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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
BDP	gross domestic product
bps	basis points
CHF	Swiss franc
CNY	Chinese yuan renminbi
CPI	consumer price index
ECB	European Central Bank
EFSF	European Financial Stability Facility
EMU	Economic and Monetary Union
Eonia	Euro OverNight Index Average
ESA 95	European System of Accounts (1995)
ESCB	European System of Central Banks
ESM	European Stability Mechanism
EU	European Union
EUR	euro
Euribor	euro interbank offered rate
Eurostat	Statistical Office of the European Communities
Fed	Federal Reserve
FRED	Federal Reserve Economic Data
GBP	Pound sterling
HICP	harmonised index of consumer prices
HRK	Croatian kuna
IER	The Institute for Economic Research
IMAD	Institute of Macroeconomic Analysis and Development of the Republic of Slovenia
IMF	International Monetary Fund
JPY	Japanese yen
LTRO	long term refinancing operations
M	month
MFIs	monetary financial institutions
NACE	Statistical Classification of Economic Activities in the European Community
NFCs	non-financial corporations
NLB	Nova Ljubljanska Banka d.d.
NPISH	non-profit institutions serving households
OECD	Organisation for Economic Co-operation and Development
p.p.	percentage points
PMI	purchasing managers' index
PPI	producer price index
Q	quarter
RUB	Russian rouble
SMP	Securities Markets Programme
SURS	Statistical Office of the Republic of Slovenia
SŽ	Slovenske železnice d.o.o.
ŠOS	Student Organization of Slovenia
ULC	unit labour costs

USA	United States of America
USD	US dollar
VAT	value added tax
WEO	World Economic Outlook

Executive Summary

The slowdown in economic activity in the euro area in the second half of 2011 halted export growth and contributed to a contraction in activity also in Slovenia. With domestic demand falling, low foreign demand means much poorer prospects for a rapid improvement in the economic situation. Demand is being curbed by the consolidation of corporate and bank balance sheets and also by fiscal consolidation. Economic activity is thus projected to slow by more than 1% this year, and growth is not expected to resume until 2013. Although the current and projected deterioration in the economic situation is significantly smaller than in the first wave of the crisis, unemployment will rise further, which will necessitate an appropriate adjustment in labour costs in relation to productivity. At the current juncture, the economy's resistance to further shocks is significantly lower than in 2008, while at the same time the possibilities of using economic policy as a stimulus are even more limited. Inflation has risen in the early part of the year, as a result of several one-off effects and the contribution made by energy prices. It is expected to fall to around 2% in the coming months, partly due to the worsening macroeconomic situation, which is preventing inflationary pressures in most product categories.

* * *

Global economic growth slowed sharply in the second half of 2011, with some countries, most notably in the euro area, again slipping into recession. The main reasons were the difficulties in connection with the debt crisis in certain euro area countries, which has been reflected in increased uncertainty on the financial markets, and fiscal consolidation measures. Growth in the euro area and in the US was relatively low on average last year, but remained high in the majority of emerging countries. Central banks responded to the deterioration in the situation, and in addition to maintaining low key interest rates took additional measures to stimulate the economy. Oil prices and prices of some other commodities have been rising since the beginning of this year, primarily as a result of geopolitical factors. The slowdown in economic activity in the rest of the world has sharply reduced growth in demand in Slovenia's most important trading partners, which will curb growth in exports this year and next year.

GDP in Slovenia declined by 0.2% last year, although once the difference in the number of working days has been taken into account, it actually increased by 0.2%. Growth in exports slowed throughout the year, but the contribution of net trade to GDP growth was nevertheless high again as a result of the decline in domestic demand. The decline in construction investment and the crisis in the construction sector deepened further, and remain the main factors acting to slow economic activity. The decline in final consumption was produced not only by the household sector, but also by the government sector. Value-added in the majority of branches of the private sector primarily dependent on domestic demand declined in the final quarter. The contribution of export activities to GDP growth declined in the second half of 2011 as a result of the deterioration in the situation in the international environment. Despite the renewed deterioration in the economic situation, the fall in employment and rise in the number of unemployed slowed throughout the year. There was an increase in the number of job vacancies compared with *previous years, while the number of new hires was also up for the first time since 2008. The labour market is nevertheless still adjusting primarily via a fall in employment, and less so by means of an appropriate adjustment in labour costs, the burden of adjustment thereby mostly falling on those who have lost their jobs.*

The current account deficit stood at 1.1% of GDP in 2011, up 0.3 GDP percentage points on 2010. The main factors in the widening of the deficit were the increase in the goods trade deficit, and the deficit in factor income caused by increased outflows of capital income. Growth in goods trade also slowed sharply in the second half of the year after the decline in growth in foreign demand in the second quarter. Weak domestic demand meant that the slowdown was more pronounced on the import side than the export side. The increase in the surplus of trade in services and current transfers acted to reduce the deficit. Trade in services saw a slowdown in growth in exports and, in particular, imports, most notably of travel services. Despite the doubling of the deficit in private transfers, the surplus in official transfers widened even further as a result of the high disbursement of EU funds.

The deterioration in the economic situation in 2011 reduced demand for loans, while at the same time contributing to a deterioration in the situation in the banking system, and conditions for obtaining loans are being tightened further. The stock of loans contracted by 1.5% last year. The banks mainly approved long-term loans to non-financial corporations, but not to an extent that would compensate for the loss of short-term financing. The process of deleveraging by non-financial corporations thus continued. Non-financial corporations partly compensated for the loss of domestic financing by means of foreign financial resources. The household sector saw a significant slowdown in growth in housing loans and another contraction in consumer loans.

The inflation development in Slovenia in 2011 and early 2012 was determined by prices of oil and other commodities, certain one-off effects, fluctuations in the prices of seasonal products and weak domestic demand. Growth in the harmonised index of consumer prices stood at 2.1% in 2011, the same as in 2010. Low economic activity and the decline in real household income were reflected in a decline in domestic consumption and the limited opportunities for companies to raise prices, despite the recent increase in cost and price pressures. Core inflation thus remained low, below the euro area average, mostly as a result of a decline in the contributions made by prices of services and non-energy industrial goods.

Economic growth projections have been revised significantly downwards, but the inflation projections are slightly higher. GDP is expected to decline by just over 1% in 2012, and to grow by around 0.5% next year. The economic growth projections have thus been revised downward since the previous projection round, by almost 3 percentage points for 2012 and by just under 2 percentage points for 2013. Adjustments of this magnitude are a reflection of the materialisation of the majority of the risks identified in last October's Price Stability Report. Given the deterioration on the labour market and the fiscal consolidation, weak domestic demand during the projection period will not be a reflection solely of the continuation of low investment activity, but also of low household consumption and a contraction in government spending. At the same time export growth will also be very limited, at least in the first half of 2012, as a result of the projected slow growth in the international environment. The contribution made by net trade is nevertheless expected to remain similar to previous projections, as a result of weaker domestic demand. These trends are also being reflected in the projections for the current account position, which is expected to be in surplus. In contrast to the downward revisions to the economic growth projections, the inflation projections have been raised slightly, primarily as a result of high energy prices on global markets. After rising temporarily in early 2012, inflation is expected to stand at around 2% over the remainder of the projection period.

The risks in the GDP growth projections remain high and are concentrated on a downside. The persistent uncertainty on the markets for government debt securities and the need for additional fiscal consolidation measures in the EU are maintaining the risk surrounding foreign demand. The uncertainties surrounding domestic factors also remain high. The fiscal consolidation measures were still vague as the projections were being drawn up, but a fiscal squeeze of the planned magnitude could have a significant impact on the majority of macroeconomic variables. However, a lack of credible measures could lead to further *deterioration in the financing conditions and increased uncertainty for the economy. The deterioration in the situation on the labour market is increasing the possibility of a further rise in structural unemployment and the related social problems, a loss of human capital and additional government expenditure. The risks surrounding inflation remain balanced, and similar to those in previous projections. The risks associated with higher energy prices have been assessed as slightly higher this time. The risks of higher inflation are linked to possible additional measures in the scope of fiscal consolidation, and to price rises in sectors with a lower level of competition. A slower recovery in domestic demand and sharper cost adjustment in the economy could reduce core inflation.*

* * *

The Stability and Growth Pact is dictating a rapid reduction in the general government deficit, and a freeze on increases in government borrowing. Fiscal consolidation is vital, despite its likely short-term adverse consequences for demand and economic activity. Credible consolidation would help to reduce uncertainty and improve confidence in the private sector, which would also have a positive effect on economic activity and employment in the medium term. It is also a prerequisite to prevent sovereign downgradings, which would make it harder for the public and private sectors to access financial resources. The general government deficit amounted to 6.4% of GDP last year, while the general government debt increased to 47.6% of GDP. The government is planning to cut the state budget deficit to around 3% of GDP this year. In the fiscal consolidation it is imperative to focus on structural measures that will permanently improve the public finance situation. It is necessary to avoid measures that would entail a decline in tax revenues without economic potential being correspondingly increased. Public sector wage policy must remain restrictive, the total wage bill in the public sector having risen since 2008 from around 11% of GDP to nearly 13% of GDP.

In the deteriorating economic situation particular attention must be given to reducing the extremely high level of unemployment, which could continue to rise in the absence of appropriate action. Although the level of labour costs relative to productivity in export-oriented sectors has adjusted to the reduced level of economic activity, this has not occurred to a sufficient extent in the majority of other sectors. It is vital that wage growth remains below productivity growth in order to improve the competitiveness of the economy, stimulate employment and reduce unemployment. At the same time the rising risk of unemployment is a major factor in the low level of domestic consumption.

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

Ensuring the long-term sustainability of public finances, the basis of which are structural reforms, is not merely an economic problem; it is also a social problem. As measures for the effective restructuring of the economy are intensified, it is vital to maintain adequate social security for weaker and more vulnerable social groups. During a period that could be crucial to establishing a sustainable model of development, the key political and social partners must reach a fundamental consensus on measures to overcome the crisis.

								Projections 2012		2013		2014	
	2005	2006	2007	2008	2009	2010	2011	**Apr.**	Δ	**Apr.**	Δ	**Apr.**	Δ
Activity, employment and wages	*growth rates, %*												
GDP (real)	4.0	5.8	6.9	3.6	-8.0	1.4	-0.2	**-1.2**	-2.9	**0.6**	-1.9	**1.7**	…
Employment	-0.5	1.5	3.3	2.6	-1.8	-2.5	-1.7	**-1.2**	-0.6	**-0.5**	-0.6	**0.3**	…
Compensation per employee	6.0	5.4	6.2	7.2	1.8	4.3	2.0	**1.4**	-1.2	**1.6**	-1.2	**2.2**	…
Productivity	4.5	4.2	3.4	1.0	-6.3	4.0	1.6	**0.0**	-2.3	**1.1**	-1.6	**1.4**	…
ULC (nominal)	1.5	1.0	2.6	6.2	8.7	0.3	-0.4	**1.4**	1.0	**0.5**	0.2	**0.8**	…
Contribution to GDP growth	*percentage points*												
Domestic demand, excl. chg. in inventories	2.5	5.0	6.9	5.1	-6.3	-2.0	-2.6	**-1.4**	-1.7	**-0.3**	-2.0	**1.1**	…
Net exports	2.2	0.2	-2.0	-0.6	2.3	1.5	1.4	**1.1**	0.2	**0.9**	0.1	**0.7**	…
Changes in inventories	-0.7	0.7	2.0	-0.9	-4.0	1.9	1.1	**-0.8**	-1.2	**0.1**	0.1	**0.0**	…
Domestic demand	*real growth rates, %*												
Domestic demand	1.8	5.6	8.9	4.1	-10.0	-0.1	-1.6	**-2.3**	-3.1	**-0.3**	-2.1	**1.1**	…
Private consumption	2.1	2.8	6.1	3.7	-0.2	-0.7	-0.3	**-1.1**	-1.7	**-0.8**	-2.0	**0.6**	…
Government spending	3.5	4.0	0.6	6.1	2.9	1.5	-0.9	**-1.8**	-2.0	**-0.8**	-1.2	**0.0**	…
Gross fixed capital formation	3.0	10.4	13.3	7.8	-23.3	-8.3	-10.7	**-2.4**	-2.0	**1.5**	-3.1	**3.9**	…
Balance of payments	*growth rates, % (if not specified otherwise)*												
Exports of merchandise and services	10.6	12.5	13.7	2.9	-17.2	9.5	6.8	**2.3**	-2.6	**4.0**	-2.5	**5.0**	…
Imports of merchandise and services	6.7	12.2	16.7	3.7	-19.6	7.2	4.7	**0.9**	-2.9	**3.0**	-2.7	**4.4**	…
Current account: EUR billion	-0.5	-0.8	-1.6	-2.6	-0.5	-0.3	-0.4	**0.0**	-0.1	**0.5**	0.2	**0.7**	…
as % GDP	-1.7	-2.5	-4.8	-6.9	-1.3	-0.8	-1.1	**-0.1**	-0.5	**1.3**	0.5	**1.8**	…
Terms of trade*	-2.0	-0.5	0.9	-1.5	4.3	-3.8	-1.9	**-1.2**	-1.8	**0.3**	0.1	**0.1**	…
Prices	*average annual growth rates, %*												
Consumer prices (HICP)	2.5	2.5	3.8	5.5	0.9	2.1	2.1	**2.3**	0.7	**1.7**	0.1	**1.8**	…
HICP excluding energy	1.2	1.7	3.8	4.9	1.7	0.3	1.0	**1.4**	-0.1	**1.7**	0.0	**1.9**	…
HICP energy	11.9	8.5	3.4	9.4	-4.5	13.9	8.8	**7.5**	5.3	**2.0**	1.6	**1.1**	…
International environment	*growth rates, % (if not specified otherwise)*							**Assumptions**					
Foreign demand**	8.2	11.6	11.3	5.9	-14.2	11.3	7.5	**1.8**	-2.7	**3.5**	-2.5	**4.5**	…
Oil (USD per barrel)	54	65	73	98	62	80	111	**120**	13	**115**	11	**113**	…
Non-oil commodities	12.0	29.1	17.4	10.1	-23.0	37.1	18.0	**-3.1**	-1.1	**3.9**	-1.1	**6.0**	…
EMU inflation	2.2	2.2	2.1	3.3	0.3	1.6	2.7	**2.0**	0.1	**1.7**	-0.1	**2.0**	…
PPI Germany	4.4	5.4	1.3	5.4	-4.0	1.5	5.6	**2.1**	-0.2	**2.1**	0.3	**1.7**	…

* Based on national accounts deflators.

** Volume of imports from the basket of foreign partners.

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

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

1 International Environment

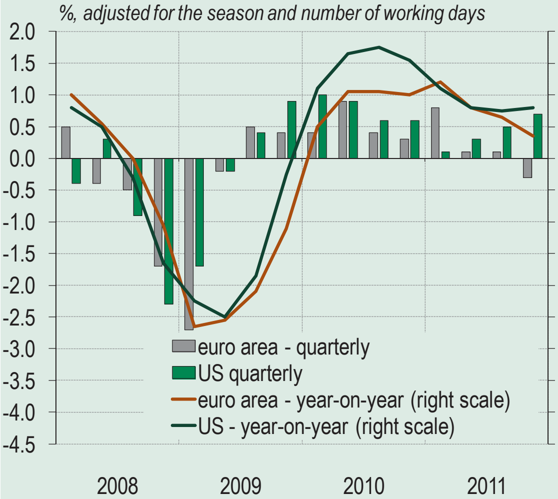
Global economic growth slowed significantly in the second half of 2011, most notably in the euro area, with some countries again slipping into recession. The main reasons lie in difficulties associated with the debt crisis in certain euro area countries, which was expressed as increased uncertainty on the financial markets, and fiscal consolidation measures. This was reflected in lower growth in demand from Slovenia's most important trading partners. Differences in economic growth between individual economic regions remained last year. Growth in the euro area and in the US was relatively low on average last year, but remained high in the majority of emerging countries. Central banks responded to the deterioration in the situation and, in addition to maintaining low key interest rates, adopted additional measures to stimulate the economy. Oil prices and the prices of certain other commodities have been rising since the beginning of this year, primarily as a result of geopolitical factors.

Economic developments

The deepening of the debt crisis and the deteriorating situation on the labour market in the final quarter of last year led to a decrease in economic activity in the euro area. Economic conditions in the US improved towards the end of the year, while growth remained relatively high in emerging countries, despite slowing. GDP in the euro area was down 0.3% in the final quarter of the year relative to the third quarter. Final household consumption and investment both declined. Among the major euro area countries, economic activity contracted by 0.2% in Germany, by 0.3% in Spain and by 0.7% in Italy, while GDP was up 0.2% in France. In the US, a slight improvement in the situation on the labour market and an increase in private consumption in the final quarter contributed to an increase in quarterly growth to 0.7%. GDP fell by 0.9% last year in Japan. However, the decline in economic activity was in part linked to the natural disaster at the beginning of the year. GDP growth declined slightly in emerging countries in the final quarter, but remained relatively high, averaging 9.2% in China and 6.1% in India.

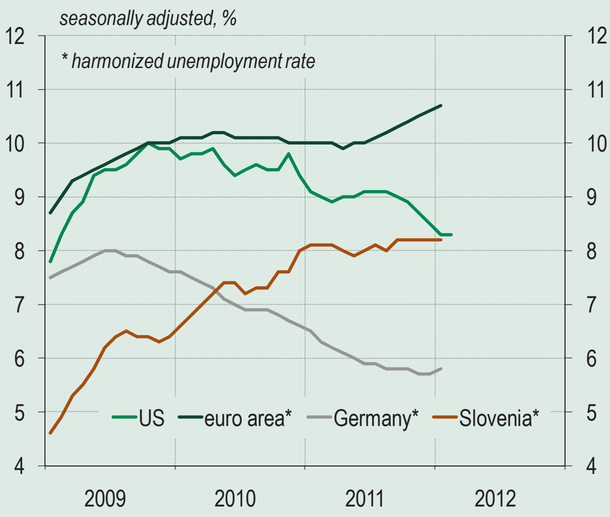
Figure 1.1: GDP growth

%, adjusted for the season and number of working days



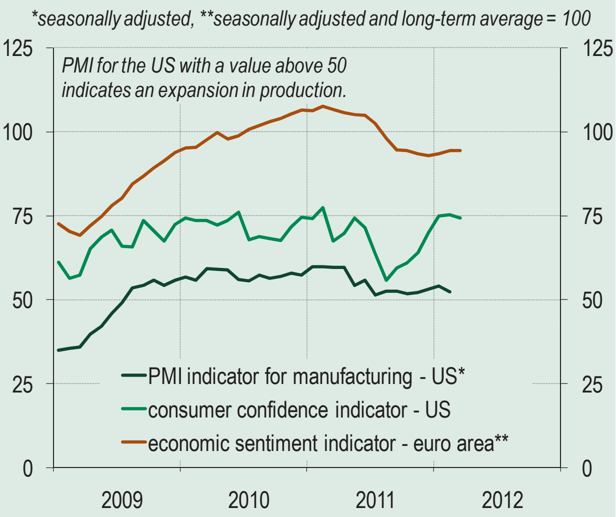
Sources: Eurostat, FRED.

Figure 1.2: Unemployment rate



Sources: Eurostat, FRED.

Figure 1.3: Economic sentiment indicators



Sources: Eurostat, FRED.

Economic sentiment indicators improved for the most part in the first quarter of this year; the improvement was more pronounced in the US. Private consumption in the euro area remains low as a result of rising unemployment and consolidation measures. Despite an improvement over the first three months of this year, indicators of economic sentiment and consumer confidence in the euro area remain well below the long-term average. Improvement in consumer confidence in the US followed a drop in the unemployment rate there in the second half of 2011. The unemployment rate in the US stood at 8.3% in February this year, the lowest rate recorded in the last two years. The rise in unemployment in the euro area during the crisis was somewhat less significant than in the US owing to temporary government measures to protect jobs. The situation is deteriorating, however, as those measures expire. Declining economic activity, fiscal consolidation and tightened financing conditions in some euro area countries are not facilitating a reduction in unemployment. The euro area unemployment rate reached 10.7% in January this year, the highest level since the introduction of the euro.

Lower economic activity in Slovenia's most important trading partners is also reflected in lower import demand from these countries. There was a significant turnaround in import demand from the most important trading partners in the second half of the year, particularly in the final quarter. Imports to Germany were down 0.3% in the final quarter, while the decline was even more pronounced in Italy, France and Austria. Economic activity and international trade also slowed in partners outside of the euro area. The decline in imports to Croatia accelerated further in the third quarter, while growth in imports to Russia slowed significantly.

Financial markets and commodity prices

The ECB responded swiftly to the deteriorating economic and financial situation in the euro area at the beginning of 2012 with additional stimulus measures. Other major central banks also continued with a stimulative policy last year. The ECB cut its key interest rate, which stood at 1.00% in March this year, in November and December 2011, both times by 0.25 percentage points. It also adopted a number of additional non-standard measures to improve the functioning of the monetary policy transmission mechanism. These included a temporary increase in purchases of government bonds via the Securities Markets Programme (SMP), the expansion of the range of liquidity-injecting instruments and the execution of 3-year longer-term refinancing operations in December 2011 and February 2012. The Bank of England, which has maintained its key interest rate at 0.50% since March 2009, implemented additional measures to stimulate the economy in February in the total amount of GBP 325 billion. Owing to the rise in the value of the Japanese yen, the Bank of Japan also increased the value of purchases of government securities in February 2012 to approximately JPY 65 trillion. It also set an inflation target of 1% growth in the CPI. The US Federal Reserve (the Fed) has not changed its key interest rate since December 2008, and is expected to maintain the rate in the interval between zero and 0.25% until at least 2014.

Due to uncertainty regarding assistance to Greece and less favourable forecasts of economic growth, premiums on the sovereign debt of certain euro area countries temporarily reached record levels at the end of 2011. The required yields on the bonds of Portugal, Spain, Italy and Slovenia rose sharply at the end of 2011. At the same time, rating agencies further downgraded a number of euro area countries and banks. In cooperation with the IMF and ECB, the EU approved assistance to Greece in February 2012. Uncertainty on the markets diminished as a result, which led to a decline in required yields on bonds. In March EU leaders, with the exception of the Czech Republic and the United Kingdom, signed a treaty to limit budget deficits. The aforementioned treaty must be ratified by the parliaments of individual countries.

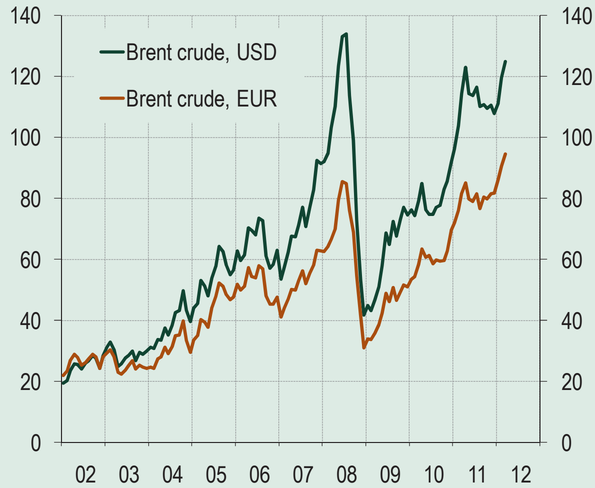
The euro fell against the US dollar from August 2011 to January 2012, when it began to rise again. Declining GDP growth in the euro area in the second half of last year and uncertainty regarding assistance to Greece at the beginning of 2012 resulted in the euro's fall against the US dollar. The euro subsequently strengthened again, averaging USD 1.32 in March 2012, slightly below the average recorded in the final quarter of last year.

The prices of oil and other commodities had fallen since last April due to the worsening economic situation, but began to rise again in the first quarter of 2012 primarily owing to geopolitical tensions. Among commodities, oil prices in particular rose in the first quarter owing to political pressures on Iran. The price of a barrel of Brent crude reached USD 124.90 in March, an increase of 9.2% on March last year. As a result of the euro's fall against the US dollar, the price of a barrel of oil expressed in euros surged by more than 15% in the same period. Commodity prices also rose quarterly the first quarter of this year. Year-on-year growth, however,

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

Sources: ECB, Federal Reserve.

Figure 1.5: Oil prices per barrel



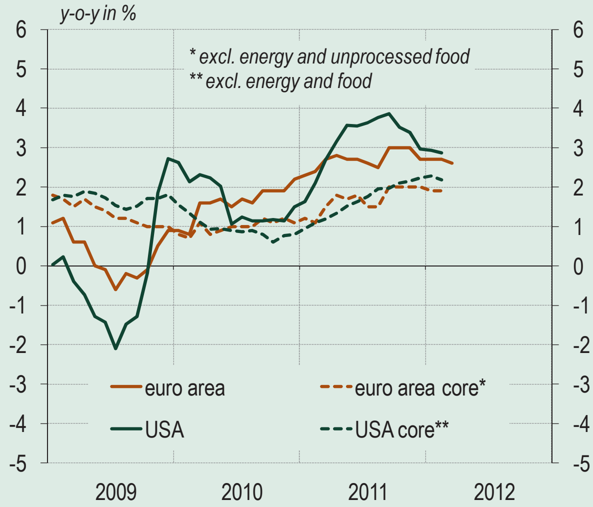
Sources: Bloomberg, ECB, Bank of Slovenia calculations.

remained negative due to a strong base effect. Precious metal prices fell during the first quarter of 2012 owing to a slight easing of uncertainty on the financial markets.

Inflation

Inflation was down at the beginning of 2012 owing to a decline in the contribution made by energy prices, while core inflation was virtually unchanged. Year-on-year growth in the HICP was 2.6% in the euro area in March, down 0.1 percentage points on February. The contribution made by energy prices fell in the final quarter of 2011, and amounted to 1 percentage point in February. Year-on-year growth in energy prices was down at the end of last year in the US, where growth in the CPI reached 2.9% in February. Core inflation in the euro area as measured by growth in the HICP excluding energy and unprocessed food stood at 1.9% in year-on-year terms in February. Core inflation in the US as measured by the CPI excluding energy and food stood at 2.1% in February.

Figure 1.6: Inflation



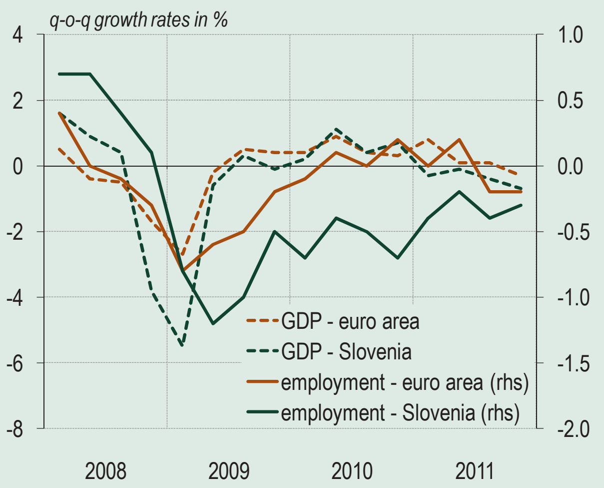
Sources: Eurostat, U.S. Department of Labor.

2 Economic Trends and the Labour Market

GDP in Slovenia declined by 0.2% last year, while working days adjusted data point to an increase by the same amount. The economic situation deteriorated primarily due to the spread of the crisis to the majority of domestic demand factors. Growth in exports slowed throughout the year, but the contribution made by net trade was again noticeable, as a result of the decline in domestic demand. The decline in construction investment and the crisis in the construction sector deepened further, and remain the main drag on economic activity. Growth in investment in machinery and equipment remained high. The decline in final consumption was the result of lower consumption of households, and also of the government sector, and was pronounced at the end of the year, when the real decline in wages also accelerated. In the final quarter, value-added in the majority of branches of the private sector that depend primarily on domestic demand declined as well. The contribution to GDP growth made by export activities declined in the second half of the year as a result of deteriorating conditions in the international environment. Growth in value-added in industry was down sharply last year and was primarily the result of a carry-over effect from the end of 2010. Despite the renewed deterioration in the economic situation, the fall in employment and rise in the number of unemployed slowed throughout the year. There was an increase in the number of job vacancies compared with previous years, while the number of new hires was also up for the first time since 2008. Declining employment at the end of 2010 in anticipation of new pension legislation resulted in a temporary rise in unemployment. Despite subdued wage growth, unit labour costs in the total economy have remained at the elevated levels recorded at the end of 2008 and in early 2009. The labour market is still adjusting primarily through contraction in employment, and less so by means of an appropriate adjustment in labour costs, the burden of adjustment thereby mostly falling on those who have lost their jobs.

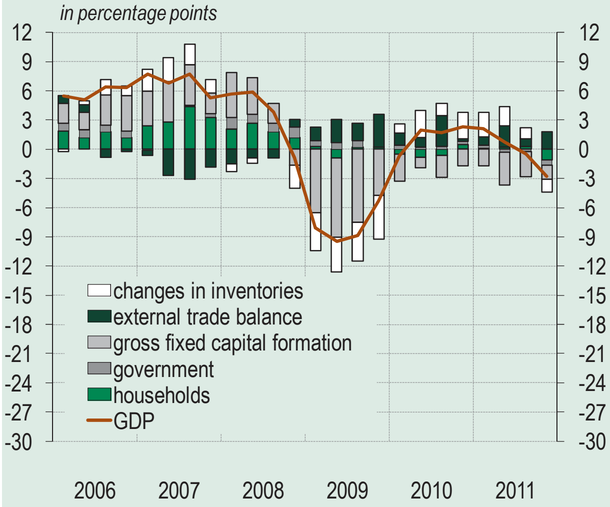
The gap by which growth in economic activity lags behind average euro area growth widened further last year, as the crisis in domestic demand deepened. GDP fell by 0.2% in Slovenia, but rose in the euro area by 1.4%. Economic activity declined throughout the year, while growth was still relatively favourable in the euro area in the first half of the year. The main factor in the lower economic growth in Slovenia remains a sharp decline in construction investment, and thus construction, which was again among the sharpest declines recorded by euro area countries. According to rough estimates, economic growth in Slovenia, excluding construction activity, would stand at around 1% in 2011. Final government consumption declined on average for the first time last year as a result of fiscal austerity measures, while final household consumption was also down sharply at

Figure 2.1: GDP and employment



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

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



Source: SORS.

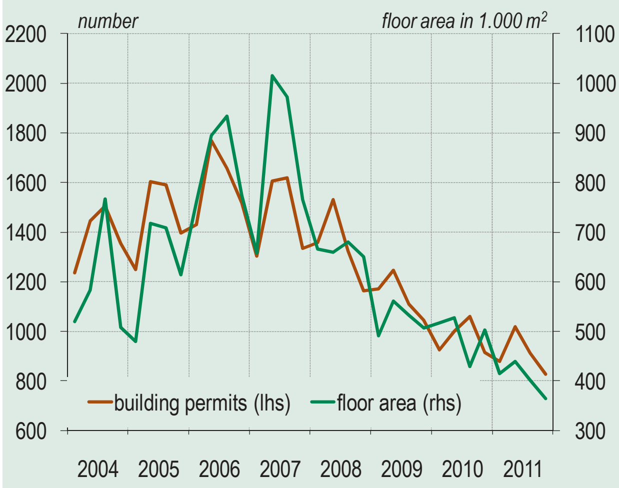
the end of the year in the context of diminishing consumer purchasing power. Final consumption was up last year in the euro area. Real growth in exports slowed in line with slowing economic growth in the most important trading partners, and was slightly higher on average than growth in exports in the euro area. The export sector remains the main driver of economic growth, which is to a great extent dependent on conditions in the international environment.

Aggregate demand

Alongside the contraction in investment and household consumption, the decline in final government consumption also contributed to the deepening of the crisis in domestic demand. Domestic consumption was down 1.5% last year. The situation deteriorated in the final quarter in particular, when the contribution made by inventories to GDP growth turned negative, in addition to other factors of consumption. The decline in construction investment accelerated further to average 25% during the year in the context of difficulties in financing, savings in public investment expenditure and declining demand on the real estate market. At the same time, growth in investment in machinery and equipment was higher than in 2010, despite lower growth in foreign demand. The decline in final household consumption, which is gradual given the situation on the labour market, continued. The contribution to GDP growth made by final government consumption turned negative at the end of the year due to austerity measures.

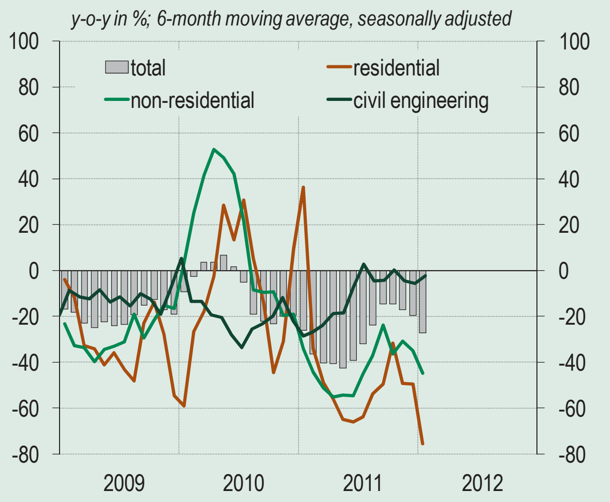
After stagnating in 2010, gross investment was down sharply again last year owing to the accelerated contraction in construction investment. The latter has been declining since the third quarter of 2008. The con-

Figure 2.3: Issued building permits and corresponding floor area



Source: SORS.

Figure 2.4: Real value of new contracts in construction



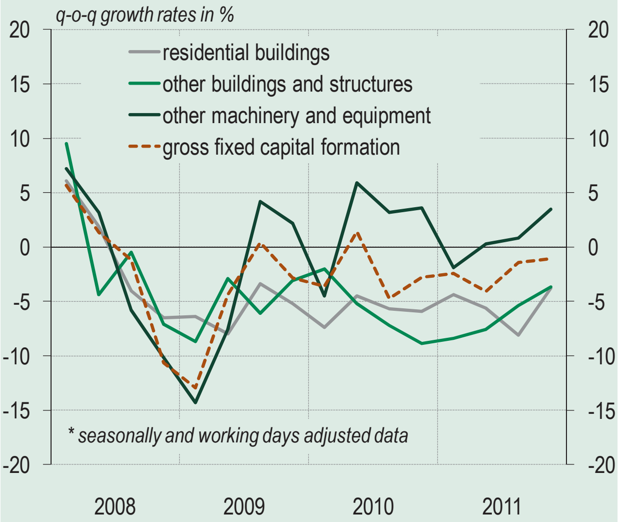
Sources: SORS, Bank of Slovenia calculations.

Figure 2.5: New dwellings

Sources: SORS, Bank of Slovenia calculations.

traction in investment in housing and other buildings and structures accelerated compared with 2010. Construction investment as a proportion of GDP fell to 9% last year, down 5 percentage points on the average for the 2000 to 2008 period and 2 percentage points lower than last year's euro area average. Insufficient demand remained the main limiting factor for construction firms, while the proportion of firms faced with such limitations rose again in the first quarter of this year. The decline in the value of new construction contracts, which last year exceeded

Figure 2.6: Gross fixed capital formation



Sources: SORS, Bank of Slovenia calculations.

30%, and the continuing decline in the number of building permits and the corresponding floor area are also reflections of declining demand. According to SORS figures, the prices of new dwellings continue to rise in contradiction to diminishing consumer purchasing power, which is difficult to explain given the excess supply on the housing market. At the same time, the number of transactions in new dwellings was down sharply last year. Stocks of unsold new dwellings will thus remain high, which is dampening new investment in residential construction. Public investment linked to construction was down around a quarter last year, while opportunities to increase such expenditure will continue to be extremely limited in the future due to the need for fiscal consolidation.

Quarterly growth in investment in machinery and equipment accelerated during the second half of last year, despite weak foreign demand and deteriorating financing conditions. Total investment in transportation equipment was up by slightly less than 8% in the final quarter relative to the previous quarter, while investment in other equipment and machinery was up 3.5%. Investment in machinery and equipment rose by 7.0% for the year overall, an increase of 2.7 percentage points on the growth recorded in 2010. This is relatively high given the level of production capacity utilisation and the current stagnation in output. Survey data for last year indicated relatively high growth in investment in machinery and equipment. Survey data for this year points to a significant decline in growth in investment in industry, which will be earmarked for the replacement of old equipment to an even greater extent than last year.

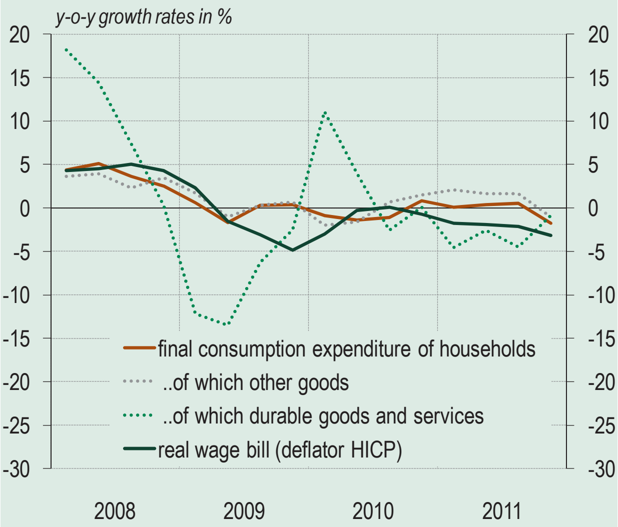
The contribution of the change in inventories to year-on-year growth in GDP turned negative in the final quarter of last year. Following a sharp decline in 2009, inventories were renewed until the third quarter of 2011. In the final quarter of last year, the contribution of inventories to GDP growth turned negative. The reversal in the movement of inventories coincides with diminishing confidence and expectations regarding developments on foreign markets, and with the rising costs of financing inventories. In 2011, the contribution of inventories to GDP growth averaged more than 1 percentage point.

Final household consumption fell 0.2% last year. This was entirely due to the decline in the fourth quarter, when the year-on-year contraction in household consumption was 1.8%. In addition to durables, consumption of other goods was also down in year-on-year terms in the final quarter of the year. The decline in household consumption was also reflected in the second half of the year in the volume turnover of numerous retail segments and in a sharp decline in imports of travel services. Consumer confidence remains low, and is virtually unchanged since the second half of 2009, while the major purchases suitability indicator also remains extremely low. The cautiousness of consumers is a reflection of diminishing consumer purchasing power as a result of declining employment, real wages and social transfers, and increased job insecurity. A fall in the value of financial investments also had a negative impact on household consumption last year.

Owing to fiscal consolidation measures, the contribution of final government consumption to GDP growth was negative on average for the first time last year. Final government consumption was down by just under 1% and contributed 0.2 percentage points to the decline in economic growth. In line with measures to reduce deficit, the decline in the real wage bill in the public sector continued last year, while expenditure on goods and services was down 2.8% according to the consolidated general government position figures.

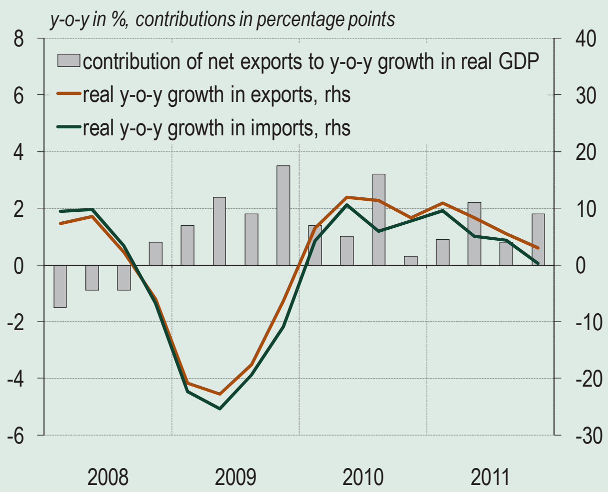
Last year's relatively high contribution to GDP growth by net trade was primarily the result of weak domestic demand. The figure stood at 1.4 percentage points, comparable with 2010. Growth in foreign trade slowed during the year in line with economic growth in the

Figure 2.7: Household consumption and real wage bill



Sources: SORS, Bank of Slovenia calculations.

Figure 2.8: Foreign trade



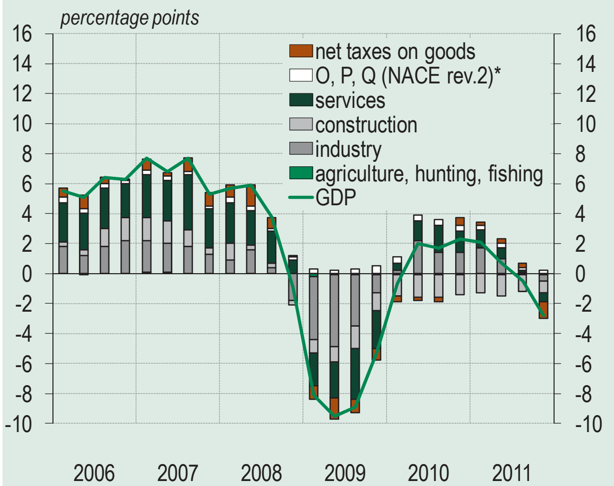
Source: SORS - national accounts.

EU. At 6.8%, growth in exports outstripped growth in imports by an average of around 2 percentage points owing to low domestic consumption. Low domestic consumption was primarily reflected in imports of services, which fell by 1.2% last year, most notably in the final quarter. According to balance of payments figures, travel abroad recorded the sharpest decline last year, of more than a tenth.

Supply side

The manufacturing sector made the most significant contribution to value-added again last year. With an increase in value-added of 3.1%, manufacturing contributed 0.5 percentage points to GDP growth, down 0.7 percentage points on 2010. High year-on-year growth in the first half of the year was the main factor in the increase in value-added. Business conditions in the manufacturing sector deteriorated in the second half of the year owing to the decline in confidence and activity in the most important trading partners. Manufacturing activity was down in the third quarter relative to the previous quarter and stagnated in the final quarter. Last year's increase in production was thus primarily the result of a pass-through of high activity from the end of 2010. Unfavourable trends in the second half of 2011 are reflected in less favourable indicators of production capacity utilisation, a lack of demand and declining confidence.

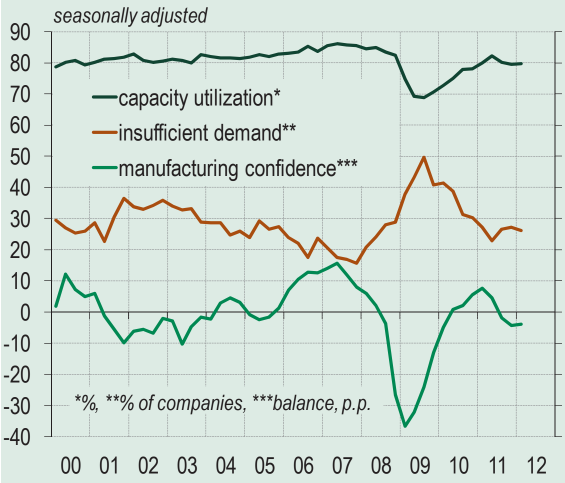
Figure 2.9: Contributions to y-o-y GDP growth, production side



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

Indicators of new orders and economic sentiment from early 2012 still do not indicate any visible signs of improvement. Indicators of current orders improved slightly at the beginning of 2012, while indicators of expected orders stagnated and remain at the level reached at the end of 2009. The economic sentiment indicator in the euro area fell for the most part last year, but rose slightly at the beginning of 2012. Its value nevertheless remains below the long-term average, meaning that the

Figure 2.10: Business trends in manufacturing



Source: European Commission.

Figure 2.11: Survey indicators of current and expected demand in manufacturing

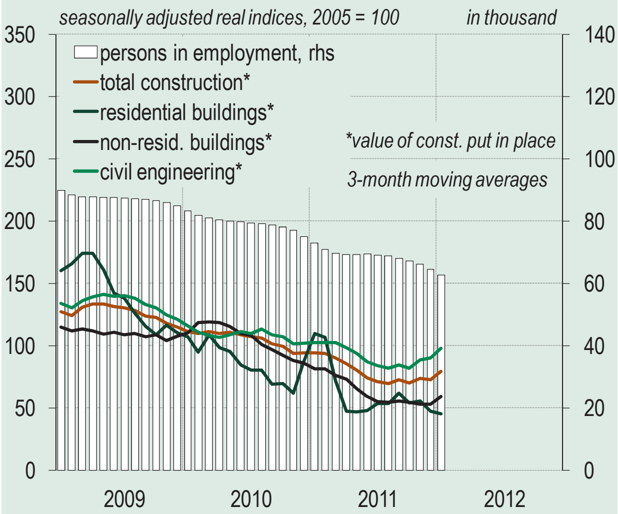
Source: SORS, Eurostat.

outlook for 2012 regarding activity in export-oriented manufacturing sectors is currently not the most favourable.

The continuing contraction in value-added in the construction sector contributed 1.2 percentage points to last year's decline in overall economic growth. Value-added in the construction sector has been declining since the end of 2008. However, the pace of contraction in quarterly terms slowed slightly in the second half of last year. Value-added was down by more than a fifth in year-on-year terms last year, while the value of construction put in place was down by more than a quarter, just over 8 percentage points more than in 2010. Activity in the main segments of construction recorded the sharpest decline in the second quarter last year, while the decline slowed significantly in the second half of the year. Civil engineering work actually began to record growth in the final quarter. The high year-on-year decline in the real value of construction put in place was partly attributable to the base effect from the construction of a major sports-commercial complex in the first half of 2010, and partly to the collapse of certain major construction firms in 2011, which had an adverse impact on their subcontractors.

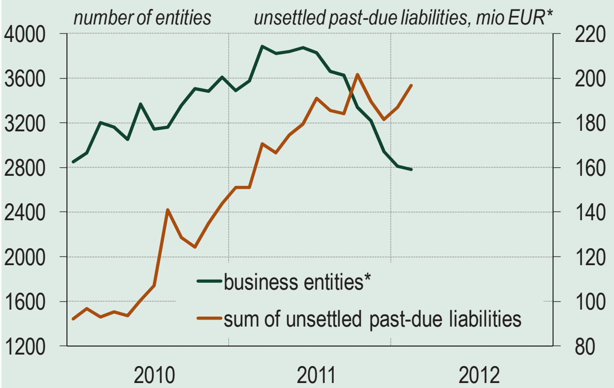
The majority of indicators still do not indicate any improvement of the situation in the construction sector. The number of firms in the construction sector with unsettled past-due liabilities[1] mostly rose until the middle of last year, and then began to decline in line with a decline in the number of firms from this sector registered in the Business Register of Slovenia. A total of 2,943 construction firms had unsettled past-due liabilities at the end of last year, representing 13.9% of all business entities in the construction sector. Despite last year's decline, the proportion of these firms and the amount of their liabilities remain the highest of all sectors. Confidence also remains lowest in the construction sector, despite a gradual increase in the value of the confidence indicator over the last year. The proportion of firms from the construction sector that face difficulties in raising loans and high borrowing costs has also begun to rise again in recent months.

Figure 2.12: Construction



Sources: SORS, Bank of Slovenia calculations.

Figure 2.13: Construction – insolvency of business entities



Source: AJPES, Bank of Slovenia calculations.
Note: *Legal entities, sole traders and other persons performing registered activities with unsettled past-due liabilities from court enforcement orders and from tax debts of more than five days uninterrupted excluding other unsettled past-due liabilities from unpaid invoices between creditors and debtors.

Value-added in the financial and insurance activities sector was up slightly last year. Growth stood at 0.3%, down nearly 5 percentage points on the previous year, and was again driven by growth in the insurance industry, where an increase of almost 8% was recorded. Growth was particularly high at the beginning of the year, but

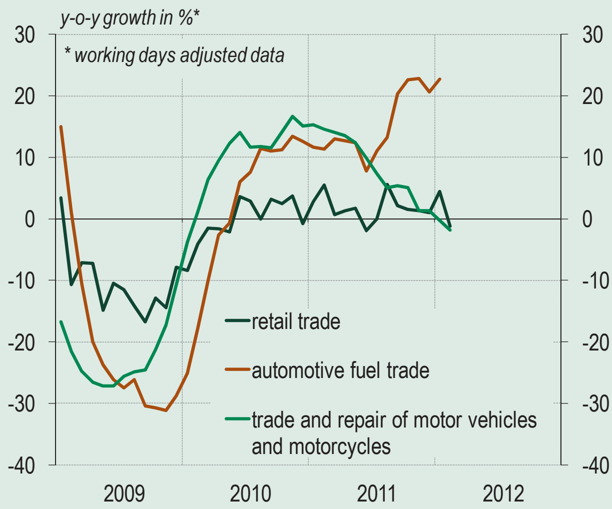
[1] Legal entities, sole traders and other individuals who pursue a registered activity with unsettled past-due liabilities from court enforcement orders and from tax debts of more than five days uninterrupted excluding other unsettled past-due liabilities from unpaid invoices between creditors and debtors. Source: AJPES.

later slowed. Value-added in financial activities was down last year. One factor in the decline was the performance of the banking sector, which generated a loss, primarily as a result of higher impairment and provisioning costs.

Year-on-year growth in value-added in the sectors of wholesale and retail trade, transportation and storage, and accommodation and food service activities declined last year, and turned negative in the final quarter. Growth in value-added averaged 1.2%, down a half on the the previous year. The highest growth in value turnover was recorded by services primarily dependent on foreign demand. Value turnover in the transportation and storage sector rose by around a tenth last year, although the year-on-year rate of growth declined gradually in line with the slowdown in industrial activity and activity in the international environment. The increase in the number of arrivals by foreign visitors also had a favourable impact on value turnover in accommodation and food service activities. Year-on-year growth amounted to around 5% until the final quarter of last year. Value turnover declined slightly in year-on-year terms in the final quarter, which was a result of a further decline in consumer purchasing power as measured by movement in the real wage bill. This was also reflected in a decline in volume turnover in some segments of the wholesale and retail trade sector.

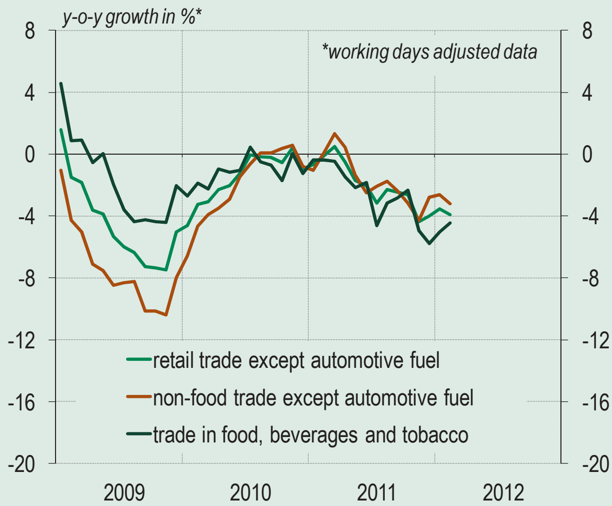
Total volume turnover in the retail sector and in trade in motor vehicles was up last year, although year-on-year growth fell gradually during the year. Total real volume turnover in wholesale and retail trade was up 3.5% last year, but only as a result of growth in volume turnover in trade in motor vehicles and fuels. Volume turnover in retail trade excluding motor fuels was down by more than 2%. As a result of the greater income elasticity of demand, the deterioration in the situation on the labour market was first reflected in a decline in volume turnover in trade in non-food products. The continuing decline in consumer purchasing power later began to have a more profound impact on volume turnover in trade in food products, beverages and tobacco products. The aforementioned products recorded their sharpest decline in the final quarter of last year, which was reflected in a fall in final household consumption during the same period. Volume turnover in the trade and repair of motor vehicles rose by slightly less 8%. However, the situation in this segment of trade also deteriorated during the year, as real year-on-year growth in sales fell sharply, from more than 14% in the first quarter to slightly more than 1% in the final quarter.

Figure 2.14: Volume turnover in trade



Sources: SORS, Bank of Slovenia calculations.

Figure 2.15: Volume turnover in trade, excluding vehicles and fuel



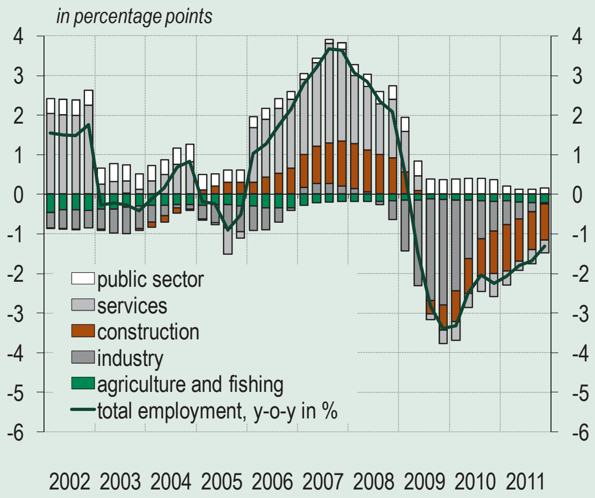
Sources: SORS, Bank of Slovenia calculations.

Labour market

Employment contracted at a slower pace last year, despite the deterioration of the economic situation during the second half of the year. Total employment, which comprises employees and self-employed persons, was down 1.7% on 2010. The number of employees fell by 2.1% on average in 2011, while there was low year-on-year growth in the number of self-employed persons, which averaged 0.2% in 2011. The number of self-employed persons had begun falling in year-on-year terms by the final quarter of 2011. In the context of these developments, employment in 2011, similar to real value-added, was close to the level recorded in 2006. According to figures from the national accounts, there were more than 942,000 people employed on average in 2011.

Employment contracted in year-on-year terms in the majority of branches of the private sector during the second half of 2011. The year-on-year fall in employment was lower in industry, and in the sectors of wholesale and retail trade, accommodation and food services and transportation. The fall in employment has slowed in the construction sector, where it was again highest among all sectors. The number of employees in the construction sector was down nearly 12% on 2010, thus further increasing the contribution of construction to the overall contraction in employment. The contraction in employment in the construction sector in 2011 was also followed by an accelerated decline in employment in real estate activities. Following three quarters of year-on-year growth in employment in information and communication activities and two quarters of year-on-year growth in financial and insurance activities, employment declined during the second half of 2011. Thus, only professional, scientific and technical activities and other service activities recorded growth in the number of employees during the second half of 2011. Year-on-year growth for the year overall slowed in the aforementioned activities to average 1.6%.

Figure 2.16: Contributions to employment growth



Sources: SORS - national accounts, Bank of Slovenia calculations.

Table 2.1: Employment

	2007	2008	2009	2010	2011	*4Q10*	*1Q11*	*2Q11*	*3Q11*	*4Q11*
	average annual growth in %					*y-o-y growth in %*				
A Agriculture, forestry and fishing	-2.4	-2.1	-1.8	-2.0	-2.4	*-2.3*	*-2.1*	*-2.3*	*-2.6*	*-2.6*
BCDE Industry	0.8	-0.3	-8.7	-5.9	-1.4	*-3.3*	*-2.6*	*-1.9*	*-1.1*	*-0.1*
F Construction	12.8	12.1	-0.9	-9.9	-12.0	*-11.7*	*-13.3*	*-12.4*	*-11.3*	*-11.1*
GHI Trade, accommodation, transport	3.9	3.9	0.1	-2.9	-1.9	*-3.4*	*-3.0*	*-2.0*	*-1.7*	*-1.1*
J Information and communication	7.5	5.8	4.0	-0.1	0.1	*0.8*	*1.6*	*0.4*	*-0.4*	*-1.2*
K Financial and insurance activities	3.6	4.5	1.8	-1.2	-0.4	*0.0*	*2.0*	*1.6*	*-2.0*	*-3.2*
L Real estate activities	11.4	11.8	4.3	-4.1	-4.3	*-3.7*	*-1.9*	*-3.8*	*-3.8*	*-7.7*
MN Professional, technical and other business activities	9.4	2.5	-0.5	1.7	1.6	*1.1*	*2.5*	*2.1*	*1.1*	*1.0*
OPQ Public administration and defence; education, health	0.7	1.9	2.2	2.2	0.8	*2.1*	*1.2*	*0.7*	*0.6*	*0.9*
RSTU Other activities	3.6	4.3	3.1	1.3	-1.6	*0.3*	*-1.5*	*-1.8*	*-1.5*	*-1.5*
TOTAL	3.3	2.6	-1.8	-2.5	-1.7	*-2.3*	*-2.1*	*-1.8*	*-1.7*	*-1.3*

Sources: SORS – national accounts, Bank of Slovenia calculations.

Contrary to government plans, employment in the public sector was up 0.8% in 2011. Growth in public sector employment in 2011 was down 1.4 percentage points on the previous year, although employment rose for the year overall. Nevertheless, monthly figures from the SORS, which are not entirely comparable with figures from the national accounts, indicate that employment in public administration and culture was down 1.3% and 2.3% respectively. Employment was up in the education and health sectors, by 1.8% and 1.7% respectively.

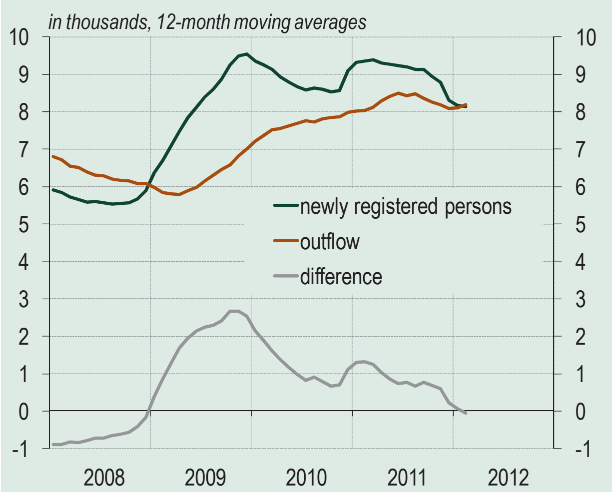
With the exception of the final quarter, demand for labour as measured by the number of hours worked was down in 2011. The number of hours worked in the private sector is generally a better reflection of short-term changes in demand for labour than employment, as employers are more flexible in changing the number of hours worked than in hiring or firing workers. According to figures from the national accounts adjusted for the season and the number of working days, the number of hours worked was down 1.5% on 2010. The decline in the number of hours worked slowed by approximately 1 percentage point relative to the previous two years. The number of hours worked in 2011 was up 0.6% on average in information and communication activities and by 1.1% in professional, scientific and technical activities and other service activities. The number of actual hours worked fell in the majority of branches of the private sector over the first three quarters of the year. With the exception of the sectors of construction, real estate activities and wholesale and retail trade, the number of actual hours worked was up slightly in current and year-on-year terms in the final quarter of 2011 in the private sector and not in line with the contraction in economic activity during the same period.

The number of vacancies rose on average last year, although the number declined again in the second half of the year. The number of new hires was also up for the first time since 2008. The average number of notified vacancies exceeded 16,000 in 2011, close to levels seen prior to the period of high economic growth from 2006 to 2008. The number of vacancies was up 11.4% on 2010. Growth, however, slowed again gradually and had turned negative in year-on-year terms by the final quarter. The number of notified vacancies was also down 2.7% in year-on-year terms during the first two months of this year. The number of notified vacancies for both permanent and temporary employment was up last year, although the number for temporary employment was significantly higher, while the number for permanent employment remained below the long-term average. In

Figure 2.17: Long-term unemployed persons

Sources: Employment Service of Slovenia, Bank of Slovenia calculations.

Figure 2.18: Newly registered unemployed persons and outflow from registered unemployment



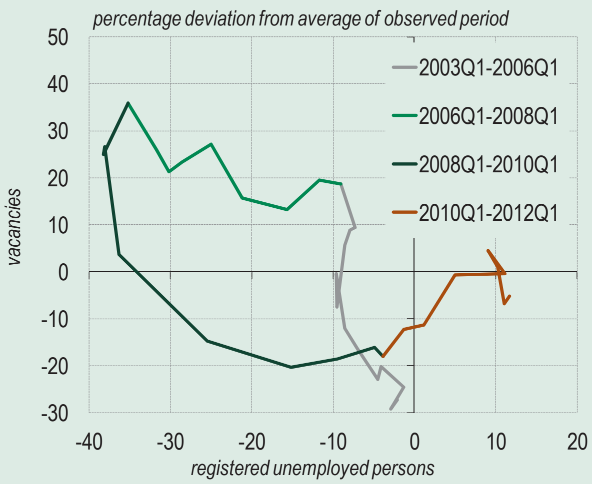
Sources: Employment Service of Slovenia, Bank of Slovenia calculations.

Box 2.1: The Beveridge curve and the labour market

The situation on the labour market can be analysed using the Beveridge curve, which illustrates the link between the number of unemployed and the number of vacancies. This link is generally negative, while there are several explanations for the position of the Beveridge curve with respect to the origin. The most frequent interpretation is that it represents changes in the matching efficiency. This process is dependent on whether or not the structure of vacancies matches the structure of the unemployed according to different properties. The Beveridge curve shifts towards the origin as these two structures become similar, and away from the origin as differences between the structures increase. When that occurs, it becomes more likely that unemployment will be structural and longer-term in nature.

The Beveridge curve for Slovenia is shown in the figure. The number of unemployed and the number of vacancies are shown as a *percentage deviation from the average* of each time series during the observation period.[1] During a period of accelerated economic growth, the number of vacancies is typically high, while the number of unemployed is low, which is why the economy is located in the upper left-hand part of the figure. The opposite is true during a recession, when the economy shifts to the lower right-hand part of the figure. From that point of view, the Slovenian labour market quite closely follows the theory: during the period of high economic growth, Slovenia was in the upper left-hand part of the figure and shifted to the lower right-hand part of the figure during the worst recession.

Figure 1 : Beveridge curve



Sources: SORS, Bank of Slovenia calculations.

The Beveridge curve for Slovenia can be split into four periods. During the first period from 2003 to early 2006, Slovenia shifted up and only slightly to the left on the Beveridge curve. The number of vacancies in particular rose sharply, while the number of unemployed fell gradually. Following 2006 and until the middle of 2008, the number of vacancies remained high, but no longer increased as rapidly as in the previous period. A sharp decline in the number of unemployed began at the same time. These trends are in line with the interpretation that the efficiency of the matching of vacancies with job seekers improved during the same period, or that frictions on the labour market diminished, as an approximately equal number of vacancies in this period absorbed a larger number of unemployed persons. The Beveridge curve shifted to the left, where the relationship between the number of vacancies and the number of unemployed persons is more favourable.

The strongest shift in the Beveridge curve occurred between the middle of 2008 and the end of 2009, when the number of vacancies initially fell sharply without a simultaneous increase in the number of unemployed. This was followed by an extremely sharp rise in the number of unemployed in the context of a virtually unchanged and very low number of vacancies. A large arcing, anti-clockwise shift along the curve is characteristic of a period when an economy is hit by a negative shock in economic activity. The apparent shift in the curve towards the origin in this period is not the result of an increase in the matching efficiency. It occurred because in the changed conditions firms initially adjusted the number of vacancies and only then the number of employees. At least in the initial phase of the economic slowdown, firms attempted to retain workers.[2] When the slowdown continued, they began to release workers, which was followed by bankruptcies.

In the most recent period since the beginning of 2010, the labour market began to show signs of a recovery, as the number of vacancies began to rise again and towards the end of 2010 and in 2011 reached the average level in the observation period. This might signal that the labour market is reallocating the workforce, not only by releasing workers, but also by hiring. The number of new hires also rose. The number of vacancies declined again in the second half of 2011 and in early 2012, but not to the extent seen at the end of 2008. Nevertheless, the return of the number of vacancies to the average level of the observation period has not yet had a significant effect on the number of unemployed, which indicates that the mismatch in the structure of vacancies and the structure of unemployed persons has increased since the beginning of 2010. This could be a sign that it is necessary to reduce unemployment by appropriately changing the qualifications structure of the unemployed.

[1] Shimer (2007) shows the Beveridge curve as a shift from the very long-term trend. Since Slovenia's very long-term trend is nearly constant, the differences between the two methods of presentation are minimal and have no effect on the interpretation.

[2] Government measures for the partial subsidisation of full-time work hours and the partial reimbursement of wage compensation were in force from January 2009 until the end September 2010 and from June 2009 until the end of March 2011, respectively.

conjunction with growth in notified vacancies last year and during the first two months of 2012, the number of new hires was also up in year-on-year terms, in particular since September. The number of new hires was up around 14% on average last year and during the first two months of this year compared with 2010, while the average number of new hires from September 2011 to February 2012 was close to the level recorded prior to the period of high growth. The breakdown of employment by temporary and permanent work is in line with the breakdown of vacancies.

The number of registered unemployed has risen at a slower pace than in the previous two years since August 2011. The number of registered unemployed rose by around 7.5% between September 2011 and February 2012, from 107,000 to nearly 115,000. The number of unemployed increased most in October 2011 and January 2012 as a result of seasonal factors. An increased number of persons whose student status expired registered with the Employment Service in October, although the seasonal influx was significantly smaller than in the previous two years. January's increased inflow into unemployment was the result of expiring temporary employment contracts, although the inflow was less than that recorded in January 2011. Despite an increase in the number of registered unemployed, the gap between the number of newly registered unemployed and the number deregistering from unemployment has narrowed since the beginning of 2011, while the number of long-term unemployed continues to rise. That figure reached 50% of all registered unemployed during the first two months of 2012. In the context of these movements, the registered unemployment rate rose by 0.5 percentage points between last September and this January to stand at 12.5%.

Inflows into unemployment due to the loss of temporary employment recorded the sharpest increase last year relative to 2010. The number of people who registered with the Employment Service due to expiring temporary employment contracts was up around 11% on average last year. There was also a sharper increase in the number of newly registered unemployed due to bankruptcies, the monthly average having reached 650, an increase of 100 compared with 2010. Inflows were up primarily during the first half of the year, followed by a decline. The number of deregistrations was up, particularly during the first half of 2011, driven in part by outflows to employment and by outflows from unemployment into non-activity. That figure has risen since the beginning of 2011. Contributing significantly to this, in addition to the likely stricter handling of persons registered with employment services, were outflows of the unemployed into retirement, the number of which was up 30% on 2010. The number of deregistrations has fallen since September due to fewer outflows into employment.

The year-on-year decline in the workforce in employment slowed over throughout last year. The workforce in employment contracted by just over 11,000 people relative to 2010, down nearly one half on the previous two years. The difference between the fall in the workforce in employment and the rise in the number of registered unemployed, which averaged just under 9,000 in 2010, fell to slightly less than 900 in 2011. The more significant contraction in the workforce in employment from the outbreak of the crisis until the end of 2010 was partly the result of a fall in the number of foreign workers. The total number of valid work permits fell by around 17,000 between the peak of the economic cycle in the middle of 2008 and the end of 2010, which roughly corresponds to the difference between the fall in the workforce in employment and the rise in the number of registered unemployed. A change in legislation governing the employment and work of foreign workers from April 2011, according to which most non-residents have free access to the labour market, was also a likely contributing factor to the narrowing of the aforementioned difference.

In addition to the fall in employment, the private sector is adjusting to the decline in economic activity by lowering growth in the average gross wage per employee. Average year-on-year growth in the gross wage per employee in the private sector declined throughout 2011, the rate averaging 1.6% in the fourth quarter. The continuing fall in employment and the curbing of wage growth are also reflected in the nominal wage bill, which

Figure 2.19: Total wage bill and average monthly gross wage

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

Table 2.2: Labour cost indicators

	2007	2008	2009	2010	2011	4Q10	1Q11	2Q11	3Q11	4Q11
	nominal year-on-year growth, %									
Gross wage	5.9	8.3	3.5	3.9	2.0	3.3	3.1	2.0	1.7	1.1
Gross wage in the private sector	6.8	7.9	1.8	5.1	2.7	4.4	3.9	2.9	2.6	1.6
Gross wage in the public sector[1]	4.0	9.8	6.6	0.0	-0.1	0.1	0.4	-0.1	-0.4	-0.1
Gross wage in manufacturing	6.9	7.6	0.9	8.9	3.9	6.8	5.4	3.6	3.5	3.1
Labour costs per hour worked[2]	4.5	9.1	3.6	1.2	2.0	2.8	2.1	2.7	2.5	0.8
Labour costs per hour worked in manufacturing[2]	5.2	10.5	5.7	3.1	1.9	4.4	1.9	3.2	0.1	2.5
Gross wage per unit of output[3]	2.4	7.3	10.4	-0.1	0.4	-1.3	-1.1	-0.5	0.6	2.7
Gross wage in manufacturing per unit of output[3]	-0.5	6.8	10.0	-5.1	-0.7	-3.9	-6.6	-3.5	2.0	5.5
Unit labour costs[3,4]	2.6	6.2	8.7	0.3	0.4	-0.7	-1.0	-0.1	0.4	2.4
Labour costs per employee[4]	6.1	7.2	1.9	4.3	2.0	3.9	3.2	2.4	1.5	0.9
Output per employee	3.4	1.0	-6.3	4.0	1.6	4.7	4.3	2.5	1.2	-1.5
Output per employee (manufacturing)	7.5	0.7	-8.3	14.7	4.6	11.2	12.9	7.4	1.4	-2.2
HICP	3.8	5.5	0.9	2.1	2.1	2.0	2.2	2.0	1.5	2.6
GDP deflator	4.2	4.1	3.0	-1.1	0.8	-1.7	0.5	0.4	0.6	1.8

1 Public administration, education, health and culture according to NACE rev. 2.
2 Labour costs according to SORS calculations.
3 Unit of output for the total economy is defined as real GDP per person employed, and in manufacturing as real value added per person employed (both based on national accounts).
4 Labour costs calculated on the basis of employee compensation (national accounts).
Sources: SORS; Bank of Slovenia calculations.

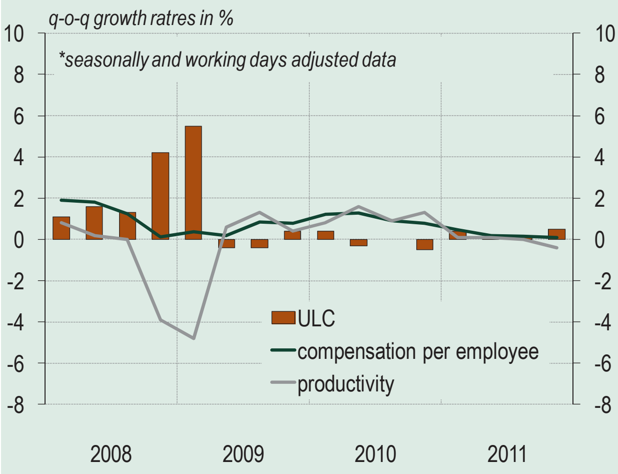
is the best reflection of corporate cost adjustments. The nominal wage bill in the private sector initially fell in year-on-year terms from the second quarter of 2011, with the decline averaging 0.2% for the year.

The average nominal gross wage per employee in the public sector stagnated again in 2011. The average gross wage in the public sector remained almost unchanged owing to austerity measures adopted by the government during the crisis. The average wage per employee in the public sector according to the standard classification of activities[2] was down 0.1% in year-on-year terms, but was unchanged in the institutional government sector[3] relative to 2010. The rise in the nominal wage bill in the public sector by 0.3% was the result of additional employment.

Labour productivity in the total economy has barely reached the pre-crisis level, despite the decline in employment. Rapid changes in labour productivity are primarily a result of changes in economic activity, to which the labour market does not immediately adapt. This is particularly true in uncertain conditions, when firms are more reserved in response to short-term changes in economic activity. The current decline in productivity in the total economy at the end of 2011 of 0.4% is thus primarily a result of the decline in economic activity in the final quarter of 2011. This is most pronounced in industry, where the decline in labour productivity in the second half of the year virtually wiped out the increase in the first half of the year. Labour productivity in industry has been above the level recorded in 2008 since the middle of 2010, as this sector has adjusted employment significantly to declining activity. If the decline in activity in industry at the end of 2011 is more sustained, there will also be increased pressure on employment, and the current stagnation in employment in this sector could turn into a decline. In terms of productivity by sectors, the sharpest decline in 2011 was again recorded in construction. Labour productivity in the total economy had nearly reached the pre-crisis level by the beginning of 2011, but then stagnated during the year.

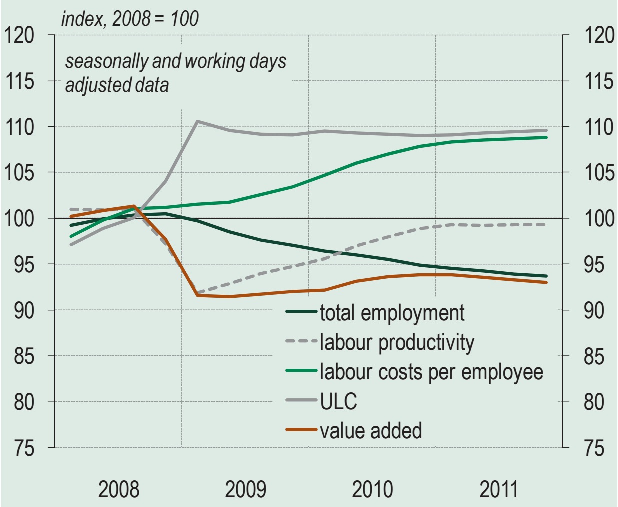
Despite the fall in employment, unit labour costs remain similar to the level recorded in 2009. Unit labour costs in the total economy were up 0.4% in 2011. Unit

Figure 2.20: Productivity, ULC, compensation per employee - total economy, Slovenia



Sources: Eurostat, Bank of Slovenia calculations.

Figure 2.21: Labour cost adjustment in total economy



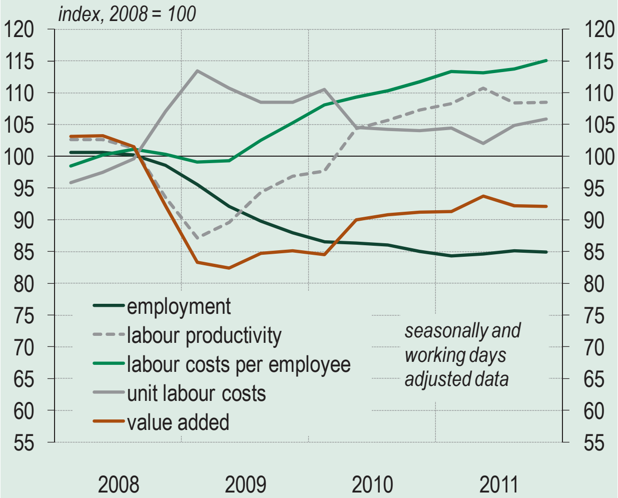
Sources: Eurostat, Bank of Slovenia calculations.

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

Figure 2.22: Labour cost adjustment - public sector*

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

Figure 2.23: Labour cost adjustment - industry*



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

labour costs in industry stagnated in the first half of 2011, and began to rise again in the second half of the year primarily due to the contraction in activity and, consequently, in productivity. Annual growth in unit labour costs in industry stood at 1.8%. Unit labour costs in the public sector have remained virtually at the level recorded in 2009, despite a 0.6% fall in 2011. The relatively high unit labour costs in the total economy since the end of 2008 and early 2009 have not declined, despite the fall in employment in the public sector. The stagnation in unit labour costs in the context of a decline in economic activity at the end of 2011 and growth in labour costs per employee in industry and in the total economy indicate that the majority of the cost adjustments are achieved by reducing the number of employees, and not by adjusting wages. This means that most of the burden of adjusting to the changing conditions has fallen on those who have lost their jobs.

3 Foreign Trade and Competitiveness Indicators

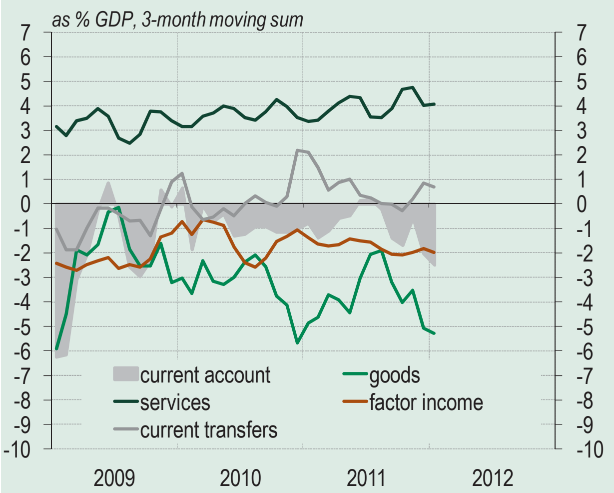
The current account deficit stood at 1.1% of GDP, up 0.3 GDP percentage points on 2010. The main factors in the widening of the deficit were the increase in the merchandise trade deficit and increased outflows of capital income. The increase in the surplus of trade in services and current transfers acted to reduce the deficit. Trade in services saw a slowdown in growth in imports and exports, particularly in travel services. Despite the doubling of the deficit in private transfers, the surplus in official transfers widened even further as a result of the high disbursement of EU funds. Growth in merchandise trade also slowed sharply in the second half of the year following the decline in growth in foreign demand in the second quarter, and also due to weaker domestic demand. The decline was more severe on the import side than on the export side. Nevertheless, the merchandise trade deficit widened by 0.3 percentage points to 3.7% of GDP. After deteriorating in 2008 and 2009, Slovenia's competitiveness indicators are gradually improving. Indicators of cost competitiveness in industry are fully comparable with those of Germany and Austria, indicating that the adjustment is slow primarily in sectors that are not exposed to international competition.

Foreign trade

The current account deficit widened slightly last year. Having narrowed to 0.8% of GDP in 2010, the deficit widened to 1.1% of GDP in 2011. Real growth in imports has lagged significantly behind growth in exports over the last two years, primarily due to falling domestic consumption. In the context of relatively high economic growth in the main trading partners, growth in merchandise trade remained high in the first quarter of last year, but has been falling since that time. The merchandise trade deficit widened by 0.3 percentage points in 2011 to 3.7% of GDP, primarily as a result of the unfavourable terms of trade. Also contributing to the current account deficit was the widening of the deficit in factor income, while the increase in the surpluses in trade in services and current transfers acted to reduce the deficit.

The merchandise trade deficit narrowed rapidly last year until the middle of the third quarter, and has been widening since then. The trend and year-on-year rates of growth in merchandise trade rose until the first quarter of last year as a result of favourable economic activity in the most important EU trading partners. Later, the escalating fiscal problems in certain euro area countries and uncertainty on the financial markets resulted in a slowdown in economic growth in the EU, which slowed growth in merchandise trade in the second half of the year. Merchandise exports were up 19.4% year-on-year during the first quarter of last year, while growth had slowed to 7.6% by the final quarter. The decline in year-on-year growth in imports was somewhat larger, from 21.3% in the first quarter to 5.8% in the final quarter. Last year's merchandise exports in the amount of EUR 20,687 million were up 12.5%, while merchandise imports of

Figure 3.1: Components of the current account



Sources: SORS, Bank of Slovenia.

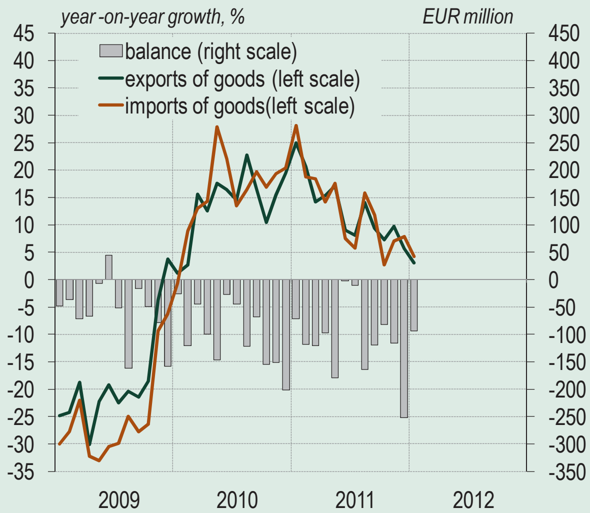
EUR 22,022 million were up 12.4%. Despite the somewhat faster growth in merchandise exports, the merchandise trade deficit widened by just over EUR 130 million in 2011 to EUR 1,335 million, or 3.7% of GDP.

The deterioration in the terms of merchandise trade continued last year, but to a lesser extent than in 2010. Driven by an accelerated decline in year-on-year growth in prices of energy, industrial commodities, metals and food, and the euro's rise against the US dollar, year-on-year growth in import prices fell throughout the year, from 9.7% in the first quarter to 3.9% in the final quarter. Import prices rose by an average of 6.2% in 2011, while export prices were up 4.5%. At 1.6%, the deterioration in the terms of trade was significantly smaller than in 2010, when they deteriorated by 4.7%, and contributed nearly a third or 1.1% of GDP to the merchandise trade deficit.

Growth in merchandise exports was also down after the second quarter as a result of declining foreign demand. The most notable slowdown was recorded by growth in exports of intermediate goods and capital goods. Year-on-year growth in exports of intermediate goods declined from 27.1% in the first quarter to 9.5% in the final quarter, but remained the highest among all categories of goods. After declining by 2.3% in year-on-year terms in the third quarter, exports of consumer goods were up 5.6% in the fourth quarter. Growth in exports of capital goods increased up to and including the third quarter. The deterioration in the economic situation was reflected in growth in exports of capital goods with a lag, and was more pronounced than in the other two categories of goods. Year-on-year growth declined from 12.3% in the third quarter to 1.6% in the final quarter. Such lags are to be expected due to the nature of the business and production process, which is relatively longer in the manufacture of capital goods than for intermediate goods and consumer goods.

The movements in components of merchandise imports were similar to exports. The main factors in the slowdown in imports of intermediate goods were the deterioration in the economic situation in the international environment and the decline in output in manufacturing in the second half of last year. Year-on-year growth in imports of intermediate goods declined from 26.8% in the first quarter to 3.5% in the fourth quarter. Among all categories of imports, the most significant fluctuation was recorded by growth in imports of capital goods, which tracked growth in investment in machinery and equipment quite closely. Following 23.3% year-on-year growth in the first quarter, imports of capital goods stagnated in the second quarter, with growth rising to 8.9% by the end of the year. In the context of low house-

Figure 3.2: Trade in goods



Source: Bank of Slovenia.

hold demand, year-on-year growth in imports of consumer goods fell to 2.3% in the final quarter of last year. Nevertheless, imports of consumer goods rose by 7.5% last year.

According to SORS figures, the trend of growth in merchandise trade with EU Member States outpacing trade with non-EU countries continued last year. At 13.4%, growth in merchandise exports to EU Member States outpaced growth in exports to non-EU countries by 4 percentage points, while growth in imports from EU Member States was more than 1 percentage point higher than growth in imports from non-EU countries at 11.7%. The proportion of total merchandise exports accounted for by EU Member States increased by 0.7 percentage points in 2011 to 72.4%, while the corresponding figure on the import side was up 0.2 percentage points at 77.7%. The merchandise trade deficit reached EUR 1,681 million in 2011, comparable to the 2010 figure. The deficit was entirely generated in trade with EU Member States. Merchandise trade with non-EU countries generated a surplus of EUR 707 million, up EUR 17 million on 2010. Coverage of merchandise imports by exports was up 0.6 percentage points at 92.4%.

With the exception of France, growth in merchandise trade with the main euro area partners was relatively high last year, while growth in merchandise trade with the former Yugoslav republics was up only slightly in 2011. Among the main trading partners, the largest increase in merchandise trade was recorded with Germany (exports: 21.3%, imports: 13.8%), and to a lesser extent with Austria (exports: 14.1%, imports: 7.9%) and Italy (exports: 10.6%, imports: 14.4%), while mer-

Table 3.1: Components of the current account

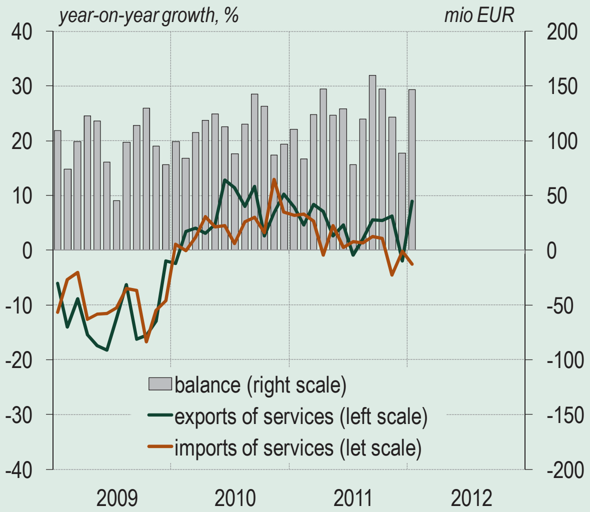
	2005	2006	2007	2008	2009	2010	2011
				mio EUR			
Current account balance	-498	-771	-1646	-2574	-456	-297	-385
1. Goods	-1026	-1151	-1666	-2648	-703	-1205	-1335
2. Services	920	993	1047	1424	1165	1308	1433
2.1. Transport	398	456	525	561	437	496	589
2.2. Tourism	743	783	834	904	891	1012	1118
- of which, exports	1451	1555	1665	1827	1804	1935	1945
2.3. Other	-221	-247	-312	-42	-163	-200	-274
3. Factor income	-295	-440	-789	-1062	-766	-507	-636
3.1. Labour income	128	107	50	-25	69	139	196
3.2. Capital income	-424	-547	-839	-1038	-835	-646	-833
4. Current transfers	-97	-173	-239	-287	-152	106	153
				as % GDP			
Current account balance	-1.7	-2.5	-4.8	-6.9	-1.3	-0.8	-1.1
1. Goods	-3.6	-3.7	-4.8	-7.1	-2.0	-3.4	-3.7
2. Services	3.2	3.2	3.0	3.8	3.3	3.7	4.0
2.1. Transport	1.4	1.5	1.5	1.5	1.2	1.4	1.7
2.2. Tourism	2.6	2.5	2.4	2.4	2.5	2.9	3.1
- of which, exports	5.1	5.0	4.8	4.9	5.1	5.5	5.5
2.3. Other	-0.8	-0.8	-0.9	-0.1	-0.5	-0.6	-0.8
3. Factor income	-1.0	-1.4	-2.3	-2.8	-2.2	-1.4	-1.8
3.1. Labour income	0.4	0.3	0.1	-0.1	0.2	0.4	0.6
3.2. Capital income	-1.5	-1.8	-2.4	-2.8	-2.4	-1.8	-2.3
4. Current transfers	-0.3	-0.6	-0.7	-0.8	-0.4	0.3	0.4

Sources: SORS, Bank of Slovenia.

chandise trade with France was down (exports: -5.1%, imports: 3.2%). Exports to the former Yugoslav republics were up 8.5%, while imports were up 15.0%. Only merchandise exports to Croatia recorded a rate above the average for total exports, at 12.7%, while imports from Croatia were up 15.6%. Growth in merchandise trade with Bosnia and Herzegovina was slightly slower (exports: 6.4%, imports: 13.6%). Growth in exports to Serbia and Macedonia was relatively low at around 4.5%, while imports were up 22.1% and 16.4% respectively. Growth in merchandise exports to Russia was low again, having fallen from 2.9% in 2010 to 1.6% last year. On the other hand, imports from Russia were up 45.9% in 2010 and 27.4% in 2011.

The gap between growth in imports and growth in exports of services was the same as in 2010. Exports of services totalled EUR 4.8 billion last year, an increase of 4.0%, while imports were up 1.9% at EUR 3.4 billion. The surplus of trade in services was thus up EUR 124 million in year-on-year terms at EUR 1,433 million, or 4.0% of GDP, at the level of the record surplus of trade in services recorded in 2008. The largest contributions to the surplus of trade in services in 2011 came from transport and travel, which recorded a combined surplus of EUR 1.5 billion. Construction services, foreign trade intermediation services and personal, cultural and recreational services also made a positive contribution to the surplus, in the total amount of slightly more than EUR 200 million. The surplus was reduced by a deficit of EUR 460 million in technical and other services.

Figure 3.3: Trade in sevices



Source: Bank of Slovenia.

Exports of travel services were up slightly in the second half of 2011. After declining by 1.1% during the first half of this year, exports of travel services were up 0.9% in the third quarter of last year and by 3.2% in the fourth quarter. Exports of travel services were up merely 0.5% last year in the context of an 8.8% increase in the number of foreign visitors and a 9.1% rise in the number of overnight stays by foreign visitors, an indication of the decline in average spending by foreign visitors to Slovenia. The surplus in travel services was thus primarily a result of the 10.4% decline in imports of travel services. The surplus of trade in travel services widened by EUR 106 million to EUR 1,118 million in 2011.

Developments in transport services were favourable, although the rates of growth continue to lag behind merchandise trade, with which they are strongly correlated. In the context of 9.0% growth in exports and 2.1% growth in imports, the surplus of trade in transport services increased by EUR 8 million to EUR 589 million. Trade in construction services and foreign trade intermediation services also recorded a combined surplus of EUR 190 million. The remaining services generated a combined deficit of EUR 464 million. The deficits amounted to EUR 239 million for intellectual property services, EUR 77 million for technical services and EUR 66 million for government services.

The deficit in factor income widened by EUR 130 million last year to EUR 636 million, or 1.8% of GDP. There has been a surplus in labour income since the onset of the economic crisis owing to a decline in the employment of foreign workers. As a result, the surplus has risen in recent years, from EUR 57 million to EUR 196 million. The contraction in economic activity, particularly in construction, has resulted in a sharp decline in outflows of labour income for foreign workers. At EUR 98 million, last year's outflows were less than a third of those recorded in 2008. After stagnating in 2009 and 2010, inflows of labour income increased sharply last year, by 26.6%. At the same time, the deficit in capital income also widened significantly last year.

In the context of rapid growth in inflows and outflows, the deficit in capital income widened to the level recorded in 2007. The deficit amounted to EUR 833 million. Inflows of capital income were up by 34.7% or EUR 156 million. Just over half of the increase was related to the effect of divestment of outward FDI, as inflows were down by EUR 115 million in 2010 and by EUR 27 million in 2011. Last year's largest increase among inflows of capital income was recorded by inflows from investments in securities, at 18.0%, while the non-government and non-banking sector recorded the largest increase, at 21.2%. Growth in interest income on loans to the rest of the world was low, at 1.5%, owing to a decline in these loans in previous years.

Having increased to 31.4%, growth in outflows of capital income was also high last year. Outflows from FDI were up 53.9%, primarily as a result of divestment of EUR 240 million in 2010 by non-residents. There was also a considerable increase of 23.0% in income from non-residents' investments in domestic securities, which mainly included income from government bonds and notes. Interest payments on loans from the rest of the world increased by 21.9%. Following extensive debt repayments by banks and a fall in interest rates, the banks' interest payments declined from EUR 805 million in 2008 to EUR 186 million in 2010, but rose again to EUR 236 million in 2011. Net payments of interest and income on investments in securities are rising again. The largest contribution to this came from an increase in interest payments on past borrowing by the government. Interest payments reached EUR 338 million in 2011, more than in 2007 and only just over EUR 200 million less than the record figure in 2008.

The surplus in current transfers increased by EUR 48 million last year to EUR 153 million. In contrast to 2010, when almost the entire surplus in current transfers was generated in the final two months, the surplus was distributed more evenly last year. The deficit in private transfers in 2011 doubled from the previous year to EUR 102 million, while the surplus in official transfers increased by less than EUR 100 million to EUR 255 million. The major contribution to the favourable results in current transfers in 2011 came from net inflows to the state budget from the EU budget. As a result, the surplus widened by EUR 81 million to EUR 407 million. Last year's largest increase was in disbursements from the structural funds, the European Regional Development Fund and the European Social Fund.

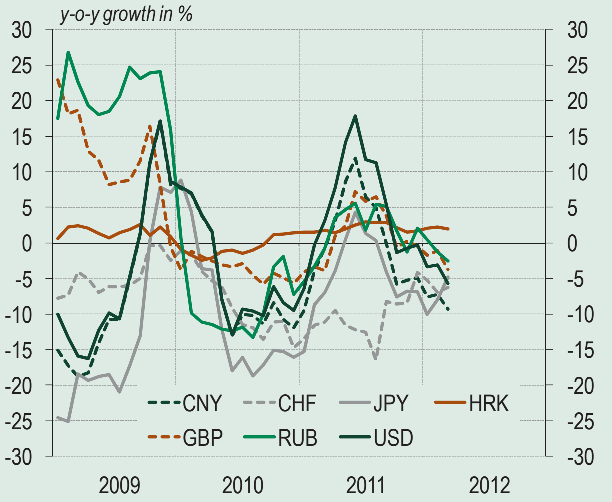
Competitiveness indicators

Nominal harmonised competitiveness indicator in Slovenia is highly dependent on movement in the euro exchange rate. Differences in the structure of foreign trade have the most significant impact on the comparison of this indicator with major trading partners in the euro area. Slovenia trades less with the US, China and Japan than the main trading partners and

Figure 3.4: Nominal harmonized competitiveness indicator (40 countries and the rest of euro area)

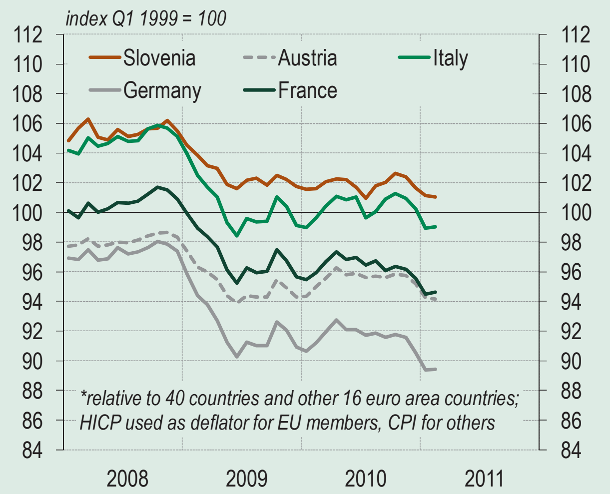
Source: ECB.

Figure 3.5: Exchange rates



Sources: ECB, Bank of Slovenia calculations.

Figure 3.6: Harmonised price competitiveness indicator*

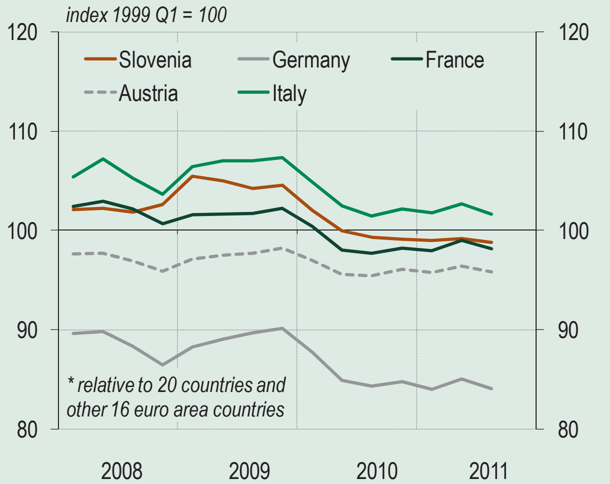


Source: ECB.

more with Croatia. Croatia's weight in the indicator is higher for Slovenia, while the euro/kuna exchange rate is more stable, which results in less pronounced fluctuations in the nominal harmonised competitiveness indicator for Slovenia. During periods of higher volatility in the exchange rates of other currencies against the euro, the effect of the aforementioned weight is more significant. Slovenia's harmonised competitiveness indicator therefore deviates from other countries during these periods. This does not, however, mean that the competitiveness of Slovenia, measured by this indicator, has systematically changed. Since the euro rose on average against most major currencies in 2011, Slovenia's nominal harmonised competitiveness indicator also appreciated. Slovenia's nominal competitiveness indicator has appreciated since the end of last year compared with the main trading partners owing to the euro's fall against the US dollar and the yen, and the euro's moderate rise against the kuna.

In the context of moderate nominal appreciation, real indicators of the price competitiveness of Slovenia have stagnated since the middle of 2010 as a result of slower growth in domestic prices, or have gradually been improving. The real indicator of competitiveness as measured by the HICP or CPI deflator is tracking the nominal price competitiveness indicator very closely owing to the relatively minor changes in inflation with respect to exchange rate fluctuations. Real competitiveness indicators show that competitiveness of Slovenia in 2008 and early 2009 deteriorated faster than the competitiveness of its main trading partners, as measured by both the GDP deflator and the HICP. Slovenia's competitiveness improved gradually after the aforementioned period, the indicator that takes into account the GDP deflator having improved more rapidly. Because the real price competitiveness indicator based on the HICP has the same deficiencies as the nominal price competitiveness indicator in

Figure 3.7: Harmonised competitiveness indicator (GDP deflator)*

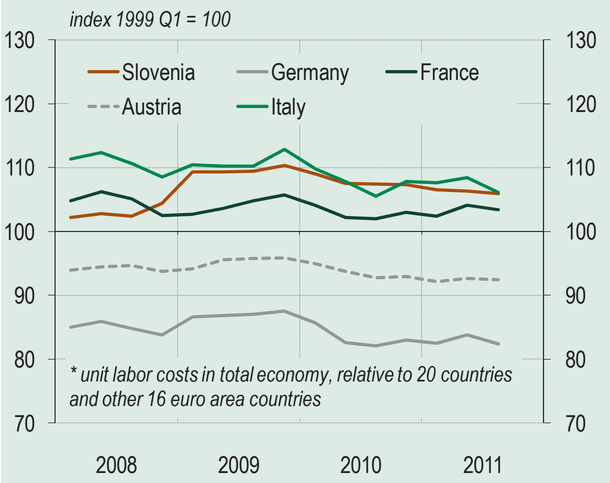


Source: ECB.

terms of weight, Slovenia's adjustment with regard to the value of this indicator appears slower. At the same time, the movement of prices that are not directly subject to international competition and that rose sharply in the inflationary cycle of 2007 and 2008 contribute more to the indicator based on consumer prices.

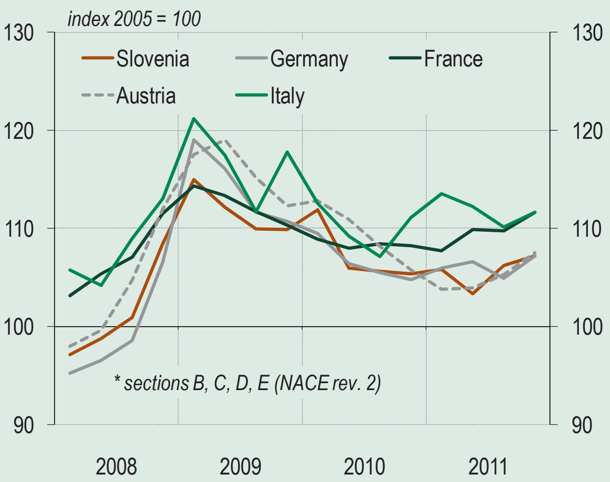
The adjustment of cost competitiveness indicators in the total economy is slow, while a more pronounced adjustment of this indicator is seen in industry. After deteriorating in 2009, the harmonised competitiveness indicator as measured by unit labour costs in the total economy is slowly improving, but remains at a relatively unfavourable level. The improvement in this indicator in 2011 was more significant than in the majority of the main trading partners. In the context of such movements, however, it will take some time before the indicator returns to the level recorded before 2009. The adjustment is significantly faster in the export sector of the economy, which is exposed to international competition. The level and pace of the adjustment of unit labour costs in industry, excluding construction, are wholly comparable to the level and pace recorded in the main trading partners. This means that the competitiveness of this sector, as measured by unit labour costs, has remained unchanged and very similar to the competitiveness of Germany and Austria since the pegging of the tolar to the euro in 2004 and the subsequent introduction of the euro.

Figure 3.8: Harmonised cost competitiveness indicator*



Source: ECB.

Figure 3.9: Unit labor costs – national accounts, industry excluding construction*



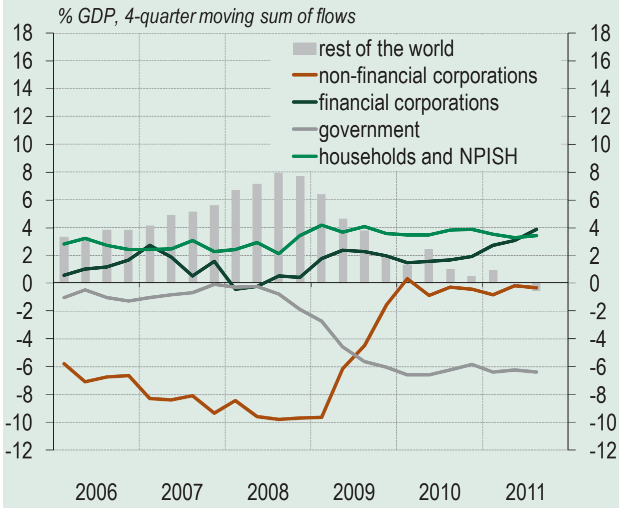
Sources: Eurostat, Bank of Slovenia calculations.

4 Financing

The deterioration in the economic situation in 2011 reduced demand for loans, while at the same time contributing to a deterioration in the situation in the banking system, which is leading to further tightening of conditions for raising loans for the corporate and household sectors. The stock of loans to non-financial corporations declined again last year. Other monetary financial institutions (banks, savings banks and money-market funds) mainly approved long-term loans to non-financial corporations, but not to an extent that would compensate for the loss of short-term financing. Thus, non-financial corporations continued to reduce their debt. Non-financial corporations partially offset the lack of domestic financing by borrowing abroad. Growth in loans to households was also down, growth in housing loans having recorded a significant decline. Consumer loans continued to decline. Other monetary financial institutions continue to restructure their sources of funding: the share accounted for by deposits by households, the government and other financial institutions, and funding from the ECB were up, while the share accounted for by foreign monetary financial institutions and issued debt securities were down.

The general government deficit was nearly equal to the net savings of the private sector last year. Thus very little net borrowing in the rest of the world was required. Weak economic activity is also being reflected in the financial flows of individual sectors. A further contraction in investments by non-financial corporations (NFCs),[4] due to difficulties in borrowing, is reflected in the narrowing of the net savings-investment gap[5] in this sector. The financial position of NFCs was nearly balanced during the 12 months to the third quarter of 2011, when the deficit was merely 0.3% of GDP. At the same time, the general government sector's financial deficit widened last year, partly owing to the functioning of automatic stabilisers, and partly due to low growth in revenues. The 12-

Figure 4.1: Savings-investment gap



Sources: Bank of Slovenia - consolidated financial accounts, SORS.

[4] According to the ESA 95 definition, non-financial corporations (NFCs) are legal entities that are market producers of goods and non-financial services.

[5] A net financial deficit is defined as a surplus in flows from financial liabilities over flows from financial assets, and is by definition equal to the surplus of investments over savings.

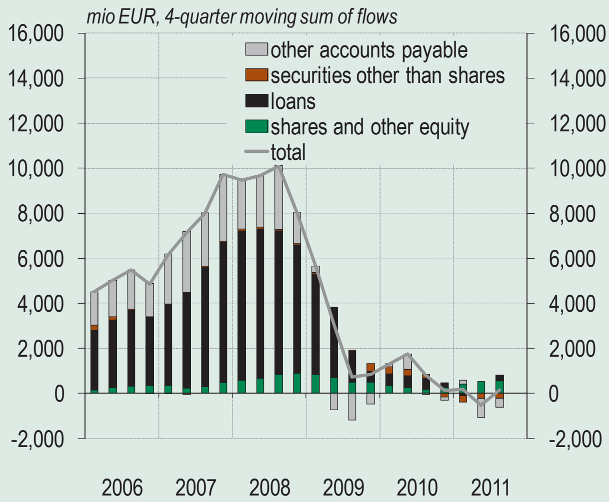
month financial deficit of the general government stood at 6.4% of GDP in the third quarter of 2011, up almost 0.6 percentage points on the end of 2010. The financial surplus of households has risen slightly since the outbreak of the crisis, and has remained at around 3.5% of GDP. Net financing from the rest of the world, or the need to import foreign savings, was down over the first three quarters of 2011, to stand at 0.6% of GDP in the third quarter.

Financing and financial assets of non-financial corporations

The liabilities of NFCs were down EUR 2.1 billion over the first three quarters of 2011, primarily as a result of negative valuation of shares and other equity. The financial liabilities of NFCs amounted to EUR 87.1 billion in the third quarter of 2011. The decrease in the financial liabilities of NFCs from shares and other equity of more than EUR 2 billion was solely the result of a decrease in the value of the aforementioned instruments. NFCs offset a portion of this decline through loans raised within the sector and in the rest of the world. Due to a renewed decline in economic activity and the deteriorating situation in the financial sector, the stock of loans raised at other MFIs was down over the first three quarters of 2011. Financing via the issue of debt securities was also down, by EUR 113 million. The financing of NFCs via other liabilities declined by more than EUR 1 billion over the first three quarters of 2011, primarily owing to a decline in the value of trade credits and advances. Predominant among the aforementioned other sources are liabilities to other NFCs and households. The value of unsettled past-due liabilities was also up.

Last year's 1.5% fall in loans to NFCs was a result of the lower investment activity of NFCs, the need to reduce relative indebtedness and the restructuring of the banks' balance sheets. The difficulties in performance of NFCs and problems with debt repayment are increasing the need to create provisions and write-offs in

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



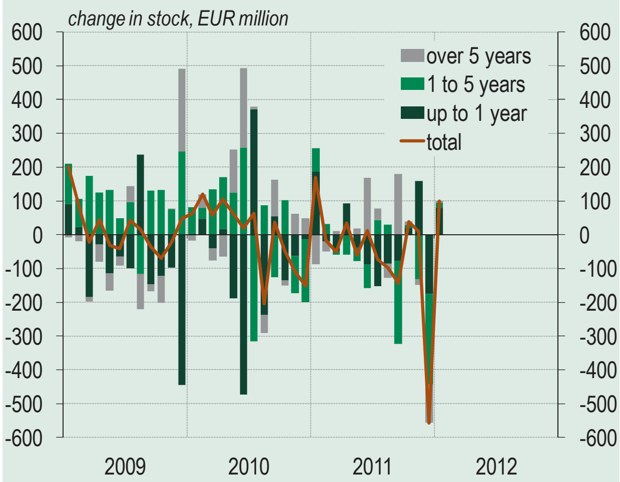
Source: Bank of Slovenia, unconsolidated data.

the balance sheets of other MFIs. This affects the performance of banks and their lending capacity. In the medium-term, other MFIs must also increase their capital relative to loans granted in accordance with Basel III guidelines. This is also necessary in terms of opportunities for renewing and securing foreign sources of funding. Access to foreign sources of funding by other domestic MFIs is also limited due to increased segmentation on the financial markets in the euro area. This has led to the further tightening of credit standards. This is particularly true for NFCs in highly indebted sectors and in the sectors hit hardest by the crisis. Weak demand for loans owing to the adverse economic situation and the debt repayment process also continue to contribute to the decline in loans to NFCs.

Other MFIs approved primarily long-term loans to non-financial corporations last year, while the stock of short-term loans fell sharply in the second half of the year. The stock of loans of 1 to 5 years recorded the largest decline last year, of more than EUR 640 million. The stock of loans of up to 1 year rose during the first half of last year, but declined sharply in the second half of the year. The decline in the stock of short-term loans continued last year, primarily owing to tighter loan approval conditions for such loans[6] and due to the high cost of

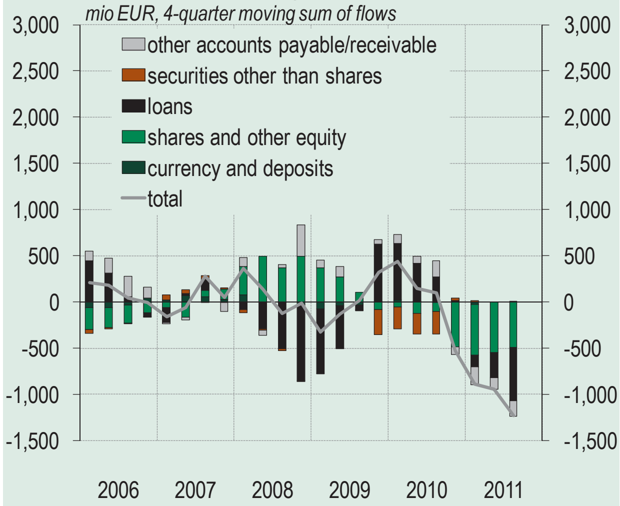
[6] Poorly performing NFCs primarily demand short-term revolving loans, partly as a result of slightly more lenient collateral requirements as a rule.

Figure 4.3: Loans by domestic MFIs to domestic NFCs, by maturity



Source: Bank of Slovenia.

Figure 4.4: Net financial flows of NFCs (S.11) with rest of the world by instrument



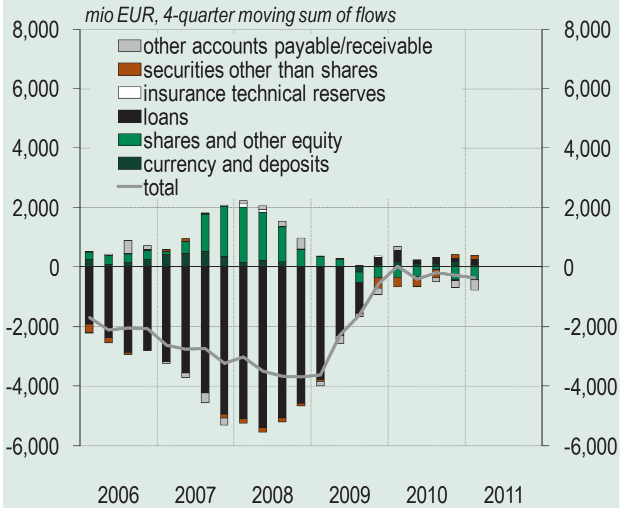
Source: Bank of Slovenia, non-consolidated data.

short-term financing compared with long-term loans. In the context of an increase in investment in machinery and equipment, the stock of longer-term loans was up last year, by EUR 132 million, but was not enough to offset the decline in short-term financing.

NFCs partly compensated for the loss of domestic financing last year by means of foreign sources of financing, primarily FDI and loans from the rest of the world. FDI rose by EUR 790 million last year, primarily as the result of a sharp increase in financing from foreign owners, which exceeded EUR 515 million. Another factor in this was acquisitions of certain Slovenian companies. Non-residents' investments in the securities of domestic NFCs rose by EUR 104 million, while NFCs invested more in foreign securities, resulting in a net outflow of funds in the amount of EUR 35 million. NFCs recorded net borrowing in the rest of the world (of more than EUR 185 million) last year for the first time since 2009. Owing to low growth in merchandise trade during the second half of the year, the net financing of domestic NFCs via trade credits was down sharply last year to stand at EUR 40 million, down EUR 138 million on 2010.

NFCs reduced their stock of financial assets by EUR 658 million over the first three quarters of 2011, primarily due to a decline in trade credits and advances to other domestic NFCs. The stock of NFCs' financial assets thus stood at EUR 44.9 billion in the third quarter of 2011. Financial assets in the form of trade credits and advances to domestic corporates were down by EUR 1.1 billion over the first three quarters of 2011. The decline in financial assets was primarily the result of a decline in trade credits and advances, and negative value changes due to the write-off of claims, in particular against other NFCs. The proportion of NFCs' total financial assets accounted for by these financial assets fell below 20%. Trade credits and advances from NFCs to

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

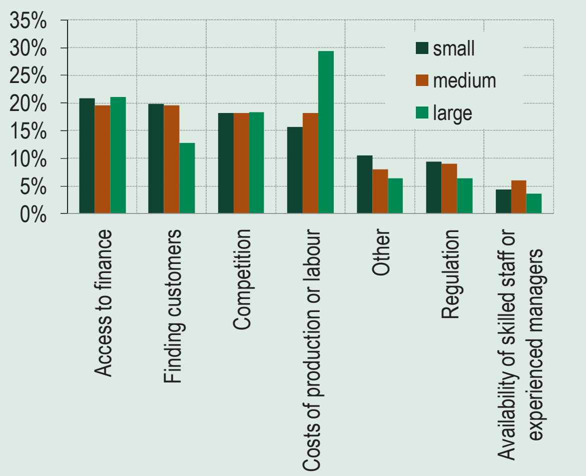


Source: Bank of Slovenia, consolidated data.

Box 4.1: Survey on the access to finance of corporates in Slovenia

In September 2011 the Bank of Slovenia conducted its first survey on the access to finance of corporate sector among micro (0 to 9 employees), small (10 to 49 employees), medium-sized (50 to 249 employees) and large (more than 250 employees) enterprises. The sample included 4,946 enterprises, 1,692 of which responded to the survey, representing a response rate of 34%. A satisfactory number of responses with regard to the total population was received for small (13.5% of the total population), medium-sized (23.7%) and large enterprises (30.0%), which represent the subject of the analysis below. The survey included questions used in surveys by the ECB and the European Commission. The first part of the survey enquired about the basic characteristics of an enterprise (ownership structure, employees and the most pressing problem), while the second part dealt with the issue of corporate financing. Questions regarding financing related to the preceding six months, while one question related to expectations for the following six months.

Figure 1: Factors restricting Slovenian firms



Source: Bank of Slovenia. All firms.

According to one fifth of respondents, the most pressing problems of small and medium-sized enterprises are access to finance, the search for costumers and the competition, while one sixth stated production or labour costs. The most significant problems for large enterprises include production or labour costs, followed by difficulties in access to finance and the competition. The construction sector stands out most among all sectors in terms of access to finance (see Table 1).

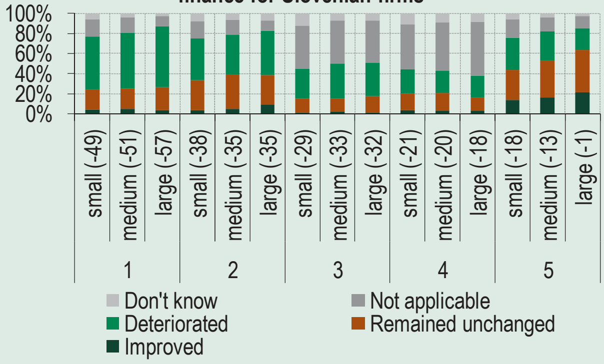
Slovenian enterprises primarily rely on own sources of financing and bank loans, and do not make use of debt market instruments in their financing. From April to September 2011 enterprises primarily used internal sources of finance in the form of retained earnings and the sale of assets (66% of large enterprises, 52% of small enterprises and 52% of medium-sized enterprises). This was followed by bank sources of

Table 1: Factors restricting Slovenian firms by activity

	Small and medium firms						Large firms						
share in %	Construction	Industry	Services	Trade	Other	TOTAL	Construction	Industry	Services	Trade	Other	TOTAL	TOTAL
Access to finance	36%	19%	19%	20%	17%	20%	67%	18%	21%	11%	25%	21%	21%
Availability of skilled staff or experienced managers	3%	6%	5%	4%	4%	5%		3%	4%	11%		4%	5%
Finding customers	17%	17%	22%	18%	27%	20%		11%	17%	22%	13%	13%	19%
Competition	22%	14%	17%	25%	15%	18%	33%	13%	13%	44%	38%	18%	18%
Don't know		2%	1%	2%	1%	1%		2%	4%			2%	1%
Other	11%	7%	11%	11%	12%	10%		3%	17%		13%	6%	10%
Regulation	1%	12%	10%	7%	11%	9%		6%	4%	11%	13%	6%	9%
Costs of production or labour	12%	23%	14%	13%	12%	16%		44%	21%			29%	17%

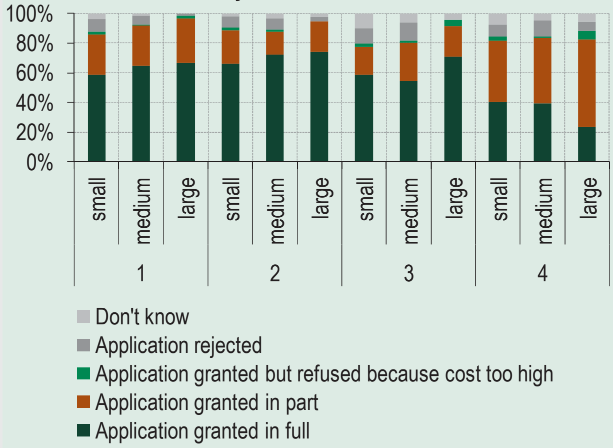
Source: Bank of Slovenia survey.

Figure 2: Underlying reasons of changes in the access to finance for Slovenian firms



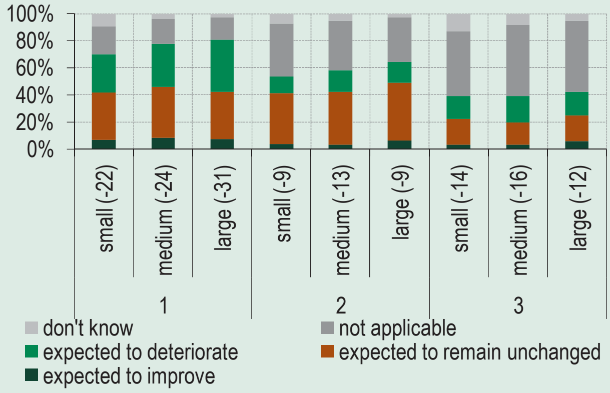
1) General economic outlook, if it affects the availability of external financing. 2) Willingness of banks to provide a loan. 3) Access to state financial support including guarantees. 4) Willingness of business partners to provide trade credit. 5) Firm-specific outlook with respect to sales and profitability or business plan, if it affects the availability of external financing. Note: Value in parenthesis represents a net percentage difference between firms that have answered "has improved" and those that have answered "has deteriorated". Source: Bank of Slovenia survey. All firms.

Figure 3: Success of applications for various sources of finance by Slovenian firms



1) Bank loan. 2) Bank overdraft, credit line or credit cards overdraft. 3) Other external financing. 4) Trade credit.
Source: Bank of Slovenia. Firms that had applied for external funds.

Figure 4: Expectations of Slovenian firms regarding the future evolvement of sources of finance



1) Bank loans. 2) Bank overdraft, credit line or credit cards overdraft.
3) Trade credit.
Note: Value in parenthesis represents a net percentage difference between firms that have answered "will improve" and those that have answered "will deteriorate".
Source: Bank of Slovenia survey. All firms.

finance. Bank loans[1] were used by 44% of small enterprises, 52% of medium-sized enterprises and 52% of large enterprises, while transaction account overdrafts, credit lines or credit card overdrafts were used by fewer enterprises (29% of small enterprises, 34% of medium-sized enterprises and 39% of large enterprises). Other forms of finance were negligible.

Access to all forms of external finance, most notably to loans, deteriorated from April to September 2011. This deterioration ranged from 34 percentage points[2] at small enterprises to 45 percentage points at large enterprises. Access to transaction account overdrafts, credit lines, credit card overdrafts and trade credits deteriorated to a lesser extent. The main factors according to the enterprises surveyed were the general economic situation, the diminished willingness of banks to approve loans and poor cooperation between partners (business partners, banks and the government sector), while small and medium-sized enterprises also cited lower profitability, which does not apply to large enterprises.

Financing conditions have deteriorated according to the enterprises surveyed. This applies to both price-related conditions and conditions unrelated to price. Price conditions have deteriorated most: interest rates have risen, while other financing costs have also increased. In terms of non-price conditions, enterprises believe that collateral requirements have tightened, while factors such as loan size and maturity have remained unchanged.

The majority of requests for bank finance was approved. Half of the enterprises surveyed submitted an application for a bank loan: 60% received the full amount of funds requested, while 28% received at least part. Fewer applications were made for other types of finance. A total of 29% of enterprises submitted a request for a transaction account overdraft, while 15% of enterprises requested other forms of external financing[3] and trade credits. The approval rate for such requests was similar to requests for bank loans. Only 4% of enterprises did not submit a request due to the possibility that it might be rejected.

Enterprises are expecting access to finance to deteriorate further over the following six months. The majority believes that external financing conditions will remain unchanged. However, negative expectations outweighed positive expectations, particularly with regard to bank loans

[1] Bank loans include new or rolled-over loans, excluding overdrafts and credit lines.

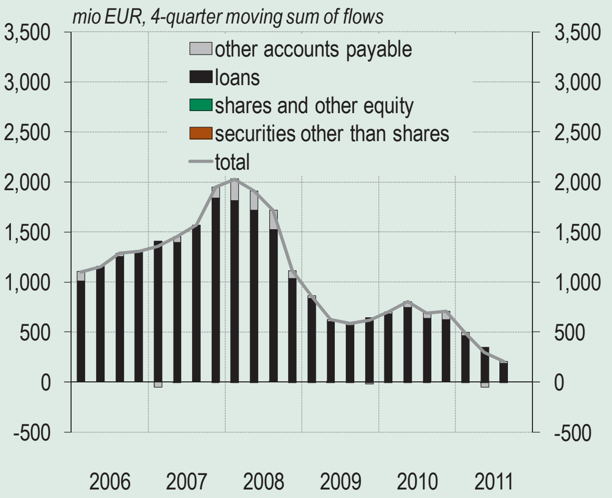
[2] This represents the net percentage difference between firms that have answered "has improved" and those that have answered "has deteriorated".
[3] Other external financing includes loans from other lenders, the issue of equity or debt securities, "leasing", "factoring", etc., excluding transaction account overdrafts, credit lines, bank loans and trade credits.

the rest of the world have increased in line with growth in exports. The stock of financial assets in shares and other equity declined by EUR 915 million, mainly due to the fall in the value of financial assets in the shares of domestic non-financial corporations, while loans to NFCs were up EUR 692 million. These loans were primarily earmarked for the financing of other domestic non-financial corporations. Total financial assets in form of deposits and debt securities were down EUR 109 million over the first three quarters of 2011.

Household financing and savings

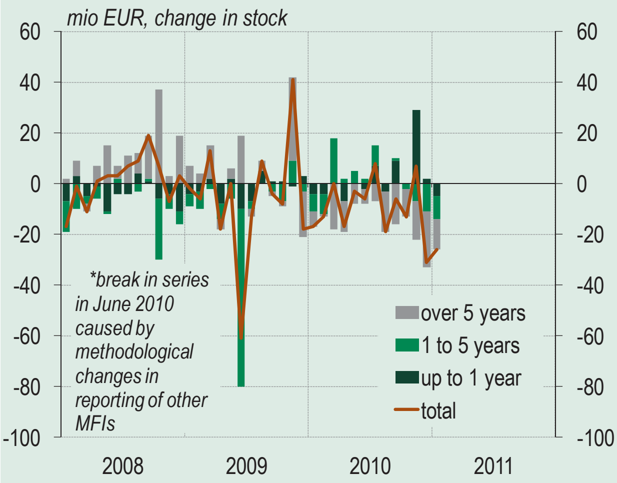
Households' financial liabilities increased by EUR 114 million over the first three quarters of 2011, mostly as the result of an increase in long-term loans. Predominant among these were housing loans, the stock of which increased by EUR 327 million last year. Housing loans, which account for more than 70% of total loans to households, rose by 14% last year, down more than 7 percentage points on 2010. Lower growth in housing loans is reflecting the decline in the number of transactions on the housing market, and is likely the result of high real estate prices given the declining consumer purchasing power. The stock of short-term loans was down again. The largest proportion of short-term loans comprises consumer loans, which have been declining since the middle of

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



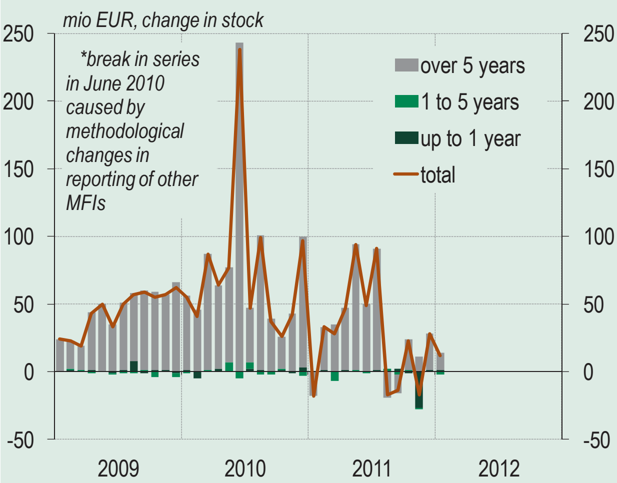
Source: Bank of Slovenia, consolidated data.

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



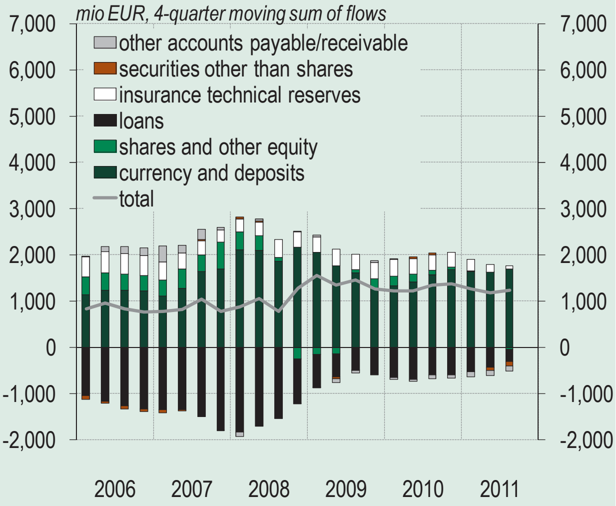
Source: Bank of Slovenia.

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



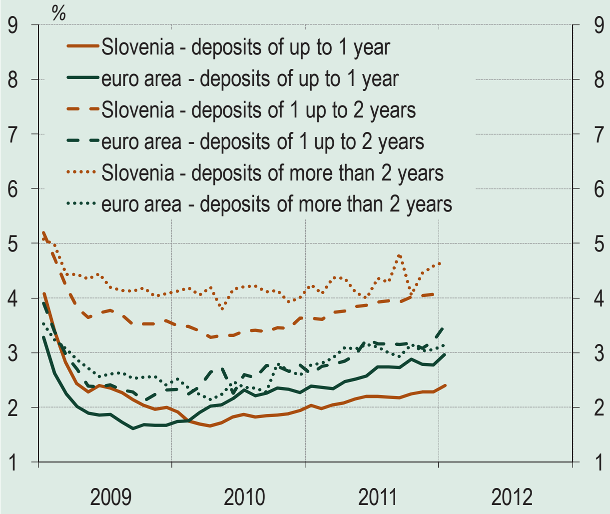
Source: Bank of Slovenia.

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



Source: Bank of Slovenia, consolidated data.

Figure 4.10: Interest rates on household deposits, by maturity



Sources: ECB, Bank of Slovenia.

2010 in line with the deteriorating situation on the labour market and the sharp decline in the consumption of durables. Consumer loans declined by 3% on average last year, compared with 0.5% in 2010. The stock of other household liabilities, predominantly trade credits and advances, was up by EUR 37 million over the first three quarters of the year 2011.

Due to a fall in the value of the shares and other equity, the stock of households[7] financial assets was down by EUR 1.3 billion in the third quarter of 2011 relative to the end of 2010.[8] Financial assets in shares and other equity, which account for a quarter of all household financial assets, were down by EUR 1.2 billion over the first three quarters of 2011, primarily as a result of negative valuations. Households' financial assets in securities other than shares were also down during the same period, by EUR 73 million. Household deposits were up EUR 289 million over the first three quarters of 2011, deposits at the domestic banks having risen by EUR 344 million. Deposits thus accounted for 39% of households' total financial assets at the end of the third quarter of 2011, where 96% of all deposits were placed at domestic banks. Insurance technical reserves, which account for 11% of households' total financial assets, were down by EUR 59 million over the first three quarters of 2011.

Sources of bank funding and interest rates

The deteriorating quality of the credit portfolio and the associated unfavourable developments in capital adequacy ratios could have an impact on the restructuring of funding of other MFIs and the costs thereof in the future.[9] The proportions/share of funding (or just funding) accounted for by deposits by households, the government and other financial institutions, and funding via the ECB were/was up, while the proportions/share accounted for by funding via foreign MFIs and via debt securities were down. Other MFIs reduced their debt to foreign MFIs by almost EUR 2.1 billion last year, repre-

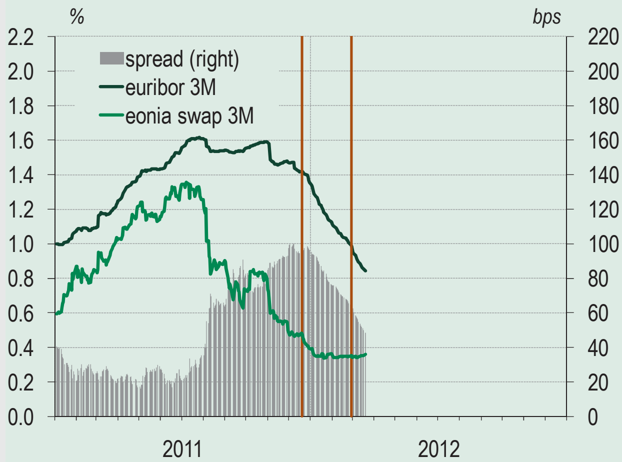
[7] Includes non-profit institutions serving households (S.15), in addition to households (S.14).
[8] Financial Accounts of Slovenia, quarterly figures, February 2012.
[9] Regulatory capital as a proportion of risk-adjusted total assets rose from 11% to 12.1% last year. Nevertheless, the Slovenian banking system remains among the worst in the euro area based on this indicator. The aforementioned proportion is above 15% for sound euro area banking systems. Only Portuguese banks have a lower capital adequacy, while Greece, Slovakia and Cyprus report a level similar to Slovenia. A comparison of the capital adequacy ratio with the book value of capital as a proportion of total assets paints a slightly better picture of the capital adequacy of Slovenian banks. In this comparison, Slovenian banks rank among the more capitally sound banks in the euro area. This probably indicates that Slovenian banking regulations are relatively stricter and/or that the risks associated with assets in the Slovenian banking system are relatively higher .

Box 4.2: Effects of additional non-standard measures by the ECB

The Governing Council of the ECB adopted the following additional monetary policy measures on 8 December 2011 to prevent the continuing decline in bank lending to non-banking sectors in the euro area and to provide sufficient liquidity:

- the execution of two 3-year longer-term refinancing operations (LTROs) with the option of early loan repayment after one year;
- the reduction of the minimum reserve ratio from 2% to 1% as of the reserve maintenance period starting January 2012;
- an increase in collateral eligibility for monetary policy loans by (a) reducing the required credit rating for certain asset-backed securities and (b) approving the temporary use of additional performing credit claims; and
- the discontinuation of fine-tuning operations at the end of the maintenance period.

Figure 1: Interest rates on unsecured money market



Note: Red vertical lines indicate the dates of three-year LTRO auctions, 21.12.2011 and 29.2. 012.
Source: Bloomberg.

Figure 2: Five year credit default swap spread of uncovered euro area bonds (iTraxx Financial)

Note: Red vertical lines indicate the dates of three-year LTRO auctions, 21.12.2011 and 29.2.2012.
Source: Bloomberg.

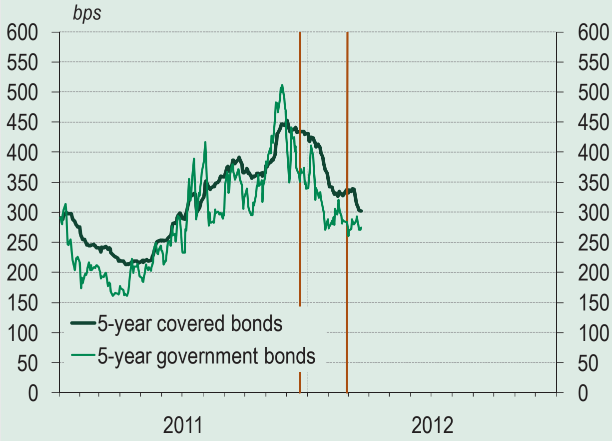
A total of 523 banks, which received loans in the amount of EUR 489.2 billion, participated in the first 3-year LTRO executed on 21 December 2011. Taking into account the effect of the re-direction of a portion of loans from the 13-month LTRO allocated in October, and the simultaneous reduction in main refinancing operations and the 3-month LTRO, the net increase in Eurosystem loans to banks amounted to EUR 212.7 billion. A total of 800 banks received EUR 529.5 billion in loans (new loans in the net amount of EUR 310.1 billion) in the second operation executed on 29 February 2012. The overall effect of both operations was a net increase in Eurosystem loans to banks of EUR 512.8 billion to EUR 1,130 billion at the beginning of March 2012.

Some analyses[1] indicate that the main reason banks participated in the aforementioned refinancing operations was to refinance liabilities, while favourable funding conditions are expected to contribute to an increase in loans to non-banking sector in the future. Several months, however, could pass before the effects of the 3-year LTROs are reflected in growth in credit and monetary aggregates.

Both operations prolonged the average residual maturity of central bank loans from 1 month to 2.7 years (assuming the early repayment option is not exploited). Together with the other measures stated above, the aforementioned operations also increased the excess liquidity of banks, which rose from around EUR 370 billion in early December to more than EUR 800 billion at the beginning of March. This has already been seen in improving conditions in various segments of the financial markets. The EONIA stabilised at 0.36%, while longer-term interest rates on the unsecured segment of the interbank money market were down sharply. The 3-month EURIBOR, for example, was down 0.5 percentage points during this period to stand at 0.97%. EONIA swap rates also fell, but less than the EURIBOR, which was reflected in a lower credit and liquidity risk premium (Figure 1).[2] There was also a notable fall in interest rates for repo transactions collateralised with the use of government and other securities from individual euro area countries such as Spain. Access by euro area banks to US dollar funding continued to normalise.

An improvement was also seen on the capital markets. The new LTROs mitigated the banking sector's liquidity and credit risk. The mitigation of credit risk was reflected in a drop in the credit default swap (CDS) rate for euro area banks (Figure 2). Also contributing to the aforementioned drop were fiscal consolidation and certain signs of economic stabilisation in the euro area. The mitigation of risks led to the gradual reopening of market sources of funding. New issues of uncovered and covered bank bonds were up over the first two months of this year relative to the second half of 2011. The volume continued to be relatively small (representing 40% of issues in the same period in 2011), but still represented an improvement on the end of 2011, when bank funding in peripheral euro area countries was not possible. An additional sign of the improvement in funding conditions can also be seen in the declining costs of medium- and long-term bank funding, which is reflected in a decrease in average spreads on uncovered bank bonds and covered bonds over the yield on German government bonds of comparable maturity. Spreads on the government debt securities of peripheral countries were also down during the same period, as evident from Figure 3.

Figure 3: Spreads of Spanish bonds over German governement bonds



Note: Red vertical lines indicate the dates of three-year LTRO auctions, 21.12.2011 and 29.2.2012.
Source: Bloomberg.

[1] Monthly Bulletin of the ECB, January and March 2012.

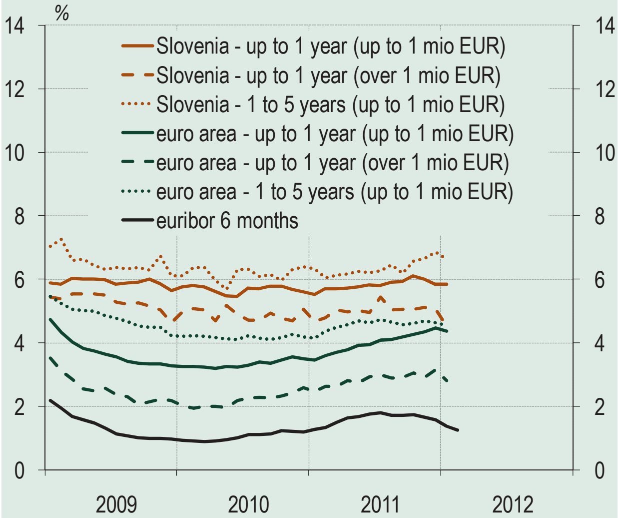
[2] An EONIA swap is a form of interest-rate swap in which the variable interest rate in a transaction is equal to the cumulative EONIA until the maturity of the transaction. Because the parties to the transaction do not exchange the principal, but only periodic (net) interest payments, credit and liquidity risks are minimal, unlike the EURIBOR (i.e. the interest rate on the unsecured segment of the interbank market). Therefore, the price (interest rate) of an EONIA swap is a good estimate of the expected (average) EONIA until the maturity of the transaction.

senting more than 4.2% of their total assets. The majority of the repaid loans were of longer maturity. The decline of EUR 786 million in debt securities on the liability side of other MFIs' balance sheets was primarily the result of two other MFIs making a partial prepayment of their own bonds that would have otherwise matured in July and September 2012. Because other MFIs only partially compensated for this decline via deposits and borrowing at the ECB, their total assets contracted again last year by more than EUR 1.5 billion. The government sector, OFIs and households increased their deposits at other MFIs by more than EUR 700 million last year. Long-term household deposits, which represent a higher-quality form of funding for other MFIs, continue to record the largest increase. This is in line with higher interest rates on longer-term deposits compared to the euro area average. Other domestic MFIs increased their borrowing at the ECB via 3-year LTROs in December 2011 and February 2012. As a result, other domestic MFIs have significantly reduced short- and medium-term refinancing risks.

The more expensive sources of funding of other MFIs and the need to maintain net interest income are reflected in higher interest rates on loans and thus in the outstanding amount, in particular to NFCs. Interest rates on new loans to NFCs were still higher than euro area interest rates last year. Higher interest rates are the result of (reflecting) several factors: (1) the relatively higher risk associated with Slovenian NFCs relative to the euro area average, in part due to a higher debt-to-equity ratio; (2) the relatively higher costs of bank funding; and (3) the need to increase the net interest income of other MFIs to cover impairment costs.[10] Interest rates on long-term loans tracked the movements in interbank interest rates last year and continue to be significantly higher than euro area interest rates. The same is also true for short-term loans, where the spread between interest rates in Slovenia and in the euro area is only gradually narrowing. The interest rates on loans to NFCs were thus around 2 percentage points above the euro area average last year.

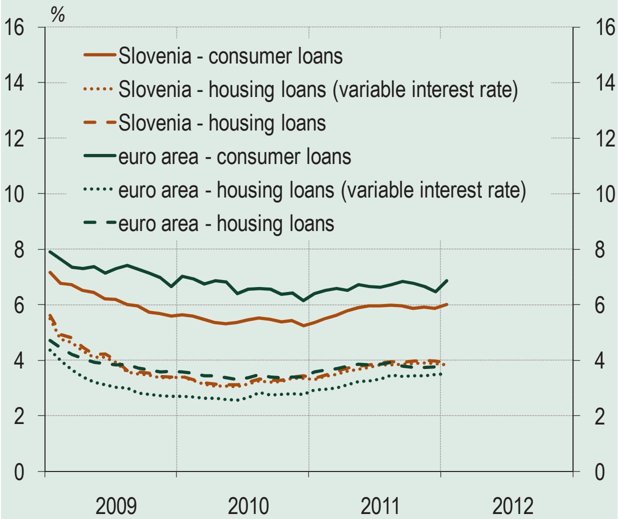
Interest rates on new loans to households are moving in line with comparable interest rates in the euro area, and are adjusting to a great extent to interbank interest rates. Interest rates on consumer and housing loans have been rising gradually since the end of 2010, mostly as a result of the gradual rise in the EURIBOR. Interest rates on consumer loans in Slovenia remain lower than euro area rates, although the spread (between them) is gradually narrowing. Interest rates on housing loans rose last year, primarily as a result of a rise in interbank interest rates. Spreads over the 6-month EURIBOR on housing loans have remained virtually unchanged since the middle of 2010. This gives no indication that other MFIs attempt to limit the supply of these types of loans by raising interest rates.

Figure 4.11: Interest rates on loans to NFCs



Sources: ECB, Bank of Slovenia.

Figure 4.12: Interest rates on loans to households



Sources: ECB, Bank of Slovenia.

[10] Other MFIs avoid reducing income owing to higher write-offs and provisioning costs and their relatively unfavourable capital position.

5 Public Finance Developments

According to SORS estimates, the general government deficit in 2011 stood at 6.4% of GDP, which is more than forecast in the Stability Programme. Three major transactions of a one-off nature accounted for a deficit in the amount of 1.2% of GDP. The general government debt increased in 2011, in part due to pre-financing for the repayment of government bond that matured in February this year. The consolidation of public finances remains a government priority due to the high deficit, the need to stabilise the debt and the financial consequences of population ageing. The revision to this year's budget is expected to ensure a significant reduction in the general government deficit, which should drop below the reference value of 3% of GDP by 2013. The achievement of the objectives set out in the Stability Programme is being hindered by the deteriorating macroeconomic situation.

General government deficit

In the environment of the deteriorating economic situation, the general government deficit remained high for the third consecutive year. The general government debt also rose. In the context of low nominal growth in economic activity, growth in revenue was low as well. The general government deficit stood at 6.4% of GDP in 2011, while the general government debt rose to 47.6% of GDP. While the European Commission projections of November 2011 indicate that the general government deficit in the euro area fell to 4.1% of GDP in 2011 (from 6.2% of GDP in 2010), the general government deficit rose by 0.4 percentage points in Slovenia. Accord-

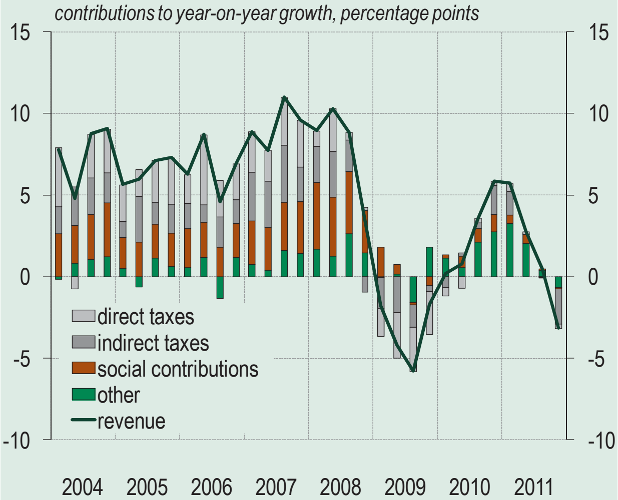
Table 5.1: General government deficit and debt in Slovenia, 2008-2014

	SORS				Stability Programme					European Commission		
as % GDP	2008	2009	2010	2011	2010	2011	2012	2013	2014	2011	2012	2013
Revenue	42.4	43.2	44.2	44.5	43.5	44.2	43.5	43.0	42.3	45.2	45.2	45.2
Expenditure	44.2	49.3	50.3	50.9	49.0	49.7	47.4	45.9	44.3	51.0	50.5	50.9
of which: interest	1.1	1.4	1.6	2.0	1.6	1.8	2.0	1.9	1.8	1.9	2.1	2.2
Net lending (+) / borrowing (-)	-1.9	-6.1	-6.0	-6.4	-5.5	-5.5	-3.9	-2.9	-2.0	-5.7	-5.3	-5.7
Structural balance	...	...	...	...	-4.3	-3.8	-3.0	-2.3	-1.7	-3.0	-3.8	-4.7
Debt	21.9	35.3	38.8	47.6	38.0	43.3	45.3	46.2	46.0	45.5	50.1	54.6
Real GDP *(growth, %)*	3.6	-8.0	1.4	-0.2	1.2	1.8	2.2	2.3	2.8	1.1	1.0	1.5

Sources: SORS (realisation), Ministry of Finance (April 2011), European Commission (November 2011).

Figure 5.1: General government revenue

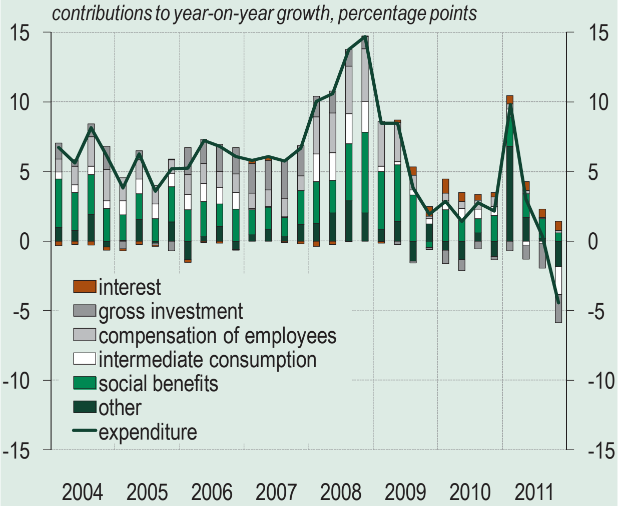
contributions to year-on-year growth, percentage points



Sources: SORS, Bank of Slovenia calculations.

Figure 5.2: General government expenditure

contributions to year-on-year growth, percentage points



Sources: SORS, Bank of Slovenia calculations.

ing to the same estimates, the general government debt in the euro area rose from 85.6% of GDP in 2010 to 88.0% of GDP in 2011.

Following relatively high growth in the first half of 2011, general government revenue was down in year-on-year terms during the second half of the year. Developments primarily reflect the deterioration of the economic situation in the second half of the year, when real wages were also down notably. General government revenue rose by 1.2% in 2011. Growth in revenue based on movement in the wage bill was low. Social security contributions were up 0.7%, while revenue from personal income tax remained at the level of the previous year. The situation on the labour market was also reflected in a decline in household consumption, which affects the volume of revenue from indirect taxes. Revenue from VAT was down on the previous year, while revenue from excise duties was higher. Revenue from excise duties on mineral oils fell due to a cut in the excise duty rate, while revenue from excise duties on tobacco, which rose twice in 2011, was up. Revenue from corporate income tax rose by 2.1%. The government's discretionary decisions in 2011 did not have a significant impact on general government revenue. Revenue from VAT was down in part due to the possibility of correcting and/or reducing tax prepayments from claims recognised in liquidity and bankruptcy proceedings.

Growth in general government expenditure remained at a similar level to the previous year. Measures adopted by the government to limit spending with the aim of reducing expenditure as a proportion of GDP were insufficient due to one-off events. General government expenditure rose by 2.0% last year. Three major transactions of a one-off nature in the amount of EUR 412 million or 1.2% of GDP contributed 2.3 percentage points to growth in expenditure. These include the recapitalisation of NLB d.d. (EUR 243 million) and Adria Airways (EUR 50 million) and a transfer to Slovenian Railways (EUR 119 million). At the same time, the government continued to restrict expenditure on wages, pensions and social transfers. The average wage in the general government sector rose by 0.4% last year. Compensation of employees in the public sector rose by 0.8% last year, in part due to a 0.4% increase in the number of employees in the government sector (S.13 under the ESA 95), although employment growth was significantly lower than the previous year. Expenditure on pensions rose by 3.4%. The number of old-age pensioners was up 4.8%, while the total number of pensioners was up 2.8%. Expenditure on government intermediate consumption was

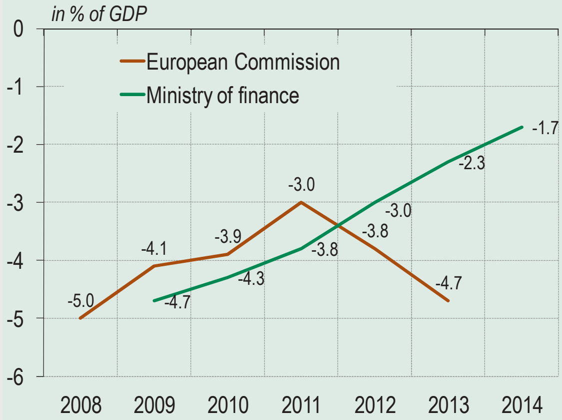
Box 5.1: The fiscal compact and its enforcement in Slovenia

Leaders of 25 EU Member States, namely all members other than United Kingdom and the Czech Republic, signed the Treaty on stability, coordination and governance in the Economic and Monetary Union on 2 March 2012, part of which is the fiscal compact. The treaty entails the continuation of the efforts to strengthen economic governance in the EU, following the entry into force of the "six-pack" in December 2011.[1] The purpose of the treaty is the long-term strengthening of budgetary discipline and enhanced coordination of economic policy, it is also expected to help prevent crises in the future. The treaty will enter into force on the first day of the month after instruments of ratification have been filed by 12 members of the euro area, with a target of no later than 1 January 2013.

The golden fiscal rule forms the basis of the treaty. This states that budgets must be balanced or in surplus. The latter is defined by the structural deficit[2], which may not exceed 0.5% of GDP on an annual basis.[3] In the event of significant deviations from the medium-term target or the adjustment path, a corrective mechanism will be automatically triggered. Any country in breach will have to take action within a specified deadline to eliminate the deviations, the goal of which will be to correct the accumulated effect of such deviations on the dynamics of the government debt. The signatories will be allowed to temporarily deviate from the medium-term budgetary objective or from action to meet this objective in exceptional circumstances (in the case of events outside the control of the government or a severe economic decline), provided that this does not jeopardise medium-term fiscal sustainability. Any signatories against which the excessive deficit procedure is invoked will have to draw up budget and economic plans based on EU guidelines, with a detailed description of the requisite structural reforms to ensure the elimination of the excessive deficit. The enforcement of the fiscal rule will limit borrowing, but the fiscal rule is also binding in the formulation of fiscal policy, and is based on the calculation of the structural deficit and the output gap, which may be subject to corrections.

Signatories will have to transpose the fiscal rule into national legislation within one year of the treaty entering into force. Constitutional provisions are desirable. The Slovenian government is planning an amendment to Article 148[4] of the Constitution, to write in the fiscal rule. The new article will stipulate that budget revenues and expenditure in Slovenia must be balanced without borrowing, or that revenues must exceed expenditure. Should this not be the case, the deficit must be covered by surpluses from other years. Exceptions will be allowed in cases of natural or other disasters and other emergencies that have significant financial implications for the government sector. The government is planning to begin applying the fiscal rule in 2015. The implementation of the fiscal rule will be set out in greater detail by a special law, which the National Assembly will have to pass by a two-thirds majority.

Figure 1: Structural deficit of the general governement sector in Slovenia



The structural deficit as estimated by the Ministry of Finance, reflects its targeted dynamics, while estimates of the European Commission reflect only implemented measures.
Sources: European Commission, Ministry of Finance.

[1] See Price Stability Report, October 2011, Box 5.1: Improving the coordination of economic policies within the EU.

[2] The structural deficit is the deficit without cyclical economic effects and one-off and temporary measures.

[3] A structural deficit of up to 1% of GDP will be allowed for any country whose general government debt is significantly less than 60% of GDP and that is deemed low-risk in respect of the medium-term sustainability of public finances. Slovenia's general government debt stood at 47.6% of GDP at the end of 2011, and it is one of the countries classed as high-risk in respect of the medium-term sustainability of public finances.

[4] Article 148 of the Constitution stipulates that all revenues and expenditures in the financing of public spending by central and local governments must be included in their budgets. Should the budget not be passed by the first day that the implementation should begin, the beneficiaries of budget financing are temporarily financed under the previous budget.

Slovenia's medium-term fiscal objective was set in the latest Stability Programme (April 2011) as a balanced structural position. Slovenia's structural deficit currently significantly transgresses the new rule from the fiscal compact (see Figure 1) and the medium-term fiscal objective. According to the most recent European Commission estimates of November 2011, last year's structural deficit was 3% of GDP. Signatories will be required to ensure rapid convergence to the medium-term objective. The convergence timetable will be proposed by the European Commission, with the risks for sustainability in each country having been taken into account. In the European Commission procedure being undergone because of an excessive deficit, Slovenia is required to reduce the structural deficit by an average of 0.75 GDP percentage points annually between 2010 and 2013.

down by 3.8%, most notably in the final quarter. Interest payments were up again in line with the rising debt, and have already reached 2.0% of GDP. Unemployment benefits went up sharply due to the situation on the labour market and the entry into force of the Labour Market Regulation Act, which expanded the pool of those entitled to unemployment benefits and increased the value of benefits during the first three months.

The central government accounted for the majority of the general government deficit. According to SORS estimates, the central government deficit amounted to 6.4% of GDP in 2011, an increase on the previous year. The deficit in local government was down 0.3 percentage points on the previous year to stand at 0.1% of GDP. The social security funds disclosed a surplus of 0.1% of GDP.

The general government deficit is to a great extent structural in nature. Eliminating the deficit will require measures to improve long-term fiscal sustainability. The available estimates of the European Commission from November 2011 indicate that the structural deficit was around 3% of GDP in 2011.[11] According to these estimates, the structural deficit has been narrowing gradually since 2008, when it reached its highest value due to uncoordinated reforms on both the revenue and expenditure sides of the budget. The budget was thus unable to generate surpluses during the period of rapid economic growth. Structural measures in the area of public finances are required to reduce the deficit, stabilise the debt, and maintain confidence on the international financial markets.

Government debt and guarantees

The general government debt reached 47.6% of GDP at the end of 2011. In addition to the financing of the deficit and the repayment of maturing debt in the current year, the government also borrowed to finance the repayment of debt maturing at the beginning of 2012. The general government debt stood at EUR 16.954 billion at the end of last December, or 47.6% of GDP. The debt had risen by more than EUR 3 billion since the end of 2010. The majority of borrowing was secured by the issue of 10-year and 15-year bonds in the first quarter of last year in the total amount of EUR 3 billion, with an ad-

Table 5.2: Government debt developments and breakdown of factors affecting the changes

	2005	2006	2007	2008	2009	2010	2011
debt in % of GDP	26.7	26.4	23.1	21.9	35.3	38.8	47.6
change in debt	**-0.6**	**-0.3**	**-3.3**	**-1.1**	**13.3**	**3.5**	**8.8**
of which: primary balance	-0.1	0.0	-1.2	0.7	4.7	4.2	4.5
interest-growth difference	0.1	-0.6	-1.4	-0.6	2.6	1.5	1.7
deficit-debt adjustments	-0.6	0.3	-0.7	-1.3	6.0	-2.2	2.6

Sources: SORS, Bank of Slovenia calculations.

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

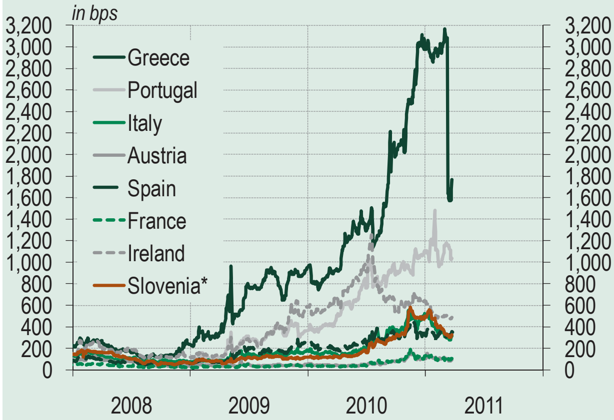
ditional 18-month treasury bill issue in the amount of EUR 907 million at the end of the year. Repayments of the consolidated general government debt[12] totalled EUR 1 billion last year, EUR 960 million of this amount from the state budget. A portion of last year's borrowing was earmarked for the repayment of EUR 1 billion in debt principal that matured in February this year. The government has primarily borrowed by issuing 3-month, 6-month and 12-month treasury bills during the first quarter of this year. Under the approved financing programme, the borrowing ceiling for the state budget is EUR 2.9 billion in 2012, which will most likely be amended following the adoption of the revised state budget.

The financing of the primary general government deficit was again the main factor in last year's rise in the general government debt. Approximately half of last year's change in the general government debt was the result of the primary deficit, which reached 4.5% of GDP. For the third consecutive year economic growth was not high enough to (at least) offset the impact of interest on the general government debt, which also contributed to the growth of the debt. Adjustment factors in 2011 related primarily to the pre-financing of debt that matured in February this year, and also included assistance to certain euro area countries. Current projections indicate that the ratio of economic growth to borrowing costs will not contribute to a reduction of the government debt in the short term, as had been the case in the years prior to the crisis.

The stock of government guarantees fell in 2011 primarily as a result of the repurchase of government-backed bonds by banks. The stock of government guarantees stood at EUR 7 billion or 19.6% of GDP at the end of last December, down EUR 752 million on the stock at the end of 2010. More than EUR 5 billion, or slightly more than 70%, comprises standard guarantees that are not linked to anti-crisis measures. The remainder relate to addressing the economic crisis and primarily originate from 2009. The stock of guarantees was down last year primarily as a result of repurchases of bank bonds that were issued with a government guarantee as part of the anti-crisis measures. The banks reduced the stock of such bonds by EUR 645 million. Their decision to repurchase was driven by the downgrading of Slovenia's sovereign rating and an increase in the required yields on government bonds and bonds with a government guarantee. The value of such bonds fell significantly as a result. By repurchasing the aforementioned bonds, the banks reduced their funding costs. The banks have continued to repurchase bonds this year. According to state budget figures, guarantees in the amount of EUR 21 million were called last year, which is an increase on previous years, but still remaining at a relatively low level.

The required yield on Slovenian government bonds rose last year from May on, and temporarily exceeded 7% towards the end of the year. The yield had fallen back to around 5.2% by the end of March this year. The required yield on 10-year Slovenian government bonds held at around 4.4% until the end of May 2011. In that period the premiums over the benchmark German bonds averaged close to 120 basis points. Following the deepening of the euro area debt crisis, which primarily involved Greece, Ireland and Portugal during the first half

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



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

[12] The consolidated general government budget includes the consolidation of the state budget, local government budgets, the Health Insurance Institute and the Pension and Disability Insurance Institute.

of the year, the premiums on Italian and Spanish bonds also rose in July. At the same time, the premiums on the bonds of certain other euro area countries, including Slovenia, began to rise. In addition to developments in the international environment, the rise in premiums on Slovenian bonds was also influenced by domestic factors linked to the political crisis, cuts in economic growth forecasts, postponement of structural reforms and the low level of liquidity on the Slovenian government bond market. Moreover, international rating agencies downgraded Slovenia's long-term debt by three steps (Moody's and Fitch) or two steps (Standard & Poor's) between last autumn and this February. The outlooks were negative at all three agencies. The required yield on Slovenian 10-year bonds fell gradually at the beginning of this year to stand at 5.2% in the second half of March, while the premium over the benchmark German bonds was close to 320 basis points. Fiscal consolidation and the implementation of structural reforms remain crucial to preventing a rise in the required yield on Slovenian bonds.

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

Slovenia participates in the programmes aimed at providing financial assistance to Greece, Ireland and Portugal. A second package of assistance to Greece was approved in March. International assistance to resolve the fiscal problems of Ireland and Portugal amounts to EUR 68 billion and EUR 78 billion respectively. Part of the aforementioned assistance is financed from the European Financial Stability Facility (the EFSF, a temporary fund to safeguard the euro): EUR 17.7 billion for Ireland and EUR 26 billion for Portugal. Slovenia's share of guarantees under the EFSF is 0.5%. This means that Slovenia's shares of assistance to Ireland and Portugal are approximately EUR 89 million and EUR 130 million respectively. The amount of EFSF loans granted to Ireland and Portugal and guaranteed by Slovenia amounted to EUR 119 million at the end of 2011. The first package of assistance aimed at helping Greece finance its debt took the form of IMF loans and bilateral loans from euro area countries in the amount of EUR 110 billion, approved in May 2010. A total of EUR 73 billion of these loans were actually used. Slovenia contributed EUR 243 million in funds for Greece in bilateral loans. A second package of assistance for Greece in the amount of EUR 173 billion was agreed in March this year, and will include the unused funds from the first package. The private sector is participating in second package of assistance to Greece in the form of a partial write-off of debt. The majority of assistance from the second package will be covered by the EFSF, while the IMF will contribute EUR 28 billion. According to Ministry of Finance estimates, Slovenia's share of the second package of assistance to Greece will take the form of EUR 938 million in guarantees.

A permanent mechanism to ensure the stability in the euro area will begin functioning in the middle of this year. The European Stability Mechanism (ESM) will begin functioning in July of this year, and not in the middle of next year as originally planned. It will replace the EFSF, which functions as part of the temporary mechanism for ensuring financial stability. The ESM will have EUR 500 billion at its disposal, a portion of which will consist of paid-in capital from Member States. Slovenia's share of ESM capital will be EUR 342 million, EUR 137 million of which it is expected to pay this year. Ratification of the Treaty on stability, coordination and governance in the Economic and Monetary Union will be a condition for access to financial assistance from the ESM from 1 March 2013 on (see Box 5.1).

Planned developments in the general government deficit

The government is drawing up a revised state budget for 2012. The adverse macroeconomic situation is making it difficult to reduce the deficit, while consolidation alone could lead to a further deterioration in already unfavourable economic developments in the

short term. Following the constitution of government in February, the government drew up a plan to draft a revised state budget for 2012, as the current budget, adopted at the end of 2010, no longer reflects the economic situation. According to information available by the middle of March, the revised state budget for 2012 is expected to include a significant reduction in expenditure. The government also submitted for public debate a proposal to amend the Corporate Income Tax Act, which would entail an easing of the tax burden for 2012 in the approximate amount of EUR 150 million or 0.4% of GDP. The current level of excise duties on mineral oils is slightly higher than in 2011. Excise duties on tobacco products were raised again on 1 April 2012, which is expected to increase annual revenue by around EUR 14 million. Excise duties on alcohol were also raised. Taking the tax cuts into account, state budget revenue in 2012 is expected to remain at approximately the same level as 2011. Expenditure in 2012 must be reduced by around EUR 450 million or approximately 5% relative to 2011 expenditure in order to achieve the target deficit of 3% of GDP or slightly more than EUR 1 billion. Expenditure on interest will continue to rise. This entails a significant cut in non-interest expenditure, while the planned simultaneous tax cuts signal the need for additional deep cuts on the expenditure side of the budget. Austerity measures in the area of healthcare are also being drawn up to ensure appropriate financial performance this year and in the coming years.

Reducing the general government deficit below 3% of GDP in 2013 and gradually eliminating the structural deficit will require additional measures in the coming years. These measures are also crucial for stabilising and gradually reducing the general government debt. Slovenia has been undergoing the excessive deficit procedure since December 2009, which requires a reduction in the general government deficit to below 3% by 2013. Additional consolidation measures will be necessary in the coming years to achieve the medium-term objective of a balanced structural position. This would also facilitate the gradual stabilisation and reduction of the general government debt, which has more than doubled during the crisis. According to the European Council recommendations of December 2009, the structural deficit should be reduced by an average of 0.75 GDP percentage points annually until 2013. According to the latest Stability Programme from April 2011, the structural deficit is expected to reach 1.7% of GDP in 2014. A new update to the Stability Programme will be published in the middle of April this year in accordance with the European Semester.

For a sustained reduction in the general government deficit, short-term intervention measures must be replaced by measures of a permanent nature and structural reforms. Limiting general government expenditure in recent years has been based primarily on limiting expenditure on wages, pensions and social transfers. General government expenditure on wages in 2011 was lower than in the previous two years on the basis of agreements with public sector unions and on account of savings in some items. Under the agreement with the unions, these obligations were deferred to future years (e.g. the second half of the wage reform was deferred until after a year when GDP growth exceeds 2.5%). In accordance with the Act on Additional Intervention Measures adopted by the National Assembly last December, growth in public sector wages, pensions and social transfers will be frozen during the first half of this year. Pension reforms, which were not passed due to rejection at the corresponding referendum nearly a year ago, are expected to be drawn up in 2013. The largest reduction in general government expenditure was achieved in the area of investment in the previous period. A sustained reduction in the deficit can only be ensured through measures aimed at a long-term reduction in specific expenditure items, including structural reforms.

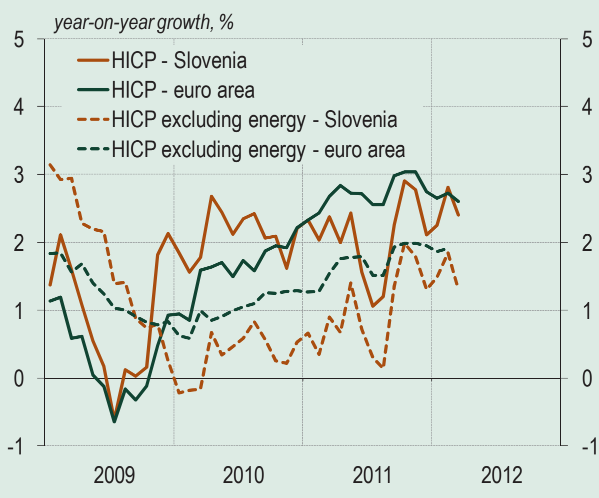
6 Price Developments

The main factors of changes in inflation in Slovenia in 2011 and early 2012 were prices of oil and other commodities, some one-off effects, fluctuations in the prices of seasonal products and weak domestic demand. Growth in the harmonised index of consumer prices stood at 2.1% in 2011, the same as in 2010. Low economic activity and a decline in real household income were reflected in a decline in domestic consumption, and limited opportunities for companies to raise prices. Core inflation thus remained low and below the euro area average, mostly as a result of a decline in the contributions made by prices of services and non-energy industrial goods. Corporate cost and price pressures have been increasing recently, however, due to low demand these pressures have so far not been fully passed through into retail prices.

Macroeconomic factors and core inflation indicators

Core inflation has remained low in the early months of this year, and is below the euro area average. Core inflation as measured by the HICP excluding energy, food, alcohol and tobacco averaged -0.4% in 2011, despite a rise in the autumn. Year-on-year price growth according to this indicator has remained relatively low in the early part of this year, and stood at 0.3% in March. Core inflation as measured by the HICP excluding energy and unprocessed food averaged 0.7% in 2011, and stood at 1.2% this March. A more pronounced fall in core inflation was prevented primarily by a rise in prices of processed food, which came as a result of rises in food prices on global markets passing through into domestic food products, and changes in excise duties on tobacco. According to the broadest indicator, the HICP excluding energy prices, price growth averaged 1.0% in 2011, and stood at 1.3% in March of this year. The core inflation indicators have been lower than those in the euro area since the end of 2009; the narrowest indicator was 1.8 percentage points lower on average in 2011, while the broadest indicator was 0.7 percentage points lower.

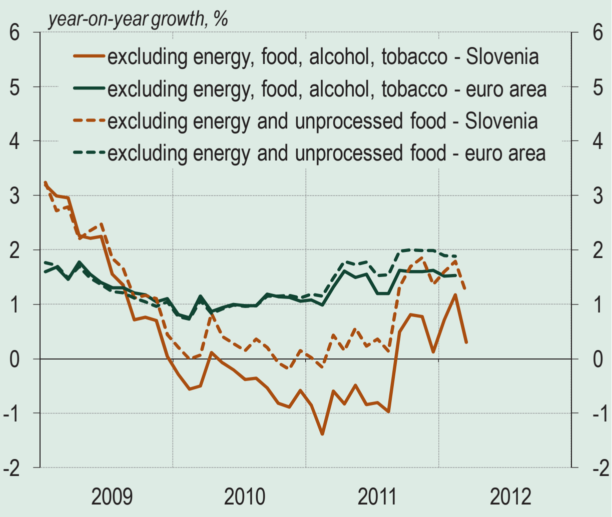
Figure 6.1: Inflation



Sources: Eurostat, SORS, Bank of Slovenia calculations.

Core inflation continues to be affected by low economic activity and weak domestic demand. Low activity in the real sector and the deterioration in the situation on the labour market are continuing to reduce real household income. Given the tighter terms of lending, this brought a further decline in domestic final consumption, which was very pronounced in the final quarter of last year. Real volume turnover and income have been declining in most segments of the retail sector since the end of the summer. Unit labour costs were up in year-on-year terms in the final quarter of 2011, but only as a result of the contraction in activity, while wage growth declined further. The cost adjustment of the economy remains slower compared with the euro area trading partners. Further rises in oil prices at the beginning of this year raised corporate operating costs, but the prevailing weak demand means that these pressures have largely not been passed through into consumer prices.

Figure 6.2: Core inflation



Sources: Eurostat, SORS, Bank of Slovenia calculations.

Microeconomic factors and the structure of inflation

As a result of high growth in oil prices on global markets, energy prices rose in year-on-year terms in 2011 and in the early part of this year, albeit the pace was slower than in the previous year. Energy prices rose on average by 8.8% in 2011, which is 5.1 percentage points

Table 6.1: Breakdown of the HICP and price indicators

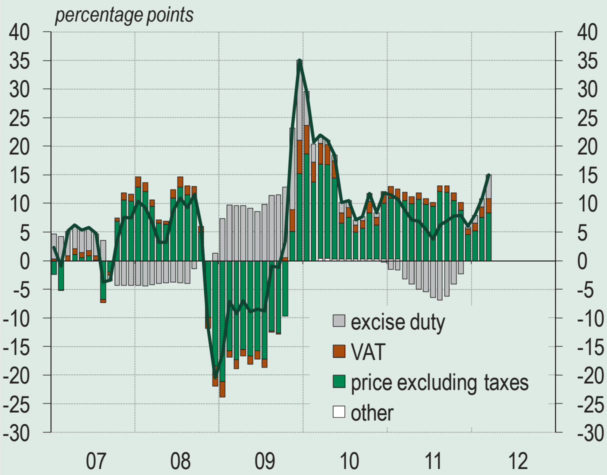
	weight 2012	average year-on-year growth, %					year-on-year growth in quarter, %					
		2007	2008	2009	2010	2011	4Q10	1Q11	2Q11	3Q11	4Q11	1Q12
HICP	*100.0%*	3.8	5.5	0.9	2.1	2.1	2.0	2.2	2.0	1.5	2.6	2.5
Breakdown of HICP:												
Energy	*14.5%*	3.4	9.4	-4.5	13.9	8.8	12.3	12.1	8.3	6.9	8.0	8.3
Food	*22.7%*	7.1	8.1	1.8	2.5	4.8	3.6	5.2	5.7	3.5	4.8	3.7
processed	*15.4%*	6.3	9.9	2.7	2.9	5.0	3.1	4.5	4.7	4.8	6.0	4.7
unprocessed	*7.3%*	8.7	4.6	0.0	1.7	4.3	4.7	6.6	7.7	0.5	2.3	1.4
Other goods	*28.8%*	0.3	2.2	0.0	-2.2	-0.9	-1.6	-1.3	-1.1	-1.4	0.0	-0.6
Services	*34.0%*	4.9	5.3	3.2	1.2	0.0	0.0	-0.7	-0.4	0.2	1.1	1.9
Core inflation indicators												
HICP excluding energy	*85.5%*	3.8	4.9	1.7	0.3	1.0	0.3	0.6	0.9	0.6	1.7	1.5
HICP excluding energy and unprocessed food	*78.2%*	3.4	5.0	1.9	0.2	0.7	0.0	0.1	0.3	0.6	1.6	1.5
HICP excluding energy, food, alcohol and tobacco	*62.8%*	2.7	3.8	1.7	-0.4	-0.4	-0.8	-0.9	-0.7	-0.4	0.6	0.7
Other price indicators:												
Industrial producer prices on domestic market		5.5	5.6	-0.4	2.0	3.8	3.2	4.5	4.1	3.7	2.9	...
GDP deflator		4.2	4.1	3.0	-1.1	0.8	-1.7	0.5	0.4	0.6	1.8	...
Import prices[1]		1.4	2.7	-4.6	6.6	5.6	8.6	8.6	5.9	4.7	3.7	...

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

Box 6.1: Price developments and comparison of excise duties on refined petroleum products

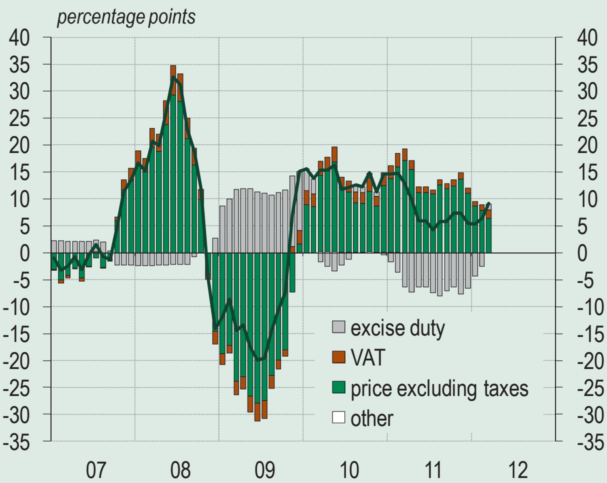
The main factor behind the increase in prices of refined petroleum products in Slovenia in 2011 and early 2012 was the development of oil prices on global markets. These averaged EUR 80 per barrel in 2011, up 32.7% on the 2010 average of EUR 60 per barrel. The rise in euro terms was slightly smaller than in the US dollar prices, as a result of the euro's overall appreciation against the US dollar during the year. In early 2012 geopolitical tensions further increased crude oil prices, fluctuated around a level EUR 95 per barrel in March. Prices of crude petroleum in euro terms thus exceeded the record levels recorded in 2008.

Figure 1: Contributions to y-o-y growth of retail price of 95 octane unleaded motor petrol



Sources: Ministry of Economic Development and Technology, Bank of Slovenia calculations.

Figure 2: Contributions to y-o-y growth of retail price of diesel fuel



Sources: Ministry of Economic Development and Technology, Bank of Slovenia calculations.

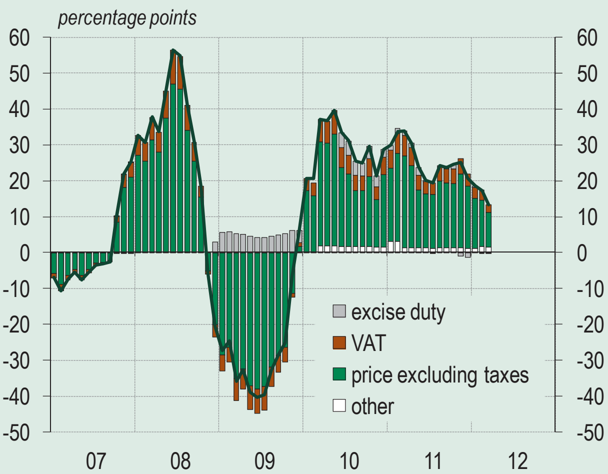
The sharp increase in crude petroleum prices is also being reflected in final consumer prices. At the same time it is also increasing corporate input costs in the majority of the economy, but the higher costs cannot be fully passed through into final prices. The Slovenian government slightly mitigated the rise in final consumer prices in 2011 by cutting excise duties, despite the need for fiscal consolidation.

In setting excise duties Slovenia is a special case in the euro area, as the government adjusts them every 14 days, while in most other countries the administrative procedure is more demanding. For example, excise duties in Germany have not changed since 2003. Under an EU directive, excise duties must exceed a certain minimum level.[1]

A comparison of the contributions of individual components to year-on-year growth in prices of refined petroleum products reveals that last year the government made cuts in excise duties on petrol during the first seven months of the year (except in June), but then began raising them from August. With prices of diesel on global markets recording higher growth than prices of petrol, primarily as a result of higher refinery margins, selling prices of diesel fuel and fuel oil were correspondingly higher. Excise duties on these products were consequently raised less in the second half of 2011 than those on gasoline.

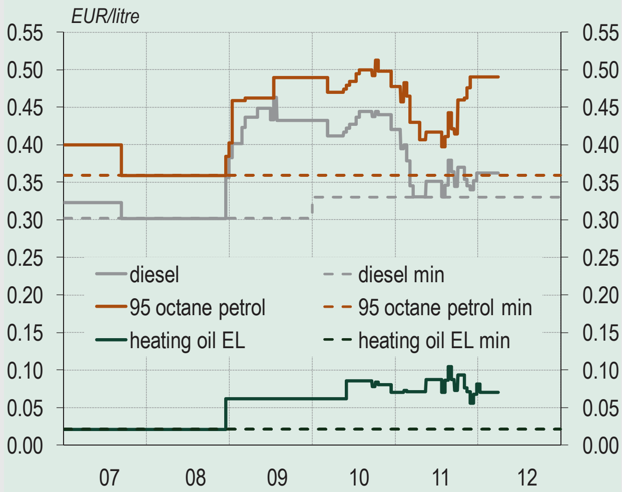
The changes in excise duties on refined petroleum products acted to reduce average annual inflation by 0.4 percentage

Figure 3: Contributions to y-o-y growth of retail price of heating oil EL



Sources: Ministry of Economic Development and Technology, Bank of Slovenia calculations.

Figure 4: Excise duties on motor fuels and heating fuels



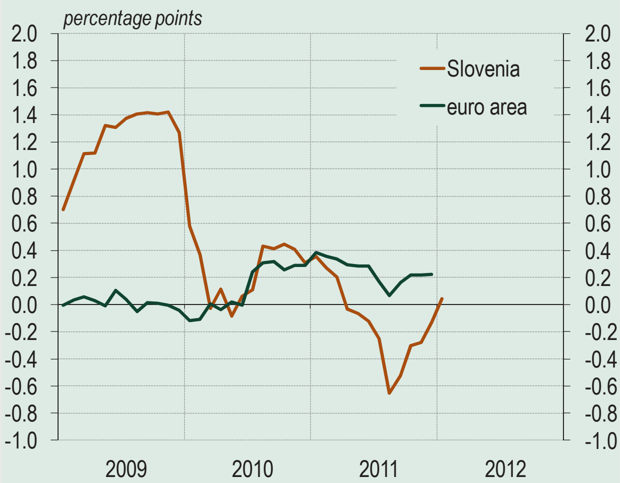
Sources: Ministry of Economic Development and Technology, European Commission.

points in 2011. Together with the changes in excise duties on tobacco, an increase in motor vehicle tax in January 2011 and VAT exemption for certain postal services, this acted to reduce headline inflation as measured by the HICP by 0.1 percentage points from the level it would have been under unchanged excise duty rates, as revealed by the HICP under constant tax rates.

Excise duties on liquid fuel rose slightly in January 2012, while there was no change in other excise duties. Should there be no further changes in excise duties this year, the contribution made to inflation this year by excise duties will be positive as a result of changes last year. Under the assumption of no change in current excise duties, this contribution is estimated at 0.2 percentage points.

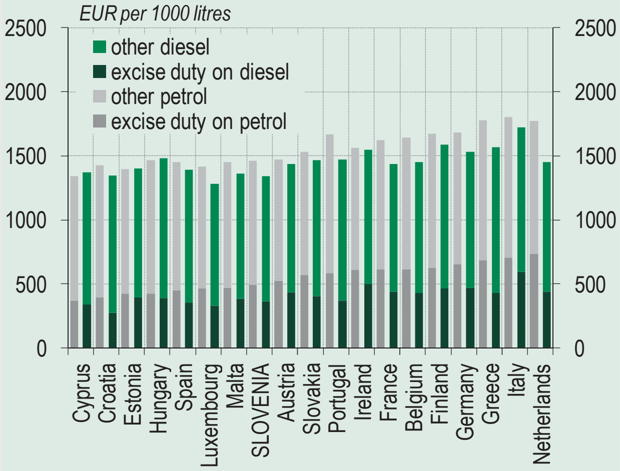
A comparison of fuel prices and excise duty levels in the euro area and in Slovenia's neighbouring countries reveals excise duties on refined petroleum products in Slovenia to be lower than the euro area average. In contrast to Slovenia, excise duties in the euro area were not lowered last year. In recent years there has also been a sharper rise in excise duties in certain countries severely affected by the debt crisis. One example is Greece, which raised excise duties on refined petroleum products sharply in 2010 for the purpose of fiscal consolidation. For the same reason, excise duties have also

Figure 5: Difference between HICP and HICP at constant tax rates (HICP-CT) y-o-y growth rates



Sources: Eurostat, Bank of Slovenia calculations.

Figure 6: Composition of retail price of motor fuels in the euro area and neighbouring countries



Sources: Oil Bulletin (15.3.2012), INA d.d.(15.3.2012), Official Gazette of the Republic of Croatia (102/2010), ECB reference rate.

been rising sharply since the outbreak of the crisis in Italy, which currently has the highest petrol and diesel prices in the euro area. Croatia, which has not yet needed to take the minimum levels prescribed in the EU into account, has the lowest excise duties on diesel fuel out of all the countries compared, and the second-lowest excise duties on petrol.

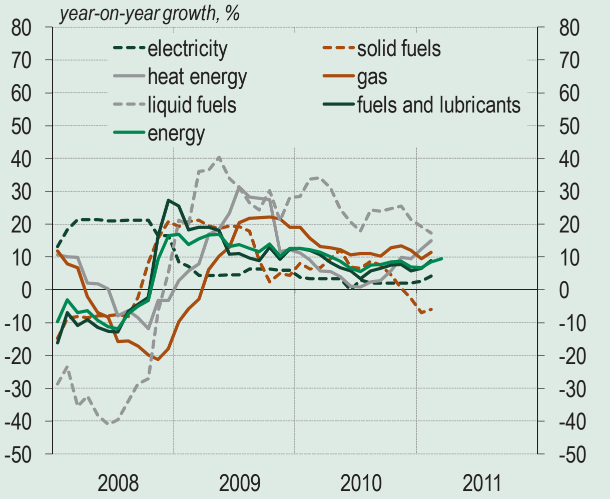
[1] The minimum level of excise duties in the EU is EUR 359 for 1,000 litres of petrol, EUR 330 for 1,000 litres of diesel fuel and EUR 21 for 1,000 litres of fuel oil (Council Directive 2003/96/EC).

less than in the previous year, and 3.1 percentage points less than in the euro area. Due to the adjustments in excise duties and the movement of the euro exchange rate, the rise in oil prices was only partly passed through into

Figure 6.3: Energy prices

Sources: Eurostat, Bank of Slovenia calculations.

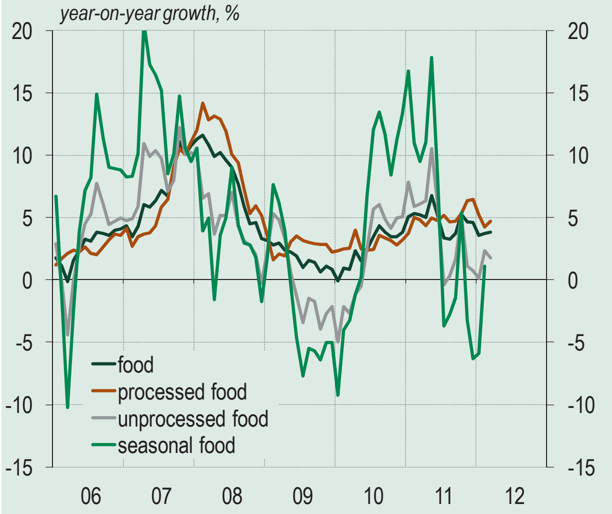
Figure 6.4: Individual energy price categories



Sources: Eurostat, Bank of Slovenia calculations.

domestic prices of motor fuels. These rose on average by 7.7% in 2011, compared with a much higher average rise of 13.6% in the euro area. The price of heating oil rose sharply in 2011, by 25.6% on average for the year. Prices of gas and solid fuels recorded higher year-on-year growth than in the euro area average. In the first quarter of 2012, year-on-year growth in energy prices averaged 8.3%. An increase in the charge for renewable resources and a rise in the electricity network fee fuelled the growth

Figure 6.5: Food prices



Sources: Eurostat, Bank of Slovenia calculations.

in energy prices in addition to the effects of rises in oil prices and excise duties.

The rise in commodity prices on global markets in 2011 was also reflected in growth in domestic food prices. These rose by 4.8% last year, 2.3 percentage points more than in the previous year and 2.1 percentage points more than the euro area. A change in the methodology for calculating prices of seasonal products had a positive contribution to the rate of inflation. Prices of processed food rose by 5.0% on average in 2011, primarily as a result of rises in prices of bread and cereals, and milk, cheese and eggs. Prices of oils and fats also recorded high growth. Prices of tobacco also rose, as a result of a rise in excise duties in accordance with EU directives. Their contribution to inflation was nevertheless lower than in 2010, and it accounted for a relatively small part of the year-on-year rise in prices of processed food. Prices of unprocessed food, most notably prices of fruit and vegetables, fluctuated more sharply in 2011 than in previous years. The sharp fluctuation was largely the result of a change in the methodology for calculating[13] prices of seasonal products, whose contribution to inflation averaged 0.2 percentage points during the year. The growth in prices of fruits and vegetables was

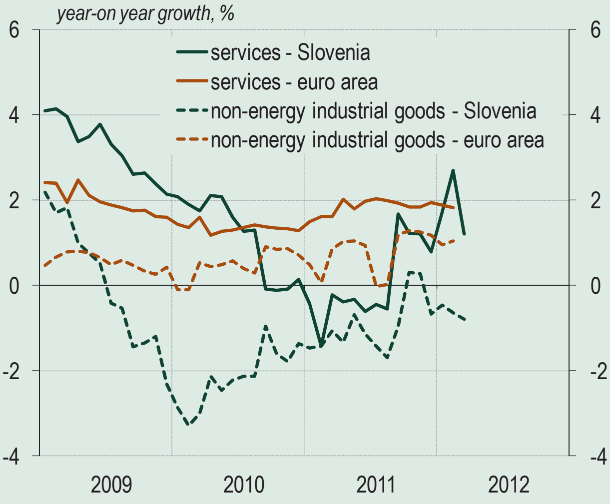
[13] For more on changes in the methodology, see:
http://epp.eurostat.ec.europa.eu/portal/page/portal/hicp/documents_pub/HICP_SP_info_note_annex_2011.pdf.

high in the first half of 2011 but slowed down slightly towards the end of the year. On average, prices of fruit increased by 12.6% in 2011 and prices of vegetables by 0.1%. Year-on-year growth in prices of meat increased rapidly during 2011 and stood on average at 3.6%, compared to -0.7% in 2010. In the first quarter of 2012, year-on-year growth in food prices was on average 3.7%.

Prices of services were down in year-on-year terms during the first eight months of 2011, but from September onwards and in the early months of 2012 they rose again. Prices of services were on average unchanged in 2011, while they have risen by 1.2% in the previous year. The most important factor in the stagnation of these prices was a base effect linked to a change in the calculation of prices of school meals in 2010. Additional reason for stagnation was the adverse situation in the labour market, which restricted household demand. Prices of package holidays continued to fall in 2011, by 4.1% on average, while prices of telephone and internet services also fell towards the end of the year. In the first quarter of 2012, year-on-year growth in services prices averaged 1.9%, partly as a result of a base effect caused by the one-off cut in the prices of radio and TV subscription in February 2011, and partly as a result of rises in this subscription and in prices of passenger road transport in January 2012.

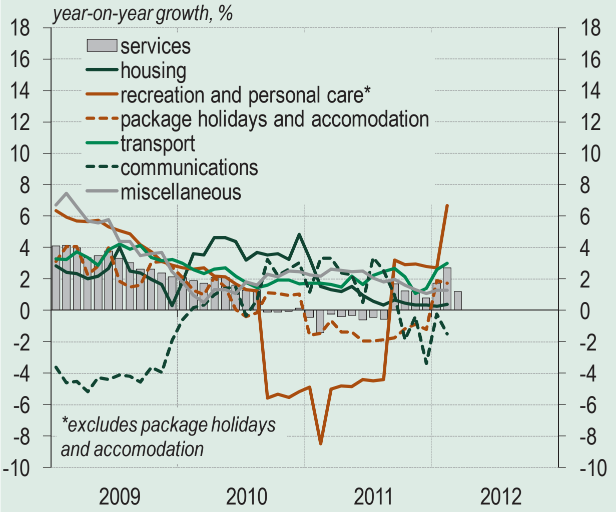
Prices of non-energy industrial goods fell in 2011, whereby the decrease was gradually slowing down over the year. Prices of industrial goods fell by 0.9% on average in 2011, compared with a fall of 2.2% the previous year. In comparison, growth in prices of industrial goods in the euro area averaged 0.8% in 2011. Prices of semi-durables were subject to sharp fluctuation due to changes in prices of clothing and footwear and prices of sports equipment during the seasonal sales. These fell by 0.9% on average in 2011, less sharply than in the previ-

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



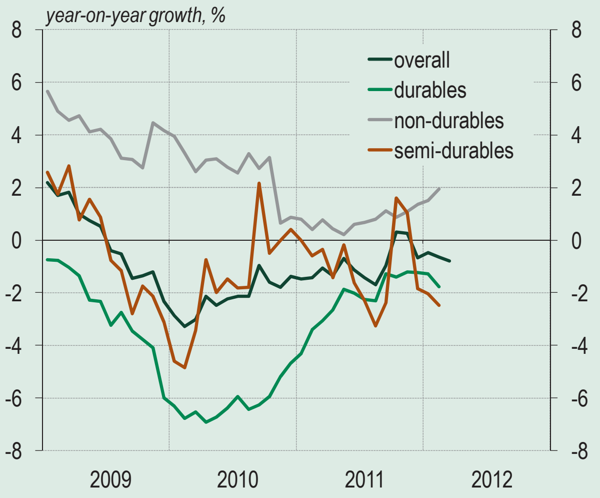
Sources: Eurostat, Bank of Slovenia calculations.

Figure 6.7: Services prices



Sources: Eurostat, Bank of Slovenia calculations.

Figure 6.8: Prices of non-energy industrial goods



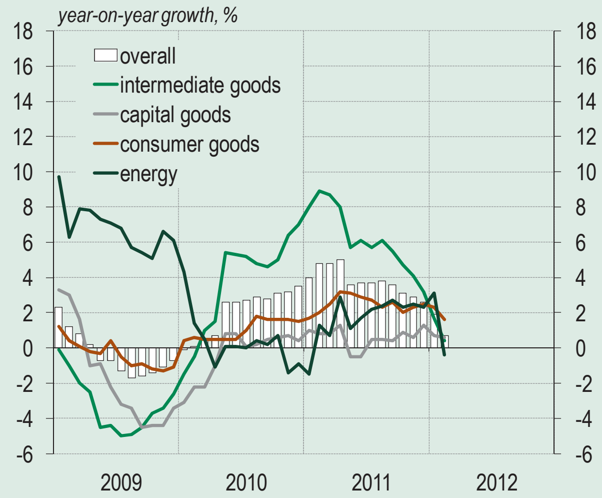
Sources: Eurostat, Bank of Slovenia calculations.

ous year. Prices of durables fell by 2.3% last year, the fall slowing primarily as a result of a slower fall in car prices than in 2010. Year-on-year growth in prices of non-durables increased slightly towards the end of the year, but the average rate for the year remained relatively low at 0.8%, 1.9 percentage points less than in 2010. Prices of non-energy industrial goods continued to fall in year-on-year terms on average during the first quarter of 2012, primarily as a result of more pronounced seasonal sales in January and February.

Industrial producer prices

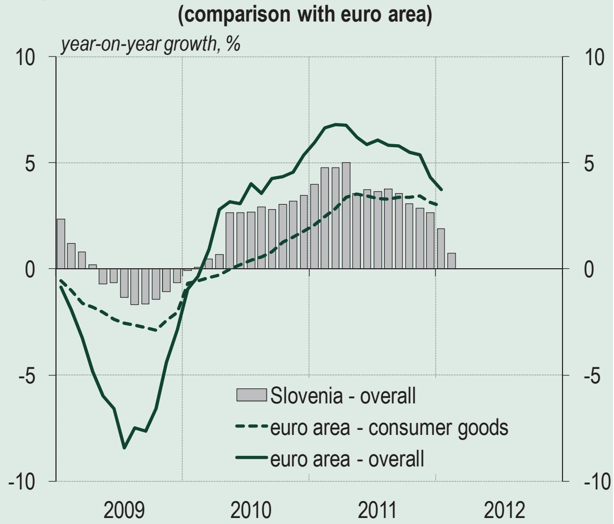
Industrial producer prices on the domestic market rose by 3.8% on average last year, compared with 5.9% in the euro area overall. The decline in year-on-year growth has continued in the early part of this year, primarily as a result of the decline in year-on-year growth in commodity prices. The sharp rise in commodity prices on global markets in late 2010 and early 2011 was reflected via higher import prices in sharp year-on-year growth in producer prices of commodities on the domestic market. These rose by 6.2% on average last year, the largest contribution coming from metals prices, which rose by 11.6%. Growth in prices of consumer goods stood at 2.5%, durables recording a larger price rise than non-durables. By contrast, producer prices of non-durables, food in particular, recorded higher growth in the euro area overall. Energy prices also rose more sharply in the euro area overall than in Slovenia, at a rate of 10 percentage points higher, primarily as a result of differences in the structure of the price index. In the euro area it includes producer prices in the extraction of crude petroleum and the manufacture of refined petroleum products, which rose sharply. Year-on-year growth in prices of capital goods was the lowest of all the categories, at 0.6%. Year-on-year growth in industrial producer

Figure 6.9: Industrial producer prices on the domestic market



Sources: SORS, Bank of Slovenia calculations.

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



Sources: Eurostat, Bank of Slovenia calculations.

prices on the domestic market in Slovenia declined to average 1.3% in the first two months of this year. The major factors acting to reduce prices in year-on-year terms were the year-on-year decline in growth in commodity prices on global markets, and base effects, which are being reflected in particular in producer prices of fabricated metals and food products.

7 Projections of Economic Trends and Inflation 2012-2014[14]

Economic growth projections have been revised significantly downwards, but the inflation projections are slightly higher. GDP is expected to decline by more than 1% in 2012, and to rise by around 0.5% next year. The economic growth projections have thus been revised downward since the previous projection, by almost 3 percentage points for 2012 and by just under 2 percentage points for 2013. Revisions of this magnitude are a reflection of the materialisation of the majority of the risks identified in last October's Price Stability Report. Given the deteriorating situation on the labour market and the fiscal consolidation, weak domestic demand during the projection horizon will not be a reflection solely of the continuation of low investment activity, but also of weak household consumption and a contraction in government spending. At the same time export growth will also be very limited, at least in the first half of 2012, as a result of the projected slow growth in the international environment. The net trade contribution is nevertheless expected to remain similar to previous projections, due to weaker domestic demand. These trends are also being reflected in the projections of the current account position, which is expected to be in surplus. In contrast to the downward revision of the economic growth projection, the inflation projection has been raised slightly, primarily as a result of high energy prices on global markets. After rising temporarily in early 2012, inflation is expected to stand at around 2% over the remainder of the projection horizon.

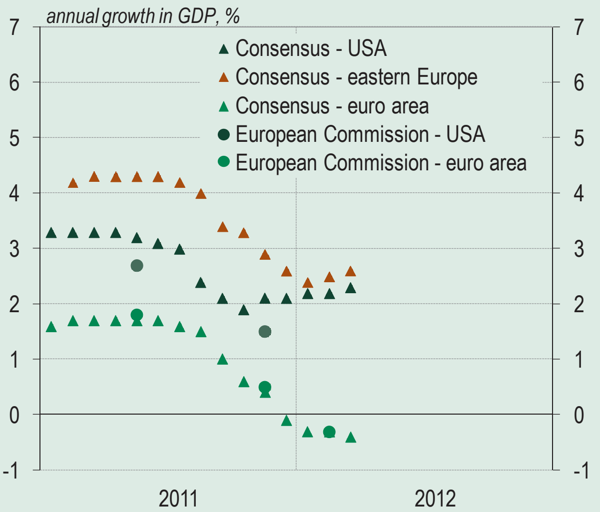
The risks in the GDP growth projection remain high, with a larger probability that growth will be lower rather than higher. The persistent uncertainty on the government debt securities markets and the need for additional fiscal consolidation measures in the EU are maintaining the risk surrounding foreign demand. The uncertainties surrounding domestic risk factors also remain high. The fiscal consolidation measures were still vague as the projections were being drawn up, but a fiscal squeeze of the planned magnitude could have a significant impact on the majority of macroeconomic variables. A lack of credible measures could lead to further deterioration in the financing conditions for the economy. The deterioration in the situation on the labour market is increasing the possibility of a further rise in structural unemployment and the related social problems, a loss of human capital and additional government expenditure. The risks surrounding inflation projection remain balanced, and similar to those in previous projection round. The risks associated with higher energy prices have been assessed as slightly higher this time. The risks of higher inflation are linked to possible additional measures in the scope of fiscal consolidation, and to price rises in sectors with a lower level of competition. A slower recovery in domestic demand and sharper cost adjustment in the economy could reduce core inflation.

[14] *The projections were made on the basis of the available data and the current statistical methodologies as at 12 March 2012. The projections of macroeconomic factors presented in this report are based on assumptions for variables in the international environment and certain domestic factors dependent on economic policy decisions. The assumptions for variables from the international environment are taken from Consensus Forecasts and Eastern Europe Consensus Forecasts (February 2012), JP Morgan (Global Data Watch, 9 March 2012), the OECD Outlook (December*

International environment and external assumptions

The outlook for economic growth in Slovenia's most important trading partners is significantly worse than the assumptions in the October projections, as a result of the deepening fiscal crisis and the decline in confidence in a number of euro area countries. Owing to the increased need for fiscal consolidation in the euro area and the decline in economic activity at the end of the year, there was a sharp reduction in the forecast for economic growth in Slovenia's most important trading partners. Other factors are the adverse situation on the labour market and tightened financing conditions, which are reducing consumer and business confidence. The assumption for growth in foreign demand in 2012 is down more than half on the previous projections, as a result of adverse developments at the end of 2011. Foreign demand is expected to increase by just 1.8% on average in 2012, although growth could become more dynamic again in the second half of 2012 according to current

Figure 7.1: Projections of economic activity for 2012



Sources: Consensus Economics, European Commission.

Figure 7.2: Projections of economic activity for 2013

Sources: Consensus Economics, European Commission.

Table 7.1: Assumptions for the international environment

						Assumptions					
						2012		2013		2014	
	2007	2008	2009	2010	2011	Apr.	Δ	Apr.	Δ	Apr.	Δ
	annual growth, %, unless stated										
Foreign demand*	11.3	5.9	-14.2	11.3	7.5	**1.8**	-2.7	**3.5**	-2.5	**4.5**	...
Oil (USD/barrel)	73	98	62	80	111	**120**	13	**115**	11	**113**	...
Non-oil commodities	17.4	10.1	-23.0	37.1	18.0	**-3.1**	-1.1	**3.9**	-1.1	**6.0**	...
EMU inflation	2.1	3.3	0.3	1.6	2.7	**2.0**	0.1	**1.7**	-0.1	**2.0**	...
PPI Germany	1.3	5.4	-4.0	1.5	5.6	**2.1**	-0.2	**2.1**	0.3	**1.7**	...

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

2011), the IMF WEO Update (January 2012) and the European Commission Interim Forecast (February 2012). The domestic factors under the influence of economic policy and exogenously included in the forecasting process are public sector spending and investment, public sector wages, the movement of administered prices and certain other variables of a fiscal nature. The assumptions used in the projections are not the same as those used by the ESCB in its projections. For the relationship between the Bank of Slovenia projections and those of the ESCB, see the annex to the April 2008 Price Stability Report.

Figure 7.3: Commodity prices

Sources: ECB, Bloomberg, Bank of Slovenia assumptions.

forecasts by international institutions. Average growth in 2013 is therefore expected to be higher at around 3.5%, although this is down almost a half on the assumption used in the previous projections.

As a result of supply-side shocks, oil prices are expected to be higher than in previous projections during the projection horizon, while prices of other commodities are expected to track the decline in global economic growth. The rapid rise in oil prices in early 2012 was the result of geopolitical tensions in the Middle East. Oil prices are expected to fluctuate between USD 110 and USD 120 per barrel until the end of the projection horizon. This represents an increase of about 10% in each year over the assumptions from the previous projections, while the revision in euro prices is just under 20%. Slow global economic activity is expected to result in slower growth in primary commodity prices, particularly in 2012. Growth in primary commodity prices in 2014 is forecast at around 6%, in line with the gradual recovery in the global economy.

Inflation in the euro area is expected to fall to 2.0% in 2012, and price growth is expected to remain low in the next two years. The slowdown in the global economy and rising energy prices will contribute to virtually unchanged price growth in 2012 and 2013. Given that no significant improvements can be expected in the situation on the labour market, core inflation will also remain low as household consumption remains weak. Higher growth in producer prices in Germany in 2011 was primarily the result of high energy prices, but the rate is expected to slow to around 2% in the 2012 to 2014 period as a result of lower other input costs.

GDP growth

GDP is forecast to fall by 1.2% in 2012, while growth over the next two years is expected to be low. The projection for GDP growth in 2012 is down almost 3 percentage points on the previous projection round, while the projection for GDP growth in 2013 has also been revised downwards, by almost 2 percentage points. This is a significant downward revision compared with the previous projections, and is comparable to that in the majority of euro area countries. In addition to the revised data for past GDP, there was a sharp decline in the assumption for growth in foreign demand, while domestic demand will also continue to decline. Currently available indicators for early 2012 do not show signs of a significant improvement in aggregate economic activity from the final quarter of last year, which also entails a pronounced negative carry-over of the activity dynamics into 2012. Economic

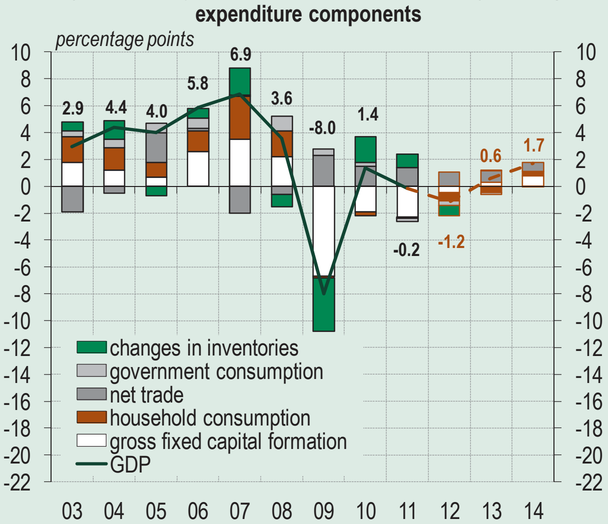
Figure 7.4: GDP at various national accounts data releases

Source: SORS.

Figure 7.5: GDP growth projection

Sources: SORS, Bank of Slovenia projections.

Figure 7.6: Projection of contributions to GDP growth by expenditure components



Sources: SORS, Bank of Slovenia projections.

growth in Slovenia is not expected to match that in the euro area until 2014 and will lag the average growth in the euro area by around 0.5 percentage points. The level of economic activity in 2014 will not reach the pre-crisis level, although GDP is expected to rise in 2013 and 2014.

Aggregate demand

A very weak recovery in domestic consumption can be expected in the medium term. The negative contribution made by construction investment will gradually decline. Construction investment will continue to be restricted primarily by difficulties in financing, large stocks of unsold housing and fiscal consolidation measures. Given the high indebtedness of construction firms, and the lack of projects with an appropriate return and the adequate insurance against risks, the banks will remain cautious in their financing. The large number of new-build homes that remain unsold will continue to prevent potential investors from building additional housing capacity. No major government investment can be expected, given the urgency of fiscal consolidation. Construction investment is thus assessed to rely primarily on increasing capacity in the energy sector (Block 6 of the Šoštanj power station and the South Stream pipeline). Railway infrastructure expansion where the technical documentation that will enable the start of construction work should be drawn up as soon as possible, represents another major opportunity for increasing construction investment.

Table 7.2: Components of domestic demand

						Projections					
						2012		2013		2014	
	2007	2008	2009	2010	2011	Apr.	Δ	Apr.	Δ	Apr.	Δ
	real growth rates, %										
Domestic demand	8.9	4.1	-10.0	-0.1	-1.6	**-2.3**	-3.1	**-0.3**	-2.1	**1.1**	...
Private consumption	6.1	3.7	-0.2	-0.7	-0.3	**-1.1**	-1.7	**-0.8**	-2.0	**0.6**	...
Government spending	0.6	6.1	2.9	1.5	-0.9	**-1.8**	-2.0	**-0.8**	-1.2	**0.0**	...
Gross fixed capital formation	13.3	7.8	-23.3	-8.3	-10.7	**-2.4**	-2.0	**1.5**	-3.1	**3.9**	...

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

After recording relatively high growth in 2011, investment in machinery and equipment is expected to record slower growth in 2012. In the event of the assumed improvement in the international environment, investment is forecast to rise again towards the end of the projection horizon. The gradual decline in production capacity utilisation in manufacturing, at least in the beginning of the projection horizon, is an indication of the relatively small need for investment. At the same time investment in machinery and equipment is also being curbed by the growth outlook in the main trading partners. The anticipated gradual improvement in foreign demand is expected to increase the need for additional investment in machinery and equipment, which will be reflected in growth in such investment, particularly in the second part of the projection horizon.

Household consumption is expected to decline this year and next year, primarily as a result of the situation on the labour market. Given the low economic activity and persistent high unemployment, which is being reflected in pessimism in the household sector, and as a result of high domestic energy prices, low growth in income in both private and public sector, and the downsizing of government social policy measures, household consumption is projected to record a cumulative decline of just over 1% during the projection horizon. Household consumption is expected to decline in 2012 and 2013, but to gradually rise in 2014 in line with the renewed growth in real disposable income.

Government consumption will also decline, in line with the need for fiscal consolidation. A revision to this year's budget is currently being drafted, and is expected to be based on a significant reduction in expenditure. Because the measures to achieve fiscal consolidation[15] are still vague, they have not been taken into account in full in the projections. The projections have therefore assumed no change in the average nominal wage in the public sector, with a small drop in the workforce in employment, and a decline in expenditure on intermediate consumption in 2012 and 2013. Given the planned reduction in expenditure in the revision to the state budget for 2012, final government consumption fall this year is expected to be larger than last year. It is also projected to fall in 2013. Final government spending during these two years is expected to be down around 2% on the previous projections.

Despite the uncertain economic situation in the international environment, net trade will record a positive contribution to GDP growth, primarily as a result of

Table 7.3: Activity, employment and wages

						Projections					
						2012		2013		2014	
	2007	2008	2009	2010	2011	**Apr.**	Δ	**Apr.**	Δ	**Apr.**	Δ
	growth rates, %										
GDP (real)	6.9	3.6	-8.0	1.4	-0.2	**-1.2**	-2.9	**0.6**	-1.9	**1.7**	…
Employment	3.3	2.6	-1.8	-2.5	-1.7	**-1.2**	-0.6	**-0.5**	-0.6	**0.3**	…
Compensation per employee	6.2	7.2	1.8	4.3	2.0	**1.4**	-1.2	**1.6**	-1.2	**2.2**	…
Productivity	3.4	1.0	-6.3	4.0	1.6	**0.0**	-2.3	**1.1**	-1.6	**1.4**	…
ULC (nominal)	2.6	6.2	8.7	0.3	-0.4	**1.4**	1.0	**0.5**	0.2	**0.8**	…
Contribution to GDP growth	*percentage points*										
Domestic demand, excluding changes in inventories	6.9	5.1	-6.3	-2.0	-2.6	**-1.4**	-1.7	**-0.3**	-2.0	**1.1**	…
Net exports	-2.0	-0.6	2.3	1.5	1.4	**1.1**	0.2	**0.9**	0.1	**0.7**	…
Changes in inventories	2.0	-0.9	-4.0	1.9	1.1	**-0.8**	-1.2	**0.1**	0.1	**0.0**	…

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

[15] See Box 7.2.

low imports caused by low domestic demand. Given the sharp slowdown in the pace of international trade at the end of 2011, driven by the decline in economic activity in the major trading partners and the continuing decline in domestic demand, the projections for export and import growth were also reduced. The contribution made to GDP growth by net trade this year will therefore be lower than in 2011. The gap between export growth and import growth will gradually narrow as a result of a gradual recovery in domestic demand. The contribution made by net trade is nevertheless expected to remain positive between 2012 and 2014, almost unchanged from the previous projections.

Supply side

As a result of the deterioration in the international environment, activity in export-oriented sectors is likely to decline slightly in 2012, before increasing only slowly. An even slower recovery is expected in sectors dependent primarily on domestic demand. The situation in the export sector will be worse than expected in the previous projection round. Demand indicators having remained unfavourable in the beginning of the year, value-added in the export sector will decline further in the first half of this year, while the carry-over of lower activity from the end of last year will also be significant. At the end of 2011 the proportion of industrial firms citing the uncertain economic situation among the limiting factors in production increased considerably and stood at its highest level in the last two years in the final quarter of 2011. This indicator of uncertainty declined slightly in early 2012, but nevertheless remained high. Growth in foreign demand, and thus the contribution made to GDP growth by export activities, is expected to increase in the course of 2012. Activity in sectors dependent primarily on domestic demand will be low this year, due to the merely gradual stabilisation of the labour market and the probable expansion of fiscal consolidation measures. Growth in domestic demand is thus expected to remain weak at least until the end of the projection horizon. The situation is expected to deteriorate in wholesale and retail trade in particular, as a result of a further decline in purchasing power and low consumer confidence.

The crisis in construction is expected to gradually ease, although activity in the construction sector will continue declining this year at least. An indication that the crisis in the construction sector is gradually easing was the halt in the decline in activity in this sector at the end of last year. Furthermore, the ratio of value-added in construction to GDP is very low, and below the euro area average. Given that infrastructure projects already begun will be continued over the projection horizon, and certain new projects will commence, value-added in construction is expected to begin rising again gradually, although it should be noted that imported goods and services will account for a large portion of the value of these projects.

Labour market

As a result of the slowdown in economic activity and the fiscal consolidation, employment will fall in 2012 and 2013, but the trend of falling employment is then expected to gradually reverse. As a result of the stagnation in economic activity and the austerity measures announced by the government, employment is expected to fall by 1.2% in 2012 and by around 0.5% in 2013. A slow recovery in employment is expected to follow in 2014. The reason for such projections is that the labour market is expected to respond to the significant slowdown in economic activity in the final quarter of last year with some lag, despite the developments on the labour market at the end of 2011 were rather favourable. Employment will fall in the public sector and in the private sector in 2012. Weak domestic demand will prevent growth in employment in sectors primarily dependent on the domestic market. As investment declines, the workforce in employment in the construction sector will drop further, albeit more slowly than in previous years. As a result of a decline in activity in sectors with low content of value-added, structural unemployment can be expected to rise. Due to announced fiscal measures, the low growth seen to date in employment in the public sector will stagnate, which will further contribute to a fall in total employment over the projection horizon. The surveyed unemployment rate is expected to exceed 9% in the first half of 2012, and to remain at this level throughout the projection horizon. Despite the fall in employment, it is expected that a certain proportion of the unemployed will continue to become inactive, as a result of which the rise in unemployment is projected to be smaller than would have been expected due to the ongoing fall in employment.

Wages in the private sector will grow more slowly than in previous years as a result of a stagnation in economic activity. Year-on-year growth in the private sector average nominal gross wage slowed notably in the final months of 2011. These trends will continue in 2012, when the average real wage is projected to decline by almost 1%. Real wages are only expected to rise slightly with the recovery of the economy in 2014. Wage growth will also depend on potential changes in the structure of new hires, as the hiring of workers in sectors with relatively low wages would have a negative statistical effect on wage growth despite the economic recovery. If some of the workers who have lost their jobs during the crisis remain permanently unemployed as a result of a permanent change in the structure of the economy, there will be no such statistical effect.

Government austerity measures will curb wage growth in the public sector. Public sector wages have been stagnating since 2010, and the average wage was down in year-on-year terms in the second half of 2011. In light of the austerity measures announced by the government and the current intervention act, the decline in public sector wages could be even deeper. The main uncertainties surrounding the development of wages in the public sector relate to the form and possibilities of the agreement between the government and the public sector unions.

Foreign trade

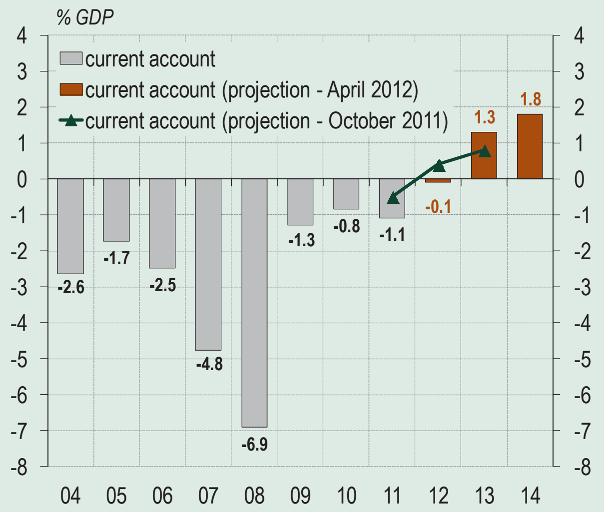
After recording a deficit last year, the current account is projected to be in balance this year, before moving into surplus in the amount of almost 2% of GDP. The contributions to the surplus compared with 2011 will come equally from a decline in the merchandise trade deficit and an increase in the surplus of trade in services. More favourable terms of trade will account for approximately a third of the surplus. There is almost no change from the previous projection of the current account position in 2012, while the position in 2013 has been revised upwards by around 0.5 GDP percentage points as a result of slower growth in domestic demand and thus slower growth in imports.

Table 7.4: Current account

						Projections					
						2012		2013		2014	
	2007	2008	2009	2010	2011	**Apr.**	Δ	**Apr.**	Δ	**Apr.**	Δ
Exports of goods and services	13.7	2.9	-17.2	9.5	6.8	**2.3**	-2.6	**4.0**	-2.5	**5.0**	…
Imports of goods and services	16.7	3.7	-19.6	7.2	4.7	**0.9**	-2.9	**3.0**	-2.7	**4.4**	…
Current account: EUR billion	-1.6	-2.6	-0.5	-0.3	-0.4	**0.0**	-0.1	**0.5**	0.2	**0.7**	…
as % GDP	-4.8	-6.9	-1.3	-0.8	-1.1	**-0.1**	-0.5	**1.3**	0.5	**1.8**	…
Terms of trade*	0.9	-1.5	4.3	-3.8	-1.9	**-1.2**	-1.8	**0.3**	0.1	**0.1**	…

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

Figure 7.7: Current account projection



Sources: SORS, Bank of Slovenia projections.

Figure 7.8: Terms of trade projection

Sources: SORS, Bank of Slovenia projections.

After widening this year, the merchandise trade deficit is expected to gradually diminish, while the surplus of trade in services is expected to remain high. The surplus in the balance of trade (merchandise trade and services) is projected to rise from around 1% of GDP this year to around 2.5% of GDP in 2014. The projection of this year's increase in the merchandise trade deficit is primarily the result of the adverse terms of trade. In addition to a gradual increase in foreign demand and an improvement in the terms of trade, slow growth in all components of domestic consumption will act to reduce the merchandise trade deficit, although imports of capital goods are expected to increase over the coming years. The merchandise trade deficit is expected to narrow from almost 4% of GDP in 2012 to around 2.5% of GDP by the end of the projection horizon. The surplus of trade in services will be a major factor in the generation of a current account surplus. The surplus of trade in services related to merchandise trade, primarily transport services and business and technical services, will gradually increase. Net exports of travel services are expected to remain relatively unchanged in the future, primarily as a result of a slowdown in the rapid decline of imports of travel services in addition to the gradual growth in exports of travel services. The surplus of trade in services is expected to stand at close to 5% of GDP throughout the projection horizon.

The terms of trade will have a significant impact on the current account position. These should again be negative on average during 2012, although almost a third less than in 2011. Based on the current assumptions for import and export prices, the terms of trade could improve as soon as 2013, thereby contributing to an increase in the current account surplus in the next two years.

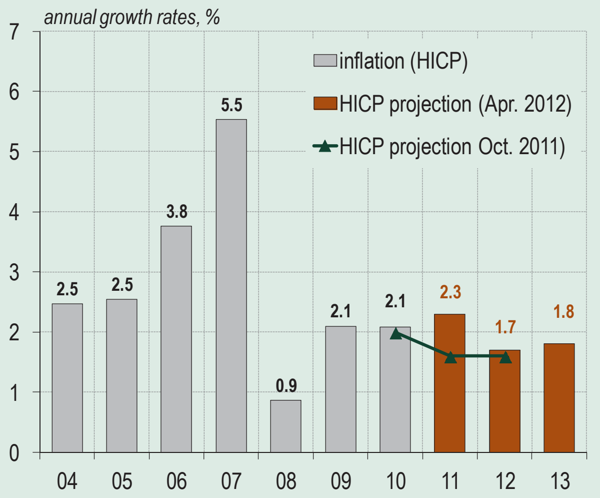
The deficit in factor income is expected to narrow from 1.5% of GDP this year to around 1% of GDP by 2014, while the surplus in transfers is projected to remain at around 0.5% of GDP. The main factor in the narrowing of the deficit in factor income is expected to be a diminishing deficit in capital income. Growth in outward interest payments is expected to be rather low, as a result of the anticipated maintenance of low interest rates until the end of the projection horizon. Government borrowing on the domestic market via treasury bill issues and a decline in government borrowing in the rest of the world could act in the same direction. The economic recovery could result in an increase in the flow of FDI, which could bring an end to the adverse impact of the disinvestment by non-residents in Slovenia and by domestic firms in the rest of the world seen in recent years. This should bring a gradual increase in receipts and expenditure for dividends and in distributed earnings. The deficit in income from investments in securities is expected to increase, primarily as a result of an increase in the stock of securities held in non-residents' portfolios, in excess of the stock of foreign securities held in residents' portfolios. As a result of a decline in the employment of foreign workers, labour income is forecast to record net inflows of around 0.5% of GDP throughout the projection horizon. Like last year, the surplus in transfers will primarily be the result of an increase in the surplus related to the disbursement of funds from the EU budget. A deficit is expected to be recorded in private and other official transfers.

Inflation

Average inflation is projected to exceed 2% in 2012. It is expected to fall slightly in 2013 and 2014, primarily as a result of lower growth in energy prices. The current inflation projection is higher than in the October projection round, primarily as a result of higher growth in energy prices at the beginning of this year. Price growth as measured by the HICP is projected at 2.3% this year, before falling to 1.7% in 2013 and remaining at a similar level in 2014. Inflation developments will remain subject to a high level of uncertainty and to tighter financing conditions, which alongside the fiscal consolidation and further decline in real household income will limit private consumption.

Energy prices are again expected to contribute the largest part to inflation this year among all the price categories. In line with the expected movement of oil prices on global markets and the euro / US dollar ex-

Figure 7.9: Inflation projections



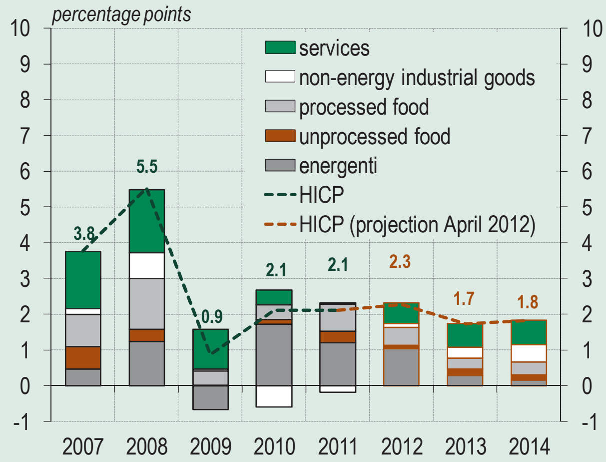
Sources: SORS, Bank of Slovenia projections.

Table 7.5: Inflation

						Projections					
						2012		2013		2014	
	2007	2008	2009	2010	2011	Apr.	Δ	Apr.	Δ	Apr.	Δ
						average annual growth, %					
Consumer prices (HICP)	3.8	5.5	0.9	2.1	2.1	**2.3**	0.7	**1.7**	0.1	**1.8**	…
food	7.1	8.1	1.8	2.5	4.8	**2.6**	0.1	**2.1**	-0.2	**2.2**	…
energy	3.4	9.4	-4.5	13.9	8.8	**7.5**	5.3	**2.0**	1.6	**1.1**	…
other goods	0.3	2.2	0.0	-2.2	-0.9	**-0.1**	-0.2	**0.6**	-0.2	**1.3**	…
services	4.9	5.3	3.2	1.2	0.0	**1.7**	-0.1	**1.9**	0.0	**2.0**	…
Core inflation indicators (HICP)											
excluding energy	3.8	4.9	1.7	0.3	1.0	**1.4**	-0.1	**1.7**	0.0	**1.9**	…
excl. energy and unprocessed food	3.4	5.0	1.9	0.2	0.7	**1.4**	-0.2	**1.6**	0.0	**1.9**	…
excl. energy, food, alcohol and tobacco	2.7	3.8	1.7	-0.4	-0.4	**0.9**	-0.2	**1.5**	0.0	**1.8**	…

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

Figure 7.10: Projection of contributions to inflation by components



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

change rate, and given no change in excise duties, energy prices are projected to rise by 7.5% this year. Their year-on-year rate of growth is expected to decline over the next two years. Other factors in the rise in domestic energy prices over the projection horizon are the anticipated rise in electricity prices and rises in prices of district heating and gas, which track oil prices with some lag. The main factors in the projection of domestic food prices are the assumed developments of food prices on global markets and changes in excise duties on tobacco. After recording high year-on-year growth in 2011, food prices are expected to rise by 2.6% in 2012, the rate then slowing to just over 2% by the end of the projection horizon. In line with the exclusion of certain one-off effects, and with the gradual recovery in domestic demand, the contributions made to inflation by services prices and prices of non-energy industrial goods are expected to increase in the future.

Low domestic consumption will limit the rise in core inflation this year, although the rate is expected to have risen by the end of the projection horizon in line with the anticipated gradual growth in the domestic economy. The decline in demand caused by the fall in consumer purchasing power and the uncertainty on the labour market are curbing growth in final consumer prices. In line with the projected improvement in economic activity and private consumption, core inflation is expected to rise slightly towards the end of the projection horizon. Average growth in the HICP excluding energy, food, alcohol and tobacco is projected at around 1% this year, and to rise to around 1.5% in 2013 and around 1.8% in 2014. This year's hike in core inflation will primarily be the result of a rise in services prices caused by last year's low basis and the one-off effect of last February's cut in the RTV licence fee. Growth in prices of non-energy industrial goods will stagnate this year, but is expected to increase over the next two years, thereby contributing to the rise in core inflation.

The overall direct impact on inflation from the announced government measures is expected to be larger this year, before declining. As a result of the European directive on raising excise duties on tobacco products, like last year tobacco prices will be raised twice this year, in April and October, and their contribution to headline inflation will stand at 0.2 percentage points. April also saw a rise of 10% in excise duties on beer, intermediate alcoholic beverages and ethanol, which will contribute 0.05 percentage points to inflation. Should the government leave excise duties on refined petroleum products unchanged, the contribution made to this year's growth in the HICP by last year's changes in these excise duties will stand at 0.2 percentage points as a result of a carry-over. According to the plan for managing administered prices in 2012 and 2013, the contribution made by administered prices is assumed at 0.1 percentage points this year and less than 0.05 percentage points in 2013.

The available monetary indicators and long-term inflation forecasts reveal that there is no expectation of strong price pressures in the medium term. Year-on-year growth in loans to households declined significantly in the second half of 2011. Growth in housing loans is declining, while the stock of consumer loans is continuing to contract. The decline in demand for bank loans is an indication of the continuing adverse situation on the labour market and the decline in consumer purchasing

Box 7.1: The impact of a rise in VAT on the economy

Tax rises are one of the possible tools for fiscal consolidation, alongside cuts in government expenditure and reductions in debt and interest via asset sales. As a consumption tax, VAT is among taxes with the lowest adverse impact on economic activity. Many countries in the EU have therefore recently decided to raise VAT rates to close the gap between general government expenditure and revenues. The average standard VAT rate in the euro area rose from 19.5% in 2007 and 2008 to almost 21% in 2011. The majority of EU Member States have raised VAT rates during the latest crisis, but Slovenia is one of nine countries (of the EU27) to have not done so since 2007.

The standard VAT rate in Slovenia was set at 19% when the system was introduced on 1 July 1999, while the reduced rate was set at 8%. VAT was raised at the beginning of 2002, to a standard rate of 20% and a reduced rate of 8.5%. The current standard VAT rate is lower than the rates in 11 other EU Member States. A rise of 1 percentage point in the VAT rate would still leave it lower than in seven other EU Member States. VAT revenues in Slovenia amount to just over 8% of GDP. According to estimates by the Ministry of Finance, a rise of 1 percentage point in the standard and reduced VAT rates would raise budget revenues by just over 6% or around 0.6% of GDP. A rise of 2 percentage points in the standard VAT rate would raise budget revenues by 8% or around 0.7% of GDP.[1] Analysis by the Institute for Economic Research[2] suggests that a rise of 2 percentage points in the standard VAT rate would reduce the budget deficit by approximately 0.3 percentage points.

Model simulations indicate that fiscal consolidation via government expenditure has fewer adverse impacts on economic activity in the long term than fiscal consolidation via increases in taxation. This is particularly true when fiscal consolidation is accompanied by monetary policy stimulus. Consolidation via expenditure may however have a stronger short-term adverse impact on economic activity. The advance announce-

Table 1: VAT rates in EU and their change in crisis

	reduced / standard rate	valid from		reduced / standard rate	valid from		reduced / standard rate	valid from
Belgium	6 and 12 / 21	1.1.2000	Ireland			Poland	3 and 7 / 22	9.4.2000
Bulgaria	7 / 20	1.1.2007	(continued)	4.8 and 13.5 / 21	1.1.2010		5 and 8 / 23	1.1.2011
	9 / 20	4.1.2011		4.8 and 9 and 13.5 / 21	7.1.2011	Portugal	5 and 12 / 21	7.1.2005
Czech Rep.	9 / 19	1.1.2008		4.8 and 9 and 13.5 / 23	1.1.2012		5 and 12 / 20	7.1.2008
	10 / 20	1.1.2010	Italy	4 and 10 / 20	10.1.1997		6 and 13 / 21	7.1.2009
	14 / 20	1.1.2012		4 and 10 / 21	17.9.2011		6 and 13 / 23	1.1.2011
Denmark	25	1.1.1992	Cyprus	5 and 8 / 15	8.1.2005	Romania	9 / 19	1.1.2004
Germany	7 / 19	1.1.2007	Latvia	5 / 18	5.1.2004		5 and 9 / 19	12.1.2008
Estonia	5 / 18	1.1.2000		10 / 21	1.1.2009		5 and 9 / 24	7.1.2010
	9 / 18	1.1.2009		12 / 22	1.1.2011	Slovenia	8,5 / 20	1.1.2002
	9 / 20	7.1.2009	Lithuania	5 and 9 / 18	1.1.2001	Slovak Rep.	10 / 19	1.1.2007
Greece	4,5 / 9	4.1.2005		5 and 9 / 19	1.1.2009		6 and 10 / 19	5.1.2010
	5 / 10	15.3.2010		5 and 9 / 21	9.1.2009		10 / 20	1.1.2011
	5,5 / 11	7.1.2010	Luxembourg	3 and 6 / 15	1.1.1993	Finland	8 and 17 / 22	1.1.1998
	6,5 / 13	1.1.2011	Hungary	5 / 20	9.1.2006		8 and 12 / 22	10.1.2009
Spain	4 and 7 / 16	1.1.1995		5 and 18 / 25	7.1.2009		9 and 13 / 23	7.1.2010
	4 and 8 / 18	7.1.2010		5 and 18 / 27	1.1.2012	Sweden	6 and 12 / 25	1.1.1996
France	2.1 and 5.5 / 19.6	4.1.2000	Malta	5/18	1.1.2004	UK	5 / 17,5	9.1.1997
	2.1 , 5,.5 and 7 / 19.6	1.1.2012		5 and 7 / 18	1.1.2011		5 / 15	12.1.2008
Ireland	4.8 and 13.5 / 21	1.1.2005	Netherlands	6 / 19	1.1.2001		5 / 17.5	1.1.2010
	4.8 and 13.5 / 21.5	12.1.2008	Austria	10 / 19	1.1.1995		5 / 20	1.4.2011

Source: VAT Rates Applied in the Member States of the European Union: Situation at 1st January 2012. European commission.

ment of measures and the credibility of fiscal policy, which could stimulate private sector activity via expectations when fiscal imbalances are limiting such activity, are another factor in the impact of tax changes. Other major factors in the impact of tax changes are the purpose for which the additional tax revenues are used, and the state of the economy.[3]

Because a change in the VAT rate affects the majority of transactions in the economy, its impact is reflected in budget revenues and other macroeconomic aggregates, most notably in inflation and in domestic consumption. A review of studies (most of which were carried out before the crisis) shows that, out of all tax instruments, changes in the taxation of consumption have the greatest impact on economic activity and inflation. In most cases a rise in the VAT rate reduces economic growth in the short term, but in the long term the impact of fiscal consolidation carried out in this manner is positive. The response of household consumption in most cases is negative, both in the short and the long term. The pass-through of a higher VAT rate into prices is mostly just a short-term effect of between 30% and 90%.

The macroeconomic changes when Slovenia introduced VAT in 1999 were rather significant. Even before the introduction of the VAT system, there was a sharp increase in spending. Higher household consumption and investment spending brought a significant change in the current account (from a surplus of 0.3% of GDP in 1997 to a deficit of almost 4% in 1999), but by 2001 the position was again balanced. As a result of the changes in relative prices and a rise in the effective tax rate, there was also a rise in inflation.[4] Following the introduction of VAT it became clear that the large increase in

[1] Delo, 28 October 2011.

[2] http://www.svrez.gov.si/fileadmin/svez.gov.si/pageuploads/docs/za_novinarje/Ocena_predlaganih_ukrepov-nov2011-_4_.doc

[3] One example is the experience of Japan from 1997, when a rise in VAT in the weak economic climate caused a further decline in economic activity. For more on this, see Coenen and McAdam (2006): How do VAT changes affect the economy? ECB Research Bulletin No. 4. April.

[4] The introduction of VAT was not the only reason of high inflation in 1999 and in the next few years. The pass-through of VAT into prices in 1999 was

Table 2: Studies of the effects of VAT changes on macroeconomic variables

Study	Country	Measure*	Variables	Effects
Almeida et. al (2011)	euro area	increase of VAT by 1 %	GDP; inflation	GDP: short-run -1%, long-run -1.5%; inflation: short-run 0.8%, long-run 0%
Barrel & Weale (2009)	panel	higher VAT rate by 1 p.p.	household consumption	increase by 1/3 in the quarter preceeding VAT increase
Cahsin & Unayama (2011)	Japan	higher VAT rate by 1 p.p.	household consumption; inflation	household consumption higher by 15% in the quarter preceeding VAT increase; substantial effect on inflation
Carare & Danninger (2008)	Germany		inflation	pass-through 70%
Coenen et. al (2008)	euro area		GDP, household consumption	in the short-run, the effect mainly through lower household consumption; positive long-run effect on GDP
Deutsche Bundesbank (2006 in 2008)	Germany		household consumption, investment; inflation	strong inter temporal effects on household consumption and private construction; pass-through to prices above 50%
ECB (2010)	euro area	increase of VAT by 1 %	GDP	short-run -0.1-0.1; long-run 0.9-2.3
Ernst & Young (2010)	USA	increase of VAT by 1 %	GDP, household consumption	GDP lower by 0.1%, household consumption by 0.8%; positive long-run effect on GDP
Henry et al (2004)	panel	increase of VAT by 1 %	GDP; inflation	GDP growth lower by 1/3 – 1/5 w.r.t. baseline scenario; pass-through to prices 60%-90 %
Keen & Lockwood (2007)	panel		budget revenues	not significant and negative in the majority of specifications
Keen et. al (2011)	Japan	higher VAT rate by 1 p.p.	GDP	in the short-run lower by 0.2 %; positive log-run effect
Mody & Ohnsorge (2007)	panel EU		inflation	pass-through 30% - 40%
De Vincent-Humphreys (2011)	United Kingdom		inflation	pass-through 30% - 60%

** Initial changes in VAT are defined differently in various analyses. Measures applied in simulations are provided if they are adequately stipulated in the analysis.*

spending was merely an inter-temporal substitution, as growth in both household consumption and investment spending diminished rapidly in the period after the introduction of VAT.

estimated at approximately 70%. The VAT rise in 2002 contributed approximately 0.7 percentage points to inflation, or approximately 10% of the overall price rise during the year. Commodity prices and rising demand had a much larger impact on inflation.

power. Loan conditions have also become tighter. At the same time, economic activity on key export markets is expected to stagnate this year. This situation does not indicate the chances of a stronger reversal in domestic demand during the projection horizon. Growth in economic activity will be lower than in the euro area overall throughout the projection horizon, primarily as a result of weaker domestic demand. There is therefore no expectation during the projection horizon of domestic inflation leading to a deterioration in the price and cost competitiveness of the Slovenian economy. Consensus is forecasting annual inflation of between 1.8% and 2.2% in Slovenia in the period 2012 - 2017.

Risks and uncertainties

The main external risk factor remains the possibility of a decline in economic activity in the rest of the world, and thus a decline in foreign demand and difficulties in financing. This risk is primarily associated with the uncertainty surrounding the resolution of the crisis on government debt securities markets. There remain uncertainties surrounding the fiscal difficulties and their resolution in certain euro area countries, despite the agreements on the resolution of the debt crisis. Domestic demand in the euro area, and thus demand for Slovenian products, could also be reduced by consumer pessimism in the EU as a result of the uncertain situation on labour markets and the fiscal consolidation measures. The impact of these measures is also uncertain because of the expected coordination of fiscal consolidation on the basis of the treaty agreed by the vast majority of EU countries. The uncertainty surrounding the sustainability of public finances in certain developed economies outside the euro area is also increasing the risk to foreign demand. Another growing risk factor is the cooling of activity in emerging economies, owing to the possibility of weaker growth in demand in developed economies. The higher energy prices that might result from geopolitical tensions in the Middle East could have an adverse impact on household disposable income and corporate earnings, and thus on demand from Slovenia's main trading partners.

The main domestic risk remains the uncertainty surrounding fiscal consolidation measures. These are likely to have an adverse impact on economic activity and employment, at least initially. The key measures by which the government will try to consolidate the public

Table 7.6: Comparison of forecasts for Slovenia and change from previous forecasts

	Publication of new/previous forecast	GDP annual growth, %				Inflation annual average, %				Current account as % GDP			
		2012		2013		2012		2013		2012		2013	
		new	Δ	new	Δ	new	Δ	new	Δ	new	Δ	new	Δ
Bank of Slovenia	Apr. 12/Oct. 11	**-1.2**	-2.9	**0.6**	-1.9	**2.3**	0.6	**1.7**	0.1	**-0.1**	-0.5	**1.3**	0.5
EIPF	Mar. 12/Sep. 11	**-0.9**	-2.9	**1.9**	-0.9	**1.5**	0.3	**1.0**	-0.5	**-0.1**	-0.6	**0.5**	-0.2
IMAD	Mar. 12/Jan. 12	**-0.9**	-1.1	**1.2**	-0.8	**2.0**	0.2	**1.8**	0.0	**0.6**	1.1	**1.2**	0.3
Consensus Forecasts	Mar. 12/Sep. 11	**-0.2**	-2.1	**1.3**	-1.2	**1.8**	-0.3	**1.9**	-0.3	**...**	...	**...**	...
European Commission	Feb. 12/Nov. 11	**-0.1**	-1.1	**...**	...	**1.6**	0.3	**...**	...	**...**	...	**...**	...
OECD	Nov. 11/May 11	**0.3**	-2.3	**1.8**	...	**1.3**	-0.9	**1.7**	...	**-0.5**	0.9	**-0.8**	...

Δ: Difference between current and previous forecasts.
Sources: Bank of Slovenia, EIPF, IMAD, European Commission, Consensus Economic Forecasts, OECD; Bank of Slovenia calculations.

Box 7.2: Fiscal consolidation measures

A revision to the state budget for 2012 was being drafted as the projections were being drawn up. The government set a deficit target of just over EUR 1 billion, or 3% of GDP. The measures proposed by the government as part of the revision to the state budget for 2012, which are still under discussion, were announced on 23 March 2012, after the cut-off date for drawing up the projections. The fiscal consolidation was thus only partly taken into account when the projections were being drawn up, in line with the information available by 12 March 2012: only a small reduction in employee compensation is envisaged for the whole projection horizon, while savings in intermediate consumption should be reflected in a nominal decline in government spending in 2012 and 2013, and in a merely low growth in 2014.

The planned measures cover a wide range of government expenditure. When they are introduced, nominal government consumption would fall by more than assumed in the projections, while a further contraction in government investments and subsidies and a wide range of measures constituting a reduction in social transfers are also planned. The measures with a major financial impact are summarised in the table below on the basis of the Ministry of Finance working material. Implementation of these measures will entail a significant decline in household disposable income, and will have an impact on the socio-economic position of certain population groups. A decline in disposable income would reduce household consumption and GDP, although this effect would partly be offset by lower imports.

Table 1: Overview of proposed government measures for fiscal consolidation

in mio EUR	2012	2013
I. Internal saving	**120.0**	**150.0**
Reduction in transfers to municipalities with reduction of financing of investments and/or lump sum	16.5	42.9
Beginning of repayment of government obligations to SŽ in 2014 (instead of 2012)	26.8	26.8
Other measures	76.7	80.3
II. Adjustments in the functioning of public sector	**402**	**408**
Cut in public sector wages, including those of officials, by 15 % by the end of the year with an option of faster elimination of wage disparities	226	176
Reduction in the percentage share of health services covered by the compulsory health insurance	66.1	88.2
Reinbursment for annual leave not paid in 2012 and halved in 2013	64	32
Savings regarding reimbursement of commuting and lunch expenses, various other reimbursments and business trips	26	52
Other measures	20.2	59.8
III. Adjustments of programs and policies	**295.8**	**390.6**
Reduction in investments, subsidies and other programs	135.0	135.0
Reduction of annual supplement for pensioners, abolition of this supplement for penisoners with pensions over EUR 622	60.5	60.5
Increase in concession fee for work of high school and university students (from 14% to 25%), decrease in the share of fee received by ŠOS and student services	24.0	36.0
Restrictions on rights to payment of supplementary health insurance for war veterans, war invalids and victims of war aggression	12.5	12.5
Reduction in pensions in part which is not based on paid contributions	12.0	-
Reductions in amount of unemployment benefit from 80% to 70% for the first two months, after that 60%; reduction in upper limit of benefit by 15%	11.9	17.7
Payment of kindergarden for second and each additional child under the same conditions as for the first child	5.3	21.5
Subsidies according to School Meals Act only to socially weak elemetary and high school students, meals for university students to be arranged in the same manner	4.7	19.0
Reduction in child allowance by 10% for classes 5 and 6 and abolition for classes 7 and 8	3.4	19.5
Reduction in amount of parental compensatin for child care, limitation of the upper limit	3.1	40.4
Other measures	23.4	28.5
TOTAL	**818.1**	**948.6**

Source: Ministry of Finance: Uravnoteženje javnih financ, Izhodišče za pripravo rebalansa proračuna za leto 2012, March 2012.

As part of the revision to the state budget, the government is also planning tax allowances in the amount of approximately EUR 150 million or 0.4% of GDP. The afore mentioned changes refer to corporate income tax and personal income tax. The impact of the first is forecast at EUR 87 million in 2012, as a result of a reduction of 2 percentage points in the tax rate, an increase in tax allowances for investment from 30% to 40% of the total sum invested in equipment and intangible assets, a rise in the ceiling for claiming the allowance (from EUR 30,000 EUR to EUR 60,000 annually), and an increase in the general tax allowance for investment in research and development from 40% to 100%. Under the proposal the corporate income tax rate is to be cut again in the next three years, by 1 percentage point each year, which would reduce revenues by EUR 32 million each year. Under the proposed changes to personal income tax, the main factor in the projected reduction in revenue of EUR 67 million for 2012 is the increase in the net annual taxable base that constitutes the boundary between the second and third tax bands. Excise duties on mineral oil and tobacco products are contrastingly being raised this year, while the government has approved a rise in excise duties on alcohol.

finances were unknown when the current projections were being drawn up. Within the framework of the targets set for the scope of the fiscal consolidation, the choice of individual measures may also have a significant impact on the macroeconomic variables included in the baseline scenario of the current projections. A decline in the public sector wage bill and in social transfers could together with a potential increase in indirect taxation temporarily reduce household disposable income, and thus household spending. However, postponement of the fiscal consolidation or a lack of clarity regarding structural reforms could damage the credibility of the new government. Government borrowing costs would remain high, which would diminish the chances of achieving medium-term and long-term fiscal sustainability. The deterioration in the financing conditions for the private sector would also reduce the chances for potential growth in the economy. The tax allowances envisaged for labour income and capital income and the increase in allowances for research and development should have a positive impact on economic growth, but the impact will be limited if these measures are not framed within a reduction of the fiscal deficit.

The mains risks to financing are associated with an rise in financing costs, the ability of corporates to increase their capital strength in light of the persistent and relatively high level of indebtedness, and a further deterioration in the quality of the banks' balance sheets and their increasing need for recapitalisation. Although the premiums on borrowing in the rest of the world have declined slightly in recent period, bank funding costs and corporate financing costs could increase, primarily as a result of a lack of credibility in fiscal consolidation. At the same time excessive fiscal consolidation could be an additional drag on economic growth, thereby adversely affecting the perceptions of the financial markets, which in an uncertain situation focus more on short-term economic outlook and expectations than on the long-term potential of the economy. Rating agencies have downgraded Slovenian banks and Slovenian government bonds in the early part of this year. There is also an increasing possibility of further downgrades, as a result of the uncertain economic outlook, the deterioration in the quality of the banks and the uncertainty regarding their recapitalisation, the lack of structural reforms, and the crisis on the financial markets. An increase in financing costs would be an additional burden for relatively highly indebted corporates, and would reduce their creditworthiness. As a result of the deterioration in the quality of their balance sheets and the increase in impairment and provisioning costs, the commercial banks are tightening the restrictions on the supply of loans, in addition to securing adequate capital.

The projections of gross investment remain particularly uncertain, owing to the uncertainty in the international environment, the deterioration in the fiscal position and the risks surrounding financing. The projected gradual easing of the decline in gross investment is based primarily on the assumption of an end to the decline in construction investment, and on the initiation of major investments in the energy sector. In the opposite case the crisis in construction could deepen further. A standstill in global economic activity could additionally delay an expansion in production capacity via investment in machinery and equipment in export-oriented sectors. Any slowdown in growth in investment in machinery and equipment could hinder productivity growth in the private sector, and expectations of future potential growth. Further restrictions on government investment as part of the fiscal consolidation could also result in slower growth in investment than projected under the baseline scenario. Here the financing of major investments (e.g. in the energy sector) via domestic banks, given their limited funding sources, could supplant private sector investment, in particular by smaller companies, which find it harder to borrow in the rest of the world.

The deteriorating situation on the labour market and the risk of a sustained rise in unemployment are an indication of the urgent need for further adjustment in labour costs to ensure the competitiveness of the economy. Unemployment could rise further as a result of the deepening of the crisis on the global markets and in the construction sector, but also due to lay-offs in the public sector. A further increase in structural unemployment would be particularly problematic. Long-term unemployment brings adverse social consequences and a loss of human capital, while eliminating it is usually a long-lasting process. Insufficient cost adjustments relative to productivity could also contribute to a more sustained rise in unemployment. The pace of the cost adjustment of the economy has recently been strong, particularly in tradable sectors. After rising in 2008 and 2009, unit labour costs have fallen, but the adjustment is proceeding more slowly than in the main euro area trading partners. Further deterioration in the situation on the labour market could, alongside higher financing costs and potential increases in indirect taxation, further reduce the projected low level of household consumption.

The risks surrounding inflation are balanced. A rise in energy prices and other commodity prices, a fall in the value of euro, potential increases in indirect taxation and administered prices as part of the fiscal consolidation and a rise in prices in sectors with a low level of competition (e.g. municipal services, district heating, public transport) could result in inflation being higher than projected under the baseline scenario. Slower economic growth as a result of reduced foreign demand and lower domestic demand caused by the situation on the labour or fiscal consolidation is the most likely factor to reduce inflation. Lower economic activity would also further delay the improvement in the situation on the labour market, thereby limiting any rise in labour costs. This would further reduce the possibility of passing higher input costs through into final consumer prices.