world will also be relatively strong, this year at least. Supply factors will remain the most significant risk factors that could give raise to significant inflationary pressures from abroad, but the role of demand-side risk factors will increase.

Table 4.1: Assumptions for international environment

					2006 Forecast		2007 Forecast		2008 Forecast	
	2002	2003	2004	2005	Oct	Δ	Oct	Δ	Oct	Δ
	annual growth, %									
Foreign demand*	1.9	3.7	5.3	4.7	7.0	1.0	6.5	0.5	6.0	0.0
USD/EUR	0.94	1.13	1.24	1.25	1.25	0.0	1.27	0.1	1.27	0.1
Oil (USD per barrel)	25	29	38	54	67	2.0	70	5.0	70	5.0
Commodities	4.6	11.3	16.0	6.0	25.0	10.0	10.0	7.0	5.0	2.0
EMU inflation	2.2	2.1	2.1	2.2	2.3	0.1	2.4	0.2	2.0	0.0
PPI Germany	-0.6	1.7	1.6	4.6	5.4	2.5	2.7	1.0	1.7	0.0
3m Euribor (%)	3.3	2.3	2.3	2.3	3.5	0.5	4.3	0.8	4.5	1.0

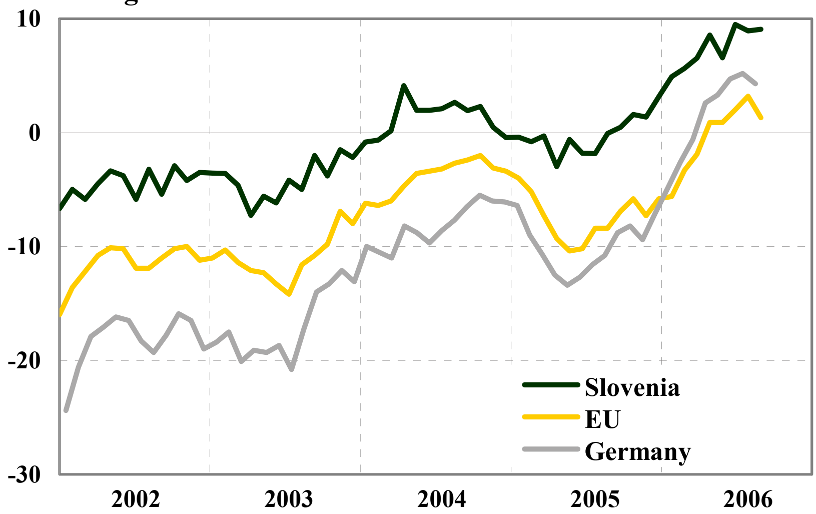
* Volume of imports - basket of foreign partners.
Source: Eurostat, Consensus Forecasts, JP Morgan, OECD Outlook, IMF World Economic Outlook.

[8] The forecasts were made on the basis of information available and the statistical methodology applicable on 15 September 2006. The projection of macroeconomic factors in this section rests on assumptions for movements in variables in the international environment and certain domestic factors conditioned by economic policy decisions. The domestic factors under the influence of economic policy and exogenously included in the forecasting process are the movements of the tolar exchange rate, public sector spending and investment, public sector wages, the movement of administered prices and certain other variables of a fiscal nature

Demand in the rest of the world is being boosted by both investment spending and final consumption

After stalling temporarily at the end of last year, demand from the rest of the world began to pick up in the first half of this year, and should increase by significantly more in the second half of the year. The Consensus forecasts for economic growth in Germany in 2006 have been revised upwards by 0.5 percentage points over the last six months, and by little less in 2007 by a little less. In addition to high GDP growth, further indications of increased economic activity come from consumer confidence in the most important trading partners, and the figures for growth in industrial production, investment and retail sales. Retail sales this year are supported primarily by the rise in VAT in Germany scheduled for the beginning of next year. Investment in the eurozone has shown an even more significant increase, thanks to sharp increases in corporate profits and the persistent signs of a favourable economic outlook in the rest of the world. A major factor in the increased corporate profits was the tougher conditions on the labour market, which also limited the recovery of household spending. Reasonably limited past wage growth significantly improved competitiveness, particularly in Germany, and will continue to contribute to high export growth. The solid performance of the world economy should maintain the eurozone's favourable export dynamic, this year at least. Despite the current favourable indicators, persistent high oil prices, tighter terms of financing, increased taxes and slower growth in the US mean that the economic climate in the eurozone will gradually cool during 2007 and 2008. Meanwhile demand from the countries of eastern and south-eastern Europe will remain relatively high in the future, although growth will not be as high as this year, primarily because of a slowdown in the currently high investment spending in Croatia. Russia will stand out for its high growth in demand, with both investment demand and consumption expenditure remaining strong as high oil prices persist.

Figure 4.1: Business outlook in Slovenia and abroad



Sources: SORS, Eurostat, ARC calculation.

The euro rising against the dollar in 2006

The euro's rise against the dollar because of the improvement in conditions in the European economy, expectations of an end to interest rate rises in the US and a gradual increase in interest rates in the eurozone, and the resulting decline in the spread between interest rates in the US and the eurozone has become particularly evident since the second quarter of 2006. The euro's trend of moderate appreciation is likely to continue on the basis of the expectations of a change in interest rates in the US and the eurozone. The forecast assumes a constant exchange rate of USD 1.27 to the euro throughout the forecasting period, which corresponds to the actual average exchange rate over the last three months and is very close to the forecasts of foreign institutions.

Oil prices remain high…

Growth in oil prices is expected to slow in the future, but they are likely to remain high. After a brief interlude at the end of last year, oil prices mainly rose this year, easing significantly only in September. The high oil prices are partly the result of high consumption; having grown by 1.2% in 2005, the oil demand should rise to 1.4% in 2006 and 1.5% in 2007, primarily owing to persistent high demand from China and other fast-developing Asian economies. The principal supply-side factors in the persistence of high oil prices are the level of production capacity and processing capacity, and the more difficult political and geopolitical conditions in certain oil producers or in their local regions. The majority of analysts thus expect oil prices to remain high, with forward contracts pointing to a price of around USD 70 per barrel. This assumption is a higher price than the one used in previous forecasts.

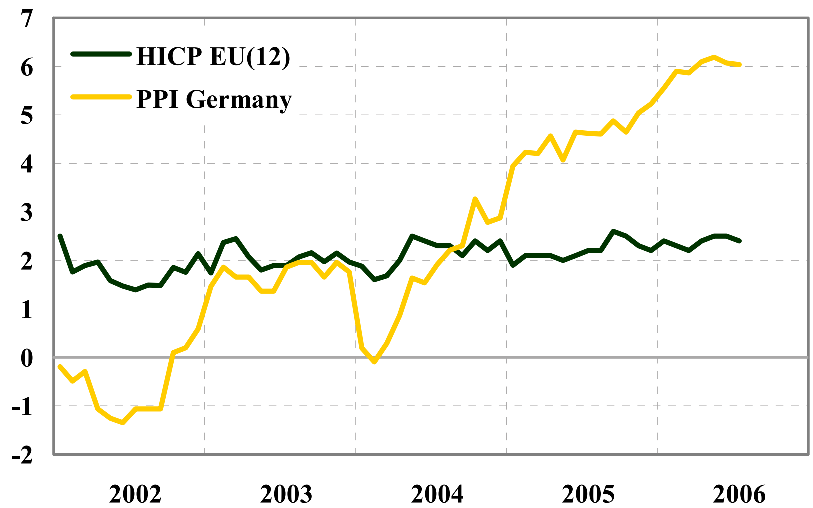
…as do prices of other commodities…

Commodity prices are also rising extremely fast this year, with all components contributing to the rise, although the rapid growth in metals prices is worthy of particular note. The rapid growth reflects continuing high demand from China and the countries of south-east Asia, and an increase in demand from wealthy countries, but also illustrates the adjustment of contractual prices for certain commodities such as steel that are not traded directly on the market. The price level reached in 2006 was far in excess of the record high at the end of the 1980s. The monthly dynamics of growth in the dollar prices of all components in the commodity basket exceed 0.7%, with metals recording the fastest monthly growth of 5.5%, and food the slowest rate of 0.7%. Given the extremely high current rate of growth, which does not show any signs of slowing, the assumption for the movement of commodity prices has been revised sharply upwards from the previous forecast for the second consecutive time.

…and are thus significantly contributing to higher prices in the rest of the world, while the first signs of energy prices feeding through into other prices have begun to appear

The assumption for the movement of inflation in the eurozone, which exceeds the ECB's target value in 2006 and 2007, is primarily the result of high growth in energy prices, the rise in indirect taxes, and the recovery of domestic demand. Having dipped below 1.5% at the end of 2005, core inflation in the eurozone (i.e. excluding energy prices and food prices) stalled at 1.5% in 2006. The slight rise in the assumption for inflation in the eurozone over the previous forecast is primarily the result of higher oil prices. The rapid growth in energy prices and other commodity prices has also had a strong impact on recent growth in producer prices of manufactured goods in Germany. Prices in other sectors are rising considerably more slowly, although there are now signs that in the context of stronger domestic demand high energy prices are partly feeding through into prices of other manufactured goods. A gradual slowdown in overall producer prices is nevertheless expected, as a result of the projected slowdown in energy prices and a slowdown in world economic growth.

Figure 4.2: HICP in the eurozone and PPI in Germany



Source: Eurostat.

Tightening of monetary policy in the eurozone

Since December 2005 the ECB has gradually been raising the interest rates on its main instruments. The assumption for the movement of interest rates is based on the market expectations of a continuing gradual rise in interest rates in the eurozone. Interest rates are expected to gradually rise during the forecasting period, which is in line with the inflationary pressures coming from renewed growth in domestic demand, the reasonably high growth in lending, and other risks associated with the potential feed-through of high energy prices into other prices.

4.2 Economic Activity, Employment and Wages

Economic growth remaining above 4%

The forecast for economic growth this year has been revised upwards to 4.5%, while those for 2007 and 2008 are unchanged at approximately 4%. GDP growth throughout the forecasting period will thus be higher than the estimated growth in the long-term trend, which is slightly less than 4%. This growth will continue to allow for a process of real convergence with the wealthier EU member-states, as economic growth will be faster than average economic growth in the EU; however being also faster than estimated potential growth the positive output gap will open further.

Table 4.2: Economic activity, employment and wages

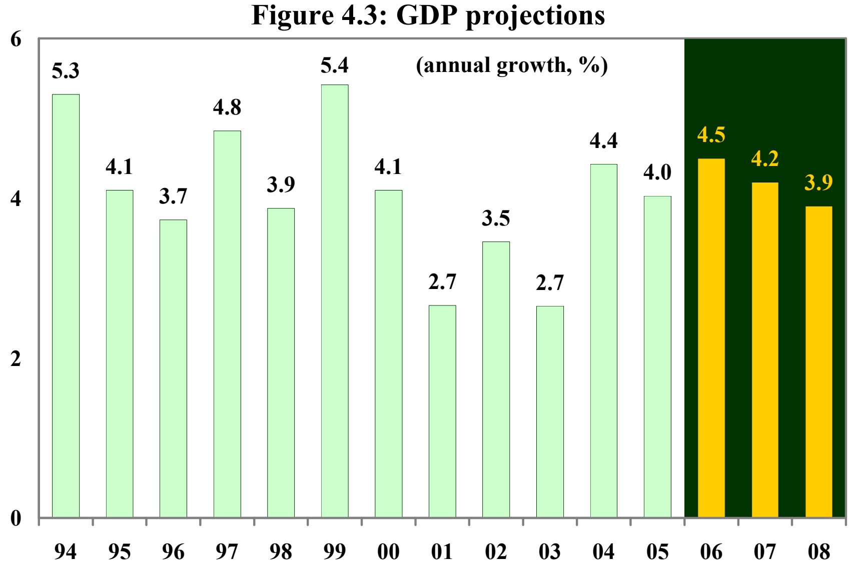
	2002	2003	2004	2005	2006 Forecast Oct	Δ	2007 Forecast Oct	Δ	2008 Forecast Oct	Δ
	real growth, %									
Real GDP	3.5	2.7	4.4	4.0	4.5	0.3	4.2	0.0	3.9	0.0
Employment	1.5	-0.4	0.5	0.3	0.9	0.5	0.6	0.3	0.5	0.2
Net wages	2.1	1.8	0.8	3.6	2.5	-0.4	4.0	1.1	2.9	0.3
Gross wages	2.1	1.9	1.0	2.2	2.5	-0.4	2.6	-0.3	2.9	0.3
Productivity	2.0	3.1	3.9	3.7	3.5	-0.4	3.6	-0.3	3.4	-0.2

Source: ARC.

The favourable employment trends will continue

Given this reasonably favourable climate, the high employment growth seen in the first half of 2006 should continue. The continuing positive employment dynamic will primarily be the result of employment in the public sector, while

Figure 4.3: GDP projections



Source: ARC.

trends in the private sector are likely to be slightly less favourable. The relatively high pace of economic growth in 2006 is being more positively reflected in developments on the labour market, although the figures at the end of last year and the beginning of this year had pointed to stagnation, and average employment rose by just 0.3% last year.

Unemployment also rose in the favourable climate, which could indicate an increase in structural unemployment, owing to difficulties with jobseekers' lack of qualifications. Nevertheless, given the favourable climate and moderate growth in labour costs, employment could also be expected to increase in the private sector. It is primarily the loss of jobs in traditional labour-intensive sectors that will prevent faster growth in private sector employment during the structural shifts in the economy.

Projected sustainable wage growth…

After rapid growth in 2005, growth in net wages has eased this year and is equal to growth in gross wages. Owing to changes in personal income taxation in 2007 it is likely that there will again be a significant discrepancy between growth in gross wages and growth in net wages, the latter outstripping the former by approximately 1.5 percentage points. The components of labour costs will grow at a similar rate to gross wages, the contribution made by payroll tax shrinking as it is gradually cut and finally abolished in 2009. While the social agreement for the 2006 to 2009 period has not yet been adopted, the social partners have agreed on one of its basic precepts, namely that real wage growth should remain behind productivity growth. Wage agreements for the coming years for the public and private sectors were concluded on this basis in June.

Box 4.1: New wage agreement

As the wage agreement covering the period from 2003 to 2005 or effectively to 30 June 2006 expired, at the end of June employers and unions signed new wage agreements for the private sector covering the 2006 to 2007 period, and for the public sector covering the 2006 to 2009 period. In both cases the maximum wage growth is defined by the precept in the social agreement, according to which it must be lower than productivity growth.

The wage agreement for the private sector stipulates that wages will increase by 2.0% this year and next year, with an additional increase allowed if inflation in either of the years exceeds 2.3%. In such an event wages will be additionally increased by the difference between the actual inflation rate and 2.3%.

The public sector agreement envisages overall wage increases of 2.56% in 2007, 3.13% in 2008 and 3.75% in 2009. There is also a safety valve built into the agreement, whereby if the actual annual inflation rate is higher than forecast, wages will be additionally increased by the difference on 1 January. Agreement was also reached that the rise in the inflation rate would be apportioned so that in 2007 62% would be earmarked for general wage growth and 38% for eliminating wage inequality in the public sector, while in the next two years the breakdown would be 50:50.

…is associated with several risks

After low growth of 0.9% in average real public sector wages in 2005, on the basis of budget documents for the coming years real wages can be expected to rise. Public sector wages should increase by 1.2% in real terms in 2006, and by 2.0% in 2007. Growth in private sector wages in the coming years will outstrip public sector wage growth by 1.0 to 1.5 percentage points in the favourable climate. Given these forecasts, the movement in total labour costs in the coming years will be in line with the projected movement in productivity, and will therefore not give rise to any inflationary pressures of a cost nature. Should this not happen, excessive growth in the element representing the majority of costs at companies could be reflected in inflationary pressures, a decline in competitiveness and a slowdown in employment.

4.3 Components of Spending

The prevailing contribution by domestic demand alongside a positive contribution by net trade

The contribution made to economic growth by domestic demand will increase during the forecasting period, while the contribution to GDP growth made by net trade will be lower than in 2005, but will remain positive. The increase in the contribution made by domestic spending is to a great extent the result of increased investment spending after the decline in total investment in 2005.

Table 4.3: Components of spending

	2002	2003	2004	2005	2006 Forecast Oct	2006 Forecast Δ	2007 Forecast Oct	2007 Forecast Δ	2008 Forecast Oct	2008 Forecast Δ
	real growth, %									
Domestic demand	2.4	4.7	4.9	2.0	4.5	0.8	4.2	0.3	3.6	0.1
Private consumption	1.3	3.4	2.6	3.4	3.5	0.3	3.4	0.3	3.1	0.0
Government spending	3.2	1.6	3.4	2.2	3.7	1.0	2.8	0.0	2.8	0.1
Gross investment	4.0	10.1	11.4	-1.1	6.5	1.1	6.2	0.2	5.1	0.2

Source: ARC.

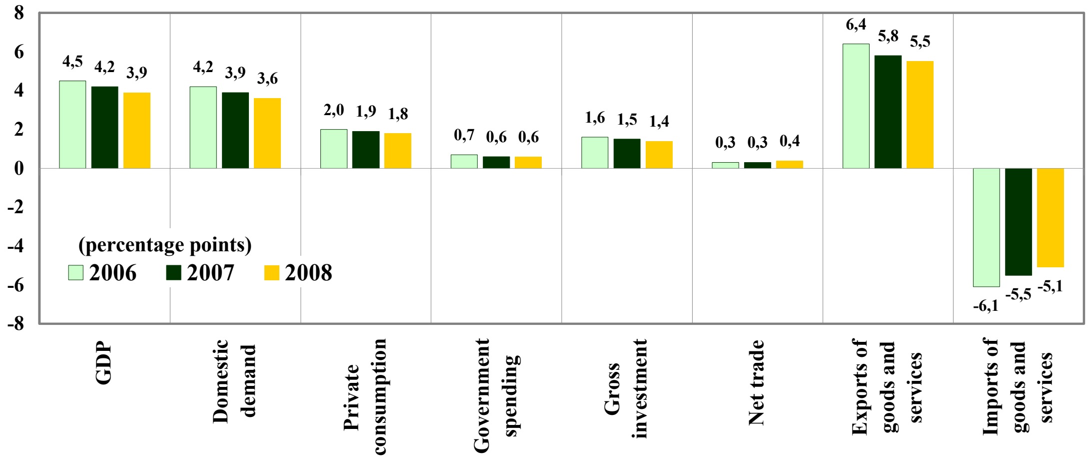
Risks to the economic growth forecast on the export side in particular

Domestic demand will be the dominant factor in the economic cycle throughout the forecasting period. Investment growth will account for over 70% of the increase in the role of domestic demand in 2006 compared with 2005, while household spending and government spending will contribute equally to the remainder of the increased contribution to economic growth made by domestic spending. The contribution made by net trade will decline in 2006 as a result of slightly slower export growth and the increased growth in import demand, which is in line with the increase in domestic consumption. In the context of the projected increase in foreign demand, the cooling in the export dynamic is to a great extent the result of expectations of stalled growth in exports by the car industry, which was the main engine of high merchandise export growth in 2005. Domestic demand will continue to account for the majority of economic growth in 2007 and 2008 (approximately 90% according to forecasts), but the contribution made by net trade will remain positive. The most likely reasons for Slovenia experiencing lower economic growth during the forecasting period than currently forecast are a further delay in the increase in economic activity in the most important trading partners and a stronger decline in export activity by the car industry.

Household spending high yet sustainable, but associated with considerable risks

Household spending will remain at a high but sustainable level, behind GDP growth, and will not give rise to any inflationary pressures. The contribution made to economic growth by household spending will increase only slightly compared with 2005. The main factors in household spending remaining reasonably high but sustainable will be the relatively high disposable income, which according to projections will be restricted by the wage policy agreement, and the relatively favourable terms of financing, which according to projections will tighten slightly from 2007 on. A major factor in household spending remaining at a high level in 2007 will be the projected abolition of the transitional period during which a lower VAT rate applies to housing, and the personal income tax reform, which will raise net wages and thus disposable income. However, some projected changes in taxation, the tightening of monetary policy in the eurozone and the consequent rise in interest rates will prevent excessive household spending. Households will continue to be encouraged to use longer-term forms of saving by the institutional changes already introduced in the area of pension insurance. The main risk factors affecting household spending are the still undefined package of tax reforms, and price rises, which could encourage additional wage increases in the event of substantial wage growth allowed by the favourable economic climate. Because pension increases have been tied to gross wages since the middle of 2005, the disposable income from pensions is also a risk to the forecast for household spending. Any changes in indirect taxation, in particular changes in the current VAT rates, would alter the assumptions on which the projections for household spending are based. Such an event would in all likelihood trigger a process of inter-temporary shifts in consumption, similar to that in 1999, with a rapid increase in household spending in the year before the change to VAT and very slow growth in household spending in the year of the change.

Figure 4.4: Projection for contributions by components of spending



Source: ARC.

…investment activity will remain strong…

Investment activity picked up pace at the end of last year, and at the beginning of this year in particular. The fastest-growing components of capital expenditure are housebuilding and investment in transport equipment. The persistent high pace of investment in housebuilding in 2006, which is expected to continue in 2007, is the result of an increase in housebuilding before the projected abolition of the transitional period for applying the lower VAT rate, which ends at the end of 2007. During the transitional period Slovenia can apply the reduced VAT rate to the construction and repair of housing and other facilities designed for permanent residence. The rapid growth in investment in transport equipment in the first half of the year was at least partly the result of one-off factors, i.e. inter-temporal shifts caused by the less favourable price terms for the purchase of specific types of transport equipment from 1 January 2007. Alongside slightly higher investment in plant and equipment as a result of the favourable economic climate and increased investment spending by the government on road infrastructure, investment in housebuilding will in particular record high growth in the future. A significant contribution to high investment this year and next year will be made by projected investment in the car industry, which is also a significant risk factor with regard to the movement of total investment. However investment spending will be restricted by the anticipated tightening of the terms of financing, the downturn in the economic climate in the rest of the world and the abolition of corporate income tax relief on investment, which is projected to enter into force at the beginning of 2007.

…government consumption will slow after high growth in 2006

The contribution made to economic growth by government spending will remain similar to that in previous years throughout the forecasting period, with the exception of 2006. Attention should be drawn to this year's increase in government spending, which is the result of high expenditure on collective consumption, which grew by 4.2% in real terms in the first half of the year. It is estimated that government expenditure on goods and services will record the fastest growth this year, but the rate should slow in the next two years. The assumption for this year's government spending was revised significantly upwards, by 1 percentage point on the previous forecast, but the assumptions for the next two years are unchanged from the previous forecasts. Growth in government spending is forecast to settle at a level around 3.0% in the next two years.

4.4 Balance of Payments

Sizeable differences between these forecasts and the previous forecasts

The estimated current account deficit will increase in the coming period by slightly more than 0.5 GDP percentage points from the level of 2% of GDP in 2005. The reasons for the increase in the deficit from the previous forecasts, despite the increase in forecast export growth, are the simultaneous increase in the forecast import growth, and, in particular, the change in methodology and the adverse movements in income account. Forecasts for import and export growth in 2006 and 2007 have both been revised upwards, with the revision for 2007 approximately half of that for 2006. The reason for the differences in the forecasts are higher foreign demand on the export side and faster growth in domestic spending in 2006 and 2007 on the import side.

Table 4.4: Current account

	2002	2003	2004	2005	2006 Forecast Oct	2006 Forecast Δ	2007 Forecast Oct	2007 Forecast Δ	2008 Forecast Oct	2008 Forecast Δ
	real growth, %									
Exports of goods and services	6.7	3.1	12.5	10.5	**8.9**	**1.5**	**7.8**	**0.7**	**7.2**	**0.0**
Imports of goods and services	4.8	6.7	13.4	7.0	**8.5**	**1.8**	**7.5**	**0.9**	**6.7**	**0.0**
Current account (EUR millions)	247	-196	-720	-547	**-770**	**-190**	**-850**	**-150**	**-810**	**-250**
as % of GDP	1.0	-0.8	-2.7	-2.0	**-2.6**	**-0.6**	**-2.7**	**-0.4**	**-2.4**	**-0.7**
Terms of trade	0.5	1.3	-1.0	-2.7	**-1.0**	**0.6**	**-0.5**	**-0.4**	**-0.1**	**-0.5**

Note: The figures used are based on the revision of certain balance of payments items made in September 2006.
Source: ARC.

A current account deficit of approximately 2.5% of GDP owing to methodological changes…

The estimated current account deficit will widen from EUR 547 million in 2005 to EUR 770 million in 2006 and EUR 850 million in 2007. This deterioration comes almost entirely from changes in the methodology for monitoring certain items in the balance of payments, and adverse movements in investment income.

The rise in domestic spending, and the corresponding increase in imports, will also make a certain contribution to the increase in the estimated deficit. Despite a further deterioration in the investment income position, the estimated current account deficit in 2008 will improve to around EUR 800 million in the context of an improvement in the goods and services position.

…unfavourable movements in the terms of trade…

Further adverse movement in the terms of trade is forecast in 2006 as a result of rapid growth in commodity prices, but the effect of the terms of trade on the current account is expected to be more neutral in the next two years as a result of a slowdown in commodity prices. The terms of trade will improve by 0.6 percentage points over the previous forecasts, despite the unfavourable commodity prices. This revision is the result of an improvement in the terms of trade in the first half of 2006, when import prices rose by 4.9% as measured by the deflator in the national accounts, compared with last year's average of 5.7%. However, growth in export prices measured in the same way rose from last year's average of 3.5% to 4.4%, the reasons for this probably lying in the gradual process of high commodity prices feeding through into prices of non-energy products in the rest of the world.

Box 4.2: Revision to the balance of payments

A comprehensive revision of the balance of payments for the 2002 to 2005 period was made in September. The current account position deteriorated significantly in the revision, the largest impact coming in 2005, when the deficit widened by almost EUR 250 million.The revision to the balance of payments was made in accordance with the recommendations of the ECB. As a rule, the figures can be changed for a period of no more than two years before the year of revision, but in the case of major methodological changes the revision can date back further. Owing to ECB reporting requirements and the gradual inclusion of direct reporting (EC 2506/2001), the subject of the latest revision is the period from 2002.

During revisions the balance of payments figures are generally changed because of methodological changes or updates, or because of the usual updating of sources.

The lastest methodological changes that contributed to the largest changes in the current account position relate to private transfers (pensions), where the data source has been changed for pensions paid by Slovenia to non-residents (the previous source underestimated these pensions). There was also a change in the data source for labour income, while the income is now being disclosed in gross amounts, the taxes and contributions from this income being disclosed under transfers as reimbursement of this part of the income. The gross labour income figures do not differ significantly from the previous net figures (or these were previously overestimated), but transfers of taxes and contributions on this income are accounted against the outflow side of transfers, and thus against the current account overall.

In the financial account, the methodology for households has been updated, and now includes changes in household accounts at foreign banks (for countries that are members of the BIS). Owing to this change, and the new estimates for labour income in cash, this item changed in all the years, but particularly in 2005.

Household accounts at banks in the rest of the world have now been included (with the opposite sign to that under households) in the item of "accounts in the rest of the world", where previously only corporate bodies were included.

Since 2004 portfolio investments data have been taken from a new source, which alongside better coverage of these transactions has taken portfolio investments to a significantly higher level.

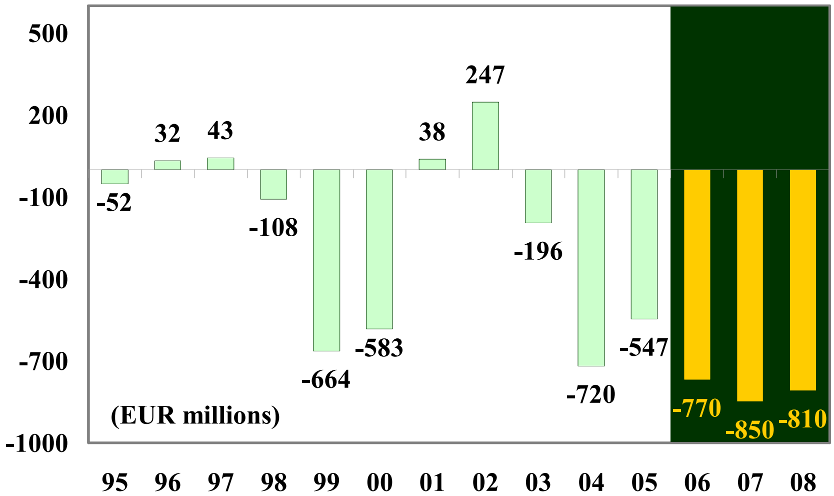
Table 1: Changes in current account items

	2002	2003	2004	2005
	EUR millions			
Current account	**-97**	**-115**	**-176**	**-246**
Factor income	-14	-46	-72	-58
Transfers	-82	-68	-105	-155
Financial account	**148**	**57**	**51**	**-314**
Portfolio investments			-62	-400
Households	5	91	126	330
Accounts abroad	84	13	-23	-205

Source: Bank of Slovenia Financial Statistics.
Note: The differences between the new and the most recent figures for balance of payments items are shown.

Growth in import prices in 2006 will thus outstrip growth in export prices by 1.0 percentage point, contributing to the increase in the current account deficit this year, and maintaining it at a relatively high level in coming years. Allowing for the unfavourable movement in the terms of trade would significantly improve the current account position. The current account deficit would fall to approximately EUR 600 million in 2006, to approximately EUR 560 million in 2007 and to approximately EUR 480 million in 2008. The terms of trade will account for between 0.6 and 1.0 GDP percentage points of the current account deficit in the coming years.

Figure 4.5: Projection of current account



Source: ARC.

…which will be reflected in a high trade deficit

In the coming years growth in merchandise exports should exceed growth in merchandise imports by between 0.2 and 0.5 percentage points. The high growth in merchandise exports in 2004 and 2005 associated with the final abolition of customs duties when Slovenia joined the EU and the high growth in exports by the car industry should settle at a level slightly above 7% in the period ahead. These projections are similar to the previous forecasts, and are in line with economic activity in Slovenia's most important trading partners. Growth in merchandise imports is linked both to growth in merchandise exports, and also to growth in domestic spending. As the pace of exports slows, growth in merchandise imports in the coming years is expected to be higher than in 2005, in line with the increase in domestic demand. The forecast for growth in merchandise imports in 2006 is 0.7 percentage points higher than the previous forecast, while that for 2007 is virtually the same.

The greatest risk is in the realisation of the terms of trade

The projections for the current account position are a reflection of the current assumptions, while the risks are primarily represented by changes in the assumptions based on which growth in imports and exports of goods and services and the terms of trade have been estimated. The risks in forecasts for growth in imports and exports of goods and services relate to a great extent to the level of economic activity in Slovenia's trading partners and the pace of growth in domestic demand. The assumed terms of trade account for a significant proportion of the deterioration in the current account position in the coming period. Given Slovenia's small size, a change in domestic demand cannot bring any pressure on prices of foreign goods, and because of the strong competition on the domestic market a change in foreign demand for domestic goods cannot significantly alter prices of domestic goods. Slovenia's terms of trade, i.e. its prices of import and export goods, are set by supply and demand, and by shocks on world markets, with the latter, such as oil prices and commodity prices, continuing to have a significant impact on the realisation of the projections in the goods balance and thus also on the current account position.

Stable increase in the surplus in services and the deficit in factor income

The balance of trade in services will remain positive in the coming years. The main factors in this will be favourable foreign demand, and growth in export prices of services that is slightly higher than growth in import prices in 2006 and 2007. Net income will deteriorate significantly in 2006, by approximately EUR 200 million, but will remain unchanged in 2007 and 2008. Alongside the rising level of interest payments and the rising expenditure on dividends and reinvested profits, the most important factor in the deterioration is the one-off payment of withheld profits to a foreign investor for the previous three years in the middle of 2006. Interest payments are expected to rise because of the increasing amount of accumulated debt from loans and deposits from the rest of the world, and also because of the projected rise in interest rates. The high and rising expenditure on dividends and reinvested earnings is in terms of volume a reflection of the inward FDI realised in Slovenia in the past, and in terms of dynamics a reflection of the projected increase in FDI in Slovenia in the future. Increases in income from investments in foreign securities, which should significantly exceed expenditure from foreign investments in domestic securities, will act to reduce the deficit in net factor income in the coming period. Net labour income will remain positive in the coming period, and will actually improve slightly as earnings record higher growth than expenditure on labour.

A deficit in transfers expected

Net transfers will be negative in the coming years, with private transfers recording a positive position, and official transfers a negative position. Since Slovenia joined the EU, both income from the EU budget and expenditure on the EU budget have increased. This income and expenditure will record a slightly positive position in the coming period, slightly reducing the negative position of net official transfers.

4.5 Terms of Financing

The increase in the volume of financial transactions with the rest of the world…

The assumptions in the projection point to a further increase in the volume of financial transactions with the rest of the world. As in previous years, the largest contributions to the high volume of financial flows will come from bank borrowing in the rest of the world and high outward portfolio investments. The adoption of the euro in 2007 will also bring changes in certain major financial outflows and claims against the rest of the world. A change in the classification of foreign exchange reserves means that portfolio investments by banks in euro-denominated first-class securities, which to date have been included in foreign exchange reserves, will now be classed as portfolio investments. Euro deposits held by banks and the Bank of Slovenia in accounts in the rest of the world will be reclassified from foreign exchange reserves to ordinary claims against the rest of the world. These changes, which have not yet been finalised in methodological terms, make it impossible for the moment to define the overall position of the financial account.

…will on the inflow side come mostly from private sector borrowing…

Net financial inflows from the rest of the world will reach 2.7% of GDP in 2006. The main factor in the high financial inflows from the rest of the world will be private sector borrowing. The government will not borrow abroad directly, but will attract a net inflow of approximately EUR 0.5 billion of portfolio investments by non-residents via its securities issued in Slovenia, which will to a great extent represent the reinvestment of the eurobonds paid out last May, and also new investments given the difference in the yield on these securities.

Table 4.5: Financial account

					2006 Forecast		2007 Forecast		2008 Forecast	
as % of GDP	2002	2003	2004	2005	Oct	Δ	Oct	Δ	Oct	Δ
Net FDI	6.6	-0.6	0.9	-0.2	**-0.2**	**-0.7**	**1.8**	**-0.1**	**0.0**	**-1.4**
Net portfolio investments	-0.5	-0.8	-2.0	-3.8	**-3.1**	**-2.2**	**-5.2**	**-4.2**	**-5.1**	**-4.3**
Net loans	2.5	3.7	5.3	8.2	**7.1**	**1.8**	**8.2**	**2.1**	**8.4**	**2.4**
External debt (EUR millions)	11,483	13,259	15,271	19,565	**23,222**	**557**	**27,336**	**1,091**	**31,788**	**1,763**
- as % of GDP	48.5	53.3	58.4	71.5	**80.1**	**1.6**	**89.6**	**4.6**	**97.5**	**6.5**

Source: Bank of Slovenia, ARC estimates.

Companies will also finance themselves primarily at domestic banks, which will mainly secure the resources for domestic loans in the rest of the world. As of this year companies' terms of financing at domestic banks for foreign currency loans have been practically the same as those abroad, with a variety of offers and competitive interest schemes. It is therefore forecast that companies will involve themselves in foreign loans to a lesser extent only. With lending continuing to grow rapidly this year and slightly more slowly in the next two years, total loans from the rest of the world will range from EUR 2.6 billion in 2006 to EUR 3.5 billion in 2008.

…banks in particular borrowing heavily…

Should the government stick to its plans to sell off state assets, inflows from inward FDI are likely to reach a high EUR 1.2 billion in 2007, returning to a lower level the following year. Outward FDI will record more stable growth to reach EUR 700 million by 2008, thus equalling inward FDI again.

….while high inflows for FDI are also expected

Outward portfolio investments will be the most prominent financial outflows, ranging from EUR 1.5 billion to EUR 2.2 billion annually. They are forecast to grow more slowly in the coming years, which is already being indicated this year, but there will be a methodology-induced leap in the total figure, as a result of the aforementioned wider classification of portfolio investments in 2007. With inflows of fresh money into mutual funds, outward investments are forecast to continue growing, partly as a result of their continuing process of portfolio diversifcation. Other noteworthy agents in this market are insurance companies and pension funds, which with rising inflows of funds will seek additional opportunities for returns.

The most important elements on the outflow side will be portfolio investments…

Slovenian exporters support an increasing proportion of their exports via loans and trade credits, either directly or via domestic banks. Lending to the rest of the world in this form is forecast to continue growing in the coming years. In the context of real growth in trade in goods and services, the volume of trade credits and lending could exceed EUR 1 billion in 2008.

…and export financing

Domestic lending in the coming period will be slightly higher than previously forecast, but the assumption of a gradual slowdown remains valid. Such movements are in line with the slightly higher forecasts for economic growth, in 2006 in particular. The depth of financial intermediation, as measured by the ratio of private sector lending to GDP, will increase from 65% in the middle of 2006 to approximately 90% at the end of 2008, although the rate of growth in the depth of financial intermediation will begin to decline during the forecasting period.

Continuation of relatively strong lending with a slowing dynamic…

These forecasts for private sector lending envisage a decline in year-on-year growth in both household lending and corporate lending. Year-on-year growth in household lending and corporate lending is expected to decline from approximately 25% in the middle of 2006 to below 20% in 2008. This increase in lending is in line with the aforementioned increase in the depth of financial intermediation. The forecast for corporate borrowing is slightly higher than the previous forecast as a result of increases in economic activity and investment. Corporate borrowing abroad is still forecast to be relatively low, and is not expected to exceed 10% of total household borrowing. Total household lending in the coming years will be only slightly higher than the previous forecast, as a result of the higher forecast for household spending. Government borrowing in the coming period reflects the need to cover the projected general government deficit and is in line with the projected debt restructuring. Government borrowing on the domestic market will increase in the coming period, with less borrowing coming from the rest of the world.

…because of private sector lending

Bank borrowing abroad and the imminent adoption of the euro mean that foreign currency lending will continue to prevail among domestic lending in 2006, which is in line with the currency coordination of the asset and liability sides of

Long-term lending will continue to prevail

banks' balance sheets. Borrowing is forecast to increase via both long-term and short-term lending in the coming period, as a result of relatively strong investment activity and relatively high housing lending.

Domestic lending will remain the main factor in growth in broad money

Domestic lending activity will be the main factor shaping broad money in the coming years. The negative contribution made by balance of payments flows to the growth in broad money will gradually decline during the forecasting period. The increase in some outflows to the rest of the world means that the negative contribution made to growth in broad money by the financial account will be larger than previously forecast, and growth in this monetary aggregate will therefore be smaller. The inclusion of some foreign currency deposits among sight deposits in domestic currency as a result of the adoption of the euro will significantly increase the amount of narrow money.

A gradual lengthening in the average maturity of deposits

The average maturity of tolar deposits will probably lengthen in the coming period, as the final setting of the conversion rate and of the date for the adoption of the euro has reduced the risk of changes in the tolar exchange rate. The change in the maturity structure of tolar deposits towards short-term deposits in the first half of 2006 was to a great extent connected to the decline in the shape of the interest rate curve.

4.6 Inflation

Inflation remains at the level of the estimated long-term equilibrium

After the end of the period with a trend of falling inflation as measured by the harmonised index of consumer prices, the average rate over the first nine months of the year of 2.6% is within the range of the long-term equilibrium that can be expected in an economy that is undergoing a process of real convergence. Taking the exogenous variables and economic policy assumptions into consideration, inflation will remain close to its 2005 level at 2.5% this year and next year, but in 2008 a slight rise in average inflation to around 2.7% can be expected.

Table 4.6: Inflation

					2006 Forecasts		2007 Forecasts		2008 Forecasts	
	2002	2003	2004	2005	Oct	Δ	Oct	Δ	Oct	Δ
	annual growth, final quarter, %									
Consumer prices (HICP)	6.9	5.0	3.5	2.6	**2.6**	**0.7**	**2.6**	**0.3**	**2.8**	**0.1**
Non-administered prices	6.7	5.3	2.3	1.4	**2.0**	**0.2**	**3.0**	**0.5**	**3.1**	**0.2**
Administered prices	7.9	3.6	9.5	8.2	**7.6**	**5.1**	**0.8**	**-0.6**	**0.9**	**-0.7**
	average annual growth, %									
Consumer prices (HICP)	7.5	5.7	3.7	2.5	**2.6**	**0.4**	**2.7**	**0.5**	**2.7**	**0.1**
Non-administered prices	7.6	5.9	3.0	1.1	**1.6**	**0.2**	**2.8**	**0.5**	**3.1**	**0.3**
Administered prices	6.7	4.6	6.9	9.1	**8.8**	**3.9**	**2.5**	**1.0**	**0.9**	**-0.7**

Source: ARC.

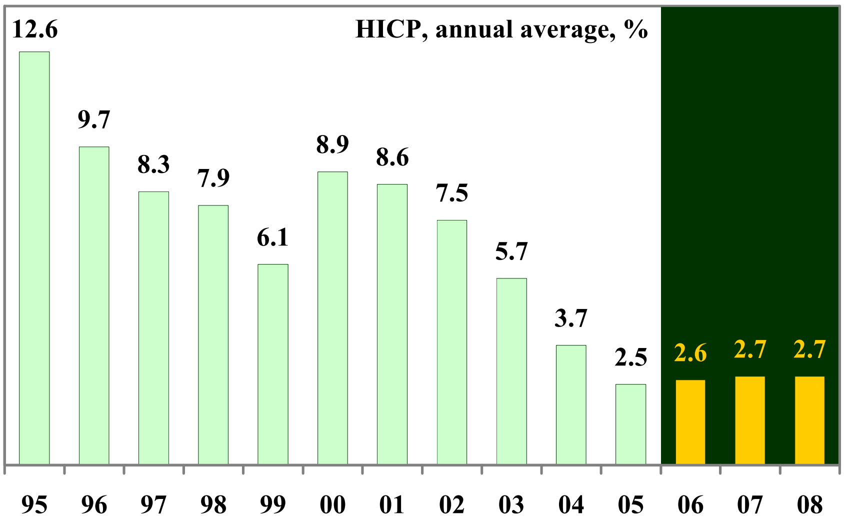
The upward revision of price inflation is the result of administered prices growing faster than expected

The upward revision in the forecast for headline inflation in 2006 from the May forecasts is almost entirely on the basis of faster growth in administered prices, which was primarily the result of high growth in oil prices on world markets. The upward revision in 2007 is partly a reflection of energy prices feeding through into non-administered prices, and the movement of non-administered prices to a level more sustainable in the long-term after the period of extremely low growth in non-administered prices brought mainly by Slovenia joining the EU.

Growth in free prices is gradually approaching the projected long-term equilibrium

Projections of factors from the domestic macroeconomic environment point to a gradual rise in inflation in non-administered prices towards the projected long-term equilibrium. Growth in non-administered prices will therefore gradually rise, following last year's extremely low growth. Year-on-year growth in non-administered prices is forecast at 2.0% in the final quarter in 2006, but will be higher in 2007 and 2008, and could reach 3.0% in the final quarter of 2007 and 3.1% at the end of 2008. Contrary to expectations, good economic performance saw the negative output gap close as early as the first half of the year, meaning that the downward pressures on inflation seen in recent years can no longer be expected. With gross wages forecast to grow moderately throughout the forecasting period, at a rate below productivity growth, no inflationary pressures will arise from labour costs. This assumption for the movement of labour costs is still in line with the assumption for trends on the labour market, which have recently presented a reasonably good picture, but is also guaranteed by the upholding of the wage agreements in the public and private sectors. The projected changes mean that growth in net wages, and thus disposable income, will be higher than previously forecast, particularly in 2007, for which reason demand-side pressures could arise given the already high level of domestic spending and additional growth in net wages. Judging by the projections for domestic and foreign movements in prices, the real effective exchange rate will remain in equilibrium and will not have a significant impact on prices or competitiveness. The risk of high energy prices gradually feeding through into non-administered prices in the context of relatively strong domestic demand is also slightly greater than previously forecast.

Figure 4.6: Inflation projections



Source: ARC.

An easing in price pressures from the rest of the world only at the end of the forecasting period

The exogenous assumptions from the international environment do not point to an easing in price pressures from the rest of the world. On the contrary, growth in consumer prices in the eurozone is expected to accelerate this year and next year, and will only ease to around 2.0% at the end of the forecasting period. Producer prices in Germany, Slovenia's biggest trading partner, are also expected to continue growing rapidly this year, with other components in the price index for manufactured goods growing faster, in addition to energy prices. Despite the assumptions of more restrictive monetary policy in the rest of the world, stronger economic activity in the rest of the world on the basis of domestic demand could entail pressure on prices in Slovenia.

Slow growth in administered prices forecast

The forecast for growth in administered prices, which assumes that energy prices are unchanged, is behind that for non-administered prices. In the administered prices forecast, the oil price on world markets is assumed to be unchanged, and as a result so too are prices of refined petroleum products on the domestic market. All other administered prices should move in line with non-administered prices, in accordance with the accepted macroeconomic price framework. Thus growth in administered prices overall will continue to exceed growth in non-administered prices this year, while in 2007 and 2008 growth in administered prices will be behind growth in non-administered prices on average owing to the lack of growth in prices of refined petroleum products. Another significant risk in these projections is the movement of oil prices, which in the event of significant deviation from our assumptions could prevent the projected decline in growth in administered prices.

Fiscal policy and administered prices policy will be decisive in maintaining price stability

Fiscal policy and administered prices policy will assume the decisive role in maintaining price stability in the coming years. By maintaining stable public finances, the first must ensure that the other macroeconomic equilibria remain stable, facilitating long-term stability in inflationary expectations. Administered prices policy will have to meet its targets more consistently, preventing rises in prices under government control that are not justified in cost terms. In the event of oil prices remaining unchanged on world markets, as proceeds from our assumptions, the forecasts are made under the assumption that prices of refined petroleum products will remain unchanged, i.e. the government will keep excise duties at the current level. The projections also assume that apart from the increases in excise duties on tobacco already announced the government will not significantly contribute to price rises through discretionary changes in indirect taxation.

4.7 Comparison with Other Institutions' Forecasts

The comparison of forecasts from various institutions…

Forecasts for Slovenia are compiled not only by domestic institutions, but also by international and private organisations. It is useful to compare forecasts because they highlight differences in thinking concerning future economic trends. However, the forecasts are not directly comparable because they cover different periods and therefore do not take into account the same information. This is particularly evident in this comparison, where the forecasts of the majority of institutions have not taken the national accounts figures for the second quarter of 2006 and the revision to the balance of payments for 2002 - 2005 into consideration. Furthermore, the forecasts rest on different assumptions with regard both to exogenous variables in the international environment and to economic policy actions.

Table 4.7: Comparison of forecasts for Slovenia and differences from previous forecasts

	Release of new/previous forecast	GDP annual growth, %				Inflation annual average, %				Current account as % of GDP			
		2006		2007		2006		2007		2006		2007	
		new	Δ	new	Δ	new	Δ	new	Δ	new	Δ	new	Δ
Bank of Slovenia	Oct 06 / May 06	4.5	0.3	4.2	0.0	2.6	0.4	2.7	0.5	-2.6	-0.6	-2.7	-0.4
EIPF	Sep 06 / Jan 06	4.7	0.2	4.1	…	2.5	0.3	2.2	…	-1.9	-0.6	-1.2	…
IMAD	Sep 06/ Mar 06	4.7	0.5	4.3	0.3	2.7	0.6	2.7	0.6	-2.4	-0.7	-1.6	-0.3
IMF	Sep 06 / Apr 06	4.2	0.2	4.0	0.0	2.5	0.1	2.3	-0.1	-2.0	-1.7	-2.3	-2.4
wiiw	Jul 06 / Feb 06	4.0	0.1	4.0	0.1	2.6	0.2	2.4	0.1	-1.2	-0.5	-1.0	-0.7
Consensus Forecasts	Sep 06 / Mar 06	4.4	0.6	4.1	0.1	2.6	0.3	2.3	0.2	-0.8	0.0	-1.0	-0.2

Sources: Bank of Slovenia, EIPF, IMF World Economic Outlook, Consensus Economic Forecasts, Wiener Institut für Internationale Wirtschaftsvergleiche (wiiw), IMAD.

The prevailing opinion regarding economic activity is that GDP growth in 2006 and 2007 will be equal to or slightly higher than growth in 2005, the forecasts for this year having been revised upwards slightly as a rule. The range in the forecast for the current account position remains similar to that in previous rounds of forecasts, when typically there were slightly larger differences between the forecasts of domestic and foreign institutions. This time the IMF, which in its most recent forecasts was predicting a minimal surplus in 2007, has significantly revised its forecast for both years in the direction of a higher deficit, while minor adjustments have been made in the same direction by the majority of the other institutions.

…shows considerable similarity…

Differences between the inflation forecasts are again minor, with the forecasts ranging between 2.5% and 2.7% for 2006 and between 2.2% and 2.7% for 2007, upward revisions typically having been made since the last round of forecasts.

…regarding inflation forecasts

Table 4.8: Selected main indicators

	2002	2003	2004	2005	2006 Forecast Oct	2006 Forecast Δ	2007 Forecast Oct	2007 Forecast Δ	2008 Forecast Oct	2008 Forecast Δ
Activity, employment, wages	*real growth, %*									
Real GDP	3.5	2.7	4.4	4.0	4.5	0.3	4.2	0.0	3.9	0.0
Employment	1.5	-0.2	0.4	0.7	0.9	0.5	0.6	0.3	0.5	0.2
Net wages	2.1	1.8	0.8	3.6	2.5	-0.4	4.0	1.1	2.9	0.3
Gross wages	2.1	1.9	1.0	2.2	2.5	-0.4	2.6	-0.3	2.9	0.3
Productivity	2.0	2.9	4.0	3.2	3.5	-0.4	3.6	-0.3	3.4	-0.2
Domestic demand	*real growth, %*									
Domestic demand	2.4	4.7	4.9	2.0	4.5	0.8	4.2	0.3	3.6	0.1
Private consumption	1.3	3.4	2.6	3.4	3.5	0.3	3.4	0.3	3.1	0.0
Government spending	3.2	1.6	3.4	2.2	3.7	1.0	2.8	0.0	2.8	0.1
Gross investment	4.0	10.1	11.4	-1.1	6.5	1.1	6.2	0.2	5.1	0.2
Balance of payments	*real growth, %*									
Exports of goods and services	6.7	3.1	12.5	10.5	8.9	1.5	7.8	0.7	7.2	0.0
Imports of goods and services	4.8	6.7	13.4	7.0	8.5	1.8	7.5	0.9	6.7	0.0
Current account (EUR millions)	247	-196	-720	-547	-770	-190	-850	-150	-810	-250
as % of GDP	1.0	-0.8	-2.7	-2.0	-2.6	-0.6	-2.7	-0.4	-2.4	-0.7
Terms of trade*	0.5	1.3	-1.0	-2.7	-1.0	0.6	-0.5	-0.4	-0.1	-0.5
Prices	*annual growth, final quarter, %*									
Consumer prices (HICP)	6.9	5.0	3.5	2.6	2.6	0.7	2.6	0.3	2.8	0.1
Free prices	6.7	5.3	2.3	1.4	2.0	0.2	3.0	0.5	3.1	0.2
Non-administered prices	7.9	3.6	9.5	8.2	7.6	5.1	0.8	-0.6	0.9	-0.7
	average annual growth, %									
Consumer prices (HICP)	7.5	5.7	3.7	2.5	2.6	0.4	2.7	0.5	2.7	0.1
Free prices	7.6	5.9	3.0	1.1	1.6	0.2	2.8	0.5	3.1	0.3
Non-administered prices	6.7	4.6	6.9	9.1	8.8	3.9	2.5	1.0	0.9	-0.7
International environment	*annual growth, %*									
Foreign demand**	1.9	3.7	5.3	4.7	7.0	1.0	6.5	0.5	6.0	0.0
USD/EUR	0.94	1.13	1.24	1.25	1.25	0.04	1.27	0.06	1.27	0.06
Oil (USD per barrel)	25	29	38	54	67	2.0	70	5.0	70	5.0
Commodities	4.6	11.3	16.0	6.0	25.0	10.0	10.0	7.0	5.0	2.0
EMU inflation	2.2	2.1	2.1	2.2	2.3	0.1	2.4	0.2	2.0	0.0
PPI Germany	-0.6	1.7	1.6	4.6	5.4	2.5	2.7	1.0	1.7	0.0
3m Euribor (%)	3.3	2.3	2.3	2.3	3.5	0.5	4.3	0.8	4.5	1.0

Note: Includes figures based on the revision of certain balance of payments items in September 2006.
* On the basis of national accounts deflators.
** Volume of imports - basket of foreign partners.
Source: ARC, Eurostat, Consensus Forecasts, JP Morgan, OECD Outlook, IMF World Economic Outlook.

5 ECONOMIC POLICY IN LIGHT OF EURO ADOPTION

Slovenia is joining the eurozone with a high level of sustainable convergence…

Following the decision made by the Council of Economics and Finance ministers on 1 July 2006, Slovenia will become a member of the eurozone and will adopt the single currency on 1 January 2007. This will completely alter Slovenia's macroeconomic environment, as after joining the eurozone it will no longer be able to exercise its own monetary policy, but will participate in shaping and implementing the eurozone's joint monetary policy. The Council's decision followed the recommendation by the European Commission of 16 May 2006, which had been based on its own Convergence Report and the separate Convergence Report issued by the ECB, found that Slovenia had achieved a high level of sustainable convergence and had thus met all the conditions for joining the eurozone.[9]

5.1 The Importance of Achieving Nominal Convergence

…and has demonstrated its readiness to adopt ECB monetary policy…

Slovenia's successful participation in the ERM II has proved that it is capable of adopting the ECB's monetary policy. Achieving nominal convergence is after all required for the ECB's monetary policy to suit the macroeconomic trends in Slovenia.

…having maintained all equilibria under the conditions of a stable exchange rate since joining the ERM II

The economic trends in Slovenia in the last two years have combined good economic growth with the maintenance of the main macroeconomic equilibria. Macroeconomic policy has acted successfully, despite the difficulties caused by certain adverse circumstances such as major oil shocks. Membership of the ERM II, however, does not merely represent a one-off test, but to a great extent illustrates the future room for manoeuvre Slovenia's economic policy within the monetary union.

A **sustained fall in inflation has been achieved…**

The year-on-year inflation rate in 2005 as measured by the HICP was 2.5%, thus bringing a successful end to the disinflation process underway since 2000. This was the result of adjustments in the conduct of economic policy, including the introduction of a new monetary policy framework,[10] the aim of which was to ensure a gradual but permanent reduction in inflation. The emphasis on the *permanence* and *sustainability* of low inflation assumes that no sudden shifts in inflation occur in the domestic economy for the purpose of corrections to internal or external imbalances.

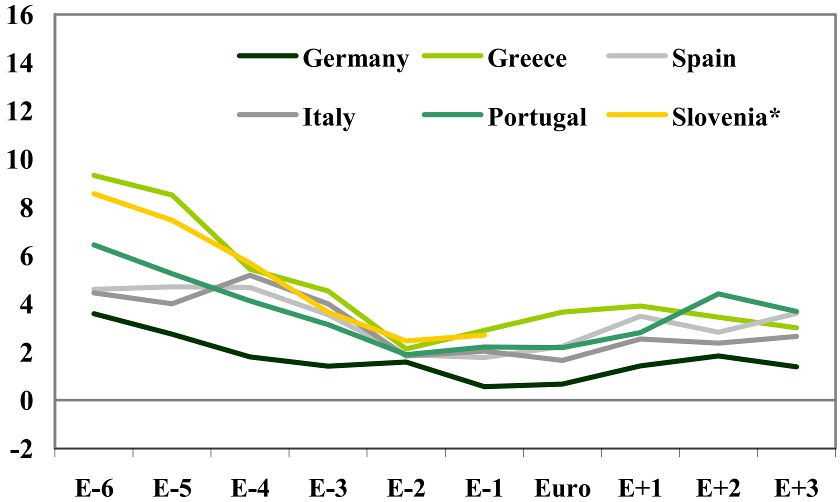
…allowing Slovenia to function in the eurozone without losing price competitiveness…

Meeting the inflation criterion means that the Slovenian economy is capable of functioning within the eurozone and under the conditions of the single monetary policy without losing external price competitiveness. The equilibrium inflation rate in Slovenia will be slightly higher than the average inflation in the eurozone as a result of the Balassa-Samuelson effect until real convergence with the average level of economic development in the eurozone. This, however, merely reflects a gradual catch-up in the level of prices of non-tradable goods, which in

[9] *Report From the Commission Convergence Report 2006 on Slovenia*, Brussels, 16 May 2006; http://ec.europa.eu/economy_finance/publications/convergence/2006/report_slovenia.pdf#search=%22report%20from%20the%20commission%20convergence%20report%202006%20on%20slovenia%22 and
Convergence Report, ECB, May 2006, http://www.ecb.int/pub/pdf/conrep/cr2006en .pdf
[10] http://www.bsi.si/html/publikacije/usm_d_p/usm_den_pol.pdf

Slovenia is lower than the average level in the monetary union, without this having an impact on the external competitiveness of the economy.

Figure 5.1: Inflation rates prior to joining the eurozone

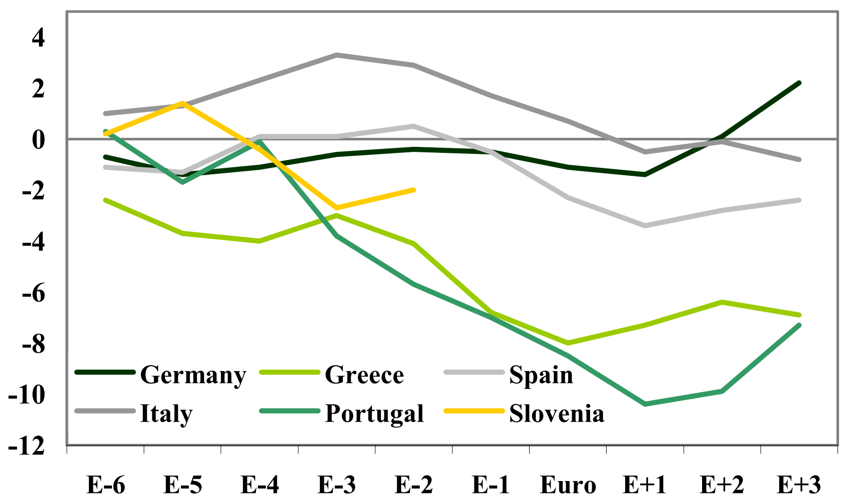


Note: Annual figures. HICP for Slovenia, CPI for other countries until 1996, then HICP; "Euro" is 2001 for Greece, 2007 for Slovenia and 1999 for the other countries.
* The 2006 figure for Slovenia represents the average year-on-year inflation up to August
Source: Eurostat.

…provided growth in costs and aggregate demand remains in line with potential supply

Sustainable nominal convergence in the inflation rate means that in the future inflation is expected to fluctuate around the level reached, provided that growth in costs remains in line with productivity growth, and under the condition that aggregate demand in the domestic economic does not outstrip its supply capacity. The key task for macroeconomic policy, one successfully achieved in the ERM II, will be to manage growth in costs and aggregate demand in accordance with the supply potential as required.

Figure 5.2: Current account prior to joining the eurozone

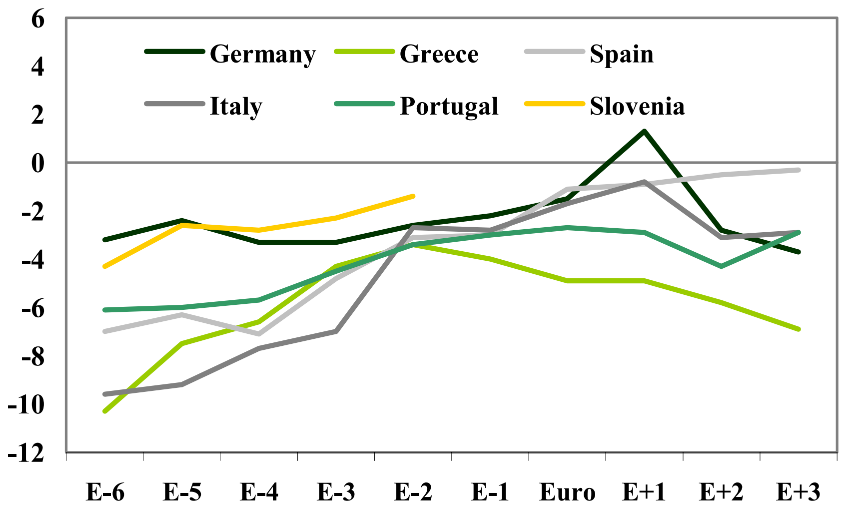


Note: Annual figures; "Euro" is 2001 for Greece, 2007 for Slovenia and 1999 for the other countries.
Source: Eurostat.

The central rate is neutrally pitched, as evident from the current account

As the Council of Economics and Finance ministers decided that Slovenia was ready to adopt the euro, the final conversion rate for the tolar was also set at the European Commission's proposal, remaining the same as the current central rate of SIT 239.640 to the euro. The Council's decision that Slovenia will join the eurozone at the current central rate confirms that the central rate is appropriate, in light of the internal an external equilibria achieved. Price stability indicates an absence of inflationary pressures that could derive from an undervalued domestic currency, while the current account close to balance reflects that the domestic currency is not overvalued. The current account position is not one of the basic criteria of nominal convergence, but a sharp increase in the current account deficit within the ERM II would in all likelihood raise doubts about whether the exchange rate is correctly pitched. The right conversion rate ensures that there will be no need for price adjustments in the Slovenian economy when the euro is adopted, which could be reflected in excessive inflation or additional disinflation.

Figure 5.3: General government deficit prior to joining the eurozone



Note: Annual figures. ESA95 for Slovenia, ESA79 for other countries until 1996, then ESA95; "Euro" is 2001 for Greece, 2007 for Slovenia and 1999 for the other countries.
Source: Eurostat, SORS.

A responsible fiscal policy is showing itself in the satisfactory budget position...

Slovenia has also met the requirements for the government budget position, thereby showing that its fiscal policy was sustainable and prudent, and remains so. The relatively low level of government sector debt entails medium-term sustainability in public borrowing. The reduction of the general government deficit since Slovenia joined the ERM II is also a sign of the maturity of fiscal policy, which proved it was capable of making savings during a favourable macroeconomic period. Because the joint monetary policy in the eurozone cannot respond to asymmetric shocks in individual economies, a counter-cyclical fiscal policy is the key to smooth macroeconomic functioning in the eurozone, both at the level of the eurozone and, in particular, at the level of the individual countries.

…which is reflected by the low long-term interest rates

Low long-term interest rates are also of curcial importance, as they are an indication of private investors' confidence in the nominal convergence of the Slovenian economy. The ECB Convergence Report states that "long-term interest rates in Slovenia moved steadily towards average bond yields in the euro area, reflecting in particular confidence […] in the general economic and fiscal developments in Slovenia".[11] In the long term this is a major achievement for the Slovenian economy, as it guarantees relatively low real interest rates in the context of low inflation. Provided that fiscal policy remains responsible, long-term interest rates will remain low, which reduces the cost of borrowing for the government, firms and households.

[11] *Convergence Report*, ECB, May 2006, http://www.ecb.int/pub/pdf/conrep/cr2006en.pdf

5.2 Possibility of Deviations from the Forecasts

Economic policy must be ready to deal with unforeseen shocks

Economic policy must be ready to respond appropriately to any deviations from the macroeconomic forecasts. In line with this it is sensible to simulate scenarios for economic developments in the event of certain macroeconomic shocks and to examine the potential scope of their effects. Some potential scenarios to which economic policy should be ready to respond with prompt measures are examined below. The purpose of these calculations is not merely to ensure readiness to respond to adverse shocks, but also to encourage the *ex ante* prevention of certain phenomena. Given that shocks can arise both on the supply-side and the demand-side, they need to be appropriately distinguished, as their effects require different approaches from economic policy with regard to this definition.

Table 5.1: Response of macroeconomic variables to simulated shocks

	Simulation	Shock (change)	Type of shock	Period of shock
	a) Foreign environment			
1.	Oil price	price USD 5 per barrel higher than forecast	supply	Q306-Q207
2.	Commodities prices	prices 10% higher than forecast	supply	Q306-Q207
3.	Foreign demand	demand 1% higher than forecast	demand	Q306-Q207
	b) Domestic environment			
4.	Wage growth	growth 1 percentage point higher than forecast	supply	Q306-Q207
5.	Household spending	growth 1 percentage point higher than forecast	demand	Q306-Q207
6.	Government spending	growth 1 percentage point higher than forecast	demand	Q306-Q207
7.	Growth in administered prices	growth 2 percentage points higher than growth in free prices	supply	Q306-Q207

	Simulation	GDP			Inflation			Current account		
		2006	2007	2008	2006	2007	2008	2006	2007	2008
	Forecasts - baseline scenario	4.5	4.2	3.9	2.6	2.7	2.7	-2.7	-2.8	-2.5
	a) Foreign environment									
1.	Oil	4.4	4.0	3.8	2.8	3.2	3.0	-2.8	-3.1	-2.9
2.	Commodities	4.5	4.1	3.9	2.7	2.9	2.8	-2.8	-2.9	-2.6
3.	Foreign demand	4.6	4.4	4.0	2.6	2.8	2.7	-2.6	-2.5	-2.3
	b) Domestic environment									
4.	Wages	4.6	4.4	4.0	2.6	3.1	2.9	-2.8	-3.1	-2.7
5.	Household spending	4.6	4.6	4.3	2.7	3.1	3.2	-2.8	-3.2	-2.9
6.	Government spending	4.6	4.3	4.1	2.6	2.9	2.9	-2.7	-2.9	-2.6
7.	Administered prices	4.4	4.1	3.9	2.6	2.9	3.0	-2.7	-2.9	-2.5

Note: Year-on-year growth in %. The simulations were conducted using the model employed by the Bank of Slovenia for its forecasts. Some simulations (1, 2, 3 and 6) consist of a change in exogenous variables, while others (4, 5, and 7) consist of an extra change that defines the simulation itself alongside the variables from the baseline scenario. All the other assumptions in the simulations are the same as those in the baseline scenario.
Sources: SORS, Bank of Slovenia, ARC calculation.

Supply-side shocks

The supply-side shocks include a shock in oil prices and commodity prices…

The fully exogenous variables within the supply-side shocks include a rise in oil prices and commodity prices compared with the assumptions, as these prices are entirely independent of developments in the domestic economy. The calculations make it clear that a sustained rise of USD 5 in the price of a barrel of oil would raise inflation by 0.2 percentage points in the third quarter until the end of 2006, by 0.5 percentage points in 2007 and by 0.3 percentage points in 2008. Economic growth would be 0.1 to 0.2 percentage points lower than forecast. A rise of 10% in commodity prices would have a similar effect, albeit smaller in scope.

...rapid growth in administered prices…

Another supply-side shock is growth in administered prices, where policy has a direct impact both on inflation and on economic activity. The impact of growth in regulated prices being 2 percentage points higher than growth in non-administered prices would be particularly strong in 2007 and 2008, raising headline inflation by 0.2 and 0.3 percentage points respectively. It is also clear that growth in administered prices does not only raise inflation, but also has an adverse effect on economic growth. Because rapid growth in administered prices has an adverse impact both on general inflation and on economic activity, it is desirable to keep the rate within the boundaries of sustainable growth. For economic policy this above all entails restricting growth in costs in regulated sectors with a monopoly market structure.

…and excessive wage growth

Faster wage growth than forecast would see the economy undergo a supply shock, with labour costs increasing, and also a demand shock, when the higher wages begin to be reflected in consumption. In this case the higher consumption would accelerate economic growth, and this would tend to raise inflation sharply as costs rise. It is evident from the simulations that wage growth of 1 percentage point more than in the baseline scenario would have a strong impact on inflation, particularly in the initial period.

Aggregate demand shocks

Aggregate demand represents another inflation risk

Worthy of particular attention among the demand shocks is excessive growth in private consumption. Were spending to rise by 1 percentage point more than forecast, economic growth would accelerate significantly, by 0.4 percentage points in 2007 and 2008. Such growth would be less sustainable with regard to the supply capacity of the Slovenian economy. This is reflected in high inflation and/or a sharp deterioration in the current account. The simulation makes it clear that as part of an appropriate fiscal policy government spending would have to be significantly lower than forecast in such an event in order to prevent a rapid overheating of the economy.

During low foreign demand it is better to avoid taxes that raise inflation

Unforeseen shocks tend to accumulate, which demands an additional readiness for economic policy to respond. Here mention should be made in particular of the danger of shocks that cause stagflation, where low economic growth is accompanied by high inflation. This combination could arise from demand being lower than forecast, e.g. low foreign demand, where a decline of 1 percentage point from the forecast lowers economic growth by 0.1 to 0.2 percentage points. Low economic growth has an adverse impact on general government revenues. In such an event it would be better to avoid raising taxes that directly increase inflation, such as the VAT, thus preventing stagflation.

Box 5.1: Potential transitory effects of a rise in the value-added tax (VAT)

Economics considers the VAT to be an efficient tax. It is difficult to avoid, and it creates less distortions than other taxes between saving and consumption, between work and leisure, and between the prices of various products (except where this is desirable from the point of view of economic policy and there are several VAT rates). In this sense the VAT is a tax that in principle places a lower burden on economic activity than progressive taxes on labour (the personal income tax) or on capital.

Despite the long-term efficiency of the VAT, the actual *raising* of this tax can trigger certain adverse transitory effects. Such a rise is reflected directly in the price levels, and if the latter encourage wage increases, a wage-inflation spiral can occur. In the medium term, such a spiral often simultaneously causes higher inflation and lower economic growth. Similar effects occurred in Slovenia when the VAT was introduced in 1999 (where inflation also increased due to other factors) and, only to a lesser extent, when it was raised in 2002.[1]

* * *

Simulations using a standard macroeconomic model assessed on data for Slovenia illustrate the dynamic effect of a rise in the VAT. Because the VAT entails a direct cost effect for all companies, these costs are generally assumed to pass through fully into consumer prices. The direct effect of the tax is therefore to reduce the private purchasing power in favour of government purchasing power. Given the ratio of VAT-subject goods to GDP, it can be assumed that a rise in the VAT rate of 1 percentage point triggers a rise in prices of approximately 0.7 percentage points.[2] The model allows us to estimate how the direct effect on prices and the decline in the disposable income could affect the dynamics of inflation and economic growth over time.

It is clear that in the medium term a rise in the VAT of this type would raise inflation more permanently than just by the direct effect of 0.7 percentage points. Inflation would be 0.8 percentage points higher than forecast in 2007, and approximately 0.3 percentage points higher in 2008 and 0.2 percentage points higher in 2009. The rise in inflation would lead to a deterioration in relative prices in the domestic economy, and would thus reduce competitiveness, lowering export growth by 0.4 percentage points. The reduced purchasing power would reduce consumption. These two items would also reduce economic activity, while there would be a partial reduction in import growth as a result of lower consumption and demand for exports. The cumulative effect on economic growth is estimated at approximately 0.2 percentage points.

The simulation illustrated is of course subject to many limitations. All macroeconomic aggregates are assumed to respond to economic shocks in the same way as in the period for assessing the model. Were incomes policy to curb wage dynamics to a greater extent, the inflation effects would be smaller. In addition, the model does not include the additional typical adverse effects of a rise in the VAT on aggregate demand, such as a direct loss of competitiveness in border regions, or the negative psychological impact on consumer confidence. The potential effect on consumption before the VAT rise, with higher demand before the rise and lower demand thereafter, is not considered. (This effect is likely to be particularly strong when the rise in the VAT takes it past a specific threshold, thus motivating consumers to move consumption forward, as at the end of 1998 in Slovenia.)

The simulation only presents a partial picture, as in reality a rise in the VAT would raise general government revenues, or would allow other, less efficient, taxes to be cut. However, in the event of a cut in other taxes, the transitory rise in price levels and inflation would not be eliminated unless the comparable tax cut affects prices at the same pace and the same intensity as the inflationary effect of the VAT. Thus, if there is a desire to compensate for a loss of revenues from other taxes, inflationary effects would be best limited by a gradual and prudent rise in VAT rates,.

[1] See the European Commission's Convergence Report
[2] See, for example, Jonker, Nicole & Carsten Folkertsma & Harry Blijenberg, 2004. An Empirical Analysis of Price Setting Behaviour in the Netherlands in the Period 1998-2003 Using Micro Data, Working Paper Series 413, European Central Bank

Table 1: Response of macroeconomic variables to a rise in the VAT

Simulation	Period 2007	2008	2009
	difference from forecast, percentage points		
Inflation (HICP)	1.1	0.4	0.3
GDP	-0.2	-0.1	-0.1
Household spending	-1.0	0.2	0.0
Exports	-0.6	0.0	0.1
Imports	-1.0	0.4	0.2
Real unit labour costs	0.8	0.6	0.4
Net wages	0.6	0.5	0.3

Note: The average VAT rate is raised by approximately 1 percentage point.
Source: Bank of Slovenia, ARC calculation.

5.3 Coordination of Macroeconomic Policy

Domestic economic policy bears the burden of stabilising demand and inflation…

After the adoption of the euro, the new framework for macroeconomic policy, which underwent its first major break when Slovenia joined the ERM II, will attain its final form. This means that the domestic monetary policy will no longer be available for the purpose of stabilising aggregate demand and the inflation, and the entire burden of smoothing cyclical fluctuations will have to be borne by the remaining domestic economic policies. Here it is vital to distinguish the effects of a policy of stabilising aggregate demand from a policy of preventing cost fluctuations that could directly bring about rises in prices. These two aims are often opposed, a least in the short term, as in the example of a tax rise that reduces demand and thus inflationary pressures, but also increases the cost burden and thus directly raises the level of prices. An appropriate macroeconomic policy proves itself by using a variety of instruments to find a combination of measures to best prevent the appearance of factors leading to inflationary pressures.

…which includes renewed interest rate rises

Slovenia will join the eurozone during a period of rising ECB interest rates. Given that the estimated output gap in Slovenia is shifting to the positive side, and that a further opening could start to generate additional demand-side inflationary pressures, the rise in interest rates in the eurozone will benefit Slovenia, and is also evidence of the symmetry of the Slovenian business cycle with the business cycle of the eurozone. In the medium term higher interest rates can be expected to stabilise the economic cycle and to prevent the economy from overheating.

Fiscal policy

The adequate fiscal policy is counter-cyclical…

Under the new conditions the role of stabilising aggregate demand and inflation belongs primarily to fiscal policy. An optimal fiscal policy moderates domestic demand during the upswing of the business cycle, and boosts it during the downswing. This mechanism is partly automatic, as during a favourable economic performance the taxable base usually rises, and with it collected tax revenues, and the need for transfers declines, which has a beneficial impact on the cyclical deficit. In addition it is desirable for fiscal policy to further support this action by reducing the general government deficit during the economic upswing, and vice-versa when the business cycle reaches a downturn. This adjustment tends to require the creation of a structural surplus in the general government position, and not merely a neutral position during the economic upswing.

…thus upholding the principles of the Stability and Growth Pact, being ready for the reversal in the business cycle

After Slovenia joins the eurozone, fiscal policy will have to act according to the principles of the Stability and Growth Pact. This envisages a reduction in the structural deficit of at least 0.5 percentage points during the economic upswing, excluding one-off effects. Under the rules of the Stability and Growth Pact, in the medium term the general government position should range from -1% of GDP to balance or surplus. In the event of a downturn in the economic cycle fiscal policy will need the possibility of unleashing adequate reserves via a deficit with the aim of preventing a hard landing and smoothing aggregate demand. Expressed in the form of the commitments in the Stability and Growth Pact, this is the basic reason for fiscal consolidation during times of favourable macroeconomic trends.[12]

Given the uncertainty over tax reform, it is unclear whether the consolidation is appropriate…

The general government deficit in 2006 is expected to be smaller than originally forecast, while uncertainty over tax reforms means that forecasts of the general government deficits in 2007 and 2008 remain unclear. In the most recent Convergence Programme (December 2005), the Slovenian government forecast a general government deficit of 1.7% of GDP for 2006, and a structural deficit of 1.6% of GDP, ignoring the latest tax reform proposals.[13] Both the overall and the

[12] The example of Portugal, which joined the eurozone just before ECB interest rates began to rise, warns of the danger of a downturn in the cycle and the resulting hard landing. When the business cycle in Portugal turned down in 2000 and 2001, the general government deficit was already large enough to prevent fiscal policy from having sufficient room for manoeuvre to boost aggregate demand. On the contrary, in the context of low economic growth, public finances began to act restrictively, which further reduced aggregate demand, resulting in a recession, several years of low economic growth and a persistent increase in unemployment. See for example *The Portuguese Economy After The Boom*, European Commission, 2004; *Monetary Policy Report*, Bank of Slovenia, April 2005, p 50

[13] Convergence Programme, update, December 2005; http://www.gov.si/mf/slov/tekgib/konvergencni_program_2005.pdf

cyclically adjusted general government positions should stand at -1.4% of GDP in 2007 and -1.0% of GDP in 2008. In its opinion the European Council assessed the efforts to reduce the general government deficit as realistic, but also found that the reduction in the structural deficit is 0.5 GDP percentage points slower than envisaged in the Stability and Growth Pact.[14]

…but it must be ready for risks arising from lower economic growth…

Alongside tax cuts, uncertainties over economic growth represent an additional risk to the general government deficit. The estimates are that a difference in cyclical economic growth of 1 percentage point from the forecast has an effect of approximately 0.5 percentage points on the general government position.[15] The risk regarding forecasts of economic growth is always present in the exercise of fiscal policy, but could become more pronounced during the adoption of the new currency and the probable peak in the economic cycle.

Table 5.2: Potential difference in the general government position owing to deviations from the economic growth forecast

	General government position in 2007 (as % of GDP)*	
Convergence Programme (update, Dec 05) - GDP growth forecast for 2007: 4.0%	-1.4	
	Calculated	Difference
Assumed GDP growth in 2007 (%)		
3.0	-1.9	-0.5
3.5	-1.7	-0.3
4.0	-1.4	0.0
4.5	-1.2	0.3
5.0	-0.9	0.5

* calculation by ARC, Bank of Slovenia, based on deviations in economic growth from the forecast in the updated Convergence Programme.
Source: Convergence Programme (update), Ministry of Finance, December 2005.

…and cannot rely on certain one-off effects

During the consolidation of the structural deficit fiscal policy cannot rely on one-off budgetary adjustments owing to unexpected improvements on the expenditure or revenue sides. According to the latest SORS figures the general government deficit in 2005 was 0.4 percentage points lower than had been forecast,[16] which can mainly be attributed to a legal change in corporate income tax and the associated method of calculating this tax. However it should be borne in mind here that only part of this effect is permanent, while the remaining portion is merely temporary under the ESA95 methodology.

Income policy

Here a restrictive income policy plays a key role…

In conjunction with fiscal policy, the income policy plays a central role in preventing demand-induced inflationary pressures, and cost-induced pressures in particular. Curbing excessive wage growth is currently the reasonable guideline of the income policy, as controlling labour costs is of prime importance in ensuring competitiveness and price stability within the monetary union. Real growth in unit labour costs in Slovenia was slightly negative overall in the 2001 to 2005 period.[17] Even though in the long term the trend should be for zero neutral real growth in costs, this in itself may still signify excessive wage growth

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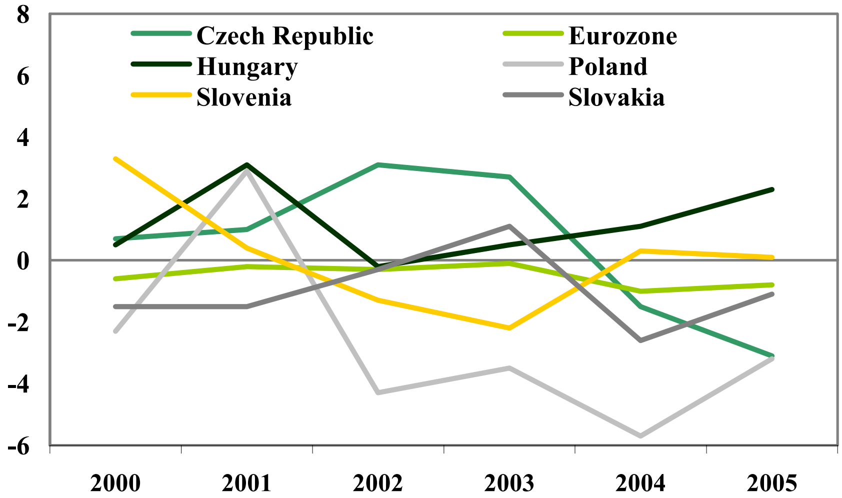
[14] Council opinion of 14 February 2006 on the updated convergence programme of Slovenia, 2005 to 2008; http://eur-lex.europa.eu/LexUriServ/site/en/oj/2006/c_055/c_05520060307en00450048.pdf
[15] Cajner, Tomaž, 2005, *Cyclically Adjusted Budget Balances in Slovenia*, Surveys and Analyses XII/2, Bank of Slovenia
[16] SORS, 31 August 2006, first issue; http://www.stat.si/novica_prikazi.aspx?id=403
[17] See Monetary Policy Report, Bank of Slovenia, May 2006, pp 12-13

if real costs are simultaneously falling in the main trading partners. Given that there has also been a decline in real labour costs in the eurozone in recent years, and even more so in the new EU member-states (see Figure 5.4), faster (positive) growth in costs could threaten the international competitiveness of Slovenian companies. Restricting wage growth in the public sector can have a demonstrative effect on wage growth in the economy as a whole, and the public sector payroll itself accounts for close to one quarter of the total. Year-on-year growth in public sector wages was 3.6% to July 2006, which is moderate and in line with expectations. A continuation of this trend in the medium term would be welcome, as it would contribute to the direct maintenance of competitiveness and to a reduction in the general government deficit.

Figure 5.4: Real growth in unit labour costs



Source: Eurostat.

Administered price policy

…and can contribute towards the right level of growth in administered prices

Administered price policy has a vital role in curbing growth in costs and maintaining price stability, in the context of structural adjustments in regulated sectors. Growth in administered prices should not outstrip growth in non-administered prices, but should not fall behind the growth in costs that is in line with productivity growth either, so as not to inflict losses on public and private companies whose prices are partly or wholly prescribed. These companies must therefore strive to control the costs that they can affect themselves. For this reason the optimal administered price policy is closely linked to the income policy, as excessive growth in costs often derives from unjustifiably rapid growth in wages.[18] This applies in particular to sectors whose product prices are formed by applying a specific profit margin determined in advance, such as for refined petroleum products.

5.4 Structural Reforms for Flexibility in Macroeconomic Policy

Economic policy faces numerous challenges

Economic policy will in all likelihood face numerous challenges in the future, while Slovenia will have to continue with specific structural reforms, partly to ensure that macroeconomic policy is more effective.

[18] See Monetary Policy Report, Bank of Slovenia, May 2006, pp 58-59, Box 5.2

Consideration should be given to a greater flexibility of fiscal policy…

Given that once it will have adopted the euro Slovenia will no longer have its own monetary policy at its disposal, it makes sense to deliberate on how to improve the effectiveness of other macroeconomic policies. In this sense fiscal policy requires the right level of automatic stabilisers such as transfers to the unemployed that automatically rise during macroeconomic downswings and do the opposite in good times. Insofar as automatic stabilisers cannot be employed to a sufficient degree, it is necessary to increase the proportion of flexible budgetary expenditure, which would also facilitate the responsiveness in fiscal policy. The systematic and planned creation of reserves in the current favourable conditions of the economic cycle is of key importance to this action.

…in an environment of greater flexibility in product markets…

Adjustments in economic structures can also aid the action of macroeconomic policy by allowing the transmission channels of macroeconomic policy to act as quickly as possible. Greater flexibility in the economy helps to prevent deeper, long-lasting adverse effects from asymmetric shocks, and additionally allows macroeconomic policy to act more directly to smooth cyclical movements in aggregate demand. For this reason already economic policy has an interest in supporting free competition and deregulation in individual sectors, even irrespective of the beneficial effects on economic growth that can be expected from such measures. In its annual Convergence Report the European Commission states that with regard to creating the conditions for the smooth functioning of the European Internal Market Slovenia is lagging in the adoption and application of Community legislation. It also assesses that structural reforms to improve the business environment and support domestic competition have stalled in recent years. Particular mention is made of the telecoms and electricity sectors as well as the professional services, which remain protected in Slovenia. It should be mentioned that privatisation needs to be speeded up in certain protected sectors, but not before adequate competition is secured in these markets.

… and in the labour market…

In addition to flexibility in markets for products, greater labour market flexibility can help to limit the duration of asymmetric shocks, since in such an environment wages respond more to developments in the economy, while shocks are recovered less through quantities and more through prices. This type of labour market flexibility also allows the income policy to function more easily. In creating optimal conditions on the labour market, economic policy can also turn to research recently conducted by the ECB within the Inflation Persistence Network.[19] One of the findings from the analysis of trends in the eurozone is that prices in sectors where labour costs are proportionately higher are more rigid than in product sectors. This suggests that the nominal rigidity of wages is reflected in the persistence of price levels or the inflation rate.

…while the long-term sustainability of public finances should not be overlooked

In order to keep the general government budget sustainable in the long term, public finances will have to be adjusted to demographic trends, which presupposes the continuation of pension reforms. Last year's change to index-link pensions to wages has led to an additional deterioration in the long-term sustainability of public finances. This has been established by various institutions, such as the IMF,[20] which estimates that each year by which reform is delayed increases the gap between the current state and the long-term fiscally sustainable state by 0.125 percentage point of GDP, and by European Commission research into this subject, which rates the long-term sustainability of Slovenia's general government budget as among the most at-risk in the EU.[21] Structural adjustments to re-establish the long-term sustainability of public finances will be needed in the pension system in the medium term.

[19] See Altissimo, Filippo & Michael Ehrmann & Frank Smets, 2006. *Inflation persistence and price-setting behaviour in the euro area, a summary of the IPN evidence*, Occasional Paper Series 46, European Central Bank

[20] *Article IV Consultation with Slovenia*, Preliminary Conclusions of the IMF Mission, http://www.imf.org/external/np/ms/2006/032806.htm

[21] The sustainability of public finances based on the 2005/06 updates of stability and convergence programmes