BANKA SLOVENIJE

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Abbreviations used in the Price Stability Report

AJPES	Agency of the Republic of Slovenia for Public Legal Records and Related Services
BoS	Bank of Slovenia
CPI	consumer price index
DARS	Motorway Company in the Republic of Slovenia
EC	European Commission
ECB	European Central Bank
EIPF	Faculty of Law Institute of Economics
EMU	Economic and Monetary Union
ESA 95	European System of Accounts (1995)
ESCB	European System of Central Banks
EU	European Union
EUR	euro
EURIBOR	euro interbank offered rate
Eurostat	Statistical Office of the European Communities
Fed	Federal Reserve
GDP	gross domestic product
H	half-year
HICP	harmonised index of consumer prices
IMAD	Institute of Macroeconomic Analysis and Development of the Republic of Slovenia
IMF	International Monetary Fund
MFIs	monetary financial institutions
NACE	statistical classification of economic activities
NFCs	non-financial corporations
OECD	Organisation for Economic Cooperation and Development
PMI	Purchasing Managers Index
PPI	producer price index
Q	quarter
RS	Republic of Slovenia
SITC	Standard International Trade Classification
SORS	Statistical Office of the Republic of Slovenia
ULC	unit labour costs
US	United States of America
USD	US dollar
WEO	World Economic Outlook

Summary

The latest figures from the national accounts indicate a return to moderate economic growth. There are still, however, significant macroeconomic imbalances, in particular high unemployment and the general government deficit. Low economic activity, low consumption and declining growth in labour costs in certain sectors are the reason for low core inflation. Overall price growth exceeds inflation in the euro area due to higher growth in energy and food prices. Forecast economic growth will be relatively low, in line with the spring projections, and is likely to temporarily decline further in the second half of this year. Such growth itself will not be sufficient to restore macroeconomic balances. Additional measures will be required, in particular with regard to cost competitiveness, the consolidation of public finances and appropriate structural reforms.

The main features of the global economy in the first half of 2010 were a gradual recovery in economic activity and low inflation in developed countries. An important factor in the global economic recovery is an increase in the volume of international trade, in particular in the imports of rapidly growing emerging economies. Global economic growth was slightly higher than forecast at the beginning of this year, but varies from country to country. Uncertainties regarding the position of public finance, which rose sharply in certain European countries in the spring, are still seen in high premiums on the debt securities of these countries. Having risen in the first half of the year, during the third quarter oil prices on global markets returned to the level seen at the beginning of the year, while metal and wheat prices are rising.

After stagnating at the beginning of the year, GDP in Slovenia rose more sharply in the second quarter, by 1.1% in current terms. Growth was driven primarily by the response of the manufacturing sector to a sharp increase in foreign demand and a partial renewal of inventories, the decrease in which contributed significantly to the decline in economic activity last year. Both growth in foreign demand and the renewal of inventories contributed to an increase in imports. Year-on-year growth in investment and private consumption remains negative. The situation remains unfavourable in the construction sector, where activity continues to contract. The decline in employment is slowing. The situation on the labour market, however, does not indicate a decline in the registered unemployment rate in the near future. The level of labour costs in relation to labour productivity is cause for concern in this situation. Growth in unit labour costs has declined recently. However, the level of unit labour costs remains high following high growth in 2008 and 2009.

The current account deficit has declined for the second consecutive year, to stand at around 1% of GDP in the first half of the year. The volume of foreign trade has risen owing to increased foreign demand and imports of intermediate goods for the needs of industry. Accordingly, the value of imports grew somewhat faster than merchandise exports. Deteriorating terms of trade are the main factor in this year's trade deficit. In addition to a slightly smaller surplus of trade in ser-

vices, lower interest rates and thus lower net outflows of factor income also contributed to the lower current account deficit.

Having fallen sharply last year, growth in loans to non-financial corporations has stabilised at low levels. Loans have recorded moderate growth in recent months, in particular longer-term loans. Year-on-year growth in loans to households was nearly 10% in May. Housing loans were the main factor in this increase. Following the outbreak of the crisis, the private sector increased its net savings, while the public sector deficit was up. Foreign financial resources in the total amount of 1% of GDP were required over the last year to finance the total deficit of the domestic sectors. However, despite the growth in net savings in the private sector, the problem of high corporate indebtedness persists. In June the banking sector's borrowings in the form of loans raised in the rest of the world were more than EUR 1.1 billion lower in year-on-year terms. The banks compensated for this funding with relatively more expensive sources, including the issue of debt securities. Interest rates on loans to households have continued to fall this year, on both consumer and housing loans. Interest rates on loans to non-financial corporations have fallen only partly and remain higher than the euro area average.

The most important factor in the rise in consumer prices is growth in the prices of certain raw materials that have an impact on energy and food prices. Higher excise duties have also contributed to growth in these prices. Year-on-year growth in the harmonised index of consumer prices has risen since the beginning of the year, and averaged 2.1% over the first nine months, outstripping the euro area average by 0.7 percentage points. In addition to energy and food prices, prices of municipal services have contributed 0.4 percentage points to the deviation from average euro area inflation. Core inflation remains at a very low level owing to the adverse macroeconomic situation. All core inflation indicators have been lower than those of the euro area since the end of last year.

The projections of economic trends indicate a gradual recovery. However, a temporary decline in growth will be seen in the second half of 2010. Core inflation is expected to be low this year, after which it is expected to rise to the level of the euro area. GDP growth is expected to be 1.1% this year and to gradually rise to nearly 3% by 2012. The downward revision to this year's economic growth forecast made since the April projections is primarily the result of continuing adverse developments in the construction sector, despite the slightly higher growth in foreign demand. The contribution of domestic demand, excluding growth in inventories, to GDP growth will be negative as a result of a drop in investment and the stagnation of private consumption and public expenditure. Short-term growth will be based on net exports. Further contributing to this is the upward revision to the assumption regarding foreign demand. Inflation is expected to stand at 2.3% in 2010 and to fall to 2.0% by 2012. The inflation projection for 2010 and 2011 is higher compared with the previous projections primarily owing to the expected higher growth in energy and food prices.

The risks that GDP growth will differ from the projection are a high and numerous, while those related to the inflation projection are lower. The greatest risk with regard to economic growth relates to the possible need for an even stronger-than-expected fiscal consolidation, which could further reduce aggregate demand. Even without this risk, growth in foreign demand remains fairly uncertain. The uncertainties also include a possible deterioration in access to financial resources both at home and abroad. The reason for this could lie in renewed deterioration in the situation on the international financial markets or in a more sustained slowdown in the lending activities of banks. The downgrading of certain domestic banks in September will further drive up the costs of bank funding. The situation remains most uncertain in the construction sector. If the economic recovery is slower, inflation could also be lower than foreseen in the baseline projection. Conversely, possible further depreciation of the euro, and increases in indirect taxes and administered prices could, alongside higher commodity prices, contribute to higher inflation.

Imbalances on the labour market and in public finance require appropriate measures in the areas of competitiveness and fiscal policy. Growth in unit labour costs has fallen recently, but they remain at a high level. The improvement in domestic price and cost competitiveness indicators at the beginning of this year was merely due to the depreciation of the euro. The cost adjustment of the economy lags behind that of the main euro area trading partners. Given the deterioration in competitiveness indicators in 2009 and the projections of macroeconomic trends, deeper-rooted adjustments to labour costs in relation to productivity growth will be required for a faster and deeper decline in unemployment. If competitiveness does not improve, there is a danger of more sustained low growth, low investments in the economy and a sustained rise in unemployment with accompanying social tensions.

The required pace of fiscal consolidation is also set out in the Stability Programme, in line with recommendations of the Council of the European Union, by which Slovenia must reduce the general government deficit to less than 3% of GDP by 2013. The Ministry of Finance projects a general government deficit of 5.6% of GDP and general government debt of 37.9% of GDP for this year. Total revenue remains low in line with the reduced level of economic activity. General government expenditure grew at a slower rate in the first half of the year compared with last year, but too rapidly to trigger a current decline in the deficit. The number of employees in the general government sector was also up by 1.6% in year-on-year terms in the second quarter of 2010. The gross general government debt had risen to 37.5% of GDP by the end of June. According to the European Commission's opinion issued in June, Slovenia complied this year with the requirements set out in the excessive deficit procedure. However, an increasing number of problems have arisen in the adoption of additional measures. Measures based on the adjustment of general government expenditure have met resistance from interest groups, which could lead to a deadlock or insufficient adjustments in the scope of fiscal consolidation. Credible consolidation is also the basis for maintaining a debtor country's favourable rating, which has a significant impact on the private sector's accessibility to financial resources. It also has an effect on the confidence of the private sector, and thus economic activity.

In addition to a medium-term contribution to the consolidation of public finances, appropriate structural reforms could also have a long-term impact on growth in potential output and on labour productivity. In the reform of the labour market, the right combination should be found between job and income security for workers and the necessary flexibility for companies in hiring and firing workers. Only in this way will companies be able to adapt to the changing situation on the market. Together with the reform of the pension system, reform of the health care system should, in addition to increasing the efficiency of this part of the public sector, primarily ensure the long-term sustainable financing of health care and pensions. Encouraging the development of human capital, market competition, quality corporate governance and innovation could expand business opportunities, thereby accelerating economic development.

								Projections					
								2010		2011		2012	
	2003	2004	2005	2006	2007	2008	2009	**Oct**	Δ	**Oct**	Δ	**Oct**	Δ
Activity, employment and wages	*real growth %*												
GDP	2.8	4.3	4.5	5.9	6.9	3.7	-8.1	**1.1**	-0.2	**1.9**	0.1	**2.9**	0.0
Employment	-0.4	0.3	-0.2	1.5	3.0	2.8	-1.9	**-2.3**	0.0	**-0.3**	-0.2	**0.3**	0.0
Compensation per employee	7.9	7.8	5.6	5.3	6.4	6.9	1.6	**3.5**	1.8	**3.1**	0.4	**3.4**	0.0
Productivity	3.2	4.0	4.7	4.3	3.7	1.0	-6.3	**3.5**	-0.2	**2.2**	0.3	**2.6**	0.0
ULC (nominal)	4.5	3.7	0.9	1.0	2.6	6.0	8.5	**0.0**	2.0	**0.9**	0.1	**0.8**	0.0
Contribution to GDP growth	*percentage points*												
Domestic demand, excl. change in inventories	4.0	3.5	3.0	5.0	7.1	5.0	-6.1	**-1.5**	-2.1	**0.8**	-0.3	**2.2**	-0.5
Net exports	-1.9	-0.5	2.2	0.2	-2.0	-0.4	2.0	**1.5**	0.0	**0.9**	0.3	**0.7**	0.5
Change in inventories	0.7	1.3	-0.7	0.7	1.8	-0.8	-4.0	**1.2**	1.9	**0.2**	0.1	**0.0**	0.0
Domestic demand	*real growth, %*												
Domestic demand	4.8	4.8	2.3	5.6	8.9	4.1	-9.8	**-0.4**	-0.2	**1.0**	-0.3	**2.3**	-0.4
Private consumption	3.2	2.7	2.6	3.0	6.7	2.9	-0.8	**-0.5**	-0.1	**0.5**	-0.1	**1.7**	-0.1
Government spending	2.2	3.4	3.4	4.0	0.7	6.2	3.0	**0.7**	0.2	**0.0**	0.0	**0.3**	0.0
Gross fixed capital formation	8.1	5.6	3.7	10.1	12.8	8.5	-21.6	**-5.4**	-8.0	**2.0**	-0.9	**5.0**	-1.4
Balance of payments	*real growth, %, unless stated*												
Exports of merchandise and services	3.1	12.4	10.6	12.5	13.7	3.3	-17.7	**9.5**	4.3	**6.6**	0.6	**7.5**	0.8
Imports of merchandise and services	6.7	13.3	6.7	12.2	16.7	3.8	-19.7	**7.1**	4.1	**5.3**	0.1	**6.6**	0.2
Current account: EUR billion	-0.2	-0.7	-0.5	-0.8	-1.6	-2.5	-0.5	**-0.4**	-0.2	**-0.7**	-0.2	**-0.9**	0.0
as % GDP	-0.8	-2.6	-1.7	-2.5	-4.8	-6.7	-1.5	**-1.1**	-0.6	**-1.7**	-0.3	**-2.2**	0.1
Terms of trade*	0.8	-1.0	-2.0	-0.5	0.9	-1.5	4.3	**-3.2**	-0.6	**-1.1**	-0.1	**-0.8**	0.0
Prices	*average annual growth, %*												
Consumer prices (HICP)	5.7	3.7	2.5	2.5	3.8	5.5	0.9	**2.3**	0.7	**2.1**	0.7	**2.0**	0.0
HICP excluding energy	6.0	3.2	1.2	1.7	3.8	4.9	1.7	**0.6**	0.4	**1.5**	0.3	**1.9**	0.1
HICP energy	3.4	7.0	11.9	8.5	3.4	9.4	-4.5	**14.3**	3.5	**6.0**	3.0	**2.6**	0.1
International environment	*average annual growth, %, unless stated*							**Assumptions**					
Foreign demand**	5.7	7.5	4.3	8.6	7.4	2.5	-12.9	**7.8**	4.7	**5.4**	0.3	**6.5**	1.4
Oil (USD per barrel)	29	38	54	65	73	98	62	**79**	4	**84**	4	**87**	5
Non-oil commodities	11.2	22.1	12.0	29.1	17.4	10.1	-23.0	**39.0**	19.0	**11.0**	4.0	**4.0**	-3.0
EMU inflation	2.1	2.1	2.2	2.2	2.1	3.3	0.3	**1.6**	0.4	**1.7**	0.2	**1.5**	-0.4
PPI Germany	1.8	1.6	4.4	5.4	1.3	5.4	-4.0	**1.0**	0.8	**2.2**	0.4	**2.0**	0.0

* Based on national accounts deflators

** Volume of imports from basket of foreign partners

Δ: Difference between current projections and projections in April 2010 Price Stability Report

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

1 The International Environment

The main features of the global economy in the first half of 2010 were a gradual recovery in economic activity and low inflation in developed countries. An important factor in the global economy recovery is an increase in international trade, in particular in the import demand of emerging economies. Economic growth in developed economies was slightly higher than forecast at the beginning of this year, while risks associated with the labour market and the public finance position remain high. The monetary policy stance of the most central banks remains accomodative. Having risen in the first half of the year, oil prices have during the third quarter returned to the level seen at the beginning of the year. Commodity prices rose sharply in the third quarter as a result of growth in the prices of metals and wheat.

Economic developments

In the first half of 2010 the recovery of global economic activity continued. Accordingly, the IMF revised its forecast of global economic growth in 2010 upward from 4.2% in April to 4.6% in July. The largest proportion of the 1% quarterly growth in real GDP in the euro area in the second quarter of this year was contributed by Germany, where q-o-q economic growth stood at 2.2%. Lower-than-expected growth was recorded in Japan and the US. In the second quarter the GDP growth in Japan

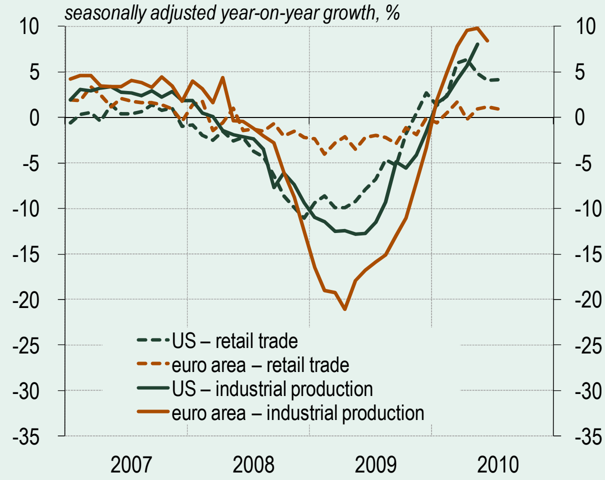
Figure 1.1: GDP growth

adjusted for the season and number of working days; growth, %

Source: Eurostat

Figure 1.2: Retail trade and industrial production

seasonally adjusted year-on-year growth, %

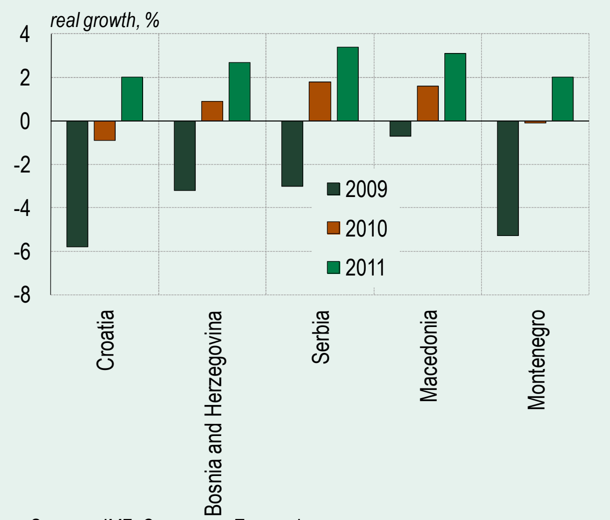


Sources: Eurostat, FRED, Bank of Slovenia calculations

Box 1.1: Economic developments in trading partners from the former Yugoslavia

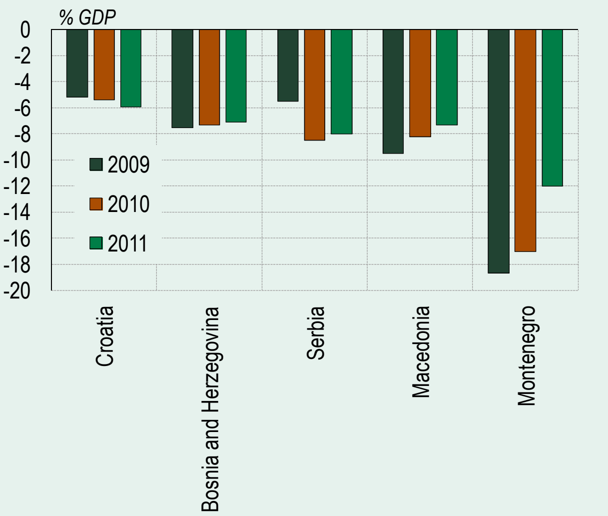
The decline in exports to the markets of the former Yugoslavia was primarily the result of the international economic and financial crisis, which led to a significant contraction in economic activity in this region. Having averaged around 17% between 2001 and 2008, exports of Slovenian goods and services to this region have declined to just over 14% of total exports during the crisis. The region has seen a substantial decrease in inflows of foreign capital in the form of direct investments and loans from the rest of the world, while labour income and private remittances from the rest of the world to the region were also lower. Real GDP fell by 5.8% in 2009 in Croatia. There was also a notable drop in industrial production in the context of a sharp contraction in exports and declining activity in the construction sector. In Macedonia, the crisis was initially seen in the final quarter of 2008 with a drop in production in the metal and textile industries. The volume of foreign trade has fallen sharply and FDI almost halved, while external imbalances have increased. In Serbia, real GDP fell by 3.0% last year, while the y-o-y drop in industrial production was slightly less than 14%. The inflow of loans has

Figure 1: GDP



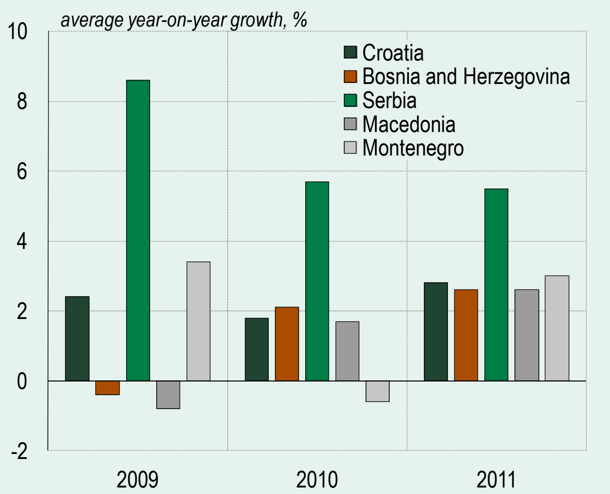
Sources: IMF, Consensus Economics

Figure 2: Current account



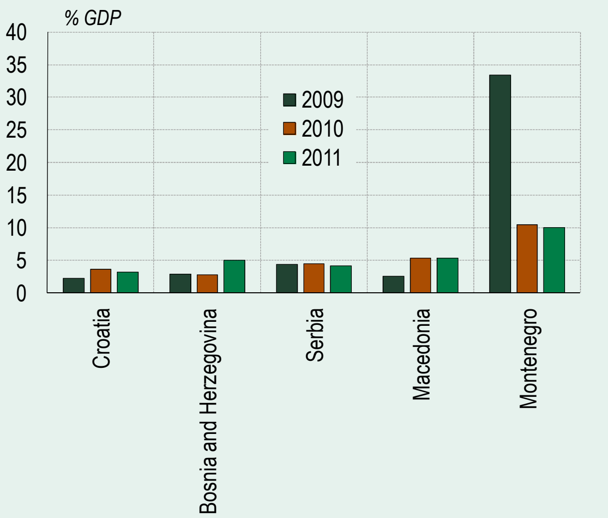
Source: IMF

Figure 3: CPI



Sources: IMF, Consensus Economics

Figure 4: FDI



Source: IMF

declined. Similar developments were also seen in Montenegro and Bosnia and Herzegovina.

Risks for the Slovenian economy in regard to this region primarily relate to the strength of the global economic recovery and the dependence of south-eastern European countries on foreign trade, foreign investment and other economic ties with the European Union. All of the countries of this region signed the new Central Europe Free Trade Agreement (CEFTA) in 2006, while individual countries also have trade agreements with the EU, Russia, Turkey and other countries. Owing to the aforementioned trade links, the recovery in industrial production in the EU is expected to have a positive impact on the recovery of the economies of south-eastern Europe. The recovery in industry is particularly evident in the production of equipment and intermediate goods, which is partly linked to FDI.

In addition to the general uncertainty, which could affect all the countries of south-eastern Europe, there are also some country-specific risks. According to the forecasts of international institutions, Serbia is expected to achieve the highest economic growth in 2010 of approximately 2%. The implementation of the pre-accession agreement between Serbia and the EU, which the EU unfroze at the end of last year, will also have a positive impact on Serbian economic growth. Estimates of economic growth in 2010 have been revised downwards for Croatia, primarily owing to the high level of government debt. Slightly more favourable are the forecasts for next year, largely as a result of the gradual winding-up of EU accession negotiations, which should increase the confidence of foreign investors. Low or zero growth is expected this year in Bosnia and Herzegovina and Montenegro, although growth in the prices of aluminium prices, an important export product, is having a positive impact on both countries.

and the US was on a quarterly basis 0.1% and 0.4%, respectively. The relatively modest growth in the US was mainly due to the negative contribution of net trade. Relatively rapid economic growth continues in Asia: GDP in India was up more than 8% in the second quarter in y-o-y terms for the second consecutive quarter, while year-on-year GDP growth slowed slightly in China, but nevertheless exceeded 10%.

Private demand in developed countries remains low, reflecting the still unfavourable situation on the labour market. The unemployment rate remains quite high in the euro area and in the US, where the rate has risen sharply during the crisis. Conversely, the unemployment rate in the euro area has not risen as sharply since the outbreak of the crisis, primarily owing to temporary government measures to protect jobs. Despite improvement, the situation on the financial markets remains uncertain, while financing conditions are unfavourable.

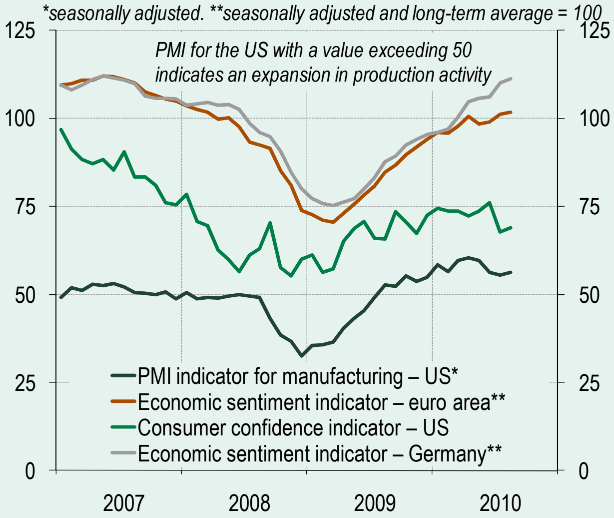
Foreign demand for Slovenian products is increasing in line with the recovery in economic activity in certain major trading partners. Import demand, primarily from certain EU Member States, has risen rapidly this year. The exception with respect to the economic recovery in Slovenia's most important trading partners is Croatia, where GDP declined 2.5% in y-o-y terms in the first quarter. According to initial estimates, a similar decline is also expected in the second quarter. This was also reflected in Slovenian exports to Croatia, which were down slightly less than one tenth in the first half of the year.

Financial markets and commodity prices

Central banks around the world continue to maintain accommodative monetary policy, despite the gradual economic recovery. Interest rates in many countries have remained low this year and will, according to the expectations of the financial markets, remain at a similar level at least during the first half of 2011. Nevertheless, the central banks of some countries have already increased key interest rates this year. The ECB's key interest rate has stood at 1.0% since last May. In the US, the Federal Reserve has maintained its key interest rate in the interval between zero and 0.25% since December 2008. The Bank of England has maintained its key interest rate at 0.5% since March 2009, while the key interest rate at the Japanese central bank has been 0.1% since December 2008. The majority of central banks are still implementing non-standard monetary policy measures[1].

[1] See the September 2009 Price Stability Report, Box 2.2, page 24.

Figure 1.3: Economic sentiment indicators



Sources: Eurostat, Federal Reserve Bank of St. Louis

Figure 1.4: Euro / US dollar exchange rate and central bank interest rates

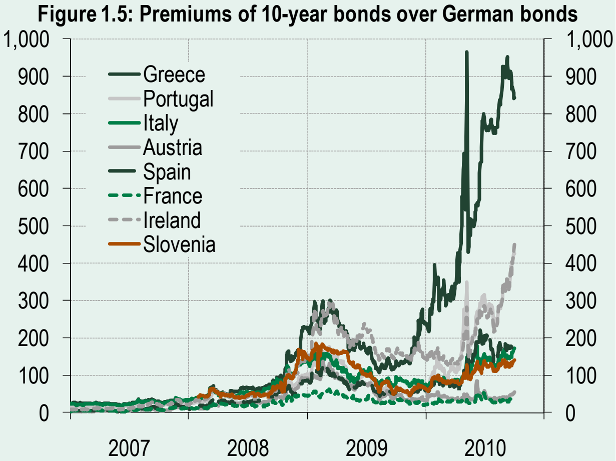
Sources: ECB, Federal Reserve

The euro's fall against the US dollar continued until July. The depreciation of the euro against the US dollar was more pronounced in the first half of the year, primarily owing to the better macroeconomic situation in the US relative to the euro area in the first quarter of this year. The euro's fall against the US dollar halted in July and August. The main factor in this development was economic growth in the euro area, which was higher than expected in the second quarter. The euro fell by 8.6% on average in y-o-y terms against the US dollar over the first eight months of the year to stand at USD 1.3170.

Stock market indices have fluctuated sharply again this year. This volatility was driven mainly by the increasing uncertainty regarding the global economic recovery and the deteriorating fiscal position of some European countries. After falling sharply in 2008 and rising gradually in 2009, stock market indices have yet to regain the levels reached before the outbreak of the financial and economic crisis.

Uncertainties on the financial markets have diminished slightly since the beginning of the year, but remain high. The adverse fiscal situation at the beginning of this year led to high premiums on reference government bonds over the comparable German bonds, particularly in Greece, Portugal and Ireland. Uncertainties on

Figure 1.5: Premiums of 10-year bonds over German bonds

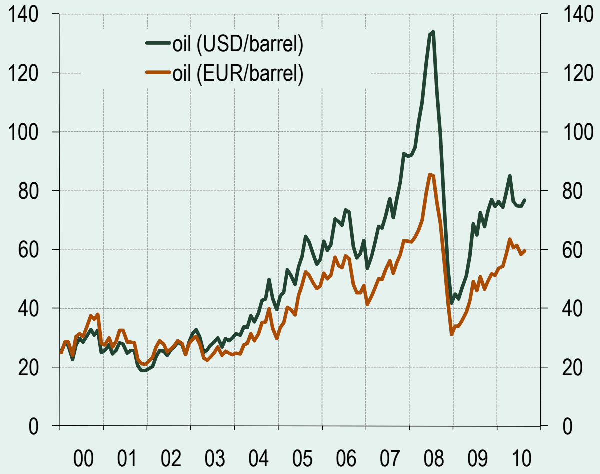


Sources: Bloomberg, Bank of Slovenia calculations
*Note: Premium is calculated as spread between yield on 10-year government bonds and yield on reference (German) bonds on a daily basis, reflecting risks ascribed to the country by markets. * SLOREP 01/20 bond included in figures for Slovenia from 18 January 2010.*

the financial markets diminished temporarily at the end of July as a result of favourable results from banking stress tests, and with the entry into force of new arrangements in the scope of Basel III. The releases of certain unfavourable global macroeconomic figures at the end of August once again resulted in an increased lack of confidence on the financial markets and the flight of investors to safer investments.

Oil and other commodity prices have fluctuated sharply this year, and are at significantly higher lev-

Figure 1.6: Oil prices per barrel



Sources: Bloomberg, ECB, Bank of Slovenia calculations

els than last year. A barrel of Brent crude averaged USD 77.2 over the first eight months of the year, up 36.8% on the same period last year. Rising oil prices were primarily the result of the gradual global economic recovery. The prices of other commodities have also risen gradually this year primarily as a result of increased demand from China and India. Food prices have also risen due to unfavourable weather conditions and natural disasters. Food prices were up an average of 4.5% in y-o-y terms over the first eight months of the year, while the prices of other commodities were up 22.7% in the same period.

Inflation

The main factor in this year's price growth in the euro area and the US has been developments in commodity prices. Inflation averaged 1.4% and 2.0% in the euro area and the US respectively over the first eight months of this year. The main factor in price growth was energy and food prices, while the contribution of domestic factors was small as a result of the still high unemployment in the two economies. Accordingly, core inflation remains low. Core inflation in the euro area this year has been quite stable, and averaged 0.9% over the first eight months of the year, while it has fallen in the US since the beginning of the year, to stand at 0.9% in July. The movement in producer prices was the result of an increase in industrial activity and energy prices. Producer prices in the euro area rose by an average of 1.8% over the first seven months of the year and, by 4.6% in the US.

2 Economic Trends and the Labour Market

Having stagnated at the beginning of the year, Slovenian GDP recorded moderate current growth of 1.1% in the second quarter. Growth was driven primarily by the response of the manufacturing sector to a sharp increase in foreign demand. Year-on-year growth in components of domestic demand remains negative, with the exception of moderate growth in government spending and the accelerated renewal of inventories. The situation remains unfavourable in the construction sector, which this year has been the main factor with a negative contribution to value-added in the economy overall. In the context of a continued fall in employment, declining private consumption also hinders the recovery in domestic demand. Nevertheless, the decline in employment is slowing down. Unemployment could begin to rise again as a result of the autumn seasonal effect and layoffs at certain companies. Growth in unit labour costs rose sharply at the outset of the crisis due to the contraction in activity, but has fallen recently on account of the economic recovery and the adjustment of employment to the decline in economic activity.

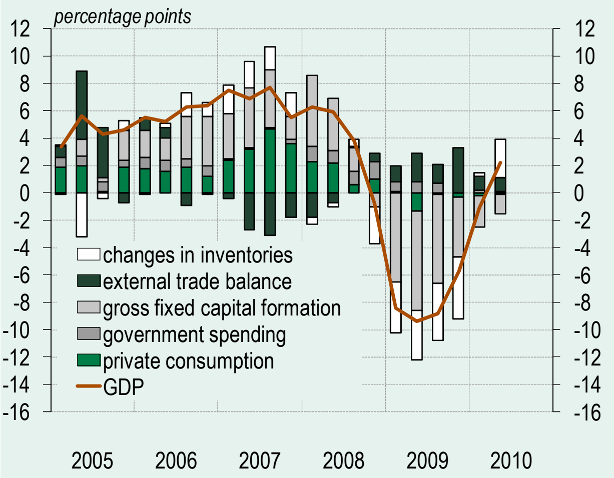
GDP rose by 1.1% in current terms in the second quarter of this year, similar to average economic growth in the euro area in the same period. Following five consecutive quarters of decline, GDP was also up in the second quarter of 2010 in year-on-year terms, by 2.2%. According to revised figures, GDP fell by 8.1% in 2009, which is 0.3 percentage points higher than the previous estimate.

Positive economic developments are the result of the response of domestic export-oriented sectors to the increase in foreign demand since the second half of 2009. Growth in value-added in the private sector was primarily driven by increased industrial production and transport. The need for intermediate goods to meet increased orders from the rest of the world is reflected in growth in imports and the renewal of inventories. A more robust economic recovery continues to be hindered by the stagnation of final domestic consumption, primarily owing to a decline in household consumption. Activity in the construction sector has also yet to achieve a new balance following the completion of major infrastructure investments and intensive house building prior to the outbreak of the crisis. Investment growth is also dampened by the relatively slow increase in the utilisation of production capacity, uncertainty regarding the sustainability of the global recovery and persisting limitations on the financing side.

Aggregate demand

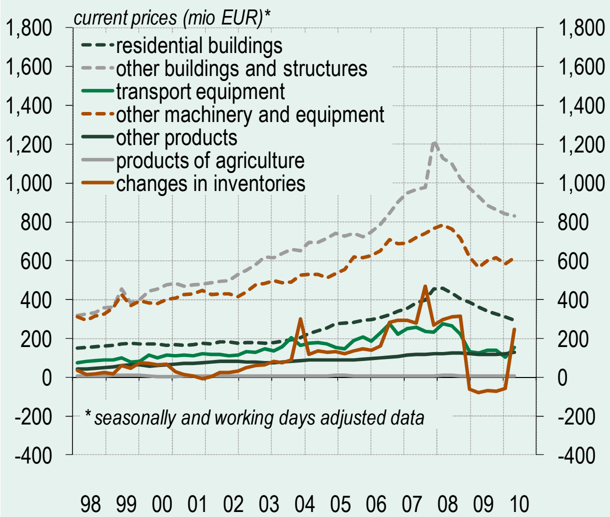
The year-on-year decline in domestic consumption slowed sharply in the first quarter of this year, while consumption was up 1.4% in the second quarter. This reversal was driven solely by the renewal of invento-

Figure 2.1: Contributions to GDP growth by components of spending



Source: SORS

Figure 2.2: Gross capital formation



Source: SORS

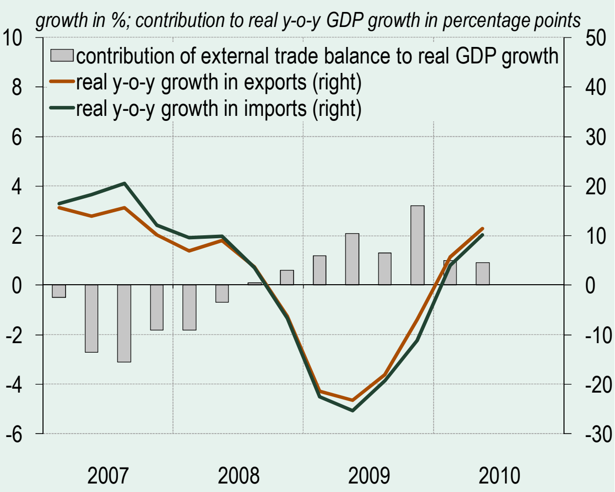
ries. The main aggregates of domestic consumption continue to decline in year-on-year terms, primarily as a result of the adverse situation on the labour market and the deepening of the crisis in the construction sector.

Final consumption stagnated in the first half of this year, as government spending merely succeeded in offsetting the decline in household consumption owing to the deteriorating fiscal situation. The current decline in household consumption deepened to 0.5% in the second quarter, while it was down in year-on-year terms for the sixth consecutive quarter. The main factors in low household consumption continue to be high unemployment and relatively low growth in households' disposable income. Having fallen last year, total net wage bill rose by 2.4% in year-on-year terms in the second quarter, primarily due to a rise in the minimum wage in March. At the same time, employment expectations at private sector companies do not yet indicate more sustainable growth in the number of new jobs. Consumer confidence remains at a low level. The potential for further employment and wage growth in the public sector is also significantly limited owing to fiscal restrictions. In the context of the rising general government deficit, the potential for fiscal policy to produce a counter-cyclical effect has been significantly reduced this year. This has resulted in a significant decline in the year-on-year growth in final government spending, which stood at around 4% in the first half of 2009, and was just slightly less than 1% in the first half of 2010.

The year-on-year decline in gross fixed capital formation slowed slightly in the first two quarters of this year, while the crisis has deepened in the construction sector. The year-on-year decline in investment, which was still close to 10% in the first quarter, slowed to slightly less than 6% in the second quarter. This is partly the result of a very low basis from the same period last year. In the context of high growth in the export sector, the renewal of inventories from the first quarter accelerated sharply in the second quarter. Their contribution to growth in domestic demand increased from 0.3 percentage points to 2.8 percentage points, expressed as the contribution to year-on-year growth in GDP. The dynamic of investment in construction projects is reflected in the deepening of the crisis in the construction sector, as the year-on-year decline in investment in buildings and structures was up from slightly less than 14% in the first quarter to nearly 16% in the second quarter, despite last year's low basis. The current decline was more pronounced than in the first quarter, both for housing and other buildings and structures. Housing investment, which was down 8% in current terms in the second quarter of this year alone, stands out. The nominal value of housing investment was equal to that recorded in early 2006. Other figures regarding the construction sector also indicate that this sector has not yet achieved a new balance, despite the significant decline in the last year and a half.

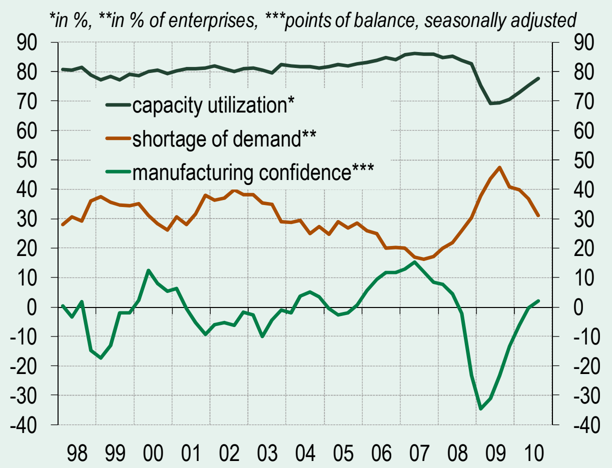
The current decline in gross fixed capital formation slowed to 1% in the second quarter, as a result of high growth in investment in transport equipment, and in other machinery and equipment. Following a break in this trend in the first quarter of this year, growth

Figure 2.3: External trade balance



Source: SORS

Figure: 2.4: Confidence indicators in manufacturing



Source: European Commission
Note: NACE rev.1.1 (until April 2010), NACE rev.2 (from May 2010)

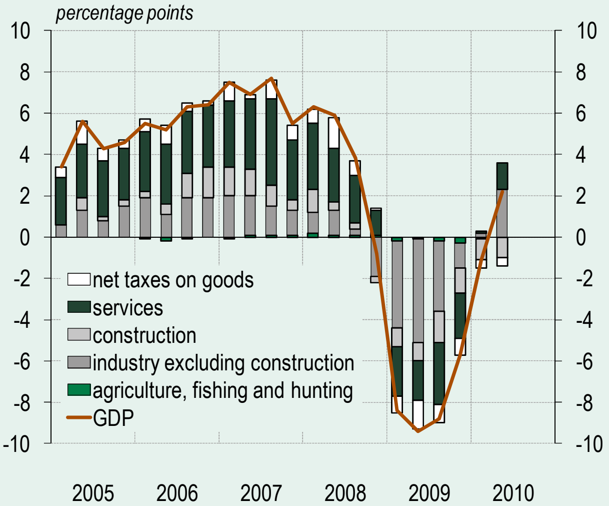
in these investments, seen in the second half of 2009 when current growth in export sectors began, continued. Nevertheless, the nominal value of investment in transport equipment was still down around 30% in the second quarter of this year compared with the several years prior to the crisis, while the nominal value of investment in other equipment and machinery was down approximately 10%. However, recent growth in these investments points more to a renewal than to an actual increase in production capacities. This, in addition to falling employment, is also confirmed by the level of production capacity utilisation, which was still almost one tenth lower in the second quarter of this year than before the crisis.

Foreign demand remained a key source of domestic economic growth in the first half of the year. Foreign trade was up sharply in the second quarter mainly due to increased economic activity in key trading partners from the EU, which was also stimulated by the lower value of the euro. Current growth in real exports reached 4.3% and was positive for the fourth consecutive quarter. Year-on-year growth in exports doubled to 11.4% compared with the first quarter. Real imports were also up sharply, primarily owing to the needs of domestic industry for intermediate goods. Year-on-year growth in imports rose from 4% in the first quarter to more than 10% in the second. At 0.9 percentage points, the contribution of net trade to GDP growth was again positive, but lower than in 2009 owing to the simultaneous increase in imports.

Supply side

The output gap remains negative as a result of low demand, while growth in potential output also declined. The negative output gap is illustrated by the production capacity utilisation, economic sentiment indicators and the lack of demand. Estimates of potential output are very uncertain in the current situation. However, on the basis of the available figures, it can be concluded that growth in potential output has slowed. Value-added, particularly in the construction sector, has declined sharply

Figure 2.5: Value added contributions to GDP growth by individual sectors



Source: SORS.

during the crisis. This results in a change in the structure of value-added and, at least temporarily, in lower growth in potential output.

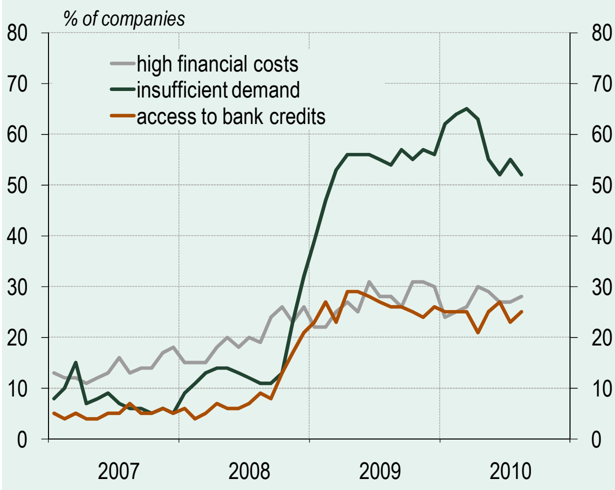
The manufacturing sector was the main factor in year -on-year GDP growth in the second quarter, contributing 2.3 percentage points to the 2.2% year-on-year growth in GDP. The high growth in value-added in the manufacturing sector derives from the increase in new orders from the non-domestic market, which was particularly notable at the end of last year. This year's current growth in new orders from the non-domestic market was actually down one half on the final quarter of last year, but was still high at 5.5%. Non-domestic new orders have also contributed most to growth in total new orders, as this year's domestic new orders remain at a low level. Growth in non-domestic new orders caused industrial production to increase since the second half of last year. At 4.4%, current growth in industrial production in the second quarter of this year was the highest recorded since 2000, manufacturing having contributed 3.9 percentage points to this growth. Turnover in industry began to rise in the second half of last year in line with growth in activity. Growth of turnover has continued this year, it has been up more than 5% in the first half of this year relative to the second half of 2009. Value-added in the transport, storage and communications sector was also up 7.1% on average over the first half of the year in year-on-year terms owing to an increase in international merchandise trade.

The decline in value-added in the construction sector contributed 1 percentage point to the year-on-year decline in economic growth in the second quarter. Despite a low basis, value-added in the construction sector fell by 14% in year-on-year terms in the second quarter. Valued-added has declined in current terms since the final quarter of 2008. Thus, the proportion of GDP ac-

Figure 2.6: Value of construction put in place and persons in employment in the construction sector

Sources: SORS, Bank of Slovenia calculations

Figure 2.7: Construction: factors limiting building activity



Source: SORS

counted for by the construction sector, which reached its peak at slightly less than 8% in the third quarter of 2008, is declining and fell below 6% in the second quarter of this year. Major infrastructure projects linked to the construction of motorways were completed in 2008. Since that time, the value of civil engineering work has been declining by around one fifth in year-on-year terms. Year-on-year growth in the real value of residential buildings exceeded 50% in 2008, and then fell by one fifth in 2009 and by more than one third in the first half of this year. This is also reflected in the number of new dwellings transactions, which has halved since 2007, while only a partial adjustment in prices has been seen. The prices of new dwellings were only down by around 15% in the second quarter of this year compared with the peak achieved just before the outbreak of the turmoil.

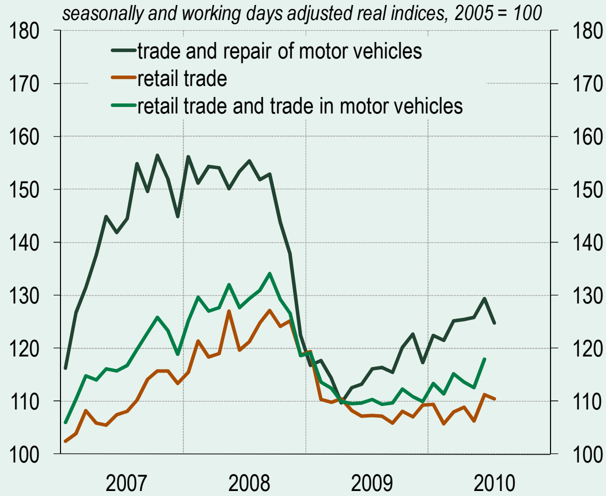
Reduced demand for real estate has increased the financial difficulties faced by construction companies. The proportion of construction companies faced with insufficient demand reached its peak in March this year at 65%. That proportion has declined slightly since that time, but remains above 50%. The proportion of companies facing high financial costs and difficulties accessing bank credits has also been high, at around one quarter, for more than a year. In terms of sectors, companies from the construction sector have accounted for the highest proportion of all companies with unsettled past-due[2] corporate liabilities since the second half of last year, at slightly less than one quarter of all companies. The amount of their unsettled liabilities accounts for slightly less than one third of all unsettled corporate liabilities.

After relatively favourable results in 2009, value-added in the financial intermediation sector was down 2.6% in year-on-year terms in the first half of this year. Value-added in the financial intermediation sector has risen by an average of slightly less than one tenth in year-on-year terms over the last ten years. Growth was still around 3% in 2009, while value-added declined notably in the first half of this year. One indicator of the deteriorating situation in this sector is the pre-tax profit of commercial banks, which was down nearly one half in year-on-year terms over the first seven months of this year, primarily due to higher impairment and provisioning costs. Some affected companies are not capable of regularly repaying loans owing to the economic crisis.

After five quarters of decline, value-added in the sector of wholesale and retail trade and motor vehicle repair was up 2.7% in year-on-year terms in the second quarter of this year. This is in line with the year-on-year growth in volume turnover in retail trade and sale of motor vehicles, which was positive again in the second quarter at 4.6% after five quarters of negative growth. This is mainly the result of the nearly 14% year-on-year growth in volume turnover in wholesale and retail trade and repair of motor vehicles and motorcycles, which has risen in current terms for the fourth consecutive quarter. This growth was primarily the result of campaigns by dealers, who responded to the drop in vehicle sales at the outbreak of the crisis in late 2008 by further cutting prices. This has encouraged vehicle sales, which was also reflected in growth in the number of new vehicle registrations. Volume turnover in the retail trade was also up

Figure 2.8: Volume turnover in retail trade

seasonally and working days adjusted real indices, 2005 = 100



Source: SORS

[2] According to AJPES figures, records only include the unsettled liabilities of corporates arising from court orders of enforcement and tax debt, and do not include other unsettled liabilities from unpaid invoices between creditors and debtors.

slightly in the second quarter after five quarters of negative year-on-year growth, which is not in line with the low level of consumer confidence and the renewed year-on-year decline in household consumption.

Labour market

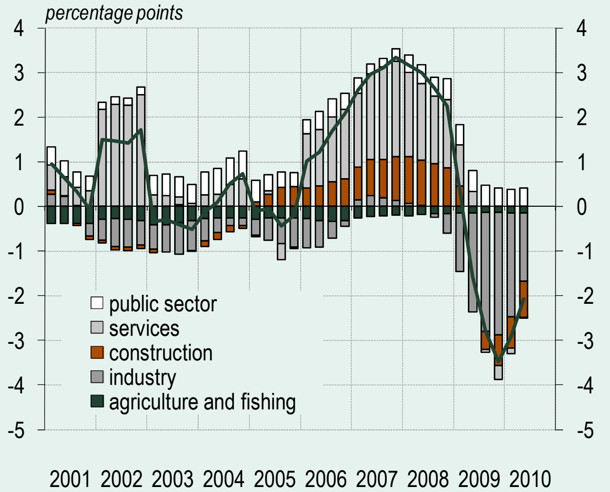
With recovery in economic activity the decline in employment is gradually slowing down. According to national accounts figures, employment fell by 1.9% in 2009. The y-o-y decline in employment reached 3.5% in the final quarter of 2009, but slowed to 2.1% in the second quarter of 2010. The q-o-q decline was sharpest in the second quarter of 2009, when it stood at 0.9%, but slowed to 0.3% in the second quarter of this year.

The fall in employment, which in 2009 was most pronounced in the manufacturing sector, has this year been highest in the construction sector, and it has continued in almost all other activities of the private sector. Employment in manufacturing declined by 9.4% in 2009. The q-o-q decline in employment has slowed since the third quarter of last year, and stood at just 0.5% in the second quarter of this year. Nevertheless, the year-on-year decline in this sector remains relatively high at 6.7%. The decline in employment also slowed in the transport, storage and communications activity, where the y-o-y fall in the fourth quarter of 2009 was 4.4%, compared with 3.9% in the second quarter of 2010. The q-o-q decline in employment in the second quarter of this year stood at 0.8%. The decline in employment in the construction sector is accelerating, as y-o-y growth was still positive in the second quarter of last year, but was negative in the second quarter of this year at -8.9%. Employment in the private sector is rising exclusively in real estate and business activities, where the number of employees was up 4.0% in y-o-y terms in the second quarter of 2010. Employment continued to contract in all other activities of the private sector in the second quarter, in both q-o-q and y-o-y terms.

Year-on-year growth in employment in the public sector stood at 1.9% in the second quarter of 2010 and mitigated the fall of the total employment in the economy. Growth slowed slightly compared to 2009 when growth still averaged 2.2%. Y-o-y employment growth was positive in all activities of the public sector, and was highest in education, where growth stood at 2.7% in the second quarter of 2010.

Changes in demand for labour are easily evident from the movement in the number of actual hours worked in the private sector. This indicator reflects short-term

Figure 2.9: Sector contributions to employment growth



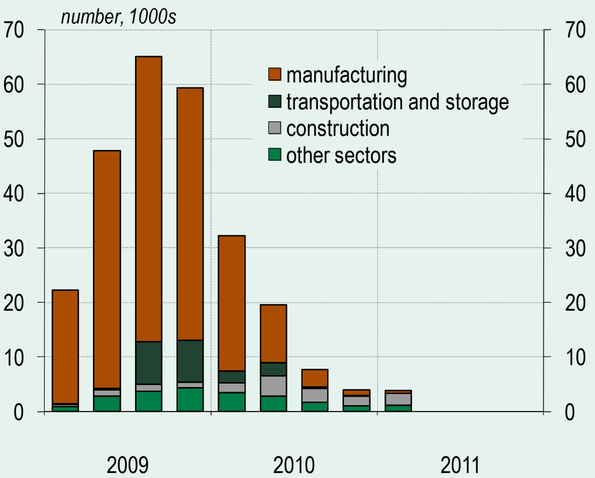
Sources: SORS (national accounts), Bank of Slovenia calculations

Figure 2.10: Hours worked – manufacturing and construction sectors

Sources: SORS, Bank of Slovenia calculations developments in demand for labour, as employers are more flexible with regard to changing the number of working hours (by ordering overtime or by cutting working hours) as compared to firing or hiring of workers. Furthermore, this indicator also excludes those workers who are temporarily laid-off within the framework of the government measure to subsidise temporary lay-offs. The seasonally adjusted number of total hours worked in the private sector peaked in the third quarter of 2008, and from then until the end of the second quarter of 2010 it fell by 12.9%. For comparison, over the same period seasonally adjusted employment in the private sector fell by 6.4%. The current rate of growth in the number of actual hours worked still indicates unfavourable situation in the labour market, with the number of hours worked falling by 0.9% from the first to the second quarter.

While the decline in the number of hours worked is slowing in the majority of sectors, it is accelerating in the construction sector. The decline in manufacturing was highest in the second quarter of 2009, when it reached 18.6% in y-o-y terms, but stood at 1.1% in the second quarter of 2010. Y-o-y growth in construction reached its peak in the third quarter of 2008, when it stood at 19.9%, but has been falling persistently since that time to stand at -12.5% in the second quarter of 2010.

Figure 2.11: Number of employees included in measures to subsidise full-time employment or temporary lay-offs



Sources: Employment Services of Slovenia, AJPES, Bank of Slovenia

The majority of employees who had been included in government measures to preserve jobs were no longer included in these measures by the third quarter of 2010. The government attempted to mitigate the fall in employment primarily through two measures: by partially subsidising full-time work and by subsidising temporary lay-offs.[3] Approximately 66,000 employees have been included in the first measure and 25,000 employees in the second measure. Both measures carried the risk that employers would postpone lay-offs only as long as they receive the subsidies, but they would lay-off workers after the termination of the programmes. One of the conditions for receiving the subsidies was that employers were not allowed to lay-off workers for business reasons for the time of being on the programme. However, the associated risks have not materialised, as the number of employees included in the measures had fallen to around 3,200 in the third quarter of 2010. Of that number, around two fifths are from manufacturing and one third from construction. In line with the economic situation, in the first quarter of 2011 the majority of remaining employees included in the measures will be from construction.

The number of job vacancies is increasing, but this is not reflected in the number of new hires. In the last two quarters the number of job vacancies began to rise from previously low levels, but still remains about one third lower than prior to the crisis, in the third quarter of 2008. In contrast to the evolution of job vacancies, the number of new hires is not rising and, amid usual short-term fluctuations, remains at an unchanged level. The

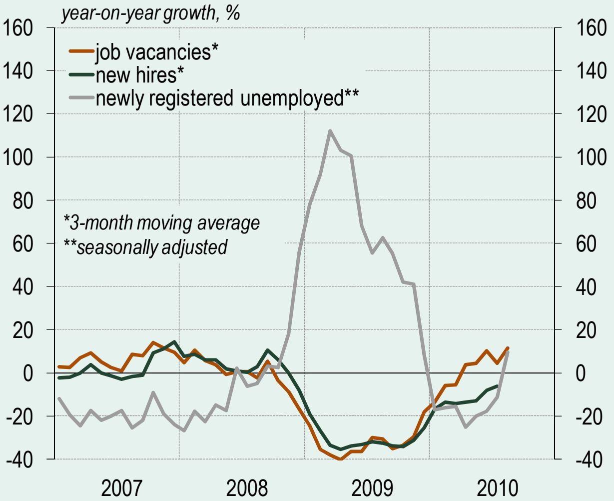
[3] On the basis of the measure for the partial subsidisation of full-time employment, which entered into force in February 2009, employers may shorten the work week by a maximum of 8 hours while receiving a subsidy in an amount of up to EUR 120 per employee a month. The other major government measure, the subsidisation of wage compensation for temporarily laid-off workers, has been in force since last June. Under this measure, a worker's wages are cut to 85% of the base wage. Of this, workers who temporarily cannot be provided with work receive just over 40% from the employer and slightly less than 60% of wages from the government. More on the government's labour market measures during the crisis can be found in the April 2010 Price Stability Report.

number of new hires continues to fall in y-o-y terms. Thus, the proportion of unfilled job vacancies, as measured by the ratio of the number of new hires to the number of newly registered job vacancies, has declined over the last six months. The proportion of unfilled of job vacancies stood at 58% in the second quarter of 2010, 9 percentage points below the average for the last five years.

The rise in the number of registered unemployed slowed in the first half of the year. However, growth in the number of unemployed is expected to rise again by the end of the year owing to the autumn seasonal effect and recent lay-offs. The sharp rise in the number of unemployed, which rose by around 40,000 from September 2008 to January 2010, came to a halt at the beginning of 2010. The number of unemployed has actually declined since the beginning of this year and reached 98,406 in July 2010. However, the number of unemployed is expected to rise again due to the usual autumn seasonal effect and recent bankruptcies of some major companies. Nevertheless, the ratio of inflows to outflows from unemployment indicates a gradual improvement in the situation in the labour market. The number of newly registered unemployed in the first half of this year was nearly one fifth lower as compared to the first half of 2009. At the same time, outflows from unemployment, primarily on account of persons entering employment, were up one fifth. The registered unemployment rate has stabilised since the beginning of the year to stand at 10.5% in June 2010. The unemployment rate from the labour force survey has also remained unchanged since the beginning of 2010 at 7.1%, but should drop in the second quarter relative to the first quarter owing to normal seasonal movements.

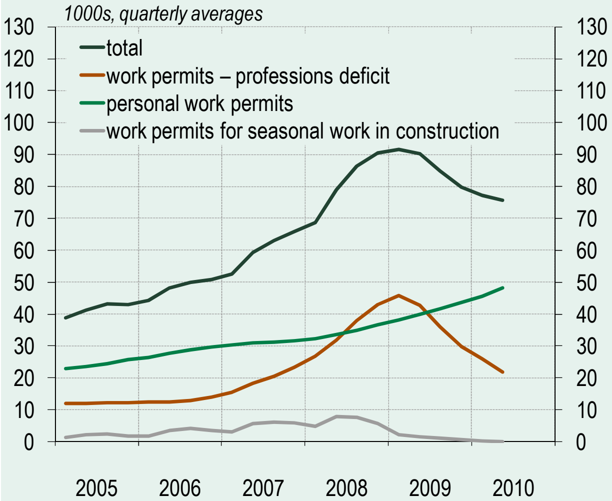
Since the outset of the crisis, the decline in the number of employed people has outstripped the increase in the number of unemployed, partly due to decline in the number of non-resident employees.[4] The number of non-residents in employment peaked in the third quarter of 2008, when their number totalled 70,300, representing 8% of total employment. The number of valid work permits for non-residents stood at 86,000 at that time. Of that number, approximately 35,000 were personal permits, where employees are potentially entitled to unemployment benefits when employment is terminated. Other permits do not entitle workers to unemployment benefits. The two other types of work permits are those linked to seasonal work, and those tied to a specific job

Figure 2.12: Job vacancies, new hires and newly registered unemployed



Sources: Employment Service of Slovenia, Bank of Slovenia calculations

Figure 2.13: Valid work permits for non-residents



Source: Employment Service of Slovenia, Bank of Slovenia calculations

4 EU citizens are not included in these figures, as they do not require a work permit. However, their number is relatively low; in the first half of this year only 2,231 became employed in Slovenia.

or employer. From the peak of the economic cycle to the second quarter of 2010 the total number of non-residents in employment declined by 10,000, which approximately corresponds to the difference between the change in the total employment and the number of unemployed.

In addition to reducing employment, the private sector has used other avenues to cut labour costs as a response to the decline in economic activity, and recently labour cost indicators suggest that the situation is gradually going back to normal. Y-o-y growth in nominal gross wages in the private sector declined sharply in 2009 to 1.8%. Growth of nominal wages rose in the year 2010 and reached 5.3% in the first half of the year. Significant factors in this year's wage developments include the statistical effect of a rise in the average wage in the private sector due to extensive lay-offs of persons with lower wages, rise in the minimum wage and the rising wages of workers, whose wages were temporarily cut during their inclusion in the government measure to subsidise temporary lay-offs. Worker lay-offs and the curbing of wage growth are also reflected in the movement of total wage bill, which better reflects the cost adjustments of firms. Thus, y-o-y growth in total private sector wage bill was negative in the second half of 2009, at 4.3%. Growth began to rise again in March 2010.

Table 2.1: Labour cost indicators

	2005	2006	2007	2008	2009	Q209	Q309	Q409	Q110	Q210
	nominal year-on-year growth, %									
Gross wage	3.6	4.8	5.9	8.3	3.5	4.6	2.3	1.7	3.7	4.3
Gross wage in private sector	3.7	5.5	6.8	7.9	1.8	1.6	1.4	1.5	5.0	5.7
Gross wage in public sector[1]	3.1	3.4	4.0	9.8	6.6	11.5	2.9	0.8	-0.6	-0.3
Gross wage in manufacturing	5.8	5.6	6.9	7.6	0.9	-0.5	0.4	3.7	10.2	10.0
Labour costs per hour worked[2]	5.1	4.5	4.5	9.1	3.7	8.0	2.5	-2.5	3.5	-0.5
Labour costs per hour worked in manufacturing[2]	8.0	3.6	5.1	10.5	5.7	10.5	5.5	-0.9	6.1	-0.7
Gross wage per unit output	-1.0	0.5	2.1	7.3	10.5	13.7	9.1	4.1	1.8	-0.1
Gross wage per trend-unit output[3]	1.4	2.6	3.7	6.1	1.3	2.4	0.1	-0.5	1.5	2.0
Gross wage in manufacturing per unit output	-0.6	-3.2	0.0	7.0	9.8	17.5	6.7	-3.0	-2.6	-9.8
Gross wage in manufacturing per trend-unit output[3, 4]	0.9	0.7	2.0	2.8	-4.0	-5.4	-4.5	-1.2	5.3	5.1
Unit labour costs[4]	0.9	1.0	2.5	6.0	8.5	10.3	7.3	3.3	1.5	0.6
Trend-unit labour costs[3, 4]	3.4	3.1	4.1	4.7	-0.5	-0.8	-1.6	-1.4	1.2	2.7
Labour costs per employee[4]	5.6	5.3	6.4	7.0	1.7	1.5	0.7	0.9	3.4	5.0
Output per employee	4.7	4.3	3.8	1.0	-6.4	-8.0	-6.2	-2.3	1.9	4.4
Output per employee (manufacturing)	6.4	9.1	7.0	0.5	-8.1	-15.3	-5.9	6.8	13.1	22.0
HICP	2.5	2.5	3.8	5.5	0.9	0.6	-0.2	1.4	1.7	2.4
GDP deflator	1.6	2.0	4.2	4.0	3.2	3.8	2.3	1.9	0.5	1.3

[1] Sectors of public administration, education, healthcare and culture according to the Standard Classification of Activities, 2008
[2] Labour costs according to SORS calculations
[3] Output per employee, average over last 10 years: 2.3%
Output per employee in manufacturing, average over last 10 years: 4.9%
Unit of output is the ration of real GDP to employment according to the national accounts, or in the manufacturing sector the ratio of value-added in manufacturing to employment in manufacturing according to the national accounts.
[4] Labour costs calculated on the basis of employee compensation (national accounts)
Sources: SORS; Bank of Slovenia calculations

Box 2.1: Proposed new labour market legislation

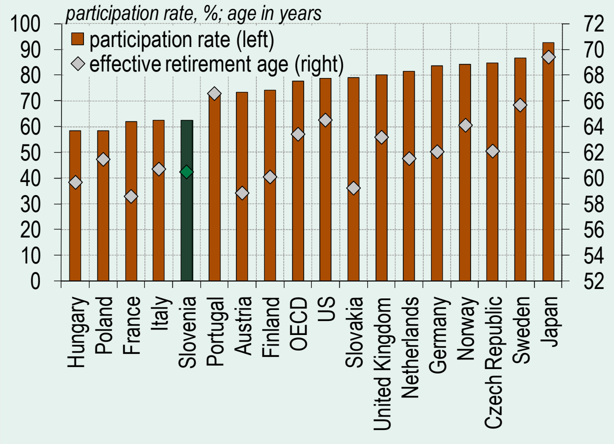
As the rest of the economy, the labour market has also been characterised by adverse developments, which are reflected in a sharp increase in the number of unemployed. However, the labour market also faces problems of a more long-term nature that call for further reforms. The most significant problems include very low participation of older people in the labour market, relatively low employment of younger people and existence of a dual labour market, where certain forms of employment are significantly better protected than others. In 2010 the government proposed amendments to the laws governing the labour market, and at the same time government is pushing forward with a reform of the pension system.[1] Through these amendments, the government is trying to partially resolve the aforementioned structural problems, and at the same time trying to bring the labour market closer to the concept of flexicurity.[2]

The participation of older people in the labour market remains very low in Slovenia, despite an increase in recent years. Among OECD countries Slovenia had the third lowest participation rate in the 55–59 age group in 2008 which, at 46.8% is 20 percentage points below the OECD average.[3] Men and women in Slovenia retire 3 years and 5 years earlier, than on average in other OECD countries, respectively. With its draft of the new Pensions Act of August 2010, the government is seeking to establish a system that will encourage older people to remain economically active for longer and to further deter them from early retirement. According to the proposal, following the end of a transitional period, insured parties are expected to have the right to retire at the age of 65, regardless of gender. For comparison, current system provides for an earliest possible retirement age of 60 for men and 58 for women. The proposed legislation also maintains a penalty for early-retirement: for each month of difference, insured persons would incur a permanent pension reduction of 0.3%. In addition, the proposed system envisages bonuses for those people who opt to remain in employment even after they have already fulfilled the conditions for retirement. For example, these persons would receive a 20% early pension on top of their wages for each year of activity following the fulfilment of the minimum conditions for retirement.

Current labour market regulations in Slovenia protect certain forms of employment considerably more than others. Legal restrictions and the tax burden are significant when employing workers on permanent contracts. Minimum legal notice periods of dismissal range from 30 to 120 days, depending on the years of service at an employer. Special restrictions also apply when dismissing a larger number of workers by an employer (this generally means at least 10% of employees). In all dismissals for business reasons employees may be entitled to severance pay in the maximum amount of 10 monthly salaries, which they receive in addition to unemployment benefits. Restrictions are even tighter for employees above 55 years of age: employers are not allowed to dismiss such workers until the workers meet the minimum conditions for receiving an old-age pension, or until the period during which they would receive unemployment benefits will have lasted up to the moment when they fulfil the conditions for retirement. On the other hand, the importance of student work, which is characterised by a very high level of flexibility in hiring and firing and a relatively low tax rate, has risen sharply in recent years.[4] Employers pay contributions at 14% of the value of student work performed, while the student pays personal income tax only on the amount of income that exceeds the annual non-taxable income. In 2009 the annual non-taxable income for students amounted to EUR 3,390 or EUR 282.5 on a monthly basis. According to some estimates, in the period from 2006 to 2008, around two-thirds of students did not pay any personal income tax on student work.[5] In addition to the low taxation, student work is appealing to employers owing to the high level of flexibility it provides, as there are no notice periods or severance pay. Moreover, employers are not obliged to pay supplements for night work, years of service, transportation and meal allowances or annual leave.

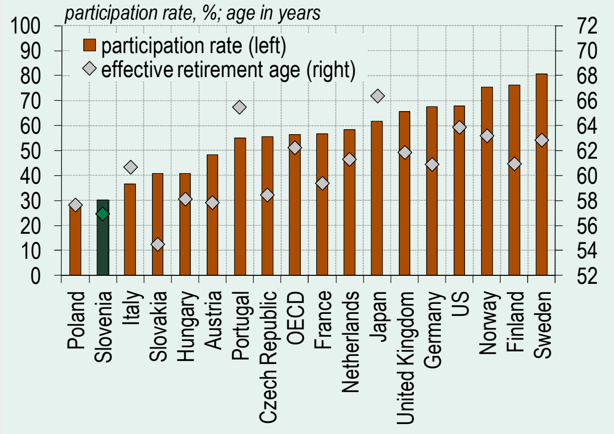
The draft law Small Jobs Act, proposed by the government, comprehensively restricts student work, which in the past has not been highly regulated in the past. In contrast to the current arrangements, by which there are no restrictions with regard to hourly wages or the number of hours worked at an employer or for a particular student, the government's proposal restricts both. The minimum hourly wage is expected to be EUR 4, which is comparable to the calculated minimum hourly wage, while income earned on small jobs may not exceed EUR 6,000 per person during a calendar year. In

Figure 1: Labour market participation rate of 55-59 age group and effective retirement age, selected OECD countries – men



Note: Figures for participation rate relate to 2008; figures for average effective retirement age relate to the period 2002-2007.
Source: OECD

Figure 2: Labour market participation rate of 55-59 age group and effective retirement age, selected OECD – women



Note: Figures for participation rate relate to 2008; figures for average effective retirement age relate to the period 2002-2007.
Source: OECD

addition, employers would be limited with regard to the permitted extent of employment within the framework of "small jobs": converted to the norm for a full-time employee, small employers could generally employ up to 2.3 small job contractors, while the largest employers could employ up to 18.3 small job contractors during a calendar month (exceptionally up to 36.6 "small job workers"). Due to the increased tax burden, this form of employment would also be less favourable from an employer's point of view compared with student work: contributions are expected to increase by a further 15.5 percentage points, on account of contributions for pension and health insurance. Although the majority of amendments in the proposal are expected to further restrict employers, somewhat greater flexibility would be achieved by expanding the pool of potential employees. In addition to pupils and students, pensioners and the unemployed are also expected to be included.

The government has also prepared a draft law amending the Employment Act and a draft law Governing the Labour Market with the aim of bringing the labour market closer to the concept of flexicurity and eliminating the duality of the labour market. Through amendments to the Employment Act, the government aims to shorten the notice periods that apply to employers in dismissals, but only for a narrow group of employees. The notice period for those employed for 25 years or more would be reduced from 120 days to 90 days, while the notice periods for other groups of employees would remain unchanged. The government is proposing more significant changes in severance payments. Under the new regulations, all workers employed by an employer for more than one year would be entitled to severance pay amounting to one fifth of the base for each year of employment. Thus, severance pay for workers employed from 5 to 15 years would be 20% lower, and 40% lower for workers employed for more than 15 years, as compared to the current legal framework.

On the other hand, the government is proposing to raise unemployment benefits and expand the pool of those entitled to unemployment benefits with the draft law Regulating the Labour Market. Under the current regulations, persons who were employed for 12 months during the previous 18 months are entitled to unemployment benefits; under the new arrangements, that right would be extended to persons who were employed for 9 months during the previous 24 months.

[1] It should be noted that the proposed amendments of legal acts are still in governmental procedure and subject to public debate, and they have not yet been put to the National Assembly for a final decision.

[2] According to this concept, greater flexibility is achieved through relatively low job security, which is expected to increase willingness of employers to hire new employees. Security is ensured through a favourable unemployment insurance system and active employment policies.

[3] Source: OECD employment database.

[4] The proportion of total hours worked accounted for by student work stood at 3.8% in Slovenia at the peak of the economic cycle in 2008.

[5] Source: Šušteršič, Janez; Nastav, Bojan; Kosi, Tanja (2010). "Ekonomski vidiki študentskega dela" (Economic Aspects of Student Work), University of Primorska, March 2010.

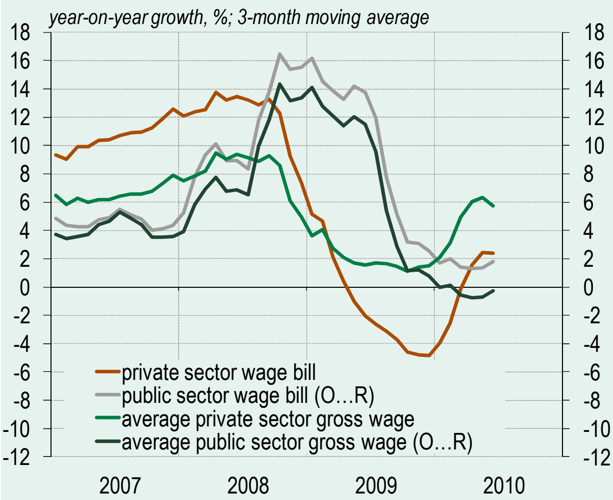
The government's primary aim in this regard is to protect young workers. The government is also proposing an increase in benefits for unemployed persons who would receive 80% of the base during the first three months, instead of 70%. To further stimulate the unemployed to find work, the act also provides for the possibility of maintaining the proportional part of unemployment benefits in the event of part-time employment. The act also regulates career counselling and active employment policies, where the government aims to increase the success and effectiveness of these measures through regulation.

Average nominal gross wages in the public sector were practically unchanged in the first half of 2010. Public sector wage growth was high in 2008 and 2009 on account of rising wages in the context of the elimination of wage discrepancies. According to the indicator based on the standard classification of activities[5], public sector wages decreased by 0.4% in year-on-year terms over the first six months of this year. On the other hand, according to the indicator based on the employees at public entities,[6] wage growth stood at 0.4% in the first half of the year. Low wage growth in the public sector is also the result of the adverse fiscal situation and the associated austerity measures implemented by the government, and low inflation.

GDP per employee fell sharply between 2008 and 2009, but has recently begun to rise again. GDP per employee fell by 8.7% in y-o-y terms in the first quarter of 2009, as the fall in output was significant and the number of employees did not yet adjust to the new situation. With a gradual increase in output and a decline in employment, the indicator began to rise gradually, by the second quarter of 2010 nearly reaching the level achieved in 2007. This development was particularly pronounced in the manufacturing sector, where with a sharp drop in output productivity fell by 15.4% in y-o-y terms in the first quarter of 2009. This, however, was followed by a sharp drop in the number of employees, so that the level of productivity in the second quarter of 2010 actually exceeded the pre-crisis level.

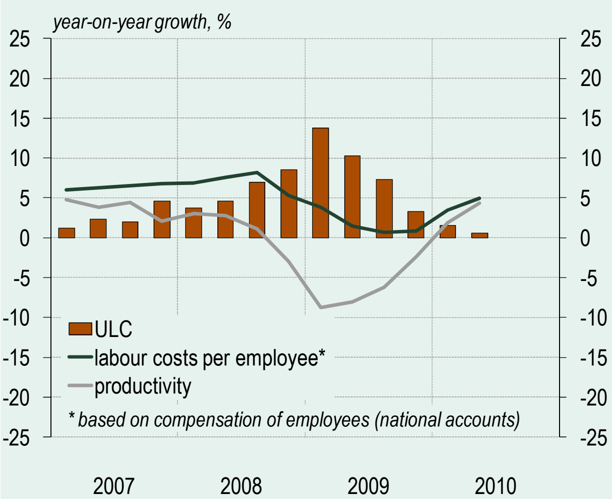
Indicators adjusted for cyclical trends reveal that firms responded quite early to the adverse economic situation. Trend-unit labour costs, where the cyclical

Figure 2.14: Total wage bill and average gross wage per employee



Sources: SORS, Bank of Slovenia calculations

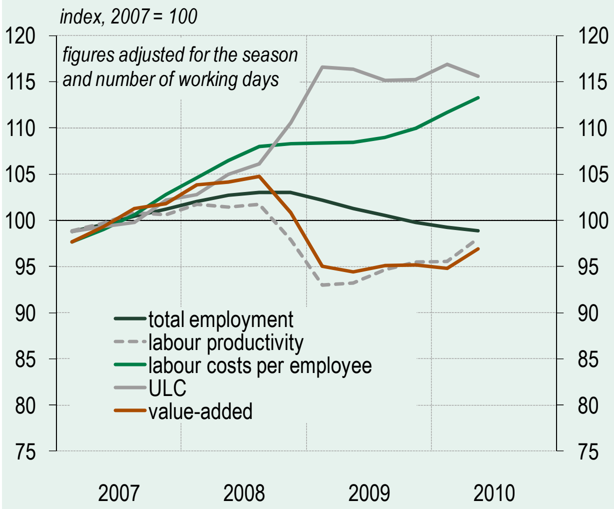
Figure 2.15: Productivity, unit labour costs and labour costs per employee (total economy)



Sources: Eurostat, Bank of Slovenia calculations

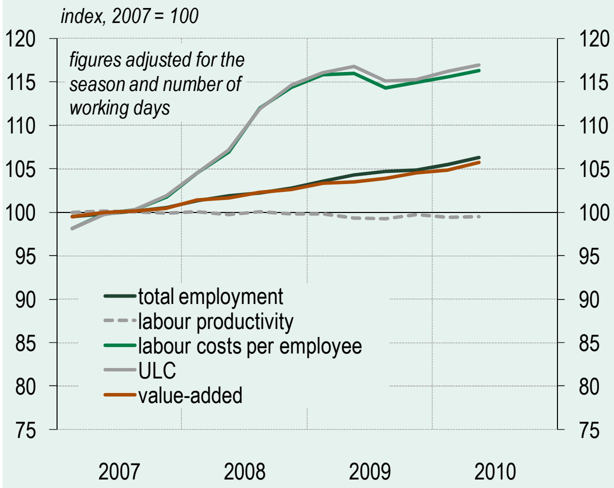
[5] This indicator includes the following activities according to NACE rev.2: Public administration and defence; compulsory social security, Education, Human health and social work activities, Arts, entertainment and recreation. Although this indicator includes legal entities that are not part of the public sector, time series data are available for a longer time period.
[6] Includes general government institutional sector, public non-financial corporations, public financial auxiliaries, public insurance corporations and pension funds, the central bank and public other monetary financial institutions. Data are available only for the last few years.

Figure 2.16: Cost adjustment of the economy (total economy)



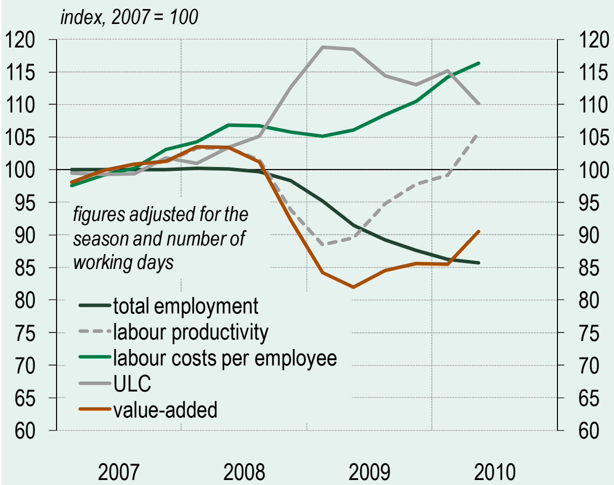
Sources: Eurostat, Bank of Slovenia calculations

Figure 2.17: Cost adjustment of the economy (public sector)*



Sources: Eurostat, Bank of Slovenia calculations
** Includes sectors L, M, N, O, P according to NACE rev. 1.1.*

Figure 2.18: Cost adjustment of the economy (industry)*



Sources: Eurostat, Bank of Slovenia calculations
** Includes sectors C, D, E according to NACE rev. 1.1.*

component is excluded from the indicator, demonstrate the inflationary pressure of labour costs, should economic growth remain close to its long-term average. Y-o-y growth in this indicator began to fall in the last quarter of 2008, soon after the outbreak of the crisis, and turned negative in 2009. This shows that companies began to take immediate steps to reduce labour costs growth. After falling for several quarters, the indicator of growth in trend -unit labour costs began to rise again in y-o-y terms, and by the second quarter of 2010 reached its average growth of the last five years.

Although year-on-year growth in unit labour costs is slowing down following extremely fast growth in early 2009, the level of unit labour costs still remains above the pre-crisis level. Growth in unit labour costs rose to 13.7% in y-o-y terms in the first quarter of 2009 due to the rapid decline in economic activity. This was nearly 9 percentage points above the average y-o-y growth of the last ten years. Subsequently, y-o-y growth began to slow down, to stand at 0.6% in the second quarter of 2010. Companies were thus able to restrain growth in labour costs by reducing employment following the sharp drop in productivity. This low y-o-y growth is also to a great extent result of the high base effect, from 2009. In the second quarter of 2010 unit labour costs were approximately 10% higher than before the outbreak of the economic crisis and before the introduction of a new public sector wage system. High unit labour costs weaken the competitiveness of the economy, which could in turn limit the pace of economic recovery and reduction of unemployment.

Unit labour costs in manufacturing haven declined considerably more than in the economy as a whole, but nevertheless remain higher than before the crisis. In manufacturing, gross wages per unit of output rose by

18.2% in y-o-y terms in the first quarter of 2009, but have been declining since the final quarter of 2009, and were down 9.8% in y-o-y terms in the second quarter of 2010. The decline in unit labour costs is the result of a significant drop in employment in and the gradual recovery of economic activity. Nevertheless, unit labour costs in the second quarter of 2010 were approximately 5% higher than in the third quarter of 2008.

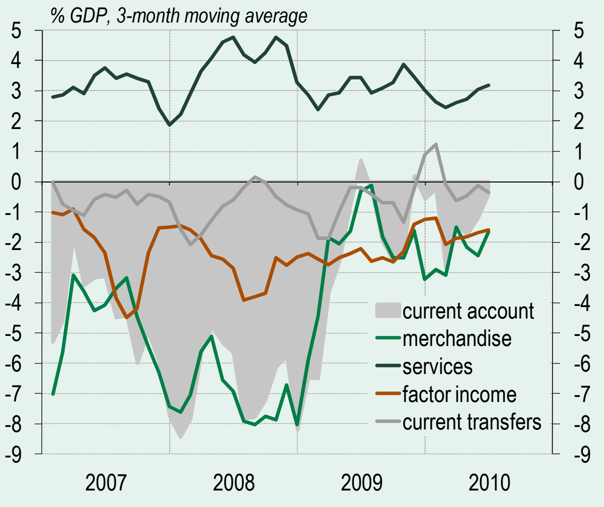
3 Foreign Trade and Competitiveness

The current account deficit has narrowed for the second consecutive year. It stood at 0.9% of GDP in the first half of this year compared with 1.4% of GDP in the first half of the 2009. Merchandise trade with the rest of the world strengthened as a result of increased foreign demand and rising imports of intermediate goods for the needs of industry. Value of merchandise imports grew slightly faster than exports. The majority of this year's deficit in merchandise trade can be attributed to the deterioration in the terms of trade. In addition to a slightly smaller surplus of trade in services, lower interest rates and a decline in net outflows of factor income also contributed to the narrowing of the current account deficit. Inflows of official transfers were also higher. Owing to the euro's fall, the competitiveness indicators mostly improved at the beginning of the year, both those expressed as price aggregates and those tied to labour costs. However, such price and cost adjustments lag behind the main euro area trading partners.

Foreign trade

The current account deficit, which widened until 2008, narrowed significantly in 2009, the narrowing of the deficit continued during the first half of 2010. The current account deficit reached EUR 2,500 million or 6.7% of GDP in 2008, the largest deficit since Slovenia's independence. Alongside foreign demand, domestic consumption and thus imports were down sharply in 2009 owing to the financial and economic crisis. Merchandise imports declined faster than exports in both current and year-on-year terms. The deficit in merchandise trade in 2009 was down to one fifth that recorded in 2008, while the current account deficit narrowed to 1.5% of GDP. The latter continued to decline in the first half of this year, when it stood at EUR 159 million or 0.9% of GDP, and was down one third in year-on-year terms primarily due to the narrowing of the deficit in factor income and transfers. In the 12 months to June the current account deficit reached EUR 445 million or 1.3% of GDP, compared with 4.7% of GDP in the 12 months to June 2009.

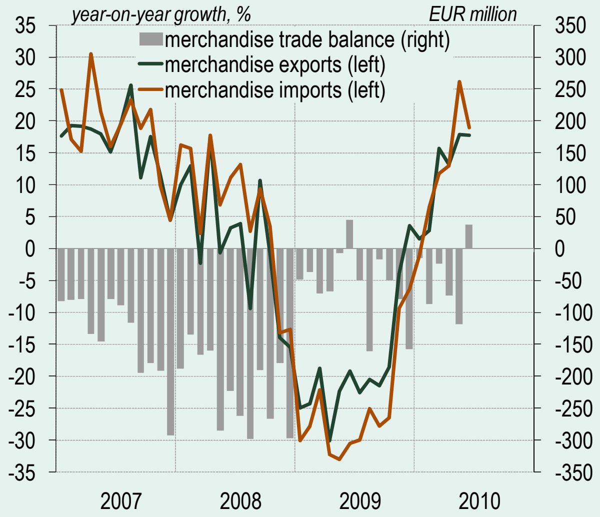
Figure 3.1: Components of the current account



Sources: SORS, Bank of Slovenia

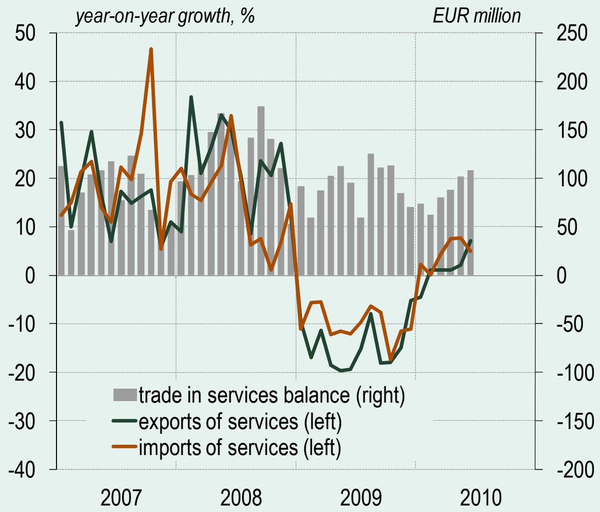
The deficit in merchandise trade was the main factor in the current account deficit. Growth in merchandise

Figure 3.2: Merchandise trade



Source: Bank of Slovenia

Figure 3.3: Trade in services



Source: Bank of Slovenia

trade was up sharply in the first half of this year in both current and year-on-year terms as a result of the strengthening of economic activity in Slovenia's most important trading partners, particularly from the euro area. In contrast to last year, growth in merchandise imports was slightly higher than growth in exports in the first half of the year, in part as a result of the deterioration in the terms of trade due to high growth in the prices of commodities and energy. The deficit in merchandise trade was thus up EUR 97 million in year-on-year terms to EUR 281 million.[7] In the 12 months to June the merchandise trade deficit stood at EUR 796 million or 2.3% of GDP, or half of that recorded last June. Merchandise trade has declined in both value and volume terms from the final quarter of 2008 and bottomed out in the first half of 2009. Merchandise trade with the rest of the world has risen gradually since that time. Current growth in imports and exports was up sharply at the beginning of this year. A low basis was also a factor in year-on-year growth in merchandise trade. Merchandise exports were up 7.1% in year-on-year terms in the first quarter and up 16.3% in the second quarter, while growth in imports was still slightly higher at 6.1% and 19.3%.

In addition to sustained fiscal stimulus in some EU Member States, the indirect effects of increased import demand from rapidly emerging Asian countries have also had an impact on the recovery in Slovenian exports. As a result of fiscal stimulus, particularly in Germany and France, current growth in exports has been positive since the middle of the second quarter of 2009. Following the withdrawal of certain measures to stimulate demand in Germany, exports to that country have risen, primarily owing to the indirect effects of higher import demand from Asian countries, China and India in particular.

The terms of trade deteriorated in the first half of the year and contributed significantly to the merchandise trade deficit. The export price index for merchandise, calculated on the basis of national accounts figures, was down 1.5% on average in 2009, while the import price index was down 6.0%. As a result, the terms of trade improved by 4.8%. The situation has changed this year. The export price index was up 0.7% in year-on-year terms in the first half, while the import price index was up 4.3% owing to rapid growth in the prices of commodities, food and energy, resulting in deterioration in the terms of

[7] According to SORS figures (fob for exports, imports CIF), and excluding any adjustments in coverage in the balance of payments methodology for disclosing merchandise trade, the merchandise trade deficit stood at EUR 463 million (explanation given in the Methodological Notes appendix to the Bank of Slovenia's Monthly Bulletin).

trade of 3.5%. The slightly higher growth in import prices is partly due to the euro's fall against the US dollar. The deterioration in the terms of trade contributed EUR 320 million or 1.8% of GDP to the merchandise trade deficit in the first half of this year.

The highest growth among all product categories was recorded by exports of intermediate goods and consumer goods, while the decline in exports of capital goods has slowed sharply compared with last year. The crisis and the decline in foreign demand at the beginning of last year had the fastest and most severe impact on exports of intermediate goods. However, in the context of a recovery in economic activity in the rest of the world, it is demand for intermediate goods that is recording the fastest growth. Exports of these goods were up 20.4% in year-on-year terms in the first half of this year. The largest increase of 27.5% in year-on-year terms was recorded in the second quarter. Year-on-year growth in exports of consumer goods reached around 13% in the final two months of last year. Growth has continued this year, but was significantly lower than the growth in exports of intermediate goods. Exports of consumer goods were up 6.0% in year-on-year terms in the first half of the year, most notably in the second quarter, when they rose by 7.4%. The decline in demand and a high level of uncertainty regarding future output and sales have significantly slowed investment activity in the rest of the world. This affects exports of capital goods, which were down 4.8% in the first half of this year relative to the same period last year.

Similar trends have also been seen in the breakdown of merchandise imports. Imports of capital goods

Table 3.1: Components of the current account

	2005	2006	2007	2008	2009	2009 H1	2010 H1
				EUR million			
Current account balance	-498	-771	-1,646	-2,489	-526	-240	-159
1. Merchandise	-1,026	-1,151	-1,666	-2,650	-699	-185	-281
2. Services	920	993	1,047	1,493	1,114	550	515
2.1. Transport	398	456	525	561	425	200	198
2.2. Tourism	743	783	834	970	832	397	383
- of which exports	1,451	1,555	1,665	1,918	1,800	773	777
2.3. Other	-221	-247	-312	-38	-143	-47	-66
3. Factor income	-295	-440	-789	-1,030	-782	-430	-306
3.1. Labour income	128	107	50	7	85	19	54
3.2. Capital income	-424	-547	-839	-1,038	-867	-449	-360
4. Current transfers	-97	-173	-239	-302	-159	-175	-86
				as % GDP			
Current account balance	-1.7	-2.5	-4.8	-6.7	-1.5	-1.4	-0.9
1. Merchandise	-3.6	-3.7	-4.8	-7.1	-2.0	-1.1	-1.6
2. Services	3.2	3.2	3.0	4.0	3.1	3.2	2.9
2.1. Transport	1.4	1.5	1.5	1.5	1.2	1.1	1.1
2.2. Tourism	2.6	2.5	2.4	2.6	2.4	2.3	2.2
- of which exports	5.0	5.0	4.8	5.1	5.1	4.4	4.4
2.3. Other	-0.8	-0.8	-0.9	-0.1	-0.4	-0.3	-0.4
3. Factor income	-1.0	-1.4	-2.3	-2.8	-2.2	-2.5	-1.7
3.1. Labour income	0.4	0.3	0.1	0.0	0.2	0.1	0.3
3.2. Capital income	-1.5	-1.8	-2.4	-2.8	-2.5	-2.6	-2.0
4. Current transfers	-0.3	-0.6	-0.7	-0.8	-0.4	-1.0	-0.5

Sources: SORS, Bank of Slovenia

Box 3.1: Breakdown of Slovenia's merchandise exports during the economic crisis

Slovenia's merchandise exports primarily comprise 18 product categories, while the majority of exports are intended for the markets of 13 countries.[1] In recent years just four product categories (*road vehicles, electrical machinery, apparatus and appliances, medical and pharmaceutical products, and general industrial machinery*) account for more than 5% of total exports. Most notable are road vehicles, accounting for between 17% and 18% of the total exports. Concentration by market is similar, as more than 5% of total exports are accounted for by just five countries, namely *Germany, Italy, Croatia, France and Austria*. Most notable is Germany, accounting for nearly 20%.

The sharp fall in exports in 2009 resulted in a slight change in the output and geographical breakdown of Slovenian exports. The most notable decline of 1.7 percentage points relative to 2008 was in the proportion of exports accounted for by iron and steel, while the proportion of exports accounted for by medical and pharmaceutical products was up 1.5 percentage points. The importance of the EU has risen, while the importance of the countries of former Yugoslavia has diminished. In terms of individual countries, the proportion of exports to France recorded the largest increase, of 1.7 percentage points, while the proportion of exports to Russia was down 1.2 percentage points. Among the main markets, only exports to France were up in 2009, by 5.6%. Exports to Russia declined by two fifths, while exports to Croatia, Bosnia and Herzegovina and Serbia were down around one quarter.

Last year's contraction in foreign trade was reflected most strongly in a decrease in the exports of certain major product categories, which are mostly considered intermediate and capital goods. Among primarily intermediate goods, the largest decline was recorded by exports of iron and steel, at just under one half, followed by non-ferrous metals with a nearly 40% fall. Exports of manufactures of metals were down by more than 30%, while the decline in exports of electrical machinery, apparatus and appliances was below average. The largest decline in exports of capital goods, of more than 40%, was recorded by specialised industrial machinery, while exports of general industrial machinery were also down, by slightly less than one quarter. Exports of road vehicles were down by slightly less than 20%. The largest contraction in exports of mainly consumer goods, of more than one fifth, was recorded by furniture. Exports of medical and pharmaceutical products fell by merely just under 1%.

Exports of product categories accounting for more than 5% of total exports were down last year on most major markets, with the exception of medical and pharmaceutical products. The

Table 1: Breakdown of merchandise exports by main trading partner

%	2009	Jan – Jun 2010
Total merchandise exports	**100.0**	**100.0**
Other countries	21.7	22.6
Germany	19.4	18.7
Italy	11.3	12.3
France	7.4	8.4
Austria	7.2	7.4
Croatia	7.8	6.3
Poland	3.3	3.9
Hungary	3.8	3.8
Russia	3.6	3.5
Serbia	3.6	3.4
Czech Republic	2.9	3.0
Bosnia and Herzegovina	3.1	2.6
Slovakia	2.8	2.2
United Kingdom	2.1	2.0

Sources: Eurostat "Comext" database according to two-digit SITC code, nominal figures in euros; Bank of Slovenia calculations

Table 2: Year-on-year growth in merchandise exports to main trading partners

%	2009	Jan – Jun 2010
Italy	-21.6	33.7
Poland	-31.1	31.2
Hungary	-18.6	28.4
France	5.3	23.6
United Kingdom	-19.1	23.4
Austria	-21.8	21.3
Other countries	-17.0	18.6
Total merchandise exports	**-19.1**	**14.9**
Germany	-15.9	10.3
Russia	-39.0	5.4
Bosnia and Herzegovina	-23.1	3.7
Serbia	-28.7	2.2
Czech Republic	-17.5	-0.1
Slovakia	-5.6	-8.4
Croatia	-23.9	-8.8

Sources: Eurostat "Comext" database according to two-digit SITC code, nominal figures in euros; Bank of Slovenia calculations main markets for *road vehicles* are France and Germany, accounting for approximately 50% of total vehicle exports. Owing to fiscal stimulus, exports of vehicles to France were up by more than 17% last year, while the decline in exports to Germany was merely 5%. The contraction in vehicle exports to Serbia, Russia, Hungary, Croatia and the United Kingdom exceeded 40%, while vehicle exports to Poland, Italy, the Czech Republic and Bosnia and Herzegovina were down by between 28% and 35%. Exports of *electrical machinery* , apparatus and appliances to the key market of Germany, which accounts for one third, were down by only slightly more than 2% last year. The contraction in exports of these products to France, Hungary and Russia exceeded 30%. In terms of country, exports of *medical and pharmaceutical products* fluctuated most. Exports of these products to Croatia, Russia and Poland decreased by between 20% and 42%, while exports to Serbia were down nearly 8%. Due to the high proportion of total exports of medical and pharmaceutical products accounted for by these countries, high growth in exports to other countries could not prevent a year-on-year fall. A decline in exports of *general industrial machinery* was seen on all the major markets. The most significant fall, of between 39% and 46%, was recorded in exports to Italy, Serbia and Russia. Exports to Germany, the main market accounting for around 20% of exports, were down by more than one fifth.

Following the recovery in the second half of 2009, Slovenian exports were up sharply in the first six months of this year, but primarily to EU Member States, which led to a further change in the geographical breakdown of exports. Exports to most major EU markets were up. The increase in exports to Germany was below average primarily due to the slowdown in growth in May. The decline in exports to Croatia and Slovakia, which exceeded 8%, has continued. Exports to the Czech Republic have stagnated, while exports to Bosnia and Herzegovina and Serbia were low. Growth in exports to Russia was also below average. This has further increased the importance of some major EU markets, in particular Italy and France, while the proportion of exports to Croatia has recorded the sharpest decline.

Having fallen sharply in 2009, exports of most of the major product categories were up significantly in the first six months of this year. Following a notable contraction in 2009, exports of non-ferrous metals have risen sharply, by more than 50%,

Table 3: Proportion of total merchandise exports accounted for by main product categories

%	2009	Jan – Jun 2010
Total merchandise export	**100.0**	**100.0**
Other products	24.2	24.0
78 Motor vehicles	17.4	17.7
77 Electrical machinery and equipment	9.2	9.3
54 Medical and pharmaceutical products	8.3	8.8
74 General industrial machinery	5.4	5.5
82 Furniture and spare parts	4.3	4.1
69 Other metal products n. i. e.	4.2	3.8
67 Iron and steel	3.1	3.4
64 Paper and cardboard, and cellulose produ	2.8	2.9
68 Non-ferrous metals	2.2	2.9
89 Miscellaneous finished goods	3.4	2.7
71 Motorised machinery and equipment	2.3	2.7
62 Rubber products	2.1	2.1
72 Specialised industrial machinery	2.3	2.1
65 Threads, fabrics and textile products	2.0	2.0
24 Cork and wood	1.7	1.7
66 Mineral products	1.7	1.5
08 Livestock feed (excluding cereal grains)	1.8	1.5
55 Essential oils, perfumes and toiletries	1.6	1.4

Sources: Eurostat "Comext" database according to two-digit SITC code, nominal figures in euros; Bank of Slovenia calculations

Table 4: Year-on-year growth in exports of main product categories

%	2009	Jan – Jun 2010
68 Non-ferrous metals	-37.5	52.3
71 Motorised machinery and equipment	-18.8	46.2
77 Electrical machinery and equipment	-13.3	27.4
67 Iron and steel	-48.5	26.1
08 Livestock feed (excluding cereal grains)	33.0	24.6
64 Paper and cardboard, and cellulose produ	-4.8	23.6
65 Threads, fabrics and textile products	-15.0	19.4
62 Rubber products	-20.2	17.8
Other products	-17.7	15.4
Total merchandise export	**-19.1**	**14.9**
78 Motor vehicles	-19.1	13.1
66 Mineral products	-20.1	9.7
74 General industrial machinery	-24.7	9.0
54 Medical and pharmaceutical products	-0.9	9.0
82 Furniture and spare parts	-22.7	6.6
69 Other metal products n. i. e.	-30.4	5.6
89 Miscellaneous finished goods	-15.3	3.8
24 Cork and wood	2.0	2.3
55 Essential oils, perfumes and toiletries	-0.9	1.3
72 Specialised industrial machinery	-41.2	-11.2

Sources: Eurostat "Comext" database according to two-digit SITC code, nominal figures in euros; Bank of Slovenia calculations among intermediate goods. Exports of electrical machinery, apparatus and appliances have risen by more than one quarter. Exports of iron and steel rose by more than one quarter, while exports of manufactures of metals did not begin to strengthen until the end of the second quarter. Among capital goods, exports of power-generating machinery and equipment were up by more than 45%, while exports of specialised industrial machinery have continued to fall. Growth in exports of general industrial machinery has been positive since March. Government incentives for the automotive industry have resulted in growth of more than 13% in exports of road vehicles, and an associated sharp increase in exports of rubber products.

Exports of the majority of product categories that account for more than 5% of exports strengthened considerably over the first six months of this year, but with some notable differences between the main markets. Growth in exports of *road vehicles* differed significantly between the key markets. Growth in exports to France reached more than one fifth, while exports to Germany fell by more than 13%, which reflects the diminishing effect of government subsidies. Exports to Italy were up more than 90% in year-on-year terms, while exports to Austria were down nearly 5%. Vehicle exports to Hungary, Poland, Serbia and the United Kingdom were up sharply. Exports of *electrical machinery* apparatus and appliances to most major trading partners were up. Growth of 26% in exports to Germany, which accounts for more than 34% of total exports of this product category, contributed most to the total growth in exports of these products. Solid growth in exports of *medical and pharmaceutical products* was primarily driven by a sharp increase in exports to Russia (by more than 16%) and to Poland (by 39%), which account for around one quarter of the market for these products. The Czech Republic and Serbia stand out negatively among the other major important markets with declines in exports exceeding 27% and 9% respectively. Growth in exports of *general industrial machinery* was below average due to a 9% contraction in exports to Germany, which is the main market for these products, accounting for 20% of exports. On the other major markets, exports to Italy rose by close to 50% and to France by more than one third, while exports to Austria and Croatia were down by almost 5% and by more than 22% respectively.

[1] The analysis included the product categories with the highest proportions of total merchandise exports. These categories combined accounted for around 75% of total exports in 2009. The same measure was also applied in the selection of importer countries of Slovenian products. The selected product categories in the selected countries cover between approximately 55% and 95% of total Slovenian merchandise exports to an individual country. Nominal figures in euros as at 20 September 2010 from Eurostat's “Comext” database according to the two-digit SITC code were used.

were down in year-on-year terms while growth of imports of intermediate goods and consumer goods was recorded. In addition to volume factors, in particular growth in foreign demand, higher import prices were also a factor in the 21.0% increase in imports value of intermediate goods. Import prices of energy and primary commodities rose sharply at the end of last year, and remained close to this level for the majority of the first half of this year. Year-on-year growth in prices of non-food agricultural products has also risen sharply since the final quarter of last year, reaching 83.8% in the second quarter. The most significant impact of the crisis was on imports of capital goods, which declined a further 7.1% in the first half of this year, following last year's decline of just under one third. In the context of an improving economic climate, current and year-on-year growth in imports of capital goods (34.8% and 9.8% respectively) were positive already in the second quarter of this year.

According to SORS figures, merchandise trade with EU Member States rose faster than with non-EU countries in the first half of this year. Comprehensive fiscal measures to stimulate domestic consumption and the depreciation of the euro resulted in faster economic growth in the most important EU trading partners compared with the majority of main trading partners outside the EU. Thus, following last year’s revival, merchandise exports to EU Member States continued to increase faster than exports to non-EU countries in the first half of 2010. Year-on-year growth in exports to the EU stood at 15.7%, compared with growth of 3.3% to non-EU countries. The regional differences in merchandise imports have narrowed in recent months, primarily owing to rising imports of intermediate goods from non-EU countries. Nevertheless, growth in merchandise imports from EU Member States, at 13.7%, was higher than the 7.9% growth recorded by non-EU countries. Merchandise exports to the former Yugoslav republics were down 6.5% in year-on-year terms in the first half of the year, while imports were up 22.4%. Above-average year-on-year growth was recorded in trade with Russia (exports and imports were up 9.7% and 52.4% respectively). The merchandise trade deficit with EU Member States rose slightly in the first half of the year to EUR 871 million, while the surplus with non-EU countries narrowed by EUR 65 million to stand at EUR 398 million.

Exports of services grew at a slower pace than imports in the first half of this year, while the increase in trade in services was smaller than the increase in merchandise trade. The surplus of trade in services narrowed by EUR 35 million in year-on-year terms over the same period to EUR 515 million. Exports of services totalled EUR 2.0 billion over the first six months of this year, up 1.5% in year-on-year terms, while imports were up 4.6% at EUR 1.5 billion. In the context of faster growth in merchandise trade, revenues from and expenditure on transport services also recorded above-average growth, of 6.2% and 10.9% respectively. Despite the economic crisis, expenditure and revenues from tourism were up 4.7% and 0.5% respectively. The narrowing of the surplus in tourism services contributed EUR 14 million to the year-on-year decline in the overall surplus of trade in services of EUR 35 million. In the context of year-on-year increases in the number of arrivals (up 3%) and the number of overnight stays by foreign visitors (up 2%), weak growth in revenues from tourism exports indicates a rise in the number of transitory guests on short stays in Slovenia in the breakdown of foreign guests. In the context of slightly faster growth in imports of transport services than in exports, the surplus of trade in transport services remained unchanged at EUR 198 million.

The deficit in net factor income in the first half of 2010 narrowed by EUR 124 million in year-on-year terms to EUR 306 million. The largest contribution to the narrowing of the deficit came from the decline in net interest expenses and the lower net outflows of FDI. The deficit in capital income narrowed sharply, by EUR 89 million to EUR 361 million. Capital income expenditure was up 3.3%, while receipts were down by just under one half. Owing to the extensive government borrowing last year and at the beginning of this year, the main factor in the deficit in capital income was net outflow in income from investments in securities. The surplus from investments of EUR 71 million in the first half of 2009 turned into a deficit in the amount of EUR 38 million during the first half of 2010. Low interest rates and net debt repayments by banks to the rest of the world meant that the largest decline among all capital income items was recorded by net interest payments to the rest of the world, from EUR 211 million in the first half of 2009 to EUR 63 million in the first half of 2010. The deficit in income from FDI narrowed during the same period, from EUR 309 million to EUR 259 million. Labour income receipts were up 9.2% in the first half of this year, while labour income expenditure was down two fifths, primarily due to a decrease in the number of foreign workers. In the context of these developments, the surplus in labour income was up sharply in year-on-terms, by EUR 19 million to EUR 54 million.

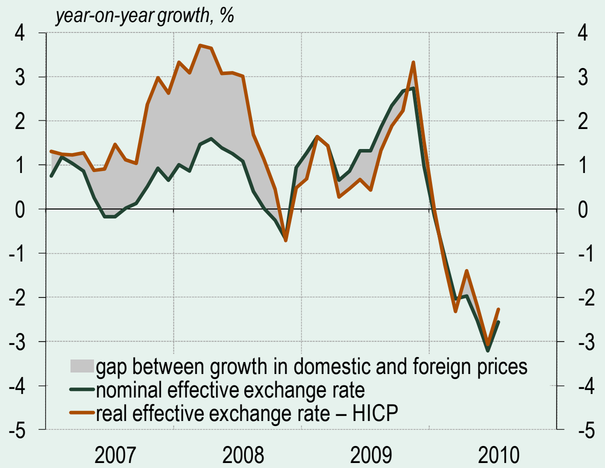
The year-on-year decline in the deficit in current transfers from the EUR 175 million to EUR 86 million in the first half of this year contributed to the narrowing of the overall current account deficit. The deficit in official transfers narrowed by EUR 89 million to EUR 86 million EUR million, while the deficit in private transfers narrowed by EUR 7 million to stand at EUR 17 million. Official transfers into Slovenia totalled EUR 292 million in the first half of the year, while official transfers to the rest of the world amounted to EUR 360 million. The resulting deficit in the amount of EUR 68 million was down by more than one half in year-on-year terms. This was primarily the result of a narrowing of the deficit in government transfers owing to a smaller deficit in taxes on products and other government transfers. The realisation of forecast annual flows with the EU budget stood at 19.6% on the receipt side, and 49.9% on the expenditure side. The overall result was a net inflow of (in current and capital transfers) of around EUR 8 million, which is only slightly higher than in the same period last year.

Price competitiveness and cost competitiveness indicators

Having depreciated at the end of last year, the harmonised indicator of the nominal effective euro exchange rate continued to depreciate in the first half of this year. The harmonised indicator of the nominal effective exchange rate peaked last November. The value of the indicator declined in both monthly and year-on-year terms over the first six months of this year, and was down 2.0% on average over same period. Contributing most to this decline, in addition to the euro's 0.2% fall against the US dollar, were the euro's 4.4% fall against the Swiss franc and a 4.1% fall against the Japanese yen. The depreciation was primarily the result of weak economic growth figures for the euro area in the first quarter and uncertainty over the fiscal problems in some euro area countries. In contrast to previous months in 2010, in July the harmonised indicator of the nominal euro exchange rate rose in monthly terms, mainly owing to weak second quarter macroeconomic figures for the US.

The harmonised indicator of the real effective exchange rate deteriorated in the first half of this year, mainly on account of movements in the nominal exchange rate. The harmonised indicator of the real effective exchange rate depreciated over the first six months, and was down more than 3% in year-on-year terms in June. The decline in the real effective exchange rate indicator was virtually the same as the decline in the nominal effective exchange rate, in both monthly and year-on-year terms. Year-on-year growth in domestic consumer prices was virtually the same as the basket of foreign prices during the first half of the year, with minor monthly deviations. The improvement in price competitiveness is thus primarily a result of the nominal depreciation of the euro. The harmonised price competitiveness indicator points to a relative deterioration in Slovenia's competitiveness compared with its main euro area trading partners since 2007. Despite this year's depreciation, the indicator's value remains above the value of Slovenia's main euro area trading partners. Thus, this indicator of price competitiveness improved by 3.5% (or by 1.3 percentage points more than in Slovenia) in the main euro area trading partners over the first six months of this year. This reflects the slower adjustment of the Slovenian economy.

Figure 3.4: Harmonised national competitiveness indicators (compared with 41 countries and the other 15 euro area countries)

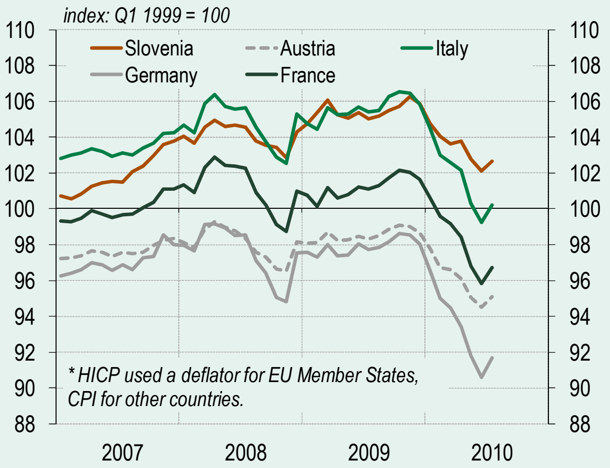


Sources: ECB, Bank of Slovenia calculations

The harmonised competitiveness indicator as measured by the GDP deflator,[8] which reflects the general level of prices in the economy, improved in both quarterly and year-on-year terms in the first quarter of this year in Slovenia. The quarterly improvement in this competitiveness indicator by 1.3% in the first quarter of 2010 contributed to the first year-on-year fall in the value of this indicator since the second quarter of 2006. The main factor in the indicator's improvement is likewise linked to the nominal depreciation of the euro. This price competitiveness indicator improved less in Slovenia compared with its main euro area trading partners, where it declined by an average of 2.1% in the first quarter. De-

[8] The European Commission also publishes price and cost competitiveness indicators (http://ec.europa.eu/economy_finance/db_indicators/competitiveness/index_en.htm). These differ from those of the ECB because of methodological differences resulting from the countries covered, the different sources for the deflators and the data conversion methods.

Figure 3.5: Harmonised competitiveness indicator based on consumer price indices*
(compared with 41 countries and the other 15 euro area countries)

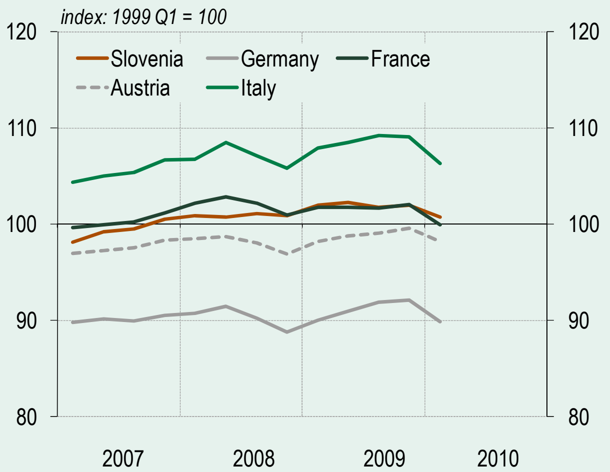


Source: ECB

Figure 3.6: Harmonised competitiveness indicator based on consumer price indices*
(compared with 41 countries and the other 15 euro area countries)

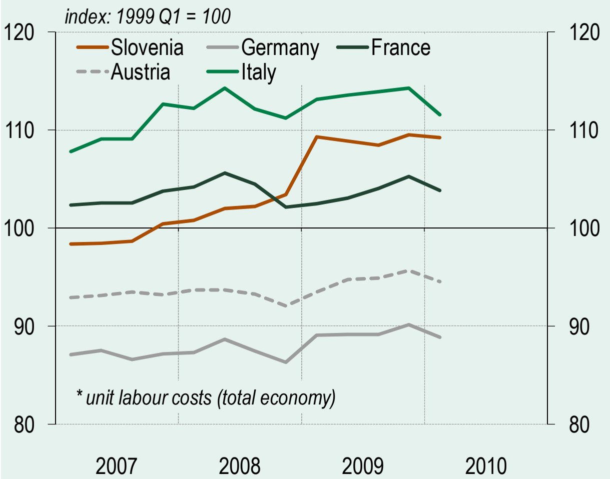
Sources: ECB, Bank of Slovenia calculations

Figure 3.7: Harmonised competitiveness indicator based on GDP deflator
(compared with 21 countries and the other 15 euro area countries)



Source: ECB

Figure 3.8: Harmonised competitiveness indicator based on ULC indices*
(compared with 21 countries and the other 15 euro area countries)

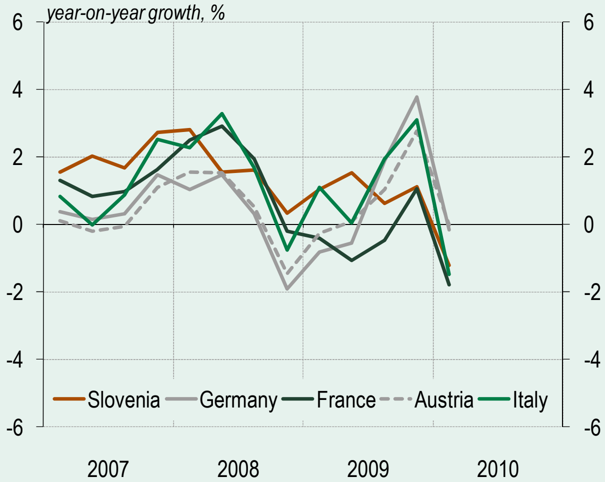


Source: ECB

spite the improvement in current terms, the value of this competitiveness indicator remains higher than the value in some of Slovenia's main euro area trading partners, and reflects still-weak price competitiveness.

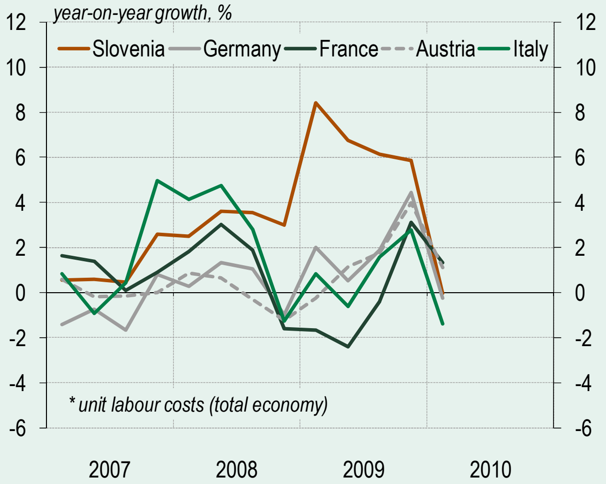
The value of the harmonised cost competitiveness indicator stagnated in Slovenia in the first quarter of this year. In the context of a sharp nominal depreciation, this indicator illustrates an insufficient adjustment in labour costs. Despite a depreciation of 0.2% in current terms, the value of the indicator as measured by unit labour costs in the total economy remains high. However, the improvement in Slovenia's cost competitiveness in the first quarter of 1.4 percentage points quarterly lags behind the average quarter improvement in this indicator in its main euro area trading partners. The smaller improvement in the Slovenian indicator compared with the average in the most important euro area trading partners is the result of relatively faster growth in unit labour costs in Slovenia. A comparison of the indicator shows that, following the outbreak of the crisis, cost competitiveness

**Figure 3.9: Harmonised competitiveness indicator based on GDP deflator
(compared with 21 countries and the other 15 euro area countries)**



Sources: ECB, Bank of Slovenia calculations

**Figure 3.10: Harmonised competitiveness indicator based on ULC indices*
(compared with 21 countries and the other 15 euro area countries)**



Sources: ECB, Bank of Slovenia calculations

in Slovenia has deteriorated significantly more than in other countries.

4 Financing

Growth in loans to non-financial corporations[9] has remained low this year following last year's sharp decline. These loans, primarily longer-term loans, have recorded moderate growth again in recent months. Year-on-year growth in loans to households exceeded 12% in June. Housing loans were the most important factor in this growth. Following the outbreak of the crisis, the private sector increased its net savings, while the public sector deficit was up. Foreign financial resources in the total amount of 1% of GDP were required to finance the total deficit of the domestic sectors. In June the sector of other monetary financial institutions[10] reduced its borrowing in the form of loans raised in the rest of the world by more than EUR 1.1 billion in year-on-year terms. The other monetary financial institutions compensated for this funding with relatively more expensive sources, primarily through the issue of debt securities. Interest rates on loans to households have continued to fall this year, on both consumer and housing loans, while interest rates on loans to non-financial corporations remain higher than the euro area average. These interest rates have fallen only partly.

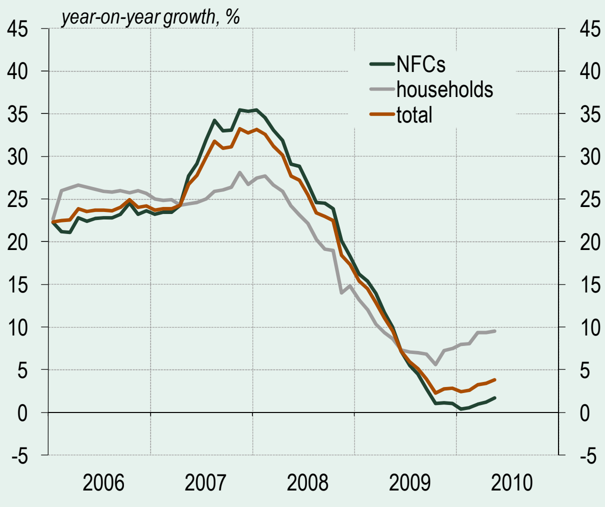
Financing of non-financial corporations and households

The financial liabilities of non-financial corporations (NFCs) were up EUR 836 million in the first quarter of 2010 relative to the first quarter of last year. There was a slight reduction in the stock of loans and debt securities and an increase in the stock of shares and other equity. NFCs reduced their financial liabilities in the form of loans by EUR 201 million in year-on-year terms in the first quarter, primarily as a result of a reduction in short-term borrowing at home and abroad. Long-term financing was up, but not enough to compensate for the reduction in short-term loans. Both new issues of equity securities and an increase in the value of equity contributed to growth in the financial liabilities of NFCs from shares and other equity.

Following last year's sharp drop, growth in loans to NFCs has stabilised at low levels, and has recorded modest growth in recent months. The decline in year-on-year growth in loans to non-financial corporations came to a halt in late 2009. Year-on-year growth averaged 1.1% over the first six months of 2010. The main reason for the decline in the growth in loans in 2009 was the drop in economic activity, which resulted in lower demand for loans. However, the growing importance of the other restrictive factors, in particular with regard to the supply of loans, has been seen in 2010. Other monetary financial institutions (other MFIs) are more cautious when approving longer-term loans or loans to the sectors that pose a greater risk.[11] Lower growth in loans to non-

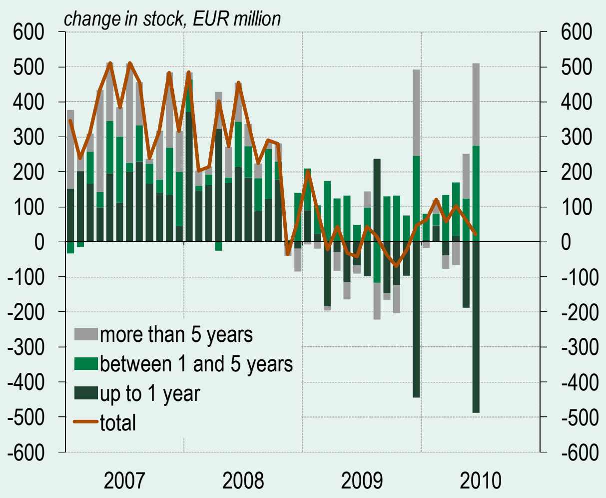
[9] According to the ESA95 methodology, non-financial corporations (NFCs) include legal entities, which are market producers of goods and non-financial services.
[10] According to the ESA95 methodology, other monetary financial institutions (MFIs) include banks, savings and money market funds.
[11] See the results of the survey on the loan demand of non-financial corporations by activity, September 2010.

Figure 4.1: Loans to households and non-financial corporations



Source: Bank of Slovenia Monthly Bulletin

Figure 4.2: Maturity breakdown of loans to domestic NFCs



Source: Bank of Slovenia Monthly Bulletin

financial corporations can therefore be attributed in part to stricter loan collateral terms, which could be a restrictive factor in this highly indebted sector. Despite the positive current growth in loans to non-financial corporations, this year's year-on-year growth has remained low since the beginning of 2010, and stood at 2% in June.

Loans to non-financial corporations with a maturity of up to one year have declined in year-on-year terms since the second half of 2009, while growth in longer-term loans has been stronger, particularly loans with a maturity of up to five years. Owing to favourable short-term financing conditions in the period prior to the crisis, non-financial corporations frequently raised short-term loans to finance longer-term activities, which they then regularly refinanced. With the outbreak of the crisis and rising uncertainties, other MFIs became more cautious and were no longer prepared to refinance these short-term loans to the same extent. The construction sector has contributed significantly to the decline in short-term loans, as NFCs from this sector primarily raised short-term loans in the past to finance their investment.[12] Loans with a maturity of between one and five years were up by more than one fifth in year-on-year terms in May. The improving climate in the export sector and the guarantee scheme intended for NFCs with a better credit rating contributed to growth in loans with longer maturities. Having declined at the beginning of the year, loans with a maturity of more than five years began to rise again in June in year-on-year terms. To stimulate the investment activity of non-financial corporations, in August 2010 SID banka published the first tender in the scope of the guarantee scheme to finance the investment of NFCs.

The financial liabilities of households were up EUR 711 million in year-on-year terms in the first quarter, primarily due to the raising of loans. The stock of loans, which accounts for around 87% of all household liabilities, was up EUR 686 million in year-on-year terms. Other household liabilities, primarily trade credits and advances, were up EUR 24 million in year-on-year terms.

Year-on-year growth in loans to households has been increasing since the final quarter of last year, and exceeded 12% in June. There was an increase in the proportion of loans to households accounted for by long-term, primarily housing loans, which were up 25% in year-on-year terms in June. This coincides with the increased number of real estate transactions this year. Falling interest rates on newly-approved loans contributed to the growth in housing loans. Consumer loans declined again in the second quarter of this year in year-on-year terms,

[12] Financial Stability Review, May 2010.

Figure 4.3: Maturity breakdown of loans to households

Source: Bank of Slovenia Monthly Bulletin

coinciding with the general decline in household consumption.[13]

Domestic and foreign sources of financing

After the outbreak of the crisis the private sector recorded high net savings, while the public sector deficit, which exceeded the net savings of the private sector, was up. Borrowing in the rest of the world was required to finance the difference. A decrease in investment and an increase in savings, following the outbreak of the crisis, significantly increased the net savings of the private sector. This was positive on average over the last 12 months and stood at 5.5% of GDP. Nevertheless, the indebtedness of domestic NFCs remains high, and considerably higher than the indebtedness of euro area NFCs. This indicates the problem of undercapitalisation, which has not been eliminated by the recent growth in the private sector's savings.[14] On the other hand, the public sector deficit increased again in the first half of the year, albeit at a slower pace than in the previous year, owing to the anti-crisis measures and low economic activity. In the 12 months to June, the public sector deficit amounted to EUR 2,414 million or 6.8% of GDP. Since the public sector deficit exceeded the net savings of the private sector, additional sources of financing were raised in the rest of the world, as reflected in the current account deficit. Gross external debt rose to EUR 41.9 billion in the first half of 2010, while gross external claims rose to EUR 30.7 billion. Slovenia's net external debt increased by EUR 530 million in the first half of 2010 to EUR 11.3 billion, or 31.7% of GDP.

The private sector's net savings[15] are rising on account of growth in net household savings, while NFCs have recorded a deficit. In the first quarter of 2010 the net financial assets of households[16] were up by

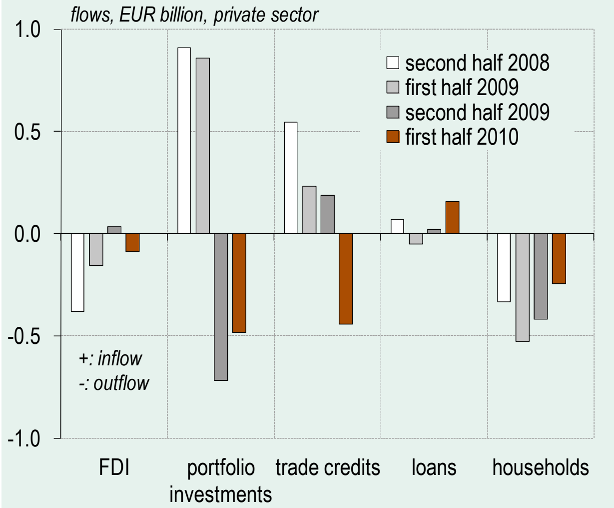
Figure 4.4: Savings-investment gap*

Sources: SORS, Bank of Slovenia

** The net savings of the public sector are defined as the consolidated public sector position using the ESA 95 methodology. Net borrowing from the rest of the world is defined as the negative of the current account position. The net savings of the private sector are defined as the difference between the current account position and the net savings of the public sector.*

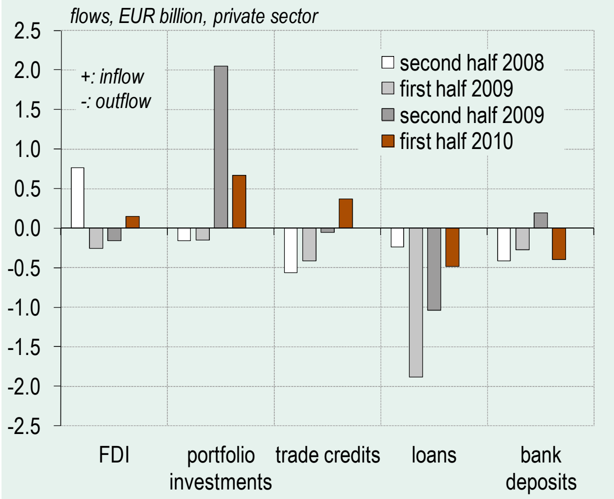
[13] Book figures of banks regarding loans indicate lower growth in loans than the figures given, in particular for NFCs. The item "loans" in the figures from the Bank of Slovenia's Monthly Bulletin includes the stock of loans according to the "gross" principle (excluding value adjustments), while this item in the book figures of banks includes loans according to the "net principle", i.e. inclusive of value adjustments. The book figures also take into account impairments, which reduce the carrying value of the loans.
[14] For a more detailed explanation, see the Financial Stability Review, May 2010.
[15] Net savings are defined as the surplus of net financial assets.
[16] Households also include the sector of non-profit institutions serving households (S.14 and S.15).

Figure 4.5: Financial claims against the rest of the world



Source: Bank of Slovenia

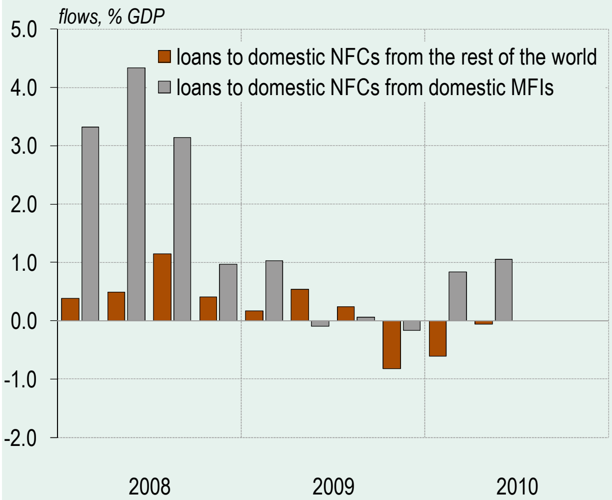
Figure 4.6: Financial liabilities to the rest of the world



Source: Bank of Slovenia

around EUR 2.6 billion[17] year-on-year, while the net financial liabilities of NFCs were up EUR 140 million. Compared with the period preceding the crisis, when the private sector borrowed heavily, the increase in the net financial liabilities of NFCs is exceptionally low. Net household savings rose by EUR 2.5 billion and EUR 3.5 billion respectively in 2006 and 2007, while the net financial liabilities of NFCs were up EUR 4.9 billion and EUR 8.6 billion respectively.

Figure 4.7: Loans to domestic non-financial corporations



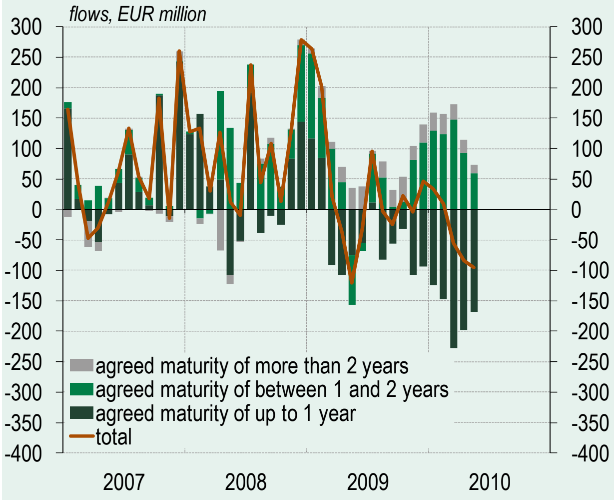
Sources: Bank of Slovenia, SORS

In the first half of the year a portion of the private sector's net savings was invested in the rest of the world. The private sector’s claims against the rest of the world rose by EUR 1,079 million in this period, while liabilities were up by EUR 276 million. The increase in claims against the rest of the world is primarily the result of an increase in the currency and bank deposits of households and NFCs in the rest of the world, and an increase in the private sector's portfolio investments. While NFCs invested primarily in shares, other MFIs invested mainly in debt securities. The private sector’s liabilities to the rest of the world were up in the first half of the year primarily on account of portfolio investments by non-residents. The decline in loans from the rest of the world to other domestic MFIs continued in the first half of the year, but at a slower pace than last year. Other MFIs made net debt repayments to the rest of the world of both a short-term (EUR 127 million) and long-term nature (EUR 96 million). Domestic NFCs made net debt repayments to the rest of the world of EUR 260 million in the first half of the year, of which the reduction in short-term debt accounted for more than 90%.

The financial assets of households and NFCs were up approximately EUR 4 billion in year-on-year terms

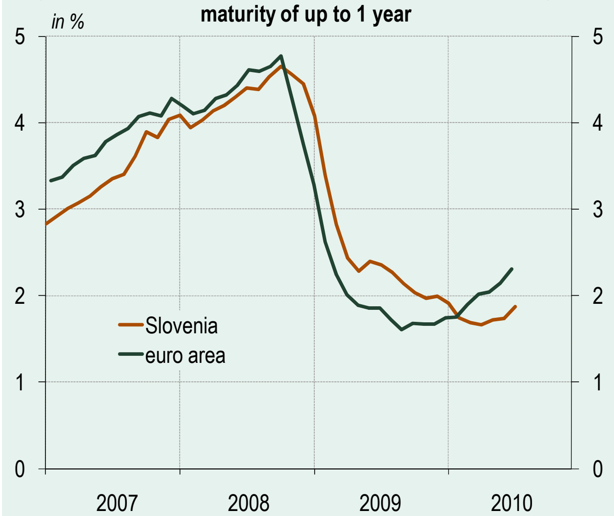
[17] Figures are from the consolidated financial accounts.

Figure 4.8: Deposits with an agreed maturity of households and non-profit institutions serving households (S.14 and S.15)



Sources: Bank of Slovenia, ECB.

Figure 4.9: Interest rates on household deposits with an agreed maturity of up to 1 year



Sources: ECB, Bank of Slovenia

in the first quarter of 2010. Of this amount, household financial assets were up EUR 3.3 billion in year-on-year terms, while the financial assets of NFCs were up nearly EUR 0.7 billion. Among household financial assets, investments in currency and deposits recorded the highest increase, of nearly EUR 1.4 billion, and in shares and other equity, by more than EUR 1.2 billion.[18] Household investments in currency and deposits redeemable at notice increased, while deposits with an agreed maturity were down. This decline, however, was seen for all maturities. Flows of deposits with an agreed maturity of up to one year have recorded the sharpest decline over the last 18 months, while flows of deposits with an agreed maturity from 1 to 2 years are positive. The related low interest rate, which in March fell below the euro area average and has actually become negative in real terms, has contributed to this year's decline in short-term deposits with an agreed maturity. Household deposits with an agreed maturity with longer maturities, of between 1 and 2 years and more than 2 years, have been rising since the middle of 2008. Since the first quarter of this year, however, their increase has not been sufficient to compensate for the decline in short-term deposits with an agreed maturity. Deposits redeemable at notice contributed EUR 231 million to the financial assets of NFCs, while deposits with agreed maturity and currency decreased by EUR 31 million over the same period.

The structure of funding for other MFIs is affected by the availability of sources. The proportion of funding accounted for by equity securities was up on the same period last year, while funding from foreign MFIs was down. In June the sector of other MFIs reduced its debt from loans raised in the rest of the world by more than EUR 1.1 billion. Thus, the proportion of funding of other domestic MFIs accounted for by foreign MFIs fell from 30% to 25%. The sector of other MFIs compensated for the loss of these sources with relatively more expensive sources of funding, such as debt securities. As a result, the proportion of total liabilities of other MFIs[19] accounted for by debt securities rose to 8.6%. Funding at the ECB still represents 4% of the total assets of other MFIs. However, this proportion will gradually fall with the withdrawal of measures. Growth in lending to the private sector is increasingly affected by opportunities to roll over the funding sources of other MFIs. With the maturing of short-term sources raised at the ECB and the possible withdrawal of government deposits with an

[18] The main factors in the increase in household wealth from investments in shares and other equity were changes in market prices (growth in global stock markets), exchange rates and other changes.

[19] See the results of the survey on the loan demand of non-financial corporations by activity, September 2010.

agreed maturity, other domestic MFIs will be forced to find alternative or additional sources to fund lending activities. The downgrading of certain domestic banks in September will drive up the costs of bank funding even further.

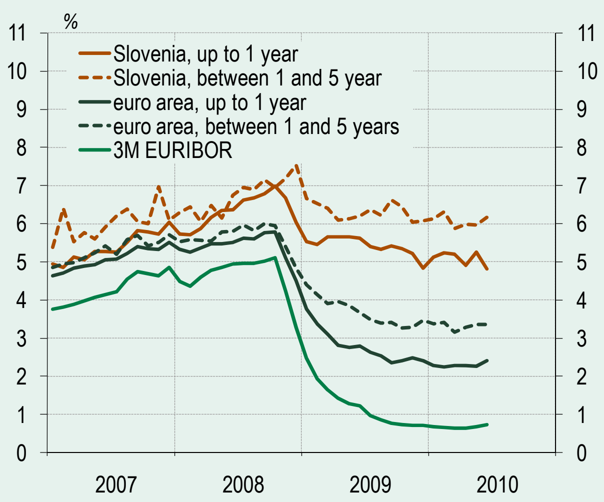
Interest rates

The average cost of funding of other MFIs, which amounted to 2.8% in the first half of 2010, also affected the supply of loans by other MFIs and interest rates. The shift to more expensive sources, such as debt securities, and premiums on sources obtained on the wholesale funding market for other MFIs do not facilitate a fall in asset interest rates. Likewise, sources obtained via ECB auctions have shorter maturities and are the result of non-standard measures. Other MFIs must therefore partially compensate for this funding with more expensive sources.

Interest rates on new loans to NFCs remain at high levels and have only moderately adjusted to the dynamics of the euro area. This is true for both short-term and long-term loans. Primarily as the result of impairment and provisioning costs, lower bank profits have forced other MFIs to increase net interest income by maintaining higher interest rates on the asset side. This continues to be reflected primarily in the segment of short-term[20] loans, where the premium over the EURIBOR persists at the level recorded in the second quarter of 2009. The interest rate on new loans with a maturity of between one and five years settled at around 6% this year, and remains nearly 3 percentage points higher than in the euro area. The interest rate spread between Slovenia and the euro area remains at a similar level to last year on loans with a maturity of more than 5 years[21].

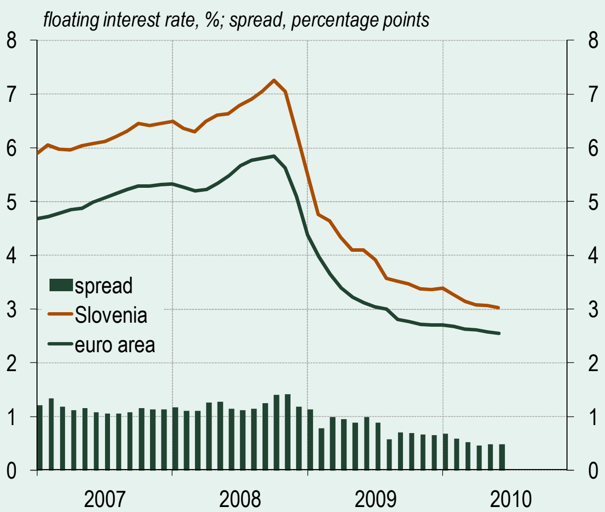
Interest rates on new loans to households have continued to fall this year, on both consumer and housing loans. Interest rates on consumer loans have fallen this year for all maturities. While interest rates on loans with longer maturities[22] were above the euro area average in June, short-term interest rates were more than 2 percentage points below the euro area average. A similar trend of falling interest rates has also been seen for housing loans, where the spread between euro area and Slovenian interest rates[23] is diminishing.

Figure 4.10: Interest rates for NFCs, by maturity



Sources: Bank of Slovenia, ECB

Figure 4.11: Interest rates on housing loans



Sources: ECB, Bank of Slovenia

[20] This segment also includes loans with a floating interest rate.
[21] With a fixed interest rate.
[22] Between 1 and 5 years and more than 5 years.
[23] Floating interest rate loans.

5 Public Finance Developments

The Ministry of Finance is projecting a general government deficit of 5.6% of GDP and general government debt of 37.9% of GDP for this year. The general government deficit reached 6.8% of GDP in a year up to June 2010. Total revenue remains low in line with the low level of economic activity. General government expenditure grew at a slower rate in year-on-year terms in the first half of the year compared with last year. Higher interest is already affecting expenditure growth. The general government debt had risen to 37.5% of GDP by the end of June. Its growth is tied to the financing of the general government deficit. Guarantees issued by the government were also up during the first half of the year, but significantly less than last year. The primary reason is diminishing interest on the part of banks. Restrictive fiscal policy is planned in the Stability Programme for the period 2011-2013. The aim is to cut the general government deficit to below 3% of GDP by 2013, in line with the commitments set out in the excessive deficit procedure. Of key importance in this respect are the state budgets for 2011 and 2012, which will be adopted by the National Assembly by the end of this year. According to the European Commission's opinion issued in June, Slovenia complied this year with the requirements set out in the excessive deficit procedure.

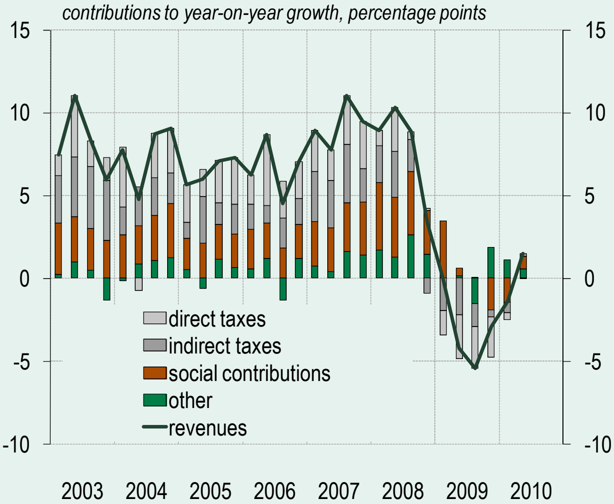
The general government deficit widened further in the first half of 2010 to stand at 6.8% of GDP in a year up to June. The Ministry of Finance is planning a deficit of 5.6% of GDP for this year. In its regular revision, the

Table 5.1: General government deficit and debt in Slovenia, 2007-2013: realisation, projections from the Stability Programme and European Commission forecasts (as % of GDP)

	SORS				Stability Programme					EC		
	2007	2008	2009	2010*	2009	2010	2011	2012	2013	2009	2010	2011
Revenues	42.4	42.3	43.2	42.9	42.4	43.2	42.9	42.7	42.5	44.4	44.6	44.7
Expenditure	42.4	44.1	49.0	49.7	48.1	48.9	47.1	45.9	44.2	49.9	50.7	49.9
of which interest	1.3	1.1	1.4	1.6	1.2	1.8	1.8	2.0	2.1	1.4	1.8	2.0
Net lending (+) / borrowing (-)	0.0	-1.8	-5.8	-6.8	-5.7	-5.7	-4.2	-3.1	-1.6	-5.5	-6.1	-5.2
Structural balance	…	…	…	…	-4.8	-4.2	-2.8	-2.1	-1.0	-3.7	-4.4	-3.8
Debt	23.4	22.5	35.4	37.5	34.4	39.6	42.0	42.7	42.1	35.9	41.6	45.4
Real GDP	6.9	3.7	-8.1	-3.6	-7.3	0.9	2.5	3.7	3.5	-7.8	1.1	1.8

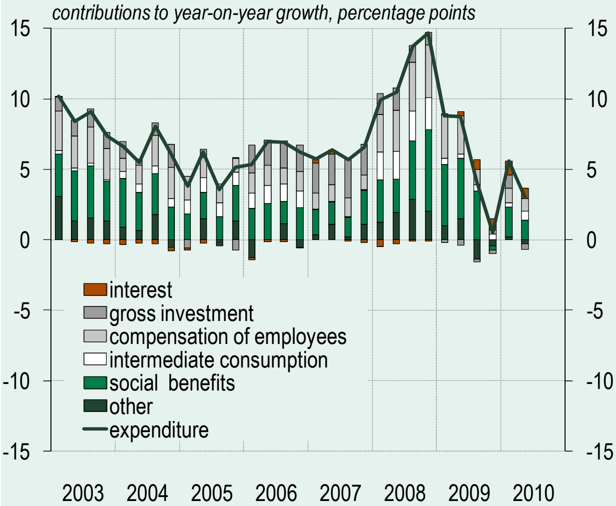
Sources: SORS, Ministry of Finance, European Commission (EC, May 2010), Bank of Slovenia calcuations.
** Debt: stock as at 30 June 2010; other items: last 12 month to end of June 2010.*

Figure 5.1: General government revenues



Sources: SORS, Bank of Slovenia calculations

Figure 5.2: General government expenditure



Sources: SORS, Bank of Slovenia calculations

SORS estimated a general government deficit of 5.8% of GDP for 2009, compared with initial estimates of 5.5% of GDP. Estimated revenues, in particular corporate income tax revenues, were revised downward. The reason lies in high corporate income tax settlements for 2009, made primarily in April and May of this year. The general government deficit widened further to EUR 1,498 million or 8.5% of GDP to stand at EUR 2,414 million or 6.8% of GDP in the 12 months to June 2010. In its September Reporting of government deficits and debt levels, the Ministry of Finance projected a general government deficit of EUR 1,999 million or 5.6% of GDP for this year.

General government revenues were practically unchanged during the first half of 2010 in year-on-year terms in the context of low economic activity. Higher excise duties on all categories subject to excise duties are expected to contribute to higher revenues in the second half of this year. General government revenues were up 0.1% in year-on-year terms in the first half of the year. The most notable declines were recorded in revenues from taxes on income and wealth, social security contributions and taxes on production and imports. The sharpest decline recorded over the last several years was in revenues from corporate income taxes. The deteriorating economic situation, more than the lowering of tax rates,[24] has contributed to this fact. The government raised excise duties when adopting the revised budget owing to lower state budget revenues. Excise duties on motor fuels were raised during the summer, and then lowered slightly in September. Excise duties on natural gas and electricity were also raised in August, but to a lesser extent than originally planned. Likewise, excise duties on electricity will not be raised in November as originally planned.

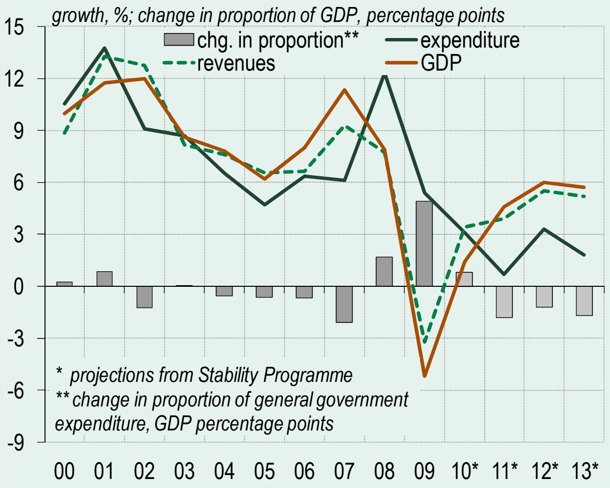
General government expenditure grew at a slower rate in the first half of 2010 than in 2009. The main factor in growth remains social benefits and assistance, while interest and subsidies are also on the rise. Labour market subsidisation measures are expiring. General government expenditure was up 4.2% in year-on-year terms in the first half of the year. Contributing most to this growth were payments of social benefits and assistance. The largest increase was in expenditure for interest and subsidies. Pensions account for the largest proportion of social benefits and assistance. The number of pensioners is rising faster this year than in

[24] The corporate income tax rate has been reduced in several phases, from 25% in 2006 to the final rate of 20% in 2010. Corporate income tax revenues amounted to 3.2% of GDP in 2007, but to just 1.8% of GDP last year (2.3% of GDP prior to the revision).

Box 5.1: General government expenditure during the crisis and in exit strategy

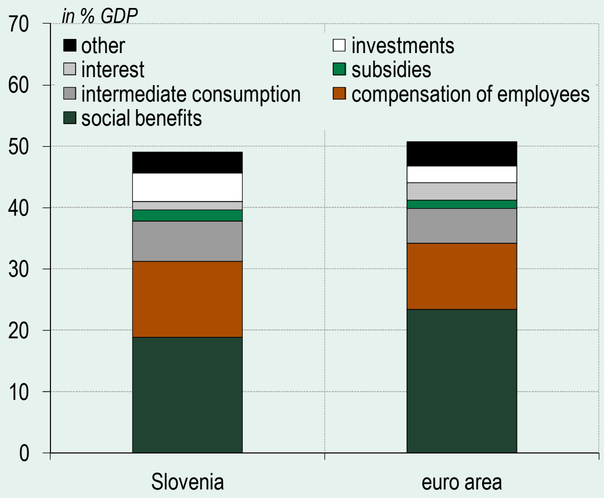
Having declined for several years, general government expenditure, measured as a proportion of GDP, has risen in Slovenia during the crisis. That proportion began to rise, in particular, from the second half of 2008 on. Nominal growth in general government expenditure in this period has declined gradually, but was significantly higher than the growth in nominal GDP. As a result, general government expenditure as a proportion of GDP rose by 1.7 percentage points in 2008 and by 4.9 percentage points in 2009. Growth in general government expenditure stood at 5.4% in 2009, and reflected the functioning of automatic stabilisers (primarily higher expenditure linked to unemployment), discretionary measures (primarily labour market subsidies), higher expenditure for interest payments (higher debt) and the rigidity of the expenditure. The crisis brought an end to a trend of declining general government expenditure as a proportion of GDP between 2002 and 2007, when growth in general government expenditure was more than two percentage points lower on average than GDP growth (Figure 1). In line with the exit strategy, general government expenditure as a proportion of GDP is expected to decline again over the next three years, by an average of around 1.5 percentage points of GDP annually.

Figure 1: Growth in general government expenditure and revenues and GDP, and change in proportion of general government expenditure



Sources: SORS, Bank of Slovenia calculations

Figure 2: Structure of general government expenditure in Slovenia and euro area in 2009



Source: SORS, Eurostat, Bank of Slovenia calculations

Table: General government expenditure in Slovenia

	2000		2008		2009		avg. growth	*2013 Stability Programme*	
	% GDP	% of exp.	% GDP	% of exp.	% GDP	% of exp.	2000–2009	*% GDP**	*% of exp.*
Expenditure	46.7	100.0	44.1	100.0	49.0	100.0	8.1	*44.2*	*100.0*
Social contributions	18.0	38.5	16.6	37.6	18.8	38.4	7.8	*18.2*	*41.2*
Compensation of employees	11.3	24.2	11.0	25.0	12.4	25.4	8.6	*11.0*	*24.9*
Intermediate consumption	6.6	14.2	6.0	13.6	6.5	13.3	7.3	*5.5*	*12.4*
Subsidies	1.9	4.1	1.6	3.6	1.9	3.8	7.3	*1.3*	*2.9*
Interest	2.4	5.1	1.1	2.5	1.4	2.8	1.0	*2.1*	*4.8*
Investment	3.2	6.8	4.5	10.1	4.6	9.4	11.9	*3.8*	*8.6*
Other	3.3	7.1	3.4	7.6	3.4	6.9	9.3	*2.3*	*5.2*

Sources: SORS, Ministry of Finance, Bank of Slovenia calculations
** Estimated figures for 2009 in the Stability Programme differ from actual values (in part due to a different estimate of GDP).*

Despite recent high growth, general government expenditure as a proportion of GDP remains lower in Slovenia than the euro area average. In the last two years general government expenditure as a proportion of GDP has also risen in the euro area, on account of similar reasons as in Slovenia. That proportion stood at 50.7% in 2009, which is almost 4 percentage points higher than the previous year and 1.7 percentage points higher than in Slovenia. While an increase in the proportion of general government expenditure was characteristic of all euro area countries, the rate of growth varied significantly. Less than half of the euro area countries recorded higher growth in general government expenditure as a proportion of GDP than Slovenia. Growth was highest in Ireland at 6.4 percentage points.

The greatest difference in the breakdown of general government expenditure in Slovenia and that of the euro area lies in the proportion of expenditure on social benefits and assistance. There are also major differences in expenditure on investment, compensation of employees and interest. The smaller proportion of expenditure on social benefits and assistance in Slovenia is partly a reflection of lower expenditure for pensions and the unemployed.[1] Slovenia, as a less-developed euro area country, earmarked more funds for investment than the average.[2] Compensation of employees in Slovenia accounts for one quarter of all general government expenditure, more than in the euro area (21.2%). Interest as a proportion of general government expenditure is higher in the euro area due to a higher debt-to-GDP ratio.

Fiscal consolidation is planned in the Stability Programme and exit strategy, namely the reduction of general government deficit to below 3% of GDP by 2013, based primarily on limiting and rationalising general government expenditure.[3] In 2013 general government expenditure as a proportion of GDP is expected return to around the 2008 level. As the experience of other countries that have carried out such consolidation shows, expenditure-based consolidation is generally more successful than consolidation based on increasing revenues.[4] Reductions in expenditure are primarily envisaged in compensation of employees, intermediate consumption and subsidies. The recent rise in indebtedness means an increase in the proportion of expenditure on interest.[5] The need to limit other (non-interest) expenditure is thus even greater. To that end, halting the excessive rise in debt is critical.

Structural reforms, in particular pension reform and the reform of the healthcare system, are also part of the exit strategy, as short-term measures are insufficient to control expenditure in the longer term. Slovenia is one of those countries expecting a sharp rise in general government expenditure on account of an ageing population. Therefore, it is in these two areas that upward pressure on expenditure can be expected in the long term. The implementation of reforms is expected to reduce the costs of ageing, and thus improve the long-term fiscal position, although a decrease in this type of spending as a proportion of GDP is not to be expected.

Limiting general government expenditure in line with the exit strategy will also be critical for maintaining a stable Slovenian debt rating. Rating agencies also analyse general government expenditure trends when preparing government ratings. For example, the indicators that Standard & Poor's[6] takes into account in the preparation of ratings include general government expenditure trends, expenditure efficiency and pressure on expenditure, pension liabilities and the proportion of funds for interest.

[1] European Commission: Ageing Report 2009.

[2] In the breakdown of general government expenditure by function, the majority of investment is earmarked for economic affairs primarily linked to transport.

[3] The International Monetary Fund (Todd, Gunnarsson: Budget Rigidity and Expenditure Efficiency in Slovenia, IMF Working Paper 131, 2007) found that non-discretionary elements dominate the breakdown of general government expenditure, which hinders adjustments. Increased expenditure flexibility would facilitate a shift in spending from relatively inefficient areas to the priority areas. The more effective use of available funds can contribute significantly to fiscal consolidation.

[4] For more, see i.e. OECD Economic Outlook, June 2007.

[5] Interest as a proportion of GDP rose by 0.3 percentage points to 1.4% in 2009. According to estimates from the exit strategy, that proportion is expected rise to 2.1% by 2013.

[6] Sovereign Credit Ratings: A Primer, 2006.

previous years, in particular the number of old-age pensioners, also due to the situation on the labour market. Changes to pension legislation are also expected. The fastest growing elements of social transfers are unemployment benefits, followed by social security transfers, owing this year's rise in unemployment. The utilisation of funds[25] for labour market subsidies was low this year, while the associated measures are winding up. Expenditure for interest is significantly higher this year compared with last year owing to the rising debt last year and in the first quarter of 2010.

The general government debt rose to 37.5% of GDP primarily due to the financing of the general government deficit. The general government debt stood at EUR 13,387 million or 37.5% of GDP at the end of June, up EUR 868 million on the end of last year. The largest increase in debt during this period was recorded by the central government. Borrowing was carried out in line with the programme for financing the state budget for 2010, which sets a maximum borrowing limit of the state budget at EUR 4.4 billion. Borrowing totalled EUR 2.6 billion in the first half of the year. The majority of borrowing in the first half of the year was secured by the issue of two government bonds on the domestic market in the total amount of EUR 2.5 billion. Short-term borrowing in the form of treasury bills amounted to EUR 50 million. According to the half-yearly state budget report, around EUR 1.4 billion remains available from the 2009 budget for the repayment of debt principal in the 2010 and 2011 budget years. In the first half of the year the government earmarked EUR 1.3 billion to cover the deficit in the state budget and EUR 1.7 billion for the repayment of debt principal. A portion of borrowings from the first half of the year will be used to cover the deficit in the second half of the year, while a smaller portion is expected to be earmarked for the pre-financing of general government debt principal maturing in the next two years.[26] According to the forecasts by the Ministry of Finance in the report on the general government deficit and debt, the general government debt will reach 37.9% of GDP by the end of this year.

The number of guarantees issued was down in the first half of the year, while guarantee payments were also low. New government guarantees totalling EUR 380 million were issued by the end of this June, which is down significantly on the whole of last year, when the government issued guarantees in the amount of EUR 2.6 billion. Similar to last year the majority of guarantees were earmarked for measures to limit the effects of the financial crisis in the banking sector. The stock of government guarantees stood at close to EUR 8 billion at the end of June 2010. Of this amount, around EUR 3 billion was linked to measures to limit the effects of the financial crisis. The payment of mature government guarantees totalled EUR 0.6 million in the first half of the year. The revised budget envisaged EUR 23.6 million for the payment of guarantees this year.

According to the Act on the Implementation of the Budget of the Republic of Slovenia for 2010 and 2011, utilisation of the guarantee quota was low in the first half of the year. It is evident from the half-yearly state budget report that the government issued new guarantees in the first half 2010 in the amount of EUR 82 million, representing 3.4% of the guarantee quota for 2010 according to the Act on the Implementation of the Budget of the Republic of Slovenia for 2010 and 2011. The majority of new guarantees were earmarked for DARS and the Public Fund of the Republic of Slovenia for Regional and Rural Development. At the end of July guarantees in the amount of EUR 300 million were issued to SOD d.d., which are also included in the quota, as stipulated by the Act on the Implementation of the Budget of the Republic of Slovenia for 2010 and 2011, bringing the guarantee quota utilisation rate to 15.6%.

[25] According to figures from the Employment Service of Slovenia (monthly information, June 2010), by the end of June 2010 the ESS had paid out EUR 47 million during the implementation of two emergency anti-crisis measures. Of this amount, EUR 32 million was earmarked for the measure for the partial subsidisation of full-time employment, while the remainder was used in the scope of the Partial Reimbursement of Wage Compensation Act.

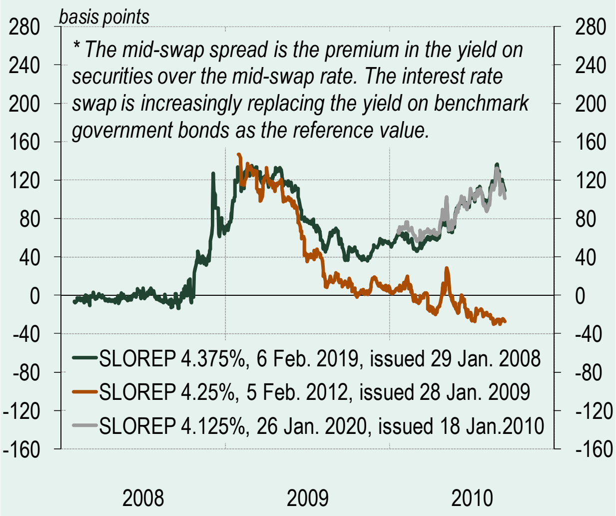
[26] The pre-financing of debt principal maturing in the next two years is permitted under Article 81 of the amended Public Finance Act, adopted at end of November 2008. According to estimates from the budget implementation report for the period January to June 2010, approximately EUR 320 million will be carried forward from this year's borrowings for pre-financing in the next two years.

New guarantees issued in the first half of the year in connection with measures to limit the effects of the financial crisis exceeded the guarantees issued according to the Act on the Implementation of the Budget of the Republic of Slovenia for 2010 and 2011. According to figures from the half-yearly state budget report, new guarantees in the amount of EUR 298 million were approved during the first half of the year for that purpose. Of this amount, EUR 200 million was earmarked for guarantees to banks for the issue of bonds, EUR 88 million for guarantees for corporate borrowing and EUR 10 million for guarantees for household borrowing. Quota utilisation[27] for various measures[28] ranged from 4% to just over 20% from the entry into force of the schemes last year to the end of the first half of 2010. The implementation of measures is of a temporary nature and will be completed at the end of 2010. In May this year the government added a legal basis to the measures to limit the effects of the financial crisis for implementation of the guarantee scheme for financing corporate investment activity. The first associated guarantee quota was auctioned in August. A commission, representing revenue for the state budget, is charged for guarantees issued. Revenues from commissions for measures to limit the effects of the financial crisis totalled EUR 10 million in the first half of the year. The amount of the commission was raised in July in line with the recommendations of the European Commission owing to the improving situation on the financial markets and the gradual withdrawal of crisis measures.

Slovenia joined a conditional financial aid programme for Greece, which is indirectly intended to stabilise financing in the euro area. On the basis of an act adopted in July, Slovenia will approve loans to Greece over the next three years in the amount of EUR 388 million, of which EUR 145 million is envisaged for this year. In April euro area countries adopted an agreement on financial aid to Greece owing to the exceptionally bad financing conditions associated with Greek debt on the financial markets and the need to safeguard the financial stability of the euro area. In accordance with the aforementioned agreement, Greece will receive loans over the next three years totalling EUR 110 billion. Euro area countries will contribute EUR 80 billion, while the IMF will contribute EUR 30 billion. In the first half of August the ECB, the IMF and the European Commission confirmed that Greece fulfilled the conditions for the payment of the second instalment of loans (the first instalment was paid in May), which was paid in September and to which Slovenia contributed EUR 104 million. According to the ESA95 methodology and the national methodology, the loan to Greece does not increase the general government deficit.

In May EU finance ministers also decided to introduce a mechanism to ensure the financial stability of the euro area, by which euro area countries in financial difficulties may obtain loans. EUR 440 billion in euro area government guarantees will be available in the scope of the mechanism for the issuing of bonds or rais-

Figure 5.3: Mid-swap spread: Slovenian government bonds' yield premium over mid-swap rate*



Source: Bloomberg

[27] The guarantee quota relating to measures to limit the effects of the financial crisis is defined separately for each measure, and is not included in the quota set out in the Act on the Implementation of the Budget of the Republic of Slovenia for 2010 and 2011.

[28] The utilisation rate with respect to the quota for bank borrowing was 18.3% from the entry into force of the guarantee scheme in 2009 until the end of the June 2010, while the utilisation rates for corporate borrowing and household borrowing were 22.5% and 4.3% respectively.

ing of loans. A company established specifically for this purpose, which will sign a loan agreement with the borrowing country, will be responsible for the issuing bonds with the highest credit rating and for the raising of loans. Moreover, an additional EUR 60 billion in loans from the EU budget and EUR 250 billion in IMF loans will be available. The instrument is temporary and will last for 3 years. In the scope of guarantees for the issuing of bonds and raising of loans, Slovenia's share will be a maximum of EUR 2,851 billion, which does not include the financial aid to Greece.

The premiums of Slovenian 10-year government bonds over the comparable German bonds rose slightly in the second quarter of this year. The main factor in this was the deteriorating fiscal situation in certain euro area countries. Following the downgrading of the long-term debt of Greece, Portugal and Spain at the end of April, the premiums of 10-year government bonds over the comparable German benchmark for the so-called peripheral euro area countries rose, including Slovenian bonds. For example, the premium over the comparable German bond stood at 89 basis points when 10-year RS67 bonds were issued in January, compared with a premium of around 125 basis points in the summer.

The government is planning adjustments in 2011 and 2012 aimed at the consolidation of public finances. The adjustments, planned primarily on the expenditure side, will have to be considerable. The contraction in primary expenditure will have to be even greater, as interest expenditure will rise. In the points of departure for the drafting of the budgets for 2011 and 2012, the government is planning a state budget deficit of 3.8% of GDP in 2011 and 3.1% of GDP in 2012. Thus, the budget deficit is expected to gradually decrease from this year's planned deficit of 5% of GDP, set out in the revision to the state budget. The government intends to limit public sector wage growth for the next two years. It is also expected to improve its control of the number of public sector employees. A number of other measures will be required to limit the deficit. These are expected to include the reduction and rationalisation of general government expenditure, including expenditure on goods and services. Structural reforms are also being drafted. The government is preparing systemic measures in the areas of pensions, and labour legislation and health, in addition to others.

In line with the commitments stemming from the excessive deficit procedure, Slovenia must bring the deficit to below 3% of GDP by no later than 2013 (see box 5.1). The European Commission's initial assessment indicates that the implementation of fiscal consolidation measures is in line with the recommendations of the Council of the European Union. Slovenia has been subject to the excessive deficit procedure since December 2009. In June the European Commission assessed that Slovenia, as well as other EU Member States subject to the excessive deficit procedure, is taking the appropriate measures. In June the National Assembly adopted the revision to the state budget for 2010, in which it adjusted the level of expenditure to lower revenues. This was achieved primarily by cutting expenditure on goods and services, and investment. The deadline to reduce Slovenia's deficit to below the reference value of 3% of GDP, set out in the Stability and Growth Pact, is 2013. Taking into account the Stability Programme from this January, the structural deficit should be reduced by an average of 1% of GDP annually in the period from 2010 to 2013, which is more than required by the recommendations of Council of the European Union with respect to rectifying an excessive deficit (3/4% of GDP annually).

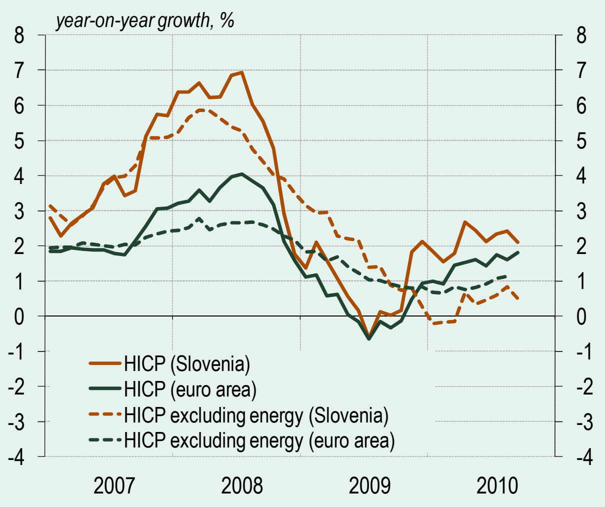
6 Price Developments

Year-on-year growth of prices, as measured by HICP, in Slovenia has risen since the beginning of this year, and averaged 2.1% over the first nine months, which is 0.7 percentage points higher than the euro area average. The main factor in this deviation was the prices of energy, food and municipal services. Core inflation is lower than in the euro area due to the low economic activity, the difficult situation on the labour market, lower household consumption and a decline in labour costs.

Macroeconomic factors and core inflation indicators

The trend of declining core inflation halted this year at a low level. On the basis of certain figures, it appears that prices actually declined on average in year-on-year terms over the first nine months of the year. All indicators point to lower growth than in the euro area. Core inflation as measured by the HICP excluding energy and unprocessed food averaged 0.3% in year-on-year terms over the first nine months of this year, down 1.6 percentage points on 2009. Growth in prices of processed food prevented a more significant fall in core inflation measured as such, primarily due to a rise in excise duties on alcohol and tobacco. The narrowest core inflation indicator, namely the HICP excluding energy, food, alcohol and tobacco, has been negative throughout the year with the exception of one month, while the broadest core inflation indicator, the HICP excluding energy, indicated a fall in prices only in the first three months. According to the narrowest indicator, prices fell by an average of 0.3% over the first nine months of the year, but rose by 0.3% according to the broadest indicator prices. Core inflation indicators in Slovenia have been lower than those of the euro area since the end of 2009. Average growth in the HICP excluding energy, food, alcohol and tobacco lagged behind the value of the same indicator in the euro area by 1.2 percentage points from January to August.

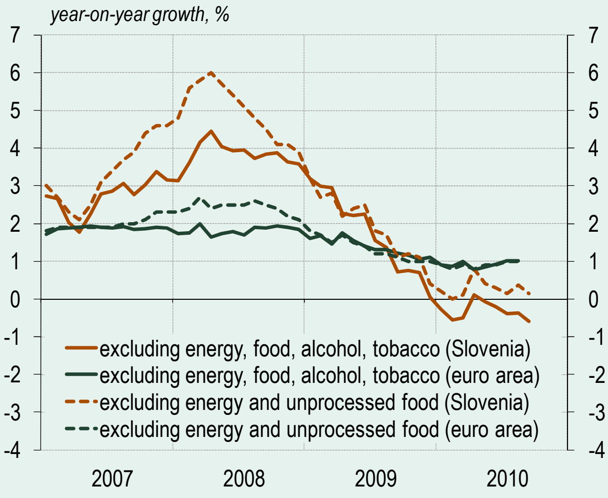
Figure 6.1: Inflation



Source: Eurostat, SORS, Bank of Slovenia calculations

Low core inflation was the result of the adverse situation in the macroeconomic environment. The output gap has remained negative in the context of a slow recovery in economic activity, which together with the conditions on the labour market, has limited the ability of suppliers of goods and services to raise prices. After rising sharply in the context of a drop in economic activity at the end of 2008, unit labour costs in the economy as a whole have adjusted downwards. Nominal growth in labour costs began to decline immediately after the downturn in economic activity. The adjustment was most notable in the manufacturing sector, with the exception of early 2010, when current growth in unit labour costs was high due to high growth in average wages in the context of lower productivity growth. In addition to rising US dollar prices of oil and other commodities, the euro's fall against the US dollar by 5% over the first nine months of this year has further driven up corporate operating costs in the euro area. High growth has been seen in import prices, which has thus far mainly affected the prices that are not included in core inflation. Lower price and cost competitiveness could have an impact on inflation in the medium term. This forces corporates to raise prices and costs at a slower pace and to a lesser extent relative to foreign partners. Low growth in loans and the still adverse financing conditions in some places will have a longer-term impact on inflation.

Figure 6.2: Core inflation



Sources: Eurostat, Bank of Slovenia calculations

Microeconomic factors and the structure of inflation

Oil prices on global markets and changes in excise duties affected developments in energy prices in Slovenia over the first nine months of this year. After rising at the end of last year, the high year-on-year

Table 6.1: Breakdown of the HICP and price indicators

	weight 2010	average annual growth, %					year-on-year growth in quarter, %					
		2006	2007	2008	2009	10H1	09Q2	09Q3	09Q4	10Q1	10Q2	10Q3
HICP	*100.0%*	2.5	3.8	5.5	0.9	2.1	0.6	-0.2	1.4	1.7	2.4	2.3
Breakdown of HICP:												
Energy	*13.9%*	8.5	3.4	9.4	-4.5	15.5	-9.1	-8.1	7.0	15.4	15.6	12.7
Food	*21.6%*	2.7	7.1	8.1	1.8	1.3	2.2	1.3	0.9	0.6	2.1	3.9
processed	*14.8%*	2.5	6.3	9.9	2.7	2.7	2.8	3.0	2.7	2.4	2.9	3.1
unprocessed	*6.9%*	3.1	8.7	4.6	0.0	-1.5	0.9	-2.2	-2.9	-3.3	0.3	5.5
Other goods	*30.7%*	-0.9	0.3	2.2	0.0	-2.7	0.8	-0.8	-1.6	-3.1	-2.3	-1.8
Services	*33.8%*	3.5	4.9	5.3	3.2	1.9	3.5	3.0	2.4	1.9	1.9	0.8
Core inflation indicators												
HICP excluding energy	*86.1%*	1.7	3.8	4.9	1.7	0.2	2.2	1.2	0.6	-0.2	0.5	0.6
HICP excluding energy and unprocessed food	*79.3%*	1.5	3.4	5.0	1.9	0.3	2.3	1.5	0.9	0.1	0.5	0.2
HICP excluding energy, food, alcohol and tobacco	*64.5%*	1.3	2.7	3.8	1.7	-0.3	2.2	1.2	0.5	-0.4	-0.1	-0.4
Other price indicators:												
Industrial producer prices on the domestic market		2.4	5.5	5.6	-0.4	1.1	-0.4	-1.5	-1.1	0.2	2.0	…
GDP deflator		2.0	4.2	4.0	3.2	0.9	3.8	2.3	1.9	0.5	1.3	…
Import prices[1]		3.3	1.4	2.7	-4.6	4.0	-5.2	-6.5	-4.4	1.3	6.5	…

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

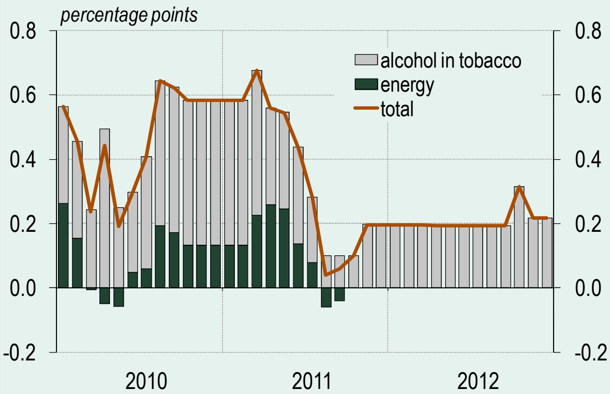
Box 6.1: Direct impact of changes in excise duties on price growth[1]

Alongside the associated fiscal effects, the Slovenian government also influences the movement in the HICP by setting excise duties. Excise duties on alcohol and alcoholic beverages, tobacco products, mineral oils and gas are governed by the Excise Duties Act and its amendments. The Slovenian government amended the Excise Duties Act in July this year with the aim of increasing budget inflows. This, together with other previously adopted changes in administered prices, will contribute significantly to higher inflation. According to currently available figures and estimates by the Bank of Slovenia, higher excise duties will contribute 0.5 percentage points to inflation in 2010, and 0.4 percentage points and 0.2 percentage points respectively to inflation in 2011 and 2012.

With the new Excise Duties Act, the Slovenian government raised excise duties on alcohol and alcoholic beverages, tobacco products, electricity and natural gas. According to estimates, the rise in excise duties on alcohol and alcoholic beverages will contribute 0.06 percentage points to inflation in 2010 and 0.05 percentage points in 2011. The raising of excise duties on tobacco products is in line with the European directive, by which all EU Member States must raise excise duties to EUR 90 per 1,000 cigarettes by no later than 1 January 2014. Three rises in excise duties on cigarettes were envisaged in the new Excise Duties Act, adopted in March this year. On 1 April 2010 excise duties were to be raised from EUR 69 to EUR 74 per 1,000 cigarettes, followed by rises on 1 April 2011 to EUR 79 and to EUR 84 on 1 April 2012. The new act, adopted on 13 July 2010, envisages two rises a year instead of one in the period from 2010 to 2012. Both rises were carried out this year, from EUR 69 to EUR 74 on 1 April, and from EUR 74 to EUR 77 on 1 August. Next year excise duties are expected to be raised on 1 April from EUR 77 to EUR 80 and on 1 October from EUR 80 to EUR 83, and in 2012 from EUR 83 to EUR 86 on 1 April and from EUR 86 to EUR 90 per 1,000 cigarettes on 1 October. Slovenia is thus expected to reach the level set out in the European directive by the end of 2012. According to estimates, the contribution of the rises in excise duties on tobacco to inflation will be 0.3 percentage points in 2010 and 0.2 percentage points in both 2011 and 2012.

Rises in excise duties on electricity for commercial and non-commercial use and on natural gas were also approved with

Figure: Estimated contribution of changes in excise duties on growth in HICP



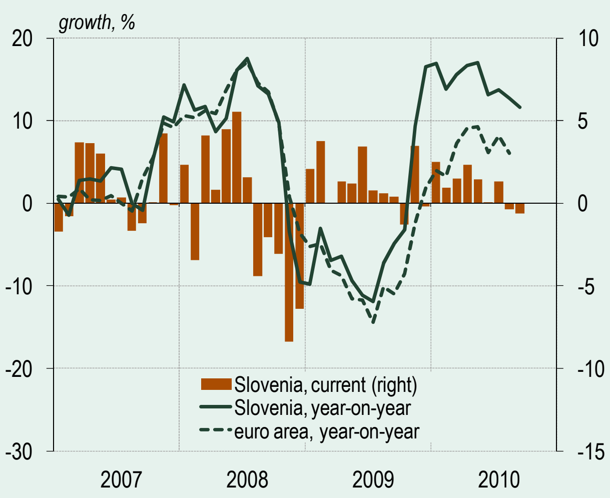
Sources: Eurostat, Ministry of the Economy, Act amending the Excise Duties Act, Government of the Republic of Slovenia, 4 June 2010; Excise Duties Act (Decree on the setting of excise duties for electricity, Official Gazette of the Republic of Slovenia, No. 61/2010), proposed Act amending the Excise Duties Act (EVA 2010-1611-150), Bank of Slovenia estimates and calculations

the new Excise Duties Act. The rise in excise duties on electricity was initially envisaged in two phases; the first in August from EUR 1.00 to EUR 6.05 per MWh, and on 1 November to EUR 12.05. At the end of July the government adopted a decree on a lower rise in excise duties in August, to EUR 3.05 per MWh. At the end of September the government withdrew the previously planned November rise in excise duties in its new draft Excise Duties Act, by which it aims to reduce the excessive burden on the Slovenian economy and the substantial deterioration in the competitiveness of the Slovenian corporate sector. Excise duties on natural gas for heating and for motor vehicles were raised in August from EUR 0.63 to EUR 3.63 per cubic metre.

Following sharp rises from December 2008 to July 2009,[2] excise duties on motor fuels were lowered by EUR 20 EUR/1,000 litres in March of this year. In May 2010 the Slovenian government then increased taxes on motor fuels by raising excise duties on the basis of discussions of the draft Regulation amending the Regulation on Environmental Tax for the Pollution of the Air with Carbon Dioxide Emissions in order to ensure higher budget revenues. Excise duties were thus raised from May to July in five phases on petrol (by 6.4%) and on gas oil for propulsion (by 7.8%). This level of excise duties is expected to apply until 1 March 2011, when taxation via excise duties is expected to be replaced by the introduction of CO_2 taxes. Excise duties on fuel oil were raised by EUR 23/1,000 litres on 1 June. Excise duties were lowered at the end of September on petrol and heating oil by EUR 8/1,000 litres and on gas oil for propulsion by EUR 7/1,000 litres. The changes in excise duties on energy are expected to contribute a total of 0.1 percentage points to inflation in 2010.

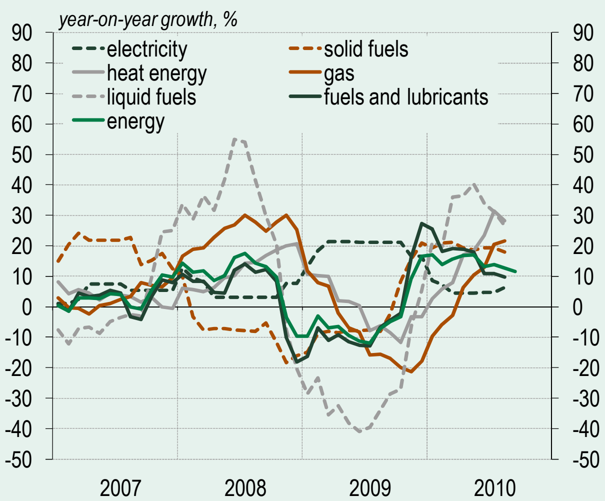
[1] Information available up to 1 October 2010 is included in the estimates.
[2] Excise duties on 95 and 98 octane petrol were raised by 36.4% and by 43% on diesel fuel.

Figure 6.3: Energy prices



Sources: Eurostat, Bank of Slovenia calculations

Figure 6.4: Individual energy price categories

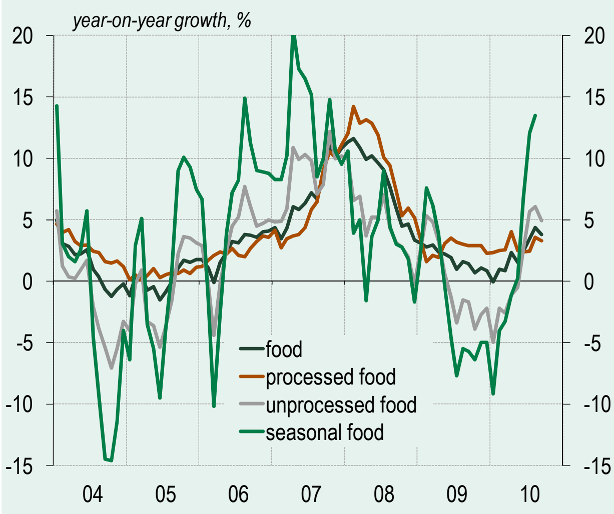


Sources: Eurostat, Bank of Slovenia calculations

growth in energy prices continued during the first nine months of 2010, when growth averaged 14.6%. This growth was largely the result of last year's growth in oil prices, which has slowed this year. Changes in excise duties on electricity, natural gas and motor fuels also affected energy prices.[29] The prices of heat energy rose by an average on 16.5% in year-on-year terms over the first eight months of the year, as a result of the rise in prices at the end of last year as part of the increase in the prices of municipal services.[30]

Year-on-year growth in food prices averaged 2.2% over the first nine months. The prices of seasonal food rose by 13.5% from the beginning of the year until the end of August. Higher excise duties on tobacco and alcohol contributed significantly to the rise in processed food prices. Despite weak final household consumption, processed food prices rose by an average of 2.8% over the first nine months, compared with 0.7% in the euro area during the first eight months of the year. Excise duties on tobacco were raised twice this year, in April and August, which contributed a total of 2.1 percentage points to growth in the prices of proc-

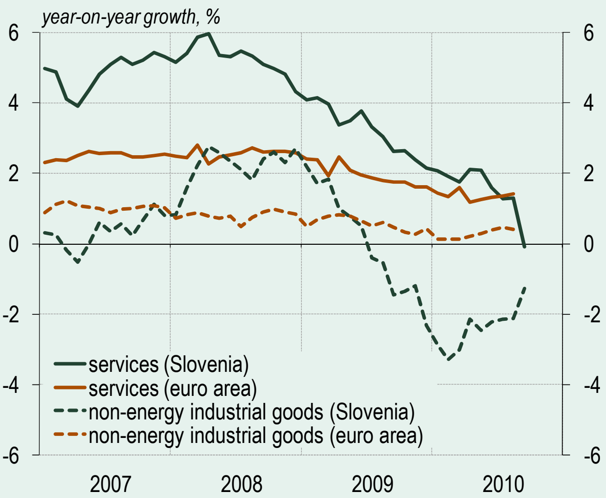
Figure 6.5: Food prices



Sources: Eurostat, Bank of Slovenia calculations

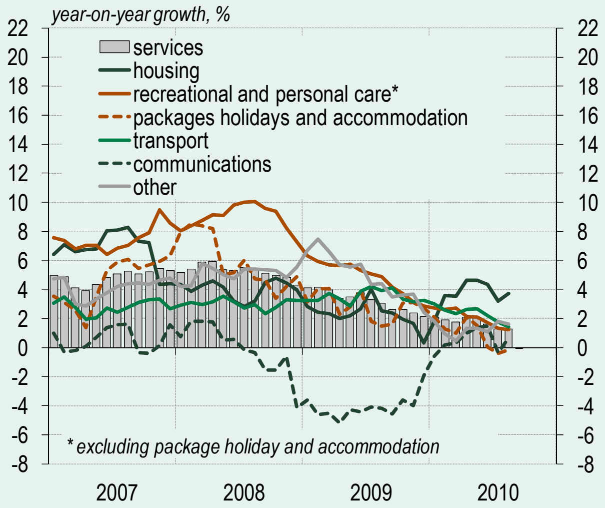
[29] See box 6.1.
[30] The Slovenian government transferred responsibility for the setting of all municipal services prices to local governments on 15 August 2009.

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



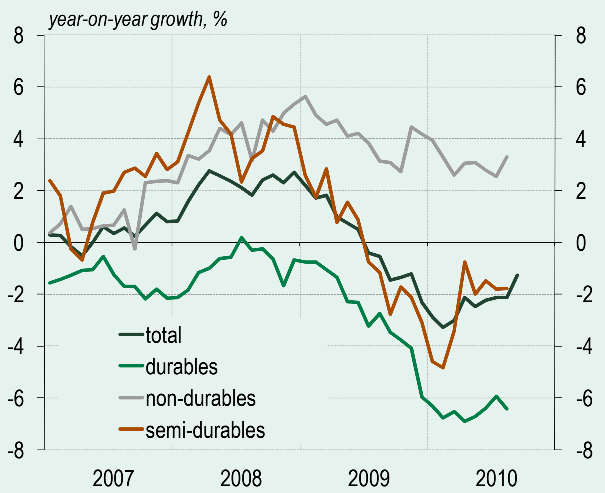
Sources: Eurostat, Bank of Slovenia calculations

Figure 6.7: Services prices



Sources: Eurostat, Bank of Slovenia calculations

Figure 6.8: Prices of non-energy industrial goods



Sources: Eurostat, Bank of Slovenia calculations

essed food. Excise duties on alcohol were raised by 5.5% in July, which contributed 0.6 percentage points. Unprocessed food prices have been rising since the second half of 2009, and in year-on-year terms since June 2010. Most notable was the rise in prices of seasonal food, which was partly linked to drought and heavy rainfall that destroyed crops. Fruit and vegetable prices rose by 12.9% and 19.1% respectively in year-on-year terms in August.

The slowdown in year-on-year growth in services prices continued during the first nine months of this year. Growth in services prices averaged 1.5% over the first nine months of 2010, down 2 percentage points on the same period last year. Services prices fell more sharply in September, by 0.1% in year-on-year terms, primarily as a result of changes in the calculation of prices for school meals. The main factor in lower growth in services prices over the first nine months of this year was lower year-on-year growth in prices of hotel and restaurant services and package holidays. Refuse collection prices rose at the beginning of the year owing to upgrades and the introduction of new services to meet higher supply and environmental protection standards. Average year-on-year growth in these prices over the first eight months of the year stood at 17.1%, compared with 0.3% in the same period last year. The prices of rail passenger transport were also up, in line with the plan for managing regulated prices. The prices of certain mobile telephone and postal services were also up in August. The VAT rate was cut from 20% to 8.5% for certain services on 1 January 2010, which had a negligible effect on falling consumer prices.

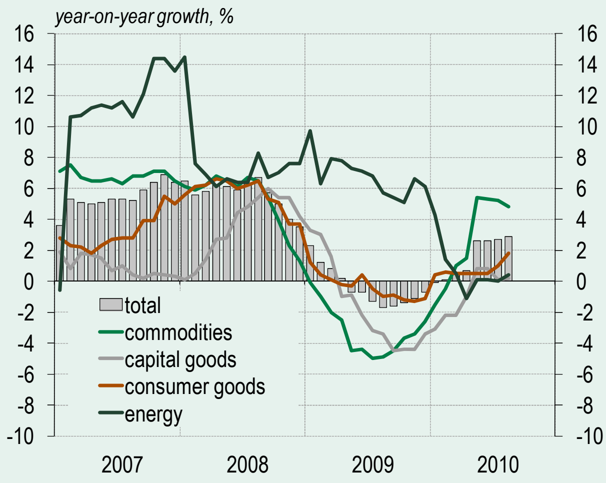
The fall in the prices of non-energy industrial goods was the most significant in the first quarter of this year and has gradually slowed over the remainder of

the year. The prices of non-energy industrial goods fell by an average of 2.4% in year-on-year terms over the first nine months of this year. The prices of cars, clothing and footwear had the largest contribution to this fall in prices. Despite the introduction of the new motor vehicle tax act[31] in March this year, the decline in prices of both new and old cars has further accelerated. Car prices fell by an average of 11.9% in year-on-year terms over the first eight months of this year, which is 7.6 percentage points more than in the same period last year. The prices of clothing and footwear fell by an average of 4.5% and 3.1% respectively over the first eight months of the year. Due to the increase in prices of water supply at the end of last year, year-on-year growth over the first eight months of the year averaged 28.9%.

Producer prices

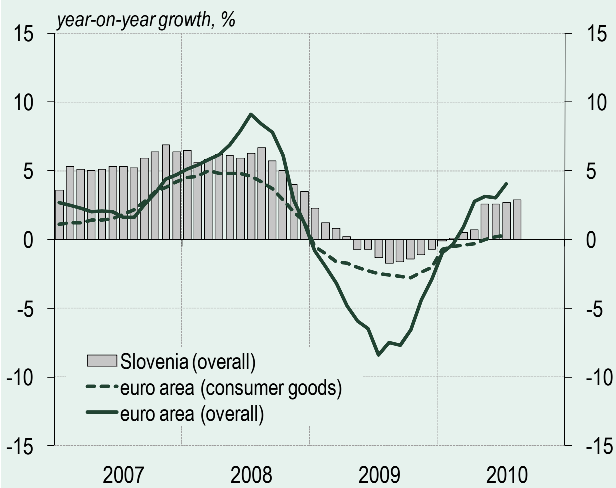
After declining at the end of 2008 and during the first half of 2009, industrial producer prices have risen on the domestic market since the middle of 2009. These prices rose by 1.5% on average in year-on-year terms over the first eight months of this year, up 1.3 percentage points on the same period last year. Among commodities prices, which were up 2.7% on average over the first eight months of the year in year-on-year terms, prices in the manufacture of basic metals recorded the sharpest rise, of 20.1%. Prices in the manufacture of furniture recorded the highest growth among durable goods, while the prices of water collection, treatment and supply recorded the highest growth, of 10.7%, among energy prices. In the euro area, industrial producer prices rose by an average of 1.8% on the domestic market over the first seven months of 2010. Energy prices recorded the most notable growth, of 4.5%, primarily on account of the high growth in producer prices of refined petroleum products, which reached 26.2%.

Figure 6.9: Industrial producer prices on the domestic market



Sources: SORS, Bank of Slovenia calculations

Figure 6.10: Industrial producer prices on the domestic market



Sources: Eurostat, Bank of Slovenia calculations

[31] Under the new act, variable taxes based on carbon dioxide emissions have replaced the progressive taxation of new cars based on engine capacity.

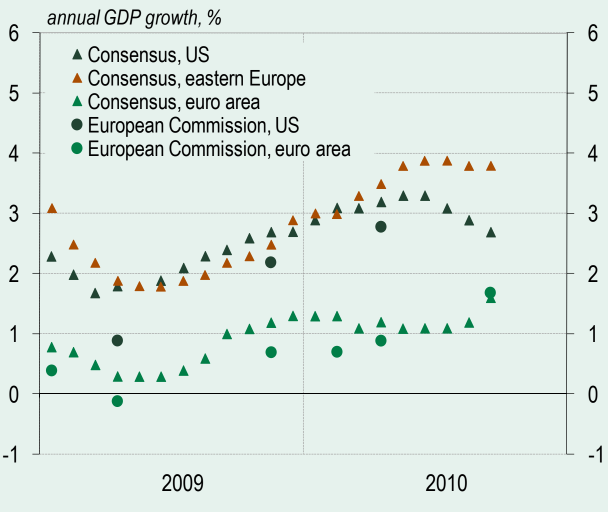
7 Projections of Economic Trends and Inflation 2010–2012[32]

GDP growth is forecast at 1.1% for this year, and is expected to rise gradually to close to 3% by 2012. Despite slightly better expectations regarding foreign demand, a smal decline in the recovery of economic activity relative to the April projections is expected this year due to the continued unfavourable situation in the construction sector. The contribution of domestic demand excluding inventories to GDP growth will be negative owing to declining investment and the stagnation of private consumption and public spending. Growth will be based on net exports in the short term owing to the more optimistic assumption regarding foreign demand. Inflation is forecast to be 2.3% in 2010, and will fall to 2.0% by 2012. The inflation projections for 2010 and 2011 are higher than in the previous projections primarily due to the effect of higher commodity prices on global markets and excise duties on energy and food prices. The total direct effect of rises in excise duties on inflation is expected to be close to 1 percentage point from 2010 to 2012. Core inflation will be extremely low this year in line with the adverse domestic economic situation.

The risks in the projections for GDP growth are high and numerous. There is a higher probability that growth will be lower. The most obvious risk is present due to the possible need for an even stronger-than-expected fiscal consolidation, both in Slovenia and the rest of the world, which could give rise to a further decline in aggregate demand. In the domestic economy, excessive wage growth and insufficient labour market adjustments could have a negative effect on competitiveness and trigger a sustained rise in unemployment. Deteriorating access to sources of financing could also slow the recovery in activity. In sectoral terms, the situation remains most uncertain in the construction sector, which could contribute to a further decline in investment demand. Inflationary risks are balanced. A slow economic recovery could have a negative impact on price growth. Pressures on price growth could increase, not only due to higher commodity prices, but also on account of the possible continued depreciation of the euro and increases in indirect taxes and administered prices.

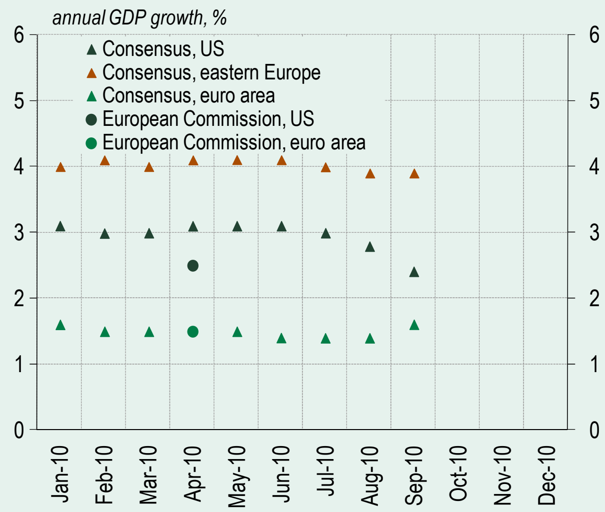
[32] The projections were made on the basis of the available data and the statistical methodologies applicable on 3 September 2010. The projections of macroeconomic factors presented in this Price Stability Report are based on assumptions for variables from the international environment and in certain domestic factors dependent on economic policy decisions. The assumptions regarding the variables from the international environment are taken from Consensus Forecasts and Eastern Europe Consensus Forecasts (August 2010), JP Morgan (Global Data Watch, 27 August 2010), the OECD Outlook (June 2010) and IMF WEO Update (July 2010). The domestic factors under the influence of economic policy and exogenously included in the forecasting process are public sector spending and investment, public sector wages, administered prices and certain other variables of a fiscal nature. The assumptions used in the projections are not the same as those used by the ESCB in its projections. For the relationship between the Bank of Slovenia projections and those of the ESCB, see the annex in the April 2008 Price Stability Report.

Figure 7.1: Economic growth forecasts for 2010



Sources: Consensus Economics, European Commission

Figure 7.2: Economic growth forecasts for 2011



Sources: Consensus Economics, European Commission

International environment and external assumptions

Assessments by international institutions regarding growth in imports in Slovenia's most important trading partners are more favourable primarily owing to very good economic activity in the second quarter. The recovery in global economic growth is expected to be uneven. Emerging Asian economies continue to be the driver of global economic growth. The latest estimates of import demand were revised upward relative to the previous projections for the entire projection period, and are higher for all of the most important trading partners, except for Croatia. The most significant upward revision of estimated import demand was made for Germany. Forecast growth in foreign demand for this year was revised upward by 4.7 percentage points relative to the assumption in the previous projections, to 7.8%. This upward revision is also the result of last year's low basis. Following rapid growth in the first half of 2010, growth in foreign demand is expected to slow towards the end of the year, and then rise only gradually. Owing to the increased need for fiscal consolidation, driven by the debt crisis in certain euro area countries, the impact of the withdrawal of fiscal stimulus in 2011 will be more pronounced than assumed in the April forecasts. At the same time, the cycle of inventory renewal is also expected to wind down. Lower

Table 7.1: Assumptions regarding factors from the international environment

						Assumptions					
						2010		2011		2012	
	2005	2006	2007	2008	2009	Oct	Δ	Oct	Δ	Oct	Δ
	annual growth, %										
Foreign demand*	4.3	8.6	7.4	2.5	-12.9	**7.8**	4.7	**5.4**	0.3	**6.5**	1.4
Oil (USD/barrel)	54	65	73	98	62	**79**	4	**84**	4	**87**	5
Non-oil commodities	12.0	29.1	17.4	10.1	-23.0	**39.0**	19.0	**11.0**	4.0	**4.0**	-3.0
EMU inflation	2.2	2.2	2.1	3.3	0.3	**1.6**	0.4	**1.7**	0.2	**1.5**	-0.4
PPI Germany	4.4	5.4	1.3	5.4	-4.0	**1.0**	0.8	**2.2**	0.4	**2.0**	0.0

** Quantitative imports from basket of foreign partners.*
Δ: Difference between current projections and projections in the April 2010 Price Stability Report..
Sources: Bank of Slovenia, Eurostat, Consensus Economics, ECB, JP Morgan, OECD Outlook

Figure 7.3: Primary commodity prices on global markets

Sources: ECB, Bloomberg, Bank of Slovenia projections

growth in foreign demand is forecast for 2011 than in 2010 owing to the withdrawal of fiscal stimulus and also on account of the start of the withdrawal of monetary policy stimulus measures, which is expected to occur towards the end of the year, given current market expectations. The global economic recovery is expected to continue in 2012 and with it the convergence of foreign demand growth rates with the long-term average.

US dollar oil prices are forecast to rise gradually, while other commodity prices are expected to fall, following high growth in 2010. The relatively slow growth in oil prices this year is linked to expected economic growth, particularly in the US, while relatively high stocks of crude oil also restrain oil prices. Given price developments on the futures markets, prices are expected to rise gradually until the end of the projection horizon. The price of a barrel of Brent crude is expected to average USD 79 USD in 2010. The price of oil is slightly more than USD 4 higher over the projection horizon on average relative to the previous projections. Growth in commodity prices has risen rapidly in 2010 on account of the global economic recovery, and also due to low metal prices the first half of 2009 and adverse weather conditions and natural disasters, which have triggered growth in food prices. Growth in commodity prices is expected to slow in 2011 and 2012 owing to the weak global economic recovery.

Inflation in the euro area and in the US is expected to remain at a level similar to this year over the projection horizon. Core inflation will remain below the long -term average. Inflation in the euro area and in the US is forecast at 1.6% and 1.7% respectively. Thus, inflation is expected to be 0.4 percentage points higher in the euro area and 0.6 percentage points lower in the US relative to the previous projections. The higher inflation in the euro area is expected to be the result of the more significant impact of energy prices due to the depreciation of the euro and the upward revision to the estimate of euro area economic growth. More significant pressures on core inflation are less likely, as growth in demand and labour costs remain relatively low, despite the economic recovery. Producer prices will also rise owing to higher energy prices. Growth in producer prices will be higher relative to the previous projections, by 0.8 percentage points in 2010 at 1%, and by 0.4 percentage points in 2011 at 2.2%.

Domestic demand

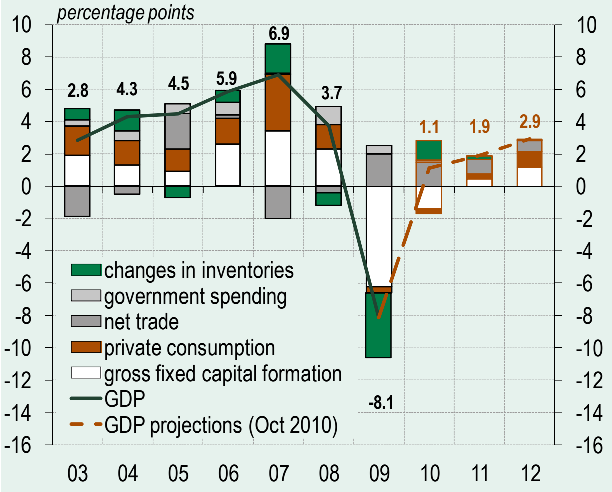
Household consumption will be down again this year, but is expected to rise gradually over the next two years. The current situation does not indicate the possibility of a significant turnaround in household spending for the remainder of the year. Figures regarding revenues in the retail sector and indicators of consumer sentiment are at low levels this year owing to the situation on the labour market. Real disposable income will be down slightly this year relative to 2009 due to higher inflation and a drop in employment similar to last year. Growth in household consumption is expected to turn positive next year and stand at 0.5%. Significant growth is not expected until 2012, when it is forecast at 1.7%, primarily as a result of employment growth.

Investment will also most likely fall this year. Growth

in gross investment could be positive over the next two years, depending on the sustainability of the economic recovery and limiting factors, in particular financing conditions and corporate profits. The still difficult financing conditions and uncertainty about the strength of the global economic recovery indicate gross fixed capital formation could decline further this year by more than 5%. Nevertheless, the decline is expected to be significantly lower than in the previous year, partly owing to the effect of the low basis from last year and partly due to the expected gradual recovery in exports this year. Financing conditions also represent a limiting factor, as banks have become more cautious during the crisis when approving long-term loans. Internal sources of funding are lower owing to lower profits. The recovery in activity in the domestic and international environment could result in an increase in investment to around 5% in 2012.

In line with the situation in the construction sector, investment in buildings will decline further according to expectations, while moderate grow in investment in machinery and equipment is forecast. The decline in investment in the construction sector is a result of previous excessive investment in residential buildings. Certain construction companies are facing liquidity problems. Confidence indicators in the construction sector persist at extremely low levels. Although the business outlook and the outlook for expected and total orders in the manufacturing sector have improved this year, corporates are not

Figure 7.4: Contributions of spending components to GDP growth



Sources: SORS, Bank of Slovenia projections

currently opting for major investments in new equipment owing to considerable excess capacity. Nevertheless, investment in transport equipment and in machinery and equipment is expected to rise over the next two years in line the expected continuation of the recovery.

In the context of higher foreign demand and a gradual increase in domestic gross fixed capital formation, inventories will also increase and contribute to growth in domestic demand. Owing to the continuing recovery in domestic industrial production, as seen primarily in growth in orders from the rest of the world, industrial inventories, particularly of raw materials and intermediate goods, will increase. Following a sharp drop in 2009, the partial renewal of inventories of merchandise in

Table 7.2: Components of domestic demand

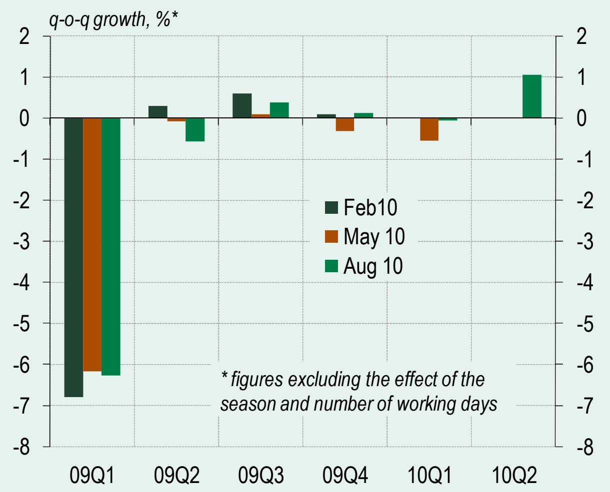
						Projections					
						2010		2011		2012	
	2005	2006	2007	2008	2009	**Oct**	Δ	**Oct**	Δ	**Oct**	Δ
	real growth, %										
Domestic demand	2.3	5.6	8.9	4.1	-9.8	**-0.4**	-0.2	**1.0**	-0.3	**2.3**	-0.4
Private consumption	2.6	3.0	6.7	2.9	-0.8	**-0.5**	-0.1	**0.5**	-0.1	**1.7**	-0.1
Government spending	3.4	4.0	0.7	6.2	3.0	**0.7**	0.2	**0.0**	0.0	**0.3**	0.0
Gross fixed capital formation	3.7	10.1	12.8	8.5	-21.6	**-5.4**	-8.0	**2.0**	-0.9	**5.0**	-1.4

Δ: Difference between current projections and projections in the April 2010 Price Stability Report..
Sources: SORS, Bank of Slovenia

Box 7.1: Changes in national accounts figures and their impact on projections

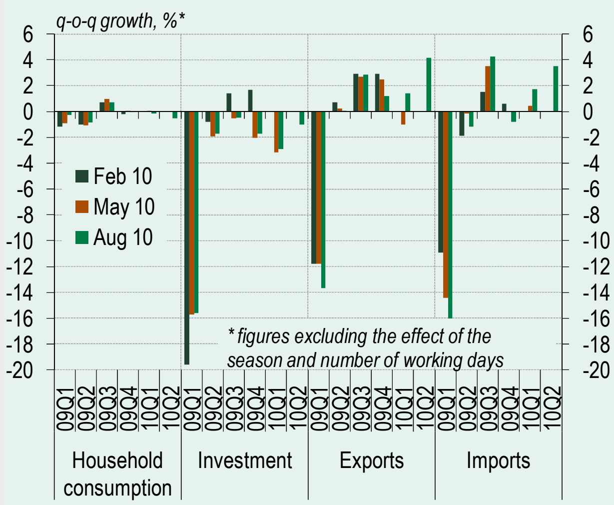
Changes in the projections occur in part due to changes in figures related to the past.[1] In its recent releases of national accounts figures, the SORS has made significant changes to published current GDP growth rates[2] and components thereof for individual quarters in 2009 and the beginning of 2010. Changes to the figures may reflect a change in methodology, while the changes are more significant during the economic crisis than in normal circumstances owing to unreliable data and sharp fluctuations. With the release of figures at the end of May 2010, the cumulative revision to quarterly GDP growth rates for 2009 relative to the figures published at the end February 2010 stood at 0.5 percentage points for year. It should be noted that the cumulative revision to the figures for the second half of 2009 of 0.9 percentage points is of particular importance for assessing developments in 2010. Owing solely to the revisions to quarterly growth, particularly those in the final quarter of 2009, the carry over effect[3] from 2009 to 2010 was 0.6 percentage points lower and stood at -0.2%. Such a lower carry over effect could lead to a significant change in the assessment of developments for the average of 2010.

Figure 1: GDP according to various releases of SORS figure



Source: SORS

Figure 2: Spending components of GDP according to various releases of SORS figures



Source: SORS

The current revision of the figures taken into account in the previous Price Stability Report (and published at the end of February) does not have any significant effect on GDP projections. Figures regarding quarterly GDP growth rates released at the end of August were practically unchanged relative to the figures released at the end of February 2010. The revision to quarterly growth rates for the second half of 2009 amounted to 0.2 percentage points. Major revisions were made to the growth rate for the second quarter of 2009, which was cut further relative to the previously released figures: quarterly growth was down 0.9 percentage points on the figure released at the end of February. In contrast, the figures from the third quarter of 2009 to the first quarter of 2010 were revised upward (cumulatively by 1.2 percentage points) relative to the figures released at the end of May.

The revision of figures regarding the individual components of expenditure was considerably higher, and thus has a significant impact on the revision of projections of certain components of GDP. Here, the revision of figures regarding quarterly seasonally adjusted growth in exports and investment deviate substantially. In the most recently released figures, quarterly growth in exports for the second half of 2009 was adjusted cumulatively by 1.7 percentage points, while quarterly growth in investment was adjusted by fully 5.3 percent-

[1] The Bank of England also prepares its projection on the basis of "forecasts" of revisions of past figures (for more see the Bank of England Inflation Report, November 2007, p. 39).

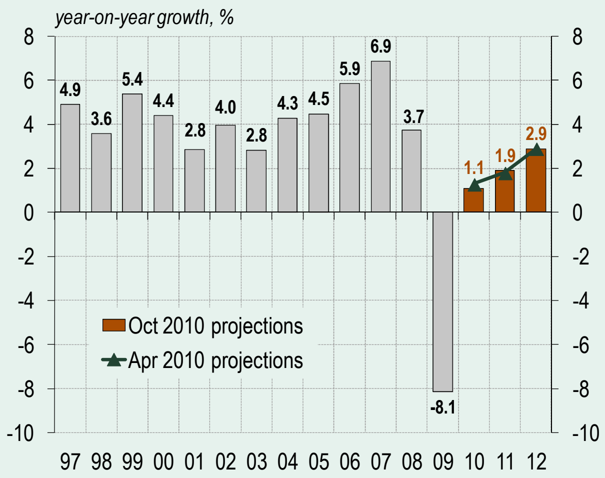
[2] We analyse the quarter-on-quarter growth rates of individual aggregates, adjusted for seasonal fluctuations.

[3] The carry over effect is defined as the level of GDP from the final quarter of the year relative to the average annual level of GDP.

age points. Thus the carry over effect from 2009 to 2010 was 1.5 percentage points lower for exports and 3.7 percentage points lower for gross investment, solely due to the revision of figures.

the retail sector can also be expected. Because the number of new building permits for buildings continues to fall, no sharp increase in inventories of unsold housing in the construction sector can be expected until the end of the year. For the whole of 2010, the contribution of inventories to growth in domestic demand will be slightly more than 1 percentage point, expressed as the contribution to GDP growth. This contribution is expected to be only marginal again in 2011.

Figure 7.5: GDP growth projections



Sources: SORS, Bank of Slovenia projections

Growth in government spending is expected to be low this year and in the next two years due to the need for fiscal consolidation. According to estimates on the basis of previously adopted budget assumptions, government spending is expected to grow by less than 1% over the projection horizon. Projections of this year's 0.7% real growth are based on nominal growth in average wages in the government sector of around 0.7%, employment growth in the government sector of 1.0% and savings in material costs. Low spending in 2011 and 2012 is also the result of the announced restrictive employment policy, low wage growth and further savings in material costs.

GDP growth and developments on the labour market

GDP growth is forecast at just over 1% this year, and is expected to rise gradually to close to 3% by 2012.

Table 7.3: Activity, employment and wages

						Projections					
						2010		2011		2012	
	2005	2006	2007	2008	2009	**Oct**	Δ	**Oct**	Δ	**Oct**	Δ
	real growth, %										
GDP	4.5	5.9	6.9	3.7	-8.1	**1.1**	-0.2	**1.9**	0.1	**2.9**	0.0
Employment	-0.2	1.5	3.0	2.8	-1.9	**-2.3**	0.0	**-0.3**	-0.2	**0.3**	0.0
Compensation per employee	5.6	5.3	6.4	6.9	1.6	**3.5**	1.8	**3.1**	0.4	**3.4**	0.0
Productivity	4.7	4.3	3.7	1.0	-6.3	**3.5**	-0.2	**2.2**	0.3	**2.6**	0.0
ULC (nominal)	0.9	1.0	2.6	6.0	8.5	**0.0**	2.0	**0.9**	0.1	**0.8**	0.0
Contributions to GDP growth	*percentage points*										
Domestic demand, excluding changes in inventories	3.0	5.0	7.1	5.0	-6.1	**-1.5**	-2.1	**0.8**	-0.3	**2.2**	-0.5
Net exports	2.2	0.2	-2.0	-0.4	2.0	**1.5**	0.0	**0.9**	0.3	**0.7**	0.5
Changes in inventories	-0.7	0.7	1.8	-0.8	-4.0	**1.2**	1.9	**0.2**	0.1	**0.0**	0.0

Δ: Difference between current projections and projections in the April 2010 Price Stability Report.
Sources: SORS, Bank of Slovenia

The pace of this year's recovery is slightly slower relative to the April projections. The growth projection for 2010 was revised downward primarily due to the relatively low quarterly GDP growth dynamics at the beginning of the year, although growth rose to just over 1% in the second quarter. GDP growth is expected to be lower in the second half of the year mainly as a result of slowing in foreign demand. The rate of growth in activity is expected to rise again at the beginning of next year. This year’s GDP growth in Slovenia will be slightly below the euro area average, but will exceed it again in 2011 and 2012.

The decline in activity in the construction sector due to the drop in investment was partly seen in a change in the composition of GDP growth in the first half of the year. The main factors in growth in value-added were export-oriented sectors and certain services. The risk of a continued decline in investment in the construction sector is currently being materialised, while investment in equipment and in transport equipment were higher in the first half of the year relative to the same period last year, mainly on account of high growth in the second quarter of 2010. Construction activity is expected to contract further in the future. Real estate prices have only partly adjusted, which is further widening the gap between supply and demand, while household uncertainty regarding earnings persists due to the situation on the labour market. The recovery in activity in the manufacturing sector in the first half of the year was in line with increased foreign demand. However, the pace of growth in the manufacturing sector is expected to slow by the end of the year. The contribution of the sectors of trade and repair, hotels and restaurants, and transport and communications to GDP growth will likely be positive this year. Following a the sharp fall in the first quarter of last year, the value-added of these sectors rose in quarterly terms in the first half of the year, although uncertainties linked to private consumption are relatively high.

The fall in employment in 2010 will be similar to that of 2009 owing to the slow economic recovery and the typically gradual adjustment of the labour market. In line with the previous projections, the decline in employment in manufacturing is easing, while the fall in the construction sector is accelerating. Employment is expected to fall again in 2010 as a result of bankruptcies and labour cost rationalisation. The largest fall in employment this year and next year will be in the construction sector. In the context of these movements and taking into account weak activity in certain service sectors, a fall in employment is forecast at just over 2% in 2010. This fall should be followed by very slow employment growth until the end of the projection horizon. The surveyed unemployment rate is expected to reach its peak in the first quarter of 2011. A small fall is expected in 2012, provided that labour costs are adjusted at the foreseen pace.

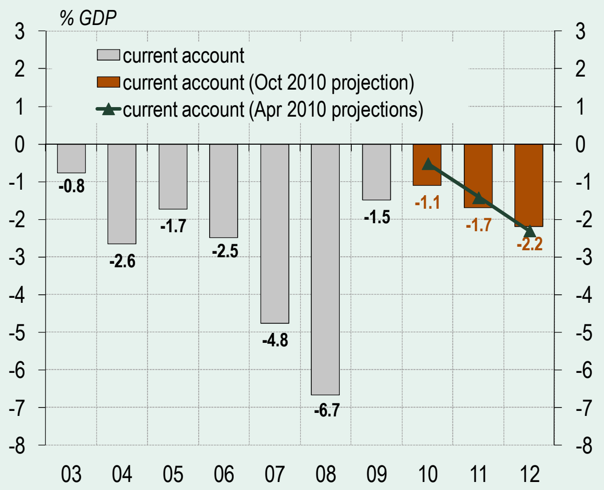
In addition to the pace of economic recovery and the rise in the minimum wage, movement in private sector wages will also be affected by certain temporary factors. The rise in the minimum gross wage in March will directly contribute slightly less than 1 percentage point to this year's wage growth, while the direct contribution of this measure will be small in 2011. Figures from the Ministry of Labour, Family and Social Affairs indicate that relatively few employers have negotiated with the unions for a gradual increase in minimum wages, as permitted by the Minimum Wage Act. Average wages will also grow more quickly on account of the changing composition of the labour force, and due to the migration of workers from job subsidisation regimes back into full employment. Private sector wages are expected to rise by around 3.7% in 2010 (growth would stand at around 2.5% excluding the rise in the minimum wage). Wage growth is expected to slow down slightly in the private sector in 2011. In the context of a gradual recovery in economic activity, the effect of certain temporary factors that affect wage growth will be smaller this year. The effects of higher economic activity are expected to prevail in 2012. Private sector wage growth will thus be somewhat higher again.

Government savings measures will act to restrict public sector wage growth. The government and the public sector unions have not reached agreement regarding the deferment of the final introduction of the new wage system, which would significantly raise wages in the public sector. The government therefore adopted an intervention act, by which public sector wages will not be adjusted this year or in 2011, and will only be adjusted to inflation in 2012, provided inflation exceeds 2%. According to the government's plans, the remaining payments to eliminate wage discrepancies would be made in the two years following the year in which economic growth exceeds 3%. The waiver of performance bonuses is expected to remain in force over the entire projection horizon, while wage grade progression is also expected to remain frozen, at least in 2011.

Foreign trade

The current account deficit is expected to narrow slightly this year and then widen gradually. The widening of the deficit is primarily linked to the less favourable terms of trade and the widening of the deficit in factor income. The current account deficit is expected to be just over 1% of GDP this year and exceed 2% of GDP in 2012. Higher growth in the volume of exports of merchandise and services than in imports will make a positive contribution to the current account balance over the entire projection horizon. In addition to the unfavourable terms of trade, the widening of the deficit in factor income will also contribute to the widening of the current account deficit. The terms of trade are expected to deteriorate by more than 5% cumulatively until 2012 owing to rising commodity prices and the euro's depreciation. In the context of the existing high level of external debt, the deficit in factor income will widen due to the expected gradual rise in interest rates. Net transfers are expected to record a small deficit in 2010 and in the coming years. Government transfers are expected to generate a deficit in the context of a surplus in the transfers of other sectors.

Figure 7.6: Current account projections



Sources: SORS, Bank of Slovenia projections

Table 7.4: Current account

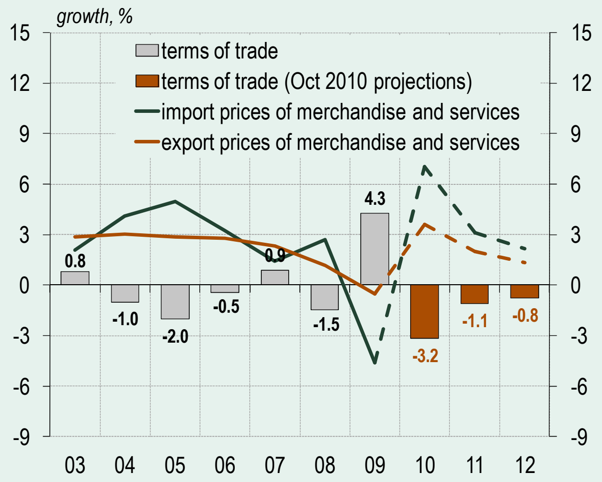
						Projections					
						2010		2011		2012	
	2005	2006	2007	2008	2009	**Oct**	Δ	**Oct**	Δ	**Oct**	Δ
Exports of merchandise and services	10.6	12.5	13.7	3.3	-17.7	**9.5**	4.3	**6.6**	0.6	**7.5**	0.8
Imports of merchandise and services	6.7	12.2	16.7	3.8	-19.7	**7.1**	4.1	**5.3**	0.1	**6.6**	0.2
Current account: EUR billion	-0.5	-0.8	-1.6	-2.5	-0.5	**-0.4**	-0.2	**-0.7**	-0.2	**-0.9**	0.0
as % GDP	-1.7	-2.5	-4.8	-6.7	-1.5	**-1.1**	-0.6	**-1.7**	-0.3	**-2.2**	0.1
Terms of trade*	-2.0	-0.5	0.9	-1.5	4.3	**-3.2**	-0.6	**-1.1**	-0.1	**-0.8**	0.0

** Based on national accounts deflators.*
Δ: Difference between current projections and projections in the April 2010 Price Stability Report.
Sources: SORS, Bank of Slovenia

The balance of trade in merchandise and services is expected to change only slowly: the merchandise trade deficit is forecast to widen slightly, as is the surplus in trade in services. The merchandise trade deficit is projected to widen from 2.0% of GDP in 2009 to slightly less than 3% of GDP in 2012. Main factor in the widening of the deficit will be the unfavourable terms of trade. Exports will rise in terms of volume, but at an increasingly slower pace. According to estimates, the faster growth in exports than imports this year should offset two thirds of the deterioration in the terms of trade, while these two effects are expected to offset one another in the next two years. The balance of net trade in services will remain positive over the projection horizon, and is expected to rise from 3.1% of GDP in 2009 to around 3.5% of GDP in 2012. The gradual growth in economic activity and higher foreign demand should initially result in growth in merchandise trade and subsequently in exports and imports of services tied to merchandise trade. Net revenues from construction services are expected to rise in the coming years owing to the expected stabilisation of the domestic construction sector and increased investment work in the rest of the world. The gradual recovery in activity in Slovenia's most important trading partners should also result in growth in revenues from tourism.

Projections of the deficit in factor income indicate a narrowing from 2.2% of GDP in 2009 to around 1.5% of GDP in 2010. The deficit is then expected to nearly double until the end projection horizon mainly as a result of the widening of the deficit in capital income. Relatively low interest rates should also result in low net outflows of factor income in 2010. The main factors in this year's narrowing of the deficit in capital income are expected to be lower interest payments and the decline in expenditure on dividends and earnings. With the expected renewed growth in economic activity and indebtedness, and the simultaneous anticipated rise in interest rates, net outflows of factor income are expected to rise again in the coming years. Another factor in the widening

Figure 7.7: Terms of trade projections



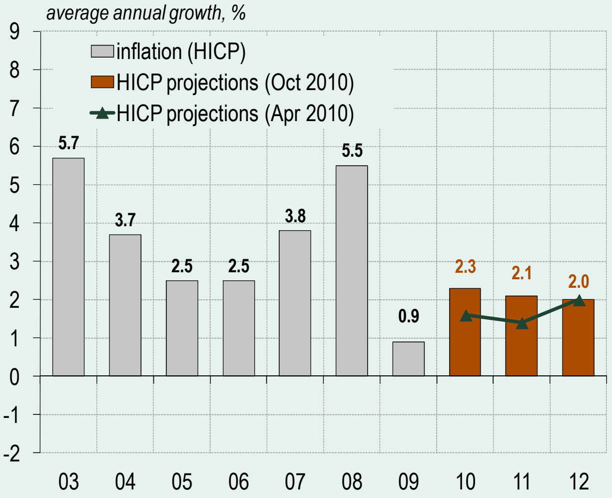
Sources: SORS, Bank of Slovenia projections

of the deficit in factor income in the future is the decline in net income from investments in foreign debt securities. As a result of the decline in employment of foreign workers, net inflows of labour income this year and in the next two years are expected to stand at around 0.2% of GDP.

Inflation

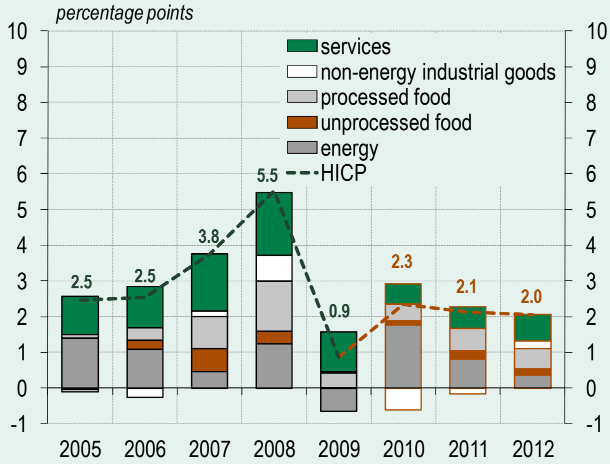
Inflation is expected to be slightly higher than 2% in 2010 and then decline in the next two years. Core inflation is forecast to be exceptionally low this year. The inflation projections for 2010 and 2011 are higher than the April projections primarily as a result of the effect of energy and food prices. The uncertain situation on the labour market and the resulting lower households' spending and limiting cost pressures act to slow core inflation, which will thus remain very low this year. Year-on-year growth in the HICP excluding energy, food, alcohol and tobacco is not expected to be positive until the final quarter, and is forecast at -0.2% for 2010. Core inflation measured as such is forecast to rise to 0.7% in 2011 and 1.4% in 2012 in line with the gradual economic recovery. The other two indicators of core inflation are expected to move similarly.

Figure 7.8: Inflation projections



Sources: SORS, Bank of Slovenia projections

Figure 7.9: Contributions of components to inflation



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

According to the price index breakdown, the high contribution made by energy prices will stand out this year, while the contribution of food prices will stand out in the next two years. Growth in energy prices is forecast at 14.3% this year. This is in line with the rise in oil prices on global markets, the euro's fall and higher excise duties. Growth in energy prices is expected to decline over the next two years, to 6.0% in 2011 and to 2.6% in 2012. Growth in food prices is forecast at 2.7% this year, and is expected to rise to 4.0% in 2011. Growth in food prices is expected to decline again in 2012 to 3.4%. Growth in the prices of unprocessed and processed food is forecast to be higher in all three years relative to the previous projections. Higher growth in unprocessed food prices is expected mainly as the result of higher growth in food prices on the global market. The main factor in the higher growth in processed food prices is expected to be higher rises in excise duties on tobacco than foreseen in previous projections. In line with the situation in the domestic macroeconomic environment,

Table 7.5: Inflation

						Projections					
						2010		2011		2012	
	2005	2006	2007	2008	2009	**Oct**	Δ	**Oct**	Δ	**Oct**	Δ
						average annual growth, %					
Consumer prices (HICP)	2.5	2.5	3.8	5.5	0.9	**2.3**	0.7	**2.1**	0.7	**2.0**	0.0
food	0.2	2.7	7.1	8.1	1.8	**2.7**	0.7	**4.0**	1.8	**3.4**	1.2
energy	11.9	8.5	3.4	9.4	-4.5	**14.3**	3.5	**6.0**	3.0	**2.6**	0.1
other goods	-0.3	-0.9	0.3	2.2	0.0	**-2.2**	0.6	**-0.8**	0.1	**0.5**	-0.4
services	3.3	3.5	4.9	5.3	3.2	**1.7**	-0.1	**1.8**	-0.3	**2.1**	-0.2
Core inflation indicators (HICP)											
excluding energy prices	1.2	1.7	3.8	4.9	1.7	**0.6**	0.4	**1.5**	0.3	**1.9**	0.1
excluding energy and unprocessed food prices	1.3	1.5	3.4	5.0	1.9	**0.5**	0.3	**1.3**	0.2	**1.9**	0.0
excluding energy, food, alcohol and tobacco prices	1.5	1.3	2.7	3.8	1.7	**-0.2**	0.2	**0.7**	-0.1	**1.4**	-0.3

Δ: Difference between current projections and projections in the April 2010 Price Stability Report.
Sources: SORS, Bank of Slovenia

the prices of services and non-energy industrial goods are expected to rise gradually over the next two years primarily owing to the forecast higher growth in services prices. Services prices are forecast to average annual growth of 1.9% over the projection horizon, while the prices of non-energy industrial goods are forecast to fall 0.8% each year.

The price changes envisaged in the plan for managing administered prices in 2010 and 2011 are expected to make an even smaller contribution to inflation in 2011 than this year. All planned rises in administered prices have already been carried out this year. These prices will contribute 0.09 percentage points to annual inflation. That contribution is expected to fall to 0.02 percentage points next year. Euro exchange rate and in oil prices on the global market will also have a significant effect in 2010 and 2011 on the increase in other prices subject to various forms of regulation. These two factors will have a direct impact on the of prices of liquid fuels for transport and heating, as well as an indirect impact on the prices of heat energy in Slovenia, for which the Slovenian government merely prescribes the price setting mechanism.

Risks and uncertainties

The assumption regarding growth in foreign demand in the coming period also depends on the possible need for a stronger and faster-paced fiscal consolidation than foreseen in the baseline projection. Owing to difficulties in the financing of public expenditure, the need for fiscal consolidation in certain countries could require the speedier and more determined withdrawal of government measures stimulating the economy. This could threaten demand for Slovenian products from the rest of the world. Insufficient, non-credible and overly slow fiscal consolidation could exacerbate macroeconomic imbalances and increase the aversion of the financial markets with regard to the financing of existing and new general government debt. This could give rise to continuing instability on the financial markets and raise the premiums on government borrowing. Not only the costs of financing of general government deficits would rise, but also the costs of financing the economy. Other uncertainty with respect to foreign demand is linked to the more adverse economic situation in the US than previously expected. A sharper slowdown in growth in demand in the US in the coming period would hit euro area economic activity hard via a decline in exports. There is also uncertainty regarding the fluctuation in the value of the euro in the international environment. The depreciation of the euro would

Table 7.6: Direct impact of changes in administered prices on inflation in 2010 and 2011

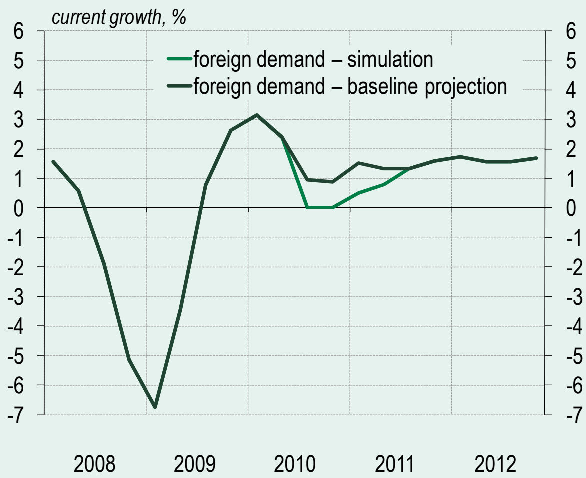
Measure	Change	Impact on HICP in 2010, percentage points	Impact on HICP in 2011, percentage points
– Changes in prices of selected textbooks	average price increase of 2.3%	-	0.005
– Changes in prices of railway tickets	average price increase of 6.0%	0.012	0.012
– Planned increase in contribution to mandatory reserves of refined petroleum products	increase in contribution of 10%	0.000	0.000
– Change in contribution for renewable energy resources and reliable supply of domestic resources	increase in final electricity price of 3.5%	0.080	-
Total impact on inflation		**0.092**	**0.017**

Source: Plan for managing regulated prices in 2010 and 2011

Box 7.2: Simulation of lower demand from the rest of the world

Lower growth in demand from the rest of the world relative to the baseline projection is assumed in this scenario. The baseline projection takes into account a decline in the high quarterly rates of growth in foreign demand, which accelerated sharply at the beginning of the year in the context of a recovery in international trade, in the second half of the year 2010. However, quarterly growth rates of foreign demand remain relatively high in the baseline projection. The alternative scenario presents the effects of significantly lower quarterly growth in foreign demand, in accordance with the risks described in this Price Stability Report. Thus, it is assumed that foreign demand will stagnate in the second half of 2010, and that the quarterly rate of growth will gradually converge with the growth set in out in baseline scenario only at the beginning of 2011.

Figure: Foreign demand



Source: Bank of Slovenia

The model assessments indicate that a simulated slowdown in growth in foreign demand would stall GDP growth via slow export growth. A decline in foreign demand by more than 3% relative to the baseline projection would result in a similar cumulative fall in exports, while GDP would be lower by slightly more than 1%. Despite the fact that a decline in imports would mitigate the effect of exports on GDP owing to lower demand for imports of intermediate goods and capital goods, the simulation indicates that the direct and transmission effects of such a decline in foreign demand would result in lower GDP growth by 0.5 percentage points on average in 2011 and 2012. This does not take into account the possible effects of lower foreign demand on other economic factors in the international environment, in particular on the situation on the financial markets, or more sustained effects on the corporate confidence. These effects could have the direct effect of further slowing the recovery of domestic demand and the economy.

Table: Deviations from baseline projection

	2010	2011	2012
rate of deviation from baseline projections, %			
Foreign demand	-0.7	-3.3	-3.4
Exports	-0.2	-1.4	-3.5
GDP	-0.1	-0.4	-1.1
deviation in annual growth from baseline projections, percentage points			
Foreign demand	-0.7	-2.6	-0.1
Exports	-0.2	-1.2	-2.1
GDP	-0.1	-0.3	-0.7

Source: Bank of Slovenia

accelerate growth in commodity prices in the domestic currency, and result in direct pressures on energy prices and indirect pressures via an increase in input costs in the corporate sector. However, the depreciation of the euro would also result in positive effects on price competitiveness and stimulate the exports of euro area countries.

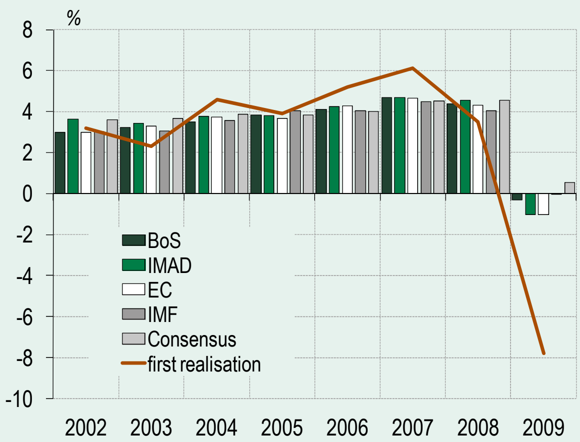
Uncertainty regarding the adjustment of the labour market and growth in labour costs is rising in the domestic macroeconomic environment. This increases the risk of a further additional deterioration in the competitiveness of the Slovenian economy, with lasting undesirable implications for employment. The negative effects of this year's rise in the minimum wage on competitiveness will likely be surmountable owing to the mere moderate effect on overall labour costs. However, a rise in the wages of the lowest paid workers could lead to rising wages in the other wage grades,

Box 7.3: Comparison of the Bank of Slovenia's forecast accuracy with other institutions

Forecasts of economic trends affect expectations and responsiveness of economic agents. They also serve as the basis for formulating and implementing economic policies. The Bank of Slovenia has been producing and publishing forecasts of major macroeconomic indicators since 2001. The forecasts are published twice a year in the spring and autumn Price Stability Reports, for the current and the following two years.

Below, we compare the Bank of Slovenia's forecasts with those of other institutions for three macroeconomic variables: GDP growth, inflation and the current account balance. We compare the forecasts to the average spring and autumn forecasts for the period from 2002 to 2008. Owing to significant errors in the forecasts for 2009 caused by uncertainties linked to the economic and financial crisis, the aforementioned year is only included in the graphical presentation of the annual forecasts, and not in the assessment of mean errors from the forecasts.

Figure 1: Forecasts of real GDP growth

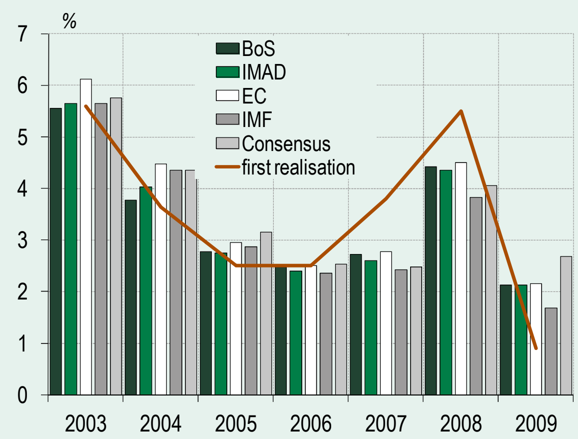


** The figure illustrates the average values of four forecasts prepared by an individual institution for a specific year.*
Sources: Bank of Slovenia, IMAD, European Commission, IMF, Consensus Economics

In the period from 2002 to 2008, **economic growth** forecasts were lower on average than the initially published figures on GDP growth. The underestimation of GDP growth is characteristic at all institutions for the forecasting period from 2004 to 2007, when the pace of economic growth was well above average. In other years, the forecasts exceeded actual growth. The most significant errors arose in the forecasts for 2007 and 2009; the errors in 2009 are primarily the result of the overestimation of domestic economic developments during the economic and financial crisis. Despite the negative mean errors, no bias in forecasts can be confirmed at any of these institutions. The smallest errors in forecasting GDP growth in the period from 2002 to 2008 were in the forecasts of domestic institutions, the Bank of Slovenia and the IMAD, while the most significant mean errors occurred in the forecasts published by Consensus.

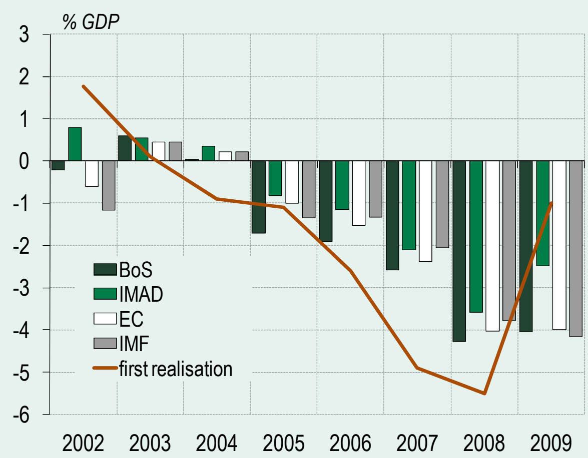
In the analysis of the period from 2003 to 2008, forecasts of **inflation** were overestimated on average in all publications,

Figure 2: Inflation forecasts



** The figure illustrates the average values of four forecasts prepared by an individual institution for a specific year.*
Sources: Bank of Slovenia, IMAD, European Commission, IMF, Consensus Economics

Figure 3: Current account forecasts



** The figure illustrates the average values of four forecasts prepared by an individual institution for a specific year.*
Sources: Bank of Slovenia, IMAD, European Commission, IMF.

except in the spring forecasts for the following year. The overestimation of inflation is characteristic for the first three years of the period analysed. In other years, with the exception of 2009, the average annual deviation between the forecasts and actual inflation is negative. Given the dispersion of errors, we can also rule out forecast bias. The most significant errors in inflation forecasts occurred in the last three years of the period analysed, which can be attributed to uncertainty in the economic environment during the economic and financial crisis. Similar to GDP forecasts, the smallest errors in inflation forecasts were in the forecasts of domestic institutions, the Bank of Slovenia and the IMAD; the most significant errors occurred in the IMF's forecasts. Relative absolute errors in forecasts of both GDP and inflation were around 20% of the actual values for both aggregates in the period from 2002 to 2008.

Forecasts of the **current account** were characterised by significant discrepancies between the forecasts of individual institutions. In the period from 2002 to 2008, the forecasts of the current account were underestimated on average, and statistically biased according to individual deviations between the forecasts and actual results. The exception was the substantial underestimation of the current account balance for 2009. Owing to uncertainties in the external economic environment, the most significant errors in forecasts of the current account occurred in the last three years of the period analysed. The European Commission achieved the highest accuracy in forecasts of the current account.

Table: Forecast accuracy estimates for the 2002–2008 period

	Institution	real GDP growth		inflation		current account (as % GDP)	
		ME	RMSE	ME	RMSE	ME	RMSE
Autumn forecasts for current year	**BoS**	-0.10	0.59	0.04	0.32	-0.08	0.73
	IMAD	0.03	0.60	0.11	0.35	0.03	0.85
	EC	-0.16	0.50	0.18	0.35	0.03	0.98
	IMF	-0.34	0.67	1.14	2.93	0.13	1.24
	Consensus	-0.03	0.72	0.03	0.42	-	-
	Average	*-0.12*	*0.62*	*0.33*	*1.43*	*0.03*	*0.97*
Spring forecasts for current year	**BoS**	-0.39	0.96	-0.27	0.48	0.23	1.83
	IMAD	-0.24	0.88	-0.46	0.70	0.73	1.51
	EC	-0.37	1.05	0.92	2.87	0.56	1.38
	IMF	-0.41	0.98	0.41	2.63	0.72	1.64
	Consensus	-0.24	1.12	-0.11	0.70	-	-
	Average	*-0.33*	*1.00*	*0.13*	*1.88*	*0.56*	*1.60*
Autumn forecasts for following year	**BoS**	-0.43	1.19	-0.47	1.13	0.73	1.89
	IMAD	-0.17	1.14	-0.27	1.19	1.00	2.13
	EC	-0.34	1.21	0.89	2.69	0.69	2.15
	IMF	-0.39	1.19	0.44	2.25	0.42	2.25
	Consensus	0.01	1.31	-0.55	1.51	-	-
	Average	*-0.26*	*1.21*	*0.10*	*1.96*	*0.71*	*2.11*
Spring forecasts for following year	**BoS**	-0.28	1.24	-0.69	1.47	1.37	2.53
	IMAD	0.00	1.33	-0.75	1.59	2.33	2.78
	EC	-0.22	1.20	-0.11	1.51	1.75	2.17
	IMF	-0.35	1.19	-0.49	1.59	1.77	2.62
	Consensus	-0.27	1.25	-0.41	1.72	-	-
	Average	*-0.22*	*1.24*	*-0.47*	*1.58*	*1.83*	*2.55*

ME: mean forecast error, defined as the average difference between forecast and actual values.
RMSE: root mean square error.
Sources: Bank of Slovenia, IMAD, IMF, Consensus Economics, European Commission, Bank of Slovenia calculations

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

	Publication of new/previous forecasts	GDP annual growth, %				Inflation annual average, %				Current account as % of GDP			
		2010		2011		2010		2011		2010		2011	
		new	Δ	new	Δ	new	Δ	new	Δ	new	Δ	new	Δ
Banka Slovenije	Oct 10 / Apr 09	**1.1**	-0.2	**1.9**	0.1	**2.3**	0.7	**2.1**	0.7	**-1.1**	-0.6	**-1.7**	-0.3
EIPF	Sep 10 / Mar 10	**1.5**	-0.2	**2.7**	-0.6	**2.1**	0.5	**1.8**	0.2	**-1.2**	0.4	**-2.8**	-0.4
IMAD	Sep 10 / Apr 10	**0.9**	0.3	**2.5**	0.1	**2.1**	0.8	**2.7**	1.1	**-0.9**	0.9	**-1.0**	2.0
Consensus Forecasts	Sep 10 / Mar 10	**1.0**	0.0	**2.1**	-0.3	**2.0**	0.2	**2.2**	-0.1	**-1.3**	0.5	**-1.9**	0.4
European Commission	May 10 / Nov 09	**1.1**	-0.2	**1.8**	-0.2	**1.8**	0.1	**2.0**	0.0	**-1.4**	-1.2	**-1.6**	-1.0
IMF	Apr 10 / Oct 09	**1.1**	0.5	**2.0**	-1.8	**1.5**	0.0	**2.3**	0.0	**-1.5**	3.2	**-1.2**	3.8
OECD	May 10 / Nov 09	**1.4**	-1.3	**2.4**	-0.6	**1.9**	0.8	**1.3**	-1.4	**0.5**	…	**-0.1**	…

Δ: Difference between current and previous projection, percentage points.
Sources: Bank of Slovenia, EIPF, IMAD, IMF, European Commission, Consensus Economics, OECD, Bank of Slovenia calculations

which would have a significantly stronger effect on unemployment. This would also have a negative impact on the competitiveness of the economy. Uncertainty also arises with regard to the regulation of student work and expected new employment legislation,[33] which is expected to bring greater flexibility in the context of a more active employment policy. It is not yet clear what effects these reforms will have on employment, unemployment and the earnings of unemployed persons. Risks are also present in the public sector where, despite the clear need for fiscal consolidation, social partners have not yet agreed on the appropriate adjustment of wages and employment in the future. Rising uncertainty on the labour market could further slow household spending.

Among economic sectors, the highest risks remain in the construction sector, which reflects uncertainty with regard to investment activity. The contraction in activity and the difficulties faced by certain major corporates have significant consequences for employment in the construction sector and on a possible indirect drop in employment in sectors tied to construction. The insufficient adjustment of real estate prices contributes to an increase in the number of unsold housing, which could further slow construction activity. Although the government is planning certain infrastructure projects, primarily in the areas of energy and the railway infrastructure, these are not yet finalised, while the scope of these projects is not comparable with the already finished construction of the motorway network. Therefore, the return of activity to the pre-crisis level in the construction sector is not to be expected. The still relatively low level of production capacity utilisation does not point to an imminent increase in private sector investment.

The rapid and in longer term unsustainable rise in public debt requires the credible consolidation of public finances in Slovenia as well. The current pace of economic recovery is quite weak. A premature withdrawal by the government could therefore represent a temporary risk for declining economic growth. On the other hand, insufficient and non-credible fiscal consolidation could result in the further deterioration in the public finance situation and increase the possibility of less favourable government ratings on the government debt markets. It is critical in the long term that the government introduces appropriate reforms of the pension and healthcare system as soon as possible that will ensure the efficient use of funds while appropriately ensuring individuals' rights. Failure in this area could seriously threaten the government's financing ability due to unfavourable demographic projections, which could have negative consequences for the whole economy.

[33] See Box 2.1.

Any additional uncertainties on the international financial markets, risk aversion and a reduction in private sector debt could further increase financing costs and hinder access to sources of financing. Corporate indebtedness in Slovenia is higher than the euro area average. The debt servicing burden has risen sharply owing to the high level of borrowing between 2006 and 2008. The rise in interest rates expected by the financial markets will increase this burden. Should the situation on the financial markets worsen and fiscal consolidation in Slovenia fail, corporates could find themselves in a longer-term adverse position due to higher financing costs. In this context, a lack of payment discipline, particularly in sectors such as construction, could hinder the financial or the liquidity position of numerous corporates in the circumstances of low demand. In terms of lending activities, there is also a risk for bank borrowing in the event of limited access to additional sources of funding. The risk regarding lending activity continues to rise due to increasing impairment and provisioning costs, and owing to the new arrangements in the scope of the Basel III.

Inflationary risks are balanced and therefore remain somewhat in the background. The risks of higher inflation are linked to euro denominated commodity prices and the effects of further rises in indirect taxes and excise duties due to the need for fiscal consolidation, and also due to increases in administered prices and the prices of municipal services. In contrast, lower core inflation and a possible deterioration in the situation in the domestic macroeconomic environment could contribute to lower inflation. This would further limit consumption and the domestic cost factors of inflation.